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SEC Regulation and The First Amendment

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

A. INTRODUCTION

Last May when Irv Einhorn invited me to be your luncheon speaker, I thought he was carrying advance planning to an extreme, but I think he knew then that I would be ready now for a trip "home". I am pleased to be here today and my pleasure is heightened by the fact that I am making my first major speech at the 17th Annual Securities Regulation Seminar because the first securities seminar I attended as a novice lawyer was your seventh annual meeting. My remarks concern the relationship between SEC Regulation and the First Amendment. That topic is one of great interest today to the courts, the bar, the Commission, and most particularly to the news media.

As I am sure you are aware, certain of the Commission's recent enforcement efforts have provoked an outcry against supposed government overreaching in the areas of freedom of the press and freedom of speech. The Commission currently has pending six cases against publishers of financial newsletters who have been charged with violating the registration and anti-fraud provisions of the Investment Advisers Act of 1940. The publishers in those cases contend that the registration requirement of the Advisers Act violates the First Amendment. The Commission and the Department of Justice have also brought actions against a former reporter for the Wall Street Journal, R. Foster Winans, Jr. and his tippees for trading on information to be published in the reporter's column. The press has reacted to these cases with an ever increasing volume of screeching headlines. In light of the alarms being set off by the press and in the press, I thought it would be useful to examine more closely the Winans case and the most prominent of the financial newsletter cases, SEC v. Lowe, and discuss whether the concerns expressed by the press are well founded.

B. THE WINANS CASE

1. Facts

On May 17, 1984, the Commission sued Mr. Winans and four others in connection with alleged trading on information to be published in the Wall Street Journal's "Heard on the Street" column. Winans was a one of the principal authors of "Heard on the Street." The Commission alleges that Winans disclosed to the other defendants, either directly or indirectly, the contents of that column in advance of publication. As you might expect, the Journal has strict rules against prepublication disclosure of the contents of columns. Winans, of course, is no longer employed by the Journal. The Commission alleges that one of the defendants, Peter Brant, a leading broker at a prestigious New York brokerage firm, paid Winans over $30,000 for the information he received. He and the other defendants made profits in excess of $700,000 by trading on Winans' information. In late August, based on these alleged events, criminal indictments were returned against Winans, Brant and several other of Winans' "tippees."

2. Press Response

Soon after the indictments were returned in the Winans case, a number of articles appeared in leading newspapers criticizing the government's actions against Winans. Let me quote from just a few of those articles. On September 2nd, the New York Times reported that a co-director of the Reporter's Committee for the Freedom of the Press, argued that the government's action in the Winans case is "an attempt to step into news rooms and enforce what are basically journalistic codes of ethics. It's an effort by the SEC to exercise regulatory jurisdiction over news gathering and publishing activities for generic newspapers, thereby indirectly regulating the newspapers themselves."

Also on September 2nd, the Los Angeles Times reported that the nation's major journalistic institutions believed that the SEC's position in the Winans case, if upheld in courts, "would amount to the government telling journalists what to write."

Finally, in the September 1984 issue of The Quill, Lyle Denniston, a Baltimore Sun reporter, argued that Winans is "a pawn in a broad and aggressive campaign by the SEC to increase its powers over the flow of information." As a result, he continues, the Winans case and the legal theories behind it "pose a sweeping threat to the press: Never before have officials gone so far to try to regulate day-to-day newsroom practices."

During this period of strong reaction to the Winans case, enforcement actions brought under the Investment Advisers

Act involving unregistered investment advisers provoked a similar response. Let's look briefly at the most prominent of those cases --

C. SEC V. LOWE

1. Facts

Lowe Management Corp., which was owned by Christopher Lowe, and which published investment newsletters, was registered with the Commission as an investment adviser. Through these newsletters, Lowe reported and analyzed the performance of various investments and made specific investment recommendations to subscribers. In 1981, the Commission revoked the registration of Lowe Management Corp. and barred Mr. Lowe from associating with any investment adviser. This action was based primarily on the grounds that Lowe had violated the anti-fraud provisions of the Advisers Act and had been convicted of two misdemeanors and two felonies in New York, one of which was for theft by deception.

Section 203 of the Investment Advisers Act provides that, after notice and opportunity for hearing, the Commission may revoke the registration of investment advisers, and prohibit persons from being associated with investment advisers, for a variety of acts, particularly where the adviser has been convicted of a crime involving moral turpitude, such as perjury and fraud. Thus, Congress has decided, and I think not unreasonably, that it is in the public interest to keep persons who have demonstrated a propensity towards dishonesty from being licensed to influence other people's investment decisions.

