CLARITY AND PREDICTABILITY AT THE SEC: ABACUS, CITIGROUP, AND THE POLITICAL ECONOMY OF SECURITIES FRAUD SETTLEMENTS

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The United States Securities and Exchange Commission ("SEC") recently brought several enforcement actions against large investment banks for transactions involving collateralized debt obligations ("CDOs")—transactions that collectively cost their investors billions of dollars in losses. In three actions involving separate banks, the SEC reached widely different results, despite alleging similar transaction structures in each case. One commentator suggested that Citigroup benefited from a "late-mover" advantage in its dealings with the SEC. This allowed the bank to reach a favorable settlement compared to the settlement achieved by Goldman Sachs.

This Note examines the salient details of each of the three transactions and settlements: Goldman Sachs' ABACUS 2007-AC1, LTD; J.P. Morgan's Squared CDO 2007-1, Ltd.; and Citigroup's CLASS V Funding III, LTD. It then evaluates how the nine factors the SEC uses to guide its settlement decisions appear to have been applied

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inconsistently across transactions. Concluding that the nine factors do not adequately explain discrepancies in the settlement results, this Note argues that other differences, such as the timing of the suits, growing uncertainty regarding the applicability of legal standards to the available facts, and the varying public perception of each bank in question, provide more insight into the results of the SEC's enforcement actions.

I. INTRODUCTION

The enforcement actions by the Securities and Exchange Commission ("SEC") relating to the American financial crisis of 2008–09 paint a mixed picture of the SEC's effectiveness in policing financial players. On the one hand, the SEC is happy to trumpet its $1.97 billion in monetary recoveries incident to the financial crisis.[1] But not all are pleased—even the nearly $2 billion recovery is comparatively little when viewed against the size of the Troubled Asset Relief Program. Amid populist anger toward investment bankers and their ilk,[2] the SEC's failures in the Bernie Madoff scandal,[3] and public outrage over Wall Street's "obscene criminal scandals that impoverished millions and collectively destroyed . . . trillions of dollars of the world's wealth,"[4] the SEC has come under significant scrutiny—judicial and otherwise—for its role in regulating the financial industry.[5]

Recently, the SEC has brought enforcement actions against several large investment banks for transactions involving collateralized debt obligations ("CDOs") that collectively cost their investors billions of dollars. CDOs, and their synthetic variants, were a major contributing factor to

[1] SEC, SEC CHARGES STEMMING FROM FINANCIAL CRISIS (OCT. 19, 2011), http://www. sec.gov/news/press/2011/2011-214-chart-stats.pdf.

[2] *See, e.g.*, William. Ferguson, *Occupy Wall Street's Tony Bennett Moment*, THE 6TH FLOOR: EAVESDROPPING ON THE TIMES MAGAZINE (Oct. 5, 2011, 1:28PM), http://6thfloor.blogs.nytimes.com/2011/10/05/occupy-wall-streets-tony-bennett-moment.

[3] SEC OFFICE OF INVESTIGATIONS, Case No. 016-509 (OIG 509) INVESTIGATION OF FAILURE TO OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME, (2009), *available at* http://www.sec.gov /news/studies/2009 /oig-509.pdf.

[4] Matt Taibbi, *Why Isn't Wall Street in Jail?*, ROLLING STONE, Feb. 16, 2011, *available at* http://www.rollingstone.com/politics/news/why-isnt-wall-street-in-jail-20110216.

[5] *Id.*

the financial crisis,[6] and received substantial negative coverage in the popular press in the aftermath of the crisis.[7] In each recent enforcement action by the SEC, the bank in question marketed CDOs that were allegedly designed to lose money—and which did lose money—to investors in the CDO without disclosing that persons who would profit if the CDOs failed to perform had played a role in designing the investments. The investment banks, Goldman, Sachs & Co. ("GS&Co."), J.P. Morgan Securities LLC ("JPM"), and Citigroup Global Markets Inc. ("Citi"), all ultimately settled with the SEC and paid fines "without admitting or denying the SEC's allegations."[8] In rejecting the settlement proposed in *SEC v. Citigroup Global Markets Inc.*,[9] Judge Jed Rakoff opined that it was difficult "to discern from the limited information before the court what the SEC is getting from this settlement other than a quick headline."[10] His

[6] FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT, xxiv (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/ GPO-FCIC.pdf.

[7] *See, e.g.*, Felix Salmon, *Recipe for Disaster: The Formula that Killed Wall Street*, WIRED, Feb. 23, 2009, *available at* http://www.wired.com/tech biz/it/magazine/17-03/wp_quant?currentPage=all; Gretchen Morgenson, *How the Thundering Herd Faltered and Fell*, N.Y. TIMES, Nov. 9, 2008, at BUI.

[8] Consent Decree, SEC v. Goldman, Sachs & Co., No. 10 Civ. 3229 (S.D.N.Y. July 14, 2010) [hereinafter *Goldman Sachs* Consent Decree].

[9] Complaint, SEC v. Citigroup Global Markets Inc., No. 11 Civ. 7387 (S.D.N.Y Oct. 19, 2011) *available at* http://www.sec.gov/litigation/ complaints/2011/comp-pr2011-214.pdf [hereinafter *Citigroup* Complaint].

[10] SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328, 334 (S.D.N.Y. 2011). The Second Circuit later granted a stay of the trial that Judge Rakoff ordered. *See* SEC v. Citigroup Global Markets Inc., 673 F.3d 158, 161 (2d Cir. 2012) (per curiam). However, the Second Circuit recognized that Judge Rakoff's order raised important questions, including "the division of responsibilities between the executive and judicial branches and the deference a federal court must give to policy decisions of an executive administrative agency as to whether its actions serve the public interest." *Id.* at 160. The Second Circuit elected not to rule on the merits of "whether the district court's order should in fact be overturned,"

comments were precipitated in part by substantial differences between the proffered *Citigroup* settlement (which occurred in October 2011) and that in *SEC v. Goldman Sachs*[11] (where the complaint was filed in April 2010), even though the relevant transactions, as alleged by the SEC, were quite similar.[12] An analysis of the similarities between *Citigroup*, *Goldman Sachs*, and *SEC v. J.P. Morgan*[13] provides substantial insight into what appear to be the SEC's motivations in settling with GS&Co., JPM, and Citi, as well as the resulting treatment of the defendants.

This Note posits several political and legal explanations for the SEC's divergent treatment of GS&Co., Citi, and JPM, including the passage of Dodd-Frank, doctrinal uncertainty, tactical considerations in litigation, and public relations issues. By contrast, the stated methodology by which the SEC determines settlement amounts does not provide a compelling explanation for the differential treatment noted above. Part II begins by providing background information on the structure of cash, synthetic, and hybrid CDOs and CDOs-squared. Part III describes the elements of Rule 10b-5 and Sectio 17(a)(2) and (3) actions, and then continues with an analysis of the relevant facts of each case with special attention to the discrepancies in the facts and resulting settlement agreements between the parties. Finally, Part IV examines the political and legal justifications for the SEC's

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finding only that the SEC had shown a "*likelihood* of success." *Id.* at 161. Nevertheless, central to the Second Circuit's reasoning was the proposition that "the scope of a court's authority to second-guess an agency's discretionary and policy-based decision to settle is at best minimal," under existing law. *Id.* at 164.

11 Complaint, SEC v. Goldman, Sachs & Co., (No. 10 Civ. 3229) (S.D.N.Y. 2011), *available at* http://www.sec.gov/litigation/complaints/2010/comp21489.pdf [hereinafter *Goldman Sachs* Complaint].

12 *Cf. Citigroup* Complaint, *supra* note 9.

13 Complaint, SEC v. J.P. Morgan Securities LLC, (No. 11 Civ. 4206), (S.D.N.Y. June 21, 2011) *available at* http://www.sec.gov/litigation/complaints/2011/comp-pr2011-131-jpmorgan.pdf [hereinafter *J.P. Morgan* Complaint].

actions in more detail, with an accounting of the ex ante costs and benefits to the SEC of alternative actions.

II. BACKGROUND: CDO STRUCTURE AND RISK ALLOCATION

A CDO is, in simplest terms, "an arrangement that raises money primarily by issuing its own bonds and then invests the proceeds in a portfolio of bonds, loans, or similar assets. Payments on the portfolio [in which the CDO invested] are the main source of funds for repaying the CDO's own securities."[14] Many of the CDOs in the recent financial cataclysm were based on Residential Mortgage-Backed Securities (RMBS), bonds whose cash flows are derived from payments on home mortgages.[15] Additionally, most modern CDOs include "credit tranching," whereby payments from the CDO's underlying securities are subordinated by class ("tranche"), such that any non-payment of the securities would reduce payouts beginning with the lowest tranche—typically termed "equity"—and affecting senior tranches only when the immediately subordinate tranche had been completely wiped out.[16] In this type of setup, a $100 CDO could be divided such that the first $80 of payments flowing through the CDO would go to the owner of the most senior tranche, the next $15 could go to the owner of the second tranche, and the last $5—the equity—could go to the owner of the junior-most tranche. Owners of the senior tranche would therefore only fail to be fully repaid if less than $80 of the CDO's $100 obligation was paid by the reference

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[14] NOMURA FIXED INCOME RESEARCH, CDOS IN PLAIN ENGLISH: A SUMMER INTERN'S LETTER HOME 1 (2004), *available at* http://www.vinodkothari.com/Nomura_cdo_plainenglish.pdf [hereinafter *CDOS IN PLAIN ENGLISH*].

[15] *See, e.g.*, *Tremors*, THE ECONOMIST NEWSBOOK, Feb. 18, 2011 3:53PM, http://www.economist.com/blogs/newsbook/2011/02/residential_mortgage-backed_securities (mentioning that RMBS were "at the heart of the financial crisis").

[16] *See CDOS IN PLAIN ENGLISH*, *supra* note 14, at 2.

securities. Accordingly, subordinate tranches, having greater risks associated with them, will receive greater annual yields.[17]

A few additional wrinkles complicate this picture for our purposes. Where, as above, a set of ordinary bonds is grouped together with credit tranching, it is deemed a "cash CDO."[18] However, CDOs also have synthetic variants, which are backed by Credit Default Swaps ("CDSs"),[19] or hybrids, which are part synthetic and part cash.[20] A CDS is an over-the-counter derivative instrument similar to insurance whereby a protection buyer will pay premiums to a protection seller.[21] The seller agrees to be liable for up to a maximum "notional amount" for a particular period of time, specified in the contract, though the actual payout may be substantially less.[22] Such payout would occur upon the occurrence of a "credit event" of a "reference entity," the specific parameters of each to be defined in the contract.[23] A CDS can be sold either when the protection buyer has a financial interest in the reference entity (the buyer is, therefore, hedging), or, alternatively, when the buyer does not have a financial interest in the reference entity—in which case a CDS would be a speculative bet.[24] In essence,

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17 *See CDOs IN PLAIN ENGLISH*, *supra* note 14, at 2; *see also* ABACUS 2007-AC1, LTD., Offering Circular (Apr. 26 2007), at 3, *available at* http://av.r.ftdata.co.uk/files/2010/04/30414220-ABACUS-Offer-Document.pdf [hereinafter Abacus Prospectus] (where the third tranche, Class A-2, received a yield 0.25% greater than Class A-1, despite having the same ratings from both Moody's and S&P).

