HARD COPY

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

RECEIVED
JUN 16 2014
OFFICE OF THE SECRETARY

ADMINISTRATIVE PROCEEDING
File No. 3-15574

In the Matter of

HARDING ADVISORY LLC and

WING F. CHAU,

Respondents.

POSTHEARING BRIEF OF THE DIVISION OF ENFORCEMENT

DIVISION OF ENFORCEMENT
Howard A. Fischer
Daniel R. Walfish
Brenda W.M. Chang
Elisabeth L. Goot
New York Regional Office
Securities and Exchange Commission
Brookfield Place, 200 Vesey Street, Suite 400
New York, NY 10281

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Federal Cases

State Cases

Administrative Materials

Statutes

Securities Act of 1933

Securities Exchange Act of 1934

Investment Advisers Act of 1940

Investment Company Act of 1940

Rules and Regulations

PRELIMINARY STATEMENT

The Division proved its case.

When all was said and done, Respondents' counter-narrative on Octans I CDO Ltd. ("Octans I") came down to the shifting and exceptionally unreliable recollections of one witness: Jung Lieu, who eventually insisted that spreadsheets created months and years after the fact somehow represented work done in a single afternoon eight years ago. Here is what the evidence shows actually happened with respect to the $220 million ABX Index trade for Octans I:

- Magnetar, a hedge fund with interests different from those of the CDO's debt investors, was heavily involved in the ramping of Octans I.
- Magnetar wanted Respondents to include ABX component bonds; the more of the 40 at issue, the better.
- Respondents understood Magnetar's preference; their approach to the Index was to accept the "lesser of evils."
- Even after relaxing the assumptions used to project losses, Respondents obtained negative results when they analyzed many of the Index bonds.
- Magnetar was pressuring Respondents to deliver their selections as quickly as possible.
- In the face of negative results, rudimentary analysis, internal dissent, and acknowledged discomfort, Respondents made the decision anyway to acquire 28 ABX bonds for the Octans I portfolio.

As for Chau's purchase, for four other Collateralized Debt Obligations (CDOs) managed by Harding Advisory, of the Norma CDO I Ltd. ("Norma") securities despite Chau's unfavorable view of them, Respondents did not actually offer a cogent defense.

This compromised decision-making was a serious abdication of Respondents' fiduciary duties, and rendered false or misleading Respondents' representations, in documents directed at investors and their advisory clients, about their rigorous asset-selection process, as well as their compliance with a standard of care defined by the "customary standards, policies and procedures followed by institutional managers of national standing."

Respondents never rebutted the Division's exposition of that standard. Instead they have tried to justify their behavior with reference to, among other things, the sophistication of investors, the transparency of the collateral, and disclaimers in the offering documents. These defenses do not work. Investors and the CDO vehicles were paying not just for the collateral but for a diligent, independent manager, and in any case, reliance does not need to be shown in an SEC enforcement action. Finally, *Janus* does not help – first, because the great weight of authority holds that *Janus* has no application to claims under Section 17(a) of the Securities Act; and second, because, even if *Janus* did apply, Respondents were the "makers" of a series of material misrepresentations in the offer and sale of securities.

In sum, then, and as alleged in the Order Instituting Proceedings ("OIP"), Respondents made misrepresentations to investors and breached their obligations to act in the best interests of the CDO vehicles for which Harding Advisory was collateral manager and investment adviser. Respondents repeatedly placed their interests in keeping Magnetar and Merrill Lynch happy ahead of their obligations to the CDO vehicles and their investors. For these reasons, Respondents violated Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a), and Sections 206(1) and (2) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. § 80b-6. Chau also aided and abetted and caused Harding Advisory's primary violations of both of those statutes. Meaningful sanctions are warranted, as set forth below.

STATEMENT OF FACTS[1]

I. RESPONDENTS

A. Overview

Chau is about 47 years old. *See* Answer ¶ 10. In 2004, after working with asset-backed securities at a succession of major financial institutions, he founded a CDO management group housed at Maxim Advisory LLC ("Maxim").[2] Maxim was a registered investment adviser affiliated with Maxim Group LLC ("Maxim Group"). Wang Tr. 229:11 – 230:6. In July of 2006, Chau transferred Maxim's business, and most of its CDO-management personnel, to Harding Advisory LLC ("Harding Advisory").[3] This brief will use the term "Harding" to refer collectively to Maxim and Harding Advisory.

Harding Advisory is a CDO manager. Substantially all of it is owned by Chau. (Chau's wife owns one percent.) Chau Tr. 1448:15-1449:7. Chau at all relevant times has served as Harding Advisory's CEO, President, and Managing Member. Answer ¶ 10; Chau Tr. 1449:8-11.

