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White Collar and Government Enforcement Practice

White Collar Watch

The Newsletter of the White Collar and Government Enforcement Practice

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SEC Changes Course: Some Companies Must Now Admit Wrongdoing

By Gregory G. Schwab

IN BRIEF

- **More defendants in cases brought by the Securities and Exchange Commission will face the possibility of making an admission of misconduct under a change in the policy on "no admit, no deny" settlements.**
- **The SEC's perceived need to create public accountability is driving this change.**

The Securities and Exchange Commission ("SEC") has changed its policy concerning "no admit, no deny" settlements to require admissions of misconduct in some settlements. SEC officials have attributed the change to the public's demand for acceptance of responsibility and accountability in some enforcement cases. While the SEC will continue its traditional practice of entering into no admit, no deny settlements, the SEC will now require some settlements to include admissions of misconduct.

Speaking at an event last month that was covered by the *Bloomberg BNA White Collar Crime Report*, SEC Enforcement Division Director Andrew Ceresney said that requiring an admission of misconduct "allows for something of a public catharsis, and the public is left with no reason to doubt the facts alleged, and the message of the case is unambiguous and unequivocal." In a June 2013 article in *The New York Times*, the recently confirmed chairwoman of the SEC, Mary Jo White, said at a separate event, "There's no question I share the desire for more accountability in cases where that is warranted. I do think there are situations where public accountability is particularly important, and that will be our focus. I don't want to overstate this – no admit, no deny will still be the way most cases are resolved – but I think it's an important change."

Exemplifying this new approach is a recent consent agreement between the SEC and Harbinger Capital, a hedge fund led by Andrew Falcone. Although the parties had originally agreed to a no admit, no deny deal, it was rejected by a majority of the SEC's commissioners in July. As part of a revised agreement, Falcone and Harbinger had to admit to wrongdoing and pay penalties of $18 million, and Falcone is barred from the securities industry for five years.

Exactly which cases, and how many, will result in admissions of wrongdoing remains to be seen. But an internal SEC enforcement memo discussing the policy change cites three criteria where the SEC may insist that a company admit wrongdoing: "misconduct that harmed large numbers of investors or placed investors or the market at risk of potentially serious harm;" "egregious intentional misconduct;" or "when the defendant engaged in unlawful obstruction of the commission's investigative processes."

The policy change follows years of criticism that the SEC has been too lenient, especially with large institutions that were at the center of the financial crisis. Bank of America, Goldman Sachs, Citigroup and JPMorgan Chase were among the defendants that settled charges related to the financial crisis while neither admitting nor denying guilt, although Goldman was required to admit that its marketing materials were incomplete.

Some of the fiercest criticism has come from the courts. We have written previously here about Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York, who ruled in late 2011 that he couldn't assess the fairness of the SEC's settlement with Citigroup in a complex mortgage case without knowing what, if anything, Citigroup had actually done. (See story at http://www.saul.com/media/site_files/3052_WhiteCollarWatch_011912_ART2sec.pdf) In his ruling, he said that settling with defendants who neither admit nor deny the allegations is a policy "hallowed by history but not by reason." Judge Rakoff described the settlement – for $285 million – as "pocket change" for a giant bank like Citigroup. Other judges have followed Judge Rakoff's lead, and an appeal of his Citigroup ruling is pending before the Court of Appeals for the Second Circuit.

The SEC is not alone in the way it settles enforcement actions. Like other federal regulatory agencies, the SEC has historically settled all its cases on a no admit, no deny basis. According to Ceresney in the *Bloomberg* report, " … the SEC has been incredibly successful in achieving great settlements with this policy. In the majority of cases, settling on a no admit, no deny basis makes good sense, as the policy provides swift remedies for misconduct and quick relief to investors while allowing the commission to conserve its precious resources and avoid litigation risk."

Even so, White, Ceresney, and other SEC officials reviewed that approach to settlements. Ceresney said in the *Bloomberg* report that the agency "concluded that there are some cases where the need for accountability and acceptance of responsibility is so important that we should be demanding admissions or else pursuing those cases to trial. In other words, an admission should be an indispensable element of the settlement."

