10. CIVIL REGULATORY ENFORCEMENT

In nearly every area of corporate crime, there is overlap between criminal liability and some form of civil regulatory enforcement, often conducted through a specialized government agency. Every prosecutor and defense attorney working a case in this field must be familiar with the civil regulations and enforcement apparatus that work alongside any relevant criminal provisions.

There is not space here to cover an array of different civil enforcement regimes (those of the EPA, FTC, FDA, DOD, FCC, FAA, and so on through Washington's alphabet soup). The purpose of this chapter is to provide a sense of the civil-criminal overlap by introducing the basic features of one of those regimes: the one governing transactions in securities, administered by the SEC.

The SEC is not a prosecutor and has no authority to bring criminal charges. It must proceed under its own statutory grants of authority. Both the Securities Act of 1933 and the Exchange Act of 1934 grant the SEC extensive civil enforcement powers. The substantive scope of those enforcement provisions extends over all violations of all provisions of the '33 and '34 acts. Of course, those prohibitions include the edicts against securities fraud covered in chapters 3 and 4—and a good deal of SEC enforcement activity is based on that substantive legal theory (fraud). Many cases are also brought to enforce the FCPA, which likewise grants the SEC enforcement powers and which we have also studied.

A. The SEC's Powers: A Brief Summary

The '33 and '34 Acts authorize the SEC to pursue enforcement action on two primary tracks, at the SEC's option:

(1) An **administrative proceeding** brought within the confines and authority of the agency itself, litigated before an administrative law judge who is employed by the Commission. These administrative proceedings are also referred to as "cease and desist proceedings."

(2) A **lawsuit** filed in United States District Court for injunctive and other relief.

As you read through the statutes below, make lists of the *remedies* that the SEC can obtain through each of these two paths. Again, those remedies don't include imprisonment, but they can be quite potent.

Perhaps the most important power the SEC has been granted by Congress is the subpoena power, as it is the power to get cases going in the first place. SEC enforcement lawyers can subpoena testimony under oath "before the Commission" (which is actually something just like a deposition that takes place in a conference room with lawyers present for both sides) as well as documents. Much of SEC practice is conducted during this investigative phase, as government and defense counsel skirmish over the scope of subpoenas, who will be called to testify, what questions will be asked, and the like.

Importantly, in civil proceedings, there is no Fifth Amendment right to not have one's refusal to answer questions used against one. In other words, a witness can "take the Fifth" when subpoenaed to testify before the SEC in order to protect herself in potential parallel criminal proceedings, but that silence can be used as evidence against her in any SEC litigation.

In recent years, the defense bar has complained that the SEC has chosen administrative proceedings over federal court lawsuits more often than it used to, allegedly to exploit the "home court advantage" said to exist in litigating before its own administrative law judges (ALJs). In *Lucia v. SEC*, 138 S. Ct. 2044 (2018), Raymond Lucia was found liable for violating several securities laws by an SEC ALJ, who had been appointed by SEC staff members. In response to Lucia's challenge to the ALJ's authority, the Supreme Court held that because SEC ALJs are "Officers of the United States" under the Constitution's Appointments Clause, they had not been hired in a constitutionally valid manner, and, therefore, did not have proper jurisdiction over pending cases. Lucia's challenge did not derail the SEC administrative enforcement process because the SEC quickly switched to appointing ALJs by vote of the SEC's Commissioners, changing the Appointments Clause analysis. Litigants challenging the ALJ process have been seeking alternative arguments in the wake of *Lucia*. The status of SEC administrative adjudication is now in some doubt. Recently, a panel of the Fifth Circuit held, contrary to prior understanding in the federal courts, that ALJ enforcement proceedings are unconstitutional for several reasons including the Seventh Amendment right to jury trial. *Jarkesy v. SEC*, 34 F.4th 446 (5th Cir. 2022). At the same time, the Supreme Court granted certiorari in a case the Fifth Circuit had decided *en banc* dealing with whether federal district courts have jurisdiction to hear constitutional challenges to the ALJ process. *Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021). The Supreme Court will hear argument in the *Cochran* case in the 2022-23 term.

These challenges to the SEC's use of administrative proceedings are usually brought through appeals from those proceedings to the federal courts. The '33 and '34 Acts contain provisions that specify when a losing defendant can file an appeal from either an administrative or district court ruling. Many of these appeals go to the D.C. Circuit, which thus exercises great influence over the powers of the SEC.

A last introductory point about SEC enforcement procedure. The Commission long ago decided to afford defendants something called a "*Wells* notice" or a "*Wells* proceeding." Under this procedure, potential SEC defendants, unlike most potential criminal defendants, receive advance notice of charges the SEC is considering bringing. Lawyers can then file what amounts to a brief, attempting to persuade the SEC not to bring the charges. The Commissioners themselves, who must vote on every enforcement action, review defendants' *Wells* submissions along with the materials that the SEC's enforcement attorneys prepare to justify their recommendations of action.[1]

B. Statutes

As discussed in Chapter 3, the '34 Act regulates the exchanges and trading markets. Its key enforcement provisions, which are the most common vehicles for SEC enforcement proceedings, are excerpted below. The '33 Act, which regulates the process of initial offerings, has similar enforcement provisions that are not provided here.

Selected Enforcement Provisions of the Securities Exchange Act of 1934

Section 21 (15 U.S.C. § 78u). Investigations and actions

(a) Authority and discretion of Commission to investigate violations

(1) The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this chapter, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated, or, as to any act or practice, or omission to act, while associated with a member, formerly associated with a member, the rules of a registered clearing agency in which such person is a participant, or, as to any act or practice, or omission to act, while a participant, was a participant, the rules of the Public Company Accounting Oversight Board, of which such person is a registered public accounting firm, a person associated with such a firm, or, as to any act, practice, or omission to act, while associated with such firm, a person formerly associated with such a firm, or the rules of the Municipal Securities Rulemaking Board, and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated. The Commission is authorized in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of such provisions, in the prescribing of rules and regulations under this chapter, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this chapter relates . . .

[1] For more depth, but not too much, on SEC enforcement—which can merit a separate law school course—consider reading Chapter 15 of the most recent edition of *Understanding Securities Law* (LexisNexis) by Mark Steinberg.

(b) Attendance of witnesses; production of records

For the purpose of any such investigation, or any other proceeding under this chapter, any member of the Commission or any officer designated by it is empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in the United States or any State at any designated place of hearing.

(c) Judicial enforcement of investigative power of Commission; refusal to obey subpoena; criminal sanctions

In case of contumacy by, or refusal to obey a subpoena issued to, any person, the Commission may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda, and other records. And such court may issue an order requiring such person to appear before the Commission or member or officer designated by the Commission, there to produce records, if so ordered, or to give testimony touching the matter under investigation or in question; and any failure to obey such order of the court may be punished by such court as a contempt thereof. All process in any such case may be served in the judicial district whereof such person is an inhabitant or wherever he may be found. Any person who shall, without just cause, fail or refuse to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, and other records, if in his power so to do, in obedience to the subpoena of the Commission, shall be guilty of a misdemeanor and, upon conviction, shall be subject to a fine of not more than $1,000 or to imprisonment for a term of not more than one year, or both.

(d) Injunction proceedings; authority of court to prohibit persons from serving as officers and directors; money penalties in civil actions

(1) Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, the rules of the Public Company Accounting Oversight Board, of which such person is a registered public accounting firm or a person associated with such a firm, or the rules of the Municipal Securities Rulemaking Board, it may in its discretion bring an action in

the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this chapter or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.

(2) Authority of court to prohibit persons from serving as officers and directors

In any proceeding under paragraph (1) of this subsection, the court may prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who violated section 78j(b) of this title or the rules or regulations thereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 78*l* of this title or that is required to file reports pursuant to section 78*o*(d) of this title if the person's conduct demonstrates unfitness to serve as an officer or director of any such issuer.

(3) Money penalties in civil actions

(A) Authority of Commission

Whenever it shall appear to the Commission that any person has violated any provision of this chapter, the rules or regulations thereunder, or a cease-and-desist order entered by the Commission pursuant to section 78u-3 of this title, other than by committing a violation subject to a penalty pursuant to section 78u-1 of this title, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

(B) Amount of penalty

(i) First tier

The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (I) $5,000 for a natural person or $50,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation.

(ii) Second tier

Notwithstanding clause (i), the amount of penalty for each such violation shall not exceed the greater of (I) $50,000 for a natural person or $250,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation, if the violation described in subparagraph (A) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(iii) Third tier

Notwithstanding clauses (i) and (ii), the amount of penalty for each such violation shall not exceed the greater of (I) $100,000 for a natural person or $500,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation, if—

(aa) the violation described in subparagraph (A) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(bb) such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons . . .

(D) Special provisions relating to a violation of a cease-and-desist order

In an action to enforce a cease-and-desist order entered by the Commission pursuant to section 78u-3 of this title, each separate violation of such order shall be a separate offense, except that in the case of a violation through a continuing failure to comply with the order, each day of the failure to comply shall be deemed a separate offense . . .

(5) Equitable relief

In any action of proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors[2]. . . .

Section 21C (15 U.S.C. § 78u-3). Cease-and-desist proceedings

(a) Authority of Commission

If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this chapter, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule, or regulation with respect to any security, any issuer, or any other person.

(b) Hearing

The notice instituting proceedings pursuant to subsection (a) of this section shall fix a hearing date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served. . . .

(e) Authority to enter order requiring accounting and disgorgement

In any cease-and-desist proceeding under subsection (a) of this section, the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest,

[2] Federal courts have long held that "equitable relief" within the meaning of this statute can include an order requiring the violator to disgorge all profits gained as a result of the violation ("disgorgement"). The SEC commonly seeks this remedy. In *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), the Supreme Court held that the remedy of disgorgement is a form of "penalty," not a remedial sanction as the SEC argued, and is thus subject to the 5-year statute of limitations that applies to SEC actions seeking to impose penalties.

periods of accrual, and such other matters as it deems appropriate to implement this subsection.

(f) Authority of the Commission to prohibit persons from serving as officers or directors

In any cease-and-desist proceeding under subsection (a) of this section, the Commission may issue an order to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated section 78j(b) of this title or the rules or regulations thereunder, from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 78*l* of this title, or that is required to file reports pursuant to section 78*o*(d) of this title, if the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer.

Section 21B (15 U.S.C. § 78u-2). Civil remedies in administrative proceedings

(a) Commission authority to assess money penalties

(1) In general

In any proceeding instituted pursuant to sections 78*o*(b)(4), 78*o*(b)(6), 78*o*-4, 78*o*-5, 78*o*-6, 78*o*-7, or 78q-1 of this title against any person, the Commission or the appropriate regulatory agency may impose a civil penalty if it finds, on the record after notice and opportunity for hearing, that such penalty is in the public interest and that such person—

(A) has willfully violated any provision of the Securities Act of 1933 [15 U.S.C.A. § 77a et seq.], the Investment Company Act of 1940 [15 U.S.C.A. § 80a-1 et seq.], the Investment Advisers Act of 1940 [15 U.S.C.A. § 80b-1 et seq.], or this chapter, or the rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board;

(B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

(C) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission or with any other appropriate regulatory agency under this chapter, or in any proceeding before the Commission with respect to registration, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or

(D) has failed reasonably to supervise, within the meaning of section 78*o*(b)(4)(E) of this title, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision;

(2) Cease-and-desist proceedings

In any proceeding instituted under section 78u-3 of this title against any person, the Commission may impose a civil penalty, if the Commission finds, on the record after notice and opportunity for hearing, that such person—

(A) is violating or has violated any provision of this chapter, or any rule or regulation issued under this chapter; or

(B) is or was a cause of the violation of any provision of this chapter, or any rule or regulation issued under this chapter.

(b) Maximum amount of penalty

(1) First tier

The maximum amount of penalty for each act or omission described in subsection (a) of this section shall be $5,000 for a natural person or $50,000 for any other person.

(2) Second tier

Notwithstanding paragraph (1), the maximum amount of penalty for each such act or omission shall be $50,000 for a natural person or $250,000 for any other person if the act or omission described in subsection (a) of this section involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(3) Third tier

Notwithstanding paragraphs (1) and (2), the maximum amount of penalty for each such act or omission shall be $100,000 for a natural person or $500,000 for any other person if—

(A) the act or omission described in subsection (a) of this section involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(B) such act or omission directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission.

(c) Determination of public interest

In considering under this section whether a penalty is in the public interest, the Commission or the appropriate regulatory agency may consider—

(1) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

(2) the harm to other persons resulting either directly or indirectly from such act or omission;

(3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

(4) whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a court of competent jurisdiction of violations of such laws or of any felony or misdemeanor described in section 78*o*(b)(4)(B) of this title;

(5) the need to deter such person and other persons from committing such acts or omissions; and

(6) such other matters as justice may require . . .

(e) Authority to enter order requiring accounting and disgorgement

In any proceeding in which the Commission or the appropriate regulatory agency may impose a penalty under this section, the Commission or the appropriate regulatory agency may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection…

C. Cease-and-Desist Proceedings

The following is a simple example of a "cease and desist" order—what the SEC would file to commence an enforcement proceeding through the administrative (as opposed to district court) process. A little review of insider trading here as well.

U.S. Secs. & Exch. Comm'n

Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Notice of Hearing

In the Matter of Jordan Peixoto, Respondent, Release No. 73263 (Sept. 30, 2014)

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Jordan Peixoto ("Peixoto" or the "Respondent").

After an investigation, the Division of Enforcement alleges that:

A. SUMMARY

1. Peixoto engaged in insider trading in connection with securities of Herbalife Ltd. ("Herbalife").

2. In 2012, Peixoto's friend, Filip Szymik ("Szymik"), was a close friend and the roommate of an analyst employed at Pershing Square Management, L.P. ("Pershing"). Pershing was a hedge fund headed by well-known activist investor William Ackman ("Ackman"). Prior to December 19, 2012, Szymik's roommate ("the Analyst") informed Szymik of an upcoming Pershing public presentation regarding its negative view of Herbalife (the "Pershing Presentation"). The Analyst also told Szymik, and Szymik understood and agreed, that any information that Szymik might learn from the Analyst concerning Pershing (including concerning the Pershing Presentation) was highly confidential and that Szymik should not trade securities on the basis of any such information.

3. Nonetheless, in breach of his duty of trust or confidence with the Analyst, Szymik informed his friend Peixoto of the essential substance and date of the upcoming Pershing Presentation, which ultimately took place on December 20, 2012. Peixoto and Szymik knew or recklessly disregarded that that information was material and nonpublic, and both understood that, once publicized, Pershing's negative view of Herbalife likely would cause Herbalife's stock price to fall.

4. On December 19, 2012, prior to any such public announcement, Peixoto purchased a number of Herbalife put options. Later that day, CNBC reported Pershing would be announcing publicly a negative view of Herbalife in a presentation the following day. Immediately following both the CNBC announcement and the Pershing Presentation the following day, Herbalife's stock price dropped considerably, falling a total of 39% by the close of trading on December 24. The market value of Peixoto's Herbalife's put options increased by approximately $339,421 (as of December 21, 2012), and he ultimately obtained $47,100 in actual profits from Herbalife options that he purchased prior to the CNBC report.

5. By purchasing Herbalife put options while in possession of material nonpublic information—when he knew or had reason to know that that information had been improperly obtained—Peixoto violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. RESPONDENT

6. **Peixoto**, age 30 and a resident of Toronto, is a Canadian citizen. During December 2012, Peixoto was employed as a research analyst at Deloitte in New York, New York. Peixoto has never been registered with the Commission.

C. OTHER RELEVANT INDIVIDUALS AND ENTITIES

7. **Szymik**, age 28 and a resident of New York City, is a Polish citizen. Since 2008, Szymik has worked as a consultant or senior consultant at a consulting firm. Szymik has never been registered with the Commission.

8. **The Analyst**, age 28 and a resident of New York City, is a Polish citizen. The Analyst began working for Pershing in April 2010, as an intern, and later became a research analyst. The Analyst left Pershing in September 2013.

9. **Pershing,** a limited partnership, was formed in New York, New York. Pershing was founded by William Ackman in 2004 and operates as a hedge fund. Pershing is registered with the Commission as an investment adviser. As of December 2012, it had approximately $11 billion in assets under management.

10. **Herbalife**, a Cayman Islands corporation, is headquartered in Los Angeles, California. Herbalife's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and is traded on the New York Stock Exchange. Herbalife common stock options are traded on various exchanges.

D. BACKGROUND

11. The Analyst began working at Pershing as an intern in April 2010 and became a research analyst and full-time employee in March 2011. Pershing's employee compliance manual states in part that "[Pershing] generates, maintains and possesses information that we view as proprietary, and it must be kept confidential by our Employees"; and that such information includes "investment positions that have not otherwise been publicly disclosed; research analyses that have not otherwise been publicly disclosed . . ." Pershing's written compliance policies further state: "Employees may not disclose proprietary information to anyone outside the Firm . . ." Upon becoming a full- time Pershing employee, the Analyst acknowledged to Pershing in writing that he had received, read, and understood Pershing's compliance manual and confidentiality policy.

12. As a Pershing employee, the Analyst also attended routine mandatory training seminars hosted by Pershing, which included training concerning Pershing's compliance manual, code of ethics, and insider trading.

13. Beginning in the first quarter of 2012, through at least September 2013, the Analyst was a member of Pershing's investment team assigned to research Herbalife. In that capacity, prior to December 2012, the Analyst learned that Pershing had concluded that Herbalife was operating an illicit pyramid scheme and that Pershing had acquired a substantial short position in Herbalife stock. The Analyst also knew that Pershing intended to publicly disclose its Herbalife thesis through a presentation at the Sohn Conference Foundation (the Pershing Presentation) ultimately scheduled for, and which occurred on, December 20, 2012.

14. All information concerning Pershing's Herbalife research -- including its negative view of Herbalife, its thesis that Herbalife was operating as an illicit pyramid scheme, its short position in Herbalife stock, and the timing of its disclosure of that information -- constituted material nonpublic information. As a Pershing employee, the Analyst knew that such information was nonpublic and highly confidential.

E. <u>THE ANALYST'S RELATIONSHIP WITH SZYMIK</u>

15. In 2012, the Analyst and Szymik were very close friends who had grown up together in Poland. From 2008 to April 2013, they shared an apartment as roommates in New York, New York. The Analyst and Szymik had a relationship of mutual trust or confidence in which they shared both personal and professional confidences.

16. In 2012, Szymik knew that the Analyst was a Pershing research analyst and that his work there was highly confidential.

17. Prior to December 2012, the Analyst expressly cautioned Szymik, and Szymik understood, that all of the Analyst's work at Pershing was highly confidential; that Szymik should not disclose anything regarding Pershing that he might hear or learn from the Analyst to anybody else; and that Szymik should not trade securities using any such information. Prior to December 2012, Szymik explicitly promised the Analyst that he would neither trade on any information he learned from the Analyst concerning Pershing nor disclose such information to anyone else.

18. Prior to December 19, 2012, in violation of Pershing's confidentiality policy, the Analyst disclosed material nonpublic information about his work regarding Herbalife to Szymik. The Analyst told Szymik, at the least, that he was researching Herbalife for Pershing and that Pershing had a negative view of Herbalife. The Analyst also told Szymik that Pershing would present its thesis concerning Herbalife at the Pershing Presentation, and he informed Szymik of the date of the presentation. As described in the preceding paragraph, Szymik had agreed with the Analyst to maintain the confidentiality of such information. Furthermore, given Szymik's and the Analyst's history, pattern, and practice of sharing confidences, Szymik knew or reasonably should have known that the Analyst expected Szymik to maintain the confidentiality of such information.

