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Self-Directed IRA Custodians Allegedly Getting a little too friendly with Fraudsters

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Self-Directed Individual Retirement Accounts (SDIRAs) – which allow individuals to invest their retirement nest egg in precious metals, real estate, partnership shares, promissory notes, race horses, or most anything else - appear to offer non-professional investors the ability to diversify their retirement portfolio in the same way more sophisticated investors can. And when put to proper use that may be true. Alas, SDIRA are also often the chosen vehicle of fraudsters and Ponzi schemers to separate investors from their hard earned money.

IRAs, in most cases, are restricted to traditional investments: market traded equities and debt, government paper, and so on. That limited scope of investment options and the electronic nature of the exchanges on which those investments are traded allows companies that generally manage IRAs - Fidelity, Vanguard and Charles Schwab - to ensure the security and safekeeping of your investments and handle the large volumes of transactions associated with those accounts.

The legal framework that governs SDIRAs is the same as any other IRA but because of the unique combination of administrative difficultly and legal risk associated with SDIRAs, those same large well know IRA custodians generally do not support these investments. Why? Those companies are simply NOT designed to support the diverse, small scale, physical investments that SDIRA often hold and generally do not feel the small volume of fees justify the regulatory and legal issues they raise. As a result, these types of investments are not approved for platforms at Fidelity, Vanguard and the like and they won't let you direct your money there.

The companies that will administer self-directed IRAs are not nearly as well known, but are also not as small as you might think. Millennium Trust Company, IRA Services Trust Company, Provident Trust Group, and Equity Trust Company – which is based in Westlake, OH – are a few examples of larger custodians in the SDIRA market. You may not have heard of Equity Trust, but it purports to have over 130,000 clients with more than $12 billion of retirement plan assets under custody.

So what does any of this have to do with Ohio's trial lawyers? Unfortunately SDIRAs, notwithstanding whatever legitimate utility they may possess, have become the preferred vehicle for Ponzi-schemers and fraudsters targeting innocent middle income investors. Fraudsters exploit self-directed IRAs because owners are allowed to hold unregistered securities in them, and custodians generally do not do any diligence on the offerings. Notwithstanding that most SDIRA custodians purport to be "passive" and pepper their SDIRA account agreements with statements to that effect, the purported "legitimacy" of SDIRA custodians is frequently a big part of the hook fraudsters use to attract their investors. And indeed, SDIRA custodians – who make money based on the number of accounts they service and the amount of money under management – have not meaningfully sought to avoid the association. In some cases they have gone so far as to embrace it, or so says the SEC.

On June 16, 2015, the Securities and Exchange Commission brought charges against Equity Trust[i], alleging that Equity Trust representatives participated in events at which fraudulent investments were promoted and ignoring serious red flags for accounts with investments that turned out to be fraudulent. Further, Equity Trust continued to charge the investors fees on their accounts even once it knew the investments in them were worthless. Investors were bilked for millions and Equity Trust benefitted.

Evidence suggests that this is not an isolated incident and that this practice does not begin and end with the two fraudsters involved in the SEC allegation. Our firm currently represents several investors who were victims of various Ponzi schemes that employed Equity Trust SDIRAs and who are making substantially similar allegations. Other cases involving other fraudsters and other SDIRA custodians are pending across the country. In those cases, as in most all of these cases, the Fraudsters are in federal prison and the money is long gone. So, aside from waiting for the slow grind of administrative justice, what can be done?

The civil justice system has yet to be widely successful in bringing the SDIRA industry to justice. While firms across the country, Spangenberg included, have started filing lawsuits, including class actions[ii], against SDIRA custodians who actively or knowingly facilitate acts of financial fraud, these cases are not easy.

SDIRA custodian contracts generally not only define the role of the custodian as "passive," they typically disclaim any fiduciary duty, any duty to actually undertake he very reporting and administrative services they are being compensated to perform, specifically prohibit any lawsuit being filed related to failed investments, and often include arbitration, fee shifting, and forum selection clauses as well anything else that might insulate the custodian from liability or deter lawsuits. There is some competition in the SDIRA custodian market, but it occurs along the axes of expense and customer service – no one reads the fine print.

But SDIRA custodians cannot write a contract that gives them the right to be active participants (or knowing and willfully silent bystanders) to a scheme to defraud. Claims of breach of contract, fraud in the inducement, and breach of fiduciary duty may be unsupportable where the custodian simply chooses not to know what it doesn't want to know. But those same claims should be viable in cases where the custodian was a necessary and knowing part of the scheme to defraud.

This is specifically the distinction that the SEC is drawing with regard to Equity Trust, alleging that "[d]espite the fact that Equity Trust promoted itself as a passive custodian that administered and custodied investments in self-directed IRAs at the request of its customers, Equity Trust took an active role in marketing the Taylor and Poulson offerings."

The allegations in the SEC complaint, which significantly mimic those in a pending class action case against Equity Trust, are a virtual road map of facts that pierce the pretense of a "passive" SDIRA custodian in a private civil action:

- Equity Trust appeared at events hosted by Taylor and Poulson where Taylor and Poulson solicited potential investors and where Equity Trust encouraged individuals to open self-directed IRAs.
- An Equity Trust salesperson also regularly spoke to individuals referred by Taylor and vouched for Taylor.
- Equity Trust sponsored Poulson's dinner events with prospective investors.
- In violation of Equity Trust's policies, many of the investments with Taylor and most of the investments with Poulson lacked proper documentation. Equity Trust's failure to obtain and hold documents reflecting the investments also was contrary to its statements to customers.
- Equity Trust knew that there were a number of mature and unpaid notes associated with Taylor and Poulson investments.
- In the case of Taylor, Equity Trust knew that Taylor made false statements about Equity Trust to an audience of thousands.
- Despite all of this information, Equity Trust continued to process and service its customers' investments with Taylor and Poulson.

So, if you have clients who have been victimized by a Ponzi scheme that required them to transfer funds from their retirement account and it appears all is lost because the fraudster is in prison and broke or on the beach in Laos drinking up your clients money, consider the role of the SDIRA custodian in endorsing, advancing or supporting the investment. While the cases are difficult, we are hopefully that the SEC's involvement will start moving them in the right direction.

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[i] https://www.sec.gov/litigation/admin/2015/33-9807.pdf, last viewed September 25, 2015

[ii] See, e.g., *Jacobs v. Equity Trust Co.*, Lorain County Court of Common Please Case No. 182283, *Moran v. Bromma*, No. 13-CV-00487 JAM-CKD (E.D. Cal., filed March 11, 2013); *Levine v. Entrust*, No. C 12–03959 WHA (N.D. Cal., filed Dec. 6, 2012).