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The SEC's New Admissions Policy Means Sometimes Having to Say You're Sorry

In 2013, the Securities and Exchange Commission (SEC) announced a new policy requiring admissions as part of settlement in certain cases. While still using "no admit, no deny" in the majority of cases, the SEC, in certain circumstances, will now require defendants to admit wrongdoing in order to settle with the agency. While some heralded this move as a step towards greater accountability, others have warned of the dire consequences of this policy shift. Thus far, the new policy appears not to have made a significant impact. However, the real danger, from the point of view of defendants and the defense bar, may be this policy bleeding into other types of enforcement actions.

The SEC's 'No Admit, No Deny' Policy, the Financial Crisis, and Judge Rakoff

For many years, the SEC, like other federal administrative agencies, allowed defendants to settle charges without admitting liability. As the price of that allowance, a settling party must agree not to publicly deny the allegations. The "no admit, no deny" policy is thus designed to allow defendants to avoid making admissions that could damage them in collateral proceedings while preventing them from publicly maligning the agency's case after reaching settlement.[1]

While this policy was mutually beneficial to both the SEC and defendants, it became a political casualty of the financial crisis. The 2007-2008 crisis was the largest and most severe financial event since the Great Depression. The explosion in the issuance of mortgage-backed securities and collateralized debt obligations fueled a housing bubble along with rampant abuses in the mortgage industry. When the bubble burst, millions found themselves under water on mortgages they could not afford while the major financial institutions were stuck with hundreds of millions of dollars in toxic assets on their books. In the wake of the 2007-2008 financial crisis, the SEC was roundly criticized, by the public, Congress, prosecutors, and the press, for both its obliviousness to the marketplace problems that precipitated the crisis (excessive risk-taking at Bear Stearns, abuses at Lehman Brothers, widespread fraud in the mortgage industry, etc.) and its failure to initiate and follow through on cases against large institutions — such as Goldman Sachs, Citigroup, and Bank of America — at the center of the crisis.[2] To make matters worse, in the midst of the financial crisis, Bernard Madoff's $50 billion Ponzi scheme, the largest in history, collapsed. It later came to light that the SEC had received numerous complaints about Madoff over the years but had failed to adequately investigate.[3]

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Judge Rakoff Enters the Fray

Adding to this mounting criticism, in September 2009, Senior Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York upset long-standing tradition by refusing to approve a $33 million settlement between the SEC and Bank of America over the use of a false proxy statement used to garner shareholder approval of the bank's $50 billion acquisition of Merrill Lynch. Decrying Bank of America's ability to pay a fine without having to admit any wrongdoing, Judge Rakoff held that:

> the proposed Consent Judgment was a contrivance designed to provide the SEC with the facade of enforcement and the management of the bank with a quick resolution of an embarrassing inquiry — all at the expense of the sole alleged victims, the shareholders.[4]

Two years later, Judge Rakoff again rejected a proposed SEC settlement; this time with Citibank over the latter's fraudulent misrepresentations related to the unloading of toxic mortgage-backed securities on investors. Judge Rakoff found that because Citibank neither admitted nor denied the agency's allegations, the settlement did "not provide the court with a sufficient evidentiary basis to know whether the requested relief [was] justified."[5] The Second Circuit later found that Judge Rakoff had abused his discretion in requiring the SEC to establish the "truth" of the allegations against Citibank and vacated his decision.[6] But that decision did not come until nearly three years later. In the interim, several other federal judges started questioning, and in some instances blocking, proposed settlements.[7]

While the SEC took steps to address the growing criticism of its "no admit, no deny" policy — including requiring defendants who had been convicted or admitted to a violation in a criminal proceeding to admit wrongdoing to settle a parallel civil action — criticism of the policy continued to mount.[8]