18 *See CDOs IN PLAIN ENGLISH*, *supra* note 14 at 5.

19 *Id.*

20 *Citigroup* Complaint, *supra* note 9, ¶ 5.

21 *Id.*

22 *CDOs IN PLAIN ENGLISH*, *supra* note 14, at 5.

23 *Id.*

24 *Hearing to Review the Role of Credit Derivatives in the U.S. Economy: Hearing Before the H. Comm. On Agriculture*, 110th Cong., 2d Sess. (2008) (testimony of Erik Sirri, Director, Division of Trading and Markets, SEC) *available at* http://www.sec.gov/news/testimony/2008/ts1

synthetic or hybrid CDOs transfer default risk to investors (protection sellers) in the CDO, who in turn receive payment streams derived from protection buyers' premium payments on the underlying set of CDSs.[25]

As Michael Lewis notes in *The Big Short*, a CDS is a zero-sum contract: you can make a substantial amount of money on either side of a CDS contract, but only if the counterparty loses the same amount of money.[26] Accordingly, protection *buyers* are, in essence, making a bet both that a credit event will occur and that the gains from a CDS referencing that event will be larger than premiums paid on it—a short position.[27] On the other hand, protection *sellers* are betting either that such a credit event will not occur or that any losses attributable to a CDS referencing that event will be exceeded by the premiums received—a long position.

In one variant of a synthetic CDO, the issuer creates both funded and unfunded tranches.[28] For a funded tranche, the protection seller would have to pay in the principal amount of that tranche (and receive compensation in the form of premiums paid by protection buyers *and* payment for the time-value of the principal),[29] but the principal amount can deviate substantially from the notional amount of the tranche.[30] By contrast, an unfunded tranche, for which a

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01508ers.htm ("Although CDSs are frequently described as insurance (buying protection against the risk of default), they, in fact, also are used by investors for purposes other than hedging. Institutions can and do buy and sell CDS protection without any ownership in the entity or obligations underlying the CDS.").

25 DOUGLAS LUCAS, JP MORGAN, CDO HANDBOOK 24 (2001), *available at* http://www.securitization.net/pdf/cdo_handbook.pdf.

26 MICHAEL LEWIS, THE BIG SHORT 29 (2d ed. 2011).

27 *Citigroup* Complaint, *supra* note 9, ¶ 5.

28 *CDOs IN PLAIN ENGLISH*, *supra* note 14, at 6.

29 *Id.*

30 *See* Abacus Prospectus, *supra* note 17, at 3 (For example, for Classes A-1 and A-2, the principal amounts were $50 million and $142 million for notional amounts of $200 million and $280 million,

long investor does not pay a purchase price up front, functions similar to a CDS that references the entire synthetic CDO, but only after the subordinate tranches had been wiped out.[31] In other words, a purchaser of the unfunded super senior tranche (i.e., a protection seller) that accounted for 55% of the notional value of an entire synthetic CDO would receive premiums without an upfront capital contribution, and would pay money to the protection buyer only to the extent that losses attributable to that CDO exceeded 45% of its value.[32]

Complicating this picture further is the CDO-squared, in which the underlying portfolio includes tranches of other CDOs.[33] In other words, the cash flows from certain levels of subordination in the underlying CDOs are then combined into a second CDO (the CDO-squared), which is then retranched to create a new subordinated structure. Although the mechanics of the CDO-squared are the same as a regular CDO with respect to credit tranching, there is an additional level of complexity as to where in the underlying CDOs defaults occur.[34] For example, in a scenario where a CDO-squared was composed of the middle tranche of three underlying CDOs (representing the payments from 70–90% of the value of that CDO), the CDO-squared would only suffer losses when one of the underlying CDOs had defaulted on more than 10% of its payments. By contrast, if all three underlying CDOs defaulted on 5% of their payments, then no losses would flow into the CDO-squared.[35]

respectively. *Id.* By contrast, the Super Senior Tranche was unfunded and had a notional amount of $1.1 billion). *Id.*

31 *CDOS IN PLAIN ENGLISH*, *supra* note 14, at 6.

32 *Id.*

33 NOMURA FIXED INCOME RESEARCH, CDOS-SQUARED DEMYSTIFIED 1 (2005), *available at* http://www.securitization.net/pdf/Nomura/CDO Squared_4Feb05.pdf [hereinafter *CDOS-SQUARED DEMYSTIFIED*].

34 *Id.* at 3–4.

35 *Id.* at 4.

One major justification for the process of grouping and tranching assets is that putting together a diversified portfolio—where there is low correlation between separate assets—can add value by reducing a hypothetical investor's exposure to any one underlying security.[36] Consider a hypothetical: an investor is looking to invest $100 into real estate. He could originate a single mortgage loan to an individual for $100, where, say, that individual had a 5% chance of defaulting and the investor would lose $100 (putting aside the more complicated mathematics and the likelihood that the investor will recover the house as collateral). The key insight is that the 5% chance of default for this investor may be composed of 2% market risk—conditions in the general economy—and 3% idiosyncratic risk—conditions unique to that mortgage borrower. Alternatively, the investor, abjuring a single mortgage loan, could instead give $1 each to 100 homebuyers, each of whom had a 5% chance of defaulting, composed of the same market and idiosyncratic risk rates. Assuming that none of the specific factors of idiosyncratic risk for each homeowner are correlated (say, to take just one example, that one homeowner losing his job will not lead to another homeowner's job loss), the investor is able to reduce his risk through diversification from 5% to approximately 2% by loaning to 100 people.[37]

The same mathematics applies to CDOs-squared. In theory, a CDO-squared should provide greater diversification than a single-layer CDO, as well as greater loss protection.[38] This is because CDOs-squared reference "between five and

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36 *CDOs IN PLAIN ENGLISH*, *supra* note 14, at 3.

37 For a more detailed discussion of idiosyncratic and market risk, including the principle "the risk of a well-diversified portfolio depends on the *market risk* [as opposed to idiosyncratic risk] of the securities included in the portfolio," see RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 162–79 (10th ed. 2011); *see also* ZVI BODIE, ALEX KANE & ALAN J. MARCUS, INVESTMENTS 197 (9th ed. 2011).

38 *CDOs-SQUARED DEMYSTIFIED*, *supra* note 33, at 3.

ten" one-layer CDOs, which themselves reference many underlying securities.[39] Moreover, there are multiple layers of tranches both within the single-layer CDOs and also within the CDO-squared, which should protect those protection sellers holding more senior layers.[40] On the other hand, CDOs-squared have "amplifie[d] sensitivity to parameters such as default probability and subordination."[41]

This picture contains many further complications. Many of the CDOs and CDOs-squared in the financial crisis were tied to the residential housing market, which implies certain payment scenarios that are not excellent fits for the description provided above. To name one example, since mortgage borrowers are frequently able to make advance payments on their obligations or refinance entirely,[42] there are likely to be variable cash flows into the underlying securities that are in excess of the security's contractual yield, and credit tranching alone provides little guidance on which investors should receive these excess payments. Moreover, such payments are likely to occur when the investors least want them.[43] While a number of possible

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39 *CDOs-SQUARED DEMYSTIFIED*, *supra* note 33, at 3.

40 *Id.*

41 *Id.* at 4. *But see generally* Joshua D. Coval et al., *Economic Catastrophe Bonds* (Harv. Bus. Sch. Working Paper No. 07-102, 2008), *available at* http://papers .ssrn.com/sol3/papers.cfm?abstract_id=995249 (explaining that, despite the amplified sensitivity to default probability and subordination, many structured finance instruments such as CDOs-squared offer less compensation than comparably risky economic catastrophe bonds; the implication of this is that market prices of these CDOs were inefficient when compared to economic catastrophe bonds, and investors in those CDOs had agreed to contracts in which they were not being compensated adequately for their risk).

42 GEORGE LEFCOE, REAL ESTATE TRANSACTIONS, FINANCE AND DEVELOPMENT 351 (2d ed. 1997) (noting that "prepayment is freely allowed in the standard FNMA/FHLMC form note for single-family, owner-occupied homes and in all FHA and VA home loans").

43 Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657, 670 (2012).

solutions to this problem exist, these solutions require careful structuring of the economic rights held by the various tranches for each CDO.[44] In other words, "there is no cookie cutter that may be used to create these transactions."[45] However, this complexity also enabled sponsors to "create securities particularly suited to meet the individualized need of different investors"[46] who were "generally capable (or at least presumed to be under applicable securities laws) of identifying, obtaining, and processing the information required to evaluate a potential investment."[47]

III. SECURITIES FRAUD? THE *GOLDMAN SACHS*, *J.P. MORGAN*, AND *CITIGROUP* TRANSACTIONS

The cases at issue here—at least as described by the SEC—are all fundamentally similar, though the suits were brought during a period encompassing more than a year. In each case, a CDO largely relying on CDSs was created and marketed to investors,[48] the marketing material for each CDO indicated that the portfolio was selected by a third party, and the marketing materials made no reference to another party that had a significant role in the portfolio selection and who was looking to short the CDO.[49] However,

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44 *See* Judge, *supra* note 43, at 673–76 (discussing the needs of heterogeneous investors and the series of decisions to be made by sponsors, such as how to allocate principal payments among investors, how many tranches to issue, and interest rates, among others). Although this discussion occurs in a section discussing private label MBS, the series of decisions and mechanisms is not irrelevant to CDOs generally.

45 *See id.* at 673.

46 *Id.* at 676.

47 *Id.* at 712.

48 *See* Abacus Prospectus, *supra* note 17, at 2–3 (demonstrating that although *Goldman Sachs* more accurately involved the creation of a partially-funded CDO which itself entered into a CDS with GS&Co., the effect of the transaction is similar in that investors would be liable for losses incurred by the protection buyer).

49 *Goldman Sachs* Complaint, *supra* note 11, ¶ 2; *J.P. Morgan* Complaint, *supra* note 13, ¶ 2; *Citigroup* Complaint, *supra* note 9, ¶ 2.

there are a few key distinctions in the SEC's complaints that merit a closer look at each individual transaction. Part III begins by detailing the elements of the causes of action used by the SEC—Section 10(b), Rule 10b-5, and Section 17(a)—and then examines each of the relevant transactions.

A. Securities Anti-Fraud Provisions: Section 10(b), Rule 10b-5, and Section 17(a)

The SEC sued GS&Co.[50] on April 16, 2010, under SEC Rule 10b-5[51]—which was promulgated under the authority granted by Section 10(b) of the Securities Exchange Act of 1934[52]—and under Section 17(a)(1), (2), and (3) of the

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50 *Goldman Sachs* Complaint, *supra* note 11, ¶ 1.

51 The full text of Rule 10b-5 is as follows:

Employment of manipulative and deceptive devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

a. To employ any device, scheme, or artifice to defraud,
b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5 (2012).

52 The full text of § 10(b) is as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of national securities exchange—

b. To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78J(b) (2012).

