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Inside Rakoff's Rejection Of SEC-Citigroup Settlement

Law360, New York (November 30, 2011, 6:22 PM ET) -- U.S. District Court Judge Jed S. Rakoff's recent opinion rejecting a proposed settlement between the U.S. Securities and Exchange Commission and Citigroup Global Markets Inc. (CGMI), the principal broker-dealer subsidiary of Citigroup Inc., could significantly affect the SEC enforcement. Simultaneously with the filing of the SEC's complaint against CGMI (the "Complaint"), the SEC and CGMI program submitted a proposed consent judgment to Judge Rakoff.

The SEC, like many federal agencies, has long had a practice of resolving civil enforcement actions through the entry of judgments in which settling defendants consent to the entry of the judgment without admitting or denying any of the substantive allegations in the Complaint. Judge Rakoff, nevertheless, held that it was not appropriate for a district court to enter a consent judgment based on allegations unless the court has a sufficient basis for determining that the consent judgment is fair, adequate, reasonable and in the public interest.

Background

SEC Complaint and Proposed Settlement

The SEC filed the Complaint on Oct. 19, 2011, in the Southern District of New York. In the complaint, the SEC alleged that CGMI violated the negligence-based provisions of Section 17(a) of the Securities Act of 1933 in connection with the offer and sale of a collateralized debt obligation (CDO) tied to the U.S. housing market. According to the Complaint:

- In early 2007 CGMI structured and marketed a CDO (known as "Class V Funding III"). Complaint ¶ 1.
- At least part of CGMI's rationale for pursuing such a transaction was that it would enable its CDO trading desk to establish a naked short position on A-rated tranches of certain mezzanine CDOs originated in 2006. These naked short positions would increase in value, and thus provide profits to CGMI, in the event of a downturn in the United States housing market. Complaint ¶ 18.

- CGMI’s marketing materials for the Class V Funding III represented that the Fund's assets were attractive investments selected by an independent investment adviser, when in fact CGMI had exercised significant influence over the selection of the assets and had retained a $500 million proprietary short position of the assets it had helped select, which gave Citigroup undisclosed economic interests adverse to those of the investors in Class V. Complaint ¶¶ 1, 2, and 3.

- CGMI realized net profits of around $160 million on the CDO transaction. Complaint ¶ 5.

Consistent with the usual practice of the SEC and simultaneously with the filing of the Complaint, the SEC presented to Judge Rakoff a proposed settlement, consisting of the entry of a judgment to which CGMI had consented without admitting or denying the substantive allegations in the Complaint. If entered, the consent judgment would have:

- “permanently restrained and enjoined” CGMI and its agents, employees, etc., from future violations of Sections 17(a)(2) and (3) of the Securities Act;

- required CGMI to disgorge to the SEC CGMI's $160 million in profits, plus $30 million in interest thereon, and to pay to the SEC a civil penalty in the amount of $95 million; and

- required CGMI to undertake for a period of three years, subject to enforcement by the Court, certain internal measures designed to prevent recurrences of the securities fraud here perpetrated. SEC v. Citigroup Global Markets Inc.

The SEC also filed a Memorandum By Plaintiff Securities and Exchange Commission in Support of Proposed Settlement (the “Initial Memorandum”). In the Initial Memorandum, the SEC stated that the applicable standard of review for the proposed consent judgment was whether the proposed judgment served the public interest:

> The standard for judicial review and approval of proposed consent judgments in Commission enforcement actions is whether they serve “the public interest.” SEC v. Randolph, 736 F.2d 525, 529 (9th Cir. 1984), see also United States v. Trucking Emp. Inc., 561 F.2d 313, 317 (D.C. Cir. 1977) (“prior to approving a consent decree a court must satisfy itself of the settlement’s overall fairness to beneficiaries and consistency with the public interest”) (citations and internal quotations omitted). To ensure that the public interest is served, the court “need not inquire into the precise legal rights of the parties nor reach and resolve the merits of the claims or controversy, but need only determine that the settlement is fair, adequate, reasonable and appropriate under the particular facts and that there has been valid consent by the parties.” Citizens for a Better Env 't v. Gorsuch, 718 F.2d 1117, 1126 (D.C. Cir. 1983) (citations omitted). Stated another way, “[t]his Court has the obligation, within carefully prescribed limits, to determine whether the proposed Consent Judgment settling [a] case is fair, reasonable, adequate, and in the public interest.” SEC v. Bank ofAmerica Corp., No. 09-CV-6829 (JSR) (S.D.N.Y. Aug. 25, 2009). In making this assessment, “the law requires the Court to give substantial deference to the SEC as the regulatory body having primary responsibility for policing the securities markets, especially with respect to matters of transparency.” SEC v. Bank of America Corp., Nos. 09 Civ. 6829 (JSR), 10 Civ. 0215 (JSR) (S.D.N.Y. Feb. 22, 2010).

