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SECURITIES IN THE ELECTRONIC AGE: A PRACTICAL GUIDE TO THE LAW AND REGULATION

Third Edition

Editors: John F. Olson and Carmen J. Lawrence

HIGHLIGHTS

Securities in the Electronic Age is a handbook for securities professionals who need to learn the fine points with respect to securities and the Internet. This new Third Edition has been revised and expanded to reflect recent changes in the electronic securities world.

The book collects and presents in one place, not only the latest rules and current practices in the online securities world, but also the latest thinking on such topics as:

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- The SEC's Online Presence, including EDGAR
- SEC and SRO Regulation and Enforcement
- First Amendment Issues
- Electronic Mail

Written by practitioners for practitioners, this guide provides the solid, authoritative information necessary to survive in today's rapidly changing electronic world.

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Sincerely,

Lynn S. Glasser
Publisher

CHAPTER 12

THE FIRST AMENDMENT IN THE ELECTRONIC AGE: FREE SPEECH VS. MARKET REGULATION

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In addition to providing a significant and powerful new tool to foster the buying and selling of securities,[1] the Internet can also be used to transmit information regarding the advisability of purchasing and selling particular securities.[2] This information can be transmitted in a variety of ways: directly from one person to another or to a group of individuals via an electronic mail ("email") message; through a World Wide Web[3] site; by posting it to a Bulletin Board;[4] or by transmission to one or more persons participating in an Internet chat room discussion.[5]

Those who engage in communications regarding the advisability of buying and selling securities or commodities, however, may be required by the federal Investment Advisors Act of 1940 ("IAA") and the Commodity

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[1] *See* Chapter 3 for a comprehensive discussion of how the Internet is used to buy and sell securities.

[2] *See* Henry H. Perritt, Jr., *Law and Information Superhighway*, § 9.23, p. 410 (1996).

[3] The World Wide Web, also known as the "Web" or "WWW," is a software tool that allows access from one location on the Internet to another via "links" or hypertext. *See* Todd H. Flaming, *Internet and the World Wide Web*. 83 ILL. B.J. 429, 430 (1995). The "Web" enables a user to "point and click" on a key word in one document and access "linked" documents stored on other computers connected to the network. G. Burgess Allison, *At the Edge of the E-Frontier, An Introduction to the Internet*, 17 Pa. Law., Sept.-Oct. 1995 at *2.

[4] An Internet "bulletin board" is similar to an ordinary bulletin board—it allows individuals to post and read notices in a centralized location, often focusing on particular topics or areas of discussion. *See* Robert A. Robertson, *Personal Investing in Cyberspace and the Federal Securities Laws*, 23 Sec. Reg. L.J. 347, 351-54 (1996).

[5] The Federal Trade Commission published a consumer bulletin that warned of several Internet fraud scams, including the practice of salespeople promoting their products in online chat rooms or on bulletin boards, while pretending to be regular consumers or, on some occasions, celebrities. *See* Federal Trade Commission, *Online Scams: Road Hazards on the Information Superhighway*, found at <http://www.ftc.gov/bcp/scamso1.htm>.

Exchange Act ("CEA"), respectively, and the regulations promulgated thereunder, to comply with a number of detailed and stringent registration and documentation requirements.[6] These requirements have been imposed as part of the overall mission of the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") to curb false and deceptive practices in the securities and commodities industries, a practice that has found its way to the Internet.[7]

The regulations established by the IAA and the CEA, however, raise significant First Amendment concerns because they impose substantial burdens on those who wish to engage in certain kinds of speech. This chapter discusses the requirements of the IAA and the CEA and their relationship to First Amendment principles. The chapter then discusses to what extent these regulations would apply to investment advice communicated via the various methods of transmitting information over the Internet.

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6 15 U.S.C. §§ 80b-1 to 80b-21 (1984); 7 U.S.C. § 1 *et seq.*

7 As one author stated, the Internet could be called the 'Net of a Million Lies.' Some claim consumer fraud on the Internet is rampant. Con artists may become bolder because it is possible to disappear into cyberspace after perpetrating their scams. On the Internet, it is indeed somewhat easier to use assumed names, change your e-mail address, etc. . ., in order to set up a business aimed mainly at defrauding innocent victims." Dee Pridgen, *How Will Consumers Be Protected On the Information Superhighway?*, 32 LAND & WATER L. REV. 237, 244 (1997) (footnotes omitted). Indeed, this author later noted that the sheer fact that information is being transmitted via the Internet may pose a heightened risk of consumer fraud: "given the Internet's current status as a new-fangled and super-hyped medium, some people may be lured into giving an Internet seller more credibility, not less, simply because the information is coming over 'the Internet.' The computer screen may be viewed as an authority figure, a modern day Wizard of Oz." *Id.* at 255.

§ 12.01 METHODS OF PROVIDING SECURITIES ADVICE VIA THE INTERNET

The most easily understood method of communication via the Internet is the use of electronic mail, or "email." This simply requires that the communicating party connect to an Internet service provider, which will allow that party to send messages, documents, and data to any other party connected to the Internet. Email can be used to communicate with a specific individual, a select group of individuals, a group organized around a common interest, or anyone else connected to the Internet. Email communications are cheap, fast, and convenient.

Another way to transmit securities information via the Internet is through the use of an individual "Web site" or "home page." This consists of a set of computer files, documents, and graphics that an individual or an organization makes available to other computers on the Web through a "permanent" Internet address.

