

# The Quiet Period in a Noisy World: Rethinking Securities Regulation and Corporate Free Speech

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*In the name of investor protection, the Securities and Exchange Commission's "Quiet Period Rules" essentially prohibit the dissemination of both truthful and misleading speech outside of the statutory prospectus filed with the Commission. While the Quiet Period Rules might have served a function when originally adopted in the 1930s, they rely on empirical assumptions about the availability of information and investor behavior that are no longer accurate.*

*Today, if Groupon or Facebook predicts, during the offering process, that it will be "wildly profitable," a plethora of news outlets and analysts stands ready to pick the statement apart. Allowing offering participants to communicate truthful information during the offering process would not have an adverse impact on investors. Instead, the efficient capital market hypothesis suggests that more information would have a positive impact, as sophisticated investors would quickly assimilate that information into the price of the securities.*

*The Quiet Period Rules are also problematic from a First Amendment perspective. The Supreme Court has recently held that speech restrictions cannot be justified simply because they apply to a heavily regulated area, such as securities. If challenged under the commercial speech doctrine, the broad prophylactic restrictions on the scope and timing of promotional activity in the capital markets would unlikely withstand First Amendment scrutiny. Further, if Quiet Period Rules are ultimately subject to strict scrutiny review under the robust articulation of corporate political speech rights in Citizens United v. FEC, the restrictions would have virtually no chance of surviving.*

*The SEC can craft regulations to protect investors against false or misleading statements while still respecting corporate speech rights and efficiency in capital markets. One approach is to narrow the definition of the term "offer" to permit communications that may "condition the market" so long as those communications do not propose a current exchange of securities. Allowing a more open dialogue about the value of securities would not only abate free speech concerns, but also increase market efficiency. Investors would still be protected against false or misleading speech under the anti-fraud provisions of the Securities Act.*

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## I. INTRODUCTION

Immediately after Groupon decided to launch an initial public offering (IPO) and file a registration statement with the Securities and Exchange Commission (the SEC), the media began to critique the company's business

model and accounting practices.<sup>1</sup> Because of the rules prohibiting an issuer or related party from making written offers outside of the statutory prospectus<sup>2</sup> under the Securities Act (the Quiet Period Rules), Groupon was limited in its potential responses.<sup>3</sup> Despite these restrictions, Groupon's Chief Executive Officer, Andrew Mason, sent a mass e-mail to thousands of Groupon employees depicting Groupon's mistreatment by the press and presenting financial information not included in the statutory prospectus. The media obtained a copy of the e-mail and published the memo within hours of its internal distribution.<sup>4</sup> The memo provided in part:

[T]he degree to which we're getting the [expletive] kicked out of us in the press had finally crossed the threshold from "annoying" to "hilarious." . . . I'll summarize my excitement with four points: [(1) Growth in our core business is strong[,] [(2) Our investments in the future . . . look great, [(3) We are pulling away from competition, and [(4) We've built a great team that I would pit against anyone. In other words, all the stuff that one would want to look good? It looks good.<sup>5</sup>

A few days later, during an interview with Bloomberg, Eric Lefkofsky, chairman, co-founder and dominant shareholder of Groupon, defended his company by predicting that it would be "wildly profitable."<sup>6</sup>

The SEC took notice of Mason's e-mail and Lefkofsky's statement because they may have violated the Quiet Period Rules. These seemingly benign communications which did not include the term "offer" may nonetheless have been construed as an unlawful offer if the SEC determined that it "condition[ed] the public mind or arous[ed] interest" in the offering.<sup>7</sup> Presumably in response

<sup>1</sup> An IPO is the issuer's original sale of a security to the investing public. This initial offering occurs in what is known as the primary market. The secondary market, by contrast, is the market in which buyers and sellers trade the security after the initial stage. Examples of secondary markets are The New York Stock Exchange and over-the-counter markets.

<sup>2</sup> A statutory prospectus, sometimes referred to as a Section 10 prospectus, refers to the prospectus filed with the SEC and consists of the first section of the registration statement. See Securities Act of 1933 § 10, 15 U.S.C. § 77j (2006).

<sup>3</sup> See *infra* Part I for a description of these restrictions.

<sup>4</sup> See Brad Allen, *Leaked Memo Leads to Groupon PR Head Exit*, INSIDER INVESTOR RELATIONS (Sept. 2, 2011), <http://www.insideinvestorrelations.com/articles/stock-exchanges-listings/18452/leaked-memo-leads-groupon-pr-head-exit>.

<sup>5</sup> Kara Swisher, *Exclusive: Groupon's Mason Tells Troops in Fiesty Internal Memo: "It Looks Good"*, ALL THINGS D (Aug. 25, 2011, 3:02 PM), <http://allthingsd.com/20110825/exclusive-groupons-mason-tells-troops-in-feisty-internal-memo-it-looks-good>.

<sup>6</sup> Corey Johnson, Douglas MacMillan & Brian Womack, *Groupon Chairman Remarks May Require Company to Make New Filing*, BLOOMBERGBUSINESSWEEK (June 7, 2011), <http://www.businessweek.com/news/2011-06-07/groupon-chairman-remarks-may-require-company-to-make-new-filing.html>.

<sup>7</sup> Letter from Mary L. Schapiro, Chairman of the SEC, to Darrell E. Issa, Chairman of the Comm. on Oversight & Gov't Reform, U.S. House of Representatives (Apr. 6, 2011)

to pressure from regulators, Groupon amended its statutory prospectus to address statements made in the controversial e-mail and interview.<sup>8</sup> Specifically, the company added a risk factor advising prospective investors to disregard Lefkofsky's statement and instead to rely only on the information contained in the prospectus in determining whether to purchase shares.<sup>9</sup> After a number of other mishaps related to the offering and the company's accounting practices and valuation, Groupon voluntarily postponed its IPO for several months.<sup>10</sup>

Groupon is not alone in taking SEC heat for communications made during the registration process. Back in 2004, Salesforce.com was forced to delay its IPO after cooperating with a *New York Times* profile of the company and its founder, Marc Benioff.<sup>11</sup> Just a few months later, SEC scrutinized Google for an interview *Playboy* had published after Google had filed its registration statement. During the interview, the founders of Google made several routine comments, including "We think we're an important company, and we're dedicated to doing this over the long term. We like being independent."<sup>12</sup> In 2006, Go Daddy filed a registration statement for its IPO and withdrew it less than three months later. One of the stated reasons for the withdrawal was the concern expressed by Bob Parson, Go Daddy's CEO, that the offering rules imposed restrictions on his ability to conduct his weekly radio show.<sup>13</sup>

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[hereinafter Schapiro Letter], available at <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf>.

<sup>8</sup>Groupon, Inc., Amendment No. 2 to Registration Statement (Form S-1) (Aug. 10, 2011), available at <http://www.sec.gov/Archives/edgar/data/1490281/000104746911007178/a2204399zs-1a.htm>. The statutory prospectus filed with the SEC includes comprehensive balanced information about the issuer and the offering that facilitates investment decisions. See Securities Act of 1933 § 10, 15 U.S.C. § 77j (2006).

<sup>9</sup>Groupon, Inc., *supra* note 8. See generally DAVID A. WESTENBERG, INTIAL PUBLIC OFFERINGS: A PRACTICAL GUIDE TO GOING PUBLIC § 11.3 (Practising Law Institute 2011).

<sup>10</sup>Alan J. Berkeley & Alissa A. Parisi, *Communications During the "Offering Process" and Securities Offering Reform by SEC*, ALI-ABA 99 (Mar. 15–17, 2012); see also Steven M. Davidoff, *In a Quiet Period, Groupon Feels the Noise*, DEALB%K (Sept. 2, 2011, 9:03 AM), <http://dealbook.nytimes.com/2011/09/02/in-a-quiet-period-groupon-feels-the-noise/>.

<sup>11</sup>Michael Liedtke, *Salesforce.com IPO Postponed Due to Too Much Publicity*, ASSOCIATED PRESS (June 5, 2004), available at [http://www.utsandiego.com/uniontrib/20040605/news\\_1b5ipo.html](http://www.utsandiego.com/uniontrib/20040605/news_1b5ipo.html).

<sup>12</sup>Google, Inc., Amendment No. 7 to Registration Statement (Form S-1) (Aug. 18, 2004), available at <http://www.secinfo.com/d14D5a.148c8.htm#1stPage>. Regulators forced Google to attach a copy of the article to its prospectus to clarify a few numbers and remind potential investors of certain risks.

<sup>13</sup>See Bob Parsons, *Go Daddy Pulls Its IPO Filing! Why I Decided to Pull It*, BOB PARSONS.ME (Aug. 8, 2006), <http://www.bobparsons.me/121/godaddy-pulls-ipo-filing-why-decided-pull.html>; see also Jonathan Berr, *Go Daddy Yanks IPO*, STREET (Aug. 9, 2006, 10:27 AM), <http://www.thestreet.com/story/10302695/1/go-daddy-yanks-ipo.html>; Matt Krantz, *IPO Indigestion Grows as Go Daddy Balks*, USA TODAY (Aug. 10, 2006, 3:34 AM), [http://usatoday30.usatoday.com/money/markets/us/2006-08-09-ipo-usat\\_x.htm](http://usatoday30.usatoday.com/money/markets/us/2006-08-09-ipo-usat_x.htm).

The theory behind the Quiet Period Rules was that investors should make investment decisions based on the full disclosures contained in the prospectus, rather than on information disseminated by the company but not reviewed by the SEC.<sup>14</sup> The concern was that the attention of investors would stray from the calibrated information contained in the prospectus to other more “glossy” documents if given the opportunity.<sup>15</sup> These prophylactic restrictions on speech may have been necessary when they were originally adopted in the 1930s, just after the invention of television and decades before the advent of personal computers and the Internet.<sup>16</sup> At that time, favorable information disseminated by issuers may have unduly influenced investors. Today there is infinitely more information available about a company or an offering and many other checks on statements made by offering participants. There are dedicated cable business channels and thousands of business blogs.<sup>17</sup> Any investor looking for critical information on a company can do a quick Google search and find it. A wider range of financial instruments is now available so that investors receive more balanced information about a company. If a company like Groupon says it’s going to be wildly profitable and it’s not, there are plenty of news outlets and analysts that will pick the statement apart. Allowing issuers to communicate during the offering period would not have an adverse impact on investors. Instead, given the efficient capital market hypothesis (ECMH), the impact would be positive: more information is beneficial, and sophisticated investors would quickly assimilate that information into the price.<sup>18</sup>

In recognition of the technological advances and to allow more information to reach investors, the SEC liberalized the offering rules in 2005 (the 2005 Securities Offering Reforms).<sup>19</sup> While seemingly making it easier for information to reach investors, these reforms meaningfully change the Quiet Period Rules only with respect to a certain class of issuers—well-known seasoned issuers (WKSIs).<sup>20</sup> For companies not required to file reports with the SEC, the reforms essentially preserve the traditional framework.

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<sup>14</sup> See Securities Offering Reform, Exchange Act Release No. 33-8591, 70 Fed. Reg. 44,722, 44,731 (Aug. 3, 2005).

<sup>15</sup> John C. Coffee, Jr., *Re-engineering Corporate Disclosure: The Coming Debate Over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1151 (1995).

<sup>16</sup> It is estimated that in 1993, the Internet carried only 1% of the information flowing through two-way telecommunication. By 2000 this figure had grown to 51%, and by 2007 more than 97% of all telecommunicated information was carried over the Internet. See Martin Hilbert & Priscila López, *The World’s Technological Capacity to Store, Communicate, and Compute Information*, SCIENCE, 60–65 (Apr. 2011).

<sup>17</sup> See *id.*

<sup>18</sup> See *infra* Part III.C for a discussion of the efficient capital market hypothesis.

<sup>19</sup> See *infra* Part II.B for a description of the 2005 Securities Offering Reforms.

<sup>20</sup> The SEC created four categories of issuers—non-reporting, unseasoned, seasoned, and well-seasoned. All issuers, except non-reporting issuers, are required to file reports with the SEC. Those issuers who do not meet the requirements of Form S-3 are referred to as “unseasoned issuers,” and those who meet those requirements are “seasoned issuers.”

Further, President Barack Obama recently signed the Jumpstart Our Business Startups Act (JOBS Act), which substantially changes a number of laws and regulations in a way that is expected to facilitate the offering process and make it easier for companies to go public.<sup>21</sup> The JOBS Act requires the SEC to ease some of the solicitation restrictions for companies launching a public offering with total annual gross revenues of less than \$1 billion, referred to as emerging growth companies (EGCs).<sup>22</sup> An additional liberalization for private offerings made only to accredited investors is that the SEC must permit “general solicitation or general advertising.”<sup>23</sup> This change will not affect the rules governing public offerings.

Despite these reforms, quiet period concerns have continued to plague corporations launching public offerings as demonstrated by Groupon’s IPO in 2011.<sup>24</sup> The antiquated investor-protection rules defy common sense, protecting mostly institutional investors and keeping other investors in the dark. As Dan Primack, a prominent journalist commented:

It’s time for the SEC to let companies communicate more freely with everyone, not just the chosen few. Today’s investors have easy access to all sorts of information—including SEC filings—and are unlikely to be suckered by just a few optimistic syllables uttered to a reporter. It’s too loud a world to keep these companies so quiet.<sup>25</sup>

In addition to normative and economic challenges, the Quiet Period Rules raise corporate free speech concerns. In 2011, Congress’ Committee on Oversight and Government Reform raised First Amendment concerns over some of the offering restrictions to the SEC.<sup>26</sup> Rather than substantively

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Seasoned issuers who also have an equity market float of \$700 million are referred to as “well-seasoned issuers.” See Securities Act of 1933 Rule 405, 17 C.F.R. § 230.405 (2012).

<sup>21</sup> Andrew L. Fabens, Glenn R. Pollner, Blaise F. Brennan, Nicolas H.R. Dumont & Kulbir S. Walha, *JOBS Act Changes the Public & Private Capital Markets Landscape*, 16 NO. 5 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 12, 12 (2012).

<sup>22</sup> See *Jumpstart Our Business Startups Act Frequently Asked Questions*, SEC. & EXCHANGE COMMISSION (Apr. 16, 2012), <http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm> (setting forth the revenue test for determining whether a company meets the requirements for an emerging growth company).

<sup>23</sup> Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 201(a) (2012). The text as of April 6, 2012 is available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

<sup>24</sup> 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.

<sup>25</sup> Dan Primack, *It’s Time to Kill the IPO Quiet Period*, CNNMONEY (Sept. 6, 2011, 5:00 AM), <http://finance.fortune.cnn.com/2011/09/06/its-time-to-kill-the-ipo-quiet-period>; see also Jesse Eisinger, *‘Quiet Period’ Ahead of IPOs Needs to End*, WALL ST. J., Aug. 18, 2004, at C1 (recommending that the SEC abandon the Quiet Period Rules).

<sup>26</sup> Letter from Darrell E. Issa, Chairman of the Comm. on Oversight & Gov’t Reform, U.S. House of Representatives, to Mary L. Schapiro, Chairman of the SEC (Mar. 22, 2011) (on file with author).

responding to the inquiries, the SEC merely reported that it had not yet had “occasion to consider the constitutionality of the quiet period rules under the First Amendment.”<sup>27</sup> However, the time is ripe for a serious exploration of the Quiet Period Rules. The Court has recently held that speech restrictions cannot be justified simply because they apply in a heavily regulated area, such as securities laws.<sup>28</sup> Further, it is increasingly likely after the Court’s robust articulation of corporate political speech rights in *Citizens United v. FEC*,<sup>29</sup> that a First Amendment challenge to the antiquated restrictions on corporate speech will be brought.<sup>30</sup> If challenged under the commercial speech doctrine, the broad prophylactic restrictions on both truthful and misleading speech for the purpose of protecting those who would hear the speech would not likely withstand First Amendment scrutiny.<sup>31</sup> Further, if Quiet Period Rules are ultimately subject to strict scrutiny review under the political speech doctrine, the restrictions would have virtually no chance of surviving.

While scholars, commentators, and practitioners have long debated whether securities regulations generally should be subject to constitutional review, there has been relatively little focus on the constitutionality of the Quiet Period Rules specifically. This Article will demonstrate that the Quiet Period Rules are problematic not only from normative and economic perspectives, but from a constitutional law perspective.

Part II describes the original offering rules under the Securities Act, the 2005 Securities Offering Reforms, and the amendments required by the JOBS Act. This Article focuses primarily on non-reporting issuers because if the regulations should be liberalized with respect to these issuers, then they should clearly be liberalized with respect to the other categories of reporting issuers. Part III demonstrates that the offering restrictions rest on empirical assumptions about the availability of information and investor behavior that are no longer accurate. Parts IV and V demonstrate that the Quiet Period Rules raise constitutional corporate free speech concerns, under the commercial speech and political speech doctrines, respectively. Part VI then proposes several reforms to the rules that would resolve the economic, normative and constitutional problems within the current landscape, including narrowing the definition of the

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<sup>27</sup> Schapiro Letter, *supra* note 7, at 7.

<sup>28</sup> See 44 *Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 502–04 (1996) (plurality opinion) (suggesting that speech restrictions cannot be justified solely because the speech relates to activities that the government can regulate).

