UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of **JOHN P. FLANNERY, AND** **JAMES D. HOPKINS,** **Respondents.**	**Administrative Proceeding** **File No. 3-14081**

DIVISION OF ENFORCEMENT'S REPLY TO RESPONDENT FLANNERY'S POST-HEARING BRIEF

Respectfully submitted,
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Respondent Flannery spins an inconsistent and utterly unconvincing tale about his role in the relevant events of July and August 2007. On one hand, he postures himself as a steadfastly responsible CIO, raising his head up to do the right thing for investors, challenging his team to examine SSgA's investment strategy thoroughly, and doing what an exemplary CIO should. On the other hand, he runs from any suggestion of real accountability, emphasizing repeatedly his lack of responsibility for the three client communications that are the basis of the charges against him. He attempts to paint himself as removed from, and little involved with, the July 26 and August 2 letters when the evidence demonstrates his consistent involvement in, discussions about, and approval of, those two letters. Also, the purported "character" evidence offered by colleagues enmeshed in the same culture that permitted these misrepresentations to be made is of dubious value, given their personal and professional biases. This brief addresses several major themes in Flannery's brief that mischaracterize the evidence or the law.

A. Key Information Omitted From the Three Mid-2007 Letters Was Not Otherwise Available to Investors.

The fundamental misrepresentation in each of the three letters that SSgA sent to investors in July and August 2007 – that SSgA had taken certain steps to reduce LDBF's risk – was meant to lull investors into holding their investments. While some information about redemptions and asset sales from LDBF may have been selectively disclosed to a few clients who knew (or were lucky) enough to ask the right questions (*see* Fl. Ex. 167), and some basic information about the fund had been leaked to an "online rag" (*see* Fl. Ex. 108), [1] SSgA made no disclosure that cured the three letters' basic misrepresentation that risk had been reduced. Flannery's brief focuses on

[1] The article in a limited circulation online publication on which Flannery relies was available on the same day as SSgA's July 26 letter, and stated that LDBF was "invested mostly in subprime mortgage-backed securities." Fl. Ex. 108. It also stated that LDBF "uses derivatives to eliminate interest rate risk" but said nothing about LDBF's significant leverage. *Id.* SSgA did not confirm the information in the article. *See id.* In any event, information in such a publication is not "reasonably available" to investors. *See In re Matter of Dolphin & Bradbury*, 88 SEC Docket 1135, 2006 WL 1976000, *9 (July 13, 2006).

certain answers in "Internal Use Only" FAQs that were first available on August 6 as a purported cure for the letters' misleading statements. *See* Fl. Br. at 57. These FAQs claimed that the sale of some AAA bonds and the expiration of total return swaps reduced LDBF's risk, stated that the Fund was leveraged, and said there had been 20-25% redemptions from LDBF as of the end of July. *Id.* There is no evidence that any or all of these answers were actually provided to investors, but even if they had been, the fundamental misrepresentations in the letters would not have been cured. Investors receiving this information would not have known that SSgA had repositioned LDBF into a far riskier fund by selling its highest rated, most liquid, assets and siphoning the cash thus raised to meet cash redemption requests by its internal advisory groups and the Related Funds. Although Flannery claims that some investors could have learned about GAA's recommendation to liquidate, the uniform decision of every SSgA-advised or controlled shareholder to liquidate was not disclosed. *See* Fl. Br. at 57, 98. Liquidation by one advisory group is far different than liquidations by all of OFA, GAA and the Related Funds. In contrast to Flannery's claim of diverse opinions within SSgA about the subprime market, the uniform view of *every* SSgA investor in LDBF by the end of July was to liquidate for cash as quickly as possible. Further, it is incorrect to state that knowledge about GAA's redemption was part of "the total mix of information available to investors" when that fact could only be given orally to an investor who asked the right question of someone who happened to know the answer. Fl. Br. at 98. Investors were simply not told that LDBF had become a much riskier fund as SSgA sold LDBF's most liquid investments, depleted LDBF's cash, and left it holding only illiquid subprime bonds and leveraged subprime derivatives that exposed the Fund to even greater risk.

B. The July and August 2007 Letters Were Misleading Because The Risk of Investing in LDBF Increased as Its Highest Rated Assets Were Depleted to Meet Redemptions By SSgA's Advisory Groups And The Related Funds.

Flannery argues that "it is unrebutted" that each step the fixed income team took to implement the Investment Committee's July 25 instructions "raised liquidity while decreasing risk in LDBF." Fl. Br. at 32. Flannery mischaracterizes the record concerning: 1) LDBF's liquidity (i.e., the cash) immediately following the huge AAA bond sale on July 26; 2) redemptions by clients of SSgA's advisory groups and the Related Funds and the real reason for in-kind redemptions and the creation of LDBF II; and 3) LDBF's risk profile in July and August.

1. The Cash Raised From The July 26 AAA Bond Sale Was Used Up Almost Immediately to Meet Cash Redemptions.

Flannery's argument that the August 2 letter was accurate is largely based on his mistaken assertion that LDBF's risk was reduced by the AAA bond sale on July 26 because selling a subprime asset necessarily reduces risk. *See* Fl. Br. at 75-79. While superficially appealing, Flannery's argument misses the point that the cash raised by that sale did not stay in the portfolio. Although Flannery takes shots at Professor Wermers' testimony, and did identify a mistake in one of Wermers' charts, the data itself is irrefutable – the cash raised by disproportionately selling LDBF's most liquid assets was used up quickly and LDBF's risk had risen dramatically by the time the August 2 letter was sent. Flannery indirectly points out that Professor Wermers' Chart III.B. mistakenly omitted $175,654,953.35 in a cash equivalent position that LDBF CTF held on August 2. *See* Fl. Br. at 78.[2] As shown below, correcting Chart III.B. to include those assets does not affect the import of Wermers' conclusions or the thrust of the Division's case.[3]

[2] Flannery also states that LDBF's "Daily Trial Balance reports show $20,664,081.65 of cash and treasury bills in LDBF on August 2." *Id.* It is unclear where Flannery gets this figure. The Trial Balances list a variety of accounting entries, including "market value of investments," "total cash balance," and fund expenses such as custodial and legal. Fl. Ex. 288. There is no entry for treasury bills, and the August 2 entries for "total cash balance" are only $86,352 for LDBF CTF and *negative* $24,488,889 for LDBF ERISA.

[3] Chart III.B. was corrected based on the data contained in Div. Ex. 217-218 (purchase and sale reports reflecting all trades made by LDBF CTF and ERISA in 2007) and Div. Ex. 230 (navigator reports containing all positions other than cash and treasury bills held by LDBF CTF and ERISA at the end of each trading day in 2007).

Professor Wermers' Original Chart III.B (Div. Ex. 245).

