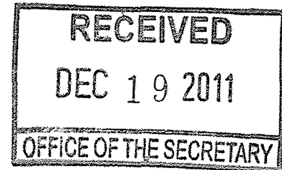
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



In the Matter of

JOHN P. FLANNERY, AND
JAMES D. HOPKINS,

Respondents.

Administrative Proceeding
File No. 3-14081

DIVISION OF ENFORCEMENT'S OPPOSITION TO REPONDENT JAMES D. HOPKINS' MOTION FOR SUMMARY AFFIRMANCE

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December 16, 2011

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Pursuant to Rules 411(e) and Rule 154(b) of the Securities & Exchange Commission's ("Commission") Rules of Practice, the Division hereby opposes the Motion for Summary Affirmance ("Motion") filed by Respondent James D. Hopkins ("Hopkins"). Hopkins urges the Commission to affirm the Initial Decision because: 1) correction of the clearly erroneous findings of fact and erroneous findings of law identified by the Division's Petition for Review will not change the Initial Decision's conclusion that Hopkins lacked culpability pursuant to Sections 17(a) and Section 10(b) and Rule 10b-5; and 2) the Initial Decision held that Hopkins lacked the requisite scienter or negligence as to all alleged conduct, and thus the Division had not otherwise adequately proven its case. Hopkins' Motion For Summary Affirmance ("Hopkins' Mot.") at 3-4. Hopkins is wrong. The Initial Decision erroneously applied the Supreme Court's recent decision in *Janus Capital Group, Inc*, v. *First Derivative Traders*, 131 S. Ct. 2296 (2011) and improperly required the Division to demonstrate reliance by so-called "sophisticated investors." The Initial Decision did not determine Hopkins' scienter as to *any* of the conduct alleged. Thus, if the Commission were to take the Division's appeal and properly applied *Janus* and concepts of materiality, the Commission should find Hopkins liable pursuant to Section 17(a)(2) and/or Rule 10b-5(b). Alternatively, in the absence of primary liability for material misstatements, the Commission should find Hopkins liable under a scheme liability theory—a separate ground that the Initial Decision (and Hopkins) wholly ignored.

The Initial Decision is also replete with other clearly erroneous findings of fact and erroneous conclusion of law that, if corrected, would cause the Commission to find Hopkins liable. The errors were preserved by the Division's detailed Rule 340 Proposed Findings of Facts—proposed findings that Hopkins conceded for the most part were accurate statements of the record. *See* Division of Enforcement's Petition for Review of Initial Decision ("Petition") at

2 n.1; Respondent James D. Hopkins' Responses to the Division of Enforcement's Proposed Findings of Fact ("Hopkins Resp. to FOF").

I. THE INITIAL DECISION MADE ERRONEOUS LEGAL FINDINGS REGARDING THE APPLICATION OF *JANUS* AND INVESTOR SOPHISTICATION THAT AFFECTED ALL ITS FINDINGS REGARDING HOPKINS.

The Initial Decision opined that Hopkins did not violate Sections 17(a) and Section 10(b) and Rule 10b-5 as to the following six sets of communications: 1) fact sheets published every quarter for six quarters that Hopkins was responsible for reviewing quarterly and correcting (Initial Dec. at 1-20, 43); 2) a "Typical Portfolio Slide" attributed to Hopkins and used by him at least in five face-to-face presentations (Initial Dec. at 20-23, 45); 3) investor presentations attributed to him regarding the Limited Duration Bond Fund's ("LDBF" or "the Fund") holdings in ABX (Initial Dec. at 46-47); 4) April 9, 2007 communications with David Hammerstein of Yanni Partners (Initial Dec. at 28-29, 47-48); 5) a March 2007 letter regarding LDBF's subprime exposure primarily drafted by Hopkins (Initial Dec. at 23-24, 49-50); and 6) a July 26 letter that Hopkins initially drafted and later revised. (Initial Dec. at 25-26, 50-52). For each of these, with the exception of the April 9, 2007 communications with Yanni Partners, the Initial Decision made two findings: 1) Hopkins was not responsible for and did not have ultimate authority over the communication; and 2) the communication did not contain material misrepresentations or omissions. As to the April 9, 2007 communications with Hammerstein of Yanni Partners, the Initial Decision relied on only one ground—that a material misstatement was not made—a clearly erroneous factual finding as will be addressed below. Contrary to Hopkins' claims, the Initial Decision made no findings regarding scienter or negligence as to any communication. At most it noted in passing as to the fact sheets—one of the six sets of communications—that it need not address the issue. Initial Dec. at 45.

