Admission of Guilt: Sinking Teeth into the SEC's Sweetheart Deals

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Throughout its existence, the 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 an admission of wrongdoing. This 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 obtain 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 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 United States Securities and Exchange Commission (“SEC”) in June.

Mr. Falcone became a billionaire in late 2006, when “he began to put in place an enormous bet that subprime mortgages would default.” At its high point, Falcone’s hedge fund company Harbinger managed $26 billion. But then things quickly started to go downhill for Falcone. In October 2008, most of Harbinger’s “assets were tied up in the collapse of Lehman Brothers,” leading Falcone to “lock-up” investor funds to keep investors from withdrawing their interests for over one year.

Shortly after the lock-up occurred, Falcone then took out a $113 million loan from the Harbinger fund to pay his personal tax liability. He gave himself a “highly favorable interest

2 Id.
3 Emily Flitter, Fund Manager Falcone’s Star Dims with Tentative SEC Settlement, REUTERS (May 9, 2013, 9:51 PM), http://www.reuters.com/article/2013/05/09/falcone-sec-settlement-idUSL2N0DQ25N20130509
5 Id. at 1–2, ¶2.
rate” and therefore “avoided paying millions of dollars in interest payments.”

6 Falcone approved the loan himself and did not obtain investor consent, nor was this loan disclosed to Harbinger investors until five months later when the company released audited financial statements. 7 It took three more months before the lock-up ended and by then over eighty percent of investors sought to redeem their investments. 8 Harbinger was unable to meet these requests, and even then Falcone did not repay his personal loan. 9

Additionally, during this time Falcone “engaged in unlawful preferential redemptions for the benefit of certain favored investors.” 10 To garner support for the lock-up, Falcone convinced several large investors to vote in favor of the lock-up and in return allowed the investors to withdraw from the fund. 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. 11

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.” 12 Matters worsened in April 2012, when the Federal Communications Commission (FCC) threatened to take away LightSquared’s license to build necessary ground stations. 13 LightSquared filed Chapter 11 bankruptcy the following month. 14 The SEC then filed its complaint against Falcone and Harbinger on June 27, 2012, for numerous violations including Falcone’s personal loan and the preferential treatment of the investors allowed to leave in exchange for their vote in favor of the lock-in. 15

Falcone settled the case with the SEC the following August. 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. 16 What makes this case truly unique, however, is that Falcone was required to

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6 Id. at 2, 15, ¶¶2, 59.
7 Id. at 7, ¶19.
8 Id. at 7, ¶20.
9 Id. Falcone did eventually pay off the loan in “March 2011, after becoming aware of the SEC’s investigation.” Id.
11 Id.
admit to acting “recklessly” and also to several violations of the securities laws including 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.”

This admission is the first case testing out the new policy requiring certain defendants to admit wrongdoings, following the announcement in June by Mary Jo White, the chairman of the SEC. It is still unclear which cases will be prosecuted, however White said that much will depend on the egregiousness of the conduct and the level of harm to investors. This paper will explore the evolution of the traditional “neither admit nor deny” policy used by the SEC, the passing of the new policy and the cases thus far requiring admissions, the social benefits of admissions versus the economic costs, and finally several factors that the SEC should consider in an attempts 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 Food and Drug Administration (FDA) have a longstanding history of allowing defendants to settle cases without either admitting or denying guilt. Even criminal defendants are permitted to plead nolo contendere, which allows a defendant to “refuse to admit guilt but accept punishment as if guilty.” This history is so entrenched, in fact, that “[e]ven before its 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.”

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

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17 Id.
18 “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 targets of investigations were allowed to settle without admitting or denying guilt.” Marc D. Powers, et al., The SEC Falcone Settlement: A Harbinger of Things to Come?, AMERICAN BAR ASSOCIATION BUSINESS LAW TODAY, October 2013, 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 (April 25, 2006), http://www2.epa.gov/enforcement/3m-company-settlement.
19 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). In addition, some courts allow “so-called Alford pleas, in which defendants plead guilty while simultaneously protesting their innocence.” Id.
litigation.21 This policy is not required by all agencies; in 2011 Facebook was allowed to settle with the Federal Trade Commission (FTC) and then shortly after denied the FTC’s allegations “that it deceived users about how it used their personal information.”22 The FTC’s settlement admissions policy has also been criticized in recent years, and will be discussed further in part II.A.2, 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 deny any wrongful conduct.23 Surprisingly, even the Justice Department has also allowed defendants to settle and then deny any wrongdoings.24

