**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

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**In the Matter of**

**JOHN P. FLANNERY, AND JAMES D. HOPKINS,**

**Respondents.**

**Administrative Proceeding File No. 3-14081**

**DIVISION OF ENFORCEMENT'S**
**PREHEARING BRIEF**

Respectfully submitted,
DIVISION OF ENFORCEMENT
By its attorneys:

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

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## INTRODUCTION

The Division of Enforcement (the "Division") alleges that, during the subprime mortgage crisis in 2007, State Street Bank and Trust Company ("State Street") and two of its employees, Respondents James D. Hopkins ("Hopkins") and John P. Flannery ("Flannery"), engaged in a course of business, and made material misrepresentations and omissions, that misled investors about the extent of subprime mortgage-backed securities held in certain unregistered funds under State Street's management.[1] This course of business and these misrepresentations caused the misled investors to continue to purchase or hold their investments in these funds. As a result of State Street's and the Respondents' conduct, investors in State Street's funds lost hundreds of millions of dollars during the subprime market meltdown in mid-2007.

State Street offered investments in certain collective trust funds to institutional investors, including pension funds, employee retirement plans, and charities. These funds included two substantially identical funds – referred to together as the Limited Duration Bond Fund (the "Fund") – made available to different categories of investors. State Street's actively managed bond funds, a commodity futures index fund, and other State Street Funds (collectively, "the Related Funds") also invested in the Fund. State Street established the Fund in 2002 and State

[1] State Street is a Massachusetts trust company and a bank that is a member of the Federal Reserve System. State Street Global Advisors ("SSgA"), which is not a legal entity, is the investment arm of State Street Corporation. SSgA's clients are investors in either unregistered funds managed by State Street or registered funds advised by SSgA Funds Management, Inc. ("SSgA FM"), a registered adviser for funds registered pursuant to the Investment Company Act. Both State Street and SSgA FM are subsidiaries of State Street Corporation. Because State Street is a bank, it relies on the exclusion from the definition of investment adviser contained in Section 202(a)(11) of the Investment Advisers Act of 1940. The unregistered collective trust funds State Street advises similarly rely on the exclusion from the definition of investment company under Section 3(c)(11) of the Investment Company Act. Because the funds that State Street advises are not investment companies and State Street is not an investment adviser, the Division does not allege that the Respondents violated the Advisers Act or the Investment Company Act directly. However, during their tenure with State Street, the Respondents were also associated with SSgA FM. SSgA FM's portfolio managers, and their managers, reported to Flannery, and Hopkins was the product engineer for certain registered funds advised by SSgA FM. Respondents' associations with SSgA FM during the period of their alleged misconduct involving State Street's unregistered funds provides the basis for instituting this action pursuant to Section 203(f) of the Advisers Act and Section 9(b) of the Investment Company Act. As discussed below, the Respondents' prior association with SSgA FM also provides an independent basis for ordering penalties and other

Street and Hopkins marketed the Fund as utilizing an "enhanced cash" investment strategy that was an alternative to a money market fund for certain types of investors. By 2007, however, the Fund was almost entirely invested in or exposed to subprime residential mortgage-backed securities and other subprime investments ("subprime investments"). Nonetheless, State Street and Hopkins continued to describe the Fund to prospective and current investors as having better sector diversification than a typical money market fund, while failing to disclose the extent of its exposure to subprime investments.

When the subprime market collapsed in mid-2007, many investors in the Fund and the Related Funds were unaware that the Fund had such significant exposure to subprime investments. The Fund's offering materials, such as quarterly fact sheets, presentations to current and prospective investors, and responses to investors' requests for proposal, all of which Hopkins was responsible for drafting or updating, contained misleading statements and/or omitted material information about the Fund's exposure to subprime investments and use of leverage. As a result, many investors either had no idea that the Fund held subprime investments and used leverage, or believed that the Fund had very modest exposure to subprime investments and used little or no leverage.

Beginning on July 26, 2007, State Street sent a series of letters to investors concerning the effect of the turmoil in the subprime market on the Fund and the Related Funds. These letters misled investors and again failed to disclose the Fund's concentration in subprime investments. Hopkins and Flannery played an instrumental role in drafting the misrepresentations in these letters. At the same time, State Street provided certain investors with

remedial action pursuant to the Advisers Act and the Investment Company Act.

accurate and more complete information about the Fund's subprime concentration. These privileged investors included clients of State Street's internal advisory groups. During 2007, State Street's Global Asset Allocation, or "GAA," advisory group became aware, based on internal discussions and internally available information, that the Fund was concentrated in subprime investments. In 2007, the head of GAA reported directly to Flannery. Also, before July 26, 2007, an investment manager in another internal advisory group called Office of the Fiduciary Advisor, or "OFA," also learned in a discussion about subprime led by Flannery that State Street was going to sell a significant amount of the Fund's distressed assets to meet major anticipated redemptions. On July 25 and 26, GAA and OFA decided to redeem their clients from the Fund and the Related Funds, or recommend such redemption. State Street Corporation's pension plan was one of the OFA clients advised to redeem. At the direction of Flannery and State Street's Investment Committee, State Street sold the Fund's most liquid holdings and used the cash it received from these sales to meet the redemption demands of better-informed investors, leaving the Fund with largely illiquid holdings.

Because Hopkins and Flannery made material misrepresentations and omitted material information that was needed to make the statements they made not misleading and/or engaged in acts, practices, or courses of business that were misleading and that operated as a fraud, they willfully violated Sections 17(a)(1), (2), and (3) of the Securities Act of 1933 ("Securities Act"), which prohibit fraudulent conduct in the offer and sale of securities, and Section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities. As a result, the Division requests that the Administrative Law Judge ("ALJ"):

(i) make findings that Respondents violated Section 17(a)(1), (2), and (3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

(ii) based on such findings, issue an order pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act requiring Respondents to cease and desist from committing or causing any future violations of Section 17(a)(1), (2), and (3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

(iii) require Respondents to pay an appropriate civil penalty pursuant to Section 8A of the Securities Act, Section 21B(a) of the Exchange Act, Section 203(i) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(d) of the Investment Company Act of 1940 ("Investment Company Act"), as a result of Respondents' willful violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

(iv) impose appropriate bars pursuant to Section 203(f) of the Advisers Act and Section 9(b) of the Investment Company Act prohibiting Respondents from associating with any investment adviser or registered investment company; and

(v) impose such other remedial relief as the ALJ deems appropriate.

## STATEMENT OF FACTS

The Division expects the evidence at the hearing to show:

### A. The Respondents

Hopkins joined State Street in 1998, and from approximately 2004 to 2007, Hopkins was the product engineer for the Fund, several Related Funds, and certain additional funds advised by SSgA FM. As a product engineer, Hopkins was the member of the State Street fixed income group who acted as the group's liaison with investors, investors' consultants, and State Street's client service representatives. In July 2008, State Street promoted Hopkins to head of product engineering for North America. Hopkins' employment with State Street ended when the Commission instituted this action.

Flannery began working for State Street in 1996, and, in January 2006, Flannery became SSgA's Chief Investment Officer of the Americas ("CIO"), a position he held until State Street terminated him in November 2007. The portfolio managers of the Fund, the Related Funds, and other fixed income funds advised by SSgA FM reported to managers in SSgA's fixed income group who reported to Flannery as CIO. GAA, one of State Street's advisory groups, also reported directly to Flannery. In 2007, Flannery was also a member of SSgA's Executive Management Group and SSgA's Investment Committee. The SSgA Executive Management Group was SSgA's most senior management group, was responsible for running SSgA's business, and was comprised of the Chairman of SSgA's Investment Committee and all the direct reports to SSgA's Chief Executive Officer. The SSgA Investment Committee, which was made up of SSgA's regional CIOs and the members of SSgA's major investment groups, including GAA and OFA, served a governance and control function for SSgA's funds, including the Fund and the Related Funds.

### B. Background – The Limited Duration Bond Fund ("the Fund")

State Street established the Fund in February 2002 as an actively-managed fund targeting a return of one-half to three-quarters of one percent per year over the London Inter-Bank Offer Rate ("LIBOR"), the interest rate that banks charge each other for short-term loans. Like a mutual fund governed by the Investment Company Act, the Fund offered daily redemptions, and investors purchased or sold units of the Fund based on the Fund's daily net asset value. However, as a bank-managed collective trust fund, State Street only offered the Fund and the Related Funds to institutional investors. At the end of June 2007, the Fund's assets had a market value of approximately $2.8 billion.

