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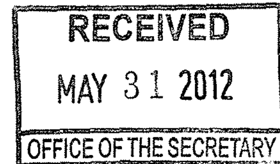

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of:	)	
	)	
	)	ADMINISTRATIVE PROCEEDING
JOHN P. FLANNERY and	)	FILE NO. 3-14081
JAMES D. HOPKINS	)	
	)	

RESPONDENT JOHN PATRICK ("SEAN") FLANNERY'S OPPOSITION TO THE DIVISION OF ENFORCEMENT'S BRIEF IN SUPPORT OF ITS PETITION FOR REVIEW

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I. INTRODUCTION

The Initial Decision dismissing the allegations against John P. Flannery should be affirmed.

This appeal concerns three letters State Street Global Advisors ("SSgA") sent to investors in the Limited Duration Bond Fund ("LDBF") on July 26, August 2, and August 14, 2007, during the unprecedented financial crisis that unfolded that summer. Div.Br. 20.[1] After an 11-day hearing involving 19 witnesses, including 5 experts, and approximately 500 exhibits, Chief Administrative Law Judge Brenda P. Murray found against the Division of Enforcement (the "Division") and in favor of John Patrick ("Sean") Flannery, SSgA's former Chief Investment Officer ("CIO"), Americas, on each of the Division's claims, issuing a 58-page Initial Decision detailing her findings and the voluminous record evidence supporting them. Not a single witness supported the Division's theory of the case against Flannery.

Among Chief Judge Murray's key findings were that (1) none of the letters was false or misleading, and (2) Flannery did not act negligently or with scienter. These findings each independently compel the result, and are fully supported by the record evidence. With respect to the first letter, Chief Judge Murray found that "[t]here 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."

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[1] The Division contends Flannery violated Section 17(a)(2) of the Securities Act of 1933 in connection with the two August letters. The Division also asserts, based on varying combinations of all three letters, that Flannery engaged in a fraudulent scheme in violation of Sections 17(a)(1) and (3) of the Securities Act, as well as Section 10(b) of Securities Exchange Act of 1934 and Rule 10b-5(a) and (c). The Division's Brief (p.20) suggests there is a 10b-5(c) claim based on the August 14 letter, but this, presumably, is an error. The Division has never pursued a scienter-based charge under Rule 10b-5 or otherwise in connection with that letter. Order Instituting Proceedings ("OIP") ¶¶43-44. The claims relating to the August 14 letter are based solely on Sections 17(a)(2)-(3).

Initial Decision ("I.D.") 51. Flannery did not author or sign the letter, and:

> 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 . . . **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 . . . [was] involved deeply in the letter's contents and approved its issuance.

I.D. 50-51 (emphasis added).[2] As the Division itself concedes, "[e]ach of the letters was circulated to numerous client service, legal, and investment team members." Div.Br. 28.

Chief Judge Murray's findings exonerating Flannery in connection with the August 2 letter included the following:

> 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 . . . **[T]here is nothing in all the numerous e-mails that supports a claim that Flannery was attempting to obfuscate or mislead. The evidence supports a finding that Flannery's edits to the August 2 letter were intended to make it more accurate, not less so.**

I.D. 53-54. Flannery offered one round of "suggested edits" to the August 2 letter, which was subsequently reviewed and edited by numerous people, including SSgA's lawyers. "[O]nly a handful of Flannery's suggested edits remained in the final letter." I.D. 27-28. And, as the Division admits, Flannery believed that the letter's risk reduction statements, which the Division challenges and which Flannery did not draft, were true. Division's Proposed Findings of Fact ("DPFOF") ¶368.

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[2] The OIP alleged Flannery made misrepresentations in the August 2 and August 14 letters, but made no specific allegations against him related to the July 26 letter. OIP ¶¶37-41. Other than reciting the statutory language, the OIP also failed to describe how Flannery allegedly engaged in a scheme to defraud; the Division also did not articulate its theories in its Pre-Hearing Brief or at the Hearing. Tr. 839-40, 961-62, 1186, 1486-87; *see Jaffe & Co. v. SEC*, 446 F.2d 387, 394 (2d Cir. 1971) (vacating order of Commission where OIP failed to provide fair notice of grounds for claims against respondent). On this basis alone, and without consideration of the extensive record evidence demonstrating there was no scheme, the Division's appeal of its scheme claims should be rejected.

Finally, regarding the August 14 letter, the only letter Flannery drafted and signed, a senior SSgA lawyer, Mark Duggan, "was responsible for substituting" the language into the letter that is the purported "touchstone" for why the Division claims it was misleading: the statement that SSgA believed "many judicious investors" would hold their positions. I.D. 55. Chief Judge Murray found:

> [A]t the time of the August 14 letter, Flannery believed that many judicious investors would, in fact, hold their positions. . . . Flannery circulated the letter widely for review and the evidence shows feedback from a variety of knowledgeable people. . . . Flannery's testimony that he "wanted to make sure everybody had a crack at it and felt it was okay," is not in dispute. . . . 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 [the] "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.**

I.D. 56-57 (emphasis added).

Chief Judge Murray also concluded that Flannery was "credible," that he evidenced "candor" and "conviction," and that witnesses were unanimous in their testaments to his "honesty, good character, hard work, and concern for clients." I.D. 3. "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." I.D. 6.

Despite the Initial Decision's ironclad findings of fact, the Division suggests the Commission should proceed as if no hearing took place, advancing factual theories that are contrary to the evidence, and legal theories that are either irrelevant to the outcome as to Flannery, inconsistent with the law, or both.[3]

[3] While the Division articulated several specific grounds for review in its Petition for Review, it now takes exception to essentially every finding of the Initial Decision, without having previously identified supporting reasons for each exception, in contravention of 17 C.F.R. 201.410(b).

As to the facts, the Division argues that in letters vetted by numerous knowledgeable SSgA investment team members, client-facing executives, and attorneys, only one of which Flannery wrote, he misled investors about subprime exposure and risk in LDBF to prevent a run on the fund, allowing "internal" investors to get out of the fund early at the expense of others. Div.Br. 1, 4 n.2, 13, 19. For this, the Division relies on propositions for which there is no evidence, and ignores evidence that expressly contradicts its theory. Among other things, there is no evidence that Flannery (or anyone else) sought to favor "internal" investors, that such investors were permitted to redeem while others were not, or that any investors were misled by the letters. Instead, the evidence is that Flannery sought to be fair to all investors. In effect, the Division contends, without evidence, that for a few weeks during the Summer of 2007, Flannery acted wildly out of character, seeking to deceive certain investors in order to "protect his reputation." Div.Br. 19, 35. Chief Judge Murray considered and properly rejected this theory based on the substantial record evidence.

As to the law, the Division takes issue with the Initial Decision's application of *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), to certain claims, and its purported analysis of investor sophistication, but these are just detours. While Chief Judge Murray properly applied the law, disposition of these issues cannot change the outcome vindicating Flannery, where the evidence conclusively demonstrates that there were no misstatements or omissions in the letters, and that Flannery was not negligent and lacked scienter. The Division failed to prove its claims because there was no fraud and Flannery acted reasonably: this appeal concerns three letters that were true and not misleading, as Flannery believed.

II. AN EVIDENTIARY HEARING BEFORE THE CHIEF ADMINISTRATIVE LAW JUDGE IS NOT A MERE FORMALITY.

While the Commission's review of the Initial Decision is *de novo*, the Commission should decline the Division's invitation to completely disregard the hearing, the extensive documentary and testimonial evidence developed during the hearing, and the detailed factual findings made by the factfinder who observed the witnesses—here, the Chief Administrative Law Judge. Under the Division's formulation of *de novo* review, the evidentiary hearing would become a meaningless ritual. The Division provides no basis for the Commission to conclude that Chief Judge Murray's factual findings, each based on substantial record evidence, were erroneous, much less "clearly erroneous." 17 C.F.R. § 201.411(b)(2)(ii)(A).

In particular, the Division suggests this is an appropriate case to disregard the hearing officer's credibility determinations, claiming the record contains "substantial evidence" to do so, but pointing to none. Div.Br. 3. There is no evidence that calls into question Chief Judge Murray's determinations regarding Flannery's character and credibility; not a single person testified that Flannery was anything other than highly ethical, trustworthy, and always concerned for clients. Chief Judge Murray found, after observing Flannery testify for three days and after observing the testimony of every witness who knew him:

> 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.**

I.D. 3 (emphasis added); *see also* I.D. 6.

The Division had a full and fair opportunity to cross-examine the witnesses, and failed to shake their testimony regarding Flannery's character, conduct or intent.[4] *See, e.g.*, Tr. 1811, 2820-21, 2213-14, 2771-72, 2381-83, 2877, 549-58, 2965-81. In these circumstances, the Commission should not substitute its judgment for that of the hearing officer. *See In the Matter of Robert Thomas Clawson*, Exchange Act Release No. 48143, 2003 SEC LEXIS 1598, at *7 (July 9, 2003); *In the Matter of Jack Schaefer*, Exchange Act Release No. 11767, 1975 SEC LEXIS 524, at *7 n.5 (Oct. 24, 1975) ("The administrative law judge saw and heard the witnesses. We did not. Hence we give great weight to his conclusions about the credibility and the probative force of the testimony.").

III. SUMMARY OF THE RECORD EVIDENCE

A. Sean Flannery

Sean Flannery has been married for 27 years and has 4 children, one of whom died [redacted]. Tr. 1125-27. Flannery has devoted himself to charitable and community service for many years, focusing on poor, troubled or ill children, and maternal and infant care in developing countries. *Id.* 1127-30.

Flannery joined SSgA in 1996 and was promoted to CIO, Americas in 2005. I.D. 6. Flannery was responsible for SSgA's nearly $2 trillion in Assets Under Management, of which LDBF, the fund at issue, was a small fraction (less than 1%). I.D. 3, 6; Div.Ex.[5] 116, p.6; Tr. 782-83, 1142-49, 1155-58, 1205-06, 1853. Flannery reported to SSgA's President and CEO. I.D. 6. 460 people in 9 organizational units reported to Flannery. I.D. 6-7; Tr. 782-85, 1144-49, 2196; Div.Ex. 90, p.9.