Historically, the SEC “vociferously defended the agency’s settlements with Wall Street firms,”25 with Enforcement Director Robert Khuzami “rejecting as ‘unwise’ the idea that the SEC should obtain an admission of guilt from firms as part of its settlements.”26 The argument in favor of the policy was that by not having to admit guilt, more companies would choose to settle, and that 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.”27 It also allows the SEC to apply its “limited resources to other enforcement efforts.”28

There are advantages for the defendants as well. More defendants choose to settle because, although they are forbidden from denying wrongdoings, they may still “assert that they never admitted to the conduct at issue in the SEC matter, precluding any collateral estoppel, as a party could settle with the SEC and still litigate liability with investors or shareholders in

21 Andrew Ackerman, SEC’s Khuzami Defends ‘Admit Nor Deny’ Settlements, WALL STREET JOURNAL (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, et al., supra note 20.
24 Wyatt, supra note 22. 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.
25 Ackerman, supra note 21.
26 Id.
separate cases.” This means that any plaintiffs pursuing the defendant in a separate civil case would still have the burden to prove their case, and would not have an admission from the defendant to rely on. Although the burden to prove guilt rests on the plaintiff in the separate cases, the plaintiff nevertheless has some arsenal going into the case because he will have access to the public information released after the SEC settlement.

Another benefit of settlement to defendants under this policy is that it “mitigate[s] reputational harm in the investor community, and among lenders and insurers.” It also saved defendants from losing their Directors and Officers Insurance or corporate indemnification because of a breach of fiduciary duties. While there may be many benefits of this kind of settlement to 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.” This section will outline some of the major turning points in the past few years that have led to the SEC’s decision to move away from this policy in certain cases.

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.” In 2011, federal district court judge Jed S. Rakoff did not rely on that presumption in a case brought by the SEC against Citigroup. 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 establish “certain internal measures designed to prevent the recurrences of the securities fraud” committed in this case. This agreement did not require Citigroup to admit to the accusations.

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29 O’Connor, et al., supra note 20.
30 Id.
31 Id.
32 Id.
33 Reid, supra note 28.
35 Citigroup, 827 F. Supp. 2d at 330.
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.” 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.

In this case, Judge Rakoff found that the court did not have the necessary facts to be able to make 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,

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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.

Judge Rakoff also expressed concern about the proposed settlement amount representing “pocket change” to Citigroup and leaving the “defrauded investors substantially short-changed.” The agreed upon settlement of $285 million falls far short of the $700 million in losses investors suffered. Because of this deficiency investors may wish to pursue private litigation, but it would be exceedingly difficult if this settlement were approved. First, because the settlement agreement only charged Citigroup with negligence, it makes it more difficult for private parties to pursue litigation because private investors are unable to bring securities claims based on a theory of negligence. Second, because Citigroup was not required to either admit or deny the allegations in the complaint, the investors are unable to use an admission as collateral estoppel. 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.”

The SEC then filed an interlocutory appeal to the Second Circuit, which granted a stay pending appeal. 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. The Second Circuit found that Rakoff “overlook[ed] the possibilities (i) that Citigroup might well not consent to settle on a basis that requires it to admit liability, (ii) that the

36 Id.
37 Id. at 332.
38 Id.
39 Id. at 333–34.
40 Id. at 329.
41 Id. at 334 (citing as an example Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)).
42 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.
43 Citigroup, 827 F. Supp. 2d at 334.
S.E.C. might fail to win a judgment at trial, and (iii) that Citigroup perhaps did not mislead investors.\textsuperscript{45}

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.”\textsuperscript{46} 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.\textsuperscript{47} The Second Circuit has not yet heard the appeal.

