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November 23, 2015

**VIA ELECTRONIC AND U.S. MAIL**

Office of the Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: *In the Matter of Equity Trust Company*, SEC Administrative Proceeding, File No. 3-16594

Dear Sir/Madam:

Equity Trust Company ("ETC") is today filing with the Commission, via electronic and U.S. Mail, in connection with AP File No. 3-16594:

(1) Respondent's Prehearing Memorandum.

Dated: November 23, 2015

Respectfully submitted,

Brian M. Walsh
Counsel for Equity Trust Company

U.S. SECURITIES AND EXCHANGE COMMISSION



Matter of

EQUITY TRUST COMPANY, A.P. File No. 3-16594

Respondent.

# RESPONDENT'S PREHEARING MEMORANDUM

Respondent Equity Trust Company ("ETC") files this prehearing memorandum pursuant to Rule 222(a) of the Rules of Practice and as directed by the August 26, 2015 scheduling order.

After a statement of facts that tracks much of the OIP, this memorandum discusses: (i) the recognition by federal and state authorities that self-directed IRA custodians like ETC do not have the duties underlying the Division's theories (**Point I**, p. 14 below); (ii) how, consistent with these authorities, ETC contractually limited its duties as a custodian (**Point II**, p. 19); (iii) the need for the Division to show scienter to establish "causing" a criminal violation, and its inability to show either scienter or negligence (**Point III**, p. 23); (iv) the missing "sufficient nexus" between ETC's specified activities and the criminal conduct of others (**Point IV**, p. 27); and (v) ETC's Constitutional objections (**Point V**, p. 38).

## STATEMENT OF FACTS

**Point A below** provides background on ETC and its business. **Point B** states the facts relating to Ephren Taylor. **Point C** states the facts relating to Randy Poulson.[1]

### A. Background on Equity Trust Company

ETC serves as a custodian of self-directed individual retirement accounts ("self-directed IRAs" or "SDIRAs"). Section 408 of the Internal Revenue Code permits a self-directed IRA to hold nontraditional investments such as promissory notes, unregistered securities, or real estate, while receiving the favorable tax treatment of an IRA. However the Internal Revenue Code requires that the self-directed IRA must be held at an account trustee or custodian, such as ETC. (OIP ¶1, 2, 11)

[1] Citations are to (i) the Division's own allegations in the Order Instituting Proceedings ("OIP"); (ii) Ephren Taylor's hearing deposition testimony ("Taylor Dep. __"), taken at FCI Texarkana on September 30 and October 1, 2015; (iii) the Division's and Respondent's hearing exhibits (respectively "DX-__" and "RX-__"); and (iv) the parties' expert reports, which have also been marked as exhibits.

Since 2001, ETC has operated as a trust company under authority granted by the State of South Dakota, which conducts biennial examinations of ETC. ETC's principal place of business is in Ohio. ETC has over 130,000 custodial customer accounts and approximately $12 billion of retirement plan assets under administration. (OIP ¶6) Of these over 130,000 customer accounts, the present matter involves approximately 80 accounts invested in entities connected with Ephren Taylor, and 26 accounts invested in entities connected with Randy Poulson. (OIP ¶30, 52)

**1. Express and Lawful Disclaimer of Duty.** An individual opened a self-directed IRA at ETC and became an ETC custodial customer by completing and signing an application agreeing to the terms of ETC's "IRA Custodial Account Agreement and Disclosure Statement." That agreement provided that ETC was "acting solely as a passive custodian to hold IRA assets," meaning that it was not "a fiduciary ... with respect to your IRA account," and that it acted only as the customer's "agent." It also stated that ETC did not "endorse any investment, investment product or investment strategy, ... investment advisor, representative, broker, or other party selected by [the customer]." (OIP ¶13, RX-92 to 96)

Such SDIRA custodial agreement provisions were consistent with industry practice. (OIP ¶13) The Securities and Exchange Commission has told investors that SDIRA custodians: "will generally *not* evaluate the quality or legitimacy of an investment and its promoters"; "likely have not investigated the securities or the background of the promoter"; "are responsible only for holding and administering the assets"; "generally do not evaluate the quality or legitimacy of any investment … or its promoters"; "explicitly state" in custodial agreements that the "custodian has no responsibility for investment performance"; and "usually do not investigate the accuracy of" any available financial information. "*SEC Investor Alert: Self-Directed IRAs and the Risk of Fraud*," pp. 1-2 (2011). (RX-46)

Acting for state regulators, the North American Securities Administrators Association has likewise told investors that an SDIRA custodian: "does NOT research or perform due diligence reviews or recommend investments to clients"; "is a passive company that simply serves as an intermediary"; is "responsible only for holding and administering the assets" in an SDIRA; does "not evaluate the quality or legitimacy of any investment ... or its promoters"; and "only reports the information provided by the issuer and does NOT verify the accuracy of the information." NASAA, "*Third-Party Custodians of Self-Directed IRAs*," pp. 1-2 (Oct. 2014). (RX-47)

**2. Disclaimer of Duty Confirmed in Each Investment Direction.** After the SDIRA custodial agreement was executed and the account was opened, the customer funded the self-directed IRA by, for example, rolling over funds from a traditional retirement account such as a Roth IRA or 401(k) plan. (OIP ¶13) The ETC customer could then invest funds held in the self-directed IRA in any investment not specifically prohibited by the Internal Revenue Service,

including real estate, interests in limited liability companies and limited partnerships, or in loans made to third parties. The investment was made through the submission of a written Direction of Investment ("DOI") form to ETC signed by the customer. The DOI form directed ETC to transfer funds for a particular investment as described in the DOI form. (OIP ¶14)

Directly above the customer's signature at the bottom of the DOI form for each customer investment (on "page 4 or 4"), it stated: "**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.** ..." Immediately below this statement, the customer signed and dated. (RX-97 to 99, emphasis in original)

The DOI form included many of the same disclosures as in the custodial agreement, including that ETC was a passive custodian and did not endorse any investment or issuer. (OIP ¶14) In particular, the DOI form (RX-97 to 99, §§1, 3-6) stated that:

- ETC "does not offer any investment advice, nor does it endorse any investment product or investment strategy";
- ETC "does not endorse any ... party involved with an investment";
- it is the customer's "own responsibility to perform proper due diligence";
- any review by ETC "shall be solely for Custodian's own purposes ... and in no way should be construed as an endorsement";
- "the acceptance of any investment should not be construed as an endorsement";
- "Neither Custodian nor any employee or agent of Custodian has selected or recommended any investment for me";
- ETC "is acting solely as a passive custodian ... and in no other capacity"; and
- ETC shall be under no obligation or duty to investigate, analyze, monitor, verify title to or otherwise evaluate any investment."

In confirming each customer's investment, ETC's "onboarding" letter to the customer expressly stated (i) that the customer had the "responsibility to guarantee delivery of all documents pertaining to your investment(s) to Equity Trust Company"; and (ii) that the customer was responsible to "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) ETC disbursed funds as directed by the customer in the DOI form, irrespective of whether or when the customer delivered all of the documentation relating to the investment. While delivery of these documents was solely the responsibility of the customer, for certain investments, such as loans on real estate secured by a mortgage, if a mortgage or deed were recorded in the county recorder's office, a copy of the recorded deed or mortgage only became

available after the investment was made. ETC's quarterly account statements listed any missing documentation the customer had not provided, and noted the maturity dates of particular investments.

**3. Reviews of Accounts.** ETC on its own initiative conducted "primary" and "secondary" reviews of investments held in its customers' accounts. (OIP ¶16) As stated in ETC's Investment Review Procedure, the purpose of these reviews was to (i) determine whether the investments were "administratively feasible" for ETC, and (ii) "despite its limited role vis-a-vis its customers," to assess ETC's "exposure to litigation risk due to such investments." (OIP ¶17) ETC's custodial agreement provided (§8.05(b)) that "[a]ny review performed by us with respect to an investment shall be solely for our own purposes ... and neither such review nor its acceptance should be construed in any way as an endorsement of any investment, investment company or investment strategy." Primary reviews were done at the inception of an investment to determine whether, among other things, the investment was appropriate from an Anti-Money Laundering and Bank Secrecy Act perspective and not a type of investment prohibited by the IRS.

ETC conducted "secondary reviews" of investments when certain thresholds were met, such as the number of investments with one issuer or total amount invested. As part of a secondary review, ETC's Audit Group considered whether ETC was holding all of the required documents, whether those documents had been properly executed, and whether income was being generated as expected. That information would then be provided to the Compliance Department for its review. Compliance would then present its findings to the ETC Governance and Risk Committee ("GRC"), made up of senior officers of ETC, including the CEO and the President / CFO. The GRC, per the Investment Review Procedure in place at the time, could decide to continue permitting those investments to be made, hold further investments in abeyance until additional information was received as to the investment, decide that no new investments may be made at ETC, or resign as custodian for any client holding the investment. (OIP ¶18)

**4. Management of Accounts.** ETC sent its customers a privacy disclosure statement that explained how ETC protected their personal and account information. The statement provided that ETC would only provide account information to third parties under limited, enumerated circumstances (e.g., to a successor custodian). In addition, ETC stated that it would share customers' personal information only in limited circumstances as permitted by law, including requests from law enforcement agencies, the IRS, or organizations that protect the customer's privacy. (OIP ¶21)

While nothing in ETC's privacy disclosure statement expressly permitted it to share personal or account information with issuers generally, neither the privacy statement nor ETC's Privacy Policy prohibited ETC from communicating with an issuer already designated for

investment by ETC's customer as to the status of a pending or consummated investment. Indeed, ETC's Privacy Policy explicitly recognized that such communications would be appropriate and necessary "for processing and servicing transactions," including to "effect a transaction requested or authorized by the consumer" and to "service or process a financial product or service requested or authorized by the consumer." (DX-46, exh. p. 14, orig. p. 12; RX-49)

ETC charged fees to its customers in connection with its custodial accounts, including account opening fees and annual fees, usually in the hundreds of dollars per account per year. ETC salespeople received commissions in connection with opening accounts, typically about $50 per account. Thus, for the approximately 100 custodial accounts referred to in the OIP, three ETC salespeople would have collectively shared a total of approximately $5,000 in commissions, spread over several years. (OIP ¶22) ETC salespeople were given a monthly custodial account opening goal, which would be part of their employee review. (OIP ¶23)

## B. Ephren Taylor and City Capital Corporation

Ephren Taylor ("Taylor") was the majority owner and chief executive officer of City Capital Corporation ("City Capital"), a Nevada corporation with its headquarters in Franklin, Tennessee. (RX-6, p. 1) At all times relevant to this proceeding, Taylor caused City Capital and related entities to raise funds by issuing promissory notes to investors who had accounts at ETC. City Capital did not have a class of securities registered under Section 12, but was subject to Exchange Act Section 15(d) periodic reporting requirements. (OIP ¶7, 8)

**1. Taylor's Financial Disclosures on Edgar.** Throughout the relevant period, and on a recurring basis, City Capital and its related entities publicly disclosed to prospective investors certain risks in SEC public filings signed by Taylor. The City Capital financial statements were accurate, were prepared by an outside accountant who had direct access to City Capital's books and records, and were audited by an independent public accounting firm. (DX-36, Taylor Dep. 229-32, 269-78)

For example in 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 – City Capital stated that: (i) City Capital's "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." (RX-2, pp. 8-9) (ii) Its net losses were continuing. (RX-2, pp. 8-9) (iii) Its ability to remain in business depended on "obtaining additional funding from the sale of its securities," and that its itemized outstanding notes had already jumped from a total of $1,980,008 payable at year-end 2007 to $3,777,556 at year-end 2008. (RX-2, p. 63) (iv) 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 risk disclosures to these also appeared in Capital City's 2008 Form 10-K/A, filed September 8, 2009 (RX-6), and its 2009 Form 10-K, filed June 15, 2010 (RX-1). Financial information and disclosures concerning City Capital's ongoing losses, accumulated deficit and other financial and business challenges similarly appeared in its Form 10-Q quarterly reports, and in other disclosures. As SEC filings, these disclosure documents were available in real time on the SEC's Edgar database, the tool used by the public to evaluate prospective investments.

