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SEC ENFORCEMENT

Understanding Recent Changes to the SEC's "Neither Admit Nor Deny" Settlement Policy

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The Securities and Exchange Commission (the "SEC") has for decades incentivized defendants to resolve enforcement charges by allowing them to settle without admitting liability, subject to the condition that they also not publicly deny it. This "neither admit nor deny" policy, which makes settlements more palatable for defendants, has been considered by the SEC to be necessary for efficiency and productivity. However, the policy has recently come under public scrutiny.

On January 6, 2012, SEC Enforcement Director Robert Khuzami announced a change to the policy in cases involving defendants who have been convicted in parallel criminal cases or who have admitted or acknowledged criminal conduct in non-prosecution or deferred prosecution agreements with criminal prosecutors (NPAs/DPAs).[1] In such cases, the SEC will delete the "neither admit nor deny" language from its settlement documents, recite the fact and nature of the criminal conviction or NPA/DPA in those documents, and give the SEC staff discretion to incorporate into them any relevant facts admitted during the plea allocution or set out in a jury verdict form or the NPA/DPA.[2] The new policy retains the SEC's prohibition on denying the SEC's allegations or making statements suggesting that the allegations are without a factual basis.[3]

This policy change does not affect the SEC's "neither admit nor deny" settlement approach in cases without a parallel criminal resolution.[4] The vast majority of SEC cases fit into that unchanged category, including the recently-filed Citigroup case in which US District Judge Jed Rakoff highlighted the "neither admit nor deny" language for a public not ordinarily interested in the intricacies of SEC enforcement policy.

The SEC's Historical Approach and Judge Rakoff's Recent Decisions

The SEC's policy of allowing settlements to specify that the defendant neither admits nor denies wrongdoing was implemented in 1972. The SEC explained that a defendant's refusal to "admit the allegations is equivalent to a denial, *unless the defendant or respondent states that he neither admits nor denies the allegations*" (emphasis added).[5] The SEC therefore will not allow silence that it views as an implicit denial, and defendants have every incentive to resist making affirmative admissions that may be used against them in parallel private litigation.[6] As a result, SEC settlements

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typically include the "neither admit nor deny" language, which serves to satisfy both the SEC's insistence that its allegations not be disavowed and also defendants' desire to argue in subsequent litigation that they are not bound by admissions.

While the SEC can settle administrative actions brought internally without review by an administrative law judge, it must obtain a federal judge's approval to settle an action brought in district court. Most district court judges will sign the proposed final judgments in SEC cases without significant scrutiny, but Judge Jed Rakoff of the Southern District of New York has refused to do so in a string of recent opinions. Instead, he has criticized the "neither admit nor deny" language and created public debate about whether the SEC's policy allows defendants to avoid accepting responsibility for their conduct.

First, in 2009, in *SEC v. Bank of America Corp*., Judge Rakoff required the SEC and the Bank to justify a proposed "neither admit nor deny" settlement that called for an injunction against future violations and a penalty of $33 million for alleged misstatements related to the bank's acquisition of Merrill Lynch.[7] Judge Rakoff took issue with several aspects of the settlement, including that Bank of America neither admitted nor denied liability while at the same time arguing in submissions to the court that its conduct was actually lawful.[8] Judge Rakoff rejected the proposed settlement, in part because the Bank, having not admitted the allegations and having taken the position that its conduct was lawful, "would feel free to issue exactly the same kind of proxy statement in the future."[9] He concluded that injunctive relief forbidding future false or misleading statements would therefore "be a pointless exercise."[10]

In March 2011, in *SEC v. Vitesse Semiconductor Corp*., Judge Rakoff was presented with another "neither admit nor deny" settlement, which he said "raise[d] difficult questions of whether the SEC's practice of accepting settlements in which the defendants neither admit nor deny the SEC's allegations meets the standards necessary for approval by a district court."[11] Rakoff approved the settlement, but only after a recitation of the history behind the SEC's "longstanding policy of settling cases on the basis of neither requiring an admission nor permitting a denial by the defendant"[12] and a critique of those settlements as a "disservice to the public" that, instead of requiring defendants to admit allegations, simply restrict their ability to deny wrongdoing.[13]