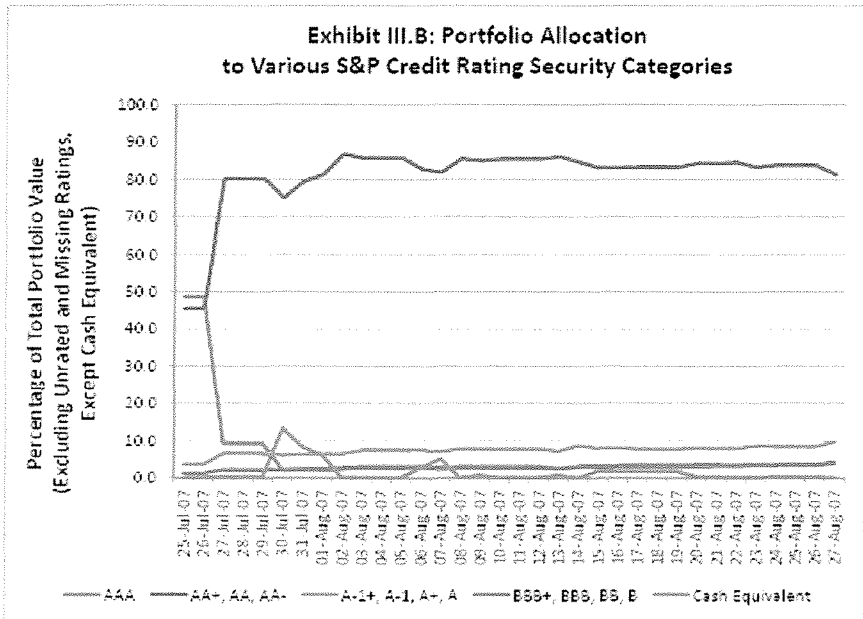


Chart III.B. As Corrected:

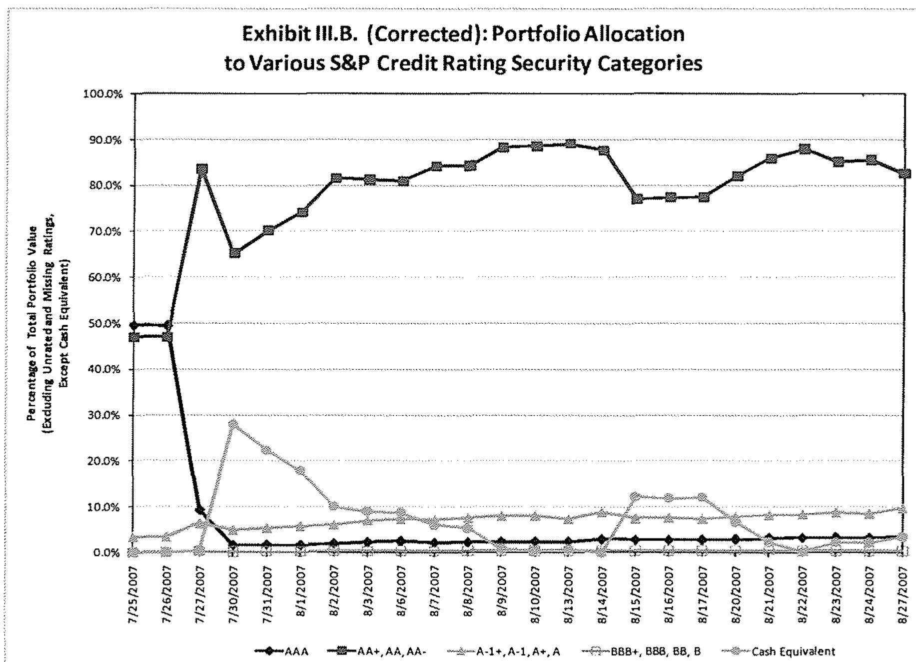
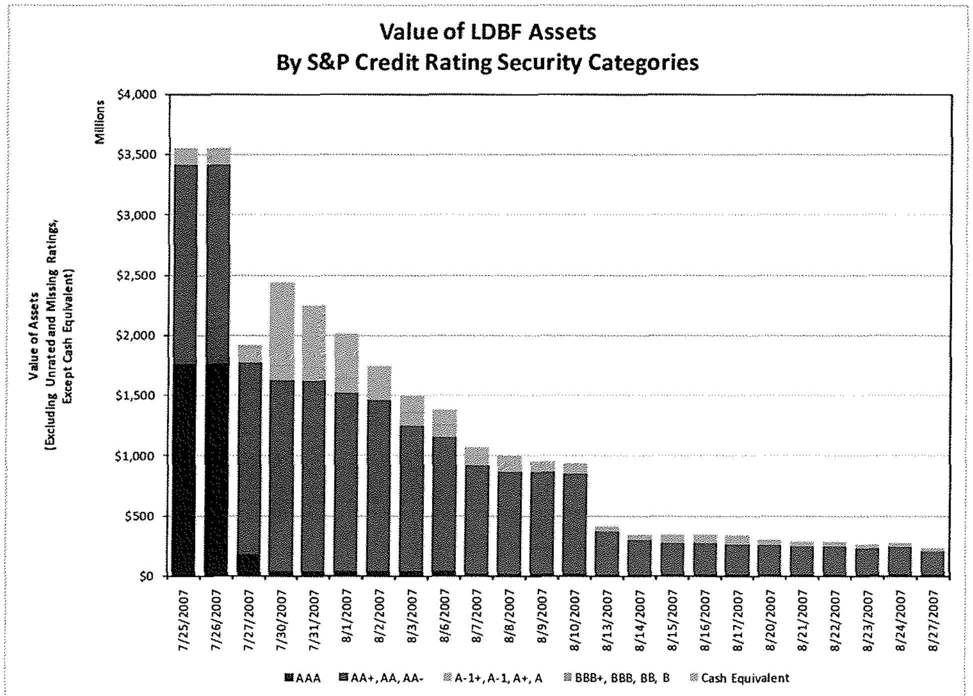


Chart III.B. displays the *percentage* of LDBF's assets in the various credit rating categories.

Below is a demonstrative showing the *dollar value* of LDBF's assets over the same period.



See Div. Ex. 217, 218, 230, Fl. Ex. 288.

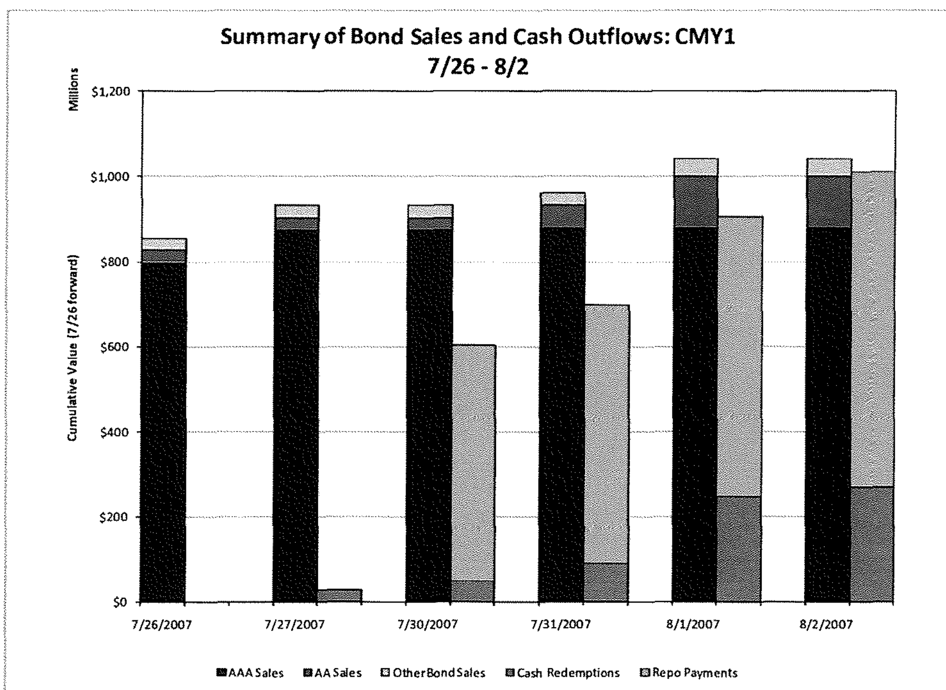
Flannery's focus on the omission of LDBF CTF's cash equivalent position in Chart III.B. is misplaced for a variety of reasons. First, the error does not change the substance of the Chart, much less the substance of the Division's position with regard to the cash raised from the AAA bond sale on July 26. Chart III.B. shows that, from July 26 to August 27: 1) there was a "repositioning" of the Fund's saleable assets whereby the Fund changed from an approximately 50/50 balance of AA and AAA-rated subprime RMBS bonds to a fund that held substantially all illiquid AA-rated subprime RMBS bonds; 2) the cash raised from the July 26 AAA bond sale was rapidly drawn down to re-pay the repurchase commitments on the AAA bonds and to meet redemptions by clients of the advisory groups and the Related Funds; and 3) SSgA used the cash from the July 26 AAA bond sale instead of selling a pro rata share of LDBF's more illiquid bonds to re-pay the repurchase commitments and satisfy cash redemptions.