---

[1] This brief generally cites witness testimony by referring to the last name of the witness (except in some cases when totally clear from context), together with the page and line of the hearing transcript. For the April 1 and 23 hearing dates, the references are to amended transcripts prepared as a result of errors discovered by the reporting service. The April 1 transcript amendment was prepared April 22; the April 23 session transcript amendment was dated April 24. Slightly amended versions also were prepared for April 21, 22, and again for April 23. These three are dated May 2, and result from errata sheets prepared by the Division on notice to Respondents. However, the parties have informally agreed not to rely on the May 2 versions pending a joint submission to the Court of a comprehensive set of errata in accordance with Rule 302(c).

[2] *See* Div. Ex. 3 at 193 (Chau bio); Wang Tr. 221:20-25, 229:2-5, 230:11-231:10.

[3] Answer ¶ 9 (Harding Advisory founded in about July 2006 as the successor to Maxim); Resp. Ex. 145 at 2 (contemporaneous description of transition); Wang Tr. 238:20 – 240:21; Jones Tr. 2796:15-17, 2798:16-23 (Chau was in the process of leaving Maxim as Jones arrived in about July 2006).

Harding served as the manager to twenty-one CDOs. Div. Ex. 239.[4] At its peak in 2007, Harding had approximately $20 billion in assets under management (AUM). *See* Answer ¶ 10.[5]

Chau's control over the affairs of Harding was pervasive, and is not seriously disputed. Alison Wang testified that Chau "was responsible for everything at Harding Advisory," was directing the firm in all respects, and had ultimate authority over what took place at Harding. Wang Tr. 261:2-8, 12-14. Everyone at the firm reported to him. Wang Tr. 258:12 – 259:6. Chau was involved in decisions on any important matter. Wang Tr. 262:7-23. He had the authority to hire, and negotiated the fees that Harding received for managing CDOs. Wang Tr. 262:24 – 263:5. Chau made investment decisions for Harding. Wang Tr. 261:9-11.

B. Chau's Responsibility for Harding's Compliance with the Advisers Act

Harding Advisory at all relevant times has been a registered investment adviser. Answer ¶ 10. As such, Harding Advisory had a chief compliance officer (CCO), namely Chau himself,[6] and a compliance manual,[7] which Chau and Wang were involved in creating. Div. Ex. 122 (distribution of Harding Advisory compliance manual on July 17, 2006); Wang Tr. 270:18-271:7, 274:16-275:11. The compliance manual discussed Harding's fiduciary obligations (Div. Ex. 122 at 3, 24):

[4] Division Exhibit 239 is a useful chart of all of Harding's CDOs that was prepared by Respondents at an earlier stage. Listed and used by both sides at the hearing, its accuracy is not questioned.

[5] Harding Advisory currently manages approximately $1 billion in assets that are in run-off mode. The firm has two or three staff members. Chau Tr. 4335:14-24. In its heyday, Harding's offices were in New York City. *See* Huang Tr. 923:20-24. Harding Advisory was subsequently based in New Jersey. During the pendency of this proceeding it relocated to Florida, as did Chau. Chau Tr. 2161:20 – 2163:15.

[6] At the hearing, Chau initially did not recall that he was CCO, *see* Chau Tr. 1449:12-22, although that fact is not disputed. *See id.*; Answer ¶ 10.

[7] The manual was titled "Investment Adviser Policies and Procedures Manual" and referred to in a contemporaneous email as the "Written Supervisory Procedures." Div. Ex. 122. Wang acknowledged that this document was the compliance manual. Wang Tr. 275:4-6.

As a registered adviser, and as a fiduciary to our advisory clients, our firm has a duty of loyalty and to always act in utmost good faith, place our clients' interests first and foremost and to make full and fair disclosure of all material facts and in particular, information as to any potential and/or actual conflicts of interests.

* * *

Every fiduciary has the duty and a responsibility to act in the utmost good faith and in the best interests of the client and to always place the client's interests first and foremost.

As part of this duty, a fiduciary and an adviser with such duties, must eliminate conflicts of interest, whether actual or potential, or make full and fair disclosure of all material facts of any conflicts so a client, or prospective client, may make an informed decision in each particular circumstance.

