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Second Circuit Reverses Judge's Rejection of SEC-Citigroup Settlement

On Wednesday, June 4, 2014, a three-judge panel of the United States Court of Appeals for the Second Circuit vacated and remanded Southern District of New York Judge Jed Rakoff's November 28, 2011 order rejecting a settlement between Citigroup Global Markets, Inc. ("Citigroup") and the Securities and Exchange Commission ("SEC") in which Citigroup neither admitted nor denied any wrongdoing.[1] On the heels of Judge Rakoff's decision, the SEC modified its no admit/no deny practices, leading to an increase in settlements in which defendants were required to admit liability for their conduct.

The Second Circuit rejected the heart of Judge Rakoff's ruling: the requirement that "the [SEC] establish the 'truth' of the allegations against a settling party as a condition for approving the consent decrees."[2] Rather, the Second Circuit explained that "trials are primarily about the truth" while consent decrees, in contrast, "are primarily about pragmatism."[3] The Court held that Judge Rakoff had abused his discretion in rejecting the proposed consent decree by applying an incorrect legal standard.[4]

The Second Circuit then articulated the appropriate standard of review for settlements with federal enforcement agencies: "the district court [must] determine whether the proposed consent decree is fair and reasonable, with the additional requirement that the 'public interest would not be disserved.'"[5] "Adequacy," cautioned the Second Circuit, would not be an apt consideration under this standard.[6] Accepting the appellants' arguments, the Second Circuit remanded the case to Judge Rakoff to evaluate the consent decree pursuant to the correct standard.

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1 *U.S. Sec. & Exch. Comm'n v. Citigroup Global Mkts. Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011).
2 *U.S. Sec. & Exch. Comm'n v. Citigroup Global Mkts. Inc.*, No. 11-5227-cv (L) (2d Cir. June 4, 2014), available at http://www.ca2.uscourts.gov/decisions/isysquery/3a6c9465-8a0c-488b-903c-0999301ab654/3/doc/11-5227_opn.pdf#xml=http://www.ca2.uscourts.gov/decisions/isysquery/3a6c9465-8a0c-488b-903c-0999301ab654/3/hilite/.
3 *Id.* at 21.
4 *Id.* at 8. Judge Rakoff evaluated the consent decree on the basis of whether it was not "unfair, unreasonable, inadequate or in contravention of public interest." He found it to fail on each criterion.
5 *Id.* at 19.
6 *Id.*

Judge Rakoff's 2011 Order

In October 2011, the SEC filed a complaint against Citigroup's principal U.S. broker-dealer subsidiary, alleging that it had violated Sections 17(a)(2) and (3) of the Securities Act of 1933 (the "Act") by negligently misleading investors about its role and economic interest in a $1 billion collateralized debt obligation ("CDO") tied to the U.S. housing market.[7] The SEC alleged that Citigroup had "exercised significant influence over the selection of $500 million of the assets" included in the CDO portfolio.[8] The SEC also alleged that after marketing the CDO, Citigroup took a short position against the assets it had helped select and that Citigroup did not disclose this to investors. The SEC concluded that ultimately, Citigroup realized roughly $160 million in profit while investors suffered significant losses.[9]

Citigroup settled the SEC's charges by agreeing to (i) not violate Sections 17(a)(2) and (3) of the Act; (ii) disgorge its profits; (iii) payment of $30 million in prejudgment interest and a civil penalty of $95 million; (iv) not seek an offset against compensatory damages awarded in related private actions; and (v) consent to internal procedures to prevent similar activities in the future.[10] Most importantly, Citigroup would not admit or deny any wrongdoing. The entirety of the $285 million collected from Citigroup was to be returned to investors of the CDO.

Judge Rakoff rejected the settlement in a widely publicized order, criticizing the SEC's long-standing policy of allowing defendants to settle charges in which they neither admit nor deny wrongdoing. Judge Rakoff found the settlement agreement to be "unfair, unreasonable, inadequate, or in contravention of the public interest" because the agreement "does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified."[11]

The SEC Revises Its No Admit/No Deny Policy

Judge Rakoff's ruling is credited by commentators as being one of several factors sparking a policy discussion about the costs and benefits to the public of the "neither admit nor deny" settlement agreements.

In a significant policy shift, the SEC announced in January 2012 that it would no longer allow defendants to say they neither admit nor deny civil fraud or insider trading charges when, at the same time, they admit to or have been convicted of parallel criminal violations.[12] Then, in June 2013, SEC Chair Mary Jo White announced an expansion of the SEC revisions, stating that the SEC would consider seeking an admission when it has evidence of egregious intentional misconduct, misconduct that harmed or had the potential to harm large numbers of investors, or obstruction of the SEC's investigative processes.

In the 11 months since Chair White's announcement, the SEC has settled fourteen cases with only four settlements containing admissions of wrongdoing. All four settlements were with well-known names in the financial world—Credit Suisse,[13] Scottrade,[14] JPMorgan Chase,[15] and Philip Falcone and his hedge fund Harbinger Capital[16]—and levied substantial aggregate fines that topped $429 million.