These conclusions are amply supported by the details. With respect to point one, on June 29, 2007, the market value of LDBF's subprime RMBS bonds was $3,630,851,806 -- 47.361%

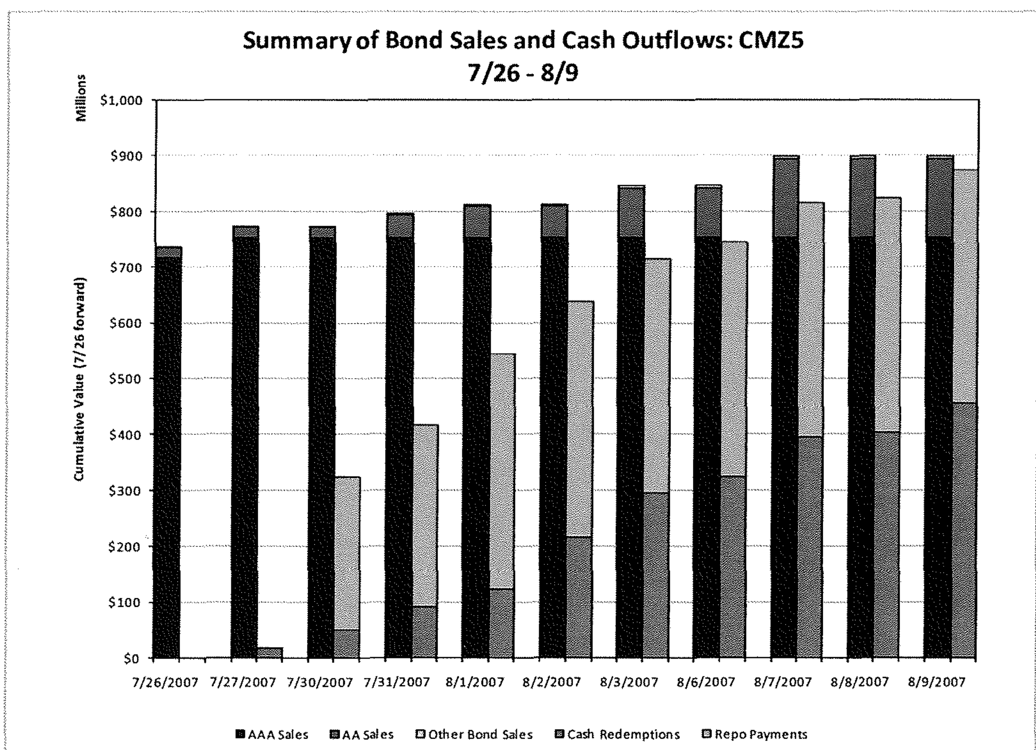
were rated AAA and 46.997% were rated AA. Div. Ex. 167 at SS 463124, 463144. LDBF's other holdings were derivatives, with no or negative market value, that could not be sold to satisfy investors' redemptions. FOF 74, 366, 369. LDBF's approximate 50/50 balance of AAA and AA-rated RMBS bonds lasted until July 26. Starting then, LDBF raised hundreds of millions of dollars by selling its most liquid bonds, and this cash was eliminated within days.

With regard to points two and three, the details differ slightly for LDBF ERISA and LDBF CTF, but the basic story is the same.

From July 26 to August 2, LDBF ERISA sold $1,041,121,722 in bonds, including $797,522,192 in AAA bonds on July 26. Div. Ex. 217. Of this $1,041,121,722 in bonds sold, 84.4% were rated AAA, 11.8% were rated AA, and 3.8% were rated lower than AA or unrated. *Id.* Over this same period, LDBF ERISA repaid $739,361,000 in repurchase commitments and satisfied $270,289,398 of cash redemptions. Div. Exs. 218, 229 (pp. 58-60), 231 (pp. 26-30). LDBF ERISA had only *one penny* in cash on August 2. Div. Ex. 230. LDBF ERISA's bond sales and cash outflows from July 26 to August 2 are summarized below:



From July 26 to August 2, LDBF CTF sold $811,990,468 in bonds, including $716,582,018 in AAA bonds on July 26. Div. Ex. 218. Of the $811,990,468 in bonds sold during this period, 92.7% were rated AAA, 6.9% were rated AA, and 0.35% were rated lower than AA or unrated. *Id.* Over this same period, LDBF CTF repaid $420,855,000 in repurchase commitments and satisfied $215,892,387 of cash redemptions. Div. Exs. 218, 229 (pp. 58-60), 231 (pp. 26-28). LDBF CTF's cash equivalent position was $175,654,953 on August 2. Div. Ex. 230. From August 3 to August 9, LDBF CTF sold another $87,482,281 in bonds and satisfied $238,784,550 of cash redemptions. Div. Exs. 218, 229 (pp. 60-61), 231 (pp. 28-30). Of the $899,472,749 in bonds that LDBF CTF sold from July 26 to August 9, 83.7% were rated AAA, 15.7% were rated AA and .6% were rated lower than AA or unrated. Div. Ex. 218. LDBF CTF's cash equivalent position was only $1,781,133 on August 9. Div. Ex. 230. LDBF CTF's bond sales and cash outflows from July 26 to August 9 are summarized below:



2. Most of the Early LDBF Redeemers Received Cash – In-Kind Redemptions Did Not Begin Until Almost All Of LDBF's Cash Was Drained.

Flannery argues that the LDBF redemptions made by those in the know at SSgA (the Related Funds and the advisory group clients) did not harm outside and uninformed investors because the internal redemptions were either: 1) a small portion of the fund, or 2) done in-kind rather than cash. *See* Fl. Br. at 37, 56, n.40, 79. Flannery's arguments are disingenuous because none of the in-kind redemptions occurred until after the early cash redemptions by the Related Funds and the advisory group clients had drained the cash from LDBF.

In LDBF ERISA, there were $270,289,398 in *cash* redemptions from July 25, 2007 to August 2, 2007 -- when the fund ran out of cash. Div. Ex. 229 at 58-60. Of that amount, $69,829,849 (or 26%) was an OFA client redemption and $194,070,562 (or 70%) were cash redemptions by the Related Funds. *Id.* In LDBF CTF, there were $227,292,387 in *cash* redemptions from July 25, 2007 to August 2, 2007, and another $238,784,550 in *cash* redemptions between August 3, 2007 and August 9, 2007 -- when the fund ran out of cash. Div. Ex. 231 at 26-30. Of the $227,292,387 in cash redemptions from July 25 to August 2, $43,190,962 (or 19%) were redemptions by OFA and GAA clients and $172,521,703 (or 76%) were redemptions by the Related Funds.[4] *Id.* Of the $238,784,500 in cash redemptions from August 3 to August 9, $139,562,000 (or 58%) were redemptions by the Related Funds. *Id.*

The LDBF funds ran out of cash on different days – August 2 for LDBF ERISA and August 9 for LDBF CTF. Div. Ex. 217-218. But for each LDBF fund, the first in-kind redemptions did not happen until immediately after that fund ran out of cash– August 3 for LDBF ERISA and August 10 for LDBF CTF. Div. Ex. 231 at 30; Div. Ex. 229 at 60. The

[4] $188,076 of the remaining $11,751,689 in redemptions from LDBF CTF during this period were by "Master Note Control" clients.