2. Citigroup’s Impact on Other Securities Cases

The Second Circuit may have criticized the \textit{Citigroup} opinion, but several other judges have bought in to Judge Rakoff’s reasoning. One case out of Wisconsin involved an action brought against Koss Corporation and its CEO, Michael Koss, for creating “materially inaccurate financial statements, books and records, and lack[ of] adequate financial controls.” The district court judge in that case found that the facts were insufficient to make a determination of whether the settlement agreement was “fair, reasonable, adequate and in the public interest.”\textsuperscript{48} The judge requested the SEC to provide enough information to make an informed decision, and would eventually approve the settlement after the SEC submitted a brief with nine exhibits to show why the settlement terms met those requirements.\textsuperscript{49}

Judge Rakoff used a similar approach in the case of \textit{SEC v. Vitesse Semiconductor Corp.},\textsuperscript{50} requiring the parties to provide written submissions and also required a hearing where parties provided oral answers to questions Judge Rakoff had, so that he had sufficient information to make a decision of whether or not to approve the settlement agreement.\textsuperscript{51} Rakoff heavily criticized the SEC in this case for its “confiden[ce] that the courts in this judicial district were no more than rubber stamps.”\textsuperscript{52} He went on to talk about 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.”\textsuperscript{53} In this case, the defendant had already admitted guilt in a parallel criminal case.\textsuperscript{54} Judge Rakoff found that, although questions were left unanswered after the hearing and the written submissions, he had enough information under the particular circumstances of this case to make an informed decision and approved the settlement agreement.\textsuperscript{55}

\textsuperscript{45} Id. at 163.
\textsuperscript{46} Id. at 165.
\textsuperscript{47} Id. at 168–69.
\textsuperscript{49} SEC v. Koss, No. 11 Civ. 991 (E. D. Wis. Feb. 22, 2012.)
\textsuperscript{50} 771 F. Supp. 2d 304 (S.D.N.Y. 2011).
\textsuperscript{51} Id. at 306.
\textsuperscript{52} Id.
\textsuperscript{53} Id. at 308.
\textsuperscript{54} Id. at 309.
\textsuperscript{55} Id. at 306.
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 Federal Trade Commission (FTC), the Environmental Protection Agency (EPA), the Federal Reserve, and the Office of the Comptroller of the Currency (OCC), and even the Department of Justice (DOJ). When the FTC Commissioner Maureen Ohlhausen was asked in an interview whether she thought the “neither admit nor deny” policy was good for settlements in light of recent judicial criticisms, she said that

[a]t 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.  

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.” The court in this case questioned “the propriety of courts approving settlements of regulatory actions,” and cited the Citigroup case. The judge in particular was concerned with the ability of defendants to settle without “admitting to any of the allegations lodged against it.” Rather than just rejecting the settlement agreement outright, however, the judge in this case ordered the parties to address several issues, among which were: (1) whether the fair, adequate, reasonable, and in the public interest standard should apply in this case (the standard typically used in settlement cases); (2) if not, what standard should the court use; and (3) if the Citigroup standard applies, then whether the settlement agreement meet those requirements.

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.” One such example occurred in December 2011 involving Wachovia Bank. Wachovia was charged with gaining “millions of dollars in profits by rigging bids in the municipal securities market.” The Justice Department settlement dated

58 Id. at *1.
59 Id.
60 Id. at *2.
61 Wyatt, supra note 27.
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.”63 The settlement also required Wachovia to not “make any public statement or take any position in litigation contradicting that admission.”64 But then the SEC published a litigation release on the same date announcing the charges and the agreed upon fines, but then stated that Wachovia consented to the entry of final judgment “[w]ithout admitting or denying the allegations in the SEC’s complaint.”65

One month later, in January 2012, the SEC changed its policy with respect to the “neither admit nor deny” in cases where defendants have already pleaded guilty in parallel criminal proceedings.66 In these cases, the SEC deletes the “neither admit nor deny” provision from the settlement agreement, and instead outlines the facts and nature of the criminal conviction.67 Robert Khuzami, the SEC’s head of enforcement at the time, 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.”68

This 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 was admitted to in the criminal case. 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.”69

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

Following Judge Rakoff’s decision in the Citigroup case, 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.”70

64 Id.
67 Khuzami, supra note 64.
68 Id.
This hearing was held on May 17, 2012, and included representatives from the Federal Reserve, the SEC, and the Federal Deposit Insurance Corporation (FDIC). 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.” The representative also argued that admissions requirements “would substantially impede and delay implementation of necessary corrective action and potentially harm the financial institution and the financial system.”

