INITIAL DECISION RELEASE NO. 438
ADMINISTRATIVE PROCEEDING
FILE NO. 3-14081

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

In the Matter of	:	
	:	INITIAL DECISION
JOHN P. FLANNERY, and	:	October 28, 2011
JAMES D. HOPKINS	:	
	:	

APPEARANCES: Deena R. Bernstein, Kathleen Burdette Shields, and Robert Baker for the Division of Enforcement, Securities and Exchange Commission

Mark W. Pearlstein, Fredric D. Firestone, Peter Acton, and Laura McLane for John P. Flannery

John F. Sylvia, McKenzie E. Webster, Marbree D. Sullivan, and Jessica C. Sergi for James D. Hopkins

Daniel J. Maher for State Street Global Advisors[1]

BEFORE: Brenda P. Murray, Chief Administrative Law Judge

The Securities and Exchange Commission (Commission) issued its Order Instituting Proceedings (OIP) on September 30, 2010. An eleven-day hearing produced an evidentiary record of 3,145 pages of transcript, reflecting the testimony of ten witnesses for the Division of Enforcement (Division), and nine witnesses for Respondents, including five experts, and about 500 exhibits.[2] Seven briefs totaled 442 pages of argument.

[1] I granted a motion to intervene for the limited purpose of preserving the confidentiality of attorney-client communications. Tr. 327; 17 C.F.R. § 201.210(a).

[2] I will cite to the transcript of the hearing as "(Tr. __.)." I will cite to the Division's and Respondents' exhibits as "(Div. Ex. __.)", "(Flannery Ex. __.)", or "(Hopkins Ex. __.)". I will use similar designations in citations to the posthearing filings.

Pending Motions

On May 6, 2011, the Division moved to strike portions of John Patrick ("Sean") Flannery's Post-Hearing Reply Brief (Motion to Strike), specifically page 50 and attached affidavits from counsel affirming that the Division represented to them that their client was not being charged in connection with what will be referred to as the July 26 letter. John Patrick ("Sean") Flannery's Opposition to the Division's Motion to Strike was filed on May 10, 2011. It included Exhibit A, a series of e-mails. On May 11, 2011, the Division wrote to the Commission's Secretary arguing that Exhibit A was incomplete and ambiguous.

I Grant the Division's Motion to Strike. It is too late in the day to try to ascertain who said what to whom before the hearing. The record is complete. The OIP sets out the allegations.

Issue

This proceeding is about whether Respondents misled or made inadequate disclosure to investors concerning the portfolio holdings in an unregistered collective trust fund.[3] Specifically, Respondents are charged with misleading investors about the extent of subprime mortgage-backed securities (MBS) held in an unregistered fund in 2006-07, and engaging in a course of conduct which resulted in willful violations of Sections 17(a)(1), (2), and (3) of the Securities Act of 1933 (Securities Act) (Section 17(a)), Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) (Section 10(b)), and Rule 10b-5 (Rule 10b-5).[4]

The Division recommends that both Respondents be: (1) ordered to cease and desist from future violations, (2) ordered to pay a civil penalty, and (3) barred from association with any investment adviser or registered investment company. Div. Brief at 76.

Findings of Fact

The findings and conclusions herein are based on the entire record. I applied preponderance of the evidence as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 102 (1981). I have considered and rejected all arguments and proposed findings and conclusions that are inconsistent with this Initial Decision.

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[3] "A *collective* trust fund, in contrast [to a common trust fund], is maintained by a bank as an investment vehicle solely for corporate stock bonus, pension, or profit sharing plans (other than Keogh plans) that meet the requirements for qualification under §401(a) of the Internal Revenue Code." Louis Loss and Joel Seligman, Fundamentals of Securities Regulation 354-55 (5th ed. 2004).

[4] At the time, subprime lending was "a relatively new and rapidly growing segment of the mortgage market that expands the pool of credit to borrowers who, for a variety of reasons, would otherwise be denied credit." Souphala Chomsisengphet and Anthony Pennington-Cross, The Evolution of the Subprime Mortgage Market, Federal Reserve Bank of St. Louis Review 31 (January/February 2006).

Credibility

John Patrick (Sean) Flannery (Flannery) and James D. Hopkins (Hopkins) were credible witnesses. This conclusion is based on observing the demeanor of both men during their two days of testimony and scrutiny of their answers compared with all other evidence in the record. The written record does not reflect the tone, the conviction, or assurance conveyed in a witness's oral responses. Both Respondents answered without hesitation or equivocation and they evidenced candor, conviction, and, at times, frustration. My conclusion is supported by the testimony of every witness who knew Flannery and Hopkins. Testaments of their honesty, good character, hard work, and concern for clients, were delivered enthusiastically and were not simply pro forma statements. Tr. 1814, 1966, 2040, 2214, 2260, 2381, 2383, 2771-72, 2778, 2815-16, 2820-21, 2871, 2877.

State Street Global Advisors

State Street Corporation is a publicly traded company with a wholly-owned subsidiary, State Street Bank and Trust Company (State Street), a Massachusetts trust company and bank. As a bank, State Street is excluded from the definition of investment adviser in Section 202(a)(11) of the Investment Advisers Act of 1940 (Advisers Act). State Street had a registered investment adviser subsidiary, State Street Global Funds Management, Inc. Tr. 773, 777, 1554; Div. Exs. 249, 254. State Street Global Advisors (SSgA) was a State Street division that managed unregistered collective trust funds and subadvised registered funds.[5] Tr. 778-79; Div. Ex. 249. The former are excluded from the definition of investment company under Section 3(c)(11) of the Investment Company Act of 1940 (Investment Company Act). OIP at 3; Flannery Answer at 3.

SSgA represented itself as the leading provider of investment services to sophisticated global investors. Div. Ex. 249. SSgA did business with more than 1,400 institutions of all sizes. Tr. 2666. Most SSgA clients were represented by consultants, investment experts that advised institutional investors. Tr. 416, 1210, 1288; Div. Ex. 31. SSgA's investors were very sophisticated; approximately 70-80% of clients had investment consultants. Tr. 2731. SSgA assumed that its clients had a certain degree of knowledge, unlike retail investors. Tr. 2851.

As of June 30, 2006, State Street was the largest institutional fund management company in the world with more than $1.5 trillion in assets under management (AUM). Div. Ex. 116 at 7. As of July 2007, AUM totaled $1.9 trillion. Id. at 6. In 2006-07, SSgA had total revenue of about $1 billion. Tr. 1206. SSgA's Chief Counsel, Mitchell Shames (Shames), and its Chief Operating Officer, Otello Sturino, reported to persons in those respective positions at State Street Corporation. Tr. 1151.

[5] SSgA was not itself a legal entity. Tr. 805. State Street, "including its SSgA division, is a bank and therefore exempt from registration" with the Commission under Section 202(a)(11) of the Advisers Act. Div. Ex. 249 at Bates 719.

Limited Duration Bond Fund

SSgA has managed fixed income portfolios, both global and domestic, for many years. Hopkins Ex. 17 at Bates 394. Most of SSgA's fixed income portfolios consist of passive investments, but it did offer a multitude of actively managed funds to individual and institutional investors. Tr. 1439-40; Div. Ex. 254. On March 1, 2002, SSgA created the Limited Duration Bond Fund (LDBF), a portfolio construction that combined a fixed, passive or indexed return (beta), with generating excess benchmark returns (alpha).[6] Hopkins Exs. 1, 17. The LDBF was an unregistered bank collective trust fund–an actively managed "enhanced cash" fund whose objective was to match or exceed the return of the J.P. Morgan one-month U. S. Dollar LIBOR (London Interbank Offered Rate) Index by 50 to 75 basis points (bps) over an interest-rate cycle.[7] Tr. 45, 128, 778-99, 1584-85; Div. Exs. 25 at 40, 98. "[F]unds following the enhanced cash strategy were riskier and less liquid than money market funds and invested in securities such as mortgage-backed and asset-backed securities." Hopkins Ex. 161 at 12-13. To achieve the goal of LIBOR plus 50 to 75 bps, investors assumed a greater measure of risk. Tr. 1143, 1959.

The LDBF:

> was designed to achieve attractive spreads above LIBOR based on the following principles:
>
> - Very low interest rate risk-duration of less than three months
> - No unsecured corporate credit
> - Focus exclusively on high quality structured products backed by real assets
>   - Historically exhibited low volatility and strong mean-reverting tendencies
> - Use of leverage, including Total Rate of Return (TRR) swaps and other synthetic tools to enhance return.

Div. Ex. 185 at 9.

[6] The LDBF was permitted to invest in the following securities: (a) repurchase agreements and U.S. Treasury securities; (b) debt of the U.S. government including, but not limited to, debt of Government Sponsored Enterprises; (c) corporate debt (including, medium term notes, Rule 144A and other types of corporate issuance); (d) asset-backed securities rated investment grade by Moody's and Employee Retirement Income Security Act (ERISA) eligible; (e) commercial mortgage-backed securities, rated investment grade by Moody's and ERISA eligible; (f) derivative securities, including but not limited to, financial futures contracts, options and swaps; (g) deposits and other debt instruments of domestic banks; and (h) bank common trust funds maintained by the Trustee which have characteristics consistent with the overall investment objective. Hopkins Exs. 3, 9; Div. Ex. 31.

[7] The LDBF included two funds: one was limited to qualified ERISA plans and the other was for non-ERISA institutional investors such as endowments and charitable trusts. Tr. 44. The two funds had similar investment goals and held similar securities. Id.

Many SSgA funds invested in the LDBF because it was "created specifically as a portable alpha pool for the U.S. Core Fixed Income Strategies and was a good source of consistent low volatility, uncorrelated and diversified alpha." Div. Ex. 185 at 11. The portable alpha investment strategy employed by the LDBF was designed to generate an excess return against a synthetic benchmark. Tr. 48, 1642-43; Div. Ex. 23 at 40. The LDBF was offered as a daily liquidity fund. Tr. 1861.

Responsibility for the LDBF was in the Global Fixed Income unit that reported to the Chief Investment Officer of the Americas (CIO). In 2006-07, the reporting levels were as follows: Paul Greff (Greff), Director of Global Fixed Income, reported to the CIO. Tr. 38-39, 1158, 1206, 1549; Hopkins Ex. 24. Michael Wands (Wands), Director of Active North American Fixed Income, reported to Greff.[8] Tr. 2845. Michael O'Hara (O'Hara), head of Active U.S. Fixed Income, reported to Wands. Bob Pickett (Pickett), lead portfolio manager with day-to-day responsibility for the LDBF, reported to O'Hara.[9] Tr. 40, 1158-59, 1206.

The LDBF employed a fundamental strategy using advanced statistical techniques, but relied on analysis and judgment in making investment decisions. Tr. 1154-55. The portfolio manager was responsible for managing the portfolio to a certain credit quality. Tr. 439. The LDBF investment or management team (Management Team) decided on the assets in the portfolio; the Management Team consisted of Pickett, in consultation with his peers and supervisors, O'Hara, Wands, and Greff. Tr. 1728-29, 2238.

The LDBF's clients consisted of public funds, pension funds, endowments, and foundations.[10] Tr. 655-56, 2731, 2850. Most LDBF clients were in comingled funds. Tr. 2849. Twenty-one SSgA active fixed income funds invested in the LDBF. Tr. 172, 207, 229, 692, 863; Flannery Ex. 211 at Bates 381-82. These included funds owned by clients advised by SSgA internal groups such as Global Asset Allocation (GAA); the Office of the Fiduciary Advisor (OFA), that provided investment services to pensions including the State Street Pension Plan, endowments

[8] Wands graduated from Rensselaer Polytechnic Institute in 1986. He is a chartered financial analyst (CFA) and worked at Drexel Burnham Lambert, Kidder Peabody, and Lehman Brothers, before joining SSGA in July 2000, where he managed portfolios and later assumed responsibility for all structured products. In 2003, Flannery appointed Wands head of U.S. Fixed Income. He reported directly to Flannery until mid-2005 when Greff was named head of Global Fixed Income. Tr. 2839-45.

[9] Pickett has a Bachelor's degree from Bentley University and a Master of Science in Finance from Babson College. Tr. 1534. He was employed at SSgA from October 1991 to January 2008, and worked on the launch of the LDBF. Tr. 1536, 1540. In the summer of 2007, he had managed portfolios for approximately ten years. Tr. 1726-27.

[10] Clients included Emory Investment Management, General Motors/Xerox, the Georgia State Foundation, the Houston Police Officers Pension System (Houston), Jordan Hospital, the Monetary Authority of Macao, and investment consultants. Tr. 702; Hopkins Ex. 161, 7 n.9; Hopkins Ex. 174 at 13-15; Div. Ex. 255 at 10.

and foundations; and State Street Charitable Asset Management (CAM), that provided investment advice to college endowments. Tr. 867-68, 891-92, 1771, 1775, 1781; Div. Ex. 255 at 4, 6.

Following its creation in 2002, the LDBF became one of SSgA's hallmark actively managed fixed income products.[11] Tr. 172; Div. Ex. 23 at 40. The LDBF had almost $2.9 billion in AUM as of June 30, 2007. Div. Ex. 98. It was not large by SSgA standards, but it was a well-performing fund and achieved its target returns in 2003 through 2006. Tr. 825; Div. Ex. 57. According to one expert, the LDBF achieved its target, returns of 50bp-75bp above LIBOR, in three of the four years since inception, i.e., 2003-2006. Hopkins Ex. 161 at 20.

Approximately 80% of SSgA's $2 trillion in AUM was in Global Equities and Cash Management. Tr. 1146, 1160. The core of SSgA's portfolio risk management calculation, including with respect to the LDBF, was an approach referred to as expected shortfall, or conditional value at risk (CVaR). The CVaR had two parts: (1) a level of risk for a particular fund using general principles, and (2) a database which was the sum of the CVaRs of specific trades and trading strategies. Tr. 1884. CVaR was a widely accepted means for calculating portfolio risk. Tr. 2200, 2284-85; Flannery Ex. 299 at 6.

John Patrick (Sean) Flannery

Flannery is a fifty-three year old native of Detroit, who has lived most of his life in the Boston area. Flannery earned a Bachelor's degree in Economics from George Washington University, and spent about sixteen years with several different firms selling and managing fixed income investments before joining SSgA in September 1996. Tr. 767-70. Flannery began as a product engineer and rose quickly through the ranks to become SSgA's Fixed Income CIO for the Americas in February 2005. Tr. 1138-43. Flannery's position was one level below William Hunt (Hunt), SSgA's President and CEO.[12] Div. Ex. 90 at 9. Flannery was a member of the Executive Management Group, SSgA's senior management group that met weekly. Tr. 785. Flannery has had an unblemished record in the industry and those who have worked with him believe him to be unusually honest, capable, and ethical. Tr. 554-56, 1811, 1957, 2214, 2381, 2383, 2771-72, 2820-21, 2877.

As of May 2007, about 460 people located globally in the following nine organizational units reported to Flannery:

1. Global Equities, which managed passive, quantitative, active, and enhanced strategies ($800 billion in AUM);

2. Cash Management ($800 billion AUM);

[11] SSgA's revenue came from a basis point fee on the assets under management, approximately fifteen basis points or fifteen one-hundredths of 1%, which in 2006-07 was about $3-$3.5 million. Tr. 1205-06.

[12] Other people involved in these events, Marc Brown, Chief Marketing Officer, and Mitchell Shames, Chief Counsel, were at the same organizational level as Flannery. Div. Ex. 90 at 9.

3. Global Fixed Income ($3 billion AUM);

4. GAA;[13]

5. Absolute Return Strategies;

6. Product Engineering;

7. Advanced Research Center, a group that worked on developing financial models and algorithms;

8. Credit Policy; and

9. Risk Management, responsible for identifying, measuring, and overseeing risk in SSgA's portfolios. Tr. 782-85, 1144-49, 2196; Div. Ex. 90 at 9.

The CIO did not have a written position description. Tr. 1369. Flannery believed his responsibilities were to: (1) manage the teams who invested client funds, ensure adequate resources, and monitor performance; (2) contemplate the future of SSgA's business; and (3) identify and address weaknesses in investment products. Tr. 1151. Twenty-four-hours-a-day, seven-days-a-week, Flannery addressed crises resulting from human errors involving potentially millions of dollars. Tr. 1152. Flannery was not involved in creating the LDBF, its investment decisions, or its day-to-day management.[14] Tr. 825-26, 1157-58.

Flannery's base salary was $450,000 in 2006, his first full year in the position, and in 2007. Tr. 788. His total earnings in 2006 and 2007, which included vested stock from prior years and other items, were $2,108,582 and $4,337,314, respectively. Tr. 788-89. His compensation was not related to the performance of the LDBF. Tr. 1163-64. Hunt informed Flannery on November 16, 2007, that his position was eliminated. Tr. 793.

James D. Hopkins

Hopkins is an Illinois native with a Bachelor's degree in English from the University of San Francisco and an MBA in Money and Financial Markets from Columbia University. Tr. 12; Div.

[13] Flannery was not involved in GAA's operations, which consisted of offering a variety of investment services and strategies to clients. Tr. 1977, 1986, 2045. Flannery never intruded on GAA's independence. Tr. 2044-45. All GAA investment recommendations involved SSgA funds. Tr. 1980. At some point, Flannery learned that some GAA clients were invested, directly or indirectly, in the LDBF. Tr. 1348-50.

[14] The Division's expert agrees that Flannery "was clearly not responsible for the day-to-day management" of the LDBF portfolio. Div. Ex. 256 at 16. Flannery knew that the LDBF portfolio had subprime and derivative exposure, but he did not know much about the actual construction of the portfolio until July 2007. Tr. 1159-60.

Ex. 9 at 27. Hopkins was employed by State Street from December 1998 through September 2010.[15] In 2006-07, Hopkins was a Vice President and head of North American Product Engineering, responsible for fixed income funds, including the LDBF.[16] Tr. 36, 38-39, 330. In 2006-07, there were between three and four product engineers in Fixed Income. Tr. 440. Hopkins was a member of SSgA's senior management group. Tr. 330. Hopkins reported to Adele Kohler (Kohler), Managing Director, Product Engineering, who reported to Flannery. Div. Ex. 90 at 9.

As a liaison between portfolio managers and client-facing personnel, Hopkins "was responsible for articulating the elements of the investment process that were managed by the portfolio managers." Tr. 54, 231, 337. The product engineer position was created to allow portfolio managers more time to manage portfolios rather than answer inquiries. Tr. 610, 1547. Hopkins saw himself as a liaison between the portfolio management team and the client-facing teams. Tr. 54, 337, 566-67. Hopkins had access to portfolio analytics, an electronic database that the portfolio managers used to manage the LDBF. Tr. 305. When he wanted information about the LDBF, he contacted the portfolio managers or members of the Management Team. Tr. 375, 487.

An example of the kind of information Hopkins provided follows: On November 10, 2006, Hopkins responded to a request from a SSgA representative in Hong Kong by transmitting information produced by SSgA's internal software that showed the LDBF's portfolio sector distribution as of September 30, 2006: cash 25.5%, MBS 9.4%, residential mortgage-backed securities (RMBS) 65.1%; and the quality distribution as cash 25.5%, AAA 37.3%, AA 27.7%, A 5.3%, and BBB 4.2%. Tr. 124-26; Div. Ex. 31. Hopkins noted in the transmittal that SSgA did not generally send portfolio holdings to prospects. Tr. 126

Hopkins did not have primary responsibility for client relationships, but because of his abilities, he was often part of a team that made presentations to potential clients, and he understood that in doing so he was offering securities. Tr. 56-57, 83, 150, 338-39, 486. Hopkins allowed his securities licenses to lapse because SSgA did not require them for his position. Tr. 339-40. He is an expert in United States fixed income securities and has an unblemished thirty-five-year career of investment industry experience. Tr. 37, 333. Hopkins received the State Street Chairman's Award for his volunteer activities with the Ronald McDonald House in Boston. Tr. 336.