Yet another method to transmit information is through posting a message to a bulletin board system ("BBS"), which is a computerized system for leaving messages, both public and private. There are thousands of BBS's spread around the world, each revolving around its own particular area of interest. A BBS discussion group is known as a "newsgroup" and there are thousands of them, on any conceivable subject.

Finally, information can be disseminated by engaging in an Internet "chat" session, which consists of a group of two or more users having a real-time discussion in printed text. This form of communication is similar to the "party

line" common to early telephone systems.

Any of the above-listed methods of communications could be utilized by an individual or an organization to give advice on whether a person should buy or sell particular securities and/or commodities. Such a communication, as discussed below, could be subject to certain regulations imposed under the IAA and/or the CEA.

§ 12.02 THE INVESTMENT ADVISERS ACT

The IAA was enacted to prevent abuses in the securities industry that had contributed to the stock market crash of 1929 and the Great Depression.[8] Its goals are to provide for the registration of investment advisers and to prevent such advisers from engaging in fraud in their dealings with clients.[9]

Under the IAA, it is unlawful for any "investment adviser" to utilize any means or instrumentality of interstate commerce "in connection with his or its business as an investment adviser" without first being registered with the SEC.[10] An "investment adviser" is defined as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or

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[8] *Securities and Exchange Commission v. Lowe*, 472 U.S. 181, 190 (1985) (quoting *Securities and Exchange Commission v. Capital Gains Bureau*, 375 U.S. 180, 186 (1963)).

[9] *See* 15 U.S.C. § 80b-6 (which provides that it is "unlawful for any investment adviser by use of mails or any means or instrumentality of interstate commerce, directly or indirectly" to defraud a client or a prospective client).

[10] 15 U.S.C. § 80b-2(a)(1) (11).

who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[11] The IAA, therefore, appears to apply to virtually every publication that is produced as part of a regular business for compensation and that discusses securities.

The IAA requires investment advisers, except those who fall within specified exemptions,[12] to register with the SEC[13] and to provide the SEC with substantial information.[14] Investment advisers must also maintain various records[15] and are prohibited from entering into a variety of transactions.[16]

Violations of the IAA can result in substantial penalties, including SEC lawsuits for injunctions,[17] loss of registration under the IAA,[18] and criminal sanctions.[19] Violations of the IAA also allow investors to cancel their contracts with investment advisers and to recover sums paid to them, although damage actions are not available.[20] Similar state laws also provide penalties for violations.[21]

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[11] *Id.* § 80b-2(a)(1)(11). The term "security" is defined at *Id.* § 80b-2(18). There has been substantial litigation over the definition of a "security." *See, e.g., International Bhd. of Teamsters v. Daniel*, 434 U.S. 1061 (1979).

[12] 15 U.S.C. § 80b-2(11) (1984).

[13] *Id.* § 80b-3(a), (b).

[14] *Id.* § 80b-3(c)(1) 17 C.F.R. § 279 (1978).

[15] 15 U.S.C. § 80b-4 (1984).

[16] *Id.* §§ 80b-5, 80b-6.

[17] *Id.* § 80b-9(e).

[18] *Id.* § 80b-3(e).

[19] *Id.* § 80b-17.

[20] *Id.* § 80b-15; *Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11 (1979).

[21] *See, e.g.*, Cal. Corp. Code §§ 25200-25246 (1977); N.Y. Gen. Bus. Law § 359eee (1987).

The IAA, however, provides an important exemption in deference to First Amendment speech interests. Under the IAA, "the publisher of any bona fide newspaper, news magazine or business or financial publication of regular and general circulation" is not an "investment adviser."[22] In *Securities and Exchange Commission v. Lowe*,[23] the United States Supreme Court discussed this exemption as well as the overall scope of the IAA. The case provides guidelines as to what manner of communicating securities advice will activate obligations under the IAA.

Christopher Lowe had once been a registered investment adviser. His registration, however, was revoked by the SEC and he had been barred from associating with any investment adviser as a result of his previous convictions for serious misconduct in connection with this investment history business.[24] Nevertheless, Lowe continued to publish financial advice through a subscription newsletter, the Lowe Investment and Financial Letter, and a telephone hotline.[25] A typical issue of the newsletter contained "general commentary about the securities and bullion markets, reviews of market indicators and investment strategies, and

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[22] 15 U.S.C. § 80b-2(a)(11)(D) (1984).

[23] 556 F. Supp. 1359 (E.D.N.Y. 1983), *rev'd*, 725 F.2d 892 (2d Cir. 1984), *rev'd*, 472 U.S. 181 (1985). *See also Securities & Exch. Comm'n v. Wall Street Transcript Corp.*, 422 F.2d 1371 (2d Cir. 1970) (upholding SEC subpoena in investigation of whether publication was within bona fide newspaper exemption); *Securities & Exch. Comm'n v. Wall Street Transcript Corp.*, 454 F. Supp. 559 (S.D.N.Y. 1978) (finding same publication within bona fide newspaper exemption); *Person v. New York Post Corp.*, 427 F. Supp. 129 (E.D.N.Y), *aff'd*, 573 F.2d 1294 (2d Cir. 1977) ("The plain truth is that newspapers of general circulation like the Post are not meant to be subject to the Investment Advisers Act.").

[24] 556 F. Supp. at 1363; 725 F.2d at 894-95; 472 U.S. at 185.

[25] 472 U.S. at 184.

specific recommendations for buying, selling, or holding stocks and bullion."[26] The SEC brought an action in federal district court against Lowe, alleging that the newsletters violated the IAA and the SEC's order against Lowe.

