Testimony of Richard W. Painter

Before the United States House of Representatives Committee on Financial Services

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Hearing on Examining the Settlement Practices of U.S. Financial Regulators

I have worked in private practice in New York and Connecticut for five years and taught securities law for seventeen years. For two and half years I served as the chief ethics lawyer for the White House under President Bush. I am familiar with the S.E.C. enforcement regime and private litigation that often grows out of S.E.C. enforcement actions. I have testified several times before the House and Senate on class action securities litigation and other aspects of federal securities law.

I agree with the Second Circuit's opinion in *SEC v. Citigroup Global Markets Inc.*[1] The S.E.C. needs discretion to decide how limited enforcement resources should be used in a way that maximizes investor protection. Federal courts should not define the way the S.E.C. litigates and settles cases. Congress also should resist the temptation to micromanage S.E.C. decision making in specific cases or even in broad categories of cases.[2]

Specific areas of concern include the following:

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[1] **After investigating Citigroup's marketing of collateralized debt obligations, the S.E.C. sued Citigroup in the Southern District of New York for negligent misrepresentation. The S.E.C. and Citigroup then proposed a consent judgment under which Citigroup would pay $285 million to compensate investors, be enjoined from violating the securities laws, and establish procedures to prevent violations. Citigroup, however, did not admit any liability. The district court rejected this settlement as "neither reasonable, nor fair, nor adequate, nor in the public interest" and criticized the S.E.C.'s policy of "allowing defendants to enter into consent judgments without admitting or denying the underlying allegations." The district court ordered the case to go to trial. Upon appeal by both parties, the Second Circuit granted a stay of this order until a separate panel of the Second Circuit could decide the merits. The Second Circuit found that Citigroup and the S.E.C. were likely to prevail and observed that "the scope of a court's authority to second-guess an agency's discretionary and policy-based decision to settle is at best minimal."**

[2] **Congressional policy determinations, if too rigid, can prevent the S.E.C. from responding to rapidly changing, and even dangerous, market conditions. For example in 1999 Congress provided that security based swap agreements cannot be regulated as securities. See e.g. 1933 Act Section 2A (providing in part that "The Commission is prohibited from—A. promulgating, interpreting, or enforcing rules; or B. issuing orders of general applicability; under this title in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement . . . ."). The debacle of 2008 showed that this policy decision may have been unwise, but regulators could do relatively little about it until Congress reversed course and regulated security based swaps in the Dodd-Frank Act of 2010.**

First, the S.E.C. has a limited budget and often must decide between competing priorities in both its investigations and enforcement actions. The S.E.C. cannot be everywhere all of the time. S.E.C. resources are sometimes better spent investigating potential wrongdoing than on litigating over wrongdoing that has already been investigated and exposed. At other times the S.E.C. should follow through with aggressive litigation, but only up to a point where alleged wrongdoers agree to compensate investors for losses and to take steps that prevent future wrongdoing. Making alleged wrongdoers "admit" they violated the law need not be part of such a settlement. If requiring such an admission discourages settlement, the S.E.C. will be forced to litigate cases it would rather not litigate, and often against defendants with far greater resources for litigation.

Second, large monetary settlements – such as the $285 million in the Citigroup case – make it clear to most observers that defendants did something wrong. The settling defendants at a minimum are guilty of careless business practices, most likely tainted with elements of "sharp dealing." The financial services industry is driven by business reputation, and monetary settlements, coupled with consent decrees prohibiting future violations, send a clear message that conduct was wrong. An admission to violating a specific law is not needed to get the point across to the public and to other industry participants.

Third, because of the way the securities laws are written and interpreted by the courts, legal liability may be an open question, even where defendants violated the spirit of the law. For example, it may not be clear whether a sale of securities took place inside or outside the United States, even if it is clear that the transaction was fraudulent. If the securities transaction took place outside the United States, the federal securities laws do not apply.[3] Rather than litigate over the location of the transaction, and thus over whether United States securities laws were violated or the laws of some other country were violated instead, both the S.E.C. and the alleged wrongdoer may prefer an injunction against future violations coupled with compensation of investors and/or a monetary penalty.

Another area of ambiguity is the difficulty in some cases of proving a defendant's intent or recklessness, as opposed to mere negligence, which is a critical issue in securities fraud claims under Section 10(b) of the Exchange Act.[4] Rather than litigate over whether the

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[3] See Morrison v. National Australia Bank, 130 S. Ct. 2869 (2010). Section 929P of the Dodd-Frank Act gives federal courts jurisdiction over S.E.C. and Department of Justice enforcement actions in connection with some securities transactions taking place outside the United States if the fraudulent conduct took place inside the United States.