The SEC Announces A New Policy

In June 2013, newly confirmed SEC Chair Mary Jo White, a former federal prosecutor, announced that in certain cases, defendants seeking to settle an enforcement action would be required to admit wrongdoing.[9] An internally circulated SEC memo cited three circumstances in which admissions could be required: (1) "misconduct that harmed large numbers of investors or placed investors or the market at risk of potentially serious harm"; (2) "egregious intentional misconduct"; or (3) "when the defendant engaged in unlawful obstruction of the Commission's investigative processes."[10] Admissions could also be required when they would "aid investors [in] deciding whether to deal with a particular party in the future" or when "reciting unambiguous facts would send an important message."[11]

Unsurprisingly, many academics and members of the plaintiffs bar hailed the policy change as a much-needed rebuttal to years of criticism that SEC settlements had devolved into little more than a cost of doing business.[12] Conversely, members of the white collar bar were quick to point to potential pitfalls of the new policy. Most significantly, they claimed that such admissions could end up costing defendants millions in related civil litigation, as collateral estoppel would preclude a defendant from litigating issues they were required to admit to in order to settle with the SEC. Some defense attorneys even predicted a "lose-lose" scenario in which the SEC, unaccustomed to taking cases to trial, would be forced to try (and potentially lose) complex financial cases that defendants, wishing to avoid making financially ruinous admissions at all costs, would likewise have no choice but to try.[13]

Effects of the New Policy

The SEC's new admissions policy has not led to either a boon to plaintiffs' firms nor to the nightmare estoppel scenarios warned about by the defense bar. This "non-result" appears to have derived from two principal realities. First, it is unlikely that offensive collateral estoppel could be successfully asserted by a plaintiff's attorney attempting to prevent a defendant from litigating an allegation the defendant admitted to as part of an SEC settlement. Moreover, it remains the case that the SEC continues to settle the vast majority of its enforcement actions under the terms of its "no admit, no deny" policy. Out of the dozens of enforcement actions the SEC has initiated since announcing the new policy two years ago, the SEC has applied the policy in only 18. In those cases where the SEC *has* required an admission of wrongdoing, the defendants have frequently been charged with violations of securities laws for which there was no private right of action. Even in those cases where the defendants face derivative civil litigation, the admissions will arguably be of little value in collateral proceedings.

Collateral Estoppel — *Parklane Hosiery*

In *Parklane Hosiery v. Shore*, the most frequently cited case regarding collateral estoppel in securities actions, the U.S. Supreme Court did allow plaintiffs in a proxy fraud class action to assert offensive collateral estoppel based on a prior SEC action.[14] However, in that case, the prior action did not settle, *but went to trial*, with the SEC winning a declaratory judgment. The court held that estoppel was appropriate when "the party against whom estoppel is asserted has *litigated* questions of fact, and has had the facts determined against him in an earlier proceeding."[15] Thus, having chosen the path of settlement *instead* of litigation, a defendant facing a derivative action would not be barred from litigating issues it admitted to in order to settle with the SEC.

Notwithstanding the narrow facts underlying the Supreme Court's decision in *Parklane Hosiery*, plaintiffs in private securities litigation could also seek to introduce into evidence the express "findings" or "admissions" in the SEC's settlement agreement. While Federal Rule of Evidence 408 ("Compromise Offers and Negotiations") prevents the admission of certain settlement-related evidence "to prove or disprove the validity or amount of a disputed claim or to impeach by a prior inconsistent statement or an admission," whether a particular plaintiff is able to introduce "findings" or "admissions" from an SEC settlement agreement will depend on an evidentiary ruling by the court.

Precedent exists, both in the Second Circuit and elsewhere, for finding that the broader policy that seeks to encourage settlement by barring admissions made in the context of settlement negotiations also applies to completed settlement agreements.[16] It would seem that these same public policy interests would also protect SEC settlements. There remains some risk, however, for defendants entering into "admit" settlements. For example, Rule 408 expressly allows federal prosecutors to use SEC settlements in later criminal prosecutions. It does not

appear that any court has ruled, in the context of a private civil action, whether regulatory settlements fall within the protection of Rule 408.

