**THE SEC’S SETTLEMENT WITH CITIGROUP—AND JUDGE RAKOFF**

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On November 28 Judge Rakoff rejected a proposed settlement between the SEC and Citigroup. Pundits have applauded this rebuff, many with good reasons, but everybody is still missing the point of these civil fines. And the bad guys are free to defraud investors another day.

The facts are straight-forward: Citigroup was a key player in the 2008 banking crisis. Among other things, the investment bank marketed a fund that invested in CDOs with ill-performing mortgage-backed assets. Citigroup sold these instruments to investors without telling them that it thought the securities were actually crap. In fact, Citigroup took a short position on these securities and profited handsomely.

The SEC brought charges against Citi and, after some haggling, they settled on a fine of $285 million. Unfortunately, they had not counted on Judge Rakoff’s dismissal of the settlement. He thought the fine too small and was disturbed by Citi’s not admitting to anything.

James Downie supplies a common take on Rakoff’s dismissal. Writing in the Washington Post [(“Judge Jed Rakoff Courageously Rejects SEC-Citigroup Settlement”](http://www.washingtonpost.com/blogs/post-partisan/post/judge-jed-rakoff-courageously-strikes-down-sec-citigroup-settlement/2011/11/28/gIQAIpaS5N_blog.html)), Downie claims there is now a “crumb of hope” that justice might be obtained. He thinks Citigroup guilty of securities fraud and desires a fine commensurate with the crime. He castigates SEC settlements in which the offending party does not admit to any wrongdoing. Given the evidence, Mr. Downie wants Citigroup either to admit guilt or to face a jury that may well convict the firm of crimes.

We also would point out the humor of the firm’s promising never again to do those things which they do not admit doing in the first place. It’s funny not only because of the convoluted logic, but also because Citigroup is a recidivist.

Andrew Hill at the *Financial Times* (“[Rakoff is Right Not to Settle for Less Than the Truth](http://blogs.ft.com/businessblog/2011/11/rakoff-is-right-not-to-settle-for-less-than-the-truth/#axzz1gG3UtPCg)”) shares these opinions, but couches them in terms of truth. He fears that a private settlement will turn facts into wraiths, never to be seen again. Mr. Hill argues for “truth and clarity, instead of settling for obfuscation and obscurity.”

Bill McConnell at *The Deal* (“[Rakoff’s Takes Aim at the Settlement Process](http://www.thedeal.com/magazine/ID/043300/commentary/rakoff's-takes-aim-at-the-settlement-process.php)”) posits the relatively small fine caused the dismissal. Rakoff, you might recall, accepted the SEC settlement with Goldman Sachs, which paid a fine of $535 million for ill-gotten gains of $15 million. Citi profited $160 million and settled for only $285 million. Clearly, the fine paid by Goldman Sachs is more punitive than the fine proposed by Citigroup.

*Investment News* extols the judge’s dismissal in “[A Wise Decision from Judge Rakoff](http://www.investmentnews.com/article/20111204/REG/312049984).” It dreams of a new regulatory climate in which regulators have the independence and courage to carry out their responsibilities instead of cuddling up with the regulated.

Daniel Kaufman, Brookings Institution, takes this even further in “[Judge Rakoff Challenge to the S.E.C.: Can Regulatory Capture be Reversed](http://www.brookings.edu/opinions/2011/1202_rakoff_challenge_kaufmann.aspx)?” He asserts that the banking industry captured the SEC some time ago, weakening the effectiveness of the regulatory power of the SEC. We agree with this assertion and quickly add the FASB and the IASB to the list of captured agencies. For proof he cites a study that shows “at least 51 cases [that] have involved recidivism by 19 Wall Street firms.”

Former mayor Ed Koch (“[Judge Jed Rakoff—A Light Unto his Fellow Jurists](http://www.huffingtonpost.com/ed-koch/judge-jed-rakoff-a-light-_b_1130133.html)”) echoed many of these thoughts and adds the culpability of Congress. By giving the SEC an inadequate amount of funds, the Congress adds to the weakening of the SEC. It is difficult to fight investment bankers if resources are severely lacking.

While we share many of the sentiments expressed in these essays, we think they miss an important point. If the proposed $285 million fine had been accepted by the courts, who would be really paying this fine? It is not management nor the board of directors. Given the firm itself is paying this ticket, it implies that the real payers are the investors of Citigroup. Sure, this group includes managers and directors who own stock in Citigroup, but unfortunately, it also includes investors and pension funds and mutual funds that had nothing to do with the fraud. How fair is it to fine innocent bystanders? How effective is this as a deterrent?

Let’s go back to basics: civil penalties and criminal sentences serve two purposes in our society. First, they satisfy, however partially, our collective sense of justice. Second, society issues civil penalties and criminal sentences to deter future crimes. The idea is that if the disincentives are sufficiently obnoxious and if the probability of enforcement is sufficiently high, then future managers are less likely to follow suit with their own crimes against investors.

In this case, the argument is persuasive as long as the courts levy fines and punishment against the malefactors and not against the victims. We much prefer the SEC to point the finger at those who actually committed the crimes and punish them.

The SEC has for a long time engaged in these civil judgments against firms that have experienced accounting and securities fraud. It would do well for the SEC to re-examine this policy, realize that its effects are pernicious and counterproductive, and then repeal the strategy. It is silly for the investors to suffer for the wrongdoing by corporate thieves masquerading as managers. If the SEC continues to fine firms for wrongdoing and gives a pass to managers, you can expect Wall Street to continue its lascivious dalliance.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*