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U.S. SECURITIES AND EXCHANGE COMMISSION


Matter of

A.P. No. 3-16594

EQUITY TRUST COMPANY

# RESPONDENT'S OPENING BRIEF

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Respondent Equity Trust Company ("ETC") urges affirmance of the Initial Decision dismissing this proceeding (**POINT I** below). Alternatively, ETC cross-petitions for dismissal based on reversal of certain determinations specified below (**POINT II**). In any event, there is no basis for the requested remedies (**POINT III**).[1]

## I. INITIAL DECISION SHOULD BE AFFIRMED

The Initial Decision should be affirmed because the ALJ's determination to dismiss is "supported by substantial evidence" and "in accordance with law." *Flannery v. SEC*, 810 F.3d 1, 8-9 (1st Cir. 2015) (ALJ is "impartial, experienced examiner who has observed the witnesses and lived with the case").

### A. Division's Standard "Made Up of Whole Cloth"

**(1) Division's Standard.** The ALJ ruled that, "while the Division's standard of care may be desirable policy and might mitigate many types of harm to customers, it is essentially made up of whole cloth and does not purport to represent or improve on industry practice or reference industry practice at all." (I.D.-34) For its "whole cloth" statement of SDIRA custodians' duties, the Division relied on a report from William Ries, a banking lawyer whose CV showed absolutely no experience with SDIRAs or their custodians, and thus no familiarity with current SDIRA industry standards and practices. (DX-39)

Ries, a Pennsylvania lawyer, based his views on the laws of South Dakota, where ETC is chartered: "South Dakota law authorizes a trust company to act as a custodian. Acting as a custodian is considered to be acting in a fiduciary capacity under South Dakota law. Therefore, when acting as custodian, Equity Trust is subject to certain fiduciary duties." (DX-39-¶15) However, the Division's other expert Tom Simmons, a South Dakota law professor – also lacking any experience dealing with SDIRA custodians – disagreed with Ries and opined that

[1] Abbreviations used: "I.D." (Initial Decision); "Tr." (Hearing Transcript); "Dep." (Deposition); "DX" (Division's Exhibit); "RX" (Respondent's Exhibit); "ALJ" (Administrative Law Judge).

South Dakota law does not apply here "at all": "[T]he ETC Account Agreements state that the parties did not intend for South Dakota law to apply at all," and based on "the parties' intent to be governed by Ohio, not South Dakota, law," it would "be inconsistent with that intent for ... South Dakota law to govern...." (DX-836-pp.2-3)

Ries began by conceding ETC's point that custodians' duties are specified in their agreements with their customers. (DX-39-¶20) But then – despite no SDIRA experience, and with no reference to practice in the SDIRA industry – Ries went on to provide, without citations, a list of supposed SDIRA custodian duties: **(i)** Ensure proper documentation is obtained and completed; deeds and mortgages are properly prepared and recorded; notes and evidences of title are obtained, endorsed properly and transferred; and all required documents are obtained. **(ii)** Obtain information on investments held, including redemptions, maturities, subscription rights and conversion privileges. **(iii)** Ensure information used to value investments is reasonable; and clearly define valuation methods in policies and procedures. **(iv)** Periodically review assets held; determine assets are not in default; advise customers of significant risk issues; and define asset review processes in policies and procedures. (DX-39-¶¶24-28)

In addition to being "made up of whole cloth," this formulation of an SDIRA custodian's duties is unreasonable on its face. As the Commission has noted, an SDIRA "permits investment in a broader set of assets than is permitted by most IRA custodians," including such "alternative" assets as "real estate, promissory notes, tax lien certificates, and private placement securities." ("*SEC Investor Alert: Self-Directed IRAs and the Risk of Fraud*," RX-46-p.1). SDIRA assets often include real property, inherently unique in characteristics and risks, in all fifty states and abroad. SDIRA assets can also include a wide variety of other unique investments – from promissory notes, with differing terms and risks, to "hard" assets like cell towers, machinery, livestock, etc., also in diverse locations. There is simply no way an SDIRA custodian can assume the responsibilities suggested by Ries for such a variety of asset types, and for tens of thousands of customers per custodian, without charging astronomical fees that would render SDIRAs unusable. "[U]sing the Division's standard would require custodians to charge much higher fees." (I.D.-34)

**(2) ETC's Expert Rebuttal.** Unlike the Division's experts who had absolutely no SDIRA experience, ETC presented a report (RX-222), rebuttal report (RX-223) and testimony from Terry Prendergast, an attorney who has worked extensively with SDIRA custodians. Prendergast helped every South Dakota-chartered SDIRA custodian get its charter (except ETC), has worked with over half of South Dakota's 80 non-depository trust companies, and serves each year on the South Dakota governor's trust administration task force. (RX-222-pp.1-2)

Based on ETC's custodial account agreement, Prendergast's opinion is that, under South Dakota statutory and case law, ETC as an SDIRA custodian **(i)** had "no duty to review or modify any direction from" an SDIRA custodial customer; **(ii)** was "not liable under South Dakota law, either individually or as a fiduciary, for any loss resulting from compliance with a direction of the custodial account" customer; **(iii)** "had no duty to perform investment or suitability reviews,

inquiries or investigation"; **(iv)** would not, by communicating about investments, be deemed to give "an undertaking to monitor such investments" or to assume "the duty to do so"; **(v)** was "relieved of any duty to communicate with, warn, or apprise any party concerning instances" where it "may have exercised its own discretion differently" than the customer; and **(vi)** did not, by carrying out the customer's investment directions, give an undertaking "to monitor, participate, or otherwise take any fiduciary responsibility for" the customer's directions. (RX-222-pp.14-15) Prendergast opined:

> Therefore, in my opinion, under South Dakota law, because Equity Trust Company had no duty to custodial account owners under the circumstances outlined above, it could not be and was not negligent in the assumed acts or omissions as set forth in the statement of assumed facts [tracking the OIP]. If the custodial agreement does not require a custodian (a) to obtain all documents reflecting an investment that are not furnished by a custodial account owner as required in the agreement, or (b) to notify a custodial account owner of matured and unpaid promissory notes held in a custodial account, the custodian has no duty to the custodial account owner to do so under South Dakota law.

(RX-222-p.15)

## B. "Most Convincing Statement" of Standard

The ALJ ruled that the "most convincing statement of the Commission's view of standards applicable to IRA custodians such as Equity Trust" is the SEC Investor Alert on Self-Directed IRAs. (I.D.-34) State regulators and the federal courts have expressed the same view of the standards governing SDIRA custodians.

**(1) Securities and Exchange Commission.** The Commission expressed its understanding of SDIRA custodians' duties, and the custom and practice among SDIRA custodians, when it advised the nation's investors that SDIRA custodians: **(i)** "will generally *not* evaluate the quality or legitimacy of an investment and its promoters"; **(ii)** "likely have not investigated the securities or the background of the promoter"; **(iii)** "are responsible only for holding and administering the assets"; **(iv)** "explicitly state" in custodial agreements that the "custodian has no responsibility for investment performance"; and **(v)** "usually do not investigate the accuracy of" any available financial information. (RX-46, "*SEC Investor Alert: Self-Directed IRAs and the Risk of Fraud*," pp.1-2).

**(2) State Securities Regulators.** The North American Securities Administrators Association's ("NASAA") president, himself a state regulator, stated that: **(i)** SDIRA custodians have "limited duties to investors"; and **(ii)** their "sole responsibility is to report information to the IRS and from the issuer to the investor." (RX-263; Mirko-Tr.1844-45) NASAA's accompanying alert, reflecting industry custom and practice, told investors that an SDIRA custodian: **(i)** "does NOT research or perform due diligence reviews or recommend investments

to clients"; **(ii)** "is a passive company that simply serves as an intermediary"; **(iii)** is "responsible only for holding and administering the assets" in an SDIRA; **(iv)** does "not evaluate the quality or legitimacy of any investment ... or its promoters"; **(v)** "only reports the information provided by the issuer and does NOT verify the accuracy of the information"; **(vi)** has as its "sole responsibility ... to report information to the IRS and from the issuer to the investor"; and **(vii)** "is merely the keeper of the deposits to and distributions from the account," and "does NOT hold the investment funds or assets," which are transferred "to the issuer when an investment is made." (RX-47, NASAA, "*Third-Party Custodians of Self-Directed IRAs*," pp.1-2 (Dec. 2014))

**(3) United States District Courts.** In *Hines v. Fiserv, Inc.*, 2010 WL 1249838 (M.D. Fla. March 25, 2010), the court held that Internal Revenue Code §408(h) "recognizes that custodial IRAs ... are not trusts. They are only treated as trusts for tax deferral purposes. Courts applying this section of the code in relation to custodial IRA accounts have held that IRC §408 and the corresponding regulations do not create any fiduciary or other duties of care." 2010 WL 1249838 at *3.

In *Mandelbaum v. Fiserv, Inc.*, 787 F.Supp.2d 1226 (D. Colo. 2011), investors charged that their SDIRA custodian: "failed to verify whether and how Bernard Madoff continued to hold the assets"; failed to keep track of, maintain custody over, and maintain title to the assets; "knew from past experience with other questionable funds" that there was risk; "enabled Madoff's theft" by "lack of oversight"; "engaged in a *quid pro quo* arrangement with Madoff" that led it "to disregard various red flags concerning Madoff's fraudulent activities"; and "obtained information about the questionable nature of Madoff's operations." 787 F.Supp.2d at 1233. In dismissing, the court said:

> ... Although Plaintiffs allege that "Madoff required IRA accounts to be handled through Fiserv," ... the Plaintiffs, not Fiserv or Defendants, made the initial decision to invest their funds with Madoff. Therefore, although Fiserv had a monopoly on IRA investments with Madoff, the Court finds that such monopoly, alone, does not provide a basis to invalidate the at-issue exculpatory provisions. ...
>
> ... Defendants have fulfilled all their obligations as delineated in the Agreements: they provided account statements that contained the information from BMIS [Madoff's firm], which they had no obligation to verify or audit; at Plaintiffs' direction, they transferred assets to BMIS; and they had no contractual obligation to prevent Madoff or BMIS from commingling Plaintiffs' assets. ...
>
> Plaintiffs' claims also fail to the extent they are premised on a failure to exercise control over, preserve and maintain, and avoid commingling of the trust assets. Plaintiffs complain that Defendants lost control over their assets when they were directed to Madoff for investment purposes. However, Defendants transferred such assets, at the express direction of Plaintiffs. ...

787 F.Supp.2d at 1241-42, 1243. So the federal courts, like the SEC and NASAA, recognize that SDIRA custodians' duties, and the custom and practice among SDIRA custodians, are very different from the views of Attorney Ries, the Division's expert.

## C. ETC's Duties "Determined by" Custodial Agreements

Reis did, however, correctly observe that "[a] custodian's duties are typically determined by the terms of the custody agreement entered with the principal which defines its duties and responsibilities as custodian." (DX-39-¶20) Here the ALJ ruled that ETC's custodial agreement and direction of investment ("DOI") form "made clear that the account holder was solely responsible for investment decisions and that [ETC] was a passive custodian, was not a fiduciary, and had no duties or responsibilities with respect to selecting or monitoring the investments." (I.D.-p.5)

**(1) Direction of Investment Form.** In the DOI form that accompanied each and every investment, the customer stipulated and agreed that: **(i)** "Equity Trust Company has not solicited, recommended or sold this investment to the retirement account owner." **(ii)** "Equity Trust Company does not endorse this investment." **(iii)** "My retirement account is self-directed and I, alone, am responsible for the selection, due diligence, management, review and retention of all investments in my account." **(iv)** "I agree that the custodian is not a fiduciary for my account." **(v)** "Equity Trust Company (custodian) does not offer any investment advice, nor does it endorse any investment, investment product or investment strategy; and custodian does not endorse any financial advisor, representative, broker, or other party involved with an investment selected by me." (RX-97-99)

Immediately above the customer's signature, the DOI form specified:

> "My Retirement Account is self-directed and I, alone, am responsible for the selection, due diligence, management, review and retention of all investments in my account. I agree that the Custodian is not a 'fiduciary' for my account, as said term is defined in the Internal Revenue Code, ERISA or any other applicable federal, state or local laws. ..."