Securities Act of 1933.[53] By contrast, its complaints against JPM and Citi (dated June 21, 2011, and October 19, 2011, respectively) only alleged violations of Section 17(a)(2) and (3). Under Rule 10b-5, the SEC must demonstrate that the defendant "(1) made a material misrepresentation or a material omission as to which he had a duty to speak, or used a fraudulent device; (2) with scienter; (3) in connection with the purchase or sale of securities."[54] Rule 10b-5 and Section 17(a) are substantially similar,[55] with only a few key differences: most notably, that Section 17(a)(2) and (3) do not require a showing of scienter (although Section 17(a)(1) does).[56] In other words, negligence is sufficient to establish a violation of Section 17(a)(2) or (3). Many courts have also held that Section 17(a) does not imply a private right of action—enforcement of Section 17(a) is at the hands of the SEC alone,[57] while a private plaintiff may sue under Rule

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53 The full text of § 17(a) is as follows:

a. Use of interstate commerce for purpose of fraud or deceit.

   It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in [section 206B of the Gramm-Leach-Bliley Act]) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

   1) to employ any device, scheme, or artifice to defraud, or
   2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
   3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. 15 U.S.C. § 77Q (2012).

54 SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir. 1999) (citing SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1467 (2d Cir. 1996)).

55 *Id.* ("Essentially the same elements are required under Section 17(a)(1)–(3) . . . .").

56 *See* Aaron v. SEC, 446 U.S. 680, 697 (1980).

57 *See, e.g.*, Maldonado v. Dominguez, 137 F.3d 1, 7 (1st Cir. 1998) (stating that every circuit to have addressed the issue recently has not

10b-5, so long as he can demonstrate both reliance and loss causation.[58]

The Supreme Court held in *Basic, Inc. v. Levinson* that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[59] To fulfill this requirement, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[60] Furthermore, in the Second Circuit, the standard for scienter for claims brought under Rule 10b-5 includes recklessness.[61]

B. *Goldman Sachs* and Paulson

In 2006, John Paulson[62] began purchasing CDSs on debt securities referencing mortgage loans via his fund, Paulson & Co. ("Paulson").[63] During the winter of 2006–07, Paulson approached representatives at GS&Co. to ask them to help it buy protection on "various bonds it expected to experience

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recognized a private right of action under § 17(a)); Finkel v. Stratton Corp., 962 F.2d 169, 175 (2d Cir. 1992) (concluding that there is no private right of action under § 17(a) and stating that circuit courts examining § 17(a) in recent decades have all come to the same conclusion).

[58] Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

[59] Basic, Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)) (expressly adopting the standard for materiality articulated in that case).

[60] *Levinson*, 485 U.S. at 231.

[61] SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976)) ("the scienter needed for proof of a claim under § 10(b) or Rule 10b-5 may be established through a showing of reckless disregard for the truth, that is, 'conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care.'") (internal citations omitted).

[62] In typically colorful language, Michael Lewis quotes a rich man referring to Paulson as "a third-rate hedge fund guy who didn't know what he was talking about." LEWIS, *supra* note 26, at 106.

[63] *Goldman Sachs* Complaint, *supra* note 11, ¶ 11.

credit events."[64] Allegedly, GS&Co. and Fabrice Tourre, a GS&Co. representative who was working with Paulson, believed that it would be difficult "to place the liabilities of a synthetic CDO if they disclosed to investors that a short investor . . . played a significant role in the collateral selection process."[65] As a result, GS&Co. sought to engage a collateral manager for the transaction, but realized that "not every collateral manager would 'agree to the type of names [of RMBS] Paulson want[ed] to use' and put its 'name at risk . . . on a weak quality portfolio.'"[66]

ACA Management LLC ("ACA"), a company that had previously sponsored twenty-two transactions,[67] ultimately agreed to serve as collateral manager, in large part, the SEC alleges, because "GS&Co. [was] responsible for ACA's misimpression that Paulson had a long position, rather than a short position, with respect to the CDO."[68] There is some contrary evidence here, however: Paolo Pellegrini, a former employee of Paulson, has stated that he informed ACA that Paulson "wanted to buy protection on traunches [sic] of a synthetic RMBS portfolio."[69] (It should also be noted that in *J.P. Morgan*, discussed in detail *infra*, the hedge fund Magnetar held a small equity position in the CDO it

64 *Goldman Sachs* Complaint, *supra* note 11, ¶¶ 15, 25.

65 *Id.* ¶ 19.

66 *Id.* ¶ 21.

67 *Id.* ¶ 22. ACA was also nominated "Financial Guarantor of the Year" in 2005 and had an excellent reputation in the marketplace. *See* Tracy Alloway, *ACA's Rather Disastrous CDO Forays*, FIN. TIMES ALPHAVILLE (Apr. 19, 2010, 8:35 AM), http://ftalphaville.ft.com/blog/2010/04/19/205571/acas-rather-disastrous-cdo-forays. ABACUS 2007-AC1 was to be ACA's fifth transaction utilizing synthetic RMBS. *See* GOLDMAN SACHS & ACA CAPITAL, ABACUS 2007-AC1: $2 BILLION SYNTHETIC CDO REFERENCING A STATIC RMBS PORTFOLIO 13, *available at* http://www.scribd.com/doc/30036962/Abacus-2007-Ac1-Flipbook-20070226.

68 *Goldman Sachs* Complaint, *supra* note 11, ¶ 45.

69 Steve Liesman & Jeff Cox, *Testimony Could Undercut SEC Charge Against Goldman*, CNBC.COM (Apr. 21, 2010, 3:23 PM), http://www.cnbc.com/id/36685026.

intended to short.[70]) Finally, after an involved bargaining process between Paulson and ACA,[71] the two parties settled on a reference portfolio of ninety RMBS for the deal.[72]

As noted above, the marketing materials for the deal did not include any mention of Paulson's involvement,[73] and in marketing to outside investors such as IKB Deutsche Industriebank AG ("IKB"), GS&Co. emphasized that the portfolio was selected by ACA.[74] IKB invested $150 million in Classes A-1 and A-2, most of which was paid to Paulson.[75] The SEC alleges that IKB would not have invested in the transaction without the presence of an "independent third-party with knowledge of the U.S. housing market and expertise in analyzing RMBS,"[76] or, in short, ACA. Similarly, ACA Capital Holdings, Inc. ("ACA Capital"), ACA's parent, sold protection on the $909 million super senior (unfunded) tranche, a substantial portion of which was eventually guaranteed by ABN AMRO Bank N.V. ("ABN").[77] ABN ultimately paid approximately $840.9 million to unwind its position in the trade, most of which went to Paulson.[78] Finally, it is worth noting that GS&Co.

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70 *J.P. Morgan* Complaint, *supra* note 13, ¶ 2.

71 *Goldman Sachs* Complaint, *supra* note 11, ¶¶ 26–35. Notably, according to the complaint, the negotiations lasted from January 8, 2007 until February 26 of the same year and included several episodes of back-and-forth revisions of the other party's suggested inclusions in the portfolio. For example, Paulson submitted a proposed list of 123 sub-prime positions, of which ACA only agreed to fifty-five (despite having previously bought sixty-two at the same rating or lower). *Id.* ¶ 30. After later agreeing on eighty-two RMBS, ACA internally reviewed the proposed portfolio, and agreed to a final selection of ninety RMBS on February 26, 2007. *Id.* ¶¶ 34–35.

72 *Id.* ¶ 35.

73 *Id.* ¶ 36.

74 *Id.* ¶ 57.

75 *Id.* ¶ 60.

76 *Id.* ¶ 53.

77 *Goldman Sachs* Complaint, *supra* note 11, ¶¶ 61, 63.

78 *Id.* ¶ 66.

also had a net long position in the trade of $90 million, which it lost.[79]

As a result of this trade, the SEC sued GS&Co. and Fabrice Tourre on April 16, 2010 for violations of Section 17(a)(1), (2), and (3), as well as Section 10(b) and Rule 10b-5.[80] Each claim, however, was tied to two actions: first, that GS&Co. had misled investors—such as IKB—through the use of misleading materials, and second, that GS&Co. had misled ACA by not correcting ACA's "misimpression" of Paulson's economic interests.[81] As a result of the SEC's suit, GS&Co.'s share price closed $23.57 below its previous day close,[82] meaning that the firm's market capitalization fell by more than $10 billion.[83] GS&Co. later settled with the SEC on July 14, 2010, and paid $15 million in disgorgement of profits and $535 million in civil penalties.[84] Although GS&Co. neither admitted nor denied the allegations of the complaint,[85] it agrees that "it was a mistake for the Goldman marketing materials to state that the reference portfolio was 'selected by' ACA Management LLC without disclosing the role of Paulson & Co. Inc.. . . . Goldman regrets that the marketing materials did not contain that disclosure."[86]

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79 Joseph A. Grundfest, *SEC v. Goldman, Sachs & Co. and Fabrice Tourre*, 12 (Apr. 27, 2010), http://rockcenter.law.stanford.edu/wp-content/uploads/2010/05/SEC-Goldman-Complaint-Analysis_-Joe_-Grundfest.ppt?9d7bd4.

80 *Goldman Sachs* Complaint, *supra* note 11, ¶¶ 68–74.

81 *Id.* ¶¶ 70, 74.

82 Historical Prices for Goldman, Sachs & Co., YAHOO! FINANCE, http://finance.yahoo.com/q/hp?s=GS+Historical+Prices (enter "Start Date" of April 10, 2010 to "End Date" of May 1, 2010, click the radio button next to "Daily," and follow "Get Prices" button) (last visited Dec. 19, 2012).

83 *See, e.g.*, Felix Salmon, *Goldman's Abacus Lies*, REUTERS, Apr. 16, 2010, http://blogs.reuters.com/felix-salmon/2010/04/16/goldmans-abacus-lies.

84 *Goldman Sachs* Consent Decree, *supra* note 8, ¶ 2.

85 *Id.*

86 *Id.* ¶ 3.

C. *J.P. Morgan* and Magnetar

Although the technicalities of the *J.P. Morgan* transaction differ somewhat from that of the *Goldman Sachs* transaction,[87] the essentials are broadly similar. In early January 2007, JPM executed an agreement with GSCP (NJ) L.P. ("GSC") to select and manage a portfolio of cash and synthetic CDO investments that were to be placed into a CDO-squared.[88] GSC selected—alone, at first, and later with the help of the hedge fund Magnetar Capital LLC ("Magnetar")—several securities to be included in the CDO-squared.[89] Magnetar bought protection on several of the CDO securities selected by GSC, while the other short counterparties were identified using a "bid wanted in competition" ("BWIC") process.[90] Magnetar purchased a small amount of equity in the CDO,[91] and then, beginning in early February 2007, began negotiating individual CDO securities to be included in the deal, many of which it shorted.[92] During this period, JPM held the warehouse risk,

[87] For example, the relevant CDO in question was a CDO-squared with a funded senior tranche as opposed to the more quotidian single-layer, unfunded Abacus 2007-AC1. *See* Squared CDO 2007-1, Ltd., Offering Circular (May 10, 2007), 1 (2007), *available at* http://s3.documentcloud.org/documents/11872/squared-cdo-2007-1-ltd-prospectus.pdf [hereinafter Squared Prospectus]. Similarly, whereas in *Goldman Sachs* Paulson is not alleged to have held any equity position at all, here, Magnetar Capital LLC ("Magnetar")—the relevant hedge fund—held a small equity position of $8.9 million, largely as a check-the-box transaction to be able to purchase protection. *See also J.P. Morgan* Complaint, *supra* note 13, ¶ 15.

