

# ADMISSION OF GUILT: SINKING TEETH INTO THE SEC'S SWEETHEART DEALS

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## Abstract

Throughout its existence, the U.S. Securities and Exchange Commission (“SEC”) has allowed defendants to settle cases without admitting to the allegations of wrongdoing. This “neither admit nor deny” policy has received heavy criticism by judges, Congress, and the public, especially in the wake of the 2008 financial crisis. On June 18, 2013, SEC Chairman Mary Jo White announced the agency’s intention to require admissions of guilt in certain cases. While Chairman White did not articulate a clear standard of when admissions would be required, she did say that the agency would focus on the egregiousness of the defendant’s conduct and the harm to investors. This Article develops a model to help determine which settlements should require admissions of wrongdoing. This proposed model balances the costs of requiring admissions in resources and litigation expenses with the social benefits of requiring admissions both in ensuring that the defendants are responsible for their actions and allowing the public to distinguish between technical violators and the more culpable offenders.

## I. Introduction

Under what circumstances is it appropriate to require an admission of wrongdoing from a defendant in a federal securities case? Should it be a condition of all settlements or just in particularly egregious cases? What are the benefits and drawbacks of requiring defendants to admit to the charges of which they are accused? On August 19, 2013, Philip Falcone and his hedge fund company, Harbinger Capital Partners (“Harbinger”), made both headlines and history as the first defendants in a civil securities settlement to admit to wrongdoings, following a new policy announced by the SEC in June 2013.<sup>1</sup>

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1. See, e.g., Saijel Kishan & Dave Michaels, *Falcone Agrees to Five-Year Ban on Stiffer Deal with SEC*, BLOOMBERG (Aug. 19, 2014, 7:09 PM), <http://www.bloomberg.com/news/2013-08-20/falcone-agrees-to-five-year-ban-in-stiffer-deal-with-sec.html>.

Falcone became a billionaire in late 2006 when “he began to put in place an enormous bet that subprime mortgages would default.”<sup>2</sup> At its highest point, the hedge fund company was managing \$26 billion.<sup>3</sup> But, things quickly started to go downhill for Falcone and his company. In October 2008, most of Harbinger’s “assets were tied up in the collapse of Lehman Brothers,”<sup>4</sup> leading Falcone to “lock-up” investor funds to keep investors from withdrawing their interests for over one year.<sup>5</sup>

Shortly *after* the lock-up occurred, Falcone took out a \$113 million loan from the Harbinger fund to pay his personal tax liability.<sup>6</sup> He gave himself a “highly favorable interest rate;” therefore, “avoid[ing] paying millions of dollars in interest payments.”<sup>7</sup> Falcone himself approved the loan and he neither obtained investor consent, nor disclosed the loan to Harbinger investors until five months later when the company released audited financial statements.<sup>8</sup> It took three more months before the lock-up ended, and by then over eighty percent of investors sought to redeem their investments.<sup>9</sup> Harbinger was unable to meet these requests, and even then Falcone did not repay his personal loan.<sup>10</sup>

Additionally, during this time Falcone “engaged in unlawful preferential redemptions for the benefit of certain favored investors.”<sup>11</sup> Falcone allowed several large investors to withdraw from the fund in exchange for their votes in favor of the lock-up.<sup>12</sup> Falcone and “Harbinger concealed these *quid pro quo* arrangements from the independent directors and from fund investors,” and allowed the preferred investors to withdraw \$169 million.<sup>13</sup>

By 2011, Harbinger’s fund was down from \$26 billion to \$7 billion, with more than half of the assets tied up in LightSquared, a private company Falcone created to “supply nationwide 4G wireless broadband service in competition with AT&T and Verizon Wireless.”<sup>14</sup> Matters worsened in April 2012 when the Federal Communications Commission (“FCC”) threatened to take away LightSquared’s

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2. Bethany McLean, *Falcone Quest*, VANITY FAIR (July 2011), <http://www.vanityfair.com/society/features/2011/07/falcones-201107>.

3. *Id.*

4. Emily Flitter, *Fund Manager Falcone’s Star Dims with Tentative SEC Settlement*, REUTERS (May 9, 2013), <http://www.reuters.com/article/2013/05/09/falcone-sec-settlement-idUSL2N0DQ25N20130509>.

5. Complaint at 6, ¶ 17, U.S. Sec. & Exch. Comm’n v. Harbinger Capital Partners, LLC, No. 12 Civ. 5028 (PAC) (S.D.N.Y. June 27, 2012), *available at* <http://www.sec.gov/litigation/complaints/2012/comp-pr20121222.pdf>.

6. *Id.* at 1–2, ¶ 2.

7. *Id.* at 2, 15, ¶¶ 2, 59.

8. *Id.* at 7, ¶ 19.

9. *Id.* at 7, ¶ 20.

10. *Id.* at 15, ¶ 59 (discussing that Falcone did eventually pay off the loan in “March 2011, after becoming aware of the SEC’s investigation”).

11. Press Release, U.S. Sec. & Exch. Comm’n, Philip A. Falcone and Harbinger Charged with Securities Fraud (June 27, 2012), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171482856#.UpGc4pG-9jT> [hereinafter SEC Press Release].

12. *Id.*

13. *Id.*

14. McLean, *supra* note 2.

license to build necessary ground stations.<sup>15</sup> LightSquared filed Chapter 11 bankruptcy the following month.<sup>16</sup>

The SEC filed its complaint against Falcone and Harbinger on June 27, 2012, in *U.S. Securities and Exchange Commission v. Harbinger Capital Partners, LLC*, for numerous violations including Falcone's personal loan and the preferential treatment of the investors allowed to leave in exchange for their votes in favor of the lock-in.<sup>17</sup> Falcone settled the case with the SEC in August 2013.<sup>18</sup> The terms of the settlement banned Falcone from the securities industry for at least five years and required him to pay \$18 million in fines.<sup>19</sup>

This case is unique because Falcone was required to admit to acting "recklessly" and also to several violations of the securities laws. Falcone admitted that he had taken an improper loan from Harbinger and that he had "granted favorable redemption and liquidity terms to certain large investors . . . and did not disclose certain of these arrangements to the fund's board of directors and the other fund investors."<sup>20</sup>

*Harbinger* is the first case testing out the new SEC policy requiring certain defendants to admit to their wrongdoing. It is still unclear which cases will be prosecuted under the SEC's new policy; however, the SEC has indicated that much will depend on the egregiousness of the conduct and the level of harm to investors.<sup>21</sup> This Article will explore the evolution of the traditional "neither admit nor deny" policy used by the SEC, the passing of the new SEC policy, and the cases thus far requiring admissions. This Article will also examine the social benefits of admissions versus the economic costs. Finally, this Article will discuss several factors that the SEC should consider in an attempt to strike the right balance between public policy and the time and resources available to the SEC.

## II. Background of the "Neither Admit nor Deny" Policy

The SEC and other federal agencies such as the Environmental Protection Agency ("EPA") and the Food and Drug Administration ("FDA") have a longstanding history of allowing defendants to settle cases without either admitting or denying guilt.<sup>22</sup> Even criminal defendants are permitted to plead *nolo*

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15. Eli Lake, *Philip Falcone: Billionaire on the Brink*, DAILY BEAST (Apr. 16, 2012, 4:45 AM), <http://www.thedailybeast.com/articles/2012/04/16/philip-falcone-billionaire-on-the-brink.html>.

