"WILLFULNESS" UNDER THE FEDERAL SECURITIES LAWS AND INTENT-BASED DEFENSES TO FEDERAL SECURITIES PROSECUTIONS

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Introduction

In the securities field, an individual who engages in conduct proscribed by the Securities Act of 1933 or the Securities Exchange Act of 1934[1] may be convicted of a crime, provided his or her conduct was "willful." Given the centrality of the concept of "willfulness" in our criminal jurisprudence, and the fact that numerous individuals have been prosecuted, convicted and imprisoned for "willfully" violating the federal securities laws, one would expect that the standard for when a "willful" violation has occurred would by now be well-settled. There is, however, a surprising paucity of case law interpreting the willfulness standard in the securities arena, and those courts that have addressed the issue have not always been uniform in defining a standard for when conduct proscribed by the statutes is criminal.[2]

This article examines the current state of the law on "willfulness" in federal securities prosecutions, and reviews in particular a recent United States Supreme Court decision, *United States* v. *O'Hagan*, 521 U.S. 642 (1997), for the important role it plays in establishing that a showing of classic mens rea -- a guilty mind or bad purpose -- is required to sustain a criminal conviction under the federal securities laws. This article next addresses the availability of a *Cheek*-type defense to federal securities prosecutions, and examines other intent-based defenses that may be available to negate the element of willfulness.

I. Evolution of the Jurisprudence of Willfulness

As numerous courts and commentators have observed, the term "willful" is a "word of many meanings" and "its construction [is] often . . . influenced by its context."[3] Early confusion regarding the meaning of the term "willful" as it applies to federal securities prosecutions arose in part from Congress' use of the same term -- "willfully" -- to prescribe the intent required for both civil and criminal violations of the Exchange Act. Thus, Section 32(a) of the Exchange Act provides that any person who willfully violates any provision of the Act can be charged with a crime, while Section 15(b)(4)(D) of the same Act authorizes the Securities and Exchange Commission ("S.E.C.") to seek civil administrative penalties against any person who "willfully" violates certain provisions of the securities laws.[4] Congress' use of the same term to define the intent that is required for both criminal and civil sanctions has caused a number of commentators to query whether a criminal violation requires a higher level of culpability, or may instead be established through reference to standard civil law requirements.[5] In the civil arena, the term "willfully" has typically been understood to mean simply that the act constituting the violation was undertaken voluntarily and intentionally, and not as the result of an accident or mistake.[6]

While commentators have debated this issue, the case law has steadily developed toward recognition that the term "willfully" as used in the criminal provisions of the federal securities laws requires a higher level of intent than that required in civil and administrative proceedings. In the first Court of Appeals decision to address the issue, the Second Circuit, in *United States* v. *Peltz*, 433 F.2d 48 (2d Cir. 1970) (per Judge Friendly), held that, in order to sustain a criminal conviction, the prosecution had to establish "a realization on the defendant's part that he was doing a wrongful act."[7]

A couple of years later, however, in *United States* v. *Schwartz*, 464 F.2d 499 (2d Cir. 1972), a different panel of the Second Circuit addressed the meaning of the term "willfully" in the context of a criminal prosecution for conspiracy to violate the anti-hypothecation provisions of the Exchange Act.[8] The court stated, without reference to *Peltz*, that a criminal conviction under Section 32(a) for willfully violating a provision of the Exchange Act would be sustained upon "satisfactory proof . . . that the defendant intended to commit the act prohibited."[9] Under this

formulation, there was no requirement of any realization of wrongful conduct on the defendant's part and thus no requirement that the prosecution show "bad purpose" or "evil motive."

Several years later, in *United States* v. *Dixon*, 536 F.2d 1388 (2d Cir. 1976), with Judge Friendly again writing for the court, the Second Circuit returned to the issue of the meaning of the term "willfully" under the Exchange Act.[10] *Dixon* involved a prosecution under Section 14(a) of the Exchange Act for violations of certain proxy disclosure and reporting requirements.[11] The defendant, president of a company, had omitted required information from reports filed with the S.E.C. and made certain false statements in the corporate books and records, but claimed that he could not be held criminally liable for violation of the Exchange Act because he had misunderstood the S.E.C. rules regarding proxy disclosure requirements and had not intentionally filed a false proxy statement.[12] The Second Circuit rejected Dixon's defense.[13] Focusing on the statements he had made when he caused the company's books falsely to reflect his level of indebtedness to the corporation, the court found his conduct to have been "wrongful," and concluded that his "intent to deceive" was sufficient to satisfy the standard of willfulness in Section 32(a).[14] Thus, although no "specific intent" to violate the proxy rules was required,[15] the court reaffirmed the requirement it first articulated in *Peltz* that, before criminal liability may attach, the Government must establish, at a minimum, "a realization on the defendant's part that he was doing a wrongful act."[16] As one commentator has observed, the formulation that the Second Circuit adopted in *Dixon* was "classic criminal mens rea, no more and no less."[17]

Although there is a striking lack of case law from other circuits interpreting the term "willfully" as it appears in the federal securities laws, a recent United States Supreme Court decision, *United States* v. *O'Hagan*, 521 U.S. 642 (1997), has confirmed (albeit somewhat cryptically) that a criminal violation of the federal securities laws requires something more than a conscious undertaking of an act that is proscribed; it requires that the individual who has voluntarily and intentionally undertaken the proscribed act also have done so with a "culpable intent" or, in other words, with mens rea -- that is, with a "bad purpose" or an "evil" or "guilty" mind.[18]