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[4] The Division contends that many of the character witnesses "were State Street employees enmeshed in the same culture that permitted Respondents' deceptive course of conduct." Div.Br. 4 n.2. But the Division elicited no evidence regarding the supposed "culture" of SSgA, or the extent to which any witness was "enmeshed" in it.

[5] "Div.Ex." refers to a Division Exhibit, "Flan.Ex." to a Flannery Exhibit, and "Hop.Ex." to a Hopkins Exhibit.

As CIO, "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." I.D. 7; Tr. 825-26, 1151, 1157-58. Flannery was not responsible for SSgA's compliance, legal or investor communications functions. *See* I.D. 6-7, 30; Tr. 1149-51; Div.Ex. 90, p.9. He did not have portfolio management responsibilities, execute trades, or otherwise have day-to-day responsibilities for managing SSgA's approximately 300 investment strategies, of which LDBF was one. Tr. 1152, 1155, 1157-58.

B. LDBF Was Only Available to Institutional Investors Who, In Order to Achieve Greater Returns, Assumed Greater Risk.

LDBF was created in 2002 as an unregistered collective trust fund whose goal was to match or exceed LIBOR by 50 to 75 basis points. I.D. 4. To achieve this goal, investors necessarily assumed a greater measure of risk than a money market fund. I.D. 4, 35; Tr. 1143, 1959, 2104-05, 2147; *see also* Hop.Ex. 161 (Report of Professor Erik Sirri), ¶21. LDBF offered daily liquidity to its investors. I.D. 5; Tr. 1861. LDBF was a relatively small fund for SSgA, but it historically performed well, achieving its target returns every year between 2003 and 2006. I.D. 6. Since its inception, LDBF invested heavily in housing-related asset backed securities ("ABS"), including those backed by subprime mortgages, because of their higher yields compared with other types of ABS. I.D. 12; Tr. 1173-75, 1573-74, 1164-65, 1183; Flan.Ex. 137, p.SS003875765; Div.Ex. 153. LDBF also invested in derivatives tied to mortgage markets, such as total return swaps, which provided leverage and contributed to the strategy's outperformance. Tr. 1172-73, 1208-09; Flan.Ex. 137, p.SS003875765-66. "During the first and second quarters of 2007, 94% or more of the LDBF's assets were rated AAA or AA. An unprecedented number

of subprime mortgages would have to default before an ABS with a high credit rating would not pay interest." I.D. 12; Div.Ex. 161; Tr. 347-48.

LDBF was only marketed to institutions, many of which received expert advice: "Most SSgA clients were represented by consultants, investment experts that advised institutional investors." I.D. 3; Tr. 416, 1210, 1288; Div.Ex. 31; Div.Br. 4. 70-80% of SSgA's clients had investment consultants. I.D. 3; Tr. 2731. In addition to independent investors, many SSgA funds invested in LDBF (the "Related Funds"), as did clients of SSgA advisory groups Global Asset Allocation ("GAA"), the Office of the Fiduciary Advisor ("OFA") and Charitable Asset Management ("CAM"). I.D. 5-6.

In 2007, Portfolio Manager Robert Pickett had day-to-day responsibility for managing and making investment decisions for LDBF. I.D. 5; Tr. 1728, 1566, 1594, 1158. Flannery was not involved in LDBF's creation or day-to-day management. I.D. 7 n.14; Tr. 825-26, 1157-58; Div.Ex. 156, p.16. His compensation was not tied to LDBF's performance. I.D. 7; Tr. 1163-64.

C. Relationship Management and Consultant Relations Were Responsible for Communicating with LDBF's Institutional Clients and Their Consultants.

SSgA's Relationship Management and Consultant Relations groups were responsible for communicating with SSgA's clients and their consultants. I.D. 9; Tr. 262, 425, 470, 1214, 2666; 2723-24. Neither group reported to Flannery. I.D. 6-7; Tr. 2665-66; Div.Ex. 90. Clients and consultants received standard information periodically, and also could request information. I.D. 9. Expert witness John W. Peavy, III testified that this communications model "was reasonable, appropriate, and customary for an unregistered investment fund in 2007." I.D. 33; Tr. 3025; Hop.Ex. 174. "[C]lients [got] the amount of information they want[ed] to receive." I.D. 34; Tr. 3021-22. Relationship Managers and Consultant Liaisons knew what information was being provided to clients and consultants and what questions were being asked. Tr. 2724, 903, 1214.

Flannery had no responsibility for SSgA's communications model (I.D. 7, 9; Tr. 1210), but he understood that investors could and did obtain information from a variety of sources. Tr. 1211-15, 1223-25.

D. SSgA's Legal Team Was Responsible for Approving Client Letters.

SSgA had a robust Legal Department with securities disclosure expertise. Shames Tr.[6] 18, 25-26. Several SSgA in-house lawyers—in addition to outside counsel—were involved in reviewing the letters at issue. *Id.* 155-56; Tr. 904. Legal "[had] a role in every letter," and had final approval power over all of the letters sent to clients during the summer of 2007. Tr. 2749-51; I.D. 26-28, 30; Flan.Ex. 127. Flannery insisted on Legal's review, and correctly understood that SSgA's lawyers were armed with the relevant facts when they did so. I.D. 51, 53, 56-57; Tr. 1270-72, 1274-75, 1299-1301, 1361-62, 1391-92; Shames Tr. 80, 89-90, 156-62. The lawyers had access to information from numerous sources within SSgA, including members of the investment and client-facing teams. *See, e.g.*, Duggan Tr.[7] 237-38, 467; Flan.Exs. 92, 172; Div.Ex. 153; Tr. 1343, 1361-62, 2743.

E. Unprecedented Housing Market Volatility In 2007

SSgA had an investment team with many years of experience investing in ABS, such as those backed by subprime mortgages. I.D. 10; Tr. 1876-77, 1901. "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." I.D. 9; Tr. 826-28; Div.Exs. 15, 16. Flannery learned that investment team members "were bullish on housing-related securities." I.D. 9; Tr. 1189-92; Div.Ex. 16.

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[6] Joint Stipulation Regarding Testimony of Mitchell Shames.
[7] Joint Stipulation Regarding Testimony of Mark J. Duggan.

1. Home Prices Decline, Affecting Housing-Related Securities

In early 2007, LDBF's performance began to change, initially because of exposure to BBB ABX Index swaps, derivatives tied to the housing market. I.D. 10; Tr. 255, 343; Div.Ex. 45; Flan.Ex. 53. Flannery solicited input from the investment team and others. I.D. 11; Tr. 1227-30. "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. They believed very strongly that subprime housing-related mortgages would return to their historical average spreads." I.D. 11; Tr. 1227, 1230-31, 1730-32, 2000-01, 2025, 2042-43, 2853, 2856.

April and May 2007 were the best months in LDBF's history. I.D. 13; Tr. 513, 1232; Div.Ex. 92, p.SS003048461; Hop.Ex. 56. However, LDBF substantially underperformed in June, as housing prices declined, and the underperformance of subprime securities was noted in the press. I.D. 13; Tr. 1232, 1195-96; Flan.Ex. 4 p.644; Div.Exs. 18, 100. Flannery again asked the investment team and others to re-examine the subprime market, and received a written memorandum in response, stating that "[w]e remain constructive on the fundamentals." I.D. 13; Tr. 1249-51; Div.Ex. 94.

In July, the market situation worsened and ratings agencies downgraded a large number of subprime bonds (though none held by SSgA). Hop.Ex. 161 ¶58; Flan.Exs. 58 p.SS002865282, 86 p.SS008524112. "Markets were in disarray and conditions were chaotic." I.D. 13; Tr. 1268, 1472-73. "Expert testimony characterized what began in the summer of 2007 as a crisis of unprecedented proportions. 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." I.D. 15; Hop.Ex. 161 p.27-36; *see also* I.D. 36.

2. Mid-July Swap Transactions to Reduce Risk

SSgA sold portions of LDBF's position in AA ABX swaps and BBB ABX swaps in mid-July, reducing the risk of loss from the subprime mortgage market. I.D. 14; Flan.Exs. 299 p.11. It is undisputed that this reduced risk in LDBF. *Id.*

3. Increase in Client and Consultant Inquiries

Client and consultant inquiries surged during this tumultuous time period. I.D. 13; Tr. 542-43, 2738-39, 2777-78. In response, SSgA developed a SWAT team to assist with the inquiries, as well as a Frequently Asked Question document ("FAQs"), used by Relationship Managers and Consultant Liaisons when answering client questions; the FAQs were reviewed and approved by Legal. Flan.Ex. 68; Tr. 2740-43, 1225, 1360-62, 1310.

4. Negative Publicity Regarding LDBF

A July 25, 2007 Money Management Letter, an investor publication reviewed by Flannery, reported that LDBF's losses in July were "terrible," and noted that LDBF was mostly invested in subprime and used derivatives. I.D. 14; Flan.Ex. 108. Later, an August 10, 2007 report from DW Online, also reviewed by Flannery, similarly chronicled LDBF's July losses and its exposure to derivatives. I.D. 14; Tr. 1399-1400; Flan.Ex. 197.

5. The Investment Team and Market Participants Continued to Believe In The Fundamentals of Subprime Investments.

In spite of the chaos, "there was no loss of the principal in the value of LDBF's assets and they continued to pay interest." I.D. 14; Tr. 1297; Div.Ex. 248. The investment team still believed in the fundamentals of the subprime sector, as did others, including the Chairman of the Federal Reserve. Flan.Exs. 86 p.SS008524112, 133 (FAQs 4, 12, 17, 21), 260 p.22[8]; Tr. 2032-

[8] Available at http://jec.senate.gov/public/?a=Files.Serve&File_id=4cdd7384-dbf6-40e6-adbc-789f69131903. While this exhibit is not in evidence, judicial notice is proper. *See, e.g., Laborers' Pension Fund v. Blackmore*

(continued...)

33, 1731-32, 1173-75. Indeed, many experts and market participants reasonably believed, even into August, that liquidity would return. Hop.Ex. 161 ¶¶77-82.