Lowe continued to publish after the revocation of Lowe Management Corp.'s registration, and the Commission filed suit to enjoin his publishing activities. The district court refused to enjoin his publishing on First Amendment grounds, but this decision was reversed by the Second Circuit. On October 1, the Supreme Court granted Lowe's petition for certiorari.

2. Press Response

The press response to the Lowe case has been only slightly less strident than the response to the Winans case. In a column published in the New York Times on August 21, Ken Noble, the author, asks: "Is the Securities and Exchange Commission a foe of the First Amendment?" Mr. Noble quotes a Washington lawyer who represents financial newsletters as stating that SEC registration of financial newsletters is "a classic case of prior restraint ... you can't publish until you are not only registered but comply with their rules." Another Washington lawyer, alluding to the exemption from registration for "bonafide newspapers", asks rhetorically whether "a form of prior restraint, and a discriminatory one at that, exists when a private newsletter ... must register with the SEC but a public newspaper like the Wall Street Journal need not."

Finally, the Washington Post has gone so far as to allege an SEC conspiracy to regulate the press in several areas. The Post, in a recent editorial, suggested that the SEC was moving from regulating specialized financial newsletters to a wider application of its so-called licensing rules. I quote!

> "The SEC is in the hands of aggressive technicians who have been given the job of regulating the stock markets, and they're consequently trying to regulate everything that affects the stock markets -- including the flow of financial news.... If the courts interpret the Bill of Rights to allow the regulation of one kind of news now, it will allow the regulation of other kinds of news in the future. The SEC says that the First Amendment is not a license to commit fraud. Absolutely true. But neither is the Winans case a license to commit assault and battery on the Constitution."

Assault and battery on the Constitution?!? I only wish that those persons who make a career of violating the securities laws lived in as much terror of the SEC as the news media seems to do.

Certainly freedom of speech is one of our most precious constitutional rights. It is, therefore, understandable why the press so jealously and zealously guards it from unnecessary governmental encroachment. In this case, however, the press has sounded a false alarm.

D. RECENT COMMISSION ACTION IS WELL SUPPORTED BY PRECEDENT AND DOES NOT VIOLATE THE FIRST AMENDMENT

I can assure you that my fellow Commissioners and I are quite sensitive to First Amendment rights; in fact, some of our best friends are journalists. I even have a sister who's a television reporter for WPUV, Channel 6 in Philadelphia. Unfortunately, she is only slightly less touchy on the question of freedom of the press than the Washington Post. Seriously, though, I hope to show you that the press is way off base in its reaction to the Winans case and the financial newsletter cases.

Those cases are well supported by precedent and certainly do not represent a "reach for authority", much less an assault and battery on the Constitution. A quick examination of the statutory language and case law in this area will demonstrate that the theories advanced in the Winans case and the financial newsletter cases do not depart from longstanding Commission positions, and that applying the law as the SEC has to reporters and financial newsletter publishers does not infringe on First Amendment rights.

1. Commission Precedent -- Winans

On what theories, you may ask as has the press, does the Commission allege that Mr. Winans has violated Rule 10b-5 and other anti-fraud provisions of the securities laws. While the Commission's critics agree that Mr. Winans did a "bad" thing, they question whether he violated the securities laws. By way of background, the celebrated Supreme Court decisions in Chiarella and Dirks admittedly seem to require the breach of a duty to a specific person or entity before liability under federal law arises for trading on inside information. Consistent with Chiarella and Dirks, the Commission alleges that Winans breached two duties; one to his employer, the Journal (the so-called "Misappropriation Theory"), and the other to his readers (the so-called "Scalping Theory"). You may know that the U.S. Attorney's Office has decided not to pursue the Scalping Theory in its criminal prosecution of Mr. Winans. The Commission, however, has not changed its position as to the validity of that theory, which was endorsed when the civil action was authorized. Let's take a closer look at both of these theories.

a. Misappropriation

The SEC has long held that the anti-fraud provisions of the securities laws are violated when an employee misappropriates proprietary material information from his or her employer and trades on that information. Although the Supreme Court has not explicitly endorsed this theory, in Chiarella and Dirks, the Court implicitly supported it. The Chiarella Court stated that it need not decide whether the Misappropriation Theory has merit, but stated elsewhere in the opinion that where a trader acquires information in a fiduciary capacity or through a relationship of trust and confidence, a duty to disclose would arise. The Dirks Court reaffirmed this position. (103 S. Ct. at 3261). It is hornbook agency law that an employee has a relationship of trust and confidence with, and a duty of loyalty to, his employer. Thus, the Supreme Court has at least implicitly endorsed the Misappropriation Theory.