[88] *J.P. Morgan* Complaint, *supra* note 13, ¶ 9. GSC is not a GS&Co. affiliate.

[89] *Id.* ¶¶ 14–16.

[90] *Id.* ¶ 14 (explaining a BWIC process is a procedure whereby "a list of bonds is submitted to various brokers to solicit bids for protection on those bonds." As discussed in Part II, *supra*, synthetic CDOs require short counterparties—protection buyers—to provide premium payments).

[91] *Id.* ¶ 2.

[92] *Id.* ¶¶ 16–19.

which meant that until the deal closed, JPM would be financially responsible for any losses in the portfolio.[93] Magnetar and GSC continued negotiating which CDO securities would be included in the portfolio until May 4, 2007.[94]

As in *Goldman Sachs*, the marketing materials made little mention of Magnetar's involvement in selecting the portfolio, instead "emphasizing the advantages of having GSC select and manage . . . the portfolio."[95] However, there was a disclosure to the effect that a noteholder could hold a short position regardless of the effect such a position might have on the transaction.[96]

Although "a number of traditional United States and European CDO investors rejected [the CDO-squared]," JPM was ultimately able to sell $150 million of notes to several investors located domestically and abroad,[97] many of whom indicated "that they would have considered it important to their investment decision to have known that the equity investor in Squared had shorted approximately half of the investment portfolio and played a significant role in the collateral selection process."[98] Additionally, JPM, like

[93] *J.P. Morgan* Complaint, *supra* note 13, ¶ 20.

[94] *Id.* ¶ 30.

[95] *Id.* ¶¶ 37–41.

[96] *Id.* ¶ 40.

[97] *Id.* ¶¶ 33, 42.

[98] *Id.* ¶ 43. The total pool of investors included seven domestic and eight international investors. Included were "Thrivent Financial for Lutherans, a Minneapolis, Minnesota-based, not-for-profit life insurance organization ($10 million notional); General Motors Asset Management, a New York City-based asset manager for General Motors' pension plans ($10 million notional); Security Benefit Corporation, a Topeka, Kansas-based provider of insurance and retirement products ($12 million notional); Moneygram International Inc., a Minneapolis, Minnesota-based provider of global money transfer and bill payment services ($15 million notional); Fifth Third Asset Management Inc., a Cincinnati, Ohio-based investment advisor and mutual fund company ($4 million notional); Morgan Asset Management Inc., the Birmingham, Alabama-based asset management unit of broker-dealer Morgan & Keegan Co. ($6 million

GS&Co., was also a protection seller on the deal, ultimately losing $880 million.[99]

The SEC sued JPM for violations of Section 17(a)(2) and (3) on June 21, 2011, and settled on the same day.[100] Unlike in *Goldman Sachs*, however, JPM was only charged with misleading investors, and not with misleading GSC.[101] According to the terms of the consent judgment, JPM paid $18.6 million in disgorgement of profits, $2 million in prejudgment interest, and a $133 million penalty.[102] JPM neither admitted nor denied the SEC's allegations.[103] In contrast with GS&Co., JPM's share price closed $0.43 higher than the previous day.[104] In addition, the SEC brought charges against Edward Steffelin, the GSC employee

notional); and Dillon Read Finance L.P., a New York City-based affiliate of a hedge fund unit within UBS known as Dillon Read Capital Management ($20 million notional)," and "two Taiwanese life insurance companies, Far Glory Life Insurance Company Ltd. ($5 million notional) and Taiwan Life Insurance Company Ltd. ($3 million notional); three banks, Paris-based Caisse D'Epargne ($20 million notional), Tokyo-based Tokyo Star Bank ($8 million notional) and Singapore-based United Overseas Bank ($13 million notional); two asset managers, Hong Kong-based East Asia Asset Management Ltd. ($1 million notional) and Tel Aviv-based Leader Capital Markets Ltd. ($2 million notional); and Sydney-based hedge fund, Basis Pac-Rim Opportunity Fund ($10 million notional)." *J.P. Morgan* Complaint, *supra* note 13, ¶¶ 44–45.

99 Kara Scannell & Justin Baer, *JPMorgan in Talks to End CDO Marketing Probe*, FIN. TIMES, Apr. 2, 2011, *available at* http://www.ft.com/intl/cms/s/0/2b73cc86-5cb1-11e0-ab7c-00144feab49a.html#axzz1jIh0E8DA.

100 J.P. Morgan Securities to Pay $153.6 Million to Settle SEC Charges of Misleading Investors in CDO Tied to U.S. Housing Market SEC Litig. Release No. 22008, 2010 WL 6796637 (June 31, 2011), *available at* http://www.sec.gov/ litigation/litreleases/2011/lr22008.htm.

101 *J.P. Morgan* Complaint, *supra* note 13, ¶ 48.

102 SEC Litig. Release No. 22008, *supra* note 100 at •2.

103 *Id.*

104 Historical Prices for J.P. Morgan Securities, YAHOO! FINANCE, http://finance.yahoo.com/q/hp?s=JPM&a=05&b=19&c=2011&d=05&e=24&f=2011&g=d (enter "Start Date" of May 19, 2011 to "End Date" of May 24, 2011, click the radio button next to "Daily," and follow "Get Prices" button) (last visited Dec. 19, 2012).

responsible for selecting the portfolio in *J.P. Morgan*. The SEC alleged that he had violated Section 17(a)(2) and (3), as well as § 206(2) of the Investment Advisers Act of 1940.[105] The SEC also authorized administrative proceedings against GSC for its role in the transaction.[106]

D. Citigroup

Although the transaction at issue in *Citigroup* shares many elements with *J.P. Morgan* and *Goldman Sachs*, one wrinkle in particular sets it apart. Whereas JPM and GS&Co. held long positions and were acting largely on behalf of outside hedge funds that were negotiating more or less independently with GSC and ACA, in *Citigroup*, Citi held a short position of $500 million and was acting on its own behalf.[107] Like JPM, Citi was charged only with violations of Section 17(a)(2) and (3),[108] and ultimately settled with the SEC for $285 million.[109]

The SEC alleges that "[Citi] knew that representing to investors that an experienced, third-party investment advisor had selected the investment portfolio would facilitate the placement of the notes that the CDO-squared would issue."[110] Accordingly, Citi approached Credit Suisse Alternative Capital ("CSAC") in October 2006, to secure

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105 15 U.S.C. § 80b-6 (2012); SEC Litig. Release No. 22008, *supra* note 100 at *2.

106 *Id.*

107 *Citigroup* Complaint, *supra* note 9, ¶ 2 (alleging that "[t]he CDO securities on which Citigroup bought protection had a notional value of approximately $500 million, representing half of the Class V III investment portfolio"). For the size of Citi's short position, see *id.* ¶ 45.

108 *Id.* ¶ 65.

109 Citigroup To Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Company Profited from Proprietary Short Position Former Citigroup Employee Sued for His Role in Transaction, SEC Litig. Release No. 22134, (Oct. 19, 2011), *available at* http://www. sec.gov/litigation/litreleases/2011/lr22134.htm.

110 *Citigroup* Complaint, *supra* note 9, ¶ 20.

CSAC's services as collateral manager for the CDO-squared.[111] After internally vetting several CDOs to include in the CDO-squared, CSAC and Citi agreed to proceed with the transaction,[112] and worked over the next couple of months to finally determine which CDOs were to be included in the CDO-squared.[113] However, it is questionable whether the dealings between Citi and CSAC were truly at arm's length: when one prospective investor began asking questions about why certain deals had been included, an internal email indicated that CSAC had a rationale for only some of the deals the investor was examining.[114]

As with *J.P. Morgan* and *Goldman Sachs*, the marketing materials focused on CSAC's role in "select[ing]" the investment portfolio did not mention the role that Citi had played in selecting the securities to be included in the CDO-squared,[115] and also did not mention the extent of Citi's short position (although they did mention that "[Citi] may provide CDS Assets as an intermediary with matching off-setting positions requested by the Manager, or may provide CDS Assets alone without any off-setting positions").[116] In the end, approximately fifteen investors sold roughly $843 million of protection on the deal.[117] Documentation for one investor, Ambac, indicates that CSAC's reputation and

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111 *Citigroup* Complaint, *supra* note 9, ¶ 21.

112 *Id.* ¶ 28.

113 *Id.* ¶¶ 29–37.

114 *Id.* ¶ 41.

115 *Id.* ¶ 42.

116 *Id.* ¶ 43.

117 *Citigroup* Complaint, *supra* note 9, ¶ 48. The investors included Ambac, intermediated by BNP, who sold protection on the $500 million super senior tranche, as well as several "hedge funds, investment managers and other CDO vehicles," who collectively invested in notes with a par value of $343 million. *Id.* ¶¶ 53–54. One such investor noted that, despite discomfort with the asset selection, it felt that CSAC's reputation was strong enough for it to invest. *Id.* ¶ 55.

"perceived disciplined approach to the selection of securities" were of particular importance to its decision to invest.[118]

The CDO-squared performed poorly, and Citi earned $34 million in fees and approximately $160 million in net profits.[119] The SEC sued Citi on October 19, 2011, and settled on the same day.[120] The consent judgment, however, is still awaiting judicial approval in light of Judge Rakoff's rejection. Such approval may or may not be forthcoming, although the Second Circuit recently granted a stay of the district court proceedings, holding that the SEC and Citigroup had shown a *likelihood* of success on the merits of their appeal.[121] Still, as in *J.P. Morgan* (and unlike in *Goldman Sachs*), Citi was only charged with misleading investors, and not with misleading CSAC.[122] Citi agreed to pay (without admitting or denying the SEC's allegations) $160 million in profit disgorgement, $30 million in prejudgment interest, and $95 million as a penalty.[123] In addition, the SEC instituted administrative proceedings against CSAC and its successors in interest (and one employee) for their roles in the asset selection process and preparation of the marketing materials; CSAC and the other defendants have also agreed to settle the SEC's proceedings against them.[124]

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118 *Citigroup* Complaint, *supra* note 9, ¶ 50.

119 *Id.* ¶¶ 62–63.

120 SEC Litigation Release No. 22134, *supra* note 109.

121 SEC v. Citigroup Global Markets Inc., 673 F.3d 158, 161 (2d Cir. 2012) (per curiam). For a discussion of the issues surrounding judicial approval of the consent judgment, see Edward Wyatt, *Citing 'Legal Error,' S.E.C. Says It Will Appeal Rejection of Citigroup Settlement*, N.Y. TIMES, Dec. 16, 2011, *at* B3.

122 *Citigroup* Complaint, *supra* note 9, ¶ 65.

