Settling with the SEC: There’s a New Sheriff in Town

By Olga Greenberg and Katherine Kelly

Since at least 1972, settling with the Securities and Exchange Commission (SEC) has meant that defendants and respondents would neither admit nor deny wrongdoing. Public pressure fueled by judicial criticism of allowing defendants in SEC cases not to admit wrongdoing has caused the SEC’s new leadership to rethink its historic policy and require admissions of wrongdoing in certain cases. In two recent cases, the SEC tested out its new settlement policy.

First, on August 19, 2013, the SEC announced that it had reached a settlement agreement with a hedge fund adviser involving claims of misappropriation of customer funds, interference with the functioning of the securities markets, breach of fiduciary duty and improper trading. Under the terms of the settlement agreement, the hedge fund and its adviser will pay more than $18 million in disgorgement, interest and penalties, and the adviser is barred from the securities industry. More notably, the settlement, in a departure from long-established policy, contains certain admissions, characterized by the settlement to be “factual” in nature.

Second, on September 19, 2013, the SEC announced another settlement with a large bank where the SEC alleged misstatements of financial results and having deficient internal accounting controls. Under the terms of that settlement, the bank will pay a $200 million penalty to settle the SEC’s charges. $720 million more is being paid to the U.K. Financial Conduct Authority, the Federal Reserve and the Office of the Comptroller of the Currency to resolve charges by these agencies. The bank, in addition to making certain factual admissions, also admitted it had violated unspecified sections of the federal securities laws. These cases represent the first instances of admissions of wrongdoing under the new policy and raise many questions about the implications of the policy going forward.

The Old Policy

The SEC traditionally allowed defendants and respondents in civil and administrative matters to settle charges without admitting liability, provided that defendants and respondents did not publicly deny
the SEC’s allegations. The “neither admit nor deny” settlement policy allowed defendants and respondents to avoid making public admissions of guilt, while at the same time prohibited them from characterizing the SEC’s charges as being without merit. This formulation encouraged settlements and minimized the impact of such settlements in collateral litigation. The SEC’s stated rationale for foregoing admissions was that, as a matter of policy, the benefits of obtaining disgorgement, monetary penalties and mandatory business reforms outweighed the absence of an admission when that relief was obtained promptly and without the risks, delay, and resources required at trial. Out of concern that an absence of admissions may constitute a denial, the SEC promulgated regulations in 1972 that required defendants and respondents to “neither admit nor deny” the allegations. Thus, the “neither admit nor deny” policy offered both sides incentives to settle.

The New Policy

In recent years, the SEC’s “neither admit nor deny” policy has faced increasing scrutiny and undergone modifications. Recent cases and pronouncements indicate that the SEC is moving away from the “neither admit nor deny” settlement policy and may require admissions in some cases. Recently, courts have begun to question settlements that do not include factual admissions by defendants. In one prominent case, Judge Jed Rakoff of the United States District Court for the Southern District of New York declined to approve the SEC’s proposed settlement, saying he could not do so “because the Court has not been provided with any proven or admitted facts upon which to exercise even a modest degree of judgment.” Other courts subsequently offered similar criticism of proposed “neither admit nor deny” settlements.

In early 2012, in the wake of such criticism, the now former SEC Division of Enforcement Director Robert Khuzami announced that the SEC had modified its settlement policy to eliminate the usual “neither admit nor deny” language from civil settlements involving parallel criminal convictions, non-prosecution agreements or deferred prosecution agreements that included admissions of criminal conduct. In June 2013, the new SEC Chair, Mary Jo White, announced a further change to the settlement policy, saying certain defendants would be required to admit wrongdoing as a condition of settlement. The new policy requiring admissions was explained to the SEC staff as affecting cases involving misconduct that harmed large numbers of investors and where the alleged conduct was otherwise “egregious.” In addition, Chair White has said that admissions may potentially be required in cases where “the conduct posed a significant risk to the market or investors”; where admissions “would aid investors in deciding whether to deal with a particular party in the future”; and where “reciting unambiguous facts would send an important message to the market about a particular case.” The SEC has not provided much commentary on what “harm” or which “egregious” conduct will warrant admissions in settlements, nor on what types of “messages” it intends to send through certain cases. Likewise, the SEC has not provided details about what the admissions will involve: will defendants and respondents have to admit only to certain factual allegations, or will violations of laws generally or of specific laws, regulations, and rules have to be admitted? The recent settlements offer a glimpse into the implications of the new policy, while also raising a number of unanswered questions.