F. Redemptions By Advisory Groups

Internal advisory groups GAA, OFA and CAM recommended that their clients redeem from LDBF in late July, 2007. I.D. 17-18; Tr. 2374. Their decisions were based on LDBF's poor performance, not on actual or anticipated redemption activity by other clients. I.D. 17-18; Tr. 1809, 2034, 2036-38; DPFOF ¶422. These groups acted independently; Flannery had nothing to do with their decisions and did not interfere with their independence. *See, e.g.*, I.D. 17-18; Tr. 1350, 1809-10, 877-79, 2018, 2044-45. Their clients' redemptions represented a very small portion of LDBF. Div.Exs. 229, 231, 130; Flan.Exs. 291, 292, 294 (advisory group redemptions totaled $125 million).

"Sometime after it made its decision on July 25, 2007, GAA advised Duggan in Legal, [Staci] Reardon in Relationship Management, and [Paul] Greff [in Fixed Income], of its decision . . . . By early August, Flannery knew that GAA had advised its clients to withdraw from the LDBF. It was also included in . . . FAQs." I.D. 18; Tr. 1349, 2042-43; Div.Ex. 153. OFA informed Legal and Relationship Management of its recommendation by July 27. Tr. 1804-05; Div.Ex. 222 p.SSgA-SEC000280698. Flannery learned of OFA's recommendation on July 27, after it occurred.[9] *Id.*; I.D. 17; Tr. 1799-1801, 1809-10.

Sewer Constr., Inc., 298 F.3d 600, 607 (7th Cir. 2002); *Washington Post v. Robinson*, 935 F.2d 282, 291-92 (D.C. Cir. 1991).

[9] The Division has historically advanced theories, unsupported by the evidence, regarding Flannery's July 27 conversation with Martha Donovan from OFA, during which he learned OFA had decided to recommend redemption, but it is unrebutted that Flannery did not provide OFA with an informational advantage during this conversation, nor did he intend to. He simply reminded Donovan that LDBF was a daily liquidity fund, as was true for all clients. Tr. 1809-10, 877-79, I.D. 17. Moreover, by the time of the conversation, OFA had already made its decision (one based solely based on LDBF's performance). Tr. 1810; Div.Ex. 222 p.SSgA-SEC000280697-98; Tr. 1809.

G. The July 25 Investment Committee Meeting Reflected the Committee's Desire To Reduce Risk and Raise Liquidity, While Treating All Investors Equally.

SSgA's "Investment Committee had ultimate authority over all SSgA investments." I.D. 15; Tr. 1255. It was Chaired by Shawn Johnson, who selected its members, including the heads of GAA, OFA and CAM. I.D. 15; Tr. 2364-66. Flannery was a member of the Committee; he had nothing to do with selecting its other members. I.D. 15; Tr. 1257.

Because the Chair and Vice-Chair were absent, Flannery acted as Chair of a regularly-scheduled Investment Committee meeting on July 25, 2007. I.D. 15; Tr. 1267-74, 989-90. Flannery's vote carried no more weight than any other member. Tr. 1269. Flannery raised the subject of LDBF's underperformance with the Committee. Tr. 1267-68. He invited a number of people to attend the meeting, including Deputy General Counsel Duggan, because he believed the situation facing SSgA to be unprecedented. I.D. 15; Tr. 1269-74; Flan.Ex. 92. Flannery considered Duggan—a securities "expert" (Shames Tr. 155-56)—to be a highly competent lawyer who understood SSgA's business, products, and the issues facing the company. Tr. 1270, 1274-75. Flannery told Duggan before the meeting what topics would be discussed. I.D. 56; Tr. 1270-72.

As usual, representatives from GAA and OFA were present at the beginning of the meeting. I.D. 15; Tr. 2364-66. The GAA representative, who reported to Flannery, left the meeting after consulting with Duggan, while the OFA representative, Jie Qin, stayed at the meeting. I.D. 15; Tr. 2007-10. "OFA and CAM reported to Johnson. 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." I.D. 16; Tr. 2372, 2391, 2397. The Division makes much of Qin's presence, but there is no evidence that this was in any way Flannery's decision, or, furthermore, that OFA's redemption

recommendation had anything to do with the meeting. Like Johnson, Flannery relied on OFA, as well as Duggan, to ensure SSgA's ethical rules were being observed; as Chief Judge Murray stated and the Division conceded, Flannery was not responsible for policing the ethics of SSgA's personnel. Tr. 995-98, 2396-97, 2005-10. The Division did not call Qin to testify. Martha Donovan of OFA testified that OFA recommended redemption based solely on LDBF's performance. I.D. 17; Tr. 1808-09. This testimony is unrebutted.

At the meeting, Flannery encouraged debate regarding the issues facing LDBF. Tr. 1736. The attendees discussed the possibility of significant redemptions, based on estimates from Relationship Management.[10] Div.Br. 12; Tr. 1279-80; Duggan Tr. 102, 104; Flan.Ex. 92 p.SSgA-SEC000252902. However, "[t]he Investment Committee struggled to establish with certainty a percentage of expected redemptions." I.D.16; Flan.Ex. 92; Tr. 1278-80, 1738-39. Nobody knew, or could know, what the actual redemptions would be. Flan.Ex. 92 p.SSgA-SEC000252909 ("it's hard to predict . . . if there will be a large number of withdrawals by clients"); Tr. 1278-80, 1289, 1738-39. Related topics were discussed at length, including the possibility of freezing the fund, the need to raise liquidity, and reduction of risk. Flan.Ex. 92 p.SSgA-SEC000252912; Duggan Tr. 232; Tr. 1018-19. Because he felt it was important to ensure accurate pricing of LDBF's assets, Flannery recommended review by the Impaired Asset Valuation Committee ("IAVC"), a step which would likely result in further price reduction. Flan.Ex. 92 p.SSgA-SEC000252909; Tr. 1276-78.[11] Duggan was an active participant in these discussions. Flan.Ex. 92. Duggan reported what had been discussed at the meeting to his boss, General Counsel Shames, shortly after the meeting concluded. Duggan Tr. 210-11.

[10] Flannery's purported "educated guess" of a need for 40% liquidity, highlighted by the Division, was actually the Investment Committee's guess of 30-40% based on Relationship Management's estimates, the only group in a position to assess potential redemptions. Flan.Ex. 92 p.SSgA-SEC000252909; Tr. 1289; DPFOF ¶280.

[11] The IAVC in fact met on July 27, and Duggan was present. Duggan Tr. 146-47, 154; Flan.Ex. 38 p.MD00454-56.

At the end of the meeting, the Committee instructed the portfolio management team "(1) to increase the liquidity in [LDBF] . . . by the end of the month; (2) sell a pro rata share (across capital structures) to warrant any withdrawals; and (3) reduce the AA exposure, a target of 5%, by the end of the week." I.D. 15; Flan.Ex. 92.

While the Division does not (and could not) pursue claims based on the Investment Committee meeting itself (Div.Br. 20), the Division erroneously theorizes that the Committee's instruction was to sell AAA bonds and raise cash only for certain investors at the expense of others. Div.Br. 35.[12] The Division totally ignores the other two instructions from the Committee, and no witness supports the Division's theory. The goal of the Investment Committee was to treat all investors equally, as Pickett testified. Tr. 1751-52; *see also* Tr. 2875, 1020-21.

H. SSgA Carried Out the Investment Committee's Instructions, Reducing Risk and Raising Liquidity.

Nobody understood the Investment Committee's three instructions would or could be carried out at once; as Pickett testified, that would have been virtually impossible. Tr. 1742. The Committee "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." I.D. 16; Tr. 1284-85, 1489.

Consistent with the first instruction, on July 26, 2007, SSgA sold $1.54 billion of AAA bonds to Citicorp. I.D. 16; Tr. 1671-73, 1691-92, Flan.Ex. 299. $1.12 billion of the proceeds was used to pay back loans on the bonds, reducing the fund's leverage. I.D. 16; Tr. 708, 1743-46. Flannery knew the sale reduced LDBF's leverage, and Patrick Armstrong, Head of Risk

[12] The Division mischaracterizes the meeting, asserting that "Flannery cautioned that this sale 'will change [LDBF's] risk profile'" (Div.Br. 13), when it was Portfolio Manager Pickett who made that statement. Flan.Ex. 92. Moreover, as discussed below, the sale actually reduced risk. *See* Section III.H, *infra*.

Management, agreed that reducing leverage would reduce risk. I.D. 16; Tr.1343, 2206; *see also* Tr. 1743-45 (Pickett); Kramer Tr.[13] 13, 16, 27. Expert Ezra Zask also opined that the AAA sale reduced risk in LDBF. I.D. 36-37; Flan.Ex. 299.

In addition, pursuant to the second two instructions of the Investment Committee, "[f]rom 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." I.D. 16; Tr. 1749-50; Div.Exs. 217, 218, 245 Ex. III.A; Tr. 1285, 1747-52. The Division ignores that these sales occurred, implying that SSgA made no effort to sell AA or A securities. To the extent the Division claims SSgA did not sell enough of these securities or did not do so fast enough, the notion that SSgA had the unfettered ability to sell any amount of lower-rated securities it desired, notwithstanding the increasingly illiquid market, is simply false. Hop.Ex. 161 ¶¶57-60. It is also not a basis for a claim against Flannery, who was not responsible for SSgA's trades.

The Division baldly states that, "[a]s Flannery expected, the cash from the July 26 bond sale was used almost immediately to meet insiders' redemption demands." Div.Br. 13. First, there is <u>no evidence</u> that Flannery—or anyone else—expected that the proceeds from the AAA sale would be used to fund only purported "insider" redemptions, that he could predict what the size of such redemptions would be in comparison to redemptions of independent clients, or that he could predict the size and timing of redemptions generally. Furthermore, there is <u>no evidence</u> that Relationship Management's estimates were limited to possible redemptions by "insiders." More fundamentally, there is <u>no evidence</u> that Flannery wanted to favor purported "insiders."