F. <u>SZYMIK TIPPED PEIXOTO</u>

19. In 2012, Szymik and Peixoto were close friends who lived within a block of each

other in New York, New York and spent time socializing together nearly every weekend.

20. Peixoto knew that Szymik and the Analyst were roommates and very close friends, having known each other since childhood. Peixoto also knew that the Analyst worked at Pershing as a research analyst, and Peixoto knew or had reason to know that the Analyst's work at Pershing was highly confidential.

21. In a series of communications prior to December 19, 2012, Szymik breached his duty of trust or confidence to the Analyst by telling Peixoto, at the least, that the Analyst was researching Herbalife for Pershing; that Pershing had a negative view of Herbalife; that Pershing would publicly disclose its Herbalife thesis; and the date that disclosure would occur. At the time of those communications, both Szymik and Peixoto either knew or recklessly disregarded that the information was material and non-public.

22. When Szymik gave Peixoto the confidential information concerning the Pershing Presentation described in paragraph 21 above, Szymik knew or recklessly disregarded both that he was violating his duty of trust or confidence to the Analyst and that Peixoto intended to trade Herbalife securities based on that information. Szymik received a personal benefit by gifting confidential information to his friend, Peixoto.

23. When Peixoto received the confidential information from Szymik described in paragraph 21 above, Peixoto knew or had reason to know that Szymik provided the information to him improperly, in breach of a duty of trust or confidence.

G. PEIXOTO TRADED HERBALIFE OPTIONS

24. On the basis of the confidential information that Szymik had provided to him, Peixoto purchased Herbalife put options in advance of the Pershing Presentation. On December 19, 2012, from approximately 12:00 p.m. to 1:23 p.m. Peixoto purchased eight out-of-the-money Herbalife put options (the "Herbalife Options"). Peixoto previously had never traded options or Herbalife securities, and he sold several other securities to fund his purchase of the Herbalife Options. Szymik did not trade in Herbalife securities.

25. At 1:58 pm EST on December 19, 2012, after Peixoto had purchased the Herbalife Options, CNBC reported that Pershing had acquired a significant short position in Herbalife stock and that Pershing would present its thesis—that Herbalife wasoperating an illegal pyramid scheme—at a conference the next day (the "CNBC Report"). At 2:04 p.m. on December 19, the New York Stock Exchange temporarily halted Herbalife stock trading due to its high volatility in the wake of the CNBC Report.

26. At the December 20, 2012 Pershing Presentation—a three-hour, 334-slide presentation entitled "Who wants to be a Millionaire?"—Ackman publicly accused Herbalife of operating an illegal pyramid scheme and disclosed that Pershing held a $1 billion short position in Herbalife stock.

27. Following the CNBC Report, the price of Herbalife stock decreased approximately 12%, from $42.50 per share at the close on December 18, 2012, to $37.34

per share at the close on December 19, 2012.

28. After the CNBC Report and the Pershing Presentation, Herbalife's stock price declined by approximately 39%, from $42.50 per share at the close on December 18, 2012, to a low of $26.06 per share at the close on December 24, 2012.

29. As of the market close on Friday, December 21, 2012, the market value of Peixoto's Herbalife Options had increased by approximately $339,421, and he ultimately obtained $47,100 in actual profits from his illicit trading in Herbalife Options. Peixoto requested that his brokerage firms permit a number of his profitable Herbalife Options to expire without exercising them. However, one of Peixoto's securities brokers refused his request, resulting in the exercise of certain of the Herbalife Options and his obtaining $47,100 in illicit trading profits.

H. VIOLATIONS

30. As a result of the conduct described above, Peixoto violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities.

In view of the allegations made by the Division of Enforcement, the Commission deems it appropriate that cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations; and

B. Whether, pursuant to Section 21C of the Exchange Act, Respondent should be ordered to cease and desist from committing or causing violations of and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, whether Respondent should be ordered to pay a civil penalty pursuant to Section 21B(a) of the Exchange Act, and whether Respondent should be ordered to pay disgorgement pursuant to Sections 21B(e) and 21C(e) of the Exchange Act.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220. . . .

D. Parallel Proceedings

The following D.C. Circuit decision is a leading case on whether subjects of overlapping civil and criminal investigations have any way to complain about being attacked by the government on two fronts at once. See how the D.C. Circuit answers this question.

SEC v. DRESSER INDUSTRIES, INC., 628 F.2d 1368 (D.C. Cir. 1980) (en banc)

J. SKELLY WRIGHT, Chief Judge:

Dresser Industries, Inc. (Dresser) appeals from a decision of the District Court requiring obedience to a subpoena duces tecum issued by the Securities and Exchange Commission (SEC) on April 21, 1978, and denying Dresser's motion to quash the subpoena. The subpoena was issued in connection with an SEC investigation into Dresser's use of corporate funds to make what are euphemistically called "questionable foreign payments," and into the adequacy of Dresser's disclosures of such payments under the securities laws.

The principal issue facing this en banc court is whether Dresser is entitled to special protection against this SEC subpoena because of a parallel investigation into the same questionable foreign payments now being conducted by a federal grand jury under the guidance of the United States Department of Justice (Justice). Dresser argues principally that the SEC subpoena abuses the civil discovery process of the SEC for the purpose of criminal discovery and infringes the role of the grand jury in independently investigating allegations of criminal wrongdoing. . . .

Illegal and questionable corporate payments surfaced as a major public problem in late 1973, when several major scandals implicated prominent American corporations in improper use of corporate funds to influence government officials in the United States and foreign countries. The exposure of these activities disrupted public faith in the integrity of our political system and eroded international trust in the legitimacy of American corporate operations abroad. SEC investigation revealed that many corporate officials were falsifying financial records to shield questionable foreign and domestic payments from exposure to the public and even, in many cases, to corporate directors and accountants. Since the completeness and accuracy of corporate financial reporting is the cornerstone of federal regulation of the securities markets, such falsification became a matter of grave concern to the SEC.

Beginning in the spring of 1974 the SEC brought a series of injunctive actions against certain American corporations. It obtained consent decrees prohibiting future violations of the securities laws and establishing internal corporate procedures for investigation, disclosure, and prevention of illegal corporate payments. However, the problem of questionable foreign payments proved so widespread that the SEC devised a "Voluntary Disclosure Program" to encourage corporations to conduct investigations of their past conduct and make appropriate disclosures without direct SEC coercion. Participation in the Voluntary Disclosure Program would not insulate a corporation from an SEC enforcement action, but the Commission would be less likely to exercise its discretion to initiate enforcement actions against participants. The most important elements of the Voluntary Disclosure Program were (1) an independent committee of the corporation would conduct a thorough investigation into questionable foreign and domestic payments made by the corporation; (2) the committee would disclose the results of this investigation to the board of directors in full; (3) the corporation would disclose the substance of the report to the public and the SEC on Form 8-K; and (4) the corporation would issue a policy statement prohibiting future questionable and illegal payments and maintenance of false or incomplete records in connection with them. Except in "egregious cases" the SEC would not require that public disclosures include specific names, dates, and places. Rather, the disclosures might be "generic" in form. Thus companies participating in the Voluntary Disclosure Program would ordinarily be spared the consequences to their employees, property, and business that might result from public disclosure of specific instances of foreign bribery or kickbacks. However, companies participating in the Voluntary Disclosure Program had to agree to grant SEC requests for access to the final report and to the unexpurgated underlying documentations.

On January 27, 1976 an attorney and other representatives of Dresser met with members of the SEC staff to discuss a proposed filing. At the meeting Dresser agreed to conduct an internal inquiry into questionable foreign payments, in accordance with the terms of the Voluntary Disclosure Program. The next day Dresser submitted a Form 8-K describing, in generic terms, one questionable foreign payment. On November 11, 1976 Dresser filed a second Form 8-K reporting the results of the internal investigation. On February 10, 1977 the company supplemented this report with a third Form 8-K concerning a questionable payment not reported in the earlier reports. The reports concerned Dresser's foreign activities after November 1, 1973. All disclosures were in generic, not specific, terms.

As part of its general monitoring program, the SEC staff requested access to the documents underlying Dresser's report. On July 15, 1977 Dresser refused to grant such access. The company argued that allowing the staff to make notes or copies might subject its documents to public disclosure through the Freedom of Information Act. Dresser stated that such disclosure could endanger certain of its employees working abroad. During the ensuing discussions with the staff Dresser attempted to impose conditions of confidentiality upon any SEC examination of its documents, but the staff did not agree. Instead, it issued a recommendation to the Commission for a formal order of investigation in the Dresser case. This recommendation was predicated on the staff's conclusions that Dresser:

> 1. may have used corporate funds for non-corporate purposes;
>
> 2. may have made false and misleading statements concerning the existence of and circumstances surrounding material obligations of Dresser to certain foreign governments and to other entities; and

> 3. may have made false entries and caused false entries to be made upon the books and records of Dresser, and its affiliates and subsidiaries with respect to, among other things, payments to foreign government officials.

Moreover, the staff reported that Dresser's proxy soliciting materials, reports, and statements may have been misleading with respect to the potential risks involved in its conduct of business through questionable foreign payments, and may have included false statements in connection with such payments. Dresser vigorously opposed issuance of an order of investigation.

Meanwhile, the Department of Justice had established a task force on transnational payments to investigate possible criminal violations arising from illegal foreign payments. Two SEC attorneys participated in the task force. In the summer of 1977 the Justice task force requested access to SEC files on the approximately 400 companies, including Dresser, that had participated in the Voluntary Disclosure Program. Pursuant to Commission authorization the SEC staff transmitted all such files to the Justice task force in August 1977. After its preliminary investigation of the Form 8-K's submitted by Dresser under the Voluntary Disclosure Program, Justice presented Dresser's case to a grand jury in the District of Columbia on January 25, 1978.

Before any summons or subpoena had issued in either the SEC or the grand jury investigation, Dresser filed suit in the Southern District of Texas against the SEC and Justice to enjoin any further investigation of it by either agency. While Dresser's suit was pending in the Southern District of Texas, the District of Columbia grand jury subpoenaed Dresser's documents on April 21, 1978. At roughly the same time the SEC issued a formal order of private investigation, authorizing the staff to subpoena the documents and to obtain other relevant evidence. Pursuant to that order the staff issued a subpoena duces tecum, returnable on May 4, 1978. This subpoena covered substantially the same documents and materials subpoenaed by the grand jury, and more. Dresser did not respond to the subpoena. . . .

Then, on June 30, 1978, the District Court (Flannery, J.) issued a memorandum opinion and order rejecting all of Dresser's objections to the SEC subpoena and requiring Dresser to comply with the subpoena within ten days after notice from the SEC. Rehearing was denied on July 15. This appeal followed. . . .

The civil and regulatory laws of the United States frequently overlap with the criminal laws, creating the possibility of parallel civil and criminal proceedings, either successive or simultaneous. In the absence of substantial prejudice to the rights of the parties involved, such parallel proceedings are unobjectionable under our jurisprudence. . . .

The Constitution, therefore, does not ordinarily require a stay of civil proceedings pending the outcome of criminal proceedings. Nevertheless, a court may decide in its discretion to stay civil proceedings, postpone civil discovery, or impose protective orders and conditions "when the interests of justice seem ( ) to require such action, sometimes at the request of the prosecution, … sometimes at the request of the defense(.)" *United States v. Kordel, supra,* 397 U.S. at 12 n.27 (citations omitted). The court must make such determinations in the light of the particular circumstances of the case.

Other than where there is specific evidence of agency bad faith or malicious governmental tactics, the strongest case for deferring civil proceedings until after completion of criminal proceedings is where a party under indictment for a serious offense is required to defend a civil or administrative action involving the same matter. The noncriminal proceeding, if not deferred, might undermine the party's Fifth Amendment privilege against self-incrimination, expand rights of criminal discovery beyond the limits of Federal Rule of Criminal Procedure 16(b), expose the basis of the defense to the prosecution in advance of criminal trial, or otherwise prejudice the case. If delay of the noncriminal proceeding would not seriously injure the public interest, a court may be justified in deferring it. . . . In some such cases, however, the courts may adequately protect the government and the private party by merely deferring civil discovery or entering an appropriate protective order. *Gordon v. FDIC,* 427 F.2d 578, 580–81 (D.C. Cir. 1970). The case at bar is a far weaker one for staying the administrative investigation. No indictment has been returned; no Fifth Amendment privilege is threatened; Rule 16(b) has not come into effect; and the SEC subpoena does not require Dresser to reveal the basis for its defense.

The case at bar concerns enforcement of the securities laws of the United States, especially the Securities Act of 1933 ('33 Act), 48 Stat. 74, 15 U.S.C. § 77a et seq. (1976), and the Securities Exchange Act of 1934 ('34 Act), 48 Stat. 881, 15 U.S.C. § 78a et seq. (1976). These statutes explicitly empower the SEC to investigate possible infractions of the securities laws with a view to both civil and criminal enforcement, and to transmit the fruits of its investigations to Justice in the event of potential criminal proceedings. . . .

Under the same subsection of the '34 Act the SEC may "transmit such evidence as may be available concerning such acts or practices . . . to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter"

Effective enforcement of the securities laws requires that the SEC and Justice be able to investigate possible violations simultaneously. Dissemination of false or misleading information by companies to members of the investing public may distort the efficient workings of the securities markets and injure investors who rely on the accuracy and completeness of the company's public disclosures. If the SEC suspects that a company has violated the securities laws, it must be able to respond quickly: it must be able to obtain relevant information concerning the alleged violation and to seek prompt judicial redress if necessary. Similarly, Justice must act quickly if it suspects that the laws have been broken. Grand jury investigations take time, as do criminal prosecutions. If Justice moves too slowly the statute of limitations may run, witnesses may die or move away, memories may fade, or enforcement resources may be diverted. The SEC cannot always wait for Justice to complete the criminal proceedings if it is to obtain the necessary prompt civil remedy; neither can Justice always await the conclusion of the civil proceeding without endangering its criminal case. Thus we should not block parallel investigations by these agencies in the absence of "special circumstances" in which the nature of the proceedings demonstrably prejudices substantial rights of the investigated party or of the government. . . .

The investigation of Dresser based as it was on the staff's conclusion that Dresser may have engaged in conduct seriously contravening the securities laws falls squarely within the Commission's explicit investigatory authority. . . .

Since the validity of summonses or subpoenas "depend(s) ultimately on whether they were among those authorized by Congress," *United States v. LaSalle Nat'l Bank*, *supra*, 437 U.S. at 307, we conclude that this subpoena is enforceable under the rule of that case.

Fulfillment of the SEC's civil enforcement responsibilities requires this conclusion. Unlike the IRS, which can postpone collection of taxes for the duration of parallel criminal proceedings without seriously injuring the public, the SEC must often act quickly, lest the false or incomplete statements of corporations mislead investors and infect the markets. Thus the Commission must be able to investigate possible securities infractions and undertake civil enforcement actions even after Justice has begun a criminal investigation. For the SEC to stay its hand might well defeat its purpose. . . .

No one would suggest that the grand jurors, unassisted by accountants, lawyers, or others schooled in the arcana of corporate financial accounting, could sift through the masses of Dresser's corporate documents and arrive at a coherent picture of the company's foreign payments and disclosure practices. In this area, as in many areas of great complexity, the grand jurors are assisted guided and influenced, in fact not only by the United States Attorneys assigned to the investigation, but also by experts provided by the federal regulatory agencies with experience in the particular subject areas. This expert assistance is permitted under Rule 6(e), and it promotes the efficiency and rationality of the criminal investigative process. In this case two SEC agents have been assigned to Justice's task force on transnational payments to assist in the investigation of companies possibly involved in illegal foreign payments. There can be little doubt that the grand jury's deliberations will be influenced by the work of these SEC agents. Any additional influence that might arise as a result of enforcement of the SEC subpoena and transmittal of documents to Justice thereafter is likely to be inconsequential. . . .

We conclude that the danger that enforcement of this subpoena might infringe the role of the grand jury is too speculative and remote at this point to justify so extreme an action as denying enforcement of this subpoena.

In essence, Dresser has launched this attack on the parallel SEC and Justice proceedings in order to obtain protection against the bare SEC proceeding, which it fears will result in public disclosure of sensitive corporate documents. The prejudice Dresser claims it will suffer from the parallel nature of the proceedings is speculative and undefined if indeed Dresser would suffer any prejudice from it at all. Any entitlement to confidential treatment of its documents must arise under the laws pertaining to the SEC; the fortuity of a parallel grand jury investigation cannot expand Dresser's rights in this SEC enforcement action. Thus Dresser's invocation of LaSalle can avail the company nothing.

Congress understands and approves of the "close working relationship" between the agencies in their investigative capacities. Since such a "close working relationship" will govern the activities of the agencies in enforcing the laws against questionable foreign payments under the new statute, it would be impractical for us to attempt to screen the agencies from each other when they are investigating the same sort of offense under the former statutes.

Congress manifestly did not intend that the SEC be forbidden to share information with Justice at this stage of the investigation. Under the panel majority's theory of the case the SEC would be foreclosed from sharing the fruits of its investigation with Justice as soon as Justice begins its own investigation through a grand jury. Only by waiting until the close of the SEC proceeding before initiating its own grand jury investigation could Justice obtain access to the evidence procured by the SEC. In view of Congress' concern that the agencies share information "at the earliest stage of any investigation in order to insure that the evidence needed for a criminal prosecution does not become stale," S. Rep. No. 114, *supra*, at 12, and that the agencies avoid "a costly duplication of effort," H.R. Rep. No. 640, *supra*, at 9, it would be unreasonable to prevent a sharing of information at this point in the investigation. . . .

In the present case the SEC plainly has a legitimate noncriminal purpose for its investigation of Dresser. It follows that the investigation is in good faith, in the absence of complicating factors. There is, therefore, no reason to impose a protective order such as that imposed by the panel majority.

Finally, we note that the panel's modification would serve no compelling purpose, and might interfere with enforcement of the securities laws by the SEC and Justice. As the Second Circuit has said, the procedure permitting the SEC to communicate with Justice during the preliminary stages of an investigation has "significant advantages.":

> Allowing early participation in the case by the United States Attorney minimizes statute of limitations problems. The more time a United States Attorney has, the easier it is for him to become familiar with the complex facts of a securities fraud case, to prepare the case, and to present it to a grand jury before expiration of the applicable statute of limitations. Earlier initiation of criminal proceedings moreover is consistent with a defendant's right to a speedy trial. . . .

The panel's modification would "interfere with this commendable example of inter-agency cooperation," *id.*, to the detriment of securities law enforcement and in contravention of the will of Congress. On the other side of the balance, the panel's concern for preserving the limitations on criminal discovery is largely irrelevant at this stage of the proceedings, as Dresser agrees. Thus this would be an inappropriate situation to impose a "prophylactic" rule against cooperation between the agencies. We believe the courts can prevent any injustice that may arise in the particular circumstances of parallel investigations in the future.

The next, more recent case, while a single district court decision, provides an example of a court finding the government to have gone far enough to have crossed the outer limit described in *Dresser Industries*.

