Legal Backgrounder

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SEC "Gag Orders":
Does Settling in Silence Advance the Public Interest?

by Gary S. Matsko

A simmering anger against "too big to fail" banks and judicial criticism of Securities and Exchange Commission (SEC) settlement practices involving Wall Street have fueled a fierce debate over those practices. To date, the controversy has centered on the propriety and wisdom of permitting defendants in SEC proceedings to settle claims "without admitting or denying" the SEC's allegations. While that issue may be worth discussing, any re-assessment of SEC settlement practices would be incomplete without considering the wisdom and impact of the post-judgment restraint on speech that the SEC imposes in every settlement.

The SEC requires all settling parties to agree that they will neither directly nor indirectly make any public statement that calls into question the accuracy of any allegation made in the SEC's complaint.[1] Thus, a settling party who had meritorious defenses, but could not afford to litigate, may not say so publicly. Moreover, the policy, intended to put teeth into the SEC's enforcement message, can have the unintended consequence of allowing government lawyers to operate "in the shadows" by preventing those with the greatest knowledge of the stated accusations or the process used to develop those accusations from criticizing either.

The Current Debate. A perception that federal securities regulators have been too lenient toward Wall Street "lawbreakers" has inspired calls for the SEC to drop or limit its practice of permitting civil action defendants to settle "without admitting or denying" the SEC's allegations. U.S. District Court Judge Jed Rakoff lent considerable weight to these demands in 2011 when he refused to approve an SEC settlement with Citigroup Global Markets, Inc., because the proposed agreement permitted Citigroup to settle utilizing the "without admitting or denying" qualifier. *U.S. Securities and Exchange Commission v. Citigroup Global Markets Inc*., 827 F. Supp. 2d 328 (S.D.N.Y. 2011).

The SEC filed an interlocutory appeal with the U.S. Court of Appeals for the Second Circuit, seeking a stay of the District Court proceedings during the pendency of the appeal. If it could not settle cases without admissions, the SEC argued, defendants would force more cases to trial, taxing the SEC's resources and limiting its ability to investigate new cases. The Second Circuit agreed with the SEC's arguments and granted the stay pending resolution of the appeal on its merits. *U.S. Securities and Exchange Commission v. Citigroup Global Markets Inc*., 673 F. 3d 158 (2d Cir. 2012). The Second Circuit heard oral argument February 8, 2013 but as of this writing has not issued a decision.

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[1] The SEC also forbids settling respondents in administrative proceedings from making statements that contradict the allegations contained in the order for proceedings.

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Nonetheless, the SEC has not ignored those who argue for requiring settling defendants to admit the charges against them. It announced in mid-2013 that it would insist on admissions in "appropriate" cases, and did so in a settlement with Philip Falcone of Harbinger Capital. SEC Litigation Release 2013-159.

The Post-Settlement Restraint on Speech. A change in the SEC's approach to what defendants can and cannot say within the context of the formal settlement process amplifies existing concerns over the Commission's post-settlement restraint on speech. Those restraints arise from SEC Rule 202.5(e), which provides that the Commission will not permit a defendant to consent to a judgment while denying the allegations in the complaint, but will accept a consent in which the defendant states "he neither admits nor denies the allegations." A lawyerly analysis of Rule 202.5(e) might lead one to conclude that the rule is intended only to prescribe the form and content of settlement papers. However, the SEC interprets the rule as a prohibition on post-settlement comments which may suggest that the defendant did not, in fact, violate the law or that the SEC's underlying allegations were, in any manner, unsupported.

