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Custodial Collies of Transparency-The Competitive Advantage of Protecting Investing Lamm[bs] from Advising Wolves: *Lamm v. State Street Bank & Trust*

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Custodial Collies of Transparency—The Competitive Advantage of Protecting Investing *Lamm*[bs] from Advising Wolves: *Lamm v. State Street Bank & Trust*

I. INTRODUCTION

Unscrupulous investment advisers who defraud their unsuspecting clients are increasingly prevalent in our society.[1] Consequently, investors must be increasingly vigilant to protect themselves from such individuals.[2] A custodial bank is one way investors can prevent mismanagement and misuse of funds and securities they entrust to financial advisers.[3] However, the United States Court of Appeals for

1. *See, e.g.*, Roger Wohlner, *Beware of Financial Fraud,* THE SMARTER INVESTOR (Apr. 24, 2013, 9:42 AM), http://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2013/04/24/beware-of-financial-fraud.

2. *See, e.g.*, *id.*

3. Dana Anspach, *4 Ways A Custodian Protects Investment Fraud: Investment Fraud And Rogue Advisers Can Be Avoided By Using A Custodian*, ABOUT MONEY, http://moneyover55.about.com/od/avoidingfraud/a/investmentfraud.htm (last visited Jan. 23, 2015); *see* 17 C.F.R. § 275.206(4)-2 (2014); *see also* Wohlner, *supra* note 1.

the Eleventh Circuit opinion *Lamm v. State Street Bank & Trust*[4] illustrates that the mere presence of a custodial bank does not adequately insulate investors from fraudulent adviser activity.[5] Under current Securities and Exchange Commission (SEC) regulations, specifically 17 Code of Federal Regulations (C.F.R.) Section 275.206(4)-2[6] and boilerplate custody agreements,[7] custodial banks have no duty to verify the validity of account statement contents, which include transactions made by clients' investment advisers and adviser-provided market valuations of account assets.[8] Therefore, there is a strong incentive for custodial banks to distinguish their commoditized accounts by giving custodial account holders the option to supplement the custodial services banks traditionally supply with account services that facilitate increased transparency.

II. FACTUAL BACKGROUND

In 2001, Douglas Lamm hired James Tagliaferri's firm, Taurus Advisory Group, LLC (Taurus), as his investment adviser. In compliance with SEC regulation 17 C.F.R. § 275.206(4)-2, which prohibits investment advisers from having direct custody of client's funds and securities, Lamm opened two custodian accounts with separate qualified custodians.[9] The two custody agreements[10] (collectively custody agreements) Lamm executed for each account were identical in all relevant parts.[11] In 2007, State Street Bank & Trust Company (State Street), in conjunction with its merger with Investors Bank & Trust Company, acquired and assumed the obligations of both Mr. Lamm's custody agreements.[12]

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4. 749 F.3d 938 (11th Cir. 2014).

5. *See id.* at 951.

6. 17 C.F.R. § 275.206(4)-2 (2014).

7. As the third-largest custodial bank, State Street's custody agreements are common in the industry. *See Assets Under Custody, Worldwide*, GLOBALCUSTODY.NET, http://www.globalcustody.net/us/custody_assets_worldwide/ (last visited Jan. 23, 2015).

8. *See Lamm*, 749 F.3d at 941.

9. *Id.*; *see* 17 C.F.R. § 275.206(4)-2(a). Lamm opened an individual account with Chase Bank and an individual retirement account with Investment Bank & Trust Company. *Lamm*, 749 F.3d at 941.

10. Custody Agreements, Lamm v. State St. Bank & Trust Co., 889 F. Supp. 2d 1321 (S.D. Fla. Aug. 21, 2012) (No. 12-CV-80317), ECF No. 1-3.

11. *Lamm*, 749 F.3d at 941 n.1; *see* Custody Agreements, *supra* note 10.

12. *Lamm*, 749 F.3d at 941. Concurrently, James Tagliaferri moved Taurus Advisory Group, Tagliaferri's firm and Lamm's investment adviser, from Connecticut to the British Virgin Islands and reorganized it as TAG Virgin Islands Inc.—a registered investment adviser with the SEC that became, by merger, TAG Virgin Islands, LLC (collectively TAG). Complaint and Demand for Jury Trial at ¶ 12, Lamm v. State St. Bank & Trust Co., 889

Taurus Advisory Group, which became by merger TAG Virgin Islands

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F. Supp. 2d 1321 (S.D. Fla. 2012) (No. 12-CV-80317), 2012 WL 1578242 [hereinafter Complaint]; Tagliaferri, Admin. Proceeding File No. 3-15215, Exchange Act Release No. 68963, Investment Advisers Act Release No. 3555, Investment Company Act Release No. 30402, 2013 SEC LEXIS 715, at *2 (Feb. 21, 2013) (Sec. & Exch. Comm'n). It was at this time that Tagliaferri stopped investing his clients' funds and securities in conservative and liquid investments, such as blue-chip stocks and municipal bonds, and began fraudulently investing clients' assets in highly illiquid securities. These actions led to Lamm's suit against State Street bank. Tagliaferri at *4, *6-7. Furthermore, Tagliaferri failed to disclose material information to clients, including Lamm, about personal conflicts of interest he had regarding investments Taurus made for them and about repaying the clients of those conflicted investments with other clients' assets. *Id.* at *3. The latter practice is, as the SEC's institution of proceedings against Lamm noted, an archetypical "Ponzi-like scheme," *id.* at *1-2, and one that, as the Eleventh Circuit noted, has been rampant in our society since the 1920's. *See Lamm*, 749 F.3d at 951 & n.10 (citing JORDAN BELFORT, THE WOLF OF WALL STREET (2007) (the autobiography by Jordan Belfort, a former stock broker who pled guilty to securities fraud in 1999); MITCHELL ZUCKOFF, PONZI'S SCHEME: THE TRUE STORY OF A FINANCIAL LEGEND (2006) (a biography of Charles Ponzi, the father of the financial scheme named after him)). Those conflicted investments consisted of promissory notes issued by private companies controlled by or affiliated with individuals who provided Tagliaferri with kickbacks and other compensation in exchange for his purchase of those notes using client funds. Tagliaferri, at *2-3. When clients demanded payment on these notes as they neared or reached their maturity date, Tagliaferri paid the interest, principal, or both, by misusing assets of other clients. *Id.* at *3. Tagliaferri accomplished this asset misuse by using his authority over advisory clients' accounts to purchase thinly-traded corporate stocks from the same persons and entities that gave Tagliaferri kickbacks for purchasing their notes. *Id.* at *2-3. Specifically, these persons included Tagliaferri himself, his brother, an unnamed "Individual A," and International Equine Acquisition Holdings, Inc. (International Equine). *Id.* The proceeds made by the kickback-giving stock sellers were in turn used to make payments owed to Tagliaferri's clients. *Id.* TAG's recognizable Ponzi scheme death spiraled until its collapse between March 21, 2010, when it managed $261,000,000, and March 21, 2012, when it filed for Chapter 7 bankruptcy. *Id.* at *4-5. TAG's total assets under management plummeted from $261 million to $9 million between March 25, 2010 and March 31, 2011, according to its filings with the SEC. *Id.* at *4. Interestingly, International Equine, a primary issuer of the fraudulently traded notes in which Lamm was invested and a provider of kickbacks, was closely associated with Tagliaferri. *Id.* at *3. Big Brown, the thoroughbred race horse that won the Kentucky Derby and Preakness Stakes in 2008—but, due its loss at the Belmont Stakes, failed to complete the Triple Crown—was owned by International Equine. Nate Raymond & Joseph Ax, *U.S. Jury Convicts Adviser over Fraud Tied to Microcaps, NY Horse Firm*, REUTERS (July 24, 2014, 7:23 PM), http://www.reuters.com/article/2014/07/24/usa-crime-tagliaferri-idUSL2N0PS2WS20140724; *see also* Ryan Goldberg, *How Big Brown's People Nearly Pulled Off Horse Racing's Biggest Scam*, DEADSPIN (June 7, 2013, 4:49 PM), http://deadspin.com/how-big-browns-people-nearly-pulled-off-horse-racings-504679834 (claiming that Tagliaferri was the "decision-maker" of International Equine). Tagliaferri was similarly involved with Fund.com, a thinly-traded stock of which he bought a substantial amount of the stock involved in the Ponzi scheme, and UMS Partners Fund II, L.P., a company from which Tagliaferri purchased non-existent promissory notes in the same manner he did with Individual A. *See* Tagliaferri, *supra*, at *2-3.