Hopkins' compensation was not related to AUM. Tr. 331. In 2007, his base salary was $200,000 and he received a $300,000 bonus. Tr. 53.

[15] When Flannery was head of Product Engineering, he hired Hopkins whom he knew professionally. Tr. 329, 550. In 2010, State Street offered Hopkins retirement as a result of this proceeding; he had not planned to retire. Tr. 332.

[16] Hopkins was responsible for both registered and unregistered fixed income funds. Tr. 20-21, 122-23.

LDBF Communications

Under its Chief Marketing Officer, Marc Brown (Brown), SSgA had a broad array of relationship managers that dealt separately with clients and consultants. Tr. 262, 425, 470, 1214, 2666. Maureen Fitzgerald (Fitzgerald) was the head of U.S. Consultant Relations. Tr. 2732. Larry Carlson (Carlson) and Staci Reardon (Reardon) were co-heads of U.S. Relationship Management (Relationship Management), which dealt with institutional clients. Tr. 2664. Fitzgerald, Carlson, and Reardon reported to Brown, who reported to the SSgA president. Tr. 2665-66; Div. Ex. 90 at 9. Relationship Management had a client-facing group that collected and delivered detailed transaction and performance information to clients on a monthly basis. Tr. 2666-71. The monthly information sent to clients and consultants included an investment summary, a performance report, fund sector breakdowns, appraisal reports, and monthly commentaries. Tr. 2775-77; Hopkins Ex. 174 at 16. Client information requests varied a great deal. Some clients asked a lot of questions, while others requested very little. Tr. 2734-35. Carlson believed any institutional client would know that it could seek information from SSgA beyond what its assigned relationship manager provided. Tr. 2736-37.

SSgA's clients and consultants were provided access to the Clients Corner and Consultants Corner, a password-protected website that provided account and performance information. Tr. 66-69, 2669-73; Hopkins Ex. 174 at 17; Div. Ex. 200 at 14. The LDBF also made available audited annual financial statements to its clients. Tr. 2550-51. The LDBF's audited financial statements for the year ended December 31, 2006, issued June 12, 2007, contained a Schedule of Investments that described the LDBF's holdings. Tr. 1217-18; Hopkins Ex. 23. The financial statements also contained a listing of total return swaps (TRS) that showed both market value and notional value. Tr. 1221; Hopkins Ex. 23 at Bates 407-08.

LDBF's Portfolio in 2007

Beginning in 2006, Flannery periodically urged his staff with direct investment responsibilities to consider developments in the housing markets and called and participated in many meetings on the subject. Tr. 826-28; Div. Exs. 15, 16. In May 2006, Flannery expressed concern about exposure to mortgage risk in the real estate market and requested discussion and a written report from SSgA's fixed income team-the heads of Risk Management, Global Fixed Income, Credit Policy, North American Bonds, Active Bonds, and Credit Research, all of whom were bullish on housing-related securities. Tr. 1189-92; Div. Ex. 16.

As of January 2007, the LDBF had outperformed the JP Morgan One Month LIBOR benchmark since its inception in 2002, and "one of the drivers of performance has been [its] exposure to the lower investment-grade cohorts of the secured debt markets, specifically the triple B rated sector . . . ." Tr. 1206-08; Div Exs. 45, 57; Hopkins Ex. 161 at 20. SSgA had several analysts focused on the subprime markets.[17] Tr. 2856-57. SSgA independently analyzed the assets it put

[17] In August 2007, Flannery considered subprime markets to be a relatively new term. Div. Ex. 160. Subprime borrowers were persons who typically did not qualify for market interest rates due to poor credit history and questionable financial situations that resulted in low FICO scores. Id. FICO is a registered trademark of the Fair Isaac Corporation. See www.myFico.com.

into the LDBF portfolio, and did not rely solely on credit ratings. Tr. 1185. It spent a great deal of money on technology that allowed analysts to examine the details of the collateral behind MBS. Tr. 1184-85. It had the ability to "drill down" and find detailed information such as the location of the mortgaged properties,[18] and the individual FICO scores of the borrowers.[19] Tr. 1171, 1184-85, 1999, 2027.

The LDBF investment team considered the portfolio diversified, i.e., there was a lack of correlation among assets because it consisted of thousands of loans on properties located in different parts of the country, from persons with varying credit quality, on deals with different loan-to-value ratios, and the loans were structured differently. Tr. 1183, 1187-88. Asset-backed securities (ABS) backed by subprime mortgages historically exhibited "mean reversion,"–after prices deviated in either direction, they returned to their historical mean. Tr. 1184, 1471-72. According to Flannery, very diversified assets exhibit "mean reversion." Tr. 1184. Peter Lindner (Lindner), in charge of Risk Management in Boston, found that SSgA had "an experienced portfolio management team and a set of analysts at the firm who just did asset-backs and had a multitude of years of experience trading and investing." [20] Tr. 1876-77, 1901.

The LDBF's performance began to change in 2007 when it underperformed its benchmark by 12 bps and 51 bps, in January and February, respectively. Div. Ex. 57. Several SSgA managed funds were impacted by the LDBF's performance. Div. Ex. 45. The LDBF's poor performance in February was due to its investment in the Series 06-2 BBB segment of the ABX Index.[21] Tr. 255, 343; Div. Ex. 45; Flannery Ex. 53. While of great concern because this was beyond anything that had been experienced, it did not spread to other higher-rated securities. Tr. 1225-27.

The ABX was a type of asset-backed derivative. Tr. 1916. "The ABX Index represents a swap whose returns are derived from underlying credit default swaps of the 20 representative subprime mortgage securitizations issued in the United States over a 6 month timeframe." Flannery Ex. 167 at Bates 147. According to Pickett, the ABX Index is a derivative or swap and the LDBF would sell protection on the swap and take a premium. Tr. 1600-01. The contract was not on the subprime securities, but on the credit default swaps written on the bonds. Tr. 1918. If the subprime securities performed well, then the LDBF performed well. Tr. 1601-02. At the end of February or early March 2007, Flannery convened a large meeting that included Shawn Johnson (Johnson), head

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[18] The Management Team tried to avoid properties in California, Florida, and the Rust Belt. Tr. 1171.

[19] SSgA took this extra step because the average FICO score of a bundle of borrowers does not reveal much about the number of expected defaults. Tr. 1171.

[20] Lindner, who earned a Ph.D. in Economics from the University of Pennsylvania, joined SSgA in Boston as the head of risk management for North America in November 2006 and testified that he left SSgA in January 2009 during a series of layoffs. Tr. 1873, 1876-77, 1880.

[21] This series represented returns from twenty bond deals in the first half of 2006. Flannery Ex. 167 at Bates 147.

of Fiduciary Services/Partnerships under the Chief Product Officer, Chairman of the Investment Committee, and the chief economist, the chief counsel, traders, portfolio managers, and credit analysts, to discuss the BBB ABX Index decline.[22] Tr. 1227-30.

Hopkins knew prior to February 2007 that the LDBF was invested primarily in subprime RMBS rated AAA and AA. Tr. 108. Hopkins explained to clients that securities backed by subprime mortgages could have different credit ratings. Tr. 264-65, 579-80; Div. Ex. 96. He believed that a AAA-rated security backed by subprime loans was no more risky, than a AAA-rated corporate security. Tr. 348.

SSgA's Management Team considered subprime assets to be one of their core competencies; they had a positive view of housing-related securities and the fundamentals of the LDBF investment strategy. Tr. 1227, 1731-32, 2000. They believed very strongly that subprime housing-related mortgages would return to their historical average spreads. Tr. 1230. However, the Management Team was becoming more particular about the kind of subprime investments it would make. Tr. 1468. Flannery shared SSgA's view that hedge funds had caused the drop in the BBB tranche of the ABX Index in February 2007, as a way to bet against the lowest quality housing-related subprime securities. Tr. 1225-26; Flannery Ex. 167. The huge move in this one particular segment of the market in February 2007 did not cause much change in other cash or derivative positions. Tr. 1227.

As of June 30, 2007, approximately 82% of the LDBF's assets were invested in RMBS. Tr. 1591. Pickett reasoned that this was an asset class that was highly available and offered a lot of spread over LIBOR; he believed in their high credit quality distribution-their AA and AAA ratings. Tr. 1594-95; Div. Ex. 98 at 4. The SSgA risk team reviewed Pickett's investment decisions either monthly or quarterly. Tr. 1595, 1645-47. For example, in February 2007, Flannery learned that the Risk Management team had not been involved in "modeling the [BBB ABX] trade" and directed that it do so. Tr. 2240-41. The Risk Management team then modeled the risk in the BBB ABX using the actual time series of the security and found greatly heightened risk in the trade and an inverse risk/return relationship. Tr. 2237-41. Risk Management notified Greff, Wands, O'Hara, and Pickett, of their conclusion, however, the investment team chose to continue with the trade. Id. Patrick Armstrong (Armstrong), Director of Risk Management, does not recall discussing the subject with Flannery.[23] Tr. 2238. It appears that in the summer of 2007, Lindner, Armstrong, and Wands had concerns about the investment decisions being made in the LDBF portfolio, but Flannery was not fully informed. Tr. 950-51, 1899-1902.

[22] Flannery considered this issue to be Greff's primary responsibility. Tr. 1227.

[23] In 2007, Armstrong was SSgA's head of Investment Risk Management. Tr. 2195-96. He was located in Paris. Tr. 2197. Armstrong has an undergraduate degree in Economics and History from Boston University and a Masters in Near East Studies from the University of Michigan. Tr. 2192-93. Armstrong has a CFA designation and is an accredited risk manager. Tr. 2193.

From 2004 through the second quarter of 2007, over 88% of the LDBF's ABS holdings were rated AAA or AA in every quarter except one.[24] Div. Ex. 161 at 25. During the first and second quarters of 2007, 94% or more of the LDBF's assets were rated AAA or AA. Div. Ex. 161 at 31. An unprecedented number of subprime mortgages would have to default before an ABS with a high credit rating would not pay interest. Tr. 347-48.

As of the end of June 2007, the LDBF's leverage was 3.50, which meant it had 3.5 times as much exposure as it had assets, or stated another way, the value of assets on a notional basis was 3.5 times greater than its capital. Tr. 1893, 1898. Risk Management did not consider the LDBF's leverage to be a serious concern. Tr. 1898-99. Risk Management reasoned that the LDBF's leverage was due in significant part to LIBOR swaps which were fairly low risk; it was clearly within the "means of the investment strategies that were being pursued by the [trading] desk, by the portfolio management team," and within the parameters set by CVaR, the main system for measuring risk in SSgA's fixed income portfolios.[25] Tr. 1898-99, 2199.

As of June 30, 2007, the LDBF portfolio consisted of about 73% AAA-rated securities, 23% AA-rated securities, 3% A-rated securities, and 1% BBB-rated securities. Div. Ex. 98 at 4. On July 30, 2007, the LDBF had a notional exposure of $2.8 billion to AAA RMBS and a notional exposure of $193 million to AA RMBS through TRS. Flannery Ex. 299 at 14. In the TRS, SSgA agreed to pay a fixed rate of return and in exchange received payments equal to interest plus any positive price movements on particular RMBS. Id. Notional amounts refer to the amount of the underlying or referenced asset. Id. The LDBF could lose more than its initial investment if the value of the bonds underlying the TRS or the ABX Index dropped when the position closed. Flannery Ex. 299 at 10-11, 15.

In July 2007, the LDBF portfolio consisted almost entirely of housing-related ABS for reasons of yield and strategy. Tr. 1173-75, 1183. Housing-related ABS had much higher yields than ABS backed by credit cards, student loans, and auto loans.[26] Id. SSgA's fixed income investment team, including the chief economist, incorrectly projected that investing in the housing sector was a preferred strategy going forward. Tr. 1173-75.

In 2007, Flannery believed that the AAA rating had the same meaning for subprime securities as it had for corporate bonds. Tr. 1181-82. In support, he stated that the Federal Reserve did not differ in its treatment of ABS-rated AAA with zero to five years duration, loaning $0.98

[24] Standard & Poor's ratings were based on the probability of default. Tr. 2070. Moody's and the Fitch Group's ratings were based on the probability of default and the likelihood of recovery of funds. Id. A Standard & Poor's AAA credit rating indicates that the security has "[e]xtremely strong capacity to meet financial commitments, while a rating of AA suggests that the security has '[v]ery strong capacity to meet financial commitments.'" Hopkins Ex. 161 at 25.

[25] SSgA calculated CVaR monthly. Tr. 2268-69.

[26] ABS supported by credit cards traded at LIBOR minus a spread and student loans were about the same; by contrast, the LDBF's objective was 50 to 75 bps above LIBOR. Tr. 1174, 1460.

against them, while loaning $0.97 against AAA corporate bonds. Tr. 1178. The difference was that the ABS were collateralized and corporate bonds were uncollateralized "IOUs." Id.

Market Conditions in Late July and August 2007

Prior to the summer of 2007, home price appreciation in the United States averaged 3%-5% annually since at least 1972, and there were few instances of severe housing defaults nationwide. Tr. 1195-96; Flannery Ex. 4 at Bates 644; Div. Ex. 18 at 16. At some point in April 2007, the LDBF had positive returns year to date, and April and May 2007 were the best months in the LDBF's history. Tr. 513, 1232; Div. Ex. 92 at 8461. However, the LDBF experienced substantial underperformance in June 2007. Tr. 1232; Div. Ex. 100. By June 2007, the underperformance of subprime securities was noted in the press.

At Flannery's request, on June 25, 2007, SSgA's Management Team, along with a member of the risk team, re-examined the subprime market. Tr. 1249-51. Flannery received a written memorandum the same day from Frank Gianatasio (Gianatasio), Head of Global Structured Products, with copies to Greff, O'Hara, Wands, and Lindner, that concluded "[w]e remain constructive on the fundamentals." Tr. 1249-50; Div. Ex. 94. The memorandum noted: the fact that, except for California and the Rust Belt states, foreclosures were lower than the 10-year average "confirms our belief that the issues in the subprime market are not as widespread as the media would have us believe." Div. Ex. 94. It concluded:

> [i]n summary, we think there will be continued weakness in certain parts of the country which will translate into higher defaults and losses in those areas, but we don't believe there is an imminent 'melt down' scenario. Subprime borrowers need loans, lenders are making loans, the street continues to fund these loans via the securitization market, and we expect to continue going forward.

Tr. 1249-54; Div. Ex. 94. O'Hara opined that the subprime market had bottomed out in February and that the problems in June at Bear Stearns with "2 super levered subprime hedge funds" were not subprime events. Div. Exs. 94 at Bates 831.

Through June 30, 2007, the LDBF trailed the LIBOR benchmark by 1.3% and by an additional 4.3% in July. Div. Ex. 138. Things got much worse for the LDBF investors in late July 2007. Tr. 1259. Spreads began to widen not only on the BBB ABX Index but also on higher-rated levels. Tr. 2865. Markets were in disarray and conditions were chaotic; AA-rated ABS were trading cheaper than some junk bonds, and subprime securities traded for less than other securities with comparable credit ratings. Tr. 1268, 1472-73. When SSgA was deluged with client inquiries about the LDBF in July and August 2007, Hopkins was one of the people assigned the stressful responsibility of being a primary contact for customers concerned about the LDBF performance. Tr. 542-43, 2738-39, 2778; Hopkins Ex. 116 at 21.

On July 18, 2007, two Bear Stearns Company hedge funds invested heavily in the subprime mortgage market were found to be virtually worthless, and the ABX BBB 07-1 Index sank to a fresh low. Flannery Ex. 64. In July, the LDBF generated negative returns unprecedented in SSgA's history as a fixed income manager. Tr. 1380. In response to the chaotic markets, Flannery became

personally involved in trying to manage the LDBF crisis.[27] Tr. 1161, 1467. He had daily contact with the SSgA risk team during the summer and fall of 2007. Tr. 1957, 2203.

Between July 11-16, 2007, the LDBF reduced its net position in AA ABX swaps by over 90% and reduced its position in BBB ABX swaps by over 25%. Flannery Ex. 299 at 11. The net effect reduced the risk of loss from the subprime residential market. Id. On or about July 30, 2007, SSgA's Executive Management Committee considered preventing further withdrawals to avoid a "run on the fund;" but decided not to do so. Tr. 1314-15

On July 25, 2007, the Money Market Letter, an online investor publication, reported that the LDBF, invested mostly in subprime MBS with $3 billion in institutional accounts as of March 2007, had lost 3-4% so far in July, following a loss of 0.68%, gross of fees, in June. Flannery Ex. 108. The publication reported that SSgA's website described the LDBF's strategy as using derivatives to eliminate interest rate risk, and that a 1% loss was terrible in a limited duration strategy that by definition was supposed to be low risk with reduced volatility. Tr. 1307; Flannery Ex. 108.

On August 10, 2007, DW Online reported that the LDBF "fell 11% last month, chalking up a USD 330 million loss," and that half of the LDBF's strategy was in ABS and it also lost on TRS. Tr. 1399-1440; Flannery Ex. 197. According to the report, the losses accelerated in the last week of July, and the results had affected other SSgA active strategies because two-thirds of the LDBF's $3 billion in assets came from different SSgA funds. Tr. 1400; Flannery Ex. 197. On or about August 10, 2007, following actions by the European Central Bank, the Federal Reserve reversed positions, and without precedent, announced that it stood ready to facilitate and maintain orderly markets. Tr. 1401-02.

In August, SSgA's Management Team acknowledged that market fundamentals were weakening. Tr. 1381, 2859. The financial crisis that began in the summer of 2007 marked the first ever nationwide decrease in home prices. Tr. 1188. As of August 8, 2007, the LDBF's assets were down 20%. Tr. 1297; Div. Ex. 248 at Bates 537. In July and August 2007, market conditions were so chaotic that Flannery had to deal with problems in every area for which he was responsible. Tr. 1153, 1376, 1381-82. The cash markets began to freeze up and SSgA, the largest player, had an asset-backed exposure of $30 billion. Tr. 1153. In a liquidity crisis, prices do not generally reflect any kind of fundamental value; in this liquidity crisis, there was no market for securities related to the subprime housing market. Tr. 1172, 1473.

In spite of the crisis conditions, there was no loss of principal in the value of the LDBF's assets and they continued to pay interest. Tr. 1297; Div. Ex. 248. On August 8, 2007, Relationship Management announced to investors in the LDBF the option to transfer funds into the LDBF II, a new fund that would follow the same investment strategy, but offer only monthly redemptions, beginning October 31, 2007. Flannery Ex. 161. The communication stated that certain SSgA

[27] Flannery believed that panic in the global markets occurred because difficulty in the mortgage markets exposed leverage that existed on bank balance sheets due to aggressive borrowing that caused concerns, which dried up liquidity globally. Tr. 1456-57.

commingled funds intended to redeem in-kind their respective LDBF interests.[28] Tr. 1412-14; Flannery Ex. 161.