Second, the Division's theory that "all of the cash raised from the AAA sale was gone from the LDBF portfolio within four days" (Div. Post-Hearing Br. 26) is wrong. Nearly

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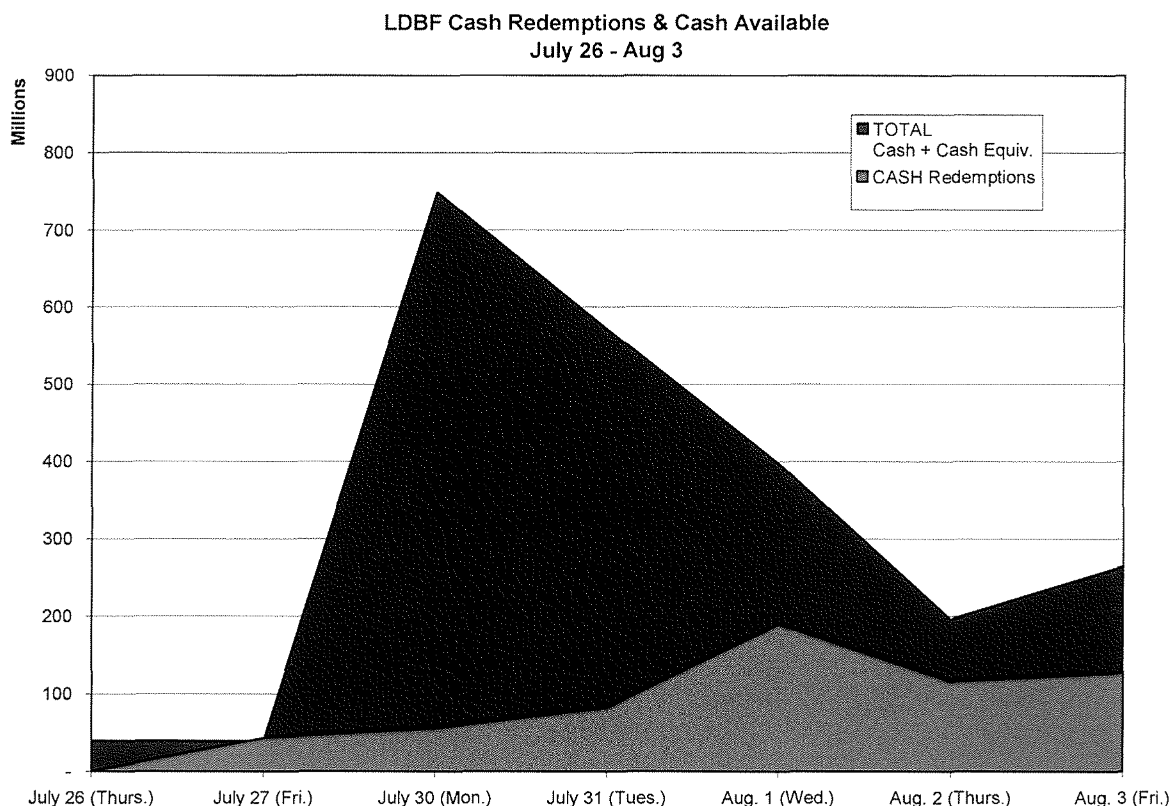
[13] Joint Stipulation Regarding Testimony of James Kramer.

$200,000,000 remained in LDBF as of August 2 (the date of the first letter in which the OIP claims Flannery made a misrepresentation or omission). I.D. 54; Div.Ex. 230; Flan.Ex. 288. As Fig. 1, below, demonstrates, even after satisfying redemptions through August 2, LDBF maintained a substantial cash balance, which increased on August 3 following additional sales, including sales of AA bonds. *See* Div.Exs. 217, 218, 230; Flan.Ex. 288.

Fig. 1[14]



Third, the Division's statement that "once SSgA made the truth available to many of these institutional investors, they immediately decided to liquidate their holdings in LDBF and the Related funds" (Div.Br. 26) is also wrong. The Division suggests, without evidence, that purported "insiders," including the Related Funds, received information early, causing them to

[14] Figure 1 is based on Div.Exs. 230 (Navigator Reports), 229 and 231 (daily redemptions), and Flan.Ex. 288 (Daily Trial Balance). The AAA sale settled and proceeds received on or about July 30. Tr. 704.

redeem early. Div.Br. 13, 18-19; Div. Post-Hrg. Br. 29. The Division merely cites evidence of redemption activity (including that of both independent clients and "insiders"), without describing, much less substantiating, what information was purportedly shared with the Related Funds, when it was shared, or that Flannery knew this. The Division also offers no evidence that these funds redeemed on the basis of this unidentified information.[15] Moreover, as the Division's own exhibits reveal, both "internal" and independent funds redeemed after the AAA sale. Div.Exs. 229, 231. To the extent some "internal" funds redeemed before some independent funds, "[n]othing in this voluminous record shows any actions by Flannery . . . that contributed to that fact." I.D. 52.

Finally, and contrary to the Division's theory, the majority of the redemptions by Related Funds were not for cash at all, but were in-kind, reflecting a decision to remain exposed to the assets of the LDBF strategy, and having no impact on cash available to fund other redemptions.[16] Tr. 672-74, 1360; Div.Exs. 229, 231. The Division ignores this fact, which demonstrates that in August 2007, many "insiders" genuinely believed subprime securities would rebound.

I. Total Return Swaps Expired, Further Reducing Risk.

In addition to carrying out the Investment Committee's instructions, SSgA decided to allow total return swaps ("TRS") to roll off the portfolio on August 1, further reducing risk of exposure to the subprime mortgage market, an undisputed fact which the Division also ignores. I.D. 32 n.49, 53; Flan.Ex. 299; Tr. 141, 718, 1292-93, 1753.

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[15] To the extent the Division contends that advisory group OFA got "superior" information due to Qin's presence at the Investment Committee meeting, it is unrebutted that (1) OFA did not redeem on the basis of such purported information; and (2) Flannery had nothing to do with Qin's decision to stay at the meeting. OFA was a member of the Investment Committee, a fact which was not Flannery's choice. I.D. 15. Furthermore, this hardly supports the Division's assertion that "many" investors received the "truth" and "immediately decided to liquidate" as a result. Div.Br. 26.

[16] In an in-kind redemption, a slice of securities represented by a percentage of the shares owned are delivered out of LDBF and into the Related Fund. Tr. 1416-17, 1360.

J. The Three Letters

The Division challenges three letters SSgA sent to investors during the summer of 2007, only one of which Flannery drafted and signed. The letters were intended to supplement substantial information that had already been provided to clients. Tr. 2724. Chief Judge Murray found that all of the statements in the letters challenged by the Division were true and not misleading. I.D. 51-57. The Division's theory that independent investors were "lulled" to stay in LDBF by the letters is supported by no evidence. No investors were called to testify that the letters fooled them. Moreover, Flannery was not the "final approver" or "gatekeeper" of the letters and he did not "oversee" communications to investors. Div.Br. 19, 24. As discussed below, each of the letters was heavily vetted by experienced securities lawyers, as well as Relationship Management personnel, members of the investment team, and others.

1. The July 26 Letter

"SSgA's client-facing team sent out an informational letter to clients on July 26, 2007." I.D. 25; Tr. 355-56, 1308, 2749; Flan.Ex. 111. The Division does not claim Flannery made misrepresentations or omissions in this letter, but instead claims that the letter *contained* misrepresentations and omissions, and therefore was part of Flannery's alleged "scheme." Div.Br. 20. The Division contests the following statement in the letter:

> 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.Br. 18; Flan.Ex. 111.

The purpose of the July 26 letter was to update clients and consultants on the subprime market and SSgA's strategies. I.D. 25; Div.Ex. 24; Hop.Ex. 98. Flannery did not request the letter be drafted. I.D. 50-51. Drafts were circulated to numerous people, including Flannery.

I.D. 25; *e.g.*, Hop.Exs. 71, 73, 74, 78. Flannery made a "couple of edits" to the letter, which made the letter more accurate. Div.Ex. 103; Tr. 937. Flannery circulated his edits to members of the investment team, who had more granular knowledge of LDBF and the housing-related ABS market. Div.Ex. 103; Tr. 369, 471, 943, 1249. Flannery also stated that he wanted SSgA's Legal team to review the letter, and General Counsel Shames agreed to do so, and to circulate it to Deputy General Counsel Duggan and another SSgA lawyer. I.D. 25; Hop.Ex. 77; Div.Ex. 106; Flan.Ex. 52. Shames consulted with outside securities counsel at Goodwin Procter LLP regarding the letter. I.D. 25; Hop.Exs. 80, 81; Flan.Ex. 283. A number of people continued to make edits, including members of the client-facing teams, the Fixed Income team, and Legal. I.D. 26; Hop.Exs. 73, 95; Div.Ex. 124. Flannery's name did not appear on the letter and he did not receive the final version when it was sent to clients. I.D. 26; Flan.Ex. 111; Tr. 1309-11.

The language in the July 26 letter that the Division challenges was accurate. It is true that SSgA had been seeking to reduce risk: SSgA had reduced its exposure to AA- and BBB-rated securities in mid-July, was finalizing the sale of AAA bonds to Citigroup, and had decided to allow total return swaps to roll off, as discussed above. Flannery believed risk had been reduced, and that SSgA would continue to seek to reduce risk. DPFOF ¶368; Tr. 1312. "The evidence in the record is that until sometime in August, the Management Team believed that long-term housing market fundamentals would prevail." I.D. 51. More generally, the letter portrayed a serious situation. Hop.Ex. 98 ("The downturn in the US mortgage market and the shake out in the subprime mortgage sector are not short-lived events. . . . it is possible that asset price declines could overshoot their fair value levels.").

2. The August 2 Letter

On July 21, Adele Kohler (Product Development & Engineering), sent a draft letter to a number of people, designed to inform clients about the impact of subprime exposure on LDBF in July. I.D. 26; Tr. 2729-30; Div.Ex. 120. Flannery did not receive this draft. I.D. 26; Div.Ex. 120. Larry Carlson, Co-Head of Relationship Management, was responsible for the letter, and understood Legal had to approve it. I.D. 26-27; Tr. 2690, 2698, 2753-54, 2759; Div. Ex. 256; Flan.Exs. 128, 129, 139, 149. Flannery was copied on an email sending a later draft of the letter to Shames and others, and made a single round of "suggested edits" to it. I.D. 27; Div.Exs. 151, 154, 155. As Flannery understood, a number of others edited the letter both before and after Flannery's suggested edits. I.D. 27; Tr. 1318-19; Flan.Exs. 123, 126. Shames reviewed the letter, and sent it to outside counsel. I.D. 27; Tr. 2751-52; Div.Ex. 122; Flan.Exs. 126, 136; Shames Tr. 102.

