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SEC ENFORCEMENT

The SEC's Troubling New Policy Requiring Admissions

BY MARC FAGEL

On June 18, recently-appointed Securities and Exchange Commission Chair Mary Jo White released something of a bombshell, announcing that the agency would break from its long-standing practice of allowing defendants to settle cases without admitting liability and, in certain cases, require admissions as a condition of settlement.[1] According to various reports, the new approach was set out in an email to the Enforcement Division staff on June 17, explaining that, while neither-admit-nor-deny settlements would remain the standard practice, admissions would be required in "certain cases where heightened accountability or acceptance of responsibility through the defendant's admission of misconduct may be appropriate, even if it does not allow us to achieve a prompt resolution."[2] While the exact parameters of when admissions will be required were not laid out, Enforcement Division Co-Directors Andrew Ceresney and George Canellos said admissions might be required in cases of "egregious intentional misconduct," where the defendant had obstructed the investigation, or where the conduct "harmed large numbers of investors."[3]

Although Chair White may have seen a need to respond to critics of the SEC's settlement approach, this policy change could have serious consequences for the agency, and ultimately for the very investors whose interests the SEC is supposed to protect. Faced with the prospect of admissions that can be used against them in other proceedings and expose them to massive collateral damages, companies and their officers will be incentivized to take more cases to trial. And the SEC, which will see its already limited enforcement resources further diminished by protracted litigation, will have less time to pursue new investigations and shut down ongoing frauds, with any incremental benefit from seeing bad actors admit their wrongdoing offset by a delay in any financial recovery for investors (if such recovery can be had at all).

A Policy Under Attack

The SEC's standard practice, like that of most federal agencies with civil enforcement remedies, is to allow defendants to settle charges without admitting liability. At the same time, any settling party must agree not to publicly deny the allegations, preventing defendants from settling with the SEC while turning around and

[1] Jean Eaglesham & Andrew Ackerman, *SEC Seeks Admissions of Fault*, WALL ST. J. (June 18, 2013), *available at* http://online.wsj.com/article/SB10001424127887324021104578553931876196990.

[2] Kurt Orzeck, *SEC To Seek More Admissions of Guilt in Settlements*, LAW 360 (June 18, 2013), *available at* http://www.law360.com/articles/451302/sec-to-seek-more-admissions-of-guilt-in-settlements.

[3] Dina ElBoghdady, *SEC to Require Admissions of Guilt in Some Settlements*, WASH. POST (June 18, 2013), available at http://www.washingtonpost.com/business/economy/sec-to-require-admissions-of-guilt-in-some-settlements/2013/06/18/9eff620c-d87c-11e2-a9f2-42ee3912ae0e_story.html.

Marc Fagel is a partner in Gibson, Dunn & Crutcher's San Francisco office and a member of the firm's Securities Enforcement and White Collar Defense Practice Groups. Prior to joining the firm, he spent over 15 years with the Securities and Exchange Commission's San Francisco Regional Office, most recently serving as Regional Director from 2008 to 2013.

disparaging the SEC's case. (Certain exceptions exist, such as allowing a settling defendant to contest the allegations in a separate legal proceeding to which the SEC is not a party.)

The controversy reached public prominence in late 2011, when Judge Jed Rakoff rejected the SEC's $285 million settlement with Citigroup in a case arising out of the firm's sales of collateralized debt obligations. The SEC heralded this as one of the more significant cases stemming from the financial crisis, going so far as to accompany the press release with a colorful chart showing this to be one of the largest financial recoveries by the agency to date.[4] Judge Rakoff of the Southern District of New York refused to enter the settlement, in part because the SEC's policy of allowing defendants to settle without admitting the underlying allegations ''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.''[5]

The *Citigroup* case remains unresolved. Both the SEC and Citigroup appealed the district court order. The U.S. Court of Appeals for the Second Circuit, which expressed doubt about Judge Rakoff's reasoning in granting a motion to stay discovery proceedings in the case, has yet to issue a decision as to whether Judge Rakoff exceeded his authority.[6] Meanwhile, several federal judges around the country – far from a groundswell, but enough to cause concern at the SEC – have followed Judge Rakoff's lead, demanding additional support before approving SEC settlements, and in some instances rejecting settlements outright because of the absence of party admissions.[7]

Members of Congress and the public have joined the fray. For example, in a February 2013 Senate hearing, Senator Elizabeth Warren grilled then-Chair Elisse Walter (as well as Ben Barnanke and Eric Holder) on why their respective agencies do not take more cases to trial. Senator Warren followed up this hearing with letters requesting ''any internal research or analysis on trade-offs to the public between settling an enforcement action without admission of guilt and going forward with litigation as necessary to obtain such admission.''[8]