**2. Taylor's National Notoriety and Image.** Taylor achieved considerable positive personal notoriety through, among other things, the following: On August 25, 2008, the Democratic National Convention presented Taylor as a speaker on "socially conscious investment." (RX-25, 227) Major media outlets uniformly profiled Taylor in a positive and attractive light, including news and interview broadcasts on ABC, CNN, Forbes, and NPR trumpeting Taylor's business success. (RX-241, 30, 31, 36, 84, 85) Megachurches presented and endorsed Taylor to their congregations. In late June 2009 – in the middle of the relevant period for this case – 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)

Building on the endorsements he received from the numerous business and religious leaders and through the aggressive use of outside marketing consultants, Taylor publicized himself as a highly successful businessperson focused on small, community-oriented businesses. He marketed himself and his investments through a series of traveling seminars and other events that he referred to as a "Wealth Builder Tour" or "Wealth Builder Network." (OIP ¶24) Taylor's mantra in his addresses to prospective investors and others was, "Let's make money together." Other than attending a single event at a church in Atlanta in October 2009, ETC never appeared at any of these events.

**3. Taylor-Related Investments.** Beginning in 2008, Taylor, through City Capital and other entities he owned and operated, raised funds from investors through the issuance of secured and unsecured promissory notes that paid interest rates from approximately 7% to 20% for terms of 1 year to 3 years (the "Taylor Notes"). Taylor and City Capital represented to investors that the funds raised would be used to purchase and support small, local businesses, such as laundries and juice bars, and real estate investments in low-income housing. (OIP ¶25)

Beginning in 2008, ETC opened self-directed IRAs for customers who used retirement funds to invest in Taylor Notes. Approximately 80 ETC custodial customers invested approximately $4.3 million in Taylor Notes. ETC received its standard custodial fees in connection with these custodial accounts. (OIP ¶30) Around the time ETC acted as self-directed

IRA custodian for these approximately 80 Taylor investors, ETC was acting as custodian for approximately 130,000 other self-directed IRA accounts.

We understand that when Taylor investors opened custodial accounts at ETC, their account opening documentation and the DOIs were at times filled out by a City Capital employee, who then delivered the documents – each of which was signed by the customers – to ETC. In at least 30 of the DOIs, the customers indicated that the promissory notes were "secured" by City Capital or other Taylor entities – *i.e.* secured by the very entities that were issuing the notes – without identifying any other specific collateral beyond the issuer's own promise to pay. Like the DOI forms, the promissory notes – also signed by the customers – did not themselves identify any specific collateral apart from the promises to pay by the issuing companies themselves. ETC processed these investments and sent custodial account statements that listed these notes as secured, reflecting the original statement in the DOI that the notes were thus secured. (OIP ¶41)

**4. ETC Staff Contact With City Capital Through June 2009.** In early 2008, an ETC SDIRA salesperson named Robert Batt ("Batt") was assigned to open the custodial accounts that were referred to ETC by Taylor. (OIP ¶31) Batt, like other ETC SDIRA salespersons, sought referrals of individuals who might open custodial accounts at ETC. Over the period of time relevant here, ETC opened approximately 80 accounts as a result of referrals from City Capital or its related entities, representing a small percentage of the accounts Batt opened.

Batt provided City Capital and Taylor with status updates on custodial customers who were directing ETC to transfer funds to City Capital and Taylor, including whether the custodial accounts were open, the timing of any transfer of funds into the custodial account, and the completion of any such transfer. This information informed Taylor when customer funds would be transferred to City Capital. Batt also communicated with Taylor every four to six weeks to make sure that City Capital was satisfied with ETC's performance as a custodian for Taylor's investors. (OIP ¶34)

In June 2009, ETC sent Batt to City Capital's offices in Raleigh, North Carolina for two days. While there, Batt trained approximately twelve City Capital employees, six in each of two sessions, concerning self-directed IRAs, and how to assist investors in opening self-directed IRA accounts at ETC. (OIP ¶36) This was the only time Batt or any ETC personnel ever actually visited any City Capital office. Taylor was not present during Batt's visit.

**5. "Landing Page" (August 2009).** In mid-August 2009 (possibly later), ETC added a public "landing page" with the heading "City Capital Corporation – Wealth Builder Network" as a subpage on ETC's own website. The landing page contained Batt's picture and contact information at ETC, as well as links to ETC's own documentation, including ETC's custodial account opening checklist and application form, ETC's DOI investment direction form, and

ETC's general information on real estate IRAs. (OIP ¶37) There was no information regarding City Capital or Taylor on the landing page. Apart from these generic information links to ETC documentation and information, the entire substantive text of the landing page read as follows:

> Welcome to the personalized Equity Trust Company page for members of the Wealth Builder Network. We're pleased to provide you with the support to grow your business and, in turn, help you grow your wealth. One way to invest in real estate is through a Self-Directed IRA, which allows you to maintain your liquidity and invest to build your wealth. With the help of Equity Trust Company, you can self-direct your IRA to invest in real estate, as well as other options. On this page, you will find links and key points about real estate IRAs – including overviews, types of real estate your IRA can purchase and guidelines for investing in real estate through a self-directed IRA. Below are the documents you need to get started. All you need to do is complete the Application, Transfer Form and Equity Investment Form. The term 'real estate IRA' encompasses any type of real estate investment in a self-directed IRA or 401(k). We've created a special checklist to ensure that you submit the proper forms and provide all documents necessary to open an account.
>
> Disclaimer: Equity Trust is a passive custodian and does not provide tax, legal, or investment advice. It does not endorse or recommend any contributor, company, or specific investments. Any information communicated by Equity Trust Company is for educational purposes only and should not be construed as tax, legal, or investment advice. Whenever making an investment decision, please consult with your legal, tax, and accounting professionals. The Wealth Builder Network educational discount applies to new educational program enrollments only and is not valid for already discounted programs.

**6. Appearance at a Single Taylor Event (October 2009).** City Capital invited Batt from ETC to attend an October 2009 event sponsored by Taylor at a large church in Atlanta, Georgia. Taylor presented to the congregation over multiple days, but Batt was in the audience for only one presentation. By then Taylor had referred individuals to ETC, and those individuals had opened custodial accounts at ETC and then invested in Taylor Notes. (OIP ¶38)

As part of his Wealth Builder Tour and other publicity efforts, Taylor spoke at literally hundreds of churches, community centers and other locations around the country over an extended period of time. But this October 2009 event – occurring almost at the end of the timeline of ETC's contact with Taylor – was the only time Batt or anyone else from ETC was invited to attend, or actually did attend, any City Capital or Taylor event. And this was the only time Batt or anyone else from ETC ever actually saw Taylor in person until Taylor was deposed at FCI Texarkana last month.

At the Atlanta church event, City Capital personnel distributed ETC marketing materials on IRA custodial accounts that were provided by ETC – materials also available on ETC's website. (OIP ¶39) The congregation's Bishop warmly introduced Taylor at the event as "my friend, my brother, the great Ephren Taylor." Taylor spoke before a large audience about problems with traditional investments in mutual funds and the benefits of alternative "socially conscious" investments. Taylor pointed out Batt in the audience, and said only the following about him:

> And so the thing is that I have a special – 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. ... (Event transcription, pp. 217-18) (RX-66, pp. 218-19)

> ... 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. (Event transcription, pp. 243-44) (RX-66, pp. 244-45)

The duration of these two comments combined was about one minute. With the sole description of ETC as an organization "where people who move a certain amount of money, you know, kind of have to put their stuff at – for thinking of things," it's hard to imagine anyone in the audience understanding what ETC was. Batt, who was sitting in the large audience, stood briefly and waved but did not have his own microphone to correct or otherwise respond to Taylor's description of Batt's profession. After Taylor's presentation, Batt spoke to a small number of persons in the church's lobby about the process for opening a self-directed IRA.

On returning to his office, Batt told his supervisor Keith Marsh about Taylor's reference to Batt as a "banker" at the Atlanta church event, but ETC took no further action to correct Taylor's reference to Batt. Thereafter, ETC opened IRA custodial accounts for a few individuals who had attended the church event and who then invested in Taylor Notes. (OIP ¶40)

**7. Review of Taylor-Related Accounts (Fall 2009).** On September 10, 2009, a few weeks before this Atlanta church event, ETC began a "secondary review" of the Taylor Notes associated with City Capital (but not all of the Taylor entities). (OIP ¶42-43) ETC's memorandum reflecting steps taken to carry out the secondary review over the next several months (RX-50) contains the following information: (i) Of 47 investments by 44 custodial clients, 23 had all documents on file, while 24 had document deficiencies. (ii) During the course of the review, ETC "requested missing documents" from City Capital. (iii) ETC's own research concerning Taylor and City Capital showed "no relevant securities violations," and "no negative news articles." There had been no customer complaints about Taylor or City Capital.

The last investment with Taylor that ETC accepted was on December 21, 2009, just two months after the Atlanta church event. (DX-40, p. 14) On December 23, 2009, ETC noted that it was still waiting for information from City Capital, and that 17 notes had matured. On that day, ETC determined to put City Capital on "hold" status. Approximately three weeks later, on January 13, 2010, ETC completed its secondary review. On that day, ETC determined to put City Capital on "DNP" (do not process) status. ETC's comment that day was that "Due to poor financial information and high concentration of unsecured notes decision was made that any further investments are not administratively feasible." (OIP ¶43-44) However ETC's quarterly account statements continued to advise its existing custodial customers already invested in City Capital of missing documentation and maturity dates, and customers with matured notes were aware that their notes had not yet been paid.

