UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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

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<u>JOHN PATRICK ("SEAN") FLANNERY'S POST-HEARING MEMORANDUM</u>

(Redacted Version)

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I. INTRODUCTION

John Patrick ("Sean") Flannery submits this post-hearing brief.

This case arose out of the losses experienced by a fund managed by State Street Global Advisors ("SSgA") as a result of its exposure to housing-related asset backed securities during July and August 2007. Mr. Flannery, SSgA's Chief Investment Officer of the Americas, genuinely believed in the investment thesis supporting such exposure — a belief that was based upon the views of SSgA's Fixed Income experts — and the Division of Enforcement ("Division") does not challenge the sincerity of that view. The Division's case focuses solely on two letters sent by SSgA to investors in certain funds in August 2007.

At the time of these events, Mr. Flannery enjoyed a sterling reputation for honesty and integrity based upon his 27-year career in the investment business. The Division's unsupported theory is that during the first two weeks of August 2007, and for the only time in his career, Mr. Flannery sought to deceive investors. The evidence, however, demonstrates that Mr. Flannery acted reasonably, appropriately, and at all times sought to provide accurate information to investors.

The Division's case against Mr. Flannery is based entirely on his role with respect to two letters sent by SSgA to investors on August 2 and August 14, 2007.[1] As detailed more fully below, neither letter was false or misleading, and Mr. Flannery should be exonerated on that basis alone. Moreover, the letters were reviewed and approved by SSgA's lawyers, senior executives, and other employees with knowledge of the facts. With respect to the August 2 letter

[1] While the Division darkly alluded at the hearing to an unspecified course of conduct that it believes renders Mr. Flannery liable, the Order Instituting Proceedings ("OIP") alleges no misconduct by Mr. Flannery, other than in connection with the two letters. Similarly, the Division's Pre-Hearing Brief alleges no misconduct by Mr. Flannery beyond the two letters. Indeed, even at the Hearing, the Division still could not identify or articulate the claimed course of conduct beyond the two letters.

— which represents the only *scienter*-based charge against Mr. Flannery — Mr. Flannery's role was limited to one set of "suggested edits" to a letter that he neither drafted nor requested, and which was extensively reviewed and revised by others without his input prior to being finalized. In the end, Mr. Flannery's contribution to the August 2 letter was five innocuous words, as to which there can be no serious contention that those words provide a basis for a claim. Mr. Flannery did not violate §§ 17(a)(1)-(3) of the Securities Act and § 10(b) of the Exchange Act with respect to the August 2, 2007 letter.

With respect to the August 14 letter, it is undisputed that the sentence deemed objectionable by the Division was inserted by an SSgA attorney, who Mr. Flannery reasonably believed was well-versed in the relevant facts. Moreover, that letter — also vetted and approved by lawyers, senior executives and others at SSgA — was entirely accurate. Mr. Flannery's actions with respect to the August 14 letter were reasonable, and did not violate §§ 17(a)(2) and (3) of the Securities Act.

It is notable that the Division did not proffer even one investor claiming to have been misled by either letter. The investors in these unregistered funds were sophisticated institutions, often assisted by expert consultants. The absence of any evidence that investors were misled by the letters is consistent with Mr. Flannery's belief that the letters were accurate, and that the letters were not misleading.

II. PROPOSED FINDINGS OF FACT

A. Sean Flannery

1. Personal Background

Sean Flannery has been married for 26 years and has four children, one of whom, Ryan, died eight years ago in an automobile accident. Ryan's death had a profound effect on Mr. Flannery and is the most difficult thing he has ever endured. Testimony of John Patrick Flannery

("Flannery Tr.") at 1125:9-1126:13, 1127:1-12. Mr. Flannery, who has always led an honest and honorable life, testified that nothing would cause him to stray from who he is and from that which he holds most important. Flannery Tr. at 1125:20-1126:4. The record is replete with testimony from witnesses regarding Mr. Flannery's impeccable character, integrity, and honesty, both personally and professionally. *See, e.g.*, Testimony of Barbara Shegog ("Shegog Tr.") at 2820:23-2821:6 ("And that's what was best about Sean is he didn't do what was best for him or me, he did what was right."); Testimony of Patrick Armstrong ("Armstrong Tr.") at 2213:12-2214:16 (testifying that Mr. Flannery was always focused on being fair to clients, he always sought diverse opinions from those around him, and was one of the most honest individuals Mr. Armstrong has ever met); Testimony of Shawn Johnson ("Johnson Tr.") at 2381:1-2383:23 (Mr. Flannery is "one of the most honorable guys in the business, period."); March 24, 2011 Joint Stipulation Regarding Testimony of Mitchell Shames ("Shames Stipulation") at ¶ 2 (Mr. Flannery is an honest person of high integrity); March 15, 2011 Joint Stipulation Regarding Testimony of Mark J. Duggan ("Duggan Stipulation") at ¶ 2 (same); Testimony of Lawrence J. Carlson ("Carlson Tr.") at 2771:14-2772:9 (testifying that Mr. Flannery "is one of the most moral, ethical people that I'm aware of"); Testimony of Martha Donovan ("Donovan Tr.") at 1811:15-19; Testimony of Michael Wands ("Wands Tr.") at 2877:5-24; Testimony of James Hopkins ("Hopkins Tr.") at 549:22-558:18 (testifying that Mr. Flannery's management style and honesty played an important role in him deciding to go to work at SSgA); *see also* Testimony of Father Kevin J. O'Leary ("O'Leary Tr.") at 2965-81.

Indeed, the prospect of this enforcement action did not cause those who know Mr. Flannery to lose faith in him. For example, Mitchell Shames, SSgA's former General Counsel and a person intimately familiar with SSgA's subprime issues, insisted on going into business with Mr. Flannery even after Mr. Flannery received a Wells notice, because he did not believe that Mr. Flannery's actions violated any laws. Flannery Tr. at 1136:17-1138:2; Shames Tr. at 13:24-14:10, 50:16-54:01.[2] Similarly, Mr. Flannery, who is deeply religious, was nominated by Father Kevin O'Leary to become a Knight of the Order of the Holy Sepulchre, the highest papal chivalrous order of the Catholic Church. Flannery Tr. at 1130:4-1131:4. The OIP in this matter was filed while Mr. Flannery's investiture was pending, and notified Father O'Leary, who insisted on proceeding with Mr. Flannery's investiture into the Order because he knew that Mr. Flannery would never engage in the conduct alleged against him, and that the evidence would demonstrate his innocence. O'Leary Tr. at 2978:14-2979:21; Flannery Tr. at 1131:19-1132:10. In October 2010, Mr. Flannery was invested into the Order. Flannery Tr. at 1130:14-17.

For many years, Mr. Flannery has devoted himself to charitable and community service, including over twenty years of work for the Sunset Point Camp in Hull, Massachusetts, which works with poor and troubled children; fifteen years of service on the Advisory Board of Trustees of the Catholic Charities of Greater Boston; involvement in the Children's Chernobyl Project, which brought children suffering from radiation exposure to Boston for medical treatment and respite; service on the Board of the U.S. Fund for UNICEF since 2000, with a focus on maternal and infant childcare in developing countries; and service as a Senior Economic Advisor to the Massachusetts General Hospital's Division of Global Health and Human Rights. Flannery Tr. at 1127:18-1130:3.

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[2] "Shames Tr." refers to the investigative testimony of Mitchell Shames, stipulated portions of which are attached to the Shames Stipulation.

2. Professional Background

a. Career Prior to Joining SSgA

Prior to 2007, Sean Flannery had a long and impeccable career in the financial services industry. After college, Mr. Flannery was hired by Kenney & Branisel, selling bonds. Flannery Tr. at 767:4-14. Thereafter, he held a variety of sales jobs at different brokerage firms in Boston. *Id.* at 767:15-768:14. After nine years on the sell-side, Mr. Flannery joined the Boston Company in 1990 as a portfolio manager in the structured investment products division, where he managed primarily index bond portfolios. *Id.* at 768:21-769:4. In 1993, Mr. Flannery left the Boston Company for Scudder, Stevens & Clarke, where he managed insurance company assets for Scudder's insurance asset management group. *Id.* at 769:7-19.

b. Career at SSgA

Mr. Flannery joined SSgA in 1996 as Product Engineer for Global Fixed Income and after approximately 10 months, became the Head of Product Engineering. Flannery Tr. at 770:11-13, 779:7-12, 780:13-17. He held that position for seven years, until he became the Head of Global Fixed Income in 2003. *Id.* at 780:18-781:9. In that role, he was responsible for both cash and bond management globally. *Id.* at 781:10-12. While the managers of cash investments must comply with money market requirements and the limitations imposed by those requirements, fixed income investments are not limited by such requirements. Fixed income investors generally take on a greater level of risk in exchange for the possibility of greater returns, as compared with those invested in money market funds. *Id.* at 1142:5-1143:7.

In early 2005, Mr. Flannery was promoted to Chief Investment Officer of the Americas. *Id.* at 1143:19-23.

(i) Responsibilities as CIO

Mr. Flannery was responsible for overseeing strategy for all of SSgA's funds, with total assets under management of nearly $2 trillion in 2007. Flannery Tr. at 782:15-783:2, 1142:9-11, 1145:6-19, 1205:16-20; *see also id.* at 1144:14-1149:16 (discussing Division Ex. 90 at SSgA-SEC000060359), 1156:18-1158:5; Cross Examination Testimony of William Lyons ("Lyons Tr.")[3] at 1853:7-12. SSgA was the largest institutional investment manager in the world. Flannery Tr. at 1142:7-8. Mr. Flannery reported to SSgA's Chief Executive Officer, William Hunt. *Id.* at 783:16-18; Hopkins Tr. at 35:2. Approximately 460 people in nine separate groups ultimately reported up to Mr. Flannery. The nine groups were: (1) Global Equities; (2) Global Fixed Income; (3) Global Asset Allocation; (4) Absolute Return Strategies; (5) Product Engineering; (6) Advanced Research Center; (7) Credit Policy; (8) Risk Management; and (9) Cash Management. Mr. Flannery's responsibilities encompassed all of these groups. Flannery Tr. at 1144:14-1149:16; Division Ex. 90 at SSgA-SEC000060359. Mr. Flannery remained responsible for overseeing each of these groups while he was helping SSgA address the unprecedented market events of the Summer of 2007. Flannery Tr. at 1152:24-1153:3.

(ii) Mr. Flannery Did Not Have Legal, Compliance, or Relationship Management Responsibilities.

As CIO, Mr. Flannery was not responsible for SSgA's compliance, legal, or client and consultant communications functions. The Compliance Department reported to Chief Operating Officer Otello Sturino, who did not report to Mr. Flannery. Flannery Tr. at 1149:17-1150:3. The Relationship Management and Consultant Relations groups reported to Marc Brown, the Chief

[3] This Memorandum contains citations to the cross examination testimony of experts (referred to herein as, *e.g.*, "Lyons Tr."), as well as the direct testimony of experts which was submitted in written form prior to the Hearing (referred to herein as "Direct Test." with the exception of expert witness Erik Sirri, whose direct testimony was submitted in report format, and as such is referred to as "Sirri Report.").

Marketing Officer, who also did not report to Mr. Flannery. *Id.* at 1150:4-23. The Legal Department reported to Mitchell Shames, SSgA's General Counsel. Mr. Shames also did not report to Mr. Flannery. *Id.* at 1150:24-1151:10; *see also* Division Ex. 90 at SSgA-SEC000060359.

(iii) Mr. Flannery Did Not Have Portfolio Management Responsibilities; Portfolio Managers Oversaw Hundreds of Distinct Strategies.

SSgA had approximately three hundred investment strategies run by several of the various groups that reported to Mr. Flannery, of which the Limited Duration Bond Fund ("LDBF"), the fund at issue, was one. Flannery Tr. at 1155:5-11; Testimony of Alistair Lowe ("Lowe Tr.") at 2021:13-16. Mr. Flannery was not involved in the day-to-day management of any of SSgA's strategies, nor were his direct reports. Flannery Tr. at 1157:23-1158:5. Mr. Flannery did not execute trades. Those tasks were the responsibilities of Portfolio Managers and traders; in the case of LDBF, the Portfolio Manager was Bob Pickett, who was a member of SSgA's Fixed Income team. *Id.* at 1152:10-13, 1158:2-15. Notably, SSgA's strategies were based on three distinct investment philosophies represented by different SSgA funds: fundamental, quantitative, and indexed. *Id.* at 1153:17-1154:23. There was no "house view," and at any given time, one strategy could be taking an investment position that was inconsistent with the position taken in another strategy. *Id.* at 1157:11-17; *see also* Lowe Tr. at 2021:3-2022:5.

(iv) As CIO, Mr. Flannery Increased The Resources of the Risk Management Team and Viewed The Team as a Critical Part of SSgA's Business.

The Risk Management team (one of the nine groups that reported to Mr. Flannery) originally did not exist as a group distinct from the Fixed Income team. Flannery Tr. at 1148:14-21. The Risk Management team was responsible for identifying, measuring, and, where necessary, escalating issues concerning risk and exposures in SSgA's portfolios. Armstrong Tr. at 2196:8-11. As CIO, Mr. Flannery separated the Risk Management team from the Fixed Income team, so that Risk Managers no longer reported to Portfolio Managers. Flannery Tr. at 1148:21-25. He did this so that the Risk Management team would be independent, and could provide their "unalloyed view" on funds and trades run by the Portfolio Managers. *Id.* at 1149:1-4. Mr. Flannery viewed Risk Management as a critical component of the organization, and he therefore increased the size of the Risk Management team and its resources while at SSgA. Armstrong Tr. at 2201:23-2202:7 (testifying regarding Mr. Flannery's increase of size and resources of Risk Management team; ". . . [Mr. Flannery] valued [the risk group] very highly as an independent source of analyzing the portfolios."). Mr. Flannery frequently sought out the perspective of the Risk Management team regarding issues facing funds managed by SSgA, and he consulted with the team on an almost daily basis during the summer of 2007. *Id.* at 2202:8-2203:9.

B. The Limited Duration Bond Fund

1. The Goals and Composition of LDBF

LDBF was an investment strategy that consisted of two different funds: an ERISA fund (SSgA fund code CMY1) and a common trust fund ("CTF" – SSgA fund code CMZ5). (Collectively, the two funds are referred to as LDBF). Flannery Tr. at 1155:14-16; Wands Tr. at 2851:10-24; Hopkins Tr. at 44:5-25; Direct Testimony of Ezra Zask ("Zask Direct Test.," Flannery Ex. 299) at A.22. LDBF was one of the approximately three hundred SSgA strategies noted above, and in 2007, the annual fees generated by LDBF for SSgA were between approximately $3 and $3.5 million, out of total SSgA revenues of approximately $1 billion for that year (or roughly 1/3 of 1%). Flannery Tr. at 1155:5-11, 1205:16-1206:9. LDBF was a small part of SSgA's assets under management: it represented less than 1% of the almost $2 trillion in assets under management for which Mr. Flannery, as CIO, was responsible for strategic oversight. *Id.* at 1142:5-11, 1145:4-1146:4. Mr. Flannery's compensation was not tied to LDBF or its performance. *Id.* at 1163:5-10.

LDBF was established in 2002, a year before Mr. Flannery became Head of Global Fixed Income. Flannery Tr. at 826:1-7; Hopkins Tr. at 450:19-21, 825:24-826:7. As an unregistered fund, LDBF was exclusively available to sophisticated investors and trusts. Expert Report of Professor Erik Sirri ("Sirri Report," Hopkins Ex. 161) at ¶ 21; *see also* Hopkins Tr. at 44:14-21. Indeed, SSgA primarily deals with institutional clients. Flannery Tr. at 1140:9-22. LDBF was exempt from regulation under the Investment Company Act and from the registration and reporting requirements of the Securities Act. Sirri Report at ¶ 21. The fund was designed to generate returns well in excess of money market funds — LDBF had a target annual return of LIBOR plus 50 to 75 basis points (Hopkins Tr. at 45:16-19) — and seeking to achieve those returns required LDBF to take on substantially more risk than a money market fund. Sirri Report at ¶ 21; Zask Direct Test. at A.22. Given the sophistication of LDBF clients and their consultants, it could hardly have been a surprise to them that the above-benchmark returns targeted by LDBF could only be achieved by assuming a meaningful level of risk, and expert witness Erik Sirri, a Professor of Finance at Babson College and the former Director of the Division of Trading and Markets at the SEC as well as the SEC's former Chief Economist, so testified. Sirri Report at ¶¶ 1-3, 9-10, 12, 15 ("higher expected returns come at the cost of exposing the investor to greater risk. This risk-return trade-off is a fundamental principle of finance that is well understood by sophisticated investors."); *see also id.* at ¶¶ 16-21, 24, 40; Testimony of David Hammerstein ("Hammerstein Tr.") at 2540:1-13 (acknowledging that higher expected returns means exposure to greater risk).

Since its inception, LDBF was heavily concentrated in housing-related securities, including securities backed by mortgages securing loans to what are now referred to as "subprime" borrowers.[4] Flannery Ex. 137 at SS 003875765; Flannery Tr. at 1164:13-1165:4; *see also* Testimony of Robert Pickett ("Pickett Tr.") at 1573:22-1574:3; Division Ex. 153 (FAQ #1). These types of securities are included within the category of Asset Backed Securities ("ABS"), a category which also includes securities backed by credit card receivables, student loans, and automobile loans, among others. Flannery Tr. at 1173:11-21; Hopkins Tr. at 90:6-14, 91:5-92:11. LDBF's sophisticated investors would have known that ABS included securities backed by residential mortgages, including what are now referred to as "subprime" mortgages. Sirri Report at ¶¶ 32-39. In 2007, housing-related ABS were considered by SSgA's Fixed Income team to be a preferable investment as compared with other ABS, because borrowers were considered more likely to default on credit card debt, for example, than on their home mortgages. Flannery Tr. at 1173:22-1175:11; Pickett Tr. at 1595:4-8, 1596:3-5; *see also* Flannery Ex. 137 at SS 003875765-67. Moreover, the yields associated with housing-related ABS were higher than other types of ABS, and more consistent with LDBF's target of a return 50-75 basis points in excess of LIBOR. Flannery Tr. at 1174:6-11; Pickett Tr. at 1595:4-8, 1596:3-5; Sirri Report at ¶¶ 32, 39; *see also* Flannery Ex. 137 at SS 003875765. LDBF was also invested in derivatives tied to residential mortgage markets, such as total return swaps, which provided leverage.[5] Flannery Tr. at 1172:20-1173:17; Flannery Ex. 137 at SS 003875765-66. LDBF's use of

[4] "Subprime" was not a commonly used term before 2007. Carlson Tr. at 2722:20-2723:13.

[5] "A total return swap is an agreement in which one party makes payments based on an established rate, either fixed or variable, while the other party makes payments based on the 'total' return of an underlying asset, which includes both its interest or dividend income and any capital gains or losses." Zask Direct Test. at A.53.

derivatives contributed to the strategy's ability to outperform LIBOR. Flannery Tr. at 1207:24-1209:7.[6]

LDBF was comprised of only investment grade securities, and was highly concentrated in AAA- and AA-rated securities; over 88% of the subprime ABS held by LDBF from 2004-Q2 2007 were rated AAA or AA. Sirri Report at ¶¶ 40, 48; Flannery Ex. 137 at 003875765. In fact, LDBF's average credit quality during the entire period relevant to this case was between AA and AA+. *See, e.g.*, Flannery Exs. 137 at SS 03875765-66, 257 at SS 003897471; *see also* Carlson Tr. at 2700:18-25, 2702:11-7, 2724:18-25; Hopkins Tr. at 438:20-22.

Prior to the 2007 financial crisis, "subprime" was not the catchphrase for disaster that it subsequently became. Sirri Report at ¶ 41. Rather, it was merely a technical description of certain housing-related assets. *Id.* Indeed, certain subprime loans were viewed as ***less*** risky than prime loans in at least one key respect. *Id.* at ¶ 42. As Mr. Sirri explained at length in his direct testimony, even if the loans underlying the tranched securities held by LDBF were subprime loans, "that would not imply that the securities themselves were risky." *Id.* at ¶ 43. To the contrary: securities backed by subprime loans can and do receive AAA ratings, and this was true of a substantial amount of the securities in which LDBF invested. *Id.* at ¶¶ 40-48; *see also* Pickett Tr. at 1597:6-1598:8.

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[6] LDBF was considered diversified by SSgA's Fixed Income team because the housing-related securities in which it was invested were backed by loans that varied geographically, had different loan-to-value ratios (the amount of the loan relative to the actual value of the house), and different loan terms. Flannery Tr. at 1183:8-1184:18, 1188:5-15. With respect to geographic diversification, the securities were regarded as being diversified because historically there was a lack of correlation in home prices among geographic markets, *i.e.*, until 2007, there had never been a national decline in housing prices. Flannery Tr. at 1188:5-15. SSgA also employed a careful process for analyzing potential investments: in selecting and evaluating securities for LDBF, among other things, SSgA would analyze where in the country (down to the zip code and individual loan level) the underlying collateral was located to ensure that, in fact, the securities were suitable credit risks. *Id.* at 1184:19-1185:11; Lowe Tr. at 1999:9-20; Flannery Ex. 48 (describing SSgA's proprietary security surveillance technology); Flannery Ex. 58 at SS 003865282, ¶¶ 2-3. In fact, this investment selection enabled LDBF to historically outperform its benchmark, regardless of whether interest rates were going up or down. Flannery Tr. at 1184:2-18. Mr. Flannery has not been charged in connection with any representations about the diversification of LDBF.

Through a process called securitization, an institution issues securities whose expected returns are based on the cash flows from an underlying pool of assets such as mortgages and home equity loans. Sirri Report at ¶ 44. In some instances, all the securities issued against a pool of loans have the same seniority and an equal right to receive the cash flows from the underlying pool. *Id.* In other instances, different classes of securities, called tranches, with different levels of seniority are issued against the same underlying pool. *Id.* In the case of tranched securities, the cash flows from the underlying pool of assets are allocated to the different tranches in order of seniority, beginning with the senior-most tranche and flowing down to more junior tranches. *Id.* at ¶ 45. Any losses in the pool due to default are typically borne in reverse order of seniority with the junior tranches providing a buffer against losses for the more senior tranches (such as AAA bonds). *Id.* The resulting securitization structure ensures that the senior tranches are less likely to be affected by the defaults of subprime borrowers than the junior tranches such that the senior tranches are less risky. As Professor Sirri explained, even if the underlying loans in a pool carry a relatively high likelihood of default, the issuer can ensure that the senior tranches are protected by adjusting the size of the junior tranches relative to the senior tranches, and through credit enhancements such as over-collateralization, excess spread, and insurance. Sirri Report at ¶¶ 46-47; *see also id.* at Ex. 7. Ultimately, through the use of these techniques, an issuer can create securities that have a low risk of default from a pool of assets that have relatively higher default risk. *Id.* at ¶ 47.[7]

[7] Thus, while the FICO score of the borrowers for the underlying mortgages may be lower such that the loans are considered to be "subprime" loans, that is not at all indicative of the level of default risk associated with the individual security or tranche — AAA means AAA, regardless of the composition of the underlying collateral. Cross Examination Testimony of Erik Sirri ("Sirri Tr.") at 2170:2-2171:5; Hopkins Ex. 162.

The securities are rated by ratings agencies such as Moody's and Standard & Poor's. Sirri Report at ¶ 48. An AAA rating given to a security backed by subprime mortgages is no different than an AAA rating given to a security backed by a different type of asset, or a non-asset backed security like a corporate bond. Sirri Tr. at 2170:2-2171:5; Flannery Tr. at 1182:8-11; Hopkins Ex. 162. Notwithstanding the type of security, in each instance, the AAA rating represents a judgment by the ratings agencies that the securities are the least likely to default, regardless of the assets underlying the securities. Flannery Tr. at 1182:13-16; Sirri Report at ¶¶ 43, 48. Thus, "[e]ven if the mortgages underlying the structured securities were primarily subprime, the AAA–A rated tranches were, by design, protected from losses by the lower tranches and would only be affected if the incidence and severity of defaults were extremely high." Sirri Report at ¶ 40 (also noting that historical data suggested that the likelihood of such extreme defaults was low for housing-related ABS). "AAA and AA rated tranches of ABS backed by subprime loans were considered by the market to have a low risk of default, in part because they were protected by the lower tranches." *Id.* at ¶ 50.[8] Notably, in 2007 AAA subprime securities could be used as collateral to secure loans to financial institutions from the Federal Reserve, and the same is true today. Flannery Tr. at 1177:14-1178:16.

2. Management of LDBF: The Role of Robert Pickett

Robert Pickett was the Portfolio Manager ("PM") for LDBF during the relevant period. Pickett Tr. at 1545:10-13. By 2007, Mr. Pickett had many years of experience as a PM, including for funds invested in asset-backed securities. *Id.* at 1538:6-1545:13. Like the PMs for all of SSgA's approximately three hundred strategies, Mr. Pickett was several steps removed

[8] Contrary to the assertion of the Division's expert Professor Wermers, S&P's ratings ". . . represent a uniform measure of credit quality globally and across all types of debt instruments. In other words, a triple A-rated corporate bond should exhibit the same degree of credit quality as a triple A-rated securitized debt issue." Hopkins Ex. 162; *see also* Sirri Tr. at 2169:9-17.

from Mr. Flannery in SSgA's reporting structure. Mr. Pickett reported to Michael O'Hara (Head of Active Fixed Income); Mr. O'Hara reported to Paul Greff (Head of Global Fixed Income), who in turn reported to Mr. Flannery. *Id.* at 1549:16-22, 1727:3-1728:10; Flannery Tr. at 1206:10-22. Mr. Pickett's role was to make the investment decisions for LDBF, including the decision to concentrate LDBF in housing-related asset backed securities, and he had the authority to make such decisions and conduct trades using the guidelines set forth in LDBF's fund declaration. Pickett Tr. at 1728:15-17, 1566:12-16, 1594:14-22; Flannery Tr. at 1158:9-15. Mr. Flannery did not play a role in those decisions and trades, and Mr. Pickett did not regularly interact with Mr. Flannery. Flannery Tr. at 1157:23-1159:1; Pickett Tr. at 1730:8-16.