In a written response to Senator Warren dated June 10, Chair White, while conceding the SEC had no formal studies on the issue, provided concise and compelling justifications for the neither-admit-nor-deny policy.[9] Among other things, White explained that SEC settlements are designed to ''obtain[] the relief that we could reasonably expect to receive at trial, without assuming the risks and costs of lengthy and protracted litigation.'' She further explained that these settlements (and the accompanying pleadings and press releases) provide detailed factual allegations and findings that ''present a virtual road map of the wrongdoing that the Commission contends violated the federal securities laws,'' and that these actions (and the accompanying public attention) have a significant deterrent effect on corporate actors. As described in greater detail below, she went on to describe the significant collateral effects of an SEC action on settling defendants, notwithstanding the absence of admissions. White's letter nonetheless assured the Senator that the agency was actively reviewing the policy.

The other shoe dropped just a week later, with the internal email from Ceresney and Canellos to the SEC staff, and Chair White's public disclosure of the policy change at a June 18 conference.

The Costs of Litigation

The most obvious result of a change in policy requiring admissions will be fewer settlements and more litigation. Admitting liability would subject the defendant to tremendous exposure in private litigation. Companies caught up in SEC investigations are already generally subject to class actions and derivative lawsuits based on the same conduct, but admitting liability will likely give private plaintiffs the benefit of collateral estoppel. Hence, a defendant settling with the SEC, in addition to whatever penalties and other sanctions are contained in the SEC settlement, runs a greater risk of liability, and potentially massive damage calculations, in various related private actions. Moreover, there is the possibility that other state or federal regulators could similarly leverage an admission of liability in a future regulatory proceeding against the individual or company. Most strikingly, some of these regulators have criminal powers, and thus the implications of admitting wrongdoing to the SEC could be huge.

Under the current policy, the primary benefit to an individual or company opting to settle with the SEC is avoiding a finding of liability that can be used against them in other cases. The SEC generally seeks from settling defendants essentially every remedy it might win at trial; indeed, some critics have noted that the remedies the SEC demands in settlement are frequently *more* severe than the relief it is likely to be awarded at trial.[10] Hence, the main thing the Enforcement staff can offer parties to induce them to settle rather than litigate

[4] *See* Press Release, SEC, *Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market* (October 19, 2011), *available at* http://www.sec.gov/news/press/2011/2011-214.htm.

[5] *SEC v. Citigroup Global Markets*, 827 F .Supp. 2d 328 at 332 (S.D.N.Y. 2011).

[6] *SEC v. Citigroup Global Markets*, 673 F.3d 158 (2d Cir. 2012) (staying the judgment and finding a substantial likelihood that the SEC and Citigroup would prevail on the merits). Gibson, Dunn and Crutcher, LLP, represents the Business Roundtable, which has submitted an Amicus Brief in support of appellant Citigroup Global Markets Inc. in the appeal pending before the Second Circuit.

[7] *See SEC v. Bridge Premium Finance*, LLC, No. 1:12-CV-02131-JLK (D. Colo. Jan. 17, 2013) (''I refuse to approve penalties against a defendant who remains defiantly mute as to the veracity of the allegations against him. A defendant's options in this regard are binary: he may admit the allegation or he may go to trial'').

[8] Letter from Elizabeth Warren to Ben Bernanke, Eric Holder and Mary Jo White (May 14, 2013), *available at* www.warren.senate.gov/documents/LtrtoRegulatorsre2-14-13hrg.pdf.

[9] Letter from Mary Jo White to Elizabeth Warren (June 10, 2013), *available at* www.thinkprogress.org/wp-content/uploads/2013/06/WARREN-Settling-Enforcement-Action-ES144264-Response.pdf.

[10] For example, in financial fraud actions against public company officials, the SEC will typically require that the settling defendant be barred from serving as the officer or director of a public company, either permanently or for some period of time (generally 5 or 10 years). Yet in numerous litigated cases in recent years, the courts have refused to grant this relief (or imposed only a short bar), even where the SEC has prevailed on the merits. *See, e.g., SEC v. Conaway*, 697 F. Supp. 2d 733 (E.D. Mich. 2005) (following jury trial finding former

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is the ability to avoid a judicial finding of liability which can be used by private plaintiffs or other parties in a subsequent proceeding. As it is, the SEC enforcement action will have serious implications in a subsequent private action. The SEC's complaint will provide a blueprint for the class action plaintiffs, and the SEC's investigative files (including testimony transcripts) are often obtained by the private litigants through discovery or a Freedom of Information Act request. But the significant benefit of avoiding a binding admission is often what tips the scales in favor of settlement.