O'Hagan involved a lawyer defendant who purchased stock in a target corporation prior to the corporation being purchased in a tender offer.[19] He did so based upon inside information he had acquired as a member of the law firm that represented the tender offeror.[20] Upholding the so-called "misappropriation theory" of insider trading liability, the Court found that a corporate "outsider" violates Section 10(b) and Rule 10b-5 of the Exchange Act when he or she "misappropriates" material non-public information for securities trading purposes in breach of a recognized fiduciary duty owed to the source of the information.[21] In so ruling, the Court emphasized that "vital" to its decision that criminal liability could be sustained under the misappropriation theory was the requirement under the Exchange Act that the Government prove, as an essential element of the offense, that the defendant acted with a "culpable intent."[22] The Court explained that this requirement weakened O'Hagan's charge that the misappropriation theory was too indefinite to permit the imposition of criminal liability and was critical to assuring that the imposition of criminal liability in the circumstances presented was just.[23] Having found that O'Hagan had engaged in "deceptive" conduct when he failed to disclose his personal trading to his law firm or his law firm's client in breach of recognized fiduciary duties, the Court was satisfied that he had acted with the requisite "culpable intent," or mens rea, for imposition of criminal liability under the Exchange Act.[24]

The *O'Hagan* Court's requirement of "culpable intent" is consonant with the Second Circuit's requirement in *Peltz* and *Dixon* that, before criminal liability may attach, the Government must establish "a realization on the defendant's part that he was doing a wrongful

act."[25] Whether termed "culpable intent" or "realization of a wrongful act" or "mens rea," all are formulations of classic criminal intent, and all require knowingly wrongful conduct.[26]

In short, although courts and commentators may not have early or uniformly arrived at a defined standard for when conduct proscribed by the federal securities laws is criminal, a classic criminal mens rea requirement has emerged from the case law and has recently been confirmed by the United States Supreme Court's decision in *O'Hagan*. A criminally "willful" violation of the federal securities laws thus clearly requires more than the voluntary and intentional doing of an act that is proscribed. A remaining question worthy of consideration is whether that "something more" is "knowingly wrongful conduct," as suggested by *Peltz*, *Dixon* and *O'Hagan*, or whether an argument can be made, as has been done successfully in other areas of the law, that the term "willfully" requires a heightened showing of "specific intent" on the defendant's part to violate the statute's commands.

II. Availability of a *Cheek*-Type Defense in Federal Securities Prosecutions

Over the course of the last decade, in the wake of the United States Supreme Court's decisions in *Cheek* v. *United States*, 498 U.S. 192 (1991), and *Ratzlaf* v. *United States*, 510 U.S. 135 (1994), a substantial number of federal criminal statutes have been construed to impose a heightened mens rea requirement in the form of "knowledge of illegality" or "specific intent" to violate the law. Thus, proof of knowledge of illegality has been required in criminal prosecutions under the federal tax statutes,[27] the antistructuring provisions of the Money Laundering Control Act,[28] the Arms Export Control Act,[29] the Medicare-Medicaid Anti-Kickback Statute,[30] the Trading with the Enemy Act,[31] the false statement statute,[32] and numerous other federal provisions. This recent plethora of cases interpreting the term "willfully" in various federal statutes to mean a "voluntary, intentional violation of a known legal duty" inevitably raises the question whether a similar "knowledge of illegality" requirement may exist under the federal criminal securities laws. Although the doctrine presents an intriguing possibility for a narrow category of cases, for the reasons set forth below, this legal requirement generally is not likely to be well received in criminal securities prosecutions.

A. Legal Landscape

In considering this question, it is worthwhile at the outset to review briefly two fundamental principles of our criminal law, as they inform the courts' jurisprudence on willfulness, and help to elucidate the development of the "knowledge of illegality" requirement. First, there is the maxim that ignorance of the law is no defense to a criminal prosecution. Under this principle, individuals may be criminally punished when they engage in prohibited conduct without regard to whether they are aware of, or fully understand, the law's requirements. Based upon the notion that the law is definite and knowable, the common law simply presumed that every person knew the law.[33] The second, and equally well-rooted principle, is that no one should be punished as a criminal unless he or she acts with "mens rea" or an "evil-meaning mind." It is this state-of-mind element that distinguishes between criminal misconduct worthy of condemnation and punishment and civil misconduct that requires only compensation for injuries sustained.[34]

While these two principles have co-existed without apparent conflict over time, the proliferation in recent years of complex, technical federal statutes and regulations, enforceable through stiff criminal sanctions, has introduced a new tension for courts seeking to interpret the term "willfully."[35] Specifically, in areas where the law is perceived to be particularly complex, and the proscribed conduct is viewed as malum in se (not intrinsically wrongful but wrongful only

because a law exists proscribing the conduct), courts have refused reflexively to follow the maxim that "ignorance of the law is no excuse." To the contrary, in such cases, the courts have carved out an exception to the rule, and have imposed a "knowledge of illegality" requirement in order to ensure that (in keeping with the second maxim), before a defendant is convicted of a crime, he or she be shown to have acted with some "wrongful purpose" -- a purpose to violate the law -- and therefore to be deserving of criminal punishment.