The district court denied the relief sought by the SEC. The court held that so long as Lowe only gave impersonal investment advice—*i.e.*, by publications, and not by telephone, individual letter, or in person—to deny him the right to register and then to use his failure to register as the basis for enjoining his publications would violate the First Amendment.[27] The district court also held that the SEC could require Lowe to disclose his criminal convictions and the SEC's previous order against him, but only after the SEC promulgated rules requiring such disclosures.[28]

On review, the Second Circuit, in a 2-1 decision, reversed. With virtually no analysis, the majority held that Lowe's newsletters were not within the press exemption.[29] The majority then held that enjoining Lowe from distributing his publications was constitutionally permissible because he was a professional being denied a license just as a lawyer or doctor might be denied a license to practice

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[26] *Id.* at 185.

[27] 556 F. Supp. at 1369-70. To the same general effect is *Securities & Exch. Comm'n v. Blavin*, 557 F. Supp. 1304, 1310 (E.D. Mich. 1983), *aff'd*, 760 F.2d 706 (6th Cir. 1985).

[28] 556 F. Supp. at 1370-71. *See also Securities & Exch. Comm'n v. Sutter*, 732 F.2d 1294 (7th Cir. 1984) (upholding preliminary injunction requiring defendant to send SEC copies of each of his publications when they are distributed to anyone else).

[29] 725 F.2d at 898. A similarly erroneous conclusion was reached in *Sutter*, 732 F.2d 1294, where the court concluded that the press exemption did not apply for no better reason than that the newsletters in question were directed to investors.

his or her profession.[30] The majority noted, however, that Lowe could continue to publish a newsletter if the content were modified to exclude any advice about securities.[31]

The dissent pointed out that Lowe's advice on securities through his publication no more made him a professional investment adviser than the publication of a magazine on good health constitutes the practice of medicine or the publication of a book on how to avoid probate constitutes the practice of law.[32] The dissent also rejected the majority's conclusion that Lowe's publications were commercial speech.[33] They were, of course, publications about commercial matters, but that is not commercial speech.

The dissent also pointed out that a prior restraint, like the one sought by the SEC against Lowe, is almost never permissible, and that no showing had been made that this was one of those truly exceptional cases—where there is "the threat of grave and immediate danger to the security of the United States"—that would make a prior restraint permissible.[34]

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[30] 725 F.2d at 901-3. The majority gave scant attention to Lowe's First Amendment argument. *Id.* at 900-01. A comparable decision was rendered, under the CEA's similar provisions (7 U.S.C. § 2(ii) and (iv)), in *Savage v. Commodity Futures Trading Comm'n*, 548 F.2d 192, 197-98 (7th Cir. 1977).

[31] 725 F.2d at 902 n.7.

[32] *Id.* at 903.

[33] *Id.* at 904. For a discussion of constitutional issues involved in restrictions on general advertising of securities, see Schoeman, *The First Amendment and Restrictions on Advertising of Securities Under the Securities Act of 1933*, 41 BUS. LAW. 377 (1986).

[34] 725 F.2d at 907.

The Supreme Court reversed.[35] Although the Court indicated that it had granted review of the case to decide "the important constitutional question whether an injunction against the publication and distribution of [Lowe's] newsletter is prohibited by the First Amendment," the Court nevertheless avoided the constitutional issue and decided the case on statutory grounds.[36] The Court examined the statutory exclusion for "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation" and concluded that it applied to Lowe's publication.[37] It found that Congress was interested in regulating the business of "rendering personalized investment advice" but did not seek to regulate the press through licensing "nonpersonalized" publishing activities.[38]

Lowe's newsletters were "bona fide" because they contained disinterested commentary and analysis, not individualized advice geared to specific portfolios or clients, and were circulated to the public at large on a "regular" basis as required by the Act.[39] These requirements differentiated exempt publications from the kind of "hit and run 'tipsters' and 'touts'" that the IAA was enacted to

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35 *Securities & Exch. Comm'n v. Lowe*, 472 U.S. 181 (1985).

36 472 U.S. at 189.

37 *Id.* at 211. *But see* Lee, *The Effects of Lowe on the Application of the Investment Advisers Act of 1940 to Impersonal Investment Advisory Opinions*, 42 BUS. LAW. 507 (1987) (author analyzes Lowe's rationale to observe that majority strongly intimated that First Amendment considerations dictated holding).

38 472 U.S. at 204. *See also* Lee, *supra*, note 37 (author concludes that *Lowe* means that impersonal investment advisory publications can no longer be required to register under IAA before publishing and selling investment views).

39 472 U.S. at 206.

regulate.[40] Thus, those who disseminate a publication with a general and regular circulation are not subject to the same restrictions as "people who send out bulletins from time to time on the advisability of buying and selling stocks."[41]

The Court considered it immaterial that Lowe himself had an unsavory history, for the exemption described the publication, not the publisher.[42] It was also not crucial that the newsletters were not "regular" in the sense of consistent circulation; the test of regularity was met because the newsletters were not timed to specific market activity or to events affecting the securities industry.[43]

The Justices who concurred in the result construed the bona fide publications exception to embrace only those publications containing general financial news, not those that were devoted primarily to providing investment advice or those that were personally tailored to individual clients.[44] In their view, the IAA applied to persons who sent out bulletins from time to time.[45] Finding Lowe's publications were covered by the IAA, the concurring Justices reached the First Amendment issue and concluded that the statute was an impermissible prior restraint.[46] The IAA unconstitutionally prohibited legitimate disinterested advice, not just fraudulent, deceptive, or manipulative advice.[47] The government's fear that Lowe would publish

