[University of Michigan Journal of Law Reform](https://repository.law.umich.edu/mjlr)

Volume 48

2015

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https://doi.org/10.36646/mjlr.48.2.admit

ADMIT OR DENY: A CALL FOR REFORM OF THE SEC'S "NEITHER-ADMIT-NOR-DENY" POLICY

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For four decades, the SEC's often-invoked policy of settling cases without requiring admissions of wrongdoing, referred to as the "neither-admit-nor-deny" policy, went unchallenged by the courts, the legislature, and the public. Then in 2011, a harshly critical opinion from Judge Jed Rakoff in SEC v. Citigroup incited demands for reform of this policy. In response to Judge Rakoff's opinion, the SEC announced a modified approach to settlements. Under the modified approach, the Commission may require an admission of wrongdoing if a defendant's misconduct was egregious or if the public markets would benefit from an admission. Many supporters of the neither-admit-nor-deny policy argue that it is the most efficient way to compensate harmed investors. In contrast, many critics condemn the ministerial role of the judiciary in approving SEC settlements. Other interested parties express uncertainty about how aggressively the SEC will pursue admissions under the modified approach and whether admissions will have collateral estoppel effects in subsequent private litigation. Both supporters and critics are mistaken in their approach to the policy, and those in the third category are justifiably uncertain. This Note emphasizes the need for an overhaul of the neither-admit-nor-deny policy, arguing that the policy is plagued by ambiguity, affords too much discretion to the SEC, and does not sufficiently punish wrongdoers. As a result of its use of the neither-admit-nor-deny policy, the SEC fails to achieve the objectives of transparency, accountability, and deterrence that are paramount to enforcing federal securities laws. By requiring specific admissions of wrongdoing in settlements and limiting the preclusive effect of those admissions in private litigation, the SEC would adopt a more aggressive and disciplined approach to enforcement—better serving the public interest—without the risk of costly litigation with defendants who refuse to settle.

Introduction

In a collection of essays published in 1914, Justice Louis Brandeis penned the well-known line, "Sunlight is said to be the best of disinfectants; electric light, the most efficient policeman."[1] The United States Securities and Exchange Commission ("SEC" or the "Commission") often invokes this line to justify its regulatory practices, which encourage public companies to be more transparent with

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1. Louis Brandeis, Other People's Money and How the Bankers Use It, 92 (2d ed. 1914).

their shareholders.[2] Interpreted more broadly, transparency and openness are powerful principles to ensure the appropriate functioning of the SEC's enforcement arm as well.

The modern SEC Division of Enforcement was formed in 1972 in response to the need for a single, consolidated division focused on enforcement and investigation of securities law violations.[3] In the decades since, the Division of Enforcement has become one of the most reputable pillars of the SEC. More specifically, the Division of Enforcement is often praised for efforts in pursuit of its mission, "to protect investors and the markets by investigating potential violations of the federal securities laws and litigating the SEC's enforcement actions."[4]

And yet, the Division of Enforcement almost never litigates. Instead, it settles. Since 2002, the SEC's settlement rate has remained constant at about ninety-eight percent, with the Commission going to trial in only twenty-two of the 734 cases it filed in 2012.[5] There is little comprehensive data on SEC settlement practices prior to 2002, but at various times during this period, the Commission publicly acknowledged settling "the vast majority of its cases."[6]

If the staggering number of settled cases does not expose a fundamental cause for concern, the most common method of

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2. John Coffee Jr., *The End of Phony Deterrence? 'SEC v. Bank of America'*, N.Y. L. Journal (2009), *available at* http://www.law.com/cs/ContentServer?pagename=pubs/nylj_07/wrapper&childpagename=NY/Article_C/pubs/nylj_07/pubarticlePrinterFriendly&cid=1202433880823.

3. Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 Fordham J. Corp. & Fin. L. 367, 372-75 (2008).

4. Securities and Exchange Commission Division of Enforcement Manual (Oct. 9, 2013) at 1, *available at* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

5. Luis A. Aguilar, Commissioner, U.S. Sec. Exch. Comm'n., Remarks Before the 20th Annual Securities and Regulatory Enforcement Seminar (Oct. 25, 2013) *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540071677#_edn47. In a letter to Senator Elizabeth Warren in June 2013, SEC Chairman Mary Jo White stated that seventy percent of the 105 financial crisis-related actions filed against individuals were filed as litigated actions. *See* Letter from Chairman Mary Jo White to Senator Elizabeth Warren, June 10, 2013, http://thinkprogress.org/wp-content/uploads/2013/06/WARREN-Settling-Enforcement-Action-ES144264. This statistic may be misleading. Since settlement can occur at any point in the pre-trial process, many cases "filed as litigated actions" will settle before any serious threat of trial. Furthermore, the SEC attributes the increase in litigation from 2012 to 2013 to a wave of complex cases related to the 2008 financial crisis, rather than a permanent or significant shift in SEC policy or practices.

6. Aulana L. Peters, Commissioner, U.S. Sec. Exch. Comm'n, Address to the Washington Bar Ass'n. (Apr. 17, 1985) *available at* http://www.sec.gov/news/speech/1985/041985peters.pdf; Mary L. Schapiro, Former Commissioner, U.S. Sec. Exch. Comm'n., Remarks Before the 20th Annual Securities Regulation Institute (Jan. 20, 1993) *available at* http://www.sec.gov/news/speech/1993/012093schapiro.pdf (describing that the SEC "instituted approximately [seventy-four] cease-and-desist actions [that year] . . . almost all of which [were] settled by consent.").

settlement certainly does. The SEC settles most of its cases via consent decree, in which a defendant accepts monetary and injunctive penalties without admitting to or denying the allegations.[7] The consent decree process is far more opaque than a civil trial, in which parties argue their positions in a public forum and accept the judgment as established by the proceedings.[8] Furthermore, a neither-admit-nor-deny consent decree, which only contains a brief statement of the allegations and settlement terms, does not expressly require the defendant to take responsibility for wrongful conduct by admitting the truth of the allegations.[9] The SEC's use of consent decrees communicates to potential wrongdoers that they will rarely face the adverse consequences of an admission.[10] This Note proposes replacing neither-admit-nor-deny with a settlement policy that better achieves the paramount public interest objectives of transparency, accountability, and deterrence.

This Note consists of three parts. Part I will provide background information on the neither-admit-nor-deny policy, including the SEC's justifications for and evolving use of the policy. Part II will discuss the need for reform, addressing weaknesses in the current policy. Finally, Part III will propose a reform to the policy that requires the SEC to obtain specific admissions of wrongdoing in all settlements and limits the preclusive effect of admissions in subsequent private litigation. This Note argues that such a policy will improve the transparency, accountability, and deterrence achieved through SEC enforcement, while mitigating concerns about the costs of risky litigation with defendants who refuse to settle.

I. BACKGROUND ON THE NEITHER-ADMIT-NOR-DENY POLICY

A. *Adoption and Codification of Neither-Admit-Nor-Deny*

The SEC traces the neither-admit-nor-deny policy to a 1972 release entitled "Consent Decrees in Judicial or Administrative Proceedings."[11] In the release, the SEC provided express approval for the Division of Enforcement to settle cases on the basis of the

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7. Danné L.Johnson, *SEC Settlement: Agency Self-interest or Public Interest*, 12 FORDHAM J. CORP. & FIN. L. 627, 647 (2007).

8. *See* Luis A. Aguilar, *Speech by SEC Commissioner: Setting Forth Aspirations for 2011* (Feb. 4, 2011) *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540071677#_edn41.

9. *See* Johnson, *supra* note 7, at 647.

10. *See id.*

11. Consent Decrees in Judicial or Administrative Proceedings, Securities Act Rel. No. 33–5337 (Nov. 28, 1972). S*ee also S.E.C. v. Vitesse Semiconductor Corp.*, 771 F. Supp. 2d 304, 308

defendant neither admitting nor denying the allegations in the complaint. The history of this practice is more complex and deeply entrenched, however, than references to the 1972 release suggest.[12] According to the Second Circuit's opinion in *SEC v. Vitesse*, the SEC began entering into neither-admit-nor-deny consent decrees well before 1972.[13] At the time, the SEC had limited ability to obtain compensatory damages.[14] Instead, it focused on injunctive relief, regardless of whether it obtained an admission of wrongdoing. The consent decree was a useful tool for obtaining injunctive relief from defendants who violated federal securities laws on multiple occasions. If a defendant settled via consent decree and then violated the federal securities laws again, the SEC could invoke the consent decree and employ the court to hold the defendant in contempt.[15] Through the mechanism of the consent decree, the SEC faced almost no barrier to penalizing repeated misconduct.[16]

By 1972, defendants began to take advantage of the SEC's settlement practices. After settling by consent decree, many defendants would publicly deny the SEC allegations and claim that they had entered into settlements only to avoid litigation with a powerful administrative agency.[17] The SEC grew concerned that such statements created a perception that the Commission was imposing sanctions when the alleged conduct did not occur.[18] The SEC saw this perception as detrimental to its integrity.[19] In response, the SEC released its official approval of the practice and codified the policy in 17 CFR Section 202.5(e),[20] adding one important modification. The release and subsequent codification required that

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(S.D.N.Y. 2011) (citing a footnote to the SEC's letter brief to the court referencing the 1972 release).