16. Kevin Fitchard, *It's Official: LightSquared Goes Bankrupt. What's Next?* GIGAOM (May 14, 2012, 12:22 PM), <http://gigaom.com/2012/05/14/its-official-lightsquared-goes-bankrupt/>.

17. See generally Complaint, U.S. Sec. & Exch. Comm'n v. Harbinger Capital Partners, LLC, No. 12 Civ. 5028 (PAC) (S.D.N.Y. June 27, 2012), available at <http://www.sec.gov/litigation/complaints/2012/comp-pr2012-122.pdf>.

18. Press Release, U.S. Sec. & Exch. Comm'n, Philip Falcone and Harbinger Capital Agree to Settlement (Aug. 19, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222#.UpZCnZG-9jQ>.

19. *Id.*

20. *Id.*

21. *Where the SEC Action Will Be: CFO Network Journal Report*, WALL ST. J., June 24, 2013, at R4, available at [http://cfonetwork.wsj.com/wp-content/uploads/2013/06/CFO\\_Network\\_Journal\\_Report\\_2013.pdf](http://cfonetwork.wsj.com/wp-content/uploads/2013/06/CFO_Network_Journal_Report_2013.pdf).

22. "For the life of the SEC Enforcement Division, spanning several generations, the SEC (and other federal administrative and regulatory agencies, such as the FDA and EPA) agreed to settlements in which the

*contendere*, which allows a defendant to “refuse to admit guilt but accept punishment as if guilty.”<sup>23</sup> This history is so entrenched, in fact, that “[e]ven before the SEC’s Division of Enforcement was created in 1972, the SEC settled actions through consent decrees in which respondents neither admitted nor denied the agency’s factual allegations.”<sup>24</sup>

Under the “neither admit nor deny” policy, defendants are not required to admit to the accusations of wrongdoings, but they are also not allowed to settle cases with the SEC and then immediately turn around and deny any wrongdoing, either to the public or in subsequent litigation.<sup>25</sup> This policy is not required by all agencies. In 2011 Facebook was allowed to settle with the Federal Trade Commission (“FTC”) and shortly thereafter to deny the FTC’s allegations “that it deceived users about how it used their personal information.”<sup>26</sup> The FTC’s settlement admissions policy has also been criticized in recent years, and will be discussed further in part II.A.3, *infra*. In 2012, the FTC allowed Google to settle charges that it had “bypassed privacy settings in Apple’s Safari browser to be able to track users of the browser and show them advertisements,” and then to deny any wrongful conduct.<sup>27</sup> Surprisingly, even the Justice Department has allowed defendants to settle and then deny any wrongdoing.<sup>28</sup>

The SEC’s former Enforcement Director, Robert Khuzami, “vociferously defended the agency’s settlements with Wall Street firms,” “rejecting as ‘unwise’ the idea that the SEC should obtain an admission of guilt from firms as part of its settlements.”<sup>29</sup> The argument in favor of the policy was that by not having to admit

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targets of investigations were allowed to settle without admitting or denying guilt.” Marc D. Powers, Mark A. Kornfeld, & Joanna F. Wasick, *The SEC Falcone Settlement: A Harbinger of Things to Come?*, A.B.A. BUS. L. TODAY (Oct. 2013), [http://www.americanbar.org/publications/blt/2013/10/keeping\\_current.html](http://www.americanbar.org/publications/blt/2013/10/keeping_current.html). The EPA frequently settles cases with defendants using the “neither admit nor deny” language, including a \$1.5 million settlement with 3M Company for violations under the Toxics Substances Control Act (TSCA). *3M Company Settlement*, EPA ENFORCEMENT (Apr. 25, 2006), <http://www2.epa.gov/enforcement/3m-company-settlement>.

23. Stephanos Bibas, *Harmonizing Substantive-Criminal-Law Values and Criminal Procedure: The Case of Alford and Nolo Contendere Pleas*, 88 CORNELL L. REV. 1361, 1363 (2003) (additionally discussing that some courts allow “so-called Alford pleas, in which defendants plead guilty while simultaneously protesting their innocence”).

24. Dan O’Connor, Steven S. Goldschmidt, & Daniel V. McCaughey, *Admitting Guilt: The SEC’s New Settlement Policy*, MONDAQ, <http://www.mondaq.com/unitedstates/x/261598/Securities/Admitting+Guilt+The+SECs+New+Settlement+Policy> (last updated Sept. 9, 2013).

25. Andrew Ackerman, *SEC’s Khuzami Defends ‘Admit nor Deny’ Settlements*, WALL ST. J. (Dec. 1, 2011, 3:55 PM), <http://online.wsj.com/news/articles/SB10001424052970204012004577072462404708198>. As originally enacted, the SEC’s policy allowed defendants to make public statements denying the allegations. This changed in 1972 when the SEC created the “neither admit nor deny” policy forbidding express denials of wrongdoing after settling. O’Connor, Goldschmidt, & McCaughey, *supra* note 24.

26. Ackerman, *supra* note 25; Edward Wyatt, *Letting Companies Settle While Denying Guilt Reconsidered by F.T.C.*, N.Y. TIMES (Aug. 10, 2012), [http://www.nytimes.com/2012/08/11/business/facebook-settlement-on-privacy-is-finalized-byftc.html?\\_r=0](http://www.nytimes.com/2012/08/11/business/facebook-settlement-on-privacy-is-finalized-byftc.html?_r=0).

27. Claire Cain Miller, *F.T.C. Fines Google \$22.5 Million For Safari Privacy Violations*, N.Y. TIMES (Aug. 9, 2012, 1:03 PM), [http://bits.blogs.nytimes.com/2012/08/09/f-t-c-fines-google-22-5-million-for-safari-privacy-violations/?\\_r=0](http://bits.blogs.nytimes.com/2012/08/09/f-t-c-fines-google-22-5-million-for-safari-privacy-violations/?_r=0).

28. Wyatt, *supra* note 26. The Justice Department settled with GlaxoSmithKline, the pharmaceutical company, in which “the company agreed to pay \$2 billion to settle civil charges that it defrauded the government with drug sales. Despite the payment, Glaxo expressly denied that it had engaged in any wrongful conduct.” *Id.*

29. Ackerman, *supra* note 25.

guilt, more companies would choose to settle, and the SEC was “usually able to get as much money from a settlement as it could win in a protracted legal case, with money being returned to investors more quickly.”<sup>30</sup> It also allows the SEC to apply its “limited resources to other enforcement efforts.”<sup>31</sup>

There are advantages for the defendants as well. More defendants choose to settle because, although they are forbidden from denying wrongdoing, they may still “assert that they never admitted to the conduct at issue in the SEC matter[s], precluding any collateral estoppel, as a party could settle with the SEC and still litigate liability with investors or shareholders in separate cases.”<sup>32</sup> This means that any plaintiff suing the defendant in a separate civil case would still have the burden to prove its case, and would not have any admission from the defendant to rely on. Although the burden of proving guilt rests on the plaintiff, the plaintiff nevertheless has some arsenal going into the case because he will have access to public information released after the SEC settlement.

Another benefit to defendants of settlement under this policy is that it “mitigate[s] reputational harm in the investor community, and among lenders and insurers.”<sup>33</sup> It also saves defendants from losing their Directors and Officers Insurance or corporate indemnification due to breach of fiduciary duties.<sup>34</sup> While there may be many benefits related to this kind of settlement for both the SEC and the individual defendants, this policy has been questioned in recent years, and not everyone believes these advantages and potential cost savings are worth the costs to the public.