[4] Misrepresentation claims under Section 17(a) of the 1933 Securities Act do not require a showing of the defendant's intent or recklessness, but claims under Section 10(b) of the 1934 Securities Exchange Act do require a showing of intent or recklessness. Section 17 is available to the S.E.C. in cases involving misrepresentation in the offer or sale of securities, but not for cases involving the defendant's misrepresentation in a purchase of securities, including insider trading. In these cases the S.E.C. often sues under Section 10(b) and must establish the defendant's scienter.

defendant was intentional, reckless or negligent in a Section 10(b) case, both the S.E.C. and the defendant may choose to settle on a consent decree, payment of a monetary penalty and no admission or denial of an actual violation.

Yes more areas of ambiguity include whether a particular financial instrument falls under the statutory definition of a "security" and whether fraudulent conduct was "in connection with" a securities transaction within the meaning of the statute. In each factually or legally ambiguous case, the S.E.C. and the defendant must weigh the risks of litigating and losing. For the S.E.C. the risks of losing a case include the loss of a monetary settlement for defrauded investors and the loss of an opportunity to enjoin future violations and to require specific steps that prevent violations. Another even greater risk is that a judicial opinion could respond to confusing facts with overly broad language that undermines the S.E.C.'s interpretation of the law in other cases. Confusing fact patterns often make for bad case law. The S.E.C. thus has good reason to settle such a case rather than litigate and lose not only that particular case but an entire category of related cases that could have been won later.

In sum, for the S.E.C. to litigate and lose a case with potential weaknesses can wreak havoc on the enforcement regime. The outcome may encourage wrongdoing by others who will see the S.E.C.'s loss as an opportunity to violate the same or related provisions of law with apparent impunity.

Finally, the expansive private plaintiffs' litigation regime in the United States, particularly the potential for class action lawsuits, makes it extremely unlikely that a defendant that has any decent legal defense will agree to settle a S.E.C. enforcement action when the settlement requires an admission of wrongdoing. Private plaintiffs' lawyers ride on the coattails of enforcement actions, seeking monetary damages that often exceed by many times the monetary payments specified in S.E.C. consent decrees. Admitting to a violation – particularly violation of a statutory provision for which courts have implied a private right of action – is an invitation to private suits.[5] Corporate defendants will instead take their chances litigating with the S.E.C., hoping that their enormous litigation resources will beat back the S.E.C. and also deter private plaintiffs. The S.E.C. rather than achieving a partial victory (including a monetary penalty and injunction) will thus be pulled into, and be forced to bear the brunt of, the defendant's battle with the plaintiffs' bar. In cases

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[5] Even an admission to violation of a provision for which there is no implied private right of action can be an invitation to lawsuits. For example, a defendant who admits to a violation of Section 17(a) of the Securities Act has for practical purposes admitted to most of the elements to a violation of Section 10(b) of the Exchange Act, with the exception of the requisite state of mind under Section 10(b). If a defendant has admitted to a violation of Section 17(a), a plaintiffs' lawyer thus is more likely to sue than if there is no such admission. The defendant knows this and will refuse to settle with the S.E.C. if admission of a Section 17 violation is required.

where the S.E.C. wins, plaintiffs' lawyers will take advantage of the S.E.C.'s expenditure of taxpayer funds for proving key elements of the violation. In cases where the S.E.C. loses, and cases which the S.E.C. may not bring at all because it knows there is no realistic chance of settlement, investors lose if defendants get away with conduct that still violates the securities laws.

In addition to these issues that arise in the Citigroup litigation I will point out two other issues to this Committee.

First, consent decrees – even if they do not involve admission of wrongdoing – often mean disqualification of the settling party from certain regulatory advantages for a period of time. These advantages include liberalized public offering rules for Well Known Seasoned Issuers and the Regulation A mini-registration regime that after the JOBS Act of 2012 will be made available for offerings up to $50 million. These regulations contain "bad boy" disqualifier provisions that make the exemption unavailable to issuers that have recently entered into consent decrees in SEC enforcement actions.

The S.E.C. sometimes agrees to waive these disqualification provisions when a defendant issuer settles an enforcement proceeding – in other words the issuer is permitted to continue to take advantage of one or more liberalized regulatory regimes intended only for issuers who have not recently been accused of violating the securities laws.