(collectively TAG), was named as Lamm's investment adviser under the custody agreements and was authorized to furnish transaction instructions—including instruction to remit funds—to State Street on behalf of and without any further approval from Lamm. Contractually, State Street was obligated to send Lamm monthly statements of all transactions into or out of his account, with an itemization of all the funds or securities in that account and, if provided to State Street, their current market values. In the agreements, State Street disclaimed any guarantee as to the accuracy of those market valuations.[13] The waiver provisions in the contracts stated that Lamm was deemed to have ratified an account statement and State Street would be "released, relieved and discharged," with respect to it unless Lamm objected in writing within sixty days after the statement was issued.[14] Moreover, the choice-of-law provisions designated the laws of the state of New York to govern any disputes arising under the agreements.[15]

The opening paragraphs of the custody agreements stated that the accounts were "for the purpose of holding or disposing of any property" State Street received from, or on behalf of, Lamm.[16] When acting in accordance with issued instructions, State Street was also authorized to purchase and sell funds and securities in the custodial accounts as well as to receive and deliver such assets without receipt.[17] The agreements further authorized State Street to accept, rely upon and effectuate all the instructions, without any further confirmation from Lamm that it believed, in good faith, were issued by Lamm or on his behalf.[18] Additionally, the custody agreements disclaimed all liability for any act or omission attributable to State Street while acting in reliance on those instructions, unless that reliance was the result of State Street's gross negligence or willful misconduct.[19] However, a reservation-of-right clause gave State Street the right to refuse to deposit into the account

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13. Lamm v. State St. Bank & Trust Co., 889 F. Supp. 2d 1321, 1328 (2012), *aff'd*, 749 F.3d 938 (11th Cir. 2014); Custody Agreements, supra note 10, at *6-7 ¶ 14(A), *8 ¶ 19, *21-22 ¶ 14(A), *24 ¶ 19.

14. Custody Agreements, *supra* note 10, at *8 ¶ 19, *24 ¶ 19.

15. *Id.* at *10 ¶ 24(A), *26 ¶ 24(A).

16. *Lamm*, 889 F. Supp. 2d at 1328 (quoting the two agreements); Custody Agreements, *supra* note 10, at *16.

17. Custody Agreements, *surpa* note 10, at *2 ¶ 2(a), (b), (g), *16 ¶ 2(a), (b), (g).

18. *Lamm*, 889 F. Supp. 2d at 1328; Custody Agreements, *supra* note 10, at *5 ¶ 13, *20 ¶ 13.

19. *Lamm*, 889 F. Supp. 2d at 1328; Custody Agreements, *supra* note 10, at *5 ¶ 13, *9 ¶ 20(B), *20 ¶ 13, *24 ¶ 20(B).

any investment that it determined was not compatible, in form or condition, with the services it provided.[20]

Tagliaferri, TAG's principal, used the investing discretion afforded to TAG under Lamm's custody agreements to effectuate fraudulent investments that resulted in Lamm losing $1,028,500.[21] Specifically, Tagliaferri invested Lamm's assets in highly speculative stocks and purported promissory notes from micro-cap companies as well as in the form of personal loans and mortgages.[22] State Street accepted these

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20. *Lamm*, 889 F. Supp. 2d at 1329; Custody Agreements, *supra* note 10, at *2 ¶ 3, *17 ¶ 3.

21. Complaint, supra note 12, at ¶ 47.

22. *Lamm*, 749 F. Supp. 2d at 941; Complaint, *supra* note 12, at ¶ 47. Tagliaferri's acts have given rise to a substantial number of civil and criminal actions, as well as an SEC proceeding, against him. Following a jury trial, Tagliaferri was convicted on twelve counts in the United States District Court for the Southern District of New York for his fraudulent investments. Jury Verdict, U.S. v. Tagliaferri, No. 1:13-cr-00115-RA-1 (S.D.N.Y. July 24, 2014). The jury found Tagliaferri guilty of one count of investment adviser fraud, 15 U.S.C. §§ 80b-6, -17 (2012); 18 U.S.C. § 2 (2012), one count of securities fraud, 15 U.S.C. §§ 78j(b), 78ff (2012); 17 C.F.R. § 240.10b-5 (2014); 18 U.S.C. § 2 (2012), four counts of wire fraud, 18 U.S.C. § 1343 (2012), and six counts of violating the Travel Act, 18 U.S.C. § 1952 (2012). Jury Verdict, *supra*. Since the jury was unable to reach a verdict on one count of wire fraud and one count of violating the Travel Act, a mistrial was declared with respect to those counts. Jury Verdict, *supra*; Indictment at 23-24, 26, 28, 30 Tagliaferri, No. 1:13-cr-00115-RA-1, ECF No. 2, at 23-24, 26, 28, 30. Tagliaferri was released on bond with restrictions limiting his travel to the Southern District of New York and the United States District Court for the District of Connecticut and imposing home detention and electronic monitoring conditions. Order, U.S. v. Tagliaferri, No. 1:13-cr-00115-RA-1 (July 25, 2014), ECF No. 56. The district court entered a money judgment of $2,500,000 against the Tagliaferri and sentenced him to concurrent sentences of 60 months imprisonment (investment adviser fraud), 72 months imprisonment (wire fraud) and 60 months imprisonment (violation of the Travel Act). Order for Forfeiture of Property, U.S. v. Tagliaferri, No. 1:13-cr-00115-RA-1 (Feb. 19, 2015), EFC No. 136, at 2; Judgement, U.S. v. Tagliaferri, No. 1:13-cr-00115-RA-1 (Feb. 20, 2014), ECF No. 137, at 3. Tagliaferri appealed the district court's judgment. Notice of Appeal – Final Judgment, U.S. v. Tagliaferri, No. 1:13-cr-00115-RA-1 (Feb. 23, 2015), EFC No. 139.

The SEC has also instituted a proceeding against Tagliaferri for the frauds he committed against his advisory clients. Tagliaferri *supra* note 12, at *1. The Administrative Law Judge (ALJ) stayed the proceeding pending adjudication of the criminal action against Tagliaferri in the Southern District of New York. *E.g.*, Tagliaferri, Admin. Proceeding File No. 3-15215, Admin. Proceedings Rulings Release No. 2655, 2015 SEC LEXIS 822, at *1 (May 8, 2014).

On June 1, 2015, the ALJ lifted the stay and ordered the SEC Division of Enforcement to make its investigative file available to Tagliaferri. Tagliaferri, Admin. Proceeding File No. 3-15215, Admin. Proceedings Rulings Release No. 2750, 2015 SEC LEXIS 2187, at *2 (June 1, 2015). Accordingly, the SEC proceeding against Tagliaferri has now begun to run its course. *See* Tagliaferri, Admin. Proceeding File No. 3-15215, Admin. Proceedings Rulings Release No. 2797, 2015 SEC LEXIS 2306, *1 (June 10, 2015) (Order Following Prehearing Conference attended by Tagliaferri appearing pro se); *see also* Tagliaferri,

purported notes on Lamm's behalf and listed them on the monthly statements it issued to him even though the notes displayed facial defects.[23] In April 2011, State Street sent Lamm a letter stating that since September 2010 it had notified him on each monthly account statement that "illiquid, thinly traded and/or private placement securities" in his account had become past due or were past their specified date of maturity.[24] Additionally, the letter also stated that although TAG had previously provided the reported asset valuations, and despite State Street's repeated efforts to obtain updated valuations, the bank had not received valuation instructions since November 2010. As a result, State Street declared that, on future statements, it would not assign a value to those assets. Furthermore, on future statements the value of these assets would be indicated as zero only as an indication that a current valuation had not been received.[25] Finally, the letter reiterated that State Street did not provide independent valuations for "illiquid, thinly traded and/or private placement securities."[26]

Consequently, Lamm filed suit against State Street in the United States District Court for the Southern District of Florida. Lamm's seven-count complaint pleaded claims for breach of (1) express contract, (2) implied contract, and (3) fiduciary duty, as well as (4) negligence, (5)

Admin. Proceeding File No. 3-15215, Admin. Proceedings Rulings Release No. 2800, 2015 SEC LEXIS 2329, *1 (June 11, 2015) (Protective Order "covering documents in the [SEC Division of Enforcement's] investigative file that contain third parties' personally identifiable or sensitive financial information").