#### A. Criticisms of the “Neither Admit nor Deny Policy”

The “neither admit nor deny” policy has been heavily criticized in recent years by judges, members of Congress, scholars, and even within the SEC. The 2008 financial crisis and following “great recession” brought with it “public calls for increased accountability and harsher penalties for financial institutions accused of wrongdoing.”<sup>35</sup> This section will outline some of the major turning points in recent years that have led to the SEC’s decision to move away from this policy in certain cases.

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30. Edward Wyatt, *S.E.C. Changes Policy on Firms’ Admission of Guilt*, N.Y. TIMES (Jan. 6, 2012), [http://www.nytimes.com/2012/01/07/business/sec-to-change-policy-on-companies-admission-of-guilt.html?\\_r=0&pagewanted=print](http://www.nytimes.com/2012/01/07/business/sec-to-change-policy-on-companies-admission-of-guilt.html?_r=0&pagewanted=print).

31. Ghillaine A. Reid, *An Uncertain Future For “Neither Admit nor Deny” Settlements*, A.B.A. SEC. LITIG. (May 10, 2012), <http://apps.americanbar.org/litigation/committees/securities/email/spring2012/spring2012-0512-uncertain-future-neither-admit-nor-deny-settlements.html>.

32. O’Connor, Goldschmidt, & McCaughey, *supra* note 24.

33. *Id.*

34. *Id.*

35. *Id.*

1. Judge Rakoff's Rejection of the SEC's Settlement with Citigroup

After the SEC has reached a settlement agreement with a defendant, the court must approve the settlement. Up until the past few years, “judges have approved proposed settlements . . . without questioning the terms, relying instead on the presumption that the SEC’s mandate to serve the investing public resulted in a fitting settlement.”<sup>36</sup> In 2011, federal district court judge Jed S. Rakoff did not rely on that presumption in a case brought by the SEC against Citigroup.<sup>37</sup> The settlement reached between the SEC and Citigroup would have asserted negligence on the part of Citigroup, and would have required Citigroup to agree to pay a total fine of \$285 million and to establish “certain internal measures designed to prevent the recurrences of the securities fraud” committed in this case.<sup>38</sup> This agreement did not require Citigroup to admit to the accusations.

Rather than approving the settlement, Judge Rakoff found that the court had “not been provided with any proven or admitted facts upon which to exercise even a modest degree of independent judgment.”<sup>39</sup> He argued that before the courts should approve a settlement, even after taking into consideration the deference owed to the government agency, the courts must “be satisfied that [the settlement] is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public interest.”<sup>40</sup> In this case, Judge Rakoff found that the court did not have the necessary facts to be able to make such a determination of whether the agreement was fair, reasonable, adequate, and not in contravention of the public interest. His reasoning was that, unlike private parties:

when a public agency asks a court to become its partner in enforcement by imposing wide-ranging injunctive remedies on a defendant, enforced by the formidable judicial power of contempt, the court, and the public, need some knowledge of what the underlying facts are: for otherwise, the court becomes a mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance.<sup>41</sup>

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36. Reid, *supra* note 31.

37. U.S. Sec. & Exch. Comm’n v. Citigroup Global Markets, Inc., 827 F. Supp. 2d 328, 332 (S.D.N.Y. 2011) *vacated and remanded sub nom*, U.S. Sec. & Exch. Comm’n v. Citigroup Global Markets, Inc., 752 F.3d 285 (2d Cir. 2014)

[W]hen a public agency asks a court to become its partner in enforcement by imposing wide-ranging injunctive remedies on a defendant, enforced by the formidable judicial power of contempt, the court, and the public, need some knowledge of what the underlying facts are: for otherwise, the court becomes a mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance.

*Id.* Judge Rakoff likewise rejected another settlement agreement in 2009 between the SEC and Bank of America, finding the agreement to be “neither fair, nor reasonable, nor adequate.” U.S. Sec. & Exch. Comm’n v. Bank of Am. Corp., 653 F. Supp. 2d 507, 509 (S.D.N.Y. 2009).

38. *Citigroup*, 827 F. Supp. 2d at 330.

39. *Id.*

40. *Id.* at 332.

41. *Id.*

Judge Rakoff also expressed concern about the proposed settlement amount representing “pocket change” to Citigroup while leaving the “defrauded investors substantially short-changed.”<sup>42</sup> The agreed upon settlement of \$285 million fell far short of the \$700 million in losses investors suffered.<sup>43</sup> The settlement would have made it exceedingly difficult for investors to pursue private litigation. First, the settlement agreement only charged Citigroup with negligence and private investors are unable to bring securities claims based on a theory of negligence.<sup>44</sup> Second, because Citigroup was not required to either admit or deny the allegations in the complaint, investors would be unable to use any admission under a collateral estoppel theory.<sup>45</sup> Finally, Judge Rakoff held that “the S.E.C., 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.”<sup>46</sup>

The SEC then filed an interlocutory appeal to the Second Circuit, which granted a stay pending appeal.<sup>47</sup> The Second Circuit found several issues with Judge Rakoff’s ruling, including the assumption that Citigroup did actually mislead investors, and that if the case went to trial, the SEC would win.<sup>48</sup> The Second Circuit found that Rakoff “overlook[ed] the possibilities (i) that Citigroup might well not consent to settle on a basis that require[d] it to admit liability, (ii) that the S.E.C. might fail to win a judgment at trial, and (iii) that Citigroup perhaps did not mislead investors.”<sup>49</sup>

The Court also questioned the district court’s reasoning that “neither admit nor deny” settlements are not in the public interest, because “[r]equiring such an admission would in most cases undermine any chance for compromise.”<sup>50</sup> Finally, the Second Circuit expressed “no reason to doubt the S.E.C.’s representation that the settlement it reached is in the public interest,” and found the likelihood of success in “setting aside the district court’s rejection of their settlement, either by appeal or petition for mandamus” was high, and therefore granted the stay.<sup>51</sup> The Second Circuit has not yet heard the appeal.

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42. *Id.* at 333–34.

43. U.S. Sec. & Exch. Comm’n v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328, 329 (S.D.N.Y. 2011).

44. *Id.* at 334 (citing as an example Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)).

45. The inability to take advantage of collateral estoppel was outlined in the above section as one of the benefits to investors in the “neither admit nor deny” policy. This is the flipside to that argument, that collateral estoppel allows certain cases to be brought that otherwise would not.

46. *Citigroup*, 827 F. Supp. 2d at 334.

47. *See generally* U.S. Sec. & Exch. Comm’n v. Citigroup Global Markets Inc., 673 F.3d 158 (2d Cir. 2012).

48. *Id.*

49. *Id.* at 163.

50. *Id.* at 165.

51. *Id.* at 168–69.