> In evaluating the reasonableness of a Commission settlement that includes a proposed penalty, a court should be satisfied that the penalty reflects an adequate consideration of relevant penalty factors. See SEC v. Worldcom, Inc., 273 F. Supp. 2d 431, 434-436 (S.D.N.Y. 2003) ...
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> Initial Memorandum at 4-5.

SEC Arguments For Why the Court Should Enter the Proposed Consent Judgment

By order dated Oct. 27, 2011, Judge Rakoff posed several questions to both the SEC and Citigroup, including whether the court should impose a judgment in a case in which the SEC alleges a serious securities fraud but the defendant neither admits nor denies wrongdoing and whether "there is an overriding public interest in determining whether the SEC's charges are true." On Nov. 7, 2011, the SEC responded in the SEC's Memorandum of Law In Response to Questions Posed by the Court Regarding Proposed Settlement (the "Memorandum").

1) The SEC Argued that Courts Had Long Endorsed the Entry of Consent Judgments and the Court should Accord the SEC Substantial Deference in Assessing Whether the Proposed Consent Judgment Satisfied the Standard of Being Fair, Adequate and Reasonable

The SEC opened the argument section of its Memorandum by observing that courts had endorsed the entry of consent judgments, including the Second Circuit, which observed that there is a "strong federal policy favoring the approval and enforcement of consent decrees." Memorandum at 3, citing, e.g., United States v. Armour & Co., 402 U.S. 673, 681 (1971); "); SEC v. Randolph, 736 F.2d 522, 525 (9th Cir. 1991) ("Unless a consent decree is unfair, inadequate, or unreasonable, it ought to be approved."); SEC v. Wang, 944 F.2d 80, 85 (2d Cir. 1991)("Unless a consent decree is unfair, inadequate, or unreasonable, it ought to be approved"), quoting SEC v. Randolph, 736 F.2d at 529.

The SEC argued that judicial review of SEC consent judgments should be limited and deferential. Memorandum at 4, citing, e.g., United States v. Akzo Coating of Am. Inc., 949 F.2d 1409, 1436 (6th Cir. 1991) ("it is not a court's function to determine whether this is the best possible settlement that could have been obtained, but only whether it is fair, adequate and reasonable."). Memorandum at 10, quoting SEC v. Randolph, 736 F.2d 525, 529 (9th Cir. 1983) ("in reviewing the parties' proposed settlement, 'the courts should pay deference to the judgment of the government agency that has negotiated and submitted the proposed judgment.'").

The SEC argued that the judicial review of a proposed consent judgment should not involve a court attempting to resolve factual disputes in the matter, Memorandum at 5, citing United States v. Oregon, 913 F.2d 576, 582 (9th Cir. 1990), noting that requiring the resolution of factual disputes as a condition of entering a consent judgment "would emasculate the very purpose for which settlements are made." Memorandum at 6, quoting City of Detroit v. Grinnell Corp., 495 F.2d 448, 462 (2d Cir. 1974).

The SEC argued that the court should approve the proposed consent judgment as fair, adequate, and reasonable and that whether the proposed consent judgment was in the public interest is not part of the applicable standard of judicial review. Memorandum at 4 n. 1 citing, e.g., SEC v. Wang, 944 F.2d at 85.

The SEC argued, as an initial matter, a presumption of fairness, adequacy and reasonableness attaches to the settlement as a result of the consent judgment's having been negotiated at arm's length between parties represented by experienced counsel after a comprehensive investigation. Memorandum at 9, citing Wal-Mart Stores Inc. v. Visa U.S.A. Inc., 396 F.3d 96, 116 (2d Cir. 2005).

The SEC argued that the consent judgment therefore should be rejected by the court "only if any of the terms appear ambiguous, if the enforcement mechanism is inadequate, if third parties will be positively injured, or if the decree otherwise makes a mockery of judicial power." Memorandum at 10, quoting Massachusetts v. Microsoft Corp., 373 F.3d 1199, 1236 (D.C. Cir. 2004).