(RX-97-99-p.4) Such language was not unusual in the SDIRA industry. (RX-253; Marsh-Tr.268-71) Above on the same page, the DOI also provided in greater detail:

> IMPORTANT: Please Ensure That You Read The Following Disclosures Before You Sign And Date These Documents.
>
> 1. Equity Trust Company (Custodian) does not offer any investment advice, nor does it endorse any investment, investment product or investment

strategy; and Custodian does not endorse any financial advisor, representative, broker, or other party involved with the investment selected by me. It is my own responsibility to perform proper due diligence with regard to any such representative, financial advisor, broker, or other party. ...

6. Custodian shall be under no obligation or duty to investigate, analyze, monitor, verify title to or otherwise evaluate any investment contemplated herein.... Custodian shall not be responsible to take any action should there be any default with regard to this investment.

7. It is not the responsibility of Custodian to review the prudence, merits, viability, or suitability of any investment made by me or to determine whether the investment is acceptable under ERISA, the Internal Revenue Code or any other applicable law. ...

11. ... Custodian shall have no responsibility to verify or determine that any [investment-related] documents are complete, accurate or constitute the documents necessary to comply with this Direction.

12. ... Custodian shall have no duty or obligation to notify the undersigned with respect to any information, knowledge, irregularities or concerns of Custodian relating to my investment or my financial advisor, broker, agent, promoter or representative, except as to civil pleadings or court orders received by Custodian.

(RX-97-99-p.4 (emphasis added)

**(2) Account Agreement.** Before signing such DOI forms to direct ETC to make particular investments, customers had to open their SDIRA accounts by completing and signing an application agreeing to the terms of ETC's "IRA Custodial Account Agreement and Disclosure Statement." (OIP ¶13) That custodial account agreement – like the DOI forms – provided **(i)** that ETC was "acting solely as a passive custodian to hold IRA assets"; **(ii)** that it was not "a fiduciary ... with respect to your IRA account"; **(iii)** that ETC did not "endorse any investment, investment product or investment strategy, ... investment advisor, representative, broker, or other party selected by [the customer]"; **(iv)** that ETC had no obligation to investigate, analyze, monitor or verify title to an investment; **(v)** that the customer had exclusive responsibility for and control over the IRA assets with "responsibility to perform proper due diligence"; **(vi)** that ETC had no responsibility to verify or assure completeness of investment documentation; and **(vii)** that ETC had "no duty or obligation to notify you with respect to any

information, knowledge, irregularities or our concerns relating to your investment ... except as to civil pleadings or court orders received by us." (RX-92-96-¶8.03)

**(3) Customer to Supply Documentation.** Across the SDIRA custodian industry, "it's the duty of the customer to supply" investment-related documentation to the custodian. When the SDIRA held real estate or a note relating to real estate, "[t]he client would" get the deed or security agreement, and it would "eventually" get to the custodian. (Marsh-Tr.261-62, 284) Before the customer supplied all documentation, the asset would still be held in the name of the SDIRA custodian for the customer's benefit. (Desich-Tr.990-92)

ETC's custodial account agreement with the customer stipulated that it was their obligation to obtain the documentation and furnish it to ETC:

> You authorize and direct us to execute and deliver, on behalf of your IRA, any and all documents delivered to us in connection with your IRA investments; and we shall have no responsibility to verify or determine that any such documents are complete, accurate or constitute the documents necessary to comply with your investment direction.

(RX-92-96-¶8.05 (emphasis supplied)). ETC could not chase after investment documents of 130,000 customers in 50 states, pursuing a wide range of self-directed "alternative" investment strategies, with widely varied forms of documentation and recordation. (Desich-Tr.997-98)

ETC's "onboarding letter" for each investment advised that funds had been transmitted to make the investment, and both listed and reminded customers to supply missing investment documentation to ETC. The letter repeated ETC's disclaimer of any duty to police documentation: "It is the IRA owner's responsibility to guarantee delivery of all documents pertaining to your investment(s) to Equity Trust Company. If your investment is backed by collateral and/or is being recorded, please verify with your investment company or the person responsible for securing your collateral that they have performed accordingly to protect your interest." (RX-142-p.10)

Where customers persisted in failing to provide missing investment documentation, ETC gave them reminders. Quarterly account statements listed particular documentation that was missing and the customer still needed to supply. This list of missing documentation appeared in the "PORTFOLIO POSITIONS" box in each account statement – the most important part of the statement as it listed the customer's holdings – following the words "AWAITING RECEIPT." (RX-214; Savary-Tr.1140, 1151-55) The quarterly statements also provided the "MATURITY DATE" of promissory notes, so customers receiving statements after the maturity date would be alerted that the maturity date had already passed.

**(4) Agreements Not Abrogated by Some Degree of Un-Passivity.** The Division argues that these binding contractual provisions on which the SDIRA industry is based – all SDIRA custodians, not just ETC – should be ignored whenever the custodian does not act as a "passive" custodian. First, the Division does not cite a single case, statute, regulation or other authority, much less a securities case, for this proposition. Second, the Division's theory is unworkable. The Division does not and cannot parse out, under its theory, just how "un-passive" a custodian would have to be to void contractual provisions. Would standing and smiling when you are recognized in a large audience be enough? How about providing training on how SDIRAs work? Will such actions void entire contracts, or just portions, or just in some circumstances? The Division does not explain.

Courts have held that SDIRA custodians' exculpatory provisions of the type in ETC's agreements do not violate public policy. As the court said in *Mandelbaum v. Fiserv, Inc.*, 787 F.Supp.2d 1226, 1241-42 (D. Colo. 2011), involving the Madoff Ponzi scheme, "many choices exist for consumers ... who seek IRA services. ... [T]he availability of choice in the market with respect to the person or entity to perform such service supports a finding that the exculpatory provisions should not be rendered void as against public policy." *See also Hines v. Fiserv, Inc.*, 2010 WL 1249838 (M.D. Fla. Mar. 25, 2010), a claim against an SDIRA custodian relating to the Pearlman Ponzi scheme, in which the court upheld contractual provisions disclaiming fiduciary and other duties, and noted that the FDIC's Trust Examination Manual "expressly provides that the custodians of self-directed accounts ... have no responsibilities beyond the provisions of the governing account instrument." *Id.* at *5.

## D. Substantial Evidence Does Not Support Finding That ETC "Knew or Should Have Known" of Taylor's Fraud

The ALJ ruled that the "knew or should have known" element was "unproven," because "Taylor appeared to be a legitimate businessman," even when it later appeared that he was "financially pressed and losing money." (I.D.-32) The ALJ ruled that, even if there were "sloppy record keeping, putative promotion of investments, or provision of PINs to an investment sponsor," this would "not bear on whether [ETC] knew or should have known of Taylor's ... violations," and "not [be] relevant to whether [ETC] is liable for a secondary violation in an enforcement charge." (I.D.-35, 37)

**(1) Taylor's Public Profile.** People invested with Taylor based on his prominent national profile and his Christian background as he roved the country on his "Wealth Builder Tour." (RX-27 to 31, 36, 37; DX-36, Taylor-Dep.220-222) On August 25, 2008, the Democratic National Convention presented Taylor as a speaker on "socially conscious investment." (RX-25, 227; Davis-Tr.1675-76) Megachurches and smaller congregations presented and endorsed Taylor to their members. In late June 2009, the National Conference on Volunteering, opened by First Lady Michelle Obama, featured Taylor with the CEOs of eBay and KPMG on a "Business Leaders for Change" panel moderated by CNN analyst and Harvard professor David Gergen. (RX-24, 228; Davis-Tr.1681-82)

Major media outlets uniformly profiled Taylor in strongly positive terms, including news reports and interviews on ABC, CNN, Forbes, and NPR, all uniformly and effusively trumpeting Taylor's business success. (RX-241, 30, 31, 36, 84, 85; Davis-Tr.1681) Among these, Taylor was interviewed on ABC's "20/20" show; appeared twice on the Montel Williams Show; appeared on CNBC's "The Big Idea" with Donny Deutsch, the nationally-syndicated Tom Joyner Morning Show, and Fox News' "Your World" with Neil Cavuto; and was a weekly panelist on Bulls & Bears on Fox News. (DX-36, Taylor-Dep.209-13) Media outlets sought out Taylor directly. (Davis-Tr.1681)

Taylor publicized himself as a highly successful business person focused on small, community-oriented businesses. Taylor's 2008 book, "Creating Success From the Inside Out," appeared twice on the Wall Street Journal's best-seller list, and was followed by his 2009 book "A Lead Entrepreneur." (Davis-Tr.1677-79) Investors were attracted by Taylor's multiple 30-minute television infomercials on Fox, Black Entertainment Television, The Word Christian network, and other outlets. (Taylor-Dep.205-08) He marketed himself, at least from 2006 through 2010, through traveling seminars and other events that he called his "Wealth Builder Tour" or "Wealth Builder Network."

Taylor's mantra in his addresses to prospective investors and others was, "Let's make money together." Other than attending a single church event in October 2009, ETC never appeared at any of these Taylor "tour" events. (DX-36, Taylor-Dep.217; Batt-Tr.454, 459-60)

From 2006 until 2011, Taylor used the "branding and public relations" firm of Ascendent Strategies, headed by Raoul Davis. (Davis-Tr.1672-73) Davis "positioned" Taylor as "the youngest black CEO of a publicly traded company," and began by booking Taylor at a Congressional Black Caucus event. (Davis-Tr.1674) Davis booked Taylor to speak at 40 to 50 events, before media outlets, government bodies, universities (including Harvard and the University of Chicago), churches and other organizations, many with national reach such as the National Urban League, the NAACP and the YMCA. (Davis-Tr.1676-77, 1679-81, 1688-89)

Davis met "between 30 and 50" times in person with Taylor, spoke by phone "several times every month," and routinely exchanged emails. (Davis-Tr.1683) He viewed Taylor as "an optimistic, nerdy kid from Kansas who was socially conscious, looked like he was changing the world, was very inspirational." Davis recalled a Southern Christian Leadership Conference event where "a gentleman who worked with Dr. King gave [Taylor] a photo of himself with Dr. King and said, you can be the next great ... civil rights leader in terms of economic empowerment," and Davis added "that was kind of what many of us working with [Taylor] ... thought he could be." (Davis-Tr.1683-84) Davis saw Taylor's 2009 public SEC filings for City Capital, showing the company in debt but still issuing promissory notes. But Davis accepted

Taylor's explanation that "he was turning the company around" and "gave him the benefit of the doubt." (Davis-Tr.1690-92) In mid-2010, Davis arranged for his new spouse to invest her own retirement funds with Taylor, using Sunwest Trust as SDIRA custodian, as ETC was no longer accepting new Taylor investors. (Davis-Tr.1673-75, 1686, 1699)