B. *Cheek* v. *United States*

The leading case in the development of this heightened mens rea requirement is *Cheek* v. *United States*, 498 U.S. 192 (1991), which involved an American Airlines pilot who was punished for criminal tax evasion for failing to file federal income tax returns.[36] Cheek defended in part on the ground that he had a sincere belief that his wages were not income under the Internal Revenue Code and that he therefore had no duty to pay taxes on them.[37] Noting that the "proliferation of statutes and regulations has sometimes made it difficult for the average citizen to know and comprehend the extent of the duties and obligations imposed by the tax laws," and seeking to protect the average citizen from prosecution for innocent mistakes due to such complexity, the Court held that the term "willfully," as used in federal tax statutes, means a "voluntary, intentional violation of a known legal duty."[38] Thus, a good faith misunderstanding of the law or a good faith belief that one is not violating the law negates willfulness, regardless of whether the claimed belief or misunderstanding is reasonable.[39]

C. Expansion of *Cheek*

The *Cheek* "knowledge of illegality" requirement was originally confined narrowly to the tax arena. Courts depicted the tax exception as narrow in scope, explained the exception as one that arose from the complexity of the Internal Revenue Code, and rejected efforts to expand the reasoning of *Cheek* to other substantive areas of the law.[40] In *Ratzlaf* v. *United States*, 510 U.S. 135 (1994), however, the Supreme Court for the first time adopted a *Cheek*-type construction of the word "willfully" in a non-tax case.[41] *Ratzlaf* involved a criminal prosecution under the antistructuring provisions of the Money Laundering Control Act, which made it unlawful to structure a financial transaction in order to avoid a financial institution's obligation to report cash transactions in excess of $10,000.[42] The evidence in *Ratzlaf* was clear that the defendant had known of the bank reporting rules and had intentionally acted to elude them by purchasing multiple cashier's checks from a number of different banks in amounts just under $10,000.[43] *Ratzlaf* defended on the ground that, in order to be convicted for a "willful" violation, the Government was required to prove that he was aware of the illegality of the structuring in which he engaged.[44]

The Supreme Court ultimately agreed with Ratzlaf and held that, "to give effect to the statutory 'willfulness' specification, the Government had to prove Ratzlaf knew the structuring he undertook was unlawful."[45] In so holding, the Court emphasized that it was unpersuaded by the argument that structuring was so obviously evil or inherently bad that the willfulness requirement was satisfied irrespective of the defendant's knowledge of the illegality of structuring.[46] In other words, the Court imposed a "knowledge of illegality" requirement in order to protect "non-nefarious" actors and ensure that no defendant would be convicted absent a showing that he or she had acted with a "wrongful purpose."

The Court's decisions in *Cheek* and *Ratzlaf* may be understood as efforts by the Court to avoid the unjust result of criminally convicting individuals who genuinely did not know that their conduct was "wrongful." As then Chief Judge Breyer observed in his concurring opinion in

United States v. *Aversa*, 984 F.2d 493 (1st Cir. 1993), the tax law violations at issue in *Cheek* and the antistructuring violations at issue in *Ratzlaf* both involve technical areas of the law and both sets of laws "sometimes criminalize conduct that would not strike an ordinary citizen as immoral or likely unlawful."[47] By requiring proof in such cases that the defendant was consciously aware of the duty at issue -- and violated it anyway -- the Court sought to establish a legal standard that would eliminate the danger of convicting a defendant with a non-culpable or "innocent" state of mind.

More recently, in *Bryan* v. *United States*, 524 U.S. 184 (1998), the Supreme Court revisited the issue of willfulness and the "knowledge of illegality" requirement in the context of a federal firearms prosecution.[48] The Court held that the key requirement for criminally "willful" misconduct is an "evil-meaning mind."[49] The Court explained that this state of mind may be established by a showing that the defendant knowingly did that which the law forbade.[50] *Bryan* involved a criminal prosecution against a defendant charged with willfully dealing in firearms without a federal license.[51] The evidence at trial established that the defendant had in fact dealt in firearms and knew that his conduct was unlawful (why else, the Court asked, would he have used straw purchasers to buy guns for him and assured them that he would shave the serial numbers off the guns).[52] There was, however, no evidence that the defendant had been aware that there was a federal law prohibiting dealing in firearms without a federal license.[53] The Court rejected Bryan's contention that his conviction should be reversed because there was no proof that he had knowledge of the federal licensing requirements and because the trial judge had erred by failing to instruct the jury that such knowledge was an essential element of the offense.[54]

The Court began its analysis by observing that, in the criminal law, the term "willfully" typically refers to a culpable state of mind.[55] Thus, the Court explained that, "as a general matter, when used in the criminal context, a 'willful' act is one undertaken with a 'bad purpose.'"[56] In order to establish a willful violation of a statute, therefore, the Government must prove that the defendant acted with an "evil-meaning mind" -- in other words, with knowledge that his conduct was unlawful.[57] In declining to hold that the defendant had to have been aware of the specific licensing provision he was charged with violating, the Court distinguished *Cheek* and *Ratzlaf*.[58] The Court did so on the ground that "[t]he danger of convicting individuals engaged in apparently innocent activity that motivated our decisions in the tax cases and *Ratzlaf* is not present here because the jury found that this petitioner knew that his conduct was unlawful."[59]

Interestingly, the import of these three Supreme Court cases addressing the "knowledge of illegality" requirement is that, as Judge Friendly first observed several decades ago,[60] a defendant who has a realization that his conduct is wrongful, and undertakes the conduct anyway, acts "willfully" and may be held criminally responsible for his conduct. Only in those technical, complex areas of the law where there is a perceived danger of convicting an individual engaged in apparently innocent activity will the court impose a heightened mens rea requirement -- specific intent to violate the statute in question -- and only then in order to ensure that the requisite "realization of wrongful conduct" on the defendant's part is present.

D. Applicability of *Cheek* and *Ratzlaf* to Securities Prosecutions

As the foregoing review of the pertinent case law suggests, the "knowledge of illegality" defense recognized under *Cheek* and *Ratzlaf* is unlikely to receive a welcome reception in criminal securities prosecutions. The securities laws are designed to ensure full disclosure of all material information in the marketplace in order to promote vigorous market competition. Federal securities prosecutions typically involve fraud or deceit arising from affirmative

misrepresentations or material omissions, or other fraudulent acts, practices or courses of business. In these circumstances, because the conduct at issue is typically viewed to be "intrinsically wrongful," courts are unlikely to be concerned about special requirements to ensure that the defendant had a "realization" of his wrongful conduct. In other words, where the defendant's "bad purpose" or "evil-meaning mind" will effectively be established through proof of the underlying fraud, there will be little perceived danger that innocent actors will somehow become ensnared by a tangle of regulations and be unfairly convicted of securities fraud.

