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A Look At Recent Challenges To SEC's Settlement 'Gag Rule'

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The settlement policy of the U.S. Securities and Exchange Commission does not allow settling while denying the allegations the commission has brought against the defendant or respondent.

Instead, the 50-year-old policy only permits settling defendants to "neither admit[] nor den[y] the allegations" if the defendants refuse to admit wrongdoing in the settlement.[1]

Legal challenges to this gag rule haven't yet been successful, but they appear to be picking up steam as the gag rule's opponents become increasingly vocal.

BACKGROUND ON THE GAG RULE

The commission amended its policy in 1972 without the traditional notice-and-comment rulemaking process, as it found the amendment "relates only to rules of agency organization, procedure and practice."[2]

Before the gag rule amendment in 1972, defendants would settle with the commission and then publicly deny allegations, claiming settlement was to avoid lengthy litigation with an administrative agency.[3] This prompted the commission to protect its integrity among the public with the 1972 amendment to prevent impressions that the conduct alleged did not occur and to encourage settlement.

Many defendants were in favor of the amendment, as it allowed them to deny allegations in private litigation matters that the commission was not a party to. This also allowed defendants the ability to defend against private litigation wherein the monetary penalties are often much higher than those imposed by the commission.

After facing vocal opposition after the 2008 financial crisis, the commission amended its policy in 2012 to no longer extend the no-admit and no-deny settlement policy to defendants with parallel criminal convictions or prosecution agreements that include admissions of criminal conduct.

Another change to the policy occurred in 2013. Gag rule settlements would no longer be offered to defendants (1) with parallel criminal convictions, (2) whose conduct placed investors or the market at risk of serious harm, (3) who had engaged in egregious misconduct or (4) who unlawfully obstructed the commission's investigation.

In practice, the updated policy changed little: In the first three years, the commission obtained admissions only in about 2.7% of the stand-alone measures brought.[4]

The gag rule remains the primary method of settlement with the commission. Indeed, the commission acknowledges it will not settle with a defendant without, at minimum, the guarantee that the defendant will not admit or deny the allegations.

About 98% of its enforcement actions end in settlement.[5] The commission often goes even further in its consent decrees, requiring defendants to retract any denials to allegations in the proceedings leading up to settlement and to never contest the truth of the commission's allegations again.

RECENT LEGAL CHALLENGES

While challenges to the gag rule are not new, they have gained speed in the last six years. Arguments for changing or ending the gag rule range from a litany of First Amendment claims to the rule's conception without notice-and-comment under the Administrative Procedures Act.

The New Civil Liberties Alliance brought a petition to amend the rule's language in 2018 to allow defendants to admit, deny or neither admit nor deny in the consent decree.[6]

Having not received an answer from the commission, the NCLA renewed its petition in late 2023.

The NCLA argues that the gag rule violates the First Amendment as a prior restraint on speech and is a content-based restriction on speech. A defendant consenting to the ban on his or her future speech by promising to never deny the commission's allegations does not negate the unlawfulness of the ban.

Further, the commission's settlement policy requiring the no-admit and no-deny language in its consent decrees prevents the public from learning the specifics of how the commission conducts its enforcement actions, the NCLA claims. The gag rule insulates the commission from criticism.

Aside from First Amendment concerns, the NCLA also raises concerns about the commission's statutory authority to impose the restrictions on speech in its settlement agreements.

Critics argue the gag rule is bad public policy as it allows the commission to pursue weak cases, because the commission settles 98% of its enforcement actions, as Commissioner Luis Aguilar noted at the 20th Annual Securities Litigation and Regulatory Enforcement Seminar in 2013.[8]

On Jan. 30, the commission denied amendment. The NCLA is planning on appealing the commission's denial to amend the gag rule.

Christopher Novinger and ICAN Investment Group LLC raised similar concerns about the breadth of the gag rule in Novinger's settlement with the commission.

Novinger settled with the commission after an enforcement action was brought alleging Novinger fraudulently sold $4.3 million worth of securities by making false or misleading statements.

Five years after the consent decree was approved by the U.S. District Court for the Northern District of Texas, in 2021, Novinger filed a motion for relief from the judgment against him, arguing the no-deny policy of the settlement violated the First Amendment and denied him due process.[9]

The district court denied, and the U.S. Court of Appeals for the Fifth Circuit affirmed the district court's judgment on procedural grounds. Novinger then moved for declaratory judgment under the Declaratory Judgment Act, which the district court again denied.

Upon appeal, the Fifth Circuit affirmed the motion was procedurally improper and dismissed the appeal on March 19.[10] While the merits of Novinger's First Amendment and due process claims were not addressed, Novinger's efforts emphasize the growing opposition against the long-standing commission policy.