Moreover, the Misappropriation Theory is established law in the Second Circuit. As recently as October 1, in SEC v. Materia, the Second Circuit confirmed, in the wake of Chiarella, the validity of the Misappropriation Theory. Materia, like Chiarella, involved an employee of a financial printer who obtained information concerning takeovers in the course of his job and traded on that information. In affirming the trial court's finding of liability in Materia, the Second Circuit reaffirmed its holding in United States v. Newman, ruling that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his advantage violates

Section 10(b) and Rule 10b-5." In the recent past, the Commission has used the Misappropriation Theory to bring actions against investment bankers, word processors and office managers who have stolen information from their employers and traded on that information or willfully tipped others who did trade. No court to my knowledge has rejected the Misappropriation Theory. Moreover, as the Second Circuit has pointed out, the Misappropriation Theory is perfectly consistent with the Supreme Court's decision in Chiarella (Materia, slip opinion at 14-15).

b. Scalping

The Commission's second theory in the Winans case is also well supported by precedent. That theory is that Winans breached a duty to his readers by failing to disclose his prior sale of the information contained in his columns to persons who intended to trade in advance of an anticipated change in the market. Although the Supreme Court in Chiarella held that a trader's possession of material, nonpublic information does not create a duty of disclosure to everyone in the marketplace, the Supreme Court has held, in situations closely analogous to the Winans case, that investment advisers owe such duties to their readers. Thus, the SEC and the courts have recognized such duties. Mr. Winans, as author of the "Heard on the Street" column, is acting much like an investment adviser and is subject to that duty of disclosure.

In the 1963 case of SEC v. Capital Gains Research Bureau, Inc., the Supreme Court described "scalping" as the practice of an investment adviser purchasing shares of a security for his own account shortly before recommending that security for long-term investment and then immediately selling the shares at a profit upon the rise in the market price following publication of the recommendations. The Court held that this practice, without disclosure, "operates as a fraud or deceit on any client" and that the Commission has the authority to seek injunctive relief based on that conduct. Although Winans did not recommend that specific securities be purchased and Winans' readers were not paying clients, his alleged conduct amounted to nothing less than scalping, which for over twenty years has been recognized as a fraud actionable under the securities laws.

Like investment advisers engaged in scalping, the Commission believes that Winans knew that the content of his column, regardless of its merit, would affect the market for the stock in the companies he discussed. Like investment advisers who try to profit from the information they publish by purchasing the stock they intend to recommend, Mr. Winans sought to profit on the value of the information published in his column, only in his case, it was by selling the information to tippees rather than by buying the stock himself. Moreover, as with any scalping case, Winans had a conflict of interest between (1) his obligations as a reporter disseminating information and opinions on which he knew his readers would rely, and (2) his personal financial well-being. Given this conflict of interest and his failure to disclose it, he defrauded his readers. Because Winans' alleged conduct was fraudulent, it is just as actionable under Rule 10b-5 as an investment adviser's fraudulent conduct is actionable under the anti-fraud provisions of the Advisers Act.

One aspect of the Commission's Scalping Theory of liability that particularly concerns the press is Winans' so-called "duty of disclosure." The press contends that this duty of disclosure is tantamount to telling Winans what he must write. For example, in commenting upon the U.S. Attorney Office's decision to drop the Scalping Theory in its prosecution of Winans, a prominent First Amendment expert called the abandoned theory "novel". He suggested that the theory threatened to establish a principle that journalists could be obliged by the government to disclose one or another type of information about themselves before they could engage in journalism itself. "It could put the government in [the] business of deciding who was able to speak and on what terms they could speak." The expert, with all due respect, has not done his homework.

