LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

SEC's Guilt Admission Policy May Bring Pricey Trials

Law360, New York (July 03, 2013, 1:40 PM ET) -- In a significant change of policy, newly appointed U.S. Securities and Exchange Commission Chairwoman Mary Jo White announced recently that, in certain cases, the SEC would require defendants to admit to wrongdoing or else face trial.

This is a potentially drastic and far-reaching departure from the SEC's long-standing practice of utilizing "neither admit nor deny" settlements, which allow companies and individual defendants to resolve enforcement actions without having to make admissions that could subject them to potential collateral criminal or civil liability and other adverse consequences.

The SEC's policy change comes in the wake of judicial and congressional pressure for the SEC to demand increased accountability from large corporations. While the extent to which the SEC plans to implement this new policy remains unknown, it could have broad implications, both for investors and for those facing SEC enforcement actions.

Past Practice of Permitting "Neither Admit Nor Deny" Settlements

Historically, "neither admit nor deny" provisions were standard in settlement agreements with the SEC. In fact, the SEC acknowledged that nearly all of the largest injunctive consent judgments proposed by the SEC in 2010 and 2011 included "neither admit nor deny" provisions.[1]

If defendants were required to admit that they violated the law as a condition of settlement, they could be exposed to collateral consequences, including criminal prosecution or liability in related civil litigation, federal debarment, and possible denial of insurance coverage or indemnification rights.

Defendants would often choose to litigate against the SEC rather than confront such potentially draconian consequences of admitting fraud in an SEC settlement.

Traditionally, the SEC has relied on "neither admit nor deny" settlement agreements to facilitate speedy resolution of enforcement actions. Just last year, Robert Khuzami, then-director of the SEC's Division of Enforcement, defended the practice of using "neither admit nor deny" settlements in a hearing before the House committee on financial services.[2]

In his May 12, 2012, testimony, Khuzami stressed that "neither admit nor deny" settlements protected investors while also holding violators accountable.[3] He noted that resolving enforcement actions quickly through settlement not only ensured recovery for investors, but also communicated to potential violators that there would be immediate and certain consequences for their actions.[4] Khuzami also noted that the time and resources that the SEC would expend to take matters to trial could be better used in "stopping the next fraud."[5]

Judicial and Congressional Pressure on the SEC to Seek Admissions

In the wake of the financial crisis, however, both Congress and the courts have increasingly scrutinized the SEC's practice of allowing "neither admit nor deny" settlements.

In 2011, Judge Jed Rakoff, who sits in the U.S. District Court for the Southern District of New York, rejected a $285 million settlement agreement between Citigroup and the SEC because it contained a "neither admit nor deny" provision.[6]

Judge Rakoff expressed his concern that wrongdoers would view settlement with the SEC as a "cost of doing business" with little connection to "where the real truth lies," and noted that the settlement in question was "pocket change" to a company like Citigroup.[7] He noted that although the settlement might serve the parties' interests, it did not serve the public interest of establishing the underlying facts of the case.[8] Judge Rakoff then ordered the parties to prepare for trial.

The Second Circuit has since questioned Judge Rakoff's decision. In granting a motion to stay the proceedings in the district court pending appeal, the Second Circuit noted that the SEC and Citigroup were likely to succeed on the merits of their appeal.[9] Specifically, the Second Circuit questioned "the district court's apparent view ... that the public interest is disserved by an agency settlement that does not require the defendant's admission of liability," noting that "[r]equiring such an admission would in most cases undermine any chance for compromise."[10]

Despite the Second Circuit's critical analysis of Judge Rakoff's reasoning, another district judge in the Southern District of New York recently followed Judge Rakoff's lead. Noting that the issue of whether a judge could reject a settlement agreement based on a "neither admit nor deny" provision was unresolved in the Second Circuit, Judge Victor Marrero conditionally approved a $602 million settlement in a case involving an alleged insider-trading scheme.[11]

Judge Marrero held that if the Second Circuit determines that district court judges must accept settlement agreements containing "neither admit nor deny" clauses, his order would become final.[12] If the Second Circuit gave district court judges the discretion to challenge such settlements, however, Judge Marrero indicated that he had serious concerns about the "neither admit nor deny" provision in a case of such magnitude.[13]

Echoing Judge Rakoff's reasoning in the Citigroup case, Judge Marrero noted that the fact the defendants decided to spend $602 million to settle the case rather than spend $1 million to litigate strongly suggested that they were culpable, and that it would benefit the public to require them to admit as much.[14]

In a recent case before the U.S. District Court for the District of Colorado, Judge John Kane rejected an SEC settlement in a case involving an alleged $15 million Ponzi scheme. In his order, Judge Kane noted, "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."[15]

Judge Kane eventually approved an amended settlement agreement, but only after several of the defendants filed an answer admitting many of the allegations.[16] Several courts in other districts have also questioned SEC settlements containing "neither admit nor deny" clauses.[17]

The SEC has also faced pressure from Congress to reevaluate its policy of allowing "neither admit nor deny" settlements. Earlier this year, at her first hearing in office, Sen. Elizabeth Warren, D-Mass., questioned former SEC Chairwoman Elisse Walter about the number of times that she had taken a Wall Street bank to trial.[18] After Walter couldn't immediately provide a number, Warren expressed the concern that "too big to fail" had become "too big for trial."[19]

Following up on her questions at the Senate hearing, Warren recently wrote to White (who took office April 10, 2013) to ask her to forward "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."[20]