**(2) Taylor's Public Disclosures on EDGAR.** Taylor's company City Capital filed periodic reports on EDGAR – including Forms 10-K and 10-Q. The financial statements in these periodic reports were accurate and prepared by an outside certified public accountant who had direct access to City Capital's books and records, and were audited by an independent public accounting firm. (Keeton-Cardno-Tr.1721-22; DX-36, Taylor-Dep.229-32, 269-78) Lynda Keeton-Cardno, the experienced outside accountant who personally prepared City Capital's statements, testified at the hearing that "[e]ven as of today, I've had nothing come to my attention that would indicate that the information [in the annual report] is incorrect." (Keeton-Cardno-Tr.1722)

Ms. Keeton-Cardno, an Arthur Andersen-trained CPA registered with the PCAOB and the AICPA, described the rigor she brought to City Capital's financial reporting. Each quarter, she obtained an electronic copy of its financial records and demanded to see relevant backup documentation, including signed copies of notes. (Keeton-Cardno-Tr.1709-10, 1713-16, 1720) After she had "scrubbed everything and written the [draft reporting] document, that's when we would publish to the external auditor," the Spector Wong CPA firm, which would then perform an independent audit of City Capital each year. (Keeton-Cardno-Tr.1721-22)

City Capital's periodic reports on EDGAR specifically told investors **(i)** that it was significantly in debt; **(ii)** that it had notes coming due to earlier investors; **(iii)** that it was still losing money; and **(iv)** that its funding was continuing to come from the new promissory notes it was selling. Each annual report itemized its growing number of outstanding promissory notes by principal amount, interest rate and maturity date. Its 2008 Form 10-K annual report – filed on May 20, 2009, and thus the disclosure document "live" during most of the relevant period in this case – publicly disclosed to investors that:

- Its "independent registered public accounting firm expressed substantial doubt about the Company's ability to continue as a going concern ... as a result of cash flow constraint, an accumulated deficit of $12,152,194 ... and recurring losses from operations." And its net losses were continuing. (RX-2, pp.8-9)

- Its ability to remain in business depended on "obtaining additional funding from the sale of its securities," and its itemized outstanding notes had nearly doubled from a total of $1,980,008 payable at year-end 2007 to $3,777,556 at year-end 2008. (RX-2, p.63)

- It had identified "material weaknesses in ... internal control over financial reporting and determined that [it] did not maintain effective internal control over financial reporting." (RX-2, p.11)

Similar disclosures to investors appeared earlier in its Form 10-KSB, filed May 1, 2008 (DX-537), and later in its Forms 10-K/A, filed September 8, 2009 (RX-6), and 10-K, filed June 15, 2010 (RX-1). Disclosures concerning its ongoing losses, accumulated deficit and other financial and business challenges similarly appeared in its Forms 10-Q and other disclosure documents.

Ms. Keeton-Cardno, the accountant, testified that "this was a business that was attempting to do very good things in inner city cultures. When I look at a business like this with my background, at some point I think they could have succeeded if they had economies of scale." (Keeton-Cardno-Tr.1723) It was not until 2010, after ETC stopped accepting new investments with Taylor, that her opinion of City Capital's viability changed. (Keeton-Cardno-Tr.1727-28)

**(3) ETC's Limited Interaction With Taylor.** Apart from seeing Taylor's mighty public profile – including endorsements by national political figures, church leaders across the country, major television hosts, and other prominent and credible people – ETC had limited interaction with Taylor and his organization.

**(a) Customer Account Information:** ETC gave City Capital status updates concerning amounts transferred to ETC by new Taylor investors, timing of transfers, and steps to complete transfers. All were for customers setting up SDIRA accounts expressly to invest with Taylor. "[I]f the investment sponsor was working together with the client on an investment," it was appropriate to "provide general information at times, that the transfer hasn't arrived yet or maybe a dollar amount or when it's going to clear." (Marsh-Tr.222-23) Likewise, ETC's privacy policy allowed communications like these to facilitate the customers' intended transactions. (DX-46, exh.p.14, orig.p.12)

Unrebutted testimony confirmed that, before ETC sent updates, City Capital furnished PIN numbers contained in customer account opening forms. (Batt-Tr.306-07, 310-14, 345, 450-53). Access to general update information was appropriate for anyone having the PIN number, and sharing such information was permitted if done in executing the customer's directed investment. (Marsh-Tr.263-64)

**(b) Single ETC Visit to City Capital Offices:** ETC employee Robert Batt's June 2009 visit to Raleigh was the only time anybody from ETC visited City Capital's offices, and Taylor neither arranged nor was present for the visit. (Batt-Tr.471-72; DX-36, Taylor-Dep.67) Batt's manager Keith Marsh testified that Batt visited City Capital "to educate or train ... staff members ... about the self-directed IRA," and Marsh saw nothing improper about Batt doing this. (Marsh-

Tr.264-65) Batt spoke two hours to ten staffers about SDIRAs, using "generic slides that everybody [at ETC] used." He did not instruct on how to fill out ETC's forms. (Batt-Tr.417-18)

**(c) Single Taylor Event (New Birth Church) Attended by ETC:** The first and only time anybody from ETC saw Taylor was when Batt met him at an event just two months before ETC stopped accepting new Taylor accounts. Batt and Taylor spoke only "between five to 10 minutes." (DX-36, Taylor-Dep.302; Batt-Tr.454, 457-59) The event was an October 2009 multi-day event at New Birth Missionary Baptist Church, an Atlanta mega-church, where its spiritual leader, Bishop Eddie Long, warmly introduced Taylor to thousands as "my friend, my brother, the great Ephren Taylor." Literally two months later, on December 23, 2009, ETC advised Taylor that it would not take new accounts from his investors. (DX-534, p.2)

Before New Birth, Taylor had spoken at hundreds of similar events, including dozens at churches. Taylor realized that it was "significantly influential" that churches were vouching for him. (DX-36, Taylor-Dep.213-217) But Taylor never once asked ETC to attend, and nobody from ETC ever did attend, any of these many church and other events. (Taylor-Dep.217; Batt-Tr.454, 459-60)

New Birth publicized the Taylor event weeks in advance through radio advertisements, banners and a handouts picturing the Bishop and Taylor. (RX-243; Wells-Tr.45-47; Jones-Tr.99; Turner-Tr.1348-49) New Birth hosted Taylor over at least five different sessions – a youth meeting (RX-230) and men's group meeting on Saturday, two worship services on Sunday, and an evening seminar attended by thousands on Tuesday evening. The church also made available conference rooms in "the executive offices that ... the church leadership uses" for Taylor staff's one-on-one meetings with potential investors. (Wells-Tr.47-48; Jones-Tr.138; Turner-Tr.1379)

At the Sunday worship services, Bishop Long introduced Taylor as an ordained minister and son of a pastor. Bishop Long described Taylor as a "man of God" and someone "very experienced." He said that Taylor, the CEO of a publicly-held corporation, could help the congregation in their financial matters and encouraged them to attend Taylor's presentations. (Wells-Tr.49-50; Jones-Tr.134-35; Turner-Tr.1349, 1381, 1384-85) Taylor showed a video about the collapse of Wall Street, and spoke about urban revitalization and rebuilding communities. (Jones-Tr.135-36)

The Tuesday evening session began with a video showing Taylor being interviewed on several national news programs. (RX-35; Wells-Tr.57-58, 60-61) Bishop Long then introduced Taylor as a "man of God" and an ordained minister. (Wells-Tr.60) Both Bishop Long and another pastor, Rev. Delatorro McNeal, endorsed Taylor from the church's stage. (Turner-Tr.1350, 1382) Taylor believed Bishop Long's introduction gave Taylor "significant" credibility

in addressing the congregation, which numbered about 10,000 people, and Taylor had his entire "sales staff and team" in attendance at the church. (DX-36, Taylor-Dep.292-95, 301-02)

After these glowing introductions, Taylor addressed the congregation about investing in real estate, clean energy and small businesses, including through the use of self-directed IRA accounts. Taylor told the congregation that large mutual funds "are investing in brothels, like Hooter's, bars and different places like that and that we need to be more vigilant in investing our money in places that we want it to go as far as being Christians." (Turner-Tr.1351) Otherwise, Taylor's investment-related remarks were general in nature and Taylor did not market City Capital notes or other specific investments during the Tuesday evening session. (Wells-Tr.61-63; Turner-Tr.1351)

ETC's Batt was in the audience only for the Tuesday evening session. During Taylor's lengthy presentation, he pointed out Batt and asked him to stand up in the audience to be recognized. With the glare of the church's television lights in his eyes so he "couldn't see a thing," Batt stood up at his seat with a deer-in-the-headlights frozen expression and waved. The following – lasting only about one minute out of a 2-1/2 hour session (one of five Taylor sessions at New Birth that week) – is a verbatim transcript of everything Taylor said about Batt and ETC:

> And so the thing is that I have ... several special guests in the audience today. One is Mr. Robert Batt, if you could stand up. He is actually my banker. ... Yeah – like, yeah. Give him a round of applause. He is actually with Equity Trust. That is where people who move a certain amount of money, you know, kind of have to put their stuff at – for thinking of things. But I wanted to introduce him to you, and he's going to be here with us tonight and tomorrow so if you have any questions specifically about what I do, I figured, why not just bring the expert with me? So you know it's something when the bank flies out your banker to hang out with you. So I thank him for that, he's been a joy with our firm and really helped us out to do a tremendous amount of community redevelopment that we've done in the community. ... (RX-66, pp.218-19, transcription pp.217-18)

> ... I need you, before you go out and jump out the window, to consult with a qualified, educated and informed financial professional. ... Now if you don't have one or if you don't like the one you have because they've been losing all your money, I brought mine with me. He's right there. Robert, you might get bombarded, they might have the security escort you right now. (RX-66, pp.244-45, transcription pp.243-44)

Batt opened SDIRA accounts for a living, and was not a banker or involved in community redevelopment. But when he stood briefly as directed and waved, he did not have a microphone to correct Taylor's description in the huge church sanctuary. Indeed, Batt did not utter a single word during the entire two-and-a-half hours and simply sat out in the audience. (Wells-Tr.64-66; Turner-Tr.1351-52; Batt-Tr.461-63)

Batt afterwards spoke with a few people who approached him in the church's lobby about the process for opening an SDIRA. Batt did not promote Taylor and limited what he said to his "stock presentation" on SDIRAs. (Wells-Tr.68-69; Batt-Tr.455-57, 465) Batt returned home early the next morning and did not participate in the one-on-one meetings that Taylor's sales staff had with congregants in the church's conference rooms over the following days to pitch specific Taylor investments. (Batt-Tr.463)

On returning to ETC, Batt told his supervisor Marsh about Taylor's reference to Batt as a "banker." Batt did not feel he had endorsed City Capital, and he was fully aware that if an ETC representative endorsed any investment sponsor "you'd get fired." (Marsh-Tr.244; Batt-Tr.411-12, 463-65) Just two months later as discussed below, following a review triggered by volume and concentration levels, ETC put Taylor on "hold" status and ceased taking new custodial customers from him. (DX-534, p.2; Batt-Tr.465-66)

**(d) Possible "Landing Page" to Download SDIRA Forms:** During the last four months that ETC accepted new Taylor accounts, ETC prepared a possible website sub-page ("landing page") that would let Taylor investors download standard SDIRA account opening forms, and link to general information on SDIRAs. (DX-576) Batt consistently testified that the City Capital landing page was a "beta" version that never went live. (Batt-Tr.379-386, 391-92, 395-96, 399-400, 416-17, 436, 486) The limited documentary evidence is inconclusive. An email to City Capital said the page was "live" to review at a particular link provided in the email, but not whether it was live on ETC's public website. Two months later, Batt and ETC technical staff were still discussing content for the landing page, suggesting it was not yet on the public website. (DX-338, 360; Batt-Tr.434-35)

Whether live or not, the landing page's text shows that ETC did not endorse City Capital or Taylor. (DX-576) Apart from a reference to "City Capital Corporation" at the top, it did not even mention City Capital or Taylor. Its first paragraph was simply a welcome generally referencing investments in real estate, not promissory notes, with language copied from other such landing pages. (Batt-Tr.429-433) Its second paragraph was a "Disclaimer" stating that ETC (i) was a passive custodian, (ii) did "not endorse or recommend" any investment, (iii) did not provide investment advice, and (iv) advised prospective customers to consult others on investment decisions. (DX-576) And any account opening forms downloaded from the page would have disclaimed investment recommendations, as discussed above.