With respect to the first point, let's look at one case remarkably similar on its facts to the Winans case which proves, I think, that the Scalping Theory is anything but novel, the Ninth Circuit's 1979 decision in Zweig v. Hearst Corp. In Zweig, a newspaper columnist for the Los Angeles Herald-Examiner purchased stock in a company he anticipated commenting favorably upon, with the intent of selling the stock after publication. The Ninth Circuit reversed the dismissal of a 10b-5 action against the columnist, stating that he had a duty to disclose his stock holdings in order to avoid misleading his readers. The court reasoned that although a reporter does not have a fiduciary relationship with his readers under common law, in this context, a reporter is an informal financial adviser in a medium that can (and does) influence the market. He controls the information that he is profiting in side dealings based on the information in his column. As a salaried columnist of a large newspaper, he benefits from his relationship with his readers, on whom his employment ultimately depends. The Ninth Circuit concluded, therefore, that the columnist has a duty to disclose his side dealings.

I should mention that it has been suggested that Zweig may no longer be good law in light of Chiarella. In Chiarella, the Supreme Court, as you know, held, in the context of a criminal case, that a proofman of a financial printer in possession of material non-public information did not owe a duty to disclose to everyone in the market. The Court reasoned that the proofman "was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions." On the other hand, in Zweig, the Ninth Circuit implicitly found that there was a relationship of "trust and confidence" between a newspaper columnist and his readers. A columnist is not a "complete stranger" to his readers, and does not deal with his readers only through impersonal market transactions. A paper such as the Journal and a reporter such as Winans hold themselves out as sources of objective news and analysis, untainted by conflicts of interest. Presumably, it is for this very reason that the Journal prohibits absolutely its reporters from engaging in scalping. Thus, the analysis in Zweig is completely consonant with Chiarella.

With respect to the second point, that is that imposing a duty of disclosure amounts to telling the reporter what to write, one may ask just what is that "duty of disclosure"? The Commission's position is that Winans had a duty to disclose his sale of the information to Brant because the sale created a conflict of interest with his role as a reporter. The duty of disclosure would not require him to disclose all of his stock holdings or any other personal financial information. Requiring that a journalist neither sell to tippees nor trade upon the market impact of his articles without disclosing his conflict of interest to his readers is not telling him what he must write. It is simply telling him that he can't defraud his readers. The Commission has no intention of getting into the business of regulating the contents of news reports or financial advice columns. However, Congress has outlawed the use of manipulative or deceptive devices in connection with the purchase or sale of securities. Clearly, it is deception, if not a manipulation of the market, for a financial reporter, for a fee, to tip his friends to the contents of his column in advance of its publication so that they can benefit from the anticipated impact the column is expected to have on the securities market.

c. First Amendment Protection

I believe you will agree with me that, First Amendment considerations aside, Winans' alleged conduct is a well-established violation of the anti-fraud provisions of the federal securities laws, and that the Commission is not breaking new ground here. We next must ask whether Winans' status as a reporter for the

Journal shields him from the federal securities laws. Without intending to make light of this argument, I would say simply that I know of no case which would confer such protection on a reporter defrauding his readers in securities matters, and I can think of no sound policy reason for doing so. The Commission's position simply put is that reporters are subject to the same insider trading rules as everyone else.

2. Commission Precedent - Lowe

Let's turn now to the basis for Commission actions against financial newsletters that are not registered.

a. Congressional Intent & Judicial Interpretation

The first and most basic point on this issue is that the registration provisions under the Investment Advisers Act of 1940 are not Commission created -- they were legislated by Congress, which, it is fashionable to believe, is representative of the people. Ergo, it is difficult to understand why the Commission is being charged with overreaching. Section 203 of the Investment Advisers Act of 1940 prohibits an investment adviser from making use of the mails or other instrumentalities of interstate commerce unless he or she is registered with the Commission. The Act defines "investment adviser" as one who advises others, either directly or through publication or writings, as to the value or investment potential of securities. Thus, it is clear that Congress intended to include persons who furnish investment advice through specialized newsletters within the definition of investment adviser and to require these persons to register with the Commission.

b. Constitutionality

Now let's consider whether the registration provisions of the Advisers Act are an unconstitutional prior restraint on expression. The Second Circuit, the Seventh Circuit, the Commission, and I believe that it is not. But why?

Investment advice of the type furnished by Mr. Lowe falls within the Supreme Court's definition of "commercial speech", that is to say, it is "expression related solely to the economic interests of the speaker and its audience." (Central Hudson Gas & Electric Corp. v. Public Service Commission, 447 U.S. at 561). Mr. Lowe and his fellow newsletter publishers are in the business of selling investment advice, and their clients subscribe to and read the newsletters in order to make money.

