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 REPLY BRIEF IN SUPPORT OF ITS PETITION FOR REVIEW

Respectfully submitted,
DIVISION OF ENFORCEMENT
By its attorneys:

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

Dated: June 13, 2012

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Respondents' briefs to the Commission, like the communications and deceptive conduct at the heart of this case, tell many misleading half-truths. Those briefs tell only the pieces of the story that fit Respondents' spin, ignore key facts, and unduly rely on findings of the hearing officer that are legally irrelevant at this stage of the proceedings. Considered impartially, the totality of the evidence compels the conclusion that Respondents violated the securities laws by engaging in a course of deceptive conduct about the nature and risk of LDBF. Respondents' attempts to downplay the misleading nature of their conduct, shift responsibility for their actions to their co-workers, or blame investors for failing to understand their disingenuous statements are unavailing. This brief highlights some of Respondents' half-truths and erroneous legal arguments.

A. Respondents Misunderstand the Standard of Review.

Respondents contend that a proper application of the *de novo* standard of review would render the evidentiary hearing conducted by the hearing officer meaningless. *See* Flannery Br. at II, Hopkins Br. at II. They are wrong. The hearing provides for the admission of documentary and testimonial evidence that will form the basis for the Commission's decision. Any factual or legal conclusions reached by the hearing officer are, however, due absolutely no deference, and need not be shown to be clearly erroneous.

Further, the Commission accepted review of all of the underlying facts of this case, and determined to resolve, following an independent review of the record, whether those facts constitute a violation. *See* Comm'n Order, March 30, 2012 at 3-4. Respondents' refrain that the Division did not challenge certain portions of the hearing officer's findings is wrong, and their repeated citation to the Initial Decision's conclusions are worth little. *See* Division's Petition for Review at 2-3. The Commission properly will make its own determinations of the facts and the

law of this case, based on the complete record.

B. Hopkins Misstates the Factual Record.

1. The Typical Slide Was a Material Misstatement When Hopkins Used It at Five Investor Presentations.

Hopkins argues that the Typical Slide's presentation of LDBF's portfolio was not misleading because it was "typical" at some earlier point in LDBF's history, and the Division is cherry-picking a relevant time period. Hopkins Br. at 11-14. Hopkins misses the point. The fact that LDBF's typical composition changed between 2004 and 2006-2007 – the time at issue here – is exactly the type of material information that an investor would want but did not receive. The Division did not "cherry-pick a time period" but instead claimed – as Hopkins concedes – that during 2006-2007, LDBF held far more securities in the ABS category than the 55 percent the Typical Slide represented. Therefore, the Typical Slide was in no way "typical." Hopkins Br. at 13; ID at 21.

Hopkins also misrepresents the degree of involvement that he had in investor presentations containing the Typical Slide. Hopkins did not just "attend a couple of presentations." Hopkins Br. at 11. Each quarter, Hopkins was responsible for reviewing the slides contained in the standard presentation for accuracy. DFF 160. He was provided the opportunity to edit the presentation on numerous occasions. DFF 183-85. He edited the presentation before attending presentations – but chose not to edit the Typical Slide even though he had that opportunity. DFF 180-82. In fact, in May 2007, he was specifically asked whether the Typical Slide was still accurate and he edited the bullet points but not the chart evidencing portfolio holdings. DFF 185-86. Hopkins cannot evade responsibility for the content of investor presentations that included the Typical Slide.

2. The Evidence Supports the Conclusion that Hopkins Misrepresented LDBF's Total Subprime Exposure.

Hopkins argues that the Commission should defer to the hearing officer's decision to discredit testimony by a Yanni Partners consultant, David Hammerstein, that Hopkins told him during a phone call that LDBF's total exposure to subprime investments was two percent. Hopkins Br. at 14-20. Hopkins is wrong.

The hearing officer did not determine that Hammerstein lacked credibility or that his testimony was self-serving; instead, she found Hammerstein credible. ID 47 n.48. Thus there is no adverse credibility determination to which the Commission could defer. Without citation to the record, and relying solely on convoluted post-hearing arguments by Hopkins' counsel, the hearing officer concluded that there was "genuine confusion" regarding what was said during the Hopkins-Hammerstein conversation. ID 48. The hearing officer supposed that Hammerstein was confused as to what Hopkins meant by two percent even though Hammerstein denied such confusion. Tr. 2622. The decision also found (belied by the record) that there were no other instances when Hopkins had been asked for information and had failed to provide that information. ID 48, 20 (at least once, Hopkins did not provide information regarding the meaning of "greater sector diversification" when directly asked). It was error to conclude that Hopkins had not misled Hammerstein simply because Hopkins may have told the truth at other times.

Instead, as Hopkins admitted, the only evidence regarding the actual phone call was Hammerstein's testimony and a contemporaneous memo. Hopkins Br. at 19. Hopkins' references other documents that are not direct evidence of the phone call but rather general evidence of the context of the phone call. Hopkins Br. at 17-18. Hopkins had no memory of whether he told Hammerstein that LDBF's exposure to subprime was only 2%. Tr. 255-56.