Expert testimony characterized what began in the summer of 2007 as a crisis of unprecedented proportions. Hopkins Ex. 161 at 27-36, Ex. 8. It began with falling home prices in late 2006, and resulted in late July and August of 2007, in a lack of liquidity that affected other aspects of the financial markets. Id. During this time the financial markets experienced a liquidity crisis in the subprime markets for housing-related securities. Tr. 1456-57; Hopkins Ex. 161 at 32. The severe liquidity crisis caused investors to shun asset-backed commercial paper, which had been considered almost risk-free. Hopkins Ex. 161 at 38. Examples of the severe global liquidity crisis include downgrades by Standard & Poor's of RMBS worth $12.8 billion in notional value in July and August; suspension of redemptions from three investment funds on August 9, 2007, by BNP Paribas, one of the largest banks in the world; reluctance of banks to lend to one another; and an unusually large number of downgrades in structured product securities from July through November 2007, by Standard & Poor's and Moody's. Tr. 2069-70; Hopkins Ex. 161 at 32-33, 36-37, Ex. 11.

In February 2009, the Federal Reserve Board of Governors reported to Congress that: "The current period of pronounced turmoil in financial markets began in the summer of 2007 after a rapid deterioration in the performance of subprime mortgages caused largely by a downturn in house prices in some parts of the country." Div. Ex. 161 at 21 n.44.

SSgA Investment Committee Meeting on July 25, 2007

The Investment Committee had ultimate authority over all SSgA investments. Tr. 1255. Johnson, as Chair of the Investment Committee, chose its members, including the heads of GAA, OFA, and CAM. Tr. 2364-66. Flannery had nothing to do with GAA and OFA's participation on the Investment Committee. Tr. 1257.

Flannery was a member of the Investment Committee, and in the absence of the Chair and Vice Chair, he presided at its meeting on July 25, 2007; he invited Mark Duggan (Duggan), Deputy General Counsel, and several others to attend because he considered the situation facing SSgA to be unprecedented. Tr. 1269-74. Flannery began by reminding the participants that the discussions were confidential. Tr. 1275. Following a discussion with Duggan, Alistair Lowe (Lowe), head of GAA, left the meeting when subprime markets were discussed because of the sensitivity of the subject matter and his fiduciary responsibilities to GAA clients. Tr. 2004; Div. Exs. 132 at 2, 134 at 2, 135 at 2. Jie Qin, proxy for Kathleen Mann, head of OFA, remained at the meeting. Tr. 2007-10; Div. Exs. 132,134.

At the July 25, 2007, meeting, the Investment Committee instructed the portfolio management team to: (1) increase the liquidity in the LDBF by the end of the month, in anticipation of expected client withdrawals; (2) sell a pro-rata share (across capital structures) of the LDBF portfolio; and (3) reduce the AA exposure, by a target of 5%, by the end of the week. Flannery Ex.

[28] It is the Division's position that many commingled funds redeemed for cash before August 10, 2007. Tr. 1414-15.

92. The Investment Committee struggled to establish with certainty a percentage of expected redemptions. Id.; Tr. 1278-80, 1738-39.

Pickett, who attended the meeting, understood that he had been instructed to achieve the goal of selling "one point something billion of AAA's by the end of the week" to raise liquidity, and that following the sale of the AAA bonds and repositioning the portfolio, he was to sell bonds pro-rata to satisfy further redemptions. Tr. 1665-67, 1676-77, 1747-48. On July 26, 2007, the Management Team sold $1.54 billion of AAA bonds to Citicorp for 94 cents of par value.[29] Tr. 1671-73, 1691-92; Flannery Ex. 299 at 12. From the proceeds, $1.12 billion was used to pay back loans on the AAA bonds, which, according to Respondents expert, reduced leverage and risk in the portfolio; $423 million remained in cash equivalents. Tr. 708, 1743-46; Flannery Ex. 299 at 12-14. The Division's expert, on the other hand, contends that the LDBF portfolio became more risky because sale of the AAA-rated bonds left remaining investors with riskier, illiquid securities. Div. Ex. 255 at 8-9.

Flannery knew on the day of the sale or shortly after, that approximately $1.1 billion from the AAA-rated bond sale was used to pay off related repurchase agreements and therefore decreased the LDBF's leverage. Tr. 1343. Armstrong agreed that to the extent the LDBF was leveraged, any sale of assets that reduced leverage would reduce risk. Tr. 2206. The Division's expert testified that by August 2, essentially all the cash from the sale of the AAA bonds had been used to satisfy investors. Tr. 712; Div. Ex. 255 at 8-9, Ex. IIIB. Respondents' position is that on August 2, the LDBF had nearly $200 million in cash and cash equivalents. Flannery Reply Brief at 8, citing Div. Ex. 230 and Flannery Ex. 288.[30] From approximately July 31 to August 24, 2007, the LDBF sold approximately $1.2 billion in AA bonds, and on August 7 and 8, it sold about $100 million of A bonds. Tr. 1749-50; Div. Ex. 245, Ex. III.A

Flannery testified that the Investment Committee's instructions were to raise liquidity in a way that would keep the same risk profile; it knew it could not control what the portfolio managers and traders could accomplish in the chaotic, illiquid market, and that the task could not be accomplished with precision. Tr. 1284-85, 1489. Flannery considered the sale of AAA and AA bonds beginning approximately July 31 to be consistent with the committee's instructions. Tr. 1285, 1749-50. Flannery deferred to the Management Team on how best to accomplish the Investment Committee's directions. Tr. 1023-31.

OFA and CAM reported to Johnson. Tr. 2372. Johnson relied on SSgA's standard of conduct that prohibits acting on insider information to ensure that GAA, OFA, and CAM did not use information from the Investment Committee meetings to benefit their clients. Tr. 2391, 2397.

[29] This was the largest sale Pickett had experienced in his eighteen years at SSgA. Tr. 1671.

[30] Div. Ex. 230, titled "9/1/06-5/18/08 Navigator Reports for Various Funds," consists of several hundred pages and was also available electronically. Flannery Ex. 288, is titled "Daily Trial Balances for CMY1 and CMZ5."

OFA

OFA had three clients invested directly in the LDBF and between three and six clients invested in four funds that were invested in the LDBF. Tr. 1775-79; Div. Ex. 130. At a meeting on July 26, 2007, when OFA was considering recommending that its clients leave the LDBF, Greff and Wands recommended August 31, 2007, as the redemption date. Tr. 1801; Div. Ex. 222 at Bates 697. When OFA informed Flannery on July 27, 2007, that it would recommend that clients terminate their LDBF investments and that the Management Team recommended the August 31 date, Flannery made clear that OFA clients did not have to wait until the end of the month to redeem. Tr. 1799-1801, 1809-10; Div. Ex. 222. Flannery did so because he believed that OFA had a fiduciary and ethical responsibility to act in the best interest of its clients and he did not want those interests to be subjugated to the preferences of the bond team, including Greff and Wands. Tr. 877-79. OFA also informed Johnson, who recalled that it was not the first time that OFA had made such a recommendation to its clients. Tr. 2374.

On July 31, 2007, OFA recommended to the State Street Corporation that the State Street Retirement Plan liquidate its position in SSgA's Daily Bond Market Fund because of its exposure to the LDBF. Div. Ex. 147. OFA followed the same procedures in making similar recommendations to all clients invested in, or exposed to, the LDBF. Tr. 1782; Div. Exs. 139, 144, 148-50.

Greff and Wands did not inform OFA what other clients were doing and OFA did not expect them to do so. Tr. 1806. According to Martha A. Donovan (Donovan), a relationship manager, fund managers do not generally share what other clients are doing, and it expected SSgA to keep information about OFA's investment decisions confidential. Tr. 1806-07. OFA's recommendation was based on the LDBF's performance. Tr. 1808. Donovan testified that OFA's recommendation had nothing to do with LDBF redemption activity.[31] Tr. 1809.

GAA

GAA met with the Management Team in February 2007 about the performance of the LDBF portfolio. Tr. 1991-98. Greff, Wands, and other investment team members expressed confidence in the LDBF; they thought February's drop in value was a liquidity event and that prices would recover substantially. Tr. 1998, 2025. Lowe was troubled by the LDBF's inconsistent performance versus risk expectations and increasing bond delinquencies. Tr. 2029-30, 2033-34, 2039-40. Lowe had experienced a dramatic drop in housing prices in England in the late 1980s, which had a lasting impression on him. Tr. 2016. Lowe mentioned his concerns about the housing market to Flannery in March or April 2007, but Flannery explained that he believed the higher tranches were protected and the Management Team did not expect a national housing decline. Tr. 2000-01.

Lowe knew the LDBF was invested in subprime, but he did not inquire about portfolio holdings because he was more interested in performance. Tr. 2023-24, 2032, 2039. Lowe began

[31] I found Donovan to be a credible witness. Jie Qin, who conducted due diligence on fund managers at OFA, was present at the Investment Committee meeting on July 25 and was part of the OFA team that made the recommendation. Tr. 1772, 1774, 1779.

considering withdrawing GAA clients from the LDBF in July, when the LDBF's performance declined. Tr. 2029. He advised Flannery at a regularly scheduled meeting on July 25, 2007, that GAA was meeting to evaluate its investments in fixed income funds. Tr. 2017-18. Flannery told Lowe to do what was best for GAA clients; he did not want to know the decision. Tr. 1350, 2018, 2044-45. Sometime after it made its decision on July 25, 2007, GAA advised Duggan in Legal, Reardon in Relationship Management, and Greff, of its decision to recommend its clients withdraw from the LDBF. Tr. 2042-43. By early August 2007, Flannery knew that GAA had advised its clients to withdraw from the LDBF. Tr. 1349. It was also included in frequently asked questions (FAQs), an internal document with answers to frequently asked client questions. Tr. 1038-39, 1349; Div. Ex. 153.

Lowe denied that redemptions or anticipated redemptions played any role in the advice GAA gave to its clients; it did not have any information about redemptions by others. Tr. 2034. Lowe testified that GAA's recommendation was based on the LDBF's underperformance and the market's treatment of subprime securities. Tr. 2033-34.

Fact Sheets

A fact sheet was created when a fund was created. Tr. 1426-27. The LDBF fact sheet was a two-page document issued quarterly that showed fund strategy and performance numbers and was disseminated to clients and prospective clients.[32] Tr. 70-71, 266; Div. Exs. 4, 8, 29. Each of the four facts sheets in 2006-07 (Fact Sheets) showed different figures for "Sector Weights-by Market Value."

September 30, 2006:	68.50% ABS, 21.90% cash, and 9.6% MBS
December 31, 2006:	85.70% ABS and 14.30% Other
March 31, 2007:	100% ABS
June 30, 2007:	81.30% ABS and 18.70% Rates

Div. Ex. 29. None of the Fact Sheets mention subprime investments, and the June 30, 2007, Fact Sheet did not disclose that the portfolio consisted primarily of subprime securities. Tr. 277. Each of the Fact Sheets contained the following information:

> Description
>
> The [LDBF] Strategy utilizes an expanded universe of securities that goes beyond typical money markets including: Treasuries, agencies, collateralized mortgage obligations, adjustable rate mortgages, fixed rate mortgages, corporate bonds, asset backed securities, futures, options, and swaps. All securities purchased by the fund have a minimum investment grade rating by either Standard and Poor's or Moody's Investor Service. The fund's maximum effective duration is one year.

[32] The paragraph headings were: Investment Objective, Description, Risk Management, Performance, Calendar Year Returns, Bond Quality[-By Market Value], Sector Weights[-by Market Value], and Characteristics. Div. Exs. 4, 29.

> The strategy employs a relative value approach identifying opportunistic investments in the short- and intermediate-sectors of the market.
>
> The fund will use the following methods to add value:
>
> Secured credit
> Term structure
> Liquidity management
> Financing opportunities
>
> Tactical allocations are made to sectors and credits that hold the most promise for appreciation when compared to available alternatives. The fund will also use structure to seek excess return.
>
> Risk Management
>
> When compared to the typical 2 A-7 regulated money market portfolio, the Strategy has better sector diversification, higher average credit quality, and higher expected returns. The tradeoff is this fund purchases issues that are less liquid than money market instruments and these instruments will have more price volatility. This Strategy should not be used for daily liquidity. Returns to the Strategy are more volatile over short horizons than traditional cash alternatives and may not benefit the short-term investor.
>
> * * *

Div. Ex. 29.

The LDBF Fact Sheets did not state that SSgA's Fixed Income unit used the Lehman Brothers Aggregate Bond Index definitions (Lehman Index), a very popular, worldwide reference for fixed income benchmarks. Tr. 442, 444-45, 451-52; Hopkins Ex. 136. Relying on the Lehman Index, the LDBF classified home equity loans or RMBS as ABS, rather than MBS.[33] Tr. 103, 106, 269, 457-58. Many other SSgA funds categorized assets the same way. Tr. 443-44.

The LDBF Fact Sheets did not define the terms ABS and MBS. Tr. 519. Hopkins does not recall referring people to the Lehman Index for the definition of ABS and MBS or providing people with definitions of those terms in the LDBF Fact Sheets. Tr. 106. The contents of the LDBF Fact Sheet had only one minor change, not relevant here, between 2002 and 2007. Tr. 590-92.

Hopkins testified that he did not write the Fact Sheets, but that he was responsible for correcting inaccuracies; he did not have the responsibility or authority to send communications to clients. Tr. 69-70, 414-15, 587-88. Hopkins checked that the data shown in the Fact Sheets were the same as that shown in the characteristics database, a computerized source of portfolio

[33] Some MBS are comprised of agency-backed securities that include mortgages issued or guaranteed by a governmental agency. Tr. 92-95, 125.

information supplied by portfolio managers. Tr. 447. Hopkins went to the portfolio management team when he wanted current information about the LDBF. Tr. 487.

Flannery, who once headed the Product Engineers, believed that: (1) Legal either wrote or approved the Fact Sheet's original narrative and it remained constant; and (2) Compliance reviewed the Fact Sheets thereafter to make sure the data updates, entered through an automated process, were accurate. Tr. 1429-30. Barbara Shegog (Shegog), the LDBF's original product engineer, testified that the statement, "[w]hen compared to the typical 2A-7 regulated money market portfolio, the Strategy has better sector diversification, higher average credit quality, and higher expected returns," was written by the original portfolio managers. Tr. 2803, 2809-10. The statement was intended to convey that, unlike a 2a-7 fund that held securities at book value, the LDBF was a market value fund and that it had an expanded universe from which to buy assets. Tr. 2809-10. Shegog recalled being responsible for reviewing the Fact Sheets quarterly to make sure the "sector characteristics" were accurate, but that a product engineer could not unilaterally change the language in a Fact Sheet. Tr. 2812-14.

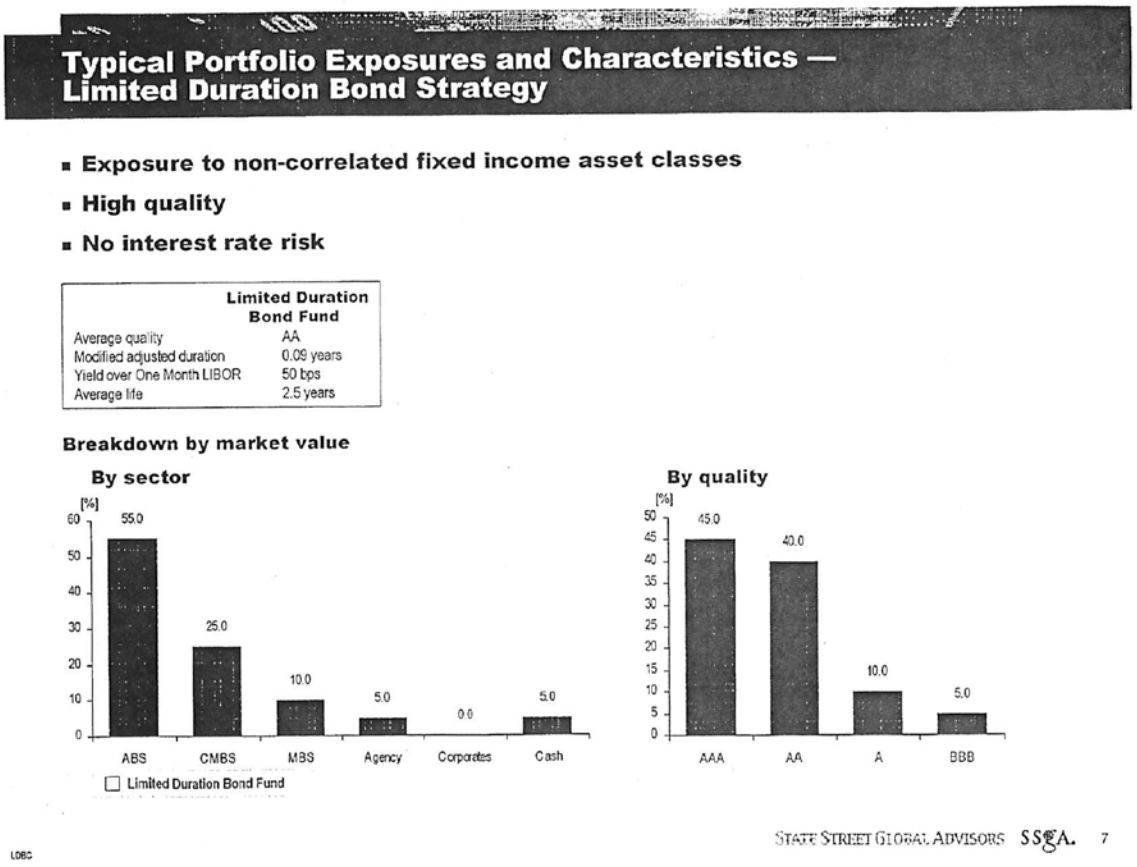
On June 18, 2007, Hopkins did not tell a client relations person who inquired about the meaning of "greater sector diversification" in the Fact Sheets that 100% of its ABS were in subprime RMBS. Tr. 273-76; Div. Ex. 91. On June 19, 2007, Hopkins believed that some people within SSgA's client-facing group did not realize that approximately 80% of the LDBF portfolio was concentrated in subprime. Tr. 260-62, 271-72, 276; Div. Ex. 92. Hopkins realized that the BBB position, specifically the ABX Index BBB tranche, was controversial, but he wanted to convey that the majority of the portfolio was in very high quality AAA and AA-rated subprime securities. Tr. 349-50; Div. Ex. 92. In his opinion, most of securities in the LDBF portfolio did not warrant the designation subprime-they were high credit securities that just happened to be backed by subprime mortgages. Tr. 350.

On June 28, 2007, Hopkins informed a person in Consultant Relations, who mistakenly thought that about 1.8% of the LDBF was in subprime, that, in fact, approximately 95% of the LDBF was in subprime, and that more than 90% was AAA and AA-rated, and 2% was BBB-rated. Div. Ex. 96. As of that date, the LDBF was down 35 bps month-to-date, all of it attributable to the ABX BBB subprime exposure. Id.

Presentations to Prospective Clients, Clients, and Consultants

SSgA received requests for proposals (RFP) from clients and prospective clients, and the RFP department looked to Hopkins for information and answers about active fixed income investments. Tr. 84-87. Hopkins was responsible for reviewing each quarter the accuracy of slides used for the standard LDBF PowerPoint presentations prepared by the portfolio (relations) management team. Tr. 83-84, 166, 192-93, 196. Hard copies of the slides were generally distributed. Tr. 173.