Furthermore, other clients have instituted actions against State Street Bank, and some, unlike Lamm, have also instituted actions against Tagliaferri and his associates for his fraudulent transactions. *See* Szulik v. State St. Bank & Trust Co., 935 F. Supp. 2d 240 (D. Mass. 2014); Handal v. State St. Bank & Trust Co., 941 F. Supp. 2d 167, (D. Mass. 2012); In re State St. Cases, Civil Action Nos. 12-11770-NMG, 12-11796-NMG, 12-11814-NMG, 12-11984-NMG, 12-11988-NMG, 12-12089-NMG, 12-12090-NMG, 12-12287-NMG, 12-12376-NMG, 2013 WL 5508349 (D. Mass. Sept. 27, 2013); *see also* Szulik v. Tagliaferri, 966 F. Supp. 2d 339 (S.D.N.Y 2013). Lamm presumably did not seek action against Tagliaferri because of State Street's obviously deeper pockets and the probability that, by the time a judgment was rendered, Tagliaferri would be unable to repay any substantial portion of Lamm's damages. Bill Singer, *State Street Prevails in Taurus Advisory Group Custodian Account Fraud, Broke and Broker* (Apr. 25, 2014), http://www.brokeandbroker.com/2388/state-street-taurus/. In fact, TAG filed for bankruptcy the day after Lamm filed suit in the district court. *Compare* Tagliaferri, *supra* note 12, *with* Complaint, *supra* note 12.

23. *Lamm*, 749 F.3d at 941 (discussing Complaint, *supra* note 12, at ¶ 30). Many of these purported promissory notes accepted by State Street were signed by the investment adviser—TAG or Tagliaferri acting through TAG—instead of the purported promisor(s), a blatant facial defect. Complaint, *supra* note 12, at ¶ 29.

24. *Lamm*, 889 F. Supp. 2d at 1324-25; Complaint, *supra* note 12, at ¶ 48.

25. *Lamm*, 889 F. Supp. 2d at 1325; Complaint, *supra* note 12, at ¶ 48.

26. *Lamm*, 889 F. Supp. 2d at 1324-25; Complaint, *supra* note 12, at ¶ 48.

gross negligence, and (6) aiding and abetting breach of fiduciary duty and (7) aiding and abetting fraud.[27] Included in each count were multiple allegations essentially claiming State Street beached its duties owed to Lamm by failing to properly monitor and verify the transactions made and valuations supplied by TAG.[28] State Street moved to dismiss Lamm's entire complaint, arguing that the custodial bank's role under the custody agreements was strictly ministerial, and therefore Lamm failed to state a claim upon which relief could be granted.[29]

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27. *Lamm*, 889 F. Supp. 2d at 1325. Lamm filed suit "individually and on behalf of the Douglass Lamm IRA" (Lamm). Complaint, *supra* note 12. In total, Lamm alleged that State Street breached its duties by:

> (a) accepting the fraudulent promissory notes; (b) failing to notify Plaintiff that certain purported promissory notes were signed by TAG rather than the purported obligor; (c) failing to notify Plaintiff that certain purported promissory notes were executed in favor of Hunter & Co. rather than Plaintiff; (d) disbursing funds to purchase securities without timely receipt of stock certificates in exchange; (e) disbursing funds to other, unknown accounts without receipt of any securities in exchange; (f) reporting false [Committee on Uniform Security Identification Procedures] CUSIP numbers on Plaintiff's monthly account statements; (g) reporting inaccurate, inflated, or false market values for the assets held in Plaintiff's accounts; (h) charging excessive custodial fees based on the inaccurate, inflated, or false market values; (i) failing to perform the auditing, reporting, and custodial duties required of IRA custodians; and (j) otherwise failing to notify Plaintiff and the SEC of the "obvious fraud" committed by TAG.

Lamm, 889 F. Supp. 2d at 1325.

28. *Id.*; Complaint, *supra* note 12, at ¶¶ 24-49.

29. *Lamm*, 889 F. Supp. 2d at 1325. The district court analyzed State Streets motion to dismiss, with respect to Lamm's fraud claims, under Federal Rule of Civil Procedure (FED. R. CIV. P.) 12(b)(6) through FED. R. CIV. P. 8(a), FED. R. CIV. P. 9(b), and other applicable case law. *Lamm*, 889 F. Supp. 2d at 1325-26 (stating that FED. R. CIV. P. 9(b) requirement is fulfilled when complaint states: "(1) precisely what statements were made in what documents or oral representations or what omissions were made; (2) the time and place of each statement and the person responsible for making (or in the case of omissions, not making) same; (3) the content of such statements and the manner in which they misled the plaintiff; and (4) what the defendants obtained as a consequence of the fraud"); *see also* FED. R. CIV. P. 12(b)(6) (2013) (motion to dismiss for "failure to state a claim upon which relief can be granted"); FED. R. CIV. P. 8(a) (2013) (requiring only "a short and plain statement of the claim showing that the pleader is entitled to relief"); FED. R. CIV. P. 9(b) (2013) (requiring that in all averments of "fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake"); Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009) ("To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'. . . A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged."); Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555 (2007) (holding that a FED. R. CIV. P. 12(b)(6) motion to dismiss does not require detailed factual allegations; however, "a plaintiff's obligation to provide the 'grounds' of his 'entitle[ment] to relief' requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action

The district court held that under Florida law the custody agreements' choice-of-law provisions were enforceable.[30] Accordingly, New York law governed Lamm's contract claims. However, the court held that the choice-of-law provisions did not embrace Lamm's tort claims.[31] Applying Florida's "'most significant relationship' test," the court determined that Florida law should be applied to Lamm's tort claims because Florida bore a more significant relationship to those claims than New York.[32]

The district court dismissed Lamm's breach of contract claim after finding that, under New York law, State Street did not breach any of the custody agreements' contractual duties.[33] The court accepted State Street's argument that none of the duties Lamm alleged State Street breached were encompassed by the bank's actual duties under the custody agreements.[34] The court also agreed that the bank's custodial

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will not do."); Hishon v. King & Spalding, 467 U.S. 69 (1984) (holding that the Court must accept all of the plaintiff's pleaded allegations as true when addressing a motion to dismiss under FED. R. CIV. P. 12(b)(6)).

30. *Lamm*, 889 F. Supp. 2d at 1326; *see* Custody Agreement, *supra* note 10, at *10 ¶ 24(A), *26 ¶ 24(A). The court applied Florida law to determine the enforceability of the custody agreements' choice-of-law provisions because "[f]ederal courts sitting in diversity jurisdiction must apply the substantive law of the forum state (Florida), including its choice of law rules." *Lamm*, 889 F. Supp. 2d at 1326.

31. *Lamm*, 889 F. Supp. 2d at 1326.

32. *Id.* at 1326-27. Under Florida's most significant relationship test,

> courts consider the following factors in order to determine which state has the most significant relationship to the incident giving rise to the tort: (a) the place where the injury occurred, (b) the place where the conduct causing the injury occurred, (c) the domicile, residence, nationality, place of incorporation and place of business of the parties, and (d) the place where the relationship, if any, between the parties centered.

Id. Since Lamm's assets were presumably located in Florida and he received his monthly account statements in Florida, the court found Florida to have the most significant relationship to Lamm's tort claims. *Id.* at 1327.

33. *Id.* at 1327, 1331. The court articulated applicable New York contract law and applied it to Lamm's breach of contract claim. *Id.* at 1331. Under New York law, to state a breach of contract claim a plaintiff must allege: (1) that a contract existed, (2) that the party seeking recovery performed the contract, (3) that the other party did not perform, and (4) damages by the party seeking recovery that are attributable to the breach. *Id.* at 1327.