3. Investor Communications Regarding LDBF: The Role of Relationship Management and Consultant Relations

Mr. Flannery did not have any day-to-day responsibility for communicating with clients and consultants. Flannery Tr. at 1210:3-11. He was not involved in the decisions about what information to provide to clients, as that was the role of Relationship Management (also referred to as Client Relations) led by Larry Carlson and Staci Reardon, as well as Consultant Relations, led by Maureen Fitzgerald; both groups reported to Marc Brown, who did not report to Mr. Flannery. Flannery Tr. at 1214:9-25; *see also* Division Ex. 90 at SSgA-SEC 000060359. Under SSgA's business model, the Relationship Management team was LDBF clients' primary point of contact at SSgA. Carlson Tr. at 2723:23-2724:7; Hopkins Tr. at 77:1-6. Relationship Managers were responsible for providing information to clients, including items such as holdings and performance information. Carlson Tr. at 2667:25-2670:21; Hopkins Tr. at 425:9-20; Flannery Tr. at 903:14-904:3, 1211:12-1212:5, 1213:22-1214:8. If clients had questions, the Relationship Managers would work with other departments within SSgA to answer those questions. *See, e.g.*, Carlson Tr. at 2736:25-2737:10. Investment consultants, who often had several clients invested in SSgA's strategies, interacted with SSgA's Consultant Liaisons in a similar way. *Id.* at 2723:23-2724:3; Hopkins Tr. at 77:7-10. Relationship Managers and Consultant Liaisons knew what information was being provided to clients and consultants and what questions were being asked. Carlson Tr. at 2724:4-7; Flannery Tr. at 903:14-25, 1214:1-8 ("That was their job, to understand the needs and preferences of the clients and to try to accommodate those.").

Clients were sophisticated institutional investors, and their consultants were also sophisticated and charged fees for their investment expertise. Flannery Tr. at 1210:12-25; Carlson Tr. at 2730:20-2731:25; Sirri Report at ¶ 21; Direct Testimony of John W. Peavy III ("Peavy Direct Test.," Hopkins Ex. 174) at A.40(a), A.42-A.44, A.54, A.67-A.68. Clients' information needs varied, and Relationship Managers were responsible for ensuring that a particular client received the information that client wanted; different investors sought different types of information. Peavy Direct Test. at A.49; Carlson Tr. at 2734:9-2735:7.

a. The Information Clients Received Regarding LDBF

(i) Standard Information

There were a number of sources of information available on a regular basis to LDBF clients. *See* Peavy Direct Test. at A.45. As an unregistered fund, LDBF was subject to much less extensive disclosure requirements than a registered fund such as a mutual fund. Flannery Tr. at 1211:4-11; Sirri Report at ¶ 21.[9] Unlike a mutual fund, for example, LDBF did not issue a

[9] Common trust funds and collective investment trusts such as LDBF are excluded from the definition of "investment company" under the Investment Company Act, pursuant to either Section 3(c)(3) or Section 3(c)(11). Disclosure for funds such as LDBF are governed directly by Regulation 9 of the Office of the Comptroller of the Currency ("OCC"). *See* 12 C.F.R. § 9.18. Regulation 9 imposes only two disclosure requirements on banks that maintain these funds. First, Regulation 9 requires banks to make available upon request a written plan that describes the bank's investment powers and policies with respect to the fund, and other matters set forth in the regulation. *See* 12 C.F.R. § 9.18(b)(1). Notably, the OCC does not require banks to send a copy of the written plan to each of its clients. *Id.* Rather, the written plan must only be made available for inspection at the bank by anyone who requests it. Second, Regulation 9 requires that a bank make available upon request an audited annual financial report that includes, among other things, a list of the fund's investments, income and disbursements, and fees charged by the
(continued...)

prospectus. Sirri Report at ¶ 21. Instead, fund declarations were provided to investors, which spelled out the objectives and limitations of LDBF, including the types of securities in which the fund could invest. Flannery Tr. at 1215:5-20. Audited financial statements were available to investors, which also contained detailed information regarding the types of securities LDBF invested in, including housing-related ABS and derivatives. *Id.* at 1216:20-1218:23, 1221:1-21; Hopkins Ex. 23 (Audited Financial Statements for CTF version of LDBF as of 12/31/06). Clients received fact sheets, which contained information about LDBF's investment strategy and the types of securities it was invested in, such as "collateralized mortgage obligations, asset-backed securities, futures, options, and swaps." Sirri Report at ¶¶ 23-25 (quoting 2002 LDBF fact sheet); Flannery Tr. at 1225:12-17. Clients also received periodic reporting packages on a monthly or quarterly basis discussing fund performance. Sirri Report at ¶ 22 (citing investigative testimony); Carlson Tr. at 2667:25-2670:21. While Mr. Flannery was aware of the foregoing sources of information, as CIO, he was not involved in the preparation or dissemination of these documents. Carlson Tr. at 2667:25-2670:21; Flannery Tr. at 1083:6-1084:20, 1211:12-1212:5, 1213:11-20.

(ii) Client-Specific Information

In addition to the standard information described above, clients could also request additional information from SSgA, or their Relationship Manager could send them information if the Relationship Manager believed it would be useful. Carlson Tr. at 2728:20-2729:7, 2733:17-2735:7 (Relationship Managers considered whether information would be of interest to the particular client); Sirri Report at ¶ 22; Peavy Direct Test. at A.45. SSgA's model for communicating with clients regarding all of its strategies, including LDBF, was reasonable,

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bank to the fund. 12 C.F.R. § 9.18(b)(6)(ii)(iv). SSgA made annual audited financial statements available for LDBF. *See, e.g.*, Hopkins Ex. 23.

appropriate and customary in the industry. Peavy Direct Test. at A.40(c), A.46; *see also id.* at A.69. SSgA's clients requested different types, frequencies and quantities of information from SSgA, and knew that if they wanted information beyond what was available, they could request it; SSgA customized information for clients accordingly. Carlson Tr. at 2734:16-2735:7, 2736:16-20 ("[A]ny institutional client would know" they could seek information from SSgA beyond that which had already been provided); Peavy Direct Test. at A.47, A.55, A.70; Flannery Tr. at 1213:11-25. While the information *requested by* clients and consultants varied depending on their needs, the information *available to* clients did not; all clients had access to the same information. Cross Examination Testimony of John W. Peavy III ("Peavy Tr.") at 3022:14-3024:12.

Although Mr. Flannery is not charged in connection with any claimed deficiencies in SSgA's model for communicating with clients and consultants, pursuant to this model, clients and consultants in fact received information that the Division claims was omitted from the two letters with which Mr. Flannery has been charged, such as information regarding the redemption activity of other clients, including clients of advisory groups and SSgA's related funds; information regarding the LDBF's exposure to subprime; information regarding the fund's liquidity; and information regarding the fund's use of derivatives and leverage. All of this information had already been disclosed to investors prior to the letters (and some of it was also highly publicized). *See* Subsections C(8), H(1), J, K, L(3), *infra*. Notably, the Division did not produce a single investor to offer testimony that they did not actually receive the information that was allegedly omitted from the letters. Moreover, as expert John Peavy explained, typical investors in a fund such as LDBF would not rely on a single letter in deciding whether to remain invested in the fund. Peavy Direct Test. at A.65, A.73. Instead, these investors and their consultants would consider the totality of information provided by, among other sources, the fund's marketing materials, discussions with fund managers, responses to questions and requests for information, and other publicly available information in deciding whether to remain invested. *Id.* at A.40(e), A.66. As set forth below, Mr. Flannery reasonably believed that substantial information was made available to investors during July 2007, prior to the two letters being sent to investors.

C. Increasing Market Volatility in 2007

Until 2007, securities backed by residential mortgages, including what later become known as subprime mortgages, performed very well. Sirri Report at ¶ 40; *see also* Flannery Ex. 137 at SS 003875765. And, between its inception in 2002 until January 2007, LDBF consistently outperformed its benchmark, regardless of the direction of interest rates.[10] Flannery Tr. at 1206:23-1208:15; Flannery Exs. 257 at SS 003897474 (showing annual performance returns for LDBF from inception through Q3 2007), 243 at SS 000166968. The Fixed Income team's view of the housing market and of the LDBF investment strategy, as reported to Mr. Flannery, remained positive throughout 2006. Flannery Tr. at 1192:3-9; Division Exs. 16, 18 at SS000287632-37. Further, as the evidence discussed below demonstrates, their view remained positive even as the market declined during the summer of 2007, consistent with the views of government officials and economic commentators.

[10] The magnitude of the outperformance was most striking when rates were low. Thus, when LIBOR was 2%, outperforming by 50-75 basis points represented a 25-33% excess return. When rates were at 5%, the outperformance would be 10-12%. Flannery Tr. at 1207:5-1208:15. The notion advanced by the Division that a return of 25-33% better than LIBOR could somehow be achieved without risk is simply wrong. *See, e.g.*, Sirri Report at ¶¶ 20-21.

1. Problems in BBB ABX and SSgA's Reduction of Exposure

By early 2007, following a period of historic strength in the housing market, housing prices began to decline and mortgage delinquencies began to rise markedly. Sirri Report at ¶¶ 52-54; Wands Tr. at 2852:18-2853:7. Hedge funds that were pessimistic about the housing market began taking large short positions against BBB ABX Index swaps, a derivative tied to the housing market.[11] Flannery Tr. at 1225:23-1226:9 (discussing hedge funds shorting BBB ABX); Wands Tr. at 2853:8-10 (source of the underperformance was the BBB ABX Index). The large short positions caused a sharp drop in the price of the BBB ABX Index swaps in February 2007, which in turn affected LDBF's performance because the strategy had BBB ABX Index exposure. However, LDBF's higher rated securities were largely unaffected. Flannery Tr. at 1226:24-1227:10.

While SSgA reduced LDBF's BBB ABX Index exposure in February 2007 (*see* Flannery Ex. 137 at SS 00387566), the Fixed Income team believed that the decline was temporary and the result of technical factors (*i.e.*, the short positions in the BBB Index swaps), and that the housing-related ABS sector remained fundamentally strong and would substantially recover. *Id.*; *see also* Wands Tr. at 2853:16-22 (The Fixed Income team believed the issues were limited to the BBB-rated securities, and would have no effect on higher rated ABS), 2856:6-12 ("I think in general the market was still very comfortable with mortgage credit and housing-related assets broadly, including our investment team, who was obviously very focused on the sector of the market.").

[11] There are five ABX Indices, or sub-indices, which correspond to the credit ratings of the securities tracked by each particular sub-index (AAA, AA, A, BBB and BBB-). Zask Direct Test. at A.37.

2. Mr. Flannery's Efforts to Ensure the Fixed Income Team Analyzed the BBB ABX Events

Notably, when the BBB ABX began to decline in value, Mr. Flannery took steps to make sure that the Fixed Income team was looking at the issues in the market from all angles. Flannery Tr. at 1227:11-1228:11. While Paul Greff was the Head of the Fixed Income team globally, Mr. Flannery wanted to ensure that Mr. Greff's team was carefully analyzing the market events. *Id.* He convened a meeting with the Fixed Income team and others, during which he challenged the team and sought opposing viewpoints regarding what was occurring. *Id.* at 1227:22-1228:11; *see also id.* at 826:1924. He invited Mitchell Shames, SSgA's General Counsel, and Shawn Johnson, Chair of the Investment Committee, to attend the meeting. *Id.* at 1227:22-1228:1. The Investment Committee is the highest investment authority in SSgA, and the Committee did not report to Mr. Flannery. *Id.* at 1255:15-19, 1257:10 ("I was just a member of the committee"), 1229:4-7; Johnson Tr. at 2365:5-14. Mr. Flannery invited Mr. Johnson to ensure that the Investment Committee was aware of the issues. Flannery Tr. at 1228:20-1229:3. SSgA's Chief Economist, Chris Probyn, was also present. *Id.* at 1229:24-1230:1. At the meeting, Mr. Flannery learned that while the Fixed Income team was becoming more conservative with respect to selecting securities, they still believed very strongly in housing-related securities. *Id.* at 1230:10-1231:5; *see also* Lowe Tr. at 1999:17-19 (in a different meeting during this timeframe, Mr. Lowe of Global Asset Allocation ("GAA") understood that the Fixed Income team was "very convinced that [the January and February underperformance] was a liquidity event, and subsequently they proved to be right"), 2025:7-25, 2042:10-2043:4.[12]

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[12] Mr. Lowe, the Head of GAA, testified that he believed the Fixed Income team firmly and honestly believed that the market would recover, and that the team's view was reasonable and based on thoughtful and rigorous due diligence. Lowe Tr. at 2028:21-2029:8. Mr. Lowe was impressed by the level of analysis the Fixed Income team was undertaking. *Id.* at 2027:3-23.

(continued...)

3. Like the Fixed Income Team, Government Officials and Commentators Remained Positive On Housing-Related Securities.

The Fixed Income team's view of the market was consistent with that held by prominent government officials. For example, Federal Reserve Board Governor Kevin Warsh characterized the February-March 2007 time frame in a June 2007 speech:

> Well, it does not take a long memory to recall that this scenario played out for a few days in late February, a bit more than three months ago. As you all know, share prices quickly recovered, and implied volatility reverted to near-record low levels. What lessons can be drawn from such an episode? Perhaps because of more complete markets, *shocks to liquidity are less likely to become self-fulfilling and less likely to impose more lasting damage. That hypothesis seems particularly credible when the shock is based neither on rapidly changing economic fundamentals nor a genuine breakdown in market infrastructure.*

(emphasis added).[13]

Mr. Flannery regularly monitored pronouncements of government economic officials, including members of the Federal Reserve and the Federal Open Market Committee ("FOMC"), on subjects relating to the economy such as subprime and the housing market, and reviewed Mr. Warsh's comments in June 2007. Flannery Tr. at 1235:20-1236:12, 1239:13-24.[14]

4. LDBF Substantially Outperforms In April-May, 2007.

Stability returned to the mortgage markets in April and May 2007. Sirri Report at ¶ 56; Wands Tr. at 2857:9-17 (the BBB ABX rallied in April and May, and Mr. Wands and other members of the Fixed Income team believed in the fundamentals of subprime securities). In fact,

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[13] Flannery Ex. 25 at 4: Kevin Warsh, Federal Reserve Board Governor, *Financial Intermediation and Complete Markets*, Address at the European Economics and Financial Centre (June 5, 2007) (emphasis added) (available at <http://www.federalreserve.gov/newsevents/ speech/Warsh20070605a.htm>).

[14] The Division has expressly stated that it does not challenge the validity of SSgA's investment decisions. Flannery Tr. at 1232:18-1233:2; Division's Pre-Trial Brief at 39-40. However, the statements of prominent government officials regarding the market are highly relevant to the question of whether the purported misstatements alleged against Mr. Flannery in the two August were false, and whether Mr. Flannery acted with *scienter* or negligence. As discussed below, the evidence shows that the letters were not false or misleading, and that Mr. Flannery acted reasonably at all times in connection with both of them.

April and May 2007 were among the best months in LDBF's history. Hopkins Ex. 56; Flannery Tr. at 1232:7-8. In a May 17, 2007 speech, Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, stated:

> [G]iven the fundamental factors in place that should support the demand for housing, we believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system. *The vast majority of mortgages, including even subprime mortgages, continue to perform well.*[15]

Chairman Bernanke's observation was important: if the "vast majority" of subprime mortgages continued performing well, the risk of default in the higher-rated AAA and AA tranches would remain very small, particularly in light of securitization and credit enhancements. Sirri Report at ¶¶ 46, 50. In response to the positive market action and its continuing bullish view of the sector, SSgA's Fixed Income team caused LDBF to slightly increase its BBB ABX exposure. Flannery Ex. 137 at SS 003875766.

5. Bear Stearns' Hedge Funds Fail and Mr. Flannery Solicits Additional Analysis from the Fixed Income Team.

In June 2007, Bear Stearns announced significant losses for two of its hedge funds that held a high percentage of subprime ABS and warned that the funds would likely have to liquidate. Flannery Tr. at 1246:21-24; Wands Tr. at 2858:3-2859:4. The failure of these Bear Stearns funds caused Mr. Flannery to request additional work and analysis from the Fixed Income team, to ensure that the "investment teams were challenging their own assumptions." Flannery Tr. at 1247:7-1248:1. This was consistent with Mr. Flannery's management style in which he sought the input of many, and challenged his colleagues and subordinates to raise and consider opposing

[15] Flannery Ex. 23 at 5: Chairman Ben S. Bernanke, Board of Governors of the Federal Reserve System, *The Subprime Mortgage Market*, Address at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007) (emphasis added).

viewpoints. *See, e.g.*, Armstrong Tr. at 2213:25-2214:6; Flannery Tr. At 1247:24-1248:10. In response, members of the Fixed Income team who had specific expertise concerning the housing-related ABS market, as well as the risk team, reaffirmed their collective view that the fundamentals of the housing-related securities market remained strong. Division Ex. 94 (e-mail to Mr. Flannery stating that "[w]e remain constructive on the fundamentals"); Flannery Tr. at 1249:9-1254:5. The view expressed to Mr. Flannery was that the Bear Stearns failure was fundamentally "not a subprime event." Division Ex. 94. Indeed, while lower rated securities declined in value, higher-rated securities, which still represented the vast majority of LDBF's assets, remained largely unaffected throughout the first half of 2007. Sirri Report at ¶ 56, Ex. 10.

6. June 27, 2007 Investment Committee Meeting

At SSgA's June 27 Investment Committee Meeting, Mr. Flannery gave an update regarding subprime. Flannery Tr. at 1257:11-25; Flannery Ex. 33 at SSgA-SEC 000251790. As discussed above, the Investment Committee was the ultimate decision-making authority regarding investments at SSgA. Flannery Tr. at 1255:6-10; Johnson Tr. at 2370:12-2372:6 (discussing the Committee's oversight role). Mr. Flannery added a "Subprime Update" to the agenda for the June 27 meeting, because he felt that it was important to escalate discussion of the Bear Stearns events to the Committee. Flannery Tr. at 1257:11-1258:20 ("we weren't required to do this but . . . I wanted to raise [market events and the corresponding underperformance of LDBF] to the investment committee and make the investment committee aware"). At the meeting, Mr. Flannery described the negative performance of SSgA funds with subprime exposure, of which LDBF was one, and reported that the Fixed Income team remained positive on the long-term fundamentals. Flannery Ex. 33; Flannery Tr. at 1258:11-1260:3.

The Fixed Income team continued to have a positive view of the market into July. Flannery Ex. 42 (Frank Gianatasio, Head of Global Structured Products, wrote that "we believe the fundamentals will hold over the long term" but discussed technical factors that might affect short-term performance); Flannery Tr. at 1262:3-7; *see also* Pickett Tr. at 1731:25-1732:5 (testifying that he believed in the fundamentals of the LDBF investment strategy during Summer 2007).

7. July Ratings Agency Downgrades and Reduction in BBB ABX Exposure

On July 10, 2007, Standard & Poor's and Moody's downgraded or placed on downgrade watch an unprecedented number of bonds backed by subprime mortgages. Sirri Report at ¶ 58; *see also* Flannery Ex. 58 at SS 003865282, ¶ 2. Most of the securities being reviewed or downgraded by the ratings agencies had ratings of A or lower; none of the housing-related bonds held by SSgA were downgraded. *See* Flannery Exs. 58 at SS 003865282, ¶ 2, 86 at SS 008524112. SSgA responding by reducing LDBF's exposure to BBB ABX derivatives (as well as AA ABX derivatives). *See* Flannery Ex. 137 at SS 003875766; Zask Direct Test. at A.38. "The net effect [of SSgA's actions] was to reduce the portfolio's risk of loss from adverse developments in the subprime residential market." Zask Direct Test. at A.38, A.39-A.43 (describing in detail how the transactions lowered LDBF's market risk as measured by CVaR,[16] lowered LDBF's credit risk, and reduced leverage), Exs. 3, 4. The reduction of BBB ABX exposure was referenced in the August 2 letter, discussed below, as among the actions SSgA had taken to reduce risk. The evidence that this transaction reduced risk is unrebutted.

[16] CVaR stands for "Conditional Value at Risk." In basic terms, if a given portfolio will lose less than $X amount 95% of the time, and will lose more than $X amount 5% of the time, CVaR calculates the size of the average loss beyond the 95% threshold. Zask Direct Test. at A.26; *see also* Armstrong Tr. at 2198:4-2199:6 (describing CVaR). CVaR is a well-recognized risk measure, and was among the ways the SSgA measured risk in LDBF and other Fixed Income portfolios. Armstrong Tr. at 2198:2-2199:24; Zask Direct Test. at A.27. Notably, a transaction can decrease risk in a portfolio, but CVaR can still rise after the transaction due to external market conditions such as increased volatility. In such a situation, CVaR would have been even higher if the transaction had not occurred. Pickett Tr. at 1754:6-11; Testimony of Peter Lindner ("Lindner Tr.") at 1960:20-1961:18.

The downgrades by the rating agencies had a ripple effect on AAA and AA subprime bonds. While the higher quality AAA and AA bonds were not downgraded, many market participants, finding bids on BBB bonds low and liquidity evaporating, began selling the more highly-rated bonds to reduce exposure to the entire sector, and AAA and AA spreads widened significantly (*i.e.*, their prices declined). Sirri Report at ¶ 60, Ex. 11; *see also* Division Exs. 120 (describing spread widening), 134 at SSgA-SEC 000252909; Pickett Tr. at 1651:21-1654:23 (discussing Flannery Ex. 218).[17] Credit conditions tightened, and the downturn resulted in a liquidity crisis affecting other sectors of the financial markets. Sirri Report at ¶¶ 57, 61.

Mr. Flannery asked the Fixed Income team to assess the impact of these developments. Flannery Ex. 53; Flannery Tr. at 1263:7-10. He did so because he thought the ratings agency downgrades were important and, whether or not the Fixed Income team agreed with the downgrades, Mr. Flannery wanted to make sure the team was taking into account their impact. He testified, "I thought this was really important. . . . I also wanted to say: Look, here's what Moody's is thinking. You know, let's try this – test this against your own assumptions . . . we were going to have to reckon with Moody's assumptions in any case because it would affect the ratings." Flannery Tr. at 1263:11-1264:6. The Fixed Income team continued to believe in the fundamentals of the subprime sector. *See, e.g.*, Flannery Exs. 86 at SS 008524112 ("from a fundamental perspective we remain constructive on [BBB ABX]. . . current pricing at all ratings levels is overstating the level of risk embedded in the underlying securities"), 133 (e.g., FAQ

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[17] *See also* Flannery Ex. 44: Mark Pittman, *S&P May Cut $12 Billion of Subprime Mortgage Bonds*, Bloomberg.com, July 10, 2007 (available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=aN4sulHN19xc>) (describing drop in pricing of bonds backed by subprime mortgages). This Exhibit is not in evidence, but the Court can take judicial notice of news and online articles. *See, e.g.*, *Laborers' Pension Fund v. Blackmore Sewer Constr. Inc.*, 298 F.3d 600, 607 (7th Cir. 2002); *United States v. Bervaldi*, 226 F.3d 1256, 1266 n.9 (11th Cir. 2000); *The Washington Post v. Robinson*, 935 F.2d 282, 291-92 (D.C. Cir. 1991).

nos. 4, 12, 17, 21); *see also* Lowe Tr. at 2032:19-2033:1; Pickett Tr. at 1731:25-1732:4; Flannery Tr. at 1173:22-1175:11.

Notwithstanding the ratings agency downgrades, in July 2007, Chairman Bernanke, like SSgA's Fixed Income team, again expressed optimism, stating that the anticipated "significant losses" due to subprime mortgages were "bumps" in "market innovations" (referring to hedge fund investments in subprime mortgages) and that, notwithstanding the problems in the housing market, the economy was "poised for moderate growth."[18] Mr. Flannery reviewed Chairman Bernanke's statements in July 2007. Flannery Tr. at 1241:6-14. Many market commentators continued to believe that what was happening in the market was a liquidity event rather than a fundamental one. Lowe Tr. at 2032:12-2033:5. Indeed, on July 19, 2007, the Dow Jones Industrial Average closed above 14,000 for the first time in its history, a reflection of investor optimism in the economy's prospects.[19]

8. July 25 Money Management Letter

On July 25, 2007, the July 30, 2007 edition of the Money Management Letter, a newsletter for institutional investors, was released. It contained an article entitled "SSgA Bond Fund Whacked by Subprime Losses." Flannery Ex. 108. The article stated that LDBF had lost between three and four percent during July. *Id.* The article also discussed the fact that "[t]he fund is invested mostly in subprime mortgage-backed securities;" that "SSgA's web site says the strategy also uses derivatives to eliminate interest rate risk;" and that "[s]ome of the firm's other active

[18] Flannery Ex. 260: Subprime Mortgage Market Crisis Timeline, Joint Economic Committee, U.S. Congress (available at <http://jec.senate.gov/index.cfm?FuseAction=Files.View&FileStore_id=4cdd7384-dbf6-40e6-adbc-789f69131903>). This Exhibit is not in evidence, but the Court can take judicial notice of news and online articles. *See, e.g., Laborers' Pension Fund*, 298 F.3d at 607; *Bervaldi*, 226 F.3d at 1266 n.9; *Washington Post*, 935 F.2d at 291-92.

