New Jersey Law Journal
STATEWIDE LEGAL AUTHORITY SINCE 1878
An ALM Publication
221 N.J.L.J. 469 MONDAY, AUGUST 10, 2015 NJLJ.COM

White Collar Criminal Litigation

What Does It Mean to Be 'Willful'?

Defending against willful violations of securities laws

©iStockphoto.com

By George W. "Tres" Arnett III

and Daniel P. D'Alessandro

Everyone can conjure up an image of a willful child—a kid who has made up his mind to disobey you. But the everyday understanding of "willful" is not what willful sometimes means in the law. Sometimes it can mean a deliberate and intentional violation of an authority, just like a willful child. However, at other times—and this is crucial—willful means simply that the actor was aware of what he was doing; no intent to violate the law is needed. Many market professionals are shocked to learn of the potential consequences of this kind of willful violation. Particularly in securities regulation, a willful violation can lead to a statutory bar from the securities industry by the Securities and Exchange Commission (SEC) or the Financial Industry Regulatory Authority (FINRA). And this is a trap for the unwary.

The Federal Regulatory Scheme

Under the Securities Act of 1933, any person who willfully violates any provision of the 1933 act or any of the rules and regulations promulgated thereunder, or who makes any untrue statement or omission of a material fact in a registration statement is subject to criminal penalties. 15 U.S.C. §77x. Under the Securities Exchange Act of 1934, any person who willfully violates a provision of the 1934 Exchange Act or any of the rules and regulations promulgated thereunder, or who, among other things, willfully and knowingly makes any untrue statement or omission of material fact in a filed application, report or document, including a registration statement, is subject to criminal penalties. 15 U.S.C. §78ff(a). The 1934 Exchange Act also provides for civil penalties, and authorizes the SEC to "censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of" any broker or dealer if it finds, after a hearing, that it is in the public interest *and* the broker or dealer has *willfully*:

> (i) made or caused to be made in any application for registration or report required to be filed with the SEC or any other appropriate regulatory agency any statement that was false or misleading with respect to any material fact or omitted to disclose any material fact;
>
> (ii) violated any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, the Exchange Act of 1934, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board; or
>
> (iii) induced or aided and abetted a violation of one of the aforementioned statutes, rules or regulations, or failed to reasonably supervise for purposes of preventing such violations.

15 U.S.C. §78o(b)(4); see also 15 U.S.C. §78c(a)(39). Article III, Section 4 of FINRA's By-Laws provide a similar power to disqualify a broker or broker-dealer for willful violations of its rules or SEC rules.

'Willfully' Defined

The term *willfully* has been described as a "'notoriously slippery term,' a 'chameleon word' that 'takes color from the text in which it appears.'" *United States v. Starnes*, 583 F.3d 196, 210 (3d Cir. 2009) (citation omitted). Because of its contextually driven nature, whether a statute, rule or regulation has been *willfully* violated is generally determined through the use of one of three formulations: (i) intentional conduct that results in a violation, irrespective of the actor's knowledge that such conduct is unlawful; (ii) general intent to engage in unlawful conduct, without regard to the actor's knowledge of the specific law violated; or (iii) a specific intent to violate a known legal duty. The three formulations ascend in numeric order to the highest level of intent required.

Where the rubber meets the road in the regulatory context is when market professionals claim to have made an inadvertent or unintentional mistake.

Under the federal securities laws in the civil regulatory context, the term *willfully* is routinely interpreted to mean "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); see also *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). In other words, a finding of willfulness does not also require that the actor intend to violate—or even have specific knowledge of—the law; rather, it merely requires an intent to do the underlying act that constitutes a violation. This is the first level formulation. Contrast this to the criminal context for a federal securities law violation, where the government must prove that the defendant engaged in unlawful conduct intending to do something that the law forbids. *See* Third Circuit Model Criminal Jury Instructions, ch. 5.05. This is the second level formulation. In fact, the Third Circuit has suggested that some instances of highly technical crimes, such as tax evasion, could require specific intent to violate a particular law. This is articulated in formulation three above.