## 2. Citigroup's Impact on Other Securities Cases

The Second Circuit may have criticized the *Citigroup* opinion, but several other judges have followed Judge Rakoff's reasoning. For example, in *U.S. Securities and Exchange Commission v. Koss Corporation*, the SEC brought an action against Koss Corporation and its CEO, Michael Koss, for creating "materially inaccurate financial statements, books and records, and [lack of] adequate financial controls."<sup>52</sup> The Wisconsin district court judge found that the facts were insufficient to make a determination regarding whether the settlement agreement was "fair, reasonable, adequate and in the public interest."<sup>53</sup> The judge requested that the SEC provide enough information to make an informed decision, and eventually approved the settlement after the SEC submitted a brief with nine exhibits showing why the settlement terms met those requirements.<sup>54</sup>

Judge Rakoff used a similar approach in *U.S. Securities and Exchange Commission v. Vitesse Semiconductor Corporation*.<sup>55</sup> Rakoff required the parties to provide written submissions and attend a hearing where the parties provided oral answers to his questions, so that he had sufficient information upon which to render a decision.<sup>56</sup> Rakoff heavily criticized the SEC in *Vitesse* for its "confiden[ce] that the courts in this judicial district were no more than rubber stamps."<sup>57</sup> He discussed the history of the "neither admit nor deny" policy, and called it "a stew of confusion and hypocrisy unworthy of such a proud agency as the S.E.C."<sup>58</sup> In *Vitesse*, the defendant had already admitted guilt in a parallel criminal case.<sup>59</sup> Judge Rakoff found that although questions were left unanswered after the written submissions and hearing, he had enough information under the particular circumstances to make an informed decision and approve the settlement agreement.<sup>60</sup>

## 3. Citigroup's Impact on Other Federal Agencies' Settlements

As noted above, the SEC is not the only federal agency criticized for its "neither admit nor deny" policy. Several other federal agencies permit "neither admit nor deny" settlements, including the FTC, the EPA, the Federal Reserve, the Office of the Comptroller of the Currency ("OCC"), and the Department of Justice ("DOJ"). When FTC Commissioner Maureen Ohlhausen was asked in an interview whether she thought the "neither admit not deny" policy was good for settlements in light of recent judicial criticisms, she stated:

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52. Letter from the Court to Plaintiff's Counsel, *U.S. Sec. & Exch. Comm'n v. Koss Corp.*, No. 11 Civ. 991 (E.D. Wis. Dec. 20, 2011), available at <http://www.wlrk.com/docs/Kossletter.pdf>.

53. *Id.*

54. *U.S. Sec. & Exch. Comm'n v. Koss*, No. 11 Civ. 991 (E. D. Wis. Feb. 22, 2012).

55. See generally *U.S. Sec. & Exch. Comm'n v. Vitesse Semiconductor Corp.*, 771 F. Supp. 2d 304 (S.D.N.Y. 2011).

56. *Id.* at 306.

57. *Id.*

58. *Id.* at 308.

59. *Id.* at 309.

60. *U.S. Sec. & Exch. Comm'n v. Vitesse Semiconductor Corp.*, 771 F. Supp. 2d 304, 306 (S.D.N.Y. 2011).



At the FTC, our role is to stop harm that's occurring in the market and to get the best result for consumers. We are not an agency that has authority to punish parties. . . . Our proper focus is on stopping bad practices and obtaining redress for consumers, which is best achieved by preserving some bargaining leverage for staff on the wording in settlements.<sup>61</sup>

In 2012, the FTC brought a case against the company Circa Direct, alleging it “engaged in deceptive acts or practices in the marketing of acai berry-based weight loss products.”<sup>62</sup> The court, citing *Citigroup*, questioned “the propriety of courts approving settlements of regulatory actions.”<sup>63</sup> The judge was particularly concerned with the ability of defendants to settle without “admitting to any of the allegations lodged against [them].”<sup>64</sup> Rather than simply rejecting the settlement agreement outright, however, the judge ordered the parties to address several issues, among which were: (1) whether the fair, adequate, reasonable, and in the public interest standard (the standard typically used in settlement cases) should apply in the case; (2) if not, what standard the court should use; and (3) if the *Citigroup* standard applies, whether the settlement agreement met those requirements.<sup>65</sup>

#### *4. Requiring Admissions Where Defendants Are Found Guilty in Parallel Criminal Cases*

Critics of the “neither admit nor deny” policy especially found fault with cases applying the policy “even when a company acknowledged the same conduct to another government agency, often the Justice Department.”<sup>66</sup> For example, in December 2011, Wachovia Bank was charged with gaining “millions of dollars in profits by rigging bids in the municipal securities market”<sup>67</sup> and the Justice Department settlement dated December 8, 2011, required Wachovia to “admit[], acknowledge[,] and accept[] responsibility for the conduct of its former employees . . . [who] entered into unlawful agreements to manipulate the bidding process and . . . engaged in other activities in connection with those agreements.”<sup>68</sup> The settlement also required Wachovia to not “make any public statement or take any position in litigation contradicting that admission.”<sup>69</sup> However, the SEC published a litigation

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61. Interview by Randy Shaheen and Kristin McPartland with Maureen Ohlhausen, Commissioner, FTC (Oct. Sept. 25, 2012), *available at* [http://www.ftc.gov/sites/default/files/documents/public\\_statements/interview-ftc-commissioner-maureen-ohlhausen/1210antitrustsource.pdf](http://www.ftc.gov/sites/default/files/documents/public_statements/interview-ftc-commissioner-maureen-ohlhausen/1210antitrustsource.pdf).

62. Fed. Trade Comm’n v. Circa Direct LLC, No. 11 Civ. 2172, 2012 WL 589560 (D.N.J. Feb. 22, 2012).

63. *Id.* at \*1.

64. *Id.*

65. *Id.* at \*2.

66. Wyatt, *supra* note 26.

67. Edward Wyatt, *Settlement with Wachovia Points up a Controversy*, N.Y. TIMES (Dec. 8, 2011), <http://www.nytimes.com/2011/12/09/business/contrasting-settlements-in-wachovia-case.html>; *see also* Complaint at 2, U.S. Sec. & Exch. Comm’n v. Wachovia Bank, N.A., No. 2:11 Civ. 7135 (D.N.J. Dec. 8, 2011).

68. Letter from Sharis A. Posen, Acting Assistant Att’y Gen., DOJ, to Karen Patton Seymour, Sullivan & Cromwell LLP (Dec. 8, 2011), *available at* [http://www.justice.gov/atr/public/press\\_releases/2011/278076a.pdf](http://www.justice.gov/atr/public/press_releases/2011/278076a.pdf) (letter regarding Wachovia Bank, N.A. Non-Prosecution Agreement).

69. *Id.*

release on the same date announcing the charges and the agreed upon fines, and stating that Wachovia consented to the entry of final judgment “[w]ithout admitting or denying the allegations in the SEC’s complaint.”<sup>70</sup>

In January 2012, the SEC changed its policy with respect to “neither admit nor deny” in cases where defendants have already pleaded guilty in parallel criminal proceedings.<sup>71</sup> In these cases, the SEC deletes the “neither admit nor deny” provision from settlement agreements and instead outlines the facts and nature of the criminal conviction.<sup>72</sup> Robert Khuzami, the SEC’s head of enforcement in 2012, made sure to emphasize that this revision applied only to “the minority of our cases where there is a parallel criminal conviction,” and that it was “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.”<sup>73</sup>

The effect of this policy change was limited due to the fact that defendants were not required to make any additional admissions of guilt beyond what had already been admitted to in the criminal cases. It was also “limited to situations where the defendant has (i) pled guilty, (ii) been convicted, or (iii) made substantive admissions in an NPA or DPA.”<sup>74</sup>

### 5. Congress’s Interest in “Neither Admit nor Deny” Settlements

Following Judge Rakoff’s decision in *Citigroup*, Congress became interested in the SEC’s “neither admit nor deny” policy. In December 2011, the “House Financial Services Committee announced that it would hold a hearing to examine the SEC’s settlement policy.”<sup>75</sup> This hearing was held on May 17, 2012, and included representatives from the Federal Reserve, the SEC, and the Federal Deposit Insurance Corporation (“FDIC”).<sup>76</sup>

The Federal Reserve representative testified that “[t]he vast majority of the Federal Reserve’s formal enforcement actions are resolved upon consent . . . [without requiring] formal admissions of misconduct.”<sup>77</sup> The representative also argued that admissions requirements “would substantially impede and delay

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70. SEC Charges Wachovia with Fraudulent Bidding Rigging in Municipal Bond Proceeds, SEC Litigation Release No. 22,183 (Dec. 8, 2011), <http://www.sec.gov/litigation/litreleases/2011/lr22183.htm>.

