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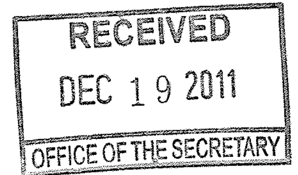
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



In the Matter of

JOHN P. FLANNERY, AND
JAMES D. HOPKINS,

Respondents.

Administrative Proceeding
File No. 3-14081

DIVISION OF ENFORCEMENT'S OPPOSITION TO RESPONDENT JOHN PATRICK ("SEAN") FLANNERY'S MOTION FOR SUMMARY AFFIRMANCE

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INTRODUCTION

Pursuant to Rules 411(e) and 154(b) of the Securities and Exchange Commission's ("Commission") Rules of Practice, the Division of Enforcement ("Division") hereby opposes the motion for summary affirmance (the "Motion") filed by Respondent John (Sean) Flannery ("Flannery"). The Motion urges the Commission to rubber-stamp the deeply flawed Initial Decision by glossing over any and all facts that are inconvenient to Flannery's arguments. Many of Flannery's claims that purported facts are "unrebutted" are based on a distorted view of the evidence, and when that evidence is viewed fully and fairly, it supports the Division's claims. Given that the Commission's *de novo* review of this case, should it choose to accept the Division's Petition for Review, would not be constrained by the multiple factual and legal errors in the Initial Decision, it should decline to accept the Motion's oversimplification of the claims against Flannery. This is a case deserving of full Commission review, both because it raises novel legal issues of first impression before the Commission, and because the erroneous view of the evidence presented by the Initial Decision should be remedied.

I. THE INITIAL DECISION'S ERRONEOUS LEGAL CONCLUSIONS REGARDING *JANUS* AND INVESTOR SOPHISTICATION CANNOT BE DIVORCED FROM ITS INCORRECT DECISION TO EXCULPATE FLANNERY.

The Motion contends that the Initial Decision's legal conclusions relating to the scope of the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), and the extension of cases concerning the reliance element of private rights of action, can be neatly severed and ignored in order to summarily affirm the Initial Decision. Such delicate surgery is not possible. The legal errors related to *Janus* resulted in the Initial Decision's failure to analyze adequately the Division's scheme and course of business claims under both Rule 10b-5(a) and (c) and Section 17(a) (1) and (3). *See* Initial Dec. at 42-43, 50, 53,

55. The Initial Decision's incorrect analysis of the relevance of investor sophistication and reliance concepts also infected its analysis of both the full factual record and the context in which Flannery's deceptive scheme took place. *See e.g. id.* at 39-40, 45. While several of the documents that contributed to LDBF investors' ignorance of the fund's subprime concentration were not Flannery's responsibility (though they were Respondent Hopkins' responsibility), the distorted picture of LDBF created by these documents was a key part of understanding how Flannery was able to further defraud LDBF investors in July and August 2007. Thus, the Initial Decision's mistakes concerning these earlier documents played a part in its erroneous decisions concerning the fraudulent scheme orchestrated by Flannery later in the summer.

The Initial Decision also failed to distinguish the Division's claims against Flannery that were based on him making material misstatements from those that were based on his participation in a fraudulent scheme and course of conduct. *See id.* at 42, 57. The Initial Decision lacks any analysis of the scheme and course of conduct claims and thus erred. As described in the Division's Opposition to Respondent Hopkins' Motion For Summary Affirmance (at page 3), the Commission has long espoused a flexible interpretation of Rule 10b-5, and rejected the overly rigid view that cases based primarily on misstatements cannot be charged under Rule 10b-5(a) or (c), or Section 17(a)(1) or (3).

In this case, when LDBF's subprime exposure – and through LDBF, the subprime exposure of many SSgA active fixed income funds – became a crisis in July 2007, Flannery affirmatively inserted himself into the process of crafting client communications, played a critical role in pushing them along, was the senior member of the investment team responsible for their accuracy, and finally approved their factual content. *See* Division's Reply to Respondent Flannery's Post-Hearing Brief ("Div. Post-Hr. Rep. Br.") at 13-14. He took these