Indeed, although only a handful of courts have addressed the applicability of the "knowledge of illegality" requirement in the securities law context, all that have done so have summarily rejected the defense as unwarranted in criminal securities cases. Thus, on remand from the United States Supreme Court's decision in *O'Hagan*, the Eighth Circuit rejected O'Hagan's argument that, in order to prove willfulness, the Government had to establish that he knew what acts Rule 10b-5 prohibited and intentionally committed acts in violation of the Rule.[61] Distinguishing *Cheek* and *Ratzlaf*, the Eighth Circuit flatly stated that, "[t]he rationale of *Cheek* and *Ratzlaf*, that knowledge of the law is required in order to prevent criminal conviction for conduct that may often be innocently undertaken, does not apply to § 32 [of the Exchange Act]. Criminal conviction for violation of rules and regulations implementing § 10(b) necessarily involves fraudulent conduct and breaches of duty by the defendant. Such actions do not involve conduct that is often innocently undertaken."[62]

The Ninth Circuit, in *United States* v. *English*, 92 F.3d 909 (1996), reached a similar conclusion.[63] *English* involved a criminal prosecution under the Securities Act of a defendant who had made false statements to investors and engaged in a scheme to defraud those investors of millions of dollars while purportedly raising capital to fund loans to acquire and develop condominium projects.[64] After being convicted for securities fraud under the Securities Act, English asserted on appeal that the trial court had erred in failing to instruct the jury that the "willfulness" requirement in the statute required the Government to prove that he had known that his conduct was in violation of the law.[65] The Court swiftly rejected English's contention, observing that, "[s]ince fraud is an inherently bad act, . . . there is no danger of prosecuting 'the innocent, feckless, or reckless'" under the Securities Act.[66] The Court further stated that, "unlike the currency transaction violations at issue in *Ratzlaf*, there can be no doubt about the inherently nefarious nature of English's fraudulent scheme."[67]

A further obstacle to recognition of a *Cheek*-type "knowledge of illegality" requirement in federal securities prosecutions arises from the fact that many, if not most, prosecutions involve claims against market professionals, many of whom are required, as members of the securities industry, to be familiar with the laws, rules and regulations that govern their conduct. Given the historical development and underpinnings of the "knowledge of illegality" requirement, the defense appears designed primarily, if not exclusively, for the benefit of lay persons who may not reasonably be expected to know and comprehend the full extent of their duties and obligations under complex regulatory regimes. Where the defendant is a market professional held to a level of knowledge regarding the securities laws, such a defense is likely to fall on deaf ears. As the S.E.C. observed in an administrative broker-dealer proceeding, "[i]t would make no sense to conclude that, even though the federal securities laws require professionals to be familiar with the basic legal requirements governing their conduct, their ignorance is a complete defense[.]"[68]

In light of these considerations and the existing case law, it appears that the only plausible application of a *Cheek*-type defense in a federal securities prosecution would be in a case involving a non-market professional who engaged in a securities violation other than fraud where there is no evidence of concealment or other indicia of "consciousness of guilt" (such as a family member tippee who traded on material non-public information without knowing of the

insider trading rules, or an employee of a company who failed to make a required S.E.C. filing or to disclose certain information without knowledge of the filing or disclosure requirement).

Even assuming a case involving such innocent circumstances, however, a potentially significant obstacle to a successful application of *Cheek* arises under the Exchange Act from the peculiar construction of the statute itself. Specifically, Section 32(a) of the Exchange Act provides:

> Any person who willfully violates any provision of this chapter or any rule or regulation thereunder . . . shall upon conviction be fined . . . or imprisoned . . . or both . . . but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.[69]

In light of this statutory language, the Government has a decent argument that Congress specifically addressed the extent to which "knowledge of illegality" is a defense to criminal Exchange Act violations, and provided only for a defense to imprisonment -- not conviction -- based upon lack of knowledge of a particular S.E.C. rule or regulation. Indeed, the Eighth Circuit in *O'Hagan*, on remand, specifically relied on the text of Section 32(a) and the language regarding imprisonment to reject O'Hagan's argument that the Government was required to prove that he had a specific intent to violate Rule 10b-5 as a predicate to conviction.[70]

Notwithstanding the language of Section 32(a), non-market professionals charged with federal securities violations other than fraud may be able to construct a viable *Cheek*-type defense to an alleged securities law violation. Such a defense would draw upon the *Cheek*, *Ratzlaf* and *Bryan* cases, coupled with *O'Hagan*, *Dixon* and *Peltz*, to argue that the term "willfully" as used in the federal securities laws requires proof that the defendant had some "realization" of his wrongful conduct, and thus acted with the requisite "culpable intent." If the conduct in issue falls outside the area of recognized fraud and is not otherwise "inherently nefarious," the defendant should have a viable argument that proof of the requisite "mens rea" in such circumstances requires evidence that the defendant knew that his conduct was proscribed by law.

The language of Section 32(a) is not to the contrary. Under this line of argument, only an actor with "mens rea" may be convicted under the first clause of Section 32(a), and he may or may not have a defense to imprisonment under the second clause depending upon whether he can separately establish that he had no knowledge of the specific rule or regulation that he is charged with having violated.[71] Moreover, even if the defense were to be limited to imprisonment and not conviction, a successful defense to imprisonment ought to provide a strong discretionary argument against criminal prosecution in the first place.[72] Thus, in an appropriate case, a *Cheek*-type defense may be available as an effective argument against the prosecution or conviction of a non-market professional.