A. The Initial Decision Erred in Its Application of *Janus* and Failed to Address Scheme Liability.

The Initial Decision based its first finding on an erroneous reading of *Janus*—a finding that Hopkins did not substantively address in his motion for summary affirmance. Initial Dec. at 42-43, 43-44, 45, 47, 49, 50-51; Hopkins Mot. at 3. As detailed in the Division's Petition for Review, the Initial Decision erred by not only applying *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 as Section 17(a) of the Securities Act. Petition at 4. In *Janus*, although the Court defined only what it means "to make" an untrue statement under Rule 10b-5(b), the Initial Decision applied *Janus* to those latter sections even though "make" does not appear. *Id.* In effect, it concluded that, if Hopkins did not "make" a misstatement for purposes of Rule 10b-5(b), he could not be primarily liable under any of the other sections—conflating all the sections into one violation.

Yet, as the Commission has recognized, the three main subdivisions of Section 17 and Rule 10b-5 have been considered mutually supporting rather than mutually exclusive. *Cady, Roberts & Co.*, 40 S.E.C. 907, 913 (1961).[1] Thus, scheme liability can be used to reach persons who either "made" false statements themselves (within the meaning of *Janus*), or who are responsible for false statements that are "made" by other persons. *See, e.g., VanCook v. SEC,* 653 F.3d 130 (2d Cir. 2011) (holding that late trading in a mutual fund is actionable under (a) as a scheme, under (c) because it operated as a fraud on the fund, and under (b) because the late trades were implied representations). The Initial Decision's erroneous conflation of all the sections of Section 17 and Rule 10b-5 resulted in its failure to address whether Hopkins'

[1] In *Cady, Roberts*, a seminal insider trading decision, the Commission went on to note that "a breach of duty of disclosure may be viewed as a device or scheme, an implied representation, and an act or practice, violative of all three subdivisions." *Id.*

participation in six different sets of communications to numerous clients over a *sixteen-month period* operated either as a scheme to defraud (Section 17(a)(1) and Rule 10b-5(a)) or operated as a fraud (Section 17(a)(3) and Rule 10b-5(c)). The Initial Decision thus failed to determine whether the communications taken as a whole were a fraud even if, in isolation, some of the communications were not materially misleading and/or made by Hopkins.

Moreover, as discussed in the Petition for Review, the Initial Decision erred in its legal finding that Section 17(a)(2) requires Hopkins to have "made" a misstatement for primary liability to attach. Petition at 5-6. Thus, the Initial Decision failed to address whether Hopkins obtained money by *means* of a material misstatement—the appropriate standard—as to five of the six sets of communications.[2] These communications included: 1) fact sheets for which he had review responsibilities and which he knew were sent to clients and prospective clients; 2) the March 2007 letter for which he was the primary drafter and that was sent to clients; 3) the "Typical Portfolio Slide" for which he had editorial responsibility as well authorship credit on the front page of the presentation and which he used at five investor presentations; 4) a July 26, 2007 letter for which he was the original drafter; and 5) investor presentations regarding LDBF's holdings in ABX that he used with at least two clients in face-to-face meetings.

