

Securities Litigation Alert

Deference to the SEC: Second Circuit Overturns Lower Court's Refusal to Approve Settlement Between SEC and Citigroup

In a long-awaited ruling, the Second Circuit reversed Southern District of New York Judge Jed Rakoff's 2011 decision refusing to approve a settlement between the Securities and Exchange Commission (SEC) and Citigroup Global Markets Inc. (Citigroup). In so doing, the Second Circuit concluded that Judge Rakoff abused his discretion by refusing to accord sufficient deference to the SEC's and Citigroup's decision to enter into the settlement.

Background

In 2011, Citigroup and the SEC settled charges relating to Citigroup's alleged negligent misrepresentation of its role and economic interest in structuring and marketing a billion-dollar investment fund known as Class V Funding III. The SEC alleged that Citigroup "exercised significant influence" over the selection of certain assets included in the fund even though Citigroup told investors that the fund's portfolio was chosen by an independent investment advisor. In addition, Citigroup purportedly stood to profit from the decline of the portfolio by taking a short position against the mortgage-backed assets. Citigroup agreed to settle the charges with the SEC by paying a \$285 million fine. As part of the settlement, Citigroup would not have to admit to any findings of fact.

Judge Rakoff rejected the proposed settlement, noting that it was "neither reasonable, nor fair, nor adequate, nor in the public interest." He also criticized the SEC's practice of allowing defendants to settle charges without admitting the allegations. In addition, Judge Rakoff disagreed with the SEC's decision to permit Citigroup to settle to a negligence-based violation

while simultaneously claiming that one of Citigroup's employees engaged in conduct relating to the same transaction that was "tantamount to an allegation of knowing and fraudulent intent." The SEC appealed Judge Rakoff's decision.

The Second Circuit Decision

On June 4, 2014, the Second Circuit vacated Judge Rakoff's decision refusing to approve the settlement and remanded for further proceedings.¹ It held that the proper standard of judicial review of an enforcement agency's proposed consent decree is whether the proposed decree is "fair and reasonable" and that the "public interest would not be disserved." By way of further explanation, the Second Circuit stated, "[a] court evaluating a proposed SEC consent decree for fairness and reasonableness should, at a minimum, assess (1) the basic legality of the decree; (2) whether the terms of the decree, including its enforcement mechanism, are clear . . .; (3) whether the consent decree reflects resolution of the actual claims in the complaint; and (4) whether the consent decree is tainted by improper collusion or corruption of some kind." The court specifically stated that it was inappropriate for a district court to review a consent decree from an enforcement agency for "adequacy."

The Second Circuit held that Judge Rakoff abused his discretion when he required that the SEC establish the truth of the allegations against Citigroup as a precondition to the settlement. The court noted that "[c]onsent decrees provide parties with a means to manage risk" and sharply rebuked Judge Rakoff for substituting his judgment for that of the SEC's. Significantly, the Second Circuit stated, "[t]he decision to require an admission of liability before entering into a consent decree rests squarely with the SEC." Similar deference is owed the SEC's decision to bring or not to bring certain charges, and a court may not withhold its approval of a settlement based on its view that the SEC did not bring sufficient or proper charges.

In a brief concurrence, Second Circuit Judge Raymond Lohier wrote that "the perceived modesty of monetary penalties proposed in a consent decree is not a reason to reject the decree." Judge Lohier also stated that he would have gone even further and reversed Judge Rakoff's decision without remanding for further proceedings.

The SEC's Reaction to the Decision

The SEC appeared pleased with the Second Circuit's decision. SEC Enforcement Director Andrew Ceresny said, "[w]hile the SEC has and will continue to seek admissions in appropriate cases, settlements without admissions also enable regulatory agencies to serve the public interest by returning money to harmed investors more quickly, without the uncertainty and delay from litigation and without the need to expend additional agency resources."

¹ *SEC v. Citigroup Global Markets Inc.*, No. 11-5227-cv (2d Cir. June 4, 2014).

Key Takeaways

The standard articulated by the Second Circuit for reviewing an enforcement agency's proposed consent decree—i.e., whether the proposed decree is “fair and reasonable” and that the “public interest would not be disserved”—is extremely deferential to the parties entering such an agreement. Thus, although the Second Circuit's decision in *SEC v. Citigroup* has been hailed as a victory for the SEC, it is also a victory for the targets of SEC enforcement actions. Companies entering into consent decrees with government agencies make difficult decisions about the costs and risks involved in continuing to defend. That risk calculus is even more difficult when a court's reception of a proposed settlement is unpredictable and potentially highly critical of the terms of that settlement. The SEC, for its part, will have difficulty citing potential disapproval by a district court as a basis for rejecting a reasonable settlement offer.

Although the Second Circuit stopped well short of removing a district court from the process of reviewing settlements, the Second Circuit's decision provides the SEC and settling defendants with the ammunition necessary to settle cases on reasonable terms.

Contact Us

Jonathan E. Green

+1 212 836 8478

jonathan.green@kayescholer.com

Aaron F. Miner

+1 212 836 7123

aaron.miner@kayescholer.com

Lindsay S. Moilanen

+1 212 836 8072

lindsay.moilanen@kayescholer.com

• Chicago
• Frankfurt
• London

• Los Angeles
• New York
• Palo Alto

• Shanghai
• Washington, DC
• West Palm Beach

KAYE | SCHOLER