<sup>29</sup> 558 U.S. 310 (2010).

<sup>30</sup> First Amendment cases have recently been brought in Massachusetts challenging state regulations on First Amendment grounds. See, e.g., *Bulldog Investors Gen. P’ship v. Sec’y of the Commonwealth*, 953 N.E.2d 691, 694–95 (Mass. 2011) (holding that restriction on hedge fund satisfied the *Central Hudson* test and was not a violation of the fund’s free speech rights).

<sup>31</sup> Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95, 96 (1995) (arguing that some aspects of mandatory prospectus regulation raise serious First Amendment concerns).

term “offer” or expanding the safe harbors created by the 2005 Securities Offering Reforms and the JOBS Act.

## II. QUIET PERIOD RULES FOR PUBLIC OFFERINGS

### A. *Quiet Period Rules Under the Securities Act*

The Securities Act of 1933 (the Securities Act) does not directly regulate speech or communications, but instead, regulates the making of offers under Section 5. These regulations are different during three distinct phases of the registration process.<sup>32</sup> During the thirty days prior to filing a registration statement (the pre-filing period) securities may not be offered.<sup>33</sup> During the period between the filing of a registration statement and when the SEC declares the statement effective (the waiting period) an issuer can make oral offers, but cannot make written offers other than by means of the statutory prospectus.<sup>34</sup> The broad definition of offer limits the ability of the issuer or related parties to disseminate written or broadcast offers other than by means of the filed statutory prospectus.<sup>35</sup> After effectiveness which usually occurs shortly after the offering is priced and public trading begins (the post-effective period) an issuer may sell and deliver securities as long as the filed prospectus accompanies or proceeds delivery of the securities.<sup>36</sup> However, a newly public company and its affiliated underwriters may not issue earnings forecasts and research reports for

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<sup>32</sup> See *Quiet Period*, SEC. & EXCHANGE COMMISSION (Sept. 2, 2011), <http://www.sec.gov/answers/quiet.htm>. A registered offering refers to an offering that is registered under Section 5 of the Securities Act, unlike a private placement which is exempt from registration.

<sup>33</sup> Under Section 5(c),

It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security . . . prior to the effective date of the registration statement . . . .

Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c)(2006).

<sup>34</sup> Section 5(b)(1) provides:

It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j . . . .

Securities Act of 1933 § 5(b)(1), 15 U.S.C. § 77e(b) (2006).

<sup>35</sup> The Act defines prospectuses to include written communications as well as broadcast communications, such as TV and radio transmissions, that offer securities for sale. See Securities Act of 1933 § 2(a)(10), 15 U.S.C. § 77b(a)(10).

<sup>36</sup> Securities Act of 1933 § 5(b)(2), 15 U.S.C. § 77e(b)(2).



a specified period of time following an IPO.<sup>37</sup> This Article focuses on the restrictions on speech prohibiting issuers, and related parties, including underwriters<sup>38</sup> and dealers from making “offers” outside of the statutory prospectus during the pre-filing and waiting periods. A violation of these rules is often referred to as “gun-jumping” and subjects the speaker to civil and possibly criminal consequences.<sup>39</sup>

The problem is that the SEC has construed the Securities Act’s definition of “offer” broadly. The Securities Act defined an “offer” to include “every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.”<sup>40</sup> However, the SEC has explained that the term “offer” goes “well beyond, the common law concept of offer”<sup>41</sup> and includes everything that “condition[s] the public mind or arouse[s] public interest in the particular securities.”<sup>42</sup> A communication releasing favorable information about the issuer to increase general awareness would not by itself constitute an offer. However, this information can become an offer when the issuer is in registration as almost any favorable information about an issuer may condition the market.<sup>43</sup> For this reason, the SEC cautions issuers and other offering participants that in the absence of a particular exemption, communications should be restricted during the quiet period.<sup>44</sup>

Such advice is prudent considering an offering participant may be liable for a Section 5 violation even if the disseminated information is not false or misleading and even if there is no proof of causation or damages.<sup>45</sup> The intent of

<sup>37</sup> In July of 2002, this post-effective quiet period was extended from twenty-five to forty calendar days as part of the global settlement between the SEC and ten large securities firms. See Daniel J. Bradley, Jay R. Ritter, Bradford D. Jordan & Jack G. Wolf, *The IPO Quiet Period Revisited*, 2 J. INV. MGMT, no. 3, 2004, at 3.

<sup>38</sup> The term “underwriter” is defined broadly under the Securities Act to include

any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such underwriting.

Securities Act of 1933 § 2(a)(11), 15 U.S.C. § 77b(a)(11) (2006).

<sup>39</sup> A violator may be civilly liable under Section 12(a) of the Securities Act regardless of intent, see Securities Act of 1933 § 12(a), 15 U.S.C. § 77e(c), and may be criminally liable for a willful violation under Section 24 of the Securities Act, see Securities Act of 1933 § 24, 15 U.S.C. § 77yyy.

<sup>40</sup> Securities Act of 1933 § 2(a)(3), 15 U.S.C. § 77b(a)(3).

<sup>41</sup> Schapiro Letter, *supra* note 7, at 2–3.

<sup>42</sup> *In re Carl M. Loeb, Rhoades & Co.*, Exchange Act Release No. 5870, Fed. Reg. 76,635 (Feb. 9, 1959).

<sup>43</sup> Tal-Cap, Inc., Investment Company Act Release No. 3844 (Dec. 6, 1963) (reiterating the Commission’s position that an offer is to be broadly defined).

<sup>44</sup> See Schapiro Letter, *supra* note 7, at 3.

<sup>45</sup> Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457, 466 (1989); see also Tal-Cap, Inc., Investment Company Act Release No. 3844 (Dec. 6, 1963).

the issuer or other offering participant is not relevant. In fact, the Second Circuit has held that a violation of the offering rules is actionable even where the issuer ultimately complies with the statute by delivering the prospectus before the sale is consummated.<sup>46</sup> As the Court reasoned, “an offeror of a security who had failed to follow one of the allowed paths [can] not achieve absolution simply by returning to the road of virtue before receiving payment.”<sup>47</sup> Further, a defendant may be liable without proof of causation between the violation and the damages, and even where the defendant can demonstrate that other circumstances caused the losses.<sup>48</sup>

Further, a number of sanctions may be invoked against an offering participant who violates the gun-jumping rules.<sup>49</sup> The SEC may impose a “cooling-off period” by forcing the company to delay the IPO for a period of time determined by the SEC. Given market volatility, a cooling-off period may jeopardize an IPO. The company may also be required to include a “rescission risk disclosure” in its registration statement acknowledging that the company could be required to repurchase the shares sold in the IPO at the original offering price for a period of one year following the date of the violation.<sup>50</sup>

Alternatively, the company may be required to file the statements made in violation of the quiet period restrictions as part of its registration statement and include a risk factor explaining why the statements are or may be inaccurate. This disclosure can be embarrassing and may require the prospectus to disclose projections or other forward-looking information that would not otherwise be included and that may expose the company to additional liability. Finally, the SEC can seek monetary penalties against a company and its directors and officers, or seek the imposition of a cease-and-desist order against future violations.<sup>51</sup>

Although the SEC may not bring actions on behalf of individual investors, several anti-fraud provisions of the Securities Act allow individual investors to bring civil actions against issuers, underwriters and other offering participants for false or misleading statements.<sup>52</sup> Specifically, Section 11 imposes liability on issuers and underwriters for registration statements that contain “an untrue statement of a material fact or omit to state a material fact required . . . to make

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<sup>46</sup> See *Diskin v. Lomasney & Co.*, 452 F.2d 871, 875–76 (2d Cir. 1971) (“Very likely Congress thought a better time for meaningful prospectus reading was at the time of the offer rather than in the context of confirmation and demand for payment.”).

<sup>47</sup> *Id.* at 876.

<sup>48</sup> *See id.*

<sup>49</sup> WESTENBERG, *supra* note 9, § 11:3.2.

<sup>50</sup> *See id.* § 11:3.

<sup>51</sup> *See id.*

<sup>52</sup> Section 15 aids investors by making “control persons,” or persons who “control” defendants liable under Sections 11 and 12 by owning stock or under agency principles, jointly and severally liable. This helps investors collect damages in cases where the defendant is insolvent or does not have enough money to pay the investor, a frequent situation in securities litigation. Securities Act of 1933 § 15, 15 U.S.C. § 77k(f) (2006).

the statements contained therein not misleading.”<sup>53</sup> Similarly, Section 12(a)(2) creates liability for any person who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission.<sup>54</sup> Section 17(a) is a catchall provision, which imposes liability for fraudulent sales of securities.<sup>55</sup>

### *B. The 2005 Securities Offering Reforms Only Nominally Benefit Non-Reporting Issuers*<sup>56</sup>

Although the SEC adopted the 2005 Securities Offering Reforms to update and liberalize offering activity and communications, these amended rules retained many aspects of the quiet period restrictions for non-reporting companies.<sup>57</sup> Several exemptions were created only for WKSIs and other reporting issuers, including the ability to make offers in the pre-filing period<sup>58</sup> and to continue to release business information and forward-looking

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<sup>53</sup> A purchaser may bring a claim under Section 11, even if he bought the security after the initial offering on the secondary markets. A purchaser can sue so long as the purchaser can trace the purchase back to the initial offering and is within the statute of limitations—there is no need to prove causation or reliance on the misstatements or omissions. Damages are limited to the difference between the offering price and value of the securities at the time of the lawsuit. Although the purchaser can sue the issuer, underwriter, or subsequent seller, all defendants but the issuer have a “due diligence” defense that they had no grounds to believe the statement contained a misstatement or omission. Securities Act of 1933 § 11, 15 U.S.C. § 77(k)(e) (2000).

<sup>54</sup> Under Section 12(a)(2), a seller is liable to the purchaser for rescission of the purchase or damages, provided that the purchaser did not know about the misstatement or omission at the time of the purchase. Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77(a)(2) (2000).

<sup>55</sup> Section 17(a) makes it unlawful to “employ any device, scheme, or artifice to defraud,” “obtain money or property” by using material misstatements or omissions, or to “engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2006). This provision is closely tracked by Section 10(b) of the Securities Exchange Act and Rule 10b-5, which is used more widely by investors suing for fraud. Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2000).

<sup>56</sup> The SEC also adopted several earlier reforms. As an example, in 1970, the SEC adopted a safe-harbor exemption to clarify that continued analyst research coverage does not constitute an unlawful offer. Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933, Exchange Act Release No. 33-5101, Fed. Reg. 18,456 (Dec. 3, 1970).

<sup>57</sup> Securities Offering Reform, Exchange Act Release No. 33-8591, 70 Fed. Reg. 44,722 (Aug. 3, 2005).

<sup>58</sup> Well-known seasoned issuers can make any written or oral communications prior to an offering of their securities. These issuers are also permitted to make offers of securities before the filing of a registration statement. Securities Act of 1933 Rule 163, 17 C.F.R. § 230.163 (2012).

statements.<sup>59</sup> Other exemptions apply to all issuers, but have not significantly altered communications made by non-reporting companies or related parties during the offering process.<sup>60</sup> Except for the free writing prospectus rule, these exemptions appear to have been adopted to assure issuers that communications completely unrelated to the offering would not be deemed gun-jumping violations.

For instance, the SEC created a bright-line safe harbor for communications made by eligible issuers more than thirty days before the filing of a registration statement. Under this broad exemption, communications will not be deemed “offers” so long as they are made by or on behalf of the issuer, do not reference the securities offering and the issuer takes reasonable steps to prevent the information from being further distributed during the offering period.<sup>61</sup> The purpose for this liberalization was to avoid unnecessary limitations on communications by issuers prior to its registered offering.<sup>62</sup>

Similarly, the SEC created a rule to enable companies to continue to disseminate regularly released, ordinary-course information during the registration process without running afoul of the gun-jumping restrictions.<sup>63</sup> This safe harbor applies to communications that involve factual business information about the company or its services or products, that is regularly released and intended for use by persons other than in their capacity as investors or potential investors (such as customers, suppliers and business partners).<sup>64</sup> This rule does not cover forward-looking statements.<sup>65</sup> Accordingly, non-reporting issuers should not issue or disclose any forecasts, projections, or predictions relating to the company’s financial performance or its value, even if the release of this information was part of the company’s prior practice.<sup>66</sup> Additionally, a company may not increase the use of advertisements, even advertisements for its products unrelated to the offering.<sup>67</sup>

Unlike the thirty-day and ordinary business safe harbors, the rule permitting the use of free writing prospectuses seemingly allows issuers and related parties

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<sup>59</sup> All reporting issuers are permitted to continue to publish regularly released factual business information and forward-looking information. Securities Act of 1933 Rule 168, 17 C.F.R. § 230.168 (2012).

<sup>60</sup> See Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85, 90 (2006).

<sup>61</sup> Securities Act of 1933 Rule 163A, 17 C.F.R. § 230.163A (2012).

<sup>62</sup> *Id.*

<sup>63</sup> Securities Act of 1933 Rule 169, 17 C.F.R. § 230.169 (2012). Rule 169 applies to Non-Exchange Act reporting issuers; there is an analogous safe harbor for Exchange Act Reporting Companies under Securities Act Rule 168. See Securities Act of 1933 Rule 168, 17 C.F.R. § 230.168(a)(1) (2012).

<sup>64</sup> Securities Act of 1933 Rule 169, 17 C.F.R. § 230.169 (2012).

<sup>65</sup> See *id.*

<sup>66</sup> See *id.*

<sup>67</sup> Securities Act of 1933 Rule 134(a), 17 C.F.R. § 230.134a (2012) (exempting tombstone ads from the definition of prospectus).

to make written offers outside of the statutory prospectus.<sup>68</sup> Because of several limitations, however, this rule has not dramatically altered communications of non-reporting issuers during the offering period. In general, prior to using a free writing prospectus in an IPO, the issuer must file a preliminary prospectus containing an estimated offering price range with the SEC,<sup>69</sup> the free writing prospectus must be preceded or accompanied by the most recent statutory prospectus,<sup>70</sup> and the free writing prospectus must include a detailed legend.<sup>71</sup> The prospectus delivery requirement makes the use of broadly disseminated free writing prospectuses infeasible unless they are in electronic form and contain an active hyperlink to the preliminary prospectus.<sup>72</sup> Although practices with respect to the use of free writing prospectuses by issuers or other offering participants are still evolving, it appears that the exception is largely relied on to update or correct offering terms during the offering process “without the delay, inconvenience, expense, or potential stigma often associated with recirculating a revised . . . prospectus.”<sup>73</sup>

To encourage the media as a communicator of valuable information, the SEC generally treats a media publication based on information provided by an issuer or underwriter as a “media free writing prospectus.”<sup>74</sup> The only

<sup>68</sup> Securities Act of 1933 Rule 405, 17 C.F.R. § 230.405 (2012). Free writing prospectuses include, in certain circumstances, e-mails, faxes, and pre-recorded electronics communications. See Securities Act of 1933 Rules 163, 164 and 433, 17 C.F.R. §§ 163, 164, and 433.

<sup>69</sup> Securities Act of 1933 Rule 433(b)(2), 17 C.F.R. § 230.433(b)(2) (2012). The price range requirement results in a delay in the use of free writing prospectuses in the waiting period until the issuer sets a price range for the offering.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* The legend must contain substantially the following information:

The issuer has filed a registration statement (including a prospectus) with the SEC for the offering to which this communication relates. Before you invest, you should read the prospectus in that registration statement and other documents the issuer has filed with the SEC for more complete information about the issuer and this offering. You may get these documents for free by visiting EDGAR on the SEC Web site at [www.sec.gov](http://www.sec.gov). Alternatively, the issuer, any underwriter or any dealer participating in the offering will arrange to send you the prospectus if you request it . . . .

17 C.F.R. § 230.433(c)(2)(i) (2012).

<sup>72</sup> Peter M. Astiz, *Publicity and Gun-Jumping*, in *ADVANCED VENTURE CAPITAL 2011*, at 391, 400 (Curtis L. Mo. & Jason Doren eds., 2011).

<sup>73</sup> WESTENBERG, *supra* note 9, § 18:3, at 18–9. Free writing prospectuses can be used to update deal-related information (e.g., revising the intended use of proceeds), to convey IPO pricing information (e.g., share price or underwriting discount), or to disclose material company developments (e.g., the commencement of litigation, financial data for a recently completed period). See *id.* at 18–12.