Related Funds that began redeeming in-kind from LDBF ERISA and LDBF CTF on August 3 and 10 respectively did so **only because the cash was gone – and they were the ones that drained most of that cash.** Flannery's suggestion that the in-kind redemptions were evidence of the Related Funds' desire to maintain their exposure to LDBF is just wrong. *See* Fl. Br. at 97.

Flannery also claims that SSgA's August 6 letter, which offered LDBF investors the option of transferring their shares to a LDBF II fund that would offer monthly liquidity instead of daily liquidity, cured deficiencies in the July 26 and August 2 letters because it told investors that certain Related Funds would be redeeming from LDBF in-kind. *See* Fl. Br. at 54, 56. To the contrary, the August 6 letter is further evidence of Flannery's fraudulent course of conduct because it omitted key facts: 1) the Related Funds had already decimated LDBF's cash position as described above; and 2) to meet any future redemptions, SSgA would be forced to sell LDBF's illiquid assets because LDBF's most liquid assets had already been sold to satisfy cash redemptions by the advisory groups' clients and the Related Funds.

3. LDBF's Risk Increased In July And August After the July 26 AAA Sale.

Flannery argues that his expert witness, Ezra Zask, provided unrebutted evidence that LDBF's risk (or CVaR) had been reduced when the July and August 2007 letters were sent. *See* Fl. Br. at 36, 75-78. The evidence is clearly to the contrary. *See* Div. Post-Hr. Br. at 44; FOF 391. In October 2007, Flannery himself represented to State Street Corporation's Board of Directors that LDBF's CVaR quadrupled from June 1, 2007 to August 1, 2007. FOF 391. LDBF's risk increased because: 1) the cash raised from the July 26 AAA bond sale was used to satisfy early redemptions; 2) after the July 26 AAA bond sale and the early redemptions, LDBF held a riskier mix of assets than before; and 3) LDBF's assets became more volatile as the subprime market continued to deteriorate. FOF 402-405. Zask computed hypothetical CVaR figures for LDBF that ignored the first and second reasons, and he avoided the third reason by relying on outdated data. If Zask had not ignored reality or relied on stale data, his conclusions would have matched those of the October 2007 Board presentation.

a. Zask's Analysis Ignored The Time Period Between July 27 And August 2.

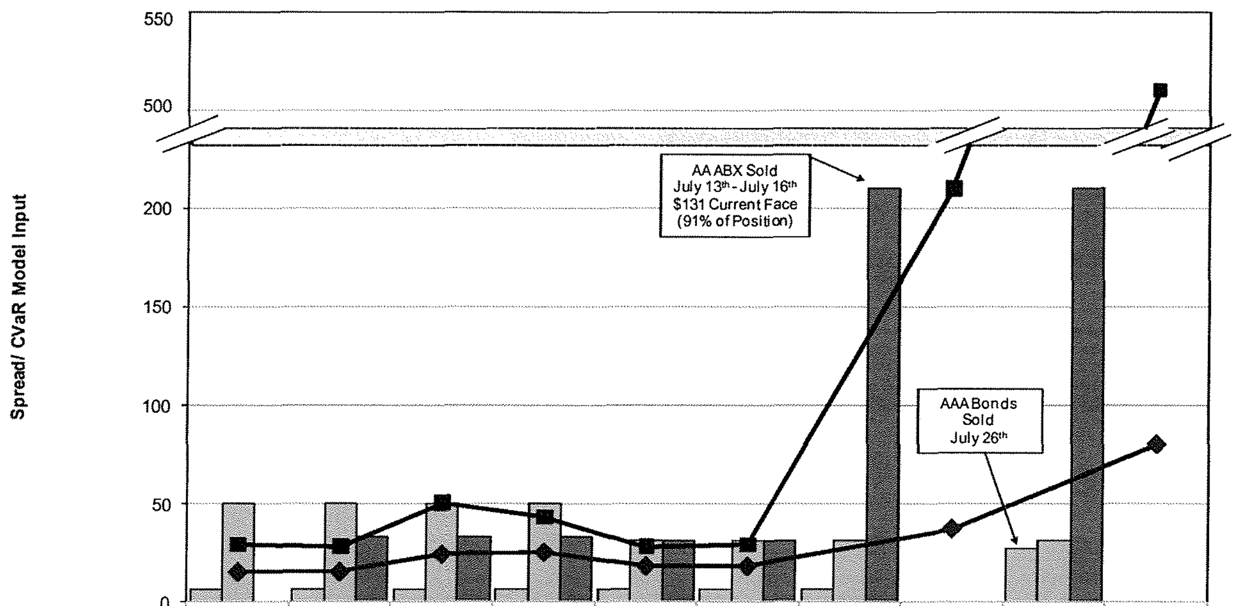
Zask's analysis did not consider what happened in LDBF after the instant the AAA bond sale was complete on July 26. He assumed that the cash generated by that sale stayed in the fund and had a CVaR of zero. Tr. 2291:5 – 2294:5 (Zask); Fl. Ex. 299, Ex. 6. If Zask had instead analyzed reality -- that the net $423 million raised from the July 26 AAA sale soon left LDBF to satisfy cash redemptions, the CVaR of LDBF would have increased -- not decreased as he opined. Attached Exhibit A applies Zask's data and model to true facts -- the net cash raised from the July 26 AAA sale was used to meet redemptions and LDBF's market value and notional value were reduced by the value of the bonds sold. It demonstrates that LDBF's risk increased as a result of the AAA bond sale, and Flannery's representations to the contrary were misleading.

b. Zask's Analysis Relied On Stale CVaR Data That Dramatically Understated The Risk Of LDBF's Investments.

After the AAA bond sale on July 26, most of LDBF's saleable assets were AA-rated RMBS bonds. FOF 301. The CVaR data Zask used for those AA RMBS bonds significantly discounted the risk of owning a portfolio dependent on selling those bonds to fund any future redemptions. Flannery's argument that the transactions described in the August 2 letter actually reduced LDBF's risk are premised on Zask's flawed analysis and can thus be rejected.

LDBF was managed using a "portfolio analytics" spreadsheet which tracked the CVaR of each category of investment held in LDBF and the overall CVaR of the LDBF portfolio. FOF 84, 394-397. For bonds, CVaR increases as the bonds' spread over LIBOR increases. Tr. 2307:12-17 (Zask); Fl. Ex. 299 at A.27. During July and August 2007, spreads on AA RMBS bonds skyrocketed. The following chart shows how spreads on AAA and AA bonds widened, yet the CVaR numbers in the portfolio analytics spreadsheet were not updated to reflect the significantly increased risk of owning AA RMBS bonds, even when the CVaR figures for the analogous AA ABX investment were updated.