**(4) ETC's Review and Hold on Accepting New Customers.** ETC was a "pioneer" among SDIRA custodians in implementing its "secondary review" process. The ALJ ruled that "the unrebutted evidence shows that no other SDIRA custodian was performing the level of review of customer accounts that [ETC] pioneered." (I.D.-34) Secondary reviews were not triggered by suspicion of wrongdoing, but rather were "[p]urely based upon the concentration risk to Equity Trust" – either twenty ETC customers in one investment or program, or collectively $1 million invested. "The intent of the ... review process is not about the detection of fraud. It's all about the management of risk to Equity Trust." (Dea-Tr.1580-81)

In late 2009, ETC conducted a "secondary review" of its customers' City Capital investments – one of the first such reviews under ETC's new investment review process, and its President-CFO Michael Dea was personally involved. (Dea-Tr.1579-82) ETC's review showed that it had complete documentation for approximately 50% of the 47 City Capital investments held by their customers. During the review, ETC "requested missing documents" from City Capital, which it promised to supply. ETC's in-house counsel also interviewed Taylor personally. ETC's review revealed "no relevant securities violations," and "no negative news articles" concerning either City Capital or Taylor. (RX-50; Dea-Tr.1583-84) Based on its Lexis-Nexis search, ETC confirmed that Taylor continued to have a "very positive" reputation in the marketplace. Nevertheless, after reviewing City Capital's SEC filings on EDGAR, including its financial statements, Dea noticed that City Capital had a negative net worth, was losing money very rapidly, had many maturing loans, and that its auditors found deficiencies in its internal controls. (Dea-Tr.1585-86)

The last Taylor-related investment ETC accepted was on December 21, 2009. (DX-40, p. 14) Two days later, with no customer complaints about City Capital, ETC determined to put it on "hold" status and not accept new business. On January 13, 2010, ETC completed its secondary review and determined to put City Capital on "DNP" (do not process) status, noting that "[d]ue to poor financial information and high concentration of unsecured notes decision was made that any further investments are not administratively feasible." (RX-50; Dea-Tr.1583-85) Although ETC had no suspicion that City Capital was violating the law, ETC "believed at that time that we had enough exposure to City Capital." (Dea-Tr.1586, 1589) ETC's Governance, Risk and Compliance Committee, composed of members of ETC's senior management team, was responsible for placing City Capital on DNP status. (Dea-Tr.1586-87)

During the course of the secondary review, a member of ETC's internal audit staff saw that some DOI forms said the Taylor notes were "secured by company." Customers testified they understood this to mean simply that the company would be on the hook to repay the note – essentially duplicating the payment promise in the company's promissory note. (Sims-Tr.1407-08, 1442-47; Dorio-Tr.880-81) However, following the review, in the absence of any separate security, ETC determined to reclassify as unsecured notes that were "secured by company." ETC did so both in its own records and in quarterly account statements to customers.

**(5) ETC's Custodial Services to Existing Customers.** ETC had no basis to accuse Taylor of fraud in 2010, nor was its determination to put City Capital on "hold" based on any finding of fraud. (Dea-Tr.1583-86, 1589-90; Desich-Tr.984-87; Marsh-Tr.262-63) The phrase "not administratively feasible," as used by ETC and other SDIRA custodians, meant simply that custodians "don't want to process the investment." This "could be for a number of different reasons," which "could be fraud-based, it could be we just choose not to hold it," or "any number of things," and it would "[n]ot necessarily ... stand for fraud." (Marsh-Tr.262-63; Dea-Tr.1589-90; Desich-Tr.984-87).

While not accepting new Taylor customers, ETC continued to provide SDIRA custodial services during 2010 to existing ETC customers who had already invested with Taylor, including customers who extended the terms of their notes during 2010. While no disclosure of DNP status or lack of administrative feasibility was required by the account agreements, ETC's quarterly account statements continued to advise existing custodial customers of any missing documentation and maturity dates, and customers with matured notes were aware that their notes had not yet been paid.

Taylor's lawyer Robert Bovarnick participated in the early January 2010 phone conversation in which ETC notified Taylor of its "hold" determination, and Bovarnick confirmed that uninvested funds of new Taylor customers would go to a different SDIRA custodian. (RX-10) Bovarnick testified that he did not think he was thus assisting a Ponzi scheme. (Bovarnick-Tr.1777-82) During the call, Bovarnick was "very stern" in making sure that ETC would not disparage City Capital to existing investors, and "[t]hat there wouldn't be anything negative said about City Capital and its operations." (DX-36, Taylor-Dep.326-27)

Following ETC's "hold" and DNP determination, it continued to have no basis to accuse Taylor of fraud, either publicly or in speaking with existing customers. Taylor continued to be held in high public regard, and respected independent players validated his reputation. Thus, in February 2010 – almost two months after the "hold" – Taylor was a featured speaker on a panel at Harvard on "Young Millionaire CEOs and Emerging Leaders," designed to "inspire and motivate" Harvard students and "give voice to young successful business leaders for the next generation." (RX-37; Davis-Tr.1676-77) The advertisement for the event, sponsored by Harvard Law School's Charles Hamilton Houston Institute, profiled Taylor – as of February 2010 – as follows:

> Ephren Taylor ... is currently the CEO of ... City Capital Corporation, ... recognized by the Wall Street Journal as one of the Top 100 Socially Conscious Corporations in the United States. ... Mr. Taylor is the youngest African-American CEO of any publicly traded company in United States history. ... In addition, through his action on green energy and philanthropy, Taylor is leading a new wave of CEO's focusing on corporate social responsibility. He appears regularly on FOX News, CNBC, and has been featured on network shows such as

ABC's 20/20, Big Idea with Donnie Deutsch and Montel Williams show. He also has regular appearances in print and radio media including PBS, Black Enterprise, and the Miami Herald. ... [RX-37]

As 2010 rolled along, there continued to be no supportable basis for ETC or others to accuse Taylor of fraud. Around March 2010 or possibly later, at least three months after the hold, Taylor's longtime outside publicist Raoul Davis had his new spouse invest her own retirement funds with Taylor – using a different custodian, as ETC was no longer accepting new Taylor investors. (Davis-Tr.1673-74, 1699) (Davis-Tr.1688-92) On June 15, 2010, six months after the hold, Taylor's company City Capital filed its financial statements, audited by a PCAOB-registered public accounting firm, with its Form 10-K on EDGAR. (RX-1) In late June 2010, Attorney Robert Bovarnick wrote as City Capital's "outside general counsel" to approximately 100 of Taylor's investors to propose a settlement trust to "ensure your entire investment is returned," and Bovarnick testified that, in so doing, he again did not think City Capital was a Ponzi scheme. (Bovarnick-Tr.1782, 1790; RX-11)

## E. Substantial Evidence Does Not Support Finding That ETC "Knew or Should Have Known" of Poulson's Fraud

The ALJ ruled that the "knew or should have known" element was "unproven," because "Poulson also appeared to be a legitimate businessman," even when he later "stalled" on providing information and "eventually was only partially responsive." (I.D.-32) The ALJ ruled that, even if there were "sloppy record keeping, putative promotion of investments, or provision of PINs to an investment sponsor," this would "not bear on whether [ETC] knew or should have known of ... Poulson's violations," and "not [be] relevant to whether [ETC] is liable for a secondary violation in an enforcement charge." (I.D.-35, 37)

**(1) Poulson's Public Profile.** People loaned Poulson money based on his status as "New Jersey's real estate investment expert." (Poulson-Tr.574) Poulson was President of South Jersey Real Estate Investors Association ("SJREIA," f/k/a South Jersey Investors), the leading real estate investment group in southern New Jersey. SJREIA had 800 regular members, and its events drew up to 300 attendees. (Poulson-Tr.576-78; Jablonski-Tr.1754-56, 1758) Poulson also led the New Jersey Association of Real Estate Professionals – a lobbying group fighting certain real estate legislation. (Poulson-Tr.579-80)

Ron Jablonski, Poulson's successor as SJREIA president, called him "a very educated person" who "knew everything there was to know about how to transact real estate," and who "had credibility" with the group. (Jablonski-Tr.1758-59) Joseph Gatto, later SJREIA's treasurer and executive director, confirmed that Poulson "ran the organization," "would pick national speakers" for its events, "ran the main meeting" each month, and spoke knowledgably about real estate investment. (Gatto-Tr.1282-84) Gatto and other SJREIA officers and directors personally invested with Poulson. (Jablonski-Tr.1762; Gatto-Tr.1285-86)

People also loaned Poulson money after attending regional real estate seminars offered by his Poulson-Russo educational business. Poulson's email signature block listed him as "President, New Jersey Association of Real Estate Professionals"; "President, South Jersey Investors, Inc."; "Lead Instructor, American Real Estate Investors Institute"; "Author and Creator of The Market Dominator Course Instruction Series" on real estate investing; and "Founder/Partner" of Poulson Russo, LLC, "The Premier Real Estate Investment Education and Training Company in New Jersey." (RX-59, 74; Poulson-Tr.575-576) His Linked-In profile listed additional credentials. (RX-34)

**(2) Poulson's Business Model.** In 2006, after years of buying and selling multi-family properties, Poulson developed a new plan: Borrow from individuals on a promissory note, use the funds to buy discounted single-family houses facing foreclosure, take title, assume the mortgage, make repairs, and lease the property to a tenant with an option to buy at a predetermined price within three years. After satisfying the mortgage balance and repaying principal and balloon interest to his promissory note lenders, Poulson expected to clear a 5-10% profit. (Poulson-Tr.546-50, 562-64)

Poulson was confident, as he saw "a multitude of people out there that were doing it," and the plan did go "fairly well" at the outset. (Poulson-Tr.550-51) However, as the financial crisis continued beyond 2008, tenants "were not paying their rent," and with credit tightening, "it was becoming that much more difficult for them ... to be able at some point in the future to exercise their option" to buy their residence. (Poulson-Tr.551-53) By "probably sometime in ... 2010 or 2011," Poulson realized his plan was not going to work. With tenants unable to pay rent and exercise their purchase option, Poulson could not pay his promissory notes coming due. (Poulson-Tr.553-54)

**(3) ETC's Limited Interaction With Poulson.** Apart from awareness of Poulson's positive image and prominence in regional New Jersey real estate circles, Ohio-based ETC had only limited interaction with Poulson.

