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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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In the Matter of

JOHN P. FLANNERY, AND
JAMES D. HOPKINS,

Respondents.

Administrative Proceeding
File No. 3-14081

DIVISION OF ENFORCEMENT'S
PETITION FOR REVIEW OF INITIAL DECISION

Respectfully submitted,
DIVISION OF ENFORCEMENT
By its attorneys:

Deena Bernstein, Senior Trial Counsel
Kathleen Shields, Senior Trial Counsel
Robert Baker, Senior Enforcement Counsel
U.S. Securities and Exchange Commission
33 Arch Street, 23rd Floor
Boston, MA 02110
(617) 573-8813 (Bernstein)
bernsteind@sec.gov

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INTRODUCTION

Pursuant to Commission Rule of Practice 410(b), the Division of Enforcement ("Division") hereby petitions the Commission for review of the Initial Decision rendered by Administrative Law Judge Brenda P. Murray on October 28, 2011. With respect to Respondent James D. Hopkins ("Hopkins"), the Division seeks review under Rule of Practice 411(b)(2)(ii) of the findings that Hopkins did not violate Section 17(a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §77(q)(a)], Section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5(b)]. With respect to Respondent John P. Flannery ("Flannery"), the Division seeks review under Rule of Practice 411(b)(2)(ii) of the findings that Flannery did not violate Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5(a) and 10b-5(c) under the Exchange Act.[1]

This matter involves two former employees of State Street Bank and Trust Company ("State Street") who, through a series of misleading statements and a fraudulent course of conduct, lulled some of the investors in State Street's commingled trust funds to remain invested in those funds by misleading them about the funds' exposure to high-risk subprime investments. Those funds were invested in State Street's Limited Duration Bond Fund ("LDBF"), which Hopkins marketed as a relatively low-risk, enhanced cash investment. In reality, LDBF's strategy was anything but low-risk. LDBF was concentrated in subprime bonds and used extensive leverage to make other subprime investments. As long as the subprime bonds performed, LDBF would modestly outperform other low-risk fixed income funds invested in a diverse portfolio of short-term, low-risk fixed income investments. In 2007, turmoil in the

[1] Pursuant to Rule 410(b), the Division petitions for review of all findings contrary to its Rule 340 Proposed

subprime market decimated LDBF's value as a result of its undisclosed exposure to leveraged subprime investments. Many LDBF investors lost a significant portion of their investments, with the exception of clients of State Street's internal advisory groups -- who received a targeted warning before calamity struck. The Respondents committed securities fraud because they misled LDBF's investors about their exposure to subprime assets in an attempt to avoid a run on the fund beyond the inside investors' redemptions. The law judge reached a different conclusion through a series of erroneous conclusions of law and clearly erroneous conclusions of fact.

The Division takes exception to many of the findings in the Initial Decision, including the misapplication of *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), which narrowly construed the phrase "to make" in Exchange Act Rule 10b-5(b). As discussed below, the Initial Decision erroneously applied this construction of the phrase "to make" to primary liability claims under Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act although the word 'to make" do not appear in those statutes and are not among the elements for violations of those provisions. The Division also takes exception to the law judge's implicit and explicit importation and extension of precedent concerning investor reliance and sophistication from decisions strictly construing a private right of action under the federal securities laws. The Division maintains that these and other erroneous conclusions of law and fact resulted in the clearly erroneous finding that none of the charged statements contained materially false or misleading statements or omissions.

The Law Judge Misapplied *Janus*.

This matter represents the first and only application of the Supreme Court's recent *Janus* decision by an administrative law judge. In *Janus*, the Court defined what it means "to make" an

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Findings including, but not limited to, all proposed findings that documents contained material misstatements.

untrue statement under Rule 10b-5(b) -- a word that appears nowhere in Section 17(a). *Id.* at 2301. The Court held that "to make" a misstatement, the "maker" must have ultimate control over the content and format of the statement. *Id.* at 2302. The Court found that, in the ordinary case, "attribution within a statement" is strong evidence that a statement was "made" by the party to whom it is attributed. *Id.* In addition, the Court stated that the definition of ultimate control is "best exemplified by the relationship between a speechwriter and a speaker." The Court explained that it is the speaker and not the speechwriter who "makes" a misstatement. *Id.* at 2302.

Throughout the Initial Decision, the law judge not only applied *Janus* to determine primary liability under Rule 10b-5(b), but also, in error, applied *Janus* to primary liability pursuant to Rule 10b-5(a) and (c) as well Section 17(a) of the Securities Act. Significantly, the phrase "to make" does not appear in any of those latter sections. Moreover, the law judge misapplied *Janus* in the context of Rule 10b-5(b) liability as well.

