New York City Bar Association
Committee on Securities Litigation
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SEC v CITIGROUP

On November 28, 2011, Judge Jed S. Rakoff of the United States District Court for the Southern District of New York handed down an important and controversial opinion rejecting a settlement between the Securities and Exchange Commission ("SEC") and Citigroup Global Markets Inc. ("CGMI") on the grounds that it failed to adequately serve the greater public interest.[1] In rejecting the settlement, Judge Rakoff broke with longstanding judicial deference to SEC settlements and challenged some of the fundamental assumptions behind the SEC's approach to enforcement of the securities laws against ongoing businesses and financial institutions. The SEC, viewing the ruling as an infringement on its enforcement powers and discretion, has appealed Judge Rakoff's decision to the Second Circuit. The Second Circuit, in turn, has stayed the case while it considers the serious questions presented by the appeal, ruling that the parties had a high likelihood of success on the merits.[2] The Second Circuit panel expressed its skepticism about a number of Judge Rakoff's conclusions, but it is likely that a different panel – not bound by this preliminary decision – will hear the appeal on the merits.

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1 *SEC v. Citigroup Global Markets Inc.*, No. 11 Civ. 7387(JSR), 2011 WL 5903733 (S.D.N.Y. Nov. 28, 2011) ("*Op.*").

2 *SEC v. Citigroup Global Markets Inc.*, 673 F.3d 158 (2d Cir. 2012) ("*2d Cir. Op.*"). The Second Circuit panel appointed *amicus* counsel to defend the decision below, in light of the fact that both parties were appealing. *Id*. at 161.

This Report discusses the issues raised by Judge Rakoff's groundbreaking opinion and the potential impact of that opinion if it is upheld by the Second Circuit.[3]

I. <u>SEC Settlements</u>: The SEC for many years has resolved enforcement proceedings – both suits in District Court and administrative proceedings – by bringing settled cases, that is, cases in which the settlement is worked out after an investigation but before the commencement of the action. Settled cases are unquestionably a large and necessary part of how the SEC deploys its finite enforcement resources. The SEC settles, on average, about 680 enforcement cases a year in federal court, and generally a similar number in administrative proceedings.[4] By contrast, no more than perhaps 15 to 20 such cases a year go to trial.[5] The SEC has consistently maintained that it lacks the enforcement resources to litigate more than a small percentage of the cases it investigates. Settled cases, as well as settlements reached after the initiation of litigation, are thus critical to the SEC's current enforcement structure.

The SEC argues that it has litigated more "core" cases arising from the 2008 financial crisis:

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[3] At least one other district judge, prior to the Second Circuit panel decision, required the SEC to show why settlements should be approved under the standard set forth by Judge Rakoff, *see SEC v. Koss Corp.,* No. 11-C-991-RTR (E.D. Wis. Dec. 20, 2011) (letter to parties), before approving the settlement, *see* http://www.sec.gov/litigation/litreleases/2012/lr22279.htm. In another case, the district judge raised similar questions at a settlement hearing and invited the parties to make further submissions. *See SEC v. Cioffi*, No. 08-CV-02457(FB) (E.D.N.Y. Feb. 13, 2012) (transcript at 10-16). The court, after reviewing the Second Circuit's opinion in *Citigroup*, ultimately upheld the settlement, expressing concern with the adequacy of the available statutory remedies but concluding that there was "no evidence of either collusion or coercion" and SEC recovery of "a sizeable percentage of the outer limits the SEC could reasonably have expected to recover from a verdict in its favor." *See SEC v. Cioffi*, No. 08-CV-02457(FB), 2012 WL 2304274, at *8-9 (E.D.N.Y. June 18, 2012).

[4] *See* Dr. Max Gulker, Dr. Elaine Buckberg & Dr. James A. Overdahl, NERA Economic Consulting, *SEC Settlements Trends: 2H11 Update*, at 1 (January 23, 2012), *available at* http://www.securitieslitigationtrends.com/PUB_SEC_Trends_2H11_0112.pdf ("*NERA 2H11 Update*"); Jan Larsen with Dr. Elaine Buckberg and Dr. Baruch Lev, NERA Economic Consulting, *SEC Settlements: A New Era Post-SOX*, at 5, 7 (Nov. 10, 2008), *available at* http://www.securitieslitigationtrends.com/Settlements_Report.pdf ("*Post-SOX*").