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.” 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.”

Following this hearing, at a Senate Banking Committee hearing in February 2013, Senator Elizabeth Warren from Massachusetts made headlines for “challenging a number of federal regulators for what she called their failure [to] take to trial more cases against financial institutions.” She asked the Office of the Comptroller of the Currency (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.” 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, in which she said:

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

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72 Id. at 6.
73 Id.
74 Id. at 10.
75 Id.
77 Id.
they get caught, settle by paying out of those profits, they do not have much inventive to follow the law.\textsuperscript{78}

Chairman White responded to Senator Warren’s letter on June 10, 2013.\textsuperscript{79} 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.”\textsuperscript{80} 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,”\textsuperscript{81} 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.”\textsuperscript{82}

\textbf{III. SEC’S POLICY-CHANGE ANNOUNCEMENT}

On June 18, 2013—just 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.”\textsuperscript{83} 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.”\textsuperscript{84} 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.\textsuperscript{85} White said it “turns on how much harm has been done to investors, [and] how egregious the fraud is.”\textsuperscript{86} The SEC is currently developing the factors that will be used and the certain cases susceptible to an admissions requirement.

Andrew Ceresney, the new Enforcement Division Co-Director, has also emphasized the continuing importance of the “neither admit nor deny” policy going forward.\textsuperscript{87} He argued that the policy is “an important way for the SEC to obtain secure relief for investors, to conserve and

\begin{footnotes}
\item \textsuperscript{78} Letter from Senator Elizabeth Warren to Chairman Bernanke, Attorney General Holder, and Chairman White (May 14, 2013), http://www.warren.senate.gov/documents/LtrtoRegulatorsre2-14-13hrg.pdf.
\item \textsuperscript{80} \textit{Id}.
\item \textsuperscript{81} \textit{Id}.
\item \textsuperscript{82} \textit{Id}.
\item \textsuperscript{84} \textit{Id}.
\item \textsuperscript{85} \textit{Id}.
\item \textsuperscript{86} \textit{Id}.
\item \textsuperscript{87} O’Connor, et al., \textit{supra} note 19.
\end{footnotes}
effectively manage its enforcement resources and to manage its litigation risk by settling cases that it might not win at trial.”

The first case to test out this new policy is the Falcone case described in the Introduction. The SEC found that Falcone and Harbinger had committed “multiple acts of misconduct that harmed investors and interfered with the normal functioning of the securities markets.”

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. This proposal was rejected by the Commissioners as being too lenient, and instead barred Falcone from the securities industry for at least five years, required Falcone and Harbinger to pay $18 million in fines, and finally, required Falcone and Harbinger to admit to the wrongdoings alleged in the complaint. Mr. Ceresney emphasized that “Falcone must now pay a heavy price for his misconduct.”

A. The Shifting Focus to Individuals Rather than Companies

Another interesting aspect of the Falcone case is that the SEC targeted Mr. Falcone himself, and not just Falcone’s company, Harbinger. This is a fairly new practice for the SEC. 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. 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. 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 on 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.”

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.” This may be why the SEC

88 Id.
92 Id.
93 Ackerman, supra note 98.
94 Emily Stephenson, U.S. Consumer Watchdog says Committed to Stiff Penalties, THOMSON REUTERS, (Oct. 23, 2013).
95 Ackerman, supra note 98.
decided to pursue Fabrice Tourre, the first individual sued by the SEC for mortgage-backed securities fraud. Tourre, who once called himself the “Fabulous Fab”, was a twenty-eight year old midlevel employee at Goldman Sachs in 2007. He was “principally responsible for” a synthetic collateralized debt obligation (“CDO”) known as ABACUS 2007-ACI. He created the marketing materials for the CDO and communicated with investors, but failed to disclose the fact that “a large hedge fund, Paulson & Co. Inc (“Paulson”), with economic interests directly adverse to investors in the ABACUS 2007-ACI CDO, played a significant role in the portfolio selection process.” 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 CDS positions yielded a profit of approximately $1 billion for Paulson.”