Hammerstein, on the other hand, testified that Hopkins told him that LDBF's total exposure was 2% when Hopkins' counsel specifically confronted Hammerstein with his theory that the 2% figure mentioned in the contemporaneous memo referred only to LDBF's ABX exposure. Tr. 2622. This is not a situation where the fact finder must determine which version of conflicting testimony about a communication to credit. *See In re Ward*, Rel. No. 8210, 2003 WL 1447865 (Mar. 19, 2003) (error to credit respondent's testimony about communications when directly contradicted by other direct testimony, tape recordings and transcripts); *In re Tricario*, Rel. No. 32356, 1993 WL 183678, *3 (May 24, 1993) (affirmed NYSE decision when respondent's self-serving testimony regarding communications was directly contradicted by two customers' alternate version). The **only** direct evidence is that Hopkins told Hammerstein that LDBF's total exposure to subprime was 2%. Thus the unrefuted evidence – supported by a contemporaneously drafted memo – is that Hopkins specifically misled Yanni Partners by stating that LDBF was only 2% exposed to subprime. DFF 236; DX 69 at 2.

3. Hopkins' Involvement in the July 26 Letter Was Substantial.

Hopkins claims that he was merely a "messenger" and lacked involvement in the July 26 letter. Hopkins Br. at 21. Hopkins mischaracterizes the evidentiary record. Hopkins' substantial role in drafting and editing the July 26 letter was part of the fraudulent scheme for which he is liable. Hopkins drafted the "skeleton" of the July 26 letter, and was primarily responsible for communications between the investment team and the client service team on subprime issues. DFF 200, 322, 339. He, perhaps alone among the letter's reviewers, knew what clients had not yet been told, knew what clients needed to know to make intelligent investment decisions about their holdings in LDBF and the Related Funds, and understood the causes of LDBF's underperformance. He knew that by mid-July there was still confusion among SSgA relationship

managers and clients about the extent of LDBF's subprime exposure. DFF 318-20, 338. He even knew that some believed LDBF's small BBB-rated ABX investment was its only subprime investment. DFF 338. By the time that Hopkins suggested the crucial change regarding risk, he knew that LDBF's underperformance was mostly being caused by its investments in AAA and AA-rated subprime securities. DFF 347. Yet, he recommended that the letter emphasize that LDBF had reduced its exposure to the subprime sector. DFF 345-46. As a result the letter ultimately misleadingly represented: "We have used this opportunity to reduce risk in the portfolio by taking advantage of liquidity in the market when it exists, and will continue to do so, without putting further pressure on asset valuations." DFF 354.

Hopkins also mistakenly argues that the letter was accurate because risk had been reduced as of July 2006. Hopkins Br. at 22. Although some lower-rated subprime securities were sold before July 26 (Tr. 2865-66), Hopkins knew that because LDBF's portfolio was almost entirely AAA and AA-rated subprime securities and that many investors would soon be redeeming from the fund (DFF 276), LDBF's risk had not been reduced.

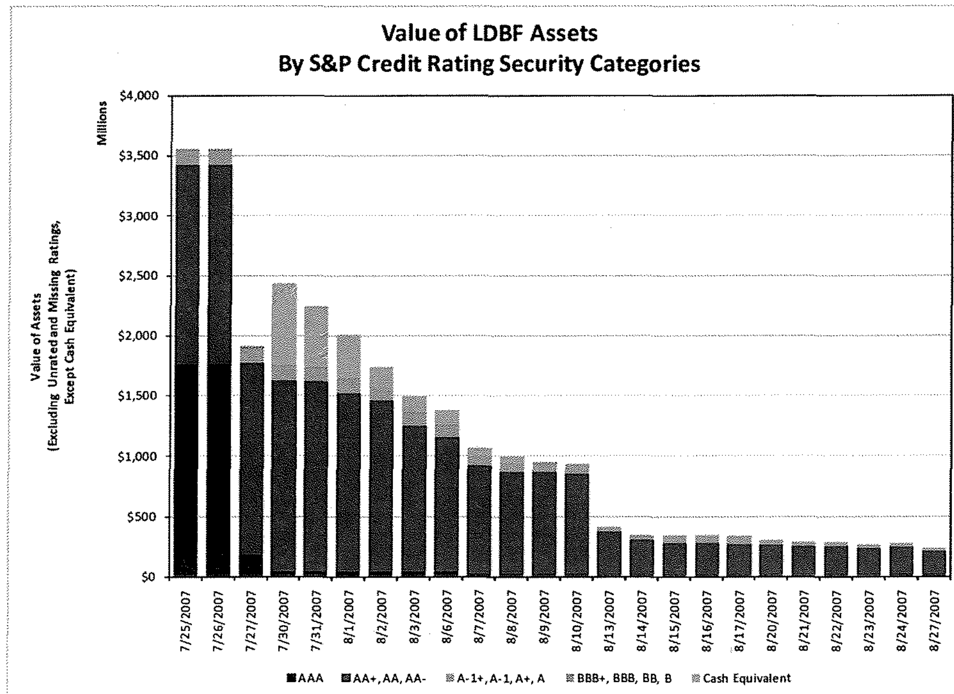
C. The July 26, August 2 and August 14 Letters Were Misleading.

Much of Flannery's argument that he did not violate the securities laws turns on his erroneous factual assertion that the letters sent to investors on July 26, August 2 and August 14 were not misleading. He argues that the letters were truthful because the risk of investing in LDBF was reduced by three transactions: 1) the sale of AA- and BBB-rated ABX swaps in mid-July; 2) the sale of AAA bonds on July 26; and 3) the expiration of some total return swaps ("TRS") on August 1. *See* Flannery Br. at 11, 15-16, 18, 20, 26-27. In context, the letters' assertions that these three transactions reduced LDBF's risk were highly misleading.