<sup>74</sup> A “media free writing prospectus” is a publication where an issuer or other offering participant provides information about the issuer or offering, to a member or the media, and the publication of that information is an offer by the issuer or underwriter. See Securities Offering Reform, Securities Act Release No. 8591, 70 Fed. Reg. 44,722, 44,756–59 (Aug. 3, 2005).

requirements for using this exception are that the publication or broadcast include a detailed legend<sup>75</sup> and be filed with the SEC within four business days after the issuer or underwriter is aware of its dissemination.<sup>76</sup> On the other hand, the requirements for using an affiliated media free writing prospectus<sup>77</sup> are almost impossible to meet for IPOs.<sup>78</sup> As a result, in an IPO, the issuer and underwriters may not prepare or pay for the release of information about the issuer, its securities, or the offering. A reporter criticized this media exemption as being “largely cosmetic” as companies were permitted to talk to the media, but only if their statements tracked almost exactly with the offering documents.<sup>79</sup> Similarly, to encourage the publication of research reports which provide valuable information, the SEC adopted rule amendments that expand the scope of safe harbors for such reports during the quiet period.<sup>80</sup>

While seemingly liberalizing the offering rules, the 2005 Securities Offering Reforms left significant restrictions on permitted communications of non-reporting issuers intact, as exemplified by the Groupon IPO. Despite these reforms, during the offering period, issuer and related party communications “should not include opinions about the value of the company and should not mention the proposed public offering. . . . Predictions of increased earnings, market share or expected industry growth should be strictly avoided.”<sup>81</sup> “Any planned press releases, advertising campaigns, news articles, interviews, speeches, industry conferences should be monitored closely and reviewed prior to release.”<sup>82</sup> These types of communications, containing comments of corporate insiders, “mentioning the offering, or discussing the company’s business prospects, could be interpreted” as gun-jumping violations even if the communications are completely accurate.<sup>83</sup>

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<sup>75</sup> The detailed legend must recommend that investors read the statutory prospectus and other filed documents on the SEC website and provide notice that investors can have a prospectus sent to them. *See supra* note 71.

<sup>76</sup> Securities Act of 1933 Rules 164, 433(f), 17 C.F.R. §§ 230.164, 230.433(f) (2012).

<sup>77</sup> An affiliated free writing prospectus exists when the issuer or underwriter prepares or pays for the preparation, publication, or dissemination of or uses or refers to a published article, television or radio broadcast, or advertisement. *See* Securities Offering Reform, Exchange Act Release No. 33-8591, 70 Fed. Reg. 44,722, 44,757 (Aug. 3, 2005).

<sup>78</sup> If the issuer is a non-reporting or unseasoned issuer, a free writing prospectus must be accompanied by or preceded by the most recent statutory prospectus. The delivery requirements are less burdensome for seasoned and well-known seasoned issuers. The issuer or underwriter must also file the publication by the date of its first use. *Id.* at 44,785.

<sup>79</sup> Primack, *supra* note 25, at 2 (“When I have conversations with CEOs who want to make public statements, I first want to know if they’re trying to sell their product, which is allowed, or if they’re really trying to sell their company, which isn’t.” (internal quotation marks omitted)).

<sup>80</sup> *See* Securities Act of 1933 Rules 137, 138, and 139, 17 C.F.R. §§ 230.137–.139 (2005).

<sup>81</sup> Laird H. Simons III, *Publicity Before and After Filing an IPO Registration Statement*, in HOW TO PREPARE AN INITIAL PUBLIC OFFERING 2012, at 181, 184 (2012).

<sup>82</sup> *See id.*

<sup>83</sup> *See id.*

C. *The JOBS Act Exception Permitting “Test the Water” Communications Only Benefits Emergent Growth Companies*

In 2012, the JOBS Act created an exception to permit certain non-reporting companies to “test the water” prior to or following the filing of a registration statement. This exception is only available to companies with less than \$1 billion in annual gross revenues, referred to as emergent growth companies (EGCs). Specifically, EGCs or persons acting on their behalf, including underwriters, are permitted to communicate orally or in writing to qualified institutional buyers (QIBs)<sup>84</sup> or institutions that are accredited investors<sup>85</sup> “to determine whether such investors might have an interest in the contemplated securities offering.”<sup>86</sup> In the absence of this amendment, such communications would constitute impermissible offers to sell or solicitations of offers to buy securities under Section 5(c). This is a significant change that should greatly facilitate the ability of EGCs and their underwriters to “test the water” to gauge potential investor interest in advance of a public offering. This exception does not alter the restrictions on larger issuers, with more than \$1 billion in annual gross revenues to communicate with potential investors.

Although the SEC recognized the problems inherent in restricting speech in the weeks before an offering when it adopted the 2005 Securities Offering Reforms and the JOBS Act,<sup>87</sup> those reforms failed to meaningfully alter the way many non-reporting companies conduct IPOs. The current rules still “deprive investors of information . . . and limit a company’s ability to respond to misinformation in the media.”<sup>88</sup>

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<sup>84</sup> A qualified institutional buyer is a purchaser of securities that is deemed financially sophisticated and is legally recognized by security market regulators to need less protection from issuers than most public investors. Rule 144A requires an institution to manage at least \$100 million in securities from issuers not affiliated with the institution to be considered a QIB. Securities Act of 1933 Rule 144A, 17 C.F.R. § 230.144A(a)(1)(iv) (2006).

<sup>85</sup> An accredited investor is an investor permitted to invest in certain types of higher risk investments including private placements. Section 501 of Regulation D defines the term to include banks, insurance companies, registered investment companies, and natural persons with individual or joint net worth (with spouse) in excess of \$1 million. Securities Act of 1933 Rule 501, 17 C.F.R. § 230.501(a) (2006).

<sup>86</sup> 79A C.J.S. *Securities Regulation* § 85 (2012).

<sup>87</sup> Securities Offering Reform, Exchange Act Release No. 33-8591, 70 Fed. Reg. 44,722, 44,722 (Aug. 3, 2005). The stated purpose of the 2005 Securities Offering Reform was to

modify and advance significantly the registration, communications, and offering processes . . . . [The new] rules will eliminate unnecessary and outmoded restrictions on offerings. In addition, the rules will provide more timely investment information to investors without mandating delays in the offering process that we believe would be inconsistent with the needs of issuers for timely access to capital. The rules also will continue our long-term efforts toward integrating disclosure and processes . . . .

*Id.*

<sup>88</sup> Eisenger, *supra* note 25, at C1.

### III. THE SHAKY FOUNDATION OF THE QUIET PERIOD RULES

Two primary objectives of the SEC are to obtain efficient capital markets<sup>89</sup> and promote investor confidence in those markets.<sup>90</sup> Despite the SEC's concerns, additional information provided by issuers during the offering process would not send investors into a speculative frenzy or otherwise have an adverse impact on investors. Instead, given the ECMH, the impact would be positive: the public availability of additional accurate information would be beneficial to rational investors. Further, even if many investors are not rational, they would be protected against misinterpreting optimistic statements as the price of the securities would accurately reflect all public information. Although the ECMH is not as compelling for IPOs as it is for secondary offerings with more analyst coverage, IPO markets are sufficiently information efficient that the public availability of additional information would benefit investors.

#### A. *Rational Investors Will Not Go into a Speculative Frenzy*

The SEC restricts speech during the offering process primarily to prevent investors from going into a “speculative frenzy” based on optimistic information about the issuer.<sup>91</sup> Investors may be unjustly persuaded to purchase securities if presented with information that promotes the issuer, even if no mention is made of the offering.<sup>92</sup> The offering rules were designed to protect investors from being exposed to the wrong type of information before they have the benefit of reviewing the statutory prospectus containing appropriately calibrated information. The concern is that attention of investors will stray away from the balanced information in the statutory prospectus to other more “flashy” documents if given the opportunity.<sup>93</sup>

However, rational investors do not need these protections as they will likely discount less reliable information (e.g., the “flashy” documents) and place greater weight on more reliable information (e.g., the statutory prospectus). These investors would value—and appropriately discount—forward-looking projections and other information from issuers and other offering participants that is not contained in the statutory prospectus.<sup>94</sup> They would also value information that is provided in the statutory prospectus if it is communicated in

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<sup>89</sup> See, e.g., *Grundfest Stresses Economic Efficiency as Goal of Commission, Securities Laws*, 18 SEC. REG. & L. REP. (BNA) 1351, 1354 (Sept. 19, 1986).

<sup>90</sup> John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors*, 81 DENV. U. L. REV. 1, 4 (2003).

<sup>91</sup> *In re Carl M. Loeb, Rhoades & Co.*, Exchange Act Release No. 5870, Fed. Reg. 76,635 (Feb. 9, 1959).

<sup>92</sup> *Id.*

<sup>93</sup> Coffee, *supra* note 15, at 1151.

<sup>94</sup> See Jill E. Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, 10 LEWIS & CLARK L. REV. 57, 82 (2006).



more salient form that can be more quickly assimilated into the market price.<sup>95</sup> Although not all investors are rational, an assumption of rationality will likely approximate how the more sophisticated investors behave in the market.<sup>96</sup> To the extent such investors set the market price in secondary markets, the price mechanism protects other retail investors.<sup>97</sup> Sophisticated investors also help set the price in IPO markets as issuers, or investment banks determine the issue price largely based on the interest of sophisticated investors.<sup>98</sup>

Assuming the offering rules were designed to prevent unsophisticated investors from going into a speculative frenzy and inflating the market price, the rules do not appear to be tailored to achieve that purpose. For instance, the rule requiring the statutory prospectus to proceed or accompany the delivery of a free writing prospectus does not appear to be appropriately calibrated to achieve its purpose. The primary purpose of the rule was to give investors meaningful time to review the balanced information contained in the statutory prospectus before making an investment decision based on the information contained in the free writing prospectus.<sup>99</sup> However, an investor, suffering from some behavioral bias, probably will not read the detailed statutory prospectus before purchasing securities.<sup>100</sup> In fact, empirical evidence suggests that retail investors are unlikely to review the dense prospectus, and even if they do, they are unlikely to absorb most of the information.<sup>101</sup> Such investors would likely participate in

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<sup>95</sup> Chiappinelli, *supra* note 45, at 499.

<sup>96</sup> Choi, *supra* note 60, at 90. To the extent the SEC created the Quiet Period Rules based on the belief that unsophisticated investors suffer from some behavioral bias and need additional protection, the SEC should clearly disclose its concerns, rather than hiding behind the generic mantra of “investor confidence.” Behavioral biases that may interfere with an investor’s ability to appropriately calibrate information include overoptimism, overconfidence, framing (i.e., determining the worth of an investment based on current holdings), hindsight (i.e., placing too great an emphasis on events that have occurred), and confirmation (i.e., rationalizing a poor investment decision as justified). Specifically, the SEC should identify the types of investors it seeks to protect, how such investors engage in flawed decision making, how the SEC predicts the regulations will protect such investors, and the cost of the regulations to other investors who do not suffer from the same behavioral bias. Such transparency would allow the courts, practitioners, scholars, and other commentators to consider whether the rules are appropriately calibrated to respond to a specific bias. Many of the offering rules appear illogical and sometimes inconsistent with limiting specific biases.

<sup>97</sup> *Id.*

<sup>98</sup> 1A HAROLD S. BLOOMENTHAL, GOING PUBLIC AND THE PUBLIC CORPORATION § 8.03[4], at 8-60, 8-60.1 (Clark Boardman, 1992 rev.).

<sup>99</sup> See *Diskin v. Lomasney & Co.*, 452 F.2d 871, 875–76 (2d Cir. 1971) (“Very likely Congress thought a better time for meaningful prospectus reading was at the time of the offer rather than in the context of confirmation and demand for payment.”).

<sup>100</sup> Robert G. Newkirk, *Sufficient Efficiency: Fraud on the Market in the Initial Public Offering Context*, 58 U. CHI. L. REV. 1393, 1393 (1991) (explaining that the typical modern investor often fails to read the prospectus of an issuing company).

<sup>101</sup> See *id.*

the hottest IPO without properly evaluating the information disclosed in the statutory prospectus.

The Facebook IPO provides an illustrative example. Despite the silence of Facebook, its Chief Executive Officer and founder Mark Zuckerberg, and its lead underwriter Morgan Stanley, many retail investors purchased the stock either without reading the prospectus or without adequately discounting the value of the stock in light of information contained in the prospectus, including specific risk factors.<sup>102</sup> As a journalist explained, “Anybody who took the trouble to read the prospectus could see that the company’s growth was slowing and that its costs were rising faster than its revenues. Anybody who didn’t bother to read the prospectus shouldn’t have been buying shares in the first place.”<sup>103</sup>

Further, if investors are not able to obtain information in salient form from the issuer or other offering participant, an unsophisticated investor may turn to chat rooms and Internet message boards to determine the worth of a company.<sup>104</sup> Information from these sources is inherently less reliable than information that an issuer or other offering participant would release and is unlikely to be filtered by analysts.<sup>105</sup> Accordingly, investors may be more likely to go into a speculative buying frenzy based on information provided by these unsecure sources, than based on information disclosed by issuers.

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<sup>102</sup> Shortly after its IPO, Facebook Inc., its Chief Executive Officer, Founder Mark Zuckerberg, and banks including Morgan Stanley were sued by the social networking leader’s shareholders, who claimed the defendants hid Facebook’s weakened growth forecasts ahead of its \$16 billion initial public offering. The defendants were accused of concealing from investors during the IPO marketing process “a severe and pronounced reduction” in revenue growth forecasts, resulting from increased use of its app or website through mobile devices. However, Facebook included in its statutory prospectus that a lack of mobile advertising was a risk factor. Jonathan Stempel & Dan Levine, *Facebook, Banks Sued over Pre-IPO Analyst Calls*, REUTERS (May 23, 2012), <http://www.reuters.com/article/2012/05/23/us-facebook-lawsuit-idUSBRE84M0RK20120523>.

<sup>103</sup> John Cassidy, *Facebook Fiasco: Don’t Leave It to the Lawyers*, RATIONAL IRRATIONALITY (May 23, 2012), <http://www.newyorker.com/online/blogs/johncassidy/2012/05/facebook-ipo-lawyers.html>.

<sup>104</sup> See Fisch, *supra* note 94, at 70 (linking the dramatic growth in Internet securities fraud to the increased investor reliance on chat rooms and other Internet sources).

<sup>105</sup> See *id.* Fisch cites as an example the case of Jonathan Lebed, a fifteen-year-old who purchased stock in small capitalization companies. See *id.* at 70–72 (citing *Lebed*, Securities Act Release No. 7891, Exchange Act Release No. 43,307, 2000 WL 1353040 (Sept. 20, 2000), available at <http://www.sec.gov/litigation/admin/33-7891.htm>). After purchasing the stock, Lebed posted hundreds of internet messages touting the stock using fictitious names. The postings contained stock price predictions and statements that the stocks were undervalued and “about to take off.” According to the SEC, these postings caused the stock price to increase dramatically, enabling Lebed to sell his shares at a significant profit. The subject companies posted no news or press releases “that might have accounted for the increases in price and volume.” See *id.*

### B. *Investor Confidence and Market Efficiency*

The concern of a speculative frenzy is not only unfounded, but allowing more information from issuers will increase, not reduce, market efficiency. Additional speech from issuers would prompt additional reports by analysts, reporters and others who would have the opportunity to debate the value of the assertions the company makes. The ECMH predicts that this public information would quickly be incorporated into the price of the securities making the price more accurate.<sup>106</sup> The Quiet Period Rules, which indiscriminately exclude information without exploring why the excluded information would distort markets, lead to market inefficiencies.

One of the negative consequences of restricting speech of issuers and other offering participants, particularly during an IPO, is that it also limits speech of independent analysts and journalists. Analysts and reporters have little reason to prepare reports on non-reporting companies when the only information that they can respond to is that contained in the statutory prospectus. Jeff Corbin, the CEO of a firm specializing in investor relations and marketing services, explained that, while he remained silent in the months leading up to Facebook's IPO, he was eager to break that silence and issue a report as soon as the quiet period ended and Facebook and the lead underwriters issued their reports:

For the past month, I have followed Facebook's lead and remained quiet during the "quiet period." The reason for this was there was nothing to say. Everything that needed to be said was already said, and Facebook hadn't put out any news of major business importance.

....

Well, today the quiet period officially ends, and so does my silence. I am anxiously awaiting the analyst reports from the banks that helped take Facebook public . . . .

....

Once I have a chance to review, I will report back on what the analysts say and what investors should be looking for before investing more money in Facebook.<sup>107</sup>

Obviously investors, especially retail investors, would prefer to hear from Jeff Corbin and other analysts before making the initial decision to invest in the Facebook IPO.

Although Facebook and other issuers would voluntarily release only positive forecasts and valuations during the offering process, countless news outlets and analysts would be anxious to filter this information and pick the

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<sup>106</sup> "Prices are conceptualized as the discounted present value of the future earnings (dividends, interest or principal payments, liquidation values, etc.) of the security." Newkirk, *supra* note 100, at 1398. Although analysts develop certain estimates of the price, they cannot precisely ascertain future events to tell the "exact" value of a security. *Id.* at 1399.

<sup>107</sup> Jeff Corbin, *Diary of an IPO: The Facebook Quiet Period Is Over*, KCSA BLOG (June 27, 2012), [http://www.kcsa.com/kcsa\\_blogcat.php?tag=diary-of-an-ipo](http://www.kcsa.com/kcsa_blogcat.php?tag=diary-of-an-ipo).

statements apart if necessary. Among the purposes analysts serve are “ferreting out facts and offering valuable insights on companies and industry trends.”<sup>108</sup> This open dialogue between issuers, underwriters, and analysts would likely increase investor confidence as they would be privy to discussions that likely now take place privately at road shows.<sup>109</sup>

Further, the ECMH predicts that additional accurate information provided by issuers, underwriters and analysts would quickly be incorporated into the price of the securities, making the price more accurate.<sup>110</sup> The most widely accepted “semi-strong” version of the hypothesis claims both that prices reflect all publicly available information and that prices instantly change to reflect new public information.<sup>111</sup> The more information that is available about a given stock, and the more reliable that information is, the more efficient the capital markets will be at generating the appropriate price for that stock.<sup>112</sup>

If the offering rules were liberalized, additional information released during the offering period would likely be reliable. Issuers and other offering participants would have incentives to release accurate information because any

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<sup>108</sup> *Analyzing Analyst Recommendations*, SEC. & EXCHANGE COMMISSION (Aug. 30, 2010), <http://www.sec.gov/investor/pubs/analysts.htm>.

