Saul Ewing LLP

WHITE COLLAR AND GOVERNMENT ENFORCEMENT PRACTICE

JANUARY 2012

White Collar Watch

The Newsletter of the White Collar and Government Enforcement Practice

Saul Ewing
White Collar and
Government Enforcement
Practice:

Christopher R. Hall
Chair

Nicholas J. Nastasi
Vice Chair

Court challenges SEC practice of settling cases without defendants admitting or denying allegations

By Nicholas J. Nastasi and Justin B. Ettelson

On November 28, 2011, Judge Jed S. Rakoff of the United States District Court for the Southern District of New York issued an order rejecting the proposed $285 million settlement of the Securities and Exchange Commission's ("SEC") lawsuit against Citigroup Global Markets, Inc. ("Citigroup") wherein the SEC alleged that Citigroup "misle[d] investors about a $1 billion collateralized debt obligation tied to the U.S. housing market in which Citigroup bet against investors as the housing market showed signs of distress." The proposed settlement consisted of $160 million of disgorged profits, $30 million in prejudgment interest, and a $95 million civil penalty, all of which the SEC proposed would be returned to harmed investors. In rejecting the settlement, Judge Rakoff noted the "long hours trying to determine whether, in view of the substantial deference due the SEC, the Court [could] somehow approve [the] problematic Consent Judgment." Ultimately, the Court concluded that it could not "because the Court ha[d] not been provided with any proven or admitted facts upon which to exercise even a modest degree of independent judgment." The Court set a trial date of July 16, 2012.

Judge Rakoff's ruling puts into question what has long been the SEC's practice of settling cases without defendants admitting or denying allegations, a practice employed to settle, among other cases, those related to the collapse of the housing market, including: a $550 million settlement with Goldman, Sachs & Co. ("Goldman") involving allegations that Goldman "misled investors in a subprime mortgage product just as the U.S. housing market was starting to collapse;" a $153.6 million settlement with J.P. Morgan Securities LLC ("J.P. Morgan") involving allegations that J.P. Morgan "misled investors in a complex mortgage securities transaction just as the housing market was starting to plummet;" and an $11 million settlement with Wells Fargo Securities LLC ("Wells Fargo") involving allegations that Wells Fargo "engaged in misconduct in the sale of two collateralized debt obligations tied to the performance of residential mortgage-backed securities as the housing market show[ed] signs of distress in late 2006 and early 2007."

On December 15, 2011, the SEC's Director of the Division of Enforcement, Robert Khuzami, released a statement in which he said that, "In deciding whether to settle, the SEC considers, among other things, limitations under the securities laws" and whether "the applicable

statute…[entitles] the SEC to recover the amount lost by investors." Moreover, said Khuzami, the SEC takes the position that "a settlement puts money back in the pockets of harmed investors without courtroom delay and without the twin risks of losing a trial or winning but recovering less than the settlement amount" and "does not limit the ability of injured investors to pursue claims for additional relief." Of the SEC's settlement practice, Judge Rakoff commented "that a consent judgment that does not involve any admission and that results in only very modest penalties is…viewed, particularly in the business community, 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."

In the present case, the SEC alleged that "Citigroup structured and marketed a CDO called Class V Funding III [(the "Fund")] and exercised significant influence over the selection of $500 million of the assets in the CDO portfolio…then took a proprietary short position against those mortgage related assets from which it would profit if the assets declined in value." Citigroup was charged by the SEC with negligence in violation of Sections 17(a)(2) and (3) of the Securities Act of 1933. The SEC alleged that Citigroup made $160 million in fees and trading profits while investors suffered losses of more than $700 million. In its Memorandum of Law in support of the proposed settlement, the SEC argued that, "The proposed consent judgment…is fair, adequate, and reasonable…and is the product of arm's-length negotiations between sophisticated parties and is therefore entitled to a presumption of reasonableness."

In his order, Judge Rakoff took particular issue with the fact that the SEC, in its original Memorandum in support of the proposed Consent Judgment, "endorsed the standard of review of 'whether the proposed Consent Judgment…is fair, reasonable, adequate, and in the public interest.'" However, in its Memorandum of Law in response to specific questions raised by the Court, the SEC argued that, "while the Consent Judgment must still be shown to be fair, adequate, and reasonable, 'the public interest…is not part of the applicable standard of judicial review.'" The Court reasoned that "the requirement that a consent judgment be in the public interest is not meaningfully severable from the requirements…that the consent judgment be fair, reasonable, and adequate…and that the settlement…be fair 'to the parties and to the public.'" Consequently, the Court held "that the proposed Consent Judgment is neither fair, nor reasonable, nor adequate, nor in the public interest…because it does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any…standards."

