Testimony before the
Committee on Financial Services
United States House of Representatives

"Examining the Role of Settlements in the Enforcement Process by Financial Regulators: The Example of the United States Securities and Exchange Commission"

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Chairman Bachus, Ranking Member Frank, and Members of the Committee:

I appreciate the opportunity to testify on the important matter of the use of settlements by financial regulators as part of the process of enforcing the laws within their jurisdictions. Settlements constitute a crucial part of the enforcement process, especially as regulators seek to allocate limited resources in fulfilling their missions. Accordingly, it is critical that regulators retain flexibility to settle the cases that they pursue. My testimony will focus on the practices of the United States Securities and Exchange Commission ("SEC" or "Commission"), where I previously served as a Special Counsel. However, the issues and concerns that I raise also might prove relevant to the enforcement efforts of other regulators, even though the details of their enforcement processes may vary.

The Use of Settlements

Settlements constitute a longstanding part of the enforcement process. Their use by the SEC are neither novel nor without a place in the broader context of the agency's overall mission. While its focus is on the securities markets, the SEC's mission in addressing those markets is a multi-faceted one. Federal financial regulators like the Commission are charged with encouraging quality markets, informing the public on financial issues, helping to shape regulations, monitoring compliance with those rules, and enforcing those rules. Those enforcement efforts might be in administrative proceedings before the Commission or in federal court. And, SEC enforcement efforts might be taken in parallel or in conjunction with actions by other federal officials, such as the United States Department of Justice as it prosecutes criminal violations of the federal securities laws. SEC enforcement efforts also exist side by side with private rights of action. The key here is that SEC enforcement actions, and the settlement of some of them, should be viewed as part of a complex system of market regulation developed over many years.

As a general matter, settlements are seen in private and public actions. Driving settlements are calculations by litigants about their potential to win and lose cases, awards that

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might be associated with particular outcomes, and the costs of continuing to pursue litigation rather than bringing it to a conclusion. Put another way, settlements are a form of risk management, where parties attempt to calculate the likelihood and ramifications of winning or losing a case. In this regard, settlements can be viewed as a mutual recognition by opposing parties that cessation of litigation with particular conditions may serve both of their interests. Thus, settlements enjoy a certain resonance as a reflection of the calculation of interests by the parties to the litigation themselves. That is not to say that settlements are perfect calculations. At times, they may reflect erroneous valuations of parties' interests. Nor are parties left entirely to their own devices in the settlement process as courts often must approve a settlement agreement reached by the parties.

The nature and value of settlements expressed above can apply both to private litigation and actions brought by public officials. Indeed, the value of a cessation of litigation even reaches the world of criminal law as reflected in the acceptance, for instance, of the legitimacy of plea bargaining. Not surprisingly, financial regulators like the SEC similarly have accepted the usefulness of settling litigation when such settlement includes an assessment that the costs of further litigation outweigh the benefits. Settlement in such instances may be especially attractive when the alleged violator of the law accepts conditions that give the agency comfort in ceasing litigation. Items providing such comfort, for example, might include acceptance by the alleged violator of monetary penalties or acquiescence to requirements related to future behavior. The SEC's decision to pursue settlements is particularly understandable given the nature of the securities laws. Although securities fraud and other important securities law violations find their foundations in statutes that date back to the 1930s—almost 80 years ago—parties continue to debate the exact meaning of those statutes. The United States Supreme Court's multi-decade securities law docket attests to the fact that law remains unsettled in this area and that litigants continue to face the real risk of not knowing exactly how courts will apply the relevant legal provisions.

Faced with the general uncertainty associated with all litigation, and the particular uncertainty of securities litigation, the Commission has utilized flexibility afforded to it in the enforcement process and actively has pursued settlement with alleged wrongdoers. When actions are settled, consequences are not necessarily insignificant. For instance, in its 2011 Performance and Accountability Report, the SEC emphasized multiple actions resulting in settlements that led to millions of dollars being paid by alleged violators.[2] In that same Report, the Commission also noted non-monetary consequences of settlements, such as consent to permanent injunction from violation of the federal securities laws' anti-fraud provisions and officer and director bars.[3] Of course, requisite for successful settlement negotiations is that notwithstanding such serious consequences, the alleged offenders also view it in their best

[2] *See, e.g.,* Securities and Exchange Commission, 2011 Performance and Accountability Report, at 14-15 (available at http://sec.gov/about/secpar2011.shtml).
[3] *See, e.g., id.* at 190-91.

interest to settle. Possible motivators for such action might be how exactly the language of settlements is phrased, especially as it relates to acknowledgement of legal violations, as well as calculations of the costs of continuation of an enforcement action and the possibility of more severe consequences were the alleged violator to lose in extended litigation.