<sup>109</sup> The road show is the company’s marketing trip to investors that takes place prior to setting the actual price for the offering. It typically involves a few of the company’s executives who try to explain to investors why their company will be a good investment. When the issuer and its underwriters “go on the road show before the offering, they presumably have two main objectives. They wish to market” the securities to potential investors, and “they seek to obtain more information on the true value of the firm.” Michelle Lowry & G. William Schwert, *Is the IPO Pricing Process Efficient?*, 71 J. FIN. ECON. 3, 20 (2004).

<sup>110</sup> Chiappinelli, *supra* note 45, at 497–99. The ECMH has generated widespread judicial acceptance. In *Basic Inc. v. Levinson*, the Supreme Court recognized the ECMH when it adopted the “fraud on the market theory” to impose liability on a company for falsely denying merger negotiations. 485 U.S. 224, 224 (1988). The Court held that a plaintiff can satisfy the reliance requirement by showing that the market price of the security as a whole was affected by the defendant’s misstatement or omission and that the plaintiff suffered a loss due to the transaction at that incorrect price. *Id.* at 247; *see also* Peter J. Dennin, *Which Came First, the Fraud or the Market: Is the Fraud-Created-the-Market Theory Valid Under Rule 10b-5?*, 69 FORDHAM L. REV. 2611, 2619–22 (2001). Since the financial crises at the turn of the century, the theory has been the subject of much critique. *See, e.g.*, Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1241 (2002); David A. Westbrook, *Corporation Law After Enron: The Possibility of a Capitalist Reimagination*, 92 GEO. L.J. 61, 112 n.300 (2003).

<sup>111</sup> *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 404 (1970). There are two other versions of the ECMH. The weak version claims that prices on traded assets such as stocks, bonds or property already reflect all past publicly available information. The strong version also claims that prices instantly reflect even hidden or “insider” information. *See id.* at 383; *see also* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555–56 (1984).

<sup>112</sup> Orcutt, *supra* note 90, at 49.

false or misleading statements would be actionable under the anti-fraud provisions of the Securities Act. Although truthful but optimistic statements may not be actionable, sophisticated investors and analysts would adequately discount the value of this puffery so that they would not influence the stock price. The market price is largely driven by institutional investors who directly own a large percentage of securities.<sup>113</sup> Unsophisticated investors or retail investors who are incapable of adequately discounting information would be protected through this price mechanism.<sup>114</sup> Accordingly, the gun-jumping restrictions which indiscriminately exclude information would result in market inefficiencies and ultimately harm all investors—even irrational investors.<sup>115</sup>

### C. The ECMH and IPO Markets

Courts and commentators have been reluctant to extend the ECMH to IPO markets which are not as open and developed as secondary markets where securities are traded after the IPO.<sup>116</sup> Supporters of the quiet period would likely contend that information released during the offering period is likely to cause more distortion in IPO markets than in more established markets. Because there is less information available about an IPO, there will be less for analysts to dissect when the company makes disclosures. Consequently, the company's statements are more likely to cause an unwarranted jump in the price of the offering. Although this argument has some merit, it does not provide sufficient support for the current offering rules, which indiscriminately restrict even truthful speech.

The mere fact that IPO markets are not as open and developed as secondary markets does not mean that IPO markets are not sufficiently information-

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<sup>113</sup> 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: FLOWS AND OUTSTANDING, FIRST QUARTER 2007, at 89 tbl.L.212, 90 tbl.L.213 (2007), available at <http://www.federalreserve.gov/releases/z1/20070607/z1.pdf>.

<sup>114</sup> The exchanges between sophisticated buyers and sellers usually set the price for securities because sophisticated investors account for a significant number of trades. See, e.g., HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 84 n.2 (1979) ("Institutions are so large a portion of the market that, as a group, they can hardly outperform the market.").

<sup>115</sup> See *id.* at 87.

<sup>116</sup> Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 714–15 (2005) (explaining that the only time a stock price has not been subjected to market forces, which protects investors by efficiently processing information and arriving at an accurate market price, is in the context of an IPO). Since the Supreme Court's adoption of the ECMH, lower courts have been reluctant to extend the theory to IPO markets. See, e.g., *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990); *Peil v. Speiser*, 806 F.2d 1154, 1161 n.10 (3d Cir. 1986); *Lipton v. Documation, Inc.*, 734 F.2d 740, 746 (11th Cir. 1984).

efficient to incorporate public information into the offering price.<sup>117</sup> To the contrary, underwriters and other professionals, involved in almost every IPO,<sup>118</sup> quickly incorporate material public information about a security into a competitive offering price.<sup>119</sup> The role of the underwriter is analogous to the role of sophisticated investors who set the stock price in secondary markets. Empirical evidence suggests that underwriters fully incorporate public information discovered during the registration period into the offer price, while they only partially incorporate private information learned during the road show.<sup>120</sup> Another study demonstrated that the underwriters' treatment of public information is almost consistent with an efficient IPO pricing process.<sup>121</sup> The study concluded that while underwriters omit some public information when they set the final offer price, the vast majority of public information is fully incorporated.<sup>122</sup> For this reason, underwriters continue to analyze new information, and do not set the final price for the issue, until a few hours before actual sales begin.<sup>123</sup>

With additional truthful information, the price of the issue will more likely reflect the expected return on an investment in the shares. Similar to secondary offerings, liberalizing the offering rules for initial offerings would likely result in the release of additional reliable information, rather than false or misleading information because of the anti-fraud provisions. To the extent issuers release promotional statements or puffery, analysts would be able to respond to these statements to ensure that underwriters appropriately discount the value of these

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<sup>117</sup> See, e.g., Newkirk, *supra* note 100, at 1407. The ECMH only requires a showing of information efficiency (i.e., that public information will quickly be incorporated into share prices). "Value efficiency," on the other hand, is a far more controversial proposition as it concerns whether the price of the security accurately represents its "value" at any point in time and requires specific, sometimes unobtainable information. See John A. MacKerron, *The Price Integrity Cause of Action Under Rule 10b-5: Limiting and Expanding the Use of the Fraud on the Market Theory*, 69 OR. L. REV. 177, 208-09 (1990) (noting the absence of value efficiency in the real world and critiquing courts' reliance on such efficiency for fraud on the market cases).

<sup>118</sup> See Newkirk, *supra* note 100, at 1412 (noting that it is rare for a company to issue securities directly to the public without at least one underwriter).

<sup>119</sup> Other, less significant indicia of efficiency in IPO markets include: "(1) the issuance of a significant volume of securities; (2) a large number of potential investors; [and] (3) participation by professional investors outside of the IPO (such as pension fund managers or brokerage firms)." *Id.* at 1414.

<sup>120</sup> *Id.* at 23. The different treatment of public and private information is probably a result of underwriters compensating investors for the private information by only partially incorporating it into the offer price, thus allowing the informed investors to earn especially high returns on the first day the IPO firms trade. *Id.* at 24. By contrast, there is no need for underwriters to reward any group of investors for providing public information, which by definition is provided to everyone, including the underwriter. *Id.* at 25.

<sup>121</sup> Lowry & Schwert, *supra* note 109, at 6.

<sup>122</sup> *Id.*

<sup>123</sup> *Id.* at 7; see also RICHARD W. JENNINGS & HAROLD MARSH, JR., *SECURITIES REGULATION* 32 (6th ed. 1987).

statements in pricing the offering. Although the sources analysts can rely on are more limited for non-reporting issuers than reporting issuers, analysts could rely on the registration statement and their general knowledge of particular industries to counter puffery.

Further, lead underwriters have incentives not to overprice the offering based on puffery. First, underwriters set the price of securities to sell the offering completely. If the offer price is set high because underwriters have not appropriately discounted promotional information, sophisticated investors would refrain from purchasing securities and the underwriters or issuers would be stuck with the unsold shares.<sup>124</sup> Also, underwriters are particularly interested in preserving their reputational capital, particularly in IPO markets where there is an opportunity to conduct follow-on offerings for the issuer.<sup>125</sup> Finally, underwriters have an interest in not over-valuing stock because a large gap between IPO price and secondary trading price may reflect some false or misleading statements and may provoke possible rescission as a remedy for such violations.<sup>126</sup> For these reasons, any unduly positive information about an IPO will be quickly discounted. IPO markets are sufficiently efficient in processing public information that additional accurate information released by underwriters, issuers, and analysts would improve market efficiency and result in a more accurate issue price.

#### IV. THE OFFERING RULES: LAWFUL RESTRICTIONS ON SPEECH OR UNCONSTITUTIONAL SUPPRESSION OF SPEECH

The offering rules not only raise efficiency concerns, but also pose serious First Amendment challenges. Government restrictions on the disclosure of truthful, non-misleading speech for the purpose of protecting those who would hear the speech are unlikely to survive a First Amendment challenge. Although the Supreme Court has provided little guidance on the constitutionality of securities regulations, the Court has developed two distinct but overlapping doctrines to protect corporate speech. The commercial speech doctrine applies an intermediate level of review to speech that is economic in nature or otherwise has the intent of convincing the listener to partake in a particular

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<sup>124</sup> Most IPOs are conducted through an underwriting group or syndicate. Typically the underwriting syndicate purchases the new issue of securities from the issuer and then sells the securities to the public. The difference between the amount paid by the underwriting syndicate to the issuer and the amount paid by the public is the underwriters' gross profit, referred to as the "underwriting spread." See Anita Indira Anand, *The Efficiency of Direct Public Offerings*, 7 J. SMALL & EMERGING BUS. L. 433, 436 (2003).

<sup>125</sup> See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 688–89 (1984).

<sup>126</sup> Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965, 965–66 (1995).

transaction.<sup>127</sup> However, speech that is political in nature receives the highest level of protection as political deliberation, and commentary is often recognized as a core purpose of the First Amendment.<sup>128</sup> The expansion of these doctrines over the past few decades and the Court's robust articulation of corporate political speech rights in *Citizens United v. FEC*<sup>129</sup> make it increasingly likely that a First Amendment challenge to the antiquated Quiet Period Rules will be brought and will succeed.

### A. *The Expansion of Commercial Speech Under the First Amendment*

Until 1976, the commercial speech doctrine established structural divides between different categories of speech.<sup>130</sup> These divides were based on a speaker-centered model of free speech which focused on the inherent right of the speaker to speak and a "prophylactic refusal to permit the government to pick and choose [which speech] should be tolerated."<sup>131</sup> This model provided significant protection for speech concerning religion,<sup>132</sup> politics,<sup>133</sup> science,<sup>134</sup> or aesthetics,<sup>135</sup> but virtually no protection for speech about consumer choice,<sup>136</sup> labor relations<sup>137</sup> or capital formation.<sup>138</sup>

<sup>127</sup> Generally, the Supreme Court defines commercial speech as speech that "proposes a commercial transaction." *Bd. of Trs. v. Fox*, 492 U.S. 469, 482 (1989).

<sup>128</sup> Burt Neuborne, *The First Amendment and Government Regulation of Capital Markets*, 55 BROOK. L. REV. 5, 12–15 (1989).

<sup>129</sup> *Citizens United v. FEC*, 130 S. Ct. 876, 886 (2010).

<sup>130</sup> *Valentine v. Chrestensen*, 316 U.S. 52, 54 (1942), *overruled by* *Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc.*, 425 U.S. 748, 761–73, 776 (1976).

<sup>131</sup> Neuborne, *supra* note 128, at 25. A classic example of the Supreme Court applying a speaker-centered theory of the First Amendment was when the Court found a state injunction preventing a Nazi group from parading swastikas and distributing literature that incited hatred against Jewish people unconstitutional. *Nat'l Socialist Party v. Vill. of Skokie*, 432 U.S. 43, 44 (1977).

<sup>132</sup> *See, e.g., W. Va. State Bd. of Educ. v. Barnette*, 319 U.S. 624, 642 (1943) (holding that children cannot be compelled to salute flag and pledge in violation of religious belief).

<sup>133</sup> *See, e.g., Hague v. CIO*, 307 U.S. 496, 515–16 (1939).

<sup>134</sup> *See, e.g., Epperson v. Arkansas*, 393 U.S. 97, 107 (1968).

<sup>135</sup> *See, e.g., Winters v. New York*, 333 U.S. 507, 510 (1948) (holding that literature is a protected form of expression).

<sup>136</sup> *See, e.g., Williamson v. Lee Optical of Okla., Inc.*, 348 U.S. 483, 491 (1955) (concluding that advertisement for optical care products was not protected).

<sup>137</sup> *See, e.g., Int'l Longshoremen's Ass'n v. Allied Int'l, Inc.*, 456 U.S. 212, 226–27 (1982) (finding that political boycott by labor union was not protected speech).

<sup>138</sup> Challenges to government regulation in the area of capital markets have been rare and unsuccessful. *See, e.g., SEC v. Wall St. Transcript Corp.*, 422 F.2d 1371, 1371, 1379–80 (2d Cir. 1970). The Supreme Court attempted to end the speculation that recognition of the protected nature of commercial speech would prohibit SEC regulation. *See Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 456 (1978); *Paris Adult Theatre I v. Slaton*, 413 U.S. 49, 61–62 (1973).



In *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council*, the Supreme Court abandoned this rigid structural divide and held that economic speech in the area of consumer affairs should be protected.<sup>139</sup> Specifically, the Court found that the right of pharmacists to advertise their products was constitutionally protected.<sup>140</sup> This paradigm shift was premised on the belief that listeners had an interest in hearing commercial speech in order to enhance their ability to make an informed choice and act more efficiently.<sup>141</sup> Although the Court did not set forth a precise standard of review, the Court held that commercial speech was subject to less protection than non-commercial speech.<sup>142</sup> Unlike political or religious speech, false or misleading commercial speech could be regulated.<sup>143</sup>

A few years later, in *Central Hudson Gas & Electric Corp. v. Public Service Commission*, the Supreme Court found that New York's attempt to diminish oil consumption by forbidding electric companies from advertising heat was unconstitutional because it was more draconian than necessary.<sup>144</sup> The Court developed a four-part inquiry for determining whether a ban on commercial speech is unconstitutional:

At the outset, we must determine whether the expression is protected by the First Amendment. For commercial speech to come within that provision, it at least must concern lawful activity and not be misleading. Next, we ask whether the asserted governmental interest is substantial. If both inquiries yield positive answers, we must determine whether the regulation directly advances the governmental interest asserted, and whether it is not more extensive than is necessary to serve that interest.<sup>145</sup>

This analysis continues to serve as the benchmark for whether a regulatory burden on commercial speech violates the First Amendment.<sup>146</sup> Generally, the party seeking to uphold a restriction on commercial speech carries the heavy burden of justifying the restriction.<sup>147</sup>

A few years after *Central Hudson* was decided, it appeared that the Supreme Court developed a vice exception to the commercial speech doctrine. The Court upheld state prohibitions on casino and lottery advertisements on the

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<sup>139</sup> Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 761–73 (1976).

<sup>140</sup> *Id.* at 762.

<sup>141</sup> *Id.* at 748.

<sup>142</sup> *Id.* at 771–72 n.24.

<sup>143</sup> *See id.* at 749.

<sup>144</sup> Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n, 447 U.S. 557, 557–58 (1980) (holding that a Public Service Commission regulation that completely banned promotional advertising by electric utilities violated the First Amendment). Justice Blackmun, whose position did not command a majority, believed that if the government wished to deter the use of electric heat or promote energy conservation, it must do so directly and not through the medium of information control. *Id.* at 579.

<sup>145</sup> *Id.* at 566.

<sup>146</sup> Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 554–55 (2001).