From 2002 until early 2007, the Fund consistently achieved its target performance by concentrating heavily in bonds backed by first lien mortgages to subprime borrowers. The Fund's consistent outperformance of its benchmark and low volatility resulted in State Street's decision to permit its portfolio managers of the Related Funds to invest up to 25% of those funds' assets in the Fund so those funds could beat their benchmarks. According to the Fund's offering materials, its minimum credit quality was BBB, but its average credit quality was always AA or AA+.

By 2006, as it became harder to achieve benchmark performance by investing in other segments of the bond market, State Street, under the direction of Flannery and those he supervised, decided to concentrate an even greater percentage of the Fund in subprime investments. Then, in 2006 and early 2007, State Street magnified the Fund's exposure to subprime investments by increasing the Fund's use of reverse repurchases, credit default swaps, and total return swaps tied to the performance of subprime investments. All of these investments had the effect of leveraging the Fund, and ultimately exposed the Fund to more risk and volatility.

### C. Hopkins' Misrepresentations Regarding Subprime Investments, Use of Derivatives, and Leverage in Offering Documents and Investor Communications in The First Half of 2007

In 2006 and 2007, as the product engineer responsible for the Fund and certain of the Related Funds, Hopkins was responsible for drafting and updating a number of offering documents and other communications about the Fund and Related Funds for current and prospective investors. These offering documents and other communications were misleading in a number of ways.

#### 1. Misstatements Relating to Sector Diversification

##### a. Quarterly Fact Sheets

In 2006 and 2007, Hopkins was the State Street product engineer responsible for updating quarterly fact sheets for the Fund. These fact sheets were marketing tools provided to prospective and current investors. During 2006 and 2007, the fact sheets stated that the Fund was sector-diversified and was an enhanced cash portfolio (or slightly more aggressive than a money market fund), when in reality by that time the Fund was concentrated in subprime bonds and derivatives tied to subprime bonds.

By at least February 2007, Hopkins knew that the Fund was concentrated in subprime investments and had an average credit quality that was lower than a money market fund. Hopkins also learned in the first half of 2007 that some investors and their State Street client service representatives believed that the Fund was sector diversified and not concentrated in subprime investments. Despite knowing that the quarterly fact sheets caused actual confusion, Hopkins *never* changed them to correct their misrepresentations even though he was responsible for their accuracy. Therefore, with regard to at least the Fund's 2007 fact sheets, Hopkins knowingly misled the Fund's investors and potential investors by causing State Street to send fact sheets to investors that contained false and misleading statements concerning the Fund's sector diversification and average credit quality.

**b. The "Typical" Slide in Investor Presentations**

In 2006 and 2007, Hopkins was also responsible for drafting or updating a set of standard slides that was frequently used in investor presentations about the Fund. He also frequently made these presentations directly to investors or their consultants. The standard presentation contained a slide describing the Fund's "typical" sector breakdown in a way that failed to disclose any exposure to subprime investments, and also indicated a greater level of sector diversification than actually existed at the time. Although the presentation stated that the Fund's "typical" exposure to "ABS" (asset-backed securities) was 55%, its actual investments during this time were almost all ABS, of which almost all was subprime ABS. Thus, the Fund's typical ABS exposure was never

55% during the time period. During that time, Hopkins knew that the "typical" sector breakdown shown in his presentations was not "typical" and was thus misleading. By continuing to use the "typical" exposure slide in his presentations to investors and causing others at State Street to use the slide by failing to update the standard slide with accurate information, Hopkins mislead investors. When Hopkins used the slide in 2007, he also knew it was false or misleading because he knew that the Fund had significant exposure to subprime derivatives that were not included in the sector breakdown on this slide.

**2. Misrepresentations Relating to Leverage**

In 2006 and 2007, Hopkins' Fund fact sheets and investor presentations also misrepresented the extent of the Fund's exposure to subprime investment risk, particularly the Fund's exposure to leveraged subprime investments. During this period, the Fund was leveraged through reverse repurchases on its subprime bonds and through derivative contracts derived from the performance of other subprime investments. The notional value of a derivative contract is the total value of the derivative contract's assets, and a small amount invested in a derivative contract often controls a much larger notional value. Therefore, where a portfolio of assets – like the Fund – includes derivative investments, a description of a portfolio's notional value relative to its market value may be necessary to determine a portfolio's exposure to leverage. The Fund fact sheets and investor presentations that Hopkins used or was responsible for drafting and/or updating failed to inform investors that the Fund's investment performance was tied to subprime and that its use of leverage magnified its subprime exposure.

In a standard slide that Hopkins presented to Fund investors, and that he was responsible for drafting and/or updating for others to present to Fund investors, Hopkins represented that one of the Fund's objectives was "[m]odest use of leverage to manage risk and enhance returns." However, in 2007, the Fund's use of leverage often resulted in exposure to the subprime market in excess of 150% of the Fund's market value. This is not "modest" leverage, and this level of leverage exposed the Fund to significant risks. Hopkins contemporaneously understood that this leverage exposed the Fund to significant risks. As a result of State Street's and Hopkins' misrepresentations regarding leverage, many of the Fund's investors and State Street's own client service personnel did not know the Fund's leveraged positions magnified its exposure to subprime investments until long after the Fund and the Related Funds began a precipitous decline in mid-2007.

### 3. Misleading Client Communications in the First Half of 2007

After a brief period of subprime market turmoil in February 2007, Hopkins drafted an internal alert to State Street's client service personnel concerning the subprime market and the Fund. Hopkins and others adapted the internal alert into a nearly identical letter that State Street sent to some investors in the Fund and the Related Funds in early March 2007. At the time, Hopkins was aware that the Fund's investments were virtually all subprime. However, the internal alert and letter stated that the Fund's recent underperformance was caused by the Fund's "modest" position in the lowest rated tranche of the ABX index, which represented credit default swaps on 20 different subprime investments rated BBB. The internal alert and March letter omitted that, besides the Fund's relatively small position in the BBB-rated ABX investment, the Fund was concentrated in subprime bonds and other subprime derivative investments.

Similarly, in various presentations to investors from April to June 2007, Hopkins represented that State Street had reduced its exposure to the BBB-rated ABX investment.

Hopkins' presentations concerning the Fund continued to make this representation even after he learned on April 25 that State Street had recently doubled the size of its BBB-rated ABX investment after reducing it in February and March.

As a result of Hopkins' communications to investors in the first half of 2007, many of State Street's client service personnel and investors in the Fund believed that the Fund's relatively small BBB-rated subprime investment was the Fund's only subprime investment. Some of these investors and client service personnel expressed their misunderstanding to Hopkins, but Hopkins did nothing to correct his and State Street's earlier misrepresentations to investors. Instead, in July 2007, Hopkins sought to strengthen State Street's statements about its risk controls while omitting the fact that the Fund was materially underperforming because of its concentration in higher rated subprime investments, a fact that Hopkins was aware of, and knew or should have known that many investors did not understand.

### D. The July 25 Investment Committee Meeting

Major investment decisions within SSgA were approved by an Investment Committee made up of SSgA's regional CIOs and the heads of SSgA's various investment groups, including GAA and OFA. On the morning of July 25, the Investment Committee met to consider, among other issues, what to do about the dramatic negative performance in a number of fixed income strategies as a result of the crisis in the subprime market. Flannery led the confidential discussion that addressed significant concerns about the liquidity of many of the Fund's investments, and how sales of the Fund's highest rated assets combined with significant investor redemption requests would affect investors who remained in the Fund. Draft minutes of the meeting reflect that Flannery stated that State Street needed to raise 30-40% liquidity in the Fund by the end of the month to meet redemptions that were estimated at 25-50% of the fund. The Committee, including Flannery and the head of OFA, voted unanimously to direct the portfolio managers of the Fund to sell assets to meet anticipated investor redemptions of 25-50% by month end.

The Fund's portfolio manager attended the July 25 Investment Committee meeting and understood that the Committee was directing him to sell virtually all of the Fund's highest rated AAA bonds. The Fund's portfolio manager worked with State Street's head fixed income trader on July 26 to carry out the AAA bond sale, which those involved in the sale considered one of the biggest bond sales State Street had ever done. As a result of the Investment Committee's directions, State Street sold almost all of the Fund's AAA-rated bonds to meet investor redemptions.