The Recent Settlements

The first settlement resolves a complaint alleging that the defendants harmed investors by the misappropriation of client assets, market manipulation, breach of fiduciary duties and other illegal trading. The settlement comes after the Commission reportedly rejected an earlier proposed settlement reached by enforcement staff that

“Recent cases and pronouncements indicate that the SEC is moving away from the “neither admit nor deny” settlement policy and may require admissions in some cases.”
included no admissions. The current deal, which was approved by the court on September 16, includes many admissions of fact, including the following:

- The adviser “improperly” borrowed $113.2 million from the fund to, among other things, pay personal taxes, at a time when investors were barred from making redemptions, and did not disclose the loan to investors for five months;
- Favorable redemption and liquidity terms were granted to certain important investors without disclosing those arrangements to other investors; and
- The normal interplay of supply and demand in certain bonds was interfered with, causing their price to double.

Importantly, the admissions are characterized by the settlement to be admissions of “facts” and do not include statements that either defendant had violated particular laws, regulations or rules.

The other settlement, which was an SEC administrative proceeding, did not require court approval. In addition to extensive admissions of fact, the settlement included an acknowledgment by the bank that “its conduct violates the federal securities laws.” The essence of the facts admitted is that the bank did not have sufficient internal controls and that the failure of the controls permitted other conduct to be concealed. It appears that the language of the factual admissions was carefully crafted to avoid, insofar as it is possible, collateral consequences in civil or criminal litigation.

### Potential Implications of Admissions

The move away from the “neither admit nor deny” policy to include admissions in SEC settlements raises a number of issues for public companies, financial services firms and individuals facing SEC administrative or civil proceedings:

- Use of admissions in parallel civil proceedings. Plaintiffs may use admissions in SEC settlements in related class actions, either through offensive collateral estoppel or by being offered into evidence, though it remains to be seen whether a settlement would be sufficiently adjudicated to trigger estoppel or would be excluded from admission into evidence under Federal Rule of Evidence 408 (excluding settlement documents). In any event, the inclusion of admissions in briefs and pleadings may make such documents more compelling.
- Triggering criminal charges. Detailed descriptions of wrongdoing in civil settlements may raise the specter of criminal charges from the Department of Justice, as some are already suggesting admissions do.
- Drain on the SEC’s resources. Requiring admissions may deter defendants from settling, forcing the SEC to litigate more matters, which in turn strains SEC resources.
- A slippery slope. The requirement for admissions in certain cases may lead to further erosion of the basic “neither admit nor deny” policy, placing institutions and individuals in a difficult negotiating position. The choice of admit or litigate may enhance the SEC’s ability to exact greater sanctions because of the resource constraints on individuals and smaller companies to engage in explosive and time-consuming litigation. Indeed, the Chair’s recent statement expanding the circumstances in which admissions will be required suggests such an eventuality.

### Conclusion

It is too early to determine the long-term consequences of the SEC’s new policy or determine the types of cases that will demand admissions. It is also unclear what language the SEC will attempt to include. Nonetheless, the policy changes heralded by the recent settlements demonstrate a much more aggressive approach by the SEC in resolving its cases. Therefore, public companies, financial services firms and individuals facing SEC administrative or civil proceedings should be mindful of this approach and consider its possible implications when negotiating settlements with the SEC.