**(a) Single Poulson Event (Runnemede Seminar) Attended:** ETC employees Irene Berlovan and Edwin Kelly attended an April 2009 Poulson-Russo educational seminar in Runnemede, New Jersey. This was the only Poulson-related event ETC ever attended. Poulson's materials touted Poulson-Russo as a "preeminent training, coaching, and mentoring company" offering "national caliber training for real estate entrepreneurs." (RX-77; Berlovan-Tr.1237) About 180-200 people paid $2,000-$2,500 to attend. (Poulson-Tr.582-83) SDIRA custodians routinely attend such educational events to speak about the benefits of SDIRAs. (Marsh-Tr.260-61) There can be five or six competing SDIRA custodians appearing at a single event looking for business. (E.Kelly-Tr.625-27)

The event transcript shows Berlovan simply giving a general introduction lasting a couple of minutes ("[i]t's a very, very neat concept to be able to use [] your IRA money just as you use your money today. To go ahead and build your future income"). She then sat out in the hallway with other vendors to hand out SDIRA information. Poulson called these hallway vendors his "power team" – a random collection including accountants, lawyers, title abstract service providers, a financial strategist and an insurance agent. (DX-824, pp. 269-71; Berlovan-Tr.1221-22, 1234-35; E.Kelly-Tr.635)

Kelly, who was "extremely ill" that day, "probably briefly" met Poulson, and then simply delivered his stock speech educating whoever would listen about SDIRAs generally. (E. Kelly-Tr.610-12, 631-33, 635-36) Kelly gave simply an "educational" presentation on SDIRAs. (Poulson-Tr.587-90) Glenn Savary, the only attendee the Division called as a witness, testified that he "wasn't paying attention" to the ETC presentation. (Savary-Tr.1107-12) By generally presenting on the myriad uses of SDIRAs, ETC's representatives were thereby suggesting alternative investments that competed with Poulson's promissory notes. (E.Kelly-Tr.632-33; Desich-Tr.982-83) Kelly's presentation and materials warned against fraud and stressed that ETC did not endorse any particular investment or strategy. (E.Kelly-Tr.629-31) Kelly also sold educational CDs on using SDIRAs to invest in a wide variety of assets, and split $4,819 sales proceeds with Poulson-Russo. Splitting CD or book sale proceeds with event hosts was "very typical within the industry." (RX-20; Poulson-Tr.588; Jablonski-Tr.1763; Marsh-Tr.261; E.Kelly-Tr.627-29)

**(b) Supposed Cross-Sponsorship of Events:** Months after this seminar, Poulson-Russo emailed a list of vendors – title companies, appraisal firms, lawyers, accountants, real estate management companies, insurance brokers, as well as ETC – offering sponsorships in Poulson-Russo's monthly dinner events for $600/year. The email guaranteed quality educational presentations with "absolutely NO sales agenda." (DX-160) ETC initially accepted in return for Poulson paying $750 to sponsor an ETC conference, but neither actually did so.

**(4) ETC's Review and Hold on Accepting New Customers.**. As noted above, ETC "pioneered" secondary reviews, based on customer numbers or amounts invested, in Fall 2009. (Dea-Tr.1576-78) In June 2010, ETC began a review of Poulson. (DX-256). ETC saw document deficiencies and sent Poulson a list of missing documents on November 30, 2010. (DX-209) Since ETC's customers had failed to provide these documents despite being reminded to do so in their quarterly account statements, ETC contacted Poulson regarding these missing documents. In response, Poulson never disputed his obligation to repay his promissory notes, regardless of whether the customers had obtained and forwarded signed copies to ETC. (Poulson-Tr.560-61)

Poulson did not become pessimistic about his business model until late 2010 or 2011, and testified that at no time did ETC know he was repaying old investors with new money. (Poulson-Tr.552-55) On January 21, 2011, Poulson sent a portion of the requested documents to

ETC, and promised to send the rest. (DX-225) Poulson admits he was stringing ETC along. (Poulson-Tr.568-70) On May 11, 2011, ETC accepted its last customer planning to invest with Poulson. (DX-41, p.10)

On September 20, 2011 – four months after taking its last Poulson customer – ETC staff recommended that Poulson be placed on "hold" status. On November 17, 2011, ETC's Governance, Risk and Compliance Committee met and formally did so. (DX-256) On November 23, 2011, the U.S. Attorney mailed ETC a letter enclosing a subpoena. The letter did not mention Poulson (DX-248), and based on the response (DX-249), it appears that the enclosed subpoena (not in evidence, but produced as SEC-ETC-P-000021) did not focus on Poulson. Years later, in May 2014 the U.S. Attorney filed a mail fraud case against Poulson. Poulson pled not guilty and defended, but later changed his plea, with judgment entered against him on January 22, 2016. (I.D.-11; DX-862) The Commission has still not filed a securities case against Poulson.

## II. DISMISSAL BASED ON REVERSAL OF CERTAIN DETERMINATIONS

The Initial Decision should be affirmed. Alternatively, the Commission should find for ETC and dismiss based on the following points that the ALJ either determined against ETC or did not consider.

### A. Causation Not Proven

**(1) "Causal Nexus" Requirement.** Liability for "causing" requires a "sufficient nexus" between ETC's custodial services and any Taylor or Poulson securities violations. *Berko v. SEC*, 316 F.2d 137, 140 (2d Cir. 1963) (while "an immediate or inducing" cause is not always required, "neither ... the Commission nor common sense suggests that the statutory requirement should be deemed to have been met by a demonstration merely that the [defendant]'s conduct was to some degree a factor.... More than this is required"); *Matter of Public Finance Consultants, Inc.*, 2005 WL 464865 at *55 (Feb 25, 2005) ("failed to prove a sufficient nexus" for causing Securities Act §§17(a)(2)-(3) violation), *finality notice*, 2006 WL 2986867 (Aug. 3, 2006); *Matter of Steinberg*, 2001 WL 1739153 at *39, *43 (Dec. 20, 2001) (failed to "establish a sufficient nexus between the Respondents' alleged conduct and the underlying violations"), *dismissed*, 2005 WL 1584969 (July 6, 2005); *Matter of Carley*, 2005 WL 1750288 at *50-51 (July 18, 2005).

**(2) ETC Not a "Cause" of Taylor's or Poulson's Misconduct.** The OIP charged that Taylor's fraud consisted of (i) issuing secured and unsecured promissory notes; (ii) saying the proceeds would be invested in small businesses and low-income housing; (iii) misappropriating some funds for personal or business expenses and for paying earlier investors; and (iv) saying certain notes were secured by their issuers. (OIP ¶25) The Division failed to prove ETC "caused" any of this Taylor conduct charged in the OIP. That is, the Division failed to prove that

ETC caused Taylor to issue notes while telling investors he would invest in small businesses or low-income housing, that it caused Taylor to misappropriate funds, or that it caused Taylor to tell investors that certain notes were secured by their issuers.

The OIP charged that Poulson's fraud consisted of (i) issuing secured promissory notes; (ii) saying the note proceeds would be used to purchase and improve particular properties; (iii) failing to record mortgages; and (iv) misappropriating some funds for personal use. (OIP ¶¶48-49) The Division failed to prove ETC "caused" any of this Poulson conduct charged in the OIP. That is, the Division failed to prove that ETC caused Poulson to issue notes while telling investors that all of the note proceeds would be used for the real estate investments, or that it caused Poulson to fail to record mortgages or to misappropriate funds.

**(3) ETC Not a "Cause" of Individual Investments With Taylor.** The Division says approximately 80 ETC customers invested with Taylor. (OIP ¶30) Based on pre-hearing disclosures, during the Division's years of investigation it spoke with most of these 80 individuals. Having the opportunity to subpoena those most favorable, the Division presented only six investors to testify, yet none invested based on anything ETC did. This selective presentation warrants an inference that the other 74 individuals would have been even weaker witnesses for the Division.

**(a) Anita Dorio:** ETC did not "cause" Taylor to defraud Dorio. When she invested in January 2009, he was a universally celebrated business leader, had recently been a speaker at the 2008 Democratic National Convention, and was presented as a big success story on numerous national television programs and in print media. His book had appeared twice on The Wall Street Journal's best seller list. Those closest to Taylor – his accountant, attorneys, and publicist – all testified they suspected no wrongdoing.

Dorio met Taylor at her church, which had a "substantial" place in her life and where she was "very active." Taylor's presentation to 300-400 church volunteers began with a video showing Taylor interviewed on prominent television shows. (Dorio-Tr.830-34) Dorio testified she invested based on what she heard in multiple in-person meetings and biweekly calls with Taylor and his staff over several months. (DX-36, Taylor-Dep.184-89; Dorio-Tr.798-99, 836-43)

In stark contrast, Dorio recalled just "two or three" calls with Batt at ETC. (Dorio-Tr.856) Dorio testified that Taylor's phone introduction simply led her to choose ETC as her SDIRA custodian. Responding to the Division's leading and focused question whether ETC's presence gave her "any comfort in deciding to invest with Mr. Taylor," she would only say that Taylor's introduction of ETC gave her comfort to use ETC as a custodian: "Sure. I mean, you know, we liked what Ephren said, we believed in Ephren, he worked with Robert Batt, Robert Batt, you know, did all the deals, you know, so I felt very comfortable working with" ETC. (Dorio-Tr.800-01) "The record shows ... it was Taylor who promoted Equity Trust, not *vice versa*." (I.D.-35)

Dorio had a business degree with accounting, finance and business law courses, and worked over a decade in accounting departments. (Dorio-Tr.826-28) The Division argues that Dorio's DOI said she wanted a secured investment with Taylor. But her testimony shows that she understood "secured" meant simply a company-backed promise to pay, which is what she got in the Taylor documentation that she accepted and signed. She understood the "secured" nature of her Taylor investment – stated in the DOI as being secured by the "company" – meant simply that it was "backed up by a business." (Dorio-Tr.805-06) This meant that "[i]f someone didn't pay the note, then that would mean that the company is the collateral." (Dorio-Tr.880-81)

Before investing with Taylor, Dorio already had experience with three other SDIRA custodians, so she understood the limited role played by SDIRA custodians: **(i)** She learned about SDIRA custodian Pensco Trust when she was the Houston chapter president of American Cashflow Association, which held meetings on "buying notes" and other non-traditional investments but was a scam. **(ii)** She used SDIRA custodian Sterling Trust to hold real estate investment trusts she bought in her mother's AIG account before her Taylor investments. **(iii)** She also used SDIRA custodian SunAmerica Trust to hold other funds in the AIG account. (Dorio-Tr.843-47, 849-51; RX-232) Indeed, Dorio said she felt "comfortable with Equity Trust" because its "forms looked exactly the same" as the forms she was already using for her mother's SDIRA investment with Sterling Trust. (Dorio-Tr.848-49)

Following a months-long "courtship" of Dorio by Taylor and his staff, she had by January 7th already directed AIG to liquidate a portion of the assets in her mother's account to fund her investment with Taylor, and the sell orders in her mother's AIG account had already been placed. (DX-278, 279) Far from warning Dorio, her AIG adviser's January 8th letter actually said that "I do believe in these types of investments," and mentioned he previously sold two real estate investment trusts to her. He just wanted to raise the risks "as well as the benefits of what you may be getting into." (DX-830) For this reason, Batt – who never actually saw the letter (Batt-Tr.474) – was misinformed in asking Dorio in a January 14th call, "[h]ow can this broker comment on real estate when he has never done it." (DX-14)

Batt and Dorio both testified at the hearing, and neither said that ETC did anything to "sell" Taylor to Dorio. The furthest Dorio would go was to say that ETC did not say that it was not recommending Taylor. (Dorio-Tr.823-24) Contrary to the Batt and Dorio testimony, and contrary to the contemporaneous documents, the Division cites Taylor's jailhouse deposition testimony that Batt "was able to dismantle" the AIG broker, "get their confidence in the deal," and "got that sold." (DX-36, Taylor-Dep.115) In addition to faulty recollection in hearsay opinion testimony after almost seven years – January 2009 events recalled in October 2015 – Taylor was plainly motivated to "please the prosecutor." He admitted on cross-examination that his "ongoing cooperation effort" could still get him "cooperation credit" to possibly get his lengthy sentence reduced, and that he believed the SEC lawyers would have input on this. (DX-36, Taylor-Dep.156)

A week after her January 7th AIG sell order, Dorio emailed Taylor's principal sales deputy Chris Lewis on January 14th that "[w]e have the victory and nothing else will hinder or delay this coming to pass." Her email gave Lewis her AIG account number, username and password, and asked if there was "anything else you need or want." (RX-232) Lewis "worked with Ephren and I was moving the funds from AIG eventually to Ephren, [and] I knew that Chris would need this information." (Dorio-Tr.859)

In the context of Dorio having just emailed Taylor's deputy that "nothing else will hinder or delay" the transfer to Taylor already in motion, Batt's email later that day (DX-14) telling Taylor that Batt would "close it," refers to completing the funds transfer into the SDIRA account, and not to convincing Dorio to invest with Taylor. Batt so testified and was cross-examined. (Batt-Tr.479) Even Taylor confirmed that "close it" meant it already "was a done deal" and that Batt would simply "get the money wired over." (DX-36, Taylor-Dep.116) Not that Batt would convince Dorio to invest with Taylor.