12. *See Vitesse*, *supra* note 11, at 308.
13. *Id.*
14. *Id.*
15. *See id* at 309.
16. *See id.*
17. *See id.*
18. *Id.*
19. *Id.*
20. *See* 17 CFR § 202.5(e); *U.S. National Archives and Records Administration, About the CFR*, *available at* http://www.archives.gov/federal-register/cfr/about.html. The Code of Federal Regulations (CFR) is an annual codification of the rules of executive departments and agencies of the federal government. The provision in its entirety reads:

> The Commission has adopted the policy that in any civil lawsuit brought by it or in any administrative proceeding of an accusatory nature pending before it, it is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact, occur. Accordingly, it hereby announces its policy not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings. In this regard, the Commission

consent decrees include a provision in which the defendant agreed "not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any allegation in the complaint or creating the impression that the complaint is without factual basis."[21] This provision allowed the SEC to obtain settlements that would not be subsequently disavowed.

Although the policy limited the defendant's ability to publicly address the allegations, it expressly left open the defendant's ability to take a different legal and factual position in proceedings to which the SEC was not a party.[22] As a result, defendants welcomed the policy. It allowed them to continue to disavow wrongdoing in subsequent private litigation, where the monetary penalties could be extremely high.[23]

B. SEC v. Citigroup and Judicial Criticism of Neither-Admit-Nor-Deny

Although SEC consent decrees receive judicial review, federal district courts did not challenge the SEC's settlement practices for over four decades.[24] Civil settlements typically receive judicial review when either the parties or non-party beneficiaries may be vulnerable or at risk.[25] SEC consent decrees may bind non-party victims of the alleged wrongful conduct.[26] Therefore, they fall into the second category of cases receiving judicial review.[27] Although a

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believes that a refusal to admit the allegations is equivalent to a denial, unless the defendant or respondent states that he neither admits nor denies the allegations.

21. 17 CFR § 10, App. A to Part 10: Commission Policy Relating to the Acceptance of Settlements in Administrative and Civil Proceedings.

22. Notwithstanding the agreement not to make public statements denying the allegations, the SEC acknowledges that defendants often "have no difficulty getting the word out that they are still denying the allegations" through the use of strategic press releases, which may subtly suggest that the conduct at issue was not that serious or that the SEC over-reacted. Aguilar, *supra* note 8.

23. *See Vitesse*, *supra* note 11, at 309.

24. *See S.E.C. v. Randolph*, 736 F.2d 525, 530 (9th Cir. 1984).

25. Linda Chatman Thomsen et al., *The Expanding Role of Judges in Settlement and Beyond*, 10 THE MAYHEW-HITE REPORT ON DISPUTE RESOLUTION AND THE COURTS (May 2012) *available at* http://moritzlaw.osu.edu/epub/mayhew-hite/2012/05/the-expanding-role-of-judges-in-settlement-and-beyond. Criminal plea bargains, for example, fall into the first category of exceptions, because the defendant is likely to be a "vulnerable party" in negotiating the settlement.

26. *Id. But see* S.E.C. v. Citigroup Global Markets Inc., 752 F.3d 285, 294 (2d Cir. 2014) [hereinafter *Citigroup II*] ("[A] consent decree does not pose the same concerns [as class action settlements] regarding adequacy – if there are potential plaintiffs with a private right of action, those plaintiffs are free to bring their own actions").

27. *See* Thomsen, *supra* note 25. Both federal district judges and administrative law judges may preside over this process.

judge reviewing an SEC consent decree must exercise independent judgment, the judge's only sources of information are the complaint and the proposed order.[28] As a result, the entry of the consent judgment is largely ministerial.[29] Courts must generally approve the consent decree if it is "fair and reasonable."[30] Most courts grant broad deference to the SEC when applying this standard.[31]

The routine judicial approval of no-admission consent decrees came to a partial halt in late 2011. In a searing opinion, Judge Jed Rakoff of the Southern District of New York rejected a proposed $285 million settlement between the SEC and Citigroup Global Markets.[32] The court found that the consent decree was "neither fair, nor reasonable, nor adequate, nor in the public interest."[33] Judge Rakoff's opinion marked the beginning of a turning point for neither-admit-nor-deny.[34] The crux of his opposition to neither-admit-nor-deny was what he viewed as the ministerial role of the courts in approving consent decrees. According to Judge Rakoff, expecting the judiciary to impose substantial injunctive relief without knowing the underlying facts of the case was an "inherently dangerous" practice.[35]

After *Citigroup*, other judges followed the lead of Judge Rakoff by expressing concern about the policy. For example, Judge Rudolph Randa of the Eastern District of Wisconsin cited *Citigroup* in rejecting a proposed SEC settlement.[36] He requested that the SEC

28. *See* Amanda S. Naoufal, *Is Judge Rakoff Asking for Too Much? The New Standard for Consent Judgment Settlements with the SEC*, 2 Am. U. Bus. L. Rev. 183, 185 (2012).

29. *See S.E.C. v. Citigroup Global Markets Inc.*, 827 F. Supp. 2d 328, 333 (S.D.N.Y. 2011), *vacated and remanded,* 752 F.3d 285 (2d Cir. 2014) [hereinafter *Citigroup I*].

30. *Citigroup II*, *supra* note 26, at 295. If the consent decree includes injunctive relief, district courts must also determine that the "public interest would not be disserved" by entry of the consent decree. *Id.* at 296.

31. *Id.* at 293. ("Our Court recognizes a 'strong federal policy favoring the approval and enforcement of consent decrees.'").

32. *See Citigroup I*, *supra* note 29.

33. *Id.* at 332. The Southern District of New York considered whether the consent decree was "fair, reasonable, and adequate." Adequacy was omitted from the standard for consent decree approval when the Second Circuit considered the case on appeal. *Citigroup II*, *supra* note 26.

34. *See Citigroup I*, *supra* note 29. *Citigroup I* was not Judge Rakoff's first public criticism of the neither-admit-nor-deny policy. *See* S.E.C v. Bank of Am. Corp. 653, F. Supp. 2d 507, 510 (S.D.N.Y. 2009) (claiming the consent decree "was a contrivance designed to provide the SEC with a facade of enforcement" and could not be considered fair even under the most deferential review); *see also Vitesse*, *supra* note 11 (stating that neither-admit-nor-deny results in "confusion and hypocrisy"). The sentiment behind these two decisions culminated in Judge Rakoff's impactful opinion in *Citigroup I.*

35. *Citigroup I*, *supra* note 29, at 333.

36. *See* Letter from Hon. Rudolph T. Randa, U.S. District Judge, to Andrea R. Wood & James A. Davidson, Counsel for SEC (Dec. 20, 2011), *available at* www.wlrk.com/docs/kossletter.pdf.

provide additional information showing why the settlement was "fair, reasonable, and in the public interest."[37] Judge Randa ultimately approved the no-admission consent decree. Then in 2013, Judge Victor Marrero of the Southern District of New York noted that he was "troubled" by a neither-admit-nor-deny settlement provision, expressly conditioning his judgment on the outcome in the *Citigroup* appeal.[38].

The Second Circuit handed down its decision in the *Citigroup* appeal on June 4, 2014.[39] It vacated the district court's order, finding that the court abused its discretion by requiring the SEC to establish the "truth" of the allegations.[40] The Second Circuit also held that district courts should not consider the adequacy of a consent decree involving an enforcement agency.[41] On remand, Judge Rakoff approved the consent decree but expressed concern that future consent decrees would be "subject to no meaningful oversight whatsoever."[42]

Although the Second Circuit reaffirmed the SEC's broad discretion to enter into consent decrees, district courts continue to disagree.[43] This recent jurisprudence with respect to SEC consent decrees demonstrates the uncertainty and instability of the doctrine.

C. *SEC Responses to Judicial Criticism of Neither-Admit-Nor-Deny*

1. SEC Justifications for Settling instead of Litigating

In response to Judge Rakoff's first opinion in *Citigroup* and the discontent that it fostered, the SEC made a series of public statements defending its reliance on settlement instead of litigation.[44]

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37. *Id.*

38. S.E.C. v. CR Intrinsic Investors, 939 F. Supp. 2d 431, 436 (S.D.N.Y. Apr. 16, 2013). The *Citigroup I* settlement was later vacated and remanded. *See Citigroup II*, *supra* note 26. The proposed $602 million settlement in *CR Intrinsic Investors* was consequently approved. S.E.C. v. CR Intrinsic Investors, No. 12-CV-8466 VM, 2014 WL 2768054, at *1 (S.D.N.Y. 2014).

39. Citigroup II, supra note 26.

40. *Id.* at 295. The court also found abuse of discretion to the extent that the lower court withheld approval of the decree because it believed the SEC failed to bring the proper charges. *Id.* at 297.

41. *Id.* at 294.

42. *S.E.C. v. Citigroup Global Markets Inc.*, No. 11-CV-7387 JSR, 2014 WL 3827497, at *1 (S.D.N.Y. Aug. 5, 2014) [hereinafter *Citigroup III*].