Finally, in October, the SEC filed a proposed $285 million "neither admit nor deny" settlement with Citigroup in the Southern District of New York to resolve allegations of misrepresentations related to the attractiveness of certain investments. The case was assigned, no doubt to the SEC's dismay, to Judge Rakoff.[14] Despite the usual "neither admit nor deny" language, Judge Rakoff found "little real doubt that Citigroup contests the factual allegations of the Complaint."[15] As a result, he questioned the settlement and rejected it because "the Court has not been provided with any proven or admitted facts upon which to exercise even a modest degree of independent judgment."[16] He held that without Citigroup admitting to factual allegations, the court lacked a "sufficient evidentiary basis to know whether the requested relief is justified," and concluded that the settlement "is not reasonable, because how can it ever be reasonable to impose substantial relief on the basis of mere allegations? It is not fair, because, despite Citigroup's nominal consent, the potential for abuse . . . is patent. It is not adequate because, in the absence of any 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."[17]

The SEC has sought review of Judge Rakoff's *Citigroup* decision by the US Court of Appeals for the Second Circuit and to stay proceedings in the District Court pending the appeal.[18] Meanwhile, Enforcement Director Khuzami has defended the settlement as "reasonably reflect[ing] the relief the SEC would likely have obtained if it prevailed at trial."[19] He argued

that Judge Rakoff's suggested approach is contrary to legal authority, "inadvertently harms investors by depriving them of substantial, certain and immediate benefits" and "is at odds with decades of court decisions that have upheld similar settlements by federal and state agencies across the country."[20]

Judge Rakoff's decisions have received support from those who believe the SEC is too lenient on corporate defendants and his approach has already been followed by at least one court.[21] Recently, in a case against headphone manufacturer Koss Corporation alleging materially inaccurate financial statements, a judge in the Eastern District of Wisconsin, relying on the *Citigroup* case, refused to endorse a consent decree until the "SEC provide[s] a written factual predicate for why it believes the Court should find that the proposed final judgments are fair, reasonable, adequate, and in the public interest."[22]

The Department of Justice's Approach

Although at times the Department of Justice ("DOJ") has allowed parties to enter into consent decrees that lack admissions of fault,[23] unlike the SEC's policy with respect to civil matters, DOJ generally requires some sort of admission of participation in connection with a guilty plea or grant of leniency to avoid a criminal conviction. In the context of plea agreements, the United States Attorney's Manual specifically says that corporate defendants "should be made to realize that pleading guilty to criminal charges constitutes an admission of guilt and not merely a resolution of an innocent distraction from its business. . . . [P] leas should be structured so that the corporation may not later proclaim lack of culpability or even complete innocence."[24] Even though the Supreme Court has upheld guilty pleas in limited situations where a defendant does not admit wrongdoing—such as so-called *Alford* pleas where a defendant pleads guilty in recognition that there is sufficient evidence of guilt but nonetheless denies wrongdoing[25]—DOJ generally refrains from toeing that constitutional line. Under DOJ's rules, *Alford* pleas are unavailable "except in the most unusual of circumstances and only after recommendation for doing so has been approved by the Assistant Attorney General," and must be followed by a tender of the government's proof of guilt.[26] In fraud cases, DOJ requires that, when possible, an "explicit stipulation of all facts of a defendant's fraud" accompany a plea agreement.[27]

Similarly, DOJ's non-prosecution and deferred prosecution agreements generally contain admissions of violations, as well as provisions: (1) voiding the agreement in the event of breach of the agreement and subjecting the company to prosecution for the violations discussed therein, and (2) authorizing the use of admissions in the agreement for the purpose of prosecuting such claims.[28] If a party breaches its obligations under a non-prosecution or deferred prosecution agreement, DOJ can thus re-initiate the case and use the admissions in the agreement against the company. That ability serves as a deterrent to prevent companies from violating the terms of agreements. It also serves as insurance for DOJ in the event that the company does. By virtue of the admissions, DOJ will have an easier case to prove if the matter moves forward and will have gained an advantage from the settlement even if the settlement failed in all other respects.