Finally, as the Petition for Review explained, the Initial Decision misapplied the *Janus* Court's interpretation of Rule 10b-5(b). Petition at 6. By doing so, the Initial Decision held that Hopkins lacked primary liability as to two sets of investor presentations: 1) investor presentations containing the "Typical Portfolio Slide"; and 2) investor presentations regarding LDBF's holdings in ABX. However, Hopkins had used these slides at numerous presentations with clients and his name appeared on the front of the PowerPoint presentation as one of the

2 For the sixth communication – the April 9th telephone conversation with Hammerstein – the Initial Decision acknowledged that Hopkins "made" a statement. Initial Dec. at 48.

authors. Initial Dec. at 20-22; FOF ¶ 164. As the speaker using slides that were attributed to him, he "made" a misstatement pursuant to *Janus*. *See* Petition at 6. Thus, the Initial Decision erred in even applying the *Janus* Rule 10b-5(b) standard to at least these two sets of presentations.

B. The Initial Decision Erred in its Use of Investor Sophistication as Part of the Materiality Analysis.

As to the Initial Decision's second finding that communications did not contain material misrepresentations, it relied heavily on the first concept in its Findings and Conclusions—"Investor Sophistication." Initial Dec. at 39-40. As the Division noted in its Petition for Review, the Initial Decision clearly erred in its factual findings concerning investor sophistication and erred in its conclusions of law that imported concepts of investor sophistication and reliance into the Division's burden of proof. Petition at 6-9.

The Initial Decision found that "LDBF's investors were sophisticated, institutional investors, most of whom engaged investment consultants to provide investment assistance." Initial Dec. at 40. Yet the evidence cited for the Initial Decision's finding was spotty at best, relying on the opinion of experts or off-handed statements by Flannery or a client relations person. Initial Dec. at 3, 33-44. The actual evidence indicated that investors were not always sophisticated as to fixed income. FOF ¶¶ 98, 107. Respondents' expert admitted that sophistication of the investors in LDBF varied. FOF ¶ 98. Moreover, Hopkins admitted that otherwise sophisticated investors might not know a lot about fixed income investing—the core of this action. FOF ¶ 107; Hopkins Resp. ¶ 107. Hopkins also admitted that the experience of consultants dealing with fixed income varied. *Id.*

However, the Initial Decision assumed sophistication across the board when it analyzed whether certain misstatements were material. For example, as to the fact sheets, the Initial

Decision determined that the absence of portfolio holding definitions was not material because "investors were sophisticated or had sophisticated consultants advising on their behalf."[3] Initial Dec. at 45. As to the "Typical Portfolio Slide," it opined that the information contained within the slide was not material because "no sophisticated investor would rely on this single piece of information but would consider a total mix of information. . . ." Initial Dec. at 46. Finally, as to the July 26, 2007 letter, the Initial Decision opined that 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." Initial Dec. at 52 (emphasis added).

In error, the Initial Decision found that investor sophistication was relevant to materiality. Initial Dec. at 40, 43-44, 45-46, 51-52. The Initial Decision erroneously relied on private implied right actions that held that investor sophistication was relevant for reliance or scienter, not materiality. *See, e.g. Myzel v. Cohen*, 386 F.2d 718, 735-36 (8th Cir. 1967) (because reliance is a subjective standard substituting the individual person for the "reasonable investor," investor sophistication is relevant to analysis); *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 891 (S.D.N.Y. 1986) (sophisticated plaintiff unreasonably relied on misrepresentation through failure to conduct due diligence); *Martin v. Steuben*, 458 F. Supp. 88, 92-93, 97 (S.D. Ohio 1979) (defendant lacked *intent* to deceive plaintiff because he thought disclosure was adequate given appearance of sophistication). The Initial Decision failed to cite a single government enforcement case supporting its finding that investor sophistication is relevant for materiality.

Yet, relying on the private right of action cases addressing reliance, the Initial Decision improperly imported a reliance element into its analysis of several sets of communications. *See*

[3] This finding contradicts the finding elsewhere that sector definitions were fluid and open to more than one meaning. Initial Dec. at 34 ("Sirri acknowledged that there can be uncertainty in how the term ABS is used.")