[19] Flannery Ex. 260 (not in evidence, but Court may take judicial notice; *see* preceding footnote).

fixed-income and large-cap enhanced index strategies have some exposure to [LDBF]." *Id.* The next morning, Mr. Flannery read the article and forwarded it to his boss, SSgA CEO Bill Hunt. *Id.*

D. July 25, 2007 Investment Committee Meeting

A regularly scheduled Investment Committee meeting took place on July 25, 2007. Flannery Tr. at 1267:11-18. Because Shawn Johnson, Chair, and Peter Leahy, Vice Chair, were unavailable, Mr. Flannery was the acting Chairman. *Id.* at 989:19-990:10, 1268:24-1269:17; Lowe Tr. at 2012:5-19. Chairing the meeting did not give Mr. Flannery any additional voting rights or decision-making authority. Flannery Tr. at 1269:21-24. It simply meant that he ran the meeting "from a protocol point of view." Lowe Tr. at 2012:23-24. As he had done in advance of the June 27 meeting, Mr. Flannery added LDBF and related issues to the agenda for the July 25 meeting in light of the turmoil in the market. Flannery Tr. at 1267:23-1268:13. He thought it was important to ensure that the Committee — the highest body at SSgA with authority over investment decisions — was apprised of the issues. *Id.* at 1267:23-1268:23 ("I thought it was important to raise it to the investment committee, to have the investment committee deliberate on all the issues that we could identify there, and I wanted the investment committee to give us direction on what to do."); Johnson Tr. at 2365:5-14 (testifying that Investment Committee is the senior governing body regarding investments).

Mr. Flannery requested that Mark Duggan, SSgA's Deputy General Counsel and the securities disclosure expert within SSgA, attend the meeting, and met with him in advance to discuss the issues that were going to be raised at the meeting. Flannery Tr. at 1269:25-1271:22; Duggan Tr. at 80:8-15[20]; Shames Tr. at 155:19-156:12 (testifying the Mr. Duggan was an "expert" regarding compliance with securities laws). Mr. Flannery, who had worked closely

[20] "Duggan Tr." refers to the investigative testimony of Mark Duggan, stipulated portions of which are attached to the Duggan Stipulation.

with Mr. Duggan for eleven years, considered Mr. Duggan to be a highly competent lawyer who truly understood SSgA's business, products, and the issues facing the Company. Flannery Tr. at 1274:7-1275:1; *see also* Duggan Tr. at 80:8-81:6 ([redacted]). Mr. Flannery wanted Mr. Duggan to attend and participate in the meeting so that he could advise SSgA on its legal obligations in light of those business issues. Flannery Tr. at 1270:9-15, 1274:7-9. Mr. Flannery also invited to the meeting a number of other key personnel who did not regularly participate in Investment Committee meetings. He invited Michael Wands, the Head of Fixed Income for the United States, to attend because he was very knowledgeable about LDBF and had been interacting with many clients and consultants. *Id.* at 1273:11-22. He invited Paul Greff, Mr. Wands' boss and the Head of Global Fixed Income, to attend because of his fixed income expertise. *Id.* at 1273:19-1274:6. He invited Bob Pickett, the LDBF PM, to attend for the same reason. *Id* at 1273:19-1274:6. And he invited Patrick Armstrong, the Head of Risk Management, to attend because of his risk management expertise. *Id.* at 1273:19-1274:6; *see also* Flannery Ex. 92 (listing meeting attendees); Wands Tr. at 2873:17-1874:1.

Consistent with his inclusion of a number of individuals with different areas of expertise at the meeting, Mr. Flannery expressly "encourag[ed] debate" regarding the issues facing LDBF among all who were present during the meeting. Pickett Tr. at 1736:12-23. Mr. Flannery also took the unusual step of requesting that the Committee provide the Fixed Income team with direction concerning the issues LDBF was facing. Flannery Ex. 92 at SSgA-SEC 000252909.[21] The contemporaneously prepared draft minutes from the meeting reflect that SSgA Deputy

[21] Flannery Exhibit 92 is a draft of the minutes of the July 25 Investment Committee meeting and, as Mr. Flannery testified, the discussions reflected in the draft minutes occurred at the meeting. Flannery Tr. at 1272:16-1273:2.

General Counsel Duggan was an active participant in these discussions. *See generally* Flannery Ex. 92. Given that (a) Mr. Flannery had requested that Mr. Duggan participate in the meeting; (b) Mr. Flannery met with Mr. Duggan beforehand to discuss the meeting; (c) Mr. Duggan was an active participant in the meeting; and (d) Mr. Duggan did not regularly attend Investment Committee meetings, Mr. Flannery expected that Mr. Duggan understood the importance of the meeting and, among other things, would communicate what occurred at the meeting to his boss, General Counsel Mitchell Shames. Flannery Tr. at 1312:15-1313:7. Mr. Duggan testified that he did, in fact, report what was discussed during the meeting to Mr. Shames on July 25, shortly after the meeting concluded. Duggan Tr. at 210:10-211:15.[22]

1. Potential Redemptions Were Discussed at the Meeting.

The likelihood of some clients redeeming their investments in LDBF was among the main topics discussed at the Investment Committee meeting. *See* Duggan Tr. at 102:13-17, 104:11-21. *See generally* Flannery Ex. 92. There was substantial discussion regarding the difficulty of predicting the precise magnitude of client withdrawals. Flannery Ex. 92 at SSgA-SEC 000252909 (Mr. Wands stated, "It's hard to predict if the market will to[*sic*] hold on or if there will be a large number of withdrawals by clients."). Indeed, nobody knew what the actual level of redemptions from LDBF would be. Flannery Tr. at 1278:22-24, 1289:10-20; Pickett Tr. at 1738:14-1739:1 (testifying that he did not know the amount of redemptions that were going to occur). Instead, Relationship Management, through its discussions with clients, had provided a rough estimate of the amount of withdrawals that might be made from the fund, suggesting that between 25 and 50%

[22] While Mr. Shames does not recall having such a discussion with Mr. Duggan, Hopkins Ex. 134 (a message slip) evidences that Mr. Duggan spoke with Mr. Shames shortly after the Investment Committee meeting ended and, furthermore, Mr. Duggan testified that this discussion occurred. In any event, Mr. Flannery reasonably believed that Mr. Duggan would be sharing this important information with his boss.

liquidity would be needed to fund potential redemptions. Flannery Tr. at 1279:9-1280:22; Flannery Ex. 92 at SSgA-SEC000252910.

2. Liquidity Issues and Raising Liquidity Were Discussed at the Meeting.

Liquidity concerns and the need to raise liquidity were also discussed extensively. *See, e.g.*, Flannery Ex. 92 at SSgA-SEC 000252909 (Mr. Pickett reported that there were "major liquidity concerns;" Mr. Wands stated, "[w]e need to have liquidity should the clients decide to withdraw;" Mr. Flannery noted the need to raise liquidity). Everybody at the meeting agreed that there was a need to raise 30-40% liquidity in the fund by month end, based on Relationship Management's estimates of possible liquidity needs of between 25 and 50%. Flannery Ex. 92 at SSgA-SEC 000252912. Mr. Duggan participated in that discussion, asking, "[d]o we sell a small portion of the AA in the next 5 days to increase liquidity because we feel there will be illiquidity issues in the future?" *Id.*

3. Freezing the Fund Was Discussed at the Meeting.

The Committee also discussed the possibility of closing the fund to redemptions (also known as "freezing" the fund), but determined not to do so. Division Ex. 132 (final meeting minutes, which state "[t]he Committee also discussed at length the possibility of closing the funds to withdrawals, but determined that such action was not warranted at this time"); Flannery Tr. at 1286:22-1288:1. The fact that this topic was discussed is notable, because the only reason for considering a "freeze" on redemptions would be to insulate LDBF from the impact of a potentially high level of redemptions. Flannery Tr. at 1287:2-22.

4. LDBF's Risk Profile and Reducing the Risk Were Discussed at the Meeting.

The Committee also focused on the need to reduce risk in LDBF. Duggan Tr. at 232:1-232:9 (testifying, with regard to the Committee meeting, that "[m]y understanding was that the risk

. . . should not increase and we should seek to reduce risk by selling AA's when there was availability"); Flannery Tr. at 1018:24-1019:9; Flannery Ex. 92 at SSgA-SEC 000252909 (Paul Greff raised a concern about ensuring the portfolio was not made more risky; Mr. Duggan noted the need to ensure that SSgA's valuations were correct, and stated that "[o]nce we get out, risk profile improves and LDBF becomes more STIF"[23]).

5. Mr. Flannery Recommended Review by the Impaired Asset Valuation Committee.

The serious and growing liquidity problems made reliable pricing of LDBF's securities increasingly difficult. Flannery Tr. at 1009:13-18, 1016:5-21. In an attempt to ensure accurate pricing, Mr. Flannery recommended during the July 25 Investment Committee meeting that LDBF's pricing issues be raised with the Impaired Asset Valuation Committee ("IAVC"). Flannery Ex. 92 at SSgA-SEC 000252909 ("In light of developments, Sean Flannery recommends that the issue be brought to the Impaired Asset Valuation Committee."). Mr. Flannery was not a member of the IAVC, and the IAVC did not report to him. Flannery Tr. 1276:11-24. The IAVC had the authority to mark securities prices lower than those reported by the pricing vendor used by SSgA. *Id.* at 1276:11-1277:24 (IAVC was part of the checks and balances at SSgA); *see also* Flannery Ex. 256 at SS009157107 (composition of IAVC ensures PMs not "marking their own books"). Thus, Mr. Flannery's recommendation that the issue be reviewed by the IAVC meant that he was taking a step that could result in the prices of LDBF's assets being further reduced. Flannery Tr. at 1276:25-1277:23. Mr. Flannery felt, however, that it was important that pricing be as accurate as possible. *Id.* at 1277:24-1278:2. The IAVC did, in fact, meet on July 27, and Mr. Duggan was present at that meeting. Duggan Tr. at 147:3-11, 154:4-10; Flannery Ex. 38 at MD00454-56 (Mr. Duggan's handwritten notes of IAVC meeting).

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[23] "STIF" is an acronym for "short-term investment fund." Flannery Tr. at 1281:18-1282:2.

6. Investment Committee's Directions to the Investment Team

At the end of the meeting, the Investment Committee unanimously voted to: "1) increase the liquidity in the Limited Duration Bond Fund portfolio, per consultation with the Relationship Management team, by the end of the month[;] 2) sell a pro-rata share (across capital structures) to warrant any withdrawals[; and] 3) reduce the AA exposure, a target of 5%, by the end of the week." Flannery Ex. 92 at SSgA-SEC 000252912. Nobody understood that these instructions would or could all be carried out at once; indeed, as the Portfolio Manager, Mr. Pickett, testified, it would have been virtually impossible to implement all three instructions at one time. Pickett Tr. at 1742:12-14; *see also* Flannery Tr. at 1283:22-1285:6. As discussed below, however, each instruction was implemented to the best of the Fixed Income team's abilities given the constraints imposed by the increasingly illiquid market, and it is unrebutted that each of the resulting transactions raised liquidity while decreasing risk in LDBF.

a. Investment Committee Instruction 1: Raising Liquidity

In order to raise liquidity and reduce risk in LDBF, on July 26, SSgA sold approximately $1.6 billion of AAA bonds. Pickett Tr. at 1743:17-1745:5; Flannery Tr. at 1035:7-11; Zask Direct Test. at A.44, A.46, A.50. Selling the bonds in a single transaction was important, because successive sales in smaller increments would likely have risked pushing down the price SSgA could obtain for the bonds. Pickett Tr. at 1745:14-24. This was a leveraged position: the bonds were financed, and approximately $1.12 billion of the proceeds realized from the sale was used to pay off that financing. Zask Direct Test. at A.44-A.45; Pickett Tr. at 1743:23-1744:18. The remaining approximately $500 million in cash was invested in cash equivalents. Zask Direct Test. at A.52; Pickett Tr. at 1746:11-19.

While nobody knew the magnitude of possible redemptions, as Professor Wermers, the Division's expert, acknowledged, taking steps, such as the sale of AAA bonds, to increase liquidity in advance of anticipated redemptions allows for a more orderly redemption process, and reduces the need for "fire sales" to raise cash on short notice. *See* Cross Examination Testimony of Russell Wermers ("Wermers Tr.") at 719:8-720:18 (agreeing that "it would be prudent to try and anticipate the redemptions and build liquidity" in order to "minimize the fire sales"). The AAA sale in fact raised liquidity, consistent with the first instruction from the Investment Committee meeting. Zask Direct Test. at A.50; Flannery Tr. at 1035:7-11 (sale increased liquidity and adjusted risk and leverage); Division Ex. 248 at SSP000105535-36.

The AAA sale also reduced risk in LDBF: "[B]oth credit and market risks were reduced as a result of the transaction, as CVaR was reduced and converting securities to cash reduced the credit risk of the fund. Also, the repayment of the repo loans associated with these securities, which totaled $1.12 billion, reduced leverage and overall risk in the portfolio." Zask Direct Test. at A.49; *see also id.* at A.46-A.48, Exs. 5-7; Pickett Tr. at 1743:17-1745:5 (selling the bonds for cash reduced risk in LDBF because cash is less risky than AAA-rated bonds; the sale also reduced risk because the financed bonds were paid back, thus reducing leverage in LDBF). James Kramer, U.S. Head of Fixed Income Trading who executed the AAA sale, understood that the purpose of the sale was to reduce leverage in LDBF, and that the sale did reduce leverage. *See* November 19, 2009 Transcription of Telephone Conversation with James Kramer ("Kramer Transcription") at 13:2-17, 16:24-17:13, 27:15-24.[24] While the Division claims the July 26 sale, which is referenced in the August 2 letter, did not reduce risk, as discussed below, the Division presented no testimony or risk analysis to rebut the expert testimony of Ezra Zask and other

[24] Attached to Joint Stipulation Regarding Testimony of James Kramer, filed on March 15, 2011.

witnesses, including Mr. Armstrong, Mr. Pickett, Mr. Kramer and Mr. Flannery.[25] *See* Armstrong Tr. at 2206:9-17, 2207:5-19; Pickett Tr. at 1743:17-1745:5; Kramer Transcription at 13:2-17, 16:24-17:13, 27:15-24; Flannery Tr. at 1052:5-9; *see also infra,* Section III(A)(1)(b)(i). Furthermore, as Paul Greff, the Head of Global Fixed Income, later reported at an August 8 Investment Committee meeting, the AAA sale raised liquidity while maintaining the fund's risk profile. Division Ex. 248 at SSP 000105535-36; Flannery Tr. at 1293:3-12.

b. Investment Committee Instruction 2: Pro-Rata Sales

With respect to the second instruction from the Investment Committee, the very purpose of attempting to make pro rata sales was to keep the risk profile of the fund as consistent as possible. Pickett Tr. at 1747:10-18. The Fixed Income team carried out the Investment Committee's instruction. Flannery Tr. at 1285:2-6; Pickett Tr. at 1747:10-1752:25; *see also* Division Ex. 248 at SSP 000105535-36 (Paul Greff notes from August 8 Investment Committee meeting, reporting that SSgA had met all redemptions while maintaining the risk profile). As a chart prepared by Professor Russell Wermers, the Division's own expert, demonstrates, a series of AA sales occurred in late July and early August; $611 million in AA bonds were sold for cash by August 14, with significant additional AA sales occurring thereafter, totaling $1.2 billion by August 24. Division Exs. 217, 218 (showing transaction data); *see also* Division Ex. 245 (summary charts used by Wermers) at Ex. III(A); Pickett Tr. at 1749:15-1750:1.[26] A-rated bonds were also sold — indeed,

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[25] The Division simply surmises that the fund became more risky because a large number of highly-rated bonds were sold, and the proceeds were supposedly immediately used to meet redemptions, leaving no cash in the fund at August 2, the date of the letter referencing the risk-reducing transactions. Division's Pre-Hearing Br. at 17-18. The Division's theories are both factually and analytically wrong, as discussed in detail in Section III(A)(1)(b)(i), below. For one thing, a substantial amount of cash remained in LDBF as of August 2.

[26] The AA sales occurring over the course of several weeks was entirely consistent with the Investment Committee's instructions. Duggan Tr. at 232:1-9 (testifying that he understood from the meeting that AA bonds were going to be sold "**when there was availability**") (emphasis added); Flannery Tr. at 1284:15-1285:1 ("the markets were essentially locked up. They were very illiquid. . . . it was possible that we might not even be able to get a bid on some bonds, I

(continued...)

$100 million in A-rated bonds were sold on August 8. Division Ex. 245 at Ex. III(A); Pickett Tr. at 1750:10-17.[27] These sales were made in response to the Investment Committee's instruction to make pro rata sales. Pickett Tr. at 1750:10-22, 1751:24-1752:7.

c. Investment Committee Instruction 3: Reduction in AA Exposure

Finally, as to the third instruction from the Investment Committee meeting, AA exposure was reduced, as discussed above, through the AA sales which occurred from late July through August 24, as demonstrated in Exhibit III(A) of Professor Wermers' summary chart. *See* Division Ex. 245. Each of these sales generated cash for LDBF. *Id.*; *see also* Division Ex. 248 at SSP 000105536 (discussing the sales of AA bonds that had occurred through August 8).

E. <u>Expiration of Total Return Swaps at Month End</u>

In addition to the transactions resulting from the July 25 Investment Committee's instructions, at the end of July, SSgA also allowed certain total return swaps to expire, or "roll off." Zask Direct Test. at A.53, Ex. 8. Because total return swaps are a form of leverage, the expiration of the swaps was a "natural deleveraging" event for LDBF. Flannery Tr. at 1292:15-1293:2; Division Ex. 248 at SSP000105535; Hopkins Tr. at 141:1-7; Wands Tr. at 2897:3-11. Moreover, as Mr. Zask explained, "[r]olling off LDBF's TRS lowered the fund's overall risk. The TRS exposed the fund to the risks of the subprime mortgage market. As a result of the TRS' expiration, the TRS notional exposure to the subprime mortgage market was eliminated and market risk decreased." Zask Direct Test. at A.55; *see also id.* at A.56, A.58, Exs. 8-9; Pickett Tr. at 1753:12-21. The fund's credit risk also decreased. Zask Direct Test. at A.57; *see also*

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mean, literally wouldn't be able to sell it. . . . we weren't necessarily in control over precisely how or when that could happen given the market conditions."). Indeed, as Mr. Pickett testified, nobody expected that the sales would all occur at once, nor could they have. Pickett Tr. at 1742:8-14.

[27] Given that most of the fund was comprised of AAA- and AA-rated securities (*see, e.g.*, Sirri Report at ¶¶ 40, 48), sales of lower-rated securities were understandably smaller.

Wands Tr. at 2897:3-11 (explaining that swaps rolling off reduce leverage and exposure to the asset class). The expiration of these swaps is described in the August 2 letter as among the transactions that had reduced risk in LDBF (along with the mid-July reduction in BBB ABX exposure and the July 26 AAA bond sale), and it, in fact, reduced risk.[28] There is no contrary evidence.

F. July 30 Executive Management Group Meeting

Mr. Flannery was a member of SSgA's Executive Management Group ("EMG"), which included the senior executives of SSgA. Flannery Tr. at 785:5-11. 1313:14-23. The group was headed by CEO Bill Hunt. Marc Brown, Chief Marketing Officer, was also a member of the EMG, as was General Counsel Mitchell Shames. Shames Tr. at 20:7-21:3; Flannery Tr. at 1313:16-23, 1315:5-10. At the July 30, 2007 EMG meeting, which both Mr. Flannery and Mr. Shames attended, the potentially high level of redemptions from LDBF was discussed. Flannery Tr. at 1315:1-15. The potential redemption levels were such that the EMG considered freezing redemptions from LDBF. *Id.* at 1314:2-1314:4. Mr. Flannery opposed freezing redemptions, because such a step would deprive investors of the daily liquidity that they had been promised. Flannery Tr. at 1288:9-1289:5.

G. Redemption Recommendations of Advisory Groups

Among the many clients directly and indirectly invested[29] in LDBF were clients of three SSgA advisory groups: Global Asset Allocation ("GAA"), the Office of the Fiduciary Advisor ("OFA") and Charitable Asset Management ("CAM"). Lowe Tr. at 1986:1-18 (GAA); Donovan

[28] No cash is generated when swaps roll off, and as such, allowing swaps to expire is not a means of funding redemptions. Wands Tr. at 2897:3-15.

[29] Some clients invested directly in LDBF, while others invested in other SSgA funds that, in turn, invested in LDBF. *See, e.g.*, Hopkins Tr. at 207:13-24. Other SSgA funds that were invested in LDBF are sometimes referred to as commingled funds. Wands Tr. at 2849:19-2850:4.

Tr. at 1775:20-23 (OFA); Flannery Tr. at 892:22-25 (CAM). Their clients' investments comprised a small portion of the overall investments in the fund, and the clients of each group had their own unique investment guidelines based on their particular needs and objectives. *See, e.g.*, Flannery Tr. at 868:7-870:5 (discussing GAA's and OFA's investment approaches and responsibilities to their clients); Flannery Ex. 301 (showing that GAA clients held less than 2% of the units in LDBF on 6/30/07); Donovan Tr. at 1812:1-9 (amount of funds OFA's clients had invested in LDBF was "very small"); Flannery Tr. at 893:1-894:3 (testifying regarding small size of CAM). While members of the advisory groups certainly interacted with others at SSgA and, in fact, the head of GAA reported to Mr. Flannery,[30] the investment recommendations and decisions made by these groups were independent from, and did not represent the views of, SSgA. *See, e.g.*, Lowe Tr. at 2042:22-2043:4 (Paul Greff informed Mr. Lowe that he thought GAA made the wrong decision in recommending redemption), 2021:8-21 (agreeing that GAA's recommendation reflected a view that would be inconsistent with one or another of SSgA's 300 strategies), 2045:4-5 (GAA "made our decisions independently"); Johnson Tr. at 2372:17-2375:3 (testifying that OFA and CAM, which both reported to him, made independent investment decisions because "[t]hat's what they get paid for"); Flannery Tr. at 1388:11-1389:12 (OFA and GAA did not speak for SSgA and had different investment objectives and risk constraints). Mr. Flannery never interfered with GAA's independence during his entire tenure as CIO, nor did he intrude on OFA's independence. Lowe Tr. at 2045:7-9; Donovan Tr. at 1809:23-1810:3. There is simply no evidence with respect to CAM as the Division did not produce any representative of CAM to testify. Indeed, Mr. Flannery made sure that he did not interfere with these groups'

[30] Although the head of GAA reported to Mr. Flannery, this was not Mr. Flannery's decision and was a reporting structure that existed before he became CIO. Flannery Tr. at 1147:1-6. The heads of OFA and CAM reported to Shawn Johnson, Chair of the Investment Committee. Johnson Tr. at 2372:17-25.

decisions and duties to their clients. *See, e.g.*, Lowe Tr. at 2018:5-13 (Before GAA's redemption recommendation, Mr. Flannery instructed Mr. Lowe to make the best decision he could on behalf of his clients, and Mr. Flannery did not want to know what GAA decided), 2045:13-20.

In late July 2007, GAA, CAM and OFA recommended that their clients redeem their investments in LDBF. Lowe Tr. at 2014:1-2015:6 (GAA); Donovan Tr. at 1780:1-6 (OFA); Johnson Tr. at 2374:14-23 (acknowledging OFA/CAM's recommendation). As Mr. Lowe, the head of GAA, testified, the decision to recommend redemption was a difficult one, as GAA was concerned that if the market rebounded, as it had after the February dislocation, GAA's clients would have already locked in losses and would miss the sort of reversion to the mean which took place in February and March. Lowe Tr. at 2016:7-2017:3, 2019:19-2020:5. Lowe and GAA were "terrified" that they were making the wrong recommendation. *Id.* at 2049:18-2050:12.

As the Division conceded at the Hearing and as Mr. Lowe agreed, GAA's recommendation was "not at all" based on anticipated redemptions by other clients. Lowe Tr. at 2034:16-20, 2036:11-2038:6 (Division conceded at the Hearing that it is no longer claiming that GAA's decision to redeem was based on anticipated redemptions of others). OFA's decision was also not based on actual or anticipated redemption activity. Donovan Tr. at 1809:4-19 (OFA's redemption recommendation was not based on any actual or anticipated redemption activity in the fund, but instead was based on LDBF's underperformance and volatility). There is no evidence that CAM's decision was based on redemption activity as again, the Division did not produce a witness from CAM.

GAA informed Relationship Management and Deputy General Counsel Duggan of its redemption recommendation shortly after July 25, the date on which the decision was made. Lowe Tr. at 2041:24-2044:6. Ms. Donovan informed the Legal and Relationship Management

Departments of OFA's recommendation by July 27. Donovan Tr. at 1804:20-1805:19; Division Ex. 222 at SSgA-SEC 000380698. GAA met with approximately twenty Relationship Managers on July 27 to discuss GAA's clients' upcoming redemptions (Lowe Tr. at 2043:9-2044:6), so that Relationship Management personnel could begin processing redemption requests from GAA and OFA clients. *Id.* at 2044:7-9; Carlson Tr. at 2726:5-2727:6 (also testifying that by the time of the August 2 letter, Relationship Management personnel knew of GAA's decision).

H. Increased Client Demands and SSgA's Response

During the summer of 2007, the level of client inquiries surged. Flannery Tr. at 1223:16-20. There were substantial interactions between Relationship Management and Consultant Relations, on the one hand, and investors and their consultants, on the other hand, and Mr. Flannery was aware of this high level of communications. Flannery Tr. at 1223:21-1225:5. Members of the Fixed Income team, such as Mike Wands, were also communicating with clients and consultants during the summer of 2007. *Id.* at 1224:20-1225:5. Indeed, the volume of questions and other inquiries from clients became so great that SSgA imported employees from Europe to supplement SSgA's domestic staff and help respond to clients. Carlson Tr. at 2740:11-13. In addition, SSgA implemented several measures intended to furnish further information to clients.

