11-5227-cv

United States Court of Appeals
for the Second Circuit

UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellant-Cross Appellee,
v.
CITIGROUP GLOBAL MARKETS INC.,
Defendant-Appellee-Cross Appellant.

On Appeal from the United States District Court
for the Southern District of New York
No. 1:11-CV-7387-JSR

BRIEF OF BETTER MARKETS, INC. AS AMICUS CURIAE IN SUPPORT OF PRO BONO COUNSEL APPOINTED TO ADVOCATE FOR AFFIRMANCE OF THE DISTRICT COURT'S ORDER

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rules of Appellate Procedure 26.1 and 29(c)(1), Better Markets, Inc. ("Better Markets") hereby states that it has no parent corporation and there is no publicly held corporation that owns 10% or more of the stock of Better Markets.

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IDENTITY AND INTEREST OF THE AMICUS

Better Markets is a non-profit organization founded to promote the public interest in the financial markets. It advocates for greater transparency, accountability, and oversight in the financial system through a variety of activities, including participation throughout the rulemaking process at the financial agencies and departments, public advocacy, litigation, and independent research.[1]

Better Markets has an interest in this appeal because it involves not just a settlement between the primary—and often only—regulator of the U.S. securities markets and one of the world's largest banks. It also involves the role, authority, and power of the federal courts to serve as the **only** check on executive power in connection with settlements between regulatory agencies and the industries they oversee.

This is a critical judicial function, since in the settlement context, the adversary process breaks down: the regulatory agency and the defendants cease to be adversaries and become united in a powerful desire to quickly end the case, the

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[1] Pursuant to FED. R. APP. P. 29 and Local Rule 29.1, Better Markets hereby states that no counsel for any party authored this amicus brief in whole or in part; no party or counsel for any party contributed money that was intended to fund the preparation or submission of this brief; and no person—other than Better Markets, its members, or its counsel—contributed money that was intended to fund the preparation or submission of this brief.

agency to conserve its resources, the defendant to minimize its liability, and both to protect or promote their reputations.[2]

All too often, the result is a weak settlement that serves the interests of expediency, but not the interests of the public in seeing those who violate the law held accountable and future violations deterred. Accountability and deterrence are particularly important to the capital and financial markets, upon which our economy and standard of living depends (as so recently evidenced by the financial crisis of 2008 and the Great Recession which has followed it). Worse, weak settlements arguably do not only reward crime, but actually incentivize it, given that the "cost" of breaking the law becomes so low as to be a virtually meaningless cost of doing business to large, global, multi-trillion dollar financial institutions.

The federal judiciary is the **only** branch of government in a position to ensure that the uniquely powerful incentives to settle in government enforcement

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[2] This case is a clear illustration of that fact: the parties here made the same arguments to the court below—often adopting each other's positions—and they are advancing the same arguments now before this Court. In substance and effect, this was a one-sided and unopposed appeal. As is typical in settlements, this case thus reflects a fundamental breakdown in the normal adversary process in which two self-interested parties opposing each other enable a court to ascertain the truth and render an informed opinion. Among private litigants in a private dispute, such a breakdown is of little moment. However, when a settlement involves an enforcement agency as important to the public interest as the Securities and Exchange Commission ("SEC"), then the breakdown of the adversary process is highly consequential because it can subvert the enforcement of the law in the U.S. financial markets and further erode public confidence and trust, not just in the SEC, but also in the judiciary.

actions do not overwhelm the public interest. Moreover, independent federal courts are the **only** governmental bodies that can properly address the breakdown of the adversary process and ensure that truth and justice are served. But, federal courts cannot perform this vital and irreplaceable function without the authority to obtain sufficient information and facts to determine whether a proposed settlement should be approved as fair, adequate, reasonable, and in the public interest.

As a result, this case, virtually unique in its rejection of an SEC proposed settlement of an enforcement action,[3] will likely have a lasting impact on the conduct of Wall Street, the U.S. capital markets, corporate America, and securities and financial markets regulators and regulation. It will also likely have a very significant impact on the public interest and the enforcement of law. Lastly, it will address key separation of power issues regarding the Executive and Judicial Branches as well as the independence of the judiciary.

Thus, this case will impact all of the core issues that Better Markets exists to promote and protect: transparency, accountability, oversight, the public interest in the financial markets, and the fair and equal application of the rule of law.

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[3] It is extremely rare for a federal court to reject an SEC proposed settlement of an enforcement action. The last one that was apparently appealed that resulted in a reported decision appears to have been in 1984. *SEC v. Randolph*, 736 F.2d 525, 529 (9th Cir. 1984). This suggests that 99.9% of such proposed settlements are approved routinely if not perfunctorily. That, rather than the one rare example of disapproval, would seem to warrant greater scrutiny and reflection.

INTRODUCTION

This case is about the power and authority of federal courts and their ability to discharge their vital role as the only check on settlements proposed by executive branch regulatory agencies. This is particularly important because these settlements occur in the context of a breakdown in the adversary process, where both parties are on the same side and only want their negotiated deal approved as quickly as possible.

Nevertheless, federal courts must, as required by law, determine whether or not a proposed settlement is fair, adequate, reasonable, and in the public interest. Therefore, a court must ensure that it has sufficient reliable information and facts to make that determination.

Importantly, this case is not about a court's particular means or method of obtaining information as much as it is about the necessity and ability to do so. For example, submitting admitted facts is one method parties can use, but others include simply providing sufficient information to the court, or filing a verified complaint, an SEC affidavit, a joint statement of facts, record evidence like depositions or documents, a 21(a) report of investigation from the SEC, or any number of other ways to provide the court with sufficient, reliable information upon which to base its determination.

Here, in their initial submissions, the parties did not even remotely provide the court with the most basic and minimal information, never mind a sufficient basis on which to evaluate the settlement. For example, the SEC's memo submitted to the Court in support of the proposed settlement was **only seven pages long** and it devoted **only one double spaced page** purporting to explain why the settlement was "fair, adequate, reasonable, and in the public interest." Tellingly, as if the court's role was in fact no more than a rubber stamp, the SEC's media blitz commenced simultaneously upon filing the complaint and proposed settlement, and the media package it distributed was almost as long as the memo submitted to the court.

The SEC, Citigroup Global Markets Inc. ("Citigroup"), and their powerful supporters are all arguing to this Court that it must require the district court to defer to the parties when the SEC submits a proposed settlement. They also strenuously and repeatedly argued the same point below in their opening briefs, in response to the district court's request for additional information, and at the hearing the district court held on the proposed settlement. If this argument were to stand, the SEC's uninformative, perfunctory seven page memo filed in support of the proposed settlement will become the standard "support" provided to courts for proposed SEC settlements. Such a standard would not only be an abdication of judicial responsibility and an affront to the law, but it would also be a great disservice to the public and the courts themselves.

Frankly, one has to question why the parties did not provide the court with more facts and information upon which to evaluate the proposed settlement. As demonstrated in detail below (and in Better Markets' filings in the district court[4]), the answer to that question is that to do so would have revealed that the settlement was **not** fair, adequate, reasonable, or in the public interest. That is presumably why the SEC—repeatedly—did not provide the information to the court, either initially, in response to the court's specific request for more information,[5] at the hearing, or otherwise.

The collaborating settling parties simply have no interest in anyone scrutinizing their proposed settlement—whether it be a court, the public, the media, elected officials, policy makers, or others. To cooperating settling parties, fewer impediments to or interference with their settlement is always desirable. Their joint goal is to win approval as quickly and painlessly as possible, with as little attention as possible, and to move on. However, their interests simply do not

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[4] *See* Better Markets' Memorandum in Opposition to Proposed Settlement (attached to its Motion to Intervene Pursuant to Federal Rule of Civil Procedure 24) (JA 5, Dkt #14) and Memorandum of Law in Support of Motion to Intervene (JA 5, Dkt #15), No. 11-cv-7387 (JSR) (S.D.N.Y Nov. 3, 2011).