43. *Id.*

44. *See* Robert Khuzami, Former Director, Div. of Enforcement, Sec. Exch. Comm'n., Remarks Before the Consumer Federation of America's Financial Services Conference (Dec. 1, 2011) *available at* http://www.sec.gov/news/speech/2011/spch120111rk.htm (defending the SEC's settlement policies).

The SEC frequently invokes three core justifications for settlement. First, the SEC argues that litigation is an expensive and resource-intensive process for an administrative agency with limited funding and staff. The SEC reasons that the expenditure of resources at trial is better allocated to investigating another fraud.[45] Second, the Commission claims that settlement is an expedited means of returning funds to harmed investors.[46] Third, the SEC prefers settlement because it offers certainty to harmed investors by eliminating the possibility of losing at trial.[47]

Although the SEC favors settlement for these reasons, SEC Chairman Mary Jo White acknowledges that litigation results in certain benefits, including greater transparency and a "more thoughtful and nuanced" examination of the conduct and laws at issue.[48] The SEC claims to weigh the costs and benefits of settlement and litigation on a case-by-case basis.[49] Its stated policy is to only recommend settlement when it believes that the terms of settlement are relatively equivalent to a reasonable outcome of prevailing at trial.[50] In making its determination, the SEC purports to consider the strength of its case, the delay and resources required for a trial, the benefits of returning money to harmed investors quickly, the chances of losing at trial, and the chances of winning but being awarded less than what the settlement achieves.[51] Given these considerations and assuming that risk-adjusted expected compensatory and injunctive relief are similar in litigation and settlement, the SEC reasons that settlement is typically the more efficient and reliable approach to enforcement.

2. SEC Justifications for Neither-Admit-Nor-Deny Settlements

The SEC responded to *Citigroup* by defending their settlement practices generally and the neither-admit-nor-deny policy specifically. The purpose of the policy at the time of codification was to

45. *Id.*
46. *Id.*
47. *See id. See also* David M. Becker, *What More Can Be Done to Deter Violations of the Federal Securities Laws?*, 90 Tex. L. Rev. 1849, 1863-66 (2012) (citing fear of loss as one reason to favor settling).
48. *See* Mary Jo White, Chairman, U.S. Sec. Exch. Comm'n., The Importance of Trials to the Law and Public Accountability, Speech before Fifth Annual Judge Thomas A. Flannery Lecture (Nov. 14, 2013) *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540374908#.UolFmy4o7IV.
49. *See* Khuzami, *supra* note 44.
50. *Id.*
51. *See id.*

ensure that defendants would not subsequently disavow settlements and call into question the SEC's integrity. The modern justification for the policy is somewhat divorced from that original purpose. Today, the SEC argues that if defendants were required to admit to wrongdoing, many would simply refuse to settle for fear that admission might expose them to additional lawsuits by private litigants seeking damages.[52] Defendants' fears are based on two possible mechanisms. The primary concern of most defendants is that an admission may have non-mutual offensive collateral estoppel effects in subsequent private litigation, barring the defendant from taking a different position or re-litigating the issues surrounding the alleged wrongdoing.[53] Defendants may also be concerned that an admission of wrongdoing could be admissible evidence in subsequent private litigation.[54]

a. Collateral Estoppel as a Disincentive for Defendants to Settle

An understanding of non-mutual offensive collateral estoppel is necessary to understanding the rationale behind the SEC's current policy. The doctrine of collateral estoppel is largely grounded in *Parklane Hosiery v. Shore*.[55] In *Parklane Hosiery*, shareholders and the SEC brought parallel suits in federal district court, alleging the issuance of a materially false and misleading proxy statement.[56] After the SEC won its case, plaintiffs in the private suit moved for partial summary judgment, arguing that non-mutual offensive collateral estoppel prevented the defendant corporation from re-litigating issues resolved in the SEC suit.[57] The U.S. Supreme Court agreed that no question of fact remained to be determined in a jury trial.[58] However, the Court asserted that the use of offensive collateral estoppel should be limited. It argued that the application of offensive collateral estoppel could diminish judicial economy by incentivizing plaintiffs to litigate against defendants in separate actions, in

52. *Id.*

53. *See* Johnson, *supra* note 7, at 666 ("Of the . . . possible types of harm . . . possible exposure to collateral estoppel is most feared by large corporations.").

54. *See* Posting of John C. Coffee, Jr. to The CLS Blue Sky Blog, http://clsbluesky.law.columbia.edu/2013/07/22/neither-admit-nor-deny-practical-implications-of-secs-new-policy (July 22, 2013).

55. *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322 (1979).

56. *Id.* at 329.

57. *Id.* at 330.

58. *See id.*

the hope that a favorable judgment would be binding in all subsequent actions.[59] The Court also identified several circumstances in which offensive collateral estoppel would result in unfair treatment of defendants, including when a defendant has little incentive to defend vigorously in the first action or when the second action "affords the defendant procedural opportunities unavailable in the first action that could readily cause a different result."[60]

Justice William Rehnquist's dissent in *Parklane Hosiery* warned that the majority's application of collateral estoppel would pressure defendants to settle SEC enforcement actions.[61] Justice Rehnquist reasoned that defendants would settle in order to avoid exposure to private suits brought by individuals seeking to rely on a previous judgment, as well as to preserve the defendant's right to re-litigate issues in private actions.[62] His dissent sharply criticized the majority for crafting a doctrine that would bully defendants to settle with the SEC, which added "a powerful club to the administrative agencies' arsenals that even Congress was unwilling to provide them."[63]

Justice Rehnquist's dissent predicted that defendants would settle to avoid application of offensive collateral estoppel, but he did not address the content of these settlements.[64] Settlements containing an admission of wrongdoing could also be interpreted as judicial orders entitled to application of offensive collateral estoppel.[65] Scholars disagree about whether and to what extent collateral estoppel would apply to admissions in SEC consent decrees. On the one hand, the doctrine only applies when defendants have had a "full and fair opportunity for judicial resolution."[66] Unlike the SEC action in *Parklane Hosiery*, in which the court entered a declaratory judgment after a complete trial, consent decrees are settlements that may not qualify as judicial resolution.[67] Even if a court did apply the collateral estoppel doctrine, the consent decree could fall

59. *See id.*

60. *Id.*

61. *See id.* at 332.

62. *Id.*

63. *Id. See also* Marvin G. Pickholz and Richard E. Brodsky, *An Assessment of Collateral Estoppel and SEC Enforcement Proceedings After* Parklane Hosiery Co. v. Shore, 28 Am. Univ. L. Rev. 37, 60 (1978) (agreeing that *Parklane Hosiery* will increase defendants' incentives to settle).

64. *See Parklane Hosiery*, *supra* note 55, at 332.

65. *See* Coffee, *supra* note 47.

66. *See id.* at 328. *See also* James Moore et al., 18 Moore's Federal Practice § 131.10 (Coquillette et al. eds., 3d ed. 2013).

67. *See* Coffee, *supra* note 54. *See also* Restatement (Second) of Judgments § 27 Cmt. E (1982) (setting forth a general rule that settlement agreements do not have collateral estoppel effect on subsequent litigation brought by a third party because the issues were not fully litigated).

under the procedural unfairness exception if the settlement process does not offer the defendant opportunities to conduct full discovery.[68]

On the other hand, consent decrees are not simply settlements between private parties; they are court orders enforced under the power of a federal or administrative law judge.[69] If other judges follow in the footsteps of Judge Rakoff, rather than the Second Circuit, and demand more information on which to base their approval of the consent decree, the process will move closer towards full adjudication.[70] If settlement via consent decree resembles full adjudication, judges in private civil litigations will have a stronger basis on which to apply collateral estoppel to the judgment. The possible application of offensive collateral estoppel may incentivize defendants to refuse to settle, which the SEC claims is a primary justification for neither-admit-nor-deny.[71]

b. Evidentiary Effect of Admission as Disincentive for Defendants to Settle

Even if courts do not apply offensive collateral estoppel to an admission, defendants may be concerned about the evidentiary effect of the admission in private litigation.[72] This concern is another important factor in the SEC's current settlement policy. Courts are somewhat divided on the question of whether SEC consent decrees are admissible as evidence. In *Lipsky v. Commonwealth United Corp.*, the Second Circuit held that an SEC consent decree was not the result of an actual adjudication of any issues, and, therefore, could not be used as evidence in subsequent litigation.[73] The Second Circuit later declined to extend the *Lipsky* principle in the case of *U.S. v. Gilbert.*[74] In *Gilbert,* the Court held that an SEC consent decree signed by the defendant was admissible to show that the defendant

68. *See* 17 CIVIL LIABILITIES: ENFORCEMENT & LITIG. § 2:108. *See also* Edmund H. Kerr Robert J., *Collateral Estoppel Implications of SEC Adjudications*, 42 BUS. LAWYER 441, 470 (1987) (stating that the fairness exception may be the only basis for refusing to apply collateral estoppel to SEC consent decrees in private civil litigation). Other courts have found that the mere existence of more limited procedures in the first forum is not sufficient, by itself, to prevent the application of collateral estoppel. *Id.* at 469.