The Division challenges the following portion of the "Actions Taken" paragraph in the letter, which Flannery did not draft:

> 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 [LDBF] simultaneously reduced risk in other active fixed income and active derivative-based strategies.

Div.Br. 18; Flan.Ex. 144. The Division contends that the risk reduction statements were

misleading.[17] Div.Br. 18. Flannery's suggested edits to what became that language were as follows:

> Within the Limited Duration Bond Fund 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** total return swaps roll**ed** off at month end. These actions ~~will~~ simultaneously serve to reduce risk in other SSgA strategies that hold units of the Limited Duration Bond Fund.

Compare Div.Ex. 151 (draft copied to Flannery) *with* Div.Ex. 155 (Flannery's "suggested edits"). These minor edits made the letter more accurate, as the AAA sale had already occurred, and the fund still held some swaps. Tr. 1321-24. This was the only time Flannery suggested edits to the letter. Tr. 1319. It is undisputed that Flannery believed the risk reduction statements in the letter were true. DPFOF ¶368. And, as Chief Judge Murray found, they were true. *See* Section IV.A.1, *infra*.

"Flannery was not included on a number of the final e-mail exchanges prior to distribution." I.D. 28; Tr. 2752; Flan.Exs. 129, 139, 140, 142. He was not asked to review the letter again. Tr. 1339. "Only a handful of Flannery's suggested edits remained in the final letter." I.D. 28; Div.Ex. 155; Flan.Ex. 144. Relationship Management sent the letter to clients on August 2, after consultation with a number of people, including Legal. I.D. 28; Tr. 1326-39; Div.Ex. 159. The final letter portrayed a negative situation. *See, e.g.*, Flan.Ex. 144 ("[LDBF] experienced even more pronounced negative performance in the second quarter of 2007 which continued in July as spread widening moved up the capital structure to AAA and AA-rated securities secured by subprime mortgages.").

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[17] The Division no longer maintains that Flannery should be liable in connection with the letter's statement about LDBF's average credit quality. "The Division concedes that Flannery believed the statement was true, and that the statement was '**technically accurate**.'" I.D. 54 (citing Div. Post-Hearing Br. 43; Div. Pre-Hearing Br. 18) (emphasis added). "Moreover, the Division failed to establish that Flannery drafted the language at issue, and, in fact, the evidence suggests otherwise." I.D. 54.

The Division's Brief is replete with inaccurate statements about the August 2 letter. Flannery was not a "final approver" of the letter. Div.Br. 24. Legal had final approval authority. I.D. 27-28; Tr. 2698, 2753-54. The Division also falsely states that Flannery "added the key additional deceptive language" to the letter. Div.Br. 24; *see also id.* at 37 (claiming Flannery edited the letter to "describe specific steps SSgA had already taken to sell certain assets . . . ."). There is no evidence supporting this assertion. The Division takes issue with language which was true, which Flannery believed to be true, and which Flannery did not add to the letter, as the Division ultimately, and paradoxically, concedes. Div.Br. 37 (Flannery "left in place" risk reduction language).

3. The August 14 Letter from Flannery

On August 2, Flannery e-mailed various client-facing personnel requesting feedback on client interactions, and offered to assist in any way he could. I.D. 30; Div.Ex. 160. Larry Carlson responded that clients thought SSgA should do more to acknowledge the situation's seriousness. *Id.* Flannery thus "took the initiative to write a letter to clients . . . because he believed investors needed an explanation and it was the right thing to do. He authored the August 14 letter even though a superior [his boss, CEO Hunt] questioned why he would 'raise his head up.'" I.D. 30; Tr. 1370-71, 1461. Flannery wanted to explain to investors his and the investment team's belief that "what happened to housing-related securities was a disaster of a magnitude unimaginable to securities professionals." I.D. 30; Tr. 1377-80, 2763. The Division's claim that the letter was designed to prevent redemptions "en masse" (Div.Br. 19) is inconsistent with the record. Indeed, heavy redemptions had already occurred: LDBF's assets by August 14 were 1/6 of what they had been in early July. Flan.Ex. 288 (LDBF's net assets under $500M). The letter painted a bleak picture, describing LDBF's "unprecedented" negative

returns, the "backdrop of weakening fundamentals," the fact that LDBF had "sharply underperformed" and that the situation was "extreme and challenging to manage." Div.Ex. 176.

The Division challenges the following statement in the letter, the key part of which was inserted by Deputy General Counsel Duggan:

> 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.

Div. Br. 18; I.D. 30; Tr. 1097-98, 1386-87; Div.Exs. 166, 176. Flannery's initial draft had stated, "[w]hile we will continue to liquidate assets for our clients when they demand it, our advice is to hold the positions for now." I.D. 30; Tr. 1382-84; Div.Ex. 165. Duggan changed the sentence to replace an opinion about what should be done to a prediction about what might occur: he added the "judicious investors" language, and e-mailed the draft, with his change, to outside counsel. I.D. 30; Div.Ex. 166.

Flannery believed Duggan's language to be true: "when the market doesn't want to offer liquidity, you don't want to demand it. The price for liquidity is too high and it couldn't be any clearer than it was in this case." Tr. 1382-83, 1457. The Division contends the prediction was misleading because GAA and OFA had recommended their clients redeem. However, "SSgA personnel were informing investors of [those] withdrawals as evidenced by the FAQs; investors act based on different objectives and risk constraints; and knowledgeable people, including attorneys, reviewed the letter and did not find the statement objectionable. Flannery consistently required that the legal department approve communications to clients." I.D. 31; Tr. 1388-89, 1417-18, 1408. Legal, including Duggan, knew GAA and OFA had recommended redemption. I.D. 18; Tr. 1349, 1038-39, 1804-05; Div. Exs. 153, 222. Moreover, many judicious investors

did hold their positions, including the Related Funds. Tr. 1387-89, 1412-13 (Related funds redemptions were largely in-kind, remaining exposed to LDBF's assets).

"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 [Elizabeth] Fries, [SSgA's] outside legal counsel." I.D. 30; Tr. 1384-97, 1402-09, 2765-70; Flan.Exs. 166, 183, 184, 202, 205, 207, 213. Carlson told Flannery he thought the letter was a good idea. I.D. 30; Tr. 2763-64; Flan.Ex. 166. Flannery's boss told him, "Sean, [t]his is a good communication." Flan.Ex. 186. Duggan reviewed the letter so many times that he asked Flannery, "**how many times do we have to sign off?**" Flan.Ex. 207 (emphasis added).

The same "many judicious investors" language was later used in an October communication to investors from Flannery's boss, in which Flannery had no involvement, and which was not a basis for charges against him. I.D. 56; Tr. 1420-21.

K. LDBF II

While the August 2 letter was being drafted, and well before the August 14 letter, SSgA was developing an alternative fund, called LDBF II. "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." I.D. 32 n.46; Tr. 1356-57, 2761. It provided LDBF's investors the option to transfer funds to LDBF II, allowing them to remain exposed to the LDBF strategy, but permitting only monthly, rather than daily, withdrawals. I.D. 14; Tr. 1293-95; Flan.Ex. 161. "The communication [announcing LDBF II] stated that certain SSgA commingled [or Related] funds intended to redeem in-kind their respective LDBF interests." I.D. 14-15; Flan.Ex. 161

(explaining that Related Funds were redeeming in-kind because "they continue to believe in this asset class and [LDBF] but . . . need[ed] to manage the underlying assets directly because of their own respective daily liquidity requirements and their desire not to be negatively impacted by the liquidity decisions of others.").

It is undisputed that LDBF II was Flannery's idea. Tr. 1293-95. The Division's own expert, William Lyons, testified that LDBF II was an extreme step and would have been damaging to Flannery's reputation. I.D. 32; Tr. 1867-68. Flannery championed LDBF II despite this fact, because he believed that making this option available would be good for investors. Tr. 1293-95, 1358-59.

The Division has never acknowledged LDBF II, or that the August 6 letter describing this "extreme step" was part of the total mix of information available to LDBF investors.

IV. FLANNERY DID NOT VIOLATE SECTION 17(A) OF THE SECURITIES ACT OR SECTION 10(B) OF THE EXCHANGE ACT.

A. Flannery Did Not Violate Section 17(a)(2) in Connection with the August Letters.

In order to establish a violation of Section 17(a)(2), the Division had to prove, among other things, that the August 2 and August 14 letters contained material misstatements or omissions, and that Flannery was negligent.[18] *Aaron v. SEC*, 446 U.S. 680, 702 (1980). Based on substantial record evidence, Chief Judge Murray found that the Division failed to prove both elements.

1. The August 2 Letter Contained No Misstatements or Omissions.

The Initial Decision found that the transactions referenced in the August 2 letter—the mid-July transactions, the AAA sale, and the expiration of TRS—reduced risk. I.D. 53.

[18] The Division dropped its 10b-5(b) claim against Flannery based on the August 2 letter, in light of *Janus*. It never pursued such a claim based on the August 14 letter.

Moreover, "[t]here 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 AAA securities" (I.D. 53), a fact the Division concedes. DPFOF ¶368. The statements in the letter also represented SSgA's sincere view: the August 1 version of the FAQs, which were not drafted by Flannery and were prepared with input from Legal, Relationship Management, and the investment team, identified the AAA bond sale and the swaps rolling off at month-end as efforts that had been taken to reduce risk in LDBF. Div.Ex. 153 (FAQ #32); Tr. 1361.

Expert witness Ezra Zask also testified that "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." I.D. 36, 53; Flan.Ex. 299; Tr. 2356-57. Indeed, all three transactions reduced exposure to subprime securities and reduced leverage. Tr. 2356-57; Flan.Ex. 299; *see also* Tr. 1743-45, 2206-07, 1050, 1052, 1292-93.