First, to suggest that the sale of ABX swaps in mid-July reduced LDBF's risk in any

meaningful way was deceptive. As Respondents knew, LDBF's underperformance in July 2007 was not caused by its ABX investments, but rather its holdings of AAA and AA-rated subprime bonds. DFF 345-47; 359. The evidence demonstrates that only .129% of LDBF's 8.159% July loss in value was attributable to anything other than its AAA and AA-rated subprime bonds, including the ABX swaps. DFF 358-60; 345-54. Telling investors that LDBF's risk was reduced by virtue of these small sales of assets – that were not causing the most significant problems for LDBF – was false comfort in the absence of disclosures about the vast majority of LDBF's risk and the way it was managed to the detriment of all but the earliest redeemers.

Second, LDBF sold a significant percentage of its highest rated and most liquid assets – AAA RMBS bonds – on July 26. Over the next week, SSgA spent that cash to fund redemptions made primarily by its other funds and those investors it advised. While Flannery's argument that LDBF's sale of AAA bonds necessarily reduced risk is superficially appealing, it is a valid argument only if the cash raised from that AAA sale stayed in the fund. It did not. After the July 26 sale, LDBF's composition changed dramatically. It went from a fund whose saleable assets were about evenly divided between AAA and AA rated subprime bonds to a fund dependent on selling riskier AA bonds to fund any future redemptions. DX 167; DFF 74, 301, 369. Below is a chart showing the dollar value of LDBF's assets from late July to late August 2007:



DX 217, 218, 230, FX 288. There is no dispute that the AA bonds remaining for sale after July 26 were far riskier and less liquid than the AAA bonds that had been sold. DFF 95 (AA bonds structurally riskier than AAA bonds); 284; 287 (Flannery acknowledges that LDBF would be stuck with only illiquid assets if it sold AAA bonds);[1] 289; 398-405 (AA bonds had greater liquidity and price risk than AAA bonds).[2]

As the light blue areas in the chart demonstrate, the cash raised by the July 26 AAA bond sale (after re-paying repurchase commitments on those bonds), was used up quickly. Despite Flannery's arguments (Flannery Br. at 12, 18), the recipients of this cash were overwhelmingly SSgA-advised or controlled investors. DFF 384. In LDBF ERISA, there were $270,289,398 in

[1] While Flannery is correct that the Division's brief mistakenly attributed a statement made by Pickett to him (Flannery Br. at 15 n.12), the Division's point was still valid. Div. Br. at 13. Flannery stated at the same Investment Committee meeting that selling the AAA bonds only would harm the overall quality of LDBF's portfolio. DFF 287.
[2] Flannery contends that the Division ignores sales of AA and A rated bonds made over time. Flannery Br. at 16. To the contrary, these sales are reflected in the charts above and in the Division's opening brief. Div. Br. at14-15; DX 217 (of $1,041,121,722 in bonds sold by LDBF ERISA between July 26 and August 2, 84.4% were rated AAA, 11.8% were rated AA, and 3.8% were rated lower than AA or unrated); DX 218 (of $899,472,749 in bonds sold by LDBF CTF from July 26 to August 9, 83.7% were AAA, 15.7% were AA and .6% were rated lower than AA or unrated). Such sales do not change the fact that the letters concealed the dramatic shift in LDBF's risk that occurred as a result of the July 26 AAA sale and the disproportionate benefit received by early redeemers. DFF 398.

cash redemptions from July 25 to August 2, 2007 -- when the fund ran out of cash. DX 229 at 58-60. Of that amount, **96%** represented cash redemptions by an OFA client ($69,829,849 or 26%) and by Related Funds ($194,070,562 or 70%). *Id.* In LDBF CTF, there were $227,292,387 in *cash* redemptions from July 25 to August 2, 2007, and another $238,784,550 in *cash* redemptions between August 3 and August 9, 2007 -- when the fund ran out of cash. DX 231 at 26-30. Of LDBF CTF's cash redemptions from July 25 to August 2, **95%** were by OFA or GAA clients ($43,190,962 or 19%) or the Related Funds ($172,521,703 or 76%), while 58% ($139,562,000) of those made between August 3 and 9 were redemptions by Related Funds. *Id.* Though Flannery contends that he did not know the proceeds of the AAA sale would be used to favor insiders (Flannery Br. at 15-16), the evidence shows that he knew of the redemptions both by OFA and GAA clients and by the Related Funds when he was involved in the preparation of the letters. DFF 309, 424-26, 432, 435-37.

Moreover, there is overwhelming evidence that Flannery knew the cash from the sale of AAA bonds on July 26 would be used for investor redemptions. On July 20, Flannery expressed surprise when he first learned from Hopkins that investors would be pulling their money out of LDBF and the Related Funds because of the funds' subprime problems. DFF 276. Then, on July 26, Flannery told the Investment Committee that, based on ongoing internal discussions, SSgA needed to build 40% liquidity in LDBF, and the Related Funds "will benefit from extra liquidity" in LDBF. DFF 280.