40 *Id.*
41 *Id.* (quoting Hearings on H.R. 10065, at 87).
42 *Id.*
43 *Id.* at 209.
44 *Id.* at 216.
45 *Id.* at 220 n.5.
46 472 U.S. at 234-35.
47 *Id.*

misleading advice because of his past misconduct did not rise to the level required to outweigh First Amendment protections.[48] Thus, the concurring Justices held that the IAA "may not constitutionally be applied to prevent persons who are unregistered (including persons whose registration has been denied or revoked) from offering impersonal investment advice through publications such as the newsletters published by [Lowe]."[49]

In *United States Securities & Exchange Comm'n v. Park*,[50] the court applied *Lowe* where a defendant who operated a Web site, sent mass emails, responded to personal emails in a chat room, and posted information on BBS bulletin boards all relating to stock trading advice.[51] The SEC accused the defendant of fraud and failing to register.[52] Defendant argued that under *Lowe* he could not be deemed to be an "investment adviser" under the IAA because he did not render "personalized" advice. The court found that the personalized nature of the publication affects whether the publisher exclusion applies, not whether the entire definition is applicable.[53] The court agreed with the SEC that defendant met the basic defini-

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48 *Id.* at 235 ("Our commercial speech cases have consistently rejected the proposition that such drastic prohibitions on speech may be justified by a mere possibility that the prohibited speech will be fraudulent."). *See also Secretary of State of Md. V. J.H. Munson Co.*, 467 U.S. 947, 964 (1984) ("Our cases make clear that a statute that requires such a 'license' for the dissemination of ideas is inherently suspect"); Schoeman, *Subscription Advisers, Blue Sky Registration and the First Amendment*, 33 BUS. LAW. 249 (1977); *but see Underhill Assocs. v. Bradshaw*, 674 F.2d 293, 296 (4th Cir. 1982).

49 472 U.S. at 236.

50 99 F. Supp. 2d 889 (N.D. Ill. 2000).

51 *Id.* at 891-2.

52 *Id.* at 892.

53 *Id.* at 893-5.

tion of an investment adviser and held that the publisher exclusion did not apply because the publications (a) were not "bona fide" as they were not disinterested and (b) were not "general and regular" in circulation but rather were timed to market activity.[54] The court also held that defendant may, in fact, have engaged in "personalized advice" by responding to specific emails, etc., thus bolstering the conclusion that he was not a "bona fide" publisher.[55]

Addressing defendant's constitutional challenges, the court found that the registration provision survived challenge because it would only be problematic if it applied to impersonal advice and under the publisher exclusion, impersonal publishers would never be considered investment advisers and thus subject to registration:[56]

> "Thus, in the instant case, if Defendants are deemed 'investment advisers', their publications are of the personalized nature, which Congress intended the Advisers Act to regulate. Defendants do not challenge the constitutionality of requiring registration of investment advisers who provide personalized advice."[57]

Moreover, given that holding, the court found that since defendant's constitutional challenge to the anti-fraud provision was based on the unconstitutionality of the registration provision, defendant's challenge was without force.[58] Nevertheless, in *dicta*, the court found that the anti-fraud

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54 *Id.* at 895-6.

55 *Id.* at 896.

56 The court also specifically distinguished the holdings in *Commodity Trend Service I & II. See infra* § 12.04.

57 *Id.* at 898.

58 *Id.*

provisions apply even to non-registered parties, that fraudulent commercial speech can be constitutionally prohibited and concluded that "[f]raudulent speech is simply not entitled to First Amendment protection of any kind."[59]

Thus, the *Lowe* and *Park* decisions provide guidance as to when the regulation of the written and electronic work of advisory professionals in the securities industry crosses over into the realm of unconstitutional restriction upon protected expression. In general, if a person provides individualized advice regarding securities to another or his publications are not disinterested and generally and regularly circulated, the person giving such advice can be regulated under the IAA. However, if a person regularly disseminates impersonal, disinterested advice regarding securities to a large number of individuals, regulation of such speech would violate the First Amendment. The following section discusses how those guidelines might apply in connection with communications over the Internet.[60]

§ 12.03 APPLICATION OF THE IAA TO THE VARIOUS METHODS OF PROVIDING SECURITIES ADVICE VIA THE INTERNET

Whether the IAA regulations would apply to investment advice given via an email message would probably

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[59] *Id.*

[60] As discussed earlier, to establish liability under the IAA it must be shown that the person giving the investment advice was doing so "for compensation" or was "in the business of advising others." 15 U.S.C. § 80b-2(a)(11). For purposes of the following discussion, it is assumed that this could be shown. For a discussion of when the "for compensation" or "in the business of advising others" elements are met, *see U.S. v. Elliot*, 62 F.3d 1304 (11th Cir. 1995), *amended*, 82 F.3d 989, *cert. denied*, 519 U.S. 859 (1995).

depend on the number of recipients of the message and the relationship between the sender and the receiver(s).

As confirmed in *Park*, an email message that provides personalized investment advice, sent to particular individuals, would almost certainly be the kind of communication requiring regulation under the IAA. By targeting a certain individual, the speaker is engaging in personalized investment advice. An email message would be regarded as a direct contact with another regarding the value of securities or the advisability of investing in, purchasing, or selling securities. Those engaging in such communications must be registered with the SEC as an investment adviser. Under the standards set forth in the *Lowe* decision, the imposition of such a requirement (and the punishment of those who engage in investment advice "speech" who do not meet such a requirement) does not raise serious First Amendment issues.