In reflection of the SEC's view of the rule's scope, Commission settlement documents commonly contain the following language:

> In compliance with this policy, Defendant agrees: (i) not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any allegations in the complaint or creating the impression that the complaint is without factual basis; and (ii) that upon the filing of this Consent, Defendants hereby withdraw any papers filed in this action to the extent that they deny any allegation in the complaint. If Defendants breach this agreement, the Commission may petition the Court to vacate the Final Judgment and restore this action to its active docket.[2]

Thus, a defendant in an SEC enforcement action cannot explain publicly that she chose to settle because she could not afford to continue her defense, or because it made more sense to resolve the matter on the SEC's terms rather than go to trial and risk further adverse consequences. To the extent the defendant's counsel filed papers in court that contradict the allegations in the complaint or negate her culpability, those papers are to be treated as if they never existed. Moreover, if the defendant slips up and tells an inquiring reporter that her real reason for settling was something other than an admission of guilt, the "gag" clause provides the SEC with a basis to undo the settlement. That stifling of free speech, particularly when it precludes the flow of information regarding how the government does business, raises some real concerns.

Unfairness to Small Defendants. It is not only the megabanks, big corporations, and billionaires that find themselves in the SEC's cross-hairs. Individuals and companies of more moderate means also end up as defendants in SEC proceedings. No doubt, many of these defendants may be actual wrongdoers, but SEC investigations and enforcement actions are human endeavors, and SEC staff cannot always get it right. Moreover, the SEC "pushes the envelope" at times, advancing aggressive and novel legal theories and versions of the facts that, if fully litigated, might not succeed.[3] Many cases involve conflicting testimony or ambiguous documentary evidence, which presents the risk (to both parties) of adverse credibility findings by the judge or jury. Although the SEC's speech restrictions affect all civil enforcement defendants, they have an especially acute impact on smaller businesses and individuals who may not have the resources for a prolonged, expensive defense, and thus may have to forego the fight even when frailties in the case might

[2] The policy does not limit how the respondent or defendant may testify in other proceedings not involving the SEC.

[3] *See* Sandra Lynch & Aruna Viswanatha, *Weak Trial Witnesses Hinder a More Aggressive SEC*, Reuters, Mar. 10, 2014, http://www.reuters.com/article/2014/03/10/us-usa-sec-court-insight-idUSBREA2907A20140310. The authors note that the SEC success rate at trial has declined to 56% and that the SEC explains that the pursuit of challenging cases was a factor.

otherwise offer them a viable avenue of defense.

The Decision to Settle. Consider the following hypothetical. Jane Doe is a senior executive at Consolidated Widgets (CW). She has accumulated shares of CW over her years of employment and decides to sell them. At the time of her decision to sell, the shares have a market value of $300,000. Doe's CW shares represent a significant part of her family's savings. Doe gives her broker a directive to sell when he thinks the timing is right. Before the sale, senior officers of CW learn that CW has lost its two most important customers. They circulate an email to certain key executives; Doe is not one of the recipients. The next day, Doe's broker sells her shares. After Doe's shares are sold, CW issues a press release about the lost customers and the resulting plant closing. Doe did not know of the negative news. Within a few days, CW's shares lose two-thirds of their value.

The SEC conducts an investigation, concludes circumstances suggest Doe knew the adverse information before she sold the shares, and brings suit, accompanied by a press release announcing that Doe is being sued for insider trading. Doe's neighbors and colleagues read the news; those allegations are now eternally available to anyone who can formulate a Google query.

The SEC asserts that Doe averted $200,000 in losses. Her counsel argues that she avoided only $75,000 in loss as of the time the market absorbed the information contained in the press release and has expert advice to support that contention. However, the SEC is willing to settle for an injunction barring future violations of the fraud provisions of the securities laws, plus disgorgement of $150,000, representing two times the loss averted, based on her own expert's assessment.

Doe's counsel tells her that if the case goes to trial, the SEC will assert that the loss averted was the full $200,000 and could seek to recover three times that amount. He acknowledges that she has a respectable defense, but a jury might well conclude, based on the timing and circumstances, that she knew the bad news when she sold. He also informs her that she should expect to pay over $500,000 in legal fees and costs to defend. Doe decides to accept the SEC's settlement because she cannot afford to do otherwise. When the settlement is complete, the SEC issues another press release, this one explaining that Doe has consented, without admitting or denying the allegations in the complaint, to the entry of a fraud judgment against her. Jane will have to stand mute.