During this same period, the Fund experienced significant redemption requests by more informed investors, including redemptions by clients of State Street's internal advisory groups and by the Related Funds. Through redemptions, State Street depleted the cash it raised from the sale of the AAA bonds at a much faster rate than it sold the Fund's lower-rated bonds. From the beginning, the very purpose of the AAA bond sale on July 26 was to raise cash to meet the redemptions Flannery and the other Committee members anticipated. Therefore, after State Street met the redemption demands of the Fund's more informed shareholders, the average credit quality of the Fund's remaining bonds decreased because its highest rated bonds had been sold. A chronology about the Fund prepared by the Fund's portfolio managers and sent to Flannery and Hopkins on August 2 stated "[The Fund's] sale in late July of approximately $1.6 billion on short AAA securities (to meet anticipated demands for liquidity) was done at an average spread. . . ."

**E. Fund Redemptions by State Street's Internal Advisory Groups And The Related Funds**

Beginning in mid-June 2007, as the market for the Fund's subprime investments was in crisis, the Fund began a precipitous decline in value. In late July 2007, GAA and OFA recommended to their clients that they withdraw from the Fund and the Related Funds while State Street encouraged others to stay invested and to continue to invest. GAA and OFA decided to redeem based on their awareness of the Fund's exposure to subprime investments and other problems with the Fund that had not been fully disclosed to other investors, such as State Street's need to sell a significant percentage of the Fund's subprime investments in an illiquid market in order to meet anticipated investor redemptions. One of the OFA clients that redeemed was State Street Corporation's Defined Benefit Plan. In addition to the redemptions by advisory group clients, State Street's Related Funds that invested in the Fund also redeemed their shares of the Fund, contributing significantly to the Fund's need to sell assets in a stressed market to meet redemption demands.

By at least July 27, Flannery was aware that OFA had decided to redeem or recommend redemption of the Fund.[2] An OFA representative was present at the July 25 Investment Committee meeting and listened to the subprime discussion led by Flannery. Then, on July 27, another representative of OFA called Flannery to tell him that OFA had decided to recommend that its clients redeem from the Fund effective August 1. Flannery responded that OFA's clients could redeem for cash before August 1.

[2] The advisory groups had discretionary authority to act on behalf of some of their clients, while for other clients, the advisory groups only made recommendations which the clients could decide to accept or

Flannery also knew about GAA's decision to redeem at least by August 1. Flannery led a confidential discussion about subprime and the Fund at an SSgA Investment Committee meeting on the morning of July 25. At the beginning of the discussion, GAA's chief, who reported directly to Flannery, left the meeting after stating that because his clients were invested in the Fund, he wanted to avoid any appearance of bias or impropriety. A few hours after the Investment Committee meeting, the GAA manager met with Flannery, who was his boss at the time. Flannery instructed the GAA manager not to discuss GAA's decision to redeem from the Fund and the Related Funds with him because he wanted to make sure GAA acted independently. A few days later, on August 1, Flannery received a document called "Frequently Asked Questions Sub-Prime/Active Fixed Income Issues" with a question and answer explicitly stating that GAA was "recommending a move to passive fixed income" (i.e. out of the Fund). Flannery's own handwritten notes also show that he knew of GAA's decision by August 6.

### F. Communications To Investors About The Fund

At the same time that State Street was preparing to redeem its internal advisory group clients' and the Related Funds' investments in the Fund, State Street began sending a series of letters to all other investors in the Fund and the Related Funds. These letters continued to mislead outside investors by omitting material information about the Fund and the Related Funds, including information State Street had made available to its internal advisory groups and to the portfolio managers of the Related Funds. Hopkins and Flannery played an instrumental role in the misrepresentations in these letters, which had the effect of causing the misled investors to continue to purchase or continue to hold their investments in the Fund and the Related Funds. As Flannery

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reject.

observed in his investigative testimony: "when you hold illiquid positions in an illiquid market, it is generally not advantageous to telegraph that holdings, that view. I don't think most investment managers would be specific about that exposure."

### 1. State Street's July 26 Letter

On July 2, 2007, Hopkins circulated an internal communication to State Street's client service personnel describing how the subprime market situation had caused recent underperformance of the Fund and stating that the cause of substantial underperformance in the month of June was the Fund's BBB-rated ABX subprime investment. By July 11, 2007, Flannery and others were revising the internal communication into an investor letter. The letter was not finalized until July 26, 2007, and the final form of the letter was much less detailed than the internal alert.

State Street's July 26 five-paragraph letter to investors disclosed little more than the fact that recent events in the subprime market "are impacting performance in some of our active fixed income portfolios in which you are invested directly or indirectly." The letter omitted that:

- the Fund was concentrated in subprime bonds;
- the Fund was leveraged through other subprime investments; and
- the Fund's highest rated assets were being sold to meet investor redemptions.

The purpose of the letter was to update investors on how the subprime market was affecting their investments, and these missing facts were essential to that message.

As for State Street's view of the subprime situation and what it would do in response to the situation, the letter stated:

> We believe that what has occurred in June, and thus far in July, has been more driven by liquidity and leverage issues than long term fundamentals... 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.

At the time State Street made this statement, it was selling the Fund's highest rated bonds, resulting in a Fund that held bonds of lower average credit quality for investors who remained in the Fund after the anticipated redemptions. State Street's Investment Committee had ordered this sale precisely to meet anticipated investor redemption requests.

Hopkins knew or was reckless in not knowing that the July 26 letter omitted the material information that the Fund was concentrated in subprime. Hopkins knew -- by at least July 18 -- that the Fund was concentrated in AA and AAA-rated subprime investments that were materially underperforming. Hopkins was also then aware that at least some investors and client service personnel believed that the Fund's only subprime exposure was the relatively small BBB-rated ABX investment that Hopkins had highlighted earlier in the year in two letters and various investor presentations about the Fund. Nonetheless, on July 24, Hopkins commented on a draft of the July 26 letter that omitted the information that the Fund was concentrated in subprime investments and the Fund's concentration in higher rated subprime investments was causing its material underperformance. In his comments, Hopkins suggested that the letter highlight that "we have in fact lessened our exposure to the subprime sector in many of these portfolios and we are continuing our analysis in terms of further risk reduction." Once again, Hopkins wanted to focus on what State Street had done with respect to the BBB-rated ABX investment while omitting two key facts he knew - that the Fund's other subprime investments made up more than 90% of the Fund and were causing its material underperformance. In suggesting his edit, which gave rise to the risk reduction language in the final version of the July 26 letter, Hopkins knowingly misled investors.

Hopkins was in a unique position to understand that many investors were unaware of what was driving the Fund's risks and underperformance, but he failed to provide that information. Instead, he suggested an edit to the letter that he knew would lull investors to stay in the Fund because they would remain uninformed about the Fund's subprime investment concentration and the significant risks of continuing to invest in the Fund.

In conjunction with the July 26 letter, State Street's fixed income group provided client service personnel with answers to Frequently Asked Questions (FAQs) concerning the subprime situation. On July 26, 2007, State Street's client service group met to discuss the communication plan, including the July 26 letter and the "rules of the road and FAQs." Right after that meeting, State Street distributed the first set of FAQs to its client service personnel with the instruction that the FAQs were "to assist you with client/consultant questions" but were "for internal use only" and should only be used for oral discussions with investors. As they developed, the FAQs were far more comprehensive than the July 26 letter, and enabled State Street's client service personnel to disclose material information to certain investors, including that the Fund was concentrated in subprime investments and that State Street's largest internal advisory group (GAA) had decided to redeem out of the Fund and the Related Funds. Many investors who received information from the FAQs redeemed their investments shortly after receiving the information. In July and early August, in response to requests from certain investors or their outside consultants, State Street also provided the Fund's holdings and disclosed the fact that State Street had decided to reprice some of the Fund's securities to reflect market prices that were lower than the vendor prices State Street had been using to arrive at the Fund's net asset value. All but one of these investors immediately sold their investments before the Fund experienced its most significant losses in August.