The manual also adopted a policy of truthful and accurate advertising,[8] and vested in Chau "the responsibility for implementing and monitoring our [advertising] policy, and for reviewing and approving any advertising and marketing to insure any materials are consistent with our policy and regulatory requirements." Div. Ex. 122 at 4. Additionally, the manual discussed the importance of "written advisory agreements," including the disclosures therein,[9] and vested in Chau "responsibility for the implementation and monitoring of the firm's advisory agreement policy, practices, disclosures and recordkeeping." Div. Ex. 122 at 5. Harding's written advisory agreements took the form of Collateral Management Agreements ("CMAs") between Harding and the CDO issuing entities. Wang Tr. 301:3-17.[10]

[8] *See* Div. Ex. 122 at 4 ("Harding Advisory's policy requires that *any advertising and marketing materials must be truthful and accurate* . . . . Harding Advisory LLC's policy prohibits any advertising or marketing materials that may be misleading, fraudulent, deceptive and/or manipulative." (emphasis added)).

[9] Div. Ex. 122 at 5 ("Harding Advisory LLC's policy requires a written investment advisory agreement for each client relationship which includes a description of our services, discretionary/non-discretionary authority, advisory fees, *important disclosures*, and other terms of our client relationship." (emphasis added)).

[10] There is no suggestion that Chau did not understand the above-reviewed obligations and policies. He was the CCO. He helped to create the compliance manual and received a copy of it from Wang. Wang Tr. 271:3-7, 272:6 – 273:2. At the hearing he acknowledged understanding his responsibilities in connection with advertising, Chau Tr. 1451:2-1452:22, understanding that investment advisers are subject to the securities laws, Chau Tr. 1493:13-1494:5, and understanding that Harding's fiduciary duties required disclosure of conflicts of interest, Chau Tr. 1495:10-19. Nor could Wang recall Chau ever questioning or

C. Organization of Harding

By the middle of 2006, Harding employed between eight and ten people, Wang Tr. 229:6-10. Harding's number-two and -three employees were, respectively, Tony Huang and Alison Wang. Wang Tr. 263:6-10; Huang Tr. 694:11-695:7. Huang had the title of Managing Director and, initially at least, was sometimes involved in approving investments. Huang Tr. 694:22, 709:5-7, 971:21-973:24; Wang Tr. 263:18 – 264:15. Huang testified, however, that his day-to-day involvement diminished over time, Tr. 973:25-974:18, and at the hearing he struggled even to explain his role at the firm. Tr. 693:20-694:9, 964:9-965:5. Wang served as Harding Advisory's chief operating officer; at Maxim she was a vice president who reviewed documents and otherwise did "whatever was necessary." Wang Tr. 210:2-20, 214:3-24.

Harding had credit analysts who concentrated on residential mortgage-backed securities (RMBS), and employees who concentrated on analyzing CDOs created by other firms for possible inclusion in the CDOs managed by Harding. Wang Tr. 266:16-267:2. The credit analysts included Jamie Moy and Jung Lieu. Wang 267:13-20, 268:9-13. CDOs tended to be analyzed by some combination of Chau, Huang, Xilun Chen, and Brett Kaplan. Wang Tr. 269:20-270:2. As a general rule, titles at Harding were unimportant and there were not clear reporting lines. Huang Tr. 963:25-964:8.

II. BACKGROUND ON CDOs, RMBS, AND THE ABX INDEX

A CDO is a special purpose vehicle (SPV) that issues securities to investors and uses the proceeds to invest in debt securities – as relevant to this case, mainly subprime RMBS. The RMBS themselves are the result of securitizing home loans. A CDO, therefore, is typically a

---

expressing confusion about the obligations in the manual. Wang Tr. 290:11-19, 292:3-10. There is also no suggestion that the relevant policies as set forth in the manual were not Harding's policies, or that Chau did not have the stated responsibilities. *See* Wang Tr. 296:6 – 299:19, Wang Tr. 301:10- 303:14.

second level of securitization: home loans are first pooled and securitized into RMBS; then RMBS are grouped and securitized in the form of a CDO. RMBS normally are issued in a series of different tranches that feature varying levels of risks and returns. The same is true of a CDO. The senior-most tranche in the capital structure (usually referred to as "super-senior" in the case of a CDO) is the highest rated, is first in the priority of repayment through what is called the waterfall, and has the lowest risk of default as well as the lowest rate of return. The inverse is true for the bottom-most tranche in the structure, which in the case of a CDO is usually referred to as its equity.[11]

With RMBS, tranches below the senior and above the most subordinate tranches are referred to as "mezzanine." As relevant to this case, "mezzanine CDO" generally refers to a CDO backed by RMBS tranches rated BBB (Baa2) but also potentially BBB- (Baa3) or BBB+ (Baa1).[12] Similarly, the "mezzanine tranches of a mezzanine CDO" would include, for example, BBB notes issued by a CDO backed by a collection of RMBS bonds at the BBB (or BBB-, etc.) level. *See* Prusko Tr. 2345:20-2346:15.