Third, the July 31 expiration of about 18% of the AAA-rated TRS held by LDBF did not cause LDBF's risk to decrease on that date. DFF 366-69 (also explaining how, at expiration, TRS had no market value and thus could not fund redemptions). Not only did the vast majority of LDBF's AAA-rated TRS remain on its books after July 31 (*id.*), but also the overall balance

of LDBF's assets was then changing in a way that dramatically increased LDBF's risk. *See supra* 6-7. Flannery's continued reliance on the discredited testimony of purported expert Ezra Zask to support his argument that LDBF's risk was reduced during the period of time when the three investors letters were sent is baffling. Flannery Br. at 27. Though he argues that expert testimony can only be rebutted by another expert, he is wrong. Zask's testimony was rebutted by the facts, and by its own multiple errors including: 1) Zask's erroneous assumption that the cash raised from the July 26 sale of AAA bonds stayed in LDBF; and 2) Zask's reliance on stale data that dramatically understated the risk of AA bonds (the majority of LDBF's portfolio after July 26 that could be sold to fund future redemptions). Div. Br. at 17. Correcting either one of Zask's errors demonstrates that LDBF's risk increased during the period at issue. *See id.*; DFF 391; 402-05.

Flannery also complains that the cash from the AAA bond sale wasn't gone quickly enough to matter, and that the Related Funds' decision to take in-kind (rather than cash) redemptions and the creation of LDBF 2 support his theory that the letters were not misleading. Flannery Br. at 16-18, 25.[3] These arguments only attempt to muddy the issues.

The two LDBF sub-funds ran out of cash on different days. On August 2, LDBF ERISA had one penny of cash. DX 230. On August 2, LDBF CTF had about $175 million in cash, but that was reduced to about $1.8 million by August 9. DX 230; DX 217-18. These totals matter, because the evidence is clear that in-kind redemptions in each LDBF sub-fund **only began after that sub-fund ran out of cash**. For LDBF ERISA that was August 3, and for LDBF CTF that was August 10. DX 231 at 30; DX 229 at 60. Flannery's contention that in-kind redemptions evidenced continued belief in LDBF is disingenuous – the Related Funds only redeemed in kind

[3] Flannery ignores the Division's appellate brief and improperly reaches back to its Post-Hearing Brief to cite to a minor factual error that was corrected in the Division's Post-Hearing Reply Brief. Flannery Br. at 16.

because there was no cash left.

Flannery also claims that SSgA's August 6 letter, which offered LDBF investors the option of transferring their shares to a LDBF II fund that would offer monthly, instead of daily, liquidity, cured deficiencies in the earlier letters because it told investors that certain Related Funds would redeem from LDBF in-kind. Flannery Br. at 25. To the contrary, the August 6 letter is further evidence of Flannery's fraudulent course of conduct because it omitted key facts: 1) the Related Funds had already decimated LDBF's cash position as described above; and 2) to meet any future redemptions, SSgA would be forced to sell illiquid assets because LDBF's most liquid assets had already been sold to satisfy cash redemptions by the advisory groups' clients and the Related Funds.

D. *Janus* and its Progeny Supports Respondents' Liability.

1. Hopkins Made Actionable Misstatements Under Rule 10b-5(b).

Hopkins argues that he did not "make" the statements contained in the investor presentations attributed to him because he lacked control over the presentations' content and because the presentations' cover pages listed several names (including his). Hopkins' argument is both legally and factually nonsensical. *Janus* explicitly held that attribution is strong evidence that a statement was "made" by the party to whom it is attributed. *Janus Capital Group, Inc. v. First Derivative Traders*, 132 S. Ct. 2296, 2302 (2011). Further, because Hopkins was acting in accordance with his job responsibilities and he was speaking on behalf of his employer when he participated in the investor presentations that included misrepresentations, he is liable for "making" those misstatements. *In re Merck & Co. Inc. Secs., Derivative & ERISA Litig.*, 2011 WL 3444199, *25 (D.N.J. Aug. 8, 2011).

Courts have recognized that several people can "make" the same misstatement. *City of*

St. Clair Shores General Employees' Retirement Sys. v. Lender Processing Servs., Inc., 2012 WL 1080953, *3 (M.D. Fla. Mar. 30, 2012) (corporate officers "made" statements in SEC filings they certified under Sarbanes-Oxley); *City of Roseville Employees' Retirement Sys. v. EnergySolutions, Inc.*, 814 F. Supp. 2d 395, 417 n.9 (S.D.N.Y. 2011) (rejecting premise that only one person can "make" a misstatement and finding that defendants "made" statements in registration statements they signed). Here, the investor presentations were attributed to Hopkins by name. Div. Br. at 22. Even if it were necessary to show that Hopkins had ultimate control over the standard investor presentation slides, he had such control by virtue of his quarterly responsibility to review the slides for accuracy. DFF 160. Moreover, Hopkins reviewed the presentations before client meetings and *could have changed* the content of the presentations had he wanted. Div. Br. at 8. Finally, Hopkins specifically presented the Typical Slide orally during the May 10, 2007 National Jewish meeting. DFF 252-53.

Hopkins cites no case that supports his position. In *SEC v. Daifotis*, 2011 WL 3295139 (N.D. Cal. Aug. 1, 2011), the only case Hopkins cites, the court concluded that Daifotis "made" statements in advertisements that included both his photograph and a quote attributed to him. *Id.* at 3; *see also SEC v. Daifotis*, No. 3:11-cv-137, slip op. at 6-9 (N.D. Cal. June 12, 2012) (sustaining claims based on presentation slides used orally by defendant and which he had some involvement in creating).