123 SEC Litig. Release No. 22134, *supra* note 109.

124 *Id.*

E. Transactions Summary

The suits against GS&Co., JPM, and Citi can be summarized as follows:

	GS&Co.	JPM	Citi
Type of trade:	Non-proprietary Single-layer CDO	Non-proprietary CDO-squared	Proprietary CDO-squared
Long or Short	Long	Long	Short
Value of Gain or (Loss) on the Trade (Including Fees)	($75.0 million)	($861.4 million)	$160.0 million
Claims Filed by SEC	§ 10(b) and Rule 10b-5, § 17(a)(1), (2), and (3)	§17(a)(2) and (3)	§ 17(a)(2) and (3)
Parties Allegedly Misled by Defendants	Investors and Structuring Party	Investors Only	Investors Only
Portfolio Selection Agent Sued by SEC?	No	Yes	Yes
Elapsed Time Between Suit and Settlement	91 Days	0 Days	0 Days
Value of Profit Disgorgement	$15.0 million	$18.6 million	$160.0 million
Value of Penalty	$535.0 million	$133.0 million	$95.0 million
Total Settlement Amount	$550.0 million	$153.6 million (includes interest)	$285.0 million (includes interest)

Some commentators—including Judge Rakoff[125]—have called Citi's alleged conduct arguably more egregious than that in *Goldman Sachs*.[126] Judge Rakoff noted that,

125 *See* SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011).

126 *See* Peter J. Henning, *The Late-Mover Advantage in Citigroup's Settlement*, N.Y. TIMES DEALBOOK, (Oct. 20, 2011, 10:15AM), http://dealbook.nytimes.com/2011/10/20/the-late-mover-advantage-in-

according to the SEC, GS&Co. could be required to pay a larger settlement because it had allegedly engaged in scienter-based infractions (the Rule 10b-5 and Section 17(a)(1) claims), but that in his view, such "logic is circular . . . because the SEC does not explain how [GS&Co.'s] actions were more culpable or *scienter*-based than [Citi's] actions here."[127] In essence, it was unclear to Judge Rakoff why GS&Co. had been charged more aggressively than Citi, since the facts as alleged did not seem to support the differences either in the number and severity of claims or in the ultimate settlement value. Finally, GS&Co. was not able to negotiate a settlement with the SEC in advance of being charged, whereas Citi and JPM were. As a result of the litigation, GS&Co. suffered a substantial plunge in stock price, while Citi was able to turn the case "into a one-day news event."[128]

In other words, GS&Co. was more harshly charged than—and paid a much larger penalty than—Citi for questionable conduct that was matched, and potentially exceeded, by Citi's conduct, without having the reprieve of favorable settlement-negotiating circumstances. In particular, the SEC was much less aggressive in pursuing claims against JPM and Citi than it was against GS&Co. in two respects. First, by removing claims with a scienter requirement (Rule 10b-5 and Section 17(a)(1)), the SEC reduced the severity of the charges it brought against JPM and Citi but increased the likelihood of extracting a successful settlement from them, because the legal standard for the remaining claims—negligence—encompasses a wider corpus of actionable conduct and eliminates the fact-specific state of mind inquiry. Second, and perhaps more importantly, the SEC was also less aggressive in pursuing Citi and JPM than GS&Co. inasmuch as it abjured claims

citigroups-settlement/ (explaining that Citi's actions could be considered "more pernicious" than the allegations against Goldman).

127 Citigroup Global Markets, 877 F. Supp. 2d at 334 n. 7.

128 Henning, *supra* note 126.

predicated on misrepresentation between the banks and the portfolio selection agents, CSAC and GSC, and instead focused on misrepresentation toward the investors—a misrepresentation that, on similar facts, GS&Co. had already admitted was "a mistake."[129]

Finally, the lack of enforcement action against ACA provides some mild additional support for the proposition that the *Goldman Sachs* transaction was more benign,[130] since at least in that case it appears that ACA went through a more contentious negotiation process with Paulson[131] in trying to discharge its role as portfolio selection agent, whereas the SEC alleged that both GSC and CSAC were complicit or otherwise had conflicts of interest in their respective transactions.[132]

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[129] *Goldman Sachs* Consent Decree, *supra* note 8, ¶ 3.

[130] Though, to be sure, since the SEC itself determines whether or not to file suit, there are many plausible interpretations of the lack of enforcement action against ACA. For example, the SEC could have independently bargained with ACA or its affiliates to forego suit in exchange for cooperation against GS&Co. Alternatively, the SEC could have determined that litigating against GS&Co. would consume all its resources and that in doing so—GS&Co. being by far the bigger fish—it would be precluded from pursuing ACA.

[131] *See supra* note 71. The SEC alleges both that GS&Co. misled investors *and* was "responsible for ACA's misimpression that Paulson had a long position," such that in the SEC's reading GS&Co. was doubly culpable for misleading both the investors and ACA, but as noted, there are reasons to doubt the SEC's version of events. *See supra* note 68.

[132] *See* Credit Suisse Alternative Capital, LLC, Securities Act Release No. 9268, Investment Advisers Act Release No. 3302, 2011 WL 4957372 at *2, (Oct. 19, 2011), *available at* http://www.sec.gov/litigation/admin/2011/33-9268.pdf ("CSAC and Bhatt [the employee] also represented in the pitch book that CSAC performed extensive credit analysis on all the assets that it selected for the portfolio. In actuality, CSAC and Bhatt performed little-to-no analysis on several assets in the portfolio."); *see also* Complaint, SEC v. Edward Steffelin, No. 11 Civ. 4204 (S.D.N.Y Jun. 21, 2011), ¶¶ 27–28 *available at* http://www.sec.gov/litigation/complaints/2011/comp-pr2011-131-steffelin.pdf (noting that Steffelin, working at GSC at the time, had approached Magnetar in seeking employment there).

IV. EXPLAINING DIVERGENT TREATMENT AT THE HANDS OF THE SEC

There are a number of potential explanatory factors for the divergent treatment of GS&Co., Citi, and JPM in the transactions discussed above. While few records of discussions inside the SEC or settlement negotiations with the parties are publicly available, in the interest of "clarity, consistency, and predictability in explaining the way that its corporate penalty authority will be exercised," the SEC has issued guidelines stating the effect of various factors on the size of settlements.[133] Unfortunately, these guidelines are not particularly helpful in understanding the differences between the settlements in *Goldman Sachs*, *J.P. Morgan*, and *Citigroup*. By contrast, the national political climate, changing evaluations of the merits of the claimed suits, and incentives for both parties to settle quickly contribute to a more plausible explanation of the settlement discrepancies highlighted above. Part IV examines each in turn.

A. The SEC's Nine-Factor Test

The settlement factors highlighted by the SEC contribute little to an understanding of the discrepancy highlighted above. The nine factors are:

1) The presence or absence of a direct benefit to the corporation as a result of the violation;
2) The extent of the injury to innocent parties;
3) The degree to which the penalty will recompense or further harm the injured shareholders;
4) The degree of difficulty in detecting the particular type of offense;
5) Extent of cooperation with Commission and other law enforcement;
6) The need to deter the particular type of offense;

133 Press Release, SEC, Statement of the SEC Concerning Financial Penalties (Jan. 4, 2006), http://www.sec.gov/news/press/2006-4.htm.

7) Whether complicity in the violation is widespread throughout the corporation;
8) Presence or lack of remedial steps by the corporation; and
9) The level of intent on the part of the perpetrators.[134]

Of these factors, several are readily measurable (notably factors (1), (2), and (3)). Unfortunately, the values of the measurable factors do not correlate in magnitude to the size of the penalties levied by the SEC. Other factors depend on data available only to the SEC—either because the data is unavailable publicly, is dependent upon the SEC's experience in investigating the bank, or because the essential ambiguity in some of the claims makes it difficult to ferret out whether a particular transaction would support a claim against the underwriting bank. Accordingly, the SEC will have difficulty relying on such opaque data to support its own estimations of an appropriate penalty.

Benefit received. GS&Co., JPM, and Citi received different benefits from the transactions. GS&Co. and JPM lost $75 and $860 million, respectively, and Citi gained $160 million. Accordingly, the penalty values relative to each other are reversed: GS&Co. had by far the largest penalty, at $535 million, for a moderate loss. JPM had the second largest penalty, at $133 million, for by far the largest loss. Citi, by contrast, had the smallest penalty ($95 million) despite having received a substantial gain.

Harm caused to investors. By a similar token, the investors in *Goldman Sachs* and *Citigroup* sold and lost similar amounts of protection (approximately $1 billion and $700 million, respectively), while the *J.P. Morgan* investors lost only $150 million. Nevertheless, the penalties paid by JPM and Citi are much closer in value (at $133 million and $95 million, respectively) than that paid by GS&Co. ($535

[134] *See* Press Release, SEC, Statement of the SEC Concerning Financial Penalties (Jan. 4, 2006), http://www.sec.gov/news/press/2006-4.htm.

million). Similarly, GS&Co. is alleged to have misled only three investors (ACA, IKB, and ABN Amro),[135] while JPM and Citi are each alleged to have misled fifteen or more investors.[136]

Harm caused to defendant's shareholders. As to the level of harm the penalties would inflict on the company's shareholders, it appears that in all cases, the penalties themselves were relatively small, though GS&Co. was likely to suffer the most harm.[137] By rough calculation (based on dividing the value of the settlement by the relevant firm's market capitalization on the day of the settlement), the penalties of GS&Co., JPM, and Citi represented 0.72%, 0.09%, and 0.13% of each firm's total market capitalization, respectively.

Difficulty of detecting wrongdoing. As to the level of difficulty of detection, it is unclear whether it was more difficult for the SEC to detect the alleged offenses in *Goldman Sachs* versus those in *J.P. Morgan* and in *Citigroup*; however, Paulson and Magnetar's successes were widely published well in advance of the SEC's enforcement actions against them,[138] which should at least have provided a nexus for the SEC to begin investigating. Similarly, given that A.K. Barnett-Hart was able to use hand-collected data from 735 asset-backed CDOs in writing her undergraduate

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135 *Goldman Sachs* Complaint, *supra* note 11, ¶¶ 52, 61.

136 *J.P. Morgan* Complaint, *supra* note 13, ¶42; *Citigroup* Complaint, *supra* note 9, ¶¶ 53–54 (alleging Ambac, BNP, and fourteen institutional investors).

137 SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328, 334 (S.D.N.Y. 2011) (finding that $95 million to be "pocket change for an entity as large as [Citi]").

138 *See, e.g.*, Jenny Anderson, *Wall Street Winners Get Billion-Dollar Paydays*, N.Y. TIMES, Apr. 16, 2008, *available at* http://www.nytimes.com/2008/04/16/business/16wall.html; Jesse Eisinger & Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA, Apr. 9, 2010, *available at* http://www.propublica.org/article/the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble-going.

thesis,[139] it seems likely that, once the details of Paulson's trades had been publicized, the SEC (far more sophisticated, one hopes, than an undergraduate) would be able to find particular instances of questionable behavior to investigate relatively easily.

Level of cooperation with law enforcement. A similar lacuna exists with respect to the level of cooperation between the firms and the SEC. GS&Co. stated that it was "cooperating" with various federal agencies with respect to subprime mortgages, securitizations, and other products,[140] while Citi provided more than 30 million pages,[141] which provides little insight into whether the SEC had a more cooperative defendant in one case than the other.