**8. Charges Against Taylor (2012 and 2014).** Two years later, on April 12, 2012, the SEC charged Taylor and City Capital with scienter-based (*i.e.* reckless or intentional) violations of Sections 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder in connection with the Taylor Notes. On August 8, 2012, the court entered a partial judgment as to Taylor, which enjoined Taylor from future violations of these provisions, and also barred Taylor from acting as an officer or director of a public company. On March 7, 2013, the court entered a default judgment against City Capital. (OIP ¶26)

Four years later, on June 10, 2014, Taylor was indicted by a federal grand jury on charges of conspiracy, mail fraud, and wire fraud in connection with offerings of these same promissory notes. Taylor pled guilty to one count of conspiracy on October 8, 2014. On March 17, 2015, Taylor was sentenced to 235 months in prison. On October 29, 2014, the Commission, pursuant to Section 15(b)(6) of the Securities Exchange Act, barred Taylor from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and from participating in any offering of a penny stock. (OIP ¶27)

## C. Randy Poulson and Equity Capital Investments, LLC

Randy Poulson owned and operated Equity Capital Investments, LLC, a New Jersey limited liability company that had its principal place of business in Swedesboro, New Jersey. Poulson, through ECI, issued promissory notes, purportedly secured by mortgages, to investors who had custodial accounts at ETC. (OIP ¶9, 10) Poulson also owned Poulson Russo, LLC, which he presented as a "premier" training organization for real estate investors.

Poulson promoted himself as an investor in residential real estate, and he conducted seminars on how to invest in real estate. (OIP ¶49) Among other things, Poulson held himself forth in the signature block on each of his emails 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) His online profile on Linked-In contained additional credentials. (RX-34)

**1. Poulson-Related Investments.** Beginning in at least 2007, Poulson, through ECI, offered to investors secured promissory notes that paid interest rates from approximately 12% to 20% for terms ranging from six months to several years ("Poulson Notes"). (OIP ¶48) Poulson referred certain of his Poulson Note investors to ETC to open self-directed IRA accounts. Between 2007 through 2011, ETC opened self-directed IRA accounts for 26 custodial customers who invested approximately $800,000 in Poulson Notes. ETC received custodial fees in connection with these custodial accounts. (OIP ¶52) Around the time ETC acted as IRA custodian for these 26 Poulson investors, ETC was acting as custodian for approximately 130,000 other IRA accounts.

**2. ETC Staff Contact With Poulson Through March 2009.** In early 2008, an ETC salesperson named Irene Berlovan ("Berlovan") was assigned to open the custodial accounts that were referred to ETC by Poulson. At the end of that year, on December 18, 2008, Berlovan sent an email to Poulson (RX-74) stating: "I have forwarded your information to Jeanette Arnholt, she will be the person that you will work to identify ways Equity Trust can support you from a marketing perspective. This will not replace me as your referral source as we have done thus far. I will still be involved in open the accounts and lining up the investment with the client." (OIP ¶53)

On February 12, 2009, Jeanette Arnholt, an ETC Channel Marketing Manager, emailed Berlovan (RX-75) stating: "I'm working with [Poulson] to see if he can be approved as a partner. He's working on his Education Mentoring Program and I think he talked with you about this about six weeks ago. We try to touch base regularly and I sent him the list of items I will need to submit to the committee to review if we can 'partner' with him or not. He is planning a

four day meeting in NJ area and we may have a speaking opportunity for Edwin [Kelly] and or you. I have to review with Brad first once we have all the info." On March 3, 2009, Arnholt emailed this review committee (RX-76) stating: "Here are the files to review and [sic] education partner. Randy Poulson is a client and had consistently been referring people to us. He's created an Education Mentoring Company called Poulson Rosso LLC. He's trying to bridge the gap between investor and seller and bringing them together. I'm attaching some marketing materials along with his operating agreement, certificate of formation and a presentation. He's looking for an exclusive arrangement with Equity Trust and services the New York // New Jersey // Philly area." As part of that process, ETC conducted a "guest speaker" review of Poulson. (OIP ¶54)

**3. Appearance at a Single Poulson Event (April 2009).** On April 17 and 18, 2009, Berlovan and Edwin Kelly, an SDIRA educational speaker with ETC's affiliate Retirement Education Group, attended one of Poulson's educational seminars. Prior to the seminar, Poulson emailed marketing materials to ETC referring to Poulson Russo LLC as a "preeminent training, coaching, and mentoring company" offering "national caliber training for real estate entrepreneurs." (RX-77) At Poulson's educational seminar attended by Berlovan and Kelly (for one day), they each gave a presentation on the benefits of self-directed IRAs, and Kelly sold ETC's educational CD sets that promoted the benefits of self-directed IRAs. ETC divided the proceeds of these CD sales with Poulson. ETC opened self-directed IRAs for seminar attendees, who used the funds in their ETC custodial accounts to invest in Poulson Notes. (OIP ¶55) Splitting proceeds from educational CD sales with an event host – here paying the host $4,819 – was consistent with ETC and industry practice. (RX-20)

In August 2009, Poulson sent an email to various entities engaged in the Southern New Jersey real estate investment industry, including title companies, appraisal firms, lawyers, accountants, real estate management companies insurance brokers, as well as ETC, asking them whether they would be willing to pay $600 to serve as a your-long sponsor of the Poulson-Russo monthly dinner events, which were described by Poulson to be focused on "'National-Caliber' education (with absolutely NO sales agenda from the stage ... and a 'comprehensive two-hour educational module straight from the Poulson-Russo curriculum'...." ETC initially indicated that it would agree to be one of the sponsors. Around the same time, Poulson initially indicated that he would pay $750, a discounted amount, to sponsor a session at an ETC conference he was personally unable to attend. ETC informed Poulson that sponsoring the session would give him "signage" and "mentions." (OIP ¶56) In fact, ETC never actually did pay to sponsor the Poulson-Russo dinner events, and Poulson never actually did pay to sponsor an ETC event.

On May 13, 2010, another ETC salesperson, Robert Yurgalewicz, replaced Berlovan as Poulson's ETC contact and provided Poulson with status updates on custodial customers who were directing ETC to transfer funds to Poulson for their investments with him, including whether the investor's custodial account was open, the timing of any transfer of funds into the account, and the completion of any such transfer. (OIP ¶57) The reality was that Poulson was a

very small source of referrals for Berlovan and Yurgalewicz that resulted in their opening a total of only 26 custodial accounts over the course of several years. (OIP ¶52)

**4. Review of Poulson-Related Accounts (2010-11).** Following an internal audit that was completed on June 29, 2010, ETC did a "secondary review" of the Poulson-related custodial accounts at ETC. The audit report had noted the following "inadequate documentation": "We have all DOIs[,] 9 mortgages are signed and not recorded, 16 are not signed or recorded[,] 10 Promissory Notes are not signed – titled correctly to IRA." The review showed that four Poulson Notes had matured and were unpaid. When ETC sought documentation from Poulson in November 2010, he promised to provide it, and ETC sent Poulson a list of needed documentation on November 30, 2010. (OIP ¶59, DX-209) On January 21, 2011, Poulson sent a portion of the needed documentation to ETC, and offered to send any additional documents still needed, including those "still with either my attorney or my title company." (DX-225)

Four months later, on May 11, 2011, ETC accepted its last investment with Poulson. (DX-41, p. 10) After an internal audit completed on July 11, 2011, ETC further reviewed the Poulson-related custodial accounts. The audit report had identified "inadequate documentation" in 25 out of 33 accounts, and noted that 13 matured notes were unpaid. On November 17, 2011, ETC determined to put Poulson on "hold" status and processed no new customer investments in Poulson Notes. (OIP ¶60) However ETC's account statements continued to advise its existing custodial customers already invested with Poulson of missing documentation and maturity dates, and customers with matured notes were aware that their notes had not yet been paid.

**5. Charges Against Poulson (2014).** Three years later, on May 13, 2014, the United States Attorney's Office for the District of New Jersey filed a criminal complaint against Poulson in connection with the Poulson Notes. On June 5, 2014, a federal grand jury returned an indictment charging Poulson with mail fraud and wire fraud. Poulson initially entered a plea of not guilty, but then changed his plea to guilty. (OIP ¶50) He will be sentenced on December 16, 2015, immediately after the hearing in this proceeding.

While the Poulson Notes were purportedly secured by mortgages of real property, some were not secured, and others were apparently secured by multiple mortgages on them. Poulson failed to sign many promissory notes and mortgages, and in many instances he failed to record the mortgages securing the notes. (OIP ¶48) Although Poulson told investors that the funds invested in Poulson Notes would be used to purchase, maintain, and improve the respective properties, including making payments on the existing mortgages, Poulson instead, unbeknownst to ETC, misappropriated a significant amount of the funds for his personal use. (OIP ¶49)

The Division has alleged that Poulson and ECI violated the federal securities laws in connection with the offering of Poulson Notes, including by using investor funds in ways contrary to what was represented to investors, failing to ensure the Poulson Notes were

sufficiently secured by mortgages of real property, and failing to record the mortgages. (OIP ¶51) However, the SEC has not yet charged Poulson with a violation of the federal securities laws.

## I. FEDERAL AND STATE AUTHORITIES DISAGREE WITH THE DIVISION'S VIEW OF SDIRA CUSTODIANS' DUTIES

The SEC (**Point A below**), the federal courts (**Point B**), state securities regulators (**Point C**), the IRS (**Point D**), and state banking regulators (**Point E**), all appear to disagree with the Division on the duties of SDIRA custodians. These federal and state authorities recognize that, in return for limited custodial fees, SDIRA custodians appropriately do not (i) evaluate an investment's quality or legitimacy; (ii) perform research or due diligence on a customer's investment; (iii) check the accuracy of available financial information regarding the sponsor of any investment; (iv) assume responsibility for investment performance; (v) independently verify accuracy of reported valuation and other information related to the investment; or (vi) obtain independent appraisals of hard-to-value assets.

### A. Securities and Exchange Commission

There are no SEC rules or regulations pertaining to the duties and responsibilities of SDIRA custodians. The only Commission pronouncement of any type on the duties of SDIRA custodians is its publication entitled "*SEC Investor Alert: Self-Directed IRAs and the Risk of Fraud*" (Sept. 2011). We know that this is the only Commission guidance because, as noted in the September 30, 2015 Order in this matter, p. 2, "Respondent requests Commission statements or guidance, if any, that show that [SDIRA] custodians were on notice of their purported duties under the securities laws and citations, if any, to other Commission enforcement actions or proceedings brought against SDIRA custodians. Apart from an 'Investor Alert,' referenced by both parties, the Division, in essence, denies that any such statements, guidance, or citations exist."

This sole Commission pronouncement on the duties of SDIRA custodians makes crystal clear – to investors and to the SDIRA industry – that SDIRA custodians like ETC do not perform due diligence or an evaluation of the investments that customers choose to put in their SDIRAs. In so acknowledging, the SEC has not expressed dissatisfaction with this limited role for SDIRA custodians or otherwise put them on notice as to any expanded duties. Specifically, the SEC has stated that SDIRA custodians:

- "will generally *not* evaluate the quality or legitimacy of an investment and its promoters";
- "likely have not investigated the securities or the background of the promoter";

- "are responsible only for holding and administering the assets";
- "explicitly state" in custodial agreements that the "custodian has no responsibility for investment performance"; and
- "usually do not investigate the accuracy of" any available financial information.