2. *Janus* Does Not Apply to Section 17(a)(2).

Flannery half-heartedly argues that the hearing officer, relying on *SEC v. Kelly,* 2011 WL 4431161 (S.D.N.Y. Sept. 22, 2011), properly found that *Janus* applied to claims brought under Section 17(a)(2). Flannery Br. at 39-40. That is not the law. The clear weight of authority rejects *Kelly* and holds that *Janus* does not apply to Section 17(a)(2) claims. Div. Br. at 25.

These cases reason that *Janus* was limited to a textual analysis of the word "make" – a word contained within Rule 10b-5(b) but not Section 17(a). *See SEC v. Stoker*, 2012 WL 2017736, *8, n.8 (S.D.N.Y. June 6, 2012) (Rakoff) (citing weight of authority that *Janus* does not apply to Section 17(a)(2) and observing lack of analysis by the hearing officer in contrary finding). *Kelly* also ignored that the policy behind *Janus* – concern that a broad definition of the word "make" would improperly expand the scope of private suits – is inapplicable to Section 17(a), under which there is no private right of action. *Stoker*, 2012 WL 2017736, *8; *SEC v. Sentinel Mgmt., Inc.*, 2012 WL 1079961, *15 (N.D. Ill. Mar. 30, 2012).

E. Soliciting Investments for SSgA Satisfies Section 17(a)(2)'s "Obtaining Money or Property" Requirement.

Respondents argue that Section 17(a) requires the Division to prove that they personally obtained money or property; obtaining money for SSgA's funds was not enough. Flannery Br. at 33; Hopkins Br. at 34-35. *Stoker* rejected that contention and concluded that it was sufficient under Section 17(a)(2) for a defendant to obtain money or property for his employer while acting as its agent. 2012 WL 2017736, *5. The court observed that the statute does not state that a defendant must obtain money personally. Instead, all sections are preceded by the modifier "directly or indirectly." *Stoker* found it contrary to the statutory language and Congressional intent to narrow the statute. *Id.* at *6. The court also found it sufficient that defendant's material misstatements and omissions led to investments that would not have otherwise occurred. *Id.* Here Respondents obtained money for SSgA funds as a result of their misconduct. DFF 384.

F. Flannery Is Liable for Engaging in a Scheme and Course of Business to Defraud.

Flannery makes several circular and conclusory arguments to deflect the Division's scheme liability claims.[4] Flannery argues that a case premised only on misstatements or

[4] Flannery is correct that the Division's scheme and fraudulent course of business claims under Rule 10b-5(a) and

omissions cannot give rise to claims for scheme liability, and also claims that there is insufficient evidence establishing that he was involved in the aspects of the scheme that immediately preceded the July and August letters and made those letters misleading. Flannery Br. at 34-35. Specifically, Flannery contends that the Division's claim that he assisted in implementing the AAA bond sale to meet internal investor redemptions is "wholly unsupported by the evidence." *Id.* at n.24. However, ample evidence demonstrates that Flannery, as Chief Investment Officer, played a management role in SSgA's scheme to sell enough of LDBF's higher-quality subprime bonds to meet immediately-expected investor redemptions, and then to mislead investors who had not yet decided to redeem about LDBF's purported risk reduction efforts. DFF 275-310. Though Flannery now contends to the contrary (Flannery Br. at 14-15), there was no doubt in his mind at the time that LDBF would need to sell about 40% of LDBF's assets to meet client redemptions. DFF 282-83; 288. The goal of this scheme, and Flannery's participation in it, was to avoid selling LDBF's illiquid, lower-rated assets before the subprime crisis passed. Flannery understood that both his reputation, and that of SSgA's active fixed income business – for which LDBF was a "hallmark" fund – depended on it. DFF 54-61, 439, 442-43. Flannery also claims that the Division's scheme liability claims fail because the three investor letters were accurate. As discussed in section C above, the evidence demonstrates that those letters were misleading. Further, though Flannery contends that the Division's theory that the securities fraud statute should be read consistently with the mail and wire fraud statutes is not supported by any securities cases, he provides no rationale for why the Division's theory is not sound. Flannery Br. at 35.

(c) do not include his conduct relating to the August 14 letter. Flannery Br. at 1 n.1. That conduct does, however, form part of the basis for the Division's course of business claim under Section 17(a)(3) of the Securities Act.

In this context where the letters were a tool in a fiduciary's scheme that favored early redeemers over everyone else in an attempt to save Flannery's reputation, the cases cited by Flannery are irrelevant. For example, Flannery relies on Ninth Circuit precedent and *SEC v. Brown*, 740 F. Supp. 2d 148 (D.D.C. 2010) for the proposition that "[i]t is well-settled that cases premised only on misstatements or omissions cannot give rise to claims for 'scheme' liability." Flannery Br. at 34. This principle is hardly well-settled, much less supported by these cases. In *Brown*, the defendants made the same argument Flannery makes here, but the court found that the SEC's allegations *did* state a claim under Rule 10b-5(a) and (c). Similarly, the Ninth Circuit precedent cited by Flannery stands for the (irrelevant) proposition that 10b-5(a) and (c) claims cannot stand exclusively on the allegations supporting a 10b-5(b) claim. Here, not only were the misstatements part of a scheme and course of business to defraud that began with the July 25 Investment Committee meeting, but the Division is no longer pursuing a 10b-5(b) claim against Flannery. Therefore, the narrow holding from the Ninth Circuit cases that 10b-5(a) and (c) claims cannot rely on only the misstatement supporting a 10b-5(b) claim does not apply.