UNITED STATES v. SCRUSHY, 366 F.Supp.2d 1134 (N.D. Ala. 2005)

BOWDRE, J., District Court Judge:

[The defendant Richard Scrushy was the former CEO of HealthSouth, a large public company based in Birmingham, Alabama which the government investigated for accounting fraud during the same era as the Enron prosecutions.]

This matter comes before the court on the Defendant's "Motion to Suppress Defendant's S.E.C. Deposition and for Exclusion of Tape–Recorded Conversations" filed on April 7, 2005. The Government responded on April 8, 2005. The court conducted a hearing on this matter on April 11, 2005. For the reasons discussed below, the motion to suppress the S.E.C. deposition is GRANTED. As a consequence of the suppression of the S.E.C. testimony and the lack of any other evidence, Counts 30, 31, and 32, the perjury counts based on that testimony, will be dismissed with prejudice at the appropriate time. . . .

The Defendant filed this motion as a direct result of the trial testimony of Neil Seiden, Senior Accountant with the S.E.C. Department of Enforcement, Atlanta, given in open court on April 5, 2005. During Mr. Seiden's testimony, the defense and the court learned for the first time that the S.E.C. had cooperated with the United States Attorney's office in the taking of Mr. Scrushy's testimony in Birmingham, Alabama, on March 14, 2003. In fact, Government counsel had affirmatively represented to the court on April 5, 2005, the day of Mr. Seiden's testimony, that Mr. Scrushy's deposition had been moved from Atlanta to Birmingham at the request of Mr. Scrushy's attorneys and not because of any request from the U.S. Attorney's office. These representations proved false. The court does not believe, however, that Government counsel deliberately misrepresented the facts to the court.

Mr. Seiden testified on April 5, 2005, that Mr. Scrushy's deposition had been scheduled to take place on Friday March 14, 2003, in Atlanta, Georgia and until Wednesday, March 12–two days before the scheduled deposition-his office received a call from the U.S. Attorney's office that lasted fifteen to twenty minutes. He further testified that, as a result of this call, the location of the deposition was changed from Atlanta to Birmingham. Although Mr. Seiden testified that Mr. Scrushy's attorneys had previously requested the change, he also testified that "[t]he U.S. Attorney's office asked us—had a preference that we take Mr. Scrushy's testimony in Birmingham....” This answer that revealed the U.S. Attorney's office, in fact, had input into the location of the Defendant's deposition—as defense counsel had suspected but Government counsel had explicitly denied—raised legal questions concerning the admissibility of the Defendant's S.E.C. testimony. The court recessed early and sought the guidance of legal briefs from both sides, which the court has received and reviewed, on the admissibility of that deposition.

On April 11, 2005, the court conducted a hearing on the motion where additional testimony was elicited from Mr. Seiden. Specifically, Mr. Seiden testified that on March 12, 2003, around 3:30 p.m., a conference call was held between the U.S. Attorney's office in Birmingham and the S.E.C. office in Atlanta. On the call were Mr. Seiden, Ron Crawford, and Robert Lough for the S.E.C.; George Martin and Pat Meadows from the U.S. Attorney's office; and Agent Gerry Kelly of the F.B.I..

During that call, Mr. Martin revealed to the S.E.C. investigators that Weston Smith and Bill Owens had disclosed to the U.S. Attorney's office that a massive fraud had been occurring at HealthSouth since its inception that exceeded one billion dollars and that Mr. Scrushy allegedly knew of the fraud. Mr. Seiden was then asked to be present at the subsequent interviews of Mr. Smith and Mr. Owens scheduled for that Friday. Mr. Seiden recounted that conversation saying, “And they said, well, we really want Neil *to participate* on Friday.... [W]e would really like Neil to sit in and *participate* in the interviews, because we need his accounting help on this.” Mr. Seiden was requested to move the deposition of Mr. Scrushy to Birmingham so that he (Seiden) would be available to participate in the interviews. Mr. Martin or Mr. Meadows suggested that Mr. Scrushy might be more comfortable on his own turf, and more inclined to testify truthfully. Mr. Martin then stated that “if [Mr. Scrushy] lies, then he will be lying in our district.” Prior to learning about the massive accounting fraud at HealthSouth in the March 12th phone conference and the request by the U.S. Attorney's office to move the deposition, the S.E.C.'s preference was to conduct the testimony in Atlanta, and Mr. Seiden, up to that point, knew of no reason to move the deposition to Birmingham.

The assistant U.S. attorneys requested Mr. Seiden specifically NOT to ask Mr. Scrushy about certain areas, including cash; property, plant and equipment (“PP&E”); and accounts payable. Mr. Seiden asked whether he could inquire about income statements or earnings per share and Mr. Martin told him that he could not do so.

Mr. Seiden received directions from his supervisor that he was to honor the United States Attorney's request, and he did so. As instructed by the U.S. Attorney's office, Mr. Seiden waited for Mr. Scrushy's attorneys to raise again their request that his deposition be moved to Birmingham because the U.S. Attorney's office did not want to let “them” know that the government knew about the fraud. According to Mr. Seiden, “them” referred to Mr. Scrushy and his attorneys. Mr. Seiden testified upon questioning by the court that, prior to the March 12, 2003, conversation with the U.S. Attorney's office, that he knew of no reason to move the deposition to Birmingham as previously requested by Mr. Scrushy's counsel. He stated that the deposition was moved because Mr. Scrushy's counsel pointed out that the room in Atlanta was too small; the S.E.C. wanted more time to question Mr. Scrushy because of the revelation of fraud from the U.S. Attorney's office; and because of the request from the U.S. Attorney's office.

Prior to Mr. Scrushy's deposition, according to Mr. Seiden, the decision had been made that Mr. Seiden would be available to participate in the interviews of Mr. Smith and Mr. Owens. Regardless of where Mr. Scrushy's deposition was taken, Mr. Seiden testified: "I apparently was out of there one way or the other, I apparently was going to Birmingham on Thursday, one way or the other."

At the deposition on March 14, 2003, Mr. Seiden did not advise Mr. Scrushy or his attorneys of the existence of the criminal investigation into the fraud at HealthSouth, or of Mr. Smith's and Mr. Owens' cooperation with the Department of Justice. Mr. Scrushy was asked a series of questions at his deposition based on information learned in the March 12th phone call. Mr. Seiden testified that, had it not been for the March 12th call from the U.S. Attorney's office, these questions would not have been asked at this deposition.

At the conclusion of Mr. Scrushy's deposition, Mr. Seiden and Mr. Lough went directly to the U.S. Attorney's office. On the next day, Saturday, March 15, 2003, Mr. Seiden participated in the interview of Weston Smith, and on Sunday, March 16, he participated in the interview of Bill Owens.

The Government asserts that the SEC civil investigation and the Department of Justice criminal investigation involved different criminal conduct. However, the testimony of Mr. Seiden elicited by Government counsel reflected a serious overlap in those investigations. Both the criminal investigation and the SEC investigation concerned aspects of accounting fraud at HealthSouth. According to the Formal Order of Investigation, the SEC investigation included "any false statements or omissions in HealthSouth's quarterly reports or press releases relating to any historical revenues or future revenues."

The issue before this court is whether the Government departed from the proper administration of criminal justice in procuring the Defendant's deposition testimony. The court finds that the Government clearly so departed. The civil action and the criminal investigation improperly merged on March 12, 2003, when the U.S. Attorney's office called the S.E.C. office, gave the S.E.C. advice or "preferences" regarding the content of the deposition and its location, and recruited Neil Seiden to participate in the interviews of Bill Owens and Weston Smith in the criminal investigation.

Counsel for both sides agree on some of the basic principles of law that must guide the court in its decision. Federal courts have supervisory authority over the manner in which Federal agents exercise their power. *Rea v. United States*, 350 U.S. 214, 217, 76 S.Ct. 292, 100 L.Ed. 233 (1956); *United States v. Parrott*, 248 F.Supp. 196, 199 (D.D.C.1965). However, a defendant cannot succeed on a theory of a "perjury trap" when the questions relate to a *legitimate, parallel* investigation. *United States v. Waldon*, 363 F.3d 1103, 1112–13 (11th Cir.2004), *cert. denied,* 543 U.S. 867, 125 S.Ct. 208, 160 L.Ed.2d 112 (2004). The question to which neither side could cite any controlling law is what distinguishes a legitimate, parallel investigation from an improper one. The court could find no controlling authority on this critical point. . . .

In the instant case, the Government had both notice and direct input. Mr. Seiden received explicit directions from the U.S. Attorney's office concerning tailoring his examination of Mr. Scrushy. He was told areas to avoid to keep Mr. Scrushy in the dark regarding the criminal investigation, and Mr. Seiden specifically included questions in the examination that he would not have included had the U.S. Attorney's office not contacted the S.E.C. and discussed the criminal investigation. Further, the deposition was moved to Birmingham at the U.S. Attorney's request, thus changing the venue of the subsequent perjury charges from the Northern District of Georgia to the Northern District of Alabama.

The Government's assertion that the civil testimony should not be suppressed because the taking of the civil deposition could not be imputed to law enforcement is disingenuous at best. Mr. Seiden is a member of the enforcement division of the S.E.C. His job is to enforce the laws that regulate securities. He is employed by the United States Government—the same United States Government whose Department of Justice is prosecuting this case. Further, he crossed over to the criminal investigation as a result of the phone conversation on March 12, 2003. The actions by Mr. Seiden in changing the venue of the deposition to accommodate the U.S. Attorney's office, extending the length of the deposition, and asking additional questions that otherwise would not have been asked after learning of the criminal investigation are properly imputed to the Government for purposes of this motion.

Despite the Government's assertions that the S.E.C. civil investigation was separate from and parallel to the Justice Department's criminal investigation, the facts belie that assertion. To be parallel, by definition, the separate investigations should be like the side-by-side train tracks that never intersect. By contrast, as of March 12, 2003, at 3:30 p.m., the S.E.C. civil investigation merged with the Justice Department criminal investigation. One of the reasons for that conference call was to recruit Mr. Seiden to participate in the criminal investigation. He was asked in that call to be present at and participate in the interviews of Mr. Smith and Mr. Owens. He, in fact, participated in those interviews that were originally scheduled for Friday, March 14—the same day as Mr. Scrushy's deposition—and that actually occurred in the two days following Mr. Scrushy's deposition. The need to have Mr. Seiden available to the Government was one of the reasons why Mr. Martin or Mr. Meadows stated the Government's “preference” that Mr. Scrushy's testimony be taken in Birmingham. . . .

When a defendant *knows* that he has been charged with a crime, or that a criminal investigation has targeted him, he can take actions to prevent the providing of information in an administrative or civil proceeding that could later be used against him in the criminal case. When a defendant does not know about the criminal investigation, the danger of prejudice increases. Failing to advise Mr. Scrushy or his attorneys about the criminal investigation of which he was a target, and that the deposition had been moved to accommodate the need of the U.S. Attorney's office to bring into the criminal investigation one of the very S.E.C. investigators who was questioning Mr. Scrushy, *and* the change of the deposition's location for venue purposes cannot be said to be in keeping with the proper administration of justice. Our justice system cannot function properly in the face of such cloak and dagger activities by those charged with upholding the integrity of the justice system. . . .

Because the Government manipulated the simultaneous investigations for its own purposes, including the transfer of Mr. Scrushy's deposition into this district for venue purposes, the court finds that the utilization of Mr. Scrushy's deposition in this case departs from the proper administration of justice. Therefore, the S.E.C. testimony must be excluded. The Government represented on the Record to the court that it has no evidence of perjury apart from Mr. Scrushy's S.E.C. deposition. As a result, the perjury counts, Counts 30, 31, and 32, of the Superseding Indictment based on that testimony will be dismissed at the appropriate time. . . .

E. SEC Settlements

The overwhelming majority of SEC enforcement actions conclude in settlements of the sort described in the following case. Should judges have any substantive role in reviewing such settlements? One influential district judge thought so, but was then reversed as you can see here.

SEC v. CITIGROUP GLOBAL MARKETS INC., 827 F. Supp. 2d 328 (S.D.N.Y. 2011)

JED S. RAKOFF, U.S.D.J.

On October 19, 2011, the U.S. Securities and Exchange Commission (the "S.E.C") filed this lawsuit, accusing defendant Citigroup Global Markets Inc. ("Citigroup") of a substantial securities fraud. According to the S.E.C.'s Complaint, after Citigroup realized in early 2007 that the market for mortgage-backed securities was beginning to weaken, Citigroup created a billion-dollar Fund (known as "Class v Funding III") that allowed it to dump some dubious assets on misinformed investors. This was accomplished by Citigroup's misrepresenting that the Fund's assets were attractive investments rigorously selected by an independent investment adviser, whereas in fact Citigroup had arranged to include in the portfolio a substantial percentage of negatively projected assets and had then taken a short position in those very assets it had helped select. Having structured the Fund as a vehicle for unloading these dubious assets on unwitting investors, Citigroup realized net profits of around $160 million, whereas the investors, as the S.E.C. later revealed, lost more than $700 million.

In a parallel Complaint filed the same day against Citigroup employee Brian Stoker, *see U.S. Securities and Exchange Commission v. Brian H. Stoker*, 11 Civ. 7388 (JSR), the

S.E.C. alleged that Citigroup knew in advance that it would be difficult to sell the Fund if Citigroup disclosed its intention to use it as a vehicle to unload its hand-picked set of negatively projected assets. Specifically, paragraph 25 of the Stoker Complaint alleges (in language some of which is notably missing from the Citigroup Complaint) that:

> Citigroup knew it would be difficult to place the liabilities of [the Fund] if it disclosed to investors its intention to use the vehicle to short a hand-picked set of [poorly rated assets] . . . . By contrast, Citigroup knew that representing to investors that an experienced third-party investment adviser had selected the portfolio would facilitate the placement of the [Fund's] liabilities, (emphasis supplied)

Although this would appear to be tantamount to an allegation of knowing and fraudulent intent ("scienter," in the lingo of securities law), the S.E.C, for reasons of its own, chose to charge Citigroup only with negligence, in violation of Sections 17(a)(2) and (3) of the Securities Act, 15 U.S.C. § 77q(a)(2) and (3).

Simultaneously with the filing of its Complaint against Citigroup, the S.E.C. presented to the Court for its signature a "Final Judgment As To Defendant Citigroup Global Markets Inc." (the "Consent Judgment"), together with a Consent of Defendant Citigroup Global Markets Inc. (the "Consent") that recited that Citigroup consented to the entry of the Consent Judgment "[w]ithout admitting or denying the allegations of the complaint . . . ." The Consent Judgment (I) "permanently restrained and enjoined" Citigroup and its agents, employees, etc., from future violations of Sections 17(a)(2) and (3) of the Securities Act, (II) required Citigroup to disgorge to the S.E.C. Citigroup's $160 million in profits, plus $30 million in interest thereon, and to pay to the S.E.C. a civil penalty in the amount of $95 million, and (III) required Citigroup to undertake for a period of three years, subject to enforcement by the Court, certain internal measures designed to prevent recurrences of the securities fraud here perpetrated.

Upon receipt of these submissions, the Court, by Order dated October 27, 2011, put some questions to the parties concerning the proposed Consent Judgment, to which the parties responded both in writing, and orally. Since then, the Court has spent long hours trying to determine whether, in view of the substantial deference due the S.E.C. in matters of this kind, the Court can somehow approve this problematic Consent Judgment. In the end, the Court concludes that it cannot approve it, because the Court has not been provided with any proven or admitted facts upon which to exercise even a modest degree of independent judgment.

The Court turns first to the standard of review. In its original Memorandum in support of the proposed Consent Judgment, filed before the case had been assigned to any judge, the S.E.C. expressly endorsed the standard of review set forth by this Court in its Bank of America decisions, i.e., "whether the proposed Consent Judgment ... is fair, reasonable, adequate, and in the public interest." Memorandum By Plaintiff Securities and Exchange Commission in Support of Proposed Settlement at 5 (quoting with approval *SEC v. Bank of America Corp.*, 653 F. Supp. 2d 507, 508 (S.D.N.Y. 2009)

("Bank of America I")); *see also SEC v. Bank of America Corp.*, 2010 WL 624581, at *6 (S.D.N.Y. Feb. 22, 2010) ("Bank of America II"). This was also the S.E.C.'s stated position in another, intervening proceeding before this Court, *SEC v. Vitesse Semiconductor Corp.*, 771 F. Supp. 2d 304 (S.D.N.Y. 2010). In its most recent filing in this case, however, the S.E.C. partly reverses its previous position and asserts that, while the Consent Judgment must still be shown to be fair, adequate, and reasonable, "the public interest . . . is not part of [the] applicable standard of judicial review." This is erroneous. A large part of what the S.E.C. requests, in this and most other such consent judgments, is injunctive relief, both broadly, in the request for an injunction forbidding future violations, and more narrowly, in the request that the Court enforce future prophylactic measures (here, for a three-year period). The Supreme Court has repeatedly made clear, however, that a court cannot grant the extraordinary remedy of injunctive relief without considering the public interest. *See, e.g.*, *eBay, Inc. v. MercExchange*, 547 U.S. 388, 391 (2006) ("According to well-established principles of equity, a plaintiff seeking a permanent injunction . . . must demonstrate . . . that the public interest would not be disserved by a permanent injunction."). Indeed, the Court has held that "In exercising their discretion, courts should pay particular regard for the public consequences in employing the extraordinary remedy of injunction.'" *Winter v. Natural Resources Defense Council, Inc.*, 555 U.S. 7, 24 (2008) (quoting *Weinberger v. Romero-Barcelo*, 456 U.S. 305, 312 (1982)). Similarly, the Second Circuit has repeatedly stated, most recently in *Salinger v. Colting*, 607 F.3d 68, 80 (2d Cir. 2010), that a court "must ensure that the public interests would not be disserved by the issuance" of an injunction. *Id.* at 80.

As a fall-back, the S.E.C. suggests that, if the public interest must be taken into account, the S.E.C. is the sole determiner of what is in the public interest in regard to Consent Judgments settling S.E.C. cases. *See* SEC Mem. at 4 n.l (citing *SEC v. Randolph*, 736 F.2d 525, 529 (9th Cir. 1984). That, again, is not the law. Although in its somewhat delphic decision in *Randolph* the Ninth Circuit found that, on the facts of that case, there was no difference between the requirement of reasonableness and the requirement of being in the public interest, it was emphatic in upholding "the appropriateness of a requirement that the decree be in the public interest." *Id.* at 529. More pertinently, the D.C. Circuit, in *United States v. Trucking Employers, Inc.*, 561 F.2d 313 (D.C. Cir. 1977), reaffirmed that "prior to approving a consent decree a court must satisfy itself of the settlement's 'overall fairness to beneficiaries and consistency with the public interest.'" *Id.* at 319 (quoting *United States v. Allegheny Ludlum Industries*, 517 F.2d 826, 850 (5th Cir. 1975) (emphasis supplied). As these and similar authorities make plain, a court, while giving substantial deference to the views of an administrative body vested with authority over a particular area, must still exercise a modicum of independent judgment in determining whether the requested deployment of its injunctive powers will serve, or disserve, the public interest. Anything less would not only violate the constitutional doctrine of separation of powers but would undermine the independence that is the indispensable attribute of the federal judiciary.