1. The FAQs and the SWAT Team

First, a series of Subprime Frequently Asked Questions ("FAQs") were developed. Flannery Tr. at 1225:6-11, 1360:20-23. This was not the first time FAQs had been employed by SSgA, as the Company had used FAQs in the past in connection with other issues and events. Carlson Tr. at 2742:17-19; Flannery Tr. at 1360:24-1361:12. The purpose of the FAQs was to assist Relationship Managers and Consultant Liaisons in responding to actual and anticipated questions from clients. Flannery Tr. at 1310:4-10. While the Legal Department had determined that the FAQ document itself could not be distributed to clients, Relationship Managers could share any information in the FAQs with clients, either in response to questions or if they believed that such information might be useful to a particular client. Flannery Tr. at 1310:11-1311:1, 1363:19-1364:5; Carlson Tr. at 2744:22-2745:12; Duggan Tr. at 326:11-17.[31] [redacted] (Duggan Tr. at 322:6-323:16), and, while SSgA has asserted privilege regarding this testimony, it is undisputed that the FAQs were used, and that the process for developing and using FAQs was subject to strict review by the Legal Department. Flannery Tr. at 1361:17-1362:2.

Other than reviewing questions in the FAQs and, when necessary, assisting client-facing employees with getting answers to various of the FAQs from members of the Fixed Income team, Mr. Flannery played a limited role in the subprime FAQ process. Flannery Tr. at 1361:13-16; Flannery Ex. 163. While Mr. Flannery volunteered to review the FAQs from time to time, it was not part of his job responsibilities to do so. Flannery Ex. 11; Flannery Tr. at 1368:23-1369:6.

Mr. Flannery understood that the FAQs had to be reviewed by the Legal Department before they were approved for use, and that Deputy General Counsel Mark Duggan had overall responsibility for such review. Flannery Tr. at 1361:17-1362:2 ("The process was expressly set up such that every question had to be approved and vetted by the Legal Department . . . ."); Carlson Tr. at 2743:2-11 (Legal had to approve FAQs before they could be used with clients); Shames Tr. at 169:1-3. [redacted]

[31] Mr. Flannery played no role in SSgA's decision to not distribute the FAQ document to clients. That decision was made by the Legal Department. Carlson Tr. at 2744:10-2744:22; Flannery Tr. at 1214:1-14 (testifying he had no role in determining how to respond to client questions or what information to push out to them), 1040:2-9 (testifying as to his "understanding" of how FAQs could be used).

[redacted]. Duggan Tr. at 330:12-19. Mr. Duggan testified that he reviewed FAQs, which were sent to him via e-mail, while on vacation in Maine between July 27 and August 6, 2007. *Id.* at 235:20-25, 237:14-24.[32]

In addition to SSgA's attorneys, Relationship Managers and Consultant Liaisons, at least the following people received the August 1 FAQs: Marc Brown, Shawn Johnson, Larry Carlson, Michael Wands. Division Ex. 153. Mr. Flannery was also copied on the e-mail circulating the August 1 FAQs to these people. *Id.*

By August 1, the FAQs contained the following information: LDBF's exposure to subprime through the use of derivatives such as total return swaps (FAQ #1); the fact that "[t]he portfolio has and continues to be double A in average credit quality" (FAQ #8); SSgA's continued belief in the underlying fundamentals of the market (FAQ #21); the fact that GAA had recommended that its clients redeem their investments in LDBF (FAQ #31); and the fact that SSgA had been seeking to reduce risk by taking advantage of liquidity when it exists (*e.g.*, FAQ #13). Division Ex. 153. In fact, in discussing SSgA's efforts to reduce risk in LDBF, the FAQs identified the AAA bond sale and the total return swaps rolling off at the end of July (FAQ #32). *Id.*

In addition to the FAQs, a "SWAT Team" was formed, consisting of client-facing individuals, to assist in responding to client demands. Flannery Ex. 68; Carlson Tr. at 2740:5-10. Mr. Flannery did not select the members of the SWAT Team, and played no role in its decision-making. Flannery Tr. at 1302:4-1303:8. However, Mr. Flannery was aware of the SWAT team

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[32] Prior to going on vacation, Mr. Duggan had already received the July 26 version of the FAQs in their final form (Flannery Ex. 135), and though he claims a failure of recollection, it is undisputed that he received the August 6 version of the FAQs on that date. Flannery Ex. 172.

and knew that it was an effort by the client-facing teams to coordinate responses to the many inquiries from clients. *Id.* at 1302:11-1303:3.

2. Summer 2007 Letters to Clients

As part of SSgA's increased communications efforts, a series of letters was sent to clients during the summer of 2007, including the August 2 and August 14 letters on which the Division bases its charges against Mr. Flannery. The letters were intended to supplement information that had already been provided to clients. Carlson Tr. at 2724:8-12. The first such letter, with which Mr. Flannery has not been charged, was sent to clients on July 26. Hopkins Ex. 98. The letter was intended to alert clients to substantial losses in LDBF due to subprime exposure; warn that market turmoil was expected to continue for some time; summarize the Fixed Income team's views on bond investments given the present circumstances and to explain its belief in the long-term fundamentals; and explain SSgA's plan of action, which involved reducing risk in the portfolios where liquidity in the market allowed. *Id.*; Wands Tr. at 2861:6-12 (at this point in time, Wands and SSgA's credit analysts still believed in the fundamentals of the subprime sector).

Mr. Flannery made clear that he wanted the July 26 client letter reviewed by the Legal Department before it was distributed. Shames Tr. at 87:16-21; Flannery Tr. at 1299:11-22; Flannery Exs. 52, 54; Hopkins Ex. 77. The letter was in fact reviewed extensively by SSgA's legal team, including General Counsel Mitchell Shames. Shames Tr. at 89:7-90:9, 94:11-17; Flannery Ex. 283; *see also, e.g.*, Flannery Exs. 68-69, 108 (reflecting that the letter will "maintain[] appropriate legal disclosure rules"); Hopkins Exs. 79-82, 84, 88-89, 94-96. Mr. Flannery's desire that the Legal Department review the July 26 letter was consistent with his practice regarding all of the letters sent to clients during the summer of 2007. Flannery Tr. at 938:20-939:5, 1299:11-14. As discussed below, the evidence shows that Mr. Flannery made certain that each letter sent to clients was heavily vetted by multiple layers within SSgA, including Legal and Relationship Management, and reasonably believed that all relevant components within SSgA were knowledgeable about the issues.

a. Substantial Role of SSgA's Legal Team in Summer 2007 Letters

In 2007, SSgA had a robust Legal Department with expertise in securities disclosure matters. Shames Tr. at 18:6-20 (SSgA's legal group had between 25 and 28 attorneys), 25:12-26:5 (Mr. Duggan, the Number Two person in SSgA's Legal Department, was responsible for securities work). Several SSgA in-house lawyers — in addition to outside counsel — were involved in reviewing the August letters, as well as other communications to investors during the summer of 2007, to ensure compliance with securities laws and other legal requirements. *Id.* at 155:8-156:5; Flannery Tr. at 904:4-23. As Larry Carlson, Co-Head of Relationship Management, testified, Legal "[had] a role in every letter." Carlson Tr. at 2749:25-2750:1. In fact, the Legal Department had final approval power over all of the letters sent to clients during the summer of 2007. *See, e.g.*, Flannery Ex. 127 (Mr. Shames advised Mr. Carlson that he needed to see any changes to the August 2 letter).

Mr. Flannery communicated with Mitchell Shames frequently (and in fact their offices were right next to one another), including regarding housing-related asset backed securities and the issues facing LDBF in 2007, and Mr. Flannery was confident in Mr. Shames' abilities.[33] Flannery Tr. at 940:8-9, 942:7-14, 1300:18-1301:14; *see also id.* at 1134:17-1135:4 (testifying that he went into business with Mr. Shames after leaving SSgA). Reporting directly to Mr. Shames was Mark Duggan, who had substantial experience in communications and disclosure issues, and was regarded by Mr. Shames as an "expert" in securities matters. Shames Tr. at

[33] When Mr. Shames (who was intimately involved in the review of the August 2 letter) learned that Mr. Flannery had received a Wells notice and its focus, he responded to Mr. Flannery with words to the effect that, "there is no case." Flannery Tr. at 1137:19-24.

156:6-12, 205:7-13. Mr. Duggan was heavily involved in reviewing and editing the August 14 letter, as discussed below.[34]

In addition to Mr. Shames and Mr. Duggan, a number of other SSgA lawyers were involved in reviewing the August 2007 letters. Elizabeth Fries of the law firm Goodwin Procter LLP, with whom SSgA's legal team had worked for many years and who is an experienced securities lawyer with specific expertise in communications and disclosure issues, was also involved in reviewing the letters; in fact, she and her firm were heavily involved in connection with advising SSgA on disclosure issues and subprime issues generally. Shames Tr. at 34:6-36:18 (testifying about Ms. Fries' and Goodwin's involvement in subprime), 37:6-11 (". . . Goodwin Procter was one of our primary firms for investment and securities matters"), 156:9-12 (describing Ms. Fries as an expert in securities matters), 207:1-8 (describing Ms. Fries' "enormous amount of experience with respect to SSgA's products and documentation, and generally, in my judgment, was an expert with respect to investment issues and in particular bank commingled funds.").

As the evidence discussed below demonstrates, Mr. Flannery reasonably believed that the lawyers were armed with the necessary information concerning LDBF when they reviewed and

[34] Regarding Mr. Flannery's Wells notice, which included allegations concerning the August 14 letter, Mr. Duggan observed: "Sean, there was nothing that was in that letter that shouldn't have been in that letter and there was nothing that wasn't in the letter that should have been in the letter." Flannery Tr. at 1425:1-11.

edited the letters. Similarly, in explaining the role of SSgA's legal team in reviewing and approving the summer 2007 client letters, Mitch Shames testified:

> As my role as general counsel of SSgA, I viewed my primary obligation and responsibility to be, to assemble the right team with the right expertise to handle various matters . . . . [W]hen I received the first draft of [the July 26, 2007 letter], ***I assembled the right team, which in my mind was Mark Duggan, Chris Douglass, Glenn Ciotti, and Liz Fries.*** And while I reviewed the documents for purposes of clarity, ***I had the confidence that my team of counsel was doing what they deemed necessary to review the communication.***
>
> . . . .
>
> When I reviewed the letter and I identified that it was a client — a market commentary, I wanted to bring in lawyers who specifically had investment and securities experience. And so I assembled a team which would have — ***a team which I would have been confident in, would have reviewed the letter in a way that they thought was necessary in order for the legal group to sign-off on the letter***.

Shames Tr. at 80:4-13; 89:21-90:2 (emphasis added). Mr. Shames further explained that his "understanding was that this was an accomplished and well-experienced team of legal advisers, and that they would raise the issues and make changes, so that the letters were consistent with whatever rules and regulations [SSgA was] subject to[]." *Id.* at 156:1-5. *See generally id.* at 156:1-162:17.

While Mr. Shames and Mr. Duggan both testified during the investigation that they do not recall knowing certain facts during July and August 2007, they are clear that Mr. Flannery is an honest person of high integrity. Shames Stipulation at ¶ 2; Duggan Stipulation at ¶ 2.

b. Substantial Role of Relationship Management and Consultant Relations in Summer 2007 Communications

The Relationship Management and Consultant Relations teams were also heavily involved in reviewing and editing the summer 2007 letters to clients, including the August 2 and August 14 letters. Flannery Tr. at 903:5-904:3 (testifying about the important role Relationship Management played in the letters); *see also id.* at 1393:2-1394:7 (testifying that he wanted Relationship Management to review the August 14 letter because he wanted "more eyes and ears on this to make sure we get it right."). The Relationship Management team was informed about the issues facing LDBF,[35] and Mr. Flannery reasonably believed they had the relevant facts, as discussed below.

I. <u>The August 2 Letter</u>

The Division has charged Mr. Flannery in connection with the August 2, 2007 letter to clients, which he did not write, did not request, did not sign, played no role in distributing, and with which he had only passing involvement. That letter stated, in relevant part:

> **Actions Taken**
>
> We believe that what has occurred in the subprime mortgage market to date this year has been more driven by liquidity and leverage issues than long term fundamentals. 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.

Division Ex. 159. As discussed below, Mr. Flannery's involvement was limited to a few "suggested edits" to this paragraph, and only five innocuous words from his "suggested edits" were included in the final version of the letter.

[35] *See, e.g.*, Lowe Tr. at 2043:9-2044:6 (GAA met with approximately twenty Relationship Managers on July 27 to discuss GAA's redemption decision), 2040:19-2042:7 (discussing Flannery Ex. 129 and stating that he notified Staci Reardon of GAA's recommendation to clients they redeem); Flannery Exs. 105 at SSgA-SEC 000380698 (stating all Relationship Managers were notified of OFA's recommendation decision on July 27); 109 (meeting to discuss communication plan and use of FAQs with clients); 133 (FAQs); 270 (subprime issue feedback document showing information flow to clients through Relationship Management); Carlson Tr. at 2710:18-2711:16 (stating he was aware of anticipated and actual redemption activity); Donovan Tr. at 1799:7-14 (testifying she left a message for Staci Reardon telling her OFA was recommending redemption to its clients).

The August 2 letter originated as a result of LDBF's poor performance in July, and was drafted by Adele Kohler, Senior Managing Director Product Development & Product Engineering, to provide clients with July performance information more quickly than they would have received it under normal circumstances. The letter made no attempt to sugarcoat the situation. Carlson Tr. at 2729:8-2730:4. Ms. Kohler initially drafted the letter on July 31, 2007, and circulated it to James Hopkins (Product Engineer), Staci Reardon (Co-Head of Relationship Management) and Nicholas Mavro (Vice President - Consultant Relations). Flannery Ex. 120. Mr. Flannery did not request that Ms. Kohler prepare this letter, and does not know who did. Flannery Tr. at 1316:18-23.

Later on July 31, Ms. Kohler sent a draft of the letter to General Counsel Shames, as well as to Ms. Reardon, Mr. Hopkins, Michael Wands (Head of North American Fixed Income), Larry Carlson (Co-Head of Relationship Management), and Mr. Mavro. Marc Brown (Chief Marketing Officer) and Mr. Flannery were copied on the e-mail, in which Ms. Kohler asked Mr. Shames to review the draft and communicate regarding any changes to Mr. Mavro and Mr. Carlson. Division Ex. 151. Mr. Shames immediately e-mailed the letter to SSgA's outside legal counsel, Ms. Fries. Shames Tr. at 102:16-19; Flannery Ex. 136.

While Ms. Kohler did not ask Mr. Flannery to review the letter, he nonetheless did so. Flannery Tr. at 1318:3-8. On August 1, 2007, Mr. Flannery replied to Ms. Kohler and all who had received her e-mail, including General Counsel Shames, Michael Wands, and the most senior employees in Relationship Management, and with minimal "suggested edits," commented on the letter for the first and only time. Division Exs. 154, 155. He provided "suggested edits" because he thought they might be helpful, though he understood that a number of capable people would also be reviewing, editing and disseminating the letter. Flannery Tr. at 1318:18-1319:2.

Division Exhibit 155 sets forth Mr. Flannery's suggested edits to the August 2 letter, which represented his entire proposed contribution to the letter. Flannery Tr. at 1319:10-18. Mr. Flannery's suggested edits were designed to make the letter more accurate. *See, e.g.*, *id.* at 1319:22-1320:9 (substituting "delinquencies" for "defaults" because there were situations where people had become delinquent on their mortgages prior to defaulting, and thus the word "delinquencies" was more accurate), 1320:10-21 (deleting description of the ABX Index as an "exchange-traded vehicle" because it was not an exchange traded vehicle and instead was traded over-the-counter), 1321:3-11 (asking that Ms. Kohler check some numbers that she had included, because Mr. Flannery "wanted to make sure that what we sent out to clients was accurate"). The Division does not contend that any of these suggested edits were problematic.

With respect to the paragraph of the letter on which the Division bases its charges, Mr. Flannery's only proposed revisions were as follows:

> **Actions Taken**
>
> While we believe that events over the past several months have ~~been largely the result of liquidity and leverage issues, versus long term fundamentals, we are also aware that~~ <u>indicate some deterioration in longer-term fundaments, we believe price action has been dominated by the unwinding of leverage in a market segment with sharply reduced liquidity. Additionally,</u> the downdraft in valuations ~~have~~ <u>has had</u> a significant impact on the risk profile of our portfolios, ~~and thus we have taken~~ <u>prompting us to</u> take steps to reduce risk across the affected portfolios. Within the Limited Duration Bond Fund we have reduced exposure to a significant portion of triple B securities, we have sold a large amount of our triple A cash positions and ~~will be reducing~~ additional triple A exposure as <u>some</u> total return swaps rolled off at month end. These actions ~~will~~ simultaneously <u>serve to</u> reduce risk in other SSgA strategies that hold units of the Limited Duration Bond Fund.

Compare Division Ex. 151 *with* Division Ex. 155. Each of Mr. Flannery's suggested edits to the "Actions Taken" paragraph were intended to — and in fact did — make the paragraph more accurate. The first deletion and substitution in the paragraph was made to express Mr. Flannery's view that this was not a mere technical issue in the market, and that some fundamental weakening was occurring. Flannery Tr. at 1321:15-1322:14. In other words, this change depicted a more negative view of the market than Ms. Kohler's initial language had: "[A]t this point we had to acknowledge that we, in fact, had seen some signs of fundamental deterioration. I didn't want to be misleading. . . . I wanted it to be accurate." *Id.* at 1322:16-25. The next change, from "have" to "has had" was a grammatical correction. The change after that, pursuant to which Mr. Flannery deleted language and added "prompting us to take" was stylistic, and did not change the meaning of the sentence. With respect to the deletion of "will be reducing" and related changes in connection with triple A exposure and swaps rolling off, this change was made because the transactions had already occurred, and thus the changes made the paragraph accurate; in other words, Mr. Flannery simply corrected the tense. *Id.* at 1324:4-12. Finally, Mr. Flannery added in the word "some" before "total return swaps" because the fund still held total return swaps. *See, e.g.*, Wands Tr. at 2896:12-22 (describing swaps that could roll off in August and September 2007). Again, this suggested edit made the paragraph more accurate.

Mr. Flannery's suggested edits were sent to a number of people, including Mr. Wands, who was far more intimately involved in LDBF than Mr. Flannery; Ms. Reardon and Mr. Carlson, Relationship Management executives who were aware of potential redemptions and actual redemptions; and Mr. Shames, who was present at the July 30 EMG meeting where the potential for significant redemptions in LDBF and freezing the fund were discussed. *See, e.g.*, Division Ex. 155; Carlson Tr. at 2752:23-25 (testifying that Mr. Wands was closer to LDBF than Mr. Flannery), 2710:18-2711:16 (stating he was aware of anticipated and actual redemption activity); Donovan Tr. 1799:7-14 (testifying she left a message for Staci Reardon telling her OFA was recommending redemption to its clients); Lowe Tr. 2042:5-7 (discussing Flannery Ex.

129 and indicating that he notified Staci Reardon of GAA's recommendation to clients they redeem); Flannery Tr. at 1315:1-15.

On August 1, Mr. Wands reviewed the draft Mr. Flannery had sent with his suggested edits and provided his own edits. Flannery Ex. 126. Mr. Wands made various changes to the letter, but did not change the "Actions Taken" paragraph, including Mr. Flannery's suggested edits to that paragraph. *Id.* Also on August 1, Mr. Carlson sent an e-mail to client-facing individuals, explaining that the Relationship Management team was in the process of preparing a letter for investors. Messrs. Hopkins, Wands, and Flannery received that e-mail, in which Mr. Carlson identified three things (among others) that needed to happen before the letter was ready to send to clients: (1) "*Legal will confirm that the letter is good to send*," (2) "We will be running holdings reports of all affected Funds," and (3) Relationship Managers "will need to decide what contacts to send [the letter] to and inform the consultant liaison for each client." Flannery Ex. 123 (emphasis added). Legal had final approval authority over the letter. Carlson Tr. at 2753:22-2754:3; *see also* Flannery Ex. 127. Patricia Hudson, a communications writer for SSgA who was copied on Mr. Carlson's e-mail, then sent an e-mail to Mr. Flannery, asking if Mr. Carlson was referring to the same letter Mr. Flannery wanted to draft, and Mr. Flannery replied, "No. He is talking about the letter they are working on with Adele."[36] Flannery Ex. 123; Flannery Tr. at 924:13-18.

[36] Ms. Hudson's reference was to the letter that Mr. Flannery was considering writing to clients, which ultimately became the August 14 letter, discussed below. Flannery Tr. at 1327:5-17.

The letter was further reviewed and revised by a number of people, and Mr. Flannery played no role in this process:

- On August 1, Ms. Reardon sent an e-mail to Ms. Kohler, Mr. Carlson, Mr. Mavro and Mr. Hopkins, containing her comments on the draft. Flannery Ex. 122. Mr. Flannery was not copied on this e-mail. *Id.*

- Mr. Shames forwarded Mr. Flannery's comments to Jodi Luster, an attorney within SSgA, on August 1. Flannery Ex. 130; Carlson Tr. at 2755:16-18 (testifying that Ms. Luster was an attorney in the SSgA Legal Department). Mr. Flannery was not copied on this e-mail. Flannery Ex. 130.

- Ms. Luster made further revisions to the letter, and then transmitted it on the same day to Elizabeth Fries at Goodwin Procter, copying Mr. Shames. Flannery Ex. 132; Flannery Tr. at 1332:3-8. Ms. Luster's transmittal e-mail, on which Mr. Flannery was not copied, stated, "I've attached an edited version of the client letter that I believe incorporates the points raise on our discussion this afternoon." Flannery Ex. 132.

- On August 1, Mr. Shames e-mailed Mr. Carlson, stating, "Larry, please make sure I have the most recent draft. Note, no more changes after my review, or if changes are made, I need to get a copy." Flannery Ex. 127. Mr. Flannery was not copied on this e-mail. *Id.*

- Mr. Carlson responded to Mr. Shames that same day, agreeing that no changes would be made without Mr. Shames' review, and indicating that Mr. Shames should be looking out for a final draft from Mr. Mavro within the next hour. Division Ex. 156. Again, Mr. Flannery was not copied on this e-mail. *Id.*

- Mr. Mavro then sent a revised version of the letter to Mr. Shames. Flannery Ex. 129. Mr. Flannery was not copied on Mr. Mavro's e-mail transmitting the revised draft. *Id.*

- On August 2, Ms. Fries circulated to Attorneys Shames and Luster her comments on the draft she had received from Ms. Luster the previous day. Flannery Ex. 136. In her cover e-mail, on which Mr. Flannery was not copied, Ms. Fries demonstrated an in-depth command of the facts pertaining to the fund: "One thing we did not discuss yesterday is that we should be certain this is exclusively targeted at investors with products that have a NAV based on fair market value. Presumably Stable Value is not affected by price action, and products such as CDOs have probably not realized 'losses' at this stage." *Id.*

- Ms. Luster then sent an e-mail to Mr. Carlson, Mr. Mavro and Vincent Thornton (Relationship Manager), copying Charles Cullinane, another attorney in SSgA's Legal Department. Division Ex. 158; Carlson Tr. at 2755:23-2756:2 (testifying that Mr. Cullinane was an attorney in the SSgA Legal Department). Mr. Flannery was not copied on this e-mail, in which Ms. Luster stated that she had "attached the revised letter which incorporates our comments from our discussion this morning." Division Ex. 158. Mr. Flannery did not participate in the discussion referenced in this e-mail. Flannery Tr. at 1334:3-1335:2.

- Mr. Carlson sent a response to Ms. Luster's email, on which Mr. Flannery was again not copied, stating "Charlie/Jodi, per our/my voicemail, changes noted below. Going up to see Marc now." Flannery Ex. 140. Mr. Carlson's reference in the e-mail is to his boss, Marc Brown. Flannery Tr. at 1335:22-1336:1.

- On August 2, Ms. Luster sent an e-mail to Elizabeth Shea, Vice President and Senior Compliance Officer, requesting that she review the draft letter. Flannery Ex. 141. Ms. Shea forwarded the e-mail and draft to Margaret Nelson in Risk Management (formerly Senior Compliance Officer), who then wrote to James Hopkins, seeking confirmation that he drafted and reviewed the letter.[37] *Id.* Mr. Flannery was not copied on this e-mail correspondence. *Id.*

- On the afternoon of August 2, Mr. Carlson e-mailed Attorneys Luster, Cullinane and Shames stating, "[h]ere is the letter after making the changes . . . thanks for your help." Flannery Ex. 142. Mr. Flannery was not copied on this e-mail. *Id.* The draft letter attached to this e-mail contained language stating that LDBF "has maintained and continues to be double A in average credit quality according to SSgA's internal portfolio analytics." *Id.* Mr. Flannery did not add this language.[38] Flannery Tr. 1337:2-1339:3; *see also* Flannery Tr. at 1339:19-23 (testifying that he made no edits to the letter after August 1, 2007).

- Later on August 2, Mr. Shames forwarded the final draft of the letter to Ms. Fries, stating, "Liz, attached find final letter as going out to clients. Thanks for all of your help. I know you've been talking with Chris [Thome] and Glenn [Ciotti] on the redemption contribution issues." Flannery Ex. 144. Mr. Flannery was not copied on this e-mail. *Id.*

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[37] The reference to Mr. Hopkins drafting the letter was inaccurate. Flannery Tr. at 1336:17-1337:1.

[38] The added language was accurate. *See, e.g.*, Flannery Ex. 137 at SSP003875765; Flannery Ex. 80 at SSgA-SEC 000252698; *see also* Section II(A)(1)(b)(ii), *infra*.