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[7] Press release, U.S. Securities and Exchange Commission, Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market (Oct. 19, 2011), available at http://www.sec.gov/news/press/2011/2011-214.htm.

[8] Complaint, *U.S. Sec. & Exch. Comm'n v. Citigroup Global Mkts. Inc.*, No. 11-cv-7387 (S.D.N.Y. Oct. 19, 2011), available at http://www.sec.gov/litigation/complaints/2011/comp-pr2011-214.pdf.

[9] *Id.* at 3.

[10] Press release, U.S. Securities and Exchange Commission, Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market (Oct. 19, 2011), available at http://www.sec.gov/news/press/2011/2011-214.htm.

[11] *U.S. Sec. & Exch. Comm'n v. Citigroup Global Markets Inc*., 827 F. Supp. 2d at 332.

[12] By way of comparison, the U.S. Department of Justice requires an admission of wrongdoing in its settlement agreements.

[13] Press release, U.S. Securities and Exchange Commission, Credit Suisse Agrees to Pay $196 Million and Admits Wrongdoing in Providing Unregistered Services to U.S. Clients (Feb. 21, 2014), available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540816517#.U4-UR3JdWTI.

[14] Press release, U.S. Securities and Exchange Commission, Scottrade Agrees to Pay $2.5 Million and Admits Providing Flawed "Blue Sheet" Trading Data (Jan. 29, 2014), available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540696906#.U4-fMXI71SF.

[15] Press release, U.S. Securities and Exchange Commission, JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges (Sept. 19, 2013), available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965#.U4-UiHJdWTI.

Other courts have also followed Judge Rakoff's lead. In April 2013, Judge Victor Marrero approved the settlement agreement between the SEC and SAC Capital Advisors,[17] but expressed similar concerns that the "neither admit nor deny" language may no longer be sufficient in the post-financial-crisis world. Judge Marrero approved the SAC settlement contingent upon the Second Circuit's decision in the Citigroup appeal.[18]

Second Circuit Standard of Review for Consent Decrees

Explaining the foundation of its decision, the Second Circuit noted that the district courts owe substantial deference to federal enforcement agencies and the "strong policy favoring the approval and enforcement of consent decrees."[19] The court underscored that it is the SEC's job to determine "whether the proposed consent decree best serves the public interest" and its decision "merits significant deference" from the district court.[20] Considerations of a settlement's "adequacy," questioning "the [SEC's] discretionary authority to settle on a particular set of terms," as well as a judge's desire for more facts in a particular case were all held to be outside a district court's purview.[21]

In the future, the Second Circuit standard for whether a settlement is "fair and reasonable" will be assessed according to "(1) the basic legality of the decree. . . (2) whether the terms of the decree, including its enforcement mechanism, are clear . . . (3) whether the consent decree reflects a resolution of the actual claims in the complaint; and (4) whether the consent decree is tainted by improper collusion or corruption of some kind."[22]

Crucial to the Second Circuit's reasoning was its finding that a district court should be able to assess the fairness and reasonableness of a consent decree by the claims set out and supported by the factual averments by the SEC, without additional facts such as those Judge Rakoff had requested. The Second Circuit left some room, albeit very little, for Judge Rakoff on remand, allowing that the district court may ask the SEC and Citigroup to provide additional information sufficient to allay any concerns of improper collusion between the parties in reaching settlement.

Conclusion

A majority of SEC settlements continue to include language in which defendants neither admit nor deny wrongdoing. Wednesday's decision thus offers comfort that negotiated settlements with the SEC and other federal enforcement agencies will be assured to receive substantial deference even if judges continue to harbor reservations about included language that neither admits nor denies factual findings. Nonetheless, the SEC and counterparties to settlement agreements in enforcement actions can expect the federal judiciary to scrutinize closely the terms of the agreements and the factual support for them.

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[16] Press release, U.S. Securities and Exchange Commission, Philip Falcone and Harbinger Capital Agree to Settlement (Aug. 19, 2013), available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222#.U4-UuHJdWTI.
[17] In the aftermath of SAC Capital's settlement with the SEC, Steven A. Cohen changed the firm's name to Point72 Asset Management.
[18] *U.S. Sec. & Exch. Comm'n v. CR Intrinsic Investors, LLC*, 939 F.Supp.2d 431 (S.D.N.Y. 2013) (stating: "In this Court's view, it is both counterintuitive and incongruous for defendants in this SEC enforcement action to agree to settle a case for over $600 million that would cost a fraction of that amount, say $1 million, to litigate, while simultaneously declining to admit the allegations asserted against it by the SEC.").
[19] *U.S. Sec. & Exch. Comm'n v. Citigroup Global Markets Inc.*, No. 11-5227-cv (L) at 17.
[20] *Id.* at 24-25.
[21] *Id.* at 21.
[22] *Id*. at 20.

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