71. Robert Khuzami, *Public Statement by SEC Staff: Recent Policy Change*, U.S. SEC. & EXCH. COMM’N (Jan. 7, 2012), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171489600#.UpZUfZG-9jQ>; see also Reid, *supra* note 31.

72. Khuzami, *supra* note 71.

73. *Id.*

74. Michael C. Macchiarola, *“Hallowed by History, but Not by Reason”: Judge Rakoff’s Critique of the Securities and Exchange Commission’s Consent Judgment Practice*, 16 CUNY L. REV. 51, 94 (2012).

75. Eric Rieder, Paul Huey-Burns, & Nikki A. Ott, *Shifting Tides for SEC Settlements: A Sea Change in the Making?*, A.B.A. BUS. L. TODAY (Mar. 23, 2012), [http://www.americanbar.org/publications/blt/2012/03/01\\_rieder.html](http://www.americanbar.org/publications/blt/2012/03/01_rieder.html).

76. See generally *Examining the Settlement Practice of U.S. Financial Regulators*, Hearing before the H.R. Comm. on Financial Services, 112th Cong. (2012), Serial no. 112-128, available at <http://financialservices.house.gov/uploadedfiles/112-128.pdf>.

77. *Id.* at 6.

implementation of necessary corrective action and potentially harm the financial institution and the financial system.”<sup>78</sup>

Likewise, the FDIC representative said that most of their “cases are resolved through stipulated settlements which achieve our statutory responsibilities and protect the public interest without admissions of liability.”<sup>79</sup> He argued that “requiring a respondent to specifically admit the alleged conduct in a settlement may have the unintended consequence of delaying prompt relief and corrective action.”<sup>80</sup>

Following this hearing, at a Senate Banking Committee hearing in February 2013, Massachusetts’ Senator Elizabeth Warren made headlines for “challenging a number of federal regulators for what she called their failure [to] take to trial more cases against financial institutions.”<sup>81</sup> She asked the OCC specifically if it had ever “conducted any internal research or analysis on trade-offs to the public between settling an enforcement action without admission of guilt and going forward with the litigation as necessary to obtain such an admission.”<sup>82</sup> The OCC responded that it had not.

Following this hearing, in May 2013, Senator Warren sent a letter to Ben Bernanke, the Chairman of the Federal Reserve, Eric Holder, the Attorney General, and Mary Jo White, the Chairman of the SEC, stating:

There is no question that settlements, fines, consent orders, and cease and desist orders are important enforcement tools, and that trials are expensive, demand numerous resources, and are often less preferable than settlements. But I believe strongly that if a regulator reveals itself to be unwilling to take large financial institutions all the way to trial—either because it is too timid or because it lacks resources—the regulator has a lot less leverage in settlement negotiations and will be forced to settle on terms that are much more favorable to the wrongdoer. The consequence can be insufficient compensation to those who are harmed by illegal activity and inadequate deterrence of future violations. If large financial institutions can break the law and accumulate millions in profits and, if they get caught, settle by paying out of those profits, they do not have much incentive to follow the law.<sup>83</sup>

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78. *Id.*

79. *Id.* at 10.

80. *Id.*

81. O’Connor, Goldschmidt, & McCaughey, *supra* note 24; *see also* Chris Morran, *Sen. Warren: Why Can Banks Commit Crimes but Get Away Without Admitting Guilt?*, CONSUMERIST (May 15, 2013), <http://consumerist.com/2013/05/15/sen-warren-why-can-banks-commit-crimes-but-get-away-without-admitting-guilt/>.

82. Morran, *supra* note 81.

83. Letter from Elizabeth Warren, U.S. Sen., to Ben Bernanke, Chairman, Federal Reserve System, Eric Holder, Att’y Gen., DOJ, and Mary Jo White, Chairman, SEC (May 14, 2013), *available at* <http://www.warren.senate.gov/documents/LtrtoRegulatorsre2-14-13hrq.pdf>.

Chairman White responded to Senator Warren's letter on June 10, 2013.<sup>84</sup> She thanked Senator Warren for her letter and spoke of her "strong desire for accountability for those individuals and institutions that commit violations of the securities laws."<sup>85</sup> Although White spoke of her belief that the "current settlement policy achieves a very public measure of accountability while at the same time allowing us to more quickly return funds to harmed investors and get wrongdoers out of the industry while conserving resources to pursue the next fraud,"<sup>86</sup> she did say that she was "actively reviewing" the "neither admit nor deny" policy to "determine what, if any, changes may be warranted and whether the SEC is making full appropriate use of its leverage in the settlement process."<sup>87</sup>

### III. SEC's Policy Change Announcement

On June 18, 2013 (only two weeks after Chairman White sent the letter to Senator Warren), the SEC announced its decision "to in certain cases be seeking admissions going forward."<sup>88</sup> The reasoning, as Chairman White explained it, was that "[p]ublic accountability in particular kinds of cases can be quite important, and if you don't get [the admissions in settlement], you litigate them."<sup>89</sup> White emphasized that while the "neither admit nor deny" settlements would continue for the majority of cases brought by the SEC, the Commission would look at certain factors and their degree of wrongfulness to determine whether to require an admission of wrongdoing.<sup>90</sup> White said it "turns on how much harm has been done to investors, [and] how egregious the fraud is."<sup>91</sup> The SEC is currently developing the factors that will be used and the certain cases susceptible to an admissions requirement.

Andrew Ceresney, the Enforcement Division Co-Director, has also emphasized the continuing importance of the "neither admit nor deny" policy going forward.<sup>92</sup> He argues that the policy is "an important way for the SEC to obtain secure relief for investors, to conserve and effectively manage its enforcement resources, and to manage its litigation risk by settling cases that it might not win at trial."<sup>93</sup>

*Harbinger* was the first case to implement this new policy. The SEC found that both defendant Falcone and his company, Harbinger, had committed "multiple acts of misconduct that harmed investors and interfered with the normal

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84. Letter from Mary Jo White, Chairman, SEC, to Elizabeth Warren, U.S. Sen., (June 10, 2013), *available at* <http://thinkprogress.org/wp-content/uploads/2013/06/WARREN-Settling-Enforcement-Action-ES144264Response.pdf> (replying to Warren's letter dated May 14, 2013).

85. *Id.*

86. *Id.*

87. *Id.*

88. *Where the SEC Action Will Be: CFO Network Journal Report*, WALL ST. J., June 24, 2013, at R4, [http://cfonetwork.wsj.com/wp-content/uploads/2013/06/CFO\\_Network\\_Journal\\_Report\\_2013.pdf](http://cfonetwork.wsj.com/wp-content/uploads/2013/06/CFO_Network_Journal_Report_2013.pdf).