For example, *In re Coinstar Inc. Sec. Litig.*, 2011 WL 4712206, *11 (W.D. Wash. Oct. 6, 2011), followed *WPP Luxembourg v. Spot Runner, Inc.* 655 F.3d 1039, 1057 (9th Cir. 2011), the only other case cited by Flannery for his purportedly "well-settled" view of scheme liability, and held: "[s]ince the sole basis for Plaintiff's §10b–5(a) or (c) against [defendants] is based on allegations underpinning a §10b–5(b) claim, the Court DISMISSES the scheme liability claims against [defendants] for failure to state a claim." Even if the Division were asserting that Flannery's only role in a 10b-5(a) scheme or 10b-5(c) course of business was his involvement in the July 26 and August 2 letters, which it is not, this narrow precedent would not apply because Flannery's role in creating these letters is not claimed to violate 10b-5(b). On June 6, 2012,

Flannery offered additional authority for his scheme liability position: *Public Pension Fund Group v. KV Pharmaceutical Co.*, 2012 WL 1970226, *13 (8th Cir. June 4, 2012). That case simply applied the irrelevant *WPP Luxembourg* precedent, noting that "a scheme liability claim must be based on conduct beyond misrepresentations or omissions actionable under Rule 10b-5(b)." This narrow precedent is irrelevant because the Division: (1) has proven Flannery's role in conduct that preceded the July and August letters (*i.e.*, a decision that began with the July 25 Investment Committee meeting to favor early redeemers and lull everyone else to hold their investment); and (2) is not pursuing a 10b-5(b) claim against Flannery.

G. Respondents' Misleading Statements Were Material.

1. Misleading Information About a Portfolio's Content is Material.

Hopkins tries to escape responsibility for his numerous misleading statements from August 2006 through July 2007 regarding LDBF's exposure to subprime RMBS by arguing that information about LDBF's subprime exposure was not "material" until the subprime crisis flowered in the summer of 2007. Hopkins Br. at 23-24. To the contrary, misleading statements about the identity of an investment are fundamentally material. *See Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 182-83 (S.D.N.Y. 2010) (misrepresentations about nature of defendant's exposure to subprime and mortgage risk were material); *Fundamental Portfolio Advisors, Inc.*, 80 S.E.C. Docket 1851, 2003 WL 21658248, *11-12 (July 15, 2003) (misrepresentations about the nature of a portfolio's investments are material).

Moreover, courts have recognized that misleading disclosures regarding subprime exposure could be material much earlier than July 2007. *See Freudenberg*, 712 F. Supp. 2d at 177, 182 (misrepresentations in late 2006 were material); *In re Moneygram Int'l Inc. Sec. Litig.*, 626 F. Supp. 2d 947, 975 (D. Minn. 2009) (2006 10K and first half 2007 10Qs were potentially

materially misleading for failure to disclose exposure to subprime and Alt-A securities). These cases recognize, as the facts here demonstrate, that there were warning signs before July of 2007 regarding the risks of subprime exposure and investors would have cared about the extent of subprime exposure. *In re Moneygram*, 626 F. Supp. 2d at 975; *Freudenberg*, 712 F. Supp. 2d at 191.

2. Investor Sophistication is Not Part of a Materiality Analysis.

Contrary to Respondents' claims, the hearing officer erred when she found that investor sophistication was relevant to materiality. Hopkins Br. at 25-28; Flannery Br. at 40-41; ID 40, 46. The hearing officer erroneously relied on *private actions* holding that investor sophistication was relevant for reliance or scienter, not materiality. *See Myzel v. Cohen*, 386 F.2d 718, 735-36 (8th Cir. 1967); *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 891 (S.D.N.Y. 1986); *Martin v. Steuben*, 458 F. Supp. 88, 92-93, 97 (S.D. Ohio 1979). The only materiality case cited – *Seibert v. Sperry Rand Corp.*, 586 F.2d 949 (2d Cir. 1978) – did not hold that investor sophistication was relevant to materiality but, instead, held that information was not material because it was widely and publicly available, and therefore added nothing to the total mix of information available to investors. *Id.* at 951. The hearing officer did not cite a single case supporting her finding that investor sophistication is relevant for materiality.

Respondents attempt to rescue the analysis by citing two SEC insider trading cases to argue that investor sophistication is properly part of a materiality analysis, but neither case supports their position. Flannery Br at 41; Hopkins Br. at 27. In *SEC v. Rorech*, 720 F. Supp. 2d 367 (S.D.N.Y. 2010), the court found that the alleged inside information was not material because it was publicly available. *Id.* at 372. The case did not apply a different standard of materiality for "sophisticated investors." At most, by referencing the investors in the particular

market – high-yield bond traders – the court emphasized that the information was public to those investors. In *SEC v. Happ*, 392 F.3d 12 (1st Cir. 2004), the court determined that, because Happ was a member of the board who had additional non-public information about the company in whose shares he traded, a jury could reasonably find that a voicemail message to Happ that the company was having "some difficulties during the quarter" communicated material information. *Id.* at 21-22. The court did not sanction a departure from Supreme Court precedent that looks to the "reasonable investor" to determine materiality. *See Matrixx Initiatives Inc. v. Sirarcusano*, 131 S. Ct. 1309, 1318 (2011). Rather, it explained that, because of Happ's position, he could interpret the non-public information he was provided. *Happ*, 392 F.3d at 21-22.