Recent Settlements Requiring Admissions

Thus far, the admissions wrested from defendants under the new policy may allay the fears of the defense bar insofar as they demonstrate it may be possible to "quench regulators' thirst for blood without spilling a drop in parallel civil litigation."[17]

Admissions in Nonfraud-Based Cases

Notably, in the majority of the early "admit" settlements, the SEC charged nonfraud-based violations, including failure to have adequate internal controls, failure to keep records properly, and failure to register properly with the SEC as an investment adviser. Nonfraud-based violations do not require a showing of intent, or even negligence, and there is *no private right of action* to bring internal control violation claims.

The admissions wrested from defendants facing collateral civil litigation have been crafted in ways that make them of little use to plaintiffs.

On Sept. 19, 2013, the SEC settled charges against JPMorgan Chase related to inadequate internal controls that failed to detect $4 billion in trading losses tied to the so-called "London Whale." This failure, in turn, caused the company to publicly misstate its financial results. The SEC alleged violations regarding the company's record keeping practices and its lack of reasonable internal accounting controls — offenses with no corresponding private rights of action. Along with paying a $200 million penalty, JPMorgan acknowledged that its conduct "violated the federal securities laws."[18]

The wording of JPMorgan's admission was important because it limited collateral liability on the part of the bank. JPMorgan admitted to having inadequate internal risk controls in place, *not* to committing any sort of fraudulent activity. Such an admission limits JPMorgan's liability significantly because it does not expose the bank to liability in a shareholder class action for fraud. Such suits usually require proof of intentional fraud and thus the bank's admission would have no bearing on that issue.

Then, on Jan. 29, 2014, the SEC settled charges with brokerage firm Scottrade. The settlement related to Scottrade's failure, over a six-year period, to provide the SEC with complete "blue sheet" data used by the agency to identify and analyze trades in the course of its investigations. Besides paying a $2.5 million penalty, Scottrade admitted to negligence as well as to three separate, willful violations of Section 17(a) of the Securities Act of 1933. These violations related to the company's failure to properly maintain and produce the blue sheet data. Because these admissions related to wrongdoing committed solely against the SEC, however, they could not be the basis for a private right of action.

On Nov. 20, 2014, the SEC settled charges with broker-dealer Wedbush Securities, along with the company's former executive and senior vice presidents. The SEC order found the company failed to have adequate risk controls in place before providing its customers with market access. Along with paying a $2.44 million penalty and retaining an independent consultant, the company, in an eight-page annex to the SEC's order, agreed that its conduct "violated the securities laws."[19] In making the admissions, Wedbush likewise did not face the threat of collateral civil litigation because there is no private right of action for inadequate risk controls.

Admissions in Fraud Cases

In those "admit" settlements where defendants were facing or had the potential to face collateral 10b-5 litigation, the admissions have generally been crafted in such a way as to provide little use to plaintiffs or their attorneys.[20]

On June 27, 2012, the SEC sued hedge fund adviser Phillip Falcone and his advisory firm, Harbinger Capital Partners LLC, for violations of Section 17(a) of the Securities Act of 1933 and Rule 10(b)(5) of the Securities Act of 1934. The complaint alleged, *inter alia*, that Falcone used fund assets to pay his taxes, that the fund treated some customers preferentially, and that the fund conducted an illegal "short squeeze" to manipulate bond prices. In addition to requiring disgorgement and the payment of penalties, the final consent judgment contained a 48-paragraph admission to the underlying allegations.[21] However, the Harbinger defendants only admitted to acting "recklessly" in "connection with the violations."[22] Such vague admissions do not meet the *scienter* standard for a private right of action under 10b-5.