Like lawyers and doctors, investment advisers must obtain a license with a governmental body prior to engaging in such speech, *i.e.*, the rendering of professional opinions. The government is entitled, within broad limits, to determine the qualifications of particular licensed professionals and, therefore, to exclude from the practice of a profession those who fail to meet these qualifications or to maintain minimum standards of conduct. The fact that a profession may entail "spoken work" does not alter the government's ability and responsibility to punish professional misconduct. Thus, such speech may be punished if it originates from an unlicensed investment adviser, and such punishment would not raise First Amendment issues.

On the other hand, a "broadcast" email sent to a number of recipients may not be subject to regulation. The

question is whether such a broadcast message rendered personalized investment advice to the targeted recipients, or whether it more closely resembled nonpersonalized and disinterested publishing activity. If an individual is sending broadcast emails to the public at large or a substantial group of individuals on a "regular" basis, such communications would probably be exempt from IAA requirements.

The posting of investment advice to a BBS in connection with a matter being considered by a particular discussion group raises the same issues. If the advice is aimed at a particular individual, it would probably be subject to the IAA. If it was regularly disseminated to the public in general, however, it would probably be exempt. Indeed, in June 1996, the SEC gave some indication of its approach to investment advice communicated via the Internet in a no-action letter[61] issued in response to a request by Real Goods Trading Corporation ("RGTC") that it be allowed to set up an Internet bulletin board without complying with various securities regulations, including the IAA.[62]

RGTC had listed its stock on the Pacific Stock Exchange since 1994, but trading in the stock was minimal. To address this problem, RGTC proposed an Internet-based trading system for its common stock, which would func-

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[61] A no-action letter is a letter written by an attorney for a governmental agency (*e.g.*, the SEC) to the effect that, if the facts are as represented in the request for a ruling, the attorney will advise the agency not to take action because the facts do not warrant prosecution. *See* BLACK'S LAW DICTIONARY 1047 (6th ed. 1990). Although not binding on the SEC, "[n]o-action letters are generally viewed as SEC approval for specific activities." Gerard R. Boyce, *Internet Stock Trading and the SEC*, N.Y.L.J., July 11, 1996, at 5.

[62] *Real Goods Trading Corp.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,226, at 77,131 (June 24, 1996) (hereinafter "*RGTC No-Action Letter*"); *See also Recent Agency Action*, 110 HARV. L. REV. 959 (Feb. 1997).

tion much like a bulletin board. RGTC would post the names, addresses, telephone numbers, and relevant securities information for buyers and sellers of RGTC stock.[63] Interested parties could transmit their information directly to RGTC's Web site via the Internet or relay the information via telephone, facsimile, mail, or email to RGTC, which would then enter the data into the system.[64]

The SEC responded that it would not recommend enforcement actions under the IAA if the RGTC operated a system in the above-described manner. The SEC did state, however, that RGTC and its affiliates could not provide information on this system that advised buying and selling RGTC or other securities.

Investment advice promulgated through the World Wide Web site is almost certainly not going to be subject to regulation under the IAA. This kind of publication is akin to the newspaper exemption provided under the IAA.

Finally, investment advice offered in an Internet chat room again depends on the relationship between the person giving the advice and the recipient(s). If an individual engages in a chat room conversation with one individual and tailors his or her advice to that one individual, this would probably be the kind of communication subject to IAA requirements. However, if the communicating party regularly disseminates information to a large group that is participating in an Internet chat session, this is not the kind of individualized advice geared to specific portfolios or clients that the IAA seeks to regulate.

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63 *RGTC* No-Action Letter at 77,131.

64 *Id.*

§ 12.04 APPLICATION OF THE CEA REQUIREMENTS TO THE INTERNET

The CEA (7 U.S.C. § 1 et seq.) imposes similar requirements on commodity trading advisors as those imposed on investment advisors under the IAA. Under the CEA, commodity trading advisors ("CTA") must register with the CFTC. The CEA's registration requirements apply to individuals who publish and sell information about futures trading. The registration requirements apply only to persons who are classified as commodity trading advisors. A commodity trading advisor is defined in the CEA as any person who for compensation or profit: (1) "engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in" the sale of commodities, commodity options, or certain leveraged transactions; or (2) "as part of a regular business, issues, or promulgates analyses or reports concerning" such transactions.[65] Although the CEA does exclude from this definition "the publisher or producer of any print or electronic data of general and regular dissemination," this exclusion applies, however, "only if the furnishing of such services . . . is solely incidental to the conduct of their business or profession."[66]

However, as the court in *R & W Tech. Servs. Ltd. v. Commodity Futures Trading Comm'n*[67] recently noted, the definition of a commodity trading adviser under the CEA is different than the definition of an investment adviser under the IAA.[68] First, the court confirmed the CFTC posi-

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65 7 U.S.C. § 1a(5)(A).

66 *Id.* § 1a(5)(C).

67 205 F.3d 165 (5th Cir. 2000).