To the extent that courts have wrapped reliance into a materiality analysis, they have done so in private rights of actions where reliance is an element, as it is in common law fraud. *See In re McKesson HBOC, Inc Sec. Litig.,* 12 F. Supp. 2d 1248, 1260 (N.D. Cal. 2000) (reasonable in proxy contest to determine whether investor would have changed investment decision for purposes of materiality where common law fraud considers justifiable reliance part of materiality and justifiable reliance part of causation). In contrast, reliance is not an element of a government enforcement action. *SEC v. Tambone*, 597 F.3d 436, 447 n.9 (1st Cir. 2010); *SEC v. Pirate Investor LLC*, 580 F.3d 233, 239 n.10 (4th Cir. 2009).

The hearing officer also erred by finding that "LDBF's investors were sophisticated, institutional investors, most of whom engaged investment consultants to provide investment assistance." ID 40. Contrary to Hopkins' argument, evidence supporting this finding was spotty at best, relying on the discredited opinion of experts, or off-handed statements by Flannery or a client relations person. ID 3, 33-44. For example, although expert Sirri opined that collective trust funds received an exemption from regulation because of investor sophistication, he

admitted that he did not know why those exemptions had been granted. Tr. 2114-15. To the extent that the experts opined that LDBF's investors were sophisticated, they relied on their review of a handful of documents; they had no contact with any investors nor did they review any documents or information from those investors. Tr. 2058-62; HX 161, App. B; Tr. 2986-87, 2995, 3005; HX 174, Ex. 2. The actual evidence indicated that investors were not always sophisticated as to fixed income. DFF 98, 107. Respondents' expert admitted that sophistication of the investors in LDBF varied. DFF 98. Hopkins also admitted that otherwise sophisticated investors might not know a lot about fixed income investing—the core of this action. DFF 107; Hopkins Resp. to DFF ¶107. Hopkins also admitted that consultants' experience in dealing with fixed income varied. *Id.* However, the hearing officer assumed sophistication across the board when she analyzed whether certain misstatements were material. ID 45, 46, 52.

H. Flannery Acted with Scienter and Was, at a Minimum, Negligent.

A significant portion of Flannery's argument that he should not be found liable for his actions turns on his purported good faith belief in the truthfulness of the three investor letters. Flannery Br. at 3, 30, 36. Flannery's self-serving assertion is contradicted by the facts he demonstrably knew, and whether he believed he was acting paternalistically in investors' best interests is irrelevant; he engaged in a course of conduct and a series of misleading statements that concealed the risk of LDBF after its most liquid and valuable assets were sold on July 26. DFF 275-443. Flannery's brief attempts to turn the issue of his scienter into one dependent on whether LDBF's investments were a good idea to begin with or whether others believed that the subprime crisis was temporary. Flannery Br. at 11, 29-32. This is a red herring. The claims involve what Flannery knew was being done, and encouraged, to manage a stream of significant redemptions by internally controlled and advised clients and what he obfuscated and concealed

in attempting to keep other investors in LDBF. Particularly in the context where SSgA and its managers, including Flannery, had fiduciary duties to treat all investors equitably, the decision to pay early redeemers with the proceeds from the AAA sale and to mislead remaining investors about their present risks, was fraud. *See SEC v. Cochran*, 214 F.3d 1261, 1265 (10th Cir. 2000); 29 U.S.C. §1002(21)(A) (ERISA fiduciary duty); Mass. Gen. Laws ch. 203A, §1 (common trust fund fiduciary duty); Hrg. Tr. 3290:10-12.

Flannery also contends that his reliance on the advice of others absolves him of scienter, both as a factual and a legal matter. Flannery Br. at 37-38. The Division disagrees. As a legal matter, the artificial distinction that Flannery seeks to draw between reliance as a factor negating scienter and the advice of counsel "defense" is utterly lacking in case law support. As a factual matter, the evidence is clear that the lawyers on whom Flannery claims to have relied to fix the misrepresentations and omissions in the client letters were actually relying on him and the investment team to get the letters' investment-related facts correct.[5] Neither the lawyers nor the client relationship managers understood either how LDBF's increased risks after the July 26 AAA sale. DFF 314, 317, 332-33, 346-57, 378-82, 405, 411-12, 418-19; Duggan Stip, Ex. A at 108-10.

I. The Requested Remedies Are Legally Proper and Should Be Imposed on Respondents.

Without parsing the four separate statutory bases for ordering penalties and bars against them, Respondents argue that the Division's request for penalties is improper because it requires retroactive application of Section 929P(a) of the Dodd-Frank Act. Not all retroactive application of Dodd-Frank is prohibited. The amendments at issue here, to Section 8A of the Securities Act

[5] The only reasonable inference from the facts is that Flannery personally added misleading statements to the August 2 letter about LDBF's average credit quality. DFF 373-83 (contradicting Flannery Br. at 2, 22). He thus engaged in at least two rounds of misleading behavior relating to that letter.

and Section 21B(a) of the Exchange Act, only permit remedies to be imposed in a new forum. Such amendments do not change substantive rights and thus may be applied retroactively.