AAA and AA CVaR and Spreads
January to August 2007



	January 31	Feb 28	March 31	April 30	May 31	June 30	July 18	July 26	July 30	August 2
AAA CVaR *	5.9	5.9	5.9	5.9	5.9	5.9	5.9		27	
AA CVaR	49.8	49.8	49.8	49.8	31	31	31		31	
AA ABX CVaR		33.2	33.2	33.2	31	31	210		210	
AAA Spread **	15	15	24	25	18	18		37		80
AA Spread	29	28	50	43	28	29		210		508

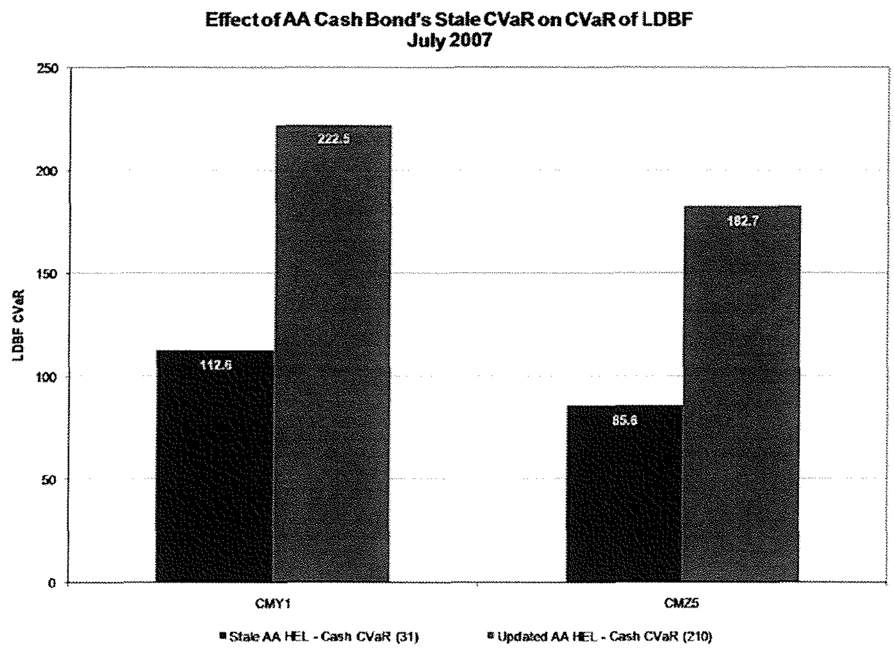
* Data showing the CVaR for AAA RMBS bonds, AA RMBS bonds and the AA-rated ABX investment is contained in Div. Ex. 252 and 253. *See* Div. Ex. 252 pp. 54-55 (January 31 data); pp. 42-43 (February 28 data); pp. 28-29 (March 31 data); pp. 19, 23 (April 30 data); pp. 16-18 (May 31 data); pp. 10, 12 (June 30 data); pp. 4, 6 (July 30 data); Div. Ex. 253, p. 4, col. M (July 18 data).

** Data listing spreads on AAA and AA RMBS bonds is located at Flan. Ex. 218 at SS 4832874.

The staleness of the AA bond CVaR data should have been evident to Zask.[5] Had he

[5] Despite billing about $200,000 for his report, Zask did not know if he noticed that the CVaR figure for AA bonds stayed the same from June 30 to July 30, while the CVaR figure for the equivalent derivative investment (AA ABX) had increased dramatically. Tr. 2331:21 – 2332:12 (Zask). When confronted with his reliance on stale figures, Zask mistakenly claimed that he relied on other individual-level CVaR data outside his model. Tr. 2347:2-3 (Zask). Not so. In fact, Flannery's counsel later disclosed that Zask relied only on Div. Ex. 251 and 252 for his analysis. Tr. 2797:7 – 2798:6. These documents, despite Flannery's counsel's suggestion to the contrary, do not contain individual security level CVaR. The only CVaR figures for LDBF's bonds treat the CVaR of all AA bonds the same and the CVaR of all AAA bonds the same (and treat the CVaR of AAA bonds differently that the CVaR of AA bonds). Div. Ex. 251, p.6, col. L, rows 349-350, 356-357; Div. Ex. 252 p.6, col. M, rows 395-396, 403-404.

updated the AA bond CVaR figure to match the analogous AA ABX CVaR figure, his conclusions would have been destroyed. *See* Fl. Ex. 299, Ex. 6, 9. The chart below shows how LDBF's CVaR would have increased had Zask used an accurate input for AA RMBS CVaR.



LDBF's risk was not reduced between July 26 and August 14. The July and August letters to investors misrepresented that fact.

C. Flannery's Course of Conduct And Fraudulent Scheme Included The Three July And August 2007 Letters.

Though Flannery attempts to paint his involvement in the July 26, August 2 and August 14 letters with the faintest of hues, the evidence shows that through his involvement in these three letters and in concealing from investors the actions taken by the Investment Committee with respect to LDBF's assets, he employed a scheme to defraud investors and engaged in a course of business which operated as a fraud. This conduct violated Section 17(a)(1) and (a)(3) of the Securities Act and Rule 10b-5(a) and (c) under the Exchange Act. Flannery's brief alternates between pretending these violations were not charged, and claiming that they are somehow an unfair surprise. Fl. Br. at 42, 71, 94. Yet again, his contentions are disingenuous.

The Order Instituting Proceedings ("OIP") expressly alleges that Flannery violated Section 17(a)(1) and Rule 10b-5(a) and (c) by engaging in the schemes and course of conduct set out in all of the paragraphs of the OIP other than the two paragraphs relating to the August 14 letter. OIP, ¶¶43, 44. The OIP further alleges that Flannery engaged in a course of business that operated or would operate as a fraud in violation of Section 17(a)(3) as described in paragraphs 1-41. OIP ¶42. The preceding paragraphs describe how the three letters were misleading and demonstrate Flannery's connection to them. OIP ¶¶31-41. Not only was Flannery not surprised by the Division's scheme and course of business charges against him, he actually sought leave to file a summary disposition motion on those very charges. *See* Memo in Support of Flannery's Mot. For Summ. Disp. at 24-28. The Division also stated its intention to prove its scheme and course of business charges in its pre-hearing brief. Div. Pre-Hearing Br. at 38. Had Flannery believed that any of these charges lacked sufficient detail, the appropriate remedy would have been to seek clarification of the Division's claims at the prehearing conference (Commission Rule of Practice 221(c)(1)), rather than save his complaints to interrupt the Division's questioning during the hearing, or to make specious arguments in his post-hearing brief.

As for the letters themselves, Flannery's brief fails to address his extensive involvement with the July 26 letter and contends that his involvement in the August 2 letter was de minimus. *See* Fl. Br. at 42, 46. He further tries to distance himself from client communications by arguing that he had neither formal responsibility over SSgA's relationship management organization or the mechanistic process of distributing the three letters to SSgA's clients. *See id.* at 6, 14. These arguments ignore that when the active fixed income funds' subprime exposure became a crisis in July 2007, Flannery affirmatively inserted himself into the process of crafting the three letters, played a critical role in pushing them along, was the senior member of the investment team responsible for their accuracy, and finally approved their factual content. FOF 313, 331-35, 342-45, 349-56, 362-68, 371-82, 406-19. He took these steps because, as CIO, he was the leader of the investment team presiding over the incipient failure of LDBF and the Related Funds, and the crisis was of sufficient magnitude that he knew it had the potential to affect his own future, and the active funds' prospects to remain viable competitors beyond the summer of 2007. The letters were Flannery's play to downplay the active funds' risk, thus convincing investors to hold their investments, and buying time for the market to recover.

This unified scheme to defraud investors and engage in a deceptive course of business informed all of Flannery's actions in connection with the three letters, and his deceptive scheme includes *all* of his conduct in connection with the July 26 letter. *See SEC v. Leslie*, 2010 WL 2991038, *34-35 (N.D. Cal. July 29, 2010) (sustaining scheme liability claim when defendant made additional misstatements in support of those that were the basis of misstatement claims); *SEC v. Brown*, 740 F. Supp. 2d 148, 172 (D.D.C. 2010) (denying motion to dismiss Rule 10b-5(a) and (c) claims because complaint alleged an action in addition to charged misrepresentations that had the "purpose and effect of creating a false appearance of fact in furtherance of" a scheme to defraud).