**2. State Street's August 2 Letter**

On August 2, 2007, State Street asked its client service personnel to send another form letter to all affected investors concerning the subprime situation and preliminary July performance returns. That letter did not disclose the information that State Street had provided to its internal advisory groups, the portfolio managers of the Related Funds, and certain other investors who requested the information. Also, in the August 2 letter, State Street again stated it had taken actions to reduce risk while maintaining the Fund's average credit quality:

> Additionally, the downdraft in valuations has had a significant impact on the risk profile of our portfolios, prompting us to take steps to seek to reduce risk across the affected portfolios. To date, in the Limited Duration Bond Strategy, we have reduced a significant portion of our BBB-rated securities and we have sold a significant amount of our AAA-rated cash positions. Additionally, AAA-rated exposure has been reduced as some total return swaps rolled off at month end. Throughout this period, the Strategy has maintained and continues to be AA in average credit quality according to SSgA's internal portfolio analytics. The actions we have taken to date in the Limited Duration Bond Strategy simultaneously reduced risk in other SSgA active fixed income and active derivative-based strategies.

These statements were misleading. On July 26, State Street had sold almost all of the Fund's highest rated AAA subprime bonds, and, after meeting investor redemptions in late July and early August, the Fund's bonds were increasingly lower credit quality (almost all AA-rated instead of half AA and half AAA). The lower rated AA bonds were much less liquid than the AAA-rated bonds State Street had already sold, so those investors who remained in the dark concerning the Fund's risks invested, or continued to hold their investment, in the Fund as it became concentrated in lower-rated and largely illiquid subprime investments.

On August 1, Flannery provided written edits to a draft of the August 2 letter. His edits failed to correct the letter's statements concerning actions State Street had taken to reduce risk in the Fund and, in fact, revised those statements to make them more misleading. Flannery's edits display his awareness of State Street's sale of the Fund's AAA-rated bonds on July 26 and his intent to soothe clients' fears by claiming that the sale reduced investors' risk. Flannery did not correct the letter to acknowledge that State Street's actions increased the riskiness of the Fund's remaining assets by disposing of the highest quality bonds and then disposing of the cash generated by those assets to fund client redemptions. Instead of using his unique knowledge concerning the Investment Committee's reason for authorizing the AAA bond sale – anticipated redemptions by better-informed investors – and his expertise concerning the illiquidity of the Fund's assets to inform investors about the risks they now faced, Flannery provided false assurances that he hoped would cause investors to wait until the market crisis passed.

There is also evidence that, on August 2, 2007, Flannery added the second to last sentence of the "actions taken" section quoted above. On both August 1 and August 2, Flannery's edits to the August 2 letter emphasized what State Street had already done (as opposed to what State Street intended to do) and asserted misleadingly that these actions reduced risk. Even if technically accurate, Flannery's edit stating that the Fund's average credit quality continued to be AA was significantly misleading. From the end of June 2007 to the end of July 2007, the AAA bonds in the non-ERISA version of the Fund went from 53.9% of the Fund's market value to .6% of the Fund's market value, and, over the same period, the AAA bonds in the ERISA version of the Fund went from 70.63% of the Fund's market value to 4.61%. The "internal portfolio analytics" were able to mask these changes because *both the non-ERISA and ERISA versions of the Fund had more than a $1 billion notional position in AAA rated total* *return swaps on subprime bonds at the end of June and July 2007.* These total return swaps had a market value of zero. In fact, State Street ultimately had to pay money to its counter-party to back out of some of the swaps before they expired. Because only the Fund's bonds could be sold to meet investors' redemptions, and State Street had sold virtually all of the Fund's liquid bonds on July 26, it was misleading to lull investors into believing that the Fund's average credit quality had not changed. None of these facts were disclosed to investors in the August 2 letter even though Flannery was aware of all of them when he revised the letter to make it even more misleading.

**3. Flannery's August 14 Letter**

On August 14, 2007, Flannery signed a letter concerning the subprime situation that State Street sent to investors in the Fund and the Related Funds. This letter represented that State Street believed investors should not redeem from the Fund and the Related Funds: "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."

While advising investors to continue to hold their investments in the Fund and Related Funds, the letter omitted key information that certain privileged investors -- who had already decided to redeem -- had learned. The letter did not disclose the illiquid nature of the Fund's remaining investments or disclose that the Fund's exposure to subprime investments was actually magnified through the use of credit default swaps, total return swaps, and reverse repurchases tied to subprime investments. Just as this information was important for the advisory groups, the Related Funds, and certain other investors to make informed investment decisions, this information was necessary for the investors who were still invested in the Fund to decide whether to continue to hold their positions.

Furthermore, the letter's statement that State Street believed judicious investors would continue to hold their investments omitted that, as Flannery was aware, State Street had already caused the Related Funds to redeem their interests in the Fund, and State Street's internal advisory groups (one of which even reported to Flannery) had already recommended that their clients exit the Fund and Related Funds. Flannery misled investors by making a statement that State Street believed many judicious investors would hold their positions in the Fund while omitting that all of the Fund's shareholders controlled by State Street had taken directly contradictory actions and decided not to hold their positions in the Fund.

In addition, the August 14 letter omitted that State Street had already sold the Fund's most liquid investments and used the cash from those sales to satisfy other investors' redemptions. This was key information for investors to have. It is entirely reasonable that judicious investors (i.e., clients advised by State Street's advisory groups) may have wanted to redeem from the Fund when the Fund still had cash from the AAA bond sales, but they may no longer want to redeem when State Street would have to sell the Fund's illiquid holdings to meet their redemption requests. Because it omits the basis for his belief that judicious investors would hold their investment (all the more liquid assets had already been sold, the cash from those sales had been redeemed, and further sales would receive distressed pricing), Flannery's statement was misleading.

Flannery will likely argue that he is shielded from liability because the misleading language was drafted by an attorney and not by him. On August 7, a State Street in-house attorney revised Flannery's initial draft of the sentence at issue to make it less misleading. As a result of the attorney's edit, the sentence changed from "our advice is to hold. . . " to "we believe that many judicious investors will hold. . . ." Flannery never discussed with the attorney whether this sentence was appropriate in light of the decisions to redeem made by the Related Funds or State Street's advisory groups. Instead, the attorney testified that he explained to Flannery that he suggested the edit because "I didn't think [Flannery] or [State Street] was normally in the position of giving that type of advice, and this was another way we could say the same thing without disturbing his language, kind of what he wanted to say to clients in providing them the information that they would need to make their own decisions." The advice of counsel defense thus provides no shelter for Flannery's own misleading statements.

## LEGAL THEORY

### Flannery and Hopkins Violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder.

Together, Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit fraud in connection with securities transactions. To demonstrate a violation of these antifraud provisions, the Division must establish that, in the offer or sale of a security (under Section 17(a)), or in connection with the purchase or sale of a security (under Section 10(b) and Rule 10b-5), a party has made an untrue statement of material fact or has omitted a material fact that is necessary to make a statement not misleading or has engaged in an act, practice or course of conduct that is misleading and operates as a fraud. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 235 n.13 (1988) (Section 10(b) of the Exchange Act and Rule 10b-5); *United States v. Naftalin*, 441 U.S. 768, 772, 778 (1979) (Section 17(a) of the Securities Act). The Division must establish scienter to prove a violation of Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act, but scienter is not required to prove a violation of

Sections 17(a)(2) and (3) of the Securities Act. *See Aaron v. SEC,* 446 U.S. 680, 697 (1980). The Division will present evidence concerning the conduct of Hopkins and Flannery that satisfies each of those elements.