[5] The fact the district court had to issue an order asking the parties to provide such basic information and facts is clear evidence of a woefully deficient record.

outweigh the duty of a court to determine whether the proposed settlement is—in fact—fair, adequate, reasonable, and in the public interest.

None of this is to suggest that the court should not give deference to the SEC. It is entitled to deference because it has expertise and must balance a number of competing and shifting concerns. However, this case is not about deference to the SEC. It is about how a court discharges its singular and independent duty to evaluate a proposed settlement in the context of a breakdown of the adversary process, **notwithstanding** any deference due to the SEC. In this case, that means upholding the decision to reject this proposed settlement because the parties failed to provide the court with sufficient information, in a reliable and credible form, to enable it to perform its vital oversight function.

ARGUMENT

I. The district court correctly rejected the proposed settlement because the parties failed to provide an adequate record. That decision must be affirmed so that federal courts can properly fulfill their role as an independent check on settlements that are not fair, adequate, reasonable, or in the public interest.

A. Overview.

Federal courts are required to independently evaluate a proposed SEC settlement and determine if it is fair, adequate, reasonable, and in the public interest. This role is vital not only to the protection of the public, but also to the integrity of the settlement process. Moreover, judicial oversight is especially critical in financial regulation because settlements are the primary means used by the SEC to enforce the laws governing the U.S. capital markets and corporate America and because courts serve as the **sole check** on settlements. Thus, it is essential that federal courts have the power and authority they need to perform this indispensable function.

To fulfill its responsibility, a district court must have a sufficient record that clearly and credibly sets forth the basis, the facts, and the rationale for the proposed settlement terms. Here, the parties failed to provide such a record to the district court, which tried repeatedly to obtain such a record.

The record below was materially deficient for two reasons, each of which constitutes an independent ground for affirming the district court's decision to reject the proposed settlement. **First,** the parties failed to provide the court—either through admissions or any number of other clearly available mechanisms discussed below—with a sufficiently reliable and credible record upon which to evaluate the proposed settlement. **Second**, the record contained material gaps, inconsistencies and ambiguities that rendered a meaningful assessment of the proposed settlement impossible.

Thus, the district court simply did not have before it a record that would allow it to determine if the proposed settlement is fair, adequate, reasonable, and in the public interest. Its rejection of the settlement should be affirmed. [6]

B. A district court asked to approve a settlement in an agency enforcement action must determine whether the settlement is fair, adequate, reasonable, and in the public interest.

When evaluating a proposed settlement in an agency enforcement action, it is well-settled that the court must determine whether the settlement is fair, adequate, reasonable, and in the public interest. *See United States v. Hooker Chems. & Plastics Corp.*, 540 F. Supp. 1067, 1072-73 (W.D.N.Y. 1982) (establishing the test as fair, adequate, and reasonable, and further stating "the the court should determine whether the [settlement] adequately protects the public interest and is in accord with the dictates of Congress."), *aff'd*, 749 F.2d 968 (2d Cir. 1984); *United States v. Akzo Coatings of Am.*, 949 F.2d 1409, 1435 (6th Cir. 1991) ("Protection of the public interest is the key consideration in assessing whether a decree is fair, reasonable and adequate."); *see also United States v. N.*

[6] This Court "may, of course, affirm on any basis for which there is a record sufficient to permit conclusions of law, including grounds upon which the district court did not rely." *Bertin v. United States*, 478 F.3d 489, 491 (2d Cir. 2007) (quoting *Cromwell Assocs. v. Oliver Cromwell Owners, Inc.*, 941 F.2d 107, 111 (2d Cir. 1991); *see also Millares Guiraldes de Tineo v. United States*, 137 F.3d 715, 719 (2d Cir. 1998).

Carolina, 180 F.3d 574, 581 (4th Cir. 1999); *Citizens for a Better Env't v. Gorsuch*, 718 F.2d 1117, 1126 (D.C. Cir. 1983).

The public interest is a key element of the test for multiple reasons. Whenever an agency seeks injunctive relief—whether or not in connection with a settlement—a court must consider the public interest. *See, e.g., SEC v. Unifund Sal,* 910 F.2d 1028, 1035-1036 (2d Cir. 1990) ("For the standards of the public interest, not the requirements of private litigation, measure the propriety and need for injunctive relief in cases" brought by the SEC.).

In addition, courts have recognized that settlements must serve the public interest by furthering the statutory objectives of the agency seeking approval. *Sys. Fed'n No. 91 v. Wright*, 364 U.S. 642, 651 (1961) ("[T]he District Court's authority to adopt a [proposed settlement] comes only from the statute which the [settlement] is intended to enforce," thus, a court "is free to reject agreed-upon terms as not in furtherance of statutory objectives."); *SEC v. Levine*, 881 F.2d 1165, 1181 (2d Cir. 1989) (If a district judge finds "that the proposed [settlement] would not further the objectives of the law on which the complaint was based, he could properly decline to approve the proposed judgment.").[7] Of course, "[t]he

[7] *See also Local No. 93, Int'l Ass'n of Firefighters v. City of Cleveland*, 478 U.S. 501, 525 (1986); *In re Cuyahoga Equip. Corp.*, 980 F.2d 110, 119-120 (2d Cir. 1992) (finding the settlement protects the public interest and is consistent with the

purpose of the securities laws is to protect the public." *SEC v. Randolph*, 736 F.2d 525, 529 (9th Cir. 1984).

Under the four part test applicable to the review of settlements, a court must consider not simply the procedural fairness of a proposed settlement, but also its substantive terms. Thus, for example, contrary to the SEC's claim, SEC Br. 44,[8] the scope of this judicial review extends well beyond ancillary issues such as whether the settlement affects parties who did not consent or whether its implementation would drain judicial resources. Indeed, the substantive contours of the test are obvious on their face: the court must evaluate whether, in addition to being "fair," the proposed settlement is also "adequate, reasonable, and in the public interest." *See SEC v. Bank of Am. Corp.*, 653 F. Supp. 2d 507, 510-11 (S.D.N.Y. 2009) (considering whether the settlement imposes pointless injunctive relief or a trivial penalty, and whether it fails to hold responsible parties accountable).

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goals of the statute); *United States v. Comunidades Unidas Contra la Contaminacion*, 204 F.3d 275, 279 (1st Cir. 2000).

[8] Citations to "JA __" refer to pages in the Joint Appendix and "SA __" to pages in the Supplemental Appendix. The parties' briefs are referred to as "SEC Br.," "Citi Br.," and "Pro Bono Br."

C. A district court must conduct an *independent* review of the proposed settlement.

A court's review of a proposed settlement must not only be substantive, guided by the public interest, it must also be **independent**. Otherwise its role is reduced to a perfunctory approval, subordinate to the regulatory agency and dependent upon whatever the agency chooses to file with the court.[9] "[T]he Court must eschew any rubber stamp approval in favor of an **independent** evaluation." *City of Detroit v. Grinnell Corp.*, 495 F.2d 448, 462 (2d Cir. 1974), *abrogated on other grounds by Goldberger v. Integrated Res., Inc.*, 209 F.3d 43 (2d Cir. 2000) (emphasis added); *see also SEC v. Levine*, 881 F.2d at 1181 ("[W]hen the district judge is presented with a proposed [settlement], he is not merely a 'rubber stamp.'"). In short, "the court must not merely sign on the line provided by the parties," *League of United Latin Am. Citizens v. Clements*, 999 F.2d 831, 846 (5th Cir. 1993), nor "blindly accept the terms of a proposed settlement," *United States v. N. Carolina*, 180 F.3d 574, 581 (4th Cir. 1999).