Significant portions of Flannery's brief set up and knock down a straw man, hoping to deflect this court's attention from the actual misrepresentations and omissions in the three letters. He contends that knowing about expected client redemptions from LDBF and the Related Funds would cure any alleged defect in the letters and that such knowledge was widespread. For example, Flannery repeatedly argues that relationship managers and the lawyers who reviewed the letters knew that heavy client redemptions from LDBF were anticipated, and he relied on them to include any necessary information about redemptions in the letters. *See* Fl. Br. at 36, 86, 88, 89, 101-04. He also contends that the letters did not mislead investors because, if they had asked the right questions, a relationship manager could have chosen to tell them that there had been 20 to 25 % redemptions in LDBF by the end of July, and they received a letter offering to insulate them from others' redemptions. *See id.* at 17, 55, 57, 98. The problem with these arguments is that the key misrepresentation in all of the letters related to the increased risks of LDBF and the Related Funds after July 26. The letters misleadingly described what had happened in LDBF between July 26 and August 14 that had significantly changed its composition and risk, and misleadingly represented that LDBF's risk had been reduced by those transactions. *See supra*, pt B. Even had investors been told, in generic terms, that there had been redemptions from LDBF and the Related Funds – and they were not – such disclosures would not have remedied the fraud.

Flannery's responsibility is unaffected by the fact that some of the same misrepresentations that were included in the August 2 letter about LDBF's risk and average credit quality were also contained in the August 1 FAQs. *See* Fl. Br. at 89. That shows only that SSgA was consistent in the misrepresentations it made to clients. The lawyers and the relationship managers who reviewed the letters did not know their statements about risk were misleading and they trusted Flannery and the investment team to get that information right. There is no reason to think they knew anything different when they reviewed the FAQs. Flannery knew the FAQs' statements about risk and average credit quality were misleading, just as he knew the letters' statements on these topics were misleading. If other members of the fixed income team who signed off on the FAQs followed their boss's lead in propagating misleading information, Flannery is no less responsible.[6]

Flannery's scheme to defraud continued through his message in the August 14 letter that expressed to clients a negative view on selling their investments in LDBF. FOF 417. It is misleading for SSgA's CIO to sign a letter expressing a negative view on selling LDBF shares and stating that "many judicious investors will hold" their LDBF shares, without disclosing that all of the LDBF shareholders advised or controlled by SSgA have done exactly the opposite. FOF 418-19; Div. Ex. 174. It is immaterial whether Flannery held a personal opinion that LDBF's shareholders should stay. *See* Fl. Br. at 95. His one-sided presentation of a purported fact without either full disclosure of contrary facts or disclosure about the perils of selling shares in a fund that had already been stripped of its most liquid and most valuable assets was part of his ongoing fraudulent scheme to buy time for LDBF to recover. Flannery's contention that the August 14 letter's statement was accurate fares no better. *See* Fl. Br. at 64, 96-97. The unrebutted evidence is that shareholders controlled or advised by SSgA redeemed from LDBF by taking most of the cash generated by selling the AAA bonds on July 26. *See supra* pt. B.2. The Related Funds continued to get out of LDBF – even when the cash was gone and all they could do was redeem in kind. *See id.* Their departure from LDBF significantly reduced the size of the Fund and locked in losses that were passed along to remaining shareholders. FOF 437, 440-42.

D. Flannery Was Systematically Involved In the Three Letters And Responsible for "Making" Misstatements And Omitting Material Information From Those Letters.

Flannery argues that he cannot be held liable for "making" a misstatement in the August 2 letter under Rule 10b-5(b) because his involvement was "minimal and inconsequential." Fl. Br. at 72. The evidence disproves his assertion. On July 24, information about the June

[6] Flannery also complains about "unspecified omissions" from the August 2 letter. *See* Fl. Br. at 80-84. While the record is clear that some investors, including those advised by OFA, were given material information that other LDBF investors were not, the Division is not pursuing charges against Flannery based on the August 2 letter's failure to level that playing field. FOF 421, 431, 435. This section of Flannery's brief may thus be disregarded.

performance of the active fixed income funds affected by the subprime crisis was taken out of the July 26 letter. FOF 354. The performance data was removed because of counsel's concern that it was stale. Duggan Stip. at 442:6-25. Flannery knew the June performance data would be deleted because he participated in the group discussion of that deletion. FOF 354. Flannery also knew that another letter – the August 2 letter – was going to be drafted to provide clients with timely July performance data once it was available at the end of the month. *Id.* Flannery was thus involved in the decision to create the August 2 letter.

Flannery was the senior reviewer of the August 2 letter for the investment team. He edited the letter, knowing of LDBF's July 26 asset sale, and failed to correct the letter's misrepresentations. He added other misleading statements to the letter. It is immaterial how many of the letter's words he changed. The drafter of the letter, Adele Kohler, was not a fixed income expert. FOF 16. Flannery was. FOF 31; Tr. 770:1-10 (Flannery). Flannery was responsible for making sure the investment-related facts in the letter were accurate. Because two key investment-related facts in the letter were misleading - risk had not been reduced and LDBF's average credit quality had been impaired – and Flannery knew they were misleading, he is responsible for the inclusion of those two facts in the letter. He, not the legal or relationship management participants in the letter, caused the letter to contain those misstatements. He is thus liable for making those misstatements. *See* Div. Post-Hr. Br. at 58-62.

Flannery cites several inapposite cases to support his argument that he cannot be held primarily liable. *See* Fl. Br. at 72-73. Two of those cases find that mutual fund distributors are not liable for misstatements in mutual fund prospectuses that were either "crafted entirely by others" or where there was no evidence that the distributors' executives ever reviewed the misleading statements. *See SEC v. Tambone*, 597 F.3d 436, 442, 446 (1st Cir. 2010); *Siemers v.*

Wells Fargo & Co., 2007 WL 760750, *19 (N.D. Cal. 2007). In another of his cited cases, the defendant, unlike Flannery, was not alleged to have had any role in drafting or editing the misleading document; it was not enough simply that the defendant went to meetings where the document was discussed without additional evidence that he suggested what the document should say or that his suggestions were heeded. *See SEC v. Fraser*, 2009 WL 2450508, *8 (D. Ariz. Aug. 11, 2009). The final two cases Flannery cited involved private claimants seeking to hold auditors liable for their role in false financial statements. *See In re SeraCare Life Sciences, Inc. Sec. Litig.*, 2007 WL 935583 (S.D. Cal. Mar. 19, 2007); *In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 166-68 (D. Mass. 2002). Such claims – that auditors failed to detect or properly report the core misconduct – are substantively different from Flannery's participation in the core misconduct, and these cases further turn on a lack of information about auditors' role in the financial statements at issue. *See SeraCare*, 2007 WL 935583, *10 (finding that confidential witness' allegations lacked sufficient detail about how auditors participated in editing or approving allegedly fraudulent 10Qs or how auditors evaluated them); *Lernout*, 230 F. Supp. 2d at 166-68 (finding some KPMG offices liable under 10(b) for participating in audit, but finding other offices not liable; distinction was whether audit partners prepared and provided certain amounts and disclosures for misleading financial statements, or only reviewed, commented on, oversaw and cleared misleading financials); *cf. In the Matter of Piper Capital Mgmt.*, 73 SEC Docket 2525, 2000 WL 1759455, *26 (A.L.J. Nov. 30, 2000) (distinguishing auditor case and finding defendant's "input, review and approval—[were] strong indicia of substantial participation"), *aff'd* 80 SEC Docket 2772, 2003 WL 22016298 (Comm'n Op. Aug. 26, 2003).

