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client alert

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SEC v. Citigroup: A New Standard for Reviewing Consent Decrees

In an appeal that had the securities industry holding its breath for two years, the Second Circuit, on June 4, 2014, vacated Southern District Judge Jed Rakoff's 2011 order rejecting a proposed settlement between the SEC and Citigroup Global Markets. Vacating and remanding the action to the district court for further proceedings, the Second Circuit held that Judge Rakoff abused his discretion and applied an incorrect standard when determining whether the settlement was "fair, reasonable, and in the public interest." Most significantly, in *SEC v. Citigroup*, the Second Circuit has altered the standard to be applied by federal district courts when analyzing an enforcement agency proposed consent decree, ruling for the first time that courts should not assess whether the terms of the settlement are adequate.

Background

After a four-year investigation of Citigroup's conduct in structuring and marketing a collateralized debt obligation (CDO), the SEC filed a civil action against Citigroup in October 2011. The SEC alleged that Citigroup sold a CDO that included poor-quality mortgage-backed securities, while simultaneously betting against those securities, without disclosing its short position or its role in selecting the assets. Citigroup had agreed to pay $285 million to settle charges that it violated securities laws and duped investors. Further, Citigroup agreed to be permanently enjoined from future violations of the securities laws and to establish stricter procedures to prevent future violations. As had been common in consent judgments, Citigroup was not required to admit any of the SEC's allegations.

Rejecting the proposed settlement, Judge Rakoff criticized the SEC's long-standing policy of allowing defendants in civil enforcement proceedings to enter into consent judgments without admitting or denying the allegations in the complaint. In an opinion bristling with sharp language, Judge Rakoff stated that, even after giving "substantial deference" to the views of the SEC, the court found the proposed consent decree "neither fair, nor reasonable, nor adequate, nor in the public interest." Chiding the SEC, Judge Rakoff declared that the government agency had essentially asked the court to become a "mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance." Judge Rakoff concluded that the parties had failed to provide a sufficient evidentiary basis to decide whether the requested relief was justified.

Judge Rakoff's controversial decision attracted national attention, principally because it was interpreted – reasonably – as rejecting the SEC's frequent use of "no admit" consent judgments. The consequences of such a result would have sweeping effect on the securities regulatory landscape. Among other things, admissions of liability for securities violations have significant consequences that would compel many defendants facing enforcement actions to proceed to trial rather than settle. This in turn would overwhelm the SEC's resources.

The Second Circuit Ruling

On appeal, in what appears to be a retraction, in both the briefing and at oral argument, the district court's *pro bono* counsel stated that the district court did not in fact seek an admission of liability before approving the consent decree. The Second Circuit suggested that Judge Rakoff's retrenchment on this point was wise, as there is "no basis in the law for the district court to require admission of liability as a condition for approving a settlement between the parties." The Second Circuit acknowledged that the decision to require an admission of liability before entering into consent decree rests squarely with the government agency.

Having dispensed with the issue of whether a liability admission is required, the Second Circuit moved to the "far thornier question" of what deference the district court must adopt when reviewing an executive agency's submission of a proposed consent decree. The Second Circuit recognized that Judge Rakoff applied the well-known standard invoked by district courts around the country when assessing settlement decrees that have an injunctive component. This standard – whether the consent decree is "fair, reasonable, adequate and in the public interest" – was rejected by the Second Circuit in favor of a new

standard that does not assess adequacy. In other words, Judge Rakoff, in considering the adequacy factor, applied the wrong standard. The appropriate standard is whether the consent decree is "fair and reasonable, with the additional requirement that the public interest would not be disserved" by the inclusion of injunctive relief. Adequacy, the court explained, was a component of the standard improperly grafted from a similar test used to measure whether a class-action settlement is appropriate under FRCP 23.

The Second Circuit, explaining the import of the modified test, stated that an evaluation of a proposed consent decree for fairness and reasonableness should assess a number of objective factors, such as whether there is a basic legality to the decree, whether the terms are clear, and whether the consent decree is tainted by improper collusion. This is a noticeably lower standard than the one that was applied by Judge Rakoff in 2011. The appellate court further stressed that it is not properly within the district court's purview to demand "cold, hard, solid facts established by either admissions or by trials." The Second Circuit also held that the district court may not find the public interest disserved simply because the court disagrees with the SEC's "decisions on discretionary matters of policy, such as deciding to settle without requiring an admission of liability."

After modifying the standard of review and providing objective factors to guide district court analysis, the Second Circuit remanded the action to Judge Rakoff for further review of the proposed consent decree under the modified standard. It will of course be interesting to see what Judge Rakoff does on remand.

Today's decision will certainly attract attention for the feature highlight that the district court was found to have abused its discretion. The securities industry should recognize, however, that the core significance of *SEC v. Citigroup* lies in the change to the standard of review for proposed consent decrees. The bar is higher and district courts will be less inclined to second guess an executive public agency.

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