The Court was also troubled by the SEC's position "that, because Citigroup did not expressly deny the allegations, the court, and the public, somehow knew the truth of the allegations." In the Court's mind, an allegation "that is neither admitted nor denied" remains an allegation and "has no evidentiary value and no collateral estoppel effect." Consequently, "consent judgments…can not be used as evidence in subsequent litigation." Therefore, the benefit to Citigroup to settle the case "is that it avoids any investors' relying in any respect on the SEC Consent Judgment in seeking return of their losses. If the allegations…are true, this is a very good deal for Citigroup; and, even if they are untrue, it is a mild cost of doing business." The Court found that the only benefit to the SEC was "a quick headline." The Court concluded by holding that:

> a proposed Consent Judgment that asks the Court to impose substantial injunctive relief, enforced by the Court's own contempt power, on the basis of allegations unsupported by any proven or acknowledged facts whatsoever, is neither reasonable, nor fair, nor adequate, nor in the public interest. It is not reasonable, because how can it ever be reasonable to impose substantial relief on the basis of mere allegation? It is not fair, because, despite Citigroup's nominal consent, the potential for abuse in imposing penalties on the basis of facts that are neither proven nor acknowledged is patent. It is not adequate, because, in the absence of facts, the Court lacks a framework for determining adequacy. And, most obviously, the proposed Consent Judgment does not serve the public interest, because it asks the Court to employ its power and assert its authority when it does not know the facts.

On December 15, 2011, the SEC filed an appeal of Judge Rakoff's ruling because it believes that the Court "committed legal error by announcing a new and unprecedented standard that inadvertently harms investors by depriving them of substantial, certain and immediate benefits." The SEC is of the position that such a standard "could in practical terms press the SEC to trial in many more instances, likely resulting in fewer cases overall and less money

being returned to investors." To that end, SEC Chair Mary Schapiro testified to Congress on December 6, 2011, that, "If the SEC does not receive additional resources, many of the issues highlighted by the financial crisis and which the Dodd-Frank Act seeks to fix will not be adequately addressed, as the SEC will not be able to build out the technology and hire the industry experts and other staff desperately needed to oversee and police these new areas of responsibility." Citigroup filed an identical appeal notice on December 19, 2011.

Signaling an apparent shift, albeit limited in scope, in its settlement policy, Khuzami announced on January 6, 2012, that the SEC will no longer settle civil cases without companies admitting or denying the charges when the company admits wrongdoing in a parallel criminal case. According to the SEC, the policy change came "[f]ollowing a review by senior enforcement staff that began [last] spring and…is separate from and unrelated to the recent ruling in the Citigroup case, which does not involve a criminal conviction or admissions of criminal law violations." Said Khuzami, "It…seemed unnecessary for there to be a 'neither admit' provision in those cases where a defendant had been criminally convicted of conduct that formed the basis of a parallel civil enforcement proceeding." In another development, the SEC sought and won on December 17, 2011, a ruling from the Second Circuit Court of Appeals for a temporary stay of the Citigroup case – apparently moments before Judge Rakoff issued a ruling denying the stay on the same date. Motions concerning whether to continue the stay were due to a panel of the Appeals Court on January 17, 2012. We will continue to monitor developments in this case.

Baltimore, MD
500 East Pratt St.
Charles O. Monk, II
410.332.8668

Boston, MA
131 Dartmouth St.
Richard D. Gass
617.723.3300

Chesterbrook, PA
1200 Liberty Ridge Dr.
Michael S. Burg
610.251.5750

Harrisburg, PA
2 North Second St.
Eric L. Brossman
717.257.7570

Newark, NJ
One Riverfront Plaza
Stephen B. Genzer
973.286.6712

New York, NY
400 Madison Ave.
Michael S. Gugig
973.286.6717

Philadelphia, PA
1500 Market St.
Bruce D. Armon
215.972.7985

Princeton, NJ
750 College Rd. E
Marc A. Citron
609.452.3105

Washington, DC
1919 Pennsylvania Ave, NW
Mark L. Gruhin
202.342.3444
Edward R. Levin
202.342.3420

Wilmington, DE
222 Delaware Ave.
Wendie C. Stabler
302.421.6865
William E. Manning
302.421.6868