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Asserting Reliance on Compliance Consultants as a Defense: Admissibility and Effectiveness

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Asset managers commonly engage regulatory compliance consultants to aid them in addressing regulatory requirements and implementing compliance programs. The work of those compliance professionals can be drawn into SEC enforcement actions in various contexts. See, e.g., *ZPR Investment Mgmt. Inc. v. SEC* (compliance consultant resigned when advice not followed and testified in proceeding). One such context is when a fund manager asserts reliance on advice of the compliance consultant as a defense to fraud charges. Earlier this year, a district court opinion addressed that very issue. Although the opinion received little attention, it could have major implications if its analysis is broadly adopted.

In *Securities Exchange Commission v. Westport Capital Markets LLC*, the trial judge, over the SEC's objection, permitted defendants to present evidence regarding their reliance on the advice of non-lawyer regulatory compliance consultants to refute the SEC's claims that they committed fraud under the Advisers Act. The issue was one of first impression in federal courts, as neither party was able to identify any federal court case that recognized a "reliance on regulatory professional" defense.

The SEC alleged that defendants, a wealth management firm and its CEO, had received undisclosed markups when trading for their advisory clients, without sufficiently disclosing their interest in the transactions. Although the firm provided some relevant disclosure of the conflict in its Form ADV, the SEC asserted that the disclosure failed to adequately disclose the financial conflict of interest to clients. There was no dispute that the firm had employed regulatory compliance consultants, who were not lawyers, to assist it in preparing the Form ADV.

Reliance on advice of compliance consultants as a potential defense to scienter-based claims.

The SEC brought claims under Section 206(1) of the Advisers Act for fraudulent failure to disclose, and under Section 207 of the Advisers Act for willfully making an untrue statement in a report filed with the SEC (the Form ADV). The court had previously ruled on summary judgment that the fund managers' conduct violated Section 206(2) of the Advisers Act, an antifraud provision that merely requires a showing of negligent conduct. In response to the Section 206(1) and 207 claims, Defendants asserted their good faith reliance on the advice of the regulatory compliance consultants was relevant to whether they acted fraudulently in failing to disclose the conflict of interest or willfully as to the filed Form ADV. In sum, defendants argued the evidence undercut the scienter required to prove a violation of Section 206(1) of the Advisers Act and the willfulness required to prove a violation of Section 207 of the Advisers Act. The SEC disagreed, and moved *in limine* to exclude the evidence as irrelevant because the guidance was given by non-lawyers and because defendants' contract with the regulatory compliance consultants "indicated that [the consultants] would not render any legal or financial advice relating to . . . compliance with securities laws."

The court sided with defendants and permitted them to introduce the reliance evidence to the jury. The fact the compliance consultants were non-lawyers did not sway the court, which noted that it would be "formalist in the extreme" to exclude evidence of regulatory professionals merely because they did not have law licenses. The question of whether defendants' reliance was reasonable turned on the expertise of the consultants, which in the court's view was a factual determination appropriate for the jury. The court did note that a provision in the contract stating defendants would not rely on the consultant for legal advice might undercut whether reliance was in good faith, but that the ultimate determination of good faith was one of fact for the jury.

Elements required to establish good faith reliance.

While the *in limine* ruling was certainly a positive for the defendants, the court's jury instructions at trial gave them a steep hill to climb. The jury instructions roughly followed the advice of counsel standard most recently articulated by the Second Circuit in *United States v. Scully*, and required the jury to find:

1. The defendants sought advice from the regulatory compliance consultants in good faith, with the belief that the consultants were competent professionals to furnish advice concerning the legality of the defendants' conduct;

2. The defendants made a complete disclosure of all relevant facts known to them at the time;
3. The defendants received actual advice from the regulatory compliance consultants that defendants' conduct complied with the law; and
4. The defendants followed the advice they were given in good faith.

Critically, the court did not require the jury to find good faith *even if* all of the factors were satisfied: "[E]ven if these four factors are satisfied, you do not need to necessarily conclude solely on this basis that they acted in good faith. Instead, [the jury] should consider all of the evidence before making [their] ultimate determination whether the SEC has proved that the defendants did not act in good faith."