By way of example, and to illustrate the category of errors addressed in this petition, a closer examination of the law judge's reasoning in connection with Hopkins' use of a misleading "Typical Portfolio Slide" is warranted. Hopkins made at least five presentations to clients using a PowerPoint presentation with his name prominently appearing on the cover page as an author. Over time, Hopkins edited the presentation. The presentation contained a slide entitled "Typical Portfolio Exposures and Characteristics" for LDBF. That slide purported to provide "typical breakdowns by market value." However, as Hopkins admitted, these breakdowns were not "actual" – or even "typical" of LDBF's sector exposure throughout 2006 and 2007. This slide, contrary to the Initial Decision, was clearly misleading. Although the slide was misleading, Hopkins used that slide with clients on multiple occasions.

The Initial Decision concluded that because Hopkins "did not author or have ultimate authority for the Typical Portfolio Slide," not only was he liable under Rule 10b-5(b), but also Rule 10b-5(a) and (c) and Section 17(a) of the Securities Act. There is no analysis in the Initial Decision as to why scheme or course of conduct liability (pursuant to both Rule 10b-5(a) and (c) as well as Section 17(a)(1) and (3)) did not apply to the various acts taken by Respondents. The decision only addressed the lack of "scheme liability" in a cursory conclusion that because there were no misstatements there was no scheme liability. The law judge erred by conflating the distinct theories of misstatement, scheme, and course of conduct liability. In doing so, the law judge did not appropriately consider compelling evidence that Hopkins used the "Typical Portfolio Slide" repeatedly as a "course of business" over a sixteen-month period and contributed to numerous other false statements made by State Street over that same period. Similarly, the law judge failed to address the Division's scheme and course of conduct claims against Flannery for directing State Street's decision to keep many of LDBF's investors uninformed about the fund's subprime concentration at the height of the subprime crisis. Even if Flannery cannot be liable under Rule 10b-5(b) because he did not "make" the statements at issue, *Janus* does not mean that Flannery's course of conduct that resulted in investors being defrauded by State Street – his scheme liability – is not actionable. Janus simply does not extend that far.

As to Section 17(a)(2), the Initial Decision does not focus on the appropriate elements that need to be proved. The decision fails to recognize that instead of "making an untrue statement" – the relevant Rule 10b-5(b) standard – Section 17(a)(2) imposes liability on those who obtain money or property "by means of any untrue statement." The crux of *Janus* – what it means to "make" a false statement, is simply not an element of Section 17(a)(2). The erroneous application of *Janus* to 17(a)(2) is evident in the context of the "Typical Portfolio Slide" because the uncontroverted evidence is that Hopkins used the false and misleading slide at several face-to-face meetings with clients, the purpose of which was to obtain investor funds. Similarly, Flannery was a senior reviewer, editor, and drafter of the misleading statement in State Street's August 2, 2007 letter to clients, and the law judge erred by applying the *Janus* speaker versus speechwriter test to the Division's Section 17(a)(2) claim against Flannery with respect to this letter.

Finally, the law judge failed to use the Supreme Court's own definition of "ultimate control" for purposes of Rule 10b-5(b), and misapplied the distinction it made between speakers and speechwriters. As one example of how this standard was misapplied in the Initial Decision, Hopkins' name appeared on the presentation containing the "Typcial Portfolio Slide" and he used the presentation in his face-to-face meetings with clients. Not only was he the speechwriter providing edits to the statement, he was the speaker using the slide in his presentations to his clients. His name appeared prominently on the cover as an author and he knew that the presentations were false and misleading. Nonetheless, the Initial Decision erroneously concluded that he was not responsible for, and did not have ultimate authority over, the "Typical Portfolio Slide."

The Law Judge Erred in Finding that LDBF Investors were Highly Sophisticated.

The first "concept" guiding the law judge's findings and conclusions was "Investor Sophistication." Init. Dec., pp. 39-40. The Division takes exception to the law judge's factual findings concerning investor sophistication as well as the conclusions of law that both implicitly and explicitly imported concepts of investor sophistication and reliance into the Division's burden of proof.

The law judge found that LDBF was only available to highly sophisticated institutional investors. *Id.*, p. 40. In fact, while LDBF was only available to institutional investors, including State Street's other funds, public funds, pension funds, endowments and foundations (*id.*, p. 5), there was no legal requirement of high sophistication to invest in LDBF, nor was there any factual evidence that all of LDBF's investors were highly sophisticated.