Of course, the other benefit of settling is avoiding the cost of going to trial. But in many cases, these costs are borne by others. Corporate executives may have indemnification agreements; companies may be able to turn to insurance policies to cover legal costs. (Notably, an admission of wrongdoing may also subject a defendant to a clawback of defense costs incurred to date pursuant to the terms of the indemnification agreement or insurance policy, another reason more defendants may opt to litigate.) Even where there is still significant out-of-pocket cost to litigating, the exposure in a related private action if the party admits liability may be far greater. As a result, most defendants may be best served by rolling the dice and taking their chances in front of a jury.

Of course, provoking more trials is seen by some as a positive development, with trials perceived as the best possible means of getting to the underlying truth of what transpired. But the downsides of trial for the government (and ultimately for the investors the SEC exists to protect) are significant. First and foremost, the resource cost to the SEC will be substantial. Financial fraud cases are particularly resource-intensive (both in terms of staff time and financial outlays), typically involving years of litigation with extensive discovery and motion practice, the hiring of high-priced experts, and so forth. In an era of budgetary tightness and sequestration, the burdens are particularly acute for the government. For each additional matter litigated to trial, the SEC will likely have to forgo multiple new investigations it might otherwise have undertaken. It will be cold comfort to investors defrauded in a Ponzi scheme that the SEC could not pursue the tips it had received because too many staff attorneys were busy litigating cases against defendants who would have been willing to settle but for the demand that they admit wrongdoing.

Second, even if the SEC ultimately receives a favorable result at trial – prevailing on the merits and obtaining at least the same relief it could have obtained in settlement – this result will be years down the road (or longer if the defendant chooses to appeal). In the interim, any financial recovery investors might have reaped from the settlement may have long since dissipated, spent on litigation costs or otherwise. Similarly, other remedies the SEC might seek in a settlement, such as an officer and director bar, will be likewise delayed until after the trial.

Finally, the government does not have a stellar win-loss record at trial, particularly in complex financial fraud cases. The Justice Department has faced several recent losses in cases coming out of high-profile financial crisis and FCPA investigations. While the SEC appears to fare a little better, it too has faced significant defeats. Indeed, in the above-referenced *Citigroup* case that triggered much of the current debate, the SEC filed a simultaneous litigated action against Brian Stoker, the Citigroup employee alleged to have had primary responsibility for structuring the CDO's at issue. Following a two-week jury trial in July 2012, Stoker was found not liable.[11] Cases alleging securities fraud are notoriously complex. It is easy for critics to demand the SEC take a harder line, but threatening to put these cases in front of a jury, particularly when the facts and law are murky, may not be the panacea the public seems to think.

How Will Admissions Help?

Given the tremendous disincentives for corporate actors to enter a settlement in which they admit wrongdoing, and the tremendous downsides for the SEC (and the investors whose interests it represents) in taking cases to trial, one has to ask: What is the benefit that an admission will supposedly deliver? The answer is, frankly, not much.

Criticism of the SEC's neither-admit-nor-deny policy has been primarily based on the premise that a settled action without admissions fails to provide the investing public with the truth about what may have transpired. But SEC settlements generally do a thorough job of laying out exactly what the Enforcement Division believes the evidence can establish. The Citigroup complaint deemed inadequate by Judge Rakoff included 16 pages of detailed allegations about the collateralized debt obligations at issue and what the SEC believed rendered the sale of those instruments fraudulent.[12] SEC settlements are filed only after the Enforcement Division has completed an extensive investigation, which in the case of a complex financial fraud case can typically last several years and involve testimony by numerous witnesses and the review of millions of pages of documents. Settling defendants have an opportunity to review the pleadings before they are filed, and have the option of rejecting the settlement and litigating if they believe the allegations are unfounded. As a practical matter, it seems highly unlikely that a member of the investing public reading the SEC's complaint does not

Kmart CFO liable for fraud, court ordered over $10 million in disgorgement and penalties, but denied SEC's request for officer and director bar).

[11] *See* Litig. Release, SEC, *Brian Stoker Found Not Liable* (November 21, 2012), *available at* http://www.sec.gov/litigation/litreleases/2012/lr22541.htm. In another high profile financial crisis case filed by the SEC against the principals of a mutual fund which collapsed in 2008, the jury found one defendant not liable on all counts, and the other not liable on all but a negligence claim. *See* Nathaniel Popper & Jessica Silver-Greenberg, *Money-Market Pioneer and Son Cleared of Fraud*, N.Y. Times (November 2012, 2012), *available at* www.nytimes.com/2012/11/13/business/bruce-bent-sr-and-son-cleared-of-fraud-charges.html.

[12] Moreover, the SEC simultaneously filed a litigated action against the above-referenced Citigroup employee, as well as a settled administrative proceeding against Credit Suisse Alternative Capital (which had participated in structuring the CDOs sold by Citigroup), with those pleadings providing extensive additional details about the case and Citigroup's actions. *See* Press Release, SEC, *Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market* (October 19, 2011), *available at* http://www.sec.gov/news/press/2011/2011-214.htm.

have a clear understanding of exactly what the SEC believes to have happened, regardless of whether or not the defendant admits the allegations.