The investment manager of a CDO's portfolio is referred to as the collateral manager. Not all CDOs have collateral managers, Answer ¶ 19, but where a CDO does have a collateral manager, the manager is expected to exercise its independent judgment and to act in the best interests of the CDO.[13] Another key participant in a CDO transaction is the investment bank, or

[11] Answer ¶ 15; Wagner Report (Div. Ex. 8001) ¶¶ 8, 9, 11, 12, 20; Prusko Tr. 2345:20-2346:12; Chau Tr. 4331:16-4332:19.

[12] *See* Wagner ¶¶ 12, 51; Prusko Tr. 2452:18-22; Chau Tr. 4331:16-4332:19; Wagner Tr. 4610:5-19.

[13] *E.g.*, Wagner Report (Div. Ex. 8001) ¶ 13; Wagner Tr. 4638:25-4639:11 (manager's job "is to pick the best bonds that fit within the CDO"); *see also* Doiron Tr. 1881:21-1882:2 (expected CDO managers to "choose the best assets they could find"); Edman Tr. 2583:24-2584:6 ("I'm reluctant to use the word 'fiduciary,' because I don't know what the legal meaning is here – but they're supposed to be looking out for the investors in the CDO.").

dealer, that structures the transaction and brings it to market, which is sometimes referred to as the "underwriter" or "arranger." *E.g.*, Wagner Report ¶ 23.

A credit default swap (CDS) is a type of derivative through which two parties transfer the risk of ownership of a particular "reference obligation." As relevant to this case, the reference obligations were generally subprime RMBS. A CDS essentially mimics the performance of the referenced asset. Thus, an investor can gain exposure to an RMBS by entering into a CDS that references the RMBS instead of by purchasing the RMBS itself. Answer ¶¶ 3, 16; Wagner Report ¶¶ 6, 14-19.

More specifically, a CDS's protection buyer (who is "short" the reference obligation) pays to purchase "protection" upon the occurrence of certain events, such as an event of default, failure to pay interest, writedowns or substantial credit ratings downgrade of the reference obligation (collectively, "Credit Events"). The protection seller (who is "long" the reference obligation) sells that protection and assumes the risk of a Credit Event on the reference obligation. In 2006, the protection buyer normally paid the protection seller a premium or spread (analogous to the coupon payments on a bond).[14] Being exposed to an asset as the "long" party in a CDS is sometimes referred to as owning that asset "synthetically." Answer ¶ 16; Wagner Report ¶¶ 6, 14-19; *see also* Huang Tr. 737:10 – 739:3.

A CDO can be backed by bonds (a "cash CDO") or by CDS (a "synthetic CDO"). A CDO backed by both bonds and CDS is a "hybrid CDO." Answer ¶ 17. Although the majority of the collateral in Octans I and certain other CDOs at issue in this case were RMBS CDS, a portion of the CDOs' portfolio, known as a "CDO bucket," was reserved for securities issued by other

[14] For example, a protection buyer may agree to pay a protection seller 150 basis points to purchase protection against default on $10 million of a designated reference obligation, or $150,000 per annum, paid periodically. OIP ¶ 16 n.2 & Answer ¶ 16; *see also* Wagner Report ¶ 16, Appendix 4.

CDOs. Chau Tr. 4145:3-8. A CDO containing primarily tranches of other CDOs was referred to as a CDO of CDOs, or a CDO-squared. Div. Ex. 239; Chau Tr. 4151:7-14.

Also relevant to this proceeding is the ABX Index ("ABX", "ABX Index," or the "Index"), which was a standardized CDS referencing a benchmark basket of 20 subprime RMBS. The ABX Index was available at various levels of credit rating. The relevant levels in this case were BBB and BBB- (equivalent, respectively, to Baa2 and Baa3, *see* March 24, 2014 Stipulation ¶ 5.). New ABX Indices became available twice per year, and in each case referenced RMBS issued in the preceding six months. Thus, for example, ABX 2006-1 referenced a basket of 20 RMBS issued in the second half of 2005. Answer ¶ 33.