("*SEC Investor Alert: Self-Directed IRAs and the Risk of Fraud*," pp. 1-2). *Cf. WHX Corp. v. SEC*, 362 F.3d 854, 860 (D.C. Cir. 2004) (sanction vacated 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"); *Monetta Financial Services, Inc. v. SEC*, 390 F.3d 952, 957 (7th Cir. 2004) (sanction vacated where "no rules expressly required disclosure").

**B. Federal Judicial Precedent**

The courts have agreed with this SEC alert on the limited role of an SDIRA custodian. "Given this statement from the SEC [the SEC alert noted above] and the self-directed nature of the accounts, it is not plausible that plaintiffs [defrauded investors] as a general matter would rely on defendants [custodians] to seek out fraud or to perform fair market valuations." *Levine v. Entrust Group, Inc.*, 2013 WL 1320498, at *5 (N.D. Cal. Apr. 1, 2013). *Accord Grant v. Pensco Trust Co.*, 2013 WL 4772673, at *5-6 (N.D. Cal. Sept. 3, 2013) (also relying on SEC alert cited above); *Matkin v. Fidelity National Bank*, 2002 WL 32060182, at *3 (D.S.C. July 11, 2002) (custodial agreement similar to ETC's "clearly provides that Defendant maintained the SDIRA solely as a custodian, and did not undertake any other obligations with respect to Plaintiff's investment decisions"). *See also, Holtz v. Hilliard,* 1 F. Supp. 2d 887,890 (S.D. Ind. 1998) (IRA custodian "had no relationship with account holder which would even remotely support a duty to question his estate planning choices" and described custodian's duties as "holding retirement plan assets, making required tax law disclosures, and ensuring that the IRAs and retirement plans meet legal requirements of ERISA and other tax laws."); *Abbott v. Chemical Trust,* 2001 WL 492388, at *8 (D. Kan. April 26, 2001) (in granting custodian's motion for summary judgment, district court held that "to the extent [the IRA custodian] owed a duty to [its account-holders], that duty was limited to executing the particular transactions requested by [the account-holders]."

**C. State Securities Regulators**

On behalf of state securities regulators, the North American Securities Administrators Association ("NASAA") has likewise acknowledged, less than a year ago, that an SDIRA custodian:

- "does NOT research or perform due diligence reviews or recommend investments to clients";
- "is a passive company that simply serves as an intermediary";

- is "responsible only for holding and administering the assets" in an SDIRA;
- does "not evaluate the quality or legitimacy of any investment ... or its promotors";
- "only reports the information provided by the issuer and does NOT verify the accuracy of the information";
- has as its "sole responsibility ... to report information to the IRS and from the issuer to the investor"; and
- 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."

(NASAA, "*Third-Party Custodians of Self-Directed IRAs*," pp. 1-2 (Dec. 2014))

**D. Internal Revenue Service**

The Internal Revenue Service's instructions to Internal Revenue Service Form 5305-A, the "model" IRA custodial agreement issued under 26 U.S.C. §408, "explicitly provides that ... the IRA account holder and account administrator ... might choose to limit each others' duties and responsibilities through exculpatory provisions." *Mandelbaum v. Fiserv, Inc.*, 787 F. Supp. 2d 1226, 1239, 1241-42 (D. Colo. 2011) (dismissing claims against SDIRA custodians where accounts invested in the Madoff Ponzi scheme, and where Madoff allegedly "required" investors to use the defendant custodians). And IRA custodians are not fiduciaries:

> IRC §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. ...

*Hines v. Fiserv, Inc.*, 2010 WL 1249838, at *3 (M.D. Fla. March 25, 2010).

And as to reporting SDIRA asset values to the IRS annually, the IRS has made it clear that SDIRA custodians are not obliged to get independent appraisals of hard-to-value assets – assets without a regular trading market. In the leading IRS guidance, an August 6, 1993 response letter, Thomas Brisendine, Chief of Branch 1, Office of the Associate Chief Counsel for Employee Benefits and Exempt Organizations, states that in reporting valuation to the IRS, "[s]o long as the trustee [the IRA trustee or custodian] reports the information that it receives from the partners, it is under no obligation to appraise the investment independently." He adds that "[e]ven if the general partners are not forthcoming with the fair market value information, the trustees who are obligated to report FMV [fair market value] do not have to determine value independently to fulfill their obligation under the [Internal Revenue] Code." (RX-69, Siegel Declaration, ¶2-3, 5-6, Exs. A, C)

## E. State Banking Laws Governing Custodians

State banking legislation also provides a point of reference in understanding the duties of SDIRA custodians, and it lines up with the statements by federal and state authorities discussed above. ETC is headquartered in Ohio, and certain of its agreements incorporate Ohio law. In defining duties and standards for custodians, the relevant Ohio statute, Ohio Rev. Code § 5815.25 (B)-(D) (2013), provides that where the customer retains the power to "direct the acquisition, disposition, or retention of any investment," the custodian is an "excluded fiduciary" that is not responsible for losses resulting from the investment the customer has directed the custodian to make, and that has no obligation to "perform investment reviews" or to "make recommendations" as to the customer's investment:

> (B) If an instrument or other applicable written agreement describes, appoints, or directs a fiduciary to handle only the administrative duties and responsibilities of a trust, that administrative fiduciary shall not have any duties, responsibilities, or liabilities to the trust beneficiaries or to other persons interested in a trust except for those administrative duties and responsibilities specifically described in the instrument or written agreement. The administrative duties and responsibilities of a trust under this division may include any of the following: (1) Opening and maintaining bank, brokerage, financial, or other custodial accounts to receive trust income or contributions and from which trust expenditures, bills, and distributions may be disbursed; (2) Maintaining and handling trust records, reports, correspondence, or communications; (3) Maintaining an office for trust business; (4) Filing any trust tax returns; (5) Employing agents in connection with the fiduciary's administrative duties; (6) Taking custody of or storing trust property; (7) Any other similar administrative duties for the trust.
>
> (C) If an instrument under which a fiduciary acts reserves to the grantor, or vests in an advisory or investment committee or in one or more other persons, including one or more fiduciaries, to the exclusion of the fiduciary or of one or more of several fiduciaries, any power, including, but not limited to, the authority to direct the acquisition, disposition, or retention of any investment or the power to authorize any act that an excluded fiduciary may propose, any excluded fiduciary is not liable, either individually or as a fiduciary, for either of the following: (1) Any loss that results from compliance with an authorized direction of the grantor, committee, person, or persons; (2) Any loss that results from a failure to take any action proposed by an excluded fiduciary that requires a prior authorization of the grantor, committee, person, or persons if that excluded fiduciary timely sought but failed to obtain that authorization.
>
> (D) Any administrative fiduciary as described in division (B) of this section or any excluded fiduciary as described in division (C) of this section is relieved from any obligation to perform investment reviews and make recommendations with respect to any investments to the extent the grantor, an

advisory or investment committee, or one or more other persons have authority to direct the acquisition, disposition, or retention of any investment.

(emphasis added). *See also* Ohio Rev. Code § 5815.08(B) (As provided in section 5815.25 of the Revised Code, a trustee is not liable for losses resulting from certain actions or failures to act when other persons are granted certain powers with respect to the administration of the trust).

As the Division's expert William Ries notes, ETC "is a state chartered non-depository trust company operating under the laws of the State of South Dakota." ETC "is regulated and subject to examination by the South Dakota Division of Banking." (DX-39, Ries Expert Report, ¶13, 15) Looking to South Dakota law, it has a provision similar to the Ohio statute quoted above. Under South Dakota Codified Laws, §55-1B-2 (2008) (RX-48), and other provisions of South Dakota law, as a custodian under a custodial account agreement, ETC had no duty to review or modify any direction from a custodial account owner, and ETC was not liable under South Dakota law, either individually or as a fiduciary, for any loss resulting from compliance with the account owner's direction. In particular, ETC had no duty to perform investment or suitability reviews, inquiries or investigations, or to make recommendations or evaluations with respect to any investments for which the custodial account owner could direct the acquisition, disposition or retention. South Dakota law also relieved ETC of any duty to communicate with, warn, or apprise any party concerning instances where ETC may have exercised its own discretion differently than the custodial account owner. (RX-222, Prendergast Expert Report)

The Division's rebuttal expert Tim Simmons does not disagree with the foregoing. His question whether an Ohio law or South Dakota law would apply to ETC is not the point. (Simmons Rebuttal Expert Report) What is the point is that the duties of SDIRA custodians are repeated over-and-over with no material change by all relevant authorities – the SEC, federal courts, state securities regulators, the IRS – and also the state banking laws in Ohio, where ETC is headquartered, and in South Dakota, where ETC is chartered and regulated.

## II. ETC's CONTRACTS WITH CUSTOMERS CLEARLY AND LAWFULLY LIMITED ITS DUTIES AS A CUSTODIAN

Consistent with the foregoing, ETC included lawful and appropriate disclaimers of duty in its "DOI" investment direction form (**Point A below**), and in its custodial agreement (**Point B**). In these core account documents, ETC stressed that it was the customer's job to select, evaluate, review and monitor the "self-directed" investments the customer was choosing to make, and that ETC was excluded from fiduciary and other duties in this regard.

### A. ETC's Direction of Investment (DOI) Form

As noted above in the statement of facts, ETC's custodial customers instructed their custodian ETC to make particular SDIRA account investments by submitting to ETC a so-called "DOI" or "Direction of Investment" form. The DOI form directed ETC to transfer out funds to make the investment indicated in the DOI form. (OIP ¶14) Immediately above the ETC customer's signature at the bottom of each and every DOI form for each customer investment (RX-97-99, p. 4), it defined ETC's role and duties as follows:

> "**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.** ..." [emphasis in original]

Immediately below this statement, the customer signed and dated. 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. ...
>
> 2. This investment is not FDIC insured and may lose value. In addition the investment selected by the undersigned may lack liquidity; may be speculative and involve a high degree of risk; and may result in a complete loss of the

investment. Any loss sustained in my Retirement Account will not affect my retirement income standard. ...

5. Custodian is acting solely as a passive custodian to hold Retirement Account assets and in no other capacity.... Custodian has no responsibility to question any investment directions given by me....

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. ...

10. The undersigned represents to Custodian that if my investment is a "security" under applicable federal or state securities laws, such investment has been registered or is exempt from registration under federal and state securities laws; and the undersigned releases and waives all claims against Custodian for its role in carrying out the instructions of the undersigned with respect to such investment. ...

11. The undersigned authorizes and directs Custodian to execute and deliver ... any and all documents ... in connection with my investment; and Custodian shall have no responsibility to verify or determine that any such 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.

13. ... The undersigned understands that Valuations of illiquid assets (assets that are not traded on a public exchange) are generally reported at cost, or values provided to us by issuers, program sponsors, Retirement Account owners or estimates of value. These values are only for guidance or reporting purposes

and should not be deemed an accurate representation of true fair market value of the asset. ...