As commercial speech, Lowe's publications may be regulated only if the registration provisions of the Advisers Act satisfy the test set forth in the Supreme Court's 1980 case of Central Hudson Gas & Electric Corp. v. Public Service Commission: suppression of commercial speech is permitted whenever it directly advances a "substantial governmental interest" and is "not more extensive than necessary to serve that interest." (477 U.S. at 566). In the case of specialized financial newsletters, the government's interest in regulating their activities and preventing fraud is indeed substantial. The Advisers Act was "the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the Depression ...." (Capital Gains Bureau, 375 U.S. at 186). Congress found that investment advisers were "of national concern" and that their activities had a substantial and significant impact on our national securities markets and financial institutions. (Section 201 of the Investment Advisers Act).

The government's interest in preventing fraud and in maintaining public confidence in the securities markets, through regulation of investment advisers, is indeed substantial. Unlike other crafts and professions where some sort of licensing procedures are in effect, investment advisers operating through financial newsletter publications are subject to little or no screening or testing processes--anyone can join the club. Yet, the opportunities for fraud and deception are abundant. There is great potential that many, many people can be misled by unregulated advisers.

Do the registration provisions of the Advisers Act directly advance that interest? I think so. The provisions allow the Commission, after notice and opportunity for hearing, to deny or revoke the registration of an investment adviser who has engaged in any one of a variety of dishonest acts, such as perjury, larceny, forgery, or in the case of Mr. Lowe, theft by deception and violations of the anti-fraud provisions of the Advisers Act. If you subscribe to the theory, as Congress did, that a tendency toward larceny and dishonesty in the past is indicative of future conduct, keeping such persons out of the investment advisory business protects the investor and directly advances the substantial governmental interest in this area.

Is there a less extensive regulatory scheme that would accomplish the same goals? I doubt it. As I mentioned before, it takes little training or experience to get into the business of publishing financial newsletters, and the Commission's authority for denying or revoking registration exists only where the adviser has committed dishonest acts. In Lowe's case, violations of the anti-fraud provisions of the Advisers Act and several criminal statutes. The registration provisions of the Advisers Act are prophylactic in nature. With the Commission's limited resources, I do not think it appropriate to eliminate the screening process with the hope that the Commission will find and prosecute errant advisers. Even where the Commission could track down the wrongdoer, those who rely on the advisers may have been irreparably harmed in the meantime.

Finally, to those who argue that any sort of licensing or registration system is a prior restraint and unconstitutional, I would point out the Supreme Court's endorsement of licensing practices for professionals, such as lawyers. (Ohralik v. Ohio State Bar Commission, 466 U.S. 447 (1978)). All we are saying is that investment advisers should be treated as professionals. The SEC proceedings against Lowe are no different than State Bar proceedings to revoke the license of a lawyer convicted of stealing from his clients. Here the government is regulating professional conduct, notwithstanding that speech is an important part of that conduct. If the Constitution does not shield the lawyer in these circumstances, I do not believe it shields the investment adviser.

Thus, it seems to me that the registration provisions of the Advisers Act, which Mr. Lowe and others have challenged on constitutional grounds, meet the established tests for regulation of commercial speech.

E. CONCLUSION

To sum up, the press' concern about developments in the law that establish fiduciary-type relationships between publishers and their readers, or that impose liability for misleading statements or omissions is quite understandable. The press is also rightly concerned about registration requirements with government agencies. However, in the cases of Winans and Lowe, these concerns are unjustifiable. With respect to *Winans*, the press offers a parade of horribles to justify its antagonism. If the government prevails against Winans, the argument goes, then the federal government will soon impose duties of disclosure on "Travel Section" reporters or restaurant critics. My response simply is that the governmental interest in the securities industry and the capital markets is far greater than any possible interest it may have in unbiased critiques of Club Med.

The securities industry is highly susceptible to fraud, and fair and orderly capital markets are clearly an important national interest. Thus, imposing a duty to disclose on reporters such as Mr. Winans will not lead to duties to disclose on travel critics. In cases such as *Winans*, the Commission is merely applying the same rules that prohibit scalping and fraud to reporters on the *Wall Street Journal* and their tippees that it applies, and has applied, to everyone else. In enforcing the registration provisions of the Investment Advisers Act, the Commission is fulfilling its clear Congressional mandate by trying to control the incidence of fraud in a highly susceptible area in the least intrusive manner possible, and it has been doing that for 40 years. As Ike Sorkin of the Commission's New York office so aptly put it, there is no First Amendment right to commit fraud, and the Supreme Court has agreed with him more than once.

I thank you for your attention, for your kind hospitality and for inviting me to join you here today.