Zask's opinion is unrebutted by any other witness; the Division's expert, Russell Wermers, did not perform a risk analysis.[19] Tr. 718. Wermers focused only on LDBF's cash, and admitted "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

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[19] While no witness controverted Zask's testimony about the effect of the three transactions on risk, the Division, which offered no expert risk analysis of its own, questions Zask's analysis in connection with a risk measure known as Conditional Value at Risk (or "CVaR"). Div.Br. 17 n.5. The Division mischaracterizes Zask's opinion, which was not dependent on whether or how long the cash proceeds from the July 26 AAA bond sale remained in LDBF. Zask's CVaR analysis properly showed the impact of the transactions referenced in the letters on LDBF's CVaR. Flan.Ex. 299 p.10-18. Each transaction reduced CVaR, and this was not rebutted. *Id.* The Division relies heavily on an after-the-fact, October 2007 presentation with a graph showing CVaR rising during the Summer of 2007 (Div.Ex. 185 p.14), but the fact that the overall CVaR of the portfolio may have continued to increase over the course of the Summer as market conditions worsened is irrelevant and does not change the fact that the transactions reduced risk (and that Flannery believed they reduced risk); as witnesses explained, a fund's CVaR can increase notwithstanding risk reducing transactions, due to external market events. Tr. 1754 (Pickett), 1960-61 (Peter Lindner, North American Head of Investment Risk Management). Stated differently, LDBF's CVaR would have further increased in the absence of the risk reducing transactions. Finally, the August 2 letter did not state that the overall CVaR of LDBF was decreasing during this time period. It said that the three transactions reduced risk. The truth of this statement **has not been rebutted.**

market value." I.D. 32; Tr. 718; Div.Ex. 255 p.9. TRS rolled off the portfolio by August 1, 2007; this was the third of the risk-reducing transactions referenced in the August 2 letter. I.D. 32 n.49; Flan.Ex. 299 p.15. Like its expert, the Division ignores the expiration of TRS, as well as the mid-July transactions referenced in the letter, focusing only on the AAA sale. But again, that sale clearly reduced risk by reducing leverage, a fact the Division refuses to confront. Instead, the Division and its expert myopically focus on the cash in LDBF subsequent to the AAA sale, claiming the cash was gone by August 2. Div. Br. 14-15. However, "[t]he evidence establishes otherwise." I.D. 53-54. There was $200,000,000 in LDBF on August 2.[20] *See* Section III.H, *supra*.

There was no testimony that the three transactions referenced in the August 2 letter did not reduce risk—a baseless theory of the Division's own making. In the end:

> 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. To Zask, it was evident: "**You've got a risk in the housing market, and you take three steps to reduce that exposure**."

I.D. 37; Tr. 2357 (emphasis added).

The Division also vaguely asserts that "[t]he letters [including the August 2 letter] also variously omitted basic facts about LDBF's subprime concentration, its use of leverage, its inconsistent credit quality, SSgA's views about whether smart investors should stay invested in LDBF,[21] and the sale of its highest rated and most liquid investments to fund the redemptions of those clients who got information before others." Div.Br. 28. Chief Judge Murray correctly rejected these contentions:

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[20] Wermers also failed to take into account that a vast amount of the Related Funds' redemptions were in-kind, and as such his analysis concerning the proceeds of the AAA sale is flawed, as in-kind redemptions are for securities, not cash, and have no effect on cash available for other clients. Tr. 667-68, 674, 687.

[21] This alleged "omission" presumably concerns the August 14 letter's "judicious investors" language, discussed below.

- First, Flannery knew that information about LDBF's subprime concentration and leverage was widely known and available, from both SSgA and the media. Flan.Ex. 108; Div.Exs. 45, 153; Tr. 1216-17, 1310, 1466-67. Flannery understood the letter was intended to supplement the substantial information available to LDBF's investors. Hop.Ex. 174 p.23; Tr. 2724, 1215-17, 1223-25, 1209-11; Flan.Ex. 109. Moreover, the letter itself discussed LDBF's subprime exposure and resulting losses. Flan.Ex. 144 p.SS-SEC000120103.

- Second, LDBF's credit quality was not "inconsistent." The Division concedes that the statement about LDBF's average credit quality being AA was (1) "technically accurate" and (2) believed by Flannery to be true. I.D. 54. This statement in fact appeared in SSgA's August 1 FAQs. Div.Ex. 153 p.SS004379042.

- Third, SSgA did not sell the AAA bonds to fund redemptions of certain clients over others as discussed above. Furthermore, the August 2 letter did not hide, but rather disclosed, the AAA sale. Div.Ex. 159. The fact that some clients were redeeming was not hidden by SSgA, *e.g.*, Div.Ex. 153, and "Flannery made no attempt to hide the LDBF's redemption activity." I.D. 54. Relationship Management and Consultant Relations personnel knew about actual and anticipated redemptions, and were heavily involved in reviewing the letter. *Id.* The same is true of Legal. I.D. 27-28, 53. Moreover, "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.D. 54.

The finding that there were no material omissions is supported by the overwhelming record evidence.[22]

2. Flannery Was Not Negligent In Connection with the August 2 Letter.

"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 letter." I.D. 54. Furthermore, everyone agrees that Flannery believed the risk reduction statements in the August 2 letter to be true. And as the Division itself admits, "[e]ach of the

[22] Moreover, because the letter's statements were not misleading, there was no duty to disclose further information. *See Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1321-22 (2011) (disclosure only required to make statements not misleading in light of circumstances in which they are made) (citations omitted).

letters was circulated to numerous client service, legal, and investment team members." Div.Br. 28. The reasonableness of Flannery's actions is demonstrated by his awareness that these groups were heavily involved in reviewing and editing the letter. Div.Ex. 151. By contrast, Flannery's involvement in the August 2 letter was extremely limited. Div.Exs. 151, 155.

3. The August 14 Letter Contained No Misstatements or Omissions.

The Initial Decision properly found that the challenged "judicious investors" language in the August 14 letter, added by Deputy General Counsel Duggan, was true and not misleading. "Flannery believed that many judicious investors would, in fact, hold their positions." I.D. 56. His belief was reasonable, as it was based on "the Management Team's belief at the time that subprime securities would recover, 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." *Id.*; Tr. 1382-84. The reasonableness of his belief was supported by uncontroverted expert testimony, as well as the fact that "the SSgA president used this same language in a letter to clients on October 5, 2007." I.D. 56; Hop.Ex. 161 p.27; Tr. 1384, 1388, 1419-20; Flan.Ex. 251. Like Flannery, others both inside and outside SSgA, including government officials, held this belief at the time. Tr. 1383-84, 1387-88; Hop.Ex. 161 p.45-46. And regardless of the reasonableness of his belief, such a forward-looking statement of opinion can only constitute a misrepresentation if the speaker did not sincerely hold the opinion. *See, e.g.*, *Brown v. Credit Suisse First Boston LLC*, 431 F.3d 36, 49 (1st Cir. 2005), *overruled in part on other grounds as stated in ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 F.3d 46, 52 (1st Cir. 2008); *Podany v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 146, 154 (S.D.N.Y. 2004). It is unrebutted that the "many judicious investors" language reflected Flannery's honest opinion on August 14, 2007. Tr. 1387-88.

Regarding purported omissions, the Division claims the August 14 letter, which contained substantial, negative information about LDBF's performance, was misleading because it did not state that "all of LDBF's shareholders controlled by SSgA had terminated their investments" or "why judicious investors might want to hold onto their LDBF shares by August 14—the only assets left in LDBF were illiquid and any future redeemers would receive fire sale prices." Div.Br. 39. The Division relies on false premises. While Flannery knew about OFA and GAA's recommendations (as did Attorney Duggan and many others), a determination by these two small groups to redeem did not change the fact that, at the time, it was reasonable to think that other investors would not redeem into an illiquid market. Tr. 1157. The language referred to "many," not "all," judicious investors. I.D. 56 n.91. With respect to the much larger investments of the Related Funds, many of their redemptions occurred in-kind, rather than for cash, and reflected their view that maintaining exposure to the assets in LDBF's strategy made sense, consistent with the "judicious investors" language. Flan.Ex. 161; Tr. 1360. Moreover, the Related Funds' redemption activity had been disclosed by SSgA in the August 6 letter announcing LDBF II. Flan.Ex. 161. The "judicious investors" statement itself made clear that redemptions were occurring and liquidity was an issue: "While **we will <u>continue to liquidate</u> 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." Div.Ex. 176 p.SS-SEC000087633 (emphasis added).

Finally, regarding the Division's claim that Flannery should have warned investors that future redeemers would receive "fire sale prices," the short answer is that Flannery was not clairvoyant, and the law does not require him to see the future. If the market had recovered as he

and others believed, those who remained exposed to LDBF would have done better than those who redeemed for cash.

4. Flannery Was Not Negligent In Connection With The August 14 Letter.

Chief Judge Murray found that the evidence is "conclusive" that Flannery was not negligent in connection with the August 14 letter. I.D. 57. Duggan was responsible for adding the "judicious investors" language to the letter. I.D. 55. Flannery ensured that Duggan and other SSgA attorneys, as well as members of the client-facing teams and other senior executives, were heavily involved in reviewing and editing the letter, and none of them told Flannery that the letter was misleading. I.D. 56. Flannery understood that all of these people were armed with complete information about LDBF's situation. *See, e.g.*, Tr. 1508-09; Flan.Exs. 92, 133; 161, 172. For example:

> At the time Duggan edited the August 14 letter, he was aware of GAA's recommendation that its clients redeem from the LDBF. OFA's recommendation had also been communicated to Legal by July 27, 2007. 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.

I.D. 56; Tr. 485-87, 1804-05, 1098, 1100.