Flannery also claims that if this court finds that he did not "make" a misstatement under Rule 10b-5(b), any claims under Section 17(a) would fail as well. *See* Fl. Br. at 92 n.51. He is wrong. While the elements of claims under Sections 10(b) and 17(a) are generally similar, as the cases Flannery cites state, the two sections have different language. Another case, on which Flannery relies heavily to support his argument that he did not "make" a misstatement, recognized that statutory difference, and accordingly dismissed a Rule 10b-5(b) claim while allowing a Section 17(a)(2) claim to proceed. *See Tambone*, 597 F.3d at 450.

Flannery further contends that he is not responsible for the letters' material omissions because the letters were not publicly attributed to him. *See* Fl. Br. at 83-84. Flannery confuses the case law on which he purports to rely. The law is clear that communications to investors must "provide complete and non-misleading information with respect to the subjects *on which [they] undertake[] to speak.*" *In re K-tel Int'l Sec. Litig.*, 300 F.3d 881, 898 (8th Cir. 2002) (internal quotations omitted). A duty to disclose material facts arises when "there have been inaccurate, incomplete or misleading disclosures" and "even absent a duty to speak, a party who discloses material facts in connection with securities transactions assume[s] a duty to speak fully and truthfully on those subjects." *Id.* When SSgA chose to speak to investors through the letters, and Flannery got involved in editing, reviewing and approving those letters, he was obligated to make sure that the letters were accurate, complete, and did not omit material information that was "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Rule 10b-5(b). Flannery quotes cases finding that defendants were not obligated to engage in distinct acts of speech to correct omissions in documents for which they were not responsible. *See SEC v. Tambone*, 417 F. Supp. 2d 127, 135 (D. Mass. 2006) ("Because the defendants . . . were not responsible for the misleading disclosures . . ., they were under no duty to correct those statements if they became misleading."), *rev'd* 550 F.3d 106 (1st Cir. 2008). These cases do not apply here. Flannery is charged with omitting material information from the very letters in which he was involved, and for which he was responsible. *See SEC v. Brown*, 740 F. Supp. 2d 148, 171 & n.15 (D.D.C. 2010) (defendant "had a duty to correct the omissions . . . which he was substantially involved in preparing"). Flannery was not charged for the failure to write additional letters and his liability is unaffected by the fact that he did not sign the July 26 or August 2 letters.

E. Flannery's Reliance On Lawyers Or Others Does Not Negate His Scienter.

Flannery's purported reliance on others to correct the misrepresentations and omissions in the July 26 and August 2 letters does not negate his scienter. Reliance on the advice of counsel (or other expert) can only negate scienter when a defendant: 1) made a complete disclosure to counsel; 2) sought advice of counsel as to the legality of his conduct; 3) received advice from counsel that his conduct was legal; and 4) relied on the counsel's advice in good faith. *See* Div. Pre-Hr. Br. at 27-31; Div. Post-Hr. Br. at 64-66. Flannery argues that advice of counsel can negate scienter even in the absence of these factors. Fl. Br. at 87-88 & n.50. That contention is flatly contradicted by the cases he cites, none of which supports his assertion that the four factors apply only to some limited subset of defendants who claim to rely on the advice of others. Each case Flannery cites resoundingly conditions a defendant's reliance on the advice of others on satisfaction of the four factors. For example, one court rejected a proffered jury instruction because it did not advise the jury "that it should consider advice of counsel as a circumstance negating fraudulent intent only upon the showing that [defendant] made a full disclosure of all relevant and material facts to his attorney, nor is the jury cautioned that such defense is raised only if counsel had advised [defendant] that, as a matter of law, he was not required to include in his schedules the specific items which the jury found had been concealed." *Bisno v. U.S.*, 299 F.2d 711, 720 (9th Cir. 1962); *see also U.S. v. Peterson*, 101 F.3d 375, 381-82

(5th Cir. 1996) (approving reliance on counsel instruction given to jury which "clarified that the defendant must have relied on his attorneys in connection with the omission or misrepresentation alleged by the Government"); *U.S. v. Stevens*, 2011 WL 1033707, *11 (D. Md. Mar. 23, 2011) (advice of counsel could only negate mens rea if defendant "relied in good faith on the advice of counsel, after fully disclosing to counsel all relevant facts").

Flannery's claim that reliance on lawyers or relationship managers negates his scienter fails because he did not disclose all of the material facts to them or seek specific advice in light of those facts. It is legally insufficient for Flannery to assume that the lawyers and relationship managers knew what he failed to tell them. It also is unreasonable for Flannery to assume that either the lawyers or the relationship managers knew that LDBF's risks had been increased when the July 26 and August 2 letters were sent. In fact, he does not argue that they understood LDBF's increased risks. Instead, he attempts a diversion, claiming that the lawyers and the relationship managers knew that client redemptions were expected and were occurring. *See* Fl. Br. at 83, 86, 88, 89. The fact that others within SSgA knew that clients were redeeming from LDBF and the Related Funds does not relieve Flannery of his responsibility for misrepresenting the funds' risks. Generic client redemptions are not the same as, and do not disclose, increased risk. Attendance at the July 25 Investment Committee meeting by attorney Duggan and by attorney Shames at the July 30 Executive Management Group meeting would not have informed them of the funds' increased risk after the July 26 sale of LDBF's highest rated assets. *See* Fl. Br. at 86-87, 43-45. Mr. Duggan's unrebutted testimony is that he never knew how the Investment Committee's July 25 instructions were carried out (FOF 354, 418; Duggan Stip., Ex. A at 108:24-110:2), and Mr. Shames testified that he did not know whether the funds' risks increased. FOF 355, 382. Similarly, neither Mr. Carlson nor Mr. Brown from the relationship management group understood the funds' increased risks after July 26. FOF 314, 378, 405. Though Flannery suggests otherwise, Shames was not involved in reviewing the August 14 letter. *See* Fl. Br. at 105; *but see* FOF 412.

F. The Division Need Not Show That Investors Relied On, Or Were Harmed By, The Three Letters And Any Arguments Founded On Reliance Should Be Rejected.

Respondents contend, both implicitly and explicitly, that the Division's proof has fallen short because no actual investor testified that it was misled or relied on the letters or other communications to its detriment. *See, e.g.,* Hop. Br. at 10-11; Fl. Br. at 82, 83. Respondents' arguments erroneously seek to import elements of a private securities fraud case into this SEC enforcement action. It is black letter law that the Division of Enforcement need not prove that a misleading communication either was relied upon by investors or resulted in harm to investors. *See* Div. Post-Hr. Br. at 58-59. Respondents' arguments should thus be rejected.

Respondents' reliance on the testimony of expert witnesses John Peavy and Eric Sirri is part of their effort to sneak reliance into this case where it does not belong. Both experts took the position that statements made directly to SSgA's clients or sent in form letters to them -- that were misleading on their face -- were nonetheless not fraudulent because sophisticated investors could have found correct information elsewhere and would not have relied solely on the misleading statements. *See, e.g.* Hop. Ex. 161 at ¶¶11, 28-31,38-39; Hop. Ex. 174 at A.40(e), A59-60, A.63, A.66, A.73. There are numerous problems with this theory. First, to be material, misleading information need only be part of the "total mix" of information available to an investor; it need not be the sole piece of information an investor considers. *See Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1321-22 (2011). Second, even if investors' actual reliance on the misleading statements were a necessary element of the Division's proof (which it is not), neither Sirri nor Peavy ever spoke with actual investors in LDBF and the Related Funds to determine what they knew and considered. *See* Tr. 2084:23-25 (Sirri); 3005:16-3006:2 (Peavy). The purported opinions of both men are based on counsels' hand-picked selection of minute portions of the investigative record developed through documents and testimony; Sirri reviewed only approximately 24 of more than one million documents produced during the investigation leading to this case and only portions of five of the 133 days of investigative and civil testimony, while Peavy reviewed only approximately 55 documents and only portions of four days of testimony. *See* Hop. Ex. 161, App. B; Hop. Ex. 174, Ex. 2. Further, both experts' opinions are founded on the assumption that investors should have conducted independent due diligence to test the routine representations made to them by the advisor to LDBF and the Related Funds. They seek to impose on investors a standard of incredulity that runs counter to the securities laws' requirements of complete and truthful disclosure. *See Fundamental Portfolio Advisors, Inc.*, 80 S.E.C. Docket 1851, 2003 WL 21658248, *11-12 (July 15, 2003). This is not a common law fraud case in which investors are required to perform due diligence to ensure that the representations on which they are relying are the truth.