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.” Tourre’s liabilities were not covered under this settlement. While the SEC has not come out directly to say why it decided to pursue Tourre individually, it is possible to find a potential answer in looking at Tourre’s conduct. Federal Judge Katherine Forrest—the judge 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.”

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!!!”

IV. Is Requiring Admissions in Certain Cases Worth it?

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

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99 Id.
One of the main concerns of 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.\(^{103}\) This impacts the amount of time and 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.”\(^{104}\) This means that many of the companies the SEC was able to pursue, would not have been pursued in the first place, leaving several hundred investors without redress.

Other issues may include: “collateral impacts in licensure processes, . . . increased insurance premiums and could limit a company’s ability to contract with governmental organizations.”\(^{105}\) 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).\(^{106}\)

It is important to recognize that the SEC expends considerable time and effort on a case before making the decision to settle. Robert Khuzami, the former head of SEC Enforcement, said that “before his division brings an enforcement action, the staff 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.”\(^{107}\)

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. . . .”\(^{108}\) Private litigants are able to use the public information released in the settlement to help form arguments for their own cases, and judges may take the settlement information into consideration when

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\(^{104}\) *Id.*

\(^{105}\) O’Connor, et al., *supra* note 19.


\(^{108}\) *Id.*
deciding these private civil suits.\(^{109}\)

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 is helping ensure the public has that admission and the defendant and others are deterred from 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.”\(^{110}\)

### 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 not to be able to distinguish between bad actors and technical violators, as they are unable to make informed choices with respect to their investment decisions.

The “neither admit nor deny” rule is similar to criminal cases which allow for nolo contendere pleas, which 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.”\(^{111}\) 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.

While it is important to consider the time and resources under the disposal of the SEC, 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.”\(^{112}\)

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 require that the SEC bring fewer cases in order to be able to litigate more intensively those that it does bring.\(^{113}\)

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\(^{109}\) 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., September/October 2003, at 18, 19.


\(^{113}\) 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,
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.” The goal for the SEC is to determine whether the SEC’s action redresses the harm and also whether it will “cause would-be future offenders to think twice.”

Because the new policy will affect only a relatively small amount of cases brought by the SEC, Chairman White does not believe it will cause delays or inefficiencies in enforcement. And even if it does have a noticeable effect, White “welcome[d] the possibility” and is ready for it: “[The SEC lawyers] are ready to go up against the best of the white-collar defense bar.”

The potential for deterrence does not just extend to the particular defendants who are required to admit wrongdoings, but 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.” 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.”

V. FINDING THE SWEET SPOT IN SEC SETTLEMENTS

There are certainly valid concerns that the Division of Enforcement “has slowly warped into a meek and abiding Division of Settlement.” If the SEC required admissions in all its cases, it would remove the “‘easy way out’ for violators of securities law [and] will promote transparency and accountability.” While this route may be the best for addressing public

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115 Id.


118 O’Connor, et al., supra note 19.


interest concerns, it of course comes at a high cost, which would require either a large budgetary increase, or fewer cases investigated with more of a focus on serious violations.\footnote{122}{Ross MacDonald, Note, Setting Examples, Not Settling: Toward A New Sec Enforcement Paradigm, 91 Tex. L. Rev. 419, 443 (2012).}

The trick in this case is not finding an “all or nothing” solution, but one that fits within the time and resources available to the SEC, and best serves the public interest at the same time. I believe that requiring admissions in certain cases is a smart step forward and can strike the appropriate balance between what is good for the public interest and the time and resources available to the government in pursuing securities litigation. I would, however, agree with the caution 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.”\footnote{123}{O’Connor, et al., supra note 19.}

Chairman White said that the SEC will look at the egregiousness of the conduct and the harm to investors. I believe that this is good policy because it makes the tradeoffs most worthwhile. The SEC has to limit the scope of requiring admissions and it chose to focus in on egregiousness which is where society is most willing to suffer the costs of litigation and delayed resolution but attains the greatest benefits – e.g. the fairness concerns mentioned above and the ability to distinguish between malicious and simply negligent actors.