34. *Lamm*, 889 F. Supp. 2d at 1329. State Street did not allege that the contact was unenforceable. *Id.* at 1327. Under New York law, the district court reads contracts in light of the parties' intent. *Id.* If the intent is clear from the contract, the provisions are to be interpreted in a way that gives them their plain meaning and purpose without stripping another provision of its effect. *Id.* Since the custody agreement clearly embodied the intent of the parties, the district court limited State Street's contractual duties to those expressly set forth in the custody agreement. *Id.* at 1331.

role was "merely administrative," and held that State Street was only contractually obligated to perform instructions provided to it by, or on behalf of, Lamm.[35] Above all, nothing in the agreements obligated State Street to ensure timely delivery of assets into the account, nor did it require State Street to verify the validity of investments it received.[36] In fact, the only discretion State Street contractually held was the reserved right to reject investments deemed incompatible, in form or condition, with the services the bank provided under the custody agreements.[37] The district court emphasized that Lamm's failure to object within the waiver provisions' sixty-day window was also fatally determinative to the breach of contract claim.[38] State Street's disclaimer of liability for claims arising from its reliance on issued instructions further barred Lamm's claim for breach of contract. Moreover, because the agreement did not require State Street to verify provided valuations, it could calculate its fees based on the values provided. Lamm's allegation that State Street charged excessive fees based on these valuations, therefore, also failed.[39]

Since the custody agreements imposed no contractual duty on State Street to discover fraudulent transactions, the obvious fraudulent nature of the promissory notes in Lamm's account was insufficient to support recognition of an independent duty. Accordingly, the district court held that Lamm's "tort claims for negligence, gross negligence, negligent misrepresentation, and breach of fiduciary duty" were, in the absence of an independent duty, barred by Florida's economic-loss rule.[40] State Street did not owe Lamm a fiduciary duty because, under Florida law, banks do not typically owe customers such a duty.[41] Moreover, in the custody agreements, State Street disclaimed any fiduciary responsibility.[42]

The district court also dismissed Lamm's aiding and abetting claims. Lamm's claim failed because the facts he alleged were insufficient to establish that State Street substantially assisted or encouraged the

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35. *Id.* at 1329.

36. *Id.*

37. *Id.*; Custody Agreements, *supra* note 10, at *2 ¶ 3, *17 ¶ 3.

38. *Lamm*, 889 F. Supp. 2d at 1330; *see* Custody Agreements, *supra* note 10, at *8 ¶ 19, *24 ¶ 19.

39. *Lamm*, 889 F. Supp. 2d at 1329-31.

40. *Id.* at 1332. The economic-loss rule allows a recovery for tort damages arising out of a contract only if the alleged tortious conduct constituted a tort independent of the parties' contractual duties. *Id.* at 1331.

41. *Id.* at 1331.

42. *Id.* at 1332; Custody Agreements, *supra* note 10, at *9 ¶ 20(A), *24 ¶ 20(A).

commission of any breach or fraud by Tagliaferri or that State Street had actual knowledge of any breach of fiduciary duty or fraud.[43]

III. LEGAL BACKGROUND

A. *SEC Rule 206(4)-2: Policy & Relevant History*

The Investment Advisers Act of 1940[44] (Advisers Act) was a Congressional effort, in light of the stock market crash of 1929, to prevent and eradicate fraudulent, deceptive, and manipulative practices by investment advisers.[45] In 1960, Congress amended the Advisers Act to give the SEC authority to promulgate rules and regulations that further the purpose of the Advisers Act.[46] Less than two years later, the SEC adopted the custody rule under 17 C.F.R. 275.206(4)-2 (Rule 206(4)-2),[47] which instituted a mandatory system of segregation between client and adviser assets designed to insulate client assets from an adviser's "financial reverses, including insolvency."[48] Under Rule 206(4)-2, advisers who have custody or possession of client's funds or securities are required to segregate the assets of each client in distinct trust accounts that name the adviser as agent or trustee.[49] In creating the original rule and all subsequent revisions, the drafters never intended or envisioned a system that placed any affirmative duties on qualified custodians to monitor an investment adviser's transactions.[50]

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43. *Lamm*, 889 F. Supp. 2d at 1332-33.

44. Investment Advisors Act of 1940, ch. 686, 54 Stat. 847, 847-52 (codified as amended at 15 U.S.C. §§ 80b-1 to -21).

45. *See* Investment Advisors Act of 1940, ch. 686, §§ 201, 203, 205, 206, 54 Stat. 847, 850-852 (codified as amended at 15 U.S.C. §§ 80b-1, -3, -5, -6).

46. Investment Advisors Act of 1940, § 9, 74 Stat. 885, 887 (1960) (codified at 15 U.S.C. § 80b-6(4).

47. 17 C.F.R. 275.206(4)-2 (2014).

48. Investment Advisers Act of 1940, Release No. 123, 27 Fed. Reg. 2149, 2149 (Mar. 6, 1962) (codified at 17 C.F.R. 275.206(4)-2); see U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-569, INVESTMENT ADVISERS: REQUIREMENTS AND COSTS ASSOCIATED WITH THE CUSTODY RULE (July 2013), *available at* www.gao.gov/assets/660/655754pdf.

49. Investment Advisers Act of 1940, 27 Fed. Reg. at 2149. The 1962 version of the rule required advisers to: (1) send clients statements every three months itemizing all funds and securities under custody or possession and (2) have an independent accountant perform a surprise examination at least once a year to verify those assets. *Id.* at 2149-50. The accountant was then required to file a certificate with the SEC affirming the occurrence and specifying the nature and extent of that examination. *Id.* at 2150. Under the contemporary version of the rule, only client assets that the adviser has custody of are subject to the surprise examination requirement. 17 C.F.R. 275.206(4)-2(a)(4).

50. *Lamm*, 749 F.3d at 949 (stating that "the system [the drafters of SEC Rule 206(4)-2] created, for better or for worse, was one of mere segregation between adviser and client

B. Case Law Before the 2003 Rule 206(4)-2 Revision: Duties of Custodians

Case law before the 2003 revisions held that absent a contract stating otherwise, the only duty a broker owes to customers over whose account the broker holds a non-discretionary role is to execute the account-holders instructions.[51] Similarly, case law after the custody rule was revised in 2003 supports this precedent by confirming that custodial banks owe no duty to provide custodial account holders with transparency into funds and securities held in custodial accounts or transactions made by clients' investment advisers.[52]

In 1971, the United States District Court for the Northern District of Alabama held in *Robinson v. Merril Lynch, Pierce, Fenner & Smith, Inc.*[53] that the only duty a broker owed to a customer with a commodity

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assets."); *see* Investment Advisers Act of 1940, 27 Fed. Reg. at 2149 (describing the custody rule as requiring segregation of client funds and securities). In 1989, the SEC added 17 C.F.R. 275.279.8 (2014), which provided a cover page, Form ADV-E, for accountant submissions of certificates of examination, and amended Rule 206(4)-2 to require such certificates to be attached to completed ADV-E forms. 54 Fed. Reg. 32,048 (Aug. 4, 1989) (to be codified at 17 C.F.R. § 275.206(4)-2(a)(5)). The revision also established a notice provision—which the current rule retains—requiring advisers, after accepting custody or possession of any client's funds or securities, to immediately notify such clients of the place and manner in which those assets would be maintained, as well as any changes of such place and manner. Investment Advisers Act of 1940, 27 Fed. Reg. at 2150. In 1997, the SEC amended the rule to apply only to investment advisers who, under 15 U.S.C. § 80b-3, were registered or required to be registered with the SEC, explaining that the application of the prophylactic provisions of the rule is a matter that was more appropriate for state law. 15 U.S.C. § 80b-3; Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633, 62 Fed. Reg. 28,112, 28,127-28, 28,135 (May 22, 1997) (Sec. & Exch. Comm'n). 15 U.S.C. § 80b-3 exempts investment advisers that, among other things, are: (1) an adviser to any private fund that only has clients in the state where the adviser's principal place of business or office is maintained and who does not furnish advice; (2) an adviser to only insurance companies; (3) a foreign private adviser; (4) a charitable organization, or an officer, trustee, director, employee, or volunteer of such charitable organization, and complies with other enumerated stipulations; (5) a church plan, or a person or entity eligible to establish such a plan, described in section 414(e) of the Internal Revenue Code of 1986, 26 U.S.C. § 414(e) (2012); (6) registered as commodity trading advisers with the Commodity Future Trading Commission and who do not primarily act as investment advisers in the course of their business and comply with other enumerated regulations; (7) non-entity investment advisers that have elected to be regulated by the Investment Company Act of 1940, 15 U.S.C. § 80a-53 (2012), and who solely advise certain categories of small business clients determined by the Small Business Investment Act of 1958, 15 U.S.C. §§ 631-657s (2012). 15 U.S.C. § 80b-3.

51. *See infra* notes 53-71 and accompanying text.

52. *See infra* notes 76-99 and accompanying text.