89. *Id.*

90. *Id.*

91. *Id.*

92. O'Connor, Goldschmidt, & McCaughey, *supra* note 24.

93. *Id.*

functioning of the securities markets.”<sup>94</sup> Originally, Falcone reached a settlement in May with the SEC staff that required him to pay \$18 million in fines and barred him from the securities industry for two years.<sup>95</sup> This proposal was rejected by the Commissioners as being too lenient. Instead, the Commissioners barred Falcone from the securities industry for a minimum of five years, and required the defendants to pay \$18 million in fines and admit to the wrongdoings alleged in the complaint.<sup>96</sup> Mr. Ceresney emphasized that “Falcone must now pay a heavy price for his misconduct.”<sup>97</sup>

#### A. The Shifting Focus to Individuals Rather Than Companies

A recent practice of the SEC, apparent in the *Harbinger* case, is to file a complaint against the individual owner of the company in addition to the company itself. At the same time Chairman White announced the SEC’s intention to require admissions in certain cases, she also announced a “subtle shift” in focus from company wrongdoings to the individual’s wrongdoings.<sup>98</sup> Rather than “starting with the entity as a whole and working in,” the enforcement staff will now start with the misconduct of the individuals, and work its way out to the entity.<sup>99</sup> This emphasis will help to make individuals more accountable, which is also the goal of obtaining admissions of wrongdoing. The SEC is not the only federal agency shifting the focus to individuals. The Consumer Financial Protection Bureau (created after the financial crisis) is also making an effort to go “after individuals, not just companies, when it punishes wrongdoers, reflecting a broader effort among enforcement officials to ensure penalties have real bite.”<sup>100</sup>

Chairman White has warned that “[i]ndividuals tempted to commit wrongdoing must understand that they risk it all if they do not play by the rules. . . . When people fear for their own reputations, careers or pocketbooks, they tend to stay in line.”<sup>101</sup> This may be why the SEC decided to pursue Fabrice Tourre, the first individual sued by the SEC for mortgage-backed securities fraud.<sup>102</sup> Tourre, who once called himself the “Fabulous Fab,” was a twenty-eight year old midlevel

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94. Press Release, *supra* note 18.

95. Emily Flitter & Sarah N. Lynch, *SEC Rejects Settlement with Fund Manager Phil Falcone*, REUTERS (July 19, 2013, 6:21 PM), <http://www.reuters.com/article/2013/07/19/us-sec-falcone-settlement-idUSBRE96I0OF20130719>.

96. Press Release, *supra* note 18.

97. *Id.*

98. Mary Jo White, Chairman, SEC, “Deploying the Full Enforcement Arsenal” Speech at the Council of Institutional Investors Fall Conference in Chicago, IL (Sept. 26, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370539841202#.Uswr33m-9jQ>.

99. Ackerman, *supra* note 25.

100. Emily Stephenson, *U.S. Consumer Watchdog Says Committed to Stiff Penalties*, REUTERS (Oct. 23, 2013), <http://www.reuters.com/article/2013/10/23/us-washington-summit-cordray-idUSBRE99M1K520131023>.

101. Ackerman, *supra* note 25.

102. Louise Story & Gretchen Morgenson, *S.E.C. Case Stands Out because It Stands Alone*, N.Y. TIMES (May 31, 2011), [http://www.nytimes.com/2011/06/01/business/01prosecute.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2011/06/01/business/01prosecute.html?pagewanted=all&_r=0).

employee at Goldman Sachs in 2007.<sup>103</sup> He was “principally responsible for” a synthetic collateralized debt obligation (“CDO”) known as ABACUS 2007-ACI.<sup>104</sup> He created the marketing materials for the CDO and communicated with investors, but he failed to disclose the fact that “a large hedge fund, Paulson & Co. Inc. (“Paulson”), with economic interests directly adverse to investors in the ABCUS 2007-ACI CDO, played a significant role in the portfolio selection process.”<sup>105</sup> Less than a year later, “99% of the portfolio had been downgraded. As a result, investors in the ABACUS 2007-ACI CDO lost over \$1 billion. Paulson’s opposite CD positions yielded a profit of approximately \$1 billion for Paulson.”<sup>106</sup>

The SEC sued both Goldman Sachs and Tourre for this fraud. Goldman Sachs settled the charges with the SEC and paid \$550 million—“the largest penalty ever assessed against a financial services firm in the history of the SEC.”<sup>107</sup> Tourre’s liabilities were not covered under this settlement. While the SEC has not directly stated why it decided to pursue Tourre individually, Tourre’s conduct may be indicative. Federal Judge Katherine Forrest, overseeing Tourre’s case, put it best when she said that “[t]he SEC essentially argues that Tourre handed Little Red Riding Hood an invitation to grandmother’s house while concealing the fact that it was written by the Big Bad Wolf.”<sup>108</sup> Tourre knew that Paulson took an adverse position to the CDO, but did nothing to warn investors. In addition, Tourre knew that it was highly likely that the CDO would fail, as is evidenced by an email he wrote proclaiming that the “whole building is about to collapse anytime now,” and the “[o]nly potential survivor, the fabulous Fab . . . [would be] standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!”<sup>109</sup>

#### IV. Is Requiring Admissions in Certain Cases Worth It?

##### A. Economic Costs of Requiring Admissions of Wrongdoings in Civil Settlements

A main concern related to requiring an admission of wrongdoing is that companies and individuals will not want to settle out of the fear of “follow-on securities litigation,” or collateral estoppel.<sup>110</sup> This impacts the amount of time and

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103. Nate Raymond, *SEC Takes Goldman’s ‘Fabulous Fab’ to Trial in Civil Fraud Case*, REUTERS (July 14, 2013, 11:07 AM), <http://www.reuters.com/article/2013/07/14/us-goldmansachs-sec-tourre-idUSBRE96B00020130714>.

104. Complaint at 2, U.S. Sec. & Exch. Comm’n v. Goldman, Sachs & Co., No. 10 Civ. 3229, (S.D.N.Y. 2011), available at <http://www.sec.gov/litigation/complaints/2010/comp21489.pdf>.

105. *Id.* at 11.

106. *Id.* at 3.

107. Press Release, U.S. Sec. & Exch. Comm’n, Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), <http://www.sec.gov/news/press/2010/2010-123.htm>.

108. U.S. Sec. & Exch. Comm’n v. Tourre, 10 CIV. 3229 KBF, 2013 WL 2407172 (S.D.N.Y. June 4, 2013).

109. Raymond, *supra* note 103.

110. Jan Eaglesham & Andrew Ackerman, *SEC Seek Admissions of Fault*, WALL ST. J., <http://online.wsj.com/news/articles/SB10001424127887324021104578553931876196990> (last updated June 18, 2013, 8:51 PM).

resources the SEC can spend on each enforcement action it decides to pursue. Stephen Crimmins, a former SEC attorney, “estimated that requiring all settlements to involve admissions of liability could have cut the number of enforcement actions filed by the SEC last year from 734 to around 400, as more companies would have decided to take their cases to trial.”<sup>111</sup> However, such a drastic reduction in potential settlements actions would leave several hundred investors without redress.