14. Custodian's responsibilities and duties shall be limited to those expressly provided herein and under Custodian's ... custodial account agreement as in effect from time to time; and Custodian shall have no liability to the undersigned, whether for negligence, breach of fiduciary duty or otherwise, except for a breach of the terms of this Agreement ... or custodial account agreement of Custodian as may be in effect from time to time. ...

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

**B. ETC's Custodial 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 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; and (vi) that ETC had no responsibility to verify or assure completeness of investment documentation.

ETC's custodial account agreement set forth ETC's duties and responsibilities to custodial customers in relevant part as follows:

8.03 Representations and Responsibilities: (a) By performing services under this Agreement we are acting as your agent. You acknowledge and agree that nothing in this Agreement shall be construed as conferring fiduciary status upon us. We shall not be required to perform any additional services unless specifically agree to under the terms and conditions of this Agreement. ....

(f) Investment Conforms to All Applicable Securities Laws. You represent to us that if any investment by your IRA is a security under applicable federal or state securities laws, such investment has been registered or is exempt from registration under federal and state securities laws; and you release and waive all claims against us for our role in carrying out your instructions with respect to such investment. ...

8.05 Investment of Amounts in the IRA: (a) In General. You have exclusive responsibility for and control over the investment of the assets of your IRA. ...

(b) Custodian Acting in Passive Capacity Only. We are acting solely as a passive custodian to hold IRA assets and we have no discretion to direct any investment in your IRA. Accordingly, we are not a fiduciary (as said term is defined in the Internal Revenue Code, ERISA, or any other applicable federal, state or local laws) with respect to your IRA account. ...

It is not our responsibility to review the prudence, merits, viability or suitability of any investment directed by you or your investment advisors or to determine whether the investment is acceptable under ... applicable law. We do not offer any investment advice, nor do we endorse any investment, investment product or investment strategy; and we do not endorse any investment advisor, representative, broker, or other party selected by you. We have no responsibility to question any investment directions given by you or by any investment advisor or representative appointed by you.

It is your responsibility to perform proper due diligence with regard to any such representative, investment advisor, broker or other party. We will follow the directions of any such investment advisor, representative, broker or other party selected by you provided you furnish us with written authorization and documentation acceptable to us, and the custodian will be entitled to all the same protections and indemnities in our reliance upon and execution of the directives of such investment advisor or other party as if such directives were given by you.

We shall be under no obligation or duty to investigate, analyze, monitor, verify title to, or otherwise evaluate or perform due diligence for any investment directed by you or your investment advisor, representative or agent; nor shall we be responsible to notify you or take any action should there be any default with regard to any investment.

Any review performed by us with respect to an investment shall be solely for our own purposes ... and neither such review nor its acceptance should be construed in any way as an endorsement of any investment, investment company or investment strategy. ...

We have no duty or obligation to notify you with respect to any information, knowledge, irregularities or our concerns relating to your investment or your investment advisor, broker, agent, promoter or representative, except as to civil pleadings or court orders receive by us.

... [W]e shall remit funds as directed, but have no responsibility to verify or assure that such funds have been invested to purchase or acquire the asset selected by you.

(RX-92-96 (emphasis supplied); cf. RX-90-91).

## III. ETC DID NOT POSSESS THE REQUIRED MENTAL STATE TO "CAUSE" TAYLOR'S AND POULSON'S CRIMINAL FRAUDS

As discussed in **Point A below**, the Division should have to prove scienter to establish a "causing" violation of the Taylor and Poulson criminal acts. However even if negligence were hypothetically the standard, as discussed in **Point B**, the Division cannot show that ETC acted with either scienter or negligence.

### A. Scienter Required to "Cause" a Criminal Fraud

In administrative proceedings charging "causing" liability under Securities Exchange Act §21C (or its counterpart Securities Act §8A), the Staff must show that the respondent had at least the mental state required to prove the primary violation charged. *Matter of KPMG Peat Marwick LLP*, 54 SEC 1135, 2001 SEC LEXIS 98, *82-*84 (Jan. 19, 2001), *aff'd*, 289 F.3d 109, 120 (D.C. Cir. 2002). *See also Howard v. SEC*, 376 F.3d 1136, 1142 (D.C. Cir. 2004). The D.C. Circuit Court in *Howard*, in considering the standard of causing culpability under Section 21C(a) of the Exchange Act, noted that the SEC did not cite the negligence standard for causing liability in that case where, unlike as in the *KPMG* case, scienter was an element of the primary violation. Taylor and Poulson were charged with criminal primary violations based on criminally "willful" conduct that, while prosecuted as mail and wire fraud, would also violate Securities Act §17(a) and Exchange Act §10(b). For this reason, under the rule laid down by the Commission in *KPMG*, the Staff should have to prove that ETC likewise acted at least "willfully" in causing the primary criminal violations charged against Taylor and Poulson.

Had Taylor and Poulson only been charged with civil primary violations of §17 and §10(b), the *KPMG* rule would still require the Division to prove that ETC acted with scienter, the mental state required for civil violations of §17 and §10(b).[2] The Supreme Court has defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud," and pointed out that scienter requires "intentional or willful conduct designed to deceive or defraud investors." *Dirks v. SEC*, 463 U.S. 646, 664 n. 23 (1983), quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 193-94, n. 12, 199 (1976). Scienter is "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to

[2] In addition to the Justice Department's criminal case, the SEC filed a civil case against Taylor.

the defendant or is so obvious that the actor must have been aware of it." *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

The Division seeks to work around the *KPMG* holding by arguing that there is embedded inside every scienter-based violation a lesser-included negligence-based violation. Such an approach would eviscerate the *KPMG* holding, as the Division could use the approach in virtually every case that presented an underlying scienter-based violation. This is on its face unreasonable and definitely not what the Commission said in *KPMG*, in which one of ETC's undersigned counsel was lead counsel for the Division.

**B. ETC's Conduct Does Not Demonstrate Either Scienter or Negligence**

From all available public information, ETC and many others saw Taylor and Poulson as well-regarded business persons and entrepreneurs with only positive information and no negative information about them. And ETC did not hear complaints about them from customers. Nevertheless, as described below, following an internally-designed review process that ETC was pioneering in the SDIRA industry without any obligation to do so, ETC's management proactively reviewed both Taylor and Poulson, became uncomfortable with particular aspects of each, and independently determined to stop accepting customer investments with both. All this took place years before law enforcement made any accusations against either.

These are plainly not the acts of one seeking to "cause" a criminal securities law violation. While Taylor or Poulson had collectively referred about 100 of ETC's 130,000 customers, ETC declined to take new accounts referred by either. Such conduct plainly does not satisfy the "willful" or "reckless" mental state required to establish "causing" liability here, as discussed above. Indeed, such conduct would not even rise to the level of negligence.

**1. ETC's Assessment of Taylor.** Taylor presented to ETC and literally millions of people nationwide as an exceptional young man committed to what is often called "socially responsible investing" or "SRI," a concept which has grown rapidly in recent years, with SRI investments now said to account for "more than one out of every six dollars under professional management in the United States."[3] Taylor, the son of a Missouri pastor, sought to raise investments in his entities, including City Capital, to deploy in projects such as rehabilitating and constructing affordable housing, and supporting small businesses in challenged neighborhoods.

[3]"Report on US Sustainable, Responsible and Impact Investing Trends 2014," a report by US SIF – The Forum for Sustainable and Responsible Investment, p. 12, http://www.ussif.org/Files/Publications/SIF_Trends_14.F.ES.pdf. *See, e.g.*, "Buffett's Grandson Seeks Own Investment Route: Social Change," N.Y. Times, Nov. 21, 2015, p. B1 (Columbia professor forming company to deploy its investors' money in startups committed to projects like breeding crickets for ecologically sound animal feed, and a machine to convert humidity to drinking water).

In so doing, he also presented a personal history of success from humble beginnings to a string of business successes at a very early age.

Nationally prominent individuals and organizations endorsed Taylor and his ideas and presented him to audiences counted in the millions. On August 25, 2008, not long after the first ETC customers began investing with Taylor, the Democratic National Convention presented Taylor as a speaker on "socially conscious investment."[4] Throughout the period, ETC customers invested with Taylor, major media outlets profiled Taylor in a positive light, including ABC, CNN, Forbes, and NPR, while megachurches like New Birth Church in Atlanta and Joel Osteen's Lakewood Church in Houston, and numerous other churches, presented him to their congregations.[5] In late June 2009 – just months before ETC conducted its review of Taylor described below – 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.[6] (RX-27 to 31, 39, 40) Taylor's book "Creating Success From the Inside Out" was then a 250-page Wall Street Journal best-seller published by the venerable Wiley & Sons, a 200-year old technical publisher in New York. (DX-36, Taylor Dep. 207-08).

Irrespective of Taylor's prominence, ETC conducted a review – indeed one of its very first secondary reviews – of Taylor and City Capital beginning in September 2009. At the time ETC was beginning to conduct these new secondary reviews, City Capital had already exceeded the customer and dollar thresholds that automatically triggered that review. After beginning its review of City Capital on September 10, 2009, ETC noted that about half of the accounts it reviewed had full documentation, and the other half did not. ETC's research turned up no negative news articles, and no relevant federal or state decisions or securities violations. ETC confirmed that City Capital was a validly existing and active Nevada corporation. ETC's summary of its phone interview with Taylor as part of the review (DX-534) stated:

> ... He does 60-90 seminars across the country every year on a variety of topics including economic empowerment, entrepreneurialism and business development. He always includes self-directed retirement investing in those seminars. He does not promote any particular investment in his seminars. They are strictly educational. His investors come as a result of the seminars and word

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[4] Available at: http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahi9UWYLBJZA.

[5] *See* Sept. 17, 2014 Vice.com article at: http://www.vice.com/read/the-black-bernie-madoff-000442-v21n9. *Also see* ABC print and video coverage at: http://abcnews.go.com/US/ephren-taylor-accused-11-million-christian-ponzi-scheme/story?id=20030745. National Public Radio's interview of Taylor is available at: http://www.npr.org/templates/story/story.php?storyId=9913840

[6] Available at: http://www.volunteeringandservice.org/past-conferences/2009/.

of mouth. He has a huge following in the US and around the world. He has been on all the major networks and all the major financial networks. Requested missing documents. Recommend continuing.