From July 2006 through the summer of 2007, the LDBF's standard PowerPoint presentation contained the following slide titled "Typical Portfolio Exposures and Characteristics – Limited Duration Bond Strategy" (Typical Portfolio Slide).



Div. Ex. 30 at 7.

The Typical Portfolio Slide did not define the sectors or state what securities were in each sector. Tr. 168, 187-88. The Typical Portfolio Slide did not reflect the LDBF's actual portfolio at the time Hopkins participated in presentations to clients and prospective clients. Tr. 169, 196-99. Hopkins believes he had authority to change the sector values to show actual, rather than typical market values. Tr. 586-87. On August 1, 2006, Hopkins was asked whether there was anything he would like to change in the LDBF slides for the current quarter, but he declined. Tr. 194-95; Div. Exs. 25, 30.

In July 2006, the Typical Portfolio Slide was used in a presentation to Johns Hopkins University. Div. Ex. 23. At the time, Hopkins knew and had recorded on his copy of the Typical Portfolio Slide that the LDBF's current portfolio was 90% ABS and 10% cash, and that almost all the ABS were RMBS. Tr. 114-16, 167-69. Similarly, on December 18, 2006, Hopkins was at a presentation to Kalson & Associates where the Typical Portfolio Slide was used when he knew that the current breakdown of the LDBF portfolio was different than the typical slide. Tr. 169-70; Div. Ex. 34. Hopkins prepared for the presentations by getting current information; he does not recall ever being asked questions at the presentations about the makeup of the LDBF portfolio. Tr. 171, 201, 208-09.

In July 2006, Hopkins received notes of a review of the LDBF by the risk team that noted "Increased investment in mid & subprime AAA/AA RMBS thru TRS swaps." Tr. 108-112; Div. Ex. 24. Hopkins understood the note to mean that the LDBF was increasing its exposure to AAA and AA mid and subprime RMBS through a derivative. Tr. 114.

On October 6, 2006, Hopkins submitted an RFP response to the State of Iowa that noted the LDBF did not use leverage, which he admitted at the hearing was inaccurate. Tr. 146-47; Div. Ex. 249 at Bates 742. The RFP response disclosed:

> Risk management is critical to our Limited Duration Bond Strategy. We believe we have a unique risk budgeting process which utilizes a Value of Risk methodology to calculate risk and determine leverage for the portfolio. Careful consideration has been given to risk budgeting in building the portfolio. We have targeted the risk profile of our strategy to be no more than 70-100 basis points on a monthly basis using a 95% confidence interval.

Tr. 505; Div. Ex. 249 at Bates 739.

On February 13, 2007, Hopkins participated in a presentation to the Los Angeles County Employees Retirement Association (LACERA) that used the Typical Portfolio Slide. Tr. 152-53, 173-74; Div. Ex. 39. At the time, Hopkins knew that the LDBF's actual sector breakdown was 90% ABS and 7% cash. Tr. 174; Div. Exs. 39, 43. Hopkins does not recall telling LACERA that the ABS in the LDBF portfolio were all RMBS, and that by February 2007, the RMBS were primarily subprime. Tr. 175.

Hopkins was part of a presentation to Catholic Healthcare Partners (Catholic Healthcare) on April 25, 2007, where the Typical Portfolio Slide was used.[34] Hopkins Ex. 135. Hopkins did not prepare the 43-page presentation and a client-facing person furnished clients with hard copies. Tr. 166, 173, 196, 252-53. One presenter was a SSgA vice president, principal of SSgA Funds Management, and a portfolio manager. Hopkins Ex. 135 at 55. The second presenter was a SSgA vice president and a Senior Relationship Manager. Id.

One slide indicated that the LDBF had reduced its exposure to the ABX Index BBB by one third; Hopkins knew at the time of the presentation that the LDBF had returned its ABX BBB holdings to the original level of approximately 3%. Tr. 247-49; Hopkins Ex. 135 at 15. Hopkins does not remember whether he corrected the slide during the presentation. Tr. 249.

In a May 10, 2007, presentation to National Jewish Medical and Research Center (National Jewish) in which Hopkins and Amanda Williams from SSgA participated, Yanni Partners received a PowerPoint presentation containing the Typical Portfolio Slide; it showed sector breakdown by

[34] Hopkins participated in other presentations that used the Typical Portfolio Slide including to Mercer Investment Consulting in May 2007. Tr. 187; Div. Ex. 85 at 19.

market value as 55% ABS, 25% CMBS, 10% MBS, 5% Agency, and 5% Cash.[35] Tr. 153-54, 2455; Hopkins Ex. 57 at Bates 487. Yanni Partners did not question that portion of the presentation. Tr. 2464. One slide, under Actions Taken, stated "Reduced ABX holdings by 1/3." Hopkins Ex. 57 at Bates 494. Hopkins did not disclose that the LDBF had brought its ABX holdings back to its original position. Tr. 2461. David Hammerstein (Hammerstein), Yanni Partners chief strategist, testified that Hopkins stated during the presentation that the LDBF had a 2-3% exposure to the ABX Index. Tr. 2424, 2459, 2461.

On May 11, 2007, a SSgA salesperson informed Hopkins that he was trying to solicit Delta Airlines' corporate cash program to invest in the LDBF. Tr. 258; Div. Ex. 84. Hopkins asked on May 14, 2007: "Isn't there some rule that states you can't sell an investment to an entity that has recently come out of bankruptcy that might send it back into bankruptcy?'' Tr. 259; Div. Ex. 84. The SSgA sales person replied, "Let's just live on the edge and think positive thoughts . . . ." Div. Ex. 84. Hopkins explained that his response was an attempt at humor; this client had taxable assets so it could not have invested in the LDBF; and while April and May were two of the best months in the LDBF's history, interest in the LDBF was low because of its underperformance in early 2007. Tr. 513-15.

On May 25, 2007, an intern at SSgA asked Hopkins if the Typical Portfolio Slide showing the LDBF's breakdown by sector and quality was still accurate. Div. Ex. 88. By May 2007, the LDBF's actual portfolio was almost entirely in ABS, and more specifically, subprime. Tr. 212. Hopkins added "or unsecured debt risk" to the bullet point, "No interest rate," and said the Typical Portfolio Slide was fine. Tr. 214; Div. Ex. 88.

Hopkins stated that the Typical Portfolio Slide was not intended to represent the LDBF's actual portfolio breakdown at the time of the presentations. Tr. 198-99. Hopkins testified, "I don't recall ever talking about this slide and I don't recall ever answering any questions about this slide." Tr. 200. Hopkins' practice was to bring with him to the presentations the actual breakdown by sector and quality in case he was asked questions. Tr. 201, 208-09. In Hopkins' experience, potential clients did not consider the LDBF's portfolio sector breakdown (e.g., ABS, CMBS, MBS, Agency, Corporates, Cash), to be material in making an investment decision, but focused on other information shown on the Typical Portfolio Slide-exposure to non-correlated fixed income asset classes, quality, and interest rate risk. Tr. 200-03; Div Ex. 88. Similarly, Carlson, the co-head of Relationship Management, testified that during the summer 2007 crisis, amid a deluge of investor inquiries, no client asked him for a sector breakdown of the LDBF portfolio. Tr. 2673.

March 2007 Letter

In February 2007, Hopkins became the point person on SSgA's new Client(s) at Risk (CAR) project established to communicate to persons inside SSgA information about developments in SSgA portfolios that might impact clients, prospects, or consultants. Tr. 220-21; Div. Ex. 45. On February 28, 2007, Kohler circulated to U.S. Sales & Marketing, Non-U.S. Sales & Marketing,

[35] Yanni Partners is an institutional investment consulting firm that develops investment objectives and strategies, constructs and monitors portfolios, and provides risk assessment. Tr. 2430, 2507-08.

Flannery, Greff, Wands, and O'Hara, a CAR alert authored by Hopkins titled, "Triple B Exposure and Impact to Our Active Funds." Div. Ex. 45. The CAR alert described the reasons for the LDBF's negative performance, i.e., exposure to the BBB ABX Index, and was intended to serve as talking points in conveying information to clients. Tr. 217-18, 365; Div. Ex. 45. The CAR alert suggested that hedge funds had seized on negative media reports about the subprime mortgage markets, but that SSgA's Credit Research group remained confident in the market's underlying fundamentals. Tr. 240-42, 1225-26, 1231-32; Div. Ex. 45. The CAR alert did not disclose the LDBF's overall exposure to subprime securities. Tr. 221.

On March 6, 2007, Hopkins transmitted his draft of a "client-friendly letter," "Triple B Exposure and Impact to Our Active Funds" (March Letter), to Carlson, Reardon, Fitzgerald, and Penny Darcey, head of Client Services, with copies to Kohler, Wands, and Bill Porter. Div. Ex. 58. The March Letter, stated:

> One of the alpha drivers in SSgA's active strategies has been taking modest exposure in the triple B asset-backed securities market, specifically the sub-prime home equity market . . . . The purpose of this short write-up is not to present an in-depth treatise of what has happened . . . . What we would like to do in this correspondence is to broadly outline the reasons for and magnitude of what has occurred, to outline the impact of this on the market generally and on our Funds more specifically and to give a sense of what we are doing as it pertains to this situation and its impact on our portfolios.
>
> . . . .
>
> This event is extremely fluid and is changing constantly. However, we felt that a state of the situation report was appropriate at this time.
>
> Senior management in the Fixed Income Group is available for additional conversations on this matter. Please contact your Relationship Manager if further conversations are desired.

Div. Ex. 58; Tr. 223-23. Relationship Management sent the March Letter out to LDBF clients. Tr. 225-26; Div. Exs. 57, 58.

The March Letter reflected the Management Team's belief that the February drop in the value of the LDBF was a liquidity-driven crisis, and that the value of derivatives based on subprime home equity securities would recover. Tr. 2026-29. The Management Team also believed that the AAA tranche of securitized assets had sufficient subordination so that they were "money good" (i.e., the securities would mature at par), a view shared by the nationally recognized statistical rating organizations. Id. Wands did not recall any concerns by the investment team in the early part of 2007 about the AAA and AA subprime securities that the LDBF owned; in fact, he remembered that the BBB rallied back in April and May. Tr. 2853-54, 2857. The expert testimony is that, prior to the summer of 2007, it was reasonable to believe that the risks involved in exposure to AAA and AA-rated MBS were moderate. Hopkins Ex. 161 at 21. As of February 2007, there was no price

correlation between the BBB and the AAA/AA tranches of the ABX Index. Tr. 2181-84; Hopkins Ex. 161 at Ex. 10.

July 26 Letter

SSgA's client-facing team sent out an informational letter to clients on July 26, 2007. Tr. 355-56, 1308, 2749; Flannery Ex. 111. Nick Mavro (Mavro), Vice President in Consultant Relations, took a lead role in sending out the letter; its purpose was to update clients and consultants on the subprime market and SSgA's active fixed income strategies. Div. Ex. 124, Hopkins Ex. 98.

On July 19, 2007, in response to Kohler's request that he prepare a "client letter," Hopkins circulated a draft using an internal CAR alert he had authored on July 2, 2007, on the subprime impact on active portfolios. Tr. 365; Div. Exs. 100, 118. The CAR alert noted that SSgA's structured products credit analysts remained confident in the underlying fundamentals of the exposure and did not believe that events in June signaled a fundamental subprime mortgage event.[36] Div. Ex. 100. Hopkins' draft stated that the substantial underperformance in June was due to exposure to the subprime market, specifically the performance of the BBB ABX Index. Tr. 283; Div. Ex. 100.

Ms. Hudson, an in-house wordsmith, circulated a draft based on Hopkins' "original notes," which she altered substantially, on July 10, 2007, to Carlson, Fitzgerald, Flannery, Greff, Kohler, Reardon, and Wands. Hopkins Ex. 71. Michael Thompson (Thompson),[37] Gianatasio, Wands, and Flannery suggested edits. Tr. 369; Div. Ex. 103, Hopkins Exs. 73, 74. Ms. Hudson sent an updated version to Carlson, Flannery, Fitzgerald, Gianatasio, Kohler, Reardon, Thompson, and Wands on July 12, 2007. Hopkins Ex. 78.

Also on July 12, 2007, Wands sent a copy to Shegog and Jo Anne Ferullo and noted that Flannery wanted Legal to review it.[38] Hopkins Ex. 77. Shames agreed to review the letter and circulate it to Duggan and Christopher Douglas of his staff. Div. Ex. 106, Flannery Ex. 52.

On July 12 and 16, 2007, Flannery sent a status report on SSgA's subprime exposure as of July 10 and July 12, 2007, to numerous people including Armstrong, Gianatasio, Greff, Hopkins, Kohler, Lindner, O'Hara, Pickett, Thompson, and Wands. Flannery Ex. 58.

Flannery discussed the July 26 letter with Shames on or about July 16, 2007, and Shames sent him an updated version on July 17, 2007. Hopkins Exs. 80, 81. In addition to consulting with

[36] Wands testified that he certainly would have reviewed this CAR alert, and that typically a member of the investment team would review anything Hopkins would prepare. Tr. 2861-62.

[37] Michael Thompson was a product engineer. Tr. 369.

[38] In 2007, Shegog and Jo Anne Ferullo were SSgA portfolio managers. Tr. 2803-04; Hopkins Ex. 24 at Bates 909. Flannery reiterated his request that legal vet the letter to Hudson. Div. Ex. 106. Carlson testified that Legal reviewed every letter. Tr. 2749.

Duggan and Douglas of his staff, on July 17, 2007, Shames consulted with outside counsel, Elizabeth Fries (Fries), regarding the July 26 letter.[39] Flannery Ex. 283. Shames indicated to Carlson on July 18, 2007, that the letter was almost ready to go. Hopkins Ex. 82.

On or about July 18, 2007, Mavro and Thompson offered additional edits which were passed on to Wands. Hopkins Ex. 73. Most of these changes were shared with Carlson, Flannery, Reardon, and Shames. Id. On July 24, Shames sent a new version to Brown, Carlson, Duggan, Flannery, Hopkins, Mavro, and Reardon. Div. Ex. 124.

On July 24, Shames asked Hopkins to check on two sentences. Hopkins responded with copies to Greff and Wands:[40]

> As it relates to your comments in the final paragraph, we have in fact lessened our exposure to the subprime sector in many of these portfolios and we are continuing our analysis in terms of further risk reduction. I'm not sure that your comments in the final paragraph reflect the fact that we have lowered our risk profile to this sector in many of the portfolios. Can we be more definitive here?

Div. Ex. 125. Hopkins also volunteered to forward edits and help with later updates. Div. Ex. 118.

After a meeting among Duggan, Flannery, Greff, Mavro, and Wands, the following sentence was added to the draft: "We have used this opportunity to reduce risk in the portfolio by taking advantage of liquidity in the market when it exists, and will continue to do so, without putting further pressure on asset valuations." Tr. 2868-69; Div. Ex. 126.

On July 25, 2007, Shames circulated the latest version of the July 26 letter to Brown, Flannery, Greff, Duggan, Mavro, Reardon, and Wands. Hopkins Ex. 95. On the same day, Duggan sent the draft to Hunt. Id.

SSgA sent the one-page letter to clients and consultants on July 26, 2007. Hopkins Ex. 97. Neither Hopkins' nor Flannery's name appeared in the letter and they did not receive copies. Tr. 356-58; Hopkins Ex. 98.

August 2 Letter

On July 31, 2007, Kohler sent the original draft of a "Client Letter for Month-end Performance" to Carlson, Hopkins, Mavro, Reardon, Shames, and Wands for review. Tr. 2729-30; Div. Ex. 155. The purpose of the August 2 letter was to inform clients of the impact that exposure to the subprime mortgage market had on the LDBF's performance in July. Tr. 2729. As co-head of

[39] Fries is a partner at the law firm Goodwin Procter LLP. Tr. 1332.

[40] Wands was actively involved in managing subprime issues in fixed income in July. Tr. 2864-65. On or about July 17, 2007, Wands made clear that he was the point person for all client inquiries about subprime inquiries. Div. Ex. 102, Flannery Ex. 63.

Relationship Management, Carlson was in charge, and understood that Legal had to approve the letter.[41] Tr. 2690, 2698, 2753-54, 2759; Div. Ex. 256, Flannery Exs. 128, 129, 139, 149.

Several people edited the August 2 letter including Flannery, Reardon, Shames, and Wands. Tr. 2751-52; Div. Ex. 122, Flannery Ex. 126. Flannery's edits would have struck the lined language and added the underlined portions.

> **Actions Taken**
> While we believe that events over the past several months have ~~been largely the result of liquidity and leverage issues, versus long-term fundamentals, we are also aware that~~ indicate some deterioration in longer-term fundamentals, we believe price action has been dominated by the unwinding of leverage in a market segment with sharply reduced liquidity. Additionally, the downdraft in valuations ~~have~~ has had a significant impact on the risk profile of our portfolios, ~~and thus we have taken~~ prompting us to take steps to reduce risk across the affected portfolios. Within the [LDBF] we have reduced exposure to a significant portion of triple B securities, we have sold a large amount of our triple A cash positions and ~~will be reducing~~ additional triple A exposure as some [TRS] rolled off at month end. These actions ~~will~~ simultaneously serve to reduce risk in other SSgA strategies that hold units of the [LDBF].

Compare Div. Ex. 151 with Div. Ex. 155.

Flannery and Shames reviewed the August 2 letter before Carlson cleared the letter for distribution with Brown. Div. Ex. 163. According to Carlson, Legal had the final call on sending the letter. Tr. 2698. The final August 2 letter stated:

> **Actions Taken**
> We believe that what has occurred in the subprime mortgage market to date this year has been more driven by liquidity and leverage issues than long-term fundamentals. Additionally, the downdraft in valuations has had a significant impact on the risk profile of our portfolios, prompting us to take steps to reduce risk across the affected portfolios. To date, in the [LDBF], we have reduced a significant portion of our BBB-rated securities and we have sold a significant amount of our AAA-rated cash positions. Additionally, AAA-rated exposure has been reduced as some total return swaps rolled off at month end. Throughout this period, the Strategy has maintained and continues to be AA in average credit quality according to SSgA's internal portfolio analytics. The actions we have taken to date in the [LDBF] simultaneously reduced risk in other SSgA active fixed income and active derivative-based strategies.

[41] In addition to Shames, Jodie Luster, an attorney in the legal department, also reviewed the letter. Tr. 1059; Div. Ex. 158, Flannery Ex. 142. A relationship manager wanted to inform a client in the August 2 letter of GAA's recommendation to reallocate assets away from active fixed income funds, but Mavro in U.S. Consultant Relations denied his request based on advice from Legal. Tr. 2758-59, 2782-83; Flannery Ex. 149.

Div. Ex. 159.

Carlson does not recall any conversations with Flannery about his edits, and Flannery was not included on a number of the final e-mail exchanges prior to distribution. Tr. 2752; Flannery Exs. 129, 139, 140, 142. Only a handful of Flannery's suggested edits remained in the final letter. Flannery Brief at 48-54; Compare Div. Ex. 155 with Flannery Ex. 144.

On August 2, 2007, Relationship Management, after consultation with a number of people, including Legal, sent out the August 2 letter to clients in twenty-three fixed income actively managed funds, signed by individual Relationship Managers. Tr. 1326-39; Div. Ex. 159.