[5] *See* Peter Schroeder, *Lawmakers to Press SEC to Change Rules on Settlements for Wrongdoing,* The Hill, Jan. 2, 2012, *available at* http://thehill.com/blogs/on-the-money/banking-financial-institutions/201915-lawmakers-to-press-sec-to-change-rules-on-settlements-for-wrongdoing.

> [I]n the cases that the SEC identifies as core financial crisis cases, we filed unsettled actions against 40 of the 55 (70 percent) of the individuals charged . . .. Similarly, we filed unsettled actions against 11 of the 26 (42 percent) of the entities we charged — eight of which we did not litigate against because they were bankrupt, defunct or no longer operating.[6]

Until 1990, the SEC was authorized to seek monetary penalties only in insider trading cases. That authority was expanded with the Securities Enforcement Remedies Act of 1990, which allowed the SEC to sue in district court for penalties for a much broader array of violations of the securities laws.[7] In 2002, the Sarbanes-Oxley Act added the "Fair Funds" provision, which allows the SEC to distribute the penalties it collects to harmed investors.[8] Maximum penalties have increased significantly since the passage of Sarbanes-Oxley.[9] From 2002 to 2006, for example, the SEC recovered $8 billion for "Fair Funds" distributions to shareholders.[10]

Around half of SEC settlements include a monetary penalty, around 59% in the case of settlements with companies rather than individuals.[11] A 2008 study found that these payments in the aggregate consist 43% of disgorgement, and 57% of civil penalties.[12] The same study found that these penalties are not ordinarily large in comparison to the corporate defendants, with

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[6] SEC Enforcement Director's Statement on Citigroup Case, No. 2011-265, dated December 15, 2011, *available at* http://sec.gov/news/press/2011/2011-265.htm

[7] Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, §§ 302, 402, 104 Stat. 931, 945, 949-50.

[8] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745, 784-85 (codified at 15 U.S.C. § 7246.).

[9] *Post-SOX*, at 2.

[10] See SEC, 2006 *Performance & Accountability Report* 23 (Nov. 2006).

[11] *NERA 2H11 Update*, at 7.

[12] *Post-SOX*, at 9.

86.8% of settlements being for less than 1% of the company's market capitalization.[13] A policy statement publicly issued by the SEC in 2006 enumerated a series of factors the SEC would consider in imposing penalties on public companies, including consideration of the fact that the penalties are ultimately borne, in the case of public companies, by innocent shareholders.[14] The SEC is not, however, authorized to recover damages suffered by investors.

The SEC has long entered into settlements in which the defendant admits no wrongdoing.[15] Since 1972, the SEC has embodied, in a regulation, a policy prohibiting settling defendants from *denying* the charged conduct.[16] Until Judge Rakoff began challenging this practice, it had largely been accepted by long usage without question by the federal judiciary.

II. <u>The SEC's Allegations and the Settlement</u>: Judge Rakoff's decision rejected a settlement arising from one of a series of enforcement actions the SEC has brought – including against a number of major financial institutions – arising from the collapse of the market for mortgage-backed securities and related securities in 2007-08. In short, the SEC alleged that the offering materials for a collateralized debt obligation ("CDO") mischaracterized the underlying assets as having been selected by an independent collateral manager.[17] The SEC alleged that, instead, the assets were selected by CGMI personnel and signed off on by the collateral manager without alteration, while CGMI retained credit default swaps that effectively constituted a short

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13 *Post-SOX*, at 14.

14 *See* Statement of the Securities and Exchange Commission Concerning Financial Penalties, No. 2006-4 (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm

15 *See SEC v. Vitesse Semiconductor Corp.*, 771 F. Supp. 2d 304, 308 (S.D.N.Y. 2011).

16 *See* 17 C.F.R. § 202.5(e).

17 Complaint in No. 11-CV-7387, *SEC v. Citigroup Global Markets Inc.* (S.D.N.Y.) ("SEC Cpl.") ¶¶ 2, 20, 39-46.

position in the bulk of the assets in the CDO.[18] The complaint asserted claims under Section 17(a)(2) & (a)(3) of the Securities Act of 1933,[19] neither of which requires proof of fraudulent intent, and neither of which is enforceable by private litigants.[20] No claims requiring proof of intentional fraud were asserted by the SEC. The SEC alleged that investors in the CDO had lost "several hundred million dollars" – estimated in its motion papers at around $700 million – while CGMI earned net profits of at least $160 million on the transaction. The allegations were similar, though not identical, to those brought by the SEC in other settled actions against major financial institutions, some of which were settled on materially different terms.