**(b) Lawrence Hill:** ETC did not "cause" Taylor to defraud Hill. (ETC Br. pp.16-17) Hill invested in June 2008, seven months before Dorio, when Taylor's public image could not have been higher. Taylor spent a week at the Florida church where Hill was a deacon. The church's pastor said that Taylor was there to help on the church's finances, that Taylor "was a young, successful millionaire and that he was a member of the church." (Hill-Tr.166-79, 181) Taylor personally told Hill that he "can get [me] retired quicker, because that was one of my dreams." Taylor said he was offering a 10% return on investments. (Hill-Tr.170-71, 179, 184-85) Nobody from ETC was at the church, and in a call that Hill testified lasted only one minute, Batt simply repeated that City Capital notes were then offering 10%, and said that Taylor had a "good" company. This one-minute call was the only conversation Hill had with anybody at ETC. (Hill-Tr.172, 186-87, 191) Hill acknowledged that ETC "wasn't endorsing the investment," and he would not say ETC gave "an okay" on investing with Taylor. (Hill-Tr.156-57, 175)

Hill and his spouse, an IRS agent, determined to invest with Taylor. And when their note matured a year later, Taylor flew Hill and his spouse for a weekend in Raleigh to see Taylor's offices. During their visit, they agreed to renew their original note and to add more funds. (Hill-Tr.165-66, 192-93) Hill had no communications with ETC before making this additional investment. (Hill-Tr.191)

**(c) Dorothy Sims:** ETC did not "cause" Taylor to defraud Sims. She too invested when Taylor enjoyed a positive public image. Sims invested based on seeing Taylor discuss socially conscious investing on a national Christian television network, after reading two of Taylor's books, and after researching Taylor online. She called City Capital directly to learn more about Taylor's community investing program. This was all before any contact with ETC. (Sims-Tr.1398-1401, 1427-34) Her sole interactions with ETC consisted of two calls setting up the SDIRA account. (Sims-Tr.1402-05)

Sims had a business degree with courses in accounting, finance and investments, and after starting in banking, she worked over 30 years as an analyst at Boeing. (Sims-Tr.1398, 1423-24, 1450-52) She understood that the "secured" nature of her Taylor investment – stated in the DOI as being secured by the "company" – meant simply that "if anything happened, you know, and for – [City Capital] would be responsible for, you know, paying the money back." (Sims-Tr.1445) So the DOI reflected City Capital's promise in its note. (Sims-Tr.1407-08, 1442-47)

**(d) Three New Birth Congregants.** ETC did not "cause" Taylor to defraud the three members of New Birth Church whom the Division selected as witnesses – Ronald Jones, Crystal Turner and Lillian Wells. (ETC Br. pp.27-30) These longtime congregants invested based on their respected Bishop's strong endorsement of Taylor and after hearing Taylor speak at multiple events during his week-long visit to their church, followed by their one-on-one meetings with Taylor's sales staff.

Ronald Jones: Jones has an MBA, and has worked as a science teacher and small business owner. (Jones-Tr.122-27) He heard his Bishop introduce Taylor on Sunday as a "man of God" and spoke personally with Taylor while buying his autographed book. Jones decided to invest based on separate discussions with several Taylor sales representatives on Sunday, all with Batt not present. (Jones-Tr.112-13, 136-39, 150-51) After deciding to invest, Jones returned on Tuesday and spoke with Batt simply about how SDIRAs worked. (Jones-Tr.111-12, 145-47) Jones understood that ETC "wasn't endorsing the investment." (Jones-Tr.156) He had never heard of ETC before attending Taylor's presentation. (Jones-Tr.100)

Crystal Turner: Turner has a BS in health administration, and her spouse was a New Birth elder. (Turner-Tr.1346-47, 1375-77) She saw Taylor on the national Montel Williams television show, heard Taylor speak at New Birth's Sunday service, heard him speak again on Tuesday, met with Taylor's sales representatives at the church to discuss investing, and then met personally with Taylor a few weeks later. (Turner-Tr.1351, 1356-58, 1378-84, 1392-93) She spoke with Batt "informally" only two or three minutes on Tuesday, could not recall what he said, and never spoke to anyone from ETC again until after her loss. (Turner-Tr.1354, 1356, 1371-72) All Turner would testify was that ETC did not say that it did not endorse Taylor. (Turner-Tr.1356) She had never before heard of ETC. (Turner-Tr.1351) After a small investment through ETC, Turner made the bulk of her investment through a different SDIRA custodian in 2010, as Taylor instructed, plus a separate non-SDIRA cash investment with Taylor. (Turner-Tr.1365-67, 1385-90)

Lillian Wells: Wells had been a New Birth member for over 20 years and considered Bishop Long "a father figure." (Wells-Tr.45) She studied applied behavioral sciences in college, worked 34 years for AT&T, and after further study became a licensed real estate broker. (Wells-Tr.81-82) Wells attended several Taylor presentations at New Birth and met one-on-one with his sales staff. (Wells-Tr.52-56, 63-64, 72-77) Her only contact with Batt was briefly listening to him talk about SDIRAs in the church lobby after Taylor's Tuesday presentation. He

referred questions about Taylor to Taylor's staff. (Wells-Tr.70-72, 79-80) Like others, all she would testify was that ETC did not say that it did not endorse Taylor. (Wells-Tr.26) She never before heard of ETC. (Wells-Tr.94-95)

**(e) DOI Form Limiting ETC's role.** Immediately above their signatures in bold type on each DOI form, customers agreed that "I, alone, am responsible for the selection, due diligence, management, review and retention of all investments in my account"; that "I agree that [ETC] is not a 'fiduciary' for my account"; and that "I hereby direct [ETC], in a passive capacity, to enact this transaction for my account." On the top of the same page, under the heading "IMPORTANT: Please Ensure That You Read The Following Disclosures Before You Sign and Date These Documents," the very first sentence said: "1. Equity Trust Company (Custodian) does not offer any investment advice, nor does it endorse any investment, investment product or investment strategy...." Each witness discussed above acknowledged this: Dorio (RX-151, image 6/121, DOI form, p.4; RX-181, image 6/103, DOI form, p.4; Dorio-Tr.866-68, 881-82); Hill (RX-135, image 13/84, DOI form, p.4; Hill-Tr.187-91); Sims (RX-168, image 6/41, DOI form, p.4; Sims-Tr.1445); Jones (RX-142, image 6/58, DOI form, p.4); Turner (DX-696, p.160, DOI form, p.4); and Wells (RX-183, image 7/36, DOI form, p.4).

**(f) Assessment by Marketing Expert.** ETC submitted the expert report of Kurt Carlson, Professor at Georgetown University's McDonough School of Business, who focuses on marketing and consumer choice decisions. In addition to teaching, "the bulk of what I do is do research on how people make decisions," and he runs an institute on how "consumers make decisions." (Carlson-Tr.1455-56) After reviewing the OIP's fact allegations, Carlson concluded "that ETC's presence in the decision process did not positively influence prospective investors' willingness to invest with Taylor." (RX-224-p.14)

Carlson explained that Taylor was a "strong brand" for prospective investors, based on his national profile and media coverage, that was "explicitly bolstered" by introductions like that given by Bishop Long at New Birth, as well as by "various dimensions of similarity" that Taylor had with his prospective investors. (RX-224-pp.14-15) For example, Taylor's New Birth presentation began with video clips of Taylor on national television shows presenting him as a highly successful young millionaire and entrepreneur. (RX-35; Wells-Tr.57-58, 60-61) Carlson also found significant that prospective investors first became interested in Taylor and then "discovered the need for a third party custodian such as ETC relatively late in the process," because "information encountered late in a choice process rarely has a material influence on choice." (RX-224-pp.14-16) Carlson also opined that "investors taken in by a Ponzi scheme might believe a third party custodian was material to their decision even though it was not," essentially for the reason that the investors would try to rationalize how, consistent with their own self-image, they could have made such a poor investment decision. (RX-224-pp.14, 20)

**(4) ETC Not a "Cause" of Individual Investments with Poulson.** The Division says 34 ETC customers invested with Poulson (DX-41), and its pre-hearing production showed it spoke with many of these during the investigation. Yet it chose to subpoena just two who plainly

did not invest based on anything ETC did. Again this warrants an inference that the other 32 customers would have been even weaker for the Division.

**(a) Joseph Gatto:** Gatto, an engineer with degrees in aerospace engineering and physics, had made multiple real estate investments and held a New Jersey real estate license. (Gatto-Tr.1255-56) Gatto met Poulson around 2006 through SJREIA, where Poulson was president. (Poulson-Tr.564-65, 577; Gatto-Tr.1278-82)

Around March 2008, Gatto loaned Poulson money for a real estate investment. Using his savings account – not an SDIRA – Gatto understood Poulson would buy the property at a price near the outstanding mortgage balance, make repairs, and lease to a tenant with an option to buy, all with the hope of selling at a profit. This first transaction with Poulson did not involve ETC in any way. (Gatto-Tr.1321-23)

Early the following year, Gatto did three more deals with Poulson, following the same model. They discussed the deals in several meetings, including at SJREIA meetings. Gatto felt "comfortable" loaning money to Poulson for this purpose. (Gatto-Tr.1295-96, 1298-99) But this time Gatto decided to use an SDIRA. (Gatto-Tr.1299) Gatto considered three SDIRA custodians – Checkbook IRA, Entrust, and ETC. He initially preferred Entrust because it had a local office, and was a "business affiliate" of SJREIA and made presentations at its meetings. Ultimately, after a phone conversation with Berlovan, Gatto decided to use ETC as his SDIRA custodian. (Gatto-Tr.1286-90, 1296-1300, 1336-37)

Gatto testified three times that Berlovan's remarks simply made Gatto want to use ETC as custodian instead of its competitor Entrust. Berlovan's comments "made me go with Equity Trust"; "sort of sent me over to Equity Trust"; and "took me over from ... Entrust." (Gatto-Tr.1261, 1262, 1288-89) Gatto did <u>not</u> say it influenced him to invest with Poulson. Gatto had already invested with Poulson a year earlier and had already decided to make these three new loans to Poulson.