The SEC Gag Order Is a Barrier to Prying Eyes. The short response to Jane's predicament may be simply that life is unfair and, perhaps if she had been more careful, she would not have found herself accused of fraud. Such a conclusion may seem harsh, but with momentum trending towards requiring an admission, there may be little sympathy for those who find themselves in Jane Doe's shoes. But it is not as easy to dismiss the concerns that arise from such a restraint on criticizing the government. Suppose Jane or any other defendant has a legitimate criticism to make about the handling of a case. Consider, for example, a defendant who obtained a favorable settlement with the SEC because his counsel was able to demonstrate that a key government witness was lying. Should that be hidden from the public? Might there not be questions worthy of public scrutiny as to whether false testimony played a role in the SEC's decision to bring charges, why the SEC did not uncover the perjury by itself, or whether a case that was tainted at its inception by perjury should be discontinued? Prohibiting a defendant from speaking out about the case brought against him, particularly under circumstances when he could do nothing other than settle, creates an unhealthy secrecy around the way government conducts its business.

Some argue that without requiring defendants in SEC actions to admit culpability, the public is denied information it is entitled to have about what the defendant really did. As one court stated, "these settlements

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[without admissions] do not always take adequate account of another interest ordinarily at stake as well: that of the public and its interest in knowing the truth in matters of major public concern." *U.S. Securities and Exchange* v. *CR Intrinsic Investors,* 939 F. Supp. 2d 431, 443 (S.D.N.Y. 2013). Following this logic, the post-settlement restraint similarly defeats "the public's interest in knowing," and in a more concerning manner because it precludes criticism of government action.

Balancing Interests. It is hard to fathom that the SEC's enforcement message will be diminished by eliminating the post-settlement restrictions on speech. If SEC defendants proclaim their innocence after agreeing to orders barring them from the securities industry, or imposing significant monetary sanctions, will most members of the public believe them? The deterrence value of SEC orders and judgments comes from the consequences they impose, which can be quite severe and will not be diminished if settling defendants are allowed to speak about the case. In contrast to the SEC, several other federal agencies permit defendants to outright deny the government's allegations upon settlement.[4] If, after settling an SEC case, a defendant can point to concrete information as to why the claims asserted were not true, were excessive or based on overly aggressive theories, then the defendant should be able to do so without risking loss of the resolution.[5] When the public's right to know is balanced against the agency's discomfort at having settling parties assert innocence, the interest in the free flow of information clearly supports allowing settling defendants to speak about the case.

Because the public attitude today points toward insisting on admissions in settlements, the outlook does not bode well for a change in the Commission's policy of prohibiting settling defendants from making statements about the SEC allegations after formal settlement. Individuals faced with SEC charges, and counsel representing them, will have to continue to factor into the settlement equation the impact of not being permitted to comment on the settlement or charges. Defendants who raise matters of public concern that may have arisen in their cases do so at the peril of having the settlement vacated and returning to active litigation.

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[4] For example, *see In the Matter of Facebook, Inc.*, U.S. Federal Trade Comm'n Docket No. C-4365 (July 27, 2012), *U.S., et al. v. Bank of America Corp., et al.*, No. 120361 (D.D.C. Apr. 4, 2012) (Department of Justice); *In the Matter of Morgan Stanley*, Docket No. 12-015-B-HC (Apr. 2, 2012) (Federal Reserve); *U.S. v. American Electric Power Serv. Corp.*, C.A. No. C2-99-1250 (S.D. Ohio Oct. 9, 2007) (Environmental Protection Agency); *F.D.I.C. v. Killinger et al.*, Docket No. 2:11-cv-00459-MJP.

[5] There is perhaps a constitutional dimension to all of this under the unconstitutional conditions doctrine. *See Koontz v. St John's River Water Management District,* 570 U.S. (2013). *See also* Russell G. Ryan, *The SEC should Admit a No-Admit Change. WSJ.com,* Sept. 4, 2013.