[9] While a court owes a degree of deference to the agency, even that deference "depends on the persuasive power of the agency's proposal and rationale, given whatever practical considerations may impinge and the full panoply of the attendant circumstances." *United States v. Cannons Eng'g Corp.*, 899 F.2d 79, 84 (1st Cir. 1990). More important, whatever deference is owed goes to the merits of the settlement, not to the court's right to compile an adequate record short of a trial.

Additionally, "more careful scrutiny" by the court is warranted when, as here, the proposed settlement incorporates injunctive provisions. *League of United Latin Am. Citizens*, 999 F.2d at 846. As a request for the court to use its equitable powers, a proposed settlement with injunctive provisions "is not a tool bending without question to the litigants' will." *Id.; see also Local No. 93, Int'l Ass'n of Firefighters v. Cleveland*, 478 U.S. 501, 525 (1986) ("[A] federal court is more than 'a recorder of contracts' from whom parties can purchase injunctions; it is 'an organ of government constituted to make judicial decisions'"); *SEC v. Globus Group, Inc.*, 117 F. Supp. 2d 1345, 1348-49 (S.D. Fla. 2000) (stating that "federal courts do not merely rubber-stamp the SEC's requests for statutory injunctions but, rather, must exercise independent judgment to determine whether the SEC has made a 'proper showing'").

This Court has similarly held that, unlike the court's role in approving settlements that affect "only private interests," "[t]he court has a larger role" when a settlement "resolves . . . **any suits 'affecting the public interest.**'" *Janus Films, Inc. v. Miller*, 801 F.2d 578, 582 (2d Cir. 1986) (emphasis added).

D. To conduct a meaningful and independent evaluation of a proposed settlement, the court must have an adequate record before it.

Given the nature and scope of a court's review of a proposed settlement—and the public interest at stake—it is imperative that the reviewing court have enough information, in a sufficiently reliable form, to discharge its duty. *See Detroit v. Grinnell Corp.*, 495 F.2d at 462-463(A court must have "before it sufficient facts intelligently to approve the settlement offer.").

In short, a court "is entitled to the [agency's] reasoning and the facts that support that reasoning." *FTC v. Circa Direct LLC*, No. 11-cv-2172-RMB/AMD (D.N.J. June 13, 2012); *cf. National Surety Co. v. Coriell*, 289 U.S. 426, 436 (1933) (an "informed, independent judgment" is required of the court in receivership proceedings, especially when the proceeding is "not an adversary one").

Accordingly, when the parties have not provided the court with an adequate record, a court has the duty and the authority to request additional information that explains or supports the proposed settlement. *United States v. N. Carolina*, 180 F.3d at 581 ([T]he court "**must take the necessary steps to ensure that it is able to reach an 'informed, just and reasoned decision'**") (emphasis added). In reviewing settlements proposed by federal agencies, courts repeatedly request additional information, and, according to this Court, the judge is "free to assess the available evidence and to ask the parties for guidance as to how the evidence supported the proposed [settlement]." Non-Dispositive Opinion at 11, No. 11-cv-5227 (2d Cir. Mar. 15, 2012); *see SEC v. Bear, Stearns & Co.*, 626 F. Supp. 2d 402, 405 (S.D.N.Y. 2009) (discussing questioning of parties about distribution of funds); *Hooker Chems. & Plastics Corp.*, 540 F. Supp. at 1071-72 (permitting multiple hearings, questioning of parties, and expert testimony by amici); *see also FTC v. Standard Fin. Mgmt. Corp.*, 830 F.2d 404, 408-09 (1st Cir. 1987) (discussing the lower courts request for financial statements in determining whether to approve the proposed settlement and finding that "the court may well consider it appropriate—sometimes necessary—to examine some or all of the documents contained in the administrative record"); *FTC v. Circa Direct LLC*, No. 11-cv-2172-RMB/AMD (D.N.J. June 13, 2012) (requesting additional briefing from the agency); Letter from the Court to Plaintiff's counsel, *SEC v. Koss Corp.*, No. 11-cv-991 (E.D.Wis. Oct. 24, 2011) (requesting from the SEC a written factual predicate for how the disgorgement figure was calculated); *FTC v. Onkyo U.S.A Corp.*, No. 95-cv-1378-LFO (D.D.C. Aug. 21, 1995) (discussing the supplemental briefing requested of the parties to demonstrate the public interest in the settlement).

The absence of a sufficient record, especially after judicial efforts to obtain a more complete record, warrants rejection of the proposal. This Court has said as much:

> [I]t is essential that a reviewing court [on appeal] have some basis for distinguishing between [the district court's] well-reasoned conclusions arrived at after a comprehensive consideration of all relevant factors, and mere boilerplate approval phrased in appropriate language but unsupported by evaluation of the facts or analysis of the law. Thus,

> appellate courts have rejected approval of settlements where the trial court acted without sufficient facts concerning the claim.

Newman v. Stein, 464 F.2d 689, 692 (2d Cir. 1972) (internal quotations omitted). Similarly, a district court's decision to reject a proposed settlement based on insufficient information, as here, should be upheld.

E. The judicial authority and duty to review settlements and to obtain an adequate record for that purpose is not displaced by the acknowledged power of the executive branch to enforce the law.

The SEC argues that a court must, with few exceptions, defer to the agency's judgment in matters of settlement, "in keeping with the constitutionally mandated separation of powers that assigns to the Commission the responsibility to execute the securities laws." SEC Br. 43. While the general principal underlying this argument may be valid, it is overstated in this case and would reduce federal courts to mere rubber stamps of proposed settlements.

First, it is irrelevant to the real issue: whether a federal court has a right to insist on an adequate record to determine **whether** a settlement meets the applicable test. Nothing cited by the SEC prevents a court from insisting that the parties to a proposed settlement in a government enforcement action provide a quantitatively and qualitatively sufficient record to enable a court to determine, as it must under the law, whether the settlement is fair, adequate, reasonable, and in the public interest. The parties' failure to provide such a record to the district court in this case is dispositive, and it serves as the fundamental basis for affirming the district court's rejection of the proposed settlement.

Second, even as to the proper scope of a court's substantive review of a settlement, the SEC's argument strikes the wrong balance under the separation of powers doctrine. It one-sidedly favors the executive function to the virtual exclusion of the judicial branch. The SEC observes that agencies have significant discretion when determining whether to investigate, prosecute, or settle violations of law. SEC Br. 43 (citing *Heckler v. Chaney*, 470 U.S. 821, 831 (1985), and *New York Law Dep't v. FCC,* 984 F.2d 1209, 1213-15 (D.C. Cir. 1993)).

However true that may be, the law is clear that courts have a profoundly important role in all phases of the enforcement process, since ultimately the broader public interest—not merely the interests of the parties—must be protected. For example, during investigations, **courts** have the power to enforce subpoenas against recalcitrant witnesses or to issue protective orders when the government overreaches by seeking information that is too sensitive or voluminous. During a prosecution that leads to trial, the **court or a jury** receives the evidence, makes findings of fact and conclusions of law, and determines the appropriate penalty that should apply to the wrongdoing that has occurred. And, in the settlement process, **courts** must determine whether the settlement is fair, adequate, reasonable, and in the public interest. *Cf.* FED. R. CIV. P. 16 (explicitly promoting judicial intervention in settlements). All of these are critical and long-standing judicial functions, consigned to the federal judiciary under Article III of the Constitution.

Thus, although the determination whether to settle is the prerogative of the administrative agency, a court order approving a settlement—with an injunction no less—is a fundamentally judicial act. Accordingly, the decision whether to enter such an order lies within the power and authority of the court, not the executive branch. For these reasons, as well as those set forth elsewhere in this brief, the district court's rejection of the proposed settlement should be affirmed.[10]

F. The district court attempted to create an adequate record, but the parties failed to supply enough credible information to enable a meaningful review of the proposed settlement.