And if a company refuses to concede wrongdoing, the SEC professes to be ready to go to trial. "The possibility of more litigation does not deter us … . If we end up litigating more frequently we will shift our resources as necessary … and we are more than willing to try cases if need be," Ceresney said in the *Bloomberg* report

There's little doubt that extracting admissions of wrongdoing gives the SEC new leverage, and not just because defendants want to avoid the damage to their reputation that comes with admitting misconduct. Private litigants in civil lawsuits will likely seize upon any admission, with potentially devastating financial consequences. If a company admits culpability to the SEC, plaintiffs in private shareholder litigation could use such an admission to reap hundreds of millions or billions of dollars in damages. These considerations can impact the strategic calculus for many corporations and individuals who are negotiating with the SEC, and Saul Ewing's White Collar and Government Enforcement Practice will continue to track the SEC's approach in these cases and keep you informed.

Fifth Circuit's Recent Dodd-Frank Whistleblower Ruling May Benefit Employers

By Jennifer L. Beidel

IN BRIEF

- **Decision contradicts regulatory guidance from the Securities and Exchange Commission and raises the prospect of employers facing fewer frivolous anti-retaliation lawsuits.**
- **The ruling, however, may also encourage more employees to report alleged fraud directly to the Commission instead of internally to their employers.**

The U. S. Court of Appeals for the Fifth Circuit ruled recently that the Dodd-Frank Act's anti-retaliation provision protects only those employees who disclose allegedly fraudulent conduct to the Securities and Exchange Commission ("SEC'), not those employees who report alleged fraud internally to their employers.

In the case of *Asadi v. GE Energy USA LLC*, No. 12-20522 (5th Cir. July 17, 2013), Khaled Asadi, a former GE Energy USA LLC executive, reported allegedly fraudulent conduct to his employer involving a possible securities law violation. Asadi was fired thereafter and filed suit in February 2012. Prior to the suit, Asadi served as GE's Iraq executive from September 2006 to June 2011. Asadi worked in the city of Amman, Jordan. From there he helped GE to coordinate with Iraq's central government. In June 2010 Asadi learned that GE had hired an individual who was "closely associated" with Iraq's senior deputy minister of electricity. Asadi alleged that the hiring had occurred to provide GE with a competitive advantage in its talks to secure a contract with Iraq's electricity agency. Asadi reported his concerns to his immediate supervisor and to GE's ombudsman for the region. Thereafter, Asadi received a negative performance review. He was fired in June 2011.

At the lower court, Asadi's complaint was dismissed on the grounds that U.S. whistleblower legislation did not apply to events that occur overseas. Asadi appealed to the Fifth Circuit. The Fifth Circuit did not decide the issue of extraterritorial application of whistleblower legislation. Instead, the Fifth Circuit questioned whether Asadi could even count as a whistleblower because he had limited his reporting to internal channels.

To resolve this question, the Fifth Circuit looked to the language of the Dodd-Frank Act. The Dodd-Frank Act defines a whistleblower as any individual who discloses potential wrongdoing "to the commission." A separate anti-retaliation provision of the Dodd-Frank Act, however, allows whistleblowers to sue their employers for retaliation in several situations, including if their activity is protected by the Sarbanes-Oxley Act. This separate anti-retaliation provision does not specifically require that the employee disclose the wrongdoing to the SEC before qualifying for the provision's protection. The SEC responded to confusion over how these two provisions should be read together by issuing a final regulation. The regulation stated that whistleblowers include individuals who report internally to their employers and those individuals who report to the SEC. At least five federal district courts have ruled on the provision and have followed the SEC's final regulatory guidance, finding the two provisions to be either ambiguous or conflicting and determining that the broader protection afforded to those reporting internally should control, but the Fifth Circuit ruled to the contrary.

Because the Fifth Circuit's decision is the first to stray from the SEC's regulatory guidance and from the decisions of the lower courts on the issue, it raises the possibility of a circuit split. Employees' and plaintiffs' attorneys, not surprisingly, favor the trend that appeared to be developing in the district courts, which permitted employees who reported internally to seek the protections of the Dodd-Frank Act. However, employers strongly favor the Fifth Circuit's ruling, believing that it will stem the tide of frivolous anti-retaliation suits.

In reality, the decision may benefit the SEC despite the fact that it reverses the SEC's regulatory guidance. The decision may actually encourage whistleblowers to report their conduct directly to the SEC rather than internally to their employers. This will serve the SEC's goal of ferreting out fraud and corruption.