Under the terms of proposed settlement, CGMI would be required to (1) pay $285 million, consisting of $160 million in disgorgement and a $95 million civil penalty; (2) agree to a series of "remedial undertakings," primarily stricter procedures for internal review of marketing materials for mortgage-backed securities; and (3) submit to an injunction against further violations of the securities laws. As is typical, CGMI would not be required to admit any of the SEC's allegations, but would be barred from denying them publicly.

In response to questions raised by Judge Rakoff, both the SEC and CGMI submitted briefs defending the settlement, and appeared at a hearing, but neither party submitted any evidence relating to the facts underlying the SEC's allegations.[21] The SEC has taken the position

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[18] SEC Cpl. ¶¶ 2, 19-27, 31-36.

[19] SEC Cpl. ¶¶ 64-65

[20] *See Aaron* v. *SEC*, 446 U.S. 680, 695-97 (1980).

[21] SEC's Memorandum of Law dated November 7, 2011 in response to questions proposed by the Court regarding proposed settlement Docket No. 21 (filed Nov. 7, 2011) in No. 1:11-cv-07387-JSR. ("SEC Br."); Memorandum on Behalf of Citigroup Global Markets Inc. In Support of the Proposed Final Judgment and Consent, Docket No. 25 (filed Nov. 7, 2011) in No. 1:11-cv-07387-JSR.

that its allegations constituted "findings" of its "investigation" and should be treated by the public as true, despite having no legal significance and not being reviewed by the court.[22]

III. **Judge Rakoff's Decision:** Judge Rakoff's opinion rejecting the settlement rested on four main points: (1) that the court was entitled to consider whether the settlement served the public interest; (2) that the court could not sign off on a continuing injunction; (3) that the public interest was not served by a settlement in which no facts were admitted, denied or otherwise conclusively established; and (4) that the monetary remedies in the settlement were insufficient to compensate investor losses. The Second Circuit panel's preliminary responses to these points are discussed below as well.

1. *Standard of Review*. The Court discussed at length the standard that U.S. District Courts should apply when reviewing and approving settlements in SEC enforcement matters. The SEC argued that the "scope of review of an SEC consent judgment presented to a District Court for approval and review is limited."[23] The SEC explained that a court should approve a settlement in an SEC enforcement action unless it is "unfair, inadequate or unreasonable," and not separately evaluate whether a settlement is in the "public interest." Judge Rakoff rejected this position, concluding that "a court cannot grant the extraordinary remedy of injunctive relief without considering the public interest."[24] Also rejected was the SEC's fall-back position that "if the public interest must be taken into account, the SEC is the sole determiner of what is in the public interest in regard to Consent Judgments settling SEC cases."[25] The Court rather found

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[22] SEC Enforcement Director's Statement on Citigroup Case, No. 2011-265, dated December 15, 2011, *available at* http://sec.gov/news/press/2011/2011-265.htm

[23] SEC's Memorandum of Law dated November 7, 2011 in response to questions proposed by the Court regarding proposed settlement ("SEC Br."), at 4.

[24] *Op.*, 2011 WL 5903733, at *2.

[25] *Op.*, 2011 WL 5903733, at *3.

that before it determines whether a proposed Consent Judgment is adequate, it must inquire whether the settlement is "adequate for what purpose?"[26] That answer, according to Judge Rakoff, is that at least in part, the settlement must be adequate to ensure that the public interest is protected."[27]

The Second Circuit panel did not expressly state what it thought should be the proper standard of review, but faulted Judge Rakoff for not giving "deference to the S.E.C.'s judgment on wholly discretionary matters of policy" and took the view that he had "misinterpreted" the cases on subjecting orders containing injunctive relief to "public interest" scrutiny:

> We understand those rulings to stand for the proposition that when a court orders injunctive relief, it should ensure that injunction does not cause harm to the public interest. The district court did not suggest that any aspect *of the injunctive provisions* of the settlement would harm the public interest in any way. What the court found contrary to the public interest was not the terms of the injunction, but rather the fact that the parties had settled on terms that did not establish Citigroup's liability for the benefit of civil claimants against it.