<sup>147</sup> Cent. Hudson, 447 U.S. at 564.

theory that if the legislature could prohibit an activity such as gambling, it could also prohibit advertising about that activity.<sup>148</sup> In the 1996 decision, *44 Liquormart v. Rhode Island*, the Supreme Court shifted back to a more speech-protective analysis, explicitly rejecting a vice exception to the commercial speech doctrine.<sup>149</sup> The Court invalidated a statute prohibiting the advertisement of alcohol prices because the ban provided only ineffective and remote support for promoting temperance, and other less speech-restrictive means were available.<sup>150</sup> Notably, the Court recognized the significance of truthful speech in First Amendment doctrine and expressed its reluctance to condone government suppression of such speech for paternalistic reasons.<sup>151</sup> As Justice Stevens explained, the Court is “especially skeptical of regulations that seek to keep people in the dark for what the government perceives to be their own good.”<sup>152</sup> In her concurrence, Justice O’Connor proposed that the government should only be permitted to restrict the flow of truthful information where (i) the regulator has conducted a “carefu[l] calculate[ion of] the costs and benefits associated with the burden on speech,” (ii) there are no “less burdensome alternatives” available, and (iii) alternative methods of communicating the same material exist.<sup>153</sup> The actual level of review in these cases appears to be closer to a strict, rather than an intermediate, level of scrutiny.<sup>154</sup>

In *Lorillard Tobacco Co. v. Reilly* the Court extended its emphasis on protecting truthful speech.<sup>155</sup> The challenge was to a ban on outdoor advertising of smokeless tobacco and cigars in Massachusetts.<sup>156</sup> The government’s concerns about tobacco use related both to healthcare spending and protection of minors.<sup>157</sup> Despite these legitimate and well-documented interests, the Court struck down the ban as unduly broad because it effectively prevented businesses from disseminating information about lawful products to adults.<sup>158</sup> The Court concluded that the ban was more restrictive than necessary to fulfill the

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<sup>148</sup> See, e.g., *United States v. Edge Broad. Co.*, 509 U.S. 418, 436 (1993) (upholding a ban on lottery advertisements in non-lottery states); *Posadas de P.R. v. Tourism Co. of P.R.*, 478 U.S. 328, 346–48 (1986) (upholding state’s prohibition on advertising for casino gambling on the theory that the state’s power to entirely prohibit gambling implied the right to restrict speech). But see *Rubin v. Coors Brewing Co.*, 514 U.S. 476, 478 (1995); *Edenfield v. Fane*, 507 U.S. 761, 763 (1993); *City of Cincinnati v. Discovery Network, Inc.*, 507 U.S. 410, 412 (1993).

<sup>149</sup> *44 Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 489 (1996).

<sup>150</sup> *Id.* at 504–08 (plurality opinion).

<sup>151</sup> *Id.* at 510 (plurality opinion).

<sup>152</sup> *Id.* at 503 (plurality opinion).

<sup>153</sup> *Id.* at 529–30 (O’Connor, J., concurring) (alteration in original).

<sup>154</sup> Antony Page, *Taking Stock of the First Amendment’s Application to Securities Regulation*, 58 S.C. L. REV. 789, 796–97 (2007).

<sup>155</sup> *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 561–66 (2001).

<sup>156</sup> *Id.* at 533–34.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.* at 564–65.

government's interest.<sup>159</sup> This decision signaled that the Court was willing to protect speech rights even in the face of a cognizable regulatory objective.<sup>160</sup>

While the commercial speech case law has been confined to product or service advertisements,<sup>161</sup> statements made by issuers during an offering are a "natural candidate" for the extension of the doctrine.<sup>162</sup> There is a broad range of speech relating to the purchase or sale of securities that is either required to be disclosed<sup>163</sup> or prohibited from being disclosed.<sup>164</sup> If such speech is considered commercial speech, the regulations calling for corporations to speak in this manner must meet the *Central Hudson* test in order for them to be constitutional.<sup>165</sup> Recently, the Court expressed interest in considering the expansion of commercial speech beyond pure product advertising.<sup>166</sup> The securities regulation would be a logical extension of the doctrine because such regulations relate to proposing or effecting a transaction, and regulators are concerned about listeners of this speech.<sup>167</sup>

The Supreme Court initially appeared reluctant to extend the commercial speech doctrine to a heavily regulated area, such as the securities laws.<sup>168</sup>

<sup>159</sup> *Id.* at 565–66.

<sup>160</sup> Lloyd L. Drury III, *Disclosure Is Speech: Imposing Meaningful First Amendment Constraints on SEC Regulatory Authority*, 58 S.C. L. REV. 757, 770 (2007); Tamara R. Piety, *Citizens United and the Threat to the Regulatory State*, 109 MICH. L. REV. FIRST IMPRESSIONS 16, 16 (2010), <http://www.michiganlawreview.org/assets/fi/109/piety.pdf> (predicting heightened protection for commercial speech).

<sup>161</sup> See, e.g., *Sorrell v. IMS Health Inc.*, 131 S. Ct. 2653, 2659 (2011); *Thompson v. W. States Med. Ctr.*, 535 U.S. 357, 360 (2002).

<sup>162</sup> Drury, *supra* note 160, at 761.

<sup>163</sup> For example, public corporations have periodic reporting obligations. See Management's Discussion of Financial Condition, Securities Act Release No. 33-6835, 43 SEC Docket 1330, 1330 (May 18, 1989).

<sup>164</sup> For example, see the gun-jumping restrictions discussed *supra* Part II.

<sup>165</sup> Drury, *supra* note 160, at 761.

<sup>166</sup> In 2003, the Supreme Court agreed to hear an appeal challenging California's ability to prevent Nike from conducting a public relations campaign in response to accusations that its labor practices in certain Asian countries were unfair. See *Kasky v. Nike, Inc.*, 45 P.3d 243, 247–48 (2002), *cert. granted*, 537 U.S. 1098, 1099–100 (2003), *cert. denied*, 539 U.S. 654, 655 (2003) (per curiam). The California Supreme Court rejected Nike's claim that California's Unfair Competition Law and False Advertising Law deprived it of its right to free speech in violation of the First Amendment. *Id.* at 262. The Supreme Court originally granted certiorari to determine if these advertisements should be treated as commercial speech, given heightened scrutiny because it was a matter of public concern, or given lower scrutiny because the speech was false or misleading. See *Nike, Inc. v. Kasky*, 539 U.S. 654, 657 (2003) (Stevens, J., concurring) (dismissing certiorari); see also *Nike, Inc. v. Kasky*, 537 U.S. 1099–100 (2003) (granting certiorari). However, the Court dismissed the case on the grounds that the writ of certiorari was improvidently granted. See *Kasky*, 539 at 655 (2003) (dismissing certiorari).

<sup>167</sup> Drury, *supra* note 160, at 771.

<sup>168</sup> In *Paris Adult Theatre I v. Slaton*, the Court noted that "both Congress and state legislatures have . . . strictly regulated public expression by issuers of and dealers in securities . . . commanding what they must and must not publish and announce." 413 U.S.

However, under the reasoning of *Liquormart*, the government cannot censor speech solely because the speech relates to activities that the government can regulate.<sup>169</sup> Accordingly, the fact that the SEC could act more drastically under its power to regulate commercial activity should not exempt the SEC's speech regulations from scrutiny under the commercial speech doctrine.<sup>170</sup> As a leading first amendment lawyer, 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."<sup>171</sup> In fact, the SEC itself recognized that its regulations may be subject to First Amendment review.<sup>172</sup>

Further, several recent cases have raised First Amendment challenges to SEC regulations, but these cases have been resolved on other grounds.<sup>173</sup> Each case involved restrictions on the flow of information that was of conceded assistance to listeners in making informed and autonomous choices about capital formation issues. As an example, in *Lowe v. SEC* the SEC sought to enjoin the publication of an investment newsletter because the author was ineligible for an investment analyst's license.<sup>174</sup> There were no allegations that the content of the newsletter was false or misleading. The Supreme Court avoided the constitutional issue by narrowly interpreting the SEC's licensing power under the Investment Advisors Act of 1940, but stated that "it is difficult

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49, 61–62 (1973). More specifically, the Court in *Ohlarik v. Ohio State Bar Ass'n* expressed the presumption that SEC disclosures were beyond the scope of the First Amendment: "Numerous examples could be cited of communications that are regulated without offending the First Amendment, such as the exchange of information about securities . . ." 436 U.S. 447, 456 (1978) (holding that Ohio may regulate face-to-face solicitations of potential clients, because the speech was intended to further a business transaction over which the state had regulatory authority).

<sup>169</sup> See 44 *Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 502–04 (1996).

<sup>170</sup> *Drury, supra* note 160, at 771.

<sup>171</sup> James C. Goodale, *The First Amendment and Securities Act: A Collision Course?*, N.Y. L.J., Apr. 8, 1983, at 1 (characterizing the First Amendment and securities regulation as on a "collision course").

<sup>172</sup> 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, 946–47 (D.C. Cir. 1995) (noting that the SEC maintained loopholes in its regulation because of its "sensitivity" to First Amendment concerns).

<sup>173</sup> See, e.g., *Long Island Lighting Co. v. Barbash*, 779 F.2d 793, 795–96 (2d Cir. 1985) (denying LILCO's request for an injunction to restrict a candidate for public office from using advertisements to urge LILCO shareholders to replace the incumbent board on the grounds that such "indirect[]" solicitations were not covered by the proxy rules and the First Amendment protected the anti-LILCO ads); *SEC v. Wall St. Publ'g Inst., Inc.*, 851 F.2d 365, 374–76 (D.C. Cir. 1988), cert. denied, 489 U.S. 1066 (1989) (holding that anti-touting provisions of the Securities Act do not require an investment newsletter to inform its readers that the authors of the articles were also the subjects of the articles, but do require disclosure of whether it was being paid to run the article).

<sup>174</sup> *Lowe v. SEC*, 472 U.S. 181, 184 (1985).

to see why the expression of an opinion about a marketable security should not” be protected by the First Amendment.<sup>175</sup>

In a concurrence, Justice White, supported by two other justices, explained that the SEC’s actions could never have survived a constitutional review because the means were more extensive than necessary to prevent a “mere possibility” of fraud.<sup>176</sup> The government’s fear that a future newsletter might contain false or misleading information cannot justify the suppression of current speech that a hearer has an interest in receiving.<sup>177</sup>

Such a reverse prophylaxis, which suppresses useful speech today in order to avoid the risk of harmful speech tomorrow, can rarely, if ever, be justified from a hearer-centered point of view. In effect, it asks current hearers to forego information that they wish to receive in order to assure that hypothetical future hearers will not risk receiving harmful information.<sup>178</sup>

What this, and similar actions demonstrate is that “challengers have begun to establish a first amendment beachhead in what once appeared to be an impregnable area.”<sup>179</sup>

Many scholars have expressed concern with extending the doctrine to securities regulation because striking down such regulation would result in widespread harm to capital markets.<sup>180</sup> Concerns over extending protections are tempered by the fact that most securities regulations would survive First Amendment review under the commercial speech doctrine. The regulation of false or misleading speech is consistent with the commercial speech doctrine.<sup>181</sup> Mandatory disclosure rules would likely survive constitutional review.<sup>182</sup> The only provisions which would raise serious free speech concerns are those that prohibit the disclosure of truthful, non-misleading, and sometimes material speech based on paternalistic concerns, such as the Quiet Period Rules.<sup>183</sup>

<sup>175</sup> *Id.* at 210 n.58.

<sup>176</sup> *Id.* at 235 (White, J., concurring).

<sup>177</sup> *Id.* at 234–35.

<sup>178</sup> Neuborne, *supra* note 128, at 43.

<sup>179</sup> *Id.* at 42.

<sup>180</sup> See, e.g., Allen D. Boyer, *Free Speech, Free Markets, and Foolish Consistency*, 92 COLUM. L. REV. 474, 495 (1992) (reviewing NICHOLAS WOLFSON, CORPORATE FIRST AMENDMENT RIGHTS AND THE SEC (1990)).

<sup>181</sup> Cases holding that the First Amendment does not protect false or misleading economic speech would remain good law under the commercial speech doctrine. See, e.g., SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

<sup>182</sup> In at least one case, the SEC rule survived strict First Amendment scrutiny. See *Blount v. SEC*, 61 F.3d 938, 938, 944–48 (D.C. Cir. 1995) (upholding Rule G-37 that restricted political contributions by parties involved in the municipal securities market).

<sup>183</sup> The Supreme Court has provided little guidance regarding the First Amendment’s application to securities regulation. When the Securities Act was enacted, the Supreme Court had already recognized constitutional rights of corporations, see *Santa Clara Cnty. v. S. Pac. R.R. Co.*, 118 U.S. 394, 396 (1886), but had not yet extended First Amendment coverage to

## B. *Quiet Period Rules and the Commercial Speech Doctrine*

Speech of an issuer or underwriter during the offering period closely resembles traditional advertising. This type of speech “alerts the market to a new product—an offering of securities—that market participants may want to purchase.”<sup>184</sup> These types of advertisements have been characterized as commercial speech in other contexts.<sup>185</sup> Further, like advertisements of consumer products, the SEC restricts offering communications because of paternalistic concerns over the listeners of such speech. The SEC’s broad prophylactic approach to speech during the offering period raises serious First Amendment concerns. For the alleged purposes of preventing fraud, protecting investors, and increasing market efficiency, the SEC restricts the dissemination of truthful, non-misleading speech that would assist many listeners in making informed autonomous decisions about whether to purchase securities and would ultimately increase market efficiency under the ECMH.

The communications disseminated by Groupon’s CEO, Andrew Mason, and its chairman, co-founder, and dominant shareholder, Eric Lefkofsky, during the waiting period provide an excellent test case for analyzing the constitutionality of the offering rules under the commercial speech doctrine.<sup>186</sup> The publication of Andrew Mason’s internal e-mail describing Groupon’s success and Eric Lefkofsky’s statement during an interview with Bloomberg that Groupon would be “wildly profitable,” likely violated Section 5(b)(1) of the Securities Act.<sup>187</sup>

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corporate speech, *see* First Nat’l Bank of Bos. v. Bellotti, 435 U.S. 765, 776–83 (1978). After the Supreme Court recognized First Amendment protection to commercial speech, an impressive list of commentators, scholars, and practitioners argued *supra* that securities regulation was outside the reach of the First Amendment. *See, e.g.,* Boyer, *supra* note 180, at 495 (“The Court has instead rejected any implication that the First Amendment should be applied in the securities field.”); Frederick Schauer, *The Boundaries of the First Amendment: A Preliminary Exploration of Constitutional Salience*, 117 HARV. L. REV. 1765, 1770–71, 1777–80 (2004); *see also* Law Professors Brief as Amicus Curiae in Opposition to Motion to Dismiss at 16–22, SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005) (No. 04 CV 5130(GBD)) (signatories are prominent securities professors including, John C. Coffee, Jr., Alan R. Bromberg, James D. Cox, Melvin 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) (arguing that there was a securities exception from the First Amendment for securities regulation based on dicta from two early cases). Recently, several scholars have demonstrated that there is no reasonable justification for a securities regulation exemption to First Amendment protection. *See, e.g.,* Drury, *supra* note 160, at 759–60; Page, *supra* note 154, at 829–30.

<sup>184</sup> Drury, *supra* note 160, at 781.

<sup>185</sup> *See* discussion *supra* Part IV.A.

<sup>186</sup> *See supra* notes 3–10 and accompanying text for a description of Groupon’s statements.

<sup>187</sup> Section 5(b)(1) prohibits a company from making any written offers other than by means of a statutory prospectus during the waiting period. Securities Act of 1933 § 5(b)(1),

The communications would constitute gun-jumping even if the statements were entirely accurate.

The communications would probably not fall into one of the exemptions created by the 2005 Securities Offering Reforms or the JOBS Act.<sup>188</sup> The only exception that would arguably protect the communications would be the media free writing exception.<sup>189</sup> Bloomberg's broadcast of Lefkofsky's statement would probably be characterized as an unaffiliated free writing prospectus. But, it does not appear that Groupon met the conditions for using this exception (e.g., it did not properly file the broadcast with the SEC or include the requisite legend).<sup>190</sup> The publication of Mason's memo would probably be characterized as an affiliated free writing prospectus as it was prepared by the CEO of Groupon.<sup>191</sup> As such, it would not be protected by the exception as it could not have been accompanied or preceded by the most recent statutory prospectus.<sup>192</sup>

To determine the constitutionality of the gun-jumping restrictions under the *Central Hudson* test, a court must determine as a threshold matter, whether the communications concerned lawful activity and were not misleading.<sup>193</sup> Assuming the statements in Groupon were factually accurate, the SEC may argue that the information was nonetheless misleading because it contained incomplete information that could unduly influence investment decisions. However, in light of the negative publicity about the Groupon offering, and the balanced information contained in the statutory prospectus, it does not appear that the Mason Memo or Lefkofsky statement were inherently misleading. Further, the Securities Act contains provisions that would minimize the risk of deception. For instance, the rules require Groupon to deliver its statutory prospectus to a potential investor at least 48 hours before any commitment to purchase securities becomes binding.<sup>194</sup> This period effectively gives investors

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15 U.S.C. § 77e (2006). The broad definition of prospectus includes written communications as well as broadcast communications, such as TV and radio transmissions. *See* discussion *supra* Part II.A.

<sup>188</sup> *See* discussion *supra* Part II.B–C for a description of these reforms.

<sup>189</sup> Securities Act of 1933 Rule 164, 17 C.F.R. § 230.164 (2012); Securities Act of 1933 Rule 433(f), 17 C.F.R. § 230.433(f) (2012). The communications would not be protected under the bright line safe harbor because they were disclosed after the filing of the registration statement. *See* Securities Act of 1933 Rule 163A, 17 C.F.R. § 230.163A (2012). They would also not be protected as ordinary course communications as they were not routine communications and they contained predictions related to the company's financial performance. *See* Securities Act Rule 169, 17 C.F.R. § 230.169 (2012). The communications would also not be protected as free writing prospectuses as they were not accompanied with or preceded by the most recent statutory prospectus and did not include other prerequisites. *See* Securities Act of 1933 Rule 433(b)(2), 17 C.F.R. § 230.433(b)(2) (2012).