Next, on March 13, 2014, the SEC settled charges with film studio Lions Gate Entertainment Group. The charges related to a series of actions undertaken by Lions Gate management to thwart a hostile takeover by channeling millions of newly issued company shares into the hands of a management-friendly director.[23] Lions Gate then misrepresented the nature of these transactions to both its investors and the SEC, claiming they were part of a previously announced debt-reduction plan.[24] Lions Gate's admissions in Annex A to the SEC order largely track the SEC's factual findings.[25] The company also admitted that its conduct "violated the federal securities laws[.]"[26]

And on Aug. 21, 2014, the SEC settled charges with Bank of America Corp. The charges related to Bank of America's failure to disclose known risks tied to its obligations during the financial crisis to repurchase mortgage loans and mortgage backed-securities.[27] In comparison to the SEC's 39-paragraph factual findings, Bank of America's admissions, in Annex A to the SEC order, took up a mere four paragraphs.[28] Bank of America also broadly admitted, *inter alia*, that its "conduct violated the federal securities law."[29]

Bleeding Into Other Enforcement Actions?

Two years into the SEC's new policy, it does not appear to have augured the sea change in enforcement heralded by its champions and dreaded by its critics. The new policy has so far been used sparingly and often in cases where there was no private right of action for the admitted violations. In those cases where the defendants were

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facing derivative litigation, the admissions have been crafted in such a way as to be of little value to plaintiffs.

However, from the perspective of defendants and the white collar bar, the real danger may be that the SEC's new admissions policy will bleed into and impact settlements under other regulatory or civil laws. For example, Preet Bharara, the U.S. Attorney for the Southern District of New York, who was originally hired as an Assistant U.S. Attorney by Mary Jo White in 2000 when she ran that office, has made requiring admissions from defendants in civil fraud cases a priority. Since creating a civil fraud unit in March 2010, his office has extracted admissions from defendants in dozens of civil cases. For instance, as part of a settlement of a False Claims Act lawsuit against Beth Israel Medical Center related to the fraudulent inflation of fees for services provided to Medicare patients, Beth Israel admitted to having selectively increased its charges to obtain larger reimbursements than it otherwise would have received.

In another enforcement context, in July 2014, in order to settle a one-count indictment brought by the Justice Department, BNP Paribas pled guilty to conspiring to violate the International Emergency Economic Powers Act and the Trading with the Enemy Act. And on May 25, 2015, several major banks pled guilty in connection with alleged manipulation of the foreign exchange market.

Yet another scenario in which admissions of wrongdoing may be sought is in so-called "parallel proceedings" in which a defendant is charged both criminally and civilly. Typically in those circumstances, the civil case is stayed pending the outcome of the criminal proceedings. In those instances in which a defendant is found not guilty after trial, it may be tempting for federal agencies like the SEC to seek an admission of wrongdoing. Why? In those circumstances there would have been enough evidence for prosecutors to believe they could prevail at a criminal trial with its much higher burden of proof than in the civil context, and the publicity such cases normally receive would further the deterrence policy underlying the admissions requirement.

Whether or not the SEC's new policy will significantly influence other federal and state agencies remains to be seen. Given how quickly the political winds can shift, it is very difficult to predict the long-term impact of this policy. With a gridlocked Congress and a presidential election 12 months away, the enforcement landscape could dramatically shift yet again in the next few years.

Notes

1. Consider this example:

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the Offer), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and *without admitting or denying the findings herein*, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order and Civil Penalty (Order), as set forth below.

In re Blackthorn Investment Group, LLC, Exchange Act Release No. 70392, at 1

(Sept. 17, 2013) (emphasis added).

2. Matt Taibbi, *SEC: Taking on Big Firms Is 'Tempting,' but We Prefer Picking on Little Guys*, Rolling Stone (May 30, 2012), http://www.rollingstone.com/politics/news/sec-taking-on-big-firms-is-tempting-but-we-prefer-whaling-on-little-guys-20120530.

3. U.S. Securities and Exchange Commission Office of Investigations, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, (Aug. 31, 2009), http://www.sec.gov/ news/ studies/ 2009/oig-509.pdf.

4. *SEC v. Bank of America, Corp.*, 653 F. Supp. 2d 507, 510 (S.D.N.Y. 2009).