Warren added her own sentiment that "if a regulator reveals itself to be unwilling to take large financial institutions all the way to trial — either because it is too timid or because it lacks resources — the regulator has a lot less leverage in settlement negotiations and will be forced to settle on terms that are much more favorable to the wrongdoer."[21]

White responded that she was "actively reviewing the scope of the commission's neither-admit-nor-deny settlement policy with the leadership of the Division of Enforcement to determine what, if any, changes may be warranted, and whether the SEC is making full appropriate use of its leverage in the settlement process."[22] One week later, White announced that the SEC would require admissions in certain cases.[23]

Implications of the SEC's New Policy

The scope of the SEC's announced policy change is not yet clear. The SEC has not enunciated criteria for when it will require admissions as a condition of settlement. Instead, the SEC will consider evolving factors such as the "egregiousness" of the offense and the amount of harm to investors.

An internal June 17 memo distributed to the Enforcement Division suggests that the SEC will seek admissions in cases where "the defendant engaged in egregious intentional misconduct; or when the defendant engaged in unlawful obstruction of the commission's investigative processes."

White also noted in remarks at a Wall Street Journal CFO Network event that "to some degree, it can turn on how much harm has been done to investors, how egregious is the fraud. So I think you will see going forward some change in that space." White emphasized that "neither admit nor deny" clauses will continue to be a "major, major tool in the arsenal" and would still be used in the "majority" of cases.

As there is no real clarity as to how and when the new policy will be used, the potential impact the policy may have on pending and future investigations is unclear. Defense counsel will be closely monitoring the number and types of cases in which the SEC exercises its discretion to seek admissions in the coming months. Overbroad application of the new policy by zealous enforcement attorneys inevitably will result in a drastic increase in contested enforcement litigation, often against well-funded and motivated defendants.

Even worse, the enforcement staff could use the threat of forcing an admission of fraud in weaker cases as leverage to bargain for other, more favorable settlement terms. Defendants, facing a myriad of adverse collateral consequences, may often have little choice but to defend themselves fully in enforcement litigation or administrative proceedings.

Given the SEC's finite resources, the possibility of more trials resulting from application of the new policy could significantly limit the number of enforcement actions that the SEC pursues each year. At the end of the day, this new policy could mean expensive trials, delayed payment to investors and fewer enforcement actions going forward.

If the SEC's new policy was the result of congressional or judicial displeasure with the agency's settlements with Wall Street institutions, its bringing fewer enforcement cases or losing several high-profile trials would be far more damaging to the SEC enforcement program than allowing the "neither admit nor deny" settlements.

—By Thomas A. Zaccaro, Edward Han and Rachana N. Fischer, Paul Hastings LLP

Thomas Zaccaro is a partner in Paul Hastings' Los Angeles office. Edward Han is a partner in the firm's San Francisco and Palo Alto, California, offices. Rachana Fischer is an associate in the Palo Alto office.

Kevin Ahlstrom, a summer associate at Paul Hastings, assisted with the research for this article.

[1] Testimony on "Examining the Settlement Practices of U.S. Financial Regulators" by Robert Khuzami at note 21 (available at http://www.sec.gov/news/testimony/2012/ts051712rk.htm).

[2] Id.

[3] Id.

[4] Id.

[5] Id.

[6] SEC v. Citigroup Global Mkts. Inc., 827 F. Supp. 2d 328, 335 (S.D.N.Y. 2011).

[7] Id. at 333-34.

[8] Id. at 335.

[9] SEC v. Citigroup Global Mkts., Inc., 673 F.3d 158, 169 (2d Cir. 2012).

[10] Id. at 165.

[11] SEC v. CR Intrinsic Investors, LLC, No. 12 Civ. 8466 (VM), 2013 U.S. Dist. LEXIS 55165, at *37-38 (S.D.N.Y. Apr. 15, 2013).

[12] Id. at *13.

[13] Id. at *23.

[14] Id. at *23-24.

[15] Order in SEC v. Bridge Premium Fin., LLC, 1:12-cv-02131-JLK-BNB (D. Colo. Jan. 17, 2013).

[16] Order in SEC v. Bridge Premium Fin., LLC, 1:12-cv-02131-JLK-BNB (D. Colo. Mar. 7, 2013).

[17] See, e.g., SEC v. Citigroup Inc., No. 1:10-cv-1277 (D.D.C Aug. 17, 2010); SEC v. Koss Corp., No. 2:10-cv-00747-RTR (E.D. Wis. Dec. 20, 2011).

[18] Wall Street Reform: Oversight of Financial Stability and Consumer and Investor Protections: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 113th Cong. (Feb. 14, 2013).

[19] Id.

[20] Letter from Senator Elizabeth Warren to Sec Chairman Mary Jo White (May 14, 2013) (available at http://www.warren.senate.gov/documents/LtrtoRegulatorsre2-14-13hrg.pdf).

[21] Id.

[22] Letter from SEC Chairman Mary Jo White to Senator Elizabeth Warren (June 10, 2013) (available at http://thinkprogress.org/wp-content/uploads/2013/06/WARREN-Settling-Enforcement-Action-ES144264-Response.pdf).

[23] The two current nominees to the Securities and Exchange Commission have also since expressed their support for the SEC's new policy of requiring admissions in certain cases during their June 27, 2013 confirmation hearing before the Senate Banking Committee.