Gatto made these three additional loans in March 2009 – with Poulson borrowing individually and not through any company – in amounts of $30,000, $60,000 and $25,000 – for Poulson to purchase and lease three specific houses in southern New Jersey. (RX-200) For each loan, Gatto sent ETC a DOI form agreeing he alone was personally responsible for all aspects of the investment, and that ETC was not a fiduciary for his account. ETC sent Gatto its standard confirmation letter advising Gatto that the funds had been sent to Poulson, and reminding Gatto that it was his responsibility to send ETC all signed documentation for the transactions and to assure that appropriate arrangements were in place to provide any security agreed upon for the transaction. Gatto provided ETC with only an unsigned promissory note and an unsigned mortgage, and he admits he never verified "anything about the collateral or whether it was a recorded mortgage or anything of that sort." (RX-200; Gatto-Tr.1300-03, 1305-14)

Gatto realized that Poulson would purchase each house at a price close to its existing first mortgage balance, and that there would thus be virtually no equity in the property to secure Gatto's loan. As an experienced real estate investor, Gatto also understood there could be additional earlier-recorded liens, including second and third mortgages, municipal tax liens and other creditors' liens. Gatto understood that the only way to determine this would be for him to do a title search, but he chose not to do a title search or to get an appraisal of fair market value. Gatto did not even drive past any of the properties, all three in his local area, to confirm the existence or condition of any buildings on the properties. (Gatto-Tr.1303-05, 1309)

In April 2009, after making his SDIRA investments with Poulson, Gatto attended Poulson's Runnemede seminar – the only Poulson event ETC ever attended – but Gatto attended on a different day and did not see any ETC personnel there. (Gatto-Tr.1333-35) Throughout 2009, 2010 and 2011, ETC sent Gatto quarterly statements that listed the principal amount, interest rate and maturity date for each of his three SDIRA loans to Poulson. (RX-200; Gatto-Tr.1326) During this time, Gatto became an SJREIA board member and later treasurer. (Gatto-Tr.1279) Each quarterly statement repeated that ETC had still not received from Gatto signed copies of the promissory notes. (RX-200; Gatto-Tr.1314-18, 1330-33) As the maturity dates approached and passed, ETC's quarterly statements continued to repeat it still had not received signed promissory notes from Gatto on these post-maturity unpaid loans.

Meanwhile, in 2009 and 2010, Gatto made his fifth and sixth loans to Poulson, both outside of Gatto's SDIRA, again for Poulson to buy properties following his usual business model. Gatto then became SJREIA's executive director, a position held until 2015. (Gatto-Tr.1279)

**(b) Glenn Savary:** Glenn Savary, an engineer with a chemistry degree, became a real estate investor by purchasing a multi-family apartment building. Savary joined SJREIA in 2008 and met Poulson at monthly meetings and weekend seminars. Poulson was SJREIA's president, and "appeared to be knowledgeable" and "successful" in real estate matters. Savary's spouse, a marketing executive, participated in his real estate investments. (Savary-Tr.1099-1102, 1105) Savary attended Poulson's April 2009 Runnemede seminar, where ETC made a "mini-presentation," and said a brief hello to Berlovan, but Savary "wasn't paying attention because at that time, [he] didn't really have an immediate need" for an SDIRA. (Savary-Tr.1107-12)

In November 2009, Savary loaned Poulson money to buy real estate, using Poulson's regular model. Savary used savings – not an SDIRA – for this loan, which "definitely" did not involve ETC in any way. (Savary-Tr.1112-15) Savary understood that the house was "distressed" or "under water." Poulson would be taking over payments on a first mortgage that could be greater than the price of the house, and Savary would only have a "second position" interest that would be junior to the first mortgage. (Savary-Tr.1114-18) Savary did not get a

title search that would have listed all prior liens on the property before making this loan. (Savary-Tr.1120-21) When the loan came due in May 2010. Poulson's "check bounced." This "didn't really bother" Savary because he trusted Poulson based on "his interactions" with him, so Savary orally extended the note. (Savary-Tr.1118-20)

In 2010, Savary made a second loan to Poulson, following the same business model, but this time Savary used his spouse's IRA funds and had her open an SDIRA account at ETC for this purpose. Again Savary did not bother to do a title search that would have revealed the mortgages and liens already on the property. (Savary-Tr.1121-23, 1137) Savary assumed that the house was "under water," and that Poulson was paying a price less than the first mortgage's balance. So even if Savary had a title search showing the first mortgage as the only lien, the property had no equity to secure Savary's junior loan to Poulson. (Savary-Tr.1126-27, 1130-32)

Savary directed ETC to make this loan from his spouse's SDIRA account in May 2010, the same month that Poulson's check bounced when he tried to pay off Savary's earlier loan. (Savary-Tr.1125-26) Immediately above Savary's spouse's signature on the May 2010 DOI directing the investment, she acknowledged that she alone would be "responsible for the selection, due diligence, management, review and retention of all investments in my account." (RX-214) Savary said he did not consider this statement to be binding because it was "a form." (Savary-Tr.1133-34)

On May 12, 2010, ETC sent its standard confirmation letter advising that the funds had been paid from the SDIRA to Poulson. ETC's letter instructed Savary and his spouse to send ETC copies of the promissory note and mortgage. The letter repeated it was the SDIRA owner's responsibility to furnish documents and assure collateral arrangements were in place. (RX-214) Savary never did so. He asked Poulson to send the documents to ETC, but he never confirmed that Poulson did so. (Savary-Tr.1139-44) ETC sent repeated quarterly statements to Savary advising ETC was still "awaiting receipt" of documents, but Savary says he did not observe this advice. (RX-214; Savary-Tr.1140) Savary continued to be "fairly active" in Poulson-Russo networking events and to see Poulson "monthly or every other month." (Savary-Tr.1148-50)

When the second loan came due six months later in November 2010, Poulson still had not paid off the first loan after his payment check bounced. Yet with the first loan still not paid, Savary decided to extend the second loan for another six months, while increasing the interest rate from 15% to 18%. ETC's quarterly statements following the extension of the second loan noted that ETC had received a copy of the promissory note and extension addendum, but that ETC was still "awaiting receipt" of the mortgage. (Savary-Tr.1151-55)

**(c) DOI Form Limiting ETC's role:** Immediately above their signatures in bold type on their DOI forms, Gatto and Savary's spouse each agreed that "I, alone, am responsible for the selection, due diligence, management, review and retention of all investments in my account";

that "I agree that [ETC] is not a 'fiduciary' for my account"; and that "I hereby direct [ETC], in a passive capacity, to enact this transaction for my account." On the top of the same page, under the heading "IMPORTANT: Please Ensure That You Read The Following Disclosures Before You Sign and Date These Documents," the very first sentence said: "1. Equity Trust Company (Custodian) does not offer any investment advice, nor does it endorse any investment, investment product or investment strategy...." (RX-200, image 6/98, DOI form, p.4 (Gatto); RX-214, image 5/59, DOI form, p.4 (Savary))

**B. Scienter (and Negligence) Not Proven**

For "causing" liability under Securities Act §8A (like Securities Exchange Act §21C), where the underlying primary violation requires proof of scienter, the Division must show that a respondent charged with causing the scienter-based primary violation also acted with scienter. *Howard v. SEC*, 376 F.3d 1136, 1141-42 (D.C. Cir. 2004). Negligence is sufficient for causing liability only where "the primary violations do not require culpability beyond negligence." *Matter of KPMG Peat Marwick LLP*, 2001 WL 47245 at *19, *20 (Jan. 19, 2001), *aff'd*, 289 F.3d 109, 120 (D.C. Cir. 2002).

Here the underlying primary violations by Taylor and Poulson were at least scienter-based. Both pled guilty to acting with criminal intent, an even higher standard. For this reason, under controlling D.C. Circuit precedent, the Division had to prove that ETC acted with scienter in causing primary violations by Taylor and Poulson. The fact that Taylor and Poulson *could have* been charged with negligence does not convert their scienter-based primary violations into negligence-based primary violations. The Division's use of a theoretical lesser-included-offense approach would totally eviscerate the D.C. Circuit's clear rule in *Howard* and *KPMG*.

While the Division should thus have been required to prove that Equity Trust acted with scienter, the Initial Decision determined (I.D.-pp.30-31) to apply only a negligence standard. Yet at the hearing the ALJ correctly determined that the Division failed to prove even that Equity Trust acted negligently. Based on the Commission and NASAA statements about an SDIRA custodian's duties, the language defining ETC's duties and responsibilities in its customer agreements, and available public information, ETC acted reasonably in viewing Taylor and Poulson as respected business people and entrepreneurs. ETC received no customer complaints about them. Indeed, it was only after conducting its "pioneering" investment review process, for reasons having nothing to do with any suspicion of the fraudulent conduct alleged to have been committed by Taylor and Poulson, that ETC determined not to take on additional accounts involving them – all years before law enforcement made accusations against either.

**C. Primary Securities Violations Not Proven**

**(1) Taylor Primary Violation**. The Justice Department prosecuted Taylor, but for wire fraud (18 U.S.C. §1343), not for securities fraud. (I.D.-11) The Division has not proven a primary securities violation by Taylor. As described above, the evidence showed that, during

2008 and 2009, Taylor's company City Capital did not hide its financial condition. It was not securities fraud for its EDGAR filings to publicly disclose to investors that it was significantly in debt, had notes coming due to earlier investors, had been losing money over several years, and that its continuing operations were funded with borrowed funds from its promissory notes. It further disclosed the growing number of outstanding promissory notes, referencing for each the principal amount, interest rate and maturity date in the audited financial statements in its annual reports.

Its disclosures were drafted by an outside accountant, who had direct access to City Capital's financial records at year-end, and who testified at the hearing that she continues to this day to believe these EDGAR financial disclosures were accurate. City Capital's outside accountant, attorney, and public relations consultant testified that City Capital and its affiliates were struggling start-ups with real aspirations of becoming profitable. By mid-2010 Taylor realized that these businesses would not survive and engaged in a fraudulent scheme to raise additional funds by misrepresenting the use of the funds. However by that time Taylor was referring SDIRA investors to two different SDIRA custodians, Sunwest Trust and American Pension Services, and no longer to Equity Trust.

Secondly, the Division failed to prove Taylor's promissory notes were securities, and not simple loans. Taylor's notes: **(i)** had set payment dates and interest schedules, "late charges" for missed payments, and the right to "prepay"; **(ii)** were "written in the manner of a loan," with "'all the economic context of a temporary loan ..., not a permanent or semi-permanent source of capital investment with which to operate a major long-term ... venture,'" *Asset Protection Plans, Inc. v. Oppenheimer & Co., Inc.*, 2011 WL 2533839, at *3 (M.D. Fla. June 27, 2011) (citing *Singer v. Livoti*, 741 F. Supp.1040, 1050 (S.D.N.Y. 1990)); **(iii)** were "almost certainly short-term, the borrower had to re-pay the note in full even if [the venture failed] and the note would not appreciate [if the venture succeeded]," *Id.* (citing *United American Bank of Nashville v. Gunter*, 620 F.2d 1108, 1118 (5th Cir.1980)); **(iv)** were either unsecured or secured by "the company" issuing the note, and thus resembled a "short-term note secured by a lien on a small business," under the "family resemblance" test of *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990); and **(v)** were not "offered and sold to a broad segment of the public," but were instead sold in private meetings with Taylor and his associates. *Id.* at 67-68.