This trichotomy in formulations as to what willfully means in the differing contexts of criminal and regulatory violations is also true in New Jersey's securities laws. About the same time that the U.S. Supreme Court in *United States v. O'Hagan*, 521 U.S. 642 (1997), ruled that criminal violations of the federal securities laws required more than an intentional act, but also a "culpable intent" (thereby adopting formulation two), New Jersey changed its securities laws to make criminal cases meet a higher standard consonant with the Model Penal Code. Notwithstanding the change in the criminal law, regulatory enforcement by the New Jersey Bureau of Securities proceeds similarly to the SEC, with willful violations having the same level of intent required as set forth in formulation one. See N.J.S.A. 49:3-49(u).

Where the rubber meets the road in the regulatory context is when market professionals claim to have made an inadvertent or unintentional mistake. For example, a regulator might take a view that the filing was made—an intentional act—and that the filing contained misinformation or omitted important information and thus, there was a willful violation. Do not despair. First, it is human nature to forgive mistakes. Second, there is some law on your side.

While reported cases arising in the FINRA and SEC context are few, there is at least one that supports, in dicta, that inadvertence or innocent oversight will negate an allegation of willfulness.

In *Mathis v. U.S. SEC*, 671 F.3d 210 (2d Cir. 2012), the Second Circuit affirmed the SEC's decision that a registered representative's repeated failure to report personal tax liens on his Form U-4 constituted willfulness under the federal securities laws for purposes of imposing statutory disqualification. Mathis was a registered representative and principal with various brokerage firms for several years. On three occasions, Mathis filed Forms U-4 responding "no" to questions concerning the existence of any unsatisfied judgments or liens against him. During that same period of time, the Internal Revenue Service informed Mathis that it had entered five unsatisfied tax liens against him. Although Mathis received notice from the IRS, he did not amend his Forms U-4 or disclose the liens on subsequently filed Forms U-4.

FINRA's Division of Enforcement filed a complaint against Mathis, charging him with willfully failing to disclose the tax liens on the Forms U-4. A FINRA hearing panel determined that Mathis became aware of his disclosure requirement in 1999, and thereafter willfully failed to disclose the tax liens on his Forms U-4. The hearing panel also concluded that Mathis did not act willfully with respect to certain failures prior to 1999 because he reasonably relied on the advice of a work colleague who was a former FINRA official. The National Adjudicatory Council largely affirmed the hearing panel's decision, but disagreed with its finding that Mathis had reasonably relied on his colleague's advice because, among other things, his colleague indicated that it was just his "opinion" and that their current employer's compliance department should determine whether disclosure was required. The SEC sustained the NAC's substantive decision relating to Mathis's Forms U–4 as well as the sanctions imposed against him.

The Second Circuit affirmed the SEC's decision. The Second Circuit adhered to the standard routinely applied to determine whether a violation of the securities laws was willful. In doing so, the court stated that Mathis's conduct involved more than "an inadvertent filing of an inaccurate form, which would not have supported a determination that his conduct was willful." In other words, Mathis's failure to report tax liens on the Forms U-4 was "intentional rather than inadvertent" or "innocent oversight." The Second Circuit further determined that, although "the proposition may be true" that a broker who justifiably relies on advice from a person of suitable experience, position and knowledge has not engaged in willful conduct, Mathis did not justifiably rely on any advice. In short, the Second Circuit recognized the viability of two defenses to alleged willful violations, but the circumstances surrounding Mathis's conduct did not support either defense.

Market professionals are required, as members of the securities industry, to be familiar with the basic laws, rules and regulations that govern their conduct. Therefore, claimed ignorance of the law will not generally suffice to defend against an alleged willful violation of the securities laws. However, consideration should be given as to availability of a defense of mistaken fact or innocent oversight to negate the willfulness of the alleged underlying conduct. Consideration should also be given as to whether the alleged willful conduct is the result of justifiable reliance on advice of persons of suitable experience, position and knowledge, such as lawyers or accountants or the in-house compliance and other staff with their firm. ■

Reprinted with permission from the August 10, 2015 edition of the NEW JERSEY LAW JOURNAL. © 2015 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited.
For information, contact 877.257.3382, reprints@alm.com or visit www.almreprints.com. #151-08-15-02