The Chief Judge rejected the Division's claim that "alone among the August 14th letter's reviewers [Flannery] knew all of the facts." I.D. 56 (citing Div. Post-Hrg. Br. 46-48). Duggan reviewed the FAQs at least up until August 6, 2007, which contained information on redemptions, including GAA's recommendation; Duggan attended the July 25 Investment Committee meeting at Flannery's invitation; Flannery met with Duggan before the meeting to advise him what would be discussed. I.D. 56; Tr. 1270-72. Duggan also attended an August 8 Investment Committee meeting where similar issues were discussed. Flan.Ex. 231. Indeed, Duggan received information from numerous sources. Duggan Tr. 237, 467; Tr. 1270-72, 910-11, 920, 939, 1274-75, 1299-1301, 1361-62, 1391-92. "With this background, it is clear that

Duggan was aware of the problems facing 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.**" I.D. 56-57 (emphasis added).

5. Flannery Did Not Obtain Money or Property By Means Of The Letters.

The Section 17(a)(2) claim also fails because the Division did not prove Flannery "obtain[ed] money or property by means of" the August letters as required by the statute. *See SEC v. Forman*, 2010 WL 2367372, at *8 (D. Mass. June 9, 2010). Flannery's compensation was not tied to LDBF or its performance. I.D. 7. There is no evidence that he "obtained money for SSgA" (Div.Br. 22) by means of the letters (assuming, *arguendo*, that would be sufficient).

B. This is Not a "Scheme Liability" Case: Flannery Did Not Violate Sections 17(a)(1) and (3) or Rule 10b-5(a) and (c).

The Division's purported "scheme liability" claims fail because (1) this is a case about alleged misstatements and omissions alone; and (2) there were none.

In light of these failings, the Division blurs its theories against Hopkins and Flannery, suggesting, without record support, they were together engaged in a larger, but undefined, "scheme." *See, e.g.*, Div.Br. 5, 34 ("both Hopkins and Flannery substantially participated in a series of misstatements and other deceptive actions that were part of a larger scheme to defraud investors in LDBF and the Related Funds").[23] This is improper: there never were allegations, much less evidence, of a "larger" scheme, who was involved in it, or what it concerned. As the Division concedes, the "scheme" claims against Flannery concern the three letters. Div.Br. 20.

[23] This also contradicts the Division's prior assertions that the Related Funds received purported "inside" information. Div. Post-Hrg. Br. 29.

1. Where a Case is About Misstatements or Omissions, and Where There Were None, Scheme Liability Claims Fail.

Three letters that were accurate and not misleading do not make a scheme to defraud.

It is well-settled that cases premised only on misstatements or omissions cannot give rise to claims for "scheme" liability. *See, e.g.*, *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011) (a defendant may "be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 10b-5(a) or (c) when the scheme also encompasses conduct *beyond* those misrepresentations;" emphasizing importance of maintaining distinction among Rule 10b–5 claims) (citations omitted); *In re Coinstar Inc. Securities Litigation*, 2011 WL 4712206, at *11 (W.D. Wash. Oct. 6, 2011); *SEC v. Brown*, 2010 U.S. Dist. LEXIS 101403, at *56-57 (D.D.C. Sept. 27, 2010). The Division's purported "scheme" claims concern the three letters alone. Div.Br. 20.[24] As such, there can be no "scheme liability."

Moreover, where there is no fraud, there can be no "scheme to defraud," as Chief Judge Murray found. I.D. 57; *see In re Express Scripts, Inc.*, 2010 WL 2671456, at *17 (E.D. Mo. June 30, 2010) (where misleading statements not alleged, scheme and other claims dismissed). While a scheme to defraud requires wrongful conduct *beyond* misstatements or omissions, there can be no scheme to defraud *without* misrepresentations or omissions. Here, the letters were accurate and not misleading. The August letters contained no misrepresentations or omissions, as discussed above. Chief Judge Murray also properly found, with ample record support, that "[t]here is no evidence that any statement in the July 26 letter, including the 'key' statement

[24] The Division's later suggestion that Flannery's alleged "role in implementing the Investment Committee decision to sell LDBF's highest-rated and most liquid assets to fund the cash redemptions of internally-advised investors" was part of his "scheme" (Div.Br. 35) is wholly unsupported by the evidence, as discussed above. Moreover, Flannery was a member of SSgA's Investment Committee, which unanimously directed the investment team to do three things; there is no evidence whatsoever that Flannery had any role in "implementing" any trade.

about LDBF's efforts to reduce risk, was false," and that the letter contained no material omissions. I.D. 51-52; Section III.J.1, *supra*. There is no scheme to defraud without fraud.

2. The Mail and Wire Fraud Statutes Add Nothing to the Analysis.

Recognizing, as it must, that this case concerns alleged misrepresentations and omissions alone, the Division suggests that the Commission look to the mail and wire fraud statutes, 18 U.S.C. §§ 1341 and 1343, to interpret its scheme claims under the securities laws. The Division argues that such statutes require a showing of a "false statement and wronging another in his property rights," that this standard should apply to its "scheme" claims under Sections 10(b) 17(a), and that it somehow absolves the Division from demonstrating more than misrepresentations or omissions. Div.Br. 32-33. The Division cites no securities case supporting this theory. Furthermore, the mail and wire fraud statutes themselve*s* require more than merely a misrepresentation or omission. *See, e.g.*, *United States v. Strong*, 371 F.3d 225, 230-31 (5th Cir. 2004) (scheme claim failed where no evidence letters had a "lulling" effect).

In any event, where each of the letters was true and not misleading, there can be no "scheme liability" under any formulation of the law. *See Perlman v. Zell*, 185 F.3d 850, 854 (7th Cir. 1999) ("The word 'fraud' in the mail-fraud statute means deliberate, material misrepresentations. No fraud, no mail fraud.") (citations omitted).

3. The Scheme Claims Fail Because Flannery Lacked Scienter and Was Not Negligent.

In order to prove its "scheme liability" claims, the Division had to prove that Flannery acted with scienter (to establish liability under Section 17(a)(1) and Rule 10b-5(a) and (c)) or negligence (to establish liability under Section 17(a)(3)). *Aaron*, 446 U.S. at 691, 697. The Division failed.

Chief Judge Murray properly found that that Flannery did not act negligently or with scienter in connection with the July 26 letter. I.D. 52 n.85. As such, the letter was not part of a "scheme." "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" (including General Counsel Shames). I.D. 50. It was Flannery who insisted that Legal review the letter, and he understood the lawyers knew the relevant facts. I.D. 51; *e.g.*, Flan.Exs. 92, 102, Duggan Tr. 80, 210, 105-06; Tr. 942; 1270-71. "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." I.D. 51.

As discussed above (*see* section IV.A, *supra*), Chief Judge Murray properly determined that Flannery was not negligent in connection with the August 2 and August 14 letters. Clearly, then, he lacked scienter in connection with any alleged scheme based on the August 2 letter (there are no scienter-based charges, "scheme" or otherwise, arising from the August 14 letter). Indeed, despite the Division's claim that Flannery sought to lull investors into remaining in LDBF, Chief Judge Murray found **"there is nothing in all the numerous e-mails that supports a claim that Flannery was attempting to obfuscate or mislead."** I.D. 54 (emphasis added). And, as the Division concedes, Flannery believed risk had been reduced. Flannery's good faith belief in the letter's truthfulness destroys any claim that he intentionally sought to mislead investors. *See United States v. Dowlin*, 408 F.3d 647, 667 (10th Cir. 2005); *United States v.*

Bradstreet, 135 F.3d 46, 51 (1st Cir. 1998). Without proof of scienter or negligence, the scheme claims fail.

C. Evidence of Counsel's Involvement is Relevant to Scienter and Negligence.

The Division contends that Flannery cannot rely on the ample evidence of lawyer involvement in the letters to negate scienter or negligence without satisfying a four-part test for the "advice of counsel" defense, regardless of whether the lawyers were fully informed as Flannery accurately believed. Div.Br. 37-40. This defies logic and is legally wrong. The Division's four-pronged test concerns situations where a defendant interposes the "advice of counsel" defense. This is not such a case. SSgA's lawyers represented the company, not Flannery. They had access to information about the issues facing LDBF from many sources, and Flannery's efforts to involve them in the creation of the letters, and his well-founded belief that they were informed, negates any claim that he acted unreasonably or with scienter.

Reliance on the involvement of counsel—just like reliance on others with knowledge—is different from the separate and distinct "advice of counsel" defense. *See SEC v. Snyder*, 292 F. App'x 391, 406 (5th Cir. 2008); *Howard v. SEC*, 376 F.3d 1136, 1147 (D.C. Cir. 2004) ("[R]eliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter."); *Oakley, Inc. v. Bugaboos*, 2010 U.S. Dist. LEXIS 123976, at *11-12 (S.D. Cal. Nov. 23, 2010). To limit consideration of the corporate lawyers' involvement to instances where Flannery personally provided the information to them, when he reasonably believed that those lawyers possessed the information, would not only be illogical, but would limit consideration of their involvement in a way not applicable to others involved in the letter, including members of the Relationship Management and investment teams. The involvement of these groups bears upon the reasonableness of Flannery's actions, and the lawyers' involvement bears on this too.

And, even if the Division's test applied, Flannery satisfies it. First, leaving aside the fact that the lawyers received information from multiple sources, Flannery made a complete disclosure to counsel, and there is no evidence that the information Flannery provided to the lawyers (and others) was anything other than completely accurate. For example:

- Flannery invited Duggan to the July 25 Investment Committee meeting, at which liquidity and potentially significant anticipated redemptions were discussed, and the three instructions to the investment team were unanimously decided upon. As Flannery expected, Duggan shared what had occurred at the meeting with Shames. I.D. 15, 56; Duggan Tr. 210.

- Flannery also met with Duggan before the July 25 Investment Committee meeting to tell him what would be discussed. I.D. 56; Tr. 1270-72, 1269-71; Duggan Tr. 80.

- Duggan participated in a July 26 IAVC meeting where, at Flannery's suggestion, pricing issues, subprime, and illiquidity were discussed. Flan.Ex. 102.

- On July 30, the Executive Management Group ("EMG"), including Shames and Flannery, discussed the potentially high levels of redemptions from LDBF, and the possibility of freezing the fund as a result. Tr. 1314-15.

- Flannery developed the idea for LDBF II, which was being considered by the Legal Department in early August; the entire premise for LDBF II was anticipated redemptions and reduced liquidity. I.D. 54; Tr. 1293-96.