53. 337 F. Supp. 107 (N.D. Ala. 1971).

account, under which the broker held a non-discretionary role, was to execute the instructions issued on the customer's behalf with reasonable care.[54] Furthermore, the broker had no duty to advise the customer on the reasonableness of those instructed transactions.[55] The court also held that because of the lack of discretionary or managerial authority brokers have over client accounts, brokers' agency relationships begin when customers issue instructions and end when those instructions are effectuated.[56] Furthermore, no special relationship of trust and confidence indicates that a fiduciary relationship exists between brokers and their customers.[57] Imposing such a duty would "destroy an important part of the marketplace," namely the non-adversarial role that custodial entities with no discretion play.[58] Accordingly, the broker in *Robinson* had no fiduciary or contractual duty to disclose any market information known to it that was potentially or actually adverse to the plaintiff's current investments.[59]

The United States District Court for the District of Hawaii, in the 1997 case of *Kaiser v. First Hawaiian Bank*,[60] held that a bank was not liable for losses incurred by a life insurance company holding a custodial account, over which the bank had no discretion, when another party had complete discretion over the account under the insurance company's co-insurance agreement and used that discretion to misappropriate funds.[61] In granting the bank's motion for summary judgment on the claims for, among others things, breach of contract, breach of fiduciary duty, negligence, and gross negligence, the court held that the bank's duties were limited to those provided for in the customer's custody agreement.[62] The bank was only obligated, under the agreement, to follow instructions issued by a discretionary party; it explicitly disclaimed any obligation to verify the current valuations of assets

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54. *Id.* at 108, 111.
55. *Id.* at 111.
56. *Id.*
57. *Id.*
58. *Id.* at 113. The court also noted that other courts have held that broker-dealers, in the absence of "an express investment advisory contract," similarly do not owe a fiduciary duty to a customer unless that customer is "infirm or ignorant of business affairs." *Id.* at 113; *see also* Leib v. Merril Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 952-53 (E.D. Mich. 1978) (compiling case law and articulating that the duties of a broker to a customer who has a non-discretionary account with the broker cease when a transaction order is effectuated).
59. *Robinson*, 337 F. Supp. at 112, 114.
60. 30 F. Supp. 2d 1255 (D. Haw. 1997).
61. *Id.* at 1257-58, 1268.
62. *Id.* at 1262-66, 1268.

previously provided.[63] Nevertheless, the court held that the bank owed a minimal fiduciary duty to the account holder, but that duty was limited to the duties imposed by the agreement.[64] The court declined to impose a fiduciary or tort duty on the bank because it would be contradictory to the parties' arms-length agreement.[65] Accordingly, the bank had no duty under the custody agreement or otherwise to ensure timely receipt of assets.[66]

Similarly, in 2001 the grant of an Individual Retirement Account (IRA) custodian's motion for summary judgment on the account-holders' negligence claim was affirmed in *Paszamant v. Retirement Accounts, Inc.*[67] by the Court of Appeals of Florida, Fifth District.[68] In *Paszamant*, the account holders executed custody agreements when they opened their IRAs with the custodian. The agreements obligated the IRA custodian to send funds on behalf of each account holder to a mortgage investing company that would, in return, assign interest on mortgages previously owned by the investing company to the IRA custodian with each respective account holder as beneficiary. When the IRA custodian entered bankruptcy, the account holders brought suit against the custodian. The account holders conceded that the custodian was not contractually liable, but claimed the custodian was negligent in failing to verify that the investing company had actually invested the funds sent by the custodian.[69] The court rejected this argument and refused to impose an independent duty on the custodian because the custody agreements disclaimed any duty to provide the account holders with advice on, or verification of account holders' investments.[70] Accordingly, the account holders, not the custodian, bore the duty to detect discrepancies in all statements the custodian issued.[71]

C. *The 2003 Rule 206(4)-2 Revision & Sekerak v. National City Bank*

In 2003, the SEC substantially revised and reformatted Rule 206(4)-2 to parallel modern custodial practices, provide increased protection of advisory clients' assets and clarify the circumstances in which an adviser

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63. *Id.* at 1258-59, 1262, 1267.
64. *Id.* at 1265.
65. *Id.* at 1264, 1266. Additionally, the court declared that it would not create a fiduciary duty that two sophisticated parties did not expressly provided for in their written agreement. *Id.*
66. *Id.* at 1266.
67. 776 So. 2d 1049 (Fla. Dist. Ct. App. 2001).
68. *Id.* at 1054.
69. *Id.* at 1050-51.
70. *Id.* at 1053.
71. *Id.* at 1053-54.

would be deemed to have custody of client assets.[72] Section (a) of the revised rule, entitled "Safekeeping required," changed the segregation language of the original rule to that of the modern "qualified custodian" requirement.[73] Further, this revision established that advisers cannot have custody of client funds or securities, unless those assets are maintained by a qualified custodian in either a distinct account for each client held under that client's name or in accounts that contain only client assets, which name the adviser as agent or trustee.[74]

Under the 2003 revision and the current custody rule, an advisor who holds—directly or indirectly—or has any authority to obtain possession of client securities or funds, is deemed to have custody of such assets.[75] Custody includes possession unless it occurs inadvertently and the assets

72. Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176, 68 Fed. Reg. 56,692, 56,692 (Oct. 1, 2003) (Sec. & Exch. Comm'n). The 2003 revision retained and revised many of the provisions from the previous rule. *See* Custody of Funds or Securities of Clients by Investment Advisers, *supra*, at 56,692 (as corrected at 68 Fed. Reg. 61,555 (Oct. 28, 2003)). It established "qualified custodian" as meaning a bank, as defined under 15 U.S.C. 80b-2(a)(2), or a savings institution, as defined under 12 U.S.C. 1813(b)(1) (2012), that "has deposits insured by the Federal Deposit Insurance Corporation" [F.D.I.C.]. 17 C.F.R. § 275.206(4)-2(d)(6)(i); Custody of Funds or Securities of Clients by Investment Advisers, *supra*, at 56,693, 56,701. A "qualified custodian" also includes financial institutions that clients and advisers, at the time, typically went to for custodial services, specifically: broker-dealers, registered under 15 U.S.C. § 78o(b)(1) (2012), that hold the clients' assets in customer accounts; "futures commission merchant registered under . . . 7 U.S.C. 6f(a)," that hold "client assets in customer accounts, but only with respect to clients' funds and securities futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon;" and "foreign financial institution[s] that customarily" hold financial assets for customers, but only if advisory clients' assets are held in customer accounts that are "segregated from its proprietary assets." 17 C.F.R. § 275.206(4)-2(d)(6)(ii-iv). The "surprise examination" by an independent accountant provision was also retained and revised, and provides that any material discrepancies found must be reported, by the accountant, to the Commission within one business day. *See* 17 C.F.R. 275.206(4)-2(a)(4); Custody of Funds or Securities of Clients by Investment Advisers, *supra*, at 56,700 (as corrected at 68 Fed. Reg. 61,555).

73. 17 C.F.R. § 275.206(4)-2(a)(1); Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,700 (as corrected at 68 Fed. Reg. 61,555).

74. 17 C.F.R. § 275.206(4)-2(a); Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,700 (as corrected at 68 Fed. Reg. 61,555). The custody rule only applies to advisers who are registered or required to register with the SEC. 17 C.F.R. § 275.206(4)-2(a); Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,700.

75. 17 C.F.R. § 275.206(4)-2(d)(2); Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,701 § (c)(1)(i)-(iii) (as corrected at 68 Fed. Reg. 61,555).

are promptly returned within three business days of receipt.[76] Furthermore, in any arrangement in which the adviser has authority or permission to withdraw those client assets by providing instructions of such to the custodian, the adviser is also deemed to have custody of client assets.[77] Custody, however, does not include the authority to issue checks payable to third parties because such payables do not constitute "client funds" within the meaning of the rule.[78] The drafters of the rule believed that the rule, and the situations described above, made it clear that an adviser is deemed to have custody when client funds or securities can be controlled by the adviser for purposes other than authorized trading.[79] Furthermore, the drafters concluded that authority to issue instructions to a custodian to effect or to settle trades of funds or securities did not constitute "custody."[80]

The 2003 revision explicitly named and revised the "Notice to clients" provision and made it applicable to situations in which advisers open accounts with qualified custodians on the client's behalf, either under the client's name or, as an agent, the adviser's name.[81] Under the revision, account statements must be sent to the client by the qualified custodian.[82] This requirement was "designed to assure the integrity"

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76. 17 C.F.R. § 275.206(4)-2(d)(2)(i); Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,701 (as corrected at 68 Fed. Reg. 61,555).