Thus, following Mr. Flannery's "suggested edits," the "Actions Taken" paragraph was extensively revised by others as follows prior to being sent to clients:

> **Actions Taken**
>
> ~~While w~~We believe that ~~events over the past several months have indicate some deterioration in~~what has occurred in the subprime mortgage market to date this year has been more driven by liquidity and leverage issues than long~~er~~ term fundamentals, ~~we believe price action has been dominated by the unwinding of leverage in a market segment with sharply reduced liquidity~~. 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. ~~Within~~To date, in the Limited Duration Bond ~~Fund~~Strategy, we have reduced ~~exposure to~~ a significant portion of ~~triple B~~our BBB-rated securities~~,~~ and we have sold a ~~large~~significant amount of our ~~triple A~~AAA-rated cash positions ~~and a~~. Additionally, ~~triple A~~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~~se~~ actions we have taken to date in the Limited Duration Bond Strategy simultaneously ~~served to~~ reduced risk in other SSgA active fixed income and active derivative-based strategies ~~that hold units of the Limited Duration Bond Fund~~.[39]

Compare Division Ex. 155 (draft containing Mr. Flannery's "suggested edits") *with* Flannery Ex. 144 (final version of August 2 letter). Just five words from Mr. Flannery's "suggested edits" to

[39] *Blue underlined text* signifies words added by others that did not appear in Mr. Flannery's "suggested edits" version. *~~Red strike-through text~~* signifies words that appeared in Mr. Flannery's "suggested edits" version but were subsequently removed by others. The remaining text was unchanged.

the "Actions Taken" paragraph were ultimately included in the letter sent to clients. Those words are in bold below:

> We believe that what has occurred in the subprime mortgage market to date this year has been more driven by liquidity and leverage issues than long term fundamentals. **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.

Compare Division Ex. 155 *with* Flannery Ex. 144 (emphases added). Mr. Flannery was never asked to review the letter again after providing his suggestions. Flannery Tr. at 1339:19-23. He was not responsible for determining who would receive this or any other letter sent to clients in the Summer of 2007. Carlson Tr. at 2748:21-2749:11.

On August 3, a Relationship Manager named James DuPont asked Mr. Carlson and Mr. Mavro if he could include information about GAA's redemption recommendation when he sent the letter to his clients. Flannery Ex. 149; Carlson Tr. at 2758:13-25. Mr. Mavro responded, "[f]or the time being please leave that sentence out of any communication. Legal was pretty particular about what we could/couldn't change. Certainly when you speak with the client on the phone you can mention that." Flannery Ex. 149; Carlson Tr. at 2759:1-16.

J. The Creation of LDBF II

As a way for clients to remain exposed to the LDBF strategy without being affected by the redemption activity of other clients, in late July, Mr. Flannery developed the idea for a fund called LDBF II. Flannery Tr. at 1293:19-1295:25, 1358:19-1359:11. LDBF II was intended to minimize the impact of a potentially high level of redemptions on those investors who wished to remain exposed to the LDBF strategy. *Id.* at 1293:23-1294:6, 1295:1-3. To the extent they wanted to do so, LDBF clients would be permitted to transfer their investments in kind to LDBF II, and LDBF II, unlike LDBF, would not allow daily withdrawals. *Id.* at 1293:22-1294:6. Rather than freezing LDBF, SSgA created LDBF II in order to provide investors with three options: they could either stay in LDBF, move to LDBF II, or redeem their investments altogether. *Id.* at 1294:7-1295:13, 1357:4-1358:4. The decision to freeze a fund or create a fund such as LDBF II was not Mr. Flannery's, but he was an advocate for a reduced liquidity fund such as LDBF II as opposed to freezing LDBF — a step which would have deprived investors of the daily liquidity that SSgA had promised. *See id.* at 1287:8-1289:5. Mr. Flannery believed that this was the best approach for investors, and advocated it even though the Division's expert, William Lyons, testified that LDBF II would have been harmful to Mr. Flannery's reputation as a CIO. Lyons Tr. at 1867:7-1868:1.

While LDBF II was formally approved on August 3, it had been subject to a legal and other approval process that began several days earlier. *See* Flannery Tr. at 1356:18-1357:9; Carlson Tr. at 2761:8-17. Thus, virtually every SSgA attorney or executive involved in the August 2 letter was aware that the level of potential redemptions was high enough that extraordinary steps to mitigate the impact of such redemptions were being contemplated.

The possibility of a high level of redemptions was not hidden from investors, either. On August 6, SSgA sent a letter to clients announcing the LDBF II option. Flannery Ex. 161. Flannery Ex. 161 is an August 5 e-mail from Larry Carlson attaching the letter, which he sent to a large number of people, including Relationship Managers and Consultant Liaisons, as well as Mr. Flannery, Marc Brown (Chief Marketing Officer), Shawn Johnson (Chair of the Investment Committee), Michael Wands (U.S. Head of Fixed Income), Mitchell Shames (General Counsel), Glenn Ciotti (an attorney in SSgA's Legal Department), and Christopher Thome (an attorney in SSgA's Legal Department). Flannery Ex. 161; Flannery Tr. at 1355:8-1356:5. The LDBF II letter had been approved by Legal. Flannery Ex. 161. The letter stated, in part:

> Recognizing that you may wish to be sheltered from these technical and liquidity issues while preserving your exposure to the strategy, effective on August [8], we are making available [LDBF II] as an investment option. LDBF II will employ the Limited Duration Bond strategy, but will only offer monthly liquidity, beginning on October 31, 2007. Your units in [LDBF] may be transferred to LDBF II on the following dates: August 8, 2007, August 15, 2007, August 21, 2007, August 31, 2007, and thereafter on the last business day of each month. Of course, LDBF will continue to be maintained with daily liquidity.
>
> Certain SSgA commingled funds . . . intend to redeem in kind their respective proportionate interests. The SSgA funds are taking this step because they continue to believe in this asset class and the Limited Duration Bond strategy, but need to manage the underlying assets directly because of their own respective daily liquidity requirements and their desire not be negatively impacted by the ***liquidity decisions of others. Because the SSgA funds are redeeming in-kind a 'perfect slice' of LDBF, the redemption will not negatively affect the liquidity of the assets in the LDBF portfolio.***

Id. at SS 004325369 (emphasis added). Sophisticated (and even not-so-sophisticated) investors would have known that LDBF II was created due to potentially high redemptions; "liquidity decisions of others" was a clear reference to redemption activity, and the premise for offering a limited liquidity fund was the possibility of a high level of redemptions. Flannery Tr. at 1293:23-1294:6. Notably, the decision by the commingled funds to take in-kind redemptions, discussed in the letter, reflected their desire to remain exposed to the LDBF strategy, similar to the option presented by LDBF II.[40] Flannery Tr. at 1360:3-10. Because the commingled funds

[40] The related funds could not participate in LDBF II owing to their own liquidity requirements. Flannery Ex. 161. The Division's Pre-Hearing Brief reflects a fundamental misunderstanding of the import of the in-kind redemptions by the related funds, erroneously suggesting that such in-kind redemptions drained cash from LDBF. *See, e.g.*, Division's Pre-Hearing Br. at 20 (arguing that SSgA had caused related funds to redeem their investments, and that such actions were "directly contradictory" to many judicious investors holding their positions in LDBF). In-kind distribution did not affect LDBF's cash balance, and contrary to the Division's suggestion, the in-kind redemptions of the related funds illustrated that many judicious investors preferred to hold their positions.

were redeeming a perfect slice in-kind, their decision did not affect the liquidity of LDBF for other investors. *Id.* at 1360:11-19.[41]

K. The August 6 FAQs

The FAQs continued to evolve during this time period. By August 6, the FAQs contained the following information:

- GAA had recommended that its clients redeem their investments in LDBF (FAQ #31) (this information was also in the August 1 version of the FAQs, as discussed above);
- SSgA had taken actions to reduce risk through the AAA bond sale and the expiration of total return swaps at the end of July (FAQ #32) (this information was also in the August 1 version of the FAQs, as discussed above);
- LDBF employed leverage and describing how leverage was measured in LDBF (FAQ 34 and 35); and
- The fact that there had been 20-25% redemptions in LDBF as of the end of July (FAQ #36).

Flannery Ex. 167. These FAQs were reviewed and approved by Legal, and were for use by Relationship Managers with clients and by Consultant Liaisons with consultants. *See, e.g.*, Carlson Tr. at 2718:21-2819:12; Shames Tr. at 169:9-14; Duggan Tr. at 238:7-9 (testifying he reviewed FAQs "from a legal point of view"), 326:4-14 (discussing how FAQs could be used with clients).

On August 6, 2007, Mr. Duggan, whose team was responsible for reviewing the FAQs, received a copy of the August 6 FAQs. Flannery Ex. 172. Mr. Shames and the following other SSgA lawyers also received this e-mail containing the FAQs: Jodi Luster, Charles Cullinane, Christopher Thome, and Glenn Ciotti. *Id.* Mr. Flannery received this FAQ document as well,

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[41] As Mr. Flannery explained, in an in-kind redemption, a slice of securities represented by a percentage of the shares owned by the commingled fund are delivered out of LDBF and into the fund. "The mechanism is exactly the same [as LDBF II]. What the other SSgA funds did was just take those shares directly into their existing funds, and in the case of LDBF 2, they just created a new fund and would move the shares there, but the process -- the in-kind transfer process works exactly the same no matter where it goes." Flannery Tr. at 1416:20-1417:5.

and knew by August 6 that Mr. Duggan and other members of his legal team had received it, because he was copied on the same transmittal e-mail. *Id.* [redacted]. Duggan Tr. at 298:12-299:22, 324:9-25, 484:24-485:20. A number of other key people, including those involved in reviewing and editing the August 2 and 14 letters to clients, received the August 6 FAQs, including Marc Brown, Larry Carlson, Staci Reardon, Shawn Johnson, Mike Wands, Patrick Armstrong, Paul Greff (Head of Global Fixed Income), and Elizabeth Shea, Ming Wong, and John Longhurst (all members of Compliance). Flannery Exs. 167, 172. Mr. Flannery thus reasonably believed that all of these people were aware of the information in the FAQs as they reviewed and commented on the August 14 letter, discussed below.

L. Further Market Turbulence

1. The FOMC Leaves Overnight Federal Fund Rate The Same, Signaling a Positive View of the Economy.

On August 7, 2007, the Federal Open Market Committee ("FOMC") left the overnight federal fund rate at 5.25%, again referring to the tightening in the credit market and ongoing housing market tumult as a "correction" and forecasting that "the economy seems likely to continue to expand at a moderate pace over coming quarters, supported by solid growth in the employment and incomes and a robust global economy."[42] As Mr. Flannery stated, "[b]y not lowering the rate, they were saying, basically, everything is fine even though we have this turmoil in the market . . . ." *Id.* at 1401:11-13. The FOMC's position was consistent with the

[42] Flannery Ex.168: Press Release, Federal Open Market Committee (Aug. 7, 2007) (available at <http://www.federalreserve.gov/newsevents/press/ monetary/20070807a.htm>).

view that the subprime market dislocations were transient, and that the market would recover, much like what had occurred in February 2007.

2. BNP Paribas Freezes Funds and Central Banks Intervene.

However, on August 9, the French bank BNP Paribas, one of the largest banks in the world, froze redemptions from three of its investment funds, citing the absence of liquidity and consequent valuation difficulties. Sirri Report at ¶ 65; Flannery Ex. 192. "This news sent a shockwave across financial markets." Sirri Report at ¶ 65. On August 10, the European Central Bank started intervening and pumping reserves into the market. Also on August 10, just three days after the FOMC had declined to take any action, the Federal Reserve Board intervened by injecting reserves as necessary for open market operations. Flannery Ex. 198; Flannery Tr. at 1243:19-1244:13; *see also* Sirri Report at ¶ 62. Mr. Flannery had never seen the Fed intervene on such an open-ended basis in his 27 years in the industry. Flannery Tr. at 1243:25-1244:10. These measures were widely publicized at the time. *Id.* at 1401:19-21 ("this is huge news in the market"). "Ultimately what we had was the largest scale global intervention of central banks we've ever seen in history." *Id.* at 1402:12-20. As Professor Sirri explained, the crisis was unprecedented, and was not anticipated even by the most sophisticated of market participants. Sirri Report at ¶¶ 68-76.

While the events in the market were serious, at this time, many experts and market participants believed that this was primarily a liquidity event, and that liquidity would eventually return. Sirri Report at ¶¶ 77-82. As the Managing Director of the International Monetary Fund stated as late as August 22, "[w]e believe that liquidity conditions will return to normal as information problems diminish and transparency improves." Sirri Report at ¶ 79. Mr. Flannery and members of the Fixed Income team shared this view. *See, e.g.*, Flannery Exs. 86 ("from a fundamental perspective we remain constructive [on BBB ABX]. . . current pricing at all rating levels is overstating the level of risk embedded in the underlying securities"), 133 (*e.g.*, FAQ nos. 4, 12, 17, 21), 137 (internal subprime chronology); Flannery Tr. 1382:5-1384:12; Lowe Tr. at 2025:7-2027:2, 2028:21-2029:8, 2042:22-2043:4 (Mr. Greff told Mr. Lowe he disagreed with GAA's recommendation because he thought prices would retrace). Indeed, as of the end of 2007, there had been no defaults on AAA-rated mortgage ABS, and defaults on AA-rated mortgage ABS were only 0.62%. Sirri Report at ¶ 80.

3. More Publicity Regarding LDBF's Subprime Exposure and Losses

On August 10, a publication called DW Online, a sister publication to the Money Management Letter published by Institutional Investor Magazine, published an article discussing the fact that LDBF had fallen 11% in July. Flannery Ex. 197; Flannery Tr. at 1399:8-16. The article further reported that LDBF was invested in ABS, and that it lost money on a total return swap. Flannery Ex. 197. The article also discussed the fact that losses in LDBF had affected other SSgA strategies that were invested in LDBF. *Id.*; Flannery Tr. at 1400:4-14.

M. The August 14 Letter

In early August, Mr. Flannery decided he wanted SSgA to send another letter to clients, and that he wanted the letter to come from him. Flannery Tr. at 1370:1-5. He discussed the potential letter with his boss, CEO Hunt, who told Mr. Flannery he did not think it was a good idea, asking Mr. Flannery, "Why would you raise your head up?" *Id.* at 1370:6-25. Mr. Flannery explained to Mr. Hunt that he thought it was the right thing to do, and Mr. Hunt ultimately agreed. *Id.* at 1371:1-5. Mr. Flannery then discussed his idea for the letter with General Counsel Shames, who provided guidance on what Mr. Flannery could and could not say in the letter, including that he could not apologize for the situation, that he should avoid forward-looking references, and that he should not give advice. *Id.* at 1371:6-1372:3.

Mr. Flannery also asked Larry Carlson, Co-Head of Relationship Management, if writing a letter was a good idea, and Mr. Carlson told him that it was. Carlson Tr. at 2764:6-10, 2766:5-8 (also testifying that Mr. Flannery's management style with respect to the letter was inclusive). In fact, the letter was in part the result of an e-mail exchange that had begun on August 2, 2007, in which Mr. Flannery asked Mr. Carlson and other senior members of the Relationship Management team what clients were asking in light of the tumultuous market conditions:

> At this point I know we have had a number of interactions with clients and consultants. It is important to get frank and constructive feedback on what is working well and what we can do to improve things. I want to underscore that our role here is to do the best job possible.
>
> Please provide that feedback to me (and directly to individuals if appropriate) so I can help. In addition, anything you need from me (I haven't had any client calls) is on the table.

Division Ex. 160. The next day, Mr. Carlson responded to Mr. Flannery, stating that there had been feedback:

> Thanks Sean. There have been a few comments that we [SSgA] may be a little cavalier about the situation. A couple of [Relationship Managers] have mentioned that we feel that we do not necessarily need to apologize per se . . . but should be saying up front that we realize that this is a serious situation, that we are disappointed in what has transpired and are doing everything we can to mitigate the damage and make sure that we rectify the situation.

Id. Out of a desire to address some of the concerns articulated in Mr. Carlson's e-mail, Mr. Flannery volunteered to draft the letter: "I wanted our clients to know that I was taking responsibility for what happened and trying to explain it to them and that we took it seriously. We understood how disappointed they were likely to be." Flannery Tr. at 1377:25-1378:3. As Mr. Flannery explained, the magnitude of the situation was like nothing SSgA had ever seen and "instead of everyone sort of scurrying around and, you know, answering in bits and pieces, I felt like somebody needed to stand up and raise their hand and say: It's me. It stops with me. And so I just felt very strongly about that." *Id.* at 1378:25-1380:5.

Division Exhibit 165 is Mr. Flannery's first draft of what would become the August 14 letter. The draft painted a bleak picture, and did not sugarcoat the situation. For example, in the very first paragraph, Mr. Flannery wrote that LDBF "[has] generated negative returns that are unprecedented in our 30 year history as a fixed income manager." Division Ex. 165. Mr. Flannery wrote this because he wanted to convey the magnitude of the situation to clients. Flannery Tr. at 1380:16-21. Later in the letter, he referenced a "backdrop of weakening fundamentals" because he felt at this point that the fundamentals of the housing market were, in fact, weakening. Division Ex. 165; Flannery Tr. at 1381:13-18. He also described the fact that the situation was "extreme and difficult to manage." Division Ex. 165.

The draft further stated that, "[w]hile we believe that the subprime markets clearly convey far greater risk than they have historically we feel that forced selling in this chaotic and illiquid market is unwise." Division Ex. 165. Mr. Flannery wrote this because "even at SSgA, whe[re] we had three competing investment philosophies, I think there's one thing that every manager would have agreed on and that is when the market doesn't want to offer liquidity, you don't want to demand it. The price for liquidity is too high and it couldn't be any clearer than it was in this case." Flannery Tr. at 1382:11-18. Mr. Flannery went on to write, "[w]hile recent events may have repriced the risk of these assets for the foreseeable future and it is unlikely that they will retrace to values at the turn of the year we believe that liquidity will slowly re-enter the market and the segment will regain its footing." Division Ex. 165. Mr. Flannery wrote this because, while it did not appear likely that prices would fully recover to pre-2007 levels, he and the Fixed Income team continued to believe that the market would slowly improve; indeed, by September, it had partially retraced. Flannery Tr. at 1383:7-17.

The charges against Mr. Flannery do not arise out of the foregoing statements, but instead relate to a single sentence later in the letter. As originally drafted by Mr. Flannery, the sentence read, "[w]hile we will continue to liquidate assets for our clients when they demand it, our advice is to hold the positions for now." Division Ex. 165. The statement reflected Mr. Flannery's honest view at the time. Flannery Tr. at 1384:6-12 ("Well, you know, the team still believed in this strategy. I mean, they were observing that these bonds are still paying, not a single bond had been downgraded in that fund, you know. So even if – even if prices never came back, as long as they continued to pay, the investors would reap greater value than if they dump it."). Through subsequent edits by others at SSgA, by August 7 that sentence became: "While we will continue to liquidate assets for our clients when they demand it, our advice is to hold the positions in anticipation of greater liquidity in the months to come." Flannery Ex. 169 at SSP000058309.

Then, on August 7, Deputy General Counsel Mark Duggan emailed a draft of the letter, with his own handwritten edits, to Elizabeth Fries of Goodwin Procter, with the words "Per my voicemail" in the subject line of the e-mail. Division Ex. 166; Flannery Tr. at 1386:8-21. Mr. Shames was also involved in the draft at this point, as he discussed it with Mr. Duggan. Shames Tr. at 188:7-19. Mr. Duggan made the following changes to the sentence in question:

> We believe that many judicious investors will
>
> the year, we believe that liquidity will slowly re-enter the market and the segment will regain its footing. While we will continue to liquidate assets for our clients when they demand it, ~~our advice is to~~ hold the positions in anticipation of greater liquidity in the months to come.

Division Ex. 166 at SS-SEC 000118350.

Mr. Flannery believed the language inserted by Mr. Duggan was true, and that many judicious investors would hold their positions. Flannery Tr. at 1387:25-1388:5. He, along with many market participants, believed that the events of the summer of 2007 were principally driven by a sudden shortage of liquidity. Sirri Report at ¶ 80; *see, e.g.*, Flannery Tr. at 1245:18-1246:16 (discussing video transcript and belief that liquidity crisis was a good opportunity to increase the quality of the portfolio); *see also id.* at 1382:5-1383:17, 1457:20-22 (stating belief that the events of July and August were driven by liquidity crisis). Mr. Flannery did not believe that Mr. Duggan's language was at all inconsistent with the decisions by the advisory groups GAA, OFA and CAM to recommend redemption, because "many judicious investors" plainly did not mean that every judicious investor would remain invested. *See, e.g.*, Flannery Tr. at 1098:8-1098:23 (stating good faith belief many judicious investors would remain), 1387:25-1389:12 (same, adding that, in fact, many judicious investors did remain), 1412:16-1413:7 (noting level of in-kind redemptions by SSgA commingled funds proves accuracy of "many judicious investors" language).

Moreover, there was nothing unusual about certain groups within SSgA taking different views on particular investment ideas. Flannery Tr. at 1156:18-1157:17, 1387:25-1389:12; Lowe Tr. at 2020:24-2021:25. Indeed, SSgA's different investment philosophies and approximately three hundred strategies regularly took positions that were inconsistent. Flannery Tr. at 1157:11-15; Lowe Tr. at 2021:17-25. The advisory groups had their own investment objectives and risk constraints, and did not represent the "house" view of SSgA — as discussed above, there was no such view. *See, e.g.*, Lowe Tr. at 2021:17-2023:13. Furthermore, GAA's redemption recommendation had already been disclosed to clients in the FAQs, and Mr. Duggan had reviewed the FAQs, along with other members of his team and outside securities counsel Liz Fries. *See, e.g.*, Flannery Exs. 133, 135, 167, 172, 175, 211; Duggan Tr. at 485:11-20, 487:1-8; *see also* Subsections H(1), K, *supra* (discussing review of FAQs). Similarly, OFA's recommendation had been communicated to Legal by July 27. Donovan Tr. at 1804:20-1805:19. If the redemption recommendations needed to be included in the letter (something which Mr. Flannery does not believe he even thought about at the time), Mr. Flannery expected that Mr. Duggan and the Legal Department would have included it. Flannery Tr. at 1389:6-12.

Ms. Fries, an experienced securities attorney upon whom Mr. Duggan and the SSgA Legal Department were heavily relying in this time period, did not make further changes to Mr. Duggan's language when she reviewed the draft. Shames Tr. at 156:9-12; Duggan Tr. at 484:25-485:9. *Compare* Division Ex. 166 at SS-SEC 118350 *with* Division Ex. 168 at SS-SEC 118358 (August 8 draft). Mr. Duggan testified that he and Ms. Fries had conversations about the August 14 letter and its various drafts. Duggan Tr. at 487:1-8 ("Well, we provided, obviously, a draft or drafts of the letter. We had conversations to discuss proposed changes. I believe they had the FAQs. They had the previous letter.").

Edits were also made to the letter by client-facing individuals who were aware of the redemption activity in LDBF, including that of GAA's and OFA's clients. *See, e.g.*, Lowe Tr. at 2043:9-2044:6 (GAA met with approximately twenty Relationship Managers on July 27 to discuss GAA's redemption decision); Donovan Tr. at 1799:7-14 (testifying she left informed Staci Reardon that OFA was recommending redemption to its clients). On August 6, Staci Reardon sent Mr. Flannery comments on the letter from herself and Larry Carlson (Co-Heads of Relationship Management), as well as Maureen Fitzgerald (Head of Consultant Relations). Flannery Ex. 166. The e-mail noted, "[a]ll in all we think that it is a good letter that will be useful and has the right tone." The e-mail went on to list out a number of specific edits from the group, and stated with respect to those edits, "[n]ot sure if you will be able to get it all through

Legal but if we keep most of this it would be nice." Flannery Ex. 166; *see also* Flannery Ex. 169 (Ms. Reardon's handwritten edits).

On August 8, the day after Mr. Duggan had inserted the "many judicious investors" language, Mr. Flannery sent a revised draft of the letter to Mr. Duggan, copying Mr. Carlson, Ms. Reardon and Adele Kohler (Head of Product Engineering). Division Ex. 168; Flannery Tr. at 1390:2-8. Mr. Flannery pointed out for Mr. Duggan an additional change he had made, to make the letter even more negative in terms of the deterioration in the market. Division Ex. 168 (making a change to a time reference because there had been further deterioration since month-end); Flannery Tr. at 1390:9-24. In addition, to ensure that Mr. Duggan's advice was followed throughout the letter, Mr. Flannery referenced the "many judicious investors" language, stating:

> I also want to draw your attention to the 3rd paragraph on the second page where I say we think it is unwise to sell under the current conditions. ***We softened the language on the last page as agreed, but I want to make sure you are comfortable with this as well.*** As you know, my preference would be to leave that in.

Division Ex. 168 (emphasis added); Flannery Tr. at 1390:25-1391:6. Mr. Flannery was directing Mr. Duggan's attention to the language in the draft that read: "[w]hile we believe that the subprime markets clearly convey far greater risk than they have historically, we feel that forced selling in this chaotic and illiquid market is unwise." Mr. Flannery indicated that he would prefer to leave the language "as is," but he brought it Mr. Duggan's attention because he wanted him to double check that the language was still acceptable, in light of the "many judicious investors" language change Mr. Duggan had made the day before. Flannery Tr. at 1390:25-1392:8. Notably, in response to Mr. Flannery's e-mail, Mr. Duggan *did change* the language in the third paragraph on the second page to language that was akin to his "many judicious investors" language:

<u>August 7, 2007 Draft Text (Mr. Flannery's initial language):</u>
While we believe that the subprime markets clearly convey far greater risk than they have historically, we feel that forced selling in this chaotic and illiquid market is unwise.

<u>August 8, 2007 Draft Text (Mr. Duggan's "final edits"):</u>
While we believe that the subprime markets clearly convey far greater risk than they have historically, we feel that investors must take into account the downside of forced selling in this chaotic and illiquid market.

Compare Division Ex. 168 *with* Division Ex. 169. *See* Flannery Tr. at 1394:8-1395:11. Mr. Flannery believed the change made by Mr. Duggan was accurate. *Id.* at 1395:9-11.