I believe that Chairman White is correct in focusing in on egregiousness and harm. The issue is that this does not provide a lot of concrete guidance in actually determining which cases should require an admission of wrongdoing. Therefore, I propose several factors that the SEC and possibly other federal agencies should consider when deciding whether or not to pursue an admission of wrongdoing.

1. Intent to Harm

The Supreme Court said in BMW of North America, Inc. v. Gore\footnote{124}{517 U.S. 559 (1996).} that “‘trickery and deceit’ . . . are more reprehensible than negligence.”\footnote{125}{Id. at 576.} This comment was made in reference to punitive damages, and the guidance for determining in what circumstances it is appropriate to impose punitives. When defendants are required to admit to wrongdoings, it is a sort of punitive damage for SEC settlements. Like punitives, the SEC should not require admissions in cases unless the defendant’s conduct is believed to be intentional. Otherwise, the admission would not serve a public benefit and it would not serve the goal of increasing deterrence.

Take for example securities fraud. Securities fraud is considered particularly egregious because it requires scienter, which is the “intent to deceive, manipulate, or defraud.”\footnote{126}{Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).} 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 of whether or not to require an admission.

2. Repeat Offenders

\footnote{122}{Ross MacDonald, Note, Setting Examples, Not Settling: Toward A New Sec Enforcement Paradigm, 91 Tex. L. Rev. 419, 443 (2012).}
\footnote{123}{O’Connor, et al., supra note 19.}
\footnote{124}{517 U.S. 559 (1996).}
\footnote{125}{Id. at 576.}
\footnote{126}{Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).}
If a defendant is being sued by the SEC for the second, third, or more time, 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 where the SEC really needs to sink in its teeth and make its settlement hurt. This situation will most likely apply to mainly 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 pursues mainly companies). Therefore, a settlement including an admission will impact an institution more than just a cash settlement because shareholders may decide they no longer want to be part of that company, and stock prices will likely fall more than they would have in an ordinary settlement.

3. Sophistication of Investors

Fabrice Tourre once bragged in an email that he was selling the “Abacus bonds to widows and orphans.”127 This conduct surely falls on the egregious end of Chairman White’s guidance of who the SEC would be going after. 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.

4. Number of Investors Harmed

There is no bright-line number to determine whether this factor is met, because it depends on 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.”128 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.

5. Amount of Damages and Harm to the Market

As mentioned in the “number of investors harmed” factor above, 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

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monetary damages and damages to investor confidence. This is especially true in cases where a large number of investors were harmed in the process.

VI. CONCLUSION

In June 2013, the Securities and Exchange Commission 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.”\textsuperscript{129} 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 which cases it will seek admissions in, Chairman White said that the focus will be on the egregiousness of the misconduct and the harm to investors.

Shortly after the Falcone case was settled, the SEC reached a $200 million settlement with J.P. Morgan Chase, with J.P. Morgan admitting that it had “violated federal securities laws when it failed to catch traders hiding \$6.2 billion in losses in 2012.”\textsuperscript{130} The SEC decided to require JPMorgan to admit guilt because its “egregious breakdowns in controls and governance put its millions of shareholders at risk and resulted in inaccurate public filings.”\textsuperscript{131} The Office of the Comptroller of the Currency (OCC) and the Federal Reserve also settled with J.P. Morgan but did not require an admission of guilt as part of the settlement agreement.\textsuperscript{132}

There are advantages and disadvantages to requiring admissions of wrongdoing. The largest disadvantage is the increased time and expense spent in litigation, where the SEC has limited resources and cannot pursue every case. The biggest advantage of requiring admissions is that it “creates an unambiguous record of the conduct and demonstrates unequivocally the defendant’s responsibility for his or her acts.”\textsuperscript{133} This benefit is in the public interest because it allows harmed investors to seek redress and creates a deterrent effect in individuals and companies seeking to do harm.

I believe the answer lies in developing a model to be used in determining which settlements should require an admission of wrongdoing. 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 are sophisticated, the number of investors harmed, the amount of damages and the effect on the market.

\textsuperscript{129} Ackerman, supra note 98.
\textsuperscript{131} Id.
\textsuperscript{132} Id.
\textsuperscript{133} Chairman Mary Jo White Speech “Deploying the Full Enforcement Arsenal” 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.