As a practical matter, moreover, and as *Randolph* implies, the requirement that a consent judgment be in the public interest is not meaningfully severable from the requirements, still acknowledged by the S.E.C., that the consent judgment be fair, reasonable, and adequate; for all these requirements inform each other. For example, before the Court determines whether the proposed Consent Judgment is adequate, it must answer a preliminary question: adequate for what purpose? The answer, at least in part, is that the settlement must be adequate to ensure that the public interest is protected. *See Randolph*, 73 6 F.2d at 529 ("the SEC ought to always be required to serve the public interest"). The same analysis applies to the determination of the fairness of the settlement. Before the Court determines whether the settlement is fair, it must ask a preliminary question: fair to whom? As the holding of *Trucking Employers* quoted above makes plain, the answer is fair to the parties and to the public. . . .

Here, the S.E.C.'s long-standing policy—hallowed by history, but not by reason—of allowing defendants to enter into Consent Judgments without admitting or denying the underlying allegations, deprives the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact. There is little real doubt that Citigroup contests the factual allegations of the Complaint. In colloquy with the Court, counsel for Citigroup expressly reconfirmed that his client was not admitting the allegations of the Complaint. He also noted, correctly, that he was free—notwithstanding the S.E.C.'s gag order precluding Citigroup from contesting the S.E.C.'s allegations in the media—to fully contest the facts in any parallel litigation; and he strongly hinted that Citigroup would do just that.

The S.E.C., by contrast, took the position that, because Citigroup did not expressly deny the allegations, the Court, and the public, somehow knew the truth of the allegations. This is wrong as a matter of law and unpersuasive as a matter of fact. As a matter of law, an allegation that is neither admitted nor denied is simply that, an allegation. It has no evidentiary value and no collateral estoppel effect. It is precisely for this reason that the Second Circuit held long ago, in *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887 (2d Cir. 1976), that "a consent judgment between a federal agency and a private corporation which is not the result of an actual adjudication of any of the issues . . . cannot be used as evidence in subsequent litigation." It follows that the allegations of the complaint that gives rise to the consent judgment are not evidence of anything either. Indeed the *Lipsky* court went so far as to hold that "neither [an S.E.C.] complaint nor reference to [such] a complaint which results in a consent judgment may properly be cited in the pleadings" in a parallel private action and must instead be stricken.

As for common experience, a consent judgment that does not involve any admissions and that results in only very modest penalties is just as frequently viewed, particularly in the business community, as a cost of doing business imposed by having to maintain a working relationship with a regulatory agency, rather than as any indication of where the real truth lies. This, indeed, is Citigroup's position in this very case. . . .

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. By the S.E.C.'s own account, Citigroup is a recidivist and yet, in terms of deterrence, the $95 million civil penalty that the Consent Judgment proposes is pocket change to any entity as large as Citigroup. While the S.E.C. claims that it is devoted, not just to the protection of investors but also to helping them recover their losses, the proposed Consent Judgment, in the form submitted to the Court, does not commit the S.E.C. to returning any of the total of $285 million obtained from Citigroup to the defrauded investors but only suggests that the S.E.C. "may" do so. In any event, this still leaves the defrauded investors substantially short-changed. To be sure, at oral argument, the S.E.C. reaffirmed its long-standing purported support for private civil actions designed to recoup investors' losses. But in actuality, the combination of charging Citigroup only with negligence and then permitting Citigroup to settle without either admitting or denying the allegations deals a double blow to any assistance the defrauded investors might seek to derive from the S.E.C. litigation in attempting to recoup their losses through private litigation, since private investors not only cannot bring securities claims based on negligence, *see, e.g.*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), but also cannot derive any collateral estoppel assistance from Citigroup's non-admission/non-denial of the S.E.C.'s allegations. Nor, as noted, does the public, especially the business public, have any reason to credit those allegations, which remain entirely unproven. . . .

An application of judicial power that does not rest on facts is worse than mindless, it is inherently dangerous. The injunctive power of the judiciary is not a free-roving remedy to be invoked at the whim of a regulatory agency, even with the consent of the regulated. If its deployment does not rest on facts—cold, hard, solid facts, established either by admissions or by trials—it serves no lawful or moral purpose and is simply an engine of oppression.

Finally, in any case like this that touches on the transparency of financial markets whose gyrations have so depressed our economy and debilitated our lives, there is an overriding public interest in knowing the truth. In much of the world, propaganda reigns, and truth is confined to secretive, fearful whispers. Even in our nation, apologists for suppressing or obscuring the truth may always be found. But the S.E.C., of all agencies, has a duty, inherent in its statutory mission, to see that the truth emerges; and if it fails to do so, this Court must not, in the name of deference or convenience, grant judicial enforcement to the agency's contrivances.

Accordingly, the Court refuses to approve the proposed Consent Judgment. Instead, the Court hereby consolidates this case with the Stoker action, adopts the Case Management Order in that action as equally applicable to the instant case, and directs the parties to be ready to try this case on July 16, 2012.

SEC v. CITIGROUP GLOBAL MARKETS, INC., 752 F.3d 285 (2d Cir. 2014)

POOLER, Circuit Judge:

The United States Securities and Exchange Commission ("S.E.C.") in conjunction with Citigroup Global Markets, Inc. ("Citigroup") appeals from the November 28, 2011 order of the United States District Court for the Southern District of New York (Rakoff, *J.*) refusing to approve a consent decree entered into by the parties and instead setting a trial date. . . . We now hold that the district court abused its discretion by applying an incorrect legal standard in assessing the consent decree and setting a date for trial. . . .

Our Court recognizes a "strong federal policy favoring the approval and enforcement of consent decrees." *Wang*, 944 F.2d at 85. "To be sure, when the district judge is presented with a proposed consent judgment, he is not merely a 'rubber stamp.'" *S.E.C. v. Levine*, 881 F.2d 1165, 1181 (2d Cir. 1989). The district court here found it was "required, even after giving substantial deference to the views of the administrative agency, to be satisfied that it is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public interest." *Citigroup I*, 827 F. Supp. 2d at 332. Other district courts in our Circuit view "[t]he role of the Court in reviewing and approving proposed consent judgments in S.E.C. enforcement actions [as] 'restricted to assessing whether the settlement is fair, reasonable and adequate within the limitations Congress has imposed on the S.E.C. to recover investor losses.'" *S.E.C. v. CR Intrinsic Investors, LLC*, 939 F. Supp. 2d 431, 434 (S.D.N.Y. 2013) (quoting *S.E.C. v. Cioffi*, 868 F. Supp. 2d 65, 74 (E.D.N.Y. 2012)); *see also United States v. Peterson*, 859 F. Supp. 2d 477, 478 (E.D.N.Y. 2012) ("A district court has the duty to determine whether a consent decree based on a proposed settlement is 'fair and reasonable.'").

The "fair, reasonable, adequate and in the public interest" standard invoked by the district court finds its origins in a variety of cases. Our Court previously held, in the context of assessing a plan for distributing the proceeds of a proposed disgorgement order, that "once the district court satisfies itself that the distribution of proceeds in a proposed S.E.C. disgorgement plan is fair and reasonable, its review is at an end." *Wang*, 944 F.2d at 85. The Ninth Circuit—in circumstances similar to those presented here, a proposed consent decree aimed at settling an S.E.C. enforcement action—noted that "[u]nless a consent decree is unfair, inadequate, or unreasonable, it ought to be approved." *S.E.C. v. Randolph*, 736 F.2d 525, 529 (9th Cir. 1984).

Today we clarify that the proper standard for reviewing a proposed consent judgment involving an enforcement agency requires that the district court determine whether the proposed consent decree is fair and reasonable, with the additional requirement that the "public interest would not be disserved," *eBay, Inc. v. MercExchange*, 547 U.S. 388, 391, 126 S. Ct. 1837, 164 L. Ed. 2d 641 (2006), in the event that the consent decree includes injunctive relief. Absent a substantial basis in the record for concluding that the proposed consent decree does not meet these requirements, the district court is required to enter the order. . . .

A court evaluating a proposed S.E.C. consent decree for fairness and reasonableness should, at a minimum, assess (1) the basic legality of the decree, *see Benjamin v. Jacobson*, 172 F.3d 144, 155–59 (2d Cir. 1999) (terminating existing consent decrees as required by the Prison Litigation Reform Act); (2) whether the terms of the decree, including its enforcement mechanism, are clear, *see, e.g.*, *Angela R. ex rel. Hesselbein v. Clinton*, 999 F.2d 320, 325 (8th Cir. 1993) (district court abused its discretion by approving consent decree that did not properly define the enforcement mechanisms); (3) whether the consent decree reflects a resolution of the actual claims in the complaint; and (4) whether the consent decree is tainted by improper collusion or corruption of some kind. *Cf. Kozlowski v. Coughlin*, 871 F.2d 241, 244 (2d Cir. 1989) ("Before entering a consent judgment, the district court must be certain that the decree 1) springs from and serves to resolve a dispute within the court's subject-matter jurisdiction, 2) comes within the general scope of the case made by the pleadings, and 3) furthers the objectives of the law upon which the complaint was based." (internal quotation marks and alternations omitted)). Consent decrees vary, and depending on the decree a district court may need to make additional inquiry to ensure that the consent decree is fair and reasonable. The primary focus of the inquiry, however, should be on ensuring the consent decree is procedurally proper, using objective measures similar to the factors set out above, taking care not to infringe on the S.E.C.'s discretionary authority to settle on a particular set of terms.

It is an abuse of discretion to require, as the district court did here, that the S.E.C. establish the "truth" of the allegations against a settling party as a condition for approving the consent decrees. *Citigroup I*, 827 F. Supp. 2d at 332–33. Trials are primarily about the truth. Consent decrees are primarily about pragmatism. "[C]onsent decrees are normally compromises in which the parties give up something they might have won in litigation and waive their rights to litigation." *United States v. ITT Continental Baking Co.*, 420 U.S. 223, 235, 95 S. Ct. 926, 43 L. Ed. 2d 148 (1975). Thus, a consent decree "must be construed as . . . written, and not as it might have been written had the plaintiff established his factual claims and legal theories in litigation." *United States v. Armour & Co.,* 402 U.S. 673, 682, 91 S. Ct. 1752, 29 L. Ed. 2d 256 (2d Cir. 1971). Consent decrees provide parties with a means to manage risk. "The numerous factors that affect a litigant's decision whether to compromise a case or litigate it to the end include the value of the particular proposed compromise, the perceived likelihood of obtaining a still better settlement, the prospects of coming out better, or worse, after a full trial, and the resources that would need to be expended in the attempt." *Citigroup III*, 673 F.3d at 164; *see also Randolph*, 736 F.2d at 529 ("Compromise is the essence of settlement. Even if the Commission's case against [defendants] is strong, proceeding to trial would still be costly. The S.E.C.'s resources are limited, and that is why it often uses consent decrees as a means of enforcement." (citation omitted)). These assessments are uniquely for the litigants to make. It is not within the district court's purview to demand "cold, hard, solid facts, established either by admissions or by trials," *Citigroup I*, 827 F. Supp. 2d at 335, as to the truth of the allegations in the complaint as a condition for approving a consent decree.

As part of its review, the district court will necessarily establish that a factual basis exists for the proposed decree. In many cases, setting out the colorable claims, supported by factual averments by the S.E.C., neither admitted nor denied by the wrongdoer, will suffice to allow the district court to conduct its review. Other cases may require more of a showing, for example, if the district court's initial review of the record raises a suspicion that the consent decree was entered into as a result of improper collusion between the S.E.C. and the settling party. We need not, and do not, delineate the precise contours of the factual basis required to obtain approval for each consent decree that may pass before the court. It is enough to state that the district court here, with the benefit of copious submissions by the parties, likely had a sufficient record before it on which to determine if the proposed decree was fair and reasonable. On remand, if the district court finds it necessary, it may ask the S.E.C. and Citigroup to provide additional information sufficient to allay any concerns the district court may have regarding improper collusion between the parties. . . .

The job of determining whether the proposed S.E.C. consent decree best serves the public interest, however, rests squarely with the S.E.C., and its decision merits significant deference:

> [F]ederal judges—who have no constituency—have a duty to respect legitimate policy choices made by those who do. The responsibilities for assessing the wisdom of such policy choices and resolving the struggle between competing views of the public interest are not judicial ones: "Our Constitution vests such responsibilities in the public branches."

Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 866, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984) (quoting *TVA v. Hill*, 437 U.S. 153,195 (1978)); *see also In re Cuyahoga Equip. Corp.*, 980 F.2d 110, 118 (2d Cir. 1992) ("Appellate courts ordinarily defer to the agency's expertise and the voluntary agreement of the parties in proposing the settlement.").

The district court correctly recognized that it was required to consider the public interest in deciding whether to grant the injunctive relief in the proposed injunction. However, the district court made no findings that the injunctive relief proposed in the consent decree would disserve the public interest, in part because it defined the public interest as "an overriding interest in knowing the truth." The district court's failure to make the proper inquiry constitutes legal error. On remand, the district court should consider whether the public interest would be disserved by entry of the consent decree. For example, a consent decree may disserve the public interest if it barred private litigants from pursuing their own claims independent of the relief obtained under the consent decree. What the district court may not do is find the public interest disserved based on its disagreement with the S.E.C.'s decisions on discretionary matters of policy, such as deciding to settle without requiring an admission of liability.

To the extent the district court withheld approval of the consent decree on the ground that it believed the S.E.C. failed to bring the proper charges against Citigroup, that constituted an abuse of discretion. In comparing the complaint filed by the S.E.C. against Citigroup with the complaint filed by the S.E.C. against Stoker, the district court noted that "[a]lthough this would appear to be tantamount to an allegation of knowing and fraudulent intent (*'scienter,'* in the lingo of securities law), the S.E.C., for reasons of its own, chose to charge Citigroup only with negligence, in violation of Sections 17(a)(2) and (3) of the Securities Act, 15 U.S.C. § 77q(a)(2) and (3)." The exclusive right to choose which charges to levy against a defendant rests with the S.E.C. *See, e.g.*, *United States v. Microsoft Corp.*, 56 F.3d 1448, 1459 (D.C. Cir. 1995) ("[T]he district court is not empowered to review the actions or behavior of the Department of Justice; the court is only authorized to review the decree itself."); *see also Heckler v. Chaney*, 470 U.S. 821, 831, 105 S. Ct. 1649, 84 L. Ed. 2d 714 (1985) ("[A]n agency's decision not to prosecute or enforce, whether through civil or criminal process, is a decision generally committed to an agency's absolute discretion."). Nor can the district court reject a consent decree on the ground that it fails to provide collateral estoppel assistance to private litigants—that simply is not the job of the courts. . . .

For the reasons given above, we vacate the November 28, 2011 order of the district court and remand this case for further proceedings in accordance with this opinion.

Problem 10-1	
(a)	Make a brief chart or table that summarizes the SEC's enforcement powers on the following dimensions: (1) who can the SEC proceed against? (2) what kinds of proceedings can the SEC bring and in what fora? (3) what sanctions can the SEC impose for securities violations?
(b)	Who has the better argument in the matter of the SEC/Citi settlement—Judge Rakoff or the Second Circuit appellate panel? If you were the Chair of the SEC (you might be one day!), how would you approach this issue? Consider, in this connection, the chart that follows this problem providing data on recent forms of SEC resolution.
(c)	What is the point of requiring an admission of wrongdoing in a civil settlement, assuming all penalties imposed are otherwise the same?

SEC Enforcement Outcomes 2010-2020

SEC ENFORCEMENT OUTCOMES (ABSOLUTE RESOLUTIONS, FY 2010-2020)

	Years (2010-2015)					
	2010	2011	2012	2013	2014	2015
Neither Admit Nor Deny	45	47	33	30	38	75
Admission of Guilt	0	1	2	1	7	7
Defendant Prevails	0	0	1	0	0	0
SEC Dismissed Case	1	0	1	1	1	0
Other	2	0	4	5	6	3

	Years (2016-2020)				
	2016	2017	2018	2019	2020
Neither Admit Nor Deny	85	50	66	83	53
Admission of Guilt	8	10	5	8	5
Defendant Prevails	1	0	0	0	0
SEC Dismissed Case	0	1	1	0	0
Other	3	5	2	4	3

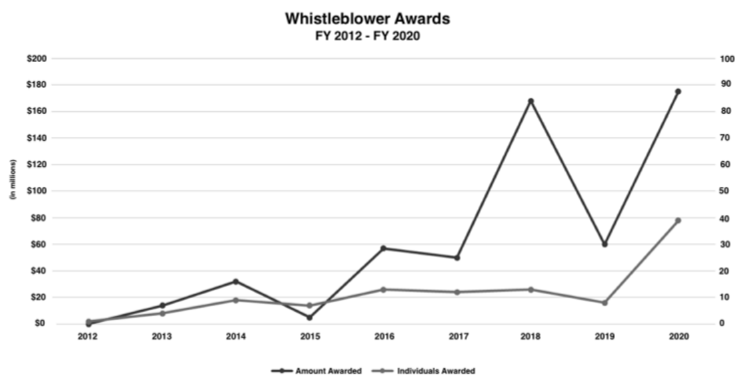
F. Whistleblowers and SEC Enforcement

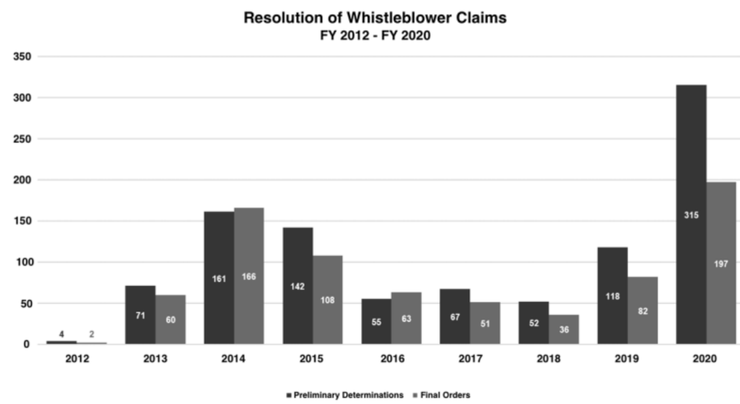
The following aspect of the 2009 Dodd-Frank legislation, enacted in the wake of the financial crisis of 2008, is potentially game-changing in the world of securities enforcement. According to the SEC's latest annual report (2020) on its whistleblower program:

> Over the past ten years, the whistleblower program has been a critical component of the Commission's efforts to detect wrongdoing and protect investors in the marketplace, particularly where fraud is concealed or difficult to detect. Enforcement actions from whistleblower tips have resulted in more than $2.5 billion in ordered financial remedies, including more than $1.4 billion in disgorgement of which almost $750 million has been, or is scheduled to be, returned to harmed investors. Recognizing the importance of rewarding meritorious whistleblowers in a timely manner, we have made efforts to streamline and substantially accelerate the evaluation of claims for whistleblower awards. These efforts paid off. Fiscal Year 2020 was a

record-breaking year for the whistleblower program. The Commission issued awards totaling approximately $175 million to 39 individuals, both greater than any other year in the program's history.

Importantly, the Division also issued substantially more preliminary determinations, which set forth its assessment of whether a claim should be approved or denied and, if approved, the proposed award amount, and final Commission orders of awards and denials. In Fiscal Year 2020, the Division issued 315 preliminary determinations, a more than 95% increase over the next highest year, and the Commission issued 197 final orders, an approximately 19% increase over the next highest year.