III. Availability of "Advice of Counsel" or "Advice of Expert" Defense

Although there may only be a narrow window of opportunity for application of a *Cheek*-type defense to negate willfulness in the securities arena, the courts' recognition that mens rea is required for criminal securities violations confirms the availability of another, potentially important, intent-based defense to alleged federal securities law violations.

Specifically, in the context of a securities prosecution, circumstances may exist where a criminal defendant sought, and relied upon, the advice of legal counsel or the advice of an expert (such as an accountant) prior to taking a particular action or making a particular

statement that is allegedly violative of the securities laws. In such circumstances, a defendant may be able to use his good faith reliance upon such advice to negate the element of "willfulness."

A. Generally

In general, defendants are entitled to an advice-of-counsel instruction if they introduce evidence demonstrating that they: (1) made full disclosure of all material facts to their attorney before receiving the advice at issue; and (2) relied in good faith on the counsel's advice that their course of conduct was legal.[73] The advice-of-counsel "defense"[74] has been specifically recognized in the context of securities fraud prosecutions.[75] Defendants who proffer evidence supporting the conclusion that they have fully disclosed all pertinent facts to counsel, and that they have relied in good faith on counsel's advice, are entitled to an advice-of-counsel jury instruction.[76] Reliance on the advice of counsel is, of course, not a defense where the defendant engaged in the allegedly illegal conduct prior to seeking the advice of counsel,[77] or where the defendant in good faith sought the advice of counsel but did not follow it.[78]

It appears that a corporation may assert and properly establish an advice-of-counsel defense even when the advice is provided by an in-house lawyer.[79] That said, in order for the defense to be effective, counsel must act independently and must not have an interest in the activity in question.[80]

B. Advice of Non-Lawyer Experts

In cases that have arisen outside the securities context, courts have routinely extended the advice-of-counsel defense to the advice of non-lawyer experts. These cases have frequently arisen in the tax context, and involve reliance on accountants.[81] The defense, however, is not by its terms limited to any particular category of expert. Rather, the defense is potentially available where a criminal defendant relied on any expert qualified to render advice with respect to the conduct at issue.[82]

Although there does not appear to be any reported cases where a court has specifically recognized the validity of an advice of "expert" (as opposed to advice of "counsel") defense in the context of a securities fraud prosecution, there does not appear to be any principled reason that a defendant in a securities case would not be able to take advantage of such a defense. Indeed, the securities field (and particularly the area of financial reporting) appears ripe for the application of such a defense. As a matter of course, individuals and companies rely heavily upon the advice of outside auditors and accountants in preparing financial statements. The complexities of Generally Accepted Accounting Principles demand such reliance. To the extent that a company or individual relies in good faith upon an accountant's judgment on a complicated accounting issue, the company or individual should be insulated from criminal liability.

C. Legal Effect of Demonstrating Good Faith Reliance on the Advice of Counsel/Expert

Although courts construe the legal impact of the advice-of-counsel/expert defense differently, all circuits recognize that satisfaction of the elements of the defense may negate any alleged "willfulness" on the part of a criminal defendant. As the Court of Appeals for the Seventh Circuit has recognized, "[i]f a person who truly does not know what the law requires seeks in good faith advice from counsel and is given wrong advice that he nonetheless believes

(and has no reason to disbelieve), he does not act willfully in following that advice."[83] Some courts consider good faith reliance on the advice of counsel to be a complete defense to a criminal prosecution.[84] In the securities context, however, the general rule appears to be that good faith reliance on the advice of counsel "is not a complete defense to an allegation of willful misconduct, but is merely one factor a jury may consider when determining [the defendant's] state of mind."[85]

Conclusion

Although the courts have been slow to bring clear definition to the mental state required for criminal violations of the federal securities laws, recent authority confirms that classic criminal mens rea -- a "bad purpose" or "evil-meaning mind" -- is required to sustain a criminal securities conviction. Although a *Cheek*-type defense is unlikely to be well-received in securities prosecutions involving market professionals or fraud, such a defense may be viable in a prosecution brought against a non-market professional for conduct that falls outside the area of fraud, provided there is no evidence of concealment or other indicia of "consciousness of guilt." One other potentially important intent-based defense available in securities prosecutions is good faith reliance upon the advice of counsel or the advice of an expert qualified to render advice with respect to the conduct in issue. In an appropriate case, one or both of these defenses may prove critical in negating willfulness and thereby avoiding conviction under the federal securities laws.

[1] There are six statutes in all that regulate securities transactions. *See* Securities Act of 1933, 15 U.S.C. §§ 77a *et seq.*; Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa *et seq.*; Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.*; Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79a *et seq.*; Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 *et seq.*; Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 *et seq.* Each of these statutes provides for potential criminal liability for violations of its provisions. *See* 15 U.S.C. §§ 77x, 77yyy, 78ff, 79z-3, 80a-48, 80b-17. The two most important of these statutes -- and those that give rise to most of the federal criminal prosecutions -- are the Securities Act of 1933 and the Securities Exchange Act of 1934. Section 24 of the 1933 Act provides that any person who willfully violates any provision of the 1933 Act or any of the rules and regulations promulgated thereunder or who willfully makes any untrue statement or omission of a material fact in a registration statement shall be fined not more than $10,000 or imprisoned for not more than five years, or both upon conviction. *See* 15 U.S.C. § 77x. Section 32(a) of the 1934 Act similarly provides that any person who willfully violates a provision of the 1934 Act or any of the rules and regulations promulgated thereunder or who, *inter alia*, willfully and knowingly makes any untrue statement or omission of material fact in a filed application, report, or document including a registration statement shall be fined not more than $1,000,000 or imprisoned not more than ten years or both upon conviction. *See* 15 U.S.C. § 78ff(a). Section 32(a) of the 1934 Act further states that "no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation." *See id.*