In his August 8 e-mail, Mr. Flannery relayed to Mr. Duggan that he wanted to make sure that Ms. Reardon and Mr. Carlson approved the letter, and also suggested that the letter be reviewed by Marc Brown and CEO Hunt, because he "wanted to make sure that everybody had a crack at it and felt like it was okay." Flannery Tr. at 1392:21-1393:1; Division Ex. 168. Further, Mr. Flannery wrote, "I do think we need to hear from relationship management as to how valuable this letter is (or is not) and to whom and under what circumstances we would send it." Division Ex. 168. Mr. Flannery made this point because, as with all of the letters sent to clients in the Summer of 2007, he did not determine the letter's distribution. Flannery Tr. at 1393:8-20. Finally, Mr. Flannery indicated that he would rely on Ms. Reardon and Mr. Carlson to decide who else needed to review the letter. Division Ex. 168. This was an effort to make sure that anyone who needed to review the letter was given the opportunity to do so. Flannery Tr. at 1393:21-1394:7. However, Legal had to approve any changes to the letter. *Id.* at 1408:21-24.

Later on August 8, Mr. Flannery e-mailed a draft of the letter to Staci Reardon, Larry Carlson, and Maureen Fitzgerald, incorporating "Mark [Duggan]'s final edits" and asking that they advise how to proceed, if, indeed, they were ready to proceed. Division Ex. 169. Mr. Carlson replied, copying Ms. Reardon, Ms. Kohler, Ms. Fitzgerald and Mr. Duggan, stating, "Looks good to me Sean . . . I think it makes some very good points." Flannery Ex. 184. Mr.

Flannery responded, asking if the letter should be sent to Bill Hunt and Marc Brown, and Mr. Duggan advised Mr. Flannery to do so. *Id.* Following Mr. Duggan's advice, later on August 8, Mr. Flannery forwarded the draft to Mr. Hunt and Mr. Brown. Flannery Ex. 185.

Mr. Hunt, Mr. Flannery's boss and SSgA's CEO, responded to Mr. Flannery on August 8, stating:

> Sean, This is a good communication. I need to ask you to hold on for another day while I review it in detail. I have some questions re a few of the messages, and want to discuss with you tomorrow.

Flannery Ex. 186. When Mr. Flannery subsequently spoke with Mr. Hunt about the letter, Mr. Hunt indicated that the draft should be sent to Hannah Grove, the Director of Media Relations for State Street Corporation. Flannery Tr. at 1397:9-24. Mr. Duggan sent the letter to Ms. Grove on August 9, as well as to Mr. Flannery, Mr. Hunt and Mr. Brown, stating that "[w]e are all OK with [the draft], but wanted your thoughts." Division Ex. 170. On August 10, Ms. Grove responded to the same group of people with her comments. Flannery Ex. 199. E-mails circulated among this group on August 10 indicated the group's view that Ms. Grove's comments improved the letter and were acceptable. Division Exs. 172, 173; Flannery Ex. 202. Mr. Flannery made one change to Ms. Grove's proposed revisions — a change he made *to ensure that clients were not being misled.* Flannery Ex. 202; Flannery Tr. at 1404:13-1405:5. In explaining the change, Mr. Flannery wrote: "I have only one edit and that is to replace [the word] reduction (which replaced meltdown) with contraction as I believe reduction might convey a lowering of exposure instead of the negative market impact to which we refer." Flannery Ex. 202; *see also* Flannery Tr. at 1390:10-24 (Mr. Flannery made revisions to the August 14 letter to reflect deteriorating fundamentals because he did not want to "soft pedal" anything).

Further e-mail correspondence regarding some final changes to the draft ensued among Mr. Flannery, Larry Carlson, and Mark Duggan on Sunday, August 12. Flannery Ex. 205. In those e-mails, Mr. Carlson asked Mr. Duggan to weigh in on the suggested changes — which concerned a slightly revised version of the letter for clients that had already terminated their investments in LDBF. *Id.* Mr. Duggan indicated that the changes were acceptable, and made another edit. Flannery Ex. 207 at SS-SEC 118389. Mr. Carlson then suggested a further, small change, to which Mr. Duggan replied, "I'm good." *Id.* at SS-SEC 118390. Subsequently, Mr. Carlson circulated the draft of the letter (in two forms, one for clients that remained in LDBF, and one for clients that had redeemed) to Mr. Duggan and Mr. Flannery, copying Ms. Reardon and Ms. Fitzgerald, stating, "please see greeting and sign off." *Id.* at SS-SEC 118389. Mr. Duggan replied to Mr. Flannery, stating, "***[h]ow many times do we have to sign off???***" *Id.* (emphasis added).

Division Ex. 176 contains the final version of the August 14 letter. Mr. Flannery believed that all of the statements in the letter were accurate, including the "many judicious investors" language, added by Mr. Duggan, with which the Division takes issue. Flannery Tr. at 1410:1-10.

N. <u>October 5, 2007 Letter From CEO Hunt</u>

On October 5, 2007, SSgA's CEO, William Hunt, sent a letter to clients concerning a lawsuit that had been filed against SSgA by Prudential Insurance Company. Flannery Ex. 251. Mr. Flannery was not involved in this letter (Flannery Tr. at 1420:21-1421:2), though the Legal Department was involved in reviewing and approving it. Shames Tr. at 78:23-79:1, 79:24-80:13;

Flannery Tr. at 1421:3-5. In that letter, Mr. Hunt quoted language from the August 14 letter, including the "many judicious investors" language, as follows:

> As Sean Flannery, SSgA CIO of the Americas reminded clients in a correspondence on August 14:
>
> ". . . investors must take into account the downside of forced selling in this chaotic and illiquid market." He went on to comment further, "While recent events may have re-priced the risk of these assets for the foreseeable future and it is unlikely that they will swiftly retrace to values at the turn of the year, we believe that over time liquidity will slowly re-enter the market. ***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.***"

Flannery Ex. 251 (emphasis added). Mr. Hunt went on to explain that:

> Unfortunately, due to certain client redemptions, we were obligated to sell otherwise unimpaired assets into a market which was largely illiquid creating realized losses. These redemptions were a contributing factor in the negative returns. They were not the result of any failure on the part of SSgA's investment management. ***This is further evidenced by the portfolio holdings of clients that did not panic during this period of turmoil, which are now experiencing a steady recovery in their values.***

Id. (emphasis added).

Mr. Flannery had no involvement in the decision to include the "many judicious investors" language, or any other language, in Mr. Hunt's October 5 letter. Flannery Tr. at 1422:13-15. The fact that the letter re-published the very portions of the August 14 letter the Division challenges demonstrates that SSgA believed that this language was accurate. The Division has brought no charges in connection with the October 5 letter.

III. ANALYSIS

A. <u>The Division Did Not Prove its Claims Arising Out of the August 2 Letter.</u>

The Division contends that Mr. Flannery violated §§ 17(a)(1)-(3) of the Securities Act and § 10(b) of the Exchange Act (along with Rule 10b-5) in connection with the August 2 letter. The Division claims the letter was misleading because (1) the letter's statements regarding three transactions reducing risk in LDBF were purportedly false because one of them allegedly did not reduce risk; (2) the letter's statement regarding the fund's average credit quality continuing to be AA, while **"technically accurate"** as the Division concedes, was misleading; and (3) the letter omitted some unspecified information that the Division has yet to identify, but claims had been provided to various other investors. Division's Pre-Trial Br. at 17-18 (emphasis added); OIP at ¶¶ 37-38. However, the evidence at the Hearing demonstrated that the three transactions undertaken by SSgA were intended to reduce risk and increase liquidity in the fund, and actually had those effects. Similarly, the Fund's average credit quality was, in fact, AA throughout the entire period. With respect to the purported omissions, the OIP, the Pre-Trial Brief filed by the Division, and the over two weeks of testimony at the Hearing have not clarified what the Division believes was omitted.

Moreover, Mr. Flannery's role with respect to the letter was very limited, and the letter was reviewed and edited by numerous other individuals with responsibility for communicating with clients, as well as by experienced securities lawyers, after Mr. Flannery provided his minimal "suggested edits."

1. The Division Failed to Prove its Section 10(b)/Rule 10b-5 Claims.

As set forth above, the Division charges a violation of § 10(b) and Rule 10b-5 only with respect to the August 2 letter. In order to prove a 10(b)/10b-5 violation, the Division must prove that, in connection with the purchase or sale of securities, the defendant made an untrue statement of material fact, omitted a fact that rendered a prior statement misleading, or committed a deceptive act as part of a scheme to defraud,[43] and that the defendant acted with the requisite scienter. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195-96, 214 (1976). The

[43] The Division does not allege a "scheme to defraud" against Mr. Flannery.

Division failed to prove the elements of its claims against Mr. Flannery arising out of the August 2 letter.

a. Mr. Flannery Did Not "Make A Statement."

The Division cannot prevail on its § 10(b)/Rule 10b-5 claim without proving that Mr. Flannery personally either made an untrue statement of material fact or omitted a fact he was obligated to disclose—in other words, that he committed a primary violation.[44] *See SEC v. Tambone*, 417 F. Supp. 2d 127, 131-35 (D. Mass. 2006) (citing, *inter alia*, *Aaron v. SEC*, 446 U.S. 680, 695 (1980); *Wright v. Ernst & Young, LLP*, 152 F.3d 169, 174-75 (2d Cir. 1998)). The Division has not done so. The evidence made clear that Mr. Flannery did not draft the language about which the Division complains. His single round of edits was minimal and inconsequential, and the letter was extensively reviewed and edited by lawyers and others — including those with responsibility for client communications — before and after Mr. Flannery's limited set of "suggested edits." *See generally* Section II(I), *supra*.

The Division must prove that Mr. Flannery actually "created" the misstatements at issue or at least caused their existence. *See SEC v. Tambone*, 597 F.3d 436, 447 (1st Cir. 2010); *Wright*, 152 F.3d at 175 (employing "bright line" test for primary liability); *SEC v. Wolfson*, 539 F.3d 1249, 1259 n.16 (10th Cir. 2008) (discussing "creation" test for primary liability). Such a standard is most consistent with the First Circuit's *en banc* decision in *Tambone* which, though not directly on point, held that a statement "crafted entirely by others" does not constitute the making of a statement under Rule 10b-5. 597 F.3d at 442, 446. Even if the Division were required to satisfy the "substantial participation" test, *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000), the Division's claim still fails, as merely contributing limited

[44] The Division has not alleged aiding and abetting liability against Mr. Flannery.

revisions to a communication cannot establish primary liability unless — contrary to the facts here — the defendant played a "significant role" in the overall drafting process, and participated in "extensive review and discussions." *See SEC v. Fraser*, 2009 WL 2450508, at *7-8 (D. Ariz. 2009) (holding that "attend[ing] and participat[ing] in . . . meetings, reviewing and discussing [forms which contained the alleged misrepresentations] . . . [and] sign[ing] sub-certifications, due diligence certifications, and management representation letters which provided that the forms were accurate" did not rise to level of substantial participation); *Siemers v. Wells Fargo & Co.*, 2007 WL 760750, at *19 (N.D. Cal. Mar. 9, 2007) (defendant's mere participation in commenting and editing a document was insufficient to show that he substantially participated in making a misstatement contained in the document); *In re Seracare Life Sciences, Inc.*, 2007 WL 935583, at *10 (S.D. Cal. 2007) ("participat[ing] in editing and approving . . . quarterly statements" is insufficient to establish "substantial participation"); *In re Lernout & Hauspie Securities Litigation*, 230 F. Supp. 2d 152, 168 (D. Mass. 2002) ("allegations of 'reviewing' audits, 'commenting on' documents, and the like, are insufficient to trigger primary [10b-5] liability").

Mr. Flannery did not commission, draft, or sign the August 2 letter. He volunteered a small set of "suggested edits" that consisted of deleting and replacing thirty-four words (out of approximately one thousand words in the draft) and asking that a single fact be re-checked. With respect to the only portion of the letter that the Division challenges, Mr. Flannery proposed replacing exactly ten words in the original draft prepared by Ms. Kohler with eight slightly different ones. As noted above, *only five* of those words survived the subsequent editing process and appeared in the final letter, and those words were inconsequential. Division Exs. 151, 154, 155.

It is undisputed that, after Mr. Flannery offered his "suggested edits," others at SSgA — including its General Counsel — reviewed and substantially rewrote the text, and did so without circulating the revisions to Mr. Flannery. *See* Section II(I), *supra*. With respect to the "continues to be AA in average credit quality" statement, that statement — acknowledged to be accurate by the Division — was inserted by someone else *after* Mr. Flannery made his comments. Flannery Tr. at 1337:2-1339:23. With respect to the risk reduction statements, those were in Ms. Kohler's draft before it reached Mr. Flannery — he simply passed along her statements, while changing some verb tenses to (accurately) reflect that the transactions being described already had occurred. Division Ex. 155. The *en banc* First Circuit in *Tambone* flatly rejected the Division's attempts to "imply that 'X' has made a false statement [because] he passed along what someone else wrote [because to do so] would flout a core principle that underpins the *Central Bank* decision—[dividing primary and secondary liability under the securities laws]." *Tambone*, 597 F.3d at 446 (citing *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 173 (1994)). Finally, to the extent the Division complains about alleged, unspecified omissions from the letter, it is legally untenable to lay those at Mr. Flannery's feet given his minimal involvement in the letter's preparation, and in client communications more generally. *United States v. Schiff*, 602 F.3d 152, 167 (3d Cir. 2010) ("[T]he plain language of § 10(b) and corresponding Rule 10b-5 do not contemplate the general failure to rectify misstatements of others.") (*citing*, *inter alia*, *SEC v. Tambone*, 597 F.3d at 446; *Wright*, 152 F.3d at 175; *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997)).

In short, the SEC cannot even satisfy the "substantial participation" test, which is the easiest of the tests for establishing that a respondent made a statement. *See SEC v. May*, 648 F. Supp. 2d 70, 78 (D.D.C. 2009) (noting that "substantial participation" is the easiest of the three tests for the SEC to satisfy). Mr. Flannery made no "statement" in connection with the August 2 letter, and the Section 10(b)/Rule10b-5 claims fail on that basis alone.

b. The August 2 Letter Was Not False or Misleading.

Even if, contrary to law and fact, the statements in the August 2 letter were attributable to Mr. Flannery, they do not form the basis for liability because those statements are true.

(i) The Three Transactions referenced in the Letter Reduced Risk.

The evidence demonstrates that the August 2 letter accurately described the steps taken to reduce risk in the LDBF portfolio. These risk reducing transactions were (1) reducing exposure to BBB-rated securities in mid-July, (2) the sale of AAA bonds on July 26, and (3) the expiration of certain total return swaps on July 31. Each of these transactions was intended to and actually reduced risk in LDBF, as expert witness Ezra Zask testified. Cross Examination Testimony of Ezra Zask ("Zask Tr.") at 2356:6-2357:16; *see also* Zask Direct Test. at A.20. Mr. Zask's analysis and opinions regarding the risk-reducing features of the transactions was not rebutted by the Division, and was corroborated by Mr. Pickett (LDBF's Portfolio Manager), Mr. Armstrong (the Head of Risk Management), and Mr. Flannery, each of whom testified that the transactions reduced risk. Pickett Tr. at 1744:19-1745:5; Armstrong Tr. at 2206:9-17, 2207:15-19; Flannery Tr. at 1052:5-9. Indeed, the Division offered no expert opinion or other testimony regarding the impact of any of these transactions on the risk of the LDBF portfolio. Notably, during the cross-examination of Professor Wermers, the Division's expert, the Division objected to questions regarding risk analysis, on the grounds that Professor Wermers did not conduct any such analysis. Wermers Tr. at 716:5-718:12.[45] The challenged statements in the August 2 letter were true, and as such provide no basis for a finding of liability against Mr. Flannery.

(a) All Three Transactions Reduced Exposure To Subprime.

All three of the transaction described in the August 2, 2007 letter reduced risk in LDBF because they reduced its exposure to subprime-related investments. Zask Tr. at 2357:10-15. The offsetting of BBB ABX Index swaps in mid-July 2007 reduced LDBF's exposure to BBB-rated securities tied to subprime. Flannery Tr. at 1050:17-23. The AAA bonds sold on July 26 were backed by subprime mortgages. *Id.* at 1467:8-12. The Total Return Swaps ("TRS") which were allowed to expire on July 31 also represented a substantial exposure to subprime. Pickett Tr. at 1753:12-21. As Mr. Zask testified, each of these transactions reduced the portfolio's exposure to the volatile subprime market and therefore, it is "self-evident" that the transactions reduced the risk of the LDBF portfolio. Zask Tr. at 2356:6-2357:16; *see also* Zask Direct Test. at A.61, A.38, A.39-A.43 (describing in detail how the transactions lowered LDBF's market risk, lowered LDBF's credit risk, and reduced the portfolio's leverage), Exs. 3, 4.

(b) All Three Transactions Reduced Leverage.

In addition to reducing exposure to subprime, all three of the transactions reduced leverage in the LDBF portfolio. The ABX Index swaps and TRS are both types of derivatives. Hopkins Tr. at 114:4-7, 130:23-131:7. When these derivative positions were reduced, the leverage of the portfolio was also reduced. Flannery Tr. at 1050:17-23, 1292:15-1293:2; Division Ex. 248 (The expiration of the TRS was a "natural deleveraging" event for LDBF). Reducing leverage in this manner also reduced the risk in the portfolio. Armstrong Tr. at

[45] Mr. Wermers only made an observation regarding the credit ratings of securities in the LDBF portfolio, which the Division has conceded is not the same as analyzing the risk of the portfolio. *See* Wermers Tr. at 716:22-717:4.

2206:15-2207:19 (reducing leverage in turn reduces risk); *see also* Zask Direct Test. at A.55-A.58 (discussing reduction in market and credit risk), Exs. 8, 9.

Similarly, the AAA bonds sold on July 26 were leveraged, in that they were financed with sale-buyback agreements. Pickett Tr. at 1743:17-22. $1.6 billion of AAA bonds were sold, and $1.12 billion of the proceeds were used to repay the loans. *Id.* at 1745:25-1746:7; Zask Direct Test. at A.44, Ex. 5. This reduction of leverage from financing also reduced risk in LDBF. Zask Direct Test. at A.46-A.49 ("a portion of the sale proceeds was used to pay down repo loans and reduce the portfolio's leverage"); *see also id.* at A.46-A.48 (discussing reduction in market and credit risk and reduction in leverage), Exs. 5-7. As Mr. Armstrong testified, "any sale of securities that reduced the leverage would have in turn reduced the risk in the fund." Armstrong Tr. at 2206:9-14; *see also* Flannery Tr. at 1050:17-1051:3, 1296:5-17.

(c) The AAA Sale Increased Cash.

In addition to reducing risk by limiting exposure to subprime and reducing leverage, the AAA sale on July 26 also reduced risk because it increased the amount of cash in the portfolio. Pickett Tr. at 1743:23-1745:5. As Mr. Zask explained, transactions can be undertaken both to reduce risk and raise liquidity. Zask Direct Test. at A.31. Mr. Zask testified that the AAA sale on July 26 "reduced the fund's position in bonds and increased its cash position, thereby reducing its risk. Although the bonds were AAA-rated, they entailed greater credit and market risk than those of cash positions." *Id.* at A.62; *see also* Pickett Tr. at 1744:23-1745:1; Wands Tr. at 2865:15-2866:2.

The Division's contention that the AAA sale was done for the sole purpose of meeting expected redemptions, and that the proceeds of the sale had been used to pay redemptions by August 2, is not supported by the evidence. As an initial matter, at the time the August 2 letter went out, nobody knew what the level of redemptions from LDBF would be; they could only make educated guesses based on estimates that were being provided by Relationship Management. *See* Flannery Ex. 92 at SSgA-SEC 000252909-10; Flannery Tr. at 1278:22-24, 1279:9-1280:22, 1289:10-20; Pickett Tr. at 1738:14-1739:1. Furthermore, as discussed below, substantial cash remained in LDBF on August 2, and it was unclear what further redemptions would take place, and when they might occur.

Without addressing Mr. Zask's risk analysis, the Division's expert, Professor Wermers, testified that the cash proceeds from the AAA sale were "largely gone within a few days" and that there was "essentially zero cash left by August 2." Wermers Tr. at 712:6-7:13-7; Direct Testimony of Russell Wermers ("Wermers Direct Test.," Division Ex. 255) at 9. However, Professor Wermers was simply wrong: LDBF held almost $200 million of cash and cash equivalents on August 2, 2007. *See* Division Ex. 230; Flannery Ex. 288.[46] Contrary to Professor Wermers' assertions, LDBF continued to hold a substantial cash position, consisting not just of the proceeds from the AAA sale, but also from the sales of other securities, such as AA- and A-rated securities. *See* Division Ex. 230; Flannery Ex. 288. Indeed, as several witnesses testified and Professor Wermers' own Exhibit III.A. indicates, additional securities were sold throughout July and August in order to increase liquidity. Pickett Tr. at 1749:15-1750:17; Wermers Tr. at 710:11-22; Lindner Tr. at 1958:15-1959:9. The cash generated by these sales was gradually reduced to pay redemptions pro rata, in proportion to the overall market value of the fund. Pickett Tr. 1750:18-22.

[46] The Navigator Reports on which Professor Wermers relied for his report clearly show $175,654,953.35 of cash equivalents on August 2. *See* Division Ex. 230. In addition, the Daily Trial Balance reports show $20,664,081.65 of cash and treasury bills in LDBF on August 2. *See* Flannery Ex. 288. This adds up to a total amount of $196,319,035.00 of cash and cash equivalents held by LDBF on August 2, 2007.

Moreover, Professor Wermers' redemptions analysis is flawed because it fails to accurately depict the use of cash to meet redemptions in LDBF. Professor Wermers admitted during his testimony that his analysis failed to take into account the fact that many of the redemptions in LDBF were done on an in-kind, rather than cash, basis. Wermers Tr. at 674:1-16. Professor Wermers' omission is significant, because these in-kind redemptions had no effect on the amount of cash in LDBF. *Id.* at 667:23-668:12. The actual amount of cash available, and the amount needed to satisfy redemptions, refute Professor Wermers' statement that "fire sales" of securities were required to meet redemptions because in-kind redemptions do not require any cash to be raised at all, let alone "fire sales." *Id.* at 687:7-12.

(ii) LDBF's Average Credit Quality Was AA or Better.

While there is no evidence that Mr. Flannery was responsible for the credit quality statement in the August 2 letter, that statement was true: LDBF's overall average credit quality remained AA throughout this period, as the August 2 letter stated and the Division concedes. *See* Division's Pre-Hearing Br. at 18 (stating that the credit quality statement was "technically accurate"). Indeed, the evidence demonstrates that the average credit quality of LDBF remained at the AA level throughout the month of August, and there is no evidence that Mr. Flannery had a contrary understanding. Division Ex. 248 at SSP000105538 (Mr. Greff reported to Investment Committee on August 8 that risk profile had been maintained); Flannery Exs. 137 at SSP 003875765, 180 at SSgA-SEC 000252698, 256 at 10 (average credit quality of LDBF CTF as of end of September 2007 still AA). Significantly, the August 1 FAQs, which Mr. Flannery did not prepare, contained the very same "average credit quality" information as that which appeared in the August 2 letter. Division Ex. 153 (August 1 FAQs; *see* FAQ #8).

(iii) The Division Cannot Prevail With Respect to the Unspecified Omissions.

With respect to alleged omissions, the Division has asserted more than once without elaboration that the August 2 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." Division's Pre-Trial Br. at 17; *see also* OIP at ¶ 37. There is no evidence that "special information" was provided to GAA and OFA and, in fact, representatives of both GAA and OFA testified that they never received special or preferential information, and did not base their redemption recommendations on expected redemption activity. Lowe Tr. at 2034:5-20 (stating that GAA's decision was not based on actual or anticipated redemption activity),[47] 2041:12-16 (stating that the Fixed Income team was not involved in GAA's decision), 2044:21-2045:20 (stating that Mr. Flannery was not involved in GAA's decision); Donovan Tr. at 1806:12-24 (testifying that the Fixed Income team did not tell OFA what other clients were doing with respect to LDBF when they met in late July), 1809:4-1810:3 (explaining that OFA's recommendation was based on the fund's performance and volatility, not actual or anticipated redemptions).[48]

Moreover, both the OIP and the Division's Pre-Trial Brief do not identify the allegedly omitted information, and, despite repeated opportunities to do so, the Division did not provide further clarity at the Hearing. As a matter of both notice pleading and fundamental fairness, this Court should not entertain any arguments advanced by the Division in its post-hearing

[47] The Division conceded on the record at trial that GAA's decision to recommend redemption was not based on actual or anticipated redemption activity. Lowe Tr. at 2036:11-2038:23.

[48] To the extent the Division claims that OFA and GAA's recommendation was based on LDBF's exposure to subprime (*see* Division's Pre-Hearing Br. at 12), the fact that the fund was invested mostly in subprime was public knowledge and Mr. Flannery knew that it was public knowledge as of July 26. Flannery Ex. 108 at SS 003837015 (MML article stating fund was invested "mostly in subprime").

submissions regarding purported omissions from the August 2 letter. *See, e.g.*, *United States v. Schiff*, 538 F. Supp. 2d 818, 841 (D.N.J. 2008) ("To the extent that the Government seeks to raise new arguments, to make a new factual proffer, or to advance a new legal theory in the post-hearing submission, such portions are beyond the scope of the ordered briefing. *A post-hearing brief is not the place for new theories. This is not arbitrary, but rather essential for a fair hearing process*.") (emphasis added).

(a) There Were No Material Omissions.

Moreover, there were no material omissions from the letter. To the extent the Division claims that the as yet unidentified omissions concerned LDBF's exposure to subprime and the fact that GAA had recommended redemption, *see, e.g.*, OIP at ¶ 36 (discussing alleged omissions from July 26 letter, as to which Mr. Flannery was not charged), such claims would lack merit. The fund's exposure to subprime was hardly a secret, and had even been the subject of an article in the Money Management Letter released on July 25. Flannery Ex. 108. The July 26 letter also discussed the fund's exposure to subprime. Hopkins Ex. 98. The information about subprime exposure, as well as the fact that GAA had recommended redemption was also available to clients through the FAQs, which Mr. Flannery understood were designed for the express purpose of assisting Relationship Managers in communicating with clients. *See* Division Ex. 153; Flannery Tr. at 1310:4-10. As the Division conceded in the OIP, the FAQs were "far more comprehensive" than the letters and "enabled" SSgA's client service personnel to disclose material information to investors, including that the fund was concentrated in subprime investments and that State Street's largest internal advisory group had decided to redeem out of the fund and the related funds. *See* OIP at ¶ 36. Mr. Flannery reasonably believed that Relationship Management was providing needed information to clients pursuant to the FAQs, which were developed for the express purpose of communicating with clients.