Recent Controversy

Notwithstanding the tradition of settlements in securities law cases and settlements' potential attractiveness to both the Commission and alleged securities law violators, such settlements are not without controversy. Action in the federal courts of the Southern District of New York as well as the United States Court of Appeals for the Second Circuit recently has drawn attention to settlement practices.

Last November, in *SEC v. Citigroup Global Markets Inc.*,[4] United States District Judge Jed Rakoff of the Southern District of New York rejected the Commission's effort to settle a case arising out of a multi-year investigation of the defendant's alleged activities related to the market for collateralized debt obligations ("CDOs").[5] When the Commission filed its complaint claiming that Citigroup had engaged in negligent misrepresentation, it also submitted a proposed consent judgment with Citigroup; that "settlement provided in essence the following: Citigroup agreed (1) to pay $285 million into a fund, which the S.E.C. may distribute to investors in a pool of CDOs marketed by Citigroup in compensation of their losses, (2) to the entry of an order enjoining it from violating certain sections of the Securities Act of 1933, and (3) to undertake to establish procedures to prevent future violations and to make periodic demonstrations of compliance to the S.E.C."[6] Judge Rakoff refused to approve the consent judgment and instead ordered that the case move to trial.[7]

The SEC staff quickly disagreed with the District Court's apparent conclusions as to the proposed consent judgment's fairness, adequacy, reasonableness, and consistency with the public interest.[8] The SEC moved to stay the District Court proceedings pending determinations on the SEC and Citigroup's interlocutory appeals and a petition for a writ of mandamus; in considering that request, a panel of the Second Circuit usefully summarized what it perceived to be the

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[4] No. 11 Civ. 07387 (JSR), __ F. Supp. 2d __, 2011 WL 5903733 (S.D.N.Y. Nov. 28, 2011) (available at http://www.nysd.uscourts.gov/cases/show.php?db=special&id=138) ("District Court Opinion").
[5] *See SEC v. Citigroup Global Markets Inc.*, 673 F.3d 158 (2d Cir. 2012) (available at http://www.ca2.uscourts.gov/decisions/isysquery/93261288-c6b0-40b6-a898-85cbe8c8b3f7/1/doc/11-5227_opn.pdf#xml=http://www.ca2.uscourts.gov/decisions/isysquery/93261288-c6b0-40b6-a898-85cbe8c8b3f7/1/hilite/).
[6] *See* 673 F.3d at 161.
[7] *See* District Court Opinion, *supra* note 4.
[8] *See* Robert Khuzami, *Public Statement by SEC Staff: Court's Refusal to Approve Settlement in Citigroup Case*, http://www.sec.gov/news/speech/2011/spch112811rk.htm (Nov. 28, 2011).

District Court’s main objections to the consent judgment as the District Court found it to be unreasonable, inadequate, and not serving the public interest:

> First, the [district] court expressed strong disapproval of what it called “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.” Without the defendant's admission, such a judgment would have “no collateral estoppel effect” in another litigation brought against the defendant by victims of its alleged wrongdoing. “[It] ... leaves the defrauded investors substantially short-changed ... [as they] cannot derive any collateral estoppel assistance from Citigroup's non-admission/non-denial of the S.E.C.'s allegations.” The court found it “hard [ ] to discern ... what the S.E.C. is getting from this settlement other than a quick headline.” Because it “does not involve any admissions and ... results in only very modest penalties [described by the court as “pocket change to an entity as large as Citigroup,”], [such a consent judgment] is just as frequently viewed, particularly in the business community, as a cost of doing business.” The court also found that the settlement “without any admissions [of liability by Citigroup] serves various narrow interests of the parties,” but not the public interest.
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> The second reason given by the court for rejecting the consent judgment was its perceived unfairness to the defendant, Citigroup.
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>> [The settlement] is not reasonable, because how can it ever be reasonable to impose substantial relief [on Citigroup] 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.
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> The court's third reason for concluding that the consent judgment was not in the public interest was that, without admission of liability, a consent judgment involving only modest penalties gives no “indication of where the real truth lies.”
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>> [The settlement] 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.
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> 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.[9]