Petition at 8-9. For example, as to the "Typical Portfolio Slide," the Initial Decision looked at whether an investor would rely on the slide by itself to determine whether it was materially misleading. Initial Dec. at 46. This finding directly contradicted the legal standard that it found applicable—materiality is governed by what a *reasonable* (not sophisticated) investor would consider as having significantly altered the total mix of information made available. Initial Dec. at 40 (*citing Matrixx Initiatives Inc. v. Sirarcusano*, 131 S. Ct. 1309 (2011)). Moreover, it is contradicted by factual testimony as discussed below. *See infra* at 8-9.

As for the fact sheets, the Initial Decision found that the absence of definitions for the different categories of portfolio holdings (ABS, MBS, CMBS, etc.) was not materially deceptive because the absence was *reasonable* given the sophistication of investors. Initial Dec. at 45 (emphasis added). By so doing it found that investors in LDBF—as sophisticated investors—would not have needed the definitions. The decision failed to determine whether a *reasonable* investor would have found that the absence of such definitions was materially misleading.

Finally, as to the July 26, 2007 letter, the Initial Decision determined that omitted information regarding LDBF's exposure to subprime and significant leverage was immaterial because the *investors* could have sought additional information from State Street, thereby placing the burden on investors to seek additional information rather than looking at the total mix as it existed. Initial Dec. at 52. In effect, the Initial Decision required the investors to perform due diligence—an analysis relevant for reliance but not materiality.

II. THE INITIAL DECISION MADE CLEARLY ERRONEOUS FINDINGS OF MATERIAL FACT.

As the Division stated in its Petition for Review, the Initial Decision clearly erred by making factual findings contrary to the record as reflected in the Division's Proposed Findings of Fact. (Petition at 2 n. 1). Hopkins admitted that most of these findings were accurate. Hopkins'

Resp. to FOF. Specifically, as to Hopkins, the Initial Decision made glaring factual errors not supported in any way in the record and most were *unrebutted* factually by Hopkins. In particular, by way of example as detailed below, the Initial Decision made clearly erroneous findings in connection with its rulings that the "Typical Portfolio Slide" did not contain material misstatements and that Hopkins did not orally make material misstatements to David Hammerstein on April 9, 2007.

A. The Initial Decision Clearly Erred in Ruling that the Typical Portfolio Slide Was Not Materially Misleading.

The Initial Decision found that the "Typical Portfolio Slide," which Hopkins used during at least five investor presentations, represented that LDBF held a 55% investment in the ABS sector (including mostly mortgage-backed securities), when LDBF's actual portfolio composition was closer to 90% ABS in 2006-07. Initial Dec. at 46-47. Yet it concluded that it was not a "material" misrepresentation because: 1) the slide was entitled "typical" not "actual"; 2) experts had opined that CMBS and MBS—two other categories—could be "reasonably classified" as ABS so the understatement of ABS was not a misstatement; and 3) no reasonable investor would rely only on the "Typical Portfolio Slide." Initial Dec. at 46. All these findings were clearly in error.

First, the Initial Decision found that during the sixteen months Hopkins used the slide with clients and prospective clients the "Typical Portfolio Slide" did not reflect LDBF's actual portfolio. Initial Dec. at 21-22. Yet, in its findings and conclusions it reasoned that because it said "typical" – although it was never remotely typical during the sixteen-month period —that it was not misleading. Initial Dec. at 46. Such a finding lacks any support in the record.

Second, the Initial Decision cited no evidentiary support for its conclusion that experts thought that the other categories detailed in the portfolio – CMBS and MBS – could be

"reasonably classified" as ABS. In fact, the evidence was that both the portfolio manager for LDBF and Hopkins considered CMBS and MBS to be separate categories from ABS, as did the Lehman Aggregate Bond Index—the index that the Initial Decision and Hopkins recognized as a "widely held reference" for its definitions of categories for fixed income. Initial Dec. at 45; FOF ¶ 64; 128-30.