The record that the parties initially submitted to the district court in support of their negotiated settlement was so woefully inadequate as to be an affront to the judicial system and its status as a co-equal branch of government. The terms of the

[10] The SEC's emphasis on the budgetary implications of requiring admissions in all settlements is unpersuasive. The accepted standard of review that courts are to apply to a proposed settlement—once they have been provided with an adequate record—is whether the settlement is fair, adequate, reasonable, and in the public interest. That test does not include whether the settlement will conserve the agency's resources. It is, of course, within the agency's discretion to consider its resource limitations when deciding whether to seek resolution of an enforcement action through settlement, the terms of any such settlement, and whether to seek court approval or an injunction. But that calculation is quite distinct from the court's separate obligation to independently assess the settlement before it. If the agency only needed to invoke resource limitations to win court approval of its settlements, no matter how paltry, then the entire process of judicial review would become utterly pointless, as the SEC is badly and chronically underfunded.

settlement, viewed in light of the serious acts of fraud alleged against Citigroup, appeared exceedingly weak. In exchange for a trifling monetary sanction, an injunction that the SEC rarely enforces,[11] and some minor adjustments in Citigroup's business practices, Citigroup resolved its regulatory liability for a fraudulent scheme that generated hundreds of millions of dollars in revenues for the bank while costing hundreds of millions of dollars in losses for investors. It accomplished this all without admitting a single fact, taking responsibility for any of its misconduct, or suffering any of the additional collateral consequences authorized by the securities laws.[12]

Yet, the SEC's memorandum to the court in support of the proposed settlement was only seven pages, and it devoted only a **single page** of double-

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[11] By its own admission, the SEC rarely seeks civil contempt. JA 101 ("[T]he Commission has not frequently pursued civil contempt proceedings and does not appear to have initiated such proceedings against a 'large financial entity' in the last ten years.").

[12] For example, Securities Act Rules 262(a)(4), (d)(2), 17 C.F.R. § 230.262; 505(b)(2)(iii), 17 C.F.R. § 230.505, bar an issuer from using Regulation A and Rule 505 of Regulation D if it has been temporarily or permanently enjoined within the past five years for violating the securities laws. The SEC, however, routinely grants waivers from these offering bars. Indeed, Citigroup is a frequent beneficiary of this policy and consistently obtains these waivers. *See, e.g.*, Letter from Gerald J. Laporte, Chief, Office of Small Business Policy, SEC, to Gail S. Ennis, Counsel for Citigroup Inc. (Oct. 19, 2010); Letter from Gerald J. Laporte, Chief, Office of Small Business Policy, SEC, to Kevin P. McEnery, Counsel for Citigroup Global Markets Inc. (Dec. 23 2008); Letter from Gerald J. Laporte, Chief, Office of Small Business Policy, SEC, to Francis P. Barron, Counsel for Citigroup Global Markets, Inc. (May 31, 2006).

spaced text purporting to explain why the settlement was "fair, adequate, reasonable, and in the public interest."[13] JA 40-41. Exemplifying the absence of helpful analysis or justification for the settlement, the SEC's memorandum offered the conclusory and groundless assertion that "[t]he proposed $95 million civil penalty will serve as an appropriate deterrent to Citigroup and other Wall Street firms. . . ." JA 40. Ninety-five million dollars represents approximately 3% of Citigroup's parent company's $2.9 billion dollars in quarterly net income. Citigroup 2012 Second Quarter 10-Q, at 105, *available at* http://www.citigroup.com/citi/investor/data/q1202c.pdf?ieNocache=257.

In response to this transparently inadequate record, the district court had to issue an order seeking additional very basic information and held a hearing that sought to require the SEC and Citigroup to address nine questions relating to clear deficiencies in the proposed settlement. JA 68-71. The court's information requests focused on issues raised by, but left unaddressed or unanswered in, the

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[13] It is noteworthy that the SEC immediately touted the settlement in the press after it filed the proposed settlement. *See* SEC Press Release 2011-214 (Oct. 19, 2011), *available at* http://sec.gov/news/press/2011/2011-214.htm. It did not wait for the court to review the filings, let alone rule on them. In fact, on the date of filing, the SEC's Director of Enforcement extolled the virtues of the settlement through an exclusive interview with Bloomberg Television. *See* SEC's Khuzami on Citigroup, Investigations, BLOOMBERG, Oct. 19 2011, *available at* http://www.bloomberg.com/video/78277766-sec-s-khuzami-on-citigroup-investigations-oct-19.html. In addition, the SEC's press package was almost as long as the memorandum it filed in court in support of the proposed settlement.

parties' initial filings, including the lack of admissions, the calculation of the penalty amount, the enforceability of the injunctive relief, the absence of accountability by individuals, the nature of the remedial undertakings, and the basis for alleging negligence in response to "a securities fraud of this nature and magnitude." JA 68-70.

Neither the SEC nor Citigroup challenged the court's right to seek additional information, but their responses were plainly inadequate and failed to provide sufficiently clear, comprehensive and consistent information.[14] As a result, the court was left with a record that was unreliable and incomplete. These defects in the record, described further below (as well as in detail in Better Market's filings in

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[14] Three examples illustrate the point. First, much of the SEC's written response evaded the court's inquiries by arguing in essence that the agency was owed deference from the court. *See, e.g.,* JA 81-88. Second, in its written response to the court's question regarding investor losses, the SEC claimed that the calculation of such losses was "difficult and imprecise" and furthermore "not contemplated by the statutory scheme"—even though the SEC's guidelines explicitly and repeatedly reference the extent of harm as a factor that bears on appropriate penalties. JA 95, 99. Moreover, the SEC never actually provided an answer, except to estimate that total investor losses exceeded $700 million—without specifying how high the losses actually were. JA 95. Third, at the November 9th hearing, counsel for the SEC simply could not explain to the district court how injunctive relief deters misconduct, since the SEC virtually never seeks to enforce injunctions. JA 213-19. Counsel was left to suggest that injunctive relief had value because it served as something of a post-it note, reminding investors and management that serious charges have been made against the bank. JA 219.

the district court[15]), provide this Court with a basis for affirming the district court's decision to reject the proposed settlement.

G. The district court's order should be affirmed because the record lacked an appropriate alternative to admissions or adjudicated facts that would have provided a reliable, credible basis for determining whether the settlement met the standard.

The basis for the district court's order was, "[m]ost fundamentally," that the settlement "does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under" the applicable standard. JA 240. The primary rationale was the court's need for "some knowledge of . . . the underlying facts" before it could impose "wide-ranging injunctive remedies on a defendant, enforced by the formidable judicial power of contempt." *Id*.

In finding that the parties failed and refused to provide a sufficient factual basis, even after it was specifically requested, the court focused on the lack of a sufficiently reliable record, specifically the absence of admissions in the proposed settlement. *See* JA 236, 241 ("[T]he court has not been provided with any proven or admitted facts;" "Judgments without admitting or denying the underlying allegations" deprives the court of any assurance that the relief has "any basis in fact.").

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[15] *See* Better Markets' Memorandum in Opposition to Proposed Settlement (attached to its Motion to Intervene Pursuant to Federal Rule of Civil Procedure 24) (JA 5, Dkt #14) and Memorandum of Law in Support of Motion to Intervene (JA 5, Dkt #15), No. 11-cv-7387 (JSR) (S.D.N.Y Nov. 3, 2011).

But it was not simply the lack of admissions or adjudicated findings that prevented the court from determining whether the settlement was fair, adequate, reasonable, or in the public interest. It was also the lack of **any** alternative facts or information that would have created a more reliable and complete record upon which to evaluate the settlement. Thus, one basis for affirmance in this case is that the proposed settlement failed to contain **either** admissions **or any other available facts or information** that would have given the court a sufficient basis upon which to evaluate the settlement and determine if it met the standard.