Moreover, the perception that a settlement without an admission is a mere slap on the wrist is misguided. The mere filing of an enforcement action has significant collateral consequences. Chair White's letter to Senator Warren highlights the findings of several published studies, which concluded that most companies sued by the SEC suffer significant stock drops, and most individual defendants end up fired.[13] And the reputational damage in the Internet age is significant; anyone who settles with the SEC will be named in a public release on the SEC's website, which will usually be among the first links returned by a Google search for that individual for years to come.

Demanding admissions may in fact turn out to be counter-productive, providing even less information to the public about the underlying conduct. In those cases where a defendant is still willing to settle even if an admission is required, counsel will no doubt push hard to narrow the factual allegations and the legal claims and have them framed in terms least likely to open the defendant up to collateral liability in other actions. The SEC staff, faced with a choice between a settlement that includes the coveted admissions and taking a complex and risky case to trial, will be hard-pressed not to accede to a narrower complaint and move on to the next investigation. At the same time, the new need to negotiate on a case-by-case basis whether an admission is required will further slow an already painstaking process and consume additional SEC staff resources. The pace of SEC investigations was one of the factors that led Congress to impose a 180-day deadline between when the Enforcement staff notifies a party of its decision to recommend an enforcement action to the Commission and when the case is actually filed.[14] As it stands, the staff frequently needs to seek extensions from the Director of Enforcement as settlement negotiations drag on. Adding one more settlement term to negotiate – and one which defendants will find among the most important – will only extend the time lag between the misconduct and the SEC's public disclosure of its findings.

Moreover, once the SEC creates a regime where there are two tiers of settlements – those that include admissions and those that don't – it runs the risk that the more typical settlements, in which defendants continue to neither admit nor deny the allegations, are trumpeted publicly by the parties and their counsel as somehow less egregious. Currently, all settlements are essentially created equally, and anyone sued by the SEC must incur the reputational harm that an enforcement action necessarily brings. That may change once a defendant has the ability to point out (at least in terms that don't run afoul of the requirement that a settling party neither admit *nor deny* the allegations) that his alleged misconduct was deemed by the SEC not to be egregious because he was not compelled to admit liability.

Finally, underlying much of the impetus for addressing the neither-admit-nor-deny policy is the incorrect perception that the SEC is unwilling or unable to litigate cases. In reality, the majority of SEC enforcement actions are filed with at least one party litigating; as of May 2012, 75 percent of the SEC's financial crisis-related cases against individual executives were filed as litigated actions.[15] While most cases will settle before reaching trial (as is the case with all civil litigation, both private and governmental), if the concern is that the SEC is too willing to quickly settle cases rather than take them to court, the concern seems to be misplaced.

What Happens Next

The new policy pronouncements from Chair White and the Enforcement Division leadership are just the beginning of a process that will roll out over time. At the moment, it is hard to project exactly how far-reaching the change will be in reality. If, as suggested by the SEC, admissions will be required only in the most egregious of cases, the change may not be terribly significant. Indeed, in January 2012, then-Director of the Enforcement Division Robert Khuzami announced a change to the settlement policy under which defendants who admitted culpability in related criminal proceedings could not settle with the SEC on a non-admit basis.[16] As cases with parallel criminal action typically represent the most egregious violations, it remains unclear how many additional SEC cases – i.e. ''egregious'' cases without a parallel criminal proceeding – will be affected by the new policy.

Nonetheless, given the relative fanfare with which the new policy has been rolled out, and the scrutiny the revised policy will receive in the eyes of Congress and the courts, it seems likely that the scope of actions in which admissions are demanded as a condition of settlement will noticeably expand. While the new Chair undoubtedly acted with the best of intentions, and only in the face of mounting public pressure, the SEC has unfortunately moved in a dangerous direction that could have monumental implications for the agency's ability to fulfill its core mission of protecting investors.

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[13] *See* Letter from Mary Jo White to Elizabeth Warren (June 10, 2013), *available at* www.thinkprogress.org/wp-content/uploads/2013/06/WARREN-Settling-Enforcement-Action-ES144264-Response.pdf, at fn 1.

[14] Dodd-Frank Wall Street Reform and Consumer Protection Act § 929U(a).

[15] *See* Robert Khuzami, SEC, *Testimony on ''Examining the Settlement Practices of U.S. Financial Regulators''* (May 17, 2012), *available at* http://www.sec.gov/news/testimony/2012/ts051712rk.htm.

[16] *See* Robert Khuzami, SEC, *Public Statement By SEC Staff: Recent Policy Change* (January 7, 2012), *available at* http://www.sec.gov/news/speech/2012/spch010712rsk.htm.

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