Third, in addition to the Initial Decision's misstatement of the legal standard for materiality, *see supra* at 5-7, it ignored unrebutted evidence that David Hammerstein, a consultant to numerous clients to LDBF, found the "Typical Portfolio Slide" materially misleading. Division of Enforcement's Reply to Respondent James D. Hopkins' Post Hearing Brief ("Div. Reply Br.") at 4. Hopkins used the slide at a May 10, 2007 in-person meeting with Hammerstein and his client National Jewish Medical Center ("National Jewish"). Division of Enforcement's. Post Hearing Brief (Div. Post Hr. Br.) at 20. Hammerstein specifically testified that the sector allocations reflected in the "Typical Portfolio Slide" suggested a fund that was sector diversified and less risky that the fund actually was. Div. Reply Br. at 4. The uncontroverted testimony as provided by David Hammerstein is that Hopkins not only presented the "Typical Portfolio Slide" but made oral misrepresentations regarding the portfolio while using that Slide – a slide that he had the responsibility to update for accuracy.[4] Div. Reply Br. at 5. At the hearing, Hopkins attempted to counter this evidence by "logically reconstructing" a memory that he had not used the presentation book containing the "Typical Portfolio Slide" when he made his presentation to National Jewish. *Id.* However, in direct questioning by the ALJ, he admitted that he had no such memory. *Id.* Thus, it was clear error to conclude that the "Typical Portfolio Slide" used by Hopkins was not materially misleading.

[4] The Initial Decision ignored these oral representations when determining whether Hopkins had ultimate authority as to the Typical Portfolio Slide communication. Initial Dec. at 45.

B. The Initial Decision Clearly Erred in Ruling that Hopkins Did Not Make a Materially Misleading Statement During the April 9, 2007 Telephone Call with David Hammerstein

Hammerstein testified that on April 9, 2007, during a telephone conference, Hopkins told him that LDBF was only 2% exposed to subprime even though the fund held more than 80% subprime at the time. Initial Dec. at 28; Div. Post-Hr. Br. at 19-20. His testimony was supported by his contemporaneous memorandum regarding the conversation. *Id.* Based on his conversation, Hammerstein recommended to his clients that they remain invested in the Dow Jones Commodities Fund – a fund almost 100% invested in LDBF. Initial Dec. at 28; Div. Post-Hr. Br. at 20. Hopkins had no memory as to whether he had provided information regarding the overall exposure of the fund—a fact that that is unrebutted. Div. Reply Brief at 5; Hopkins Resp. to FOF ¶ 237.

Hammerstein repeatedly testified, however, that after he asked Hopkins about subprime exposure, Hopkins told him that the total exposure to subprime was 2%. Div. Reply Br. at 7; Hopkins Resp. to FOF ¶ 237. He did so even when Hopkins' counsel suggested that he had never actually asked about subprime exposure. Div. Reply Br. at 7. Hammerstein also testified that Hopkins told him that the total exposure was 2% when counsel for Hopkins specifically confronted Hammerstein with his theory that the 2% in the memo referred only to the ABX exposure. *Id.* Thus, the unrebutted evidence is that Hopkins specifically misled Yanni Partners by stating that LDBF was only 2% exposed to subprime.

Yet, with no citations to the record, and relying solely on convoluted argument by Hopkins' counsel in his brief, the Initial Decision concluded that there was "genuine confusion" regarding what was said during the conversation. Initial Dec. at 48. Its conclusion was based on supposition that Hammerstein was confused as to what Hopkins meant by 2% even though Hammerstein denied that he was confused and the Initial Decision made *no findings* that

Hammerstein lacked credibility as a witness. It also based its finding on the conclusion (without specific support in the record) that there were no other times that Hopkins had been asked for information and he failed to provide that information.[5] Initial Dec. at 48. It was a clear error of fact to conclude that Hopkins had not mislead Hammerstein based on the Initial Decision's conclusion that he had told the truth at other times.

CONCLUSION

For the reasons stated above, the Division requests that the Commission deny Hopkins' Motion for Summary Affirmance. 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 Hopkins under Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

Respectfully submitted,

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[5] Interestingly, the Initial Decision did allude to at least one time that Hopkins did not provide information regarding the meaning of "greater sector diversification" when directly asked. Initial Dec. at 20.