69. The Supreme Court does not recognize any inherent preference for jury trials over bench trials. *See Atlas Roofing Co. v. Occupational Health & Safety Review Comm'n*, 430 U.S. 442, 460-61 (1977).

70. *See Citigroup I, supra* note 29, at 336.

71. *See* Khuzami, *supra* note 44.

72. *See* Coffee, *supra* note 54.

73. *Lipsky v. Commonwealth United Corp.,* 551 F.2d 887, 893 (2d Cir. 1976).

74. *United States v. Gilbert*, 668 F.2d 94, 97 (2d Cir. 1981).

knew of certain SEC reporting requirements involved in the terms of the decree.[75] The *Gilbert* Court based its decision on Federal Rule of Evidence 404(b), which provides that evidence of a wrongful act "may be admissible for certain purposes, such as proving motive, opportunity, intent, preparation, plan, knowledge, identity, absence of mistake, or lack of accident."[76] The Court also emphasized that admitting the decree as evidence was appropriate because "the decree's prejudicial potential was not great, and [the lower court] properly cautioned the jury as to the limited inferences they could permissibly draw from it."[77] Recent cases have largely followed the *Gilbert* approach, admitting the SEC consent decree as evidence if it constitutes an adjudication of the issues and will not be prejudicial.[78]

Under the standard set forth in *Gilbert*, most courts would likely grant some evidentiary effect to an admission in a consent decree.[79] The value of that evidence in private litigation would depend on factors such as the claim being brought, the facts of the case, and the form of adjudication—judge or jury trial, or administrative proceeding. Notwithstanding these factors, the admission of the consent decree into evidence would not be legally dispositive of issues in the private cause of action.[80] In other words, unlike the application of offensive collateral estoppel, giving an admission evidentiary effect would not preclude defendants from re-litigating the issues.[81]

Although the jurisprudence surrounding the effect of SEC consent decrees is not conclusive, it suggests that admissions would have an impact on defendants in private litigation, either through the application of offensive collateral estoppel or as admissible evidence.[82] The SEC argues that, because defendants fear this impact, the Commission must allow neither-admit-nor-deny language to shield defendants from the consequences of admissions.[83] The absence of an admission offers an additional benefit to the defendant

75. *See id.*

76. Federal Rule of Evid. 404(b); *see also Gilbert*, *supra* note 74, at 97.

77. *Gilbert*, *supra* note 74, at 97.

78. *See S.E.C. v. Pentagon Capital Mgmt PLC*, No. 08-CV-3324, slip op. (S.D.N.Y. Mar. 11, 2010) (citing *Gilbert* and holding that *certain* SEC factual findings are admissible evidence in subsequent litigation and regulatory proceedings) (emphasis added).

79. *See Gilbert supra* note 74, at 97.

80. *See* Coffee, *supra* note 54.

81. *See id.*

82. *See id.*

83. *See* 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, 74 (2012); *see also Carpenters Health & Welfare Fund v. The Coca-Cola Co.*, No. 00-CV-2838,

by allowing it to mitigate potential economic and reputational consequences of an admission.[84] Although the SEC may also benefit from obtaining an expeditious settlement, obtaining a settlement without admission of wrongdoing represents a significant concession on its part.[85]

3. SEC's Modification of Neither-Admit-Nor-Deny

Although the SEC responded to Judge Rakoff's first opinion in *Citigroup* by defending its existing settlement policy, the Commission later modified its blanket policy favoring no-admission settlements.[86] In June 2013, Chairman White promised that the SEC would take a tougher stance on no-admission settlements.[87] In a September 2013 appearance, she identified the following four types of cases in which the SEC may require admissions from corporate or individual defendants: (1) cases where a large number of investors have been harmed or the conduct was otherwise egregious; (2) cases where the conduct posed a significant risk to the market or investors; (3) cases where admissions would aid investors in deciding whether to deal with a particular party in the future; and (4) cases where reciting unambiguous facts would send an important message to the market about a particular case.[88] After listing these four types of cases, Chairman White reiterated that no-admission settlements would continue to be the favored method of enforcement for the SEC.[89]

Despite Chairman White's statements, there has been little meaningful change in the SEC's approach to enforcement.[90] The Commission only invoked the heightened standard twice in the six months following Chairman White's June statement. The first of the two cases was settled in August 2013 with hedge fund advisor

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slip. op. at *3 (N.D. Ga. Apr. 23, 2008) (noting the "chilling effect" that allowing SEC findings into evidence in future civil litigation would have on the SEC's ability to settle cases).

84. *See* Coffee, *supra* note 54.

85. *See id.*

86. *See* Mary Jo White, Chairman, Sec. & Exch. Comm'n, Deploying the Full Enforcement Arsenal, Speech at Council of Institutional Investors Fall Conference (Sept. 26, 2013) *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539841202#.UlxZdS7D_IU.

87. *See* James B. Steward, *SEC Has Message for Firms Not Used to Admitting Guilt*, NEW YORK TIMES, June 21, 2013, *available at* http://www.nytimes.com/2013/06/22/business/secs-new-chief-promises-tougher-line-on-cases.html?_r=0.

88. *See* White, *supra* note 86.

89. *See id.*

90. *See* Posting of John C. Coffee, Jr. to The CLS Blue Sky Blog, http://clsbluesky.law.columbia.edu/2013/10/10/in-the-wake-of-the-whale-whats-changed (Oct. 10, 2013).

Philip Falcone and his advisory firm, Harbinger Capital Partners.[91] The SEC's complaint alleged that Falcone improperly used $113 million in fund assets to pay his personal taxes, made secret deals favoring particular customer redemptions, and manipulated the bond market.[92] In addition to an $18 million fine and a five-year bar from the securities industry, Falcone admitted in the settlement to acting recklessly and to a list of facts related to the conduct.[93] He did not, however, directly admit to violating any specific rules or federal securities laws.[94]

In the second case to apply the modified approach, JP Morgan agreed in September 2013 to pay a $920 million penalty to four agencies, including the SEC.[95] The cause of action resulted from a $6.2 billion derivatives trading loss managed by one of its traders, nicknamed "The London Whale."[96] The settlement included an admission, but only to violations of the non-scienter-based books-and-records provision under Section 13(b) of the Securities Exchange Act of 1934.[97] Most practitioners consider violations of this corporate governance provision to be minor as compared to violations of anti-fraud provisions like Section 10(b) of the Securities Exchange Act of 1934,[98] which requires proof of intentional or reckless misconduct.[99] The negotiated settlement allowed the SEC to claim a political victory, while JP Morgan avoided admission of any serious wrongdoing.[100]

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91. *See* U.S. Sec. & Exch. Comm'n Press Release, Philip Falcone and Harbinger Capital Agree to Settlement, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222#.UlyV8y7D_IU (Aug. 19, 2013).

92. *See id.*

93. *See id.*

94. Marc D. Powers, et al., *The Falcone Settlement: A Harbinger of Things to Come?*, http://www.mondaq.com/unitedstates/x/261910/Financial+Services/The+Falcone+Settlement+A+Harbinger+Of+Things+To+Come (Sept. 11, 2013).

95. Ben Protess & Jessica Silver-Greenberg, *JPMorgan Expected to Admit Fault in 'London Whale' Trading Loss*, N.Y. Times, Oct. 15, 2013, *available at* http://dealbook.nytimes.com/2013/10/15/jpmorgan-said-to-reach-deal-with-trading-regulator.

96. *Id.*

97. Securities Exchange Act of 1934 § 13(b), 15 U.S.C. § 78m (requiring a company to ensure that its records "accurately and fairly reflect the transactions and dispositions of the assets of the issuer.").

98. The agency commonly brings actions under § 10(b) and its corollary provision SEC Rule 10(b)-5, both which require proof of scienter.

99. *See* Kevin LaCroix, *A Closer Look at JP Morgan's $920 Million 'London Whale' Regulatory Settlements*, Sept. 20, 2013 *available at* http://www.dandodiary.com/2013/09/articles/securities-litigation/a-closer-look-at-jp-morgans-920-million-london-whale-regulatory-settlements/ (citing various practitioners who argue § 13 violations are not as serious as fraud-based violations).

100. *See* Dan Freed, *'Historic' Admission to SEC Won't Help JP Morgan Plaintiffs*, http://www.thestreet.com/story/12042919/1/historic-admission-to-sec-wont-help-jpmorgan-plaintiffs.html (Sept. 20, 2013, 9:12 AM).