A. **<u>The Respondents' Misrepresentations Were In Connection With The Purchase or Sale of a Security And in the Offer or Sale of a Security.</u>**

First, Hopkins' and Flannery's misrepresentations and omissions were made in connection with securities transactions. The "in connection with" requirement of Section 10(b) and Rule 10b-5 is satisfied if the fraud touches upon a securities transaction. *See SEC v. Zandford,* 535 U.S. 813, 819-20 (2002). Their statements were part of the offering documents provided to investors and potential investors in the Fund and Related Funds, were part of routine updates to investors that were necessary to retain investments in the Fund and Related Funds, and were sent to investors in an attempt to ease investors' concerns about the Fund and Related Funds, and thus discourage redemptions. Their misrepresentations thus occurred both in the context of investors who continued to hold their investments and in the context of investors who continued to purchase shares of the Fund and the Related Funds after they received the misrepresentations.[3]

Second, Hopkins' and Flannery's misrepresentations and omissions were made in the offer or sale of a security as those terms are understood in the context of Section 17(a) of the Securities Act. The Supreme Court defines the terms "in," "offer" and "sale" broadly. *See Naftalin,* 441 U.S. 768, 773 (1979) (applying Section 17(a) to a defrauded broker and finding

[3] In addition to $5,836,901 in dividend reinvestments in the Fund on September 28, 2007, there were purchases of the Fund after the July 26, August 2 and August 14 letters: 1) the purchase of 20,080 shares on July 31, 2007 for a total of $171,966, 2) the purchase of 7,979 shares on August 3, 2007 for a total of $78,671, and 3) the purchase of 2,828 shares on August 16, 2007 for a total of $18,158.

that "[t]he statutory terms ['in,' 'offer,' and 'sale'] Congress expressly intended to define broadly, are expansive enough to encompass the entire selling process...") (citing *SEC v. National Securities, Inc.*, 393 U.S. 453, 467 n.8 (1969)). The Supreme Court has also rejected the argument that Section 17(a) should be limited to fraud in registration statements and offering documents. *Naftalin*, 441 U.S. at 777-78 ("Unlike much of the rest of the [Securities Act], [Section 17(a)] was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading."). The evidence at the hearing will demonstrate that State Street continued to offer and sell the Fund and the Related Funds to investors after the misrepresentations were made, and that some investors received the Respondents' misleading statements, including the July 26, August 2 and August 14 letters, and then made purchases of the Fund after receiving the statements. Thus, the Respondents' misrepresentations were in the offer and sale of a security as these terms are broadly understood by the courts. *See, e.g., SEC v. Wolfson*, 539 F.3d 1249, 1263 (10th Cir. 2008) (a misrepresentation is "in the offer or sale" of securities under Section 17(a) "because the relevant misstatements were contained in filings available to the public at the time [the entity the defendant worked for] offered and sold [a public company's] stock to overseas investors.").

Finally, under Section 17(a), Flannery and Hopkins were both offerors or sellers. In the context of a case against individuals, the offeror or seller requirement is satisfied where the defendant made the statement on behalf of his employer, which is in the process of selling the security. *See Wolfson*, 539 F.3d at 1263-64 (defendants "alternatively suggest that unless a defendant is an actual seller or offeror of securities, liability cannot attach under any of § 17(a)'s three subsections. We simply do not read § 17(a)'s nexus requirement so strictly, and neither have any of the courts that have considered the statute in misstatement cases."); *see also SEC v. Czarnik*, 2010 WL 4860678, *3 (S.D.N.Y. Nov. 29, 2010) ("...[S]ection 17(a) establishes broad anti-fraud prohibitions that are not limited to actual sellers of securities and can apply to persons 'who neither passed title nor solicited offers on behalf of securities issuers or sellers...'. [T]he statutory language of section 17(a) . . . is broad and does not impose a requirement that the defendant be an actual seller of securities.") (quoting *SEC v. Badian*, 2008 WL 3914872, *6 (S.D.N.Y. Aug. 22, 2008); *SEC v. Durgarian*, 477 F. Supp. 2d 342, 356 (D. Mass. 2007), *aff'd*, *SEC v. Papa*, 555 F.3d 31 (1st Cir. 2009) (finding Commission stated a §17(a) claim against defendants who engaged in fraud while working in operational and administrative roles for a mutual fund transfer agent); *In the Matter of Weiss*, Admin. Proc. File No. 3-11462, 2005 WL 3273381 (Dec. 2, 2005), *rev. denied*, 468 F.3d 849 (D.C. Cir. 2006) (finding bond counsel liable under §17(a)(2) and (3) for his misstatements and omissions concerning bond's eligibility for tax exemption).

**B. <u>The Respondents' Misrepresentations Were Material.</u>**

The facts misrepresented or omitted by Hopkins and Flannery in their communications with investors and potential investors were material. A fact is material if a reasonable investor would view its disclosure as significantly altering the total mix of information in evaluating the merits of the investment. *Basic*, 485 U.S. at 231-32. A fact is material if it "may affect the desire of investors to buy, sell, or hold the company's securities," or if it "in reasonable and objective contemplation might affect the value of the corporation's stock or securities." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). The information that Hopkins and Flannery provided in a misleading way, or failed to provide, touched upon key attributes affecting the risk, performance, composition and quality of the investments held by sophisticated institutional investors, who analyzed all of this information in determining whether to purchase and hold their investments in the Fund and Related Funds. The materiality of this information is clearly demonstrated by the fact that, once State Street made the truth available to many of these institutional investors, they decided to liquidate their holdings in the Fund and Related Funds. *See, e.g., SEC v. Mayhew*, 121 F.3d 44, 52 (2d Cir. 1997) ("a major factor in determining whether information was material is the importance attached to it by those who knew about it").

### C. Flannery and Hopkins Acted With Scienter.

#### 1. Scienter May be Established by Indirect Evidence of Extreme Recklessness

The Division must establish scienter to prove a violation of Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act, but scienter is not required to prove a violation of Sections 17(a)(2) and (3) of the Securities Act. *See Aaron,* 446 U.S. at 697. Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud". *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Scienter may be established by indirect evidence, and "may extend to a form of extreme recklessness[.]" *In re Cabletron Sys., Inc.*, 311 F.3d 11, 38 (1st Cir. 2002); *Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 74 (2d Cir. 2001), *cert. denied*, 534 U.S. 1071 (2001). "Reckless conduct is, at the least, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978).

After February 2007, Hopkins continued to describe the Fund as a sector diversified and enhanced cash fund, when the Fund was concentrated in subprime investments and leveraged. Also, each of the mid-2007 letters to investors omitted material information that was necessary to make the statements in those letters not misleading, including that the Fund was concentrated in subprime investments and leveraged through other subprime investments. The letters were also misleading because they reflected that State Street had a relatively bullish view on the subprime situation when, in fact, State Street's internal advisory groups had decided to redeem or recommend redemption from the Fund, the Related Funds had largely redeemed their investment in the Fund, and State Street was selling the Fund's most liquid assets not to reduce risk but to meet these and other anticipated investor redemptions.

In making misleading statements, Hopkins and Flannery acted with at least extreme recklessness. With respect to the offering materials and investor communications about the Fund's subprime investments in the first half of 2007, Hopkins drafted, used, or failed to update statements about the Fund's diversification, use of leverage, and exposure to subprime investments that he knew were misleading because they were either false or omitted material information about how the Fund was actually invested. Moreover, Hopkins continued to make misleading statements about the Fund even after he knew that some investors had inaccurate information about the Fund's exposure to subprime investments.

With respect to the July 26 letter, Hopkins was at least extremely reckless in omitting the fact that the Fund was concentrated in subprime investments. Hopkins knew the Fund was primarily invested in AA and AAA rated subprime investments that were having a materially negative effect on the performance of the Fund. Hopkins also knew that many investors in the Fund were either unaware of the Fund's concentration in these subprime investments or incorrectly understood that the Fund was not concentrated in subprime.

With respect to the August 2 letter, Flannery was a least extremely reckless in editing the letter to describe specific steps State Street had already taken to sell certain assets and misleadingly asserting that these actions reduced risk when he knew that State Street had sold the Fund's highest rated bonds to meet investor redemptions, resulting in a Fund that held bonds of lower average credit quality. As Chief Investment Officer, Flannery certainly knew that investors deciding whether to continue to hold their investments or make additional purchases would attach significance to whether State Street had reduced the funds' risk, and his efforts to misrepresent the facts concerning whether State Street had reduced risk for those who remained in the funds demonstrates his scienter. *See SEC v. Nacchio*, 438 F. Supp. 2d 1266, 1282 (D. Col. 2006) ("The Complaint adequately alleges that [the CFO] knew that investors differentiated between revenue obtained from recurring transactions and revenue from non-recurring transactions, and that [the CFO] knew that non-recurring revenue... was being presented to investors as revenue derived from recurring sources. This is sufficient to allege that [the CFO] acted with the intent to deceive investors."). Finally, although motive is not required to establish scienter, the evidence at the hearing will demonstrate that Flannery had a motive to preserve his reputation and career by discouraging investor redemptions in the face of an increasingly illiquid market for subprime investments. This motive offers an explanation for Flannery's extreme recklessness in making misrepresentations concerning the funds' reduced risk.

