

Bad Facts Make Good Law for Investment Advisers

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Interpreting the negligence standard applicable to investment advisers, the U.S. Court of Appeals for the Second Circuit has [reversed a finding](#) of non-scienter securities fraud against Mohammed Ali Rashid, a former senior adviser of Apollo Management LP (Apollo), a private equity firm registered as an investment adviser with the U.S. Securities and Exchange Commission (SEC). In October 2017, the SEC filed an enforcement action in the U.S. District Court for the Southern District of New York that alleged Rashid, acting individually as an investment adviser, breached his fiduciary duties to the funds he advised by submitting phony business expenses that were charged to and paid by certain Apollo funds. The SEC charged Rashid with violating Sections 206(1) and (2) of the Investment Advisers Act of 1940 (Advisers Act) for intentionally or, at the very least, negligently defrauding the funds.¹

The district court held a nine-day bench trial, after which the judge determined that Rashid violated his fiduciary duty as an investment adviser to the funds but that his conduct was negligent, not intentional. The district court [permanently enjoined](#) Rashid from further violations of Section 206(2) of the Advisers Act and imposed a penalty of \$240,000. Rashid appealed the lower court's decision to the Second Circuit, and a divided panel reversed the lower court's decision on March 13, 2024.

Bad Facts

Rashid managed several private funds at Apollo that invested in a variety of portfolio companies. The funds were structured as limited partnerships with partnership agreements that governed the allocation of certain expenses to the funds. There was no dispute that over the course of three years, Rashid knowingly and falsely described personal expenses as business expenses and submitted them to Apollo for reimbursement. Examples of Rashid's phony business expenses included travel to "Montreal for a friend's bachelor party, Miami for a friend's wedding, Brazil for a vacation with his wife and New Orleans for the Super Bowl" as well as "expensive dinners and lavish gifts for his friends and family" and other personal expenses incurred at high-end hair salons, spas and clothing stores.

When submitting these false business expenses, Rashid entered investment codes that corresponded to the portfolio companies associated with the funds that he advised, making it appear that the expenses were for work done for the funds. After Rashid had submitted the

¹ The complaint [followed a 2016 settlement](#) between Apollo and the SEC in which Apollo agreed to pay \$52.7 million to resolve, among other claims, the SEC's contention that Apollo failed to supervise Rashid.

false business expenses and codes, Apollo's accounts receivable department determined which entity (i.e., Apollo or a fund) should be billed. Although the fund partnership agreements did not permit work performed with respect to the portfolio companies to be billed to the funds, Apollo's accounts receivable department improperly billed all of Rashid's false business expenses to the funds that Rashid advised. In 2010 and 2012, Apollo questioned the purpose of Rashid's expenses and, in response to both inquiries, Rashid agreed to reimburse the funds \$15,000 and \$325,000 respectively.

Rashid testified at trial that he was unaware that Apollo would charge his personal expenses to the funds he advised. Although other Apollo employees testified that they also did not believe that Apollo would charge administrative expenses to the funds, the district court judge found Rashid's testimony incredible.

District Court Ruling

The district court found that while Apollo bore "significant responsibility" for charging the expenses to the funds in contravention of the partnership agreements, Rashid's falsification of the expenses "began a chain of events that operated as a fraud upon investors in the private equity funds." The court determined that Rashid was not liable for intentional fraud pursuant to Section 206(1) of the Advisers Act because he was unaware that Apollo charged his personal expenses to the funds. However, the court found Rashid liable for violating his fiduciary duty under Section 206(2) because he was "recklessly indifferent," and thus negligent, as to which entity would pay for his expenses. The district court noted that although Rashid did not have "actual knowledge" that the funds were paying his expenses, he "should have" investigated the matter further by "drilling down within Apollo."

Court of Appeals Ruling

Relying on decades-old precedent, the Second Circuit affirmed that pursuant to the Advisers Act, "negligence is the failure to exercise the degree of care that a reasonably prudent person would use under like circumstances" and that a "person's conduct lacks reasonable care [when there exists a] 'foreseeable likelihood that the person's conduct will result in harm.'" Applying this definition of negligence to Rashid's conduct, the Second Circuit held that the district court imposed a heightened duty of care when it concluded that Rashid had a duty to "drill down" on how Apollo had elected to charge his expenses. The Second Circuit found that many Apollo professionals believed, as Rashid had, that Apollo — not the funds — would be charged for the expenses incurred in advising the funds. Had Rashid investigated further, he would have "reached the same conclusion as his peers: that [Apollo was] supposed to pay for his claimed expenses." Hence, while Rashid was the "investment adviser" to the funds, as defined under the Advisers Act, he did not breach his duty of care nor proximately cause the funds harm.²

Importantly, the Second Circuit held that "the [Advisers Act] imposes only a duty of *reasonable* care on fiduciaries such as Rashid, even when those fiduciaries' conduct runs afoul of other legal or ethical proscriptions." The court stated that a "fiduciary's duties under the [Advisers Act] are demanding, but they are not boundless." Despite the egregious facts surrounding Rashid's conduct, the Second Circuit clarified the importance of "not confus[ing] the fraud Rashid committed against his employer with fraud committed against the funds." Rashid's fraud against his employer did not violate Section 206(2), which is "limited to a 'transaction, practice or course

² Second Circuit Judge Amalya Kearse dissented from the majority's ruling and stated that Rashid "deliberately sought to defraud someone into paying for his personal expenses" and noted the fund codes he entered on his expense forms and his lack of credibility on the stand.

of business which operates as a fraud or deceit upon any *client* or *prospective client*.” Rashid’s clients were the funds, not Apollo.

Key Takeaways

- In reversing the lower court’s finding of securities fraud, the Second Circuit looked past Rashid’s egregious conduct to limit the scope of an adviser’s fiduciary duty pursuant to the Advisers Act. An adviser cannot violate Section 206(2) if it commits fraud on an entity other than a client or prospective client.
- Moreover, the Second Circuit held that while an adviser is subject to a heightened fiduciary duty, such duty only requires that an adviser exercise the degree of care of a reasonably prudent adviser: “Any contrary conclusion would not just impose an unduly high duty of care on Rashid but would be effectively the equivalent of imposing strict liability.”
- Advisers should ensure that they are aware of the roles of their advisory personnel, especially when responding to an SEC exam or enforcement investigation.
- Advisers should be aware of the judiciary’s interpretation of the Advisers Act and the elements that constitute liability and not simply rely upon SEC settled matters or agency guidance. While Rashid clearly defrauded his employer and ultimately repaid the funds for the phony business expenses that Apollo billed to them, he did not violate the Advisers Act.

For more information, contact:



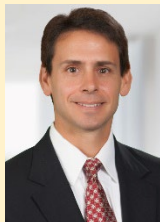
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