As you read and analyze the statutes and regulations that make up the Dodd-Frank whistleblower regime, think about (1) who is able to take advantage of this whistleblower regime and who is not, and (2) how this regime might change incentives and processes in SEC enforcement.

15 U.S.C. § 78u–6. Securities whistleblower incentives and protection ("Dodd-Frank whistleblower law")

(a) Definitions

In this section the following definitions shall apply:

(1) Covered judicial or administrative action

The term "covered judicial or administrative action" means any judicial or administrative action brought by the Commission under the securities laws that results in monetary sanctions exceeding $1,000,000.

(2) Fund

The term "Fund" means the Securities and Exchange Commission Investor Protection Fund.

(3) Original information

The term "original information" means information that—

(A) is derived from the independent knowledge or analysis of a whistleblower;

(B) is not known to the Commission from any other source, unless the whistleblower is the original source of the information; and

(C) is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information.

(4) Monetary sanctions

The term "monetary sanctions", when used with respect to any judicial or administrative action, means—

(A) any monies, including penalties, disgorgement, and interest, ordered to be paid; and

(B) any monies deposited into a disgorgement fund or other fund pursuant to section 308(b) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7246 (b)), as a result of such action or any settlement of such action.

(5) Related action

The term "related action", when used with respect to any judicial or administrative action brought by the Commission under the securities laws, means any judicial or administrative action brought by an entity described in subclauses (I) through (IV) of subsection (h)(2)(D)(i) that is based upon the original information provided by a whistleblower pursuant to subsection (a) that led to the successful enforcement of the Commission action.

(6) Whistleblower

The term "whistleblower" means any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission.

(b) Awards

(1) In general

In any covered judicial or administrative action, or related action, the Commission, under regulations prescribed by the Commission and subject to subsection (c), shall pay an award or awards to 1 or more whistleblowers who voluntarily provided original information to the Commission that led to the successful enforcement of the covered judicial or administrative action, or related action, in an aggregate amount equal to—

(A) not less than 10 percent, in total, of what has been collected of the monetary sanctions imposed in the action or related actions; and

(B) not more than 30 percent, in total, of what has been collected of the monetary sanctions imposed in the action or related actions. . . .

(c) Determination of amount of award; denial of award

(1) Determination of amount of award

(A) Discretion

The determination of the amount of an award made under subsection (b) shall be in the discretion of the Commission.

(B) Criteria

In determining the amount of an award made under subsection (b), the Commission—

(i) shall take into consideration—

(I) the significance of the information provided by the whistleblower to the success of the covered judicial or administrative action;

(II) the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in a covered judicial or administrative action;

(III) the programmatic interest of the Commission in deterring violations of the securities laws by making awards to whistleblowers who provide information that lead to the successful enforcement of such laws; and

(IV) such additional relevant factors as the Commission may establish by rule or regulation; and

(ii) shall not take into consideration the balance of the Fund.

(2) Denial of award

No award under subsection (b) shall be made—

(A) to any whistleblower who is, or was at the time the whistleblower acquired the original information submitted to the Commission, a member, officer, or employee of—

(i) an appropriate regulatory agency;

(ii) the Department of Justice;

(iii) a self-regulatory organization;

(iv) the Public Company Accounting Oversight Board; or

(v) a law enforcement organization;

(B) to any whistleblower who is convicted of a criminal violation related to the judicial or administrative action for which the whistleblower otherwise could receive an award under this section;

(C) to any whistleblower who gains the information through the performance of an audit of financial statements required under the securities laws and for whom such submission would be contrary to the requirements of section 78j–1 of this title; or

(D) to any whistleblower who fails to submit information to the Commission in such form as the Commission may, by rule, require. . . .

(f) Appeals

Any determination made under this section, including whether, to whom, or in what amount to make awards, shall be in the discretion of the Commission. Any such determination, except the determination of the amount of an award if the award was made in accordance with subsection (b), may be appealed to the appropriate court of appeals of the United States not more than 30 days after the determination is issued by the Commission. The court shall review the determination made by the Commission in accordance with section 706 of title 5. . . .

(h) Protection of whistleblowers

(1) Prohibition against retaliation

(A) In general

No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower—

(i) in providing information to the Commission in accordance with this section;

(ii) in initiating, testifying in, or assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information; or

(iii) in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.), this chapter, including section 78j–1 (m) of this title, section 1513 (e) of title 18, and any other law, rule, or regulation subject to the jurisdiction of the Commission. . . .

(B) Enforcement

(i) Cause of action

An individual who alleges discharge or other discrimination in violation of subparagraph (A) may bring an action under this subsection in the appropriate district court of the United States for the relief provided in subparagraph (C). . . .

(C) Relief

Relief for an individual prevailing in an action brought under subparagraph (B) shall include—

(i) reinstatement with the same seniority status that the individual would have had, but for the discrimination;

(ii) 2 times the amount of back pay otherwise owed to the individual, with interest; and

(iii) compensation for litigation costs, expert witness fees, and reasonable attorneys' fees.

SEC Regulations Pursuant to Dodd-Frank Whistleblower Law

17 C.F.R. § 240.21F–4. Other definitions.

(a) Voluntary submission of information.

(1) Your submission of information is made voluntarily within the meaning of §§ 240.21F–1 through 240.21F–17 of this chapter if you provide your submission before a request, inquiry, or demand that relates to the subject matter of your submission is directed to you or anyone representing you (such as an attorney):

(i) By the Commission;

(ii) In connection with an investigation, inspection, or examination by the Public Company Accounting Oversight Board, or any self-regulatory organization; or

(iii) In connection with an investigation by Congress, any other authority of the Federal government, or a state Attorney General or securities regulatory authority.

(2) If the Commission or any of these other authorities direct a request, inquiry, or demand as described in paragraph (a)(1) of this section to you or your representative first, your submission will not be considered voluntary, and you will not be eligible for an award, even if your response is not compelled by subpoena or other applicable law. However, your submission of information to the Commission will be considered voluntary if you voluntarily provided the same information to one of the other authorities identified above prior to receiving a request, inquiry, or demand from the Commission.

(3) In addition, your submission will not be considered voluntary if you are required to report your original information to the Commission as a result of a pre-existing legal duty, a contractual duty that is owed to the Commission or to one of the other authorities set forth in paragraph (a)(1) of this section, or a duty that arises out of a judicial or administrative order.

(b) Original information.

(1) In order for your whistleblower submission to be considered original information, it must be:

(i) Derived from your independent knowledge or independent analysis;

(ii) Not already known to the Commission from any other source, unless you are the original source of the information;

(iii) Not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless you are a source of the information; and

(iv) Provided to the Commission for the first time after July 21, 2010 (the date of enactment of the Dodd–Frank Wall Street Reform and Consumer Protection Act).

(2) Independent knowledge means factual information in your possession that is not derived from publicly available sources. You may gain independent knowledge from your experiences, communications and observations in your business or social interactions.

(3) Independent analysis means your own analysis, whether done alone or in combination with others. Analysis means your examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public.

(4) The Commission will not consider information to be derived from your independent knowledge or independent analysis in any of the following circumstances:

(i) If you obtained the information through a communication that was subject to the attorney-client privilege, unless disclosure of that information would otherwise be permitted by an attorney pursuant to § 205.3(d)(2) of this chapter, the applicable state attorney conduct rules, or otherwise;

(ii) If you obtained the information in connection with the legal representation of a client on whose behalf you or your employer or firm are providing services, and you seek to use the information to make a whistleblower submission for your own benefit, unless disclosure would otherwise be permitted by an attorney pursuant to § 205.3(d)(2) of this chapter, the applicable state attorney conduct rules, or otherwise; or

(iii) In circumstances not covered by paragraphs (b)(4)(i) or (b)(4)(ii) of this section, if you obtained the information because you were:

(A) An officer, director, trustee, or partner of an entity and another person informed you of allegations of misconduct, or you learned the information in connection with the entity's processes for identifying, reporting, and addressing possible violations of law;

(B) An employee whose principal duties involve compliance or internal audit responsibilities, or you were employed by or otherwise associated with a firm retained to perform compliance or internal audit functions for an entity;

(C) Employed by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law; or

(D) An employee of, or other person associated with, a public accounting firm, if you obtained the information through the performance of an engagement required of an independent public accountant under the Federal securities laws (other than an audit subject to § 240.21F–8(c)(4) of this chapter), and that information related to a violation by the engagement client or the client's directors, officers or other employees.

(iv) If you obtained the information by a means or in a manner that is determined by a United States court to violate applicable Federal or state criminal law; or

(v) Exceptions. Paragraph (b)(4)(iii) of this section shall not apply if:

(A) You have a reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors;

(B) You have a reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct; or

(C) At least 120 days have elapsed since you provided the information to the relevant entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or your supervisor, or since you received the information, if you received it under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or your supervisor was already aware of the information.

(vi) If you obtained the information from a person who is subject to this section, unless the information is not excluded from that person's use pursuant to this section, or you are providing the Commission with information about possible violations involving that person.

(5) The Commission will consider you to be an original source of the same information that we obtain from another source if the information satisfies the definition of original information and the other source obtained the information from you or your representative. In order to be considered an original source of information that the Commission receives from Congress, any other authority of the Federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, you must have voluntarily given such authorities the information within the meaning of these rules. You must establish your status as the original source of information to the Commission's satisfaction. In determining whether you are the original source of information, the Commission may seek assistance and confirmation from one of the

other authorities described above, or from another entity (including your employer), in the event that you claim to be the original source of information that an authority or another entity provided to the Commission.

(6) If the Commission already knows some information about a matter from other sources at the time you make your submission, and you are not an original source of that information under paragraph (b)(5) of this section, the Commission will consider you an original source of any information you provide that is derived from your independent knowledge or analysis and that materially adds to the information that the Commission already possesses.

(7) If you provide information to the Congress, any other authority of the Federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the Public Company Accounting Oversight Board, or to an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law, and you, within 120 days, submit the same information to the Commission pursuant to § 240.21F–9 of this chapter, as you must do in order for you to be eligible to be considered for an award, then, for purposes of evaluating your claim to an award under §§ 240.21F–10 and 240.21F–11 of this chapter, the Commission will consider that you provided information as of the date of your original disclosure, report or submission to one of these other authorities or persons. You must establish the effective date of any prior disclosure, report, or submission, to the Commission's satisfaction. The Commission may seek assistance and confirmation from the other authority or person in making this determination.

(c) Information that leads to successful enforcement. The Commission will consider that you provided original information that led to the successful enforcement of a judicial or administrative action in any of the following circumstances:

(1) You gave the Commission original information that was sufficiently specific, credible, and timely to cause the staff to commence an examination, open an investigation, reopen an investigation that the Commission had closed, or to inquire concerning different conduct as part of a current examination or investigation, and the Commission brought a successful judicial or administrative action based in whole or in part on conduct that was the subject of your original information; or

(2) You gave the Commission original information about conduct that was already under examination or investigation by the Commission, the Congress, any other authority of the federal government, a state

Attorney General or securities regulatory authority, any self-regulatory organization, or the PCAOB (except in cases where you were an original source of this information as defined in paragraph (b)(5) of this section), and your submission significantly contributed to the success of the action.

(3) You reported original information through an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law before or at the same time you reported them to the Commission; the entity later provided your information to the Commission, or provided results of an audit or investigation initiated in whole or in part in response to information you reported to the entity; and the information the entity provided to the Commission satisfies either paragraph (c)(1) or (c)(2) of this section. Under this paragraph (c)(3), you must also submit the same information to the Commission in accordance with the procedures set forth in § 240.21F–9 within 120 days of providing it to the entity. . . .

17 C.F.R. § 240.21F–5. Amount of award.

(a) The determination of the amount of an award is in the discretion of the Commission.

(b) If all of the conditions are met for a whistleblower award in connection with a Commission action or a related action, the Commission will then decide the percentage amount of the award applying the criteria set forth in § 240.21F–6 of this chapter and pursuant to the procedures set forth in §§ 240.21F–10 and 240.21F–11 of this chapter. The amount will be at least 10 percent and no more than 30 percent of the monetary sanctions that the Commission and the other authorities are able to collect. The percentage awarded in connection with a Commission action may differ from the percentage awarded in connection with a related action.

(c) If the Commission makes awards to more than one whistleblower in connection with the same action or related action, the Commission will determine an individual percentage award for each whistleblower, but in no event will the total amount awarded to all whistleblowers in the aggregate be less than 10 percent or greater than 30 percent of the amount the Commission or the other authorities collect.

17 C.F.R. § 240.21F–6. Criteria for determining amount of award.

In exercising its discretion to determine the appropriate award percentage, the Commission may consider the following factors (and only the following factors) in relation to the facts and circumstances of each case in setting the dollar or percentage amount of the award. In the event that awards are determined for multiple whistleblowers in connection an action, these factors will be used to determine the relative allocation of awards among the whistleblowers.

(a) Factors that may increase the amount of a whistleblower's award. In determining whether to increase the amount of an award, the Commission will consider the following factors, which are not listed in order of importance.

(1) Significance of the information provided by the whistleblower. The Commission will assess the significance of the information provided by a whistleblower to the success of the Commission action or related action. In considering this factor, the Commission may take into account, among other things:

(i) The nature of the information provided by the whistleblower and how it related to the successful enforcement action, including whether the reliability and completeness of the information provided to the Commission by the whistleblower resulted in the conservation of Commission resources;

(ii) The degree to which the information provided by the whistleblower supported one or more successful claims brought in the Commission or related action.

(2) Assistance provided by the whistleblower. The Commission will assess the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in the Commission action or related action. In considering this factor, the Commission may take into account, among other things:

(i) Whether the whistleblower provided ongoing, extensive, and timely cooperation and assistance by, for example, helping to explain complex transactions, interpreting key evidence, or identifying new and productive lines of inquiry;

(ii) The timeliness of the whistleblower's initial report to the Commission or to an internal compliance or reporting system of business organizations committing, or impacted by, the securities violations, where appropriate;

(iii) The resources conserved as a result of the whistleblower's assistance;

(iv) Whether the whistleblower appropriately encouraged or authorized others to assist the staff of the Commission who might otherwise not have participated in the investigation or related action;

(v) The efforts undertaken by the whistleblower to remediate the harm caused by the violations, including assisting the authorities in the recovery of the fruits and instrumentalities of the violations; and

(vi) Any unique hardships experienced by the whistleblower as a result of his or her reporting and assisting in the enforcement action.

(3) Law enforcement interest. The Commission will assess its programmatic interest in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws. In considering this factor, the Commission may take into account, among other things:

(i) The degree to which an award enhances the Commission's ability to enforce the Federal securities laws and protect investors; and

(ii) The degree to which an award encourages the submission of high quality information from whistleblowers by appropriately rewarding whistleblowers' submission of significant information and assistance, even in cases where the monetary sanctions available for collection are limited or potential monetary sanctions were reduced or eliminated by the Commission because an entity self-reported a securities violation following the whistleblower's related internal disclosure, report, or submission.

(iii) Whether the subject matter of the action is a Commission priority, whether the reported misconduct involves regulated entities or fiduciaries, whether the whistleblower exposed an industry-wide practice, the type and severity of the securities violations, the age and duration of misconduct, the number of violations, and the isolated, repetitive, or ongoing nature of the violations; and

(iv) The dangers to investors or others presented by the underlying violations involved in the enforcement action, including the amount of harm or potential harm caused by the underlying violations, the type of harm resulting from or threatened by the underlying violations, and the number of individuals or entities harmed.

(4) Participation in internal compliance systems. The Commission will assess whether, and the extent to which, the whistleblower and any legal

representative of the whistleblower participated in internal compliance systems. In considering this factor, the Commission may take into account, among other things:

(i) Whether, and the extent to which, a whistleblower reported the possible securities violations through internal whistleblower, legal or compliance procedures before, or at the same time as, reporting them to the Commission; and

(ii) Whether, and the extent to which, a whistleblower assisted any internal investigation or inquiry concerning the reported securities violations.

(b) Factors that may decrease the amount of a whistleblower's award. In determining whether to decrease the amount of an award, the Commission will consider the following factors, which are not listed in order of importance.

(1) Culpability. The Commission will assess the culpability or involvement of the whistleblower in matters associated with the Commission's action or related actions. In considering this factor, the Commission may take into account, among other things:

(i) The whistleblower's role in the securities violations;

(ii) The whistleblower's education, training, experience, and position of responsibility at the time the violations occurred;

(iii) Whether the whistleblower acted with scienter, both generally and in relation to others who participated in the violations;

(iv) Whether the whistleblower financially benefitted from the violations;

(v) Whether the whistleblower is a recidivist;

(vi) The egregiousness of the underlying fraud committed by the whistleblower; and

(vii) Whether the whistleblower knowingly interfered with the Commission's investigation of the violations or related enforcement actions.

(2) Unreasonable reporting delay. The Commission will assess whether the whistleblower unreasonably delayed reporting the securities violations. In considering this factor, the Commission may take into account, among other things:

(i) Whether the whistleblower was aware of the relevant facts but failed to take reasonable steps to report or prevent the violations from occurring or continuing;

(ii) Whether the whistleblower was aware of the relevant facts but only reported them after learning about a related inquiry, investigation, or enforcement action; and

(iii) Whether there was a legitimate reason for the whistleblower to delay reporting the violations.

(3) Interference with internal compliance and reporting systems. The Commission will assess, in cases where the whistleblower interacted with his or her entity's internal compliance or reporting system, whether the whistleblower undermined the integrity of such system. In considering this factor, the Commission will take into account whether there is evidence provided to the Commission that the whistleblower knowingly:

(i) Interfered with an entity's established legal, compliance, or audit procedures to prevent or delay detection of the reported securities violation;

(ii) Made any material false, fictitious, or fraudulent statements or representations that hindered an entity's efforts to detect, investigate, or remediate the reported securities violations; and

(iii) Provided any false writing or document knowing the writing or document contained any false, fictitious or fraudulent statements or entries that hindered an entity's efforts to detect, investigate, or remediate the reported securities violations.

As litigation relating to the SEC whistleblower program picks up—in part due to a large and active "whistleblower bar" that has been representing persons on a contingency fee basis—some case law is developing about who is covered by the Dodd-Frank regime and under what circumstances.

DIGITAL REALTY TRUST, INC. v. SOMERS, 138 S. Ct. 767 (2018)

Justice GINSBURG delivered the opinion of the Court.

Endeavoring to root out corporate fraud, Congress passed the Sarbanes–Oxley Act of 2002, 116 Stat. 745 (Sarbanes–Oxley), and the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376 (Dodd–Frank). Both Acts shield whistleblowers from retaliation, but they differ in important respects. Most notably, Sarbanes–Oxley applies to all "employees" who report misconduct to the Securities and

Exchange Commission (SEC or Commission), any other federal agency, Congress, or an internal supervisor. 18 U.S.C. § 1514A(a)(1). Dodd–Frank delineates a more circumscribed class; it defines "whistleblower" to mean a person who provides "information relating to a violation of the securities laws to the Commission." 15 U.S.C. § 78u–6(a)(6). A whistleblower so defined is eligible for an award if original information he or she provides to the SEC leads to a successful enforcement action. § 78u–6(b)–(g). And, most relevant here, a whistleblower is protected from retaliation for, *inter alia,* "making disclosures that are required or protected under" Sarbanes–Oxley, the Securities Exchange Act of 1934, the criminal anti-retaliation proscription at 18 U.S.C. § 1513(e), or any other law subject to the SEC's jurisdiction. 15 U.S.C. § 78u–6(h)(1)(A)(iii).

