Securities Regulation Daily Wrap Up, ENFORCEMENT—S.D.N.Y.: Judge approves final judgment in SEC's Tesla tweet case against Elon Musk, (Oct. 16, 2018)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

A Manhattan federal judge approved a final judgment between the SEC, Tesla, Inc., and Tesla CEO Elon Musk in a case involving what may be one of the loudest corporate tweets ever posted. Musk had tweeted that he could take Tesla private and that funding was secured with the only outstanding contingency being a shareholder vote. The SEC brought an enforcement action against both Tesla and Musk which, after some wrangling, was quickly settled with Musk and Tesla agreeing to pay a total of $40 million and with Musk further agreeing to leave his post as Tesla chairman while the company itself would implement governance changes to better manage Musk's public communications (*SEC v. Musk* (*SEC v. Tesla*), October 16, 2018, Nathan, A.).

Penalties and governance changes. The terms of Tesla's and Musk's settlements with the SEC are by now well known. Although neither admitting nor denying the Commission's allegations, Musk agreed in the final judgment to be permanently enjoined from violating Exchange Act Section 10(b) and Rule 10b-5, to pay a civil penalty of $20 million, resign as Tesla's chairman of the board (he cannot hold that position for three years), and comply with various governance procedures to be implemented that are designed to reign-in Musk's public communications about material Tesla business. Tesla, also without admitting or denying the SEC's allegations, will be permanently enjoined from violating Exchange Act Rule 13a-15 regarding disclosure controls and procedures. Tesla and Musk must both certify to the SEC that they have complied with the settlement terms.

Judge Nathan had ordered the SEC and Musk to submit a joint letter telling the court why it should approve the proposed settlement. With respect to the governance changes, the letter explained that Tesla would appoint a new chairman to replace Musk and appoint two new, independent directors. Tesla's board also must establish a committee on corporate disclosures, implement procedures for monitoring and pre-approving Musk's communications about Tesla, and designate or hire an "experienced securities lawyer" to ensure compliance with the disclosure procedures.

The SEC also explained the several factors it considered in deciding to settle: (1) how serious are the violations? (2) what was the market impact of the violations? and (3) what are Tesla's and Musk's financial means? The SEC further explained that it mulled several countervailing factors, including how willing Tesla and Musk were to quickly settle, the lack of financial gain to Tesla and Musk from the violations, and that the violations occurred within a circumscribed time frame.

Moreover, SEC Chairman Jay Clayton publicly expressed his support for both the SEC's enforcement action and the resulting settlement the same day, a Saturday, that the agency announced the settlement. "I also fully support the settlements agreed today and believe that the prompt resolution of this matter on the agreed terms, including the addition of two independent directors to the Tesla board and the other governance enhancements at Tesla, is in the best interests of our markets and our investors, including the shareholders of Tesla."

Almost foregone conclusion, Citigroup and "sour grapes". Second Circuit law leaves little to the imagination following the blockbuster *Citigroup* case in which the appeals court said that settlements between regulators and those they regulate need only be fair and reasonable and, if there will be an injunction, not disserve the public interest. "The job of determining whether the proposed S.E.C. consent decree best serves the public interest, however, rests squarely with the S.E.C., and its decision merits significant deference," said the Second Circuit, a

point the SEC emphasized in its reply to Judge Nathan's request for an explanation of the settlement with Tesla and Musk.

The *Citigroup* decision was prompted by U.S. District Judge Jed Rakoff's decision to reject a settlement involving the SEC without further evidence that the settlement was proper. Then-SEC Enforcement Director Robert Khuzami issued a public statement outlining the reasons for the SEC's appeal of Judge Rakoff's decision, including that the district court had applied an erroneous standard which, if applied in future cases, could limit the SEC's ability to bring enforcement cases and to recover funds for harmed investors.

The Second Circuit in *Citigroup* concluded that Judge Rakoff had gone too far in demanding that the SEC offer additional evidence of the propriety of the settlement. The Second Circuit also said that Judge Rakoff's consideration of the "adequacy" of the settlement was unnecessary because the case involved a government agency enforcement action and not a private class action. Judge Rakoff ultimately approved the SEC-Citigroup settlement, but not without reiterating his concern that courts still lack the ability to review such settlements. "That Court has now fixed the menu, leaving this Court with nothing but sour grapes," said Judge Rakoff.

Courts within the Second Circuit's ambit, such as the Southern District of New York, the locus of the *Tesla*/*Musk* cases, have since applied *Citigroup* in numerous cases involving the SEC and have approved proposed settlements. For example, Judge Nathan approved a settlement between the SEC and an individual and firm that included disgorgement and injunctions against future securities law violations; Judge Nathan concluded the settlement was fair and reasonable per *Citigroup* "especially when considered in conjunction with the judgment in the parallel criminal case" (*See*, *SEC v. Wells*, Case No. 15-cv-7738 (May 17, 2017).

Judges outside the Second Circuit often cite *Citigroup* and approve settlements while sometimes questioning the propriety of those settlements, such as Judge Ross of the Eastern District of Missouri did in an SEC case where the settlement contained no admit/no deny language and there was a question whether a director and officer bar could be enforced (*See*, *e.g.*, *SEC v. Donnelly*, Case No. 14-CV-1970 (February 3, 2015). Still other courts, such as the District of Columbia District Court, have retained the adequacy inquiry in in reviewing proposed settlements (*See*, *e.g.*, *SEC v. Hitachi, Ltd.*, Case No. 15-cv-01573 (November 24, 2015).

The case is No. 18-cv-8865.

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Companies: Tesla, Inc.

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