Judge Rakoff's opinion at least raises questions about whether the District Court went beyond reviewing the consent judgment in the more traditional fashion to perhaps substituting some of its own judgments for that of the parties in assessing the relevant interests. While leaving the underlying legal issues of the appeal open to determination by the merits panel, in granting the SEC's motion for stay, the Second Circuit panel made some important observations. First, the panel recognized the significance of the issues raised by the District Court's order. Those issues "include[d] the division of responsibilities as between the executive and the judicial branches and the deference a federal court must give to policy decisions of an executive administrative agency as to whether its actions serve the public interest (and as to the agency's expenditure of its resources) [as well as] a court's authority to reject a private party's decision to compromise its case on the ground that the court is not persuaded that the party has incurred any liability by its conduct."[10]

Second, the Circuit Court rightly recognized that the District Court appeared to reach too hasty a judgment that the defendant misled investors and that the Commission could prove the defendant's liability at trial. The panel took notice of litigation risks seemingly overlooked by the District Court, including the chance that maybe the defendant did not mislead investors, that the SEC might lose at trial, and that the defendant might not consent to settlement if forced to admit liability.[11] The panel seems directly aligned with the realities that often drive settlements. Parties often settle when they see uncertain results in continuing litigation and the ability to secure important concessions in ceasing litigation early.

Third, the panel properly warns that the District Court seemed to encroach on the realm of policy judgments traditionally reserved to administrative agencies. The Circuit Court notes

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[9] 673 F.3d 161-62 (citations omitted).
[10] *Id.* at 160.
[11] *See id.* at 163-65.

that "[w]hile we are not certain we would go so far as to hold that under no circumstances may courts review an agency decision to settle, the scope of a court's authority to second-guess an agency's discretionary and policy-based decision to settle is at best minimal."[12] The Circuit Court's concern that the District Court may have failed to exercise proper deference to the SEC seems consistent with broader notions of prosecutorial discretion often seen, for instance, in the criminal law context. Government authorities pursuing supposed wrongdoers must harness limited resources to pursue an agenda that is fair to the parties involved and that secures both goals of punishment and deterrence of future violations by the alleged violator and others who might violate the law.[13] The calculation of how best to serve the public interest is a difficult one, and great deference to the agency seems merited as it pursues its mission.

That is not to say that courts must rubber stamp all settlements without reflection on their contents. Courts can, and as this case illustrates do, ask tough questions about settlements. However, courts also must remember the importance of deference and be mindful of other branches of government's role in the policy-making process. If such deference is not given on settlements, one wonders whether officials with discretion on whether or not to pursue violators in the first instance will simply refuse such pursuit given lack of control at the settlement stage of litigation.

In the wake of the financial crisis, one can understand frustrations of members of the public, including those who might happen to serve in the judiciary. However, great difficulties may attach to regulating within what might be termed the crucible of scandal.[14] Ultimately, "regulation" involves those who make laws and rules, those who administer them, and those who judge their application. All must be careful to respect their particular roles. The enforcement process certainly remains subject to possible improvements. However, the more transparent and ultimately more effective way to improve that process is by addressing its components in a direct way. If enforcement efforts seem inadequate at times, then one should focus on the effectiveness of efforts to detect wrongdoing[15] and the actions of officials actually charged with pursuing

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[12] *See id.*

[13] Although a District Court might view settlements as "pocket change" to large financial institutions, others certainly could view payment of hundreds of millions of dollars as significant, and as a punishment for potential future violators to avoid. It also seems useful to note that avoidance of an admission of guilt in a settlement does not necessarily equate to avoidance of reputational harm for the institution that settles. Indeed that type of reputational harm may be significant to entities seeking to convince others to allow them to handle their money and investments.

[14] *See* Kenneth M. Rosen, *Mickey, Can You Spare a Dime? DisneyWar, Executive Compensation, Corporate Governance, and Business Law Pedagogy*, 105 MICHIGAN LAW REVIEW 1151, 1166-68 (2007).