5. *SEC v. Citigroup Global Mkts.*, 827 F. Supp. 2d 328, 332 (S.D.N.Y. 2011).

6. *SEC v. Citigroup Global Mkts.*, 752 F.3d 285 (2d Cir. 2014).

7. *See, e.g., SEC v. Bridge Premium Finance, LLC*, No. 1:12-CV-02131-JLK-BNB, slip op. at 1 (D.C. Jan. 17, 2013) ("I refuse to approve penalties against a defendant who remains defiantly mute as to the veracity of the allegations against him. A defendant's options in this regard are binary: he many admit the allegation or he may go to trial.").

8. Edward Wyatt, *Settlements Without Admissions Get Scrutiny*, N.Y. Times (Feb. 24, 2012), http://www.nytimes.com/2012/02/25/business/neither-admit-nor-deny-settlements-draw-judges-scrutiny.html.

9. James Stewart, *SEC Has a Message for Firms Not Used to Admitting Guilt*, N.Y. Times (June 21, 2013), http://www.nytimes.com/2013/06/22/business/secs-new-chief-promises-tougher-line-on-cases.html.

10. *Id.*

11. Mary Jo White, Chair, Sec. & Exch. Comm'n, Speech Before the Council of Institutional Investors: Deploying the Full Enforcement Arsenal (Sept. 26, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539841202.

12. Stewart, *supra* note 9.

13. *See, e.g.*, Marc Fagel, *The SEC's Troubling New Policy Requiring Admissions*, Bloomberg BNA, Securities Regulation & Law Report (June 24, 2013), *available at* http://www.gibsondunn.com/publications/Documents/Fagel-SECs-Troubling-New-Policy-Requiring-Admissions.pdf.

14. 439 U.S. 322, 99 S. Ct. 645 (1979).

15. *Id.* at 335 (emphasis added).

16 *See, e.g., Alpex Computer Corp. v. Nintendo Co.*, 770 F. Supp. 161, 166-67 (S.D.N.Y. 1991).

17. Alison Frankel, *Don't Get Too Excited About JPMorgan's Admissions to the SEC*, Reuters (Sept. 19, 2013), http://blogs.reuters.com/alison-frankel/2013/09/19/dont-get-too-excited-about-jpmorgans-admissions-to-the-sec/.

18. In re JPMorgan Chase & Co., Exchange Act Release No. 70458 (Sept. 19, 2013).

19. The violations of Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisers Act of 1940 do not provide for private rights of action.

20. The admissions provide little use — except perhaps to survive a motion to dismiss.

21. Consent of Defendants Philip A. Falcone; Harbinger Capital Partners LLC; Harbinger Capital Partners Offshore Manager, LLC; and Harbinger Capital Partners Special Situations GP, LLC, *SEC v. Falcone*, Nos. 12 Civ. 5027 and 12 Civ. 5028 (S.D.N.Y. Aug. 19, 2013).

22. *Id.* at 18.

23. In re Lions Gate Entertainment Corp., Exchange Act Release No. 71717, at 2-3 (Mar. 13, 2014).

24. *Id.* at 8.

25. *Id.* at 13-21.

26. *Id.* at 13.

27. In re Bank of America Corp., Exchange Act Release No. 72888, at 2-3 (Aug. 21, 2014).

28. *Id.* at 12-13.

29. *Id.* at 12.

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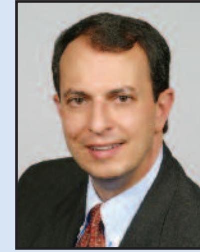

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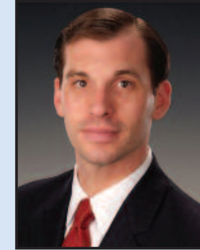

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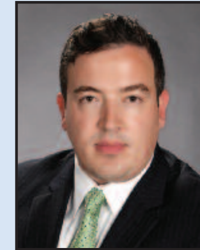

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