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Rakoff Revisited

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Rakoff revisited

The district court judge lost his battle against the SEC's settlement practices. But the regulator's new neither admit nor deny policy suggests he may have won the war

In November 2011, US district court Judge Jed Rakoff refused to approve a settlement between the Securities and Exchange Commission (SEC) and Citigroup Global Markets. This sparked a storm of controversy with regard to the SEC's longstanding practice of allowing defendants to neither admit nor deny allegations in a complaint when a case is settled. In June 2014, the Second Circuit found that Judge Rakoff abused his discretion when he applied an incorrect legal standard in the court's review of the settlement. As a result, the Second Circuit vacated his decision and remanded the case.

While Judge Rakoff lost this battle with the SEC over its policies regarding the settlement of enforcement cases, he nevertheless prevailed in changing the regulator's policies. In between the time of Judge Rakoff's decision and the Second Circuit's decision, the SEC altered its policy of always allowing a defendant settling a case to neither admit nor deny the facts alleged in the complaint. Rather, in appropriate cases the SEC now requires the defendant to admit to the charges. The Department of Justice has also become more aggressive in pursuing financial institutions and recently required Credit Suisse to plead guilty to tax evasion. This was the first time a major financial institution has been required to admit to criminal charges since Drexel Burnham Lambert in 1989.

District court ruling

The SEC's complaint alleged that Citi created a billion-dollar fund that dumped some dubious assets on misinformed investors. This was accomplished by Citi's misrepresentations that the fund's assets were attractive investments rigorously selected by an independent investment adviser, when in fact Citi arranged to include in the portfolio negatively projected assets. Citi even took a short position in those very assets and realised net profits of around $160 million. The investors, meanwhile, lost more than $700 million. The consent judgment would have permanently restrained Citi from violations of sections 17(a)(2) and (3) of the Securities Act of 1933, ordered disgorgement of $160 million in profits plus $30 million in interest, imposed a civil penalty of $95 million, and required an undertaking for certain internal measures designed to prevent recurrences of the securities fraud charged. A parallel complaint was filed the same day against a Citi employee Brian Stoker.

Judge Rakoff was outraged by the contrast in the facts alleged against Stoker, which seemed to suggest *scienter* (or specific intent to deceive), whereas Citi was charged only with negligence. Also, Judge Rakoff believed that the $95 million civil penalty assessed against Citi compared unfavourably with the $535 million penalty assessed against Goldman Sachs in an earlier settlement. The SEC argued that Goldman Sachs had been charged with *scienter*, but Judge Rakoff found this a circular argument because he obviously felt that Citi also should have been charged with *scienter*. He therefore refused to approve the proposed settlement between the SEC and Citi, consolidated the case with Stoker, and set a trial date for a month after his decision. The decision as to Citi was stayed pending the Second Circuit's review. The case against Stoker went to trial and he was acquitted by a jury.

The basis for Judge Rakoff's decision was that the SEC had not provided him with sufficient facts to make a determination that the consent settlement was 'fair, adequate and reasonable'. Further, he thought the consent was not in the public interest because all he could go on were the allegations in the complaint, which deprived the public of knowing the truth in a matter of public importance. Although this opinion was widely interpreted as a rejection of the SEC's policy of permitting defendants to neither admit nor deny allegations in a complaint, in the briefing and at oral argument before the Second Circuit, counsel for Judge Rakoff stated that the district court did not seek an admission of liability before approving the consent decree.

Circuit court ruling

The Second Circuit held that a district court judge was not required to find a settlement to be 'adequate' before entering an injunction based on the settlement. While adequacy is required for an approval of a settlement in a class action, it is not required in a settlement with the SEC. Rather, the proper standard for reviewing a proposed consent judgment initiated by an enforcement agency is that the decree is fair and reasonable, and that the 'public interest would not be disserved' (*eBay Inc. v MercExchange (2006)*). To determine whether a consent decree is fair and reasonable, four tests are set forth by the circuit court. First, is the decree basically legal? Second, are 'the terms of the decree, including any enforcement mechanism, clear'? Third, does the decree 'reflect a resolution of the actual claims in the complaint'? Fourth, is the decree 'tainted by improper collusion or corruption of some kind'?

The Circuit Court believed the district court abused its discretion in requiring the SEC to establish the truth of the allegations against Citi. It stated: 'Trials are primarily about the truth. Consent decrees are primarily about pragmatism'. Further, the 'job of determining whether the proposed SEC consent decree best served the public interest...rests squarely with the SEC, and its decision merits significant deference'.

SEC's new policy

After Judge Rakoff's decision, a few other district court judges balked at signing consent injunctions where the defendants had not admitted to allegations in the SEC's complaint. Then, in January 2012 the SEC announced that it would no longer settle with defendants on a neither admit nor deny basis where parallel criminal proceedings were being resolved. Also, in June 2013, SEC chair Mary Jo White announced that while neither admit nor deny settlements would remain the norm, the SEC would require defendants to admit to wrongdoing in 'certain cases where heightened accountability or acceptance of responsibility through the defendant's admission of misconduct may be appropriate'. This is irrespective of whether the change of policy leads to more cases where the SEC is required to litigate rather than achieve a prompt resolution. To date, there have been eight cases in which the SEC required the defendant to admit to its allegations. One of these was the case against JP Morgan with regard to its so-called London whale trading strategy.

Notwithstanding the Second Circuit's reversal of Judge Rakoff's criticism of the SEC's neither admit nor deny allegations, the regulator has altered the policy. It will be interesting to see how the SEC applies its new policy and whether it generally reverts to its established mode of settling cases.