Waivers of these provisions should be evaluated carefully by the S.E.C. before they are granted as part of a settlement. They should not be routine. These waivers also should be explained carefully to the parties in the case and to the investing public. A common justification for such waivers is that the settling party committed the alleged violation in connection with securities other than its own, and that therefore its own investors were not harmed by the violation and do not need the added protection that is achieved by disqualifying the issuer from regulatory exemptions. This may be true in some cases, but in other cases, particularly if an issuer is in the business of buying and selling other issuers' securities, the issuer's conduct could have a direct effect upon its own investors. In retrospect after 2008 we know that some issuers such as Lehman Brothers, Bear Stearns and Merrill Lynch were not as well known or as seasoned as investors thought they were. Investors in many other investment banks lost a lot of money as well.

Second, I am concerned that we rely too much on regulation and enforcement to solve problems. The 1933 and 1934 Acts and SEC regulations apparently were not enough to prevent Enron and Worldcom, so we got the Sarbanes-Oxley Act in 2002. That did not prevent the disaster of 2008, so we got the lengthy Dodd-Frank Act in 2010 and dozens of new regulations from many federal agencies.

I am not opposed to regulation – sometimes we need it. But so far regulation has not compelled people who run financial institutions to make responsible decisions about risk.

Regulation alone probably cannot accomplish this. Bankers need a reason to make responsible decisions on their own – not because government tells them what to do.

One solution is for investment banks to return to a particular aspect of the successful business model that prevailed for decades until the 1980's: the personal liability of senior investment bankers for the debts of their firms.

My grandfather, Sidney Homer, Jr. was a bond market dealer with his own two-man firm from the 1930's through 1943 when he went to work for the Treasury Department's effort to impose an economic blockade on Germany. He left his partner in charge of the business. The partner took risky bets and the business failed. My grandfather, after he finished his government service, went back to New York and worked to pay his firm's creditors over five years. He did not ask the Treasury Department for a "bailout" and he did not hide behind the mantra of limited liability. He paid the money back.

In 1960 he joined Salomon Brothers as head of bond market research. That firm also was a partnership where each partner was liable for the debts of the firm. The same was true at Lehman Brothers, Morgan Stanley, Goldman Sachs and many other investment banks. These firms were capitalized with the partners' money, which they were paid gradually after they retired. If these firms failed the partners' other assets also would be at the creditors' disposal. It is no surprise that most investment banks were relatively conservative in the risks they took both with customers' money and their own.

Beginning in the 1980's many of these investment banks became corporations. For Salomon Brothers it happened in 1981, with a merger into Phibro Commodities. The era of Liar's Poker -- Michael Lewis's famous book about Salomon Brothers in the 1980's – had begun. The culture of even the most cautious investment banks changed quickly. Lewis told the story of how traders placed big bets and became instant heroes, boasting not only of their new riches but also the size of their male anatomy. Potential downsides from risk taking were an afterthought. There were Wall Street trading scandals throughout the 1990's and early 2000's, but each time investment bankers and regulators assumed that the industry as a whole was under control. Then came the debacle of 2008. And even now we still do not have the situation under control, as shown by the failure of MF Global and the $2 billion trading loss that J.P. Morgan announced last week.

If is for this reason that I have worked with Professor Claire Hill, also of the University of Minnesota law faculty, to propose in an article[6] and a forthcoming book that some measure

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[6] See Claire A. Hill and Richard W. Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE LAW REVIEW 1 (June 2010) (symposium on Adolf Berle)

of personal liability for firm debts be imposed upon the most highly paid officers of investment banks and some other financial institutions. We do not insist upon the unlimited liability that characterized Salomon Brothers before 1981 or Lehman Brothers in the days when its prudence and solvency were beyond dispute. We do, however, suggest that creditors and shareholders of large financial institutions should demand personal accountability of high ranking executives that goes beyond loss of pay or even employment. People who make risk decisions for financial institutions, and are paid enormous amounts when those risks pay off, should be required to put a significant portion of their personal assets at the disposal of firm creditors in the event the firm fails.

I do not suggest that Congress take steps now to implement such a rule. The private sector has the means at its disposal. Personal guarantees of corporate indebtedness are a common phenomenon in the financial sector and indeed bankers often insist upon them before advancing loans to corporate customers. A financial institution should do the same for itself and identify who among its leaders is willing to stand personally behind the institution's solvency. Shareholders and creditors should insist that it do so.

Personal responsibility of financial services executives is a more general topic than the specific focus of today's hearing – settlement of S.E.C. enforcement actions. Nonetheless, we have learned in many contexts, including at this hearing, that there is only so much the S.E.C. can accomplish in enforcement actions and settlements, particularly on a limited budget. There is only so much that the S.E.C., or even Congress, can do to prevent financial failures by imposing new regulations. The financial services industry will become safer and sounder when the industry norm is once again that people, not just institutions, are held accountable.