2. **The Involvement of Counsel Does Not Negate the Respondents' Scienter.**

The involvement of counsel in reviewing the July 26 and August 2 letters does not negate the Respondents' scienter. Courts consider the claimed reliance on the advice of counsel as a factor relevant to a lack of scienter only where the defendant can show: 1) the defendant made a complete disclosure to counsel; 2) the defendant sought advice of counsel as to the legality of his conduct; 3) the defendant received advice from counsel that his conduct was legal; and 4) the defendant relied on the counsel's advice in good faith. *See Markowski v. SEC*, 34 F.3d 99, 104-105 (2d Cir. 1994); *see also United States v. Wenger*, 427 F.3d 840, 854 (10th Cir. 2005), *cert. denied*, 548 U.S. 913 (2006) (appellant could not rely on good faith reliance on counsel defense since he did not establish that he disclosed all relevant facts to his attorneys); *SEC v. Savoy Ind., Inc.*, 665 F.2d 1310, 1314 n.28 (D.C. Cir. 1981); A respondent must also demonstrate these elements in the context of an administrative proceeding. *See e.g., Charles F. Kirby*, Rel. No. ID-177, 2000 WL 1787908, *19 (Dec. 7, 2000) (J. Murray) (citing *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1101-02 (2d Cir. 1972) and *United States v. Custer Channel Wing Corp.*, 376 F.2d 675, 683 (4th Cir. 1967), *cert. denied*, 389 U.S. 850 (1967)); *WHX Corp.*, ID-173, 2000 WL 1482921, *20, n.20 (Oct. 6, 2000) (J. Foelak) (citing *C.E. Carlson v. SEC*, 859 F.2d 1429, 1436 (10th Cir. 1988) and *Savoy*); *William H. Gerhauser, Sr.*, Rel. No. 34-40639, 1998 WL 767092, *6 n.25 (Nov. 4, 1998) (citing *John Thomas Gabriel*, 51 S.E.C. 1285, 1292 (1994), *aff'd*, 60 F.3d 812 (2d Cir. 1995)) (Commission Opinion). In the investigation, State Street waived its attorney-client privilege with regard to the drafting of the mid-2007 letters to investors, and the record developed after State Street's privilege waiver revealed that the Respondents cannot prove any of these factors.

The Respondents' advice of counsel argument fails because Flannery and Hopkins did not make complete disclosures to counsel. They also did not seek advice, and were not given advice, concerning whether the statements they made were misleading in light of the material facts that the Division believes were omitted from the letters. With regard to the July 26 letter, Hopkins did not inform counsel of the relevant facts he knew were omitted from the letter, including the fact that the Fund's concentration in higher rated subprime investments was causing underperformance. Nor did Hopkins inform counsel that his risk reduction language was focused on State Street's modest efforts to reduce exposure to the Fund's lower rated subprime investments that were only a small percentage of the Fund. With regard to the August 2 letter, Flannery made no effort to ensure that the attorney who actually reviewed the August 2 letter, State Street's General Counsel Mitchell Shames, was aware of what happened at the July 25th Investment Committee meeting, or had any knowledge about how the AAA bond sales affected the riskiness of the Fund. Although another attorney attended the Investment Committee meeting, there is no evidence that attorney communicated with Attorney Shames about the meeting or the resulting decision to sell virtually all of the Fund's AAA-rated bonds. Flannery also made no effort to ensure that Shames was aware of facts concerning what investors already knew about the Fund or what the portfolio managers were actually doing to in response to anticipated liquidity demands.

Flannery and Hopkins cannot present a valid reliance on counsel defense by asserting that it might have been reasonable for either of them to assume that lawyers had sufficient information. Instead, the Respondents must have actually known that the attorneys reviewing the investor communications knew the same facts that the Respondents omitted from the communications. *See C.E. Carlson, Inc.*, 36 S.E.C. Docket 591, 1986 WL 72650, *3, n.16 (Sept. 11, 1986) (Commission Opinion) ("Respondents further contend that, even if they failed to make the necessary disclosure, [the in-house counsel "who assertedly approved the transactions in question"] possessed information from which he could have derived pertinent facts. However, respondents were not entitled to assume that [the in-house counsel's] advice was based on anything except the facts they specifically presented to him.") (citing Hamermesh, *The Reliance on Counsel Defense*, 18 Review of Securities and Commodities Regulation 240, 244 (Dec. 18, 1985)).

Next, just as the involvement of counsel does not negate scienter, good faith does not "constitute a defense to reckless or intentional conduct." *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *see also Cooper v. United States*, 834 F. Supp. 669, 672 (D.N.J. 1993), *aff'd*, 9 F.3d 1539 (3d Cir. 1993) (reliance must be "reasonable" and "cannot function as a substitute for compliance with an unambiguous statute").

Finally, even when it is applicable and properly established, courts treat good faith reliance on counsel not as an absolute or automatic defense, but only as a factor to be considered in determining the propriety of the relief sought. *See, e.g., SEC v. Goldfield Deep Mines Co.*, 758 F.2d 459, 467 (9th Cir. 1985) (citing *Savoy*, 665 F. 2d at 1314 n.28); *Arthur Lipper Corp. v. SEC*, 547 F.2d. 171, 181-182 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978) (reliance on counsel's advice goes not to violation, but to penalty); *Draney v. Wilson, Morton, Assaf & McElligott*, 592 F. Supp. 9, 11 (D. Ariz. 1984) ("[i]n reality, reliance on advice of counsel is not so much a defense for liability as it is a factor to be considered.") (citing *SEC v. Scott*, 565 F. Supp. 1513, 1535 (S.D.N.Y. 1983), *aff'd*, 734 F.2d 118 (2d Cir. 1984)). Likewise, in the context of an administrative hearing, good faith reliance on counsel is only a factor in determining the appropriate relief. *See, e.g., Monetta Fin'l Serv., Inc.*, 67 S.E.C. Docket 299, 1998 WL 275917, *1 (May 8, 1998) (J. Broder) ("in order to establish a defense of good faith reliance on the advice of counsel, the Movants must show that they (1) made a complete disclosure to counsel; (2) requested counsel's advice as to the legality of the contemplated action; (3) received advice that was legal; and (4) relied in good faith on that advice. Furthermore, even when this defense is established, said reliance 'does not operate as an automatic defense, but is only one factor to be considered in determining the propriety' of relief.") (citing *Savoy* and *Markowski*); *David M. Haber*, 59 S.E.C. Docket 46, 1995 WL 215272, *4 (April 5, 1995) (Commission Opinion) ("The defense of reliance on advice of counsel has a limited role. This defense usually is not available where intent is not an element of the violation. And, even when intent is an element, such reliance does not operate as an automatic defense, but is only one factor to be considered.") (citing *Savoy* and *New York & Foreign Sec. Corp.*, Rel. No. 34-33175 (Nov. 9, 1993)); *Gearhart & Otis, Inc.*, 42 S.E.C. 1, 1964 WL 66874, *20, *5, n.9 (June 2, 1964) (Commission Opinion) ("reliance on the advice of counsel does not negate willfulness," but "[s]uch reliance, however, has been taken into consideration in determining the nature of the sanction, if any, to be imposed in the public interest").

**D. <u>Flannery and Hopkins "Made" Misrepresentations.</u>**

The Division also expects that Respondents will argue that they cannot be held liable for making misrepresentations in fact sheets, presentations, letters to clients, and other communications with clients because they were not involved in "making" those statements as required by Rule 10b-5(b). Respondents may contend that they cannot be liable if others joined them in editing the statement at issue, or if the statement in the document is not publicly attributed to them. While the Division disagrees, at best, Respondents' argument would relieve them of liability under Rule 10b-5(b), which specifically states that a defendant must "make" an untrue statement or omission. The Division's claims under Section 17(a) and Rules 10b-5(a) and 5(c) are unaffected, as these claims do not require proof that Respondents "made" a misrepresentation.

Respondents' argument may be founded on *SEC v. Tambone*, 597 F.3d 436 (1st Cir. 2010), a recent First Circuit *en banc* case. *Tambone* addressed a narrow issue -- whether underwriters "made" a misstatement under Rule 10b-5(b) when they sent to clients a prospectus they had no part in drafting. *Id.* at 442. *Tambone* dismissed the Division's Rule 10b-5(b) claim because it found that dissemination *by itself* did not constitute "making" a misstatement. *See id.* at 442. Though there had been arguments in the district court about the level of the underwriters' participation in preparing the prospectuses, those facts and legal arguments were not before the First Circuit in either its panel or *en banc* decisions. *See id.* at 441. The *Tambone* decision specifically left open how much involvement in the preparation of a document was necessary for a person to have "made" a misstatement under Rule 10b-5(b), and did not address at all the proof required by Rules 10b-5(a) and (c). *See id.* at 441.