Sirri's supposition about what investors could have known about the composition of LDBF's portfolio had they doubted Hopkins' and SSgA's representations and done their own independent research also strains common sense. His opinion that an investor could have reverse-engineered the contents of LDBF's portfolio by examining the detailed and definition-dependent prospectuses of registered mutual funds with names similar to LDBF's should be given little credence. *See* FOF 133-38. Even had investors undertaken such extreme measures, however, they would have obtained no information suggesting that LDBF was invested exclusively in subprime RMBS. *See* FOF 136 (ultra-short bond funds had ABS investments (of which subprime RMBS was only one component) ranging between 5.5 and 39.3 percent).

Finally, both experts suggested that the misleading statements at the heart of this case were not misleading because investors could have obtained some of the information misstated in, or omitted from, the communications in question if they had known enough to ask focused questions. These suggestions elide over an important fact – investors frequently got bad information when they asked additional questions. *See* FOF 110-11 (responses to investors' requests for proposal contained false and misleading information); FOF 112-15 (audited financial statements were stale by the time they were available and contained confusing information); FOF 123 (Hopkins concealed information about leverage from an investor to avoid scaring the investor away from a fund). More fundamentally, as one of the experts conceded, it was reasonable for investors to accept and rely on Respondents' representations. FOF 237-38.

CONCLUSION

For the reasons stated above, and in the Division's Pre-Hearing and Post-Hearing briefs, the Division requests that the Court make findings that Hopkins and Flannery willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and impose the previously-requested remedies as punishment for those violations.

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Respectfully submitted,

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by its attorneys,

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EXHIBIT A

	A	B	C	D	E	F	G	H
1	CMY1 and CMZ5 - Before July 26 AAA Sale Division Exhibit 252 - Absolute Return Analytics.Xls				CMY1 and CMZ5 - After July 26 AAA Sale Removing all Cash Raised from Fund			
2	Market Value	2,782,081			Market Value	2,268,991		
3								
4	Trade	Reference	Exp Shortfall		Trade	Reference	Exp Shortfall	
5	Strategy	Notional	5% C.I. (bps)	Calc Column	Strategy	Notional	5% C.I. (bps)	Calc Column
6	RMBS AAA	2,823,615	15.4	43,483,671	RMBS AAA	2,823,615	15.4	43,483,671
7	RMBS AA	192,770	33	6,361,410	RMBS AA	192,770	33	6,361,410
8	Long AA ABX.06-2	0	210	0	Long AA ABX.06-2	0	210	0
9	Long BBB ABX.06-2	62,277	1500	93,415,463	Long BBB ABX.06-2	62,277	1500	93,415,463
10	3YR 1M3M LIBOR Bas	780,000	3	2,340,000	3YR 1M3M LIBOR Bas	780,000	3	2,340,000
11	4YR 1M3M LIBOR Bas	1,509,300	3	4,527,900	4YR 1M3M LIBOR Bas	1,509,300	3	4,527,900
12	Long Basis	0	158.7	0	Long Basis	0	158.7	0
13	AAA HEL - Cash	**1,840,480**	27	49,692,960	AAA HEL - Cash	**208,588**	27	5,631,876
14	AA HEL - Cash	1,604,532	31	49,740,492	AA HEL - Cash	1,604,532	31	49,740,492
15	A HEL - Cash	183,150	120.4	22,051,260	A HEL - Cash	183,150	120.4	22,051,260
16	BBB HEL - Cash	11,760	238	2,798,880	BBB HEL - Cash	11,760	238	2,798,880
17	Sum Notional	9,007,884	sum I*M	274,412,036	Sum Notional	7,375,992	sum I*M	230,350,952
18	Sum Not/MKT	3.24	Wt Avergae Exp Shortfall	30.46	Sum Not/MKT	3.25	Wt Avergae Exp Shortfall	31.23
19			Portfolio CVaR	98.6			Portfolio CVaR	101.5
20								

21 The analysis above compares the CVaR of LDBF before the AAA sale to what its CVaR would have been if all of the net cash raised from the AAA sale after re-paying the repurchase commitments of those bonds was used to meet redemptions. As demonstrated during the hearing, LDBF's portfolio CVaR is based on four variables: (a) the notional value of LDBF (row 17, columns B and F), (b) the market value of LDBF (row 2, columns B and F), (c) the notional value of each asset class in LDBF's portfolio (column B, rows 6-16 and column F, rows 6-16), and (d) the CVaR figures applicable to each asset class in LDBF's portfolio (column C, rows 6-16 and column G, rows 6-16). Calculating the CVaR of LDBF is a 5-step process: (1) Divide the notional value of LDBF (row 17, columns B and F) by the market value of LDBF (row 2, columns B and F). (2) Multiply the notional value of each asset (column B, rows 6-16 and column F, rows 6-16) by the CVaR figure applicable to that asset (column C, rows 6-16 and column G, rows 6-16). This produces each asset's weighted CVaR figure. (3) Add together each asset's notional weighted CVaR figure from step 2. (4) Divide the result of step 3 by the notional value of LDBF (row 17, columns B and F). (5) Multiply the result of step 1 by the result of step 4. Tr. 2310:3 - 2316:6 (Zask).

22 The market value in the post transaction scenario is reduced by the net amount of cash raised from the AAA sale ($423,472,000) and the loss on the sale of the AAA bonds ($89,618,000). Flan. Ex. 299 at Exhibit 5. The net amount of cash raised from the AAA sale is calculated by subtracting the amount required to repay the repurchase commitments (Flan. Ex. 299, Ex. 5, column 10) from the proceeds of the AAA bond transactions (Flan. Ex. 299, Ex. 5, column 7). Zask also calculated a loss on the AAA bond sale of $98,446,824 (Flan. Ex. 299, Ex. 5, column 8), but he made a mistake because he subtracted the proceeds of each bond sold from the par value of the bonds instead of from the pre-transaction value of the bonds as reflected in State Street's records. This calculation fixes Zask's error by subtracting base net proceeds from the pre-transaction value. The loss is therefore $89,618,000 instead of $98,446,824. Despite coaching from Flannery's counsel during Zask's examination that the mistake "has no bearing on the numbers," Zask agreed that it "would have an effect on the CVaR." Tr. 2299:14 – 2300:23 (Zask). The error has an effect on LDBF's CVaR because Zask assumed an additional approximately $9 million reduction in LDBF's market value. Because LDBF's CVaR is driven in large part by the ratio of the Fund's notional value to its market value, any reduction in market value (while leaving notional value the same), will increase the Fund's CVaR.

23 **The reduction in the AAA RMBS bond position is a subtraction of the pre-transaction value of the AAA bonds sold on July 26 as indicated in column 5 of Exhibit 5 of Zask's analysis (Flan. Ex. 299) from the notional value of the AAA RMBS bond position in the July 30 portfolio analytics (Div. 252. at p. 6).**