Securities Regulation Daily Wrap Up, CORPORATE GOVERNANCE—5thCir.: 5th Circuit says stock buyback disclosure rule is arbitrary, (Nov. 1, 2023)

Securities Regulation Daily Wrap Up

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By Rodney F. Tonkovic, J.D.

The court directed the SEC to fix the rule in 30 days.

A Fifth Circuit panel remanded the SEC's share repurchase disclosure rule back to the agency to correct defects. The U.S. Chamber of Commerce challenged the rule, arguing that the rule violated the First Amendment and that the Commission violated the Administrative Procedure Act. The panel concluded that the SEC acted arbitrarily and capriciously by failing to respond to petitioners' comments and to conduct a proper cost-benefit analysis. The panel accordingly remanded the matter to the SEC to remedy the identified deficiencies within 30 days (*Chamber of Commerce of the U.S. v. SEC*, October 31, 2023, Smith, J.).

Disclosure rule. The SEC adopted its share repurchase disclosure modernization rule (Release No. 34-97424) by a 3-2 vote on May 3, 2023. Intended to reduce information asymmetries between issuers and investors in share buybacks, the final rule requires issuers to disclose the reasons for the share repurchase (the "rationale-disclosure requirement"). Issuers must also file daily repurchase data either quarterly or semi-annually.

At the time, the Chamber of Commerce opposed the rule, stating that it would disincentivize share repurchases. The Chamber indicated that it would evaluate the impact of the rule and consider pursuing litigation. This petition for review was filed on May 12, 2023.

First Amendment concerns. The Chamber first claimed that the rationale-disclosure requirement impermissibly compels speech and thus violates the First Amendment. The panel disagreed and found that the requirement passed constitutional muster.

Laws compelling speech normally trigger strict scrutiny, but lesser scrutiny can apply when disclosures are compelled in the context of commercial speech. Relying on the Supreme Court's 1985 decision in *Zauderer v. Off. Disciplinary Couns. Sup. Ct. Ohio* (471 U.S. 626), the court examined whether the compelled disclosures are "purely factual." The court also looked to *NetChoice v. Paxton's* analysis of the constitutionality of a Texas provision regulating social media platforms. *NetChoice*, the court said, stands for the proposition that compelling a company to explain its actions is a purely factual disclosure, and this case cannot be distinguished from *NetChoice*. The court also rejected the Chamber's argument that share repurchases are "controversial," stating that if content moderation was not controversial in *NetChoice*, neither is an issuer's reason for repurchasing its own shares.

Continuing, the court concluded that the required disclosures are not unjustified or unduly burdensome. Here, the SEC has a legitimate interest in promoting the free flow of information, and the disclosure requirement is reasonably related to that interest. And, the requirement is not unduly burdensome: a requirement compelling speech within the narrow confines of SEC filings is not the type of disclosure that would chill protected speech, the court said.

Arbitrary and capricious. The court then found, however, that the SEC acted arbitrarily and capriciously, in violation of the APA, when it failed to respond to petitioners' comments and failed to conduct a proper cost-benefit analysis.

In the proposing release, the SEC said that many of the rule's economic effects could not be quantified. Commenters were invited to submit suggestions, and the Chamber helpfully provided three ways via which the agency could quantify the proposed rule's effects using readily available data. The Commission admitted, however, that it never considered any of the Chamber's suggestions.

"It is hard to fault petitioners for giving the SEC exactly what it had asked for," the court said. All three suggestions provided ways to quantify the rule's expected costs and benefits, which the SEC averred could not be quantified. By continuing to insist that the economic effects are unquantifiable, despite suggestions to the contrary, the SEC failed to demonstrate that the rule was the product of reasoned decisionmaking.

The court also found that the Commission failed to adequately substantiate the rule's benefits and costs. The SEC argued that the rule helps investors evaluate if a share repurchase would increase the value of a firm and promotes price discovery. While these benefits may be more than purely hypothetical, the court said, they were not adequately substantiated. First, the SEC conceded that it never substantiated the proposition that improperly motivated buybacks are a problem: if this is so, there is no rational basis for investors to experience any of the uncertainty the SEC said warrants the rule. The court then found that the theory underpinning the purported price discovery benefits was internally contradictory and that this benefit was also unsubstantiated.

The court stressed that the rule's claimed primary benefit—decreasing investor uncertainty—was inadequately substantiated. This concern was reflected in almost every part of the SEC's justification and explanation of the rule, the court said, and the error infects the entire rule.

30 days. The court accordingly concluded that the Commission acted arbitrarily and capriciously. The rule was not vacated because the court recognized that there is a possibility that the agency could substantiate its decision if given the opportunity. To that end, the Chamber's petition for review was granted, and the matter is remanded for the SEC to correct the defects in the rule within thirty days of this ruling. The panel also retained jurisdiction to consider the decision made on remand.

The case is No. 23-60255.

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Companies: Chamber of Commerce of the United States of America; Longview Chamber of Commerce; Texas Association of Business

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