The last DOI investment direction that ETC accepted for a Taylor customer was December 21, 2009. (DX-40, p. 14) On December 23, 2009, an ETC compliance representative phoned Taylor for additional information, and was told the requested information would be supplied. However, ETC put Taylor on "hold status" that day, subject to "clear[ing] up with operations the issue of 17 notes that have matured." ETC then opened no new accounts for investors planning to invest with Taylor, and formally put him on "DNP" (do not process) status on January 13, 2009. (DX-534, p. 2)

At this point, ETC had enough concern regarding City Capital's financial condition and unpaid matured notes to determine that new Taylor accounts would be "not administratively feasible." (DX-534, p. 2) However ETC did not have any information to contend or even suggest – either to customers who had previously invested with Taylor or to the public – that he might be perpetrating fraud or other violations. Customers agreed in their DOI investment direction forms that ETC would 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 (¶12)

**2. ETC's Assessment of Poulson.** Poulson presented to ETC and many others as solid and responsible, and as particularly knowledgeable about real estate investing in his region. (RX-77) He was the president of his regional real estate investment association, the South Jersey Real Estate Investors Association (f/k/a South Jersey Investors), a chapter of the National Real Estate Investors Association. (RX-78-81) He regularly ran well-attended multi-day educational seminars for residential and commercial real estate investors in the South Jersey-Philadelphia area. (DX-746, 747, 761, 762)

ETC conducted a secondary review of Poulson in 2010, reflected in ETC's review documentation on Poulson, at a point when 18 ETC customers were invested with Poulson, actually just shy of the specified 20-customer threshold for such a review. (DX-256) The review showed that ETC had received DOI instruction forms from all 18 customers who had directed ETC to invest their SDIRA accounts with Poulson. However the review also showed that all of these customers had failed to send ETC one or more documents necessary to complete the files for their accounts. On November 15, 2010, ETC compliance representative Mary Juristy phoned Poulson and asked him to directly provide the customers' missing documentation, which Poulson agreed to do. Juristy noted that Poulson said "anything we need to keep file updated they are happy to provide." On November 30, 2010, Juristy sent Poulson a "detailed list

of documents required for file." (DX-209) Over the next several months, Poulson began sending customer documentation to ETC, including on January 21, 2011, when he sent a portion of the needed documentation to ETC, and offered to send any additional documents still needed, including those "still with either my attorney or my title company." (DX-225)

Four months later, on May 11, 2011, ETC accepted its last DOI investment direction for a Poulson customer. (DX-41, p. 10) By July 11, 2011, an ETC re-review of Poulson showed that some of the then 26 customers had adequate documentation in their ETC files, but many files were still incomplete. On September 20, 2011, ETF staff recommended putting Poulson on "hold" status, meaning ETC would take no new accounts planning to invest with Poulson, based on continued missing documentation and the fact that by then a number of notes had matured without payment. ETC's staff simultaneously tried to contact Poulson for an explanation. (DX-256, p. 2) ETC's staff also obtained a 2011 LexisNexis profile of Poulson that disclosed a 2003 criminal case against a business associate. (DX-258, pp. 35-37)

ETC's review committee accepted the ETC staff's recommendation on November 17, 2011, and placed Poulson on "hold" status. (DX-256, p. 2) As with Taylor, any concerns ETC had at that point did not support charging Poulson with fraud or other violations, or suggesting such violations, to persons who had already invested their money with Poulson or others. And again, ETC's DOI investment direction forms provided that ETC would have "no duty or obligation to notify" the customer of "any information, knowledge, irregularities or concerns ..., except as to civil pleadings or court orders received by Custodian." (RX-97-99, p. 4 (¶12)

## IV. THE MISSING "SUFFICIENT NEXUS" BETWEEN ETC's ACTIVITIES AND THE TAYLOR AND POULSON FRAUDS

As discussed in **Point A below**, the particular ETC activities specified by the Division in its OIP allegations did not in fact "cause" the Taylor and Poulson criminal frauds. As discussed in **Point B**, absent a "sufficient nexus" between a respondent's conduct and another person's violation, there can be no "causing" liability.

### A. ETC's Challenged Activities Did Not "Cause" Fraud

Once past the Division's angry rhetoric in the OIP, we see that it enumerates the following particular conduct as its basis for charging ETC with "causing" fraud. As to each of the Division's specified items listed below, ETC acted reasonably as an SDIRA custodian. But even if ETC hypothetically had not acted reasonably as to one or more of these items, this specified ETC conduct did not "cause" a fraud by either Taylor or Poulson.

**1. Gathering Account Documentation.** With respect to obtaining the documentation supporting their chosen investments, ETC stressed to customers that it was their obligation to obtain the documentation and furnish it to ETC. And not ETC's obligation to chase after the investment documents of 130,000 customers in 50 states pursuing a wide range of self-directed "alternative" investment strategies, many with widely varied forms of documentation. In this regard, ETC's custodial account agreement with the customer stipulated:

> 8.05 Investment of Amounts in the IRA: ... (c) Investment Documentation. In directing us with respect to any investment, you must utilize our Direction of Investment form suitable to such investment or such other form acceptable to us. ...
>
> 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 (emphasis supplied)

In addition, ETC's "onboarding letter" for each investment, advising the customer that the funds had been transmitted as the customer had instructed to make the investment, reminded the customer to supply the investment documentation. The letter told the customer to "[p]lease remit the following original documents to Equity Trust Company within sixty days of this letter," and then listed missing documentation for the investment.

In addition to thus itemizing the particular missing documentation that the customer still needed to supply to ETC, the onboarding letter repeated ETC's disclaimer of any duty to police documentation and reminded that it was the customer's job to do this: "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)

ETC disbursed funds as directed by the customer in the DOI form, and the disbursement could be before or after the customer's delivery of all of the documentation for the investment. For certain investments, such as loans on real estate secured by a mortgage, if a mortgage or deed were recorded in the county recorder's office, the recorded deed or mortgage, if any, could only become available after the investment was made.

In addition, in situations where customers persisted in failing to provide missing investment documentation, ETC gave them a reminder on their quarterly account statements.

The account statement listed the 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, following the words "AWAITING RECEIPT." The quarterly statements also provided the "MATURITY DATE" of promissory notes, so customers receiving statements after the maturity date would know that the maturity date had already passed.

Finally, if ETC determined to do a secondary review of an investment sponsor, based on volume and concentration thresholds, ETC would note and consider any missing documentation, and where possible, ETC acting as a volunteer would proceed to ask the sponsor to supply the missing documentation. If, despite all of the foregoing, certain customers were still missing documentation, this did not make ETC a "cause" the Taylor or Poulson frauds.

**2. "Secured" Status of City Capital Notes.** Certain customers who invested with City Capital furnished to ETC both (i) the customer's signed DOI form directing investment in a City Capital promissory note, describing that note as being "secured" by "the company," and identifying that company as being City Capital itself; and (ii) the promissory note itself, also signed by the customer as lender (and City Capital as borrower), that contained City Capital's promise to repay the customer at the end of the term. In virtually every case, the customer signed both the DOI form and the promissory note on or about the same day, as reflected in the date columns on Division's tabulation exhibit. (DX-40, pp. 10-14)

By signing the promissory note reflecting City Capital's promise to pay, and simultaneously signing the DOI form, the customer thereby saw that the customer's representation to ETC in the DOI form that the note was "secured" by "the company" referred simply to the company's promise to pay. No other form of security or collateral was stated in either document. The fact that it was the customer who personally signed and gave ETC these two documents as a direction to fund the investment, and ETC's acceptance of the documents as presented by the customer, does not show that ETC was thereby "causing" City Capital to defraud the customer.

On this point it is also important to note that, in confirming each customer's investment, ETC's "onboarding" letter to the customer advised (i) that the customer was responsible to "verify with your investment company or the person responsible for securing your collateral that they have performed accordingly to protect your interest"; and (ii) that the customer, not ETC, had the "responsibility to guarantee delivery of all documents pertaining to your investment(s) to Equity Trust Company." (RX-142, p. 10)

Finally, in the course of conducting its "secondary review" of City Capital in Fall 2009, a member of ETC's internal audit team noted that "Based on the audit / compliance review of the

investments – the notes that are classified as 'Secured by Other' will need to be revised to the Unsecured Note class." (DX-434) The fact that ETC – in the midst of the review ETC initiated of City Capital – determined to change its own classification of the notes likewise does not show that ETC was "causing" City Capital to defraud the customer.

**3. "Landing Page" for Taylor Investors to Download SDIRA Forms.** The record in this matter contains no evidence that Taylor or Poulson touted or even mentioned ETC on the websites they presented to their prospective investors. And an examination of an archived version of Taylor's City Capital website affirmatively shows that Taylor did not mention ETC at all. (RX-225, Golbeck Expert Report; DX-799) Indeed, Taylor was promoting his own IRA account, which he called the "City Capital 'Active' IRA." Again not what you would expect from someone supposedly using ETC to get credibility.

The record likewise contains no evidence that ETC's own website mentioned Taylor or Poulson – with a single exception. During the last two to four months that ETC accepted new accounts from Taylor investors, the ETC website had a "landing page," a sub-page where individuals who had decided to invest with Taylor could go to download linked SDIRA account opening forms, as well as ETC's own linked generic literature on using IRA accounts to buy real estate. (DX-576)

Apart from these links, the entire City Capital "landing page" contained only two substantive text paragraphs. The first paragraph was simply a welcome that resembled other landing pages on ETC's site – with no unique or different treatment for City Capital, and no recommendation of investments in City Capital – and read as follows (DX-576):

> Welcome to the personalized Equity Trust Company page for members of the Wealth Builder Network. We're pleased to provide you with the support to grow your business and, in turn, help you grow your wealth. One way to invest in real estate is through a Self-Directed IRA, which allows you to maintain your liquidity and invest to build your wealth. With the help of Equity Trust Company, you can self-direct your IRA to invest in real estate, as well as other options. On this page, you will find links and key points about real estate IRAs – including overviews, types of real estate your IRA can purchase and guidelines for investing in real estate through a self-directed IRA. Below are the documents you need to get started. All you need to do is complete the Application, Transfer Form and Equity Investment Form. The term 'real estate IRA' encompasses any type of real estate investment in a self-directed IRA or 401(k). We've created a special checklist to ensure that you submit the proper forms and provide all documents necessary to open an account.

This welcome paragraph thus talks about investing in real estate using SDIRAs, not investing in Taylor notes. And its language is copied verbatim or in substance from examples of other "landing pages" on the ETC site that have been provided in the Division's exhibit. (DX-576)

The second substantive paragraph of the City Capital landing page on ETC's site was a "Disclaimer" that once again stressed that ETC was a passive custodian, that ETC did "not endorse or recommend" any investment, that ETC did not provide investment advice, and that ETC advised prospective customers to consult others on investment decisions, as follows:

> Disclaimer: Equity Trust is a passive custodian and does not provide tax, legal, or investment advice. It does not endorse or recommend any contributor, company, or specific investments. Any information communicated by Equity Trust Company is for educational purposes only and should not be construed as tax, legal, or investment advice. Whenever making an investment decision, please consult with your legal, tax, and accounting professionals. The Wealth Builder Network educational discount applies to new educational program enrollments only and is not valid for already discounted programs.

(DX-576, emphasis added)

The short life of the landing page ended when ETC determined not to take new accounts investing in City Capital. Batt first told City Capital that the page was "live" on August 14, 2009, but it may actually have gone live at a later date. As late as October 12, 2009, Batt appears to have been still talking with ETC's technical staff about the content that would go into the landing page. (DX-338, 360) However, whether the landing page's actual live date was in August or October, its functional lifespan was a maximum of about four months, as ETC took its last Taylor investment on December 21, 2009 (DX-40, p. 14) and put Taylor on "hold" status on December 23, 2009 (DX-534, p. 2), and did not accept any new accounts after that date.[7]

But even if a prospective customer did visit the page, the person would have seen on the page the plain disclaimer of investment recommendations by ETC quoted above, and not an endorsement of Taylor. Likewise, any account opening forms downloaded from the landing page would have repeated that disclaimer of investment recommendations. Again, ETC was not "causing" Taylor's fraud by providing links to account forms and a disclaimer on this page.