2) The SEC Argued that Court Should Accept Consent Judgments in which the Settling Defendant Does Not Admit the Substantial Allegations

In direct response to the court's question as to whether the court should impose a judgment even though the defendant neither admits nor denies wrongdoing, the SEC argued that the use and entry of consent judgments had long been endorsed by the Supreme Court and that courts have expressly endorsed the entry of consent judgments notwithstanding a defendant's explicit denial of material allegations of the complaint. Memorandum at 11, citing, e.g., Swift & Co. v. United States, 276 U.S. 327 (1928) (approving an antitrust injunction in a matter in which the settling defendants expressly denied the Government's material allegations); United States v. Microsoft, 56 F.3d 1448, 1461 (D.C. Cir. 1995) (observing that defendants ordinarily do not admit to having violated the antitrust or other laws alleged as violated in complaints that are settled and that "the district judge's criticism of Microsoft for declining to admit that the practices charged in the complaint actually violated the antitrust laws was thus unjustified").

The SEC noted that, consistent with this standard practice, it had long utilized consent judgments in which defendants admit no wrongdoing and that since 1972 the SEC had generally included in its proposed consent judgments a provision prohibiting a settling defendant from denying any allegation in the SEC's complaint. The SEC argued that its approach clearly conveys the conduct that did in fact occur. Memorandum at 13.

Judge Rakoff had previously questioned whether the SEC's no admit/deny policy is consistent with the policy of the Justice Department not to accept nolo contendere pleas in criminal cases. SEC v Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 309 (S.D.N.Y. 2011).

The SEC argued in the Memorandum that because the Federal Rules of Criminal Procedure and constitutional law limit the conditions under which criminal punishment may be imposed, criminal cases are not analogous to SEC enforcement cases. Memorandum at 13. The SEC noted that the SEC's no admit/deny policy is consistent with the position taken by the Justice Department and other federal agencies in civil enforcement cases, except that the Justice Department often obtains consent decrees in civil enforcement actions in which the defendant expressly and repeatedly denies liability. Memorandum at 13-14.

3) The SEC Argued that the Public's Interest in Transparency Was Addressed by The Public Filing of the Complaint

In direct response to the court's question as to whether there is an overriding public interest in determining whether the SEC's charges are true, the SEC argued that the detailed allegations in the Complaint, the substantial payment by CGMI, CGMI's lack of a denial of the allegations, and CGMI's public statement regarding the settlement (which focused on the fact that the company had "overhauled the risk management function, significantly reduced risk on the balance sheet, and returned to the basics of banking"), Citigroup Announces Class V Settlement (Oct. 29, 2011), available athttp://www.citigroup.com/citi/press/2011/111019c.htm, put the public on notice as to Citigroup's conduct. Memorandum at 15-16.

The SEC further noted that the ongoing litigation by the SEC against former Citigroup employee in connection with the marketing and sale of the Class V Funding III CDO would provide further information to the public regarding events at issue.

Judge Rakoff's Analysis

Judge Rakoff rejected the SEC's position that the appropriate standard of review was whether the proposed consent judgment was fair, adequate, and reasonable, but did not include consideration of whether the proposed consent judgment was in the public interest. Memorandum at 4-6. Judge Rakoff observed that the SEC previously had expressed a standard of review that expressly included the public interest:

> In its original Memorandum in support of the proposed Consent Judgment, filed before the case had been assigned to any judge, the S.E.C. expressly endorsed the standard of review set forth by this Court in its Bank of America decisions, i.e., "whether the proposed Consent Judgment ... is fair, reasonable, adequate, and in the public interest." Memorandum By Plaintiff Securities and Exchange Commission in Support of Proposed Settlement at 5 (quoting with approval SEC v. Bank of America Corp., 653 F.Supp.2d 507, 508 (S.D.N.Y. 2009) ("Bank of America I ")); see also SEC v. Bank of America Corp. (S.D.N.Y. Feb. 22, 2010) ("Bank of America II "). This was also the S.E.C.'s stated position in another, intervening proceeding before this Court, SEC v. Vitesse Semiconductor Corp., 771 F.Supp.2d 304 (S.D.N.Y. 2010).