The Law Judge Erred in Finding that LDBF Investors Had Access to All Relevant Information Including Information Held Solely by State Street.

In addition to the incorrect factual premise of high sophistication, the Initial Decision applies the standard in such a way that would make it practically impossible for the Division to prove fraud in a context involving highly sophisticated investors. One of the Division's witnesses was a representative of an investment consultant to several charitable organizations that invested in a State Street commodity fund that invested its back-up liquidity in LDBF. *Id.*, p. 48. The witness is a CFA charterholder, and he repeatedly testified that when he asked Hopkins about LDBF's subprime exposure, Hopkins told him that LDBF's total exposure to subprime was 2%. Hopkins had no recollection one way or the other of what he told the witness. Nonetheless, the Initial Decision disregards evidence of Hopkins' false statement about LDBF's subprime exposure by finding that "[t]he 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." No factual evidence supported this conclusion. Rather, the Initial Decision relied on expert opinion that was built on a series of premises that were only partially true:

- All investors in LDBF were institutions.
- All institutional investors are highly sophisticated.
- All highly sophisticated investors are aware of all relevant information that is publicly available, reasonably available, or otherwise available.

Some of State Street's internal investors (including State Street Corporation's pension fund) actually had all available information about LDBF and even participated in an Investment Committee meeting to determine what assets LDBF should sell to meet their redemptions. Internal investors were the exception. The factual record revealed that most other LDBF investors were lulled by Hopkins or Flannery's course of conduct to remain in LDBF and suffered severe losses as a result. The Respondents did not call any investor witnesses to testify about what they were aware of, and it was clearly erroneous for the law judge to conclude from the record that all investors would have received information about LDBF's subprime exposure by asking a State Street Relationship Manager. Some of State Street's Relationship Managers were not even themselves aware of LDBF's subprime exposure. Regardless, under the law, the total mix of information available to investors only includes information "reasonably available" to the investors. *See, e.g., Koppel v. 4987 Corp.*, 167 F.3d 125, 131-32 (2d Cir. 1999); *SEC v. Mozilo*, 2009 WL 3807124 at *10 (C.D. Cal Nov. 3, 2009). Courts have refused to find information "reasonably" available to an investor even when the information was publically available but difficult to decipher. *Id.* at *10. In sum, the law judge's conclusion that LDBF's investors were, or should have been, aware of their subprime exposure was clearly erroneous in both fact and law.

<u>The Law Judge Erroneously Required Proof of the Reliance Element of a Private Cause of Action.</u>

The law judge's incorrect reliance on investor sophistication also resulted in the erroneous application of reliance caselaw in the government enforcement context where it does not belong. In fact, only private securities cases are cited in the Initial Decision in describing why investor sophistication concepts were generally applicable to the findings of fact and law. Init. Dec., p. 40. This standard is part of private securities cases because courts have narrowly construed a private cause of action to require investor reliance on a misrepresentation. The Division, unlike private securities law plaintiffs, need not prove reliance. *See SEC v. Pirate Investor LLC*, 580 F.3d 233, 239 n.10 (4th Cir. 2009), *cert. denied*, 130 S. Ct. 3506 (2010); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993); *Schellenbach v. SEC*, 989 F.2d 907, 913 (7th Cir. 1993). The Initial Decision sets out erroneous findings concerning what highly sophisticated investors would and would not rely on based only on the testimony of one of Respondents' expert witnesses. Relying on those findings, the law judge found that certain misleading statements would not have been material to LDBF investors; for example, that LDBF's fact sheets did not contain material misrepresentations and omissions because "[t]he testimony was that a sophisticated investor would not rely on information in a fact sheet…" *Id.*, p. 45. Similarly, in finding that the "Typical Portfolio Slide" did not contain material misrepresentations or omissions, the law judge "accept[ed] as reasonable [an] expert opinion that no sophisticated investor would rely on this single piece of information…" In sum, the law judge erred by importing a reliance standard into a Commission cause of action and then relying only on expert evidence to make a factual conclusion about reliance. The law judge's erroneous standards of investor sophistication and knowledge render all of the findings concerning the materiality of the Respondents' alleged misrepresentation clearly erroneous.

CONCLUSION

For the reasons stated above, the Division requests that the Commission grant its petition for review.

Respectfully submitted,

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Deena Bernstein, Senior Trial Counsel
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Robert Baker, Senior Enforcement Counsel
U.S. Securities and Exchange Commission
33 Arch Street, 23rd Floor
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(617) 573-8813 (Bernstein)
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