When looking at the volume of commission enforcement actions and the value recovered from those actions, critics of the gag rule paint a compelling picture.

In fiscal year 2023, the commission filed 784 total enforcement actions, recovering a record $4.949 billion in financial remedies, which is the second-highest amount in commission history after 2022.[11]

While the commission did not disclose the percentage of actions that ended in settlement in 2023, it continues to emphasize that most of its enforcement actions end in settlement.

The time and expense of litigating against a large administrative agency often leaves settlement as the only viable option for defendants, as Commissioner Hester Peirce notes in her dissent to the commission's denial to amend the gag rule.[12]

The commission views the settlement process as one of negotiation and affirms its policy to use the gag rule in settlements because allowing denial of any wrongdoing would undermine the educational aspect that settlements provide to the public and market, which "muddies the message to the public."[13]

Allowing settling defendants to deny the allegations would inhibit clarity on the securities laws for market participants. The gag rule itself emphasizes "it is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact, occur."[14]

The commission is tasked with protecting both investors and the market itself, and allowing denials of allegations while settling dampens the message that enforcement actions bring.

Commission Chair Gary Gensler asserts settlement is a consequential choice, not just for the defendant but also for the commission. Defendants who do not agree with the constraints of the gag rule do not have to accept settlement.

FUTURE OF THE GAG RULE

Challenges to the gag rule's legitimacy have yet to succeed in the courts, often due to procedural deficiencies.

While some federal judges are skeptical of the gag rule, district courts overwhelmingly approve commission consent decrees with minimal review. The U.S. Supreme Court has signaled apprehension over the broad growth of administrative agencies, providing momentum to opponents of the commission's long-standing policy.

Justice Neil Gorsuch, in his concurrence in Axon Enterprise Inc. v. Federal Trade Commission and Cochran v. Securities & Exchange Commission last year, notes his skepticism for such policies in settlement agreements with agencies: "[F]ew can outlast or outspend the federal government [and] agencies sometimes use this as leverage to extract settlement terms they could not lawfully obtain any other way."[15]

In the U.S. District Court for the Southern District of New York, U.S. District Judge Jed Rakoff, in reviewing a settlement between the commission and Vitesse Semiconductor Corp., among others, emphasized the disservice such a policy does for the public:

[H]ere an agency of the United States is saying, in effect, "Although we claim that these defendants have done terrible things, they refuse to admit it and we do not propose to prove it, but will simply resort to gagging their right to deny it."[16]

But what would settlement with the commission look like without the gag rule? Would we return to the landscape that prompted the commission to officially adopt the rule in 1972, wherein defendants immediately deny the allegations post-settlement?

If the NCLA succeeds in its appeal to amend the rule, the NCLA's proposed language does not remove the gag rule in its entirety, but may allow more negotiating power to defendants by permitting admission, denial or no-admission-or-denial language in the consent decree.

This would more greatly protect defendants' First Amendment rights and minimize concerns of agency overreach as the gag would no longer be a nonnegotiable component of settling with the commission but rather a true negotiating tool.

Settlement with the commission would no longer be a gun to the head, as critics, such as Vermont Law and Graduate School President Rodney Smolla, claim.[17]

Other opponents of the gag rule prefer to move in the opposite direction: to mandate admissions to the allegations to settle with the commission. This seems an unlikely result, as the commission prefers the more expedient route of settlement, which returns funds to harmed investors faster and with more certainty.

In the years after the commission amended its policy in 2013 to require admissions in certain instances, settlements with admissions were a minor percentage of all settled enforcement actions.

Settlement removes the risk that litigation results in unexpected outcomes, as then-director of the SEC's Division of Enforcement Robert Khuzami noted in his testimony before the Committee on Financial Services in the U.S. House of Representatives in 2012.

Khuzami emphasized that if cases could only be resolved if the defendant admitted the allegations or went to trial, there would be "far fewer settlements, and much greater delay in resolving matters."[18]

Pragmatically, admissions in settlements would expose defendants to additional lawsuits by private litigants as well as criminal liability, and risk a collateral estoppel effect, preventing the defendant from challenging liability in the private suit.

With the current gag rule regime, defendants may negate any allegation in lawsuits in which the commission is not a party. These risks would greatly outweigh the cost of litigation against the commission.

The Supreme Court has signaled its wariness at agency overreach before, including rulings against the commission for its administrative law judges being too isolated from the president's removal authority in Axon Enterprise Inc. v. Federal Trade Commission and Cochran v. Securities & Exchange Commission in April 2023.

But overruling the gag rule for lack of a notice-and-comment period before the commission enacted the policy in 1972 likely would not change much about the policy of the commission.

