Cato sues SEC over ‘gag rule’ barring defendants from protesting allegations after settlement

Alison Frankel

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Adding to mounting conservative criticism of a Securities and Exchange Commission rule that prohibits people who settle with the commission from thereafter denying the government’s allegations, the libertarian Cato Institute sued the SEC Wednesday in federal court in Washington, D.C., alleging that the SEC’s "gag rule" is unconstitutional.

“The government uses its extraordinary leverage in civil litigation to extract from settling defendants a promise to never tell their side of the story, no matter how outrageous the government’s conduct may have been and no matter how strong the public’s interest may be in knowing how the government conducts itself in high-stakes civil litigation,” the Cato suit said. “This civil-rights lawsuit seeks to end the federal government’s decades-long use of gag orders in violation of the First Amendment to the United States Constitution.”

Cato alleges that it was contacted by a would-be author who sought advice about the validity of a provision in the settlement he reached with the SEC that barred him from taking any action or making any public statement denying the commission’s allegations. Cato lawyer **Clark Neily** read the author’s manuscript, an account of “a long and expensive battle at the end of which the author (who was accused of substantial wrongdoing by the SEC in both legal documents and press statements) ultimately admitted to engaging in certain limited conduct in order to avoid crippling litigation expenses,” according to the complaint. (In a blog post Wednesday, Neily revealed that the unnamed author was also criminally prosecuted and reached a plea agreement.)

Cato believed the manuscript touched on some of its important criminal justice policy concerns, including overzealous prosecution. It entered a contract with the author to publish the book. But it contends in Wednesday’s suit that it cannot fulfill the contract because the author’s SEC settlement bars him from publicly disputing any of the SEC’s allegations.

Cato contends the gag provision of the author’s settlement – which has been a standard feature of SEC settlement agreements since 1972 – violates the First Amendment because it is a content-based restriction on free speech. Cato is asking the court to strike down all of the SEC’s previous gag agreements and enjoin the commission from entering broad speech prohibitions in the future.

Cato’s suit is not the first attack on the SEC’s gag rule. You may recall that back in 2011, when U.S. District Judge **Jed Rakoff** of Manhattan was a persistent thorn in the SEC’s side, the judge

said in his opinion in SEC v. Vitesse Semiconductor that the SEC's policy of allowing defendants to settle without admitting or denying allegations as long as they agree not to dispute the commission's claims publicly results in "a stew of confusion and hypocrisy unworthy of such a proud agency as the SEC."

The judge explained that the SEC adopted the gag rule in 1972 to stop defendants from proclaiming that they hadn't done anything wrong and had entered settlement agreements simply to get the SEC off their backs. (In those days, Judge Rakoff pointed out, the SEC's enforcement powers were not particularly fearsome, particularly because the commission allowed defendants, via "neither admit nor deny" deals, to avoid the collateral consequences of admitting liability.) But the practical effect of the gag rule, Judge Rakoff said, was to undermine public confidence in the SEC. "The defendant is free to proclaim that he has never remotely admitted the terrible wrongs alleged by the SEC; but, by gosh, he had better be careful not to deny them either (though, as one would expect, his supporters feel no such compunction)," the judge wrote. "Only one thing is left certain: The public will never know whether the SEC's charges are true, at least not in a way that they can take as established."

Judge Rakoff's crusade against the SEC's policies ended abruptly at the 2nd U.S. Circuit Court of Appeals in 2012, but a group called the New Civil Liberties Alliance, which is headed by Columbia law professor **Philip Hamburger**, has recently taken up the mantle of protest against SEC gag provisions. Last October, NCLA filed a 40-page petition calling on the SEC to amend the gag rule. The petition contends the rule violates both the First Amendment, as a prior restraint and a sweeping content-based restriction on speech, and constitutional due process protections against vague prohibitions. The rule was also adopted, according to NCLA, without regard for the processes specified in the Administrative Procedure Act.

"The rule is unconstitutional, without legal authority, and further is ill-conceived policy," the NCLA petition said.

The SEC has not responded to the petition, according to NCLA lawyer **Peggy Little**, but the group's campaign has caught the attention of the Wall Street Journal and the U.S. Senate. The Journal ran Little's op-ed, "How the SEC Silences Criticism," in November. In December, Arkansas Senator Tom Cotton asked SEC Chair Jay Clayton about the gag rule during Clayton's testimony before the Senate Banking Committee. (Cotton quoted that colorful Rakoff language from the Vitesse opinion.) Clayton, who was surprised by the question, responded that the gag rule and the related "neither admit nor deny" policy has effectively promoted settlements, which is in the public's interest. Senator Cotton suggested that the SEC should reconsider its policy in light of First Amendment precedent casting doubt on the government's authority to erect prior restraints on speech.

Little told me it's not clear whether the SEC has ever taken action against a former defendant for breaching the gag rule, but said the rule's threat – of reopening the defendant's case – is so onerous a condition that it's against public policy. She said the NCLA is also targeting similar rules at the Commodity Futures Trading Commission and other government agencies.

SEC spokesman John Nestor declined via email to comment on the new Cato suit or the NCLA petition.