2d Cir. Op., 673 F.3d at 163 & n. 1 (emphasis in original). The Second Circuit panel commented that the public interest factors to be considered by the SEC represented "precisely the factors that the Supreme Court has recognized as making a discretionary agency decision unsuitable for judicial review." *Id.* at 164. "It is not . . . the proper function of federal courts to dictate policy to executive administrative agencies . . . While we are not certain we would go so far as to hold that under no circumstances may courts review an agency decision to settle, the scope of a court's authority to second-guess an agency's discretionary and policy-based decision to settle is at best minimal." *Id.* at 163-64.

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[26] *Op.*, 2011 WL 5903733, at *3.

[27] *Op.*, 2011 WL 5903733, at *3.

2. *Injunction*. During oral argument, Judge Rakoff questioned the Commission on why it had so infrequently sought contempt orders when defendants violate injunctions and whether, consequently, the Court should impose an injunction here on top of prior injunctions courts have imposed previously against the same defendant in SEC enforcement actions.[28] The Court found the "injunctive power of the judiciary is not a free-roving remedy to be invoked at the whim of a regulatory agency, even with the consent of the regulated. If its deployment does not rest on facts – cold, hard, solid facts, established either by admissions or by trials – it serves no lawful or moral purpose and is simply an engine of oppression."[29] In sum, the Court found that, particularly in light of the financial turmoil over the past few years, "the SEC, of all agencies, has a duty, inherent in its statutory mission, to see that the truth emerges; and if it fails to do so, this Court must not, in the name of deference or convenience, grant judicial enforcement to the agency's contrivances."[30]

The Second Circuit panel did not address the issue of the SEC's uses of the contempt power, but criticized the view that the court had an obligation to require a public accounting of the facts of particular cases:

> The district court's reasoning was that the settlement must be deemed to be either insufficiently onerous or excessively onerous unless the liability of Citigroup had been either proved or disproved at trial or one side or the other had conceded the issue. This is tantamount to ruling that in such circumstances, a court will not approve a settlement that represents a compromise. It is commonplace for settlements to include no binding admission of liability. A settlement is by definition a compromise. We know of

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[28] Tr. of Hearing Nov. 9, 2011 ("Tr."), at 17-23. The Eleventh Circuit has recently expressed the related view that what it deems "obey the law injunctions" against future violations of antifraud laws exceed the power of district courts under Rule 65 of the Federal Rules of Civil Procedure by virtue of failing to give adequate notice of the conduct that would violate the injunction. *See SEC v. Goble*, 682 F.3d 934, 948-52 (11th Cir. 2012).

[29] *Op.*, 2011 WL 5903733, at *6.

[30] *Op.*, 2011 WL 5903733, at *6.

> no precedent that supports the proposition that a settlement will not be found to be fair, adequate, reasonable, or in the public interest unless liability has been conceded or proved and is embodied in the judgment. We doubt whether it lies within a court's proper discretion to reject a settlement on the basis that liability has not been conclusively determined.

2d Cir. Op., 673 F.3d at 166 (footnote omitted).

3. "*Neither Admit Nor Deny.*" Judge Rakoff again challenged the SEC's decades-old practice of entering into settlements in which defendants "neither admit nor deny" allegations. He challenged the SEC to explain whether, when it makes serious allegations of misconduct, defendants should be forced to admit to the conduct in question. The SEC responded that "neither admit nor deny" settlements were appropriate essentially because they serve as a compromise, creating a scenario in which defendants are willing to consent to important relief and thus allowing the SEC to devote to other matters resources that it otherwise would have to spend litigating the case. The SEC also argued that "neither admit nor deny" settlements made sense because defendants were precluded from denying publicly, other than in the context of further litigation, the SEC's allegations. Judge Rakoff rejected this reasoning, finding the practice instead "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."[31] Consent judgments without any admissions have rather come to be viewed "as a cost of doing business imposed by having to maintain a working relationship with a regulatory agency, rather than as any indication of where the real truth lies."[32] Such a policy therefore serves the interest of the

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[31] *Op.*, 2011 WL 5903733, at *4.