The case may also make the Dodd-Frank Act less attractive to attorneys seeking recourse for clients who fail to meet the requirements of the Sarbanes-Oxley Act. Sarbanes-Oxley requires a whistleblower to report his or her concerns to the Department of Labor and has a relatively short 180-day statute of limitations. The Dodd-Frank Act's statute of limitations is 10 years. As a result, many employees who fail to report to the Department of Labor or who fail to meet the strenuous 180-day statute of limitations have sought relief under Dodd-Frank. The Fifth Circuit decision may limit the number of such actions and may make relief under Dodd-Frank and Sarbanes-Oxley more equivalent.

We will continue to report on developments on this issue as additional circuits decide it. The Third Circuit, the Fourth Circuit and other circuit courts in our Northeast footprint have yet to weigh in on the issue. While the trend looks positive for employers, the current state of the law suggests that employees who report internally may still seek relief under Dodd-Frank. Employers must guard against this possibility until such time as the relevant circuit or the U.S. Supreme Court decides the issue.

"Love and Marriage" – New Jersey Supreme Court Poised to Determine Whether the Marital Privilege Can Defeat Wiretap Evidence

By Christopher R. Hall and Andrea P. Brockway

IN BRIEF

- **Over the past four years, the government has broadened the use of wiretaps to include insider trading, and to great success (the recent convictions of Raj Rajaratnam and Rajat Gupta serve as examples of the trend).**
- **A pending prosecution in New Jersey, however, offers a potential new defense tactic. Although the case concerns a traditional drug prosecution, the issue – whether the marital privilege trumps wiretap interceptions – would apply with equal force to all types of white collar crimes and perhaps give new meaning to Ol' Blue Eyes' verse that "Love and Marriage [is] an institute you can't disparage."**

The New Jersey Supreme Court recently granted cert in the criminal prosecution of Yolanda Terry and her husband Teron Savoy, the alleged leader of a drug distribution network. The Court will determine whether interception of spousal communications by wiretaps pursuant to the New Jersey Wiretap and Electronic Surveillance Control Act ("the Wiretap Act"), N.J.S.A. 2A:156A-1, destroys the marital communications privilege, N.J.R.E. 509. The Court will also weigh whether the crime-fraud exception applies to the privilege.

At trial, the State offered several intercepted cell phone and text message communications into evidence. The communications showed that Savoy had directed Terry to pick up drug money and recover hidden heroin from a seized car. Savoy and Terry attempted to exclude the evidence on the grounds that the marital communications privilege applied. The trial judge ruled that wiretap officers who had monitored the communications during the wiretap could testify to their content. The court reasoned that N.J.R.E. 509 only prevents spouses from disclosing confidential communications, not third parties. As an issue of first impression, the trial court also found that a crime-fraud exception applied.

Upon conviction, Savoy and Terry appealed. The Superior Court reversed and remanded, holding that marital communications do not lose their privilege upon interception regardless of whether a third party in the form of a police officer overhears the conversation. The Superior Court acknowledged the well-established New Jersey common law exception to the privilege that applies when third parties accidentally overhear or eavesdrop on a communication, but refused to extend this exception to wiretap interceptions. Indeed, the Wiretap Act mandates this holding. It states: "No otherwise privileged wire, electronic or oral communication intercepted in accordance with, or in violation of, the provisions of this act, shall lose its privileged character." The Court also rejected on other grounds the State's argument that the privilege would not be violated because the intercepted communication would be testified to by a wiretap officer (rather than husband or wife). The Court observed that the State had improperly conflated the marital communications privilege (N.J.R.E. 509) with the privilege against spousal testimony (N.J.R.E. 501(2)).

Turning to the crime-fraud exception, the Court held that neither the law division nor the appellate division could unilaterally engraft a crime-fraud exception onto the marital communications privilege. While numerous states and federal courts apply a crime-fraud exception, the Court found that adding an exception to a privilege adopted by statute required a legislative change to the rules of evidence.

Now the State has appealed, and the New Jersey Supreme Court is poised to weigh the interplay between the marital communications privilege and the Wiretap Act – an increasingly utilized prosecutorial tool, as demonstrated by the government's tactics in the recent trials of Raj Rajaratnam and Rajat Gupta on white collar charges. The Saul Ewing White Collar and Government Enforcement Practice will keep you apprised of developments.

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