The commission could proceed with a notice-and-comment period and potentially revise the rule after input or keep the rule the same. Or the commission could officially end the gag rule, reverting to its practices before 1972, which did include the use of no-admit and no-deny settlements to a lesser degree.

The gag rule's future remains uncertain, but one thing is clear: Its opponents are becoming increasingly vocal and hoping that the 50-year rule is coming to an end.

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[1] 17 C.F.R. § 202.5(e). https://www.govinfo.gov/content/pkg/CFR-2013-title17-vol2/pdf/CFR-2013-title17-vol2-sec202-5.pdf.

[2] Consent Decrees in Judicial or Administrative Proceedings, 37 Fed. Reg. 22,224 (Nov. 29, 1972). https://archives.federalregister.gov/issue_slice/1972/11/29/25222-25229.pdf#page=3.

[3] See SEC v. Vitesse Semiconductor Corp ., 771 F. Supp. 2d 304, 308 (S.D.N.Y. 2011). https://casetext.com/case/securities-exch-comm-v-vitesse-semiconductor-corp.

[4] See David Rosenfeld, Admissions in SEC Enforcement Cases: The Revolution That Wasn't, I.L.R. 113, 131 (2017). https://ilr.law.uiowa.edu/sites/ilr.law.uiowa.edu/files/2023-02/ILR-103-1-Rosenfeld.pdf.

[5] Luis A. Aguilar, Comm'r, SEC, Remarks Before the 20th Annual Securities and Regulatory Enforcement Seminar (Oct. 25, 2013), https://www.sec.gov/news/speech/2013-spch102513laa.

[6] New Civil Liberties Alliance, In re SEC Rule Imposing Speech Restraints in Consent Orders (Oct. 30, 2018). https://nclalegal.org/wp-content/uploads/2024/01/petn4-733.pdf.

[7] New Civil Liberties Alliance, Renewed Petition to Amend the Rule Restricting Speech that is set forth in 17 C.F.R. § 202.5(e) ("The Gag Rule"), File No. 4-733 (Dec. 20, 2023). https://nclalegal.org/wp-content/uploads/2023/12/2023.12.20-Renewed-Petition-for-Rulemaking.pdf.

[8] Luis A. Aguilar, Comm'r, SEC, Remarks Before the 20th Annual Securities and Regulatory Enforcement Seminar (Oct. 25, 2013), https://www.sec.gov/news/speech/2013-spch102513laa.

[9] SEC v. Novinger & ICAN Investment Grp., L.L.C. , No. 21-10985 (5th Cir. 2022). https://law.justia.com/cases/federal/appellate-courts/ca5/21-10985/21-10985-2022-07-12.html.

[10] SEC v. Novinger & ICAN Investment Grp., L.L.C., No. 23-10525 (5th Cir. 2024). https://www.ca5.uscourts.gov/opinions/pub/23/23-10525-CV-0.pdf.

[11] SEC Press Release, SEC Announces Enforcement Results for Fiscal Year 2023 (Nov. 14, 2023), https://www.sec.gov/news/press-release/2023-234.

[12] https://www.sec.gov/news/statement/peirce-nand-013024.

[13] Gary Gensler, Comm'n Chair, Statement on the Denal of a Rulemaking Petition Regarding the Commission's No-Admit/No-Deny Policy (Jan. 30, 2024), https://www.sec.gov/news/statement/gensler-denial-rulemaking-petition-013024.

[14] 17 C.F.R. § 202.5(e). https://www.govinfo.gov/content/pkg/CFR-2013-title17-vol2/pdf/CFR-2013-title17-vol2-sec202-5.pdf.

[15] 598 U.S. 175, 216 (2023) (Gorsuch, J. concurring). https://www.supremecourt.gov/opinions/22pdf/21-86_l5gm.pdf.

[16] See SEC v. Vitesse Semiconductor Corp. , 771 F. Supp. 2d 304, 309 (S.D.N.Y. 2011). https://casetext.com/case/securities-exch-comm-v-vitesse-semiconductor-corp.

[17] See Robert A. Smolla, Why the SEC Gag Rule Silencing Those Who Settle SEC Investigations Violates the First Amendment, 29 Widener L. Rev. 1, 13 (2023). https://heinonline.org/HOL/Page?handle=hein.journals/wlsj29&id=11&collection=usjournals&index=journals/wlsj.

[18] Robert Khuzami, Dir., Div. of Enf't, SEC, Testimony on "Examining the Settlement Practices of U.S. Financial Regulators" (May 17, 2012). https://www.sec.gov/news/testimony/2012-ts051712rkhtm.

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