[15] For the SEC, this might, for instance involve operations of the Office of Compliance Inspections and Examinations.

wrongdoers. Review of settlements in individual cases seems a second-best solution[16] that is a less likely vehicle for change in how the enforcement processes generally operates.

The Continued Need for Agency Discretion

Although frustration with the economic crisis might lead some to seek more restrictions on financial agencies' ability to enter settlements, discretion to settle remains an important regulatory tool. Indeed, at a time of rapidly shifting regulatory landscapes in light of the crisis, such discretion might be more important than ever.

Informing an agency's decision to consider settlement might be genuine concern about the general level of understanding of what constitutes a violation as rules rapidly change. Settlement may permit agencies to ameliorate the consequences of confusion during regulatory transitions. This may be especially significant as agencies under modern financial legislation increasingly must implement new regulatory rule requirements with specific content under tight time frames, leaving them with little discretion in the rulemaking context.[17] Discretion in the enforcement context may help agencies at the margins to avoid some unintended consequences of new rules as the agencies may work on their own and with Congress to adjust such regulations. While some might seek rigid outcomes on issues, like imposition of particular language in settlements related to new rule violations, efforts to impose such rigidity might incentivize odd results. Agencies might opt out of pursuing violations in the first instance when results would be dictated in the settlement process related to such violations. This might further fray investor confidence.

As previously mentioned, enforcement is only one of a modern financial agency's many difficult tasks. As limited resources are taxed by those same schedules of rulemakings and other legislatively mandated actions, agencies may by necessity have to pull back on some enforcement efforts. Settlements likely will remain a vital tool for agencies to have some regulatory impact without expending the full resources involved with taking all enforcement actions to trial or administrative completion. That is not to say that less enforcement is a good result, but rather that it might be the only practical option under the circumstances. To the extent that is disturbing, all branches of the government will need to work together to revisit the issue of how to prioritize the use of limited regulatory resources.

In considering the case for continued agency discretion, one should not neglect the fact that such discretion, as long has been the case, will not be absolute. One way to interpret the events of the *Citigroup* situation is that the system on some level works. Federal judges actually do examine settlements. But as the Second Circuit implied, they must do so with great care. Moreover, agencies themselves can and do engage in self-reflection of their settlement practices.

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[16] *Cf.* Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILLANOVA LAW REVIEW 1097 (2003).

[17] *See* Kenneth M. Rosen, "*Who Killed Katie Couric?" and Other Tales from the World of Executive Compensation Reform, 76* FORDHAM LAW REVIEW 2907 (2008); *see also* http://sec.gov/spotlight/dodd-frank.shtml .

Of note, the Commission actually has initiated its own analysis of how it goes about settlements in some circumstances.[18] In its oversight role, Congress should monitor these efforts. More generally, it should continue to seek more data, like the Commission provides in its annual reports, to help evaluate objectively to what extent tools like settlement are used and more generally the effectiveness of financial regulators' enforcement programs.

The challenges are great for such programs, and the success of these programs are critical to the investor confidence that helps drive capital formation and economic growth. While it might be attractive to promulgate many new rules, actual enforcement of existing rules may drive public confidence as well. Now is a time for a comprehensive and vigorous dialogue on issues like limited resource allocation prioritization as it relates to enforcement. And, as financial instruments and markets become more complex—and frauds and other problems associated with those instruments and markets become more difficult to address—more regulators at all levels of government, local, state, and federal, likely will be drawn into the battle against financial irregularities. Coordinating those efforts will be critical.[19] Task forces and joint efforts already are underway, but potentially significant legal issues will continue.[20] These important issues also deserve attention.

Conclusion

Thank you again for the opportunity to share my insights on the use of settlements. I welcome the chance to answer your questions.

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[18] *See* Robert Khuzami, *Public Statement by SEC Staff: Recent Policy Change*, http://sec.gov/news/speech/2012/spch010712rsk.htm (Jan. 7, 2012) (noting adjustment to policy on "'neither admit nor deny' language" in cases involving certain parallel criminal matters). Moreover, agency operations may be monitored by an inspector general.

[19] This likely will lead to the revisiting of settlement issues as well in a world of additional universal settlements involving multiple regulators.

[20] For example, access to information and documents produced by a government agency in one investigation may raise issues about access to those materials in other matters.