By Roberta Karmel, Centennial Professor of Law at Brooklyn Law School and co-director of the Dennis J Block Center for the Study of International Business Law

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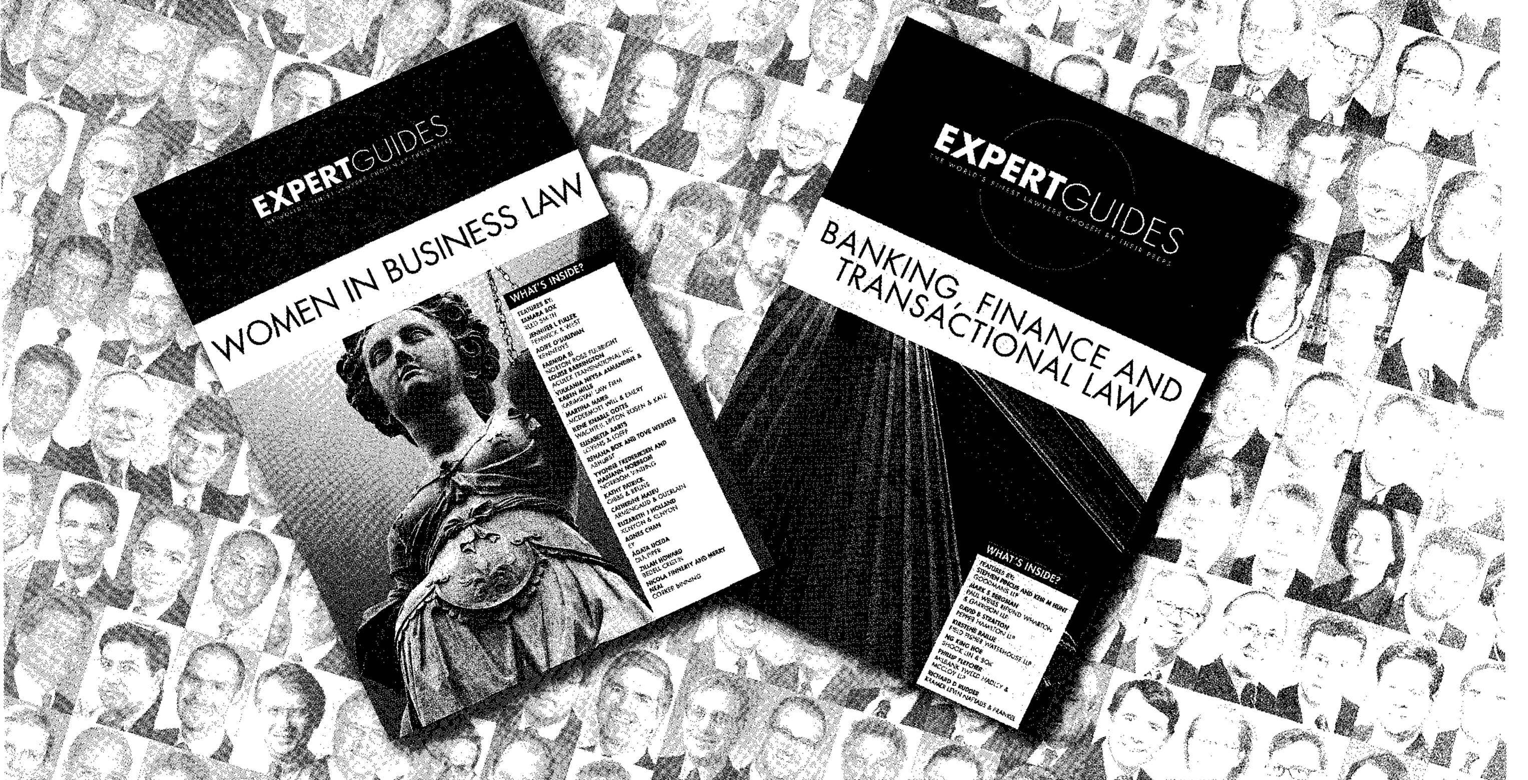

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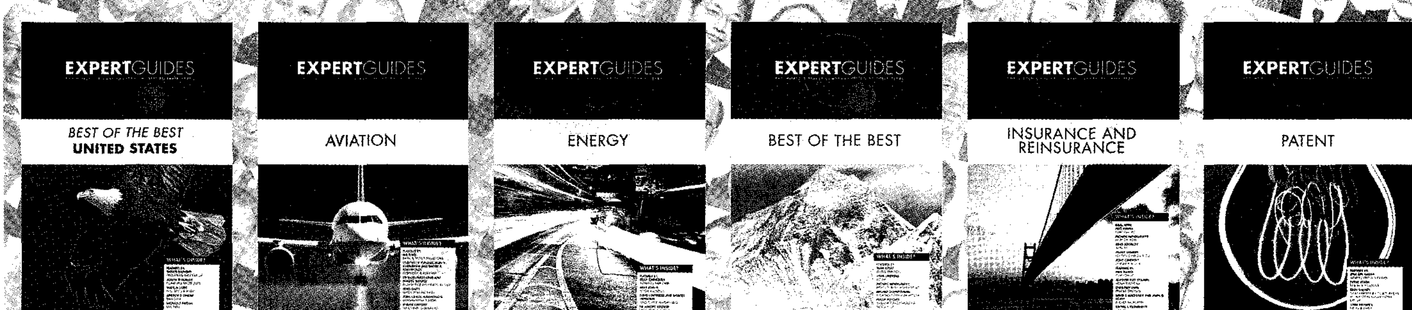

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