Deterrent effect of settlement. Deterrence is also difficult to predict, since it appears that the securitization market, at least for the moment, is quite weak.[142] However, given that the SEC's settlements have been widely discussed in the popular and legal press, and that the *Goldman Sachs* complaint had such a large effect on GS&Co.'s market capitalization, it seems obvious that the settlements collectively will deter future behavior of this sort. On the other hand, the strength of such deterrence is dependent upon the magnitude of the penalty, which would argue for a

139 Anna Katherine Barnett-Hart, The Story of the CDO Market Meltdown: An Empirical Analysis (Mar. 19, 2009) (unpublished B.A. thesis, Harvard University), *available at* http://www.hks.harvard.edu/m-rcbg/students/dunlop/2009-CDOmeltdown.pdf.

140 Goldman, Sachs & Co., Annual Report 3 (Form 10-K) (Feb. 26, 2010), *available at* http://www.sec.gov/Archives/edgar/data/886982/000095012310018464/y81914e10vk.htm.

141 Jean Eaglesham & Nick Timiraos, *The Science of a Settlement*, WALL ST. J., Nov. 9, 2011, at C2.

142 *See, e.g.*, JONATHAN D. MILLER, URBAN LAND INSTIT. & EMERGING TRENDS IN REAL ESTATE 2012, 19, fig.2-10 (Oct. 2011), *available at* http://www.uli.org/wp-content/uploads/ULI-Documents/ET_US2012.pdf (showing that 2011 Commercial Mortgage Backed Securities issuance is only a tiny fraction of the 2007 value).

larger penalty in both *Citigroup* and *J.P. Morgan*, rather than a smaller one.

Amount of wrongdoing at defendant. With respect to the amount of wrongdoing within the firms, available data from S&P, via A.K. Barnett-Hart, shows that Citi underwrote eighty CDOs during 2002–07, while GS&Co. underwrote sixty-two during the same period.[143] JPM was not among the top ten underwriters during this period, and most likely underwrote fewer than thirty-two CDOs. While this arguably indicates that "wrongdoing" was more widespread throughout GS&Co. and Citi than JPM, it is nevertheless unclear whether one firm may have used questionable stratagems more frequently in underwriting its CDOs than other firms.

Remedial steps taken by the firm. It is also unclear at this time what any of these firms may have done to prevent themselves from getting into messes like this one.

Intentional, reckless, or negligent violation. Finally, although the SEC argued that GS&Co.'s higher settlement is justified by the scienter-based claims that it, and not JPM or Citi, was charged with, Judge Rakoff has already skewered this reasoning.[144] If the mere presence of a more aggressive claim—without any fact-finding by the court—could by itself support a large settlement, the SEC would not have moderated its claims against Citi and JPM any more than it moderated its claims against GS&Co. While the colorful language used by GS&Co.'s employee Fabrice Tourre[145]

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[143] Barnett-Hart, *supra* note 139, at 26.

[144] SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328, 334 n.7 (S.D.N.Y. 2011).

[145] For example, Tourre referred to the ABX index—which served as a "benchmark of the market for securities backed by home loans issued to borrowers with credit," Grace Wong, *Behind Wall Street's Subprime Fear Index*, CNNMONEY, http://money.cnn.com/galleries/2007/news/0711/gallery.abx_index (last visited Dec. 19, 2012)—as comparable to the *Frankenstein* monster, Christine Harper, *Goldman's Tourre E-Mail Describes 'Frankenstein' Derivatives*, BLOOMBERG, Apr. 24, 2010, *available at* http://www.bloomberg.com/news/2010-04-24/-frankenstein-derivatives-

arguably indicates a greater degree of culpability on the part of GS&Co. than Citi, this is an evidentiary issue, which seems easily outweighed by the proprietary nature of the *Citigroup* trade. Additionally, *J.P. Morgan* also contained similarly colorful language,[146] with no concomitant escalation of the claims the SEC filed.

As a result, the directly measurable factors do not appear to correlate well to the size of the penalties levied against each firm, and those factors relying on non-public data are either circular or do not seem to provide a principled means of distinguishing *Goldman Sachs*, *J.P. Morgan*, and *Citigroup*.

B. Changing Political Landscape and Media Focus

In contrast to the settlement factors highlighted above, the national political climate during the time of *Goldman Sachs* as compared to *J.P. Morgan* and *Citigroup* does offer some explanation for the settlements. In January 2010, the United States was entering its third consecutive quarter of growth. The 4% annual growth rate was also its fastest since the recession,[147] although a substantial amount of this growth had been contributed by the American Recovery and Reinvestment Act of 2009 ("Recovery Act"). At the same time, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was wending its way through Congress and encountering substantial political resistance. During this period, the SEC—and, to be sure, the Federal

described-in-e-mail-by-goldman-s-fabrice-tourre.html. He also referred to some of the purchasers of Abacus bonds as "widows and orphans." *Id.*

146 *J.P. Morgan* Complaint, *supra* note 13, ¶ 34 (quoting "[t]he J.P. Morgan Securities employee in charge of Squared's global distribution effort" as saying in an email that "we are soooo pregnant with this deal, we need a wheel-barrel to move around . . . [l]et's schedule the cesarean, please!").

147 Gross Domestic Product (GDP) Graph, BUREAU OF ECONOMIC ANALYSIS, http://www.bea.gov/newsreleases/national/gdp/gdp_glance.htm (last modified Oct. 26, 2012).

Reserve[148]—was recovering from the black eye of both the financial crisis, which it had failed to prevent,[149] and the Bernie Madoff scandal, which it had been informed of several years earlier and had decided not to investigate.[150] As a result, the SEC was coming under significant criticism at the time.[151]

Faced with these challenges, it seems obvious that the SEC needed, in Judge Rakoff's vernacular, a "quick headline."[152] GS&Co., perennially at the top of Vault.com's annual prestige survey of investment banks[153] and heavily profiled in Michael Lewis's then forthcoming book *The Big Short*,[154] was the perfect target. And what a target it turned

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148 Sewell Chan & Eric Dash, *Fed Reviews Find Errors in Oversight of Citigroup*, N.Y. TIMES, Apr. 8, 2010, *available at* B1.

149 For one viewpoint on how the bond market came to be relatively under-regulated vis-à-vis the stock market, see LEWIS, *supra* note 26, at 60.

150 SEC OFFICE OF INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME, Case No. 016-509 (2009), *available at* http://www.sec.gov/news/studies/2009/oig-509.pdf.

151 For example, Harry Markopolos, a financial investigator who had tipped off the SEC regarding the Madoff transaction, charged that "[t]he SEC is bogged down in turf wars, undercut by regulatory gaps, unwilling to investigate large firms such as Madoff's and hobbled by a lack of financial derivatives experts." Kevin McCoy, *Madoff Accuser to Reveal Another Ponzi Scheme; Calls SEC Ineffective*, USA TODAY, Feb. 5, 2009, http://www.usatoday.com/money/economy/2009-02-04-madoff-tipster-blasts-sec_N.htm.

152 SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328, 333 (S.D.N.Y. 2011).

153 GS&Co. held first place every year from 2008 through 2013. *See Banking Employers Ranking 2013: Prestige*, VAULT.COM, http://www.vault.com/wps/portal/usa/rankings/individual?rankingId1=162&rankingId2=-1&rankings=1&regionId=0&rankingYear=2013 (last visited Dec. 19, 2012).

154 For example, the April 2010 issue of *Vanity Fair* ran an excerpt from the book that charted Mike Burry's "almost comical dealings with Goldman Sachs and other banks." Michael Lewis, *Betting on the Blind Side*, VANITY FAIR, Apr. 2010, *available at* http://www.vanityfair.com/business/features/2010/04/wall-street-excerpt-201004. Additionally, Lewis

out to be. By alleging fraud at one of the most storied Wall Street firms and erasing more than $10 billion in market capitalization, the SEC was able to incite popular rage, even from relatively sophisticated commentators such as Felix Salmon.[155] By raising the profile of one particular bank and subjecting it to months of media scrutiny, the SEC also enabled the Democratic Party to use the case as further evidence that significant financial reform was required.[156] For example, Senator Byron Dorgan of North Dakota said, "If the disclosures at these hearings are not the final nail that persuades the American people to demand this be done now, I don't know what would be."[157] Shortly after the complaint was filed, Representative Darrell Issa of California "opened an investigation into allegations that SEC employees communicated or coordinated with the White House [or several other political groups] concerning . . . the timing of bringing an action against [GS&Co.]."[158] Although no evidence was found that the timing of the complaint was intended to influence or was influenced by the financial reform legislation, "maximizing and shaping positive press

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referred to GS&Co. as "the big kid who ran the games in this neighborhood," while "Merrill Lynch was the little fat kid assigned the least pleasant roles, just happy to be a part of things." LEWIS, *supra* note 26, at 175.

155 Felix Salmon, *Goldman's Abacus Lies*, REUTERS, Apr. 16, 2010, http://blogs.reuters.com/felix-salmon/2010/04/16/goldmans-abacus-lies/ (noting that ACA was "essentially lied to by [GS&Co.]," that "[t]he SEC has the right defendant," and that it deserved to lose $10 billion in one day because it lied to its clients).

156 Carl Hulse, *Democrats Use Goldman to Push Bank Overhaul*, N.Y. TIMES, Apr. 28, 2010, at A1.

157 Hulse, *supra* note 156.

158 SEC OFFICE OF THE INSPECTOR GENERAL, Case No. OIG-534, ALLEGATIONS OF IMPROPER COORDINATION BETWEEN THE SEC AND OTHER GOVERNMENTAL ENTITIES CONCERNING THE SEC'S ENFORCEMENT ACTION AGAINST GOLDMAN, SACHS & CO. 12 (2010) [hereinafter SEC Allegations] *available at* http://www.sec.gov/foia/docs/oig-534.pdf.

coverage" was a key concern governing the timing of the suit.[159]

There is another wrinkle here as well. Robert Khuzami, the SEC's head of enforcement, had joined the organization a little more than a year previously from a post as the General Counsel at Deutsche Bank,[160] and was faced with "convinc[ing] skeptics that [the SEC could] reassert itself and adequately police Wall Street."[161] *Goldman Sachs* served as an excellent opportunity for Khuzami to assert himself and the SEC. After GS&Co. acquiesced, he stated that "[t]his settlement is a stark lesson to Wall Street firms that no product is too complex, and no investor too sophisticated, to avoid a heavy price if a firm violates the fundamental principles of honest treatment and fair dealing."[162] This assertion of the SEC has shown through in other, subtler ways as well. For example, as of January, 2011, the first link in the "Spotlight" section of the SEC's home page was entitled "SEC Enforcement Actions Related to the Financial Crisis." Clicking the link revealed that three of the first four actions listed were (and still are) those related to *Citigroup*, *Goldman Sachs*, and *J.P. Morgan*.[163]

By the time of the *J.P. Morgan* and *Citigroup* cases, the SEC faced a substantially different political picture. First, Dodd-Frank was, by then, old news—as of June 2011, the

159 SEC Allegations, *supra* note 158, at 13.

160 Press Release, SEC, Robert Khuzami Named SEC Director of Enforcement (Feb. 19, 2009), http://www.sec.gov/news/press/2009/2009-31.htm.