Yanni Partners

In 2006-07, Yanni Partners recommended the SSgA Enhanced Dow Jones-AIG Commodities Index Fund (Dow Jones Commodities Fund) to four or five clients. Tr. 2433-35. The Dow Jones Commodities Fund replicated the index by buying swaps and invested cash in the LDBF to avoid leverage and generate a return to pay for swap contracts. Tr. 2457, 2538-39. Almost all funds invested in the Dow Jones Commodities Fund were invested in the LDBF. Tr. 2456. There is no evidence that Yanni Partners requested a list of holdings of the Dow Jones Commodities Fund. Tr. 2444.

Hammerstein believed the LDBF was a conservative, high quality, and defensive fund, with no interest rate risk and limited credit risk. Tr. 2441-42. From the literature provided, he believed the LDBF had a very diversified portfolio in which ABS and commercial MBS were important components. Tr. 2441-43, 2549, 2567. Yanni Partners received an RFP response from SSgA on April 6, 2006, and on May 11, 2006, it recommended that National Jewish invest in the Dow Jones Commodities Fund. Tr. 2553, 2562; Hopkins Exs. 140, 142. Hopkins' name did not appear on the RFP response. Tr. 2568-69; Hopkins Ex. 140.

On April 9, 2007, Hammerstein and Ryan Lennie at Yanni Partners had a phone conversation with Bailey Bishop, Hopkins, and Mark Dacey from SSgA, about the performance of the Dow Jones Commodities Fund and were satisfied with SSgA's explanation of the first quarter results.[42] Tr. 2604; Div. Ex. 69. Yanni Partners asked about holdings and was told that the LDBF held only securitized debt and investment-grade issues. Tr. 2619-20; Div. Ex. 69. Yanni Partners claims it was also told that the LDBF's total subprime exposure was 2%. Tr. 2620, 2622, 2624, 2626; Div. Ex. 69. On April 24, 2007, based on information largely from Hopkins, Yanni Partners recommended that its clients stay invested in the Dow Jones Commodities Fund because it understood that the LDBF was well diversified, primarily invested in ABS and MBS, and had in the neighborhood of 2% exposure to the subprime sector. Tr. 2450-55, 2632-33; Div. Ex. 69.

Hopkins denies that he told Hammerstein in April 2007 that the LDBF's exposure to subprime was only 2%. Hopkins Brief at 62-66. Hopkins maintains that the purpose of the

[42] Ryan Lennie was a Consulting Analyst at Yanni Partners. Bailey Bishop was in SSgA's Structured Product Group and Mark Dacey was in Consultant Relations. Div. Ex. 69.

conference call was to explain the LDBF's underperformance in February and March. Id. SSgA consistently attributed that poor performance to its 2-3% exposure to the BBB ABX Index. The minutes of National Jewish's Investment Committee meeting on May 10, 2007, state that Hopkins represented that "State Street had just fewer than 3% of BBB subprime investment exposure." Hopkins Ex. 62 at Bates 694. Hopkins maintains that Hammerstein's testimony was not based on an independent recollection, and his memorandum reflecting the conference call uses "imprecise language." Hopkins Brief at 62-64. Hopkins notes several references in the memorandum to BBB exposure, and argues that Hammerstein wrote "sub-prime issues" to remarks made about the LDBF's BBB position. Id.

In a phone call on July 25, 2007, Yanni Partners found it remarkable to learn that the LDBF engaged in leverage, and that 82% of the portfolio was invested in the subprime market as of June 30, 2007.[43] Tr. 2464-69, 2489; Div. Exs. 128, 161 at Bates 062. Yanni Partners was surprised, because in previous discussions, SSgA had focused on the 5% of the LDBF portfolio, as of February 27, 2007, invested in BBB-rated subprime instruments, and had not disclosed that the portfolio's high quality issues were also tied to subprime mortgages. Tr. 2466-67; Div. Exs. 128, 161 at Bates 063.

On August 3, 2007, Yanni Partners recommended that a client, Welborn Baptist Foundation, terminate immediately its investment in the Dow Jones Commodities Fund. Div. Ex. 161. In a letter, Yanni Partners explained that the underperformance was caused by losses suffered by the LDBF, a "collateral management piece of the commodities strategy," and complained that the LDBF's sector allocations were inadequate. Id. Yanni Partners stated in the letter that it had been shown a typical portfolio allocation where the LDBF had a 55% exposure to ABS, but as of March 31, 2007, 100% of the LDBF portfolio was in ABS. Id. Yanni Partners questioned SSgA's risk management process and complained that SSgA's responses to its Manager Information Request did not detail the actual risk of the portfolio. Id. Yanni Partners made similar recommendations to all its clients. Tr. 2471. The Dow Jones Commodities Fund was much riskier than Yanni Partners thought, and it had lost faith in SSgA and its ability to manage the LDBF's portfolio risk. Tr. 2470-72.

SSgA made available to Yanni Partners account information, fund performance, and investment and research commentary; the information was available at Clients Corner and Consultants Corner on SSgA's website. Tr. 2576-77, 2580-82; Hopkins Ex. 160. There is no evidence that Yanni Partners requested information as to the ABS sectors, or types of ABS in the LDBF portfolio. Tr. 2549. Yanni Partners did not request the LDBF portfolio holdings because it saw no risk; it has since changed its procedures. Tr. 2444. Yanni Partners did not request copies of the annual audited financial statement of the Dow Jones Commodities Fund or the LDBF.[44] Tr.

[43] There was some confusion about the exact date of the call, but it was July 25 or 26, 2007. Tr. 2489-90.

[44] The annual audits contained a list of portfolio holdings as of the end of the calendar year. Tr. 2550-51.

2550. Yanni Partners relied on SSgA's representations and did not evaluate the LDBF's holdings. Tr. 2568.

August 14 Letter

On August 2, 2007, Flannery sent an e-mail to Brown, Carlson, Fitzgerald, Kohler, and Reardon, requesting feedback on interactions with clients and consultants "re Bond Problems," and offering to assist any way he could. Div. Ex. 160. Carlson responded the following day with information that there had been comments that SSgA might be a little cavalier about the situation and that some Relationship Managers believed that SSgA should be "saying up front that we realize that this is a serious situation, that we are disappointed in what has transpired and are doing everything we can to mitigate the damage and make sure that we rectify the situation." Id.

Flannery's duties did not include client communications, but he took the initiative to write a letter to clients in August 2007 because he believed investors needed an explanation and it was the right thing to do. Tr. 1371, 1461. He authored the August 14 letter even though a superior questioned why he would "raise [his] head up." Tr. 1370. Flannery's purpose in writing the August 14 letter was to explain to LDBF investors that what happened to housing-related securities was a disaster of a magnitude unimaginable to securities professionals. Tr. 1377-80, 2763. Flannery's draft of the August 14 letter stated:

> While we believe that the subprime markets clearly convey far greater risk than they have historically we feel that forced selling in this chaotic and illiquid market is unwise. Even if mortgage delinquencies soar beyond our expectations we would expect significantly higher values for our sub-prime holdings. While recent events may have repriced the risk of these assets for the foreseeable future and it is unlikely that they will retrace to values at the turn of the year we believe that liquidity will slowly re-enter the market and the segment will regain its footing. While we will continue to liquidate assets for our clients when they demand it, our advice is to hold the positions for now.

Tr. 1382-84; Div. Ex. 165.

The final August 14 letter, signed by Flannery, contained the above paragraph with the last sentence revised by Duggan to read: "While we will continue to liquidate assets for our clients when they demand it, we believe that many judicious investors will hold the positions in anticipation of greater liquidity in the months to come." Tr. 1097-98, 1386-87; Div. Exs. 166, 176.

Carlson, Reardon, and Fitzgerald reviewed the draft and Carlson told Flannery he thought it was a good idea to send the letter. Tr. 2763-64; Flannery Ex. 166. In addition to review by the co-heads of Relationship Management and the head of U.S. Consultant Relations, the August 14 letter was reviewed by SSgA's president and CEO, the head of Product Engineering, the Chief Marketing Officer, Duggan in Legal, State Street's Director of Media Relations, and Fries, outside legal counsel. Tr. 1384-97, 1402-09, 2765-70; Flannery Exs. 166, 183, 184, 202, 205, 207, 213.

Flannery testified that it did not occur to him to discuss redemptions in the letter, and he believed that Duggan's revision was true even though GAA and OFA recommended that clients withdraw from the LDBF. Tr. 1388-89, 1417. Flannery reasoned that: SSgA personnel were informing investors of these withdrawals as evidenced by the FAQs; investors act based on different investment objectives and risk constraints; and knowledgeable people, including attorneys, reviewed the letter and did not find the statement objectionable. Tr. 1388-89, 1417-18. Flannery consistently required that the legal department approve communications to clients. Tr. 1408.

Compliance

On August 10, 2007, a member of the risk management team with a compliance background reported to SSgA's COO that: (1) there had been no violations of any client requirements with respect to the LDBF's purchase of "Home Equity ABX securities (now referred to as subprime)"; (2) the LDBF began concentrating on Home Equity about three years previous because the returns were so much better than other collateralized assets; (3) the LDBF, like other commingled funds, had few investment restrictions; and (4) risk management and compliance review processes were in place, but no one could have predicted the extreme market conditions. Tr. 2209-11; Flannery Ex. 203. A member of the compliance staff informed the COO in October, 2007, on two separate occasions, that there had been no compliance violations in connection with subprime investments. Flannery Ex. 253. SSgA's president requested a meeting with compliance personnel on October 5, 2007, and received the same information. Tr. 2211-12; Flannery Ex. 253.

Expert Testimony

William M. Lyons

William M. Lyons (Lyons), a Division expert, testified that someone in Flannery's position would be naturally motivated to act to retain investors and assets for the period of time necessary to improve the LDBF's performance.[45] Tr. 1846-50; Div. Ex. 256 at 10-12. Lyons opined that redemptions in excess of available cash would require selling assets for less than what management believed to be their intrinsic value; if this occurred poor performance would be locked into the fund's permanent investment record. Div. Ex. 256 at 11, 15-16. Management is also motivated to retain assets and limit redemptions because fees are typically based on AUM. Id. at 11-12. Concerns about reputation, employment, and personal finances could cause someone in Flannery's position to act to keep investor confidence, discourage redemptions, and maintain the stability of AUM. Id. at 13-14. Lyons did not opine on whether Flannery acted improperly because of these motives.

[45] Lyons is a graduate of Yale University and Northwestern University School of Law. Div. Ex. 256 at 2. He spent five years in private practice and joined American Century, an investment management company, in 1987. Id. Lyons was American Century's General Counsel from 1989 to 1996, COO in 1996, President in 1997, and President and CEO in 2000. Id. at 2-3. At one time, Lyons held Series 6, 7, 26, and 63 certificates. Id. at 5. When Lyons retired in 2007, American Century managed approximately $100 billion in mutual funds, institutional accounts, and a collective investment trust. Tr. 1838, 1854; Div. Ex. 256 at 3. He is a member of the Board of Morningstar, Inc., NIC, Inc., and The NASDAQ Stock Market LLC. Div. Ex. 256 at 5.

In Lyons' opinion, if the LDBF froze redemptions, the CIO would be held responsible because it would suggest inadequacies in the fund's design and risk controls. Id. at 16. Lyons opined that the creation of the LDBF II, which was damaging to Flannery's professional reputation, was an extreme step done to remedy as much as possible an exceptional situation.[46] Tr. 1867-68.

Russell Wermers

Russell Wermers (Wermers), a Division expert, testified that the LDBF had total net assets of roughly $2.8 billion at the beginning of 2007.[47] Div. Ex. 255 at 4. Except for large outflows in May 2007, caused by a fund managed by GAA, the LDBF experienced steady growth until late July 2007. Id. According to Wermers, during the period July 26 to August 10, 2007, about 60% of the LDBF's January 1, 2007, assets (about $1.7 billion) were lost to outflows. Div. Ex. 255 at 5. To raise cash, it sold assets at "fire sale" prices, i.e., prices substantially lower than original quoted prices.[48] Div. Exs. 245, 255 at 4, 5. In Wermers' opinion, the LDBF became more risky almost immediately after the sale of the AAA-rated securities because its portfolio consisted of riskier, illiquid securities. Div. Ex. 255 at 8.

Wermers found that SSgA funds and investors advised by State Street's advisory groups began making large redemptions on July 27, 2007, and completed them on August 10, 2007. Id. at 6. After July 25, 2007, independent investors did not begin making substantial redemptions until August 2, 2007, and then continued at a more gradual pace. Tr. 697-98; Div. Ex. 255 at 6-7.

Wermers focused on the sale of assets to meet redemptions and what assets remained to meet further redemptions. Div. Ex. 255 at 9. He did not consider the LDBF's large risk exposure in TRS tied to the performance of AAA and AA-rated subprime bonds because these derivatives had no liquid market value.[49] Id.

Wermers opined that the market reacts to credit ratings relative to the sector, and it would be "crazy" to treat AAA ABS the same as AAA corporate bonds. Tr. 742. However, another expert, Erik Sirri (Sirri), represented that during his time at the Commission, the rating agencies represented to him that a AAA rating for a corporate and a structured security had the same meaning, but that a

[46] The LDBF II, a fund designed to protect LDBF investors from frequent redemptions, was approved formally on August 3, it was subject to review and approval by Legal and others several days prior, and was announced to the public on August 6. Tr. 1356-57, 2761.

[47] Wermers is a tenured Associate Professor of Finance at the University of Maryland. He holds two Bachelor of Science degrees from the University of Idaho, and Masters in Business Administration and Doctor of Philosophy degrees from the University of California, Los Angeles. Div. Ex. 255 at 1.

[48] Unregistered funds, like the LDBF, do not have quoted prices, but SSgA calculated the share price daily. Tr. 677-78, 688, 732.

[49] The TRS rolled off the portfolio on August 1, 2007. Tr. 718.

AAA municipal is safer than either.[50] Tr. 2168-69. Sirri was not surprised that Standard & Poor's has stated: "Our ratings represent a uniform measure of credit quality globally and across all types of debt instruments. In other words, a triple A-rated corporate bond should exhibit the same degree of credit quality as a triple A-rated securitized debt issue." Tr. 2170; Hopkins Ex. 162.

Wermers concluded:

> Starting on July 26, 2007, Advisor funds and SSgA funds began to redeem *en masse* from the fund. Later, Independent clients also redeemed. To meet redemptions in late July 2007, State Street sold almost all of LDBF's AAA-rated bonds on July 26 and 27, 2007, leaving less liquid, riskier securities to remain in LDBF. The Advisor funds and SSgA funds redeemed earlier, with lower losses because their redemptions came from the more liquid AAA-rated securities. The independent investors who got out later lost more money because they continued to hold shares in a Fund that held lower rated subprime bonds, which had less market liquidity.

Div. Ex. 255 at 10.

John W. Peavy III

John W. Peavey III (Peavy), an investment management expert, was called by Respondents.[51] Hopkins Ex. 174. Peavy opined that: (1) typical investors in the LDBF were large institutions that possessed the necessary expertise to evaluate different types of investments and the vast majority employed investment consultants; (2) unregistered fund investors typically have a level of comfort with a fund's communication model before investing; (3) the LDBF's communication and disclosure model was customary in the industry, reasonable, and appropriate; (4) investors typically collect extensive information prior to investing; (5) typical investors in the LDBF would not rely on a single disclosure, such as a fact sheet or slide presentation, in making an investment decision; and (6) the investment decisions of investors and investment consultants are typically considered confidential and not generally made available to others. Tr. 3007-10; Hopkins Ex. 174 at 11-12, 18-25.

Peavy described SSgA's communication and disclosure as a two-step model that was reasonable, appropriate, and customary for an unregistered investment fund in 2007. Hopkins Ex. 174 at 16-18, 26-27. The first step provided periodic information about fund performance, investor

[50] Sirri's expert testimony follows.

[51] Peavy holds a B.B.A. from Southern Methodist University, an MBA from the Wharton School at the University of Pennsylvania, and a Ph.D. in Finance from the University of Texas. Hopkins Ex. 174 at 2. Peavy is the Chief Investment Strategist at Smith Group Asset Management, L.P., owner of Peavy Financial Services, Inc., and Professor of Professional Practices in Finance at the M.J. Neeley School of Business at Texas Christian University. Id. at 1. Peavy has been a member of the Board of Trustees of the Employees' Retirement Fund of the City of Dallas since 2004. Id. He was the first CIO of the Teachers Retirement System of Texas. Id. at 2.

holdings, and trade summaries; the second step provided additional information on request. Tr. 3025; Hopkins Ex. 174 at 26-27. Peavey found nothing unusual in the fact that materials the LDBF sent in response to a client inquiry, which he considered a step one disclosure, did not show subprime holdings.[52] Tr. 3030-33; Div. Ex. 268.

Peavy testified that clients get the amount of information they want to receive. Tr. 3021-22. Peavy found "plenty of evidence" that investors went to SSgA and got answers. Tr. 3076-77. According to Peavy, it would be unusual for sophisticated investors with ABS in their portfolio not to have made specific inquiries about those holdings during the biggest global financial crisis in our lifetimes. Tr. 3045, 3068-69. According to Peavy, due diligence is verifying information received and fact sheets are just a "starting point." Tr. 3013-15, 3064-68. Peavy would not rely on information in a fact sheet or presentation. Tr. 3013-15, 3064-66. It is his opinion that investors act on the total mix of information. Tr. 3066-67. He believes that sophisticated investors get the information they want, evidenced by the fact that unregistered funds do not have the investor protection features required of registered funds. Tr. 3022, 3077.

Peavy testified that consultants would be given the LDBF portfolio holdings if requested. Tr. 3051-52. In his experience, it is not uncommon for clients to ask for holdings, but most clients do not want to see portfolio holdings.[53] Tr. 3033. Peavy has never heard anyone ask for the percentage of fund assets invested in subprime. Tr. 3032. In his experience, the investment decisions of other investors in a fund are considered confidential. Hopkins Ex. 174 at 19.

Erik Sirri

Sirri, Respondents' expert, opined on many subjects.[54] Sirri opined that sophisticated investors knew that the LDBF's strategy carried risks beyond those of a typical "2a-7 money market fund," and that the term ABS encompassed structured securities backed by first-lien subprime mortgages and home equity loans.[55] Tr. 2081; Hopkins Ex. 161 at 3. The Division disputes these

[52] The request was for "SSgA May 2007 statements and State Street custody April 2007 appraisal reports." Div. Ex. 268. The transmittal advised recipient to contact OFA's client service officer or the sender directly with any questions or additional requests. Id.

[53] The Employees' Retirement Fund of the City of Dallas only asked about the asset classes in the portfolio of one of its investments, an unregistered fund, in June and July 2007. Tr. 3044-46.

[54] Sirri has a B.S. from the California Institute of Technology, an M.B.A. from the University of California at Irvine, and a Ph.D. in Finance from the University of California, Los Angeles. Hopkins Ex. 161, Appendix A. He has taught at Harvard Business School and at Babson College, where he is presently a Professor of Finance. Id. He was the Commission's Chief Economist from 1996 to 1999, and Director of the Division of Trading and Markets from 2006 to 2009. Id. He is an independent director of the Natixis family of mutual funds. Hopkins Ex. 161 at 1.

[55] Sirri considered the SSgA funds that invested in the LDBF to be sophisticated investors. Tr. 2120-21.

two opinions. Sirri acknowledged that there can be uncertainty in how the term ABS is used. Tr. 2153.