The question presented: Does the anti-retaliation provision of Dodd–Frank extend to an individual who has not reported a violation of the securities laws to the SEC and therefore falls outside the Act's definition of "whistleblower"? We answer that question "No": To sue under Dodd–Frank's anti-retaliation provision, a person must first "provid[e] . . . information relating to a violation of the securities laws to the Commission." § 78u–6(a)(6). . . .

Section 78u–6 begins by defining a "whistleblower" as "any individual who provides . . . information relating to a violation of the securities laws *to the Commission,* in a manner established, by rule or regulation, by the Commission." § 78u–6(a)(6) (emphasis added). That definition, the statute directs, "shall apply" "[i]n this section"—*i.e.,* throughout § 78u–6. § 78u–6(a).

Section 78u–6 affords covered whistleblowers both incentives and protection. First, the section creates an award program for "whistleblowers who voluntarily provid[e] original information to the Commission that le[ads] to the successful enforcement of [a] covered judicial or administrative action." § 78u–6(b)(1). A qualifying whistleblower is entitled to a cash award of 10 to 30 percent of the monetary sanctions collected in the enforcement action. See § 78u–6(b)(1)(A)–(B).

Second, § 78u–6(h) prohibits an employer from discharging, harassing, or otherwise discriminating against a "whistleblower" "because of any lawful act done by the whistleblower" in three situations: first, "in providing information to the Commission in accordance with [§ 78u–6]," § 78u–6(h)(1)(A)(i); second, "in initiating, testifying in, or assisting in any investigation or . . . action of the Commission based upon" information provided to the SEC in accordance with § 78u–6, § 78u–6(h)(1)(A)(ii); and third, "in making disclosures that are required or protected under" either Sarbanes–Oxley, the Securities Exchange Act of 1934, the criminal anti-retaliation prohibition at 18 U.S.C. § 1513(e), or "any other law, rule, or regulation subject to the jurisdiction of the Commission," § 78u–6(h)(1)(A)(iii). Clause (iii), by cross-referencing Sarbanes–Oxley and other laws, protects disclosures made to a variety of individuals and entities in addition to the SEC. For example, the clause shields an employee's reports of wrongdoing to an internal supervisor if the reports are independently safeguarded from retaliation under Sarbanes–Oxley. *See supra,* at 772–773.

The recovery procedures under the anti-retaliation provisions of Dodd–Frank and Sarbanes–Oxley differ in critical respects. First, unlike Sarbanes–Oxley, which contains an administrative-exhaustion requirement and a 180–day administrative complaint-filing deadline, *see* 18 U.S.C. § 1514A(b)(1)(A), (2)(D), Dodd–Frank permits a whistleblower to sue a current or former employer directly in federal district court, with a default limitation period of six years, *see* § 78u–6(h)(1)(B)(i), (iii)(I)(aa). Second, Dodd–Frank instructs a court to award to a prevailing plaintiff double backpay with interest, *see* § 78u–6(h)(1)(C)(ii), while Sarbanes–Oxley limits recovery to actual backpay with interest, *see* 18 U.S.C. § 1514A(c)(2)(B). Like Sarbanes–Oxley, however, Dodd–Frank authorizes reinstatement and compensation for litigation costs, expert witness fees, and reasonable attorneys' fees. *Compare* § 78u–6(h)(1)(C)(i), (iii), *with* 18 U.S.C. § 1514A(c)(2)(A), (C).

Congress authorized the SEC "to issue such rules and regulations as may be necessary or appropriate to implement the provisions of [§ 78u–6] consistent with the purposes of this section." § 78u–6(j). Pursuant to this authority, the SEC published a notice of proposed rulemaking to "Implemen[t] the Whistleblower Provisions" of Dodd–Frank. 75 Fed. Reg. 70488 (2010). Proposed Rule 21F–2(a) defined a "whistleblower," for purposes of both the award and anti-retaliation provisions of § 78u–6, as one or more individuals who "provide the Commission with information relating to a potential violation of the securities laws." *Id.*, at 70519 (proposed 17 C.F.R. § 240.21F–2(a)). The proposed rule, the agency noted, "tracks the statutory definition of a 'whistleblower'" by requiring information reporting to the SEC itself. 75 Fed. Reg. 70489.

In promulgating the final Rule, however, the agency changed course. Rule 21F–2, in finished form, contains two discrete "whistleblower" definitions. *See* 17 C.F.R. § 240.21F–2(a)–(b) (2017). For purposes of the award program, the Rule states that "[y]ou are a whistleblower if . . . you *provide the Commission* with information . . . relat[ing] to a possible violation of the Federal securities laws." § 240.21F–2(a)(1) (emphasis added). The information must be provided to the SEC through its website or by mailing or faxing a specified form to the SEC Office of the Whistleblower. *See ibid.*; § 240.21F–9(a)(1)–(2).

"For purposes of the anti-retaliation protections," however, the Rule states that "[y]ou are a whistleblower if . . . [y]ou possess a reasonable belief that the information you are providing relates to a possible securities law violation" and "[y]ou provide that information in a manner described in" clauses (i) through (iii) of § 78u–6(h)(1)(A). 17 C.F.R. § 240.21F–2(b)(1)(i)–(ii). "The anti-retaliation protections apply," the Rule emphasizes, "whether or not you satisfy the requirements, procedures and conditions to qualify for an award." § 240.21F–2(b)(1)(iii). An individual may therefore gain anti-retaliation protection as a "whistleblower" under Rule 21F–2 without providing information to the SEC, so long as he or she provides information in a manner shielded by one of the anti-retaliation provision's three clauses. For example, a report to a company supervisor would qualify if the report garners protection under the Sarbanes–Oxley anti-retaliation provision. . . .

"When a statute includes an explicit definition, we must follow that definition," even if it varies from a term's ordinary meaning. *Burgess v. United States*, 553 U.S. 124, 130, 128 S. Ct. 1572, 170 L. Ed. 2d 478 (2008) (internal quotation marks omitted). This principle resolves the question before us.

Our charge in this review proceeding is to determine the meaning of "whistleblower" in § 78u–6(h), Dodd–Frank's anti-retaliation provision. The definition section of the statute supplies an unequivocal answer: A "whistleblower" is "any individual who provides ... information relating to a violation of the securities laws *to the Commission*." § 78u–6(a)(6) (emphasis added). Leaving no doubt as to the definition's reach, the statute instructs that the "definitio[n] shall apply" "[i]n this section," that is, throughout § 78u–6. § 78u–6(a)(6).

The whistleblower definition operates in conjunction with the three clauses of § 78u–6(h)(1)(A) to spell out the provision's scope. The definition first describes *who* is eligible for protection—namely, a whistleblower who provides pertinent information "to the Commission." § 78u–6(a)(6). The three clauses of § 78u–6(h)(1)(A) then describe what *conduct*, when engaged in by a whistleblower, is shielded from employment discrimination. *See* § 78u–6(h)(1)(A)(i)–(iii). An individual who meets both measures may invoke Dodd–Frank's protections. But an individual who falls outside the protected category of "whistleblowers" is ineligible to seek redress under the statute, regardless of the conduct in which that individual engages.

Reinforcing our reading, another whistleblower-protection provision in Dodd–Frank imposes no requirement that information be conveyed to a government agency. Title 10 of the statute, which created the Consumer Financial Protection Bureau (CFPB), prohibits discrimination against a "covered employee" who, among other things, "provide[s] . . . information to [his or her] employer, the Bureau, or any other State, local, or Federal, government authority or law enforcement agency relating to" a violation of a law subject to the CFPB's jurisdiction. 12 U.S.C. § 5567(a)(1). To qualify as a "covered employee," an individual need not provide information to the CFPB, or any other entity. *See* § 5567(b) ("covered employee" means "any individual performing tasks related to the offering or provision of a consumer financial product or service").

"[W]hen Congress includes particular language in one section of a statute but omits it in another[,] . . . this Court presumes that Congress intended a difference in meaning." *Loughrin v. United States,* 573 U.S. ——, ——, 134 S. Ct. 2384, 2390, 189 L. Ed. 2d 411 (2014) (internal quotation marks and alteration omitted). Congress placed a government-reporting requirement in § 78u–6(h), but not elsewhere in the same statute. Courts are not at liberty to dispense with the condition—tell the SEC—Congress imposed. . . .

In sum, Dodd–Frank's text and purpose leave no doubt that the term "whistleblower" in

§ 78u–6(h) carries the meaning set forth in the section's definitional provision. The disposition of this case is therefore evident: Somers did not provide information "to the Commission" before his termination, § 78u–6(a)(6), so he did not qualify as a "whistleblower" at the time of the alleged retaliation. He is therefore ineligible to seek relief under § 78u–6(h). . . .

Applying the whistleblower definition as written, Somers and the Solicitor General further protest, will create "an incredibly unusual statutory scheme": "[I]dentical misconduct"—*i.e.,* retaliating against an employee for internal reporting—will "go punished or not based on the happenstance of a separate report" to the SEC, of which the wrongdoer may "not even be aware." The upshot, the Solicitor General warns, "would [be] substantially diminish[ed] Dodd–Fran[k] deterrent effect." *Ibid.*

Overlooked in this protest is Dodd–Frank's core objective: to prompt reporting to the SEC. *Supra,* at 773–744, 777–778. In view of that precise aim, it is understandable that the statute's retaliation protections, like its financial rewards, would be reserved for employees who have done what Dodd–Frank seeks to achieve, *i.e.,* they have placed information about unlawful activity before the Commission to aid its enforcement efforts. . . .

For the foregoing reasons, we find the statute's definition of "whistleblower" clear and conclusive. Because "Congress has directly spoken to the precise question at issue," *Chevron*, 467 U.S., at 842, 104 S. Ct. 2778 we do not accord deference to the contrary view advanced by the SEC in Rule 21F–2. *See* 17 C.F.R. § 240.21F–2(b)(1); *supra,* at 775–76. The statute's unambiguous whistleblower definition, in short, precludes the Commission from more expansively interpreting that term. *See Burgess,* 553 U.S., at 130, 128 S. Ct. 1572.

LIU MENG-LIN v. SIEMENS AG, 763 F.3d 175 (2d Cir. 2014)

GERARD E. LYNCH, Circuit Judge:

The Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010), includes a provision, 15 U.S.C. § 78u–6(h), that prohibits employers from retaliating against whistleblower employees who make certain protected disclosures. The instant case requires us to determine whether § 78u–6(h) protects a foreign worker employed abroad by a foreign corporation where all events related to the disclosures occurred abroad. Because (1) legislation is presumed to apply only domestically unless there is evidence Congress intended otherwise; (2) there is no indication Congress intended the whistleblower protection provision to have extraterritorial application; and (3) the facts in the complaint unequivocally demonstrate that applying the statute in this case would constitute an extraterritorial application, we conclude that the district court properly dismissed the complaint.

Plaintiff-appellant Liu Meng-Lin, a citizen and resident of Taiwan, was employed as a compliance officer for the healthcare division of Siemens China Ltd., a Chinese corporation that is a wholly owned subsidiary of defendant-appellee Siemens AG ("Siemens"), a German corporation whose shares, at all relevant times, were listed on the New York Stock Exchange. According to his complaint, Liu discovered that Siemens employees were indirectly making improper payments to officials in North Korea and China in connection with the sale of medical equipment in those countries. Liu believed that these payments violated both company policy and U.S. anti-corruption measures. He therefore reported this conduct to his superiors through internal company procedures, including in a meeting with a high-ranking Siemens executive in Shanghai, China. Liu claims that as he sought to address these alleged violations, Siemens progressively restricted his authority as a compliance officer, demoted him, and ultimately fired him. Liu does not plead that any of the events related to his firing—the allegedly corrupt conduct, Liu's discovery of that conduct, Liu's efforts to address the corrupt conduct through Siemens's internal protocols, or his subsequent mistreatment by Siemens—occurred within the territorial jurisdiction of the United States.

Two months after Siemens fired him, Liu reported the allegedly corrupt conduct to the Securities and Exchange Commission ("SEC"), charging that Siemens had violated the Foreign Corrupt Practices Act ("FCPA"). Liu then brought this action in the United States District Court for the Southern District of New York (William H. Pauley III, *Judge*), alleging that by firing him Siemens had violated the antiretaliation provision of the Dodd-Frank Act, 15 U.S.C. § 78u–6(h)(1)(A). Siemens moved to dismiss the suit for failure to state a claim, Fed. R. Civ. P. 12(b)(6), asserting two separate defects in the complaint: that the antiretaliation provision does not apply extraterritorially, and that none of Liu's disclosures were "required or protected" by a relevant statute as the antiretaliation provision requires. The district court granted Siemens's motion to dismiss with prejudice on both grounds, holding (1) that on the facts pled, the complaint sought an extraterritorial application of the antiretaliation provision, which does not have extraterritorial reach, and (2) that Liu's complaint failed to establish that he had made a disclosure to the SEC that was "required or protected" by any of the specific statutes enumerated in § 78u–6(h)(1)(A)(iii).

Liu timely appealed, and upon de novo review of the district court's grant of the motion to dismiss, *Lundy v. Catholic Health Sys. of Long Island, Inc.*, 711 F.3d 106, 113 (2d Cir. 2013), we affirm on the ground that Liu seeks an extraterritorial application of the antiretaliation provision, and that that provision does not apply extraterritorially. . . .

"[I]t is a longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States." *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 255, 130 S. Ct. 2869, 177 L. Ed. 2d 535 (2010), quoting *EEOC v. Arabian Am. Oil Co.* ("*Aramco* "), 499 U.S. 244, 248, 111 S. Ct. 1227, 113 L. Ed. 2d 274 (1991). "This principle represents a canon of construction, or a presumption about a statute's meaning, rather than a limit upon Congress's power to legislate. It rests on the perception that Congress ordinarily legislates with respect to domestic, not foreign matters." *Id.* (internal citations omitted). The presumption that "[w]hen a statute gives no clear indication of an extraterritorial application, it has none," *Kiobel v. Royal Dutch Petroleum Co.*, ––– U.S. ––––, 133 S. Ct. 1659, 1664, 185 L. Ed. 2d 671 (2013), quoting *Morrison*, 561 U.S. at 255, 130 S. Ct. 2869 (alteration omitted), is rebutted only when the statute's "text, history, and purposes . . . evince a 'clear indication of extraterritoriality.'" *Id.* at 1665, quoting *Morrison*, 561 U.S. at 265, 130 S. Ct. 2869. Moreover, it is "well established that generic terms like 'any' or 'every' do not rebut the presumption against extraterritoriality," *id.*, nor do "fleeting reference [s]" to possible international ramifications of an otherwise domestic statute, *Morrison*, 561 U.S. at 263, 130 S. Ct. 2869.

We have read *Morrison* to "wholeheartedly embrace[ ] application of the presumption against extraterritoriality, finding that 'unless there is the affirmative intention of the Congress clearly expressed to give a statute extraterritorial effect, we must presume it is primarily concerned with domestic conditions.'" *Norex Petroleum Ltd. v. Access Indus., Inc.*, 631 F.3d 29, 32 (2d Cir. 2010), quoting *Morrison*, 561 U.S. at 255, 130 S. Ct. 2869. We will "thus look for a 'clear' and 'affirmative indication' that a statute applies to conduct occurring outside the territorial jurisdiction of the United States before concluding that the presumption has been overcome." *United States v. Weingarten*, 632 F.3d 60, 65 (2d Cir. 2011), quoting *Morrison*, 561 U.S. at 265, 130 S. Ct. 2869 (citations and internal quotation marks omitted).

This case involves the reach of the antiretaliation provision of the Dodd-Frank Act, which directs, in relevant part, that

> [n]o employer may discharge . . . or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower . . . in making disclosures that are required or protected under the Sarbanes–Oxley Act of 2002 . . . , this chapter, . . . and any other law, rule, or regulation subject to the jurisdiction of the [Securities and Exchange] Commission.

15 U.S.C. § 78u–6(h)(1)(A). To survive Siemens's motion to dismiss, Liu must demonstrate either (1) that the facts alleged in his complaint state a domestic application of the antiretaliation provision of the Dodd-Frank Act, or (2) that the antiretaliation provision is intended to apply extraterritorially.

The first alternative need not detain us long. We have no occasion here to define the precise boundary between domestic and extraterritorial application of this relevant provision, or to delineate the types of contacts within the United States that would render an application of the statute domestic rather than extraterritorial because this case is extraterritorial by any reasonable definition. Liu is a resident of Taiwan employed by the Chinese subsidiary of a German company; he reported to superiors in China and Germany regarding allegedly corrupt activities that took place in China, North Korea, and Hong Kong; and his employers decided, apparently in China and/or Germany, to terminate his employment. In short, the whistleblower, his employer, and the other entities involved in the alleged wrongdoing are all foreigners based abroad, and the whistleblowing, the alleged corrupt activity, and the retaliation all occurred abroad. The facts alleged in the complaint reveal essentially no contact with the United States regarding either the wrongdoing or the protected activity.

Liu attempts to avoid this conclusion by pointing to one slim connection to the United States. He argues that "Siemens voluntarily elected to have a class of its securities publicly listed on the New York Stock Exchange and thereby voluntarily subjected itself to—and undertook to comply with—United States securities laws," including the antiretaliation provision. Liu argues that because Siemens has securities listed on an American exchange, his case is "fundamentally distinguishable" from *Morrison, id.* at 14.

This argument is unavailing. *Morrison* addressed whether Australian purchasers of shares listed on an Australian stock exchange could rely on § 10(b) of the Securities Exchange Act of 1934 to sue the Australian bank that issued the shares. The Supreme Court concluded that § 10(b) did not have extraterritorial reach, but rather applied "only [to] transactions in securities listed on domestic exchanges, and domestic transactions in other securities." *Morrison*, 561 U.S. at 267, 130 S. Ct. 2869. The Court reached this conclusion despite the fact that "[t]here [were] listed on the New York Stock Exchange . . . the [defendant bank's] American Depositary Receipts (ADRs), which represent the right to receive a specified number of" the Australian shares. *Id.* at 251, 130 S. Ct. 2869. *Morrison* thus decisively refutes Liu's contention that the United States securities laws apply extraterritorially to the actions abroad of any company that has issued United States-listed securities.

Far from helping Liu, *Morrison* establishes that where a plaintiff can point only to the fact that a defendant has listed securities on a U.S. exchange, and the complaint alleges no further meaningful relationship between the harm and those domestically listed securities, the listing of securities alone is the sort of "fleeting" connection that "cannot overcome the presumption against extraterritoriality." 561 U.S. at 263, 130 S. Ct. 2869. *See also In re Royal Bank of Scotland Grp. PLC Sec. Litig.*, 765 F. Supp. 2d 327, 336 (S.D.N.Y. 2011) ("The idea that a foreign company is subject to U.S. [s]ecurities laws everywhere it conducts foreign transactions merely because it has 'listed' some securities in the United States is simply contrary to the spirit of *Morrison*."). In short, "simply alleging that some domestic conduct occurred cannot support a claim of domestic application [because] '[i]t is a rare case of prohibited extraterritorial application that lacks *all* contact with the territory of the United States.'" *Norex*, 631 F.3d at 33, quoting *Morrison*, 561 U.S. at 266, 130 S. Ct. 2869 (emphasis in original).

