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Outside Counsel

‘Citigroup’ Highlights Problems With SEC Settlements

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In *SEC v. Citigroup Global Markets Inc.*, Southern District Judge Jed S. Rakoff on Monday rejected a proposed $285 million settlement between the Securities and Exchange Commission and Citigroup.[1] The SEC charged Citigroup with negligence based on its sale of collateralized debt obligations. The proposed settlement would have resolved the action with Citigroup neither admitting nor denying the allegations but with the court enjoining it from future violations of the securities laws.

SEC settlements, of course, always permit defendants to settle without admitting or denying liability and routinely include court-ordered injunctions against future violations of the securities laws. During an earlier hearing regarding the proposed settlement, however, Judge Rakoff questioned whether a district court judge should reject a settlement as against the public interest when there has been no determination as to liability, i.e., without getting to the truth of the allegations. In his opinion rejecting the settlement, Judge Rakoff expressed numerous concerns and concluded that the SEC's policy of permitting defendants to settle without admitting or denying liability "deprives the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact."

Judge Rakoff has repeatedly challenged the SEC on the fundamental aspects of its settlement policy. The components and precise language of standard SEC settlements also contain inherent technical inconsistencies that lead to awkward results. The question remains whether a better SEC settlement policy is possible.

Getting to the Truth

The *Citigroup* action was not the first time Judge Rakoff challenged the SEC on its settlement policy. In 2009, Judge Rakoff famously rejected a $33 million settlement between the SEC and Bank of America (BoA).[2] The SEC alleged that BoA made material misrepresentations regarding executive compensation in its proxy statement seeking shareholder approval of its acquisition of Merrill Lynch & Co.

In his opinion rejecting the deal, Judge Rakoff noted that the settlement seemingly permitted the same management accused by the SEC of victimizing shareholders to resolve the matter without admitting liability and by paying another $33 million of shareholder money. Judge Rakoff accused the parties of having a "cynical relationship" wherein the SEC can claim it prosecuted a large bank and the bank's management can claim it had no choice but to settle with the powerful regulator. Judge Rakoff concluded his opinion by stating, "[A]ll this is done at the expense, not only of the shareholders, but also of the truth."

SEC's Settlement Policy

The SEC's policy prohibiting settling defendants from denying liability is codified in 17 C.F.R. §202.5(e). Passed in 1960, Section 202.5 was amended in 1972 to include the prohibition on denying liability. Section 202.5(e) now states, "[T]he Commission believes that a refusal to admit the allegations is equivalent to a denial, unless the defendant or respondent states that he neither admits nor denies the allegations."

The history of this policy was recounted by Judge Rakoff in an opinion in *SEC v. Vitesse Semiconductor Corp.*, which garnered less media attention than his remarks in *Citigroup* or *BoA* but that was far more scathing in its criticisms of the SEC's settlement policy.[3] In *Vitesse*, Judge Rakoff was asked to approve SEC

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settlements with a corporation and two individuals accused of fraudulent revenue recognition and stock options backdating. Judge Rakoff noted that even before the SEC's 1972 policy shift, defendants sought to neither admit nor deny liability due to collateral estoppel concerns.

Judge Rakoff also noted that because the SEC at the time could primarily seek only injunctive relief, it was more interested in preventing future violations rather than punishing past violations. Defendants at the time, however, routinely settled with the SEC while publicly professing their innocence. The policy adopted by the SEC in 1972 restricted defendants to neither admitting nor denying liability.

The result, according to Judge Rakoff, "is a stew of confusion and hypocrisy unworthy of such a proud agency as the SEC." Judge Rakoff reiterated his concern that settlements without admission of liability prevent the public from ever learning whether the allegations are true. Judge Rakoff stated that such outcomes might be acceptable for disputes between private litigants, but are not acceptable for a federal agency. Judge Rakoff pointed to the Department of Justice's disavowal of nolo contendere pleas in criminal cases as an example of a more appropriate policy.

Judge Rakoff's statements seem harsh given that the SEC and other civil regulatory authorities occupy a unique status. Although the SEC is charged with the responsibility of protecting the investing public, the procedural tools available to it are limited. It possesses broad investigative power, but in a district court action has few tools available to it beyond those available to any civil litigant. Although public corporations are regulated by the SEC and thus far more likely to defer to it than to the ordinary civil litigant, the SEC's authority is tempered by the fact that any action it takes against a public corporation—no matter how well-intended—necessarily harms innocent shareholders, at least in the short term.

Other Technical Problems

In addition to the problems articulated by Judge Rakoff, the SEC's settlement policy also creates technical inconsistencies within the actual components of the settlements. These contradictions are detrimental to the SEC to the extent they make SEC rules and procedures appear perfunctory.

> The components and precise language of standard SEC settlements contain inherent technical inconsistencies that lead to awkward results.

For example, the consent Citigroup executed as part of its proposed settlement with the SEC plainly states that a component of the $285 million settlement is a $95 million civil penalty. The tension is immediately apparent—how could Citigroup not be liable if it's paying a $95 million penalty?