Judge Rakoff further observed that the Supreme Court has repeatedly made clear that a court cannot grant the "extraordinary remedy of injunctive relief without considering the public interest." Id. at *2. Judge Rakoff then reasoned that the public interest factor is implicit in the standard proposed by the SEC in that the consideration of the adequacy and of the fairness of the proposed relief inherently requires consideration of the public interest. Id. at *3.

Judge Rakoff agreed that the SEC was entitled to "substantial deference" but asserted that the court must still exercise independent judgment in determining whether the proposed injunction will serve the public interest:

> [T]he D.C. Circuit, in United States v. Trucking Employers, Inc., 561 F.2d 313 (D.C. Cor. 1977), reaffirmed that "prior to approving a consent decree a court must satisfy itself of the settlement's "overall fairness to beneficiaries and consistency with the public interest." Id. at 319 (quoting United States v. Allegheny Ludlum Industries, 517 F.2d 826, 850 (5th Cir. 1975). As these and similar authorities make plain, a court, while giving substantial deference to the views of an administrative body vested with authority over a particular area, must still exercise a modicum of independent judgment in determining whether the requested deployment of its injunctive powers will serve, or disserve, the public interest. Anything less would not only violate the constitutional doctrine of separation of powers but would undermine the independence that is the indispensable attribute of the federal judiciary.
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> Without multiplying examples, it is clear that before a court may employ its injunctive and contempt powers in support of an administrative settlement, it is required, even after giving substantial deference to the views of the administrative agency, to be satisfied that it is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public.

> Judge Rakoff did not, however, expressly address the substantial case law cited by the SEC (e.g., Swift and Microsoft), in which courts had endorsed the entry of consent decrees involving the issuance of injunctions.

> Judge Rakoff stated that the SEC's no admit/deny policy not only denied the court any assurance regarding the validity of the allegations in the Complaint, but led to a conclusion that the proposed consent judgment is "neither fair nor reasonable, nor adequate, nor in the public interest." Id. *4. It is not, however, clear from Judge Rakoff's opinion how the absence of an admission could lead to a conclusion that the consent judgment was unfair, unreasonable, inadequate and not in the public interest:

> Applying these standards to the case in hand, the Court concludes, regretfully, that the proposed Consent Judgment is neither fair, nor reasonable, nor adequate, nor in the public interest. Most fundamentally, this is because it does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards. Purely private parties can settle a case without ever agreeing on the facts, for all that is required is that a plaintiff dismiss his complaint. But 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.

> Here, the S.E.C.'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.

> Id. at *4.

Potential Implications of Judge Rakoff's Opinion

The implications of Judge Rakoff's opinion are uncertain. Judge Rakoff expressed specific concerns regarding the terms of the proposed consent judgment, see, e.g., id. at *5, and emphasized the public interest in uncovering information regarding the conduct that led to the 2008 financial crisis, id. at *6. Nevertheless, it appears that Judge Rakoff's reasoning applies broadly, not only to all SEC settlements involving the entry of an injunction but to any government settlements that involve the entry of an injunction:

> It is not reasonable, because how can it ever be reasonable to impose substantial relief on the basis of mere allegations? It is not fair, because, despite Citigroup's nominal consent, the potential for abuse in imposing penalties on the basis of facts that are neither proven nor acknowledged is patent. It is not adequate, because, in the absence of any facts, the Court lacks a framework for determining adequacy. And, most obviously, the proposed Consent Judgment does not serve the public interest, because it asks the Court to employ its power and assert its authority when it does not know the facts.

> An application of judicial power that does not rest on facts is worse than mindless, it is inherently dangerous. The injunctive power of the judiciary is not a free-roving remedy to be invoked at the whim of a regulatory agency, even with the consent of the regulated. 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.
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> Id. at *6.

The SEC practice of settling most enforcement actions conserves SEC resources that otherwise would have to be expended in litigation. As SEC Enforcement Director Robert Khuzami emphasized in a statement he releases shortly after the issuance of Judge Rakoff's opinion insisting on admissions would come at a significant cost to the enforcement program:

> The court's criticism that the settlement does not require an "admission" to wrongful conduct disregards the fact that 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. It also ignores decades of established practice throughout federal agencies and decisions of the federal courts. Refusing an otherwise advantageous settlement solely because of the absence of an admission also would divert resources away from the investigation of other frauds and the recovery of losses suffered by other investors not before the court.
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> Robert Khuzami, Public Statement by SEC Staff: Court's Refusal to Approve Settlement in Citigroup Case (Nov. 28, 2011), available athttp://www.sec.gov/news/speech/2011/spch112811rk.htm.