<sup>190</sup> *See* discussion *supra* Part II.B.

<sup>191</sup> *See* discussion *supra* Part II.B.

<sup>192</sup> *See* discussion *supra* Part II.B.

<sup>193</sup> *See* Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n, 447 U.S. 557, 566 n.9 (1980).

<sup>194</sup> DAVID A. LIPTON, 15 BROKER-DEALER REGULATION § 3:57 (2012) (outlining prospectus dissemination requirements).

an opportunity to carefully calibrate all material information regarding the offering before purchasing securities.<sup>195</sup> Although an investor may irrationally ignore the information contained in the prospectus, this mere potential for deception would not justify a categorical suppression of speech.<sup>196</sup> Rather such potentially misleading speech could only be suppressed if the restriction is appropriately tailored and satisfies the remaining prongs of the *Central Hudson* test.<sup>197</sup> Accordingly, under *Central Hudson*, the release would not be false or misleading unprotected speech.

The next step would be to determine whether the proffered government interests in enacting the offering rules are substantial.<sup>198</sup> One interest the government would likely assert is preventing fraud orchestrated by manipulative communications advertising securities offerings.<sup>199</sup> The government would also assert the related interest of protecting investor confidence in capital markets.<sup>200</sup> Finally, the government would assert an interest in providing for greater market efficiency by ensuring that investors have access to, and time to consider, the disclosures contained within the prospectus and the registration statement.<sup>201</sup> The government clearly has a substantial interest in regulating speech during the offering period.

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<sup>195</sup> Securities Exchange Act 15c2-8(b), 17 C.F.R. § 240.15c2-8(b) (requiring the broker or dealer for an offering involving a nonreporting company to deliver a copy of the preliminary prospectus).

<sup>196</sup> See *Peel v. Att’y Registration & Disciplinary Comm’n*, 496 U.S. 91, 100 (1990) (holding that while inherently misleading speech may be prohibited entirely, potentially misleading speech may not be categorically suppressed unless the character or the statements create a state interest sufficiently substantial to justify a categorical ban on their use).

<sup>197</sup> Edward T. Highberger, Note, *Not So Fast! Scrutinizing the “Gun Jumping” Provisions of the Securities Act Under the Commercial Speech Doctrine*, 83 NOTRE DAME L. REV. 2141, 2169 (2008).

<sup>198</sup> *Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm’n*, 447 U.S. 557, 566 (1980).

<sup>199</sup> This purpose can be traced to the original enactment of the Securities Act which was to prevent fraud by providing for full disclosure of a company’s operations, financials, markets, and risks. Orcutt, *supra* note 90, at 42.

<sup>200</sup> Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,721, 44,796 (Aug. 3, 2005) (justifying the 2005 Securities Offering Reforms as increasing both “market efficiency” and “investor confidence” leading to “more efficient capital formation”).

<sup>201</sup> H.R. REP. NO. 73-85, at 1 (1933) (stating that one of the purposes was to “provide full and fair disclosure of the character of securities sold”). The waiting period was

intended to interfere with the reckless traditions of . . . the securities business. It contemplates a change from methods of distribution lately in vogue which attempted complete sale of an issue sometimes within 1 day or at most a few days. . . . [A]ny issue which cannot stand the test of a waiting inspection over a month’s average of economic conditions, but must be floated within a few days upon the crest of a possibly manipulated market fluctuation, is not a security which deserves protection . . . .

*Id.* at 7-8; see also *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569, 574 (2d Cir. 1970) (“One of the evils of a premature offer is its tendency to encourage the formation



Since the first two inquiries yielded positive answers, *Central Hudson* requires analysis of whether the regulation directly and materially advances the governmental interests asserted.<sup>202</sup> The SEC would not be able to satisfy this burden “by mere speculation or conjecture; rather, . . . the [the SEC] must demonstrate that the harms it recites are real and that its restriction will in fact alleviate them to a material degree.”<sup>203</sup> The SEC would likely be able to provide sufficient evidentiary support that the gun-jumping restrictions directly advance their interests in preventing fraud. The speech restrictions imposed on issuers and related parties during the offering period make it more difficult for those parties to deceive investors.

However, it will be difficult for the SEC to demonstrate that the offering rules make markets materially more efficient.<sup>204</sup> The SEC would probably contend that the offering rules increase investor confidence and market efficiency because they restrict issuers and underwriters from disclosing optimistic information, which may result in an unwarranted jump in offering price. This conclusion relies on a flawed premise that optimistic information released during the offering period would cause investors to go into a speculative frenzy. Instead, given the ECMH, the impact of more speech would be positive: the public availability of additional accurate information would be beneficial to sophisticated investors who would quickly assimilate the additional information into the share price. Even if some investors are not sophisticated, they would be protected against misinterpreting optimistic statements through the price mechanism. Although the hypothesis is not as strong for IPOs as it is for secondary offerings, IPO markets are sufficiently information efficient to incorporate additional information into the offering price.<sup>205</sup>

Whatever the strength of the SEC’s evidence to justify the offering regulations, the rules would not satisfy the final step of the *Central Hudson* analysis. The critical inquiry in a case challenging the offering rules will be whether the government can demonstrate a “reasonable fit between the means and ends of the regulatory scheme.”<sup>206</sup> The SEC has used a “radical prophylactic approach to speech—banning all speech that might be harmful to someone, some day.”<sup>207</sup>

The SEC would probably assert that the broad prophylactic rules restricting most speech for IPOs are necessary to prevent harmful speech, despite its concededly restrictive effect on speech that would be of use to listeners. Broad

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by the offeree of an opinion of the value of the securities before a registration statement and prospectus are filed.”).

<sup>202</sup> *Cen. Hudson*, 447 U.S. at 566.

<sup>203</sup> *Greater New Orleans Broad. Ass’n v. United States*, 527 U.S. 173, 188 (1999).

<sup>204</sup> See Chiappinelli, *supra* note 45, at 497–99.

<sup>205</sup> See *supra* Part III.C for a discussion of the ECMH in IPO markets.

<sup>206</sup> *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 561 (2001) (citing *Cen. Hudson*, 447 U.S. at 569).

<sup>207</sup> Neuborne, *supra* note 128, at 51.

restrictions are necessary, the SEC would contend, because it is difficult to differentiate fraudulent or misleading advertisements from truthful and harmless commercial speech before listeners are harmed by such speech. Post-hoc litigation often comes too late to protect investors, especially if the issuer is insolvent. Broader restrictions on securities advertisements are necessary, the SEC would argue, because securities are intangible and derive their value from information supplied by issuers and related parties rather than some inherent worth.<sup>208</sup> This concern is particularly acute in an IPO market where there is less analyst coverage and no past reporting obligations.

This argument proceeds from the premise that it is intrinsically more difficult to distinguish the false or misleading from the truthful and helpful in advertisements involving the value of a company than in advertisements involving goods or services.<sup>209</sup> This notion is belied by the fact that distinguishing deceptive from nondeceptive claims in advertising in virtually any field of commerce may require resolution of exceedingly complex and technical factual issues and the consideration of difficult questions of semantics.<sup>210</sup> Further, the SEC often carries the regulatory burden of distinguishing between truthful and false or misleading statements.<sup>211</sup> Often statements contained in an advertisement, publication or broadcast involving the value of a company are verifiable, and if they are indeed false or misleading they would be actionable under the anti-fraud provisions of the Securities Act. Another safeguard against deception in the securities markets are research analysts and news outlets. Unlike when the Securities Act was originally enacted, today if a company like Groupon says it is going to be wildly profitable and it is not, there are plenty of news outlets and analysts that will immediately pick the statement apart. Justice White's concurrence in *Lowe v. SEC* signals that the Supreme Court may invalidate restrictions that suppress speech as part of a prophylactic assault on potentially harmful speech.<sup>212</sup>

Although the SEC may be concerned that optimistic communications released during the offering period may mislead unsophisticated investors, commercial speech cases do not allow such paternalistic concerns over whether listeners or investors can handle truthful information to serve as the basis for

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<sup>208</sup> See Arthur R. Pinto, *The Nature of the Capital Markets Allows a Greater Role for the Government*, 55 BROOK. L. REV. 77, 82-83 (1989).

<sup>209</sup> *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626, 644-45 (1985).

<sup>210</sup> The *Zauderer* Court wrote:

A brief survey of the body of case law that has developed as a result of the Federal Trade Commission's efforts to carry out its mandate under § 5 of the Federal Trade Commission Act to eliminate 'unfair or deceptive acts or practices in . . . commerce,' reveals that distinguishing deceptive from nondeceptive advertising [is challenging].

*Id.* at 645 (citation omitted) (quoting 15 U.S.C. § 45(a)(1)).

<sup>211</sup> *Id.* at 646.

<sup>212</sup> 472 U.S. 181, 211 (1985) (White, J., concurring).

prohibiting speech.<sup>213</sup> As the leading commercial speech case reasoned, the government may not “completely suppress the dissemination of concededly truthful information about entirely lawful activity, fearful of that information’s effect upon its disseminators and its recipients.”<sup>214</sup> Any argument that the SEC would make that the rules are necessary to protect unsophisticated investors would probably be unavailing. The Supreme Court has reasoned that the government should not “chok[e] off access to information that may be useful to” some citizens, in order to protect other citizens.<sup>215</sup> As the Court explained, if it allowed the differentiation argument to prevail, First Amendment protection of commercial speech would be rendered virtually meaningless.<sup>216</sup> It would be difficult to prevent the government from suppressing other forms of truthful and nondeceptive advertising “simply to spare itself the trouble of distinguishing such advertising from false or deceptive advertising.”<sup>217</sup> Recent commercial speech decisions have been “grounded in the faith 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.”<sup>218</sup>

The policy chosen and expressed by Congress is “[d]isclosure, and not paternalistic withholding of accurate information.”<sup>219</sup> Rather than suppressing speech, the Supreme Court prefers disclaimers or warnings as a means of limiting the influence of potentially misleading speech.<sup>220</sup> The requirement

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<sup>213</sup> *Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc.*, 425 U.S. 748, 773 (1976).

<sup>214</sup> *Id.*; see also 44 *Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 502–04 (plurality opinion) (noting that a state may regulate commercial speech to protect consumers from misleading or deceptive speech, but may not prohibit the dissemination of truthful, non-misleading speech). The Supreme Court seems reluctant to suppress truthful speech in the name of protecting the public. See *Drury*, *supra* note 160, at 780–82.

<sup>215</sup> *Zauderer*, 471 U.S. at 645 n.12; see also *id.* at 647 (holding that the restriction on attorney advertisements containing truthful nondeceptive information and advice regarding legal rights could not be justified).

<sup>216</sup> See *id.* at 646.

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 234 (1988); see also *Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc.*, 425 U.S. 748, 773 (1976) (“[The State may not] completely suppress the dissemination of concededly truthful information about entirely lawful activity, fearful of that information’s effect upon its disseminators and its recipients.”).

<sup>220</sup> The restrictions also seem too extensive with respect to the government’s interest in market efficiency. The restriction on all paid advertisements suppresses not only false or misleading speech but also truthful speech. Less restrictive disclaimers or warnings combined with anti-fraud measures would serve to prevent the dissemination of false or misleading advertisements without interfering with the dissemination of truthful information. Accordingly it does not appear that the reach of the gun-jumping restrictions is reasonably fitted to the purpose of market efficiency.

contained in offering rules that certain permissible communications, such as a free writing prospectus, contain a detailed legend serves this purpose.<sup>221</sup>

The indiscriminate suppression of both fraudulent and truthful speech, suggests that the SEC “did not carefully calculat[e] the costs and benefits associated with the burden on speech imposed by the regulations.”<sup>222</sup> In fact when questioned about such a cost benefit analysis of the Quiet Period Rules the SEC responded: “Neither the Commission nor the staff has had occasion to consider the constitutionality of the quiet period rules under the First Amendment,” and such questions are “typically best considered in context.”<sup>223</sup> The time is ripe for the SEC to consider the constitutionality of the offering rules and the burdens it places on issuers and underwriters, especially in IPO markets.

The broad prophylactic restrictions on the scope and timing of accurate promotional activity in the capital markets raises serious First Amendment corporate free speech concerns.

## V. IMPACT OF *CITIZENS UNITED* ON CONSTITUTIONALITY OF OFFERING RULES

In a recent landmark decision, *Citizens United v. FEC*, the Supreme Court held that corporations engaging in political speech are entitled to the same First Amendment protection as individuals.<sup>224</sup> Although directed at political speech, the broad language undercuts one of the basic premises of the commercial speech doctrine—that corporations advertising their products or services are entitled to less protection than individuals engaging in more valuable speech. This case also suggests that the offering rules may ultimately be subject to a strict scrutiny review as the current rules would prevent issuers from engaging in political speech during the offering process.<sup>225</sup>

### A. *Citizens United* and Corporate Political Speech

While *Central Hudson* imposed significant restrictions on the government’s ability to restrict commercial speech, the opinion did not reach political speech. It was not until 2010, in *Citizens United*, that the Court imposed meaningful restrictions on the government’s ability to regulate political speech of

<sup>221</sup> See *supra* note 71 and accompanying text for an example of such a legend.

<sup>222</sup> *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 561 (2001) (alteration in original) (quoting *City of Cincinnati v. Discovery Network, Inc.*, 507 U.S. 410, 417 (1993)) (internal quotation marks omitted).

<sup>223</sup> Schapiro Letter, *supra* note 7, at 9.

<sup>224</sup> See 130 S. Ct. 876, 899 (2010).

<sup>225</sup> See Alexander F. L. Sand, Note, *Invested in Politics: Gun Jumping, Corporate Political Speech, and Citizens United*, 40 HOFSTRA L. REV. 309, 324 (“It is *Citizens United* however, the most recent case to address the issue of corporate speech protections, that provides the broadest and fiercest articulation of corporate free speech to date.”).

corporations.<sup>226</sup> Before *Citizens United*, the Court had vacillated in its approach to corporate speech. Under *Buckley v. Valeo*<sup>227</sup> and *First Nat'l Bank of Bos. v. Bellotti*,<sup>228</sup> restrictions on speech could not be based on the speaker's corporate identity: "In the realm of protected speech, the legislature is constitutionally disqualified from dictating the subjects about which persons may speak and the speakers who may address a public issue."<sup>229</sup> To bypass this line of cases, the Court in *Austin v. Michigan Chamber of Commerce*<sup>230</sup> and *McConnell v. FEC*<sup>231</sup> identified a new government interest in limiting political speech of corporations: an anti-distortion interest. These decisions identified a compelling governmental interest in preventing "the corrosive and distorting effects of immense aggregations of wealth that are accumulated with the help of the corporate form and that have little or no correlation to the public's support for the corporation's political ideas."<sup>232</sup>

In rejecting *Austin*'s anti-distortion rationale, the *Citizens United* Court held that the First Amendment prohibited the government from suppressing corporate political speech, but permitted the government to impose disclaimer and disclosure obligations.<sup>233</sup> *Citizens United* made clear that the government's ability to restrict corporate political speech runs congruent to its ability to restrict individual political speech.

The case involved Citizens United, a nonprofit corporation that planned to release a ninety-minute documentary entitled *Hillary: The Movie*, within thirty days of the 2008 primary elections.<sup>234</sup> The film criticized Hillary Clinton, a candidate in the Democratic Party's presidential primary elections.<sup>235</sup> Concerned that the release would violate Section 441b of the McCain-Feingold Act and Section 2003 of the Bipartisan Campaign Reform Act of 2002 (the BCRA), Citizens United sought declaratory and injunctive relief against the Federal Election Commission (FEC).<sup>236</sup> The Supreme Court concluded that the

<sup>226</sup> *See id.*

<sup>227</sup> 424 U.S. 1, 58–59 (finding the independent expenditure ceiling on campaign contributions unconstitutional because it fails to serve any substantial government interest in curtailing corruption in the electoral process).

<sup>228</sup> *First Nat'l Bank of Bos. v. Bellotti*, 435 U.S. 765, 767 (1978) (striking down a state-law prohibition on corporate independent expenditures related to referendum issues).

<sup>229</sup> *Id.* at 784–85.

<sup>230</sup> 494 U.S. 652, 664 (1990) (upholding a statute that prohibited corporations from using their general treasury funds for independent expenditures opposing or supporting candidates in state elections), *overruled by* *Citizens United v. FEC*, 130 S. Ct. 876 (2010).

<sup>231</sup> 540 U.S. 93 (2003) (upholding a federal regulation that barred corporations from using general treasury funds to create advertisements that mention a candidate's name within sixty days of an election), *overruled by* *Citizens United v. FEC*, 130 S. Ct. 876 (2010).

<sup>232</sup> *Austin*, 494 U.S. at 660.

<sup>233</sup> *Citizens United*, 130 S. Ct. at 876–77.

<sup>234</sup> *Id.* at 888.

<sup>235</sup> *Id.* at 887.

<sup>236</sup> *Id.* at 876, 904–05; Darrell A.H. Miller, *Guns, Inc.: Citizens United, McDonald, and the Future of Corporate Constitutional Rights*, 86 N.Y.U. L. REV. 887, 893 (2011).