III. BACKDROP: THE DEVELOPMENT OF MAGNETAR CDOs AND HARDING'S INCENTIVES

A. Merrill Lynch Agrees To Bring to Market CDOs in Which Magnetar Buys Equity and Plays a "Significant Role" in Portfolio Composition

In the first half of 2006, Magnetar approached Merrill Lynch about the possibility of Magnetar and Merrill working together on a series of CDOs. Lasch Tr. 116:8-14, 119:10-13. James Prusko of Magnetar asked Richard Lasch, the Merrill salesperson who covered Magnetar, to set up a meeting with the heads of Merrill's CDO group. Lasch Tr. 111:20-112:15, 119:10-13. The co-heads of Merrill's CDO business were Ken Margolis and Harin DeSilva; Andy Phelps was in charge of syndicating, or distributing, securities issued in CDO transactions. Lasch Tr. 117:14-118:13, 119:20-120:5.

On April 18, 2006, Lasch wrote to Prusko: "Phelps is coming back to me on CDO meeting. … Idea would be *to have you as a partner early in the construction of deal and portfolio*. Then we can talk about equity investment. U agree with that approach, right?" Div. Ex.

11 (emphasis added); Lasch Tr. 121:18-20 (email reflected Lasch's contemporaneous understanding).

The meeting took place on May 3, 2006. Lasch Tr. 138:23-139:8. The contemporaneous "call report" in which Lasch documented the meeting reads as follows, in pertinent part:

> Brought Jim Prusko from Magnetar into our offices in NY for a meeting with Ken, Harin and Andy to discuss working together on Mezz ABS deals, whereby *we pick mutually agreeable managers to work with, Magnetar plays a significant role in the structure and composition of the portfolio*...and in return they retain the equity class and we distribute the debt. *We agreed in principle to do a series of mezz abs deals . . . with largely synthetic collateral*. . . . It is definitely their preference to do multiple deals with us . . . . Attractive initiative with largely synthetic composition . . . . *We have agreed to a short list of managers, have engagement letter to them for first deal (Maxim as manager)* . . . .

Div. Ex. 12 (some ellipses in original; emphases added). Lasch testified to the accuracy of the call report. *See* Tr. 123:8-125:14, 129:11-130:8, 133:15-23, 134:19-135:12.

As Lasch's report reflects, Magnetar and Merrill discussed collaborating on a series of CDOs with largely synthetic collateral. "Mezz ABS deals" was a reference to CDOs backed by mezzanine RMBS. Lasch Tr. 127:9-128:12, 128:19-129:10. Magnetar was to purchase the CDOs' equity. Lasch acknowledged discussion of Magnetar playing a "significant role" in the "composition of the portfolio," testifying that Magnetar wanted to have an "iterative" or "communicative" process by which they would provide input into portfolio composition. Lasch Tr. 130:9-132:8.[15] Magnetar and Merrill agreed on Maxim – Chau's firm – as the manager of the

---

[15] Prusko's suggestion on direct examination that the reference to input into portfolio composition referred merely to "general sector allocation," *see* Prusko Tr. 2412:17-2414:7, is not credible. (Prusko, of course, has a motive to downplay aspects of Magnetar's involvement, which has attracted negative press, Prusko Tr. 2357:20-2358:5, interest from the Enforcement Division, *see* Letter from N. Rabner to J. Elliot (March 28, 2014); Tr. 668:24-669:16, and a fair amount of private litigation, *e.g.*, *Loreley Financing (Jersey) No. 28, Ltd. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 2014 WL 1810646 (N.Y. App. Div. 1st Dep't May 8, 2014); *Loreley Financing (Jersey) No. 3 Ltd. v. Citigroup Global Markets Inc.*, 2014 WL 1809781 (N.Y. App. Div. 1st Dep't May 8, 2014); *Fin. Guarantee Ins. Co. v. Putnam Advisory Co.*, 2014 WL 1678912 (S.D.N.Y. Apr. 28, 2014).) As an initial matter, Prusko did not write the report and did not recall what was discussed at the meeting. Prusko Tr. 2412:7-11, 2722:11-15. As Lasch's report

first Merrill-Magnetar CDO, which eventually became Octans I. Lasch Tr. 135:10-12, 136:13-18.

B. The "Top Priority" of Merrill's CDO Group: The Relationship with Magnetar

Having an equity investor was extremely important. The equity portion of a CDO was typically the most difficult piece to sell,[16] and finding an equity investor was essentially a prerequisite to initiating a CDO transaction. Huang Tr. 716:23-25 ("Without the equity investor you cannot even start a deal."). Nor could a CDO transaction close without an equity buyer. Huang Tr. 711:11-13, 716:17-19.