steps because, as CIO, he was the leader of the investment team presiding over those funds' impending failure, and the crisis was of sufficient magnitude that he knew it had the potential to affect his own future, and the active funds' prospects to remain viable competitors beyond the summer of 2007. *Id.* at 14. Flannery's involvement in client communications, as well as his role in implementing the July 25th Investment Committee's decision to sell LDBF's highest-rated and most liquid assets to fund the cash redemption requests of internally-advised investors, were part of his deceptive scheme and course of business. *Id.* In order to buy time for the subprime market to recover, Flannery tried to convince investors to hold their investments by misleading them about the risks of continuing to invest in LDBF. Rule 10b-5(a) makes it unlawful for any person "to employ any device, scheme, or artifice to defraud." Flannery "employed" a device or scheme to defraud the active funds' investors within the meaning of Rule 10b-5(a), and Section 17(a)(1), whether or not he personally "made" misrepresentations within the meaning of *Janus*. Similarly, Flannery's knowledge of, acquiescence in, and then attempts to conceal, the dramatically increasing risk of the active funds after July 25 was also a "course of business" that operated as a fraud in the language of Rule 10b-5(c), and Section 17(a)(3).

Finally, even if Flannery is correct that no prejudicial error was committed because the Initial Decision's legal conclusions with respect to *Janus* would not change the result, Rule 411 of the Commission's Rules of Practice states that the Commission "shall consider whether" a petition for review "makes a reasonable showing that. . . [t]he decision embodies. . . [a] conclusion of law that is erroneous."[1] Until the Commission determines whether *Janus* applies to scheme liability and misrepresentation claims outside of the Rule 10b-5(b) context, the Initial Decision's erroneous conclusion of law will be cited as precedent by the defense bar to constrain

[1] Flannery misquotes Rule 411, stating in bold print that the petition for review must demonstrate that the decision embodies "a conclusion of law that is ***clearly erroneous***." Motion at 3.

the scope of primary liability in cases brought by the Commission. For this reason alone, the petition should be granted.

II. THE INITIAL DECISION FAILED TO ANALYZE PROPERLY THE DIVISION'S SCHEME AND COURSE OF BUSINESS CLAIMS.

As a preliminary issue, the Motion disingenuously portrays the Division's scheme and course of business claims as afterthoughts that were first articulated only in the post-hearing briefing. Contrary to Flannery's complaints, both the Division's scheme and course of business claims were expressly alleged in the OIP, along with citations to the very detailed paragraphs of facts that supported those claims, and were again presented by the Division at every opportunity – including in pre-hearing briefing, and during discussions before the hearing and on the record at the hearing. *See* OIP at ¶42; Div. Pre-Hg. Br. at 38; Tr. at 961-62. Flannery's own conduct belies the Motion's claim of unfair surprise. More than two months before the hearing even began, Flannery's counsel sought leave to file a summary disposition motion on the Division's scheme and course of business charges. *See* Memo. in Support of Flannery's Mot. for Summ. Disp. at 24-28. Perhaps most importantly, Flannery was given access to the Division's full investigative file in this case and chose not to pursue separate discovery. Thus, Flannery can make no legitimate claim that he was deprived of access to information relevant to defending the claims against him.

Second, the Motion places undue emphasis on the Initial Decision's finding that Flannery was credible. The Initial Decision cited the unsurprising facts that Flannery consistently maintained that he never meant to hurt investors, and that he thought he was acting in investors' best interests. *See* Initial Dec. at 3. Having chosen to contest the OIP, of course Flannery would claim a pure heart. What matters is not what a Flannery character witness thinks of him (Initial Dec. at 37-38), or what his biased colleagues who also participated in the collapse of LDBF and

the other active funds thought of him (Initial Dec. at 3), but what the evidence shows he did – mislead investors. The claims against Flannery do not present a case where credibility matters in the sense that there are diametrically opposed versions of a conversation, or meaningful factual disputes about whether an event took place. The Initial Decision errs to the extent that it elevates the finding that Flannery was credible above facts that are unaffected by credibility determinations.

The facts paint a compelling conclusion of Flannery's culpability. The facts demonstrate that Flannery was determined to keep investors invested in LDBF and SSgA's other active fixed income funds for as long as possible. *See* Div. Post-Hr. Br. at 32-33, 38-41, 45-48. Under Flannery's supervision, and with his direct approval, LDBF sold its most liquid and highest-rated assets to benefit early redeemers (who were mostly clients advised by his SSgA colleagues, including SSgA's internal investor advisory groups and other SSgA funds). *See* Div. Post-Hr. Br. at 22-30; Div. Post-Hr. Rep. Br. at 3-9. Flannery understood that these transactions substantially increased the funds' risks, but he used his authority as an editor and approver of client communications to prevent investors from learning this information. *See* Div. Post-Hr. Br. at 32-33; Div. Post-Hr. Rep. Br. at 13-15. In hopes of preventing a further "run on the fund," Flannery systematically engaged in a course of conduct that resulted in outside investors being deceived, and consequently losing millions of dollars.