The Court's imposition of the *Scully* standard on the defendants is puzzling. Although the Court expressly recognized that reliance on regulatory compliance consultant advice is not an affirmative defense, but rather "an issue concerning the mental state that the SEC must prove in its case-in-chief)," it nonetheless saddled the defendants with the burden of establishing good faith reliance. Going forward, defense counsel would be wise to argue that requiring the defendants to "prove" good faith reliance improperly shifts the burden of proving scienter away from the government.

Reliance as a potential defense to negligence-based claims – federal court.

The defendants' compliance consultant evidence did not ultimately persuade the jury, which rendered a verdict for the SEC on all claims. Although not a panacea, the court's decision to admit the evidence may open new arguments for other defendants if adopted more broadly. Indeed, earlier in the case, the court granted summary judgment in favor of the SEC as to defendants' negligence under Section 206(2) of the Advisers Act, finding that no reasonable jury could conclude that defendants' reliance on the compliance consultants was reasonable. The court's determination that the reliance evidence was not relevant—or at least did not create a triable issue of fact—as to the defendants' reasonableness under Section 206(2)'s negligence provisions does appear to be at least partially in tension with its decision to allow the evidence to be considered by the jury on the question of scienter. In particular, it is not immediately clear why consultations with compliance consultants would be admissible with respect to good faith but not with respect to reasonableness of defendants' actions, even in view of the contractual language specifying that the consultants would not be providing legal advice.

Reliance as a potential defense to negligence-based claims – administrative actions.

The decision raises further questions regarding practice before not only federal district courts, but also the SEC, going forward. The court's opinion touched briefly on the Securities and Exchange Commission's 2016 Opinion in *In the Matter of the Robare Grp., Ltd., Mark L. Robare, & Jack L. Jones, Jr.*. *Robare* also concerned violations of Sections 206 and 207 of the Advisers Act. In *Robare,* the administrative law judge held against the Division on several grounds, finding the Division failed to prove scienter or negligence, meaning that neither Sections 206(1) or 206(2) were violated. The Division appealed to the Commission, which affirmed the ALJ's finding of no scienter (Section 206(1)), but found the firm's disclosure failures were negligent in violation of Section 206(2), and that the firm violated Section 207 by filing Forms ADV with material misrepresentations or omissions.

Notably, in *Robare*, the Commission assumed *arguendo* that an advice of regulatory compliance consultants defense could theoretically be applied to Section 206(2) and Section 207 claims involving negligence and willfulness, respectively, but rejected the argument on the merits. The Commission found the record was vague with regard to whether the firm actually sought or received any advice specific to the disclosure in question from their regulatory compliance consultants regarding the firm's conflict disclosures, or that the firm followed any advice that it did receive in good faith. The Commission did not consider the advice of compliance consultant evidence in the context of Section 206(1), involving scienter, as it had already found the Division failed to advance sufficient evidence of scienter to sustain a claim.

In other words, the Commission in *Robare* apparently considered the use of compliance consultant reliance evidence at least potentially permissible in the context of Section 206(2) claims involving negligence. The D.C. Circuit later determined that Section 207 included a scienter requirement, and vacated the Commission's judgment on that claim. *Robare Grp. Ltd. v. SEC*. On remand to the Commission for re-determination of appropriate sanctions for a violation of Section 206(2), the Division again argued the firm's reliance on compliance counsel was not a proper defense and was not supported by the facts. Division of Enforcement's Response to Respondents' Opening Brief on Remand, *In the Matter of the Robare Grp., Ltd., Mark L. Robare, & Jack L. Jones, Jr.*. The Commission is expected to render a decision on the matter very soon.

In contrast, the *Westport* court found the compliance consultant evidence insufficient as a matter of law to put the Section 206(2) negligence question to the jury. Defense practitioners should consider leveraging both opinions to argue in district courts and before the SEC that advice of compliance professionals, even non-lawyer consultants, is relevant and admissible in defense of claims brought under Section 206(1) and Section 206(2) of the Advisers Act.

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