(b) Sophisticated Investors Would Not Have Relied On the Letter Alone.

The August 2 letter was intended to supplement what Mr. Flannery understood to be very substantial information available to investors. Carlson Tr. 2724:8-12; *e.g.*, Flannery Tr. at 1215:1-7, 1216:20-1217:1, 1223:6-1225:17, 1309:19-1311:1 (discussing use of FAQs with clients); Flannery Ex. 109. The investors in LDBF were sophisticated, often represented by experienced investment consultants. Peavy Direct Test. at A.40(a). As expert witness John Peavy testified, such sophisticated investors and consultants would not have relied solely on information contained in a single letter to guide their investment decisions.[49] *Id.* at A.40(e). The Division's claims regarding purported omissions simply ignore the total mix of information available to these sophisticated clients. Peavy Tr. at 3072:7-17 (the letters were just part of the total mix of information available to investors); Peavy Direct Test. at A.40(e); *see TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (materiality of an omission turns on whether there is "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" to investors); *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (same); *Zirkin v. Quanta Capital Holdings Ltd.*, 2009 U.S. Dist. LEXIS 4667, at *39 (S.D.N.Y. Jan. 23, 2009) (dismissing Securities Act claims because no reasonable investor could have been misled "after reading the Prospectus and Registration Statement as a whole").

[49] In Section 10(b) claims in private securities actions, courts have routinely held sophisticated investors to a higher standard when determining whether a plaintiff investor was entitled to rely on the statements in question. *See, e.g.*, *Banca Cremi, S.A. v. Alex Brown & Sons*, 132 F.3d 1017, 1029 (4th Cir. 1997) (rejecting claim of justifiable reliance in a § 10(b) action where plaintiff was a business entity with experienced and educated employees and a unit whose function it was to invest funds); *Quintel Corp. N.V. v. Citibank, N.A.*, 596 F. Supp. 797, 802 (S.D.N.Y. 1984) ("However, the sophistication of [the investor] is relevant to the adequacy of the disclosure and the extent of the reliance of [the investor] on any alleged misrepresentation.") (internal citations omitted).

Tellingly, just two business days after the August 2 letter was sent, SSgA sent the August 6 letter to clients, which announced the creation of LDBF II, a fund developed for the sole purpose of enabling investors to maintain LDBF exposure without being affected by the potentially high level of redemptions. Flannery Ex. 161. The August 6 letter demonstrates that SSgA was not hiding information about redemptions from clients. Indeed, on that same day, a new version of the FAQs was released which disclosed that heavy redemptions had taken place as of July 31. Flannery Ex. 167.

Notably absent from the Division's case was <u>any</u> testimony from <u>any</u> investor that they were misled by any aspect of the August 2 letter (or the August 14 letter). This is fatal to the omissions claim: with very substantial information available to investors from both SSgA and the Media, there is no evidence that any investor was misled by the August 2 letter. The failure to offer any investor testimony further dooms the Division's claim. *See In the Matter of Marc N. Geman*, Exchange Act Release No. 112, 1997 WL 436272, at *7 (ALJ Aug. 5, 1997) (initial decision) (rejecting Division of Enforcement's allegation of false representation in part because Division failed to elicit testimony from anyone who had allegedly been misled).

(c) Mr. Flannery Did Not Have a Duty to Speak.

With respect to the unspecified omissions, the Division would have to demonstrate *both* that the omitted fact was material under the circumstances and that Mr. Flannery had a duty to speak on that subject. *See, e.g.*, *Basic*, 485 U.S. 224 at n.17 ("To be actionable, of course, a statement must also be misleading. Silence, absent a duty to disclose, is not misleading under Rule 10b-5."). While a duty to disclose can arise if "disclosure is required to prevent a voluntary statement from being misleading," *In re K-tel Int'l Sec. Litig.*, 300 F.3d 881, 897 (8th Cir. 2002), such a duty applies ***only*** to those individuals to whom the voluntary statement is publicly attributable. *Tambone,* 417 F. Supp. 2d at 135 (citing *SEC v. Druffner*, 353 F. Supp. 2d 141, 148

(D. Mass. 2005); *SEC v. PIMCO Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 467 (S.D.N.Y. 2004)). The August 2 letter was not attributed to Mr. Flannery, he was not generally responsible for client communications, and he had no duty to speak.

c. Mr. Flannery Did Not Act With Scienter.

The Division's § 10(b)/Rule 10b-5 charge fails for a third reason: the Division cannot demonstrate that Mr. Flannery acted with *scienter* — "an intention to deceive, manipulate, or defraud." *See Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 639 (D.C. Cir. 2008) (explaining that "Section 17(a)(1) of the Securities Act, section 10(b) of the Exchange Act, and Rule 10b-5 require proof of *scienter*") (citing *Aaron*, 446 U.S. at 697; *Hochfelder*, 425 U.S. at 193); *see also SEC v. Druffner*, 517 F. Supp. 2d 502, 508 (D. Mass. 2007) (*aff'd sub nom.*, *S.E.C. v. Ficken*, 546 F.3d 45 (1st Cir. 2008)). There simply is no evidence that Mr. Flannery either harbored a "conscious intent to defraud" or acted with a "high degree of recklessness" at any time. *See Ficken*, 546 F.3d at 47; *see also SEC v. Fife*, 311 F.3d 1, 9 (1st Cir. 2002), *cert. denied*, 538 U.S. 1031 (2003). The degree of recklessness the Division would need to prove is "a highly unreasonable omission, involving not merely simple, *or even inexcusable* [] negligence, but an extreme departure from the standards of ordinary care . . . which present[ed] a danger of misleading buyers or sellers that [was] either known to [Mr. Flannery] or [was] so obvious [that he] must have been aware of it." *Ficken*, 546 F.3d at 47-48 (quoting *Fife*, 311 F.3d at 9-10); *accord, e.g., Ezra Charitable Trust v. Tyco Int'l, Ltd.*, 466 F.3d 1, 12 n.10 (1st Cir. 2006) (inexcusable negligence is "well short" of the required showing); *Wells v. Monarch Capital Corp.*, 1997 U.S. App. LEXIS 30031, at *19 (1st Cir. Oct. 29, 1997) (*per curiam*) (even "carelessness approaching indifference" may not be sufficient to establish *scienter*) (quoting *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516 (1st Cir. 1978)).

(i) Mr. Flannery's Limited Role In The Letter Itself Shows Scienter is Absent.

Mr. Flannery's limited involvement in the August 2 letter itself belies any notion that he acted with extreme recklessness or with an intent to defraud investors. *See Plumbers and Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc.*, 2011 WL 338865, at *25 (S.D. Ind. Jan. 28, 2011) (holding, in Section 10(b) claim arising out of communication that was allegedly misleading by omission, that *scienter* element was not satisfied because of defendants' "minimal" and "vague" involvement, and further holding that "[d]efendants' [additional] public disclosures . . . weigh against an inference that their [allegedly misleading] statements were knowingly false."); *see also In re Gap Stores Securities Litigation*, 457 F. Supp. 1135, 1145 (D.C. Cal. 1978) (granting summary judgment for defendant charged with 10b-5 aiding and abetting where defendant's participation in alleged misrepresentation was so "minor" as to defeat any characterization of his conduct as "knowing or reckless").

Mr. Flannery, who volunteered his "suggested edits" to the letter, was not provided with any of the many later drafts that were circulated among lawyers, Relationship Managers, and others. He did not request that the letter be prepared, had no role in the initial draft, and no role with respect to the final version of the letter. In these circumstances, there is no basis for a finding of recklessness or an "intent to defraud" against Mr. Flannery. Indeed, the evidence shows that that Mr. Flannery acted reasonably and carefully throughout his tenure at SSgA, including during the summer of 2007. *See, e.g.*, Armstrong Tr. at 2202:3-7 (when he was CIO, Mr. Flannery increased the size and resources of Risk Management); Flannery Tr. at 826:19-24, 1227:11–1228:11, 1247:7-1248:10 (during the market turbulence of 2007, Mr. Flannery regularly challenged the Fixed Income team to re-examine their investment philosophy and sought opposing viewpoints), 939:3-5, 1299:11-22 (Mr. Flannery sought Legal's review of the letters to investors), 1269:25-1274:6 (Mr. Flannery invited numerous people, including Mark Duggan, to the July 25 Investment Committee meeting to seek multiple perspectives, and encouraged debate about the issues); Pickett Tr. at 1736:12-23 (same); Flannery Ex. 33; Flannery Ex. 92 (Mr. Flannery raised the subprime issues with the Investment Committee).

(ii) Mr. Flannery's Awareness of and Reliance on the Substantial Role of Legal and Relationship Management Is Further Evidence That He Lacked *Scienter.*

Mr. Flannery knew that Mr. Shames was involved in reviewing the August 2 letter, as he was copied on the e-mail from Ms. Kohler asking that Mr. Shames review her draft. Division Ex. 151. Mr. Flannery also knew that Mr. Shames and the Legal team were aware of potential redemption activity in LDBF. For example, Mr. Shames was present at the July 30 EMG meeting, at which Mr. Flannery was also present, where a discussion took place about the possibility of redemptions so large that freezing LDBF was considered. Flannery Tr. at 1343:3-23. Mr. Duggan, who reported to Mr. Shames, was present at the July 25 Investment Committee meeting as a result of Mr. Flannery's invitation, and potentially high levels of redemptions were discussed at that meeting. *Id.* at 1269:25-1270:22; Flannery Ex. 92. Mr. Flannery reasonably expected that Mr. Duggan would discuss what had transpired at that meeting with his boss, and Mr. Duggan did so. Flannery Tr. at 1344:11-17; Duggan Tr. at 210:5-24, 439:17-440:3. LDBF II, which was premised on potentially high redemptions, was being formed before the August 2 letter was transmitted, and Legal was involved. Flannery Tr. at 1356:10-1357:3; Carlson Tr. at 2761:4-17. The FAQs, which Legal was heavily involved in reviewing and approving, disclosed GAA's redemption recommendation by August 1, and OFA informed Legal and Relationship Management of its recommendation by July 27. *See* Division Ex. 153; Flannery Tr. at 1361:17-24; Carlson Tr. at 2743:2-11; Duggan Tr. at 298:25-300:15; Donovan Tr. at 1804:20-1805:19. As Mr. Shames repeatedly testified, his legal team, as well as outside counsel, were highly competent attorneys who knew to request information if they thought it necessary in providing advice. Shames Tr. at 80:4-13, 89:16-90:2, 156:18-157:8, 158:10-162:11. Mr. Flannery also held this view. Flannery Tr. at 1274:16-1275:1 (testifying that Mr. Duggan is "a highly skilled lawyer"), 1344:13-18 (Mr. Duggan is "a careful and thoughtful attorney"). In short, Mr. Flannery reasonably that the lawyers were well informed, would review and approve the August 2 letter after he provided his "suggested edits," and the evidence demonstrates that they did so.

Evidence of Mr. Flannery's good faith is a relevant consideration in evaluating his *scienter*. *See SEC v. Snyder*, 2006 U.S. Dist. LEXIS 81830, at *13 (S.D. Tex. Aug. 22, 2006) Reliance on the involvement of counsel — just like reliance on others with knowledge — is evidence of good faith, and need not be asserted as a separate and distinct "advice of counsel" defense. *See, e.g.*, *SEC v. Selden*, 632 F. Supp. 2d 91, 98-99 (D. Mass. 2009) (recognizing that advice of counsel can mitigate defendant's degree of s*cienter*) (quoting *Howard v. SEC*, 376 F.3d 1136, 1147 (D.C. Cir. 2004)). As the D.C. Circuit held:

> [R]eliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter.

Howard, 376 F.3d at 1147; *see also SEC v. Snyder*, 292 F. App'x 391, 406 (5th Cir. 2008) (reliance on counsel's advice is . . . 'a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud'").[50] And as the District of Maryland explained

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[50] The Division asserts that Mr. Flannery cannot point to his reliance on and involvement of counsel without demonstrating that he (1) made a complete disclosure to counsel; (2) sought advice from counsel regarding the legality of his conduct;(3) received advice from counsel that the conduct was legal; and (4) relied on that advice in good faith. Division's Pre-Hearing Br. at 28. The Division's four-pronged test is inapposite, and is designed for situations where a defendant asserts a formal "advice of counsel" defense as a complete defense to a claim in which an individual relied on incorrect advice from his personal lawyer. The test is not relevant to situations where reliance on or involvement of counsel is presented as evidence that the defendant acted without *scienter*, particularly in the corporate context, where, as here, the lawyer acts for the corporation, and has access to multiple sources of information from within the corporation. Counsel's involvement plainly underscores Mr. Flannery's lack of recklessness; he reasonable believed that well-informed experts in disclosure would carefully review and approve

(continued...)

last month, "reliance on counsel's advice . . . is simply a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud." *United States v. Stevens*, 2011 U.S. Dist. LEXIS 30107, at *21 (D. Md. Mar. 23, 2011) (quoting *United States v. Peterson*, 101 F.3d 375, 381 (5th Cir. 1996)); *see also Oakley, Inc. v. Bugaboos*, 2010 U.S. Dist. LEXIS 123976, at *11-12 (S.D. Cal. Nov. 23, 2010) (good faith reliance on advice of counsel "is not an affirmative defense" but rather "is relevant to determining whether [defendant] acted with intent to deceive").

Lawyers were not the only ones who Mr. Flannery knew were involved in the August 2 letter, and who had full knowledge of the issues. Mr. Wands, a member of the Fixed Income team who had been present at the July 25 Investment Committee meeting where anticipated redemptions and liquidity issues were discussed and who had more granular knowledge about LDBF than Mr. Flannery, reviewed the letter after Mr. Flannery offered his suggested edits. Flannery Ex. 126; Flannery Tr. at 1345:11-19. Though Mr. Wands offered edits to the letter, he did not make any changes to the "Actions Taken" paragraph, or to Mr. Flannery's suggested edits to that paragraph. Flannery Ex. 126. The Relationship Management team was the actual source of the redemption estimates discussed at the Investment Committee meeting. Flannery Tr. at 1345:5-8; Flannery Ex. 92. The co-heads of Relationship Management, Staci Reardon and

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the letters. *See SEC v. Reserve Mgmt. Co. (In re Reserve Fund Sec. & Derivative Litig.)*, 732 F. Supp. 2d 310, 321 (S.D.N.Y. 2010) ("consultation with counsel is one factor, or 'possible evidence,' that might be taken into account in evaluating whether those accused of fraud acted in good faith.") (citing *Snyder*, 292 F. App'x. at 406); *see also Bisno v. United States*, 299 F. 2d 711, 719 (9th Cir. 1961) (noting that the defendant's imperfect consultation with a lawyer "may constitute some evidence of good faith"); *Howard*, 376 F.3d at 1147-48. Even if, contrary to law, the four-pronged test were a prerequisite to Mr. Flannery's ability to point to the involvement of knowledgeable lawyers, Mr. Flannery satisfies that test: (1) Mr. Shames and Mr. Flannery were both present at the EMG meeting and, as Mr. Flannery expected, Mr. Duggan informed Mr. Shames of what had been discussed at the July 25 Investment Committee meeting; (2) Mr. Flannery knew the letter was circulated to Mr. Shames, as he was copied on the e-mail requesting legal advice from him; (3) Mr. Shames, and other attorneys who he supervised, extensively reviewed and provided advice on the letter; and (4) Mr. Flannery relied on these experienced lawyers who he knew were commenting on the letter. To the extent the Division claims that Mr. Flannery's conduct does not fit neatly within its inapplicable four-pronged test, it is because of Mr. Flannery's limited involvement in the letter, which itself belies the notion that he acted with *scienter*.

Larry Carlson, who were familiar with the information previously received by clients, were heavily involved in the many iterations of the letter, and Mr. Flannery knew they were involved. *See, e.g.*, Division Ex. 151; Flannery Ex. 123. Mr. Flannery also knew that their boss, Marc Brown, was involved in the letter, and was present at the EMG Meeting where redemptions were discussed and freezing the fund was considered. Division Ex. 151; Flannery Tr. at 1346:5-11. Relationship Management was aware of the redemption recommendations of GAA and OFA by late July. Lowe Tr. at 2043:9-2044:6; Donovan Tr. at 1804:20-1805:19. While Ms. Reardon, Mr. Carlson, and Mr. Brown were aware of actual redemptions and the possibility of additional redemptions, none of them sought to include any language regarding redemptions in the "Actions Taken" paragraph, or otherwise suggested that the information in that paragraph was inaccurate or incomplete. Flannery Tr. at 1346:12-17.

(iii) Earlier FAQs Contained The Same Information About Risk Reducing Transactions As That Contained in the August 2 Letter.

Even if the August 2 letter could be attributed to Mr. Flannery, he was not reckless. The statements in the letter represented SSgA's honest view: the August 1 FAQs, prepared with input from Legal, Relationship Management, and the Fixed Income team, identified the AAA bond sale and the swaps rolling off at month-end as efforts that had been taken to reduce risk in LDBF (FAQ #32). Division Ex. 153. These FAQs also disclosed that LDBF continued to be an average credit quality of AA (FAQ #8). *Id.* The statements in the FAQs were identical in substance to statements in the August 2 letter. While the evidence indicates that the statements were accurate, even if they had not been accurate, Mr. Flannery hardly could be deemed reckless in connection with a letter containing information that others at SSgA believed to be accurate and published in the FAQs.

(iv) Mr. Flannery Reasonably Believed The Letter Was True.

Mr. Flannery reasonably believed that the transactions described in the August 2 letter reduced risk, and that LDBF's average credit quality remained AA (and, as discussed above, these propositions were both true). Flannery Tr. at 1049:19-1052:9 (stating transactions reduced risk), 1075:22-1076:12 (stating that he was familiar with the fact that the average credit quality was AA but that he did not ever calculate average credit quality, which was done by Portfolio Management team), 1337:24-1338:23 (same); *see also id.* at 1341:5-1343:14 (discussing AAA cash bond sale and stating "Actions Taken" paragraph was not misleading because transaction reduced leverage and exposure to subprime). Mr. Flannery's good faith belief in the letter's truthfulness destroys any claim that Mr. Flannery intentionally sought to mislead investors. *See United States v. Dowlin*, 408 F.3d 647, 667 (10th Cir. 2005) (affirming jury instruction that "[a]n honest belief or 'good faith' belief by the defendants that the statements or representations made were true is a complete and total defense to the charge of securities fraud."); *United States v. Bradstreet*, 135 F.3d 46, 51 (1st Cir. 1998) (affirming jury instruction that "a good faith belief on the part of a defendant in the truth of his actions or statements will necessarily negate [a specific or deliberate] intent [to defraud]").

(v) The Testimony of the Division's "Motivations Expert" Demonstrates That Mr. Flannery Lacked *Scienter.*

While the Division's "motivations" expert, William Lyons, lacked a basis for providing expert testimony, even he helped to demonstrate that Mr. Flannery did not act with *scienter*. Mr. Lyons' purported expert opinion regarding the motivations of a CIO is unreliable, as Mr. Lyons has never been a CIO; has limited experience with unregistered funds; does not know Mr. Flannery and concedes he has no basis to opine on Mr. Flannery's actual motivations during the summer of 2007; and did not rely on any academic research or studies, and instead relied solely on his own personal experience. Lyons Tr. at 1832:22-1846:20.

In any event, it is undisputed that Mr. Flannery conceived of LDBF II as a way to protect the interests of investors. Mr. Lyons testified that LDBF II would be harmful to Mr. Flannery's reputation:

> ***[D]oing this [i.e., creating LDBF II] would be harmful to the reputation of a person such as Mr. Flannery because I believe that this is a truly extraordinary event in the life of a fund, and it was . . . to remedy, as best they can, an exceptional situation. . . . I still believe the statement I made about a closure or freeze, this was a version of that, of a fund would be harmful to reputation.*** *This was not an everyday garden variety occurrence in investment management business.* This was an extreme step. . . .
>
> [I]t would have been an acknowledgement of a serious issue within the portfolio of this fund that required the creation of this parallel or clone fund and the segregation of investors to it that would agree to less liquidity, i.e., monthly rather than daily, their ability to get out of this new vehicle would be limited which I don't think would be a happy thing necessarily.

Lyons Tr. at 1867:7-1868:18 (emphasis added). LDBF II was Mr. Flannery's idea, and it was developed contemporaneously with the August 2 letter. Flannery Tr. at 1294:24-1295:1, 1356:6-1358:4. As Mr. Lyons' own testimony shows, LDBF II proves that Mr. Flannery was seeking to do what was right for investors even if his reputation as a CIO might be harmed, and in doing so ensured that investors would learn about the gravity of the situation facing LDBF, including that potential redemptions were at such a high level that SSgA needed to create a limited liquidity fund.

2. The Securities Act § 17(a) Charges Fail.

The Division's § 17(a) charges fail for the same reasons the Division's Section 10(b) claim fails: (1) Mr. Flannery did not make a "statement" within the meaning of the law,[51] (2) the August 2 letter was not false or misleading, and (3) Mr. Flannery did not act with *scienter* for purpose of § 17(a)(1). *See SEC v. Patel*, 2008 U.S. Dist. LEXIS 23553, at *40 (D. N.H. Mar. 24, 2008). In addition, the August 2 letter did not constitute an offer or sale of securities within the meaning of Section 17(a). *See* 15 U.S.C. § 77q(a); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 945 (2d Cir. 1984) (dismissing § 17(a) claims after determining that the alleged misstatements were not "in the offer or sale of a security."), *cert denied*, 469 U.S. 884 (1984).

Moreover, the Division's Section 17(a)(2) and (3) fail for the following additional reasons: Mr. Flannery was not negligent in connection with the August 2 letter; he did not obtain money or property as a result of the letter as required by § 17(a)(2), and the Division has not identified, and Mr. Flannery did not engage in, a fraudulent or deceptive course of conduct as required by § 17(a)(3).

a. Mr. Flannery Acted Reasonably and Was Not Negligent.

For purposes of its §§ 17(a)(2) and 17(a)(3) claims, the Division must establish Mr. Flannery acted negligently. However, Mr. Flannery acted reasonably in offering minor suggested edits to the August 2 letter, and circulating them to SSgA's General Counsel, key members of the Relationship Management Department, and a member of the Fixed Income team close to the day-to-

[51] The Division's claim in pages 31-32 of its Pre-Hearing Brief that it need not prove that Mr. Flannery made a statement in connection with its Section 17(a) claims misstates the law. *See In the Matter of Piper Capital Management*, Exchange Act Release No. 175, 2000 WL 1759455, at *31 (ALJ Nov. 30, 2000) (initial decision) ("The elements for alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder are essentially identical to the elements for alleged violations of Section 17(a) of the Securities Act."); *see also SEC v. Forman*, 2010 WL 2367372, at *4 (D. Mass. June 9, 2010) (same).

day activities in LDBF and the market. *See, e.g.*, *In the Matter of Albert Glenn Yesner, CPA*, Exchange Release No. 184, 2001 WL 587989, at *29 (ALJ May 22, 2001) (initial decision) ("With respect to the non-*scienter* primary violations [defendant] is alleged to have caused, a negligence standard will be applied, and [his] conduct will be measured by reasonableness . . . The reasonableness standard . . . enunciates a standard of care being that of a reasonable man under like circumstances.") (citations omitted).

b. Mr. Flannery Did Not Obtain Money or Property As a Result of the Letter.

Section 17(a)(2) requires that the Division allege and prove that the defendant actually obtained money or property by means of the untrue statements. *Fund of Funds, Ltd. v. Arthur Anderson & Co.*, 545 F. Supp. 1314, 1325 n.1 (C.D.N.Y. 1982) (dismissing Section 17(a)(2) charge against defendant on the grounds that "there was no evidence that defendants obtained any money or property in the offer or sale of securities."). The Division did not prove that Mr. Flannery obtained money or property by means of any alleged misstatement, or that his compensation was in any way tied to asset levels in LDBF or to LDBF's performance. In fact, the evidence is to the contrary. Flannery Tr. at 1163:5-10.

c. The Division Has Not Alleged or Proven a Fraudulent or Deceptive Course of Conduct.

With respect to its Section 17(a)(3) claim, the Division also has both failed to allege and failed to prove that Mr. Flannery, in the offer or sale of a security, "engage[d] in any transaction, practice, or course of business which operate[d] or would operate as a fraud or deceit upon the purchaser." *See* 15 U.S.C. § 77q(a)(3). As is the case with Rule 10b-5(c) (not alleged against Mr. Flannery), "the alleged conduct must be more than a reiteration of the misrepresentations underlying the [§ 17(a)(2)] misstatement claims." *SEC v. Brown*, 2010 U.S. Dist. LEXIS 101403, at *56-57 (D.D.C. Sept. 27, 2010) (quoting *SEC v. Lucent Techs., Inc.*, 610 F. Supp. 2d

342, 361 (D. N.J. 2009)); *accord United States v. Naftalin*, 441 U.S. 768, 774 (1979) ("each subsection of § 17(a) proscribes a distinct category of misconduct ").

The OIP and the Division's Pre-Trial Brief do not identify any alleged misconduct of Mr. Flannery's other than that arising out of the August 2 and August 14 letters. When confronted regarding the issue at the Hearing, Division's Counsel continuously failed to identify any additional conduct forming the basis for this claim. *See, e.g.*, Flannery Tr. at 839:5-840:13, 961:8-962:2, 1186:9-20; 1486:20-1487:16.[52] To the extent the Division's Post-Hearing Brief advances new "course of conduct" theories (which, in any case, would not be supported by the evidence), such theories should be disregarded. *See Schiff*, 538 F. Supp. 2d at 841 (D. N.J. 2008) ("A post-hearing brief is not the place for new theories. This is not arbitrary, but rather essential for a fair hearing process.").