As described below, Flannery's scheme started in July and continued into August 2007. He should be found liable because of the actions he took and the authority he wielded. He was able to perpetrate his scheme, despite the involvement of many other people in the communications at issue, because of his superior understanding of the investment issues

involved (on which many others deferred to him), his longstanding position and influence in SSgA and his role in acting as a final approver of the communications at issue.

III. EACH OF THE MAJOR CLIENT COMMUNICATIONS – THE JULY 26, AUGUST 2, AND AUGUST 14 LETTERS – WERE DECEPTIVE IN ONE SIGNIFICANT, AND COMMON WAY – THEY UNDERSTATED THE RISK OF LDBF AFTER JULY 25.

A. On July 26, SSgA Sold LDBF's Highest Rated And Most Liquid Assets To Meet Investor Redemptions.

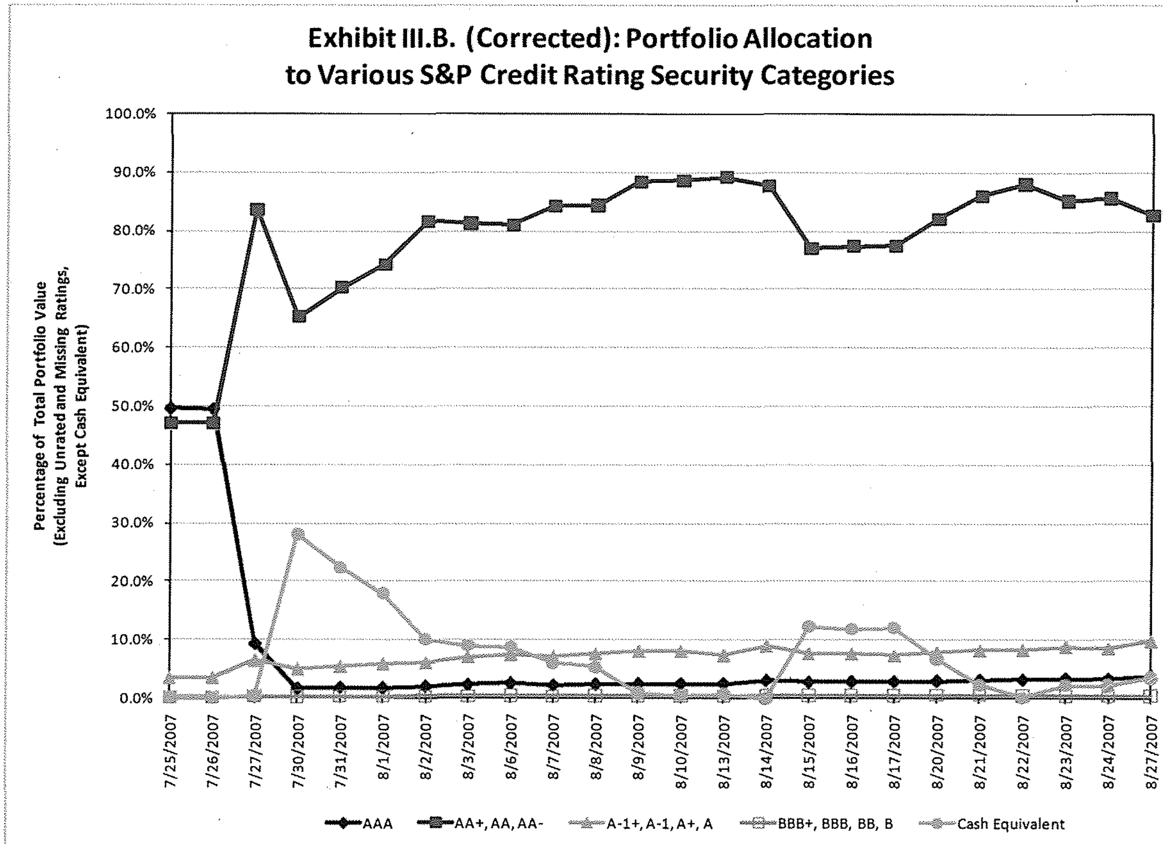
At 8:30 am on July 25, Flannery chaired a meeting of SSgA's Investment Committee to determine LDBF's fate given the recent and dramatic negative performance in the subprime market and the need to raise cash to meet investor redemptions. Div. Post-Hr. Br. at 22-25. At the meeting, Flannery announced that: (1) SSgA Relationship Management estimated LDBF would experience 25-50% redemptions, (2) he was uncomfortable only reacting to client redemption requests, and therefore (3) his educated guess was that SSgA would have to sell about 40% of LDBF's assets to satisfy redeeming clients' demands for liquidity. *Id.* As to which assets SSgA should sell to raise cash for redemptions, Flannery told the Committee that if SSgA decided to sell only LDBF's most liquid assets "we will be stuck with just illiquid and so the situation could get much worse. . . If we don't sell a slice across the portfolio then we end up with a less liquid portfolio – valued less." *Id.* However, because LDBF would be forced to realize large losses if it sold its more illiquid, lower-rated assets to raise cash for redemptions, LDBF's portfolio manager told the Committee that SSgA "should raise cash through selling the AAA." *Id.* He cautioned that this sale "will change [LDBF's] risk profile." *Id.* Fully informed about the dilemma between avoiding immediate losses and changing the risk profile of LDBF, the Committee voted unanimously to direct LDBF's portfolio manager to sell the fund's highest rated assets (AAA subprime bonds) to meet anticipated investor redemptions of 25-50% by month end. *Id.*