[2] Commentators have frequently bemoaned the lack of clarity in the law on this important issue. *See, e.g.*, Norwood P. Beveridge, *Is Mens Rea Required for a Criminal Violation of the Federal Securities Laws?* 52 Bus. Law. 35, 37 (1996) (noting that the state of the law on the degree of culpability required for a violation of the federal securities laws has been described as a "confusing state of affairs," "unsettled," and a "matter of great concern"); Charles M. Carberry & Harold K. Gordon, *After* O'Hagan*: Less Expansive Duties and Higher Mental States Restrict Criminal Securities Law Prosecutions*, *in Securities Enforcement Institute: A Practical Guide to Investigation, Settlement & Litigation* 165, 172 (PLI Corp. Law & Practice Course Handbook Series No. B4-7240, 1997) ("An examination of prior case law interpreting Section 32(a) reveals that the courts have been less than uniform with regard to the degree of culpability required to sustain a criminal securities charge based upon an alleged Exchange Act violation."); Julian W. Friedman & Charles A. Stillman, *Securities Fraud*, *in* 2 *White Collar Crime: Business and Regulatory Offenses* §12.02 (Otto G. Obermaier & Robert G. Morvillo eds., 1990) (noting that courts have been far from unanimous in articulating a standard for when conduct in violation of the securities laws rises to the level of "willfulness" and therefore constitutes a crime); John P. James, *Culpability Predicates for Federal Securities Law Sanctions: The Present Law and the Proposed Federal Securities Code*, 12 Harv. J. on Legis. 1, 5, 39, 61 (1974) (stating that the "meaning of willfully in the criminal context remains unsettled between positions of low and high culpability").

[3] *Spies* v. *United States*, 317 U.S. 492, 497 (1943); *see also Ratzlaf* v. *United States*, 510 U.S. 135, 141 (1994).

[4] *Compare* 15 U.S.C. § 78ff(a) (criminal penalty provision), *with* 15 U.S.C. § 78o(b)(4)(D) (civil penalty provision).

[5] *See* Jonathan Eisenberg, *"Willful Violations" of the Federal Securities Laws: Why the SEC's No-Fault Approach Is Now Ripe for Rejection*, 5 Insights 13, 15 (1991) (suggesting that civil-type standard ought to apply uniformly to level of intent required for both criminal and civil sanctions and noting that "there appears to be no legislative history suggesting that Congress intended 'willfully violate' to mean one thing in Section 32(a) [of the Exchange Act] and an altogether different thing in Section 15(b)(4)(D) [of the Exchange Act]"); *see also* 2 Louis Loss, *Securities Regulation* 1309-1310 & n. 88 (1951) (commenting on uncertainty regarding level of intent required for criminal and civil sanctions and noting that level of intent may be lower for civil sanction than criminal sanction); Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 1168-1169 (3d ed. 1995) (recognizing the confusion surrounding the meaning of the term "willfully" in civil and criminal provisions); Jed S. Rakoff, *"Willful" Intent in Criminal Securities Cases*, N.Y.L.J., May 11, 1995, at 3 (noting that "[t]he use of the same term . . . to describe the intent requirement of both criminal and administrative sections under the Exchange Act has led some commentators to argue that a uniform interpretation of 'willfully' should apply throughout -- although these same commentators are divided as to whether this common definition should include a mens rea component or not" and concluding that the term "willful" should be given its customary meaning in both the civil law provisions, i.e., voluntary, and the criminal law provisions, i.e., with evil purpose).

[6] *See, e.g.*, *Tager* v. *Securities & Exch. Comm'n*, 344 F.2d 5, 8 (2d Cir. 1965) (in S.E.C. proceeding to revoke broker-dealer registration, holding that the term "willfully" in this context means "intentionally committing the act which constitutes the violation"); *see also United States* v. *Murdock*, 290 U.S. 389, 394-395 (1933); *Screws* v. *United States*, 325 U.S. 91, 100 (1945).

[7] *United States* v. *Peltz*, 433 F.2d 48, 55 (2d Cir. 1970) (quoting with approval Judge Herlands' article, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 Va. L. Rev. 139, 149 (1934), which was published contemporaneously with passage of the Act). In an earlier decision, Judge Friendly had addressed the willfulness issue in passing, affirming without elaboration a trial judge's instructions on willfulness and referencing with approval the Herlands article. *See United States* v. *Guterma*, 281 F.2d 742, 753 (2d Cir. 1960). In his law review article, Herlands had concluded that the term "willfully" in the Exchange Act meant "not merely voluntarily but with a bad purpose." William B. Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 Va. L. Rev. 139, 148 (1934) (citations omitted).

[8] *United States* v. *Schwartz*, 464 F.2d 499, 501 (2d Cir. 1972).

[9] *Id.* at 509.

[10] *United States* v. *Dixon*, 536 F.2d 1388, 1397-98 (2d Cir. 1976).

[11] *See id.* at 1391.

[12] *See id.* at 1391-93, 1395-96.

[13] *See id.* at 1395-96.

[14] *See id.*

[15] *See id.* at 1395 ("A person can willfully violate an SEC rule even if he does not know of its existence[.]").

[16] *Id.*

[17] Rakoff, *supra* note 5, at 3.

[18] *See United States* v. *O'Hagan*, 521 U.S. 642, 665-66 (1997).

[19] *See id.* at 647-48.

[20] *See id.* at 648 & n.1.

[21] *See id.* at 653-54.

[22] *See id.* at 665-66.

[23] *See id.* at 666.