77. 17 C.F.R. § 275.206(4)-2(d)(2)(ii); Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,701 (as corrected at 68 Fed. Reg. 61555). Furthermore, having custody of client funds or securities also includes any "capacity" that the adviser or the adviser's supervised person has access to or legal ownership of those client assets. 17 C.F.R. § 275.206(4)-2(d)(2)(iii); Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,701 (as corrected at 68 Fed. Reg. 61,555).

78. Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 55,693, 56,701 (as corrected at 68 Fed. Reg. 61,555).

79. *Id.* at 55,692-93.

80. *Id.* (as corrected at 68 Fed. Reg. 61,555). This conclusion was due to the fact that custodians generally are under "delivery versus payment" arrangements where assets are only transferred out of a client's account upon receipt of the corresponding transfer into the account. *Id.* The drafters declined to adopt an exception to the custody definition for advisers who were authorized to access client funds purely to deduct their incurred fees. *Id.*

81. Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,700 (as corrected at 68 Fed. Reg. 61,555); 17 C.F.R. § 275.206(4)-2(a)(2). This version of the notice provision is retained in the current rule. 17 C.F.R. § 275.206(4)-2(a)(2).

82. Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, 56,700 (as corrected at 68 Fed. Reg. 61555); 17 C.F.R. § 275.206(4)-2(a)(2). The adviser must have a reasonable belief that the qualified custodian sends at least the required quarterly account statements itemizing all funds and securities in the account and related transactions directly to the client. 17 C.F.R. § 275.206(4)-2(a)(3); Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,700 (as corrected at 68 Fed. Reg. 61,555).

of such account statements and allow clients to identify any erroneous or fraudulent activity by their adviser.[83] Therefore, the rule presupposed diligence and prudence by advisory clients because the purpose of requiring custodians to issue account statements is to ensure that clients have adequate information to review and monitor their investments.[84]

In *Sekerak v. National City Bank*,[85] a 2004 case factually similar to *Lamm* heard in the United States District Court for the Northern District of Ohio, Jean Sekerak entered into a custody agreement with a qualified custodian.[86] That agreement gave the company adviser, Thomas Durkin, total investing discretion over funds and securities in Sekerak's account, which Durkin used to defraud Sekerak. Subsequently, Sekerak sued the custodial bank, and the court granted the bank's motion for summary judgment on Sekerak's claims for breach of contract, breach of fiduciary duty, negligence, and aiding and abetting fraud.[87] Citing *Kaiser*, the court held that the custody agreement, which relieved the bank of any duty to verify the transactions made by the investment adviser, was enforceable and dispositive.[88] The court further found that Sekerak waived any objection to Durkin's discretionary transactions by failing to timely object to the account statements the qualified custodian issued to her.[89] The court also held that, like a broker who owes no fiduciary duty to non-discretionary account holders, the custodial bank owed Sekerak no fiduciary duty.[90] Furthermore, since Sekerak's damages were economic and governed by the custody agreement, the economic-loss rule barred her negligence claim.[91]

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83. Custody of Funds or Securities of Clients by Investment Advisers, *supra* note 72, at 56,694 (as corrected at 68 Fed. Reg. 61,555).

84. *See id.* A client may, under the rule post-the 2003 amendment, specify an independent representative to receive notices and account statements on his behalf. *Id.* at 56,700-01 (as corrected at 68 Fed. Reg. 61,555); *see* 17 C.F.R. 275.206(4)-2(a)(7). An independent representative is a person that acts as an agent and is contractually obligated to act in the best interest of the advisory client, does not control or is not controlled by the adviser, and does not or has not had a material business relationship with the adviser. 17 C.F.R. § 275.206(4)-2(d)(4).

85. 342 F. Supp. 2d 701 (N.D. Ohio 2004).

86. *Id.* at 703.

87. *Id.* at 707, 711, 712, 715-17.

88. *Id.* at 707.

89. *Id.* at 708.

90. *Id.* at 712.

91. *Id.* at 715. The economic-loss rule, which bars tort claims if the only damages suffered are purely economic contractual losses, may also pose an additional barrier to such tort law claims against custodial banks. *See* Tiara Condo. Ass'n v. Marsh & McLennan Cos., 110 So. 3d 399, 400 (Fla. 2013) (restricting Florida's economic-loss rule to products liability claims); *see also* City of Atlanta v. Benator, 310 Ga. App. 597, 605, 714 S.E.2d 109, 116 (2011) (citing Georgia cases applying Georgia's economic loss rule, O.C.G.A. § 51-1-

Aiding and abetting requires that the party asserting the claim prove the conduct that gave rise to the underlying claim was known by the defendant and the defendant substantially assisted or encouraged the commission of that act.[92] The court further held that no material fact in the record supported that the bank had knowledge or was even aware of Durkin's fraudulent activity.[93] Therefore, Sekerak's aiding and abetting fraud claim did not satisfy the claim's knowledge element.[94] Additionally, other courts have held that allegations that the suggested aider and abettor should have known of the commission are insufficient to establish the knowledge required to sustain a claim for aiding and abetting either fraud or a breach of fiduciary duty.[95]

11(a) (2010 & Supp. 2014), to contexts other than products liability claims); Pub. Bldg. Auth. v. St. Paul Fire & Marine Ins. Co., 80 So. 3d 171, 184 (Ala. 2010) (extending Alabama's economic-loss rule from products liability cases to a commercial construction case). However, the Supreme Court of Florida recently limited the economic-loss rule's application to products liability claims. *Tiara*, 110 So. 3d. at 407. Recovery may still be possible if the breach of contract also constitutes an independent tort, such as negligence. *See Lamm*, 749 F.3d at 947 (quoting Rushing v. Wells Fargo Bank, N.A., 752 F. Supp. 2d 1254, 1263 (M.D. Fla. 2010) (holding that tort claims against a bank were not barred where, under the account agreement, the bank "could be held liable for losses caused by [its] own negligence.")).

92. *See, e.g.*, *Sekerak*, 342 F. Supp. 2d at 716-17. Aiding and abetting a breach of fiduciary duty and aiding and abetting fraud both require knowledge on the part of the defendant of the underlying fraud or breach of fiduciary duty. *See, e.g.*, Plantinum Estates, Inc. v. TD Bank, No. 11-60670-CIV-Marra/Johnson 2012 U.S. Dist. LEXIS 30684, at *9 (S.D. Fla. Mar. 8, 2012) (holding that, under Florida law, the plaintiff must prove the defendant had actual knowledge of the underlying fraud to sustain a claim for aiding and abetting fraud); *see also* Court Appointed Receiver of Lancer Off shore, Inc. v. Citco Grp. Ltd., No. 05-60080-CIV-Marra/Johnson 2008 U.S. Dist. LEXIS 25740, at *16 (S.D. Fla. Mar. 31, 2008) (holding that, under Florida law, the plaintiff must prove the defendant had actual knowledge of the underlying breach of fiduciary duty to sustain a claim for aiding and abetting a breach of fiduciary duty). However, as the district court and the Eleventh Circuit noted, the validity of aiding and abetting fraud as a cause of action is unclear under Florida law. *Lamm*, 749 F.3d at 950 n.9. In Georgia, aiding and abetting fraud and aiding and abetting a breach of fiduciary duty are recognized claims. *See* Cohen v. Morgan Schiff & Co. (*In re* Friedman's Inc.), 385 B.R. 381, 430-31 (S.D. Ga. 2008) (applying the tort of aiding and abetting fraud). In Alabama, it is also unclear whether aiding and abetting fraud is a recognized cause of action. *See* Tucker v. Ernst & Young, LLP, No.1121048, 2014 Ala. LEXIS 87, at *1, n.1 (Ala. June 13, 2014) (stating that the plaintiff's complaint contained an aiding and abetting fraud claim, but giving it no further analysis).

93. *Sekerak*, 342 F. Supp. 2d at 717.

94. *Id.* Because the claim failed the knowledge requirement, the court found it unnecessary to analyze the second element of a claim for aiding and abetting fraud: requiring substantial assistance or encouragement of the primary tortfeasor. *Id.*

95. *See Platinum Estates, Inc.*, 2012 U.S. Dist. LEXIS 30684, at *10 (holding that allegations of knowledge are not sufficient to sustain a claim of aiding and abetting fraud "where the facts in the complaint only suggest[] that the defendant should have known"

Case law before and after the 2003 revision to the custody rule and the revision itself emphasize an adherence to the following: the express duties of the account agreements; the implicit obligation of account holders to use reasonable care in examining their account statements; and that failing to object to discrepancies within a reasonable time constitutes acquiescence.[96] Accordingly, custodial banks are not liable for investor losses caused by clients' investment advisers.