Admissions could also “have collateral impacts in licensure processes, result in increased insurance premiums and could limit a company’s ability to contract with governmental organizations.”<sup>112</sup> One critic of requiring admissions proclaimed that:

Faced with the prospect of admissions that can be used against them in other proceedings and expose them to massive collateral damages, companies and their officers will be incentivized to take more cases to trial. And the SEC, which will see its already limited enforcement resources further diminished by protracted litigation, will have less time to pursue new investigations and shut down ongoing frauds, with any incremental benefit from seeing bad actors admit their wrongdoing offset by a delay in any financial recovery for investors (if such recovery can be had at all).<sup>113</sup>

It is important to recognize that the SEC expends considerable time and effort on a case before making the decision to settle. Before the SEC ever brings an enforcement action, it spends “months or even years building a case by gathering evidence and supporting facts, which are set forth in detail in the civil complaint or administrative order on which a proposed settlement is predicated.”<sup>114</sup>

SEC defendants are not only punished through monetary fines, but are also “held accountable through the public dissemination of information about their misconduct; that, where appropriate, private litigants are able to utilize the SEC’s detailed allegations to assist their own cases; and that the public sees that wrongdoers suffer penalties, bars, and other sanctions.”<sup>115</sup> Thus, private litigants are able to use the public information released in the settlement to help form arguments for their own cases. Additionally, judges may take the settlement information into consideration when deciding these private civil suits.<sup>116</sup>

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111. *Id.*

112. O’Connor, Goldschmidt, & McCaughey, *supra* note 24.

113. Marc Fagel, *The SEC’s Troubling New Policy Requiring Admissions*, GIBSON DUNN 1 (June 24, 2013), <http://www.gibsondunn.com/publications/Documents/Fagel-SECs-Troubling-New-Policy-Requiring-Admissions.pdf>.

114. KHUZAMI DEFENDS SEC SETTLEMENT POLICIES ON CAPITOL HILL, U.S. SEC. & EXCH. COMM’N, 2008 WL 10615406, 1 (July 2012).

115. *Id.*

116. Len Costa, *Stock Phrase When Wall Street Analysts “Neither Admit Nor Deny” Their Bad Behavior, Are They Fessing Up or Just Dodging the Bullet?*, LEGAL AFF. (Sept./Oct., 2003), [http://www.legalaffairs.org/issues/September-October-2003/termsofart\\_costa\\_sepoct03.msp](http://www.legalaffairs.org/issues/September-October-2003/termsofart_costa_sepoct03.msp).

Taking these considerations into account, it is possible that requiring admissions in too many cases could cost the SEC and the investing public more than it could help. On the contrary, requiring an admission of wrongdoing helps to ensure that the public has the information it needs to bring a successful case against wrongdoers and to deter defendants and other interested parties from committing these harms in the future. Marc Fagel, a securities law partner at Gibson Dunn, warns that the “SEC has unfortunately moved in a dangerous direction that could have monumental implications for the agency’s ability to fulfill its core mission of protecting investors.”<sup>117</sup>

## B. Social Benefits of Admitting to Wrongdoings in Settlement Agreements

One of the great flaws of the “neither admit nor deny” policy is that there is no way to distinguish between truly bad actors who knowingly violated the securities laws, and those who make technical violations with no intent to break the law or harm investors. It is unfair to the technical violators to be placed in the same category as the more culpable offenders. It is also unfair to investors who must make informed investment decisions to not be able to distinguish between bad actors and technical violators.

The “neither admit nor deny” rule is similar to criminal cases which allow for *nolo contendere* pleas that can result in “public doubt, uncertainty, and lack of respect for the criminal justice system. Far from encouraging honesty, they let guilty defendants cloak their pleas in innocence. In contrast, jury verdicts and unequivocal guilty pleas suppress residual doubts and promote public confidence.”<sup>118</sup> In cases brought by the SEC, public confidence is undermined when investors are unable to determine whether a defendant is truly guilty of misconduct, or simply wishes to avoid the cost of litigation.<sup>119</sup>

While it is important to consider the time and resources at the SEC’s disposal, it is possible that this focus has undermined the mission of the SEC, which “is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”<sup>120</sup>

Too often, the goal of the SEC has been to achieve a settlement with a defendant that affirms its authority, but makes no sense. This may be the product of logistical constraints and caseload pressure, and a partial answer may be to allocate more resources to the SEC. But the SEC has to be prepared to litigate (and not reflexively settle). Ultimately, this dilemma may

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117. Fagel, *supra* note 113, at 4.

118. Bibas, *supra* note 23, at 1386-87.

119. See Dina El Boghdady & Danielle Douglas, *JPMorgan’s Admission: A Symbolic Victory For the SEC, of Limited Use in Private Lawsuits*, WASH. POST. (Sept. 19, 2013), [http://www.washingtonpost.com/business/economy/jpmorgan-chase-to-pay-920-million-for-london-whale-trading-loss/2013/09/19/0c9d7d52-2130-11e3-b73c-aab60bf735d0\\_story.html](http://www.washingtonpost.com/business/economy/jpmorgan-chase-to-pay-920-million-for-london-whale-trading-loss/2013/09/19/0c9d7d52-2130-11e3-b73c-aab60bf735d0_story.html) (finding that admissions of wrongdoing both “improve[e] the SEC’s leverage in future negotiations with alleged wrongdoers and bolster[s] public confidence for an agency long criticized for being too soft on Wall Street”).

120. *About the SEC: What We Do*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/about/whatwedo.shtml> (last updated June 10, 2013).



require that the SEC bring fewer cases in order to be able to litigate more intensively those that it does bring.<sup>121</sup>

As part of a broader enforcement effort, Chairman White, who is a former federal prosecutor, emphasized the need “to be certain our settlements have teeth, and send a strong message of deterrence.”<sup>122</sup> The objective for the SEC is to determine whether action would redress the harm and also whether it would “cause would-be future offenders to think twice.”<sup>123</sup> Because the new policy will affect only a relatively small number of cases brought by the SEC, Chairman White does not believe it will cause enforcement delays or inefficiencies.<sup>124</sup> And, even if it does have a noticeable effect, White “welcome[s] the possibility” and is ready for it, stating, “[the SEC lawyers] are ready to go up against the best of the white-collar defense bar.”<sup>125</sup>

The potential for deterrence does not just extend to the particular defendants who are required to admit wrongdoings, but to society in general. While it remains to be seen how much this new policy will affect SEC settlements, it will surely “provide added impetus for firms to enhance their proactive training and compliance activities—lest they be placed in the unenviable position of having to admit wrongdoing in order to settle an SEC matter.”<sup>126</sup> This is another social benefit of requiring admissions and will hopefully prevent other players in the securities industry from violating the law in the first place. “Time will tell if the commission’s interest in obtaining admissions of wrongdoing will advance a fair and effective enforcement program.”<sup>127</sup>

## V. Finding the Sweet Spot in SEC Settlements

There are certainly valid concerns that the SEC Division of Enforcement “has slowly warped into a meek and abiding Division of Settlement.”<sup>128</sup> If the SEC requires admissions in all of its cases, it will remove the “easy way out” for violators of securities law [and] will promote transparency and accountability.<sup>129</sup> While this route may be the best for addressing public interest concerns, it of course comes at a high cost, which requires either a large budgetary increase, or fewer cases investigated with a greater focus on serious violations.<sup>130</sup>

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121. Macchiarola, *supra* note 74, at 96 (quoting John C. Coffee, Jr., *The End of Phony Deterrence? “SEC v. Bank of America”*, N.Y.L.J., Sept. 17, 2009).

122. Andrew Ackerman, *SEC Chairman White Outlines Agenda to Toughen Enforcement – Update*, WALL ST. J. (Sept. 26, 2013, 12:24 PM), <http://online.wsj.com/article/BT-CO-20130926-708628.html>.

123. *Id.*

124. Eaglesham & Ackerman, *supra* note 110.

125. Aruna Viswanatha, *SEC Chair says Agency Prepared For Increase in Trials After Policy Change*, REUTERS (Nov. 14, 2013), <http://www.reuters.com/article/2013/11/15/sec-white-idUSL2N0IZ2E720131115>.