[24] *See id.* at 653-56 ("A misappropriator who trades on the basis of material, nonpublic information . . . gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.").

[25] *Peltz*, 433 F.2d at 55; *Dixon*, 536 F.2d at 1395.

[26] *See also Bryan* v. *United States*, 524 U.S. 184, 191 (1998) (in federal firearms case, observing generally that the term "willfully" in the criminal law "typically refers to a culpable state of mind" and stating that, "[a]s a general matter, when used in the criminal context, a 'willful' act is one undertaken with a 'bad purpose'").

[27] *See Cheek* v. *United States*, 498 U.S. 192, 201 (1991).

[28] *See Ratzlaf* v. *United States*, 510 U.S. 135, 149 (1994).

[29] *See United States* v. *Murphy*, 852 F.2d 1, 7 (1st Cir. 1988).

[30] *See United States* v. *Jain*, 93 F.3d 436, 441 (8th Cir. 1996) (requiring Government to prove defendant knew conduct was wrongful); *Hanlester Network* v. *Shalala*, 51 F.3d 1390, 1400 (9th Cir. 1995) (concluding that Government must show defendant knew of statute's prohibitions and acted with specific intent to violate statute).

[31] *See United States* v. *Macko*, 994 F.2d 1526, 1532-33 (11th Cir. 1993); *United States* v. *Frade*, 709 F.2d 1387, 1391-1392 (11th Cir. 1993).

[32] *See United States* v. *Curran*, 20 F.3d 560, 569 (3d Cir. 1994). *But see United States* v. *Daughtry*, 48 F.3d 829, 831-832 (4th Cir. 1995).

[33] *See, e.g.*, 1 John Austin, *Lectures on Jurisprudence* 497-503 (4th ed. 1873) (recognizing that ignorance of the law "excuseth none" and discussing reasoning behind rule); 4

William Blackstone, *Commentaries on the Laws of England* 27 (1769) (recognizing, as a maxim in English and Roman law, that mistake or ignorance of the law is not an excuse to criminal punishment); Sharon L. Davies, *The Jurisprudence of Willfulness: An Evolving Theory of Excusable Ignorance*, 48 Duke L.J. 341, 350-61 (1998) (reviewing history of maxim that ignorance of the law is no excuse).

[34] *See, e.g.*, 4 Blackstone, *supra* note 33, at 21 (noting that no one may be punished as a criminal unless he has a "vicious will" and commits an unlawful act); 2 James Fitzjames Stephen, *A History of the Criminal Law of England* 95 (1883) (noting that all or nearly all crimes contain a mens rea requirement); Francis Bowes Sayre, *The Present Signification of Mens Rea in the Criminal Law, in Harvard Legal Essays* 399 (1934) (stating that "[s]ince the twelfth century an unbroken line of judges and text writers has authoritatively laid it down as undisputed law that a criminal intent lies at the very foundation of criminality"); Rakoff, *supra* note 5, at 3 ("This emphasis on knowledge and intent reflects the fact that the criminal law, whatever other purposes it may seek to serve, speaks with the voice of morality.").

[35] *See* Davies, *supra* note 33, at 395 (noting courts' concerns regarding "overcriminalization" and the federalization of crime, and observing that legal writers have estimated that over 300,000 federal regulations are enforceable through the use of criminal penalties, that substantive federal criminal provisions have experienced dramatic growth and that, at the same time, Congress has increased the criminal sentences that may be imposed upon offenders by attaching mandatory minimum provisions and "three strikes" penalties to many crimes) (citations omitted).

[36] *See Cheek* v. *United States*, 498 U.S. 192 (1991).

[37] *See id.* at 196-97.

[38] *Id.* at 199-201.

[39] *See id.* at 203-04.

[40] *See, e.g.*, *United States* v. *Lorenzo*, 995 F.2d 1448, 1455 (9th Cir. 1993) (rejecting application of *Cheek* to false statement statute); *United States* v. *Aversa*, 984 F.2d 493, 500 (1st Cir. 1993) (referring to *Cheek* as a "narrow exception" and refusing to apply it to currency transaction report provisions); *United States* v. *Caming*, 968 F.2d 232, 240-241 (1992) (deciding to follow other courts that had refused to extend *Cheek* to other contexts); *United States* v. *Gay*, 967 F.2d 322, 327 (9th Cir. 1992) (declining to apply *Cheek* rationale to mail and property fraud charges); *United States* v. *Chaney*, 964 F.2d 437, 446 n.25 (5th Cir. 1992) (finding *Cheek* inapplicable to crime of making false statements on bank records); *United States* v. *Hildebrandt*, 961 F.2d 116, 118-119 (8th Cir. 1992) (refusing to follow *Cheek*-rationale in violation of false statement statute); *United States* v. *Dashney*, 937 F.2d 532, 540 (10th Cir. 1991) (refusing to extend *Cheek* beyond tax law violations); *see also* Davies, *supra* note 33, at 370 n.119 (citing cases interpreting *Cheek* narrowly and refusing to extend it to areas other than federal tax crimes).

[41] *See Ratzlaf* v. *United States*, 510 U.S. 135, 149 (1994).

[42] *See id.* at 136-38.

[43] *See id.* at 137.

[44] *See id.* at 138.

[45] *Id.*

[46] *See id.* at 144-45.

[47] *United States* v. *Aversa*, 984 F.2d 493, 502 (1st Cir. 1993) (Breyer, C.J., concurring).

[48] *See Bryan* v. *United States*, 524 U.S. 184 (1998).

[49] *See id.* at 193.

[50] *See id.*

[51] *See id.* at 186.

[52] *See id.* at 189 & n.8.

[53] *See id.* at 189.

[54] *See id.* at 193-96.

[55] *See id.* at 191.

[56] *Id.*

[57] *See id.* at 191-92.