The tension can be even more apparent in settlements of SEC enforcement actions against individuals. In cases where the SEC alleges fraud, the SEC typically insists as a condition of settlement that the individual, in addition to paying disgorgement or fines, consents to a bar against employment in the industry. While a district court has the authority to impose a bar against serving as an officer or director of a public corporation, broader employment prohibitions such as bars against associating with any broker, dealer or investment advisor or against practicing before the SEC as an accountant require a companion SEC administrative action. The SEC brings these administrative actions pursuant to Rule 102(e) of the SEC Rules of Practice and requires settling defendants to execute a separate offer of settlement for the administrative proceeding. Again, the respondent neither admits nor denies the allegations.

As a result, it is commonplace for CFOs or other high-profile securities professionals to settle SEC actions through multiple documents—readily available in court dockets and on the SEC's website—that describe in great detail egregious securities law violations and resulting injunctions, civil penalties and industry bars that may last for life. The SEC also routinely issues press releases repeating the allegations and terms of settlement. Yet in each instance the individual does not admit liability.

Another inconsistency is found in the portions of standard SEC consent documents specifically addressing the SEC's policy against denying liability. The typical SEC consent document states that the prohibition applies only to that particular SEC action, and that the settling defendant maintains the right to take different legal or factual positions in any action to which the SEC is not a party. This exception seems particularly contradictory, but without it, defendants likely would resist settling over collateral estoppel concerns.

Standard SEC settlement language also states that the prohibition against denying liability does not affect the defendant's "testimonial obligations." This can lead to an even more awkward situation. A defendant may settle an SEC enforcement action through public documents detailing egregious wrongdoing and severe punishments. If, however, another defendant in the action continues to litigate, the settling defendant can subsequently deny wrongdoing under oath during a deposition or even at trial. Indeed, a settling defendant who genuinely disputes the allegations may later testify in open court that, for example, he settled not because he was liable but because he could not afford to defend himself.

The collateral consequences to SEC settlements can also create inconsistencies. For example, a CPA who settles an SEC action without admitting liability may nevertheless lose his or her CPA license because SEC settlements trigger inquiries by state accounting boards. Similarly, a corporation involved in government contracting that settles an SEC action without admitting liability may find itself debarred from government contracting because the settlement triggers inquiries pursuant to the Federal Acquisition Regulations or similar state contracting rules. Defendants thus question why their career or business has effectively been terminated after they were able to resolve the more serious case with the SEC without admitting liability.

Possible Solutions

Although Judge Rakoff has brought attention to the problems inherent in SEC settlements, the question remains whether a better procedure is possible. Judge Rakoff's interest in the SEC getting to the truth of allegations raises one obvious possible solution—that the SEC bring more of its actions to trial. Taking a case to trial, however, requires greater expenditures of resources and offers no guarantee of success. Indeed, the most egregious cases are prosecuted criminally, oftentimes leaving the SEC with cases that are not as clear cut and thus harder to prove even under the lower civil standard of proof. The SEC reports that 92 percent to 93 percent of its enforcement actions are "successfully resolved," but this figure includes settlements and default judgments.[4] Presumably, the SEC's success rate at trial is significantly lower.

Another possibility would be to require settling defendants to admit wrongdoing. The "neither admit nor deny" language could be reserved for cases that settle quickly and thus spare the SEC the time and expense of litigation. Defendants who genuinely dispute the allegations but are unable to litigate against the SEC could opt for the quick settlement without any admissions.

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For defendants who settle and are required to admit wrongdoing, the problem of preclusion in subsequent private actions could be addressed by imposing limitations on the use of such admissions in private actions. This possibility presents its own problems, not only logistically but also because victims might feel particularly aggrieved at having to pursue private litigation after an admission of liability.

Such negative perceptions might be lessened by borrowing concepts from federal criminal procedure. Under the federal Sentencing Guidelines, judges sentencing defendants in fraud cases must make a loss calculation. The parties litigate the issue and the judge makes an ultimate determination as to the actual extent of the harm. Requiring judges in SEC enforcement actions to make loss calculations as part of the settlement approval process would help clarify the extent of the harm. Judge Rakoff seemingly hinted at such an approach in an Oct. 27, 2011, order in the *Citigroup* action asking the parties various questions including what the total loss was to victims resulting from Citigroup's actions. Under such an approach, egregious and recidivist conduct (such as prior injunctions) could be addressed through a culpability determination by the judge similar to that required in criminal sentencing of corporations including commensurate multipliers of financial penalties.

As any criminal practitioner would attest, however, loss and culpability calculations carry their own problems. But an admission of liability coupled with loss and culpability calculations by a federal judge might go further in satisfying the public interest and lessen the perception among victims that the corporation is getting an unfair break. At the very least, the process should help prevent the perception that a judge "rubber-stamped" a lenient settlement.

A simple solution to the problem is not readily apparent, but the current SEC settlement regime contains inherent contradictions that create confusion among the public and potentially undermine the SEC's role as the protector of investors. Judge Rakoff has repeatedly brought attention to the issue, and the SEC and the Legislature should now undertake to resolve it.

1. Opinion & Order dated Nov. 28, 2011, 11 CV 7387 (JSR).
2. *SEC v. Bank of America Corp.*, 09 CV 6829 (JSR), 653 F.Supp.2d 507 (S.D.N.Y. Sept. 14, 2009).
3. 10 CV 9239 (JSR), 771 F.Supp.2d 304 (S.D.N.Y. March 21, 2011).
4. See U.S. Securities and Exchange Commission's FY 2011 Performance and Accountability Report, available at http://www.sec.gov/about/secpar/secpar2011.pdf.