There are a variety of methods, apart from admissions, that the parties could have used to ensure that the record before the district court was sufficiently reliable to allow meaningful review of the proposed settlement. These mechanisms have the virtue of resolving one of the parties' chief concerns: the fear that if courts routinely require admissions in settlements, defendants will rarely settle because they will face collateral estoppel in private litigation. *See* JA 205-07 (colloquy regarding Citigroup's desire to avoid collateral estoppel arising from admissions).

On the most basic level, the SEC could have—and should have—provided the court with a fact-based explanation of Citigroup's conduct and far more convincing support for the proposed settlement. The district court's concerns over the SEC's "simpl[e]" allegations, JA 242, were evidently attributable in part to the gulf between the nature of Citigroup's alleged behavior and the SEC's inexplicable willingness to accept the meager settlement terms: "It is harder to discern from the limited information before the Court what the S.E.C. is getting from this settlement other than a quick headline," JA 243.[16]

Unreasonably vague, generalized allegations without factual support should cause concern that the proposed settlement lacks merit and cannot meet the test of fair, adequate, reasonable, and in the public interest.

A more complete and fact-based narrative, along with a more convincing justification of the settlement terms, would have gone a long way towards ameliorating the court's concerns regarding the deficient record. A number of mechanisms were available to achieve this goal. For example, in *SEC v. Bank of America Corp.*, the SEC provided the court with an extensive supplement to the record, which was uncontested by the defendant. No. 09-cv-6829-JSR, 2010 U.S. Dist. LEXIS 15460, 3-4 (S.D.N.Y. Feb. 22, 2010) (referring to the "S.E.C.'s presentation to this Court of a 35-page Statement of Facts and a 13-page Supplemental Statement of Facts, the accuracy of which is not contested here by

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[16] The SEC certainly did garner quick press coverage. It launched a media blitz simultaneously with the filing of the complaint and proposed settlement, which generated bold headlines from major news sources. *See, e.g.*, Jean Eaglesham & Suzanne Kapner, *Citigroup to Pay $285 Million to Settle Fraud Charges*, WALL ST. J. (Oct. 20, 2011), *available at* http://online.wsj.com/article/SB1000142405 2970204618704576640873051858568.html; Jonathan Stempel & Aruna Viswanatha, *Citigroup to pay $285 million to settle fraud case*, REUTERS (Oct. 19, 2011), http://www.reuters.com/article/2011/10/19/us-citigroup-sec-idUSTRE79I4 TL20111019.

the Bank"). The supplemental information was clearly pivotal in the court's view of the record: the court observed that the "greatest virtue [of the proposed settlement] is that it is premised on a much better developed statement of the underlying facts and inferences drawn therefrom which . . . have been carefully scrutinized by the Court here and found not to be irrational." *Id.* at 18-19.

Furthermore, the SEC could have used other devices, apart from admissions, that would have, by their nature, added to the content and reliability of the record. For example, the SEC could have filed a verified complaint or an affidavit. As is the case under Federal Rule of Civil Procedure 65(b), a verified complaint or an affidavit can supply a heightened degree of reliability when necessary to justify a court's issuance of relief. Similarly, the SEC and Citigroup could have developed a set of stipulations or even a statement of undisputed material facts of the type used to support summary judgment motions under Federal Rule of Civil Procedure 56. Any of these devices would have assured the district court that the award of injunctive relief at least had a stronger and more credible factual basis than mere allegations.[17]

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[17] At the November 9th hearing convened by the district court to address its many questions about the proposed settlement, counsel for the SEC tried to defend the record with the assertion that the allegations in the complaint, coupled with Citigroup's lack of denial and willingness to pay sanctions, were sufficient to inform the public about Citigroup's misconduct. JA 210-11 ("And so we believe that that package leaves the public with a clear understanding of what, in fact,

Alternatively, to enhance and supplement the record for the court, the SEC could have issued a formal report of investigation of the type permitted under Section 21(a) of the Securities Exchange Act of 1934. 15 U.S.C. § 78u(a). That provision authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to "publish information concerning any such violations." The information that the SEC often sets forth in such reports includes investigatory findings based on admissions from the subject of an investigation. *See* The Commission's Practice Relating to Reports of Investigations and Statements Submitted to the Commission Pursuant to Section 21(a), Exchange Act Release No. 15,664, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,014 (Mar. 21, 1979). They therefore carry an additional measure of credibility or reliability.

When parties ask a federal district court to approve a proposed settlement and to invoke the court's equity power, they have a duty to provide the court with a record comprised of more than mere allegations in a complaint, which are neither admitted nor denied. They could have done so through the alternatives to

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occurred here sufficient to serve the public interest."). In addition to being simply wrong on its face, that claim is also belied by the additional measures that parties can and do take to endow a record with more credibility than mere allegations. *See* Consent of Defendant Goldman Sachs & Co. ¶ 3, SEC v. Goldman Sachs & Co., No. 10-cv-3229-BSJ (S.D.N.Y. 2010) ("Goldman acknowledges that the marketing materials for the . . . transaction contained incomplete information"); *see also SEC v. Bank of America,* discussed *supra.*

admissions or adjudicated facts described above, or through other steps that would have achieved the same result, such as providing the court with some of the underlying evidence from the case file.

Their failure to do any of this and to submit the proposed settlement with little more than vacuous allegations deprived the court of a basis for determining whether the settlement was fair, adequate, reasonable, or in the public interest.[18] That is why the proposed settlement deserved to be rejected, and the district court's order should be affirmed on this ground.

H. The district court's order should be affirmed also because the record contained so many material gaps, inconsistencies, and ambiguities that the court did not have a sufficient record to determine whether the proposed settlement was fair, adequate, reasonable, or in the public interest.

The parties simply failed to provide the court with a sufficient amount of clear and coherent information for it to properly evaluate the proposed settlement. The omissions and inconsistencies in the record relate to key aspects of the proposed settlement, including (1) the actual measure of Citigroup's ill-gotten

[18] This repeated failure also suggests that the parties did not actually want to elucidate the basis for the settlement, since a clear and accurate portrayal of Citigroup's conduct would have removed any doubt that the settlement was **not** fair, reasonable, adequate, or in the public interest—as detailed herein below and in Better Markets' filings in the district court. *See* Better Markets' Memorandum in Opposition to Proposed Settlement (attached to its Motion to Intervene Pursuant to Federal Rule of Civil Procedure 24) (JA 5, Dkt #14) and Memorandum of Law in Support of Motion to Intervene (JA 5, Dkt #15), No. 11-cv-7387 (JSR) (S.D.N.Y Nov. 3, 2011).

gains; (2) the penalty amount and its adequacy in light of the nature of Citigroup's conduct, Citigroup's recidivist history, and the losses suffered by investors; (3) the identity and role of individuals in the scheme; and (4) the deterrent value of the injunctive relief.[19] These are also among the very issues that the district court viewed as central to its review of the settlement, and about which it sought additional information. *See* JA 68-71.

By presenting the district court with such an incomplete and inconsistent record, the parties were in effect requesting a no-questions-asked, rubber-stamp of approval.[20] And it left the court without a basis to discharge its duty to independently assess whether the proposed settlement was fair, adequate, reasonable, and in the public interest.

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[19] Although some of the record deficiencies are discussed below by reference to the court proceedings against Credit Suisse Alternative Capital ("CSAC"), *In the Matter of Credit Suisse Alternative Capital*, SEC Admin. Proceeding File No. 3-14594 (Oct. 19, 2011), and Brian Stoker, *SEC v. Brian Stoker*, No. 11-cv-7388 (S.D.N.Y. Nov. 5, 2011), it is neither fair nor in the public interest to ask the court to ferret out a true picture of the settlement from these collateral sources. *See* JA 93 (claiming that the ongoing litigation against Brian Stoker "provides a vehicle for resolution of the Commission's actions" and "[a]ccordingly, whatever factual resolution of any disputed issues is likely to be realized in the related proceedings against Mr. Stoker").