[32] *Op.*, 2011 WL 5903733, at *5.

parties, not the public interest – particularly the "overriding public interest in knowing the truth."[33]

As noted above, the Second Circuit panel found this to be an improper basis for overturning a settlement, commenting that "[w]e doubt whether the absence of proven or admitted liability could justify the refusal to approve the settlement" and emphasizing the record available to the district court. *2d Cir. Op.*, 673 F.3d at 166. The Second Circuit panel also specifically questioned whether the district court had any business assessing whether the settlement was unfair to the defendant, noting its concern with "whether it is a proper part of the court's legitimate concern to protect a private, sophisticated, counseled litigant from a settlement to which it freely consents. We doubt that a court's discretion extends to refusing to allow such a litigant to reach a voluntary settlement in which it gives up things of value without admitting liability." *Id.* at 165.

4. *Monetary Remedies*. Judge Rakoff challenged the SEC to explain why its proposed monetary remedies – $160 million in disgorgement, $30 million in pre-judgment interest, and $95 million for a civil penalty – were appropriate given the SEC's estimate that investor losses amounted to approximately $700 million. The SEC responded that the disgorgement figure was appropriate because it represented the SEC's best estimate of the ill-gotten gains to CGMI from the alleged misconduct, and because disgorgement of ill-gotten gains has been the SEC's approach to monetary remedies for many years. The SEC explained that, generally, it does not seek orders of restitution or damages to make investors whole, but relies, instead, on private litigants to seek those remedies in class action and other private litigation. Judge Rakoff disagreed, objecting to the SEC's failure to propose a plan to return any of the

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[33] *Op.*, 2011 WL 5903733, at *6.

$285 million obtained from CGMI to defrauded investors.[34] The Court also found such a settlement "deals a double blow" to defrauded investors seeking to recover losses in private litigation, since (a) private investors cannot bring securities claims based on negligence, and (b) there is no collateral estoppel based on CGMI's non-admission and non-denial.[35]

The Second Circuit panel "express[ed] no opinion one way or the other" as to whether the monetary relief was adequate – treating that question as within the SEC's enforcement discretion – beyond questioning how it could be both inadequate and burdensome for the defendant. *2d Cir. Op.*, 673 F.3d at 165 & n. 3. It was, however, apparently skeptical of the view that the interests of private litigants were significantly affected, taking the view that its review of the basis for injunctive relief was narrower because – unlike in cases involving structural remedial injunctions in anti-discrimination cases – "the terms of the settlement do not have adverse impact on anyone." *Id*. at 166 n. 5.

IV. Issues Raised: Judge Rakoff's decision raises a number of issues that the Second Circuit will need to grapple with, and that could affect securities enforcement practice and private litigation if the decision is upheld by the Second Circuit. Specifically, the decision (1) raises significant separation of powers issues; (2) could affect the SEC's choices to seek injunctions or file actions administratively rather than in district court; and (3) could potentially affect the usefulness of SEC settlements to private plaintiffs. Additionally, the Second Circuit must consider the possibility that the standards it imposes for review of proposed settlements could affect settlement policies of other government agencies (e.g., antitrust consent decrees). Indeed, the Second Circuit panel explicitly noted the broad reach of these issues:

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[34] *Op.*, 2011 WL 5903733, at *5.

[35] *Op.*, 2011 WL 5903733, at *4-5.

> The challenge by both parties to the district court's order raises important questions. These include the division of responsibilities as between the executive and the judicial branches and the deference a federal court must give to policy decisions of an executive administrative agency as to whether its actions serve the public interest (and as to the agency's expenditure of its resources). They include also the question of a court's authority to reject a private party's decision to compromise its case on the ground that the court is not persuaded that the party has incurred any liability by its conduct.

2d Cir. Op., 673 F.3d at 160.

1. *Separation of Powers*. Judge Rakoff's decision raises a number of questions of fairness and the public interest in the decision to settle SEC enforcement actions. But the threshold question is *who decides* those questions. As noted above, the SEC for many years has accepted settlements in which the defendant does not admit liability, and since 1972 had embodied a policy, set forth in the Code of Federal Regulations, to prohibit defendants from denying liability.[36] Other federal agencies have similar, though not identical, practices.[37] The SEC also has the statutory authority to obtain disgorgement and civil monetary penalties, but does not have the authority to recover damages suffered by investors.[38] Investors, in turn, have

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[36] 17 C.F.R. § 202.5(e) (2010); 37 Fed. Reg. 25,224 (Nov. 29, 1972).