As a preliminary matter, *Tambone* is not controlling law in this Commission proceeding. Even if it were, however, *Tambone* is of little use to Respondents because it does not answer the question that determines Respondents' liability in the situation presented here – how much involvement in the preparation of a fraudulent statement is necessary to hold a person liable for violating Rule 10b-5(b). *Tambone* recognized that two divergent tests had developed to answer this question: the "substantial participation" test and the "bright line" test. *See id.* at 447. It did not select one of these tests, or create its own, as it determined that the underwriters' conduct did not constitute "making" a misstatement under any reasonable test. *See id.* at 447 Respondents, however, are liable under a proper reading of either test.[4]

Under the substantial participation test, a person's "substantial participation or intricate involvement in the preparation of a fraudulent statement' is enough to establish a primary violation." *Id.* (citing *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000)); *see also In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994), *cert. denied*, 516 U.S. 907 (1995) (accountants could be held primarily liable when they reviewed and played a significant role in drafting two letters sent by their client to the SEC). *Tambone* unhelpfully describes the bright line test, which developed in private securities litigation, as requiring that the "defendant must actually make a false or misleading statement in order to be held liable [as a primary violator] under section 10(b)." *See* 597 at 447 (quoting *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997)). *Tambone* concedes, however, that the attribution portion of the bright line test should not apply in an SEC enforcement case because the attribution prong reflects a private litigant's need to prove reliance – an element that the SEC need not prove in a Rule 10b-5 case. *See id.* at 447 n.9 (citing *Wolfson*, 539 F.3d at 1260); *see also SEC v. KPMG*, 412 F. Supp. 2d 349, 374-75 (S.D.N.Y. 2006).

The Division believes that it can establish a violation of Rule 10b-5(b) by showing that Respondents substantially participated in the drafting, editing and review of the misstatements at issue in this case, or were otherwise responsible for their content, even when the misstatements are not personally spoken or otherwise attributed to them. *See Howard*, 228 F.3d at 261 n.5.

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[4] Because *Tambone* did not adopt a standard for how much participation in the preparation of a statement is necessary to "make" a misstatement, Respondents may make arguments based on their reading of the tea leaves scattered by the Supreme Court Justices during oral argument in *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525 (December 7, 2010). Should the *Janus* decision address what it means to "make a misstatement," the parties will provide additional briefing at that time. Guessing about

Even if a more stringent standard were to apply, however, the Division believes it can demonstrate that Respondents caused the misstatement to occur. *See Wolfson,* 539 F.3d at 1260-61; *McConville v. SEC,* 465 F.3d 780, 786-87 (7th Cir. 2006), *cert. denied,* 552 U.S. 811 (2007) (causing a misstatement is sufficient for liability under Rule 10b-5(b)); *SEC v. May,* 648 F. Supp. 2d 70, 77 (D.D.C. 2009) (same); *KPMG,* 412 F. Supp. 2d at 374-75 (finding liability "so long as the SEC is able to show that the defendant was sufficiently responsible for the statement - in effect, caused the statement to be made - and knew or had reason to know that the statement would be disseminated to investors"). Allegations, like those here, that Respondents "reviewed, commented on, and approved" drafts of their employer's public statements are sufficient to show that they "made" a misstatement in those publicly-released documents under even the stricter test for evaluating Rule 10b-5(b) liability. *See SEC v. Brown,* 2010 WL 3786563, *16-17 (D.D.C. Sept. 27, 2010) (addressing misstatements in annual reports and proxy statements).

This case is analogous to *Wolfson,* in which the court found that a non-employee consultant "made a misstatement" when he drafted misleading public filings on behalf of a public company. 539 F.3d at 1261. The court reasoned that the consultant had been hired to draft the filings and thus had "caused" the misstatements that were ultimately disclosed to the public. *Id.* The court found that it was unnecessary to demonstrate that the consultant had directly communicated the misrepresentation to the public or that the filings had been publicly attributed to him. *See id.*; *see also KPMG,* 412 F. Supp. 2d at 374 (audit partners "made" alleged misstatement in audit opinions because, as the individuals ultimately responsible for the issuance of the audit opinion, they caused those misstatements to exist).

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what that opinion may contain is pointless.

In another analogous case decided after *Tambone*, the District of Massachusetts applied *Wolfson* and *KPMG* to determine whether the controller of a public company "made" misstatements under Rule 10b-5. *See SEC v. Forman*, 2010 WL 2367372, *4 (D. Mass. June 9, 2010). The controller sought summary judgment on the SEC's Rule 10b-5 claim, arguing that he did not "make" misstatements contained within public filings, press releases, and earnings releases because of his lack of involvement in creating and sending those statements. Although the controller prepared a first draft of the public filings, and circulated drafts for comments, others were involved in the final drafting of the public filings. The controller provided the numbers contained within the earnings press release but did not send the release out. Further, he provided the financial numbers discussed in the conference call, but he did not participate in the call. The court denied summary judgment as to all three categories of documents, finding that the controller's involvement in each of them was enough to "make a misstatement." *Id.* at * 4-5.

The Division will demonstrate that Respondents did not just disseminate documents over which they had no control and that others wholly prepared. Instead, the evidence will show that Respondents were responsible for the content of the documents at issue in this case, had the opportunity to edit them, and made significant edits on numerous occasions. Moreover, the evidence will demonstrate that Respondents knew that all categories of communications would be disseminated to clients. For all of these reasons, the narrow decision in *Tambone* does not relieve either Flannery or Hopkins of liability under Rule 10b-5(b).

## E. Flannery and Hopkins Were Negligent

To prevail on its claims under Section 17(a)(2) and (3) of the Securities Act, the Division need only establish that the Respondents were negligent in making each of the misrepresentations at issue. *See, e.g.*, *SEC v. Scott*, 565 F. Supp. 1513, 1525-26 (S.D.N.Y. 1983), *aff'd*, 734 F.2d 118 (2d Cir. 1984) ("The Commission can establish a violation of Sections 17(a)(2) or (a)(3) ... by showing merely that the [statement] was materially false and misleading and that defendants negligently caused those misrepresentations or omissions."). Section 17(a)(2) of the Securities Act makes it unlawful for any person in the offer or sale of any securities "to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in the circumstances under which they were made, not misleading." Section 17(a)(3) makes it unlawful for any person in the offer or sale of any securities "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

### 1. Flannery Was Negligent With Respect to the August 14 Letter Because He Failed to Make an Adequate Disclosure to Counsel Concerning The Misrepresentations in The Letter

First, reliance on counsel is not a defense to a non-scienter claim. *See Haber*, 1995 WL 215272, *4; *Louis Feldman*, 57 S.E.C. Docket 2512, 1994 WL 615120, *2 (Nov. 3, 1994) (Commission Opinion) ("Moreover, even if [Respondent] had made the requisite showing [of reliance on advice of counsel], the defense would be unavailable. A valid claim of reliance on counsel may defeat the element of scienter. Scienter is not an element of the Article III, Section I violation here.") (citing *Gary E. Bryant*, 54 S.E.C. Docket 431, 441 (May 24, 1993)).

Second, even if reliance on counsel were relevant to whether Flannery acted negligently, Flannery did not make an adequate disclosure to counsel to justify such reliance with regard to the August 14 letter. The evidence at the hearing will demonstrate that the August 14 letter was misleading because Flannery omitted to state the following material facts that he was aware of on August 14: (1) State Street's largest advisory group, GAA, which reported directly to

Flannery and had significant investments in the subprime funds, had redeemed or recommended that its investors redeem from the funds; (2) OFA, another State Street advisory group that advised investors in the funds, including State Street Corporation's pension plan, had decided to recommend redemption from the funds; and (3) the Fund was now concentrated in only illiquid subprime investments because State Street had sold the Fund's most liquid AAA cash bonds to meet anticipated investor redemptions. In contrast, Duggan was not aware of either (2) or (3) and even with regard to (1), Duggan erroneously believed that GAA's investors held only a very small part of the funds. Nor did Flannery have any basis for believing that Duggan was aware of either (2) or (3). OFA's decision to recommend redemption was not disseminated in FAQs and was not discussed with investors outside the OFA group. Flannery knew of OFA's decision because an OFA representative called Flannery on the telephone on July 27 to inform him of the group's decision to recommend redemption. No OFA representative called Duggan. Also, Flannery (not Duggan) tracked the asset sale following the July 25 Investment Committee meeting and Flannery understood that the huge asset sale was of the funds' most liquid securities. In sum, there is no reason to believe that Flannery reasonably believed Duggan was aware of all relevant facts that were omitted from the August 14 letter.