IV. COURT'S RATIONALE

The United States Court of Appeals for the Eleventh Circuit affirmed the district court's dismissal of the plaintiff's entire complaint in *Lamm v. State Street Bank & Trust*.[97] The court focused on the lack of any authority imposing a duty on a financial custodian with no discretion to guarantee the legitimacy, reasonableness, reported valuations, or any duty—notwithstanding the duty to execute instructions issued by discretionary parties.[98]

A. *State Street's Duties Under the Custody Agreements*

Using the same analogy as the court in *Sekerak*, the Eleventh Circuit compared State Street, a bank with no investment discretion, to a broker whose only duty is to execute orders when issued on behalf of the account holder.[99] Accordingly, the court held that State Street did not

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(quoting Groom v. Bank of Am., No. 8:08-CV-2567-JDW-EAJ, 2012 U.S. Dist. LEXIS 2374, at *3 (M.D. Fla. Jan. 9, 201))); Rosner v. Bank of China, No. 06-CV-135621 2008 U.S. Dist. LEXIS 105984, at *32 (S.D.N.Y. Dec. 18, 2008) (holding that allegations that the defendant should have known are insufficient to sustain a claim for aiding and abetting fraud); *cf. Court Appointed Receiver of Lancer Offshore, Inc.*, 2008 U.S. Dist. LEXIS 25740, at *49 (holding that allegations that the defendant should have known, based on "red flags" such as "atypical activities" are insufficient to sustain a claim for aiding and abetting breach of fiduciary duty).

96. *See supra* notes 54-95 and accompanying text.

97. 749 F.3d 938 (11th Cir. 2014).

98. *See infra* notes 99-114 and accompanying text. The Eleventh Circuit reviewed the district court's grant of State Street's motion to dismiss *de novo* and construed all of Lamm's factual allegations as true and in a light most favorable to his claims. *Lamm*, 749 F.3d at 942-43. The court also noted that to survive the defendant's motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6), his "'[f]actual allegations must be enough to raise a right to relief above the speculative level.'" *Id.* at 943 (quoting *Twombly*, 550 U.S. at 555).

99. *Lamm*, 749 F.3d at 943 (quoting *Sekerak*, 243 F. Supp. 2d at 712); Martinez Tapia v. Chase Manhattan Bank, N.A., 149 F.3d 404, 412 (5th Cir. 1998); *see also* J.C. Bradford Futures, Inc. v. Dahlonega Mint, Inc., No. 89-5581 1990 U.S. App. LEXIS 11787, at *20 (6th Cir. July 11, 1990); Hill v. Bach Halsey Stuart Shields Inc., 790 F.2d 817, 824-25 (10th Cir. 1986).

breach its contracts with Lamm by distributing funds for the purchase of fake notes.[100] The court emphasized that, under the custody agreements, State Street was authorized to act in accordance with issued instructions without inquiring into the circumstances and to rely on any instructions the bank believed were issued in good faith.[101] Since Lamm failed to sufficiently allege that State Street knew the instructions were not issued in good faith, the court held that State Street did not breach the agreements by listing false or inflated valuations on Lamm's statements.[102]

The court further noted that the custody agreements' waiver provisions and Lamm's failure to timely object meant he was deemed to have approved the reported market values—a further bar on Lamm's breach of contract claim.[103] Citing *Kaiser*, the court held that the custody agreements authorized State Street to remit funds based on authorized instructions to any payee without receipt of any asset.[104] In regard to Lamm's claim that State Street charged excessive fees, the court held that the agreement only obligated State Street to charge fees based on provided market values, and that in doing so, State Street did not breach the agreement because under the custody agreements' waiver provisions, Lamm ratified those reported valuations.[105]

B. State Street's Duties Independent of the Custody Agreements

The Eleventh Circuit noted that because the Supreme Court of Florida in *Tiara Condo. Ass'n v. Marsh & McLennan Co.*[106] limited the application of Florida's economic loss rule to products liability cases, the rule no longer barred Lamm's tort claims against State Street.[107] However, Lamm still had to prove that State Street's tortious conduct constituted an independent tort outside any breach of contract.[108] The court compared *Lamm* to *Paszamant* and held that Lamm failed to establish that State Street owed him any independent duty to supervise his

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100. *Lamm*, 749 F.3d at 945.
101. *Id.* at 944.
102. *Id.* at 945.
103. *Id.*
104. *Id.* at 944 (citing *Kaiser*, 30 F. Supp. 2d at 1266 (holding that a custodial bank was not liable under the custody agreement that did "not expressly provide that the acquisition of securities must occur simultaneously with the release of funds form the Custodial Account")).
105. *Id.* at 946.
106. 110 So. 3d 399 (Fla. 2013).
107. *Lamm*, 749 F.3d at 947.
108. *Id.*

account.[109] In support of this holding, the court stated that the policy underlying Rule 206(4)-2 did not support imposing such an independent duty.[110]

The court also held that the facial defects on the funds and securities State Street accepted were insufficient to establish the knowledge required to prove a claim for aiding and abetting fraud or breach of fiduciary duty.[111] Because the arm's length custody agreements did not establish a relationship of trust and confidence required to impose minimal fiduciary duties, the court held that Lamm failed to state a claim upon which relief could be granted.[112] Furthermore, Lamm failed to plead facts sufficiently demonstrating that State Street induced him to rely on any representation as to the validity of the accounts' funds or securities.[113] For this reason, Lamm's negligent misrepresentation claim also failed.[114]

V. IMPLICATIONS

While *Lamm v. State Street Bank & Trust Co.* was decided correctly under the facts of the case and its controlling custody agreements, it illustrates a need for increased transparency of the transactions executed by investment advisers not subject to the surprise examination requirement under Rule 206(4)-2. The investing community as a whole may not be aware of this need; however, it is necessary to avoid similar occurrences. This transition can occur as a top-down change to current banking practices, through new or amended regulations, or as a bottom-up integration, through consumer demand or creation of transparency services by custodial banks.

Since the system focuses on segregation of client funds and securities by custodial banks and not the transparency of adviser discretionary transactions, Rule 206(4)-2 presupposes and relies on clients diligently reviewing account statements that their qualified custodians issue. With an absence of such diligence by advisory clients, the system that the

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109. *Id.* at 948, 950.

110. *Id.* at 948; *see supra* note 50 and accompanying text. Additionally, Florida's version of U.C.C. § 4-103, FLA. STAT. § 674.103(1) (1993 & Supp. 2015), which prohibits banks from disclaiming liability for a failure to exercise ordinary care, did not impose an independent duty because U.C.C. Article 4 only applies to deposits and collections, not custodial banks. *Lamm*, 749 F.3d at 949-50; U.C.C. § 4-202 (2002). Even if this duty did apply, Lamm presented no allegation that State Street effectuated unauthorized transactions. *Lamm*, 749 F.3d at 950.

111. *Lamm*, 749 F.3d at 950-51.

112. *Id.* at 951.

113. *Id.*

114. *Id.*

drafters of Rule 206(4)-2(a)(4) created cannot function properly. Furthermore, advisers that do not have custody of client funds or securities are, implicitly under subsection (a)(4), not subject to the custody rule's surprise examination by the independent accountant requirement. Customarily, custodian banks do not contractually provide for and, in fact, explicitly disclaim, all duties to ensure the legitimacy of adviser transactions or verify the adviser-provided valuations of funds and securities in custodial accounts. When advisory clients habitually neglect to review their account statements and their custodial banks provide no transparency into their advisers' transactions, the circumstances are ripe for unscrupulous advisers, such as Tagliaferri, to defraud their clients.

Lamm's lack of diligence is more responsible for his lost principal than State Street. The losses Lamm sustained could have been mitigated by diligent review of the monthly account statements State Street issued. His own neglect and delay is to blame for his loss, not State Street. Had he reviewed his account statements in a timely manner, he would have at least noticed monthly notifications that State Street was unable to obtain updated valuations. Nevertheless, a change is necessary to prevent future less-negligent victims from experiencing similar losses.

