REQUIRED READING FOR U.S. PUBLIC COMPANIES: THE NEW RULES OF WAR FROM THE SEC

When the U.S. Securities and Exchange Commission (SEC) says to watch out, it is good advice to take them at their word and *duck!* Recently, in a speech to the Council of Institutional Investors, the Commission’s new Chair set out their new enforcement principals. In this Alert, we focus on a key change to settlement protocols.

OVERARCHING PRINCIPLES

After considering the Commission’s dual goals of pursuing wrongdoers and deterring wrongdoing, Mary Jo White articulated five key principles for robust enforcement:

- Be aggressive and creative
- Demand accountability
- Pursue individuals
- Cover the whole market
- Win at trial

THE CURRENT NORM OF “NEITHER-ADMIT-NOR-DENY” SETTLEMENTS

Under existing policy, the SEC settles a case only when it believes that the settlement is within the range of outcomes that could be reasonably expected if the matter were litigated. In these instances, the Commission permits defendants to settle civil charges on a “neither-admit-nor-deny” basis. As the label suggests, the settling parties may agree to pay a fine or penalty, and/or to an injunction against future wrongful conduct and/or to take specific corrective actions – but they do *not* admit or deny the specific charges brought by the Commission.

This form of settlement is a common practice across U.S. federal agencies, and the SEC was previously on record as stating that it “...serve(d) the critical enforcement goals of accountability, deterrence, investor protection, and compensation to harmed investors.”2 Certainly, the settlements were far more acceptable to defendants, speedier than trial and kept litigation costs to a minimum.

“...when investors realize there is a strong and effective cop on the beat, they have greater confidence and are more willing to participate in the markets. The tap for capital opens more widely, providing more funding for our nation’s businesses. And with access to new capital, businesses can hire more workers, develop new products, and find new ways to deliver greater returns to shareholders.”

SEC Chair Mary Jo White
And while the SEC may have been viewed in some quarters as lenient in allowing defendants to settle matters without admitting guilt, it took the “nor deny” side of things seriously and prohibited settling defendants from declaring their innocence and denying wrongdoing after entering such a settlement. The Commission has demanded retractions or corrections when it has viewed a defendant’s post-settlement statements as tantamount to a subsequent denial of the settled charges.³

The first major change in this policy occurred back in January 2012. Since then, the SEC has refused to allow the “neither admit nor deny” wording in settlements where there are parallel criminal cases with either convictions or admissions of guilt.⁴ In the U.S., where criminal cases involving securities fraud are still quite rare, this will impact only a small minority of cases.

BE AFRAID, BE VERY AFRAID: PURSUING ADMISSIONS OR FINDINGS OF INTENTIONAL MISCONDUCT

While we expect this new push to apply to only a small subset of civil enforcement cases, it is important to note the four-point test set by the Commission for situations in which it will consider requiring admissions.

The four scenarios are:

1. Cases where a large number of investors have been harmed or the conduct was otherwise egregious
2. Cases where the conduct posed a significant risk to the market or to investors
3. Cases where admissions would aid investors deciding whether to deal with a particular party in the future
4. Cases where reciting unambiguous facts would send an important message to the market about a particular case

Some may view these factors as somewhat vague. The lack of guidance on how to weigh the factors may also be disconcerting.

FALLOUT

The SEC’s change in policy reflects a push-back that it was facing in some cases where judges were reluctant to approve neither-admit-nor-deny settlements.⁵ So, to a limited extent, we were already seeing some of the impact of a change in settlement practice at the Commission.

In the limited instances where the SEC decides not to settle without an admission, we are likely to see:

- More civil litigation, as cases that the SEC would previously have settled at an early stage may now go to trial
- A potential negative influence on any related criminal litigation
- More protracted litigation and appeals with the regulator and from shareholders in parallel shareholder securities class actions
- In that small subset of cases, where there is an admission or findings of liability, any right to indemnification from the company involved may now be limited or cease at the same time that protection under D&O insurance is likely to be impaired for specific defendants.

When considered in light of a strategic defense of the SEC charges, the possibility that an admission or finding of guilt will be sought against some defendants is likely to fracture the defense. Individuals seeking separate counsel as a result of this fracture will immediately increase the cost of defending the matter.

Individuals considering admitting guilt to some or all of the SEC’s charges are perhaps unlikely to be consulting and cooperating with their D&O insurer(s). This may lead to a failure to meet the cooperation clause found in most D&O insurance contracts.

Finally, an admission or finding of securities fraud may trigger a personal conduct exclusion (speaking to fraud or intentional illegal profiting) found in D&O insurance policies.

Clearly, these are complex matters, and individuals will be consulting with both knowledgeable legal counsel and their insurance brokers and claim advocates.
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