Sirri asserts that ABS trade infrequently and bear a higher level of liquidity risk and thus offer higher returns. Hopkins Ex. 161 at 6. Home equity loans are the largest segment of ABS. Id. at 20, Ex. 5. ABS also include credit card receivables, automobile loans, manufactured housing, student loans and others. Tr. 2073. Sirri defined RMBS as prime mortgages that have been put into securitization. Tr. 2074.

Sirri maintained that it is generally not possible to earn higher returns without taking greater risk; therefore, sophisticated investors who invested in the LDBF, a fund that aimed for returns 50 to 75 bps above the LIBOR benchmark, would know that such returns came with higher risks than traditional money market funds. Tr. 2104-05, 2147-47; Hopkins Ex. 161 at 4-8. He opined that sophisticated investors would know in the summer of 2007 that the LDBF portfolio had a substantial amount, or well over 50%, of first-lien subprime loans. Tr. 2146-48.

Sirri noted that information was available in SSgA's monthly or quarterly performance reports which were sent to investors and made available online in the Clients Corner on SSgA's website. Hopkins Ex. 161 at 8-9. In addition, information was available from relationship managers on a wide array of topics, and there was a great deal of publicly available information about funds that followed an "enhanced cash" strategy. Tr. 2133-38; Hopkins Ex. 161 at 8-9, 12-15. Sirri believed that the risks involved in an enhanced cash strategy were well known in the financial community, citing articles in MSN Money, The Financial Times, and other publications. Hopkins Ex. 161 at 13, Ex. 3. He noted that the enhanced cash strategy was referred to by mutual funds as an "ultra-short" strategy for which information was available on the Commission's website. Id. at 13-15, Ex. 4.

In the period 2003 through 2006, over 60% of ABS issuances were collateralized by home equity loans, by far the largest asset group.[56] Tr. 2103; Hopkins Ex. 161 at Ex. 5. Of the primary categories of ABS, only home equity ABS had an average or median spread substantially above 50 bps from January 1, 2003, through December 31, 2006. Hopkins Ex. 161 at 20-21, Ex. 6. Sirri believed that sophisticated investors would have understood that the LDBF's ABS category included structured securities backed by first-lien subprime mortgages because such information was publicly available, and the fact that the spreads on other securitized assets were insufficient to produce the returns sought by the LDBF. Tr. 2156-59; Hopkins Ex. 161 at 3, 15-21, Ex. 6. He noted that the convention was that home equity securities were categorized as ABS, citing the U.S. Floating-Rate Asset-Backed Securities Index compiled by Barclays Capital that included home equity as one type of collateral. Tr. 2176; Hopkins Ex. 161 at 19.

Sirri also opined that the securitization structure used in mortgage ABS substantially diminished the credit risk of the subprime first-lien and home equity collateral so that it was

[56] The Securities Industry and Financial Markets Association defined home equity as including first-lien and junior-lien home equity loans and lines of credit, subprime, small balance issues, and servicing rights. Tr. 2155.

reasonable to believe prior to the summer of 2007 that the LDBF's ABS credit risk exposure was moderate. Hopkins Ex. 161 at 3, 21-25, Ex. 7. Sirri used the term "cash flow waterfall" to describe a design where different tranches of securities are issued against a pool of assets or Special Purpose Vehicle (SPV), with revenues from the pool allocated to different asset groups in order of seniority. Hopkins Ex. 161 at 23-24; Ex. 7.[57] AAA-rated ABS securities were paid first. Id. Sirri believed that SSgA's expectation of low default risk on AAA and AA-rated ABS assets in the LDBF portfolio was reasonable. Id. at 27.

Sirri contended that the severity of the "subprime crisis" was not anticipated by knowledgeable investment people, and SSgA's expectation in August 2007 that highly-rated structured securities could eventually recover was within the range of reasonable outcomes. Id. at 46. In June 2010, Moody's told the Financial Crisis Inquiry Commission that it had not anticipated the magnitude or severity of the ultimate losses on 2006 subprime mortgages and bonds secured by them. Id. at 31. According to one member of the Federal Reserve, the performance of loans that collateralized securities was more highly correlated than anticipated and the risks associated with securitized securities were significantly more concentrated than anticipated. Id. at 40.

Sirri noted that the price decline of highly-rated ABS securities despite the fact that their cash flows continued was unexpected and irrational market behavior. Tr. 2066-67, 2171-75.

Ezra Zask

Ezra Zask (Zask) appeared as Respondents' expert.[58] He concluded that: (1) CVaR was an appropriate measure of portfolio risk; (2) credit ratings alone are not an appropriate measure of total portfolio risk, and credit ratings and CVaR are complimentary measures of different types of risk; and (3) the transactions described in the August 2 letter reduced risk by reducing exposure to securities that could generate losses, increasing liquidity, and decreasing the portfolio's credit risk.

[57] Hopkins Ex. 161 at Ex. 7 shows individual mortgages consolidated into a SPV and cash flowing from the SPV first to a "AAA Super Senior Tranche", and then in order to a "AA Senior Tranche," a "A Mezzanine Tranche," a "BBB Junior Tranche Excess Spread," and "Residual or Equity Tranche." Losses are suffered in the opposite order.

[58] Zask earned a Bachelor's from Princeton University, Cum Laude, and two Masters degrees from Columbia University. Flannery Ex. 299 at 1-3, Ex. 1. He is president of SFC Associates, LLC. Id. He has thirty years of experience in the financial services industry, including working for banks with responsibility for trading operations, risk management, and investment portfolios, including structured securities and mortgage-backed instruments. Id. He founded and managed a hedge fund. Id. He has advised on asset allocation and managed portfolios, provided litigation support, and taught courses on mortgage-backed securities, risk management, and portfolio management. Id. He is the author of Global Investment Risk Management and the eFinance Reader published by McGraw-Hill. He has also testified for the Commodity Futures Trading Commission in litigation. Id.

Tr. 2340, 2354-55; Flannery Ex. 299 at 4. Zask found that SSgA's application of CVaR captured more risk than others in the industry who used CVaR.[59] Tr. 2282-87, 2307-09.

SSgA's August 2 letter discussed swap transactions on July 11-16, the sale of AAA-rated bonds on July 26, and the expiration of TRS at the beginning of August. Zask testified that:

> These transactions reduced the fund's market and credit risk by (1) decreasing exposure to the subprime residential market; (2) reducing the portfolio leverage; and (3) increasing liquidity by converting securities into cash and cash equivalents.

Flannery Ex. 299 at 10.

Zask opined that the CVaR analysis showed a reduction in portfolio risk because of the sale of the AAA-rated bonds. Flannery Ex. 299 at 13, Ex. 6. The Division disagreed, claiming Zask mistakenly assumed that the proceeds of the bond sale were put into cash. Tr. 2281-82, 2290-93, 2320-28. The Division also argued that Zask's analysis relied on stale data that dramatically understated the risk of the LDBF's assets. Div. Reply Brief to Flannery at 10-12. In response, Zask testified that he stands by his calculation, but noted that a reduction in CVaR would not equate to a reduction in portfolio risk; the issue is much more complicated. Tr. 2331. According to Zask, authoritative figures agree that something like CVaR should always be used in conjunction with at least two other methods of risk analysis, such as stress testing and scenario analysis. Id.

Zask contended that his conclusion that portfolio risk was reduced had to do with liquidity, credit risk, leveraging, and exposure to the subprime market. Tr. 2328. Zask found that SSgA's August 2 letter laid out clearly that the way to deal with the LDBF's deteriorating portfolio was to reduce exposure to the subprime mortgage market. Tr. 2328, 2356-57. To Zask, it was evident: "You've got a risk in the housing market, and you take three steps to reduce that exposure." Tr. 2357.

Character Witnesses

Kevin Joseph O'Leary

Kevin Joseph O'Leary (O'Leary) has known Flannery for ten years.[60] Tr. 2967. He has seen Flannery's considerable charitable endeavors and admires him and his wife for instilling an

[59] There was an error in a calculation on Ex. 5 to Flannery Ex. 299, but Zask did not consider it material. Tr. 2300, 2352-53; Flannery Ex. 299 at 12-13, Ex. 5.

[60] O'Leary is a graduate of St. Louis University. Tr. 2980. He has a Masters in Divinity and is a candidate for a Masters in Administration and Education. Id. O'Leary is a Catholic priest and rector of the Cathedral of the Holy Cross in Boston with several additional administrative and pastoral responsibilities. Tr. 2965-66. O'Leary knows of Flannery's generosity in his parish, in Catholic Charities, and in a project that brought children from Chernobyl to Boston for medical treatment and a summer vacation, where for several years, Flannery took children into his home. Tr. 2969, 2973-74.

ethic of serving the community in their children. Tr. 2972. O'Leary believes Flannery to be a person of faith, honor, and integrity; he has witnessed Flannery deal with tragedy in the death of a son. Tr. 2973-75, 2979. Because of his high regard for Flannery, O'Leary has nominated him for membership in a prestigious society within the Catholic Church. Tr. 2976-78.

Andrew Richards

Andrew Richards (Richards), Co-Executive Director of the Boston Ronald McDonald House (McDonald House) and staff psychologist and instructor in medicine at Children's Hospital Boston, testified for Hopkins.[61] Tr. 2836. Richards has known Hopkins for at least ten years and considers him to be a person of great integrity. Tr. 2836, 2838. Hopkins initiated contact with the McDonald House and has volunteered there faithfully for three hours each Monday evening for ten years. Tr. 2836-37. Hopkins has served as president of the McDonald House. Tr. 2837. It was unusual for someone who was not a parent of a sick child to be asked to hold that position, but at the time, the Board needed an honest person with no agenda who was able to bring people together. Tr. 2837-38. Hopkins is presently a member of the Board. Tr. 2837. Richards considers Hopkins one of the most honest people he knows. Tr. 2838. He testified without a subpoena because he wants to go on the record as to Hopkins' integrity and good works. Tr. 2838-39.

Findings and Conclusions

The Division alleges Respondents willfully violated Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 thereunder.[62] As pertinent here, the statutes and rule provide as follows:

Securities Act Section 17(a)(1)-(3) makes it unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly -

(1) To employ any device, scheme, or artifice to defraud, or

(2) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(3) To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[61] Richards holds a Bachelor's degree from Kenyon College, a Master's in Psychology from Boston College, and a Ph.D. in Clinical Psychology from Antioch College. Tr. 2835-36.

[62] "Willful" means intentionally committing the act that constitutes the violation. See Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000). There is no requirement that a person be aware that he is violating a statute or regulation. Id.

Similarly, Exchange Act Section 10(b) makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange:

> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

To establish a violation of the antifraud provisions, the Division must establish that Respondents made material misrepresentations or materially misleading omissions in connection with the offer, sale, or purchase of securities, either acting with scienter or negligently. See S.E.C. v. Pirate Investor LLC, 580 F.3d 233 (4th Cir. 2009); SEC v. Morgan Keegan & Co., 2011 U.S. Dist. LEXIS 71481, (N.D. Ga. 2011) (citing SEC v. Merch. Capital, LLC, 483 F.3d 747, 766 (11th Cir. 2007)); SEC v. Steadman, 967 F.2d 636, 641-42 (D.C. Cir. 1992). Violations of Sections 17(a)(1), Section 10(b), and Rule 10b-5 require a showing of scienter; Sections 17(a)(2)-(3) require a showing of negligent conduct. See Steadman, 967 F.2d at 641 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976); Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980)).

Both Respondents engaged in activities "in connection with" the offer, purchase, or sale of securities, and employed the mails and means of interstate commerce in doing so. The parties do not dispute these elements.[63]

The following concepts are generally applicable:

[63] The case law calls for a reasonably broad approach on the concept of "in connection with." See Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25, 37 (2d Cir. 2005) (the "in connection with" language in § 10(b) and Rule 10b-5 must be read flexibly, not technically and restrictively so that novel and atypical as well as garden type variety frauds do not escape its prohibitive scope) (citing Superintendent of Ins. v. Bankers Life & Casualty, 404 U.S. at 6, 11 n.7, 12 (1971)). See also Pross v. Katz, 784 F.2d 455, 459 (2d Cir. 1986).

Investor Sophistication

The LDBF's investors were sophisticated, institutional investors, most of whom engaged investment consultants to provide investment assistance. "Investment vehicles that remain private and available only to highly sophisticated investors [such as the LDBF] have historically been understood not to present the same dangers to public markets as more widely available investment companies, like mutual funds." Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006).

Many courts have considered an investor's sophistication to be a factor in evaluating allegations of fraud. "[T]here is no duty to disclose information to one who reasonably should already be aware of it." Myzel v. Fields, 386 F.2d 718, 736 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Seibert v. Sperry Rand Corp., 586 F.2d 949, 952 (2d Cir. 1978) (following Myzel, notwithstanding the underlying philosophy of federal securities regulations being full disclosure). Investor sophistication is relevant to assessing the adequacy of disclosure.[64] See e.g., Hunt v. Enzo Biochem, Inc., 530 F. Supp. 2d 580, 599 (S.D.N.Y. 2008); Drobbin v. Nicolet Instrument Corp., 631 F. Supp. 860, 891 (S.D.N.Y. 1986); Quintel Corp. v. Citibank, N.A., 596 F. Supp. 797, 801-02 (S.D.N.Y. 1984) ("Sophisticated investors are entitled to the protection of [S]ection 10(b) of the Securities Exchange Act of 1934 . . . and Rule 10b-5[.] However, the sophistication [of investors] . . . is relevant to the adequacy of disclosure . . . ."); Martin v. Steubner, 485 F. Supp. 88, 92-93, 97 (S.D. Ohio 1979), aff'd, 652 F.2d 652 (6th Cir. 1981), cert. denied, 454 U.S. 1148 (1982) (holding that the defendant lacked scienter as required under Rule 10b-5 because he assumed, based on plaintiff's representations, that the plaintiff was sophisticated).[65]

Materiality

A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision and if disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available. See Matrixx Initiatives Inc. v. Siracusano, 131 S. Ct. 1309 (2011); Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). It is not sufficient to allege that the investor might have considered the information important, nor is it necessary to assert that the investor would have acted differently had the disclosure been made. See Ganino v. Citizens Utils. Co., 228 F.3d 154, 162 (2d Cir. 2000).

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[64] Not all courts consider investor sophistication to be relevant in assessing the adequacy of disclosure. See e.g., Stier v. Smith, 473 F.2d 1205, 1207 (5th Cir. 1973) (reversing the district court and finding that defendant violated Rule 10b-5 "in view of the sophistication and financial acumen of the Plaintiff," reiterating: "Appellant was entitled to judgment as a matter of law because sophisticated investors, like all others, are entitled to the truth.")

[65] It seems the disclosure would have been adequate if the plaintiff had, in fact, been sophisticated. Investor sophistication may also be considered a mitigating factor in determining sanctions. See e.g., Siegel v. SEC, 592 F.3d 147, 157, 164 (D.C. Cir. Jan. 2010) (finding the sophistication of investors to be a mitigating factor in holding that the SEC abused its discretion in imposing restitution on a former registered representative who violated NASD rules).

Negligence

Negligence is defined as:

> [t]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights. The term connotes culpable carelessness.

BLACK'S LAW DICTIONARY 1056 (7th ed. 1999).

Primary Liability

To establish primary violations by Flannery and Hopkins under Section 17(a), the Division must prove that Respondents (1) "employed" a device, scheme, or artifice to defraud; (2) obtained money or property "by means of" an untrue statement of material fact or material omission; or (3) "engaged" in a transaction, practice, or course of business which operates or would operate as a fraud upon the purchaser. Similarly, to establish a primary violation of Section 10(b) and Rule 10b-5(b), the Division must prove that Respondents "made" an untrue statement of material fact or material omission.[66] Absent such a showing, the Division may only establish that Respondents aided and abetted such violations.[67]

Respondents contend that their conduct with respect to the Division's allegations must be analyzed under a new test set forth by the U.S. Supreme Court. See Flannery, Notice Regarding Recent Supreme Court Decision, June 14, 2011; Hopkins Letter, dated June 16, 201[1]. In Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011), the Supreme Court resolved a circuit split and established what it means to "make a statement" for purposes of Rule 10b-5. The Court held that Janus Capital Management LLC (JCM), a mutual fund investment adviser, was not liable in a private implied right of action under Rule 10b-5 for false statements included in its client mutual funds' prospectus. Id. at 2301. The Court focused on who had "ultimate control" over the allegedly misleading statement, holding that JCM did not "make" the material misstatements:

> For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not "make" a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker.

Id. at 2301-2302.

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[66] Rule 10b-5(a) and (c) mirror the language in Securities Act Sections 17(a)(1) and (3).

[67] The Division has not alleged aiding and abetting liability.

The Division contends that the Janus ruling applies only for the purposes of Rule 10b-5(b) implied private rights of action and does not affect its "scheme liability" and "course of conduct" claims pursuant to Rule 10b-5(a) and (c), its similar "scheme liability" and "course of conduct" claims pursuant to Securities Act Section 17(a)(1) and (3), or its "misstatement liability" claim pursuant to Securities Act Section 17(a)(2).[68] Div. Letter dated June 21, 2011.

Respondents reject the Division's contention that Janus be construed narrowly, citing SEC v. Kelly, 2011 U.S. Dist. LEXIS 108805 (S.D.N.Y. 2011), in which the Court dismissed the SEC's claims for primary liability under Exchange Act Section 10(b) and Rule 10b-5 and Securities Act Section 17(a) because neither defendant "made" a misleading statement under the new Janus standard. See Flannery, Notice Regarding Recent Decision Dismissing Division's Claims Based on Supreme Court's Holding in Janus, September 29, 2011; Hopkins Letter, dated September 30, 2011. The Court in Kelly expressly rejected the Commission's position that Janus does not affect its ability to assert a "scheme liability" claim under Rule 10b-5(a) and (c), noting: "[W]here the primary purpose and effect of a purported scheme is to make a public misrepresentation or omission, courts have routinely rejected the SEC's attempt to bypass the elements necessary to impose 'misstatement' liability under *subsection (b)* by labeling the alleged misconduct a 'scheme' rather than a 'misstatement.'"[69] Kelly, 2011 U.S. Dist. LEXIS 108805 at *8. The Court similarly rejected the Commission's position that Janus does not apply to claims brought under Section 17(a), noting that the elements of a Section 17(a) claim are "essentially the same" as those for claims under Rule 10b-5.[70] Id. at *14-15 (citing cases).

SEC v. Kelly did not cause the Division to change its position. Div. Letter, dated October 5, 2011. Rather, the Division cites a slightly earlier District Court decision, SEC v. Daifotis, 2011 WL 3295139 (N.D. Cal. Aug. 1, 2011), in which the Court declined to apply Janus to Section 17(a) claims because: (1) the word "make," at issue in Janus, does not appear in the language of Section 17(a); and (2) the Janus Court's narrow interpretation of "make" followed from the Court's prior decisions limiting the scope of implied private rights of action (which is not an issue in the context of Section 17(a)).[71] Daifotis, 2011 WL 3295139 at *5-6.

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[68] The Janus holding does not expressly apply to Section 17(a) of the Securities Act, nor does it address whether or how its interpretation of "to make a statement" for purposes of Rule 10b-5(b) affects the "scheme liability" and "course of conduct" provisions of that Rule.