Magnetar's willingness to purchase the equity in a series of large transactions thus made it highly sought-after. In Chau's telling: "So Magnetar was the new kid on the block with equity. . . . And all the underwriters lined up at the door . . . ." Chau Tr. 1791:2-1792:7. For its part, Merrill Lynch clearly regarded Magnetar as the most important client of the bank's CDO

---

reflects (and Prusko himself confirmed, *see* Tr. 2722:16-23), it was a given that the transactions were going to be "mezz ABS" CDOs. Prusko explained that "mezz ABS" refers to "Bbb rated subprime," *i.e.*, RMBS – and that "we're not talking about corporate bonds or commercial mortgages. We're talking about primarily subprime bonds," a term interchangeable with RMBS. Prusko Tr. 2722:16-2723:8. In other words, there would be no need for "significant input" into "portfolio composition" if only sector allocation was at issue – nothing besides mezzanine RMBS was ever on the table. Finally, it is a fact, and the evidence at the hearing showed, that Magnetar wanted to have, and did have, the kind of "communicative" review of and input into portfolio selection that Lasch testified about. *See* sections V.C., V.D., X.A. below; Prusko Tr. 2723:21-24; *see also* Prusko Tr. 2412:21-25 ("As the equity investor, we would want to understand what exactly we were buying the equity in, which would include . . . *exactly what assets were going to be in the CDO.*"). Relatedly, Magnetar often traded against its own CDOs, buying the protection on (*i.e.*, shorting) the CDO securities referenced by CDS in the "CDO buckets" of its CDOs – another form of input into portfolio composition. *See* Prusko Tr. 2724:4-15.

[16] Lasch Tr. 144:17-145:8 (prior testimony: "equity investors were difficult to come by in the CDO market . . . . And I think that was a common theme in the marketplace . . . . "), 146:7-147:3 (prior testimony: "It always seemed to be driven by you had to find an equity investor for the deal"); Huang Tr. 713:15 – 716:13 (prior testimony: "equity was the hardest. Until Magnetar got into this big time equity was the hardest thing [to find a buyer for]").

business – its "top priority" from "top to bottom" – as Lasch's testimony and contemporaneous emails made crystal clear.[17]

Relatedly, Magnetar had substantial leverage over the assembly and management of these transactions. *See* Chau Tr. 1792:18-1793:20 (prior testimony that Prusko had "substantial leverage. He [is] the equity investor in the CDO and he can go to any underwriter to do a deal."); Lasch Tr. 144:22 – 145:2 (prior testimony: "if you had a willing equity investor, there was more influence or there could be more say in what a structure may or may not look like in general because of, again, the lack of equity investors in general.").

C. <u>Harding's Incentives</u>

Respondents, too, were strongly motivated to please and accommodate Magnetar, as well as Merrill Lynch. Harding's fees, which came from the CDO being managed, were typically based on the amount of assets under management in the CDO. Wang Tr. 255:16 – 20, 256:23 – 257:5. Accordingly, the more CDOs and the bigger their size, the more paid to Harding. *See* Chau Tr. 2141:7-9. And Harding could not get paid for its work assembling a CDO's portfolio unless the CDO closed (Wang Tr. 255:21-256:21; Chau Tr. 1473:8-14) – which required an equity investor.

---

[17] See Div. Ex. 121 at 2 (Lasch to Magnetar partner Snyderman: "Extremely important to us that you know this partnership is the top priority of the CDO group (top to bottom) . . . . They are def[initely] approaching as a partnership with you and want you to feel that way. They view you as an issu[]er rather than a [counterparty]."); *id.* at 1 ("Their hope is to do a lot of business with you . . . so that relationship is important."); Div. Ex. 147 (email on the occasion of pricing Octans I sent by Margolis to Snyderman, copying three levels of supervision up from Margolis to one of Merrill Lynch's senior-most executives: "We view our relationship as a partnership and will do whatever it takes to make this [*i.e.*, Octans I] (/future) transaction(s) successful and are committed to helping your platform in every way possible."); Div. Ex. 181 (Lasch email regarding briefing Merrill's CEO on Magnetar: "if approached correctly [Magnetar] should prove to be an extremely valued and profitable Merrill Lynch partner for years to come"); Lasch Tr. 188:4-190:10, 190:21-194:20, 195:16-198:2 (corroborating emails).

Harding, moreover, unlike some CDO managers, had no meaningful "skin in the game" – no capital at risk, invested in the equity or other lower tranches of the CDO under management. Huang Tr. 1419:12-15; *compare* Jones Tr. 2805:24-2806:11 (equity in Maxim Capital Management's CDOs owned by Jones himself and senior officers of Maxim Group); Resp. Ex. 908 at 8 (pitchbook for the Hartford Investment Management Company's (HIMCO) CDO noting that HIMCO or affiliates would purchase some of the riskier portions of the CDO's capital structure)[18]; *see also* Huang Tr. 730:5-8 (some managers invest their own capital in a CDO).

