

February 8, 2024

## Client Alert

Securities Litigation and Enforcement



### SEC's 'Gag Rule' Faces Increased Scrutiny

For more than 50 years, the U.S. Securities and Exchange Commission (SEC) has maintained a policy that requires all defendants in enforcement matters to agree not to deny the SEC's allegations or do anything that would give the impression that the case was without merit as a condition to settlement. The vast majority of those targeted by the SEC ultimately agree to settle their cases, often factoring in the enormous amount of time and expense required to fully litigate a case against the government to conclusion. Those wishing to settle SEC enforcement actions — meritorious or not — are presented with no choice but to agree to the SEC's "gag rule" and relinquish their First Amendment rights to speak out against the SEC and its actions.

Two targets of an SEC enforcement action who settled under the SEC's take-it-or-leave-it terms are now challenging the constitutionality and continued viability of the gag rule in a case that the U.S. Court of Appeals for the Fifth Circuit is set to hear on February 8.

#### The Gag Rule

In 1972, the SEC [adopted the policy](#) that "in any civil lawsuit brought by it or in any administrative proceeding of an accusatory nature pending before it, 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." Accordingly, the SEC codified in the Code of Federal Regulations the so-called policy "not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings."

#### The *Novinger* Settlement

The SEC [filed an enforcement action](#) in 2015 in the U.S. District Court for the Northern District of Texas against a number of defendants — including Christopher Novinger and his company ICAN Investment Group LLC — alleging they made materially false or misleading statements in connection with the sale of \$4.3 million worth of securities. A year later, the defendants in *SEC v. Novinger*, including Novinger and ICAN, [settled with the SEC](#) through consent judgments, which, like all other SEC settlements, included a gag rule provision. Specifically, the consent judgments provided that the defendants:

- (i) will not take any action or make or permit to be made any public statement denying, directly or indirectly, any allegation in the complaint or creating the impression that the complaint is without factual basis; (ii) will not make or permit to be made any public statement to the effect that Defendant does not admit the allegations of the complaint, or that this contains no admission of the allegations,

without also stating that does not deny the allegations; [and] (iii) upon the filing of this Consent, Defendant hereby withdraws any papers filed in this action to the extent that they deny any allegation in the complaint.

Should the defendants breach any of those provisions, the SEC “may petition the Court” to vacate the settlements and return the case to the active docket.

### **Novinger and ICAN’s First Challenge to the Gag Rule**

Novinger and ICAN filed a motion in 2021 for post-judgment relief with the district court under Federal Rules of Civil Procedure 60(b)(4) and (5) challenging the gag rule provisions of the consent judgments and arguing, among other things, that the gag rule violates the First Amendment, violates due process and was not lawfully promulgated. The district court denied the motion on grounds that it did not meet the standards for relief from a final judgment pursuant to Rules 60(b)(4) and (5). The district court did not address the merits of the constitutional arguments.

Novinger and ICAN appealed to the Fifth Circuit, which [affirmed the district court’s ruling](#). The court of appeals also did not address the merits of the constitutional arguments. Two of the three judges on the panel issued a concurring opinion, however, in which they stated that “nothing in the opinion ... approves of or acquiesces in the SEC’s longstanding policy that conditions settlement of any enforcement action on parties’ giving up First Amendment rights. ... If you want to settle, the SEC’s policy says, ‘Hold your tongue, and don’t say anything truthful — ever’ — or get bankrupted by having to continue litigating with the SEC. A more effective prior restraint is hard to imagine. ... Given the agency’s current activism, I think it will not be long before courts are called on to fully consider this policy.”

### **The Current Challenge**

Novinger and ICAN then filed a motion for declaratory relief under the Declaratory Judgment Act in the district court, challenging the gag rule largely based on the same arguments as in their first challenge to set aside the judgments. Once again, the district court denied the motion without addressing the merits of the constitutional arguments. The court held that Novinger and ICAN could not seek relief under the Declaratory Judgment Act by motion; rather, they would need to file a new lawsuit.

Novinger and ICAN have again appealed to the Fifth Circuit. Procedurally, they argue that the district court’s ruling essentially shields the gag rule from judicial review because they effectively have been precluded from challenging the rule. Novinger and ICAN, however, focus much of their brief on the substance of their constitutional challenge to the gag rule; namely, that it suppresses speech in violation of the First Amendment. Addressing that they consented to the gag rule, Novinger and ICAN argue that the SEC wields significant power over those it brings enforcement actions against. They quote [U.S. Supreme Court Justice Neil Gorsuch’s statement](#) that “few can outlast or outspend the federal government,” thus, “agencies sometimes use this as leverage to extract settlement terms they could not lawfully obtain any other way.”

In response, the SEC primarily focuses on the procedural aspects of the case and argues that Novinger and ICAN cannot challenge the gag rule under the Declaratory Judgment Act. With respect to the constitutional argument, the SEC contends that Novinger and ICAN voluntarily waived their First Amendment rights by accepting the settlement terms.

## The SEC's Intervening Actions

The New Civil Liberties Alliance (counsel to Novinger and ICAN) [petitioned the SEC](#) in 2018 to amend the gag rule on the grounds that it violates the First Amendment. The SEC waited until this year to [deny the petition](#). However, Commissioner Hester Peirce issued a [staunchly worded dissent](#) seemingly agreeing with Novinger and ICAN's position in which she highlighted "obvious First Amendment ramifications" of the gag rule, including that it is a "plain prior restraint on speech." Commissioner Peirce also called the gag rule a "content-specific and permanent restraint on speech [that] effectively shields the Commission's allegations from criticism." Commissioner Peirce agreed with the purpose of the rule — that it would look bad if SEC enforcement actions were shown to be baseless — but argued that the solution is not to silence dissent.

## Takeaways

There appears to be a trend of growing dissent against the gag rule, including in the courts and within the SEC itself. While the SEC's purported justification for the gag rule was to protect the integrity of the agency, many view it as an effort to shield the SEC's actions from public scrutiny.

While two Fifth Circuit judges have predicted that it will not be long before the courts are called on to weigh the constitutionality of the gag rule, it is unclear whether Novinger and ICAN's current challenge will be deemed the appropriate path to obtaining that judicial review.

In light of the current challenges and until courts rule on the constitutionality of the gag rule, those involved in SEC enforcement actions and considering entering into settlement agreements with the SEC should be sure that they understand the implications of such agreements, including terms that the SEC views as "standard." In particular, before negotiating with and settling with the SEC, proposed defendants to enforcement actions should weigh and consider the legality of the SEC's proposed settlement terms and the other options available to them before possibly agreeing to relinquish their rights unnecessarily.

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