68 *Id.* at 174-75.

tion that the CEA's registration requirement applies not only to those who engage in personalized, client-specific trading advice, but also to those who dispense impersonal information regarding the performance or value of a particular commodity.[69] Second, the publisher exception of the CEA not only requires general and regular dissemination, but also that any advising services are "solely incidental to the conduct of their business."[70]

In *R & W*, the defendants were sellers of computer software which made buy and sell recommendations to customers for trading commodity futures contracts.[71] The CFTC sued defendants alleging fraud in the solicitation of customers and in their advertising, as well as failing to register under the CEA.[72] The court rejected defendants' argument that they came under the publisher exception, finding that defendants' dissemination of their services was not "general" nor "regular", but rather timed to market conditions.[73] Moreover, the court rejected defendants' assertions that under *Lowe* only "personalized" advice would be covered. Although conceding that defendants were "impersonal" publishers, the court held that "[j]ust because *Lowe* found that the IAA excluded [impersonal] publishers, however, does not entail that the CEA must."[74]

The court, as in *Lowe*, sidestepped defendants' constitutional challenge to the registration requirements because

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[69] *Id.* at 175. *But see* recent amendment to CFTC regulations in 17 C.F.R. §§ 4.14(a)(9)(i) & (ii). *See also* discussion about amendment *infra at* 12-23, 12-24.

[70] 7 U.S.C. § 1a(5); *R & W Tech.* at 174.

[71] *R & W Tech.* at 168.

[72] *Id.*

[73] *Id.* at 174.

[74] *Id.* at 175.

the CFTC had abandoned its registration claim against defendants. However, the court found that application of the anti-fraud provisions would not imperil the First Amendment:

> "Instead, the Commission argues that the CEA can define impersonal publishers as CTAs, even if the CEA cannot impose registration requirements upon them. Then, once the CEA has defined such advisors as CTAs, the CEA can impose liability on them for violations of the CEA's antifraud provisions, since liability for fraud would not run afoul of the First Amendment."[75]

However, in *Commodity Trend Serv. v. Commodity Futures Trading Comm'n* ("*Commodity Trend Service I*"),[76] the Seventh Circuit did address plaintiff Commodity Trend Service, Inc.'s ("CTS") First Amendment challenge to the registration requirement. The Seventh Circuit primarily addressed a procedural challenge, holding that the district court had erred in dismissing the case as unripe for judicial review. The Seventh Circuit did, however, offer a detailed discussion of what level of First Amendment protection should apply to speech of this nature.

CTS distributes a number of publications concerning the commodity futures market. These publications were distributed via "books, periodicals, updates by facsimile, voice recordings accessible by telephone, and *materials that can be downloaded via the Internet.*"[77] In the mid-

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75 *Id.*

76 149 F.3d 679 (7th Cir. 1998).

77 *Id.* at 682 (emphasis added).

1990s, the CFTC began a program to register financial publishers. In July 1996, the CFTC launched an investigation into CTS's activities. CTS, alleging that this investigation and the statutory registration requirements chilled its First Amendment rights, brought an action in the United States District for the Northern District of Illinois. The district court dismissed the action, holding that CTS's claims were not ripe for review. The Seventh Circuit reversed, holding that because CTS had alleged an intention to violate the registration requirement, there was a justiciable case or controversy.[78] Accordingly, the Seventh Circuit remanded the case for further consideration.

Prior to making this ripeness determination, however, the Seventh Circuit addressed what First Amendment standard should apply to commodity trading advice. CTS brought a facial challenge to the registration requirements, arguing that impersonal advice and commentary concerning commodity trading constituted protected expression under the First Amendment.[79] The district court had held that a facial overbreadth challenge could not be brought because the speech at issue was "'concededly' commercial speech."[80] The Seventh Circuit disagreed, holding that the speech deserved full First Amendment protection, and not the lesser protection accorded under the commercial speech test.

Under the traditional test for whether speech should be deemed "commercial speech," courts look at whether the

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[78] *Id.* at 690.

[79] *Id.* at 683 (citing *Lowe v. Securities & Exch. Comm'n*, 472 U.S. 181, (1985)).

[80] *Commodity Trend Service I*, 149 F.3d at 683 (quoting the district court).

expression at issue is "related solely to the economic interests of the speaker and its audience" and whether the expression's fundamental purpose is to propose an economic transaction.[81] The Seventh Circuit held that these definitions did not apply to CTS's publications. "[The CTS publications] do not appear to propose commercial transactions between CTS and any customers. Rather, they appear to provide information on commodity trading in general and leave any actual trading to other parties."[82] The Seventh Circuit held that the CTS publications were "analogous to a restaurant or performance review, or a Consumer Reports article, in the context of the commodity markets . . . . Just like a restaurant review does not propose a transaction between the individual reader and the restaurant, [CTS's] publications themselves do not propose any commodity transaction. Courts have held that such impersonal information is not commercial speech."[83] Accordingly, the Seventh Circuit reversed the district court's determination that CTS's publications were commercial speech.

Upon remand the district court issued another ruling that CTS again appealed. In *Commodity Trend Service, Inc. v. Commodity Futures Trading Comm'n* ("*Commodity Trend Service II*"),[84] the Seventh Circuit further considered First Amendment challenges to the CEA. First, engaging in simple statutory construction, the court rejected CTS' argument that the anti-fraud provisions in the CEA were not applicable because the term "clients" was not applicable to its impersonal advising.[85] Second, the court rejected

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81 *Id.* at 684 (citations omitted).
82 *Id.* at 685-86.
83 *Id.* at 686 (citations omitted).
84 233 F.3d 981 (7th Cir. 2000).
85 *Id.* at 988-991.

a constitutional challenge to the anti-fraud provision. As applied by the CFTC to certain of CTS' advertisements the speech involved was deemed commercial speech and a series of Supreme Court decisions have held that commercial speech is entitled to less protection and can be prohibited if it is misleading or fraudulent.[86]