[20] Some of the obvious omissions and their impact on the court's ability to discharge its duty are detailed in Better Markets' filings in the court below. *See supra* note 18.

1. The SEC did not fully discuss or properly calculate the $160 million disgorgement amount, even after the court specifically asked them to do so.

The calculation of a defendant's unjust enrichment is crucial in an SEC enforcement action. Not only does such a calculation inform the disgorgement amount which will be returned to the victims of the scheme, but it also ensures that violators are appropriately deprived of their ill-gotten gains, thus deterring future misconduct. *SEC v. Fischbach Corp.*, 133 F.3d 170, 175-76 (2d Cir. 1997).

According to the SEC, "[t]hrough its fees and its short positions, Citigroup realized **net profits** of **at least** $160 million in connection with Class V III," JA 16 (emphasis added), which represented the bulk of the entire $285 million settlement. There are at least three material deficiencies with this representation to the court.

First, the SEC inexplicably failed to disclose all the direct and indirect remuneration to Citigroup—even after the court specifically asked for this information.[21] From the limited information that was provided, Citigroup's total unjust enrichment appears to be far in excess of $160 million.

[21] *Compare* JA 69 (asking: "How was the amount of the proposed judgment determined? In particular what calculations went into the determination of the $95 million penalty?") *with* JA 96-7 (SEC memo in response to district court's questions failing to address these questions).

These apparent direct and indirect benefits include:

- The profits earned on the $500 million short of specifically selected positions in the collateralized debt obligations ("CDOs"),[22] JA 15, 25;
- The "sale" of $92.25 million in face value of worthless or near worthless unsold cash CDOs from Citigroup's own books, thereby allowing Citigroup to avoid booking a loss (or larger loss) on those unsold CDOs, which might have negatively impacted its stock price, *see* JA 26; Order Instituting Administrative Cease-and-Desist Proceedings ¶ 4, *In the Matter of Credit Suisse Alternative Capital*, SEC Admin. Proceeding File No. 3-14594 (Oct. 19, 2011) ("CSAC C&D");
- The fees paid for structuring and marketing the deal of apparently $34 million, JA 15; and
- The other fees received by Citigroup as arranging bank from intermediating trades and capturing the spread between buying protection for the Class V III special purpose vehicle and selling protection to its customers. JA 19-20.

Thus, the SEC's claim that Citigroup was unjustly enriched by "at least $160 million" is not only poorly explained, but also appears to be a gross understatement. Indeed, in *SEC v. Brian Stoker*, the SEC admitted that Citigroup

[22] Although the record is unclear on the point, Citigroup also may have paid minimal and below-market rate premium payments to Class V III for those positions. CSAC C&D at ¶ 5, 39-43.

has made profits on the deal of "at least" **$284 million**, an astounding $124 million more than stated in this case. *See* Pl's Counter-Statement of Undisputed Material Facts at ¶¶ 100-01, 11-cv-7388 (May 23, 2012).

Obviously, a court cannot determine if a settlement is fair, adequate, reasonable, and in the public interest if the parties refuse to tell the court such basic information as the amount of total revenue the fraud generated as well as the gross profit the offending party made on the fraudulent deal.[23]

Second, the SEC utterly failed to address whether and to what extent it deducted Citigroup's costs in calculating net profits. This Court has explicitly recognized that in securities cases, defendants are "**not** entitled to deduct costs associated with committing their illegal acts." *FTC v. Bronson Partners, LLC*, 654 F.3d 359, 374-375 (2d Cir. 2011) (emphasis added) (citing as examples of cases requiring disgorgement of proceeds rather than profits, *SEC v. DiBella*, 587 F.3d 553, 572 (2d Cir. 2009), and *FTC v. Verity Int'l, Ltd.*, 443 F.3d 48, 68 (2d Cir. 2006)). Thus, a "net profit" disgorgement figure is not legally justifiable.

Third, even assuming some offsets should have been allowed (a dubious claim), the SEC failed to identify and explain the basis for those offsets. Any

[23] There can be no genuine doubt that this information was very carefully tracked by Citigroup and its officers, executives, and employees (if for no other reason than for their substantial bonus payments). But even if it was not, an inability to be precise does not relieve the parties of the duty to disclose this information to the court, with whatever caveats, assumptions, or ranges are necessary.

offsets must be legitimately and directly related to the fraud and, even then, it is in the court's discretion whether to deduct those offsets or not—without any information, the court cannot make this determination. *SEC v. McCaskey*, No. 98-cv-6153, n.6 and accompanying text (S.D.N.Y. Mar. 26, 2002) (distinguishing direct transaction costs with general overhead costs). What little information the record does contain on this issue suggests that some costs were improperly deducted. According to Citigroup, offsets included losses it and its affiliates sustained by retaining other Class V III securities. JA 187. The court was left to speculate, but it appears that because the SEC's complaint only references investor purchases or protection sold on $843 million of the $1 billion deal, JA 29, Citigroup was left with $157 million of Class V III securities on its books. Like the other Class V III securities, this allotment presumably became worthless and it appears that the SEC permitted a $157 million offset to Citigroup's proceeds in the deal. Not only would this be grossly unfair, but it is also contrary to law. *See SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (2d Cir. 1978) (finding "no reason why, in determining how much should be disgorged in a case where defendants have manipulated securities so as to mulct the public, the court must give them credit for the fact that they had not succeeded in unloading all their purchases at the time when the scheme collapsed"); *SEC v. McCaskey*, No. 98-cv-

6153 (S.D.N.Y. Mar. 26, 2002) ("The disgorgement amount should not be offset by any losses incurred by the wrongdoer when the scheme collapsed.").

Because the SEC failed to disclose clear and complete information regarding proceeds and offsets, the lower court did not have an adequate record to assess the terms of the proposed settlement. Rather, the court was left in the dark as to the true magnitude of Citigroup's ill-gotten gains and forced to guess whether the disgorgement amount was an appropriate approximation and whether the unidentified offsets should have been permitted.

This is, of course, a stark example of why courts must have the power and authority to demand information and why their role as the sole check on such settlements is so important.

2. <u>The SEC omitted information necessary to assess the appropriateness of the $95 million penalty.</u>

"The civil penalties authorized by the securities laws serve a dual purpose, i.e., to both punish the individual violator for his past violations and deter future violations of the securities laws." *SEC v. Razmilovic*, 822 F. Supp. 2d 234, 280 (E.D.N.Y. 2011); *see also* S. Rep. No. 101-337, at 1 (1990); *SEC v. Haligiannis*, 470 F. Supp. 2d 373, 386 (S.D.N.Y. 2007). Therefore, adequate information on the penalty calculation is crucial for the court in reviewing a proposed settlement.

In this case, the SEC improperly failed to fully discuss the penalty amount, implying that it was somehow capped by the statutory maximum in the Securities

Act and that comparable settlements were distinguishable. The agency also omitted key information on the nature of Citigroup's conduct, Citigroup's recidivism, and the total investor losses, which, by the SEC's own admission, are relevant to the penalty calculation.

a. <u>The SEC erroneously claimed that the statutory maximum penalty is a cap on penalties in settlements and that it is equivalent to disgorgement plus prejudgment interest.</u>

The SEC proclaimed the reasonableness of the proposed penalty amount, stating that it "was more than half of the maximum that the Commission could have obtained at trial under the controlling statute ($95 million, as compared with $160 million)." SEC's Unopposed Emergency Motion at 10, No. 11-cv-5227 (2d Cir. Dec. 27, 2011). Thus, according to the SEC, because the statutory maximum "is roughly equivalent to the amount of disgorgement and prejudgment interest," the settlement including a $95 million penalty is fair, adequate, and reasonable. JA 97.

