PUBLICATION

SEC Alters Policy on 'No Admit, No Deny' Settlements

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January 13, 2012

Summary

On January 6, 2012, Robert Khuzami, the Director of Enforcement at the United States Securities and Exchange Commission (SEC) announced a change in its long-standing policy of allowing defendants to enter into settlement agreements without admitting or denying the SEC's allegations of wrongdoing. Under the new policy, defendants who have admitted to, or been convicted of, a criminal offense may not settle parallel civil proceedings brought by the SEC without admitting guilt. This change will require companies litigating parallel proceedings to properly consider the collateral effects of taking a plea, or entering into a Non-Prosecution Agreement (NPA) or Deferred Prosecution Agreement (DPA) with the United States Department of Justice (DOJ) or with another criminal enforcement agency.

Background

The SEC's practice of allowing defendants to enter into settlement agreements without admitting or denying wrongdoing has become its standard policy. A typical SEC settlement provides a detailed recitation of the SEC's allegations in the matter, followed by a statement that the defendant "without admitting or denying the findings [t]herein, except as to the Commission's jurisdiction over it" consents to the entry of the settlement order. This practice has been justified as serving to balance the SEC's interest in compensating harmed investors without years of courtroom delay and without the risks of losing at trial or recovering less than the settlement amount, with the defense bar's interest in ensuring admissions of violations will not be used against them in subsequent civil lawsuits.

This long-standing practice has recently come under significant criticism. In *SEC v. Citigroup Global Markets*, Judge Jed S. Rakoff of the Southern District of New York was faced with a typical "No Admit, No Deny" provision and refused sign-off on the settlement. In a scathing opinion, Rakoff concluded that without any proven or admitted facts the court could not approve the settlement. Rakoff stated:

The SEC's long-standing policy - hallowed by history, but not by reason - of allowing defendants to enter into consent judgments without admitting or denying the underlying allegations, deprives the court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact... An application of judicial power that does not rest on facts is worse than mindless, it is inherently dangerous... If its deployment does not rest on facts - cold, hard, solid facts, established either by admissions or by trials - it serves no lawful or moral purpose and is simply an engine of oppression.

In response to this opinion, and in defense of the SEC's practice, Khuzami issued a statement contending that Rakoff committed legal error by announcing a "new and unprecedented standard that inadvertently harms investors by depriving them of substantial, certain and immediate benefits." He further contended that Rakoff's opinion was at odds with decades of court decisions across the country that have upheld similar settlements by federal and state agencies. Khuzami went on to articulate several justifications for the SEC's "No Admit, No Deny" settlement policy, including:

- Obtaining disgorgement, monetary penalties and mandatory business reforms may significantly outweigh the absence of an admission when that relief is obtained promptly and without the risks, delay and resources required at trial;
- Securities law generally limits the disgorgement amount the SEC can recover to ill-gotten gains, plus a monetary penalty in an amount up to a defendant's gain. The SEC does not currently have statutory authority to recover investor losses;
- The SEC only recommends settlement when the outcome in penalties is in the range of what the staff reasonably expects if it went to trial;
- Without the policy, there would be many fewer settlements, which would mean taking a chance on always unpredictable trials. This would eliminate the certainty of victims of frauds actually getting compensation, and would certainly delay such compensation;
- Fewer settlements would result in a lack of SEC resources. On this point, Khuzami stated "[W]e are an agency on a modest budget... Settling a case in Miami today could mean preventing the next account fraud in Phoenix, [and] pursuing the next manipulation case in Memphis"; and
- The SEC is fully prepared to refuse to settle and proceed to trial when proposed settlements fail to achieve the right outcome for investors.

The defense bar also supports the SEC's "No Admit, No Deny" policy. Companies insist on such language in settlements because private litigants would otherwise be able to use a company's admissions of wrongdoing in related derivative, class-action, and other private litigation. Therefore, without such "No Admit, No Deny" language in settlement agreements, companies would be more inclined to fight, and the SEC would be unable to enter into settlement agreements with scores of companies which otherwise would have settled. In addition, with the possibility of settlement removed, it is also likely that companies would be reluctant to cooperate in the SEC's investigatory process, thus chilling investigations across the country.

The SEC has appealed Judge Rakoff's decision in the *Citigroup* case to the Second Circuit Court of Appeals.

Changes to the "No Admit, No Deny" Policy

The SEC's recent changes to its "No Admit, No Deny" policy are modest, and not intended to address the concerns raised by Judge Rakoff. The new policy will no longer allow "No Admit, No Deny" language in settlement agreements where the defendants: (a) have been subject to parallel criminal proceedings and have pled guilty, (b) have been convicted in a parallel criminal proceeding, or (c) have entered into an NPA or a DPA which contains admissions or acknowledgments of criminal conduct. Instead, the SEC will now include the "fact and nature" of the criminal conviction, NPA, or DPA in the SEC settlement, and the defendant will be prohibited from denying that fact.

However, there are several reasons why this new policy will not have a substantial effect on SEC enforcement actions. First, the policy applies only to the minority of SEC enforcement actions that are brought as parallel proceedings. Khuzami acknowledged this fact, stating "[t]he revision applies in the minority of our cases." The SEC will continue to use "No Admit, No Deny" language in settling cases that do not involve criminal convictions or admissions of criminal law violations, which constitute the substantial majority of SEC enforcement actions. Second, the new policy will not require the SEC to include any additional admissions that were not made in the criminal proceeding. Finally, the SEC is not required to include facts admitted in the criminal proceeding; rather, the settlement must merely note that the defendant has admitted the parallel criminal action. Therefore, the decision to include findings of fact from the criminal proceeding is within the SEC's discretion.

As a practical matter, this new policy appears likely to have two significant implications on companies that are subject to parallel criminal and SEC investigations. First, companies will likely attempt to settle actions with the

SEC before settling criminal proceedings, in an effort to avoid the incorporation of admissions or acknowledgment of guilt in the SEC settlement. Second, where a company has settled a parallel criminal proceeding before entering into a settlement with the SEC, the company will have to consider the collateral effects such action may have on the SEC settlement, and on related derivative, class action, and other private litigation.

Next Steps

It remains to be seen whether other judges will be persuaded by Rakoff's analysis, and whether the Second Circuit will uphold his decision. Additionally, the House Financial Services Committee has announced that it will hold a hearing this year to examine the SEC's practice of settling cases with defendants where the defendants neither admit nor deny the SEC's allegations. Committee Chairman Spencer Bachus stated "the SEC's practices of using 'no-contest' settlements raised concerns about accountability and transparency." Ranking Member Barney Frank mirrored this sentiment stating the policy "raises serious issues."

The effect of these determinations cannot be understated. If courts refuse to accept "No Admit, No Deny" settlements, we expect the landscape of SEC enforcement action litigation to change dramatically.

If you are currently facing parallel criminal and SEC proceedings, have questions about how these issues might affect your company, or have any other securities-related issues, please contact any of the following Baker Donelson attorneys:

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