[58] *See id.* at 194-95.

[59] *Id.* at 195.

[60] *See Dixon*, 536 F.2d at 1395-96.

[61] *See United States* v. *O'Hagan*, 139 F.3d 641, 646-47 (1998).

[62] *Id.* at 647.

[63] *See United States* v. *English*, 92 F.3d 909, 915 (1996).

[64] *See id.* at 911, 914.

[65] *See id.* at 914.

[66] *Id.* at 915 (quoting *United States* v. *Brown*, 578 F.2d 1280,1283 (9th Cir. 1978)).

[67] *Id.*

[68] *In the Matter of Jacob Wonsover*, Exchange Act Release No. 34-41123, 1999 WL 100935, at *10 (S.E.C. Mar. 1, 1999).

[69] 15 U.S.C. § 78ff(a).

[70] *See O'Hagan*, 139 F.3d at 647.

[71] This analysis is consistent with the United States Supreme Court's decision in *O'Hagan*, in which Justice Ginsburg relied upon two separate and distinct "sturdy safeguards" provided by Congress in the Exchange Act: The "willfulness" requirement in the first clause of Section 32(a) that requires "the presence of culpable intent," and the "no imprisonment" provision in the second clause of Section 32(a) that precludes imprisonment of a defendant "for violating Rule 10b-5 if he proves that he had no knowledge of the *Rule*." *O'Hagan*, 521 U.S. at 665-66 (emphasis supplied). Although there is scant other authority interpreting the "no imprisonment" clause, two federal district courts that addressed the issue adopted an interpretation, contrary to the Supreme Court's subsequent interpretation, that conflated the two provisions in Section 32(a) and found that only a defendant who did not know that his conduct was "contrary to law" could use the "no imprisonment" provision to avoid incarceration. *See United States* v. *Sloan*, 399 F. Supp. 982, 984 (S.D.N.Y. 1975) ("It was not intended by the Congress that the 'no knowledge' clause of the penalty statute (78ff(a)) should be available to persons who were charged with knowing their conduct to be in violation of the law, but did not happen to know that it was in violation of a particular rule or regulation of the SEC such as Rule 10b-5."); *United States* v. *Lilley*, 291 F. Supp. 989, 993 (S.D. Tex. 1968) (same).

[72] *See* Carberry & Gordon, *supra* note 2 (observing that, without incarceration as a possible punishment, no purpose would be served by a criminal prosecution, where fines would remain available in a civil action).

[73] *See United States* v. *Lindo*, 18 F.3d 353, 356 (6th Cir. 1994); *cf. Markowski* v. *Securities & Exch. Comm'n*, 34 F.3d 99, 104-05 (2d Cir. 1994) (elements of an advice-of-counsel defense are (1) a request for advice of counsel regarding the legality of the proposed action; (2) full disclosure of all relevant facts to counsel; (3) an assurance by counsel of the action's legality; and (4) good faith reliance on counsel's advice).

[74] As discussed, *infra*, some courts do not consider the advice-of-counsel defense to be a complete defense to an alleged criminal violation.

[75] *See, e.g.*, *Lindo*, 18 F.3d at 356; *United States* v. *Medical & Surgical Supply Corp.*, 989 F.2d 1390, 1403-04 (4th Cir. 1993); *United States* v. *Peterson*, 101 F.3d 375, 381 (5th Cir. 1996).

[76] *See Lindo*, 18 F.3d at 356.

[77] *See United States* v. *Polytarides*, 584 F.2d 1350, 1352-53 (4th Cir. 1978).

[78] *See United States* v. *Evangelista*, 122 F.3d 112, 117 (2d Cir. 1997).

[79] *See Burruss Land & Lumber Co., Inc.* v. *United States*, 349 F. Supp. 188, 189-90 (W.D. Va. 1972) (in non-securities context, court holds that company, having followed advice of in-house attorney, could assert an advice-of-counsel defense even though attorney was employee of defendant company).

[80] *C.E. Carlson, Inc.* v. *Securities & Exch. Comm'n*, 859 F.2d 1429, 1436 (10th Cir. 1988) (holding counsel must be independent); *Sorrell* v. *Securities & Exch. Comm'n*, 679 F.2d 1323, 1327 (9th Cir. 1982) (upholding sanctions imposed by National Association of Securities Dealers against defendant who sold unregistered securities; advice-of-counsel defense unavailable because counsel was interested party).

[81] *See, e.g.*, *United States* v. *Michaud*, 860 F.2d 495, 499 (1st Cir. 1988) (recognizing that reliance on accountant is valid variation of advice-of-counsel defense); *Shokai, Inc.* v. *Commissioner of Internal Revenue Serv.*, 34 F.3d 1480, 1486 (9th Cir. 1994) ("A taxpayer may rebut . . . proof of fraud by showing that he relied in good faith on his accountant's advice after full disclosure of tax related information.").

[82] *See, e.g.*, *United States* v. *Anderson*, 879 F.2d 369, 377 (8th Cir. 1989) (recognizing validity of advice-of-expert defense where defendant relied on minority business specialist).

[83] *United States* v. *Benson*, 941 F.2d 598, 613 (7th Cir. 1991).

[84] *See, e.g.*, *United States* v. *DeFries*, 129 F.3d 1293, 1309 (D.C. Cir. 1997) ("good faith reliance on advice of counsel was a valid defense that, if proved, required acquittal").

[85] *Medical & Surgical Supply Corp.*, 989 F.2d at 1403; *see also Peterson*, 101 F.3d at 381 ("A good faith reliance on the advice of counsel is not a defense to securities fraud. It is simply a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud."); *Markowski*, 34 F.3d at 104 (finding that reliance on advice of counsel is "not a complete defense").