As soon as he left the Investment Committee meeting, LDBF's portfolio manager began working to implement the Investment Committee's instruction to raise liquidity by selling LDBF's AAA bonds. *Id.* at 25-28. The AAA bond sale was completed on the afternoon of July 26, 2007, and LDBF raised a net of $431,932,795 from the sale after repaying outstanding reverse repurchase commitments. *Id.* Flannery was informed about the AAA bond sale shortly after it was complete on the afternoon of July 26. *Id.*

After the AAA bond sale, LDBF's portfolio was very different. Its saleable assets had gone from roughly equal proportions of AAA and AA subprime bonds to almost exclusively AA subprime bonds, and the AA bonds left in LDBF after July 26 were far more illiquid than the AAA bonds that had been sold. *Id.* The AA bonds left in LDBF thus carried greater liquidity and price risk if the subprime market drop of July 2007 proved to be more than a short-term crisis. *Id.* The AA bonds were also inherently riskier because they were structurally designed to be less protected from default than AAA bonds. *Id.*

B. As Flannery Expected, The Cash From The July 26 AAA Bond Sale Was Used Almost Immediately To Meet Insiders' Redemption Demands.

Had the cash generated by the AAA bond sale stayed in the portfolio, LDBF's risk profile may have been reduced by the sale for the common sense reason that holding cash is less risky than holding securities of any type. *Id.* Unfortunately for LDBF's investors, LDBF's risk profile increased as a result of the July 26 AAA bond sale because the cash raised from the sale was used up almost immediately to meet cash redemptions. Div. Post-Hr. Reply Br. at 2-7. The following chart demonstrates the dramatic deterioration in LDBF's portfolio after July 26:



Id. This chart shows that, from July 26 to August 27:

- LDBF changed from a fund evenly balanced between AA and AAA-rated subprime bonds to a fund that held substantially all illiquid AA-rated subprime bonds[2] (*id.*);