161 Jenny Anderson & Zachery Kouwe, *S.E.C. Enforcers Focus on Avoiding Madoff Repeat*, N.Y. TIMES, Feb. 9, 2010, at B1.

162 Press Release, SEC, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), http://www.sec.gov/ news/press/2010/2010-123.htm.

163 *See SEC Enforcement Actions*, http://www.sec.gov/spotlight/enf-actions-fc.shtml (last modified Nov. 28, 2012). It is worth noting that, although the actions are listed alphabetically within groups, the groups themselves are organized according to what one assumes is perceived prominence, rather than alphabetically or chronologically.

media had shifted its attention to Greece, the Arab Spring, Anthony Weiner, and preparations for the Republican primary races.[164] Furthermore, Khuzami had been at the SEC for an additional year, and had successfully guided the Commission through the furor surrounding Raj Rajaratnam and speculation on the legal status of GS&Co. board member Rajat Gupta.[165] Moreover, daily news about Bernie Madoff, Allen Stanford, and the various other relics of the financial crisis had largely ceased, and—at least as of the *J.P. Morgan* announcement—there was little speculation about the impending debt-ceiling debate. It was a brief period of normalcy. Certainly, by the time Occupy Wall Street was making headlines, the SEC was likely deep into its negotiations with Citi, but even then—and despite the moniker "Occupy *Wall Street*"—it seems that public anger had subtly morphed from being directed at the financial services industry to being directed at wealthy individuals and the political system generally.[166] Huge settlements with the banks, while gratifying, simply no longer carried the political immediacy of a year before.

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[164] *See generally*, THE ECONOMIST, June 11, 2011.

[165] *See* Peter Lattman, *In Galleon Case, Spotlight on Rajat Gupta*, N.Y. TIMES DEALBOOK, (Apr. 24, 2011, 7:48PM), http://dealbook.nytimes.com/2011/04/24/in-galleon-case-spotlight-on-rajat-gupta.

[166] For example, on the home page of "We are the 99 Percent," the sidebar spends substantial real estate detailing the tribulations of the bottom 99%—the difficulty making rent, ubiquitous environmental hazards—while devoting relatively little space to the gains accrued by the top 1%. WE ARE THE 99 PERCENT, http://wearethe99percent.tumblr.com (last visited Dec. 19, 2012). While the page does mention that the banks, the mortgage industry, and the insurance companies are "the important ones," the rapid proliferation of "Occupy" movements in cities with nonexistent or picayune financial industries, such as Oakland, California indicates, a focus on "social and economic inequality," rather than financial services injustice.

C. Legal Uncertainty: Applicability and Application of Anti-Fraud Provisions

A subtler reason for the SEC's caution in later cases is that the charges by the SEC are novel—a shortcoming the SEC has tried to mitigate in subsequent settlement negotiations. As Stanford's Joseph Grundfest has observed in analyzing *Goldman Sachs*, "the more you know about the [synthetic CDO] market, the less likely you are to side with the SEC's version of events."[167] This observation reflects a couple of different elements. First, it is not entirely clear that, on the facts provided, the use of anti-fraud provisions—Section 10(b), Rule 10b-5, and Section 17(a)—to regulate the alleged behavior is conceptually appropriate. Of similar weight, it is questionable whether the factual allegations lead to an inference of scienter (in *Goldman Sachs* only) and materiality, given the type and volume of disclosure available in the prospectus and other exogenous information sources. Although it is difficult to say with certainty what caused the SEC to treat JPM and Citi more leniently, it is certainly conceivable that criticisms of the SEC's claims by reputable commentators—including Professor Grundfest, a former commissioner of the SEC[168]—could have led to a stronger negotiating position for Citi and JPM as compared to GS&Co.

1. Applicability of Anti-Fraud Provisions to Transactions

In the wake of the filing of the *Goldman Sachs* complaint, there was much analysis around whether non-disclosure of Paulson's involvement could be held to be actionable. There is some authority indicating that GS&Co. had a duty to

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[167] Grundfest, *supra* note 79, at 14.

[168] Joseph A. Grundfest, *W.A. Franke Professor of Law and Business*, STANFORD L. SCH., http://www.law.stanford.edu/mode/166376 (last visited Dec. 19, 2012).

Paulson *not* to disclose his role in the transaction,[169] not least since the theory under which the SEC had sued GS&Co. was based on enforcement of misstatements, rather than non-disclosure.[170] For example, Professors Davidoff, Morrison, and Wilhelm described the controversy as follows:

> [F]rom a transactional perspective, [Paulson's trading strategy] was the only piece of information that [GS&Co.], as Paulson's broker, was explicitly expected *not* to reveal. . . . Perhaps it is unsurprising that the main source of conflict with the SEC was over what [GS&Co.] did and did not reveal about Paulson. But the SEC's case was attenuated because while explicit enforcement of the anti-fraud rules for misstatements here was appropriate, there was no misstatement, and no party should have expected that the controversial role of Paulson should have been disclosed absent the imposition of some fiduciary-like, objective standard on this transaction.[171]

They continued, "such duties are inappropriate in this context either as a reflection of the parties' expectations or as a matter of economic theory"[172] for two reasons. First, these

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169 Steven M. Davidoff et al., *The SEC v. Goldman Sachs: Reputation, Trust, and Fiduciary Duties in Investment Banking*, 37 J. CORP. L. 529, 539 n.57 (2012) (citing Thomas W. Heath, III, Exchange Act Release No. 59,223, 2009 WL 56755, at *4 (Jan. 9, 2009)) ("The requirement in the Heath case was under NYSE Rule 476(a)(6) and its obligation that member 'conduct [be not] inconsistent with just and equitable principles of trade . . . .'"). Grundfest, *supra* note 79, at 13. Professor Grundfest, telegraphing GS&Co., asked: "How can [GS&Co.] be sued for maintaining client information as confidential when it had an obligation to maintain the information as confidential?" *Id.*

170 Davidoff et al., *supra* note 169, at 540.

171 *See id.* at 540.

172 *Id.* In part, this relies on the assessment that "counterparties evaluate [GS&Co.] along technical and competence-oriented lines, rather

duties are inappropriate since, inasmuch as judicial oversight would tend to undermine tacit contracting, such a standard would be inefficient where parties can "represent themselves and . . . negotiate bespoke standards." Second, it is difficult for the banks to determine the beliefs and incentives of the parties to the deal.[173] By contrast, other commentators—notably Professor John Coffee—argued that applying a fiduciary duty to broker/client relationships would fill a "fundamental hole" in the financial reform bill.[174] While Professors Davidoff and Coffee disagree over the merits of applying a fiduciary duty, both arguments affirm the proposition that there was not, as of the time of *Goldman Sachs*, such a fiduciary duty, which may have weakened the SEC's implied position that a fiduciary duty did exist.

2. Scienter

Much of the alleged misconduct in the SEC's complaints against GS&Co., JPM, and Citi revolves around the misrepresentation that the portfolios were selected by ACA, GSC, and CSAC.[175] As Judge Rakoff noted, the language in

than according to its ability to sustain trust-based private contracts," *id.* at 545, and that, since "codified rules can crowd out tacit contracts . . . codified and formal regulation seems most likely to succeed in a marketplace that is dominated by arm's-length transactional trade . . . . [R]eputational incentives are of least importance in such a market, and, moreover, traders in these markets rely to a greater extent upon bright-line law . . . . [A]nd it is because of the formality necessary in this bright-line law that legal standards like fiduciary duty with their inherent ambiguity are inappropriate." Davidoff et al., *supra* note 169, at 549.

173 *Id.* at 550.

174 *See* Press Release, Columbia Law School, Measure to Impose Fiduciary Duty on Brokers and Dealers Backed by John Coffee (May 4, 2010), http://www.law.columbia.edu/media_inquiries/news_events/2010/May2010/johncoffee-fiduciary.

175 *See, e.g.*, *Goldman Sachs* Complaint, *supra* note 11, ¶ 19 (arguing that, "[b]y contrast, [GS&Co.] knew that the identification of an experienced and independent third-party collateral manager as having selected the portfolio would facilitate the placement of CDO liabilities in a

each of these allegations is "tantamount" to an allegation of scienter.[176] Yet, as Professor Samuel Buell argues, such allegations are naturally plagued with evidentiary issues[177] that raise questions of intent and the reasonable interpretation of statements by relatively sophisticated investors.[178]

For example, if the allegation that GS&Co. "knew that the identification of an experienced and independent third-party collateral manager as having selected the portfolio would facilitate the placement of CDO liabilities" is true, does that mean that GS&Co. necessarily sought to deceive the investors in the security? Or instead, could it mean that GS&Co. believed that one of the essential mechanisms to

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market that was beginning to show signs of distress"). Similar statements are available in *J.P. Morgan* Complaint, *supra* note 13, ¶ 35 ("[JPM] knew that emphasizing that the portfolio had been selected by GSC would assist in selling the notes of Squared [the CDO-squared in question]") and *Citigroup* Complaint, *supra* note 9, ¶ 20 ("[Citi] knew that representing to investors that an experienced, third-party investment adviser had selected the investment portfolio would facilitate the placement of the notes that the CDO-squared would issue").

176 SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328, 330 (S.D.N.Y. 2011) (noting that "scienter" is "knowing and fraudulent intent"). He notes that allegations in a separate complaint against Brian Stoker are tantamount to an admission of scienter. In particular, he highlights the following:

> 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

Id. (emphasis and insertions in original).

177 Samuel Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 532 (2011).

178 PRESENTATION TO PROSPECTIVE INVESTORS, IKB CREDIT ASSET MANAGEMENT GMBH 3 (2007) *available at* http://www.scribd.com/doc/30393274/Ikb-Marketing-Brochure-PDF-000038548747 (explaining that "[s]ecuritization and CDO investments are an integral part of [IKB]'s business model").

limit potential conflicts of interest in the CDO market was the selection of an independent third-party collateral manager?[179] In a similar vein, the banks' statements that each portfolio was selected by one party (and omission of a second, adverse party) do not necessarily lead to the conclusion that the banks were trying to hide the presence of that adverse party from potential investors. Rather, in a paradigm where the portfolio selection agent is independent, neutral, and carries a reputation that investors use to assess the "quality" of the CDO, the identity of the other party—Paulson, Magnetar, Citigroup—should not matter if the portfolio selection agent is doing its job. This is not to imply that the banks collectively had entirely benign motives (which we are unlikely ever to know), but simply that they have a plausible argument that their motives were benign, thus weakening even a recklessness-based allegation of scienter. Accordingly, claims that rely in part on assessments of the defendant's motives, as scienter-based claims do,[180] have certain weaknesses that negligence-based, objective claims will not carry.

3. Materiality

A separate issue here is the question of materiality, that is, whether telling the investors (or, in the case of GS&Co., ACA) that Paulson, Magnetar, and Citi itself had a substantial role in the creation of the relevant CDOs would have significantly altered the total mix of information

[179] By the end of September 2007, ACA had participated in 29 CDOs and received the "Financial Guarantor of the Year" award at the Securitization News Awards in 2005. Tracy Alloway, *ACA's Rather Disastrous CDO Forays*, FIN. TIMES ALPHAVILLE (Apr. 19, 2010 8:35AM), http://ftalphaville.ft.com/blog/2010/04/19/205571/acas-rather-disastrous-cdo-forays. Given the extent to which parties like ACA were repeat players in the industry, the fact that the banks thought that it would be advantageous to use a portfolio selection agent to help place securities is hardly surprising.