FEC could not prevent Citizens United from using funds from individuals and for-profit corporations to make a documentary about Hillary Clinton available on cable television.<sup>237</sup>

In finding the Section 441b prohibition to be facially unconstitutional, Justice Kennedy equated the constitutional dignity of corporations to that of natural persons.<sup>238</sup> Corporations enjoy the same right to speech as individuals because “[s]peech restrictions based on the identity of the speaker are all too often simply a means to control content.”<sup>239</sup> Like individuals, corporations and other associations are participants in the marketplace of ideas.<sup>240</sup> “Political speech is ‘indispensable to decision making in a democracy, and this is no less true because the speech comes from a corporation rather than an individual.’”<sup>241</sup> Accordingly, restrictions on corporate political speech should be subject to the same strict scrutiny review as restrictions on individual core speech.<sup>242</sup> Under this standard, the government must show that the restriction “furthers a compelling interest and is narrowly tailored to achieve that interest.”<sup>243</sup>

Relying on *Austin*, the government asserted that the restriction should pass muster even under a strict scrutiny review because it had a compelling interest in regulating corporate political speech to prevent corporations from gaining an “unfair advantage” in the political marketplace.<sup>244</sup> Without these restrictions corporations with large amounts of resources could distort the tenor of political debates.<sup>245</sup> The Court found that this distortion rationale could not justify restrictions on speech. The fact that individuals choose to use the corporate form to amplify their message is inconsequential.<sup>246</sup> In debunking the anti-distortion rationale the Court reasoned:

When Government seeks to use its full power, including the criminal law, to command where a person may get his or her information or what distrusted

<sup>237</sup> *Citizens United*, 130 S. Ct. at 904–05.

<sup>238</sup> *Id.* at 898. (“If [BCRA] applied to individuals, no one would believe that it is merely a time, place, or manner restriction on speech. Its purpose and effect are to silence entities whose voices the Government deems to be suspect.”).

<sup>239</sup> *Id.* at 899.

<sup>240</sup> *Id.* at 900 (“Corporations and other associations, like individuals, contribute to the discussion, debate, and the dissemination of information and ideas that the First Amendment seeks to foster.” (quoting *Pac. Gas & Elec. Co. v. Pub. Util. Comm’n*, 475 U.S. 1, 8 (1986) (plurality opinion)) (internal quotations omitted)).

<sup>241</sup> *Id.* at 904 (quoting *First Nat’l Bank of Bos. v. Bellotti*, 435 U.S. 765, 777 (1978)).

<sup>242</sup> *Cf.* Michael R. Siebecker, *Corporate Speech, Securities Regulation, and an Institutional Approach to the First Amendment*, 48 WM. & MARY L. REV. 613, 636 (2006).

<sup>243</sup> *FEC v. Wis. Right to Life, Inc.*, 551 U.S. 449, 464 (2007). “[T]he First Amendment has its fullest and most urgent application to speech uttered during a campaign for political office.” *Eu v. S.F. Cnty. Democratic Cent. Comm.* 489 U.S. 214, 223 (1989) (internal quotation marks omitted).

<sup>244</sup> *Citizens United*, 130 S. Ct. at 904 (quoting *Austin v. Mich. Chamber of Commerce*, 494 U.S. 652, 659 (1990)).

<sup>245</sup> *See id.*

<sup>246</sup> *See id.* at 911 (citing *First Nat’l Bank of Bos. v. Bellotti*, 435 U.S. 765, 794 (1978)).

source he or she may hear, it uses censorship to control thought. This is unlawful. The First Amendment confirms the freedom to think for ourselves.<sup>247</sup>

The Court found that the narrow band of exceptions to this expansive view of First Amendment protection were inapposite. These exceptions include situations where the federal or state government is carrying out a basic service such as operating a public school, a prison, or the military.<sup>248</sup> For example, the Court held that a student's suspension from school for making speech full of sexual innuendos at a school assembly did not violate the First Amendment.<sup>249</sup> It also held that prison inmates do not have a First Amendment right to join labor unions,<sup>250</sup> and army physicians do not have a First Amendment right to make public statements urging enlisted men to disobey orders and refuse to go to Vietnam.<sup>251</sup> The Court explained that unlike these cases, allowing corporate independent expenditures would not interfere with basic government functions.<sup>252</sup> Similarly, allowing issuers to speak during the offering period would not jeopardize essential government functions. The SEC as a regulator of capital markets is a step removed from these functions—more like the FEC regulating elections than like a state regulating a public school or prison.

In his concurrence, Justice Scalia agreed that corporate identity did not justify restrictions on speech, but he rested his conclusion on textual grounds.<sup>253</sup>

<sup>247</sup> *Citizens United*, 130 S. Ct. at 908. Another argument the government asserted to justify the restriction was the dissenting shareholder rationale. *See id.* at 911. Under this theory, the government argued that it should be allowed to limit political speech of corporations in order to protect dissenting shareholders from being compelled to fund disagreeable speech. *See id.* The Court concluded that this rationale could not support the speech restriction because harm to dissenting shareholders should be tempered by procedures of “corporate democracy.” *Id.* The last two arguments the government made related to its ability to prevent the appearance of corruption and prevent foreigners from influencing American elections. *See id.*

<sup>248</sup> *Id.* at 899 (citing *Bethel Sch. Dist. No. 403 v. Fraser*, 478 U.S. 675, 683 (1986); *Jones v. N.C. Prisoners’ Labor Union, Inc.*, 433 U.S. 119, 129 (1977); *Parker v. Levy*, 417 U.S. 733, 759 (1974)).

<sup>249</sup> *Bethel Sch. Dist. No. 403 v. Fraser*, 478 U.S. 675, 683 (1986) (protecting the “function of public school education”).

<sup>250</sup> *Jones v. N.C. Prisoners’ Labor Union, Inc.*, 433 U.S. 119, 129 (1977) (furthering “the legitimate penological objectives of the corrections system”) (internal quotation marks omitted).

<sup>251</sup> *Parker v. Levy*, 417 U.S. 733, 759 (1974) (ensuring “the capacity of the Government to discharge its [military] responsibilities” (quoting *United States v. Priest*, 45 C.M.R. 338, 343 (1972))).

<sup>252</sup> *Citizens United v. FEC*, 130 S. Ct. 876 (2010). By contrast, “it is inherent in the nature of the political process that voters must be free to obtain information from diverse sources in order to determine how to cast their votes.” *Id.* at 899.

<sup>253</sup> *See id.* at 929 (Scalia, J., concurring). “[T]he ‘normal rule’ is that ‘partial, rather than facial, invalidation is the required course,’ such that a ‘statute may . . . be declared invalid to the extent that it reaches too far, but otherwise left intact.” *Id.* at 932 (quoting *Brockett v. Spokane Arcades, Inc.*, 472 U.S. 491, 504 (1985) (alteration in original)).

Justice Scalia found that any attempt to create a special category of corporate persons for core First Amendment protections would be in clear derogation of the text: “The [First] Amendment is written in terms of ‘speech,’ not speakers. Its text offers no foothold for excluding any category of speaker, from single individuals to partnerships of individuals, to unincorporated associations of individuals, to incorporated associations of individuals . . . .”<sup>254</sup>

### B. *The Impact of Citizens United on Central Hudson and the Offering Rules*

At the very least, *Citizens United* suggests that the SEC may not prohibit issuers from making public statements with political impact. However, *Citizens United* may ultimately undermine *Central Hudson* for other speech as well, because the thrust of the opinion is to reduce the disparity in treatment between commercial and political speech.

To ensure a strict scrutiny review under the political speech doctrine, an issuer like Groupon may insert a political message into its communication. Doing so would change otherwise “commercial speech” into “political speech” or “mixed speech.” Given that the gun-jumping restrictions would likely not survive scrutiny under the *Central Hudson* test, it certainly has little chance to survive if challenged under the strict scrutiny standard of the political speech doctrine as articulated by the Court in *Citizens United*.<sup>255</sup> The Court stated conclusively that “[n]o sufficient governmental interest justifies limits on the political speech of . . . corporations.”<sup>256</sup> Given this broad language, a court would likely find that the gun-jumping restrictions affecting such a wide range of speech, including truthful speech, are not narrowly tailored to achieve the government’s purposes of preventing fraud, increasing efficiency, and increasing investor confidence. Further, less restrictive measures to the more heavy-handed restrictions currently in place are available.<sup>257</sup>

The publication and broadcast in Groupon would likely be characterized as commercial speech as it relates to a transaction in securities and is similar to advertisements for consumer products.<sup>258</sup> In order to receive the heightened protections afforded to political speech, Groupon could have used a different tactic to enhance its public image during the offering period. For instance, Groupon could have launched an advertising campaign taking a popular

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<sup>254</sup> *Id.* at 929.

<sup>255</sup> *See id.* at 903–05 (majority opinion).

<sup>256</sup> *Id.* at 913.

<sup>257</sup> *See supra* Part III.A; *see also* Highberger, *supra* note 197, at 2170 (arguing that mandatory disclaimers or warnings, in conjunction with existing anti-fraud provisions, would be sufficient to protect the capital markets); Page, *supra* note 154, at 790 (suggesting that adequate protection can be achieved through self-regulation or optional regulation combined with market forces).

<sup>258</sup> *See supra* Part III.A.



political stance—similar to Nike speaking out against sweatshop labor.<sup>259</sup> Or Groupon could have lauded its positive impact on the national economy by promoting domestic business and encouraging consumers to do their part in revitalizing the economy. This type of speech would probably be characterized as “mixed speech” as it involves both a political and a commercial message. Empirical evidence suggests that increased corporate political activity increases firm performance and profits.<sup>260</sup>

Assuming Groupon increased its corporate political activity during the offering period in violation of the offering rules, a strict scrutiny level of review under *Citizens United* would apply, rather than a lesser standard under *Central Hudson*. Under strict scrutiny, the government would have to demonstrate that the offering restrictions “further[] a compelling interest and [are] narrowly tailored to achieve that interest.”<sup>261</sup> The SEC would likely be able to establish that it has compelling interests in preventing fraud, protecting investors, and improving market efficiency. However, the government would probably not be able to set forth sufficient evidence to demonstrate that the prophylactic offering rules which indiscriminately restrict truthful and misleading speech are narrowly tailored to achieve its compelling interests. As the government would probably not be able to demonstrate a “reasonable fit” between the means and the ends of the regulatory scheme under *Central Hudson*, it would be virtually impossible to meet the higher “narrowly tailored” standard under *Citizens United*. Further, there are several less restrictive means of achieving the government’s purposes of preventing fraud, improving market efficiency and increasing investor confidence.

The restrictions placed on Groupon’s communications during the offering period may be subject to a strict scrutiny level of review even without the insertion of a political message. Although directed at political speech, *Citizens United* may ultimately result in the abandonment of the commercial speech

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<sup>259</sup> Another example of political speech is Toyota encouraging consumers to fight global warming. See Keith Naughton, *Toyota’s Green Problem*, DAILY BEAST (Nov. 10, 2007, 10:02 AM), <http://www.thedailybeast.com/newsweek/2007/11/10/toyota-s-green-problem.html> (describing a Toyota commercial: “Against a moody mountain backdrop, the Prius slowly disintegrates back into the land, while an announcer says, ‘Can a car company grow in harmony with the environment? Why not? At Toyota, we’re not only working toward cars with zero emissions. We’re also striving for zero waste in everything else we do.’”); see also Deborah J. La Fetra, *Kick It Up a Notch: First Amendment Protection for Commercial Speech*, 54 CASE W. RES. L. REV. 1205, 1206–07 (2004) (discussing the difficulties in drawing lines between political, commercial, and mixed speech).

<sup>260</sup> See Sean Lux et al., *Mixing Business with Politics: A Meta-analysis of the Antecedents and Outcomes of Corporate Political Activity*, 37 J. MGMT. 223, 239 (2011).

<sup>261</sup> *FEC v. Wis. Right to Life, Inc.*, 551 U.S. 449, 464 (2007). “[T]he First Amendment ‘has its fullest and most urgent application’ to speech uttered during a campaign for political office.” *Eu v. S.F. Cnty. Democratic Cent. Comm.*, 489 U.S. 214, 223 (1989) (quoting *Monitor Patriot Co. v. Roy*, 401 U.S. 165, 272 (1971)).

doctrine as formulated by *Central Hudson*.<sup>262</sup> *Citizens United* radically affirmed the principle that the First Amendment must be neutral as between different speakers, holding that even corporate speech (at least on political matters) is fully protected by the First Amendment and cannot be subject to increased regulation merely because of its corporate authorship.<sup>263</sup> Accordingly, the basis for treating commercial speech differently must be its content, not its corporate authorship.<sup>264</sup> Above all, the Court made clear that it takes seriously that the First Amendment is meant to safeguard the “marketplace of ideas” with all its free market connotations.<sup>265</sup> The Court also rejected as a basis for legislation the notion that the government should address the market power of large corporations within the “marketplace of ideas.”<sup>266</sup>

In the decade leading up to *Citizens United* some commentators had already argued that the distinction between commercial speech and more protected speech was becoming less important as the Supreme Court was becoming more protective of commercial speech.<sup>267</sup> In a series of commercial speech cases related to liquor,<sup>268</sup> gambling,<sup>269</sup> tobacco,<sup>270</sup> and prescription drugs,<sup>271</sup> the Supreme Court found the speech limitations unconstitutional. The level of review for commercial speech cases appears to have moved closer to strict rather than intermediate scrutiny.<sup>272</sup>

## VI. REFINING THE QUIET PERIOD RESTRICTIONS AND SAFE HARBORS IN LIGHT OF CONSTITUTIONAL, ECONOMIC, AND NORMATIVE CONCERNS

Quiet period regulations can be crafted to protect investors against false or misleading statements while still respecting corporate speech rights and efficiency in capital markets. One approach would be to narrow the definition of

<sup>262</sup> See Darrel C. Menthe, *The Marketplace Metaphor and Commercial Speech Doctrine: Or How I Learned to Stop Worrying About and Love Citizens United*, 38 HASTINGS CONST. L.Q. 131, 132 (2010).

<sup>263</sup> *Citizens United v. FEC*, 130 S. Ct. 876, 913 (2010).

<sup>264</sup> *Id.*

<sup>265</sup> See *id.* at 904–07, 914.

<sup>266</sup> *Id.* at 899.

<sup>267</sup> See, e.g., Eugene Volokh, *Freedom of Speech and Intellectual Property: Some Thoughts After Eldred*, 44 LIQUORMART, and Bartnicki, 40 Hous. L. Rev. 697, 732 (2003) (“[The Court] has been providing more and more protection [to commercial speech] since the early 1990s.”); *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2272 (2004) (“[C]ommercial speech has enjoyed greater protection in recent years. . .”).

<sup>268</sup> *44 Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 489 (1996).

<sup>269</sup> *Greater New Orleans Broad. Ass’n, Inc. v. United States*, 527 U.S. 173, 176 (1999).

<sup>270</sup> *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 553 (2001).

<sup>271</sup> *Thompson v. W. States Med. Ctr.*, 535 U.S. 357, 360 (2002).

<sup>272</sup> See, e.g., Menthe, *supra* note 262, at 132; Note, *Making Sense of Hybrid Speech: A New Model for Commercial Speech and Expressive Conduct*, 118 HARV. L. REV. 2836, 2853–56 (2005).

the term “offer” in Section 5 of the Securities Act to permit communications that may “condition the market” so long as those communications do not propose a current exchange of securities. Although this measure may appear radical at first glance, on deeper reflection it is a logical and reasonable solution. Allowing a more open dialogue about the value of securities would not only abate any free speech concerns, but would also increase market efficiency. Investors would still be protected against false or misleading speech under the anti-fraud provisions of the Securities Act.

Less aggressive reforms that would still alleviate some free speech and market efficiency concerns would expand the scope of some of the existing safe harbors. For example, the safe harbor for EGCs to “test the water” under the recently enacted JOBS Act could be expanded to allow *all* issuers to communicate with potential investors to gauge interest in the offering. Also, the safe harbor for ordinary business information for non-reporting companies implemented as part of the 2005 Securities Offering Reform could be expanded to allow forward-looking projections, similar to the safe harbor for reporting companies.

#### A. Narrow Definition of Term “Offer”

The government has adopted so many variegated and complex exceptions to the definition of the term “offer” in Section 5 of the Securities Act; it appears that the exceptions may eventually swallow up the rule.<sup>273</sup> Rather than adopting additional exemptions to the gun-jumping rules to reflect the realities of today’s marketplace and corporate free speech rights, the SEC could issue a release narrowing the interpretation of the term “offer”<sup>274</sup> for all eligible issuers<sup>275</sup> and offering participants.

Currently the SEC interprets the term “offer” broadly to include any communications that “condition the public mind or arouse public interest in the particular securit[y],”<sup>276</sup> and then applies a host of exceptions. Instead, the SEC could interpret the term “offer” narrowly to include only communications that indicate a current intention to be bound. The SEC could adopt the common law contract definition of “offer”: “the manifestation of willingness to enter into a

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<sup>273</sup> See *supra* Part II.B and accompanying notes for a description of the 2005 Securities Offering Reform and *supra* Part II.C for a description of the JOBS Act Reform.

<sup>274</sup> The Securities Act definition of an offer would not have to be revised as it defines an offer as “every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.” Securities Act of 1933 § 2(a)(3), 15 U.S.C. § 77b(a)(3) (2006).