[37] Indeed, at least one district court – ruling prior to the Second Circuit panel decision on the stay – cited Judge Rakoff's opinion as a basis for closer examination of an FTC settlement made without any admission of liability, noting that the settlement "presents similar concerns" and requiring briefing specifically on the question of whether to follow Judge Rakoff's analysis. *See FTC v. Circa Direct LLC*, Civ. No. 11-2172 RMB/AMD, 2012 WL 589560, at *1-2 (D.N.J. Feb. 22, 2012). In another case, the Antitrust Division of the Department of Justice, responding to comments by the AARP and the Public Service Commission of the State of New York (citing Judge Rakoff's opinion) on the settlement of a proceeding challenging a retail electric supplier market, opposed the notion that an antitrust settlement must contain admissions of wrongdoing. *United States v. Morgan Stanley; Public Comments and Response on Proposed Final Judgment*, 77 Fed. Reg. 15,125-02, at 15,128-29 (D.O.J. Mar. 14, 2012). The Justice Department noted that the Clayton Antitrust Act specifically provides that litigated judgments, but not consent decrees, are admissible prima facie evidence of an antitrust violation, and thus "[r]equiring admissions or findings of liability as a prerequisite to entering a consent decree would undercut Congress's purpose and contravene the public interest in allowing the government to obtain relief without the risk and delay of litigation.." *Id.* (*citing* 15 U.S.C. § 16(a)).

[38] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745, 784-85 (codified at 15 U.S.C. § 7246.).

express statutory remedies for securities law violations (including Sections 11 and 12 of the Securities Act and Sections 9 and 18 of the Exchange Act) as well as implied remedies that Congress has long acquiesced in, such as under Section 10(b) of the Exchange Act.

Under this carefully balanced statutory and regulatory scheme, the SEC has substantial prosecutorial discretion in deciding what actions to bring or not bring, whether to bring them as administrative actions or actions in district court, and whether and when to litigate or settle. Indeed, this independent discretion is arguably one of the main purposes of the SEC being established as an independent regulatory agency run by a bipartisan panel of Commissioners with fixed terms, rather than subject to the sort of direct political control that governs the Department of Justice.

There is little question that the political branches have, at least implicitly, approved of this arrangement. Generations of SEC Commissioners appointed by presidents of both parties have signed off on settlements of the type rejected by Judge Rakoff, in reliance on the blessing of generations of federal judges. Congress has repeatedly legislated in the area of SEC enforcement authority, most recently expanding, in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act,[39] the SEC's ability to pursue aiders and abettors of violations of the Securities Act of 1933 and the Investment Company Act of 1940 and to impose civil monetary penalties under the Investment Advisers Act of 1940.[40] In the 2002 Sarbanes-Oxley Act, Congress empowered the SEC to direct its recoveries to shareholders.[41] And it has also returned regularly to the subject of investor remedies, sometimes expanding them (lengthening the statute of

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[39] Pub. L. No. 111-203, § 929Z, 124 Stat. 1376, 1871 (2010).

[40] *Id.* Title IX, sec. 929M, 15 U.S.C. § 80a-47, sec. 929N, 15 U.S.C. § 80b-9 & sec. 929O, 15 U.S.C. § 78-t, 124 Stat. at 1861–62.

[41] *See* 15 U.S.C. § 7246(a).

limitations in 2002, creating new remedies against rating agencies in 2010), sometimes imposing limits (imposing pleading loss causation requirements in 1995 and preempting state law class actions in 1998), sometimes expressly declining to extend to investors causes of action available to the SEC (as when the SEC, but not private investors, was given the express right to sue aiders and abettors in 1995) but at no time altering the SEC's longstanding practices regarding settlement of cases brought in district court. This suggests the approval of the executive and legislative branches over time – or at least the absence of disapproval – of the SEC's approach to settlements, which in turn cautions against a judicial rewriting of the relevant policies.