Third, as applied to the non-commercial speech CTS used, the court held the anti-fraud provision "is constitutional because it is a narrowly tailored measure that is directly related to preventing fraud in statements that purport to convey factual information. The provision is narrow because it targets only a certain group of deceptive activities and requires negligence, and is directly related to fraud because it punishes only a limited group of activities that deceive or defraud a CTA's customers or potential customers."[87] The court also refused to address CTS' challenge to certain affirmative disclosure requirements as compelled speech, finding that the challenge was not ripe.[88]

Finally, the court did not address the constitutionality of the registration provisions as applied to impersonal advice because on March 10, 2000 the CFTC amended the governing regulations to add a provision that exempted certain impersonal advisers.[89] The CFTC, in response to court decisions in *Taucher*[90] and *Commodity Trend Service I* and concerns about constitutionality, added a

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[86] *Id.* at 994 ("The government can directly regulate deceptive advertising without any further justification").

[87] *Id.*

[88] *Id.*

[89] *Id.* at 991.

[90] *See infra* 53 F. Supp. 2d 464.

provision that exempted a party from being a CTA if: "(9) It does not engage in any of the following activities: (i) Directing client accounts; or (ii) Providing commodity trading advice based on, or tailored to, the commodity interest or cash market positions or other circumstances or characteristics of particular clients."[91] In describing the amendment in the Federal Register, the CFTC summarily explained that the "exemption adopted today is intended to apply to CTAs that provide standardized commodity trading advice by means of media such as newsletters, pre-recorded telephone newslines, Internet Web sites, and non-customized computer software."[92] The CFTC also provided various illustrative examples of business activities, including Internet and electronic, that would and would not come under the new exemption.[93]

In *Commodity Futures Trading Comm'n v. Vartuli*,[94] the defendant manufactured and sold a computer program called "Recurrence," which provided customers with instantaneous buy or sell signals in the futures market, along with providing occasional supplemental telephone advice to customers and a list of "authorized brokers" who could complete trades.[95] The CFTC sued defendants alleging fraud in the solicitation of customers and in their advertising, as well as failing to register under the CEA.[96]

First, the court found that defendants did not come under the publisher exception to the CEA because they did

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91 17 C.F.R. §§ 4.14(a)(9)(i) & (ii).
92 65 Fed. Reg. 12938, § I.
93 *Id.* at 12938, § III.
94 228 F.3d 94 (2d Cir. 2000).
95 *Id.* at 98-99.
96 *Id.* at 100.

not "generally" or "regularly" disseminate their information nor was their advice "solely incidental" to their business.[97] Also, the court rejected defendants' assertions that *Lowe* mandated that only personalized advice would be covered. Quoting *R & W Tech.*, the Court found that *Lowe* did not consider the CEA, which was significantly different from the IAA, and did not address the constitutional issues, and thus was not determinative.[98]

Second, the court addressed defendants' constitutional challenges. As in *Commodity Trend Service II*, the court found that the fraudulent advertising regulations could easily withstand constitutional scrutiny under the lesser standard for commercial speech.[99] However, the court went on to discuss defendants' compelled speech argument regarding the affirmative disclosure requirements:

> "In the commercial speech context, however, 'an advertiser's rights are adequately protected as long as disclosure requirements are reasonably related to the State's interests in preventing deception of consumers.' The disclosure requirement at issue here was reasonably related to the government's interest in preventing consumers from being deceived by misleading hypothetical statistical presentations that, as Congress observed, could lead to inefficiencies in the commodities markets that are contrary to the public interest."[100]

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97 *Id.* at 103-4.

98 *Id.* at 104-5.

99 *Id.* at 108.

100 *Id.* (Citations omitted) (quoting *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626, 651 (1985).

In addition, the court held that the constitutionality of the anti-fraud provisions in the CEA was a separate issue from the constitutionality of the registration requirements because the fraud provisions applied to any CTA regardless of whether they were subject to registration.[101]

Finally, the court agreed that the registration provisions presumptively constitute impermissible prior restraints, but held that the "Recurrence" software system was not constitutionally protected speech at all and thus defendants "could, consistent with the First Amendment, be required to register, and [their] failure to do so can constitutionally be punished."[102] The court found "[t]he language at issue here was to be used in an entirely mechanical way, as though it were an audible command to a machine to start or stop."[103]

By contrast, in *Taucher v. Born*,[104] the court followed the decision in *Commodity Trend Service I.* In *Taucher*, the plaintiffs were the publishers of books, newsletters, Internet Web sites, instruction manuals, and computer software that provided information, analysis, and advice on commodity futures trading. The court held that the plaintiffs could publish without being registered as CTA with the CFTC, holding that the registration requirement as applied to the plaintiffs was unconstitutional under the First Amendment.[105]

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[101] *Id.* at 103.

[102] *Id.* at 111.

[103] *Id.*

[104] 53 F. Supp.2d 464 (D.D.C. 1999).

[105] *See* Stanton, *A Bear Market for Freedom of Speech: The First Amendment and Regulation of Commodity Trading Advisors Under the Commodities Exchange Act*, 76 Wash. U. L. Q. 1121 (1998).

The Court found that the plaintiffs fell squarely within the definition of a CTA because: (1) they engaged in the business of advising others, through publications, writings and electronic media, as to the value of or the advisability of trading in the futures market and did so for compensation or profit; and (2) they were not excluded as publishers of "print or electronic data of general and regular dissemination" because the furnishing of such services was *not* solely incidental to their business—it was, in fact, plaintiffs' primary business or profession.