In October 2013, the Commodity Futures Trading Commission (CFTC) notably settled with JP Morgan over the same massive trading losses. Unlike the SEC, the CFTC settlement required JP Morgan to admit to "recklessly employing manipulative devices," in addition to paying about $100 million in fines.[101] Although the CFTC settlement focused on misconduct in actual trading practices, the precise language could protect the bank from an onslaught of shareholder litigation.[102] JP Morgan has noted that it admitted to the wrongful conduct, but it neither admitted nor denied the CFTC's legal conclusion that there was a violation.[103]

II. THE NEED FOR REFORM OF THE NEITHER-ADMIT-NOR-DENY POLICY

A. *Problems with the SEC's Old Approach to Neither-Admit-Nor-Deny*

The old approach to neither-admit-nor-deny resulted in the SEC settling an overwhelming majority of its cases without an admission of wrongdoing. This approach remains the SEC's preferred practice despite failing to meet its core objectives.[104] First, the old policy lacks transparency. By taking very few cases to trial, the SEC relinquishes the openness of the litigation process.[105] Arguments at trial reveal and publicize facts uncovered after thorough discovery by both parties. Furthermore, court hearings are often open to the public and often result in a published judicial opinion explaining the decision.[106] This openness informs the public at large about interpretation of the laws, the rights of victims, and the nature of the claims.[107] Settlement by the SEC, however, curtails this process. Judge Patricia Wald of the D.C. Circuit has criticized settlement for replacing a "full trial record that may more accurately represent the

101. Protess & Silver-Greenberg, *supra* note 95.

102. *See id.*

103. Ben Protess, *A Regulator Cuts New Teeth on JP Morgan in 'London Whale' Case*, N.Y. TIMES, Oct. 16, 2013, *available at* http://dealbook.nytimes.com/2013/10/16/jpmorgan-to-pay-100-million-and-make-admission-of-wrongdoing-in-london-whale-pact.

104. *See* Jayne W. Barnard, *Evolutionary Enforcement at the Securities and Exchange Commission*, 71 U. PITT. L. REV. 403, 404 (2010) (noting former Chairman Khuzami altered the Division of Enforcement's performance metrics to emphasize "quality, timeliness and deterrent impact" rather than simply the number of cases initiated).

105. Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631, 1662 (2005).

106. *See* Johnson, *supra* note 7.

107. *Id. See also* Owen M. Fiss, *Foreword: The Forms of Justice*, 93 HARV. L. REV. 1, 2 (1979) ("Adjudication is the social process by which judges give meaning to our public values.").

complexity and ambiguity of life" with facts that are only "pleaded, stipulated, or inferred."[108]

Although settlement is less transparent than adjudication, not all settlements are equally opaque.[109] Parties to a settlement may choose how to conduct the settlement process and draft the agreement, as long as the settlement meets minimum standards of legality and reasonableness.[110] The SEC embraces a settlement policy that is highly opaque. Negotiation of an SEC consent decree is frequently beyond public record. Therefore, only the negotiating parties know the factors on which a settlement is based and the extent to which each party compromised on settlement terms.[111] The SEC's private negotiations with defendants result in a brief Order Instituting Proceeding, typically no more than a few paragraphs long, listing the allegations and terms of settlement.[112] This notice contains only a small part of the complete set of facts and allegations uncovered by the SEC's investigation.[113] Furthermore, the absence of an admission means that the allegations contained in the consent decree are simply allegations, and, therefore, they cannot be afforded any certainty as to their truth.[114]

Public policy favors an opaque settlement process when two private parties negotiate a compromise that has no impact on third parties and does not require agreement on facts.[115] Yet the benefits of private settlement cannot be inferred in the arena of settlement with a public agency.[116] Unlike most private settlements, SEC settlements demand transparency because of their impact on third

108. *See* White, *supra* note 48 (describing Judge Wald's support of trial).

109. *See* Johnson, *supra* note 7 (quoting David Luban as stating "We cannot really be against settlements . . . . But we can be against the wrong settlements." Luban argues that the "wrong" settlements are those that are secret.).

110. *Id.*

111. *See* Coffee, *supra* note 54.

112. *See also* Litigation, U.S. Sec. Exch. Comm'n website (May 30, 2013), *available at* http://www.sec.gov/litigation.shtml (providing links to notices and orders concerning settlements).

113. *See id.*

114. *See Citigroup I*, *supra* note 29, at 334 (stating that an allegation that is neither admitted nor denied "has no evidentiary value and no collateral estoppel effect," and that the public "has [no] reason to credit those allegations, which remain entirely unproven.").

115. *See Citigroup I*, *supra* note 29.

116. Macchiarola, *supra* note 83 (stating that public accountability through no-admission settlements may be more elusive). The neither-admit-nor-deny settlement is similar in many ways to a nolo contendere plea in the criminal setting. The Department of Justice has long discouraged use of the nolo contendere plea. A 1953 DOJ directive reflects the agency's approach to the use of nolo contendere: "Uncontrolled use of the plea has led to shockingly low sentences and insignificant fines that are no deterrent to crime. Moreover, a person permitted to plead nolo contendere admits his guilt for the purpose of imposing punishment for his acts and yet, for all other purposes, and as far as the public is concerned, persists in his denial of wrongdoing. It is no wonder that the public regards consent to such a plea by the

parties. SEC settlements influence market participants, affect the development of securities law, and implicate public financial markets that are interconnected with societal interests.[117] A 2010 settlement between the SEC and Goldman Sachs, in which Goldman admitted to materially misleading investors, sent Goldman's stock price up nearly ten percent the day after settlement.[118] The Goldman settlement suggests that when the SEC resolves charges against public companies, investors respond. Greater transparency in the resolution would better inform investors' decision-making.[119] Investment experts generally agree that the SEC would "best serve investors by focusing on making data more accessible, not limiting the amount."[120]

Not only does lack of transparency fail to hold defendants fully accountable for wrongful conduct, but it also fails to hold the SEC accountable for its settlement practices. Under the current policy, the SEC has no minimum standard to meet with regards to settlement terms or burdens of proof, other than the standard of fairness and reasonableness theoretically imposed by judges.[121] Therefore, the policy gives the Commission expansive authority to prioritize efficiency over obtaining an admission of wrongdoing.[122] The SEC may easily and expeditiously obtain settlements, but those settlements may not make sense given the severity of the crime or the evidentiary basis for the allegations.[123]

One way in which the neither-admit-nor-deny policy fails to hold the SEC accountable is by permitting the SEC to offer no-admission settlements even when its case is weak. In 2005, the SEC brought

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Government as an admission that it has only a technical case at most and that the whole proceeding is just a fiasco." Ronald J. Waldron et al., *The Criminal Justice System: An Introduction*, 229 (CRC Publishing 2009).

117. *See* Johnson, *supra* note 7, at 652.

118. Walter Hamilton et al., *Goldman Sachs Agrees to Settle SEC Fraud Case for $550 Million*, L.A. TIMES, July 15, 2010, *available at* http://articles.latimes.com/2010/jul/15/business/la-fi-0716-goldman-sec-20100716.

119. *See* Johnson, *supra* note 7.

120. Eleanor Bloxham, *Do Investors Have Too Much Information?*, CNN Money, *available at http://management.fortune.cnn.com/2013/10/29/investor-information-overload-sec/* (quoting Laura Berry, executive of an investor coalition).

121. *See Citigroup I*, *supra* note 29 (holding that district courts should not inquire into the truthfulness of the allegations in approving a consent decree). *See also* Becker, *supra* note 47 (stating that while working in the Division of Enforcement, he noticed a "tendency at times to want to dispose of a matter," resulting in the SEC giving defendants "a settlement discount to avoid litigation.").

122. *See also* Posting of John C. Coffee, Jr. to The CLS Blue Sky Blog, http://clsbluesky.law.columbia.edu/2013/01/02/sec-enforcement-what-has-gone-wrong (Jan. 2, 2013) (arguing that the SEC favors "quick, publicity generating settlements").

123. *See* Coffee, *supra* note 54.

sweeping charges against executives from telecommunications company Qwest, seeking $300 million for what it called "massive financial fraud."[124] The SEC later "quietly agreed" to a no-admission settlement, which one attorney for the defendant said was an "indication of the merits of [the SEC's] case."[125] Settlements based on minimal evidence inspire little confidence in the SEC. Had the Commission been required to obtain an admission of wrongdoing, it would have been compelled to either build a case with actual merit or drop the charges. The trade-offs involved in obtaining settlements raise serious concerns about the SEC's use of its broad discretion in a process lacking transparency.[126]

These accountability concerns are aggravated by the likelihood of unequal bargaining power in such negotiations. Relatively equal bargaining power between parties is a hallmark of traditional settlement.[127] This standard is difficult to meet when applied to settlement negotiations between individuals or corporations and government entities.[128] An ABA Task Force Report found that although both parties in an SEC settlement have a number of sources of power in the negotiation, the SEC typically has the upper hand.[129] For example, one source of power that may embolden the SEC is its perceived relationship with Congress or the Department of Justice.[130] Although the use of these relationships as a source of bargaining power would be difficult to eliminate from the SEC settlement process, greater transparency and higher standards of accountability would limit the ability of either party to negotiate based on factors unrelated to the merits of each individual case.

Lastly, the SEC's old approach fails to sufficiently deter potential wrongdoers. In its effort to settle cases rapidly, notwithstanding an

124. Andy Vuong, *SEC Settlement Comes at "Low Cost" to Nacchio*, Denver Post, *available at* http://www.denverpost.com/ci_16016370.

125. *Id.* (quoting Kevin Evans, an attorney for co-defendant and former Qwest accountant James Kowlowski).

126. In a letter to Senator Warren, Chairman White admitted that the SEC has never conducted any macro analysis of the trade-offs to the public of settling without an admission of guilt or wrongdoing and going forward with litigation. *See* Letter from Chairman Mary Jo White to Senator Elizabeth Warren, *supra* note 5.