Put differently, if one of Harding's CDOs failed, Harding did not actually lose money. Of course, it would cease to earn fees, but from the standpoint of an asset manager's incentives, particularly one with many billions under management, that is entirely different from losing invested capital. *See* Huang Tr. 1419:19-22 ("Q. If the CDOs died, what money would Harding have lost, if any? / A. Nothing, other than the fees that it expects."); *see also* Chau Tr. 1455:14-1457:5 (prior testimony conceding truth of media report that "Chau stood to make money for a while even if the CDO's he managed didn't return principal to investors.").

Because Harding had no capital of its own, it depended on investment banks for its business, Huang Tr. 729:21 – 731:19, and was unusually beholden to Merrill Lynch. By May of 2006, Merrill Lynch had brought Maxim all six CDOs (total AUM: $7.3 billion) for which Maxim was serving, or would shortly begin serving, as collateral manager.[19] In other words, at the time that Octans I was getting started – which was also the time that Chau was getting ready

[18] Doiron also explained that generally speaking, his group at HIMCO invested the assets of HIMCO's corporate family – a large insurance company. Doiron Tr. 1860:14-21, 1948:24-1949:7.

[19] Div. Ex. 239; Wang Tr. 247:11 – 248:3 (prior testimony: "all of the CDOs that were arranged at Maxim were Merrill Lynch underwritten CDOs"), 250:20 – 251:16.

to spin off his business into an independent firm –Merrill Lynch was responsible for 100% of Chau's revenues, Chau Tr. 1472:12-16, 1482:22-25, by then about $4 million.[20]

Merrill, moreover, was in a position to keep sending Chau business. *See* Div. Ex. 125 (July 24, 2006 email from Chau to "Don Margolis": "Here's the game plan . . . we maximize my deal flow."). After Octans I closed, even as the previous CDOs kept generating revenue, Harding became the manager of four additional Merrill CDOs. *See* Div. Ex. 239; Wang Tr. 251:25-252:8, 253:8-15. By early 2007 (when Chau accepted the Norma bonds as a favor to Merrill Lynch and Magnetar, *see* section X. below), Merrill CDOs had brought Harding in the neighborhood of $10 million in fees, and by the end of 2010, the number was over $42 million.[21] In total, by a wide margin, Harding did more transactions with Merrill Lynch than with any other underwriter. Chau Tr. 1483:2-9; Wang Tr. 244:5-246:3 (prior testimony); Huang Tr. 729:11-17.

(Chau, who clearly understood the importance of manager independence, apparently was sensitive to the suggestion that Harding was unduly beholden to Merrill Lynch. Hence his response to Xilun Chen's complaint that, "[i]f we give in to" "another merrill jam job," then "we are truly a subsidiary of merrill": "*Emails are retained for 5yrs.*" Div. Ex. 258. Chau's email speaks for itself, and his attempts to downplay the sensitivity of the issue were not convincing. Chau Tr. 1435-1447.)

Keeping Magnetar happy also was important to Respondents. Chau was seeking equity investors to help grow his CDO business, and he saw that Harding would benefit from the Magnetar relationship. Huang Tr. 719-8-22. Chau valued the relationship with Magnetar, and

[20] *See* Div. Ex. 240A; Smith Tr. 2228:2-2229:5; Div. Ex. 240; Chau Tr. 1458:17-1459:10.

[21] *See* Div. Ex. 240A; Smith Tr. 2228:2-2229:5; Div. Ex. 240; Chau Tr. 1458:17-1459:10.

was in charge of cultivating it. Huang Tr. 720:25 – 721:7, 726:3-8.[22] In January 2007, Prusko, in the course of urging Chau to buy the lower-rated Norma notes, playfully reminded Chau that Prusko had been "there for u when u were a little guy." Div. Ex. 200. Presented with this email at the hearing, Prusko acknowledged that "we were one of the first significant purchasers of CDOs managed when the group went from Maxim to Harding." Prusko Tr. 2643:15-20.

Magnetar, in conjunction with the underwriting banks, ultimately selected Harding to work on four CDOs: Octans I, Octans II, Octans III, and Tigris. Answer ¶¶ 13, 26; Wang Tr. 254:23 – 255:15; Chau Tr. 1487:25-1488:7, 1488:23-1489:22.[23] This was among the most transactions that any CDO manager participated in with Magnetar. Huang Tr. 719:23–720:4. In fact, Magnetar – along with Merrill – helped Harding become one of the highest-volume CDO managers of its time. *See* Jones Tr. 2818:23-25 ("Wing was a pretty big issuer.").