Plaintiffs asserted that the application of the CEA's registration requirement to them constituted a violation of their rights under the First Amendment. The CFTC responded that the registration requirement was a permissible regulation of a profession. The court held that although the government is entitled to regulate the entry into a profession, "[t]here comes a point, however, where government legislation crosses the line between the regulation of a profession and the regulation of speech. It is at this point where the protections of the First Amendment are invoked and the regulation becomes subject to a less deferential level of judicial scrutiny."[106] Relying on the concurring opinion of Justice White in *Lowe*,[107] the court held that the CFTC's application of the CEA's registration requirement to the plaintiffs constituted an attempt to regulate speech, not profession. Several facts lead the court to this conclusion:

> "The plaintiffs, through their publishing activities, do not go so far as to exercise judgment on behalf of

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[106] *Taucher*, 53 F. Supp. 2d at 476.

[107] *Lowe v. SEC*, 472 U.S. 181 (1985).

> those who purchase their products. Through their products, they provide advice on commodities futures trading strategies and techniques; they sell trading systems designed to influence their customers' trading decisions; in some instances, they even go so far as to offer specific buy and sell recommendations; but their advice and recommendations are identical for every customer and their products are available to all who wish to purchase them. Moreover, the plaintiffs never have any personal contact with their customers. They never supplement their general recommendations with specific recommendations directed at individual customers. They never make trades for their customers. They simply sell their products and leave it to their customers to decide for themselves whether and how they will use the advice and recommendations purchased from the plaintiffs."[108]

The court distinguished these facts from those in *Commodity Futures Trading Commission v. AVCO Financial Corp.*,[109] a case involving the CFTC's application of the same registration requirement. In *AVCO*, the plaintiffs provided specific buy and sell recommendations, a telephone number that customers could call to receive additional advice about AVCO's general recommendations, and a service by which brokers authorized by AVCO could actually make trades for AVCO's customers. In contrast, the plaintiffs in *Taucher* "never engage in individual consultations with their customers regarding their standard advice

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[108] *Taucher*, 53 F. Supp. 2d at 478.

[109] 979 F. Supp. 232 (S.D.N.Y. 1997).

and recommendations and under no circumstances do they make trades for their customers."[110]

Thus, because the CFTC's regulations as applied to the plaintiffs crossed the line between the regulation of a profession into the regulation of speech, the court next determined what level of First Amendment protection should be applied, *i.e.*, whether the speech at issue was fully protected speech, or speech that could be considered "commercial" and therefore subject to a lesser degree of First Amendment protection as set forth in *Central Hudson Gas & Electric Corp. v. Public Service Commission of New York*.[111] The court, relying on *Commodity Trend Service I*,[112] held that the plaintiffs' publications were not commercial speech:

> "The plaintiffs' publications in this case do not propose any commercial transaction between the plaintiffs and their customers and the publications are not related solely to the economic interests of the plaintiffs and their customers. Like the publications in [*Commodity Trend Service I*], the various publications distributed by the plaintiffs here provide impersonal information and provide the exact same advice and recommendations to all customers, regardless of any customer's individual circumstances."[113]

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[110] *Taucher*, 53 F. Supp. 2d at 478.
[111] 447 U.S. 557, 561 (1980).
[112] 149 F.3d 679 (7th Cir. 1998).
[113] *Taucher*, 53 F. Supp. 2d at 480-81.

Moreover, even though portions of the plaintiffs' publications, particularly their Internet Web sites, included advertisements for their publications, this did not turn the publications' contents into commercial speech.

> "In the instant case, the CFTC is seeking not to regulate the plaintiffs' advertisements, but rather to apply the CEA's registration requirement in such a way as to prevent the plaintiffs from publishing any of the information contained in their publications without first obtaining a license. The relevant inquiry, therefore, is not whether the plaintiffs' advertisements are commercial speech, but whether the substance of the plaintiffs' publications is commercial speech. For the reasons outlined above, the court concludes that it is not."[114]

Having concluded that the plaintiffs' publications constitute fully protected speech, the court went on to hold that the restrictions imposed upon the plaintiffs' speech by application of the CEA's registration requirement amounted to a licensing scheme and thus a prior restraint on speech. The court noted that under well-established Supreme Court authority, a restriction that imposes a prior restraint on speech "'comes to the Court bearing a heavy presumption against its constitutional validity.'"[115] Relying on the reasoning in the concurring opinion in *Lowe*, the court held that the CEA's registration requirement, as applied to the plaintiffs by the CFTC, was an unconstitutional prior restraint on speech:

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[114] *Id.* at 481.

[115] *Id.* (quoting *New York Times Co. v. United States*, 403 U.S. 713, 714 (1971).

"As in *Lowe*, the defendants in this case have imposed a drastic prohibition on speech based on the mere possibility that the prohibited speech will be fraudulent. As applied by the CFTC, the CEA imposes a ban on the plaintiff's publishing of impersonal commodity futures trading advice unless they register with the CFTC . . . This is no different than the regulation in *Lowe* in that it seeks to prevent individuals from publishing information based solely on a fear that someone may publish advice that is fraudulent or misleading, regardless of whether or not the information published actually is fraudulent or misleading. Such prior restraint on fully protected speech cannot withstand the searching scrutiny of the First Amendment."[116]

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[116] *Taucher*, 53 F. Supp. 2d at 482.