Liu's argument that the statute nevertheless applies to his case requires a somewhat lengthier discussion, but is equally unavailing. The support for the conclusion that the antiretaliation provision has no extraterritorial application is straightforward: there is absolutely nothing in the text of the provision, set forth above, or in the legislative history of the Dodd-Frank Act, that suggests that Congress intended the antiretaliation provision to regulate the relationships between foreign employers and their foreign employees working outside the United States. Given the presumption against extraterritoriality, and the absence of any direct evidence of a congressional intent to apply the relevant provision extraterritorially, Liu's effort to cobble together indirect, circumstantial suggestions of extraterritorial application faces powerful headwinds.

Liu offers several arguments that the statutory language or context of the antiretaliation provision indirectly demonstrates that it is intended to have extraterritorial reach. None provides the "clear and affirmative indication," *Weingarten*, 632 F.3d at 65, required to overcome the presumption against extraterritoriality. First, Liu's contention that the antiretaliation provision "contains very broad language that includes all employees" is of no avail. The plain text of the statute contains no hint that the antiretaliation provision is meant to apply extraterritorially, but rather simply indicates that "[n]o employer" may retaliate against a whistleblower, 15 U.S.C. § 78u–6(h)(1). That is precisely the sort of "generic" language that the Supreme Court has expressly stated is insufficient to overcome the presumption against extraterritorial application. *See Kiobel*, 133 S. Ct. at 1665.

Liu next points to other sections of the Dodd-Frank Act that do have some extraterritorial application to argue, in effect by association, that the antiretaliation provision also should be read to have extraterritorial reach. He points to § 929P(b) of the Dodd-Frank Act, 124 Stat. at 1864–65, which, inter alia, grants district courts jurisdiction where a suit brought by the SEC or the United States government

> allege[s] a violation of the antifraud provisions of [the Securities Exchange Act of 1934] involving (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

15 U.S.C. § 78aa(b). Liu argues that "by specifically providing for extraterritorial jurisdiction in a related section of the statute, Congress clearly evidenced its intention to protect SEC whistleblowers located abroad."

Liu's argument inverts the ordinary canons of statutory interpretation. "Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Russello v. United States*, 464 U.S. 16, 23, 104 S. Ct. 296, 78 L. Ed. 2d 17 (1983) (alteration omitted). There is no exception to this general rule for language effecting extraterritorial application; to the contrary, the Supreme Court has specifically cautioned against acceptance of arguments such as Liu's: "[W]hen a statute provides for some extraterritorial application, the presumption against extraterritoriality operates to limit that provision to its terms." *Morrison*, 561 U.S. at 265, 130 S. Ct. 2869. That limitation is founded in "Congress' awareness of the need to make a clear statement that a statute applies" extraterritorially through "express [ ] legislat[ion]" that enables such application. *Aramco*, 499 U.S. at 258, 111 S. Ct. 1227. As *Morrison* observes, it would be "superfluous" for a statute to note that a particular provision applies extraterritorially if the entire statute had extraterritorial reach. *See* 561 U.S. at 265, 130 S. Ct. 2869. Since § 929P(b) identifies a particular provision of Dodd-Frank as having such reach, the logical inference is that the antiretaliation provision, enjoying no such explicit grant of extraterritorial application, has none, a conclusion which at least one district court has also reached. *See Asadi v. G.E. Energy (USA), LLC*, No. 4:12-345, 2012 WL 2522599, at *4 (S.D. Tex. June 28, 2012).

Moreover, Liu's argument fails even on its own terms. Liu does not explain his contention that § 929P(b)'s crisply delineated jurisdictional grant is somehow "related" to the whistleblower antiretaliation provision. In § 929P(b), Congress provided the district court with limited extraterritorial jurisdiction over specific types of antifraud suits brought by governmental entities when the conduct at issue has particular types of relationships to the United States. Liu is not a governmental actor, he has not pled facts of the sort that would confer jurisdiction under § 929P(b), and he cannot argue that the antiretaliation provision qualifies as an antifraud provision of the Securities Exchange Act. In sum, there is no colorable argument that the limited extraterritorial reach of § 929P(b) supports extraterritorial application of the antiretaliation provision in circumstances such as those alleged by Liu.

Liu next turns to the Dodd–Frank's whistleblower bounty provision, 15 U.S.C. § 78u–6(b), to make a similar argument. The bounty provision allows the SEC, in its discretion, to make award payments to "whistleblowers who voluntarily provided original information to the Commission that led to [a] successful enforcement" action. *Id.* § 78u–6(b)(1). Liu asserts that the SEC regulations which define the eligibility for a whistleblower bounty suggest that the agency conceives of the bounty as having international reach. He cites a regulation providing that "you are not eligible [for an award] if: . . . You are . . . a member, officer, or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority." 17 C.F.R. § 240.21F–8(c)(2). Liu further asserts that aspects of the agency's discussion of the bounty provision included in the promulgation of the final rule, 76 Fed. Reg. 34300–01 (June 13, 2011), offer additional support for the idea that the bounty provision is meant to have extraterritorial reach. In particular, he points to the agency's discussion of the tax filing procedures for an award payment to a foreign national, *id.* at 34348 n.370, and the agency's decision to *avoid* making a categorical determination as to whether a whistleblower's possible violation of foreign laws should affect the eligibility for an award, *id.* at 34320. . . .

[E]ven if we assume that the regulations clearly apply the bounty program to whistleblowers located abroad and that some deference would be due such an agency interpretation, it would not follow that Congress intended the antiretaliation provision to apply similarly. As with our analysis of § 929P(b), we must restrict an indication of extraterritorial application "to its terms," *Morrison*, 561 U.S. at 265, 130 S. Ct. 2869; a regulation addressing the bounty provision cannot be taken to support the proposition that the antiretaliation provision should apply extraterritorially. 17 C.F.R. § 240.21F–8(c)(2) does not mention the antiretaliation provision, and indeed, other SEC regulations suggest that the requirements of the antiretaliation and bounty provisions are to be considered separately. Moreover, extraterritorial application of the bounty and antiretaliation provisions have far different international ramifications. Providing rewards to persons, foreign or domestic, who supply information about lawbreaking is far less intrusive into other countries' sovereignty than seeking to regulate the employment practices of foreign companies with respect to the foreign nationals they employ in foreign countries. Applying the antiretaliation provision in circumstances such as Liu's would effect such an intrusion. Thus, whatever their merits, none of the arguments that the *bounty* provision is meant to have extraterritorial reach provide any support for Liu's claim that the *antiretaliation* provision is meant to have extraterritorial reach. . . .

Problem 10-2
Now that you have examined the very different Dodd-Frank securities law whistleblower regime, reconsider the question posed in chapter 6 when the False Claims Act was discussed: Are such legal "bounty" regimes beneficial on balance? What is the optimal way to structure such regimes? Would you modify the SEC regime if you could? How?

G. DOJ Civil Enforcement: Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)

Following the outcry about enforcement against large banks in the wake of the 2008 financial crisis, the Justice Department rediscovered a statutory tool—FIRREA—which it used to lever a series of enormous civil settlements for conduct related to mortgage-backed securities.[3] (The statute was originally enacted in the 1980s in the wake of what was known as "the savings and loans scandal," a matter involving widespread failure and management misconduct among smaller, regional lending institutions.) Let's take a brief look at this powerful non-criminal statute, an example of one of the FIRREA settlements, and a recent decision from the Second Circuit rejecting one of DOJ's FIRREA cases. Notice that the statute provides for *civil* enforcement for violations of some *criminal* statutes, including the mail and wire fraud statutes, meaning that the government must prove the elements of the criminal offenses but only under the civil burden of proof.

Here we have an example of criminal prosecutors engaging in civil enforcement: DOJ has both criminal and civil powers; the other federal agencies, again, have only civil enforcement powers (though their statutory regimes often include criminal provisions, which they must rely on DOJ to enforce).

[3] For an overview, see Peter J. Henning, *U.S. Finds Fresh Use for Seldom-Used Statute in Subprime Cases*, N.Y. TIMES DEALBOOK, Aug. 11, 2014, available here: https://dealbook.nytimes.com/2014/08/11/u-s-finds-fresh-use-for-seldom-used-statute-in-subprime-cases.

12 U.S.C. § 1833a ("FIRREA")

(a) In general

Whoever violates any provision of law to which this section is made applicable by subsection (c) of this section shall be subject to a civil penalty in an amount assessed by the court in a civil action under this section.

(b) Maximum amount of penalty

(1) Generally

The amount of the civil penalty shall not exceed $1,000,000.

(2) Special rule for continuing violations

In the case of a continuing violation, the amount of the civil penalty may exceed the amount described in paragraph (1) but may not exceed the lesser of $1,000,000 per day or $5,000,000.

(3) Special rule for violations creating gain or loss

(A) If any person derives pecuniary gain from the violation, or if the violation results in pecuniary loss to a person other than the violator, the amount of the civil penalty may exceed the amounts described in paragraphs (1) and (2) but may not exceed the amount of such gain or loss.

(B) As used in this paragraph, the term "person" includes the Bank Insurance Fund, the Savings Association Insurance Fund, and after the merger of such funds, the Deposit Insurance Fund, and the National Credit Union Share Insurance Fund.

(c) Violations to which penalty is applicable

This section applies to a violation of, or a conspiracy to violate—

(1) section 215, 656, 657, 1005, 1006, 1007, 1014, or 1344 of title 18;

(2) section 287, 1001, 1032, 1341 or 1343 of title 18 affecting a federally insured financial institution; or

(3) section 645 (a) of title 15.

(d) Effective date

This section shall apply to violations occurring on or after August 10, 1984.

(e) Attorney General to bring action

A civil action to recover a civil penalty under this section shall be commenced by the Attorney General

(f) Burden of proof

In a civil action to recover a civil penalty under this section, the Attorney General must establish the right to recovery by a preponderance of the evidence.

(g) Administrative subpoenas

(1) In general

For the purpose of conducting a civil investigation in contemplation of a civil proceeding under this section, the Attorney General may—

(A) administer oaths and affirmations;

(B) take evidence; and

(C) by subpoena, summon witnesses and require the production of any books, papers, correspondence, memoranda, or other records which the Attorney General deems relevant or material to the inquiry. Such subpoena may require the attendance of witnesses and the production of any such records from any place in the United States at any place in the United States designated by the Attorney General.

(2) Procedures applicable

The same procedures and limitations as are provided with respect to civil investigative demands in subsections (g), (h), and (j) of section 1968 of title 18 apply with respect to a subpoena issued under this subsection. Process required by such subsections to be served upon the custodian shall be served on the Attorney General. Failure to comply with an order of the court to enforce such subpoena shall be punishable as contempt.

(3) Limitation

In the case of a subpoena for which the return date is less than 5 days after the date of service, no person shall be found in contempt for failure to comply by the return date if such person files a petition under paragraph (2) not later than 5 days after the date of service.

(h) Statute of limitations

A civil action under this section may not be commenced later than 10 years after the cause of action accrues.

Example: Statement of Facts, JPMorgan FIRREA Settlement with DOJ

Between 2005 and 2007, affiliates of each of JPMorgan Chase & Co. ("JPMorgan"), The Bear Stearns Companies, Inc. ("Bear Stearns"), and Washington Mutual Bank ("WaMu") securitized large amounts of subprime and Alt-A mortgage loans and sold the resulting residential mortgage-backed securities ("RMBS") to investors, including federally-insured financial institutions. Each of JPMorgan, Bear Stearns, and WaMu developed and maintained mortgage origination and securitization processes and controls, including processes for conducting credit, compliance, and property valuation due diligence on loans prior to acquisition and/or securitization as well as processes for the monitoring of loan originators and sellers based, in part, on the subsequent performance of loans acquired from those parties.

JPMorgan, Bear Stearns, and WaMu described these processes to investors in marketing materials, and represented to investors in offering documents that loans generally complied with underwriting guidelines. As discussed below, employees of JPMorgan, Bear Stearns, and WaMu received information that, in certain instances, loans that did not comply with underwriting guidelines were included in the RMBS sold and marketed to investors; however, JPMorgan, Bear Stearns, and WaMu did not disclose this to securitization investors.

JPMorgan

Between 2005 and 2007, JPMorgan purchased loans for the purpose of packaging and selling residential mortgage-backed securities. Before purchasing loans from third parties, employees at JPMorgan conducted "due diligence" to (1) confirm that the mortgage loans were originated consistent with specific origination guidelines provided by the seller, (2) confirm the mortgage loans were originated in compliance with Federal, State, and local laws, rules, and regulations, and (3) confirm that the property collateral had the value represented in the appraisal at the time of origination. Through that due diligence process, JPMorgan employees were informed by due diligence vendors that a number of the loans included in at least some of the loan pools that it purchased and subsequently securitized did not comply with the originators' underwriting guidelines, and, in the vendors' judgment, did not have sufficient compensating factors, and that a number of the properties securing the loans had appraised values that were higher than the values derived in due diligence testing from automated valuation models, broker price opinions or other valuation due diligence methods. In addition, JPMorgan represented to investors in various offering documents that loans in the securitized pools were originated "generally" in conformity with the loan originator's underwriting guidelines; and that exceptions were made based on “compensating factors,” determined after “careful consideration” on a “case-by-case basis.” The offering documents further represented, with respect to representations and warranties made to JPMorgan by sellers and originators of the loans, that JPMorgan would not include any loan in a pool being securitized “if anything has come to [JPMorgan’s] attention that would cause it to believe that the representations and warranties of a seller or originator will not be accurate and complete in all material respects in respect of the loan as of the date of initial issuance of the related series of securities.” Notwithstanding these representations, in certain instances, at the time these representations were made to investors, the loan pools being securitized contained loans that did not comply with the originators’ underwriting guidelines.

JPMorgan began the process of creating RMBS by purchasing pools of loans from lending institutions, such as Countrywide Home Loans, Inc., or WMC Mortgage Corporation, that originated residential mortgages by making mortgage loans to individual borrowers. After entering into a contract to purchase loans, but prior to purchase, JPMorgan performed “due diligence” on samples of loans from the pool being acquired to ensure that the loans were originated in compliance with the originator’s underwriting guidelines.

JPMorgan salespeople marketed its due diligence process to investors through oral communications that were often scripted by internal sales memoranda, through presentations given at industry conferences, and to certain individual investors. In marketing materials, JPMorgan represented that the originators had a “solid underwriting platform,” and that JPMorgan was familiar with and approved the originators’ underwriting guidelines; that before purchasing a pool, a “thorough due diligence is undertaken to ensure compliance with [underwriting] guidelines”; and that such due diligence was “performed by industry leading 3rd parties (Clayton and Bohan).”

JPMorgan contracted with industry leading third party due diligence vendors to re-underwrite the loans it was purchasing from loan originators. The vendors assigned one of three grades to each of the loans they reviewed. An Event 1 grade meant that the loan complied with underwriting guidelines. An Event 2 meant that the loans did not comply with underwriting guidelines, but had sufficient compensating factors to justify the extension of credit. An Event 3 meant that the vendor concluded that the loan did not comply with underwriting guidelines and was without sufficient compensating factors to justify the loan, including in certain instances because material documents were missing from the loan file being reviewed. JPMorgan reviewed loans scored Event 3 by the vendors and made the final determination regarding each loan’s score. Event 3 loans that could not be cured were at times referred to by due diligence personnel at JPMorgan as “rejects.” JPMorgan personnel then made the final purchase decisions.

From January 2006 through September 2007, in the course of JPMorgan’s acquisition of certain pools of mortgage loans for subsequent securitization, JPMorgan’s due diligence vendors graded numerous loans in the samples as Event 3's, meaning that, in the vendors' judgment, they neither complied with the originators' underwriting guidelines nor had sufficient compensating factors, including in many instances because of missing documentation such as appraisals, or proof of income, employment or assets. The exceptions identified by the third-party diligence vendors included, among other things, loans with high loan-to-value ratios (some over 100 percent); high debt-to-income ratios; inadequate or missing documentation of income, assets, and rental/mortgage history; stated incomes that the vendors concluded were unreasonable; and missing appraisals or appraisals that varied from the estimates obtained in the diligence process by an amount greater than JPMorgan's fifteen percent established tolerance.

The vendors communicated this information to certain JPMorgan employees.

JPMorgan directed that a number of the uncured Event 3 loans be "waived" into the pools facilitating the purchase of loan pools, which then went into JPMorgan inventory for securitization. In addition to waiving in some of the Event 3 loans on a case-by-case basis, some JPMorgan due diligence managers also ordered "bulk" waivers by directing vendors to override certain exceptions the JPMorgan due diligence managers deemed acceptable across all Event 3 loans with the same exceptions in a pool, without analyzing these loans on a case-by-case basis. JPMorgan due diligence managers sometimes directed these bulk waivers shortly before closing the purchase of a pool. Further, even though the Event 3 rate in the random samples indicated that the un-sampled portion of a pool likely contained additional loans with exceptions, JPMorgan purchased and securitized the loan pools without reviewing and eliminating those loans from the un-sampled portions of the pools.

According to a "trending report" prepared for client marketing purposes by one of JPMorgan's due diligence vendors (later described by the vendor to be a "beta" or test report), from the first quarter of 2006 through the second quarter of 2007, of the 23,668 loans the vendor reviewed for JPMorgan, 6,238 of them, or 27 percent, were initially graded Event 3 loans and, according to the report, JPMorgan ultimately accepted or waived 3,238 of these Event 3 loans—50 percent—to Event 2.

During the course of its due diligence process, JPMorgan also performed a valuation review. JPMorgan hired third-party valuation firms to test the appraisal's estimate of the value of the mortgaged properties through a variety of data points, including (1) automated valuation models, (2) desk reviews of the appraisals by licensed appraisers, and (3) broker price opinions. After reviewing the relevant data, the valuation firm would provide a "final recommendation of value." JPMorgan had a "tolerance" of 15 percent in the valuation review, meaning that JPMorgan would routinely accept loans for securitization, including those with loan-to-value ratios as high as 100 percent, when the valuation firm's "final recommendation of value" was up to 15 percent under the appraised value. In the same marketing communications described above, JPMorgan salespeople disclosed that its property valuation review involved an "Automated review of appraisals, with secondary reviews undertaken for any loans outside of tolerance." JPMorgan did not disclose that its "tolerance" was 15 percent.

In one instance, JPMorgan's due diligence revealed that several pools from a single third-party originator contained numerous stated income loans (i.e., loans originated without written proof of the borrower's income) where the vendor had concluded that borrowers had overstated their incomes. Initially, due diligence employees and at least two JPMorgan managers decided that these pools should be reviewed in their entirety, and all unreasonable stated income loans eliminated before the pools were purchased. After the originator of the loan pools objected, JPMorgan Managing Directors in due diligence, trading, and sales met with representatives of the originator to discuss the loans, then agreed to purchase two loan pools without reviewing those loan pools in their entirety as JPMorgan due diligence employees and managers had previously decided; waived a number of the stated income loans into the pools; purchased the pools; and subsequently securitized hundreds of millions of dollars of loans from those pools into one security. In addition, JPMorgan obtained an agreement from the originator to extend contractual repurchase rights for early payment defaults for an additional three months.