B. The Division Failed to Prove its Claims Arising Out of the August 14 Letter

With respect to the August 14 letter, the Division charges violations of Sections 17(a)(2) and (3). The Division contends that the following statement in the August 14 letter, which was drafted by Mark Duggan, SSgA's Deputy General Counsel, was misleading: "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." The Division contends this statement was misleading because it was allegedly inconsistent with the fact that "related funds" and internal advisory groups had already redeemed their investments in

[52] However, during the Hearing, the Division for the first time opaquely asserted that the July 26 letter is part of the Division's course of conduct charge against Mr. Flannery. Flannery Tr. at 961:12-962:2. Even as recently as the Division's Pre-Hearing Brief, filed on February 14, 2007, the Division made no such allegation. Other than referencing the undisputed fact that Mr. Flannery was involved in revising the July 26 letter, the Division alleges no wrongdoing by Mr. Flannery in connection with that letter; all of the purported wrongdoing is alleged against Mr. Hopkins. *See* Division's Pre-Hearing Br. at 14-16, 26-27. It is fundamentally unfair and contrary to basic principles of notice pleading to allow the Division to pursue its new theory (which, in all events, is unsupported by the evidence) at this late date.

LDBF. The Division also claims the August 14 letter was generally misleading because it omitted information that had been provided to certain other investors, namely, the allegedly illiquid nature of the fund and the exposure to derivatives tied to subprime investments, such as total return swaps. Division's Pre-Hearing Br. at 19-21. As discussed below, the Division did not prove its claims arising out of the August 14 letter and, as with the August 2 letter, the Division provided no evidence that any investor was misled.

1. The August 14 Letter Was Accurate.

The "many judicious investors" language challenged by the Division was an opinion that Mr. Flannery and others both inside (*e.g.*, the Fixed Income team) and outside SSgA undisputedly held at the time. Flannery Tr. at 1383:25-1384:2, 1387:17-1388:5; Sirri Report at ¶ 80. Such a forward-looking statement of opinion can only constitute a misrepresentation if the speaker did not sincerely hold that opinion when he made the statement. *See, e.g.*, *Brown v. Credit Suisse First Boston LLC*, 431 F.3d 36, 47, 49 (1st Cir. 2005) (to establish that a statement of opinion constituted securities fraud, a plaintiff must prove "that the speaker did not believe that particular opinion to be true when uttered"), *overruled in part on other grounds as stated in ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 F.3d 46, 52 (1st Cir. 2008); *Podany v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 146, 154 (S.D.N.Y. 2004) (allegations that "it would have been possible to reach a different opinion than that reached by defendant based on information available to defendant at the time, or even that the defendant's opinion was unreasonable" are insufficient to state a Section 10(b)/Rule 10b-5 claim) (cited with approval in *Credit Suisse First Boston*, 431 F.3d at 48-49). The evidence is unrebutted that the "many judicious investors" language reflected Mr. Flannery's honest opinion as of August 14, 2007. Flannery Tr. at 1387:17-1388:5.

Even if the "many judicious investors" language were viewed as a statement of fact, it was not false. Market conditions in the summer of 2007 were unprecedented and the vast majority of government officials and investment professionals misjudged the scope, extent, and consequences of the market turmoil. Armstrong Tr. at 2211:8-14 (agreeing that no one could have predicted the extreme market conditions of Summer 2007). Expert witness Erik Sirri testified regarding the tumultuous and rapidly changing nature of the market during the summer of 2007 and the belief held by many that the market events were the result of a liquidity crisis; as such, during the time period before and including the August 14 letter, it was reasonable to believe that many investors would continue to hold their positions in anticipation of greater liquidity in the months to come. As Professor Sirri explained:

> During a liquidity crisis, asset values may temporarily become disconnected from fundamental values. The value of an asset may fall simply because there is no one to take the other side of a trade, not because the asset will fail to produce its promised cash flows. In such a scenario, different investors react differently. Some investors may reasonably prefer to liquidate their holds of illiquid assets in these market conditions even at sharply lowered prices, while other investors reasonably prefer to wait for more information to arrive in the market, for volatility to subside and for liquidity to return rather than sell.

Sirri Report at ¶ 81. On August 14, Mr. Flannery sincerely believed that liquidity would return and, in light of the similar views held by government officials, the Fixed Income team, and investment professionals, Mr. Flannery's belief was reasonable. Flannery Tr. at 1383:25-1384:2, 1387:17-1388:5; Sirri Report at ¶ 80.

The fact that internal advisory groups had recommended redemption to their clients did not render the "many judicious investors" language misleading. As an initial matter, "many judicious investors" does not mean that every such investor would remain invested. Indeed, "many" suggests that there are some who would not. Additionally, each of the advisory groups was relatively small, and had its own investment guidelines. *See, e.g.*, Flannery Tr. at 868:2-870:2, 893:1-894:3; Donovan Tr. at 1812:1-9; Flannery Ex. 301. A determination by one or all of the groups to redeem did not change the fact that, at the time, it was reasonable to think that many other investors would not redeem into an illiquid market. Flannery Tr. at 1157:11-15. Indeed, it was unremarkable that different components of SSgA held contrary investment positions: there was no "house" investment view at SSgA, and SSgA's different investment philosophies and approximately 300 strategies often took inconsistent positions. *Id.* at 1157:16-17; Lowe Tr. at 2021:13-21. Nothing about the advisory groups' recommendations caused Mr. Flannery or anyone else to think those recommendations should have been disclosed in the letter. Notably, the advisory groups viewed their recommendations as proprietary and confidential, and did not want their recommendations to be disclosed. *See, e.g.*, Donovan Tr. at 1806:25-1809:3, 1812:10-21.

Furthermore, while the Division claims that the activity of the commingled, or "related," funds was inconsistent with the August 14 letter (*see* Division's Pre-Hearing Br. at 20), the Division's facts are wrong: the commingled funds (which represented a much larger percentage of the portfolio than GAA/OFA/CAM), *did* believe that holding their investments was the reasonable thing to do at the time, and thus took redemptions *in kind* in order to remain exposed to the LDBF strategy. Flannery Ex. 161; Flannery Tr. at 1360:3-9. The actions by the related funds were disclosed by SSgA to its investors in the August 6 letter. Flannery Ex. 161. It is difficult to see why those facts would need to again be disclosed in the August 14 letter.

The language of the very sentence that the Division challenges makes it abundantly clear that redemption activity was occurring. That sentence begins, "[w]hile ***we will <u>continue to liquidate</u> assets for our clients when they demand it***, we believe that many judicious investors will hold the positions in anticipation of greater liquidity in the months to come." Division Ex.

176 at SS-SEC000087633 (emphasis added). There was no attempt to hide redemption activity in LDBF by Mr. Flannery or anyone else.

Finally, as discussed above, the information regarding pre-existing redemption activity of advisory groups, commingled funds, and others was already available to investors before the August 14 letter was disseminated via the FAQs and the August 6 letter, and was thus part of the total mix of information available to investors. *See* Division Ex. 153 (August 1 FAQs: FAQ #31, disclosing GAA's redemption recommendation); Flannery Ex. 167 (August 6 FAQs: FAQ #31, disclosing GAA's redemption recommendations, and FAQ #36, disclosing substantial redemption activity through the end of July); Flannery Ex. 161 (August 6 LDBF II Letter, disclosing in-kind redemptions of commingled funds and providing a way for clients to protect themselves from the "liquidity decisions of others"). The same is true of the information the Division claims was omitted from the letter, as both the FAQs and the August 6 letter addressed subprime exposure and liquidity issues, and both the FAQs and public sources made clear that LDBF used derivatives such as total return swaps. *See id.*; *see also* Flannery Exs. 108 (July 25 Money Management Letter, discussing LDBF's subprime exposure, use of derivatives), 197 (DW Online article discussing LDBF's losses, and use of total return swaps), 111 (July 26 letter to clients disclosing, *inter alia*, subprime exposure and impact on performance). And, as with the August 2 letter, the Division's failure to present testimony from <u>anyone</u> who claims they were misled by the August 14 letter underscores the fact that it simply was not misleading.

2. Mr. Flannery Was Not Negligent, But Instead Acted Reasonably In Connection with the Letter.

Mr. Flannery volunteered to write the August 14 letter, over the reservations of his boss, Mr. Hunt, because he felt it was important for someone at SSgA to step up and acknowledge the poor performance of LDBF and funds invested in LDBF. Flannery Tr. at 1370:1-1371:5. After receiving approval from his boss to write the letter, Mr. Flannery consulted General Counsel Shames about what he should and should not write. *Id.* at 1371:6-1372:3. In addition, Mr. Flannery consulted with Mr. Carlson from Relationship Management, in order to obtain Mr. Carlson's view on the utility of the contemplated letter. Division Ex. 160.

a. Mr. Flannery Acted Reasonably By Ensuring the Letter Was Broadly Circulated and Reviewed.

Throughout the drafting process, Mr. Flannery circulated multiple drafts of the letter to Legal, Relationship Management, members of the Fixed Income team, and others to ensure it was both accurate and appropriate. He did not do anything to limit the universe of people who reviewed the draft letter, and instead took steps to ensure that it was shared with and reviewed by a broad group of people. Carlson Tr. at 2765:25-2766:11. The following people reviewed and edited the letter:

- SSgA Deputy General Counsel Mark Duggan (*e.g.*, Division Exs. 166, 168, 169, 170, 172, 173; Flannery Exs. 184, 199, 202, 205, 207);
- Goodwin Procter Partner Liz Fries (*e.g.*, Division Ex. 166; Duggan Tr. at 487:2-8);
- Co-Head of Relationship Management Larry Carlson (*e.g.*, Flannery Exs. 166, 184, 205, 207; Division Exs. 168, 169);
- Co-Head of Relationship Management Staci Reardon (*e.g.*, Flannery Exs. 166, 184, 205; Division Exs. 168, 169);
- Head of Consultant Relations Maureen Fitzgerald (*e.g.*, Flannery Exs. 166, 184, 205; Division Ex. 169);
- Head of Product Engineering Adele Kohler (*e.g.*, Division Exs. 168, 169; Flannery Exs. 166, 184);
- CEO Bill Hunt (*e.g.*, Flannery Exs. 185, 186, 199, 202; Division Exs. 170, 172, 173);
- Chief Marketing Officer Marc Brown (*e.g.*, Flannery Exs. 185, 199, 202; Division Exs. 170, 172, 173); and
- State Street Corporation's Director of Media Relations Hannah Grove (*e.g.*, Division Exs. 170, 172, 173; Flannery Exs. 199, 202).

In addition to a number of conversations about the letter, the evidence demonstrates that at least eleven drafts and/or e-mails containing edits to the letter were circulated among these people. Division Ex. 165 (Mr. Flannery's initial draft); Flannery Ex. 166 (e-mail with edits from Mr. Carlson, Ms. Reardon and Ms. Fitzgerald); Division Ex. 166 (Mr. Duggan's handwritten edits); Division 168 (August 8 draft); Division Ex. 169 (later August 8 draft); Division Ex. 170 (draft sent to Hannah Grove); Flannery Ex. 199 (Ms. Grove's edits); Flannery Ex. 202 (e-mail containing a change from Mr. Flannery); Flannery Ex. 205 (e-mail reflecting additional changes); Flannery Ex. 207 (e-mail reflecting further changes from Mr. Duggan and Mr. Carlson); Division Ex. 176 (final letter). The evidence further demonstrates that Mr. Flannery took care to heed the advice he received from all those involved in the letter. *See, e.g.*, Division Ex. 168 (seeking confirmation from Mr. Duggan that the letter was consistent with his changes); Flannery Ex. 185 (sending the letter to Messrs. Hunt and Brown on Mr. Duggan's advice); Division Ex. 172 (following Ms. Grove's comments). Mr. Flannery's initial draft portrayed a very dark picture, and his subsequent edits continued to depict an unhappy, but accurate, set of circumstances. *See, e.g.*, Division Ex. 168; Flannery Tr. at 1390:9-24, 1405:1-8; Flannery Ex. 202.

Mr. Flannery's inclusion of a broad group of people in the process demonstrates his care and reasonableness in connection with the August 14 letter. And, while Mr. Flannery is charged only with negligence in connection with the August 14 letter, Mr. Flannery certainly had no motive to paint a rosier view of the fund; by August 13, the assets in LDBF had been very substantially reduced, and LDBF constituted a tiny percentage of SSgA's assets under management. *See* Flannery Ex. 288 (Daily Trial Balance showing LDBF's net assets at $452 million, down from approximately $2.7 billion at July 1, 2007).

b. Mr. Flannery Reasonably Believed That Mr. Duggan, Who Drafted and Approved the Challenged Language, Was Armed With the Relevant Facts.

It was SSgA's lawyer — the securities law expert within SSgA — who authored the very language at the heart of the Division's claims, and Mr. Flannery had no reason to believe the language drafted by Mr. Duggan was improper; indeed, he believed the language was true because, as discussed above, many judicious investors did, in fact, remain invested in the fund, and the advisory groups' recommendations did not represent the "view" of SSgA, as there was no such view. Division Ex. 166; *see, e.g.*, Flannery Tr. at 1387:17-1388:5. Mr. Flannery simply was not negligent in any way in connection with the August 14 letter.

First, Mr. Duggan knew that GAA had made its withdrawal recommendation well before inserting the "many judicious investors" language, and Mr. Flannery reasonably believed that Mr. Duggan had that knowledge. Flannery Tr. at 1508:15-1509:2. Mr. Lowe informed Mr. Duggan of GAA's decision to recommend redemption shortly after the decision was made on July 25. Lowe Tr. at 2042:2-4. Similarly, OFA informed Legal of its redemption recommendation by July 27.[53] Donovan Tr. at 1804:20-1805:19. In addition, the evidence demonstrates that on August 6, 2007, Mr. Duggan received a copy of the FAQs, which were prepared by SSgA's Legal and Relationship Management Departments to help Relationship Management personnel respond to the flood of client inquiries. Flannery Ex. 172. Mr. Flannery was copied on the transmittal e-mail to Mr. Duggan. *Id.* In fact, Mr. Duggan likely received the

[53] In any event, it does not matter what Mr. Duggan knew about OFA's and CAM's recommendations, as the evidence is clear that he knew about GAA's recommendation, which was sufficient to allow him to consider whether an advisory group recommending redemption was inconsistent with the "many judicious investors" language.

FAQs earlier, as he testified that he reviewed FAQs while on vacation between July 27 and August 6. Duggan Tr. at 235:20-25, 237:9-17. The FAQs included the following information:

> ***31. What affect has this* [*i.e.*, exposure to subprime] *had on your Asset Allocation Funds? What is your GAA Team doing to address this?***
>
> **Our GAA team has reviewed the situation**, *relative to whether they should continue to hold various strategies (Active Core Bonds/Limited Duration Bond Fund)* **and are recommending a move to passive fixed income**. *Their concern is that turmoil in the ABX segment of the market may continue for several months and they would like to limit, to the extent possible, any further losses.*

Flannery Ex. 167 (emphases added). FAQ number 31 was drafted and finalized by no later than August 1, well before the August 14 letter was sent to clients. Division Ex. 153. In-house lawyers Ms. Luster, Mr. Shames, Mr. Cullinane and Mr. Ciotti also reviewed drafts of the FAQs containing this information. Flannery Ex. 172.

Furthermore, at the July 25 Investment Committee Meeting, at which Mr. Flannery was present, Mr. Lowe recused himself after consulting with Mr. Duggan, because Mr. Lowe had a previously scheduled meeting to discuss what his GAA clients should do with respect to their investments. Lowe Tr. at 2004:2-2005:16; Flannery Ex. 92.

Mr. Duggan also knew more generally about client redemptions before the August 14 letter was sent. He attended the July 25 Investment Committee meeting where the discussion included potentially high levels of redemptions and the possibility of freezing redemptions. Flannery Ex. 92; Division Ex. 132. The August 6 FAQs disclosed that through July 31 there had been substantial redemptions. Flannery Ex. 167. The August 6 letter announcing LDBF II was premised upon giving clients the opportunity to protect themselves from the liquidity — *i.e.*, redemption — decisions of other clients. Flannery Ex. 161. Both LDBF II and the August 6 letter were reviewed and approved by Legal. Flannery Tr. at 1356:1-5. Finally, two versions of the August 14 letter were prepared and approved by Mr. Duggan, one of which was for clients

who had already redeemed. Flannery Ex. 207. It is thus clear that Mr. Duggan was well aware of redemption activity in LDBF.

Mr. Flannery also reasonably believed Mr. Duggan was fully informed of the information the Division claims was omitted from the August 14 letter (*i.e.*, the allegedly illiquid nature of the remaining investments in LDBF, and the fact that LDBF had subprime exposure and used leverage), in part because Mr. Duggan attended both the July 25 and August 8 Investment Committee meetings. Flannery Ex. 92; *see also* Flannery Ex. 231 at SSP-SEC 000002805 (Mr. Duggan's handwritten mark-up of draft Investment Committee minutes). As discussed above, at the July 25th Investment Committee meeting, the following topics, among others, were discussed: there were serious liquidity concerns in the market, there was a need to increase liquidity in LDBF, and SSgA's Relationship Management team was anticipating redemptions in the range of 25 to 50% from LDBF. Flannery Ex. 92. At the August 8 Investment Committee meeting, the Committee again discussed the illiquidity in the market, how the liquidity issues were affecting LDBF, and how best to protect clients' interests. Flannery Ex. 231. Mr. Duggan attended they July 27 IAVC meeting which focused on LDBF's pricing problems — problems that resulted from liquidity issues so severe that SSgA's pricing vendor was unable to generate reliable prices. Duggan Tr. at 147:3-11, 154:4-10; Flannery Ex. 38 at MD00454-56. Additionally, Mr. Flannery was also aware that Mr. Duggan received the FAQs. That document unambiguously discussed the illiquidity of the market and its impact, and LDBF's subprime exposure and use of leverage. Flannery Ex. 167. Finally, Mr. Flannery knew the allegedly omitted information was also available from public sources which Mr. Flannery reviewed. *See, e.g.*, Flannery Exs. 108 (July 25 Money Management Letter discussing LDBF's subprime exposure and use of derivatives), 197 (August 10 DW Online Article discussing LDBF's exposure to ABS and use of total return swaps). The public nature of the allegedly omitted information belies any notion that Mr. Duggan or anyone else was "in the dark." To the contrary, the evidence shows that Mr. Flannery reasonably believed that Mr. Duggan was armed with all of the relevant facts when he reviewed and edited the August 14 letter.

c. Mr. Flannery Reasonably Believed That Client-Facing and Other Senior Executives Were Armed With The Relevant Facts When They Reviewed and Approved the Letter.

Mr. Flannery actively solicited the input of Relationship Management, a group which knew what information was being provided to clients. For example, after incorporating Mr. Duggan's "many judicious investors" revision to the letter, Mr. Flannery circulated the draft letter and wrote:

> I do think we need to hear from relationship management as to how valuable this letter is (or is not) and to whom and under what circumstances we would send it. I will rely on [Relationship Management co-heads Ms. Reardon] and [Mr. Carlson] to advise re anyone else in SSgA that needs to review this letter or send it.

Division Ex. 168. Mr. Flannery's actions were completely reasonable. He was soliciting input from the group within SSgA that dealt with clients and knew what information they had received. Relationship Managers were aware of GAA's and OFA's recommendations, as well as LDBF's use of leverage and exposure to subprime, well in advance of the August 14 letter (as well as the August 2 letter). Division Ex. 153 (E-mail circulating August 1 FAQs, on which Mr. Flannery and Relationship personnel were copied); Carlson Tr. at 2725:21-2726:14; Flannery Ex. 149 (e-mail correspondence between Carlson, Mavro and Dupont regarding inclusion of GAA's recommendation in the August 2 letter, indicating that Legal was "pretty particular" about what could and could not be included); Donovan Tr. at 1804:20-1805:19 (Relationship Management and Legal informed of OFA's recommendation). In fact, Relationship Management both knew about and processed redemption requests of GAA and OFA clients prior to August 14. Carlson Tr. at 2726:5-2727:8. That Relationship Management knew about liquidity issues and the redemption activity in LDBF, including that of the commingled funds, is also demonstrated by the announcement of LDBF II on August 6. Flannery Ex. 161.

A number of Relationship Management executives and other senior executives reviewed and commented on the August 14 letter. CEO Hunt reviewed, commented on, and approved the letter. Flannery Ex. 186; Division Ex. 173. Mr. Brown (Chief Marketing Officer), who was ultimately responsible for determining who would (and would not) receive this letter, reviewed and commented as well. Flannery Ex. 202. Mr. Carlson (Managing Director of U.S. Relationship Management), who reported to Mr. Brown, not only reviewed the letter and determined who would receive it, he reported to Mr. Flannery that he was pleased with the content. Flannery Ex. 184. In fact, in addition to the two most senior lawyers within SSgA (Messrs. Shames and Duggan) and SSgA's outside counsel (Ms. Fries), senior Relationship Management professionals Mr. Brown, Mr. Carlson and Ms. Reardon reviewed a draft of the August 14 letter *after* they had received the FAQ that disclosed GAA's recommendation to its clients, after Relationship Management had begun processing redemption requests of FAA and OFA clients, and after they received the August 6 letter disclosing the redemption activity of the commingled funds. *See, e.g.*, Division Exs. 168, 169, 172; Flannery Exs. 184, 185. None of them suggested that the "many judicious investors" language was incompatible with the recommendations of GAA, OFA, or the actions of the commingled funds, or was otherwise false.

d. The Fact That CEO Hunt Used The Very Same "Many Judicious Language" Investors in a Subsequent Letter Shows That Mr. Flannery Acted Reasonably.

That Mr. Flannery acted reasonably in connection with the August 14 letter is further demonstrated by the fact that almost two months later and long after clients of GAA, CAM and OFA withdrew, SSgA included the "many judicious investors" language in an October 5 letter to clients from CEO Hunt, in which Mr. Flannery was not involved. Flannery Ex. 251; Flannery Tr. at 1420:21-1421:2. SSgA and its lawyers, who were involved in reviewing and approving the October 5 letter, thus continued to believe, even in October, that the challenged language was consistent with the advisory groups recommending withdrawal and with the in-kind redemption activity of the commingled funds. There is simply no basis for finding that Mr. Flannery was negligent in connection with the August 14 letter containing the very same language.

3. The Division's Claims Based on the August 14 Letter Fail For Other Reasons.

The Division's claims arising out of the August 14 letter claim also fail for the same additional reasons discussed in connection with the August 2 letter, above:

- Like the August 2 letter, the August 14 letter was not an offer or sale of securities;
- With respect to § 17(a)(2), the Division did not prove that Mr. Flannery obtained money or property in connection with the August 14 letter; and
- With respect to § 17(a)(3), in addition to the reasons just discussed, the Division failed to identify or prove any fraudulent or deceptive course of conduct other than the letter itself.

IV. SANCTIONS ARE NOT WARRANTED AND ARE NOT IN THE PUBLIC INTEREST

Even if the Division had proven its claims in connection with either letter, there would be no sound basis for sanctioning Mr. Flannery, as the imposition of sanctions would be contrary to the public interest. *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981) (public interest factors to be considered include the egregiousness of the respondent's actions; the isolated or recurrent nature of the infraction; the degree of *scienter* involved; the sincerity of the respondent's assurances against future violations; the respondent's recognition of the wrongful nature of its conduct; and the likelihood of future violations; no one factor is controlling).

In his 27-year career in the investment business, Mr. Flannery has never been sanctioned or otherwise professionally disciplined. He has led an unblemished existence, both professionally and personally. His life has been marked by extensive service to charitable organizations, to his church, and to the community, and he has been significantly honored as a result of such service. Flannery Tr. at 1127:18-1132:12. He received no profit or other benefit as a result of either letter. *Id.* at 1163:5-10. Numerous witnesses testified about Mr. Flannery's impeccable character, honesty and integrity. *See, e.g.*, Shegog Tr. at 2821:3-5; Armstrong Tr. at 2213:12-2214:10; Johnson Tr. at 2381:5-6; Shames Stipulation at ¶ 2; Duggan Stipulation at ¶ 2; Carlson Tr. at 2771:19-20; Donovan Tr. at 1811:15-19; Wands Tr. at 2877:5-24; *see also* O'Leary Tr. at 2965-2981.

Mr. Flannery is an honest man who sought to do the right thing in the midst of unprecedented economic conditions. In connection with the August 2 letter, he merely offered a "single set" of suggested edits. Division Exs. 154, 155; Flannery Tr. at 1318:18-1324:12. He volunteered to author and send the August 14 letter, over the reservations of his boss, who asked Mr. Flannery why he would "raise his head up." Flannery Tr. at 1370:1-1371:5. Sanctioning Mr. Flannery would simply dissuade other executives from taking responsibility and promoting transparency, particularly where, as here, the Division has taken no action against those who had a far greater role in both letters and in investor communications generally.

It is easy to view the subprime crisis in hindsight, and it is tempting to seek to lay blame for the losses sustained. But it would be contrary to the public interest and fundamental fairness to place such blame at the feet of Mr. Flannery. Even a minimal sanction against Mr. Flannery would unfairly tarnish his otherwise highly distinguished career and personal reputation, and would not advance the public interest.

V. CONCLUSION

The evidence demonstrates that throughout the summer of 2007, Mr. Flannery behaved as he had throughout his career, acting honestly and with a singular focus on investor welfare. The Division has wholly failed to prove that he sought to mislead investors, or that any investors were misled. Having unfairly been placed under a cloud since the investigation began, Mr. Flannery asks that the Court rule in his favor on each of the Division's claims.

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Respectfully Submitted,

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