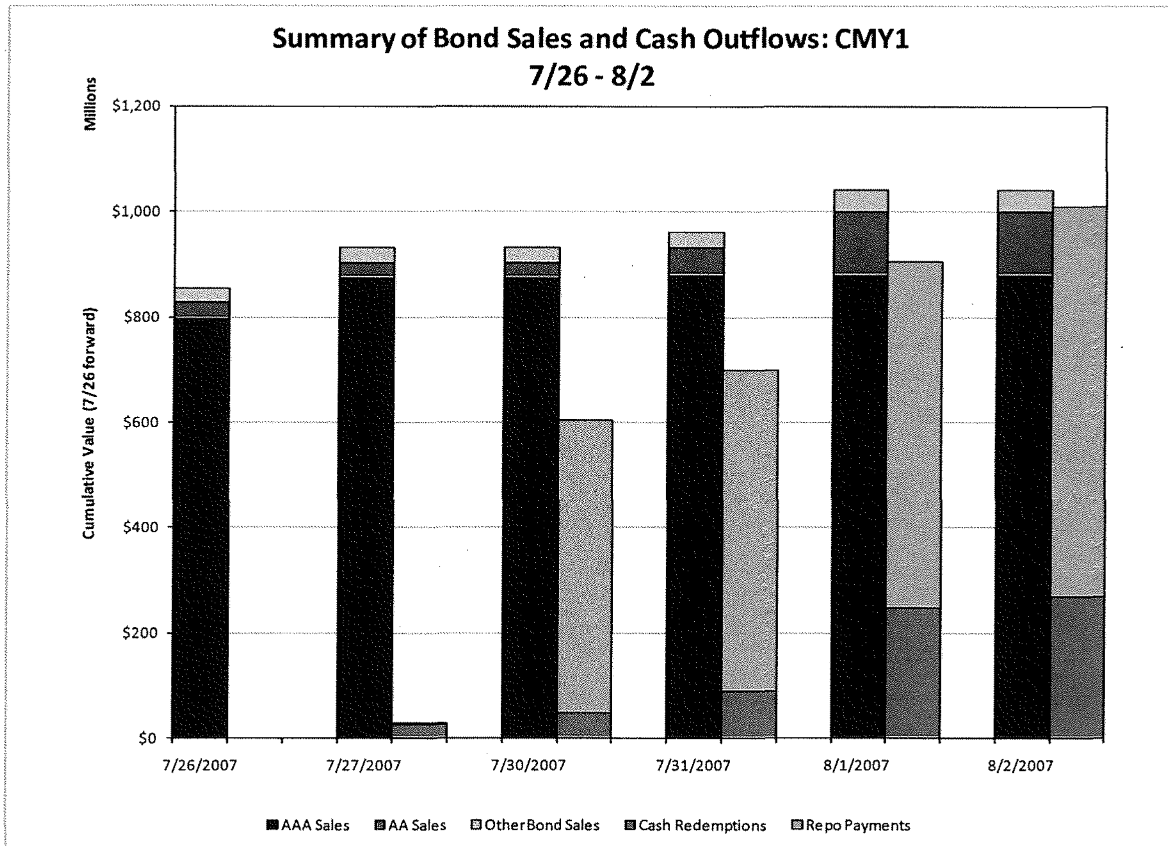
- the cash raised from the July 26 AAA bond sale was rapidly drawn down to re-pay the repurchase commitments on the AAA bonds and to meet redemptions by clients of SSgA's internal advisory groups and other SSgA funds invested in LDBF (*id.*); and

- SSgA used the cash from the July 26 AAA bond sale instead of selling a pro rata share of LDBF's more illiquid bonds to re-pay reverse repurchase agreements and satisfy cash redemptions. *Id.*

For example, from July 26 to August 2, the ERISA version of LDBF sold $1,041,121,722 in bonds, including $797,522,192 in AAA bonds on July 26. *Id.* Of this $1,041,121,722 in bonds sold, 84.4% were rated AAA, 11.8% were rated AA, and 3.8% were rated lower than AA

[2] LDBF's other holdings were derivatives, with no or negative market value, that could not be sold to satisfy investors' redemptions. *Id.*

or unrated. *Id.* Over this same period, LDBF ERISA repaid $739,361,000 in reverse repurchase agreements and satisfied $270,289,398 of cash redemptions. *Id.* LDBF ERISA had only *one penny* in cash on August 2. *Id.* LDBF ERISA's bond sales and cash outflows from July 26 to August 2 are summarized below:



This chart demonstrates how early redeemers received the proceeds of the July 26 sale, leaving later redeemers to satisfy their claims from illiquid, lower valued assets.

C. The One-Two Punch Of Selling LDBF's AAA Bonds And Then Using The Cash To Meet Redemptions Caused A Significant Shift In LDBF's Risk Profile.

