Blogs
July 06, 2016
Asset Management ADVocate

SEC Judge Recognizes the Limits of Custodian Liability

In a recent enforcement proceeding, *In the Matter of Equity Trust Company*, the SEC sought to impose a standard of care to an IRA custodian that the administrative law judge ("ALJ") found to be "essentially made up of whole cloth." The ALJ dismissed the case due to this weakness, among other reasons. The SEC's loss illustrates the limits of liability for the acts of others. **Could a Passive Custodian "Cause" Fraudulent Behavior?** Equity Trust was a private corporation not registered with the SEC in any capacity. Equity Trust was a custodian for "self-directed" IRAs ("SDIRAs") that permitted investments in alternative assets such as promissory notes. Equity Trust advised customers that it was a passive custodian. The custodial agreement and direction of investment forms signed by customers made clear that the account holder was solely responsible for investment decisions, and that Equity Trust was a passive custodian, was not a fiduciary, that had no duties or responsibilities with respect to selecting or monitoring the investments. Equity Trust processed investments for customers referred by two promoters, Ephren Taylor and Randy Poulson, who were subsequently convicted of fraud. Representatives of Equity Trust had participated in certain marketing events conducted by the promoters. However, the ALJ found that it was Taylor and Paulson who promoted Equity Trust, not *vice versa*. Equity Trust had an investment review procedure in place and eventually stopped processing investments relating to Taylor and Paulson, but the reasons had nothing to do with suspected fraud. The SEC alleged that Equity Trust's procedures were deficient such that it was a "cause" of violations by the two promoters of Securities Act Sections 17(a)(2) and 17(a)(3). As the ALJ noted, Equity Trust could only be liable for causing a primary violation by the promoters if it knew, or should have known, that its conduct would contribute to the violations. **SEC Cannot Regulate Custodians through Enforcement** The SEC did not present any evidence that Equity Trust knew of the frauds carried out by the promoters, so the question before the ALJ was whether Equity Trust "should have known" that its acts or omissions would contribute to the promoters' violations. The SEC conceded that it had not established by rule a standard of care for IRA custodians. In fact, Equity Trust was not even subject to SEC regulation. The ALJ pointed out that when the SEC did speak on the duties of custodians of SDIRAs, the SEC said such custodians have "limited duties" and "generally do not evaluate the quality or legitimacy of any investment." Nevertheless, the SEC sought to impose (through enforcement) a standard of care for SDIRA custodians, based on the testimony of its expert witness. In strong words, the ALJ rejected the SEC's proposed standard of care as

> essentially made up of whole cloth and does not purport to represent or to improve on industry practice or reference industry practice at all."

The ALJ concluded that Equity Trust was not a cause of Taylor's or Paulson's violations. A custodian with limited duties known to the customer (and the SEC) cannot be said to have "caused" the violations of another when the custodian did not know nor should have known that its conduct would contribute to the violations. We have written elsewhere of the dangers of SEC enforcement based on a theory that an entity "caused" the violation of the primary actor, where the entity did not have actual knowledge of the violations and did not affirmatively participate in the violations. Violations often occur despite the policies and procedures that are in place. Such policies and procedures are rarely perfect and may not prevent violations. For entities that carry out specific and limited duties relating to investments directed and controlled by others, *Equity Trust* is a welcome decision.

Explore more in

Investment Management
Blog series

Asset Management ADVocate

The Asset Management ADVocate provides unique analysis and insight into legal developments affecting asset managers in the United States.

View the blog