While the drafters of Rule 206(4)-2 did not intend, and the policy underling the rule does not support, a duty on the part of custodial banks to protect their customers from unethical investment advisers, this case, and many like it, demonstrates that the rule may need to be revised to continue to effectuate its purpose of providing a system facilitating transparency into the activities of investment advisers. The SEC could reform the original system of segregation to create one that imposes an active role on custodians by requiring them to ensure the validity of transaction instructions and provide independent valuations of funds and securities.

Unfortunately, a top-down reform is unlikely because the drafters of Rule 206(4)-2 did not envision a rule requiring custodial banks to have an active role beyond merely holding client assets and issuing account statements.[115] Decreased regulations facilitate the market to function effectively. Furthermore, increased regulations ultimately increase the cost of financial services to the consumer because of the increased cost compliance that providers of financial services incur in rendering services.[116] Additionally, any top-down regulation will inevitably leave loopholes. Regulations also maintain incentives for unscrupulous

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115. *Id.* at 949; *see supra* notes 49-50 and accompanying text.

116. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 48 (stating the GAO is statutorily mandated to study and report the cost of compliance for investment advisers).

advisers to find loopholes. Further, additional regulations will create more loopholes because of the inability to foresee all possibilities. Specifically, Tagliaferri is an example of the adage, "Where there is a will there is a way." In this case, not much "will" was needed to find a "way" because TAG qualified for an exemption to the surprise audit requirement of Rule 206(4)-2 and claimed on its filings with the IRS that it did not have custody of client funds.[117] Drafting and implementing regulations also costs both the SEC and those required to comply additional time and money. Furthermore, the only incentive regulations give qualified custodians is ensured compliance. Above all, such a system would increase the cost of compliance for custodial banks, which would then increase the costs passed on to the custodial account holder.[118]

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117. *See* Taurus Advisory Group LLC, Uniform Application for Investment Advisor Registration, Form ADV, Part 1A, Item 9(A)-(C) (Feb. 2005) (Sec. & Exch. Comm'n) (ADV form for Taurus, signed by Tagliaferri as president, stating that the company had no custody of advisory client funds or securities); *see also* TAG Virgin Islands, Uniform Application for Investment Advisor Registration, Form ADV, Part 1A, Item 9(A)-(D) (Nov. 2010) (Sec. & Exch. Comm'n) (ADV form, signed by Tagliaferri as president, for Tag Virgin Islands stating that the company did not have custody of advisory clients' funds or securities with no annual surprise examination report attached; *see also* TAG Virgin Islands, Inc., Firm Disclosure Brochure, at Portfolio Administration: Custody, Form ADV, Part 2 (Mar. 31, 2011) (Sec. & Exch. Comm'n) (Stating that "[c]lients [of TAG Virgin Islands, Inc.] are responsible for selecting an independent bank or broker/dealer as custodian for their assets. TAG Virgin Islands, Inc. does not have physical control of clients' assets, money or securities. To the extent the firm may withdraw advisory fees directly from client accounts, it may be considered to have custody in a limited capacity. Custody due solely to the direct withdrawal of fees does not entail all of the same legal and regulatory requirements as an investment adviser with physical custody of clients' assets. Accordingly, clients only receive account statements from their bank or broker/dealer custodian").

118. In fact, in 2009, after the events that gave rise to Lamm's suit against State Street, and in light of recent frauds by investment advisers, including Bernard Madoff, the SEC amended a substantial number of rules to combat such fraud. *See also* Custody of Funds or Securities of Clients by Investment Advisers, Investment Adviser Act Release No. 2876, 74 Fed. Reg. 25,354, 25,355 (May 27, 2009) (Sec. & Exch Comm'n); U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 48; *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Adviser Act Release No. 2968, 75 Fed. Reg. 1456 (January 11, 2010) (Sec. & Exch. Comm'n). The revision, among other things, expanded the scope of the surprise examination requirement, but only with respect to advisers who retained custody of client funds or securities. 17 C.F.R. § 275.206(4)-2(a)(4); *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, supra 48; *see* Custody of Funds or Securities of Clients by Investment Advisers, *supra* at 1484. The revision required independent accountants to notify the Commission of any resignation, dismissal, removal, or termination of its engagement to perform the surprise examination along with "[a]n explanation of any problems relating to [the] examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination." 17 C.F.R. § 275.206(4)-2(a)(4)(ii)-(iii); Custody of Funds or Securities of Clients by Investment Advisers, *supra* at 1484. This

Even after almost a decade of highly publicized fraudulent investment advisers, consumers have not collectively demanded changes to custodial banking practices. In part, this request is missing because most advisory clients who have entrusted substantial portions of money to investment advisers are prudent enough to check their account statements regularly, as the system presupposes they will. Under Rule 206(4)-2, advisory clients can appoint an independent representative to receive all notices and account statements required under the rule on their behalf.[119] Clients could use this avenue to provide transparency without insisting on a change to current custodial banking practices. Unfortunately, it is evident that many advisory clients that should elect to implement this regulatory option do not do so.

Less prudent advisory clients, like Lamm, who would benefit from the protection of a system that provides more than mere segregation, are unlikely to demand reformation. When this is compounded with the improbability of a change from the SEC, qualified custodial banks are therefore the only other logical source for improved transparency. If custodial banks provide for systems that ensure transparency and verify investment adviser transactions, they can gain a competitive advantage over other entities offering commoditized custodial accounts. Banks will have to educate consumers that may not currently be aware of the need for such provisions. However, there is an incentive for banks to do so because it will result in an increased demand for these new account offerings. Consumer education will also result in an investing community that is more knowledgeable and protected. Many critiques of economic analysis of financial services say the market is unique.[120] This is true, but the average reasonable consumers in the industry are

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revision defined "independent public accountant." 17 C.F.R. § 275.206(4)-2(d)(3); Custody of Funds or Securities of Clients by Investment Advisers, *supra* at 1485. The previously rejected fee deduction exception was also added to this revision. 17 C.F.R. § 275.206(4)-2(b)(3); Custody of Funds or Securities of Clients by Investment Advisers, *supra* at 1485. A definition of control was added, improving the rule's clarity. 17 C.F.R. § 275.206(4)-2(d)(1); Custody of Funds or Securities of Clients by Investment Advisers, *supra* at 1485. The new rule also required that the adviser's reasonable belief that the qualified custodian is sending the required account statements must be formed "after 'due inquiry.'" *See* Custody of Funds or Securities of Clients by Investment Advisers, *supra* 1457-58, 1482-83. Above all, the rule still allows the exception to the independent audit requirement for advisers who are not deemed to have custody of client funds. 17 C.F.R. § 275.206(4)-2(a)(4). Consequently, the original system of segregation is still in effect. *See* Custody of Funds or Securities of Clients by Investment Advisers, *supra* at 1457-58, 1483.

119. 17 C.F.R. § 275.206(4)-2(a)(7), -2(d)(4)(i)-(iii).

120. *See, e.g.*, John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications* 4 (European Corporate Governance Inst., Working Paper No. 234, 2014), *available at* http://papers.ssrn.com/sol3/papaers.cfm?abstract_id=2375396.

much more knowledgeable than the average consumer of other goods and services. Furthermore, custodial banks can preempt regulations that could imposes even more expansive duties than contractual reform.

Through accounting services that ensure the validity of transactions and valuations without providing advice on the wisdom of those transactions, custodial banks can remain in their current non-discretionary segregation role that insulates them from liability for advisory client losses while providing custodial clients with a mutually-beneficial account service. This strategy, however, would result in increased cost to the end consumer. Therefore, banks will not desire to offer such provisions universally across all custodial account offerings. Nevertheless, for those niche custodial clients, like Lamm, who would feel and be more protected by such services, this change can be a source of increased revenue from custodial accounts.[121] Under a system where custodial banks control the customary transparency mechanisms, the industry can quickly adapt the current practices to respond to any previously unforeseen loopholes. By contractually adding more duties than required by regulation, banks are forcing their competitors to stop hiding behind regulations and compete with this emerging opportunity to gain a competitive advantage in a commoditized market. Consequently, State Street, as the world's third-largest custodial bank, or one of its competitors, could gain a significant competitive advantage and increase the revenue generated by custodial accounts.[122]

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121. Under the custody agreements, State Street charged five basis points (.0005 percent) annually, which was to be paid in advance every quarter. Custody Agreements, *supra* note 10, at 8 ¶ 16, 23 ¶ 16. State Street charged no transaction fee and an annual minimum fee of $800 and $400 for related accounts. *Id.*

122. *See Assets under Custody, Worldwide*, *supra* note 7.