At the same time, Judge Rakoff viewed the posture of a federal agency seeking federal district court approval of the settlement, and in particular the entry of an ongoing injunction (which at least implicitly involved the court in an ongoing supervisory role over the settlement and the parties), without regard to the public interest or the determination of the underlying facts as an incursion on the judiciary's proper role. The fact of judicial review implies, as Judge Rakoff indicated, that the judiciary must have something to review: some way to distinguish between a good settlement and a bad settlement. Even the Second Circuit panel, in casting doubt on Judge Rakoff's analysis, noted the court's authority to *inquire* before approving a settlement:

> The substantial evidentiary record amassed by the S.E.C. over its lengthy investigation was available to the court, and the S.E.C. did provide information to the court regarding how the evidence supported the proposed consent judgment. See SEC's Memorandum of Law in Response to Questions Posed by the Court Regarding Proposed Settlement, supra, at 16–22. Even assuming the doubtful proposition that a court has authority to demand assurance that a voluntary settlement reached between an administrative agency and a private party somehow reflects the facts that would be demonstrated at a trial, the court was free to assess the available evidence and to ask the parties for guidance as to how the evidence supported the proposed consent judgment.

2d Cir. Op., 673 F.3d at 165-66.

In particular, the entry of an injunction directly implicates the power of the courts, and Judge Rakoff contended that it therefore required a determination of whether that power should be invoked in the public interest.[42] However, if the Second Circuit ultimately agrees with Judge Rakoff that the presence of a request for injunctive relief justifies close scrutiny of the settlement to determine whether it is in the public interest, that may not end the question of what level of judicial scrutiny is required. Judge Rakoff's decision did not significantly criticize the scope of the proposed injunction, other than to note that the SEC has regularly obtained such injunctions without making later use of them.[43] It does not necessarily follow, from considering the public interest in the provisions of the injunction, that the court has plenary power to review *the entire settlement* on the same grounds. The Second Circuit could conclude (as did the stay panel, *2d Cir. Op.*, 673 F.3d at 163 n. 1) that only the injunction – or only a settlement *containing* a proposed injunction – is subject to review for its impact on the public interest. As discussed below, such a rule would give the SEC significant latitude going forward to avoid such review of its settled cases by the expedient of not seeking injunctive relief.

Even if the Second Circuit reverses and rejects Judge Rakoff's view of the standard of review for settled cases, his decision could spur the political branches to rethink the proper balance between encouraging settlements and allowing them to be entered without judicial scrutiny, without any admission of wrongdoing, or without payment to potentially harmed investors. As with many political decisions, this may turn on the political balance of power following the 2012 elections. The House Financial Services Committee held a hearing on the policy on May 17, 2012, at which Robert Khuzami, director of the SEC's Enforcement Division,

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[42] *Op.*, 2011 WL 5903733, at *2-3.

[43] *Op.*, 2011 WL 5903733, at *5.

defended the SEC's approach, and the committee's chairman, Representative Spencer Bachus of Alabama, defended the SEC's posture: "A policy that has judges micromanaging federal agencies in their exercise of enforcement authority and requires the government to engage in lengthy and expensive trials in every instance would not serve the best interests of taxpayers or investors . . . It makes more sense, in my view, to leave the judgment of whether to try a case or attempt to settle largely to the agencies' discretion."[44]

2. *SEC Enforcement Choices*. The decision could have a significant ripple effect on SEC enforcement actions and settlements going forward. The decision might prompt the SEC to alter its decades-old practice of entering into district court settlements in which defendants neither admit nor deny allegations. Following Judge Rakoff's decision, the SEC announced a modest modification of its settlement policy in January 2012: defendants who are convicted of criminal wrongdoing are no longer able to say they "neither admit nor deny" SEC charges stemming from the same conduct.[45] This is similar to the line drawn by Congress in 1995 when it eliminated RICO liability in securities lawsuits, except where the defendant was convicted of a crime. There is, however, as of yet no indication that the SEC is preparing to make any more significant change in its practice.

Rather than alter its own rules, the SEC could choose to alter its enforcement approach in response to a new standard of review. For example, the SEC could elect to forego injunctive relief to avoid a higher standard of review.

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[44] *See* Ian Thoms, *Regulators, Lawmakers Stand By No Admit Settlements*, Law360 (May 17, 2012); Jonathan Hemmerdinger, *Regulators Defend 'No Admit, No Deny' Settlements,* The Bond Buyer (May 18, 2012), available at http://www.bondbuyer.com/issues/121_96/financial-regulators-defend-settling-charges-without-admit-wrong-1039848-1.html.