127. Johnson, *supra* note 7, at 658-59.

128. *See id.* at 659. Judges may reject proposed settlements if they perceive unequal bargaining power between two private parties. Although SEC consent decrees undergo judicial review as well, judges almost never scrutinize or reject the proposed settlement.

129. *See* Committee on Federal Regulation of Securities, ABA Task Force on SEC Settlements, Report of the Task Force on SEC Settlements, 47 BUS. LAW. 1087, 1098 (1992) (stating that the SEC dominates most settlement negotiations).

130. *See* Johnson, *supra* note 7, at 659 (listing various factors that affect negotiating power, including wealth, authority, strength, persuasion, capacity, influence, a willingness to engage in conflict, and other less visible factors).

admission of wrongdoing, the SEC reduces deterrent effect.[131] In Judge Rakoff's first opinion in *Citigroup*, he noted that because potential wrongdoers know that they will not have to admit to unlawful conduct, a consent decree is "frequently viewed by companies as a cost of doing business."[132] Under neither-admit-nor-deny, defendants may anticipate that the SEC will not require them to publicly acknowledge wrongdoing or litigate cases.[133] Accordingly, they know that resolving an SEC action will require limited expenditure of resources and reputational risk.[134] Senator Elizabeth Warren is another vocal critic of this settlement approach, particularly as it applies to Wall Street Banks. After a Senate Banking Committee Hearing in which none of the major financial regulators could recall the last time they faced a major bank in trial, Senator Warren expressed concern that "Too Big to Fail" had become "Too Big for Trial."[135]

Compensatory penalties imposed by the SEC may deter some potential wrongdoers. However, the fact that many members of the corporate community consider SEC settlements to be a cost of business suggests that these settlements do not impose a sufficiently severe punishment to meaningfully deter wrongful conduct.[136] Under a more forceful approach, defendants could no longer rely on simply paying a fine to resolve an SEC action. Instead, they would have to structure their conduct knowing that they might face the consequences of an admission, including reputational harm.[137] Admissions would supplement monetary and injunctive penalties to send a message to potential wrongdoers that an SEC action has, at minimum, the punitive consequences of an admission. Furthermore, potential wrongdoers would have to consider the legitimate possibility that the SEC might litigate the case. Even SEC Commissioner Luis Aguilar admits that the SEC "must be willing to litigate" as proof to potential wrongdoers that the Commission can and will

131. *See* Coffee, *supra* note 54.

132. *Citigroup I*, *supra* note 29, at 335.

133. *See id.*

134. *See* Coffee, *supra* note 2 (arguing that corporate defendants do not fear the SEC's enforcement because, "once the public has been shown the little man behind the curtain, the great and powerful Wizard looks far less foreboding or impressive").

135. *See* Senator Elizabeth Warren's First Banking Committee Hearing, Senator Elizabeth Warren, Hearing, Senator Elizabeth Warren, YOUTUBE, Feb. 14, 2013 *available at* https://www.youtube.com/watch?feature=player_embedded&v=dxhyUAWPmGw.

136. *See Citigroup I*, *supra* note 29, at 335.

137. *See* Coffee, *supra* note 2.

wield this enforcement tool.[138] A willingness to litigate would compel potential wrongdoers to weigh the additional costs of trial before violating the federal securities laws.

B. Problems with the SEC's Modified Approach to Neither-Admit-Nor-Deny

The SEC's modified approach to neither-admit-nor-deny identifies four triggering factors for admissions under the modified policy: (1) cases where a large number of investors have been harmed or the conduct was otherwise egregious; (2) cases where the conduct posed a significant risk to the market or investors; (3) cases where admissions would aid investors in deciding whether to deal with a particular party in the future; and (4) cases where reciting unambiguous facts would send an important message to the market about a particular case.[139] This modified approach fails to effectuate the core principles of transparency, accountability, and deterrence. First, the modified policy does not establish with any certainty that the SEC will in fact take a more aggressive stance in settlements.[140] These four factors—which may, but will not necessarily, lead to more admissions—are ambiguous, difficult to apply, and afford too much discretion to the SEC.[141] Interpreted broadly, almost any SEC action could fall within the standard since the Commission pursues many actions where multiple investors have been harmed or a company is well-known in the public markets. Interpreted narrowly, the SEC may find that a securities violation is seldom egregious enough to require settlement.[142]

The Commission's settlement with SAC Capital Advisors in October 2013 illustrates the deficiencies of the modified approach.[143] The agreement between the SEC and SAC Capital represented the largest settlement ever for insider trading charges.[144] Although SAC Capital agreed to pay the SEC a total of over $2 billion in penalties, the firm did not admit or deny any wrongdoing in the civil settlement.[145] As compared to the settlements with Harbinger Capital

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138. Aguilar, *supra* note 5.
139. *Id.*
140. *See* White, *supra* note 86.
141. *See* Coffee, *supra* note 54.
142. *See id.*
143. Michael Rothfield & Juliet Chung, *Prosecutors and SAC Head Toward a Possible Record-Breaking Settlement* (Oct. 17, 2013), http://stream.wsj.com/story/latest-headlines/SS-2-63399/SS-2-357268.
144. *Id.*
145. *Id.*

and JP Morgan,[146] the massive fraud at issue in the SAC Capital case should have qualified for a required admission under the SEC's heightened standard. Instead, the SEC reflexively settled without an admission of guilt. Only one month later, SAC Capital pled guilty to charges of criminal fraud in a $1.8 billion settlement with federal prosecutors.[147] The criminal plea further illustrates fundamental shortcomings of the SEC's enforcement policy, under which perpetrators of fraud rising to a criminal level may not be required to admit wrongdoing in a civil settlement with the SEC.[148] One explanation for the no-admission settlement may be that the SEC works backwards in applying the modified approach, declining to require admissions if it believes the defendant may choose to litigate instead. Such reasoning would render the four triggering factors relatively meaningless, since the SEC would base its application of the modified standard on its fear of trial rather than those four factors.

Admittedly, the SEC has always maintained discretion over decisions to bring and settle cases.[149] Yet the Commission's discretion when acting in the public interest is not absolute or unrestricted.[150] The current check on this expansive authority is the requirement that courts exercise independent judgment in approving the settlement.[151] An even more effective approach to ensure fair and consistent treatment of wrongdoers would involve the SEC self-imposing specific guidelines on its settlement practices. By setting minimum standards for settlement and limiting the ad hoc application of the standards, the SEC could avoid reverting back to its old approach of never requiring admissions.

In addition, the modified approach fails to address, and even amplifies, the collateral estoppel problems that disincentivized admissions under the old policy. Under the old approach, the neither-admit-nor-deny provision typically precluded the settlement from having collateral estoppel effects in private litigation.[152] If the SEC requires admissions in the types of cases it claims to target under the modified approach, such as those where harm is widespread or egregious, those admissions would have devastating

146. *See discussion*, Part II.

147. *See* Jonathan Weil, *SAC Capital's Guilty Plea Makes Old Deal Look Silly*, Nov 6, 2013 10:18 AM ET, available at http://www.bloomberg.com/news/2013-11-06/sac-capital-s-guilty-plea-makes-old-deal-look-silly.html.

148. *See id.*

149. *See* White, *supra* note 48.

150. *See id.*

151. *See Citigroup II*, *supra* note 26, at 294.

152. *See supra* notes 55–71 (discussing the possible application of offensive collateral estoppel to SEC consent decrees).

collateral estoppel effects.[153] Defendants would likely respond by refusing to settle.[154] Thus, the heightened standard will likely force the SEC to litigate matters that are particularly difficult and expensive to try.[155]

Because the collateral consequences of an admission are often worse for individuals than companies, individuals will likely be more reluctant to admit wrongdoing under the modified policy.[156] Individuals who admit to violations of the federal securities laws can lose their license to work in the financial industry or can face public humiliation.[157] Individuals also risk losing their Directors' and Officers' Liability (D&O) insurance if they admit to fraud or intentional misconduct.[158] D&O insurance is an important tool used by companies to protect their directors and managers against the costs of litigation.[159] The admissions sought by the SEC would likely trigger exceptions in the payment schemes of these insurance policies.[160] Given the costs of admission, individuals charged under the new policy will typically take their chances at trial, regardless of the settlement offer.[161]

If the SEC wants to avoid excessively high trial costs under the modified policy, there are several options it may apply. Each one, however, is problematic. First, the Commission could use its discretion to apply the modified approach infrequently and only when it knows that it will not have to go to trial. The inconsistent application of the heightened standard thus far suggests the SEC may prefer this option. Infrequent application of the modified approach and the absence of a legitimate threat of litigation would fail to wholly address the problems of transparency, accountability, and deterrence that persisted under the old approach.[162]

Second, the SEC may require admissions only from wrongdoers who have perpetrated the very worst financial crimes and have already been criminally convicted. Requiring admissions only "from the Madoffs, WorldComs, and Enrons of financial wrongdoing . . .

153. *See* Alison Frankel, *Should Defendants Fear New SEC Policy on Admissions in Settlements?* (June 19, 2013), http://blogs.reuters.com/alison-frankel/2013/06/19/should-defendants-fear-new-sec-policy-on-admissions-in-settlements.