At the July 25 Investment Committee meeting, Flannery said, in substance, that if SSgA did not sell LDBF's liquid and illiquid assets then the fund would be stuck with only illiquid assets and the situation could get worse. Div. Post-Hr. Br. at 23. This statement captures the

essence of the tradeoff SSgA faced at the end of July 2007. If SSgA sold a pro rata share of LDBF's assets to meet the immediate need to satisfy investor redemptions, LDBF would have to realize significant losses on lower rated subprime bonds -- but all investors (both investors who chose to redeem and investors who chose to hold) would share those losses pro rata. Conversely, if SSgA sold LDBF's most liquid assets (AAA subprime bonds) to satisfy immediate redemption needs, the fund would not need to incur significant realized losses in the short term, but investors who chose not to redeem at the end of July would bear all the risk of future volatility in the subprime market. Flannery and the SSgA Investment Committee chose the second alternative, and, as they expected during the Committee meeting, LDBF's risk increased in July and August 2007 as a result of their decision.

Flannery argues that his expert witness, Ezra Zask, provided "***unrebutted testimony***" that the July 26 AAA bond sale reduced LDBF's risk. Motion at 7 (emphasis in original). In fact, Zask's opinion was rebutted. The Division proved that Zask offered a hypothetical opinion based on assumed facts that were never intended to occur and never did occur. Div. Post-Hr. Rep. Br. at 10. The Initial Decision erroneously relied on Zask's hypothetical opinion in reaching its conclusions that LDBF's risk had decreased at the time of the July and August 2007 investor letters. Init. Dec. at 53. These erroneous findings about LDBF's risk profile were the basis of the Initial Decision's mistaken findings that the investor letters were not misleading.

Zask measured LDBF's risk according to the fund's conditional value at risk (or CVaR), which was the risk measurement tool SSgA itself used at the time. See Div. Post-Hr. Br. at 44; Div. Rep. Post-Hr. Br. at 9-12. Zask opined that, hypothetically, LDBF's risk would have been reduced if one were to assume that the cash from the July 26 AAA bond sale stayed in the fund. Div. Post-Hr. Rep. Br. at 10. However, contrary to Zask's assumption, the purpose of the July

26 AAA bond sale was to raise cash to meet redemption demands, and, in fact, the cash raised from the sale was almost immediately used up for exactly that purpose. After the AAA bond sale and the investor redemptions that immediately followed, LDBF's mix of assets was more volatile, lower rated, more illiquid, and thus indisputably riskier. As a result, LDBF's risk -- as measured by SSgA's own risk measurement tool, CVaR -- increased substantially after the July 26 AAA bond sale. Div. Post-Hr. Rep. Br. at 9-12.

Further demonstrating the absurdity of Zask's opinion, Flannery himself represented to State Street Corporation's Board of Directors in October 2007 that LDBF's risk (as measured by CVaR) had *quadrupled* from June 1, 2007 to August 1, 2007. *Id.* LDBF's risk increased during this period because: 1) the cash raised from the July 26 AAA bond sale was used to satisfy early redemptions; 2) after the July 26 AAA bond sale and the early redemptions, LDBF held a riskier mix of assets than before; and 3) LDBF's remaining, lower-rated assets became even more volatile as the subprime market continued to deteriorate. *Id.* Zask computed hypothetical CVaR figures for LDBF that ignored the first and second reasons, and he avoided the third reason by relying on outdated data. *Id.* If Zask had not ignored reality or relied on stale data, his conclusions would have matched Flannery's. The opinion that Zask offered at the hearing is thus demonstrably useless. The Initial Decision erred by relying on it to find that the investor letters were not deceptive.

D. The Decision To Sell LDBF's AAA Bonds On July 26 Caused Investors Who Remained In LDBF After July To Realize A Disproportionate Share of Losses.

SSgA's decision to hold most of LDBF's lower rated and more illiquid bonds until after July 26 harmed investors more than if assets had been sold pro rata across investment grades. Spreads on the AA- and lower-rated bonds continued to rise, and their prices continued to decline, after July 26, and SSgA was forced to sell these bonds to fund redemptions that occurred

after the early redeemers received the proceeds of the July 26 sale. In a presentation to State Street Corporation's Board, Flannery and others at SSgA described the cost of "forced liquidation" on LDBF. In their presentation, they told the board that the July 26 AAA bond sale cost the fund 3%, whereas the sale of LDBF's AA-rated bonds one month later cost the fund 10%. Div. Post-Hr. Br. at 28. That means that investors who were not among the early redeemers bore a 10% loss that the early redeemers avoided. For investors in a fund with LDBF's purportedly conservative investment goals, such a loss was staggering.