However, there are two material deficiencies with this claim. First, it misreads the statute, which explicitly caps penalties by **either** a specific monetary figure **or** "the **gross** amount of pecuniary gain to such defendant as a result of the violation." 15 U.S.C. § 77t(d)(2) (emphasis added). Therefore, to the extent that the SEC argues that the cap on penalties amounts to the disgorgement figure, or "net profits," rather than its total "ill-gotten gains," the SEC's maximum penalty calculation conflicts with the statute. Indeed, the SEC's interpretation would render meaningless the presence of the word "gross," which is defined as "consisting of an overall total exclusive of deductions."[24] Merriam-Webster, http://www.merriam-webster.com/dictionary/gross; *see also Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883) (Court must give effect "to every clause and word of a statute, avoiding, if it may be, any construction which implies that the legislature was ignorant of the meaning of the language it employed.").

Second and more important, while the maximum amount obtainable under the statute may be relevant, it is not binding in the settlement context. As held by the Supreme Court, "a federal court is not necessarily barred from entering a [proposed settlement] merely because the [settlement] provides broader relief than the court could have awarded after a trial." *Local No. 93, Int'l Ass'n of Firefighters*, 478 U.S. at 525.

Indeed, there are numerous instances where the SEC has settled for a penalty far greater than that permitted under the statute. As admitted by the SEC, these comparable judgments are relevant in determining the penalty amount. JA 97.

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[24] Even if the SEC were correct with respect to the formula for computing disgorgement and penalties, the total penalty the SEC could recover at trial would be at least $284 million plus prejudgment interest, given the SEC's admission in *SEC v. Brian Stoker* that Citigroup's gains were in that amount. *See* Pl's Counter-Statement of Undisputed Material Facts at ¶ 100-01, 11-cv-7388 (May 23, 2012). From this point of view, the $95 million penalty, which amounts to just one third of the supposed maximum, appears less than reasonable.

The agency briefly mentions both *SEC v. Goldman Sachs & Co.,* No. 10-cv-3229-BSJ (S.D.N.Y. July 20, 2010), and *SEC v. J.P. Morgan Sec., LLC,* No. 11-cv-4206-RMB (S.D.N.Y. Jun. 29, 2011). JA 97,105. However, more explanation as to these two prior settlements, and the far larger penalties involved, is essential for evaluating the proposed penalty in this case.

With respect to *SEC v. Goldman Sachs & Co*, the SEC attempted to distinguish the $535 million penalty from the mere $95 million proposed penalty in this case, stating that "Goldman Sachs was charged with scienter-based violations," which "are worthy of more significant sanction." JA 97. Although in general, a higher penalty may be appropriate for scienter-based violations, the SEC fails to account for the fact that despite the initial charge, the actual settlement in Goldman relied on the **same** negligence statutes at issue here. *See* Consent of Def. Goldman, Sachs & Co, No. 10-cv-3229-BSJ (July 20, 2010) (enjoining violations of only section 17(a) of the Securities Act of 1933 and applying the Securities Act penalty provisions, 15 U.S.C. § 77t(d)(2), rather than the initial section 10(b) charge). Moreover, the amount Goldman Sachs disgorged under its settlement was only $15 million, well below the $535 million penalty. This contradicts the SEC's claim in this settlement that the penalty is limited to disgorgement plus prejudgment interest. JA 97.

Even more startling is the penalty imposed in the settlement with J.P. Morgan Securities ("JPM"), which also involved the same violations and substantially similar conduct as alleged here. *SEC v. J.P. Morgan Sec., LLC*, No. 11-cv-4206-RMB (S.D.N.Y. Jun. 29, 2011). According to the SEC, JPM structured a $1.1 billion deal in 2007, "when the housing market and the securities referencing it were beginning to show signs of distress." Complaint at 1, No. 11-cv-4206-RMB. "[U]nbeknownst to investors," a hedge fund "played a significant role in the selection process with the knowledge of [JPM]" and shorted over half the deal's portfolio that it had helped select. *Id.* at 2. JPM "was paid approximately $18.6 million for structuring and marketing the transaction." *Id.* at 2, 3.

Although it purportedly lost $880 million, JPM nevertheless entered into a settlement requiring it to disgorge the $18.6 million in fees, along with prejudgment interest of $2 million, and imposing a **civil penalty of $133 million**. *See* Final Judgment, No. 11-cv-4206-RMB (S.D.N.Y. June 29, 2011). When compared to the instant case, the allegations are substantially similar, but the SEC was inexplicably able to obtain a penalty amount worth over **six times** the amount of JPM's disgorgement and prejudgment interest.

These two settlements are not isolated occurrences. Indeed, in prior settlements with Citigroup itself, the SEC has obtained far more than the disgorgement amount plus prejudgment interest in penalties. *See, e.g., SEC v. Citigroup, Inc.*, 10-cv-01277-ESH (D.D.C. Oct. 8, 2010) (settling for disgorgement of $1.00 and a penalty of $75 million).

Thus, by failing to disclose this information and implying that the statute serves to limit the penalty amounts obtainable in the settlement, the SEC omitted information necessary to permit the court to independently assess an important element of the proposed settlement.

b. <u>The SEC omitted sufficient disclosure of the nature of Citigroup's offense, Citigroup's recidivism, and the total investor losses, factors which bear on the penalty amount.</u>

In determining the penalty amount to seek against a corporation, the SEC admits it considers, among other factors, "[t]he level of intent on the part of the perpetrators," a defendant's recidivism or "prior unlawful conduct," and "[t]he extent of injury to innocent parties." JA 99, 101. *Cf. SEC v. Milligan*, 436 Fed. Appx. 1, 3 (2d Cir. 2011) (listing similar factors courts consider in imposing penalties under the securities laws).

Although the SEC stated that these "were considered in determining the appropriate penalty in this case," the SEC failed adequately to disclose such information to the court and explain how it influenced decisions regarding the settlement's terms. In so doing, the agency omitted information the court needed to assess the proposed penalty.

First, the SEC failed to reconcile the fraudulent nature of the alleged violations with the ultimate decision to charge negligence only. The SEC repeatedly phrased its allegations in terms of Citigroup's "knowledge," and it alleged that "Citigroup engaged in **fraud** in connection with the structuring and marketing of [Class V III]." JA 35 (emphasis added); *see also* Pro Bono Br. 11-13 (listing allegations in the complaint and in the Brian Stoker proceeding that show intentional conduct). Despite these allegations that reflect knowledge and fraudulent intent (i.e. scienter), the SEC only charged Citigroup with negligence, JA 16, and found that because "the evidence did not clearly establish an intent to defraud," "this counsels in favor of a more reduced monetary sanction." JA 99. These inconsistencies were never adequately explained to the court.

Second, with respect to Citigroup's recidivist history, the SEC failed to mention that the corporation (or its affiliates) had been similarly sanctioned for the same negligence violations five times since 2000. *See SEC v. Citigroup, Inc.*, 10-cv-01277-ESH (D.D.C. Oct. 8, 2010); *In the Matter of Citigroup Global Markets, Inc.*, SEC Admin. Proceeding File No. 3-12629 (May 7, 2007); *In the Matter of Bear, Stearns & Co. Inc.*, SEC Admin. Proceeding File No. 3-12310 (May 31, 2006); *In the Matter of Citigroup Global Markets, Inc.*, SEC Admin. Proceeding File No. 3-11869 (Mar. 23, 2005); *In the Matter of Salomon Smith Barney Inc.*, SEC Admin. Proceeding File No. 3-10177 (Apr. 6, 2000). In each of these cases, with the exception of the 2007 proceeding, Citigroup was ordered to stop violating the same negligence statute at issue here. The only reason the 2007 proceeding did not include a similar order was because the bank was "already subject to such an order concerning the same type of misconduct," as a result of the 2006 proceeding. SEC Admin. Proceeding File No. 3-12629, at 5.