154. *Id.*

155. *See id.*

156. *See* Lindsay Fisher, *D&O Insurance: The Tension Between Cooperating with the Insurance Company and Protecting Privileged Information from Third Party Plaintiffs*, 32 Seattle U. L. Rev. 201, 209 (2008).

157. Becker, *supra* note 47.

158. *See* Frankel, *supra* note 153.

159. Fisher, *supra* note 156.

160. *Id.*

161. *See id.*

162. *See discussion*, Part III.A.

[would not] have much impact" though, because it would not represent a significant departure from the SEC's current policy.[163] Since 2011, the SEC has claimed to require admissions of wrongdoing in cases where the defendant admits to or has been convicted of a parallel criminal violation.[164] Scholars have noted that this claim is largely insignificant, requiring admissions in only a small subset of cases in which the defendant already admitted to or was proven guilty of the wrongdoing.[165] Should the SEC require admissions in such cases, under the guise of a modified approach, the change would be as insignificant as the 2011 policy exception.

Third, the SEC could aggressively pursue admissions, but carefully craft the settlement language in a way that dilutes an admission's significance. By drafting the settlement to avoid implicating specific or serious violations, the SEC can claim a public relations victory without achieving true accountability for the wrongdoing committed.[166] Moreover, if the SEC were to require admissions in egregious cases, it would be meaningless for the defendant to admit to only lesser charges.[167] For example, under the theory of the modified approach, the SEC believed JP Morgan's wrongdoing in the London Whale case was so harmful as to justify requiring an admission.[168] Yet it seems unlikely that the books-and-records violation to which the SEC required JP Morgan to admit was actually the wrongdoing that triggered the modified policy.[169] As compared to the allegations of fraud, it seems equally unlikely that the books-and-records violation is the wrongdoing about which the public cares.[170]

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163. Frankel, *supra* note 153.

164. *See* Khuzami, *supra* note 44.

165. Lynndon Groff, *Is Too Big to Fail Too Big to Confess?: Scrutinizing the SEC's "No-Admit" Consent Judgment Proposals*, 54 B.C. L. REV. 1727, 1744 (2013).

166. *See* Andrew Ross Sorkin, *As JPMorgan Settles Up, Shareholders Are Hit Anew*, Sept. 23, 2013, http://dealbook.nytimes.com/2013/09/23/as-jpmorgan-settles-up-shareholders-are-hit-anew/?_r=0NY (quoting John Coffee as saying the Commission often settles because it "desperately needs a victory. . . . that [it] can celebrate").

167. *Id.*

168. *See* Protess & Silver-Greenberg, *supra* note 95.

169. *See id.*

170. *See id.*

III. Proposed Reform to Neither-Admit-Nor-Deny

A. *Repeal of 17 CFR Section 202.5 and Adoption of the "Mandatory Admission" Policy*

An effective solution to the problems presented by neither-admit-nor-deny must achieve several goals. First, the new policy must improve the transparency, accountability, and deterrent effect of SEC enforcement actions. Second, it must address the collateral estoppel concerns that have impeded the SEC's ability to obtain admissions. Third, it must achieve the first two goals in a systematic manner that limits the SEC's discretion, ensuring that the Commission applies the new standard consistently.

This Note proposes a repeal of neither-admit-nor-deny and adoption of a new regulation, called the "Mandatory Admission Rule." More specifically, this Note urges the SEC to replace 17 CFR Section 202.5(e) with a rule that (1) requires every defendant entering into a settlement with the SEC to admit to violations of specific federal securities laws and (2) prohibits the admission from being given collateral estoppel effect in actions not involving the SEC.[171]

The first provision of the Mandatory Admission Rule establishes the unambiguous minimum requirement of an admission for the resolution of SEC claims via settlement. If a defendant refuses to admit to wrongdoing, then the SEC must weigh public interest considerations, agency resource limitations, and the circumstances of the case to decide whether to litigate or drop the case. Although this decision involves trade-offs, it will lead to more transparent resolution, greater accountability for the SEC, and a stronger deterrent effect on potential wrongdoers who will face more serious consequences when the SEC brings suit.[172]

171. Courts are not bound to follow SEC regulations. Therefore, under the proposed reform, they would not be statutorily required to limit the collateral estoppel effect of an admission in a subsequent private action. However, courts defer to the language of the consent decree and the intentions of the parties when making determinations about the application of collateral estoppel. Therefore, the proposed reform will still have the desired effect in subsequent private actions. *See e.g.*, *New Jersey Turnpike Authority v. PPG Industries*, 16 F. Supp. 2d 460, 473 (D.N.J. 1998) *aff'd*, 197 F.3d 96 (3d Cir. 1999) ("The clear words of the [consent order] itself preclude reliance upon [it] as evidence of liability"); *Kramas v. Security Gas & Oil, Inc.*, 672 F.2d 766, 772 (9th Cir. 1982) (excluding a consent decree that "contained a recitation that it did not constitute evidence of wrongdoing."); *In re Chinnery*, 181 B.R. 954, 960-61 (Bankr. W.D. Mo. 1995) (stating parties' intentions as set forth in the settlement agreement are key to determining whether a consent judgment collaterally estops a party from re-litigating a factual issue already resolved).

172. *See infra* Part IV.B and IV.C.

The second provision of the Mandatory Admission Rule mitigates the forceful approach of the first provision by prohibiting the application of offensive collateral estoppel to admissions. Under the Mandatory Admission Rule, a defendant may settle an SEC claim with an admission and retain the right to take a different position in subsequent private litigation. There are a number of reasons that a defendant may choose to adopt this approach. For example, the individual or company may want to dispose of an SEC claim quickly and with minimal media attention; they may believe that the costs of an admission are worth bearing; or they may have an incentive to fight harder in trial, either because the stakes are higher or because evidence uncovered during discovery strengthened the defendant's case.[173] By eliminating an admission's preclusive effect, the Mandatory Admission Rule removes a significant disincentive to settlement and allows the SEC to avoid being overwhelmed by litigation with defendants refusing to settle due to collateral estoppel concerns.[174]

This proposed reform does not attempt to change the jurisprudence with respect to admissibility of SEC consent decrees as evidence in private litigation. As previously noted, courts will likely allow the admission to have some evidentiary effect in subsequent litigation.[175] At the present time, there is no way of predicting whether this evidentiary issue will have an empirically significant impact on defendants refusing to settle. However, the incentive to refuse settlement is far less than if the admission is given preclusive effect. If an admission is admitted as evidence, defendants retain the right to refute the plaintiff's evidence.[176] Furthermore, if courts apply the *Gilbert* standard, under which judges assess the prejudicial potential of the consent decree and may caution the jury to limit the inferences it draws from the decree, the courts may mitigate the concerns of some defendants that their admission could be dispositive in litigation.[177] The Mandatory Admission Rule declines to affect the admissibility of admissions, instead focusing on the problem of offensive collateral estoppel.

Although the Mandatory Admission Rule will apply to all SEC actions, its implications will differ based on the federal securities

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173. *See e.g., Isaacson v. California Insurance Guarantee Association*, 44 Cal.3d 775, 794 (1988); *Charles B. Pitts Real Estate, Inc. v. Hater*, 602 So.2d 961, 963 (Fla.App. 1992) ("[T]here were many logical and practical reasons for the [defendants] to pay $540,000 to settle that case, even if they believed they could ultimately prevail in that lawsuit.").

174. *See infra* Part IV.C.

175. *See discussion* Part I.D.

176. *See* Coffee, *supra* note 54.

177. *See supra* notes 72-76.

laws involved. For example, the SEC frequently brings actions under Section 10(b) of the Securities Exchange Act of 1934 or under corollary provisions in SEC Rule 10(b)-5.[178] Both Section 10(b) and Rule 10(b)-5 place broad prohibitions on securities fraud and provide a private right of action.[179] In order to establish a claim under these provisions, both the SEC and private plaintiffs must prove scienter.[180] An admission in a settlement with the SEC could serve as valuable evidence of scienter in a private right of action. The defendant would be entitled to introduce evidence to rebut the claim, notwithstanding the settlement. In contrast, another key anti-fraud provision of the federal securities laws is Section 17 of the Securities Act of 1933.[181] The provision closely tracks Rule 10(b)-5, but requires proof of mere negligence rather than scienter.[182] Even if an admission of wrongdoing under Section 17 is admissible as evidence in private litigation, the plaintiff would still have to meet a higher standard of mens rea in a scienter-based fraud claim.

B. Advantages of the Mandatory Admission Rule

A blanket policy that requires specific admissions of wrongdoing in SEC settlements would advance the Commission's interests in transparency, accountability, and deterrence. Settlement negotiations would still be private and afford discretion to the SEC, but specific admissions would force defendants to undergo a public shaming process and shed light on the conduct at issue.[183] Even if defendants respond to the Mandatory Admission Rule by refusing to settle, transparency will improve. In that case, the SEC would be justified in filing more aggressive and candid complaints that are not the product of a quiet plea bargain.[184] In either case, the public will be far more informed than under the current policy. Such information aligns the public's understanding of the wrongful conduct, the charges brought, and the resolution. The public can then use this information to respond in the securities market or to express approval or disapproval of the SEC's practices.