- The very draft of the August 2 letter containing Flannery's suggested edits, which Flannery edited and circulated to Shames and others for review, disclosed the AAA bond sale, and contained substantial information regarding LDBF's underperformance and subprime exposure. Flan.Ex. 144.

- Flannery and Duggan were both present at an August 8 Investment Committee meeting where all of the issues facing LDBF were discussed. Flan.Ex. 231.

- Shames and Flannery regularly discussed the market situation. Tr. 942. Flannery also provided Shames and others with periodic reports on the amount of subprime exposure in the fund. Shames Tr. 213; Hop.Ex. 171 (Shames a member of EMG).

Second, Flannery sought advice from counsel regarding each letter. He directed that Legal review the July 26 letter. He sent his single round of "suggested edits" to the August 2 letter to Shames, among others. He consulted with Shames before writing the August 14 letter, sent a draft to Duggan, and worked closely with Duggan in editing it. I.D. 25-28, 30, 50-51, 56-57. These facts are undisputed.

Third, lawyers were required to, and did, approve each of the letters. Shames Tr. 89-90; Flan.Exs. 52, 127, 123, 142, 144, 149, 207; Div. Ex. 137; Hopkins Ex. 95; Tr. 2698.

Fourth, Flannery relied in good faith on the expertise and advice of the many experienced lawyers who reviewed and approved the letters, and there is no contrary evidence.

Whether or not the Division's four-part test is applied, the substantial involvement of the numerous SSgA lawyers who Flannery reasonably believed possessed the relevant facts demonstrates that Flannery lacked scienter and instead acted reasonably.

D. *Janus*, While Properly Applied, Has No Impact on the Outcome.

In *Janus*, the Supreme Court held that a "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." 131 S. Ct. at 2303. Due to *Janus*, the Division dropped its Rule 10b-5(b) claim (which concerned only the August 2 letter), but claims *Janus* is inapplicable to its misstatement claims pursuant to 17(a)(2) and to its "scheme liability" claims. However, the Initial Decision found that because "[t]his case involves allegations of materially false or misleading statements or omissions," *Janus* governs. I.D. 43. This application of *Janus*, while correct, did not impact the outcome exonerating Flannery, in light of Chief Judge Murray's other, unrelated findings that the letters were true and not misleading and Flannery did not act negligently or with scienter.

Janus applies to claims pursuant to Section 17(a)(2). In *SEC v. Kelly*, 817 F. Supp. 2d 340, 344 (S.D.N.Y. 2011), the court "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." I.D. 42 (citing *Kelly*, 817 F. Supp. 2d at 345). Accordingly, Chief Judge Murray properly held that while Flannery made a statement in the August 14 letter, he did not do so in the August 2 letter. I.D. 55, 53 ("Flannery did not have anything approaching ultimate authority for the contents of the letter or its distribution").

Janus also applies to the Division's purported scheme liability claims, which are based on the three letters. *See Kelly*, 817 F. Supp. 2d at 343 (holding that "courts have routinely rejected the SEC's attempt to impose misstatement liability under subsection (b) by labeling the alleged misconduct a 'scheme,'" and that purported scheme claim premised on alleged false statement fails where defendant did not "make" the statement). This holding comports with the weight of the case law. *See* Section IV.B, *supra*.

Nevertheless, even if the Commission disagrees with *Kelly* and the Initial Decision regarding *Janus*, the Division's Section 17(a)(2) and scheme liability claims fail because the letters were true and not misleading, and Flannery was not negligent and lacked scienter.

E. <u>The Initial Decision's Investor Sophistication Findings Were Correct, But Do Not Change The Outcome</u>.

The Division argues that investor sophistication is irrelevant to materiality in an enforcement action, and that evidence of sophistication was "spotty at best." Div.Br. 29. First, like *Janus*, the sophistication issue does not change the outcome as to Flannery given Chief Judge Murray's other findings. Second, there is ample evidence that investors <u>were</u> sophisticated. As the Division concedes, LDBF was "only offered to institutional investors."

Div.Br. 4. Most of the investors were advised by experienced investment consultants. I.D. 40. Expert testimony confirmed that typical investors in LDBF were large institutions advised by expert consultants. Hop.Ex. 174 p.10-16; Tr. 1210. The Division called no investors to testify that they lacked sophistication.

To the extent the sophistication of LDBF's investors was among the factors in Chief Judge Murray's materiality analysis, this was proper. Courts in both private and enforcement actions have held that investor sophistication is relevant to materiality. *See, e.g.*, *SEC v. Happ*, 392 F.3d 12, 21-22 (1st Cir. 2004) (defendant's status as a "financial expert" relevant to assessing materiality of information he allegedly traded on) (citing *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1028-29 (4th Cir. 1997)); *Alton Box Board Co. v. Goldman Sachs*, 560 F.2d 916, 922 (8th Cir. 1977) (genuine issue of material fact existed regarding materiality; "[t]his is especially true where there was testimony from sophisticated institutional purchasers that these facts would have been important to them."); *SEC v. Rorech*, 720 F. Supp. 2d 367, 372 (S.D.N.Y. 2010) (SEC failed to prove materiality; "[I]t was publicly known—particularly to sophisticated high yield bond buyers—that . . . Deutsche Bank would be [taking action]."). Investors in LDBF were not retail investors. Where a fund is only offered to institutional investors, it would be truly incongruous to address what a hypothetical retail investor might consider important while turning a blind eye to who the actual investors were.

But, in the end, this is a diversion having no impact on the result. The letters were true and not misleading, and Flannery lacked scienter and acted reasonably. The correctness of the "sophistication" analysis does not change these findings, which are fatal to the Division's claims.

V. SANCTIONS SHOULD NOT BE IMPOSED.

The Division presses for sanctions, contending Flannery committed "egregious securities violations." Div. Br. 41. But there were no violations here, and Chief Judge Murray thus found

that "no remedial action is appropriate." I.D. 58. There is also no evidence, contrary to the Division's claim, that any investors lost money as a result of the letters, or that the alleged "misstatements and omissions were made in furtherance of keeping [Flannery's] lucrative job[]." Div.Br. 41-42. Flannery, whose compensation was not tied to LDBF, affirmatively took steps during the summer of 2007 out of concern for clients, including promoting LDBF II, even though a Division expert conceded this would harm his professional reputation and, presumably, his employment prospects.

A. The Division is Not Entitled to Penalties or a Bar.

The Division's request for penalties seeks improper, retroactive application of Section 929P(a) of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, 124 Stat. 1376 (2010), which permits the Commission to provide penalties in an administrative cease-and-desist proceeding against unregulated persons. *See Molosky v. Washington Mut., Inc.*, 664 F.3d 109, 113 n.1 (6th Cir. 2011) ("The Dodd–Frank Act itself declares that its contents should not be construed as retroactive."); *Gupta v. SEC*, 796 F. Supp. 2d 503, 507 (S.D.N.Y. 2011). Penalties under Section 8A of the Securities Act and Section 21B of the Exchange Act are unavailable, because this case concerns events occurring in 2007. *See* 17 U.S.C. § 77h-1 (authority to impose 8A penalties added by 2010 amendment); 15 U.S.C. § 78u-2 (Section 21B(a)(2) added by Dodd-Frank, expanding availability of civil penalties). Penalties and other remedies are also unavailable under the Investment Advisors Act because the Division failed to prove Flannery was a "person associated with an investment advisor." 15 U.S.C. §§ 80b-3(f), 3(i)(1)(A). Similarly, with respect to the Investment Company Act, there is no evidence Flannery was "performing advisory services for the registered investment companies advised by [SSgA Funds Management, Inc. ("SSgA FM")]." Div. Post-Hearing Br. at 74. Finally, the Division is not entitled to relief under the Investment Advisors

Act or the Investment Company Act because there is no evidence Flannery acted "willfully." 15 U.S.C. §§ 80a-9(b)(2), 80b-3(i)(1).

B. Sanctions Would Be Contrary to the Public Interest.

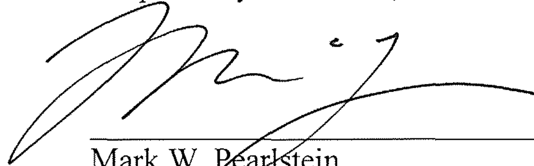
The public interest counsels against sanctions. *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). During his 27-year career in the investment business, Flannery has never been sanctioned or otherwise professionally disciplined. His life has been marked by extensive charitable and community service. He received no profit or other benefit as a result of the letters. Numerous witnesses testified about Flannery's impeccable character. No witness offered contrary testimony.

Flannery is an honest man who sought to do the right thing in the midst of unprecedented market conditions. He made one set of proposed edits to the July 26 and August 2 letters. He sought to—and did—involve multiple knowledgeable lawyers, Relationship Management, and investment personnel in the letters. He volunteered to write the August 14 letter, over the reservations of his boss, because "he believed investors needed an explanation and it was the right thing to do." I.D. 30. He reasonably believed the statements in the letters were true, they were, in fact, true, and the Division failed to prove anyone was harmed by the letters. There is no basis for sanctioning Flannery, and sanctions would dissuade other executives from taking responsibility and promoting transparency, particularly where, as here, the Division has taken no action against those who had a far greater role in the letters and investor communications generally.

VI. CONCLUSION

Flannery respectfully requests that the Commission affirm the Initial Decision and dismiss this proceeding.

Respectfully Submitted,



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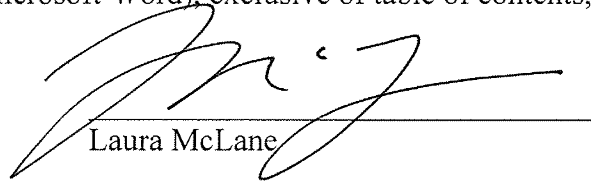
Certification Pursuant to Rule 450(d)

I hereby certify that this Opposition to the Division's Brief in Support of its Petition for Review complies with Commission Rule of Practice 450(d), as the word count of the brief (as calculated by the word count feature of Microsoft Word), exclusive of table of contents, table of authorities and cover page, is 13,975.



Laura McLane