Additionally, Citigroup has recently violated a host of other securities law provisions.[25] Thus, Citigroup's recidivism shows clearly that prior enforcement actions and their penalties, have failed to deter the bank from violating the securities laws. This recidivism should have been fully disclosed to the court, yet it was not. *See* JA 99 (disclosing only the 2010 proceeding).

Third, the SEC's submissions to the court lacked detail and reliability regarding total, direct, and indirect investor losses. The complaint states that "approximately 15 different investors purchased (or sold protection on) tranches of Class V III with a face value of approximately $843 million." JA 29. It also states that "the Subordinate Investors and the Super Senior Investors "lost several

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[25] *See In the Matter of Citigroup Inc.*, SEC Admin. Proceeding File No. 3-13070 (June 16, 2008); *SEC v. Citigroup Global, Markets, Inc.*, 1:08-cv-10753-DAB (S.D.N.Y. Dec. 22, 2008); *In the Matter of Smith Barney Fund Management LLC*, SEC Admin. Proceeding File No. 3-11935 (May 31, 2005); *SEC v. Citigroup Global Markets Inc.*, 03-cv-2945-WHP (S.D.N.Y. Oct. 31, 2003); *In the matter of Citigroup Inc.*, SEC Admin. Proceeding File No. 3-11192 (July 28, 2003); *In the Matter of The State Bank of India*, SEC Admin. Proceeding File No. 3-10643 (Nov. 19, 2001).

hundred million dollars," and that the Subordinated Investors, who invested "$343 million" in the scheme, "lost most, if not all, of their principal when their notes became nearly worthless." JA 16, 31, 33. As to the Super Senior Investors, both Ambac Financial Group ("Ambac"), who sold "protection on $500 million super senior tranches of Class V III," and BNP Paribas ("BNP"), who effectively guaranteed Ambac's performance, also sustained losses, which were only vaguely addressed. JA 30, 33.

None of these allegations actually disclose the amount of the losses that the victims sustained. When questioned by the district court about the calculation of investor losses, the SEC responded simply with the conjectural and imprecise observation that "[i]t is reasonable to estimate . . . that total investor loss or expected loss with respect to the . . . transaction is **in excess of $700 million**." JA 95 (emphasis added).

Taken together, these brief statements by the SEC fail to provide the detail and reliability necessary for the court to evaluate the proposed settlement. Moreover, the SEC's statements in the proceedings against CSAC and Brian Stoker bring into question the validity of the $700 million estimate of investor losses here. According to the CSAC cease-and-desist order, these same investors "lost virtually their entire investments," or "approximately $847 million"—over 20% more than the amount represented to the district court. CSAC C&D ¶ 7, 9.

Even more startling is the SEC's conflicting statement in the case against Brian Stoker, indicating that this figure amounted to "approximately **$893 million**"—over 25% more than the amount represented to the district court. SA 21, 24; Pl's Counter-Statement of Undisputed Material Facts, at ¶ 91, 98.

Likewise, the record provided to the district court made no mention of indirect losses caused by Citigroup's deal. For example, Ambac ultimately filed for bankruptcy. Erik Holm & Eric Morath, *Ambac Files for Chapter 11*, WALL ST. J., Nov. 9, 2010. Citigroup's contribution, if any, to Ambac's bankruptcy was not addressed. Also, the record did not discuss losses sustained by BNP as guarantor of Ambac's obligation to pay Citigroup under the deal, were not discussed. *Cf.* SA 24 ("BNP has suffered additional losses on the super senior tranche in excess of $100 million"). Indeed, apparently all of the investors suffered indirect losses by being underpaid for their premiums, as Citigroup "paid prices well below what was available in the market." CSAC C&D ¶5, 43 (Investors in Class V III assumed heightened risk "without the necessary corresponding increase in premiums.").

Because this information is, at the very least, relevant to the penalty amount, the SEC should have clearly and precisely disclosed all direct and indirect losses sustained by investors in connection with the scheme. In addition, it should have resolved the inconsistent statements quantifying the magnitude of losses.

3. The record fails to identify the individuals responsible for the alleged fraud.

Another key omission by the SEC was the identities of the individuals responsible for the alleged fraud, and their respective roles. The scheme involved many Citigroup employees, including the syndicate, trading, structuring, marketing, and sales desks. In its complaint, the SEC vaguely references some of these individuals, but **only** by title. *See, e.g.*, JA 22-4 (naming a "a senior Citigroup CDO structurer," a "CDO salesperson," and "the senior CDO structurer's immediate supervisor"); JA 27 (naming "the head of Citigroup's CDO syndicate desk").[26]

Indeed, the SEC carefully made no specific identification of individuals. For example, the SEC redacted names from quoted emails, substituting defined terms for the individual's actual title: "The structurer responded: . . . 'This is [Trading Desk Head]'s prop trade (don't tell CSAC).'" JA 23.

The record also omits any information regarding the involvement or knowledge of senior management. It is inconceivable the scheme was carried out without the knowledge and active participation of senior level executives. Yet, the SEC only identified and charged one mid-level employee, Brian Stoker. By not

[26] From the case against Brian Stoker, the identities of some, but not all, of these individuals are now evident. *See* Mem. Order at 3-4, 11-cv-7388-JSR (July 10, 2012) (citing Pl.'s Counter-Statement of Undisputed Material Facts).

"adequately accounting for why, in contravention of its own policy, it did not pursue charges against [the individuals] who allegedly were responsible for the false and misleading . . . statements," the proposed settlement is presumptively unreasonable. *SEC v. Bank of Am. Corp.*, 653 F. Supp. 2d 507, 510-11 (S.D.N.Y. 2009) (internal citations omitted).

This information is crucial to assessing the terms of the settlement since it relates to the nature of Citigroup's fraud and the complicity in the violation throughout the corporation, two factors the SEC admits are relevant to the penalty calculation. *See* JA 99. Further, this information influences the proper disgorgement figure. Because only one individual is identified and charged, the SEC failed to provide the court with a proper accounting of the benefits, which necessarily must include the bonuses and compensation presumably paid to numerous other individuals, including supervisors and executives, as a result of the deal.

The SEC's complaint in the proceeding against Brian Stoker discloses that Mr. Stoker was to "ensure that the structuring desk received '**credit** for [the CDO trading desk's] profits' on Class V III." SA 12 (emphasis added). However, the SEC did not disclose what "credit" these individuals received. The SEC only disclosed that as Mr. Stoker and his colleagues were marketing and selling the Class V III deal, Citigroup agreed to increase Mr. Stoker's bonus by more than

100%, to $2.25 million, and to guarantee it. SA 24. It is unlikely that this dramatic increase in compensation, contemporaneous with the transaction, was coincidence. It is even more unlikely that Mr. Stoker's supervisors, colleagues, peers, and others did not demand a similar compensation package, at a minimum.

As is customary in the financial services industry, compensation for desks and individuals is well-documented and specifically detailed. To enable the district court to determine whether the disgorgement and penalty provisions and hence the entire proposed settlement met the applicable standard, the SEC should have provided the court with information regarding these topics. Without disclosure of these issues, and those described above, the court did not have an adequate basis on which to determine whether the proposed settlement was fair, adequate, reasonable, or in the public interest.

CONCLUSION

For all of the foregoing reasons, this Court should affirm the order of the district court rejecting the parties' proposed settlement agreement.

Dated: August 20, 2012

Respectfully submitted,

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CERTIFICATE AS TO WORD COUNT

I hereby certify that the foregoing brief is in 14-Point Times New Roman proportional font and contains 11,246 words.

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CERTIFICATE OF SERVICE

I hereby certify that on August 20, 2012, I caused the foregoing "Brief of Better Markets, Inc. as Amicus Curiae in Support of Pro Bono Counsel Appointed to Advocate for Affirmance of the District Court's Order" to be electronically filed using the Court's CM/ECF system, which served a copy of the document on the following counsel of record:

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