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[7] Assuming the landing page was being tracked by the Google Analytics service – an assumption that has just been placed in question – it may be that few or no visitors actually used this landing page to download the forms it provided. (RX-225, 226, Golbeck Expert Report; Risalvato Rebuttal Expert Report) Whether the page was being tracked, as ETC had assumed it was, depends on whether certain computer code was added to the surviving HTML versions of the page before the page went live back in 2009. We have so far been unable to lay that foundation.

**4. Attendance at New Birth, a Single Taylor Event.** The first and only time anybody from ETC personally laid eyes on Taylor was at an event just two months before ETC stopped accepting new accounts that planned to invest with him. (DX-36, Taylor Dep. 302) The event was on October 20, 2009 at Atlanta's New Birth mega-church, whose Bishop warmly introduced Taylor as "my friend, my brother, the great Ephren Taylor." This introduction by the Bishop, who "said a lot," gave Taylor "significant" credibility in addressing the Bishop's church audience, which numbered about 10,000 people, and Taylor had his "sales staff and team" there to personally pitch investments in City Capital. (DX-36, Taylor Dep. 292-95, 301-02) Two months later, on December 23, 2009, ETC advised Taylor that it would not take new accounts from his investors. (DX-534, p. 2)

By the time of the event at New Birth, Taylor had spoken at hundreds of similar events, including at dozens of churches around the country. Taylor realized that by holding events at churches, the churches were vouching for him and that this was "significantly influential." (DX-36, Taylor Dep. 213-217) Yet not once before did Taylor ask anybody from ETC to attend any of these many church and other events. (Taylor Dep. 217) This is certainly not what you would expect from someone supposedly trying to use ETC to get credibility in front of his audiences.

And Taylor did not need some IRA custodian from Elyria, Ohio that nobody in the audience had ever even heard of to get credibility with his New Birth audience. Taylor has acknowledged that his investors would never have heard of Pensco or Entrust (the custodians he used before Equity Trust), would never have heard of Equity Trust, and would never have heard of Sunwest or American Pension Services (the custodians he used after Equity Trust put him on "hold" and "DNP" status). (DX-36, Taylor Dep. 278-83)

People invested with Taylor based on his prominent national profile. As noted above, this included speaking at the 2008 Democratic National Convention on "socially conscious investment"; highly positive profiles and interviews by major media outlets, including ABC, CNN, Forbes, and NPR; presentations at many churches across the country; and the appearance just four months earlier, in late June 2009, at the National Conference on Volunteering, opened by the First Lady, that featured Taylor on a panel with the CEOs of eBay and KPMG that was moderated by David Gergen of CNN and Harvard. (RX-27 to 31, 39, 40; DX-36, Taylor Dep. 220-222) Taylor was also interviewed on ABC News' long-running "20/20" newsmagazine show, appeared twice on the Montel Williams Show, appeared on CNBC's "The Big Idea" with Donny Deutsch, the Tom Joyner Morning Show, and Fox News' "Your World" with Neil Cavuto, and was a regular weekly panelist on Bulls & Bears on Fox News. (DX-36, Taylor Dep. 209-13) People also read Taylor's best-selling book "Creating Wealth From the Inside Out," and saw his multiple 30-minute television infomercials on Fox, Black Entertainment Television, The Word Christian network, and other outlets. (Taylor Dep. 205-08)

From the New Birth stage, Taylor spent a total of about one minute recognizing the presence of ETC's Batt at the event and at one point had him stand up from his seat in the huge audience. Batt stood for a moment in the glare of the church's television lights with a deer-in-the-headlights frozen expression and waved. The totality of what Taylor said about Batt – who had no microphone to respond – in both mentions of him was the following:

> "And so the thing is that I have a special – 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. ..." (Event transcription, pp. 217-18) (RX-66, pp. 218-19)

> "... 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." (Event transcription, pp. 243-44) (RX-66, pp. 244-45)

Compared with Taylor's national exposure on popular television shows, political events, and print media – plus the solid endorsement by New Birth Church and its Bishop – this stone silent appearance by ETC's Batt as a figure out in the audience counted for nothing. This was plainly not an "endorsement of" or "vouching for" Taylor or City Capital. Nor did Taylor's unilaterally calling Batt his "banker" – with Batt lacking a microphone to reply – convert this Taylor comment into an endorsement of himself by ETC.

Just two months later, following a review required by volume and concentration levels, ETC put Taylor on "hold" status and ceased taking new business. (DX-534, p. 2) Again, ETC was not "causing" Taylor's fraud by Batt's single silent audience appearance.

**5. Attendance at a Single Poulson Event.** As with Taylor, over the course of several years of receiving customer referrals, ETC appeared at only one Poulson-sponsored event. As with Taylor, Poulson had numerous educational seminars and marketing events, but the Poulson-Russo educational event in April 2009 was the only one ETC attended. As with Taylor,

Poulson's single event to which he invited ETC, compared with so many not involving ETC, did not reflect a use of ETC by Poulson to boost his own credibility.

On April 17 and 18, 2009, ETC retirement specialist Irene Berlovan and Edwin Kelly, an SDIRA educational speaker with ETC's affiliate Retirement Education Group, attended the single Poulson educational seminar. Poulson's materials for the event presented Poulson Russo LLC as a "preeminent training, coaching, and mentoring company" offering "national caliber training for real estate entrepreneurs." (RX-77) At the seminar, Berlovan and Kelly each gave a presentation that the event transcript shows was focused solely on the benefits of self-directed IRAs, and not about Poulson or any entity connected with him, and Berlovan's presentation was simply an introduction that lasted a couple of minutes. (DX-824, pp. 269-71) Kelly also sold ETC's educational CD sets that promoted the general benefits of using self-directed IRAs to invest in a wide variety of investment categories, such as cell towers and real estate. ETC splitting proceeds from its own CD sales with Poulson as the event host – here paying the host $4,819 – was consistent with ETC and industry practice. (RX-20)

People invested with Poulson based on attending his numerous real estate seminars and other events across New Jersey and surrounding areas, as well as on Poulson's status as President of the South Jersey Real Estate Investors Association, the leading non-profit regional group for real estate investors. With a serious tone and business-focused style, Poulson's seminars portrayed him as knowledgeable, respected and experienced in real estate investing, and these sessions and his written materials were plainly the pitch that lured investors. Indeed, investors had already made the decision to commit to pay for admission to Poulson's seminars before actually seeing any vendors like ETC offering their respective services at such seminars. ETC did not "cause" Poulson's fraud by making a presentation regarding the myriad uses of an SDIRA (indeed alternative investments to Poulson's notes) at only one of Poulson's many events.

**6. Dorio Investment With City Capital.** Ephren Taylor has testified at his recent hearing deposition that he recruited Anita Dorio to invest with him through a number of direct personal presentations. Dorio first saw Taylor make a presentation at her mega-church, Pastor Joel Osteen's Lakewood Church in Houston. (DX-36, Taylor Dep. 185-86) When she expressed interest, Taylor and his two sales deputies, Chris Lewis and Anthony Hall, flew back to Houston to meet personally with Dorio and her spouse. (Taylor Dep. 184-86) Taylor, Lewis and Hall then met again personally with Dorio in New York and Kansas City to propose investments, and "during the sales process, they probably talked to her several times a week" by phone for "over a month." (Taylor Dep. 187-89, 191-92) ETC did not attend the Lakewood Church event, and did not attend Taylor's follow-up personal meetings with Dorio.

Following these multiple interactions with Taylor and his sales team, Dorio had by early January 2009 already determined to invest mostly money that she managed for her mother Virginia Wallace, as well as a relatively smaller amount of Dorio's own money. But Dorio ran into some resistance from Robert ("Rick") Wheeler, her investment adviser at AIG Financial Advisors. Batt noted in an email to Taylor on January 7, 2009 that AIG had "put the sell (Wallace/Dorio) orders in," and that ETC's legal counsel had opined that this was "an investment we can hold." (DX-278, 279) But on January 8, 2009, Wheeler of AIG wrote Dorio a letter, as follows (DX-830):

> I am sorry to see you move most of your assets away to do more "private placements" – the things you refer to as items that you can "see, feel and touch". (By the way this is a very clever marketing concept for these items, and will use it myself in the future.)
>
> As you must know, I do believe in these types of investments or I would not have sold you the Cole and Inland REITS [real estate investment trusts]. And, you may wonder why, if they are so good, why I did not just diversify you into more of these types of programs. Please understand that these programs are NOT without risk – especially if the economy continues to slow and the recession continues for some time. ...
>
> Anita, I care for you and your mom. I know you are a Christian and have prayed over this. So have I. Rather than just let you go, I feel I have been directed to ensure you have a full understanding of the all-encompassing risks as well as the benefits of what you may be getting into. ...

A few days after the AIG broker's January 7, 2009 sell orders and this January 8 letter, Dorio sent a January 14 email to Taylor's principal sales deputy Chris Lewis, with the caption "Getting into Wallace Accounts." In the email, Dorio gave Lewis the account number, and the secure username and password, for her mother Virginia Wallace's IRA account with Wheeler at AIG, custodied through Sunamerica Trust Company, as well as a smaller Wallace account. Dorio concluded her message to Taylor's colleague Lewis with the following: "Let me know if there's anything else you need or want. We have the victory and nothing else will hinder or delay this coming to pass." (RX-233) Thus, by the time Dorio wrote this email giving her AIG account password to Lewis at City Capital, Dorio was firmly committed to investing with Taylor. Again in Dorio's own words to Lewis on January 14, "nothing else will hinder or delay this coming to pass."

Dorio also copied this email to ETC's Robert Batt with a request that, "when the transfer is complete, please give me the total amount transferred from AIG." Batt briefly replied that he

would "follow up" with her "next week." (RX-233) Later the same day, January 14, 2009, Batt sent an email to Taylor that read in its entirety as follows:

> I did a conference call with Anita today and it was a good call. The broker at AIG blocked the transfer and sent Anita Dorio a letter. The letter basically trashed commercial real estate and said don't transfer out ... "you will regret it". It was so cheesy it sounded like a 1st grader wrote it. I said "Anita ... how can you comment on something you know nothing about ... how can this broker comment on real estate when he has never done it". She said "great point" lets do it ... we called the brokers PA/trading assistant ... they sold one bond (hence why transfer was rejected ... they did not sell everything) and the wire to us will go out Monday or Tuesday of next week ... I am on it ... I will close it .... Thanks for your business." [ellipses in original]

(DX-14) The foregoing chain of events shows that it was Taylor, Lewis and others at City Capital who sold Dorio on this investment, and further that Dorio had firmly made up her mind and set in motion the steps to invest with Taylor at a point well before Batt – then engaged in the mechanics of the account transfer – emailed that he would "close it." Again, ETC did not "cause" Taylor's fraud.