For many SEC enforcement matters, there is a significant risk of parallel criminal or civil actions, especially if the settling entity or individual made damaging admissions as a condition of settlement. Accordingly, it is to be expected that if the SEC insisted that settling companies or individuals admit damaging facts as a condition of settlement, the SEC would either obtain fewer settlements or have to make offsetting concessions (e.g., obtain monetary penalties that are significantly smaller than the SEC would be able to obtain if the SEC did not insist on such admissions). If Judge Rakoff's opinion results in fewer settlements, his opinion could substantially impair the capacity of the SEC to investigate potential violations of the federal securities laws.

It is not clear how much traction Judge Rakoff's reasoning will gain in the courts. Unless the SEC or Citigroup obtains a grant of mandamus from the U.S. Court of Appeals for the Second Circuit, Judge Rakoff's opinion remains the opinion of one district court judge. Judge Rakoff is highly respected, this opinion has garnered much favorable comment. See, e.g., James Downie, "Judge Rakoff Courageously Rejects SEC-Citigroup Settlement," TheWashington Post (11/28/2011), available at http://www.washingtonpost.com/blogs/post-partisan/post/judge-jed-rakoff-courageously-strikes-down-sec-citigroup-settlement/2011/11/28/gIQAIpaS5N_blog.html; "The SEC's Enabling," The New York Times(Nov. 28, 2011) available at http://www.nytimes.com/2011/11/29/opinion/the-secs-enabling.html. Nevertheless, the SEC has a strong argument that Judge Rakoff's opinion is contrary to substantial precedent.

In addition, Judge Rakoff's position conflicts with the courts' wide-spread practice of accepting consent judgments that are not accompanied by admission of the material allegations. As SEC Enforcement Director Khuzami noted:

> The settlement provisions cited by the court have been included in settlements repeatedly approved for good reason by federal courts across the country — including district courts in New York in cases involving similar misconduct.
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> Robert Khuzami, Public Statement by SEC Staff: Court's Refusal to Approve Settlement in Citigroup Case (Nov. 28, 2011), available athttp://www.sec.gov/news/speech/2011/spch112811rk.htm. Accordingly, it is likely that most other district court judges will continue to enter SEC's consent judgments that are not accompanied by admission of material allegations.

The SEC — unlike many federal law enforcement agencies — has the option of bringing charges in administrative proceedings. The SEC now has the general power in an administrative proceeding to issue cease and desist orders and to impose monetary penalties and orders of disgorgement.

Currently, the SEC settles some enforcement actions through consent decrees entered in court and some through administrative proceedings. In light of Judge Rakoff's position that a court should not enter an injunction in a matter in which the court lacks information, the SEC might increase its reliance on settled administrative proceedings in order to avoid the risk of other proposed consent judgments being rejected by the courts.

The SEC might also be able to address the concerns raised by Judge Rakoff by submitting to a court a memorandum detailing the evidence supporting the material allegations. Although such a court memorandum would not establish the facts either by admission or by trial, such a memorandum would provide the court with some assurance "that the substantial injunctive relief it is being asked to impose has any basis in fact."

A similar approach is suggested by Judge Rakoff's observation that CMGI did not make any material admissions even though in the SEC's enforcement action against Goldman Sachs, Goldman Sachs' consented to the entry of the judgment included the following express admission from Goldman: "Goldman acknowledges that the marketing materials for the ABACUS 2007–ACI transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was 'selected by' ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to [portfolio] investors. Goldman regrets that the marketing materials did not contain that disclosure." Id. at 5 n. 7.

Although Goldman's express admission fell substantially short of an admission of legal liability, such an admission might satisfy a court that wants more of a basis for entering an injunction than the SEC's allegations combined with the defendant's consent and a commitment by the defendant not to deny to the substantive allegations in the SEC's complaint.

Conclusion

Judge Rakoff's opinion rejecting the proposed consent judgment between the SEC and CGMI departs from substantial predicate. If the reasoning behind his opinion gains traction, the adverse impact on the SEC enforcement program could be substantial. There are, however, a number of steps that the SEC might take to reduce that adverse impact.

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