Justifications for the Different SEC and DOJ Approaches

The SEC views "neither admit nor deny" language as sometimes necessary to procure settlements from companies. Enforcement Director Khuzami has explained that companies might refuse to settle cases if they were forced to admit unlawful conduct to the SEC "because that might expose them to additional lawsuits by litigants seeking damages."[29] That exposure arises from the significant overlap between the causes of action available to the SEC and those available to private litigants. Judge Rakoff has actually noted—albeit disapprovingly—that the "neither admit nor deny language" prevents private plaintiffs from piggybacking on SEC settlements.[30]

The SEC therefore justifies use of "neither admit nor deny" language by focusing on the practical consideration that it is necessary to facilitate settlements that, although compromise outcomes, conserve resources and eliminate litigation risk.[31] That explanation is not simply an argument that settlements reduce the SEC's costs. Rather, it speaks instead to the SEC's desire to preserve the breadth of its enforcement reach. Simply put: Settlements preserve the SEC's scarce resources (both monetary and human) and enable it to investigate and bring more cases. If Rakoff's reasoning in the *Citigroup* case prevails, Khuzami fears it "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."[32] Moreover, the SEC believes that its settlement terms reasonably approximate the likely recovery at trial and obtain that same result without the delays of litigation. As Khuzami explains, "[A] settlement puts money back in the pockets of harmed investors without years of courtroom delay and without the twin risks of losing at trial or winning but recovering less than the settlement amount."[33]

Although DOJ routinely procures settlements while also obtaining admissions from defendants, the comparison of the SEC to DOJ in that regard is unfair. DOJ has more leverage in negotiations with defendants by virtue of its ability to bring criminal charges if negotiations fail. It therefore has less need to concede on the issue of admissions in order to obtain settlements. While the monetary penalties that can follow from charges brought by the SEC may be significant, they are not as daunting as a criminal conviction, which for many defendants can threaten ongoing operations regardless of the penalty that comes along with it. This reality of the difference between criminal and civil liability is itself reflected in the fact that when DOJ settles a civil matter, it does not always require admissions of wrongdoing.[34] Moreover, by requiring an admission of guilt in criminal cases, DOJ guards itself against charges that it has abused its prosecutorial power to coerce settlements from innocent parties.

The SEC's New Policy

Perhaps the area in which the SEC seems most vulnerable to criticism of its "neither admit nor deny" language is cases where DOJ has already extracted admissions from a defendant. However, such criticism is superficial. It fails to realize that wrestling an admission of civil liability out of a defendant who has already pleaded guilty to criminal charges is not likely to be a particularly valuable prize for the SEC, subsequent private plaintiffs, or the public generally. The SEC's "neither admit nor deny" practice likely endured in such cases precisely because its actual impact was minimal. However, given the recent criticism of "neither admit nor deny" settlements generally, the inconsistency with DOJ in parallel enforcement actions makes the SEC look unnecessarily weak. The SEC's new policy remedies that inconsistency.

Under the settlement policy announced in January 2012, the SEC will no longer include "neither admit nor deny" language in cases involving parallel criminal convictions, non-prosecution agreements, or deferred prosecution agreements. Although settling defendants will still be prohibited from denying allegations in an SEC complaint, the new policy does not go so far as to require admissions or put an end to use of "without admitting or denying" language in cases where there has been no criminal admission. Instead, settlements will now recite the fact and nature of the criminal conviction (or NPA/DPA), and the SEC staff has discretion as to whether to incorporate the facts that were admitted in the criminal matter.

Because the new policy is limited to situations in which there have already been admissions in a criminal case, it is unlikely to have an impact on most defendants. As recently as December, Mr. Khuzami publicly stated that he thinks it would be "unwise policy" for the SEC to reject a "reasonable settlement due to the absence of an admission."[35] Accordingly, until such time as more courts and critics join Judge Rakoff in questioning settlements that do not include admissions, the SEC can be expected

to continue including "neither admit nor deny" language in settlements that do not involve admissions in parallel criminal cases.

Notes

1. Steve Schaefer, *SEC Rule Change Doesn't Mean Much for Wall Street*, Forbes, Jan. 6, 2012 (quoting the full statement by Khuzami outlining the new policy).