126. O’Connor, Goldschmidt, & McCaughey, *supra* note 24.

127. Powers, Kornfeld, & Wasick, *supra* note 22.

128. Ross MacDonald, Note, *Setting Examples, Not Settling: Toward A New SEC Enforcement Paradigm*, 91 TEX. L. REV. 419, 420 (2012).

129. Amanda S. Naoufal, Comment, *Is Judge Rakoff Asking For Too Much? The New Standard For Consent Judgment Settlements with the SEC*, 2 AM. U. BUS. L. REV. 183, 206 (2012).

130. MacDonald, *supra* note 128, at 443.

The trick in this situation is not to adopt an “all or nothing” solution, but a solution that serves the public’s best interest and is appropriate considering the time and resources available to the SEC. Requiring admissions in certain cases is a smart step forward and can strike the appropriate balance between what is good for the public and what is impactful, considering the time and resources available to the government in pursuing securities litigation. However, one should be cautious against “[a]n overly aggressive application of the policy . . . [as it] may carry significant costs, including hindering the prompt resolution of cases; losing trials that could have been settled; and losing the opportunity to investigate more claims of wrongdoing as resources are shifted to support trial work.”<sup>131</sup>

Chairman White stated that in requiring admissions of wrongdoing, the SEC will look at the egregiousness of the conduct and the harm to investors.<sup>132</sup> These considerations will limit the number of cases requiring admissions to those which by their severity have inflicted the greatest costs on the public, and because of the culpability involved, will result in the greatest benefits, because it will not simply be negligent actors involved, but those who are truly acting maliciously.

The correct focus should be on the egregiousness of the conduct and the harm to the investors. However, this general focus does not provide concrete guidance regarding which cases should require admissions of wrongdoing. Therefore, this Article will propose several factors that the SEC and other federal agencies should consider when deciding whether to pursue such admissions.

#### A. Intent to Harm

In *BMW of North America, Inc. v. Gore*, the U.S. Supreme Court stated, “trickery and deceit . . . are more reprehensible than negligence,”<sup>133</sup> referring to what circumstances allow punitive damages to be appropriate. Admissions of wrongdoing in SEC settlements are similar to punitive damages in criminal cases. Similar to the imposition of punitive damages, the SEC should not require admissions of wrongdoing unless the defendant’s conduct is believed to be intentional. Otherwise, admissions would not serve a public benefit and would not serve the goal of increasing deterrence.

For example, securities fraud is considered particularly egregious because it requires scienter—the “intent to deceive, manipulate, or defraud.”<sup>134</sup> This specific intent is most often wrought upon individuals. The SEC should look at fraud cases very closely, and this factor should weigh heavily on its decision regarding whether or not to require an admission.

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131. O’Connor, Goldschmidt, & McCaughey, *supra* note 24.

132. White, *supra* note 98.

133. *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 576 (1996) (internal quotations removed).

134. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

## B. Repeat Offenders

If a defendant is a repeat offender of the securities laws, then it is likely that a simple cash payment is not going to deter the culprit from breaking the law in the future. This is a situation in which the SEC really needs to sink its teeth and make its settlement hurt. This situation will most likely apply to institutions rather than individuals (because individuals are typically enjoined from participating in the securities industry for a set amount of time as a condition of the settlement, and because the SEC still mainly pursues companies). A settlement including an admission will likely impact an institution more than a cash settlement will because shareholders may decide they no longer want to be part of the company, and stock prices will likely fall more than they would have as a result of an ordinary settlement.

## C. Sophistication of Investors

Fabrice Tourre once bragged in an email that he was selling the “Abacus bonds to widows and orphans.”<sup>135</sup> This conduct surely falls on the egregious end of Chairman White’s guidance. It is much worse for a defendant to target less sophisticated investors who may not understand the basics of the investments they are making (even sophisticated investors have a difficult time trying to figure out synthetic CDOs), than to deal with savvy investors who are willing to take large risks. If the defendant is being sued by the SEC, that means that he may have violated one or more securities laws, and if the investors involved are unsophisticated, then the defendant has not only violated the securities laws but also a moral code that society deems important.

## D. Number of Investors Harmed

There is no bright-line number to determine whether this factor is met because it is dependent upon the other factors, especially the amount of damages the defendant has caused. That being said, this factor will assist in showing the level of harm inflicted on investors. The SEC has said that it may require admissions in “[c]ases where a large number of investors have been harmed.”<sup>136</sup> The more investors harmed, the more likely the damages are high, the investors are not sophisticated, and the defendant intended to defraud or otherwise harm the investors.

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135. Christine Harper, *Goldman’s Tourre E-Mail Describes ‘Frankenstein’ Derivatives*, BLOOMBERG NEWS (Apr. 24, 2010, 5:34 PM), <http://www.bloomberg.com/news/2010-04-24/franken-stein-derivatives-described-in-e-mail-by-goldman-s-fabrice-tourre.html>.

136. White, *supra* note 98.

## E. Amount of Damages and Harm to the Market

As mentioned in the previous factor, there is no bright-line amount of damages that should determine whether the SEC should seek an admission of wrongdoing. Again, this depends to a large degree on whether the defendant intended to harm investors. It is important to punish those who have caused great damage to the market, both in monetary damages and damages to investor confidence. This is especially true in cases in which a large number of investors were harmed in the process.

## VI. Conclusion

In June 2013, the SEC announced a departure from its “long-time practice of allowing companies to strike guilt-free deals over serious allegations, such as responsibility for some of the worst blowups of the financial crisis.”<sup>137</sup> Instead, the SEC decided to require, in certain cases, an admission of wrongdoing in order to settle. Although the SEC is currently developing guidance to help determine in which cases it will seek such admissions, Chairman White explained that the focus will be on the egregiousness of the misconduct and the harm to investors.<sup>138</sup>

Shortly after *Harbinger* was settled, the SEC reached a \$200 million settlement with J.P. Morgan Chase (“Chase”) in which Chase admitted that it had “violated federal securities laws when it failed to catch traders hiding [\$6.2 billion in] losses in 2012.”<sup>139</sup> The SEC decided to require Chase to admit guilt because its “egregious breakdowns in controls and governance put its millions of shareholders at risk and resulted in inaccurate public filings.”<sup>140</sup> The OCC and the Federal Reserve also settled with Chase, but they did not require an admission of guilt as part of their settlement agreements.<sup>141</sup>

There are advantages and disadvantages of requiring an admission of wrongdoing. The largest disadvantage is the increased time and expense spent in litigation since the SEC has limited resources and cannot pursue every case. The biggest advantage is that requiring admissions “creates an unambiguous record of the conduct and demonstrates unequivocally the defendant’s responsibility for his or her acts.”<sup>142</sup> This benefit is in the public interest because it allows harmed investors to seek redress and creates a deterrent effect upon individuals and companies seeking to do harm.

The best way to balance these competing interests lies in developing a model to determine which settlements should require an admission of wrongdoing.

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137. Ackerman, *supra* note 25.

138. White, *supra* note 98.

139. Joshua Gallu, *JPMorgan Guilty Admission A Win For SEC’s Policy Shift*, BLOOMBERG (Sept. 19, 2013, 10:01 PM), <http://www.bloomberg.com/news/2013-09-19/jpmorgan-s-guilty-admission-marks-victory-in-sec-s-policy-shift.html>.

140. *Id.*

141. *Id.*

142. White, *supra* note 98.

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The SEC should consider the following factors: whether the defendant intended to harm investors, whether this is the first offense or the defendant has been guilty of similar misconduct in the past, whether the harmed investors were sophisticated, the number of investors harmed, and the amount of damages and the effect on the market.