**7. ETC's Privacy Policy.** ETC adopted a privacy policy that expressly and reasonably allowed it to communicate appropriate customer information with third parties as part of carrying out the customer's intended transactions. The policy provided that ETC could disclose customer information, among other things: (i) "In the course of business to administer, enforce, or effect a transaction requested or authorized by the consumer"; (ii) "To service or process a financial product or service requested or authorized by the consumer"; or (iii) "To carry out a transaction or product or service the business of which the transaction is a part, and record, service, or maintain the consumer's account in the ordinary course of providing the financial service or product." (DX-46, exh. p. 14, orig. p. 12)

In Taylor's case, the customer would sign ETC's account application to open an ETC custodial account for the very purpose of investing with City Capital, and furnish information for ETC to transfer over funds held by the previous custodian. The customer would then sign a DOI investment direction form instructing ETC to disburse the funds to City Capital. With the customer's entire account opening and funding intended for the purpose of a City Capital investment, it was consistent with ETC's privacy policy for the ETC account-opening representative to communicate with City Capital – in informal email or phone communications – concerning the status of the funds transfer "in the course of business to administer ... or effect," or "to service or process," or "to carry out" the transaction its customer was requesting with City Capital. The same process and forms were used in the case of Poulson investments.

Thus, emails from Batt, Berlovan or Yurgalewicz concerning the transactions an ETC's customer was then requesting ETC to carry out did not violate ETC's privacy policy. This is the case whether the representative's language and tone was more formal or more familiar. The key point is that such communications did not "cause" Taylor or Poulson's fraudulent conduct.

**B. Absence of "Sufficient Nexus" for a "Causing" Violation**

As to each item of ETC's conduct in the Division's OIP allegations, there was not the required "sufficient nexus" between ETC's custodial services and the criminal violations of the securities laws by Taylor and Poulson that would be required to hold ETC responsible for a "causing" violation under Securities Act §8A or Securities Exchange Act §21C. For just this reason, in similar circumstances in *Matter of Public Finance Consultants, Inc.*, 2005 WL 464865, I.D. Rel. 274 (Feb 25, 2005), *notice of finality as to relevant parties*, SEC Rel. 33-8729 (Aug. 3, 2006), ALJ Kelly dismissed charges against a public authority's financial adviser PFC and its president Fowler in a case where the Division failed to prove a "sufficient nexus" between PFC and Fowler's conduct and the public authority's deception of purchasers of the authority's bonds:

> I conclude that the language in the [Authority's offering document] defined the limits of PFC and Fowler's engagement on the ... transaction in that Fowler was under no duty to speak to the Authority about perceived disclosure deficiencies in the offering document. ... Congress has not forbidden such limiting language by statute and the Commission has not forbidden it by regulation, interpretive statement, or adjudicatory opinion. ... If the Authority had insisted that Fowler perform a broader range of duties, Fowler could have negotiated a higher fee or withdrawn from the engagement. [2005 WL 464865 at *53 (emphasis added)] ...
>
> I conclude that it was beyond the scope of PFC's and Fowler's engagement to advise the Authority about the accuracy, completeness, or fairness of the disclosure language in the [offering document]. ... Finally, I conclude that Fowler had no duty to speak on disclosure issues on July 8, 1998, or at any other time. The Division has failed to prove a sufficient nexus between Fowler's silence and the Authority's violations. On that basis, I conclude that PFC and Fowler were not shown to be "a cause" of the Authority's violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act. [2005 WL 464865 at *55 (emphasis added)]

Similarly, in *Matter of Steinberg*, 2001 WL 1739153, I.D. Rel. 196 (Dec. 20, 2001), *dismissed by equally divided Commission*, 2005 WL 1584969, Rel. 2272 (July 6, 2005), ALJ Mahony rejected the argument that any act that contributes to a primary violation is a "cause" of that violation for purposes of a cease-and-desist order. Again based on the principle that the Division "must establish a sufficient nexus between the Respondents' alleged conduct and the underlying violations, if any," 2001 WL 1739153 at *39 (emphasis added), the ALJ dismissed charges against an audit partner for misrepresentations in its periodic reports:

> The Division further alleges that Steinberg caused Spectrum's violations by drafting and revising "inadequate" disclosures about these transactions in the footnotes to the financial statements in the First Quarter and Second Quarter Forms 10-Q. ... However, I conclude that Respondents did not cause these violations. ... His uncontradicted testimony, which I credit, is that he did not know until much later that the Apex and U.S. Robotics agreements were not signed in the quarters for which they were reported. ... I conclude, therefore, that the Division has failed to prove that Respondents caused Spectrum's violations of Section 13(a) of the Exchange Act and Rules 13a-13 and 12b-20 thereunder. Accordingly, the OIP must be dismissed. [2001 WL 1739153 at *43]

ETC had limited contact with Taylor and Poulson – who collectively had referred only about 100 of ETC's 130,000 custodial customers. ETC was merely providing the same kind of account custodial services offered by numerous vendors with whom customers were investing their SDIRA funds. Offering routine SDIRA custodial services for a modest and usual fee in the ordinary course of business lacked the required "sufficient nexus" to the criminal fraud being perpetrated by Taylor and Poulson.

Indeed, following routine internal concentration reviews, ETC made the affirmative decision to stop doing business with both Taylor and Poulson years before their criminal schemes were unmasked. Other SDIRA custodians dealt with Taylor and Poulson before, at the same time and subsequently, but ETC was the only SDIRA custodian that put Taylor and Poulson on "hold" or "DNP" status and stopped taking new accounts. Again, there is not the "sufficient nexus" to the fraud for "causing" liability.

## V. ETC's CONSTITUTIONAL OBJECTIONS

Respondent hereby asserts and preserves the Constitutional defenses stated in its Answer in this matter, as follows. Following the Dodd-Frank amendments, Pub. L. 111-203, § 929P(a) (2010), the Commission can now commence a litigated case against an unregistered person or entity either in federal court or through an administrative proceeding and get essentially the same

relief in either forum. After accepting the Division's recommendation for enforcement action, the Commission must not select a forum that will give the Division a procedural or other advantage, and it should not force an unregistered party into the administrative forum over that party's objection.

### A. Fifth Amendment Right to Due Process

ETC objects to the administrative forum because it benefits the Division and prejudices ETC for the following reasons, among others: **(i)** Although the Division has been able to take as many discovery depositions as it chose during its multi-year investigation, the Rules of Practice have denied ETC the opportunity to take any discovery depositions at all. **(ii)** Although the Division has already obtained responses to its requests for extensive document productions and other discovery, during investigations by the Fort Worth and New York offices, the Rules of Practice unfairly limit ETC's third-party discovery to limited-scope subpoenas during a short time span. **(iii)** The Rules of Practice lack rules of evidence, and thus result in a record that necessarily includes extensive amounts of hearsay evidence gathered by the Division during its lengthy investigation, without allowing ETC to test that evidence through cross-examination or otherwise. **(iv)** While two offices of the Division have had years to prepare its case with investigative subpoenas, ETC must proceed to hearing in just a few months under Rule 360(a)(2). **(v)** After being rushed to hearing, ETC will have to wait years for the Commission's *de novo* review of the initial decision, if review is sought by either side on any issue, before the Commission issues its "final decision," far longer than in federal district court.

### B. Seventh Amendment Right to Jury Trial

ETC objects that the administrative forum denies it a jury trial. A defendant should have the same Seventh Amendment right to demand a jury that the Commission and its staff have. However by allowing the Commission to pursue defendants for virtually the same relief in federal court or in administrative proceedings, the Dodd-Frank amendments have unwittingly upended this Constitutional balance in the following way. In situations where the Commission and its staff want a jury trial, the Commission always gets a jury by proceeding in federal court and filing a jury demand. However where the Commission and its staff do not want a jury, the Commission now has the opportunity to prevent the case from being jury-tried by instituting a non-jury administrative proceeding for virtually the same relief. This effectively means that the Commission and its staff get total control over whether there is a jury in its enforcement cases, regardless of whether, as here, the defendant wants a jury.

Such an imbalance in access to the jury process is unfair and offends both the Fifth and the Seventh Amendments. To be clear, the question is not whether Congress can commit certain types of civil law enforcement to the non-jury administrative forum. Rather, the question is

whether, in cases where an agency has power to choose the forum, it can routinely do so in a way that has the effect of reposing only in the agency the right to demand a jury – and to deny a jury to the defendant whenever the Commission does not want a jury. *See Tull v. U.S.*, 481 U.S. 412 (1987) (Seventh Amendment guarantees defendant right to jury trial in civil action where government seeks civil penalties); *Atlas Roofing v. Occupational Safety and Health Review Commission*, 430 U.S. 442 (1977) (no right to jury trial in administrative proceedings).

### C. Article II Requirements Concerning Executive Power and Appointments

Article II, Section 1, provides that the "executive power shall be vested in" the President. Article II, Section 2, provides that the President "shall appoint ... officers," and that Congress may allow "heads of departments" to appoint "inferior officers." Administrative Law Judges ("ALJs") are executive branch "officers" within the meaning of Article II. The SEC is a "department" of the United States, and the SEC Commissioners collectively function as the "head" of the "department" with authority to appoint such "officers" as Congress authorizes through legislation.

Such officers – charged with executing the laws, a power vested by the Constitution solely in the President – may not be separated from Presidential supervision and removal by more than one layer of tenure protection. In particular, if an officer can be removed from office only for good cause, then the decision to remove than officer cannot be vested in another official who also enjoys good-cause tenure. Yet SEC ALJs have not been appointed by the SEC Commissioners, and SEC ALJs enjoy at least two layers of tenure protection. SEC administrative proceedings therefore violate Article II of the U.S. Constitution.

## Conclusion

For the foregoing reasons, the Division will fail to carry its burden of proof at the hearing, and following the hearing this proceeding should be dismissed.

Dated: November 23, 2015

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## CERTIFICATE OF SERVICE AND FILING

Pursuant to Rule 150(c)(2), I certify that on November 23, 2015, I caused the foregoing reply to be sent: **(1)** by **email and US Mail** directed to Honorable Carol Fox Foelak, Administrative Law Judge, Securities and Exchange Commission, 100 F Street NE, Washington DC 20549-2557, and alj@sec.gov; **(2)** by **email and US Mail** directed to William Miller, OALJ Attorney-Advisor, Securities and Exchange Commission, 100 F Street NE, Washington DC 20549-2557, and millerwi@sec.gov; and **(3)** by **email and US Mail** directed to David Stoelting, Luke M. Fitzgerald, and Andrew Dean, New York Regional Office, Securities and Exchange Commission, 200 Vesey St., Suite 400, New York NY 10281, and StoeltingD@sec.gov, FitzgeraldL@sec.gov, and DeanAn@sec.gov. The **original and 3 copies** are being filed by **US Mail**, directed to the Office of the Secretary, Securities and Exchange Commission, 100 F Street NE, Washington DC 20549-1090.

Stephen J. Crimmins