[69] The Court continued: "Where the SEC is attempting to impose primary liability under *subsections (a) and (c) of Rule 10b-5* for a scheme based upon an alleged false statement, permitting primary scheme liability when the defendant did not 'make' the misstatement would render the rule announced in Janus meaningless." Kelly, 2011 U.S. Dist. LEXIS 108805 at *11-12 (emphasis added).

[70] Section 17(a)(2) and Rule 10b-5(b) do not share identical language, however, they have the same functionality when it comes to establishing primary liability–proof that the defendant made materially false statements or omissions. Kelly, 2011 U.S. Dist. LEXIS 108805 at *14-15.

[71] There is no implied private right of action pursuant to Securities Act Section 17(a). Daifotis, 2011 WL 3295139 at *6.

This case involves allegations of materially false or misleading statements or omissions, and I find the Janus test to be the appropriate standard to apply in evaluating the extent of Respondents' conduct. Therefore, with respect to allegations involving documentary evidence, the Division must establish that Respondents' had ultimate authority and control over such documents.

Scienter

Scienter is a mental state consisting of an intent to deceive, manipulate, or defraud. Ernst & Ernst, 425 U.S. at 193 n.12 (1976). Scienter has also been described by the Supreme Court as a "wrongful state of mind." Dura Pharm. v. Broudo, 544 U.S. 336, 341 (2005). Scienter may be established by indirect evidence and may extend to a form of extreme recklessness. See Herman & MacLean v. Huddleston, 459 U.S. 375, 379 n.4 (1983) (noting that while the Supreme Court has not explicitly addressed the issue, it is the prevailing view of the appellate courts that reckless behavior may satisfy the scienter requirement); In re Cabletron Sys., Inc., 311 F.3d 11, 38 (1st Cir. 2002); In re Scholastic Corp., 252 F.3d 63, 74 (2d Cir. 2001). Recklessness is defined as an extreme departure from standards of care such that the danger of misleading buyers or sellers is either known or so obvious that the person must have been aware of it. Steadman, 967 F.2d at 641-42 (D.C. Cir. 1992).

I. Hopkins Did Not Violate Sections 17(a) and 10(b) and Rule 10b-5 in Connection with the LDBF Fact Sheets

The Division contends that Hopkins committed the violations by being responsible for, and using, quarterly Fact Sheets that falsely and misleadingly stated that the LDBF:

- invested in a diversified portfolio;
- had better sector diversification than a "typical 2A-7 regulated money market portfolio;" and
- had average credit quality higher than a money market fund.

Div. Brief at 13. The Division alleges that in 2006-07, certain Fact Sheet statements-"investing in a diversified portfolio" and "had better sector diversification" than a "typical 2A-7 regulated money market portfolio"-were misleading because Hopkins did not update the "list of securities" that the LDBF utilized and did not reflect the significant changes that occurred in the LDBF portfolio. Id. The Division charges that the sector weights in the Fact Sheets were misleading because they concealed the LDBF's concentration in subprime RMBS and "failed to disclose that LDBF's exposure to subprime RMBS risk greatly exceeded the market value of its assets and thus failed to inform investors that its use of leverage magnified its subprime exposure." Id. at 13-14.

A. Hopkins Was Not Responsible for, and Did Not Have Ultimate Authority over, the Fact Sheets

Product engineers did not produce Fact Sheets. The Fact Sheets were not Hopkins' work product. He did not write them or have responsibility for them, sole or otherwise, and he was not the product engineer working on the LDBF when they were created. Hopkins was asked to review the Fact Sheets quarterly and make corrections; however, his ability was limited. I find persuasive

Flannery and Shegog's testimony that the Fact Sheets were written by the original portfolio manager and others, including Legal, and remained constant; Compliance reviewed them thereafter to ensure that automatic data updates were inputted accurately. The two-page Fact Sheets consist of narrative accompanied by small graphic representations of performance, returns, bond quality, sector weights, and characteristics (collectively characteristics). Hopkins was responsible for verifying the accuracy of the characteristics.

The Division's allegations go primarily to the narrative of the Fact Sheets, and the persuasive evidence is that Hopkins did not have authority to make substantive changes in their contents.[72] Because Hopkins did not have responsibility for, or have ultimate authority over, the contents or distribution of the Fact Sheets, he cannot be primarily liable under Sections 17(a) and 10(b) and Rule 10b-5.[73]

B. The Fact Sheets Did Not Contain Material Misrepresentations and Omissions

The evidence does not show that the Fact Sheets contained material misrepresentations or omissions about the LDBF portfolio and sector diversification vis-a-vis a regulated money market fund. Going into the summer of 2007, SSgA believed that the LDBF portfolio, which consisted almost entirely of RMBS, was diversified, and this belief was reasonable. Until the summer of 2007, there was a lack of price correlation among the various ratings of subprime RMBS securities; SSgA took special care to assure that the assets underlying the LDBF's RMBS varied in terms of credit quality, specific geographic location, individual FICO scores, and loan structure, among other things. The expert testimony is that it was reasonable to believe prior to the summer of 2007 that the LDBF's ABS credit risk exposure was moderate. Moreover, the Fact Sheet statements compared the LDBF's strategy to that of a typical 2A-7 money market fund, yet the Division's allegations are based on a snap-shot of the LDBF's portfolio. Also, Shegog's testimony established without contradiction that the original Fact Sheet's reference to a 2A-7 money market fund was to highlight that the LDBF was a market value fund with an expanded universe from which it could purchase assets.[74]

The evidence does not show that (1) reporting the LDBF's holdings of MBS in the ABS category; and (2) failing to disclose in Fact Sheets that the LDBF portfolio consisted almost entirely of subprime RMBS were material misrepresentations or omissions.

As to the first point, that some people did not understand that housing-related collateralized instruments would be in the ABS category does not automatically make this way of categorizing

[72] The Division's limited allegation about the characteristics is covered in the following section.

[73] Even if Janus was applied only to its Rule 10b-(5) claim, as the Division contends, its claims under Section 17(a) and Rule 10b-5(a) and (c) would fail because the evidence does not show that Hopkins substantially participated or was intricately involved in the preparation of the allegedly fraudulent statement. See Howard, 228 F. 3d at 1061 n.5 (9th Cir. 2000).

[74] The Division also alleges that the Fact Sheets falsely stated that the LDBF had average credit quality higher than a money market fund. There is no evidence in the record on which to evaluate this claim.

portfolio holdings deceptive.[75] There is no evidence that SSgA's use of definitions from the Lehman Index, a widely accepted reference, was anything but reasonable, particularly when most investors were sophisticated or had sophisticated consultants advising on their behalf. Moreover, SSgA used this sector breakdown in many of its funds; it would be well above Hopkins' "pay grade" to change in 2006-07, a definition that had been in place since the LDBF was created.

As to the second point: (1) the term subprime took on new meaning beginning in late 2006, and the LDBF Fact Sheets were created in 2002; (2) there is no evidence that it was customary to disclose information about a fund's subprime portfolio in materials such as Fact Sheets. The expert evidence is persuasive that Fact Sheets were considered to be a snapshot of the fund, and not intended to convey detailed information. The testimony was that a sophisticated investor would not rely on information in a fact sheet, but rather would consider the totality of information from various sources before making an investment decision.

The findings obviate the need to address Hopkins' scienter or negligence, however, it is significant that with regard to the Fact Sheets, other materials, and other inquiries addressed specifically to him, there is no persuasive evidence that Hopkins conveyed information that he knew, or should have known, was materially false or misleading.

II. Hopkins Did Not Violate Sections 17(a) and 10(b) and Rule 10b-5 in Connection with the Typical Portfolio Slide

According to the Division, Hopkins misled investors because he personally "made" at least five presentations to clients in 2006-07, using a chart showing "Typical Portfolio Exposures and Characteristics - LDBF" that he knew did not show the LDBF's typical portfolio composition. Div. Brief at 15-17.

A. Hopkins Was Not Responsible for, and Did Not Have Ultimate Authority over, the Typical Portfolio Slide

Hopkins did not prepare the PowerPoint presentation and he did not author or have ultimate authority for the Typical Portfolio Slide. Similar to the Fact Sheets, Hopkins was asked to review and correct material that others prepared. It is undisputed that he was asked to make corrections, but this did not make him responsible for, or give him ultimate authority over, its contents or distribution.

B. The Typical Portfolio Slide Did Not Contain Material Misrepresentations or Omissions

The Typical Portfolio Slide did not reflect the LDBF's actual portfolio composition when it was used in presentations. It represented a 55% investment in the ABS sector, when the LDBF's

[75] The definition of ABS in Section 3(a)(77) of the Exchange Act includes collateralized mortgage obligations.

actual portfolio composition was closer to 90% ABS in 2006-07.[76] I do not find this fact to be a material misrepresentation for the following reasons. First, the disputed page on its face states that it is "typical." As its name makes clear, the slide represented a typical portfolio breakdown, not the composition of the LDBF's actual portfolio at a particular point in time. Typical is not actual. In addition, the Typical Portfolio Slide showed the remaining 35% as 25% CMBS and 10% MBS, categories that expert testimony established can be reasonably classified as ABS. Finally, The undisputed evidence is that when requested, SSgA provided information about actual LDBF portfolio holdings to clients and consultants. Furthermore, information about holdings of the LDBF and other similar funds was available from a variety of other sources all within reasonable reach of the LDBF's sophisticated investors.

Second, I accept as reasonable Peavy's expert opinion that no sophisticated investor would rely on this single piece of information, but would consider a total mix of information such as discussions with fund managers, responses to questions, and requests for information before making an investment decision. I also accept Sirri's expert opinion that enhanced cash strategies were widely discussed in the public press and well known in the financial community. Third, Hopkins had with him at the presentations information on the actual composition of the LDBF's portfolio. Hopkins' position that he does not recall anyone asking about the LDBF's portfolio composition is not unreasonable. No evidence was presented as to whether Hopkins did, in fact, disclose the actual composition of LDBF's portfolio. And, according to Carlson, Lowe, and Peavy, most investors do not inquire into the composition of a fund's portfolio holdings.

In sum, the evidence does not show that the Typical Portfolio slide was false or materially misleading on its face, or that Hopkins represented that it was the LDBF's actual portfolio composition. It is therefore not necessary to evaluate Hopkins' culpability as it pertains to his use of the Typical Portfolio Slide. Accordingly, I find that Hopkins did not violate Sections 17(a) and 10(b) and Rule 10b-5 in connection with the Typical Portfolio Slide.

III. Hopkins Did Not Violate Sections 17(a) and 10(b) and Rule 10b-5 in Connection with Client Presentations in April and May 2007

The Division charges that Hopkins failed to correct a slide used in presentations to Catholic Healthcare and National Jewish on April 25 and May 10, 2007, respectively, that stated that the LDBF had "reduced ABX holdings by 1/3" when Hopkins learned immediately prior to April 25, that the LDBF had increased its BBB ABX Index exposure back up to 3%. Division Brief at 18-21. The Division alleges that Hopkins used the slide that stated "reduced ABX holdings by 1/3" in the presentations and provided copies to the clients. Div. Brief at 18-19.

[76] The Division also contends that the Typical Portfolio Slide omitted to state that the LDBF's actual composition was 90% subprime RMBS. I have decided allegations about the "RMBS" and "subprime" designations elsewhere in this Initial Decision.

A. Hopkins Was Not Responsible for, and Did Not Have Ultimate Authority over, the Slide Presentation[77]

Hopkins was asked to review the portion of the standard slide presentation referencing the LDBF, approximately 7 pages, and he was present at both presentations to answer questions about the LDBF. Hopkins was one of three SSgA personnel making the presentation to Catholic Healthcare. One presenter to Catholic Healthcare was a SSgA vice president, principal of SSgA Funds Management, and portfolio manager. The second presenter was a SSgA vice president and Senior Relationship Manager. Amanda Williams from SSgA made the presentation to National Jewish with Hopkins. On these facts, I do not find that Hopkins was responsible for, or had ultimate authority over, the slide used in the presentations.

B. The April and May 2007 Presentations Did Not Contain Material Misrepresentations or Omissions

The information about reducing ABX holdings by one-third appeared in a section of the presentation titled "Actions Taken." Reducing the ABX holdings was an "action taken" by the LDBF, and therefore the statement was true. Hopkins was prepared to provide updates and details about material in the slides, which he had noted on his copy of the presentation. I accept Hopkins' position that he could not specifically recall what he said at any one presentation in 2006-07, and he does not recall ever answering questions about the composition of the LDBF portfolio. His testimony that people were primarily interested in the LDBF's average quality, interest rate risk, and average yield, and not portfolio composition, is supported by other evidence in the record. Hopkins spoke about the LDBF for about 25 minutes. In this abbreviated period, I do not find that he made a material omission by failing to state that the LDBF Management Team had increased the BBB ABX holding back up to 3% of the portfolio. The slide at issue focused on explaining actions taken as a result of negative performance in February 2007; the Management Team's decision to increase its ABX exposure correlated to the market segment's rebound in the following months. There is no evidence in this record that Catholic Healthcare or National Jewish claimed that they made an inquiry and Hopkins misled them.

There is no persuasive evidence that the presentation slide included material misrepresentations or omissions in violation of Sections 17(a), 10(b) or Rule 10b-5. It is therefore unnecessary to address Hopkins' culpability.

IV. Hopkins Did Not Violate Sections 17(a) and 10(b) and Rule 10b-5 in Communications with Hammerstein/Yanni Partners on April 9, 2007

The Division alleges that Hopkins made a series of misrepresentations to Hammerstein in the spring and summer of 2007.[78] Specifically, the Division charges that Hopkins misled

[77] This allegation is similar to the allegation about the Typical Portfolio Slide. See Findings and Conclusions II.

[78] Hammerstein was a credible witness.

Hammerstein on April 9, 2007, by allegedly stating that the LDBF's total exposure to subprime RMBS was 2% when, in actuality, the portfolio was over 80% concentrated in subprime RMBS.[79] Division Brief at 19-20.

A. Hopkins Was Responsible for Representations to Hammerstein and Yanni Partners

Hopkins was responsible for, and had ultimate authority over, statements he made in the April 9 phone call.

B. Hopkins Did Not Make Material Misrepresentations or Omissions to Hammerstein and Yanni Partners

Hopkins denies that he told Hammerstein on April 9, 2007, that the LDBF's total subprime exposure was 2%. Hopkins Brief at 62. The evidence indicates genuine confusion about what was said in the phone conversation, but the weight of the evidence is that Hopkins did not misrepresent the subprime holdings in the LDBF. I reach this conclusion for two reasons. First, the subject of the April 9 conversation was to discuss the LDBF's first quarter performance and its impact on the Dow Jones Commodities Fund. SSgA attributed that poor performance to a 3% exposure to the BBB ABX Index, an investment in BBB-rated subprime securities. In early April, Hopkins believed that the BBB ABX exposure had been reduced from 3% by one-third. There could reasonably be confusion between what Hopkins believed at the time was a 2% exposure to subprime securities in the BBB ABX Index, and a general 2% exposure to subprime in all ratings. Hopkins' comments about the BBB ABX subprime could have been heard by Hammerstein as comments about subprime generally. The preponderance of the evidence is that Hopkins made no such unequivocal statement.

There are no other instances where, when asked, Hopkins is alleged to have been anything but forthcoming about the LDBF's subprime exposure. The evidence is that in June 2007, he informed a SSgA person gathering information for a consultant that she was mistaken and that approximately 95% of the LDBF was in subprime. Div. Ex. 96. There is no reason why Hopkins would mislead Hammerstein and provide others with accurate information.

For the reasons stated, I conclude that Hopkins did not violate Sections 17(a) and 10(b) and Rule 10b-5 in his communications with Hammerstein/Yanni Partners on April 9, 2007.[80]

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[79] The Division here again alleges violations stemming from Hopkins' participation in, and use of, the Typical Portfolio Slide and the slide which stated that the LDBF had reduced its exposure to the ABX Index by one-third. See generally Findings and Conclusions at II and III.

[80] There is no persuasive evidence that Hopkins acted with scienter or negligence.

V. Hopkins Did Not Violate Sections 17(a) and 10(b) and Rule 10b-5 in Connection with the March 2007 Letter

The Division alleges that the March 2007 letter was materially misleading because the letter failed to disclose that:

- the LDBF's BBB-rated ABX Index exposure was only 3% of assets;
- the LDBF and related funds were invested in higher-rated tranches of the ABX Index, and higher-rated subprime RMBS bonds and derivatives; and
- the LDBF was invested almost exclusively in subprime bonds and derivatives.

Div. Brief at 18. The Division claims that these omissions misled people into thinking that the LDBF's sole exposure to subprime RMBS was its investment in the BBB-rated ABX Index. Id.

A. Hopkins Was Not Responsible for, and Did Not Have Ultimate Authority over, the March Letter

On March 3, 2007, at the request of his supervisor, Hopkins transmitted his draft of a "client-friendly letter" to a variety of knowledgeable professionals within SSgA, including Carlson, Reardon, Fitzgerald, Darcey, Koehler, Wands, and Porter. In the circulation, he stated that people were free to send it out and to suggest improvements. Hopkins had no authority to send out the letter, and, in fact, did not do so. The head of U.S. Relationship Management sent out the March letter. Hopkins did not sign the letter and his name does not appear in it. Therefore, Hopkins was not responsible for, and did not have ultimate authority over, the March Letter.

B. The March Letter Did Not Contain Material Omissions[81]

The March 2007 letter was intended to describe the reasons for the LDBF's poor February performance, i.e., exposure to the BBB ABX Index. The March letter did not state that the LDBF's investment in the BBB-ABX Index was 3%; rather, it stated that SSgA's active strategies, including the LDBF, took "modest exposure to the investment grade triple B" ABS market. The LDBF's actual BBB ABX exposure of 3% is consistent with the March letter's characterization of "modest exposure."

The Division's alleged omissions go beyond the stated purpose of the March Letter. One version of the March letter was titled "Triple B Exposure and Impact to SSgA's [LDBF]" and another version was titled "Triple B Exposure and Impact to Our Active Funds." Div. Exs. 57, 58. In March, there was no price correlation between the 2-3% BBB ABX tranche and the remainder of the LDBF's portfolio, invested largely in AA and AAA-rated subprime securities. The March 2007 letter's purpose was stated clearly: "The purpose of this short write-up is not to present an in-depth treatise of what has happened . . . . What we would like to do in this correspondence is to broadly outline the reasons for and magnitude of what has occurred . . . ." Div. Exs. 57, 58. The March

[81] The Division does not allege that the March Letter contained misrepresentations.

Letter closed with an invitation for further communications: "Senior management in the Fixed Income Group is available for additional conversations on this matter. Please contact your Relationship Manager if further conversations are desired." Id. This invitation indicates a willingness to provide more information upon request and negates any fraudulent intent to omit material information. I also find that Hopkins acted as a reasonably prudent person would in tailoring the March 2007 letter to its stated purpose.[82]

The Division has failed to establish that Hopkins violated Sections 17(a) and 10(b) and Rule 10b-5 in connection with the March 2007 Letter.

VI. Flannery and Hopkins Did Not Violate Sections 17(a) and 10(b) and Rule 10b-5 in Connection with the July 26 Letter

The Division alleges that the July 26 letter was misleading because it:

- emphasized risk reduction based on the sale of the LDBF's BBB-rated ABX Index, when the LDBF faced its greatest risks from its exposure to higher-rated AAA and AA subprime bonds and derivatives;
- omitted that the LDBF was concentrated in subprime RMBS bonds and was leveraged through other subprime instruments; and
- omitted that the LDBF's highest-rated assets were being sold to fund redemptions by other SSgA funds and OFA and GAA clients. Div. Brief 38-39.