[180] *See* Buell, *supra* note 177, at 548.

available, or whether a reasonable investor would have considered it important in evaluating the transaction. Although the SEC has pleaded facts that certainly look material—notably, that investors in *J.P. Morgan*, at least, "would have considered it important to their investment decision to have known" about Magnetar's role—the SEC would have to establish that such a viewpoint is reasonable. Given the nature of this type of transaction, it is far from certain that such a position can be maintained.

Several factors in *Goldman Sachs* lead to this conclusion. First, it does not appear that Paulson had superior information to ACA or IKB, since every party had full access to the portfolio of reference securities and other information in the prospectus.[181] Similarly, reports about the frailties of the subprime housing market's difficulties were beginning to make it into the press in early 2007, so investors were arguably on notice.[182] Every party to the deal also knew which reference securities were included in the deal, since they were described in the prospectus; in *Goldman Sachs*, at least, every reference security was rated Baa2 by Moody's.[183] Additionally, the prospectus contained a long list of relevant factors an investor should keep under consideration, including some that became highly relevant to the eventual turn of events.[184] As a synthetic CDO, investors—protection

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[181] *See* Davidoff et al., *supra* note 169, at page 540.

[182] For example, *The Economist* published an article on March 22, 2007, noting that "subprime loans . . . have a nasty case of dry rot." *The Trouble with the Housing Market*, THE ECONOMIST, Mar. 22, 2007, *available at* http://www.economist.com/node/8888776. Meanwhile, GSC and Magnetar were still negotiating which bonds would be included in that transaction two weeks later, on April 9, 2007. *J.P. Morgan* Complaint, *supra* note 13, ¶ 25.

[183] Abacus Prospectus, *supra* note 17, at S-A-2.

[184] The prospectus in *Goldman Sachs* included the following statement:

> Recently, delinquencies, defaults and losses on residential mortgage loans have increased and may continue to increase, which may affect the performance of RMBS, in particular RMBS Residential B/C

sellers—could not have received payments without the presence of an equally large protection buyer. This is an artifact of the zero-sum nature of these deals: a protection seller must have known that, and been undeterred by the fact that, another party was taking the opposite side of the bet. Moreover, the fact that Paulson—or Magnetar, or Citi—was short on a particular transaction itself would be unimportant to the protection sellers, since without information about the protection buyer's broader trading strategy, a particular short or long position could simply be a hedge for another, largely unrelated position.[185] Finally, it appears that reputation mattered in the market,[186] and

> Mortgage Securities which are backed by subprime mortgage loans . . . [and are] more sensitive to economic factors that could affect the ability of borrowers to pay their obligations under the mortgage loans backing these securities. Market interest rates have been increasing and accordingly . . . borrowers are likely to experience increases in their monthly payments and become increasingly likely to default on their payment obligations. Discovery of fraudulent mortgage loan applications in connection with rising default rates with respect to subprime mortgage loans may indicate that the risks with respect to these mortgage loans are particularly acute at this time. Such risks may result in further increases in default rates by subprime borrowers as it becomes more difficult for them to obtain refinancing. These economic trends have been accompanied by a recent downward trend or stabilization of property values after a sustained period of increase in property values. Because subprime mortgage loans generally have higher loan-to-value ratios, recoveries on defaulted mortgage loans are more likely not to result in payment in full of amounts owed under such mortgage loans, resulting in higher net losses than would have been the case had property values remained the same or increased. A decline in property values will particularly impact recoveries on second lien mortgage loans that may be included in the mortgage pools backing RMBS Residential B/C Mortgage Securities.

Abacus Prospectus, *supra* note 17, at 30.

185 *See* Davidoff, et al., *supra* note 169, at 535.

186 IKB and the *Citigroup* investors all indicated that a track record of successful CDOs was important to them. *See Goldman Sachs* Complaint, *supra* note 11, ¶ 53; *Citigroup* Complaint, *supra* note 9, ¶ 55.

disclosure of Paulson's position ("a third-rate hedge fund guy who didn't know what he was talking about,"[187]) seems particularly unlikely to change the proclivities of an investor starry-eyed by ACA, the "Financial Guarantor of the Year."[188]

D. Incentive to Settle

One final criticism of the SEC's treatment of this series of related claims revolves around the alacrity with which the Commission has settled them. Of course, there are some substantial justifications for quick settlement, both for the SEC and for defendants. For one, each party benefits because trials are "expensive, time-consuming, and capricious."[189] The SEC can also "rack up more enforcement actions by settling,"[190] of particular importance where much of the Commission's collections from penalties are disgorged to the U.S. Treasury[191] and settlement amounts are designed to be "roughly the same amount in penalties that [the SEC] could 'reasonably' expect to win at trial."[192] Defendants benefit by being able to manage the timing and spin of a news announcement and turn it "into a one-day news event,"[193] while also avoiding "any investors' relying in any

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187 *See supra* note 62 and accompanying text.

188 *See supra* note 179 and accompanying text.

189 Jesse Eisinger, *Needed: A Cure for a Severe Case of Trialphobia*, PROPUBLICA, Dec. 14, 2011, *available at* http://www.propublica.org/thetrade/item/needed-a-cure-for-a-severe-case-of-trialphobia.

190 *Id.*

191 SEC, FY 2010 PERFORMANCE AND ACCOUNTABILITY REPORT 109 (2011), *available at* http://www.sec.gov/about/secpar/secpar2010.pdf#financial (showing that of the $1.2 billion collected in penalties and disgorgement, $665 million was remitted to the Department of the Treasury).

192 Andrew Ackerman, *SEC's Khuzami Defends 'Admit Nor Deny' Settlements*, WALL ST. J., (Dec. 1, 2011, 3:55PM) http://online.wsj.com/article/SB10001424052970204012004577072462404708198.html.

193 Henning, *supra* note 126.

respect on the [SEC] consent judgment" for a "mild and modest cost of doing business."[194]

However, there are significant costs to the practice of settling early and often. As Judge Rakoff stated, settlements that are approved without knowledge of the underlying facts "deprive" the public "of ever knowing the truth in a matter of obvious public importance."[195] Professor Buell, in commenting on *Goldman Sachs*, noted that "the public almost never learns—and the SEC almost never has to decide—whether the defendant committed core fraud or merely some form of misrepresentation. . . . [T]he law permitted the SEC to investigate and file its case without committing" to any of the legal theories of fraud that could result in GS&Co.'s culpability.[196] This is important: settling with the SEC does not create a precedent and does not create an appealable judgment. Even if it did, it is unclear who would have standing and the inclination to appeal such a judgment. In essence, using settlements as a way of getting quick headlines and racking up enforcement actions perpetuates a lack of clarity over what counts as securities fraud, and deprives the public of the law that would result from litigated cases.[197] Similarly, as noted above,

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194 SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328, 333 (S.D.N.Y. 2011). However, it should be noted that, because Citi settled only § 17(a)(2) and (3) claims, which do not have a private right of action, the implications for offensive non-mutual collateral estoppel of admitting the SEC's allegations may be limited. For a more substantial discussion on this point, see generally John C. Coffee, Jr., *Collision Course: The SEC and Judge Rakoff*, N.Y. L.J. (Jan. 19, 2012), *available at* http://www.law.columbia.edu/null/download?&exclusive=filemgr.download&file_id=61575.

195 Citigroup Global Markets Inc., 827 F. Supp. 2d at 332.

196 Buell, *supra* note 177, at 554. "Core fraud," in Professor Buell's terms, is a "goal-oriented" behavior, while "misrepresentation" need not be. Core fraud operates essentially as a form of scienter, requiring a description of the actor's "level of mental state, fault, culpability, or moral blameworthiness." *Id.* at 548.

197 *See generally* Buell, *supra* note 177 at 54.

discrepancies in settlement values can make the SEC's enforcement actions appear as capricious as litigation, which has the effect of eroding the SEC's legitimacy as a purportedly principled administrative agency. Finally, some commentators have even charged the SEC with "showing its belly to Wall Street in a sign of submission," by touting its many settlements as "record-breaking performance in a period of resource constraints."[198] Essentially, they claim that the SEC has told Wall Street that it lacks the funds to pursue the banks to the full extent of its mandate, which has obvious drawbacks inasmuch as Wall Street is galvanized to use questionable tactics in marketing securities.

V. CONCLUSION

The legal academy generally gives greater attention to decided cases than to settlements. While there may be several good reasons for this practice—not least of which is the availability of a robust public record—there is a sizeable discrepancy in three settlements with very similar facts, and the analysis above sheds light on some of the extralegal considerations that can affect final settlement values. But this inquiry bespeaks several troubling questions relating to the extent to which the SEC should be responsive to "political" issues rather than "legal" issues in negotiating agreements, as well as the appropriate level of judicial deference to be given to the SEC in enforcing—and enjoining—actions by regulated entities.[199] While these are

198 Eisinger, *supra* note 189.

199 For example, is the lack of transparency in these actions appropriate inasmuch as it allows the SEC flexibility in ensuring that a particularly arcane market continues to function properly, even in the absence of perfectly on-point law? Alternatively, would such a regime degenerate swiftly into regulatory capture and further galvanize public opinion against the financial industry and the federal government? These, and other similar questions, are not inapposite in reviewing the SEC's effectiveness and regulatory mandate, as the Second Circuit noted in

questions more properly answered by the circuit courts of appeals and the Supreme Court, the current opacity regarding how settlement values are calculated—even if not closely scrutinized by the courts—can still generate significant costs by making settlement results seem arbitrary and capricious, and by allowing for a rhetoric among commentators regarding the SEC's weakness in policing its charges.

As Justice Louis Brandeis assured us, "sunlight is said to be the best of disinfectants."[200] CDOs are fantastically complex instruments that, used wisely, have the potential to create substantial value both by diversifying products and by allocating risks (and returns) to those parties with appropriately fortified constitutions. Yet the SEC's enforcement actions and resulting settlements—motivated as the actions appear to be by the political climate, legal uncertainties, and arguably counterproductive incentives, rather than the individual merits of the claims—perpetuate uncertainty in the CDO market over what type of conduct and disclosure is required in underwriting deals. While upcoming statutes prohibiting proprietary trading will undoubtedly curb the most egregious of actions (such as those alleged in *Citigroup*), in order to meet the SEC's goal of providing the "maximum possible degree of clarity, consistency, and predictability,"[201] additional disclosures detailing the rationale for various negotiated results—beyond the SEC's reasonable belief that it received the same relief as it would obtain at trial[202]—are necessary.

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addressing Judge Rakoff's order. SEC v. Citigroup Global Markets Inc., 673 F.3d 158 (2d Cir. 2012) (per curiam).

200 LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 62 (Nat'l Home Library Found. ed. 1933) (1914).

201 Press Release, SEC, Statement of the SEC Concerning Financial Penalties (Jan. 4, 2006), www.sec.gov /news/press/2006-4.htm.

202 Eisinger, *supra* note 189 ("The agency's message is . . . 'come in and be prepared to provide the type of relief we would obtain at the end of a trial . . . .'").