<sup>275</sup> Rule 405 sets forth circumstances under which an issuer will be deemed “ineligible,” including issuers that within the past three years were a blank check or shell company or issued a registered penny stock offering; issuers that violated the anti-fraud provisions of the federal securities laws; and issuers that filed a bankruptcy petition (with certain exceptions). Securities Act of 1933 Rule 405, 17 C.F.R. § 230.405 (2006).

<sup>276</sup> *In re* Carl M. Loeb, Rhoades & Co., Exchange Act Release No. 5870, 38 SEC Docket 843, 850 (Feb. 9, 1959).

bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it.”<sup>277</sup> Accordingly, a communication would not violate the offering rules unless it proposed a current exchange in securities.

Narrowing the definition of the term offer may appear to be a drastic change to the offering rules. However, this change is something that has slowly been occurring over the past decade through the adoption of several reforms to the original offering rules. The 2005 Securities Offering Reforms, while retaining the general structure of the offering rules, introduced several safe harbors that allowed issuers and other offering participants to disseminate a greater variety of information to investors. The SEC adopted safe harbors to protect issuer and related party communications made more than 30 days before the filing, releases of factual business information, the dissemination of free writing prospectuses, and additional exceptions for certain classes of issuers. Further, the JOBS Act recently created a safe harbor for EGCs to “test the water” and solicit interest in the offering during the offering process.<sup>278</sup>

These reforms, however, have not fully addressed the free speech and efficiency concerns because many only apply to certain types of issuers, such as WKSIs or EGCs but do not protect issuers in between.<sup>279</sup> Those issuers with annual gross revenues above \$1 billion that are not WKSIs are still significantly restricted in the types of communications they can make during the offering process.

Another problem is that some of these safe harbors, such as the free writing prospectus safe harbor, are convoluted and hard to understand.<sup>280</sup> Accordingly, even those issuers who are entitled to rely on the safe harbor may be reluctant to do so because of the draconian consequences they may face if they are wrong in their assessment of the applicable legal rules.<sup>281</sup> The SEC may conclude that a seemingly benign communication violated the Quiet Period Rules and order rescission as a possible remedy to investors.<sup>282</sup> Narrowing the definition of the term “offer” would therefore have the added benefit of providing certainty for issuers and other offering participants. Rather than maintaining convoluted offering rules that eliminate the restrictions on certain types of speech for certain types of issuers, the SEC could simplify matters and permit all communications that do not propose a current exchange of securities during the offering process.

Narrowing the definition of the term “offer” would also resolve the free speech problems that the current rules raise. Restrictions limiting an offering participant’s ability to propose a current exchange of securities outside of the statutory prospectus would likely pass muster under the *Central Hudson* test.

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<sup>277</sup> RESTATEMENT (SECOND) CONTRACTS § 24 (1981).

<sup>278</sup> See *supra* Part II.B–C for a description of these reforms.

<sup>279</sup> See *supra* Part II.B–C.

<sup>280</sup> See Davidoff, *supra* note 10.

<sup>281</sup> See Securities Act of 1933 §§ 11–12, 15 U.S.C. § 77j (2000).

<sup>282</sup> See *supra* Part II.A for a discussion of remedies for gun-jumping violations.

Such restrictions would directly and materially advance the government's interests in preventing fraud and increasing investor confidence in capital markets. Further, the government should be able to demonstrate a reasonable fit between the narrow restrictions and its interests. Unlike defending the broad prophylactic constraints on speech, the SEC would be able to defend the more narrow restrictions as a necessary means of accomplishing its objectives. Adopting narrow constraints on speech would demonstrate that the SEC "'carefully calculat[ed] the costs and benefits associated with the burden on speech imposed' by the regulations."<sup>283</sup>

The prohibition on proposing a current exchange of securities outside of the statutory prospectus may also pass muster under the strict scrutiny standard articulated in *Citizens United*.<sup>284</sup> The government may be able to set forth sufficient evidence to demonstrate that the restriction on speech is narrowly tailored to achieve its compelling interests. There do not appear to be any less restrictive means of achieving the government's purpose of preventing fraud, improving market efficiency and increasing investor confidence. Accordingly, narrowing the definition of offer and prohibiting offers during the quiet period would be consistent with *Central Hudson* and *Citizens United*.

Some may be concerned that if the rules were liberalized to broaden the definition of the term "offer" issuers and other offering participants may release false or misleading information. Several safeguards are available to temper this concern. Most importantly, speakers would still be liable under the anti-fraud provisions of the securities laws for the contents of their communications.<sup>285</sup> Under these provisions, an issuer or other offering participant would be civilly and criminally liable for false or misleading statements made during the offering period. Accordingly, broadening the definition of the term "offer" would only provide incentives for issuers or underwriters to release accurate, non-misleading information whose accuracy would be easy to establish in any subsequent litigation.

Moreover, even if an issuer were to release misleading statements or statements of mere puffery, investors would be protected as research analysts and various news outlets would be available to pick apart these statements.<sup>286</sup> This open dialogue between issuers, underwriters and analysts would actually increase market efficiency, as this additional public information would be incorporated into the price of the securities. Further, sophisticated investors would appropriately discount any statements that would be deemed mere puffery. As sophisticated investors help set the price for securities, retail investors would also be protected against the statement's distorting effect.

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<sup>283</sup> *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 561 (2001) (quoting *City of Cincinnati v. Discovery Network, Inc.*, 507 U.S. 410, 417 (1993)).

<sup>284</sup> See *Citizens United v. FEC*, 130 S. Ct. 876, 898 (2010).

<sup>285</sup> See Securities Act of 1933 §§ 11, 12(a)(2), and 17(a), 15 U.S.C. §§ 77k, 77l, and 77q (2006).

<sup>286</sup> See *supra* Part II.B.

In sum, narrowing the definition of the term “offer” to allow additional communications during the offering process would be the most effective way to resolve the free speech and market efficiency concerns. There are sufficient protective measures in place to temper the ability of issuers to distort the true value of the securities by releasing false or misleading information. However, if the SEC is reluctant to make this type of change, other reforms would also serve to ameliorate the constitutional and efficiency concerns.

### *B. Expand Permissible Communications Between Issuers and Prospective Investors*

As an alternative, the SEC could revise the current offering rules to permit issuers and related parties to “test the water” to gauge interest among prospective investors, during the registration process.<sup>287</sup> Congress and the SEC have already enacted legislation and adopted rules permitting certain classes of issuers to make these types of communications to certain classes of investors. For example, the JOBS Act recently created an exception to the offering rules to allow EGCs to “test the water” prior to or following the filing of a registration statement. Specifically, EGCs or persons acting on their behalf, including underwriters, are permitted to communicate orally or in writing to QIBs or accredited investors, “to determine whether such investors might have an interest in a contemplated securities offering,” without violating the quiet period restrictions.<sup>288</sup>

The 2005 Securities Offering Reforms include a similar exception for WKSIs. Rule 163 of the Securities Act permits WKSIs to engage in unrestricted oral and written offers for their securities during the pre-filing period without violating the gun-jumping provisions of the Securities Act.<sup>289</sup> The SEC has recognized, in proposing amendments to Securities Act Rule 163, that additional accommodations are necessary to allow WKSIs acting through underwriters, to “assess the level of investor interest in their securities before filing a registration statement.”<sup>290</sup>

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<sup>287</sup> IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH 28 (2011), available at [http://www.sec.gov/info/smallbus/acsec/rebuilding\\_the\\_ipo\\_on-ramp.pdf](http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf).

<sup>288</sup> Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong., § 105(d) (2012), available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

<sup>289</sup> See Securities Act of 1933 Rule 163, 17 C.F.R. § 230.163 (2006). In order to rely on this exception, certain conditions must be met, including that: (1) all communications made by or on behalf of the issuer would continue to be subject to Regulation FD; (2) every written communication that is an offer made in reliance on the exemption would contain substantially the legend required by the rule; and (3) every written communication that is an offer made in reliance on the exemption would be filed with the Commission as a free writing prospectus when the registration statement is filed. *See id.*

<sup>290</sup> Revisions to Rule 163, 74 Fed. Reg. 68,545, 68,546 (Dec. 28, 2009) (to be codified at 17 C.F.R. pt. 230) (proposing to amend Securities Act Rule 163 to allow underwriters,

These exceptions currently available only to EGCs or WKSIs could be expanded to permit all issuers and offering participants to communicate with potential investors to gauge interest in the offering during the registration process. The JOBS Act and 2005 Securities Offering Reforms created the exception for EGCs and WKSIs to help these businesses raise capital. There seems little reason not to assist companies which have more than \$1 billion in annual gross revenues but are not WKSIs to also raise capital.

Allowing all issuers to communicate more openly with potential sophisticated investors would increase market efficiency. Meetings between investors and management at an early stage in the offering process would allow investors to be better prepared to make investment decisions at the time of the IPO. "The limited context of a formal road show presentation" makes "it more difficult for some investors to engage in a meaningful deliberative process, particularly for the type of long-term investors whose participation is most desirable to IPO issuers."<sup>291</sup> "Moreover, investors have repeatedly asked for more contact with management during the marketing process."<sup>292</sup>

This reform would not entirely resolve the free speech problems created by the offering rules, as significant speech restraints would remain. However, permitting additional communications between offering participants and potential investors would demonstrate that the SEC is attempting to find "a reasonable fit between the means and the ends" of promoting investor confidence, preventing fraud, and increasing market efficiency under the *Central Hudson* test.<sup>293</sup> Further, expanding the safe harbor would signal that the SEC is trying to "narrowly tailor" its restrictions to achieve its compelling interest as required under *Citizens United*.<sup>294</sup>

Some skeptics may be concerned that issuers or underwriters would disseminate false or misleading statements during these meetings. However, speakers have an incentive to only disclose accurate, non-misleading information because "test the water" communications will be subject to anti-fraud provisions under the federal securities laws.<sup>295</sup> Further, sophisticated investors would be capable of appropriately discounting any puffery or misleading statements.

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acting on behalf of "well-known seasoned issuer[s]," to offer securities before filing a registration statement to gauge investor interest without requiring public disclosure of an intent to conduct an offering, 74 Fed. Reg. at 68,545).

<sup>291</sup> IPO TASK FORCE, *supra* note 287, at 29 (recommending expanded road shows, but only for accredited investors or qualified institutional buyers).

<sup>292</sup> *Id.*

<sup>293</sup> See *Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n*, 447 U.S. 557, 566 (1980).

<sup>294</sup> See *Citizens United v. FEC*, 130 S. Ct. 876, 898 (2010).

<sup>295</sup> See Securities Act of 1933 §§ 11, 12(a)(2), and 17(a), 15 U.S.C. §§ 77k, 77l, and 77q (2006).

*C. Revise Ordinary Business Communications Safe Harbor to Include Forward-Looking Information for Non-Reporting Issuers*

In 2005, the SEC adopted a safe harbor for non-reporting companies to continue to release ordinary-course information during the registration process without violating the offering rules.<sup>296</sup> Although expanded use of safe harbors may be less attractive than more global revisions of the Quiet Period Rules, the 2005 safe harbor could be expanded to permit the release of forward-looking information including forecasts, projections, and predictions relating to the company's financial performance or its value. Allowing forward-looking projections of growth, revenues, and profits would increase market efficiency as it would allow sophisticated investors and other intermediaries who act to "filter" the information to less sophisticated investors to more accurately predict the value of an IPO.<sup>297</sup> Sophisticated investors would be capable of discounting the risks inherent in relying on forward-looking information and would place greater weight on more reliable information contained in the statutory prospectus.

Further, the release of this information would prompt additional reports by analysts, reporters and others who would have the opportunity to debate the value of the assertions the company makes. Analysts and reporters have little reason to prepare reports on non-reporting companies when the only information they can respond to is that contained in the statutory prospectus.<sup>298</sup> According to the ECMH this additional information from issuers, underwriters and analysts would quickly be incorporated into the price of the securities making the price more accurate.

The SEC would likely contend that unlike reporting companies, non-reporting companies should not be permitted to disseminate forward-looking information because of the lack of publicly available information or history for these companies.<sup>299</sup> As the SEC explained when adopting the 2005 Reforms, "the potential for abuse in permitting a safe harbor for the continued release of forward-looking information as a way to condition the market for the issuer's

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<sup>296</sup> Securities Act of 1933 Rule 169, 17 C.F.R. § 230.169 (2006).

<sup>297</sup> See generally HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 104-05 (1979); Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1164-70 (1970). This filtering process is sometimes flawed as indicated by the recent lawsuits against several underwriters of the Facebook Inc. IPO, including Morgan Stanley. Stempel & Levine, *supra* note 102. The shareholders alleged that research analysts had lowered their business forecasts for Facebook during the IPO process, but that these changes were selectively disclosed by defendants to certain "preferred investors" rather than to the public generally. *Id.* (internal quotation marks omitted). However, Regulation FD was implemented to remedy this type of unjust distribution of information.

<sup>298</sup> See *supra* text accompanying notes 117-23.

<sup>299</sup> See Securities Offering Reform, 69 Fed. Reg. 67,392, 67,404 (proposed Nov. 17, 2004).



securities outweighs the legitimate utility to the issuer of the safe harbor.”<sup>300</sup> However, the SEC did not detail how it determined that “potential for abuse” or how it weighed the risks of such abuse against the loss to investors of depriving them of this forward-looking information.<sup>301</sup> Investors would likely value forward-looking projections and other information from non-reporting companies without a large analyst following.<sup>302</sup> Without such information provided by issuers, “investors may turn to chat rooms and Internet message boards to fill the information void for forward-looking information.”<sup>303</sup> Information from these sources is inherently less reliable than information that an issuer or other offering participant would release and is unlikely to be filtered by analysts. Also, if the SEC is concerned about verifying the accuracy of projections, it could require underwriters, accountants, bankers, lawyers, or even insurers to monitor or vouch for the company’s public statements.<sup>304</sup>

Further, issuers and underwriters have an incentive not to overprice the offering based on puffery. First, if underwriters set the offer price too high based on overly optimistic forecasts, sophisticated investors would refrain from purchasing securities and issuers or underwriters would be stuck with unsold shares. Second, underwriters are concerned with preserving its reputational capital, particularly in IPO markets where there is often an opportunity for follow-on offerings. Finally, a large gap in IPO price and secondary trading price may reflect some false or misleading statements and possible rescission as a remedy for such violations.

Given the safeguards to both prevent issuers or underwriters from releasing overly optimistic forecasts and to protect investors from being unduly influenced by positive forecasts, the safe harbor should be expanded. Allowing the dissemination of forward-looking statements would show that the SEC is attempting to find a reasonable fit between the offering restrictions and its legitimate goals of preventing fraud and increasing investor confidence as required by *Central Hudson*.

In accord with the SEC’s stated objectives, these suggested reforms would better strike “the appropriate balance between improving the capital formation process and modernizing offering communications, while preserving investor

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<sup>300</sup> *Id.*

<sup>301</sup> *See id.*

<sup>302</sup> *See* Fisch, *supra* note 94, at 70 (linking the dramatic growth in Internet securities fraud to the increased investor reliance on chat rooms and other Internet sources).

<sup>303</sup> Choi, *supra* note 60, at 112.

<sup>304</sup> *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”); 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 . . .”).

protection and avoiding unnecessary impediments to the capital formation process.”<sup>305</sup>

## VII. CONCLUSION

The Quiet Period Rules, which served a legitimate purpose when originally adopted in the 1930s, pose significant economic, normative and constitutional law problems. Despite several recent reforms attempting to liberalize the antiquated rules, the current regime continues to plague non-reporting companies launching public offerings as demonstrated by the Groupon and Facebook IPOs. During the offering process, issuer and related party communications must take care not to mention the proposed offering, include opinions about the value of the company, or include forward-looking statements, projections, or forecasts. These types of communications could be interpreted as gun-jumping violations even if the disclosures are entirely truthful and accurate.

The theory behind restricting both accurate and misleading speech is that investors should make investment decisions based on the carefully calibrated disclosures contained in the statutory prospectus, rather than on the positive information disseminated by the company that has not been reviewed by the SEC. However, given today’s technology, the release of positive information from issuers or underwriters would prompt a plethora of analysts and news outlets to issue their own reports confirming or disputing the information. According to the ECMH sophisticated investors would quickly assimilate the additional information into the price of the securities. Irrational investors who are not capable of adequately discounting information would also be protected through this price mechanism. Accordingly, the Quiet Period Rules which indiscriminately exclude information results in market inefficiencies and ultimately harms all investors.

Further, the offering rules which restrict the disclosure of truthful non-misleading speech for the purpose of protecting those that would hear the speech are unlikely to survive a First Amendment challenge. The expansion of the commercial speech doctrine over the past few decades, combined with the robust articulation of corporate political speech rights in the recent *Citizens United* case makes it increasingly likely that such a challenge will be brought. The time is therefore ripe for the SEC to consider liberalizing the offering rules. Offering rules can be crafted to protect investors against false or misleading

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<sup>305</sup> Securities Offering Reform, 70 Fed. Reg. 44,722, 44,724 (Aug. 3, 2005).

statements while still respecting corporate speech rights and efficiency in capital markets.