A. Neither Hopkins nor Flannery Was Responsible for, or Had Ultimate Authority over, the July 26 Letter

Flannery and Hopkins were but two of many people involved with the July 26 letter, which was an attempt to explain to clients the LDBF's underperformance in June 2007. Neither Flannery nor Hopkins authored the letter, decided on the final wording, signed the letter, authorized its distribution, or received a copy of what was finally sent to investors.

The Division alleges that Flannery played an oversight role and that it was his responsibility to check the letter's factual accuracy. Div. Brief at 39. I disagree. SSgA personnel from within and outside departments that reported to Flannery participated in ensuring the accuracy of the July 26 letter. The letter went through numerous iterations in which it was revised, additions made, and approvals given by a variety of people who were members of SSgA's legal, investment, and client relations teams. Brown and Shames, who were at the same organizational level as Flannery, were heavily involved in producing the letter, as were Carlson, Duggan, Fitzgerald, Gianatasio, Greff, Hudson, Kohler, Mavro, Reardon, Thompson, and Wands. As members of the Management Team, Greff and Wands had hands-on responsibility for LDBF investments and knew the composition of the portfolio. Flannery and Hopkins did not have that level of knowledge.

[82] My findings obviate the need for an analysis of culpability, however, there was no showing that Hopkins acted with scienter or that he acted recklessly.

On July 11, Flannery offered a few edits to the July 26 letter and directed that the July 26 letter be vetted by SSgA's legal office. There is no evidence that Flannery insisted on any particular language in the letter. The unambiguous evidence is that Flannery deferred to the wording offered by the legal department, and that Legal, particularly Duggan and Shames, were involved deeply in the letter's contents and approved its issuance.

Hopkins' involvement with the July 26 letter stems from his preparation of an initial draft using the July CAR alert as a template and suggesting the letter reference the steps the LDBF had taken to lower risk.[83] Hopkins was a messenger. He did not decide on the message; rather, the July 26 letter delivered the Management Team's message. Hopkins was asked to comment on only one portion of one of many drafts; Hopkins did not review the final July 26 letter before it was sent.

The record shows that neither Flannery nor Hopkins was responsible for, or had ultimate authority over, the contents or dissemination of the July 26 letter.

B. The July 26 Letter Did Not Contain Material Misrepresentations or Omissions

The Division considers the following sentence in the July 26 letter as "key:"

> We have been seeking to reduce risk in those portfolios where we believe it is appropriate by taking advantage of liquidity in the market when it exists, and will continue to do so, while seeking to avoid putting undue pressure on asset valuations.

Div. Brief at 37; Hopkins Ex. 98.

I reject the Division's position that the July 26 letter contains material misrepresentations and omissions. There is no evidence that any statement in the July 26 letter, including the "key" statement about the LDBF's efforts to reduce risk, was false. The evidence in the record is that until sometime in August, the Management Team believed that long-term housing market fundamentals would prevail. One of these market fundamentals was that a security rated AA or AAA would not be adversely affected and would retain value over the long term. Sirri opined that in the summer of 2007 a sharp increase occurred "in the correlation between the price movements of assets that were hitherto not thought to be highly correlated" and the "rolling 90-day correlations between AAA and BBB-index prices show[ed] a pronounced increase during the onset of the subprime crisis in the summer of 2007." Hopkins Ex. 161 at 38-39. Unrefuted expert testimony established that it was reasonable to believe in August 2007, that highly-rated structured securities in the LDBF portfolio could eventually recover in value and become more liquid. Hopkins Ex. 161 at 3-4. It is with the benefit of hindsight that the Division believes it was incumbent on Flannery and Hopkins to warn investors of something that the evidence shows they were unaware of at the time–the vulnerability of AA and AAA-rated subprime bonds.

[83] Wands or a member of the investment team reviewed for accuracy materials that Hopkins prepared for circulation. Tr. 2862.

The Division's allegations that the July 26 letter omitted material information that was necessary in order to make the statements made not misleading involves a different analysis. Materiality requires a substantial likelihood that disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. The Division argues that the July 26 letter was actionably deficient because it did not disclose that the LDBF was concentrated in subprime RMBS bonds and was leveraged through other subprime instruments, and that the LDBF's highest-rated assets were being sold to fund redemptions by other SSgA funds and OFA and GAA clients.

The evidence is persuasive that the LDBF's sophisticated investors knew or should have known about the LDBF's subprime exposure; they could have obtained the information from their Relationship Managers as SSgA often invited them to do. Peavy's analysis showed that SSgA provided information to investors, and he opined that in a time of market tumult it would have been unusual for sophisticated investors with ABS in their portfolio not to have made specific inquiries. Information about funds following an "enhanced cash" strategy, like the LDBF, was publicly available in the financial press. Also persuasive is Sirri's opinion that sophisticated investors knew, or should have known, that a fund that aimed for returns 50 to 75 bps above LIBOR came with increased risk, and that, by the summer of 2007, the LDBF had a substantial amount of first-lien subprime loans. Finally, there has been no showing that the LDBF's use of leverage was hidden; leverage was authorized in the LDBF's governing documents and leverage information was available in the audited financials and from Relationship Managers.

I also reject the Division's allegation that the July 26 letter was materially misleading and omitted material information by not disclosing that the LDBF was selling its highest-rated assets to fund redemptions by other SSgA funds and OFA and GAA clients. First, the July 26 letter was weeks in preparation, while the Investment Committee's decision, a matter of business judgment, was made on or about July 25. Second, redemption requests were confidential. Third, the letter's purpose was to explain what caused the LDBF's past performance, and actions taken in response; its purpose was not to discuss future actions. Finally, the Division considered significant Wermer's analysis showing SSgA-related funds had basically completed their redemptions by August 10, while investors funds with no relationship with SSgA had redeemed only 60% of their ultimate redemptions by that date. Nothing in this voluminous record shows any actions by Flannery or Hopkins that contributed to that fact. Persons from OFA and GAA gave credible testimony that their redemption decisions were independent and confidential.[84]

For all these reasons, I reject the Division's allegation that Flannery and Hopkins violated Sections 17(a) and 10(b) and Rule 10b-5 with respect to the July 26 letter.[85]

[84] GAA and OFA's participation in the SSgA Investment Committee appears to be a conflict of interest; however such activity is beyond the scope of this proceeding.

[85] My findings obviate the need for an analysis of culpability, however, there was no showing that Flannery or Hopkins acted with scienter or that they acted recklessly.

VII. Flannery Did Not Violate Sections 17(a) and 10(b) and Rule 10b-5 in Connection with the August 2 Letter

The Division alleges that Flannery violated the antifraud provisions because the August 2 letter contained material misrepresentations and omissions in that the letter:

- focused on prior risk reduction measures taken, without disclosing the intent to use the proceeds from the AAA sale to fund redemption requests, including those from clients advised by SSgA internal advisory groups, that, in fact, increased the risks to remaining LDBF shareholders; and
- stated that the LDBF's Strategy "maintained and continues to be AA in average credit quality."[86]

Div. Brief at 39-41. The Division also alleges that the August 2 letter failed to disclose the leverage employed by the LDBF portfolio. Div. Brief at 44.

A. Flannery Was Not Responsible for, and Did Not Have Ultimate Authority over, the August 2 Letter

Flannery did not author any of the drafts of the August 2 letter, his name does not appear in the letter, very few of his edits appear in the final product, he did not sign it, he did not have final approval authority, nor did he control the letter's distribution.

The letter was a joint effort by many people, including at a minimum, Brown, Kohler, Reardon, Shames, and Wands. In late July and August, the LDBF's problems were a priority at SSgA; all of the named people, and others, were knowledgeable about the LDBF's issues. Brown and Shames occupied positions equal to Flannery in authority, and they were involved heavily in editing the August 2 letter. Finally, the unequivocal evidence is that Legal gave the final sign-off on the letter. Tr. 2698. Flannery did not have anything approaching ultimate authority for the contents of the letter or its distribution.

B. The August 2 Letter Did Not Contain Material Misrepresentations or Omissions

The evidence is that the statements in the August 2 letter about risk reduction were true. There is nothing in the record that contradicts Flannery's sworn testimony that on August 2, he believed that the LDBF had reduced risk in the portfolio by selling the AAA securities. The August 2 letter discussed swap transactions on July 11-16, the sale of AAA-rated bonds on July 26, and the expiration of TRS at the beginning of August. According to expert testimony, these transactions reduced the LDBF's portfolio, market and credit risk.

The Division claims that Flannery knew on August 2 that the LDBF had very little cash left from the sale of the AAA bonds and thus he knew or should have known that the LDBF faced certain risks which the letter should have disclosed. The evidence establishes otherwise. The

[86] The Division claims that Flannery "likely" added the "average quality" statement to the August 2 letter. Div. Brief at 41.

Management Team did not know with certainty what the level of redemptions would be, and the LDBF raised over $400 million in net proceeds from the sale of the AAA-rated bonds. Moreover, the evidence is that approximately $200 million in cash and cash equivalents remained in the LDBF as of August 2. Div. Exs. 217, 218; Flannery Exs. 299, 300.[87]

The Division finds it actionable that the August 2 letter, crafted to explain the past month's performance, did not warn sophisticated investors, in a time of market turmoil, that the LDBF portfolio consisted almost entirely of subprime securities or that the portfolio would, might, or was likely to face risks in the future because of the actions taken in the portfolio. Div. Brief at 40, 44. The Division claims Flannery's motives were to keep investors in the LDBF. Div. Brief at 40-41. However, there is nothing in all the numerous e-mails that supports a claim that Flannery was attempting to obfuscate or mislead. Tr. 908-09. The evidence supports a finding that Flannery's edits to the August 2 letter were intended to make it more accurate, not less so. He suggested adding language to the "Actions Taken" section of that letter which would have acknowledged more specifically "some deterioration in longer-term fundamentals"–an edit that was not accepted or incorporated into the final August 2 letter. The fact that his edit was not in the final letter shows that Flannery did not have responsibility for, or ultimate authority over, the August 2 letter.

The evidence also supports a finding that Flannery made no attempt to hide the LDBF's redemption activity. Carlson, Mavro, and Reardon were in Relationship Management and had the best information about possible redemptions, and they, along with Consultant Relations, knew that GAA and OFM were recommending that their clients redeem. All of these people were involved in reviewing the August 2 letter, thus it seems unlikely that Flannery intended to use the August 2 letter to keep people invested in the LDBF. Moreover, the LDBF's redemption activity was the focus of the SSgA August 6 letter announcing the creation of LDBF II; a letter being circulated in draft at the same time as the August 2 letter.

I also reject the Division's claim that the statement that the LDBF's Strategy "maintained and continues to be AA in average credit quality" was materially misleading. The Division concedes that Flannery believed the statement was true, and that the statement was "technically accurate." Div. Brief at 43; Div. Prehearing Brief at 18. Moreover, the Division failed to establish that Flannery drafted the language at issue, and, in fact, the evidence suggests otherwise.

For the reasons stated, I find that Flannery did not violate Sections 17(a), 10(b), or Rule 10b-5 in connection with the August 2 letter.[88]

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[87] These exhibits were provided on disk and in thousands of pages of hard copy, showing the LDBF sales in 2007. The parties generally agree on the amount of net proceeds received from the AAA-rated bond sale.

[88] My findings make addressing scienter and negligence unnecessary, but the evidence shows neither.

VIII. Flannery Did Not Violate Sections 17(a)(2), (3) of the Securities Act in Connection with the August 14 Letter

The Division alleges that Flannery acted negligently in connection with the August 14 letter, which was materially misleading because it:

- stated that many judicious investors will hold their positions, but failed to disclose that shortly before August 14, the LDBF shareholders advised by SSgA had taken contrary action and decided to redeem; and
- failed to state why judicious investors would want to hold onto their LDBF shares, when by August 14, "the only assets left in LDBF were illiquid and future redeemers would receive fire sale prices." Div. Brief at 47.

The Division also claims that Flannery is responsible for the alleged material misstatements and omissions because he was the only reviewer of the August 14 letter who knew all the relevant facts. Div. Brief at 48.

A. Flannery Was Responsible for, and Had Ultimate Authority over, the August 14 Letter

Flannery was responsible for, and had ultimate authority over, the August 14 letter because he initiated it, wrote the first draft, approved the edits, signed it, and directed that it be sent out.

B. The August 14 Letter Did Not Contain Material Misrepresentations or Omissions

The Division highlights the following sentence as the "touchstone" of why the August 14 letter was misleading: "While we will continue to liquidate assets for our clients when they demand it, we believe that many judicious investors will hold the positions for now." [emphasis added] Div. Ex. 166; Div. Brief at 46. Duggan was responsible for substituting the underlined words in place of "our advice is to" in Flannery's draft.

The Division argues that Flannery knew by August 14 that both GAA and OFA had recommended that their clients redeem from the LDBF and related funds, some for cash and others for in-kind distribution.[89] Div. Brief at 47. The Division maintains that Flannery cannot rely on Duggan's review of the letter because there is no evidence that Flannery discussed this key sentence with Duggan or that Duggan knew of OFA's recommendation. Id. The Division contends that Flannery knew by August 14 that the LDBF had sold its most liquid assets and that the cash generated had been used to satisfy redemptions. Id. The Division alleges further that future judicious investors might not have wanted to redeem when SSgA would have to sell illiquid assets to meet redemption requests. Id. at 47-48. According to the Division, Duggan would have done more checking on the "many judicious language" if he had known that the overall asset quality of the LDBF had gone significantly down by August 14. Joint Stip. Duggan at 482; Div. Brief at 48.

[89] In an in-kind distribution, no cash leaves the fund and the shares are transferred out of the LDBF into another account. Tr. 668, 703, 736, 754.

First, at the time of the August 14 letter, Flannery believed that many judicious investors would, in fact, hold their positions. His conclusion was based on the Management Team's belief at the time that subprime securities would recover,[90] the conventional wisdom that you do not want to demand liquidity when the market does not want to offer it, and the fact that none of the bonds in the LDBF portfolio had been downgraded and continued to pay interest. Tr. 1382-84. Flannery's belief that investors who held their securities would reap greater value, even if prices did not recover, as long as the securities continued to pay interest, is supported by expert testimony:

> Indeed, even after the price decline in the highly rated sectors of the subprime ABS market in July-August 2007, highly rated structured products continued to pay interest on time. There were no defaults on AAA rated mortgage ABS securities as of the end of 2007, while defaults on AA rated mortgage ABS were no higher than 0.62%.

Tr. 1384; Hopkins Ex. 161 at 27. Flannery maintains that many judicious investors did, in fact, hold their positions.[91] Moreover, the reasonableness of the statement is confirmed by the fact that the SSgA president used this same language in a letter to clients on October 5, 2007. Tr. 1388, 1419-20; Flannery Ex. 251.

Flannery circulated the letter widely for review and the evidence shows feedback from a variety of knowledgeable people including Carlson, Duggan, Fitzgerald, and Reardon. Flannery's testimony that he "wanted to make sure that everybody had a crack at it and felt it was okay," is not in dispute. Tr. 1392-93. There is no evidence that anyone who reviewed the letter told Flannery that anything in it was false, or that additional information should be included to make it not misleading. At the time Duggan edited the August 14 letter, he was aware of GAA's recommendation that its clients redeem from the LDBF. Tr. 485-87. OFA's recommendation had also been communicated to Legal by July 27, 2007. Tr. 1804-05. Flannery had worked with Duggan for eleven years and accepted his "many judicious investors" language because he knew it to be true and he respected Duggan's ability. Tr. 1098, 1100.

The Division is incorrect that "alone among the August 14th letter's reviewers [Flannery] knew all of the facts," and that Flannery did not provide reviewing lawyers with the facts necessary for their review. Div. Brief at 46-48. Duggan, SSgA's Deputy General Counsel, was, or should have been, knowledgeable on the facts required for a legal opinion on the August 14 letter. Tr. 910-11, 920, 939, 1274-75, 1299-1301, 1361-62, 1391-92. Duggan reviewed FAQs at least up until August 6, 2007. Joint Stip. Duggan at 237, 467. Duggan was counsel to the Investment Committee; he attended the meeting on July 25, 2007, at Flannery's invitation. Flannery also met Duggan before the Investment Committee meeting on July 25 to advise him of what was going to be covered at the meeting. Tr. 1270-72. Duggan knew when he approved the August 14 letter that GAA had recommended to its clients to leave the LDBF and related funds. With this background, it

[90] When Lowe informed Greff of GAA's decision, Greff thought it was the wrong decision because he still felt strongly that the securities were going to return to par. Tr. 2042-43.

[91] The allegedly misleading statement referred to "many," not "all," judicious investors.

is clear that Duggan was aware of the problems facing the LDBF. Finally, a lawyer would not, or should not, approve a letter if he was not familiar with its contents, and even if Duggan did, that does not change the fact that Flannery acted reasonably in relying on Legal's opinion.[92]

In fact, Duggan testified that if the quality of the portfolio had "gone from AA to maybe A during that time period," he would have talked more to people; he did not testify that he would have changed the "many judicious investors language." Joint Stip. Duggan at 482. However, there is no evidence that the average rating of assets in the portfolio dropped from AA to A; the average quality of the portfolio remained at AA in July 2007. Div. Ex. 121. The LDBF's average credit quality has always been AA to AA+. Div. Ex. 157 at Bates 765.

The evidence is also conclusive that Flannery was not negligent in connection with his authoring of the August 14 letter. He believed in the truthfulness of "judicious investor" language; the statement itself was reasonable; and Flannery reasonably relied on the review of other knowledgeable persons within the SSgA organization, including Duggan in Legal.[93] Flannery did not violate Sections 17(a)(2) and (3) of the Securities Act by his authorship, participation, and distribution of, the August 14 letter.

Summary

For the reasons stated above, I find that neither Flannery nor Hopkins was responsible for, or had ultimate authority over, the allegedly false and materially misleading documents at issue in this proceeding. Those documents include the LDBF Fact Sheets, Typical Portfolio Slide, the "reduction in ABX holdings" slide, and several 2007 letters sent to LDBF investors (March 2007, July 26, and August 2).[94] Moreover, I find that these documents, as well as Hopkins' representation to Hammerstein on April 9, 2007, and Flannery's August 14 letter, did not contain materially false or misleading statements or material omissions. Because I find there were no materially false or misleading statements or omissions, there can also be no fraudulent "course of conduct" or "scheme liability."

Record Certification

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the Record Index issued by the Secretary of the Commission on October 14, 2011.

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[92] Fries, SSgA's outside legal counsel, also reviewed the August 14 letter. Joint Stip. Duggan at 487.

[93] Representatives of GAA and OFA testified that they considered their advice to clients to be privileged and confidential, and Peavy's expert opinion confirmed that funds do not disclose customer transactions to other customers. Hopkins Ex. 174 at 19.

[94] However, I did find that Hopkins had some authority over the Characteristics portion of the Fact Sheets and ultimate authority over his representations to Hammerstein on April 9, 2007, and that Flannery had ultimate authority over the August 14 letter.

Order

I find that no remedial action is appropriate pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, and I Order that the proceeding is dismissed.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

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Brenda P. Murray
Chief Administrative Law Judge