2. *Id.*

3. *Id.*

4. *Id.*

5. SEC News Digest, Issue No. 72-227, at 2 (Nov. 28, 1972); 17 C.F.R. 202.5(e) (2010).

6. The SEC's settlement policy applies to both corporate defendants and individuals alike. *See, e.g.*, Consent Order & Judgment as to Defendant David Plate, *SEC v. Galleon Mgmt., LP*, 09 Civ. 8811, at 1 (S.D.N.Y. June 29, 2011).

7. 653 F. Supp. 2d 507 (S.D.N.Y. 2009).

8. *Id.* at 511.

9. *Id.*

10. *Id.* at 512. Five months after Judge Rakoff's rejection of the settlement, the parties presented a new $150 million consent judgment, which was approved. Before submitting that agreement, the parties conducted discovery, Bank of America waived the attorney-client privilege and the SEC submitted detailed statements of fact to the court. *SEC v. Bank of America Corp.*, Nos. 09 Civ. 6829 & 10 Civ. 0215, 2010 WL 624581, at *1 (S.D.N.Y. Feb. 22, 2010).

11. 771 F. Supp. 2d 304, 305 (S.D.N.Y. 2011). In the period between *Bank of America* and *Vitesse*, a judge in the District of Columbia required the SEC to respond to a set of eight written questions about the allegations in the complaint and terms of a "neither admit nor deny" settlement, before ultimately accepting the $75 million agreement. Order, *SEC v. Citigroup*, No. 10-1277 (D.D.C. Aug. 17, 2010).

12. 771 F. Supp. 2d. at 308 (quoting the SEC's brief).

13. *Id.* at 309.

14. *SEC v. Citigroup Global Markets Inc.*, 11 Civ. 7387, 2011 WL 5903733 (S.D.N.Y. Nov. 28, 2011).

15. *Id.* at *4.

16. *Id.* at *2.

17. *Id.* at *6.

18. Order, *SEC v. Citigroup Global Mkts. Inc.*, No. 11-5227 (2d Cir. Dec. 27, 2011).

19. *SEC Enforcement Director's Statement on Citigroup Case*, SEC News Digest, Issue 2011-241 (Dec. 15, 2011).

20. *Id.*

21. *See, e.g.*, Neal Lipschutz, *Rakoff Decision May Be 'Unprecedented,' But He's Still Right*, WSJ Law Blog, Dec. 16, 2011; Len Boselovic, *Not so fast, judge tells SEC, Citi*, Pittsburgh Post-Gazette, Dec. 4, 2011; Louise Story, *Plain Talk from Judge Weighing Merrill Case*, N.Y. Times, Aug. 23, 2009.

22. Letter from Hon. Rudolph T. Randa to counsel, *SEC v. Koss Corp.*, No. 11-C-991 (E.D. Wis. Dec. 20, 2011).

23. *See, e.g.*, Order, *United States v. Oracle Corp.*, No. 1:07cv529 (E.D. Va. Oct. 11, 2011).

24. DOJ, United States Attorneys' Manual, § 9-28.1300.

25. *See generally North Carolina v. Alford*, 400 U.S. 25 (1970).

26. *See supra* n.24, at § 9-16.015.

27. *Id.* at § 9-16.040.

28. *See, e.g.*, Non-Prosecution Agreement, U.S. Department of Justice–Antitrust Division, *In re: Wachovia Bank, N.A.*, at ¶¶ 9-10 (Dec. 8, 2011).

29. Robert Khuzami, Remarks Before the Consumer Federation of America's Financial Services Conference (Dec. 1, 2011).

30. *See Citigroup Global Markets Inc.*, 2011 WL 5903733, at *5 ("[By] permitting Citigroup to settle without either admitting or denying the allegations . . . [a private plaintiff] cannot derive any collateral estoppel assistance from Citigroup's non-admission/non-denial of the S.E.C.'s allegations.").

31. *See supra* n.29.

32. *Supra* n.19.

33. *Id.*

34. *See, e.g.*, DOJ Release, *Tennessee Fraud Settlement Announced* (July 13, 2011) (settling a civil fraud case for $220,000 where a defendant "does not admit liability in the settlement").

35. *Supra* n.29.

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