Before Dodd Frank, the Commission had the authority to seek penalties in injunctive actions for primary violations of the Securities Act and the Exchange Act. Section 8A of the Securities Act and Section 21B(a) of the Exchange Act allow those same remedies in administrative actions. Courts have recognized that a new statute may apply retroactively when the statute only acts to confer or withdraw jurisdiction from a particular forum. In *Landgraf v. USI Film Products*, 511 U.S. 244, 273 (1994), the Supreme Court noted that it has regularly applied statutes that confer or oust jurisdiction in cases where the underlying controversy occurred before the provision's enactment because application of a new jurisdictional rule "usually takes away no substantive right but simply changes the tribunal that is to hear the case." *Id.* at 274. Courts have applied this principle where jurisdiction is transferred from an Article III court to an administrative tribunal. *See, e.g., Hallowell v. Commons*, 239 U.S. 506, 508 (1916) (upholding retroactive application of a statute transferring jurisdiction of probate disputes among American Indians from an Article III court to the Department of Interior); *see also Kolster v. INS*, 101 F.3d 785, 788 (1st Cir. 1996) (upholding retroactive application of statute stripping Article III courts of jurisdiction over appeals of deportation proceedings involving certain crimes, leaving final appeal to an administrative body). Because the Commission was able to seek penalties in district court against non-registered persons for violations of the Securities Act or the Exchange Act before passage of the Dodd-Frank Act, the ability to seek civil penalties for the same conduct in administrative proceedings does not change the nature or extent of a defendant's potential liability for conduct, only the forum in which the relief may be sought. The cases cited by Respondents are simply inapposite because they deal with the retroactive

application of different Dodd Frank provisions or reach no conclusions about whether Section 929P(a) is properly applied in a case like this. *See* Flannery Br. at 42; Hopkins Br. at 39.[6]

In any event, the Commission would have had the authority to impose penalties and bars in this case under Section 203(f) and (i) of the Advisers Act or Section 9(b) and (d) of the Investment Company Act regardless of the Dodd-Frank Act.

Section 9(d) of the Investment Company Act allows for a penalty in any proceeding instituted under Section 9(b) of that Act, which gives the Commission the authority to bar ***any person*** from affiliation with an investment adviser or investment company if he has willfully violated the Securities Act or the Exchange Act. Respondents both ignore the broad provisions of the Investment Company Act, and Flannery makes the irrelevant, conclusory statement that there is "no evidence" he performed advisory services for a registered investment company. Flannery Br. at 42; Hopkins Br. at 40. Being a person and willfully violating the Securities Act or the Exchange Act are the statutory requirements for imposing remedies under the Investment Company Act, not performing advisory services for a mutual fund.

The Commission may also impose bars and penalties on Respondents under Section 203 of the Advisers Act which provides (both before and after Dodd-Frank) that the Commission can impose a bar and penalty against any person associated with an investment adviser, including any employee of an investment adviser or any person directly or indirectly controlling an investment adviser. Both Respondents satisfy this standard. Flannery meets it because the portfolio managers of registered investment companies advised by SSgA Funds Management Inc. ("SSgA FM"), a registered investment adviser and a subsidiary of State Street Corporation, reported up to Flannery during the relevant time period. DFF 7. For example, in 2006 and 2007

[6] Hopkins miscites the pages of the Dodd Frank discussion in *SEC v. Daifotis*, 2011 WL 2183314, *12-14 (N.D. Cal. June 6, 2011). *Daifotis*, unlike this case, addresses Dodd Frank provisions affecting substantive rights.

Robert Pickett was both the lead portfolio manager of LDBF and the backup portfolio manager of the Yield Plus Fund, a registered fund advised by SSgA FM. *Id.* Pickett reported up to Flannery through two midlevel managers, Michael O'Hara and either Michael Wands or Paul Greff, who then reported to Flannery. *Id.* Similarly, Hopkins was once a product engineer for registered investment companies advised by SSgA FM and later supervised the product engineer who took on this role for all of SSgA FM's funds. DFF 21-22. While these facts are not required for remedies under the Investment Company Act, they clearly provide the basis for Advisers Act remedies.

CONCLUSION

For the reasons stated above, and in the Division's opening brief, the Division requests that the Commission find that Hopkins and Flannery willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and impose appropriate remedies as punishment.

Dated: June 13, 2012

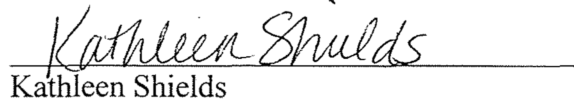
Respectfully submitted,

DIVISION OF ENFORCEMENT,
by its attorneys,

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

CERTIFICATE OF COMPLIANCE WITH COMMISSION RULE 450(D)

Pursuant to Commission Rule 450(d), I certify that the Division of Enforcement's Reply Brief in Support of its Petition for Review is 6,968 words, exclusive of the cover page, table of contents, table of authorities, this certificate and the certificate of service. This total was calculated using Microsoft Word 2007's word count function.



Kathleen Shields