E. What Happened To LDBF After The Investment Committee Meeting Stands In Sharp Contrast To The Message of the July 26, August 2, and August 14 Letters.

As described above, on July 25, 2007, the SSgA Investment Committee decided to reposition LDBF to meet immediate redemption demands. Flannery and others on the Committee minimized the immediate costs of forced liquidations by selling only the fund's highest rated assets to cover those immediate demands. This decision was fair to *all* of LDBF's investors only if the fund's remaining investors chose not to redeem before the subprime market recovered. Unable to control what happened in the market, Flannery commenced a deceptive course of conduct in an attempt to control the second factor. That is, he attempted to quell investors' desire to redeem by providing false information about the steps he claimed SSgA had taken to protect investors. This course of conduct included his editing and approval of letters that provided deceptive information to investors:

- SSgA's July 26 letter to investors: "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." *Id.* at 37.

- SSgA's August 2 letter to investors: "To date, in [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 Limited Duration Bond Strategy simultaneously reduced risk in other SSgA active fixed income and active derivative-based strategies." *Id.* at 43.

- Flannery's August 14 letter: "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." *Id.* at 46.

Each of these statements was deceptive because they led most investors to believe that SSgA had taken steps to reduce LDBF's risk attributable to the subprime market. Of course, some investors already knew the truth about LDBF and had decided to redeem, but these letters were targeted at investors who had not yet decided to redeem.[3] Although SSgA had decided to sell LDBF's most liquid assets to satisfy immediate investor redemptions, including the internal advisory groups' redemptions, Flannery oversaw a course of business that communicated the opposite message to investors. In some sense, he had left himself with no other choice. Having pillaged the fund for early-redeeming investors, LDBF would not survive even a short-term liquidity crisis if all of the fund's investors knew the truth about what was left in the fund.

[3] Flannery argues that OFA, an internal SSgA group that advised clients invested in LDBF and funds invested in LDBF, "had no information about actual or anticipated redemption activity by others." Motion at 9. In fact, an OFA representative attended the entire July 25 Investment Committee meeting and thus learned the confidential information that SSgA would be selling LDBF's highest rated bonds to satisfy immediate investor redemptions. Div. Post-Hr. Br. at 22. After the Investment Committee meeting, and with the active participation of its representative who attended that meeting, OFA decided to recommend that its investors, including the State Street Corporation Retirement Plan, redeem from LDBF and the funds invested in LDBF. Division's Proposed Findings of Fact ("Div. FOF") at 420, 423. While Flannery did not decide to recommend LDBF's termination to OFA's clients, he was informed about OFA's decision on July 27. *Id.* at 424. Flannery was well aware that the internal SSgA investors who knew the truth about LDBF (OFA, GAA, and State Street's other funds invested in LDBF) had decided to redeem and would therefore receive the cash from the July 26 AAA bond sale. *Id.* at 420-437.

Though the Motion argues that Flannery's role in communicating with clients was negligible, the record demonstrates to the contrary. *See* Motion at 5-6, 17-18, 20. Flannery was the main gatekeeper of the letters' accuracy for their statements relating to investment facts. *See* Div. Post-Hr. Rep. Br. at 13-14, 16-17. The letters were primarily deceptive because of their mischaracterization of the investment facts about LDBF. Flannery even drafted and signed the third of the letters because he knew that his own reputation was on the line if investors began to defect from the funds *en masse*. *See* Div. Post-Hr. Br. at 33, 64.

The Motion also contends that Flannery lacked scienter and was not negligent in connection with his role in any of the three broadly-distributed client letters. *See* Motion at 10-11, 15-16, 20. Though Flannery makes various arguments in support of his contention that he did not act with a culpable state of mind, all of his arguments are premised on factual disputes, about which the Initial Decision reached erroneous conclusions. The Commission should accept full review of the Division's claims and conduct its own *de novo* review of the evidence – evidence that, the Division contends, will demonstrate that Flannery acted negligently or extremely recklessly.

CONCLUSION

For the reasons articulated above, the Commission should deny Flannery's motion for summary affirmance in its entirety. No portion of the Initial Decision should be excised and affirmed. Instead, the Commission should accept the Division's petition for review and should conduct a full *de novo* review of the Division's claims against Flannery under Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5(a) and (c) thereunder.

Respectfully submitted,

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