2nd Circ. Adviser Liability Ruling May Shape SEC Enforcement

By **Elisha Kobre** (March 29, 2024)

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The U.S. Court of Appeals for the Second Circuit on March 13 issued a highly consequential decision in U.S. Securities and Exchange Commission v. Rashid, interpreting and applying the mental state for liability of investment advisers under the Investment Advisers Act.

Over a strong dissent, the court reversed a finding of liability of the defendant investment adviser under basic principles of negligence law, and in doing so, provided a road map for future enforcement actions under the act.

Background: Investment Adviser Fraud Liability Under the Investment Advisers Act

Section 206(2) of the act makes it unlawful for an investment adviser to "engage in any transaction ... which operates as a fraud or deceit any client or prospective client." Unlike Section 206(1), this provision does not have a scienter requirement, and therefore has long been interpreted to impose liability for even negligent acts.

Negligence in this context, as in the Court of Appeals of New York's familiar 1928 decision in Palsgraf v. Long Island Railroad Co., is the failure to exercise the degree of care that a reasonably prudent person would use under similar circumstances.

This, in turn, implicates the familiar concepts of foreseeability and proximate cause, as applied to the statutorily imposed duty on advisers "of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading [their] clients."

Takeaways on the Negligence Standard for Investment Adviser Fraud

In Rashid, the Second Circuit applied these basic negligence principles to the Investment Advisers Act, holding that:

- Foreseeability in the context of investment adviser fraud should be measured by the beliefs or understandings of others in the defendant's position and owing the same fiduciary duties to the client. These employees "are the 'reasonable persons' against whom [the defendant] should be compared when evaluating whether" the harm that occurred was foreseeable.

- An investment adviser's fiduciary duty "only require[s] [the adviser] to 'drill down' to the level of a reasonably prudent investment adviser ... [i.e.,] to that of his peers." If that reasonable investigation had not provided reason to believe that the harm would occur, the harm would not have been foreseeable even if a more robust inquiry had uncovered the harm.

- A knowing breach of a fiduciary duty does not necessarily translate into a greater degree of foreseeability. That is, an adviser's involvement in or awareness of fraudulent conduct does not necessarily imply the foreseeability of harm to clients resulting from that conduct.

- All these principles apply with equal force to the foreseeability of an intervening cause for harm to the client, i.e., the question of proximate cause.

The Facts of SEC v. Rashid

Mohammed Ali Rashid was a senior partner with the private equity firm Apollo Management LP, a registered investment adviser. Apollo managed several investment funds, organized as limited partnerships, each of which was managed by a distinct Apollo-affiliated management company.

Written agreements specified that it was the management companies that were to be responsible for expenses incurred in monitoring the investments of the funds, including business expenses incurred by individual Apollo investment advisers like Rashid.

Rashid for years sought reimbursement for personal expenses that he knowingly and falsely submitted as business expenses. Although the governing documents of the funds required business expenses to be charged to the management companies, rather than the funds, Apollo's accounts receivable department improperly charged all such expenses — legitimate business expenses and Rashid's fraudulent personal expenses — to the funds themselves.

Charged by the SEC with violating the Investment Advisers Act by submitting fraudulent claims for reimbursement, Rashid did not seriously contest that he had intentionally and falsely sought reimbursement for personal expenses under the guise of legitimate business expenses. But he argued that he was not liable under Section 206(1) because he did not know that the funds — the relevant clients under the act — were being charged for the personal expenses.

He also argued that he was not even negligent, as required for Section 206(2) liability, because it was not foreseeable that the expenses would be charged to the funds, rather than the management companies, and that Apollo's erroneous practice of charging expenses to the funds was an intervening act that broke the chain of causation.

Following a bench trial, the U.S. District Court for the Southern District of New York agreed that Rashid had not known the source of reimbursement for his expenses, and so did not have the scienter required under Section 206(1), but it also held that Rashid was at least negligent in breaching his duties to the funds.

The Second Circuit reversed, holding that the SEC had failed to prove even negligence. Applying the principles in the bullet-point list above, the court pointed out that many other Apollo professionals, like Rashid, believed that it was the management companies, not the funds, that would be charged the expenses. His belief in this regard was therefore reasonable.

The court also found that, even if Rashid had investigated "the matter further, he would have reasonably consulted the fund ... agreements and reached the same conclusion as his peers: that the ... management companies were supposed to pay for his claimed expenses."

The Second Circuit rejected the district court's reasoning that Rashid's own fraud should have made him more aware of Apollo's billing practices, finding that nothing about the fraud itself put Rashid on heightened notice of Apollo's billing practices.

The court then applied these same principles to its "calculus as to proximate cause," finding that Apollo's intervening actions in improperly charging the funds for administrative expenses were not reasonably foreseeable.

The dissent would have found that it was foreseeable that the funds would be charged with the personal expenses. In the dissent's view, other Apollo managers were not like Rashid because, although they, too, were fiduciaries, their personal interests did not conflict with the interests of their clients.

And, citing the Restatement (Second) of Torts, Apollo's erroneous practice of billing the client funds themselves did not break the chain of causation, both because it was foreseeable and because Rashid had "reason to expect" that his false representations would be conveyed to the funds.

Rashid is one of the most fulsome analyses of the negligence standard applicable to Investment Advisers Act Section 206(2) claims and is likely to be heavily relied upon in future SEC enforcement proceedings.

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