Prior to JPMorgan purchasing the loans, a JPMorgan employee who was involved in this particular loan pool acquisition told an Executive Director in charge of due diligence and a Managing Director in trading that due to their poor quality, the loans should not be purchased and should not be securitized. After the purchase of the loan pools, she submitted a letter memorializing her concerns to another Managing Director, which was distributed to other Managing Directors. JPMorgan nonetheless securitized many of the loans. None of this was disclosed to investors.

On some occasions, prospective investors in mortgage-backed securities marketed by JPMorgan requested specific data on the underlying loan pools, including information on due diligence results and loan characteristics, such as combined-loan-to-value ratios. JPMorgan employees sometimes declined to provide information to such investors concerning such loan data, including combined loan-to-value ratio data. In some instances, JPMorgan employees also provided data on the percentage of defective loans identified in its own due diligence process as a percentage of the pool that was acquired rather than as a percentage of the diligence sample, without disclosing the basis of their calculation.

Bear Stearns

Throughout the relevant time periods described below, Bear Stearns made various statements concerning the processes by which Bear Stearns monitored third party loan sellers and aspects of the performance of the loans Bear Stearns purchased from those sellers.

Between 2006 and 2007, Bear Stearns purchased, securitized and sold to investors billions of dollars of Alt-A mortgage loans. Some of these loans were acquired by Bear Stearns through what was known as its "flow-conduit." Flow-conduit loans were acquired by EMC Mortgage—a wholly owned Bear Stearns subsidiary—from a wide variety of sellers and mortgage originators ("Flow-Conduit Sellers"). After acquiring these loans, Bear Stearns would generally bundle them, securitize that bundled pool of loans, and sell the securities ("Flow- Conduit Securities") to investors. Investors included federally-insured financial institutions and other institutional investors nationwide.

Between 2006 and 2007, Bear Stearns implemented a program for monitoring Flow-Conduit Sellers. Among other things, Bear Stearns monitored the financial well-being of the Flow-Conduit Sellers, tracked aspects of the performance of loans being originated by individual Flow-Conduit Sellers, and reviewed a sample of the loans post-acquisition to determine whether they complied with certain underwriting and/or origination standards.

Beginning in approximately June 2006 and continuing through 2007, as part of its monitoring program, Bear Stearns assigned "grades" to individual sellers. Bear Stearns employed different grading systems over different time periods. But, at relevant times, the Bear Stearns grading system included a grade of "F" for sellers whose financial condition or credit profile, loan performance, and claims history warranted significant scrutiny and potentially a discontinuation of the business relationship, and also allowed for sellers to be "suspended" or "terminated."

Flow-Conduit Securities typically included loans from many, and in some cases, as many as hundreds, of Flow-Conduit Sellers. Prospectus supplements for Flow-Conduit Securities were required by regulation to identify the Flow-Conduit Sellers only if those sellers exceeded a specified concentration of loans in the security pool. In only one security during the relevant period, a Flow-Conduit Seller exceeded that concentration; in that instance, the prospectus supplement identified the relevant Flow-Conduit Seller. Consistent with the applicable regulatory disclosure requirements, Bear Stearns did not otherwise identify the Flow- Conduit Sellers in any given security.

Bear Stearns discussed its seller monitoring process with certain investors. In some communications with investors, Bear Stearns described its seller approval and seller monitoring processes as a way to filter out poor-performing sellers. Bear Stearns informed certain investors in Flow-Conduit Securities that, as a result of Bear Stearns' seller monitoring, certain Flow-Conduit Sellers had been terminated or suspended. Bear Stearns further communicated that it would not continue to purchase loans originated by terminated or suspended sellers. Certain of this same information was also communicated to rating agencies in January 2007. Between 2006 and 2007, certain Flow-Conduit Securities included a number of loans originated by sellers that, at the time of securitization, had received "F" grades, or had been designated as "suspended" or "terminated." Purchasers of Flow-Conduit Securities were not informed as to the presence of loans from those sellers in Flow-Conduit Securities. In certain instances, Bear Stearns employed a quality control process to review the loans after they had been purchased, which meant in certain circumstances that the loans were already included in

Flow-Conduit Securities (among other securities) when the review took place. In certain investor presentations and communications, Bear Stearns stated that its loan acquisition processes included post-purchase quality control reviews, but, by the end of the relevant time period, once Bear Stearns made a decision to suspend or terminate and discontinue loan purchases from sellers, it did not undertake this post-purchase review for loans that had been originated by those Flow-Conduit Sellers. The absence of a quality control process for such loans meant that Bear Stearns did not take certain steps that might have been undertaken to cure potential exceptions in the underlying loans, or to determine if Bear Stearns had to repurchase them out of the trusts holding them for investors.

Bear Stearns personnel, including certain managers, were aware that Flow- Conduit Securities included a number of loans from poorly graded Flow-Conduit Sellers, and were likewise aware that the loans originated by these poorly graded sellers sometimes experienced high rates of default. At least one Bear Stearns employee questioned the continued inclusion of loans from those sellers in Flow-Conduit Securities.

Certain of the Flow-Conduit Securities also included loans acquired through bulk purchases of pools of loans from larger originators ("bulk purchases") rather than from Flow- Conduit Sellers. For bulk purchases of Alt-A, as well as subprime, loans, Bear Stearns often conducted credit-related due diligence on the loan pool (or, in the case of Alt-A loans, on a sample of the loan pool) to be acquired. Bear Stearns typically hired a third-party due diligence vendor to review the loans selected for diligence and to provide a score reflecting the vendor's judgment as to whether the loan was originated in accordance with applicable underwriting guidelines or had adequate compensating factors.

Bear Stearns' due diligence managers reviewed the vendor's determinations and made the final decision as to whether Bear Stearns would purchase the loan or not. In certain circumstances, Bear Stearns due diligence managers or other employees determined after their review of the loans that, notwithstanding a vendor's identification of exceptions to specified underwriting guidelines, Bear Stearns would purchase loans where there was a variance from the guidelines that the managers or other employees deemed acceptable. In addition, Bear Stearns completed bulk purchases of Alt-A loan pools even though the rate of loans with exceptions in the due diligence samples indicated that the un-sampled portion of a pool likely contained additional loans with exceptions.

The last securitization by Bear Stearns was in 2007. The conduct described above with respect to Bear Stearns all occurred prior to JPMorgan's acquisition of Bear Stearns in March 2008. . . .

UNITED STATES ex rel. O'DONNELL v. COUNTRYWIDE HOME LOANS, INC., 822 F.3d 650 (2d Cir. 2016)

WESLEY, Circuit Judge:

When can a breach of contract also support a claim for fraud? This question—long an issue in common-law courts—comes before us in the context of a judgment in the United States District Court for the Southern District of New York (Rakoff, *J.*), imposing civil penalties exceeding $1.2 billion on Defendants–Appellants Countrywide Home Loans, Inc.; Countrywide Bank, FSB; Bank of America, N.A. (collectively, "Countrywide"); and Rebecca Mairone (together with Countrywide, "Defendants") under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), 12 U.S.C. § 1833a. As the necessary predicate for these penalties, the Government alleged that Defendants violated the federal mail and wire fraud statutes by selling poor-quality mortgages to government-sponsored entities. On appeal, Defendants argue that the evidence at trial shows at most an intentional breach of contract—*i.e.*, that they sold mortgages that they knew were not of the quality promised in their contracts—and is insufficient as a matter of law to find fraud. We agree, concluding that the trial evidence fails to demonstrate the contemporaneous fraudulent intent necessary to prove a scheme to defraud through contractual promises. Accordingly, we reverse with instructions to enter judgment in favor of Defendants.

This case arises in the context of the post-financial-crisis restructuring of the Full Spectrum Lending Division ("FSL") of Countrywide Home Loans. Prior to the events at issue in this case, FSL had been the subprime lending division of Countrywide; after the collapse of the subprime market in 2007, Countrywide undertook a transformation of FSL into a prime origination division with the goal of selling prime loans to two government-sponsored enterprises ("GSEs"): the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). The overall reorganization of FSL was referred to as "Central Fulfillment," one component of which was a loan origination process called the "High Speed Swim Lane" or "HSSL," introduced in August 2007 and expanded in October 2007. Rebecca Mairone, the only named individual defendant, was the Chief Operating Officer of FSL during 2007 and 2008 and was responsible for overseeing FSL's reorganization, including the implementation of HSSL. . . .

Pursuant to contracts with Fannie Mae, Countrywide as the seller of mortgages represented that, "as of the date [of] transfer," the mortgages sold would be an "Acceptable Investment." Similarly, Freddie Mac's selling guide contained a representation by the seller—again, Countrywide—that "all Mortgages sold to Freddie Mac have the characteristics of an investment quality mortgage." J.A. 6368; *see also* J.A. 6366 (representing quality "[a]s of" the date the loans were delivered to Freddie Mac). The Government adduced no evidence and made no claim that Countrywide had fraudulent intent during the negotiation or execution of these contracts.

The Government's theory is that Countrywide sold loans under these purchase agreements to the GSEs, knowing that the loans were not investment quality and thus intending to defraud them. To support this argument, the Government presented extensive evidence of quality problems in the loans approved through the HSSL program. The Government also identified three FSL officers (the "Key Individuals") as to whom they alleged fraudulent intent: Mairone; Greg Lumsden, President of FSL; and Cliff Kitashima, Chief Credit Officer of FSL. To demonstrate the requisite intent, the Government presented evidence that the Key Individuals were informed of the poor quality of HSSL loans by FSL employees and internal quality control reports and nonetheless sold them to the GSEs.

With respect to the Key Individuals, the Government also presented evidence that at least Kitashima and Mairone knew of the investment-quality representations made in the contractual documents between Countrywide and the GSEs. The Government presented no evidence that any of the Key Individuals were involved in the negotiation or execution of these contracts, nor did it present evidence that any of them communicated with either GSE regarding the loans sold; in fact, Defendants elicited testimony from GSE witnesses to the contrary. The Government's case rested upon facts showing that the Key Individuals knew of the pre-existing contractual representations, knew that the loans originated through HSSL were not consistent with those representations, and nonetheless sold HSSL loans to the GSEs pursuant to those contracts. For example, in its closing argument, the Government summarized as follows:

> And now that all the evidence has come in, this case still comes down to a few simple facts. First, the Hustle loans were bad. Second, the defendants knew the Hustle loans were bad. And third, the defendants passed the Hustle loans off as good loans anyway to cheat Fannie and Freddie out of money. . . .

A simple hypothetical presents the central issue in this case. Imagine that two parties—*A* and *B*—execute a contract, in which *A* agrees to provide widgets periodically to *B* during the five-year term of the agreement. *A* represents that each delivery of widgets, "as of" the date of delivery, complies with a set of standards identified as "widget specifications" in the contract. At the time of contracting, *A* intends to fulfill the bargain and provide conforming widgets. Later, after several successful and conforming deliveries to *B*, *A*'s production process experiences difficulties, and the quality of *A*'s widgets falls below the specified standards. Despite knowing the widgets are subpar, *A* decides to ship these nonconforming widgets to *B* without saying anything about their quality. When these widgets begin to break down, *B* complains, alleging that *A* has not only breached its agreement but also has committed a fraud. *B*'s fraud theory is that *A* knowingly and intentionally provided substandard widgets in violation of the contractual promise—a promise *A* made at the time of contract execution about the quality of widgets at the time of future delivery. Is *A*'s *willful* but silent noncompliance a fraud—a knowingly false statement, made with intent to defraud—or is it simply an intentional breach of contract?

This question, not an unusual one at common law, poses a novel issue in the context of the federal fraud statutes before us. Supreme Court precedent instructs us to apply the common-law understanding of fraud principles to these statutes, absent inconsistency with their text. Once we do so, however, the trial record reveals a basic deficiency in proof under the statutes, and accordingly, we conclude the evidence is insufficient to sustain the jury's verdict. . . .

The federal mail and wire fraud statutes, in relevant part, impose criminal penalties on "[w]hoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises" uses the mail, 18 U.S.C. § 1341, or wires, *id.* § 1343, for such purposes. Thus, the essential elements of these federal fraud crimes are "'(1) a scheme to defraud, (2) money or property as the object of the scheme, and (3) use of the mails or wires to further the scheme.'" *United States v. Binday*, 804 F.3d 558, 569 (2d Cir. 2015) (quoting *Fountain v. United States*, 357 F.3d 250, 255 (2d Cir. 2004)). "The gravamen of the offense is the scheme to defraud, and any 'mailing that is incident to an essential part of the scheme satisfies the mailing element,' even if the mailing itself 'contain[s] no false information.'" *Bridge v. Phoenix Bond & Indem. Co.*, 553 U.S. 639, 647, 128 S. Ct. 2131, 170 L. Ed. 2d 1012 (2008) (alteration in original) (citation omitted) (quoting *Schmuck v. United States*, 489 U.S. 705, 712, 715, 109 S. Ct. 1443, 103 L. Ed. 2d 734 (1989)). The exact contours of what kinds of conduct constitute a "scheme to defraud" have been the subject of some judicial discussion.

It is well established that statutes employing common-law terms are presumed, "unless the statute otherwise dictates, . . . to incorporate the established meaning of these terms." *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322, 112 S. Ct. 1344, 117 L. Ed. 2d 581 (1992) (internal quotation marks omitted); *accord United States v. Castleman*, ––– U.S. ––––, ––––, 134 S. Ct. 1405, 1410, 188 L. Ed. 2d 426 (2014). The Supreme Court has expressly applied this rule to the term "scheme to defraud," holding that the statutes require proof—as at common law—that the misrepresentations were material, notwithstanding the fact that a solely "natural reading of the full text" would omit such an element. *Neder v. United States*, 527 U.S. 1, 21, 25, 119 S. Ct. 1827, 144 L. Ed. 2d 35 (1999) (internal quotation marks omitted). . . .

[T]he common law does not permit a fraud claim based solely on contractual breach; at the same time, a contractual relationship between the parties does not wholly remove a party's conduct from the scope of fraud. What fraud in these instances turns on, however, is *when* the representations were made and the intent of the promisor *at that time*. As explained below, where allegedly fraudulent misrepresentations are promises made in a contract, a party claiming fraud must prove fraudulent intent at the time of contract execution; evidence of a subsequent, willful breach cannot sustain the claim. Far from being "arcane limitations," *Countrywide I*, 961 F. Supp. 2d at 607, these principles fall squarely within the core meaning of common-law fraud that neither the federal statutes nor *Durland* disrupted. *See Neder*, 527 U.S. at 24 ("[*Durland*] did not hold, as the Government argues, that the [mail fraud] statute encompasses more than common-law fraud.”).

It is emphatically the case—and has been for more than a century—that a representation is fraudulent only if made with the contemporaneous intent to defraud—*i.e.,* the statement was knowingly or recklessly false and made with the intent to induce harmful reliance. While on the New York Court of Appeals, then—Chief Judge Benjamin Cardozo wrote that “[a] representation even though knowingly false does not constitute ground for an action of deceit unless *made with the intent* to be communicated to the persons or class of persons who act upon it to their prejudice.” *Ultramares Corp. v. Touche*, 255 N.Y. 170, 187, 174 N.E. 441 (1931) (emphasis added); *see also* RESTATEMENT (FIRST) OF TORTS §§ 526, 531 (1938). . . .

[W]here the relevant representation is made within a contract, the common law rejects any attempt to prove fraud based on inferences arising solely from the breach of a contractual promise:

> [T]hat proof that a promise was made and that it was not fulfilled is sufficient to prove fraud . . . is not, and has never been, a correct statement of the law.

Tenzer, 39 Cal.3d at 30, 216 Cal. Rptr. 130, 702 P.2d 212. This rule exists because, at common law, a post-agreement intent to breach the contract is not actionable as fraud:

> [I]f the promises or representations were made in good faith at the time of the contract, and the defendant subsequently changed its mind, and failed or refused to perform the promises, then such conduct of the company, originally or subsequently, would not constitute such fraud, in legal acceptation, as would justify the rescission of the contract or the cancellation of the deed. . . .

In sum, a contractual promise can only support a claim for fraud upon proof of fraudulent intent not to perform the promise at the time of contract execution. Absent such proof, a subsequent breach of that promise—even where willful and intentional—cannot in itself transform the promise into a fraud. Far from being an arcane limitation, the principle of contemporaneous intent is, like materiality, one without which “the common law could not have conceived of ‘fraud.’” *Neder*, 527 U.S. at 22. . . .

Having described the proof that the federal fraud statutes require, we conclude the Government’s proof at trial failed to meet its burden. The only representations alleged to be false were guarantees of future quality made in contracts as to which no proof of contemporaneous fraudulent intent was introduced at trial. The Government did not prove—in fact, did not attempt to prove—that at the time the contracts were executed Countrywide never intended to perform its promise of investment quality. Nor did it prove that Countrywide made any later misrepresentations—*i.e.,* ones not contained in the contracts—as to which fraudulent intent could be found.

Although the Government was not always clear as to what theory of fraud applied in this case, the record shows that the jury was charged only as to a theory of fraud through an affirmative misstatement, *i.e.*, a statement that was either "an outright lie" or partially true but "omitt[ed] information necessary to correct [a] false impression." Thus, we review the proof at trial only by reference to this charged theory, *see Yates v. Evatt*, 500 U.S. 391, 409, 111 S. Ct. 1884, 114 L. Ed. 2d 432 (1991), and we do not address whether other situations, such as silence without *any* affirmative statement while under a duty to disclose material information, can constitute fraud under the federal statutes, particularly in the context of a breach of contract, *cf. United States v. Gallant*, 537 F.3d 1202, 1228 (10th Cir. 2008) (nondisclosure is actionable under the federal fraud statutes where there is a duty to speak); *United States v. Altman*, 48 F.3d 96, 102 (2d Cir. 1995) (failure to disclose material information while in a fiduciary relationship constituted a scheme to defraud). . . .

[At] oral argument before this Court, counsel for the Government identified no representations or statements other than those contained in the contracts and instead argued that the contractual representations were "made" not at contract execution but at the point of sale.

The plain language of the contracts does not admit this characterization. In the relevant contractual provisions, Countrywide "makes" or "warrants and represents" certain statements (*i.e.*, present-tense acts), including that the future transferred loan will be investment quality "as of" the transfer or delivery date. The use of a present-tense verb in a contract indicates that the parties intend the act—here, the making of the representation—to occur at the time of contract execution, not in the future. . . .

The testimony of the GSE employees, as well as former Countrywide employees, focused on the meaning and importance of the contractual representations but did not identify any promise, statement, or representation outside of the contract made to induce loan sales or to mask nonperformance. For example, an employee of Freddie Mac testified that he understood the contractual representation to mean that "the information that they're presenting to us at time of sale is accurate," which describes the timing of the representation's content, not the underlying promise itself. . . .

Accordingly, the jury had no legally sufficient basis on which to conclude that the misrepresentations alleged were made with contemporaneous fraudulent intent. . .

Problem 10-3

(a) Why might DOJ have chosen to pursue civil cases rather than criminal cases in the JP Morgan/Wamu/Bear Stearns matter and in the Bank of America/Countrywide matter?

(b) Is it good policy to have a statute (FIRREA) that enables DOJ to extract multi-billion dollar settlements from the large banks for a civil violation, that only has to be proven by a preponderance of the evidence, based on criminal violations that have not, in these cases, been charged criminally.