### 2. Hopkins and Flannery Obtained Money or Property by Means of Their Misrepresentations.

As Section 17(a)(2) requires, both Flannery and Hopkins "obtain[ed] money or property by means of" State Street's misstatements to investors in the Fund and the Related Funds. Nothing in the statutory language limits its applicability solely to situations where a respondent steals from defrauded investors, or obtains compensation directly from the fraud. Here, the evidence will demonstrate that Respondents' misrepresentations were in the offer or sale of securities to investors. State Street thus obtained investors' money as a result of Respondents' conduct. This alone is sufficient to satisfy the statutory requirement where, as here, Respondents made the misstatements in the course of their employment by State Street and with the purpose of benefitting their employer. *See SEC v. Delphi Corp.*, 2008 WL 4539519, *9, 20 (E.D. Mich. Oct. 8, 2008) ("Section 17(a)(2) does not require that the person alleged to have made the false or misleading statement in an offering document obtain money or property for them self. Rather, it is sufficient that the complaint alleges that [the defendant] made false statements to investors in connection with [his employer's] efforts to raise money through its public offerings."). Further, the evidence will demonstrate that both Respondents earned significant salaries and bonuses from State Street during the period of time that they were making their misstatements to investors in the Fund and the Related Funds, and those misstatements permitted them to keep earning those salaries and bonuses. *See Wolfson*, 539 F.3d at 1264 (finding that consultants obtained money or property under §17(a)(2) when they were paid for their services in preparing misleading public filings); *Weiss*, 2005 WL 3273381, at *12 (finding bond lawyer violated §17(a)(2) when he was paid to issue an opinion about the tax exempt nature of a bond issuance and the opinion was negligent).

### 3. Hopkins and Flannery Were Instrumental in State Street's Course of Business That Operated as a Fraud or Deceit Upon Purchasers of the Fund And The Related Funds

As the Division will prove at the hearing, Hopkins and Flannery engaged in a course of business that misled investors about the extent of subprime mortgage-backed securities held in certain unregistered funds under State Street's management. This course of business began with the offering materials Hopkins was responsible for and concluded with the mid-2007 letters to investors.

## ISSUES PRESENTED BY FLANNERY'S WITNESS AND EXHIBIT LISTS

Respondent Flannery's witness and exhibit lists disclose that a significant theme in his case will be that investments in the subprime mortgage sector were reasonable throughout most of 2007 and that the liquidity crisis that struck the subprime market in 2007 could not reasonably have been anticipated. As purported support for this theme, Flannery has indicated that he will seek to introduce approximately 30 speeches by government financial regulators and hear expert testimony on market conditions in 2007. All of this purported evidence is a classic red herring. The OIP does not charge Flannery with making a bad investment decision, or any other direct violations of the Investment Advisers Act. In fact, paragraph 11 of the OIP alleges the point Flannery will apparently go to great lengths to prove:

> Over the years, the Fund consistently achieved its target performance by heavily concentrating in bonds backed by first lien mortgages to subprime borrowers. The Fund's consistent outperformance of its benchmark and low volatility resulted in State Street's decision to permit its portfolio managers of the related funds to invest up to 25% of those funds' assets in the Fund so those funds could beat their benchmarks.

The OIP makes it clear that this case is about disclosure and misleading statements, and the OIP charges Flannery with misleading State Street's clients about the nature of their investment in violation of Section 17(a), Section 10(b) and Rule 10b-5 thereunder. Flannery should not be permitted to unduly extend the hearing by introducing repetitive evidence about an irrelevant issue. The proper focus of the hearing should be whether the Respondents should be liable for the fact that many investors in the Fund and the Related Funds were misled about the funds' subprime concentration and the steps State Street took in late July 2007 that exposed investors who remained in the funds to even greater risk. The wisdom of investing in subprime in 2007 is not an issue for this tribunal to decide.

## RELIEF REQUESTED

### A. <u>Each Respondent Should Be Ordered to Pay a Civil Penalty.</u>

Under Section 8A of the Securities Act, Section 21B of the Exchange Act, Section 203(i) of the Advisers Act and Section 9(d) of the Investment Company Act, the Commission may impose a civil monetary penalty if a respondent has willfully violated any provision of the Exchange Act, the Securities Act, or the rules and regulations thereunder. It must also find that such a penalty is in the public interest. Pursuant to Section 21B(c) of the Exchange Act, Section 203(i)(3) of the Advisors Act and 9(d)(3) of the Investment Company Act, in considering whether a penalty is in the public interest, the Commission may consider the following six factors: (1) fraud; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) need for deterrence; and (6) such other matters as justice may require.

Here, the Division expects to show that: (1) the Respondents committed fraud in willful violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by means of their misleading statements concerning the Fund and the Related Funds; (2) their conduct harmed the investors in the Fund and Related Funds; (3) there is a clear need for deterrence here because the Respondents were in a unique position to understand why their statements were misleading, investors in the Fund and Related Funds lost hundreds of millions of dollars as a result of the Respondents' misrepresentations, and the Respondents have refused to acknowledge any wrongdoing in this matter; and (4) penalties are appropriate to send a message that the Respondents' conduct will not be tolerated. For all these reasons, the Division will argue that a penalty is appropriate.

Where the violative act or omission at issue (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, and (2) directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act of omission, the Commission may impose a "third-tier" penalty of $130,000 for a natural person for each act or omission occurring after February 15, 2005 and on or before March 3, 2009. 17 C.F.R. §201.1001-.1004. Because the violations here involved fraud and resulted in substantial losses to investors, third-tier penalties of $130,000 are appropriate for both Flannery and Hopkins.

**B. <u>The ALJ Should Issue a Cease and Desist Order.</u>**

Section 8A of the Securities Act and Section 21C(a) of the Exchange Act authorize the Commission to impose a cease and desist order upon any person who "is violating, has violated, or is about to violate" any provision of the Securities Act or the Exchange Act or the rules and regulations thereunder. In determining whether a cease and desist order is appropriate, the Commission considers numerous factors, including the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his conduct, the respondent's opportunity to commit future violations, the degree of harm to investors, the extent to which the respondent was unjustly enriched, and the remedial function to be served by the cease-and-desist order in the context of other sanctions being sought. *WHX Corp. v. SEC*, 362 F.3d 854, 860 (D.C. Cir. 2004) (appeal of administrative cease and desist order); *KPMG v. SEC*, 289 F.3d 109, 124-25 (D.C. Cir. 2002) (same). "The risk of future violations required to support a cease-and-desist order is significantly less than that required for an injunction, and, absent evidence to the contrary, a single past violation ordinarily suffices to raise a sufficient risk of future violations." *Rodney R. Schoemann*, S.E.C. Rel. No. 9076, 2009 WL 3413043, *12-13 (Oct. 23, 2009), *aff'd*, 2010 WL 4366036 (D.C.Cir. Oct 13, 2010).

Here, the Division intends to show that Hopkins and Flannery committed egregious securities violations when they knowingly or recklessly made material misrepresentations to investors in the Fund and the Related Funds. The Respondents have not only failed to provide any assurances against future violations, they have refused to acknowledge that there ever was a violation. For these reasons, a cease-and-desist order is warranted.

### C. <u>The ALJ Should Impose Appropriate Bars on Hopkins and Flannery.</u>

Section 203(f) of the Advisers Act authorizes the Commission to bar or suspend a person from association with an investment adviser for willful violations of the Securities Act or the Exchange Act. The record will show that at the time they misrepresented facts concerning the Fund and the Related Funds, Hopkins and Flannery were associated with SSgA FM, a registered investment adviser, and were performing advisory related services with respect to the registered investment companies advised by SSgA FM. Section 9(b) of the Investment Company Act also authorizes the Commission to bar or suspend a person from serving in a variety of positions with a registered investment company as a sanction for willful violations of the Securities Act or the Exchange Act. As a result, the Division will request that the ALJ impose an appropriate bar once it has heard the evidence.

Respectfully submitted,

DIVISION OF ENFORCEMENT,
by its attorneys,

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

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