**(2) Poulson Primary Violation.** The Justice Department prosecuted Poulson, but for mail fraud (18 U.S.C. §1341), not for securities fraud. (I.D.-11) The Division has not proven a primary securities violation by Poulson. Poulson was engaged in buying, renting and selling houses. As described above, to finance a particular home purchase, he would obtain a loan from another individual, through a one-on-one personal request and discussion. The loan was to Poulson personally, not to an entity, and loans were not to be pooled.

The loan was simply to allow Poulson to buy a particular house in Poulson's own name, fix it up, and find a tenant willing to enter into a short-term lease with option to buy. The

personal loan was documented by a note containing Poulson's personal promise to repay, with fixed interest at the end of the stated short term, generally six months to a year. Poulson's lenders testified they understood that the particular property in question already had at least a first mortgage. Poulson believed that these real estate transactions would be successful and the loans repaid, based on past real estate experience, but after the 2008 financial crisis set in, tenants became unable to pay rent or get mortgage financing that would allow them to exercise their options to buy the houses.

Secondly, the Division failed to prove that Poulson's promissory notes were securities, and not simple loans. This inability to prove securities transactions likely explains why neither the SEC nor anyone else has filed a securities case against Poulson. According to the Division's evidence at the hearing, each Poulson note stated that it would be secured by a specifically identified house. Thus, the Division's record shows nothing more than a "note secured by a mortgage on a home." *Reves* 494 U.S. at 65.

## D. Constitutional Arguments

**(1) Article II (Appointments Clause).** The ALJ is an "inferior officer" within the meaning of Article II, but she was not appointed by the Commissioners, who collectively are the "head" of the agency. Additionally, the ALJ is subject only to good-cause removal by Commissioners also enjoying good-cause tenure, and thus the ALJ is separated from Presidential supervision and removal by more than one layer of tenure protection.

**(2) Fifth Amendment (Due Process).** The Division took a dozen discovery depositions during its multi-year investigation, but Equity Trust was denied any discovery depositions. The Division obtained extensive document productions and other discovery during investigations by two SEC offices, but Equity Trust was only allowed limited-scope third-party subpoenas. The Division took years to prepare its case with investigative subpoena power, and interviewed over 60 prospective witnesses, but Equity Trust was forced to hearing in a few months.

**(3) Seventh Amendment (Jury Trial).** Dodd-Frank let the Commission obtain virtually the same relief in federal court or administrative proceedings, and let the Commission choose the forum. This gives the Commission total control over whether there is a jury. When it wants a jury, it files a complaint and jury demand in federal court. When it does not, it files administratively. The defendant thus has no say at all on whether there is a jury. While jury trial has long been viewed as a fundamental right protecting the citizen from the sovereign's judge, Dodd-Frank thus transforms it into a prerogative only of the sovereign. This turns the jury right upside down and is the opposite of what the Founders decreed in the Seventh Amendment. *See Tull v. U.S.*, 481 U.S. 412 (1987) (civil jury trial protects citizen); *Pacific Mutual Life Ins. Co. v. Haslip*, 499 U.S. 1, 28 (1991) (Scalia, J., concurring); Austin W. Scott, "Trial by Jury and the Reform of Civil Procedure," 31 Harv. L. Rev. 669, 676 (1918).

## III. THE DIVISION HAS NOT PROVEN A BASIS FOR THE REMEDIES IT SEEKS

Even if there were to be a liability finding here – which there plainly should not be – the Division has not proven a basis for the cease-and-desist order, compliance consultant, disgorgement of some unspecified portion of fees, and penalty it seeks.

### A. Cease-and-Desist Order and Compliance Consultant

The Division has never before charged an SDIRA custodian for "causing" another's violation of Securities Act §§17(a)(2) and (3). The Division's allegations concerning a custodian's duties in this case are directly contrary to what the Commission has said in its investor alert quoted above. Even if the Division were able to show that ETC "caused" Taylor and Poulson to violate the securities laws, this would without question be a novel and unprecedented case.

Under circumstances where the there is no formal Commission precedent or official interpretive guidance – and indeed where the only Commission pronouncement as to a party's duties is to the contrary – there should be no cease-and-desist order. Thus, in *WHX Corp. v. SEC*, 362 F.3d 854, 860 (D.C. Cir. 2004), the D.C. Circuit vacated a cease-and-desist order where, "[a]lthough WHX received informal indications that its provision violated the Staff's understanding of the rule..., there was no formal Commission precedent or official interpretive guideline on point." Likewise in *Monetta Financial Services, Inc. v. SEC*, 390 F.3d 952, 957 (7th Cir. 2004), the court vacated a cease-and-desist order and civil penalty where "no rules expressly required disclosure."

ETC's determination to defend this proceeding is certainly not a factor to be considered in determining whether to impose a cease-and-desist order. In *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1229 (D.C. Cir. 1989), the D.C. Circuit said that defendants "are not to be punished because they vigorously contest the government's accusations. We think 'lack of remorse' is relevant only where defendants have previously violated court orders ... or otherwise indicate that they did not feel bound by the law...." *See also SEC v. Todd*, No. 03CV2230, 2007 WL 1574756, at *50 (S.D. Cal. May 30, 2007) ("argu[ing] that they did not in fact commit a fraud" is "a wholly appropriate position during the pendency of ... motions [for new trial or other relief]," and should not be grounds for a sanction), *aff'd in part and rev'd in part on other grounds*, 642 F.3d 1207 (9th Cir. 2011).

Finally, there should be no order mandating a compliance consultant. In *Matter of Raymond James Financial Services, Inc.*, 2005 WL 2237628, I.D. Rel. 296 (Sept. 15, 2005), Chief ALJ Murray denied the Division's request for an order requiring respondent to retain a compliance consultant. "Intervention of the type the Division proposes is an extreme measure warranted when it appears that the broker-dealer will not, or cannot, take remedial action on its

own initiative." *Id.* at *67 (emphasis added). An order for a compliance consultant was unwarranted there, even though respondent was an SEC-regulated broker-dealer, unlike ETC which is not subject to the SEC's regulatory oversight. And such an order would be particularly unwarranted where the ALJ found that ETC was a "pioneer" among SDIRA custodians in implementing a review process that led it to stop taking any new Taylor or Poulson business, all well before law enforcement raised questions and at times when both enjoyed very positive reputations and public profiles. There is thus no basis to require the "extreme measure" of hiring a compliance consultant in the present matter.

## B. Disgorgement of Fees

**(1) No Proof of Gross Disgorgement Amount.** The Division's pre-hearing brief (p.23) said only that it wanted "approximately $180,000" in disgorged fees. No specifics, no breakdown, no calculation. The hearing record then closed on December 10, 2015. At that point the Division had not proven even a gross amount as disgorgement. During the hearing, the Division's witnesses did not address disgorgement at all. However after the record closed, the Division's post-hearing brief attached a new exhibit that was not in evidence and had never before been shown to ETC's counsel. The new unadmitted exhibit purported to do calculations based on particular items of data selected from hundreds of pages of account transaction details and other materials, in order to formulate a summary exhibit to support the Division's disgorgement claim.

As the new exhibit was not admitted, it should not be considered. If it is offered now, we object because admitting the exhibit so late in the process would create substantial prejudice. Even if we could recreate the Division's calculations by analyzing the hundreds of pages of underlying transaction records, we would be unable to cross-examine or submit contrary proof with the hearing concluded long ago.

**(2) No Proof of the Portion of Fees Subject to Disgorgement.** The Division has not shown in its unadmitted exhibit or elsewhere what portion of the fees were for allegedly "causing" a securities violation, versus the portion for custodial services. Nor what portion of the fees pertain to time periods when nobody suspected any irregularities for either Taylor or Poulson. Nor what portion of the fees were refunded to customers. Nor what portion of the fees were paid on customers' behalf by City Capital, and not using customer funds.

To prove a disgorgement claim the Division would have had to present evidence showing the portion of fees that it claimed were ill-gotten gains. "[T]he Commission distinguishes between amounts earned through legitimate activities and those connected to violative activities, and it falls on the Division to show what a reasonable approximation of the ... fees was unjust enrichment." *Matter of Riad*, 2014 WL 1571348, at *32 (Apr. 21, 2014) (ALJ Foelak). Where "the Division failed to meet its initial burden of presenting a 'reasonable approximation' of the profits connected to the violations," as in the present matter, "no disgorgement will be ordered."

*Matter of Natural Blue Resources, Inc.*, 2015 WL 4929878, at *33 (Aug. 18, 2015) (ALJ Foelak).

Finally, a "court may exercise its equitable power only over property causally related to" a violation of the federal securities laws. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989); *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978); *SEC v. Jones*, 476 F. Supp.2d 374, 386 (S.D.N.Y. 2007). Here the charge is that Taylor and Poulson obtained illegal proceeds from their respective violations. But fees for custodial services, even if negligently performed, are not proceeds from the Taylor and Poulson violations.

**C. Civil Monetary Penalty**

While charging this as a negligence case, but not proving it, the Division now seeks "maximum" Third Tier penalties. And it asks for multiple penalties. The Division seeks 19 separate penalties for ETC's custodial services relating to Poulson notes, and 2 separate penalties for Taylor's custodial services relating to Taylor notes.

While the Division realizes that it cannot seek penalties for activity before July 22, 2010, the Dodd Frank effective date, most of the notes used for its penalty calculation were simply customer-directed renewals of their earlier notes, where the customer actually invested before July 22, 2010. There should be no penalty here for the reasons stated above, but if there were to be a penalty, it should be limited to one course of action. *E.g. Matter of Havanich*, 2016 WL 25746, at *11, I.D. Rel. 935 (Jan. 4, 2016) (ALJ Foelak); *Matter of Natural Blue Resources, Inc.*, , at *33, I.D. Rel. 863 (Aug. 18, 2015) (ALJ Foelak); *Matter of Riad*, 2014 WL 1571348, at *34, I.D. Rel. 590 (Apr. 21, 2014) (ALJ Foelak).

The Division's penalty calculation asks the Court to apply the penalty provision in Securities Act §8A in a manner that would deny due process. Section 8A(g)(2)(A), (B) and (C) allow a penalty for "each act or omission described in" Section 8A(g)(1), which in turn describes only a unitary act – the act of being "a cause" of a violation – thus suggesting that in the normal course only a single course of action should form the basis for a computation. Instead, the Division here arbitrarily seizes on notes renewed after July 2010 as being separate bases for penalties, as in other cases it has seized on a variety of other supposedly separate actions. *See Rapoport v. SEC*, 682 F.3d 98, 108 (D.C. Cir. 2012) ("SEC must provide some meaningful explanation for imposing sanctions"); *Rockies Fund,* Inc. *v. SEC*, 428 F.3d 1088, 1099 (D.C. Cir. 2005) ("SEC's penalty analysis was not just superficial; it was nonexistent" and "arbitrarily and capriciously imposed" penalties).

## CONCLUSION

The ALJ's Initial Decision should be affirmed. If it is not affirmed, the Commission should find for ETC on the points raised in its cross-petition and dismiss this proceeding.

October 17, 2016
(corrected Oct. 18)


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### Certificate of Compliance

The undersigned certifies that this brief contains 15,944 words, based on the word-count function of the Microsoft Word software used to prepare the brief.

*/s/ Stephen J. Crimmins*
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## CERTIFICATE OF SERVICE AND FILING

I certify that on October 19, 2016, I caused the foregoing corrected filing to be filed with the Office of the Secretary of the Commission via hand-delivery by courier and to alj@sec.gov via email, and served copies on the following persons:

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