[45] Edward Wyatt, *S.E.C. Changes Policy on Firms' Admission of Guilt*, N.Y. Times, Jan. 6, 2012, at B1, *available at* http://www.nytimes.com/2012/01/07/business/sec-to-change-policy-on-companies-admission-of-guilt.html.

Alternatively, if the SEC prefers to continue with its current enforcement posture, it may elect to institute enforcement actions administratively, thus avoiding consent judgments presented to a federal court for approval. The Dodd-Frank Act amended the Securities Act and the Exchange Act to allow the SEC to impose civil monetary penalties in cease-and-desist administrative proceedings,[46] thus removing most of the reason for suing in district court if a case is to be settled from the outset. Or, the SEC could simply abandon the practice of seeking injunctive relief, at least in cases to be settled in district court. The desirability of this course of action would depend on two variables: whether the Second Circuit draws a distinction between the standards for reviewing settlements with and without injunctions, and what value the SEC places on structural injunctions requiring corporate defendants to alter their practices going forward.

Finally, the Second Circuit may have to consider the risk that requiring the SEC to present more detailed factual findings even in settled cases may mean more resources are devoted to preparing these findings, potentially leading to fewer enforcement actions being brought, particularly in contested cases against ongoing businesses.

3. *Impact on Private Litigation*. A key theme of Judge Rakoff's opinion was the reality that, in the absence of any factual or legal admissions, a settlement with the SEC is not admissible in evidence in private litigation against a corporate defendant. Moreover, the settlement contained no express provision for compensating potentially harmed investors (a fact the SEC excused by noting the absence of any statutory authority for it to seek damages on behalf of investors).

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[46] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929Z, 124 Stat. 1376, 1871 (2010).

A settlement containing admissions can be of great use to private litigants, eliminating the need to prove essential elements of a cause of action such as scienter, false statements, or materiality. Such admissions rarely cover all the elements of a claim, and thus may not be sufficient to establish liability to plaintiffs who may have difficulty establishing reliance or loss causation, but they can still provide additional settlement leverage or reduce costs of pursuing private suits. Recoveries for the benefit of investors, by contrast, are a double-edged sword for private lawsuits (which could be mooted if most or all damages are recovered by the SEC), but would nonetheless be of value to harmed investors.

The relationship between the SEC and private litigants, most notably private class actions pursuing the implied right of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, has always been ambiguous. The private cause of action is itself implied rather than express in the statute,[47] and the SEC has no statutory authority to make recoveries on behalf of investors, although it does have the authority – added in the Sarbanes-Oxley Act of 2002 – to direct its disgorgement and penalty recoveries to harmed investors through the Fair Funds provisions.[48] On the other hand, investor protection is the SEC's ultimate reason for existence, and it may be incongruous for the SEC to pursue settlements that provide no direct, tangible benefits to investors.

Judge Rakoff's opinion raises a third, related concern: that regardless of their use in private suits, if SEC settlements were required to contain some admissions of fact, the courts would have a better independent basis upon which to distinguish between settlements that impose fair and proportionate penalties for genuine wrongdoing, and those that either (1) let

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[47] *See Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13, n.9 (1971).

[48] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745, 784-85 (codified at 15 U.S.C. § 7246.).

defendants off unduly leniently or (2) coercively impose penalties on defendants who have legitimate defenses but choose to settle with their regulator as a cost of doing business. In the absence of any evidentiary or factual proffer by the SEC or the defendant, the court has – as Judge Rakoff noted – no basis upon which to conduct an independent review, and thus has no realistic choice but to defer to the prosecutorial judgment of the SEC. But despite the potential risks of being coerced into settlements, most corporations prefer to continue entering into no-admit no-deny settlements that do not burden them with admissions in private litigation.

V. Conclusion: Judge Rakoff's decision has drawn greater attention to the longstanding SEC enforcement practice of settling cases with corporate defendants, especially regulated entities with ongoing businesses, without admitting or denying liability. That attention is healthy, even if the judicial and political branches ultimately decide to continue with existing practices, as the Second Circuit panel considering the stay motion clearly preferred to do. These practices raise genuine public policy issues, but also serious questions about whether the courts are the best venue to resolve those issues. The Second Circuit's resolution of the appeal will present a choice to either take judicial ownership of those issues or put the onus back on the political branches to resolve them.