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178. § 10(b) of the Securities Exchange Act of 1934.
179. *Id.*
180. *Id.*
181. § 17 of the Securities Exchange Act of 1934.
182. *See id.*
183. *See* White, *supra* note 48.
184. *See* Coffee, *supra* note 54.

The Mandatory Admission Rule may result in more trials if defendants refuse to settle and the SEC chooses to litigate at least some of those cases. A greater willingness to resolve cases at trial would mark a significant and positive shift towards more transparency and greater deterrence in SEC enforcement practices. The effectiveness of the policy depends at least in part on the ability of the SEC to win at trial. In 2012, the Commission prevailed in ninety-five percent of the cases it litigated.[185] If the SEC pursues cases in which its claims are based on strong and convincing evidence of wrongdoing, the Commission can maintain this rate of success under the proposed reform. Courtroom wins, particularly in key cases, would further improve the SEC's credibility. Not only would winning trials deter wrongful behavior, but it would also give the SEC a stronger bargaining position in future settlement negotiations. When faced with the prospect of trial against an opponent with an impressive success rate of close to ninety-five percent, defendants would be incentivized to settle.[186]

Although the Mandatory Admission Rule would place limitations on the SEC's settlement options, it provides minimum guidelines for settlements and limits the Commission's expansive discretion.[187] Under the rule, the SEC's alternatives to settlement are litigation or dropping the case. Faced with this choice, the SEC must seriously evaluate the strength of its case and the importance of the issue to the public interest. The rule therefore constrains the ability of the SEC to obtain slap-on-the-wrist settlements with mild terms. The policy holds the SEC to a higher standard that promotes thorough investigation and pursuit of quality claims based on strong evidence. Within these constraints, the SEC would continue to maintain discretion over which cases to pursue and how to allocate resources between them.

C. Trade-offs of the Mandatory Admission Rule

This proposed reform is not without trade-offs. Critics will likely point to the risks and costs of increased litigation with defendants

185. *See* Aguilar, *supra* note 5 (stating that the SEC won in 21 out of 22 trials in fiscal year 2012).

186. *See* Thomas Gorman, SEC Actions Blog, http://www.secactions.com/#sthash.prLESDy0.dpuf (Sept. 23, 2013).

187. *See supra* notes 127–130.

refusing to settle under the admissions requirement.[188] Admittedly, the SEC will likely have to drop some cases and devote more resources to each case it does pursue under the Mandatory Admission Rule. However, the trade-off will encourage greater quality in enforcement practices. Under the current policy, the Commission may bring actions based on minimal evidence, knowing that it will not have to prove wrongdoing at trial because the defendant will likely settle the case.[189] Although the corporations and individuals subject to SEC scrutiny rarely elicit sympathy, justice requires that punishment follow proof of wrongdoing. Under the Mandatory Admission Rule, the SEC will face the legitimate possibility of litigation. The Commission must expend its resources pursuing those cases that have a strong evidentiary basis and that will serve the public's interest. Although the Mandatory Admission Rule may involve tradeoffs with respect to the number of cases brought and settled, it will encourage the SEC to prioritize quality over quantity in enforcement.

Increased litigation may be more likely when the defendant is an individual, as opposed to a company. As previously noted, individuals who admit to violations of the securities laws may face severe collateral consequences, including industry bars and reputational harm.[190] Critics may also argue that because admitting to violations of securities laws often bars D&O claims, individuals will forgo settlement and take their chances at trial. Yet, it is also possible that individuals with D&O insurance may contract for different terms in their insurance agreements to avoid triggering an exception. Scholars criticize the current regime of D&O insurance for providing insufficient loss prevention services and litigation defense cost management.[191] An ancillary advantage to the Mandatory Admission Rule could be improvements in the operation of the D&O insurance market and the broader scheme of enforcement.

Other critics may argue that the Mandatory Admission Rule goes beyond the scope of the SEC's mandate. These commentators may believe that the SEC's fundamental task is to regulate the securities

188. *See* Frankel *supra* note 153 (stating that where the SEC requires admissions, "too many SEC resources going to a small number of cases in which the agency is demanding admissions . . . will significantly undercut the entire enforcement program").

189. *See* Macchiarola, *supra* note 83.

190. *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1545 (2006) (noting difficulties in differentiating between insurance for corporations, corporate directors, and officers).

191. Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1808-1817 (2007).

market, and the Division of Enforcement's primary role is remedial.[192] According to such reasoning, requiring admissions is a punitive approach associated more often with the Department of Justice than a civil administrative body.[193] This argument fails to account for the unique history and responsibilities of the SEC. Historically, the SEC did not consider recovering damages for injured investors to be an important part of its mission, attributing that function to private securities class actions.[194] Although the Sarbanes-Oxley Act of 2002 gave the SEC a more prominent role in compensating investors, the Commission's goals have always focused on punishing wrongdoers, deterring potential wrongdoers, and protecting investors.[195] The SEC's mandate clearly extends beyond simply remedying harmed investors, and the Mandatory Admission Rule aims to better achieve this existing mandate.

Critics may also believe that allowing defendants to take a contradictory position in future litigation threatens the integrity of the SEC's settlement process. However, this reasoning is rarely cited by the SEC to support its modern enforcement approaches.[196] Furthermore, if the outcome of private litigation differs from the SEC settlement, it would not necessarily compromise the validity of the SEC's claim. As previously described, settlement and trial may reasonably lead to different outcomes, because incentives and available information differ in each process. To the extent that the outcome does raise skepticism about the SEC's settlement practices, this skepticism may be an appropriate check on the SEC's authority. If defendants are able to easily and routinely rebut the evidence of their admission in subsequent litigation, these consequences may signal to the SEC that it needs to improve its enforcement practices.

Finally, critics may argue that the Mandatory Admission Rule will lead to less compensatory relief for victims if the SEC lowers penalties in order to obtain admissions of wrongdoing. Requiring admissions and exposing defendants to disadvantageous private litigation may be factors in the settlement negotiation and may dwarf

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192. *See* Posting of Marc D. Powers to The CLS Blue Sky Blog, http://clsbluesky.law.columbia.edu/2013/09/27/baker-hostetler-discusses-the-philip-falcone-harbinger-capital-settlement.

193. *Id.*

194. Barbara Black, *Should the SEC Be A Collection Agency for Defrauded Investors?*, 63 Bus. Law. 317, 318 (2008).

195. *See id.* Section 308 (the "Fair Fund provision") of Sarbanes-Oxley gives the SEC a larger role in compensating investors. After the passage of the Act, the SEC stated that it "intend[ed] to use [Section 308] whenever reasonably possible, *consistent with its mission to protect investors*." (emphasis added)

196. *See Vitesse*, *supra* note 11, at 309.

the SEC's recovery.[197] Yet, a substantial amount of compensation for harmed investors comes from private litigation, not SEC enforcement actions.[198] The monetary penalties obtained in SEC settlements are typically divided between the U.S Treasury general fund and a "fair fund" set up to compensate harmed investors.[199] Investors often only receive a small percentage, either because the administrative costs of distribution are too high or it is too difficult to identify the victims.[200] Even if investors do receive funds, the recovery is typically much lower than their losses.[201] Although the Mandatory Admission Rule may lead to a reduction in the compensation that investors receive from the SEC, it would not impede their ability to recover damages through private actions.

Conclusion

The SEC's neither-admit-nor-deny policy has been widely discussed among legal scholars and practitioners, particularly since Judge Rakoff's first *Citigroup* opinion in 2011. Although many people agree that the policy needs reform, there are differing views about how this should be done. This Note urges the SEC to take the meaningful and unambiguous step of repealing neither-admit-nor-deny. In its place, the SEC should enact a rule that (1) requires every defendant entering into a settlement with the SEC to admit to violations of specific federal securities laws and (2) prohibits the admission from receiving collateral estoppel effect in actions not involving the SEC. This sweeping reform would strike a balance between resolving enforcement actions in a way that best serves the public interest and awarding due respect to the discretion and inherent limitations of the SEC.

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197. *See* Frankel, *supra* note 153.

198. *See* Johnson, *supra* note 7.

199. Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 Fla. L. Rev. 1103, 1127 (2008).

200. *Id. See also* Tony Chappelle, *Where Does All the Settlement Money Go? Maybe Not Where You Think* Stanford Law School Securities Class Action Clearinghouse (Nov. 1, 2002), http://securities.stanford.edu/news-archive/2002/20021101_Headline09_Chapelle.htm.

201. *See e.g.*, Adoption of Amendments to the Rules of Practice and Delegations of Authority of the Commission, Exchange Act Release No. 34-49412, 66 Fed. Reg. 13,166, 13,173 (2004) (codified at 17 C.F.R. pt. 200, 201, 240) (stating that, under the Fair Fund provision, investors "are more likely to be made whole"); James D. Cox et. al., *S.E.C Enforcement Heuristics: An Empirical Inquiry*, 53 Duke L.J. 737, 755 (2003) ("It is unlikely that profit disgorgements generated by the Fair Fund provision can be expected to displace private recoveries in many situations.").