Magnetar's leverage, and Harding's willingness to bow to it, were sufficiently great that Harding's second-most-senior employee was uncomfortable with the extent of Magnetar's involvement in Octans I. As Huang previously testified (Tr. 725:3-726:2):

> Q. It looks like there was quite a bit of involvement back and forth with Mr. Prusko and members of the Harding team. Did you personally feel comfortable with that level of interaction, involv[ement] in the Octans 1 CDO?
>
> A. Yeah, *I thought it was too much involvement, frankly*, but that's what – *you know, I guess he wanted to do deals. You have to please the equity investor, trying to keep him happy.*

[22] Huang even suspected that Chau may not have wanted Huang involved in the relationship with Magnetar because Chau wanted to take credit for all the business that Magnetar was going to bring to Harding. Huang Tr. 726:9 – 727:3.

[23] There were also discussions about a potential Octans IV and Octans V. *E.g.*, Resp. Ex. 446; Chau Tr. 1489:23-1490:7.

IV. MAGNETAR'S STRATEGY AND RESPONDENTS' KNOWLEDGE OF IT

A. "Indifferent to the Performance of the Transaction"

Magnetar was seeking not just to buy CDO equity, but also to enter into off-setting "hedges" – that is, short bets on the "mezzanine" tranches of CDOs (those just above the equity) that would pay off if the CDO began to experience defaults above a certain level. According to Prusko, Magnetar's goal was to remain "market neutral," *i.e.*, to profit from good performance or bad, which required betting against two dollars of mezzanine CDO debt for every dollar invested long in CDO equity. Prusko Tr. 2681:4-2682:9, 2336:22-2341:5, 2363:22-2364:3.[24]

Magnetar explained its general strategy, including its intention to short its own CDOs, in its discussions with the investment banks and collateral managers whose cooperation was needed to assemble the transactions. *See* Prusko Tr. 2684:19-2687:20 (prior testimony that Magnetar took "the dealers and the managers . . . through the general outlines of the strategy" because Magnetar needed their help both for the equity and to facilitate shorts), 2764:6-15 (Magnetar discussed with market participants both its long equity investments and its short positions on CDO mezzanine debt). Prusko testified that Magnetar explained its strategy to Harding some time in 2006. Prusko Tr. 2397:2-7, 2685:11-2686:7.[25]

---

[24] Prusko acknowledged that the eventual failure of the CDO market was extremely profitable for Magnetar. Prusko Tr. 2682:10-16.

[25] At the hearing, Respondents effectively argued out of both sides of their mouth, simultaneously insisting that Magnetar's strategy of shorting the CDOs in which it had invested equity was common knowledge (such that other investors in Octans I could not or should not have been misled), but that Chau did not understand it. In reality, the evidence showed that while Magnetar openly discussed its strategy with insiders who put its CDOs together – banks and certain CDO managers, including Harding – it did not do so with other market participants, some of whom would not have purchased the CDOs if they had known of Magnetar's involvement. *See* Prusko Tr. 2368:19-2369:8; Chau Tr. 1765:16-1766:6. For instance, Ken Doiron of HIMCO (a more traditional institutional investor) was unaware of Magnetar's involvement and would not have invested in Octans I if he had known of it. Doiron Tr. 1934:3-1936:3. *See also* Prusko Tr. 2683:2-5 (acknowledging that some people knew what Magnetar was doing and others did not); Edman Tr. 2569:17-2570:16 (Edman confident that banks, "prop shops," and CDO

Huang clearly understood Magnetar's strategy, or at a minimum strongly suspected it even if he lacked hard confirmation. Huang Tr. 740:8-10 ("I always thought that they wanted to short something"), 743:17 – 744:4, 744:23 – 745:4 (prior testimony: "I certainly know[26] that *they wanted long and short, long equity, short mezz. That was clear.*"[27]), 754:20 – 755:3, 755:22 – 756:16 (prior testimony acknowledging that Huang knew "ultimately [Prusko] wants to short the mezz. *I thought he was shorting the mezz of the deal itself*, frankly actually at that time, not necessarily on the individual names themselves."), 746:10 – 747:3 ("I am sure they wanted to short [the mezzanine debt of CDOs], in retrospect certainly. *At that time I thought they wanted to do that.*").[28] Relatedly, Huang understood that Magnetar was using the income stream generated at least temporarily by the equity to pay for the protection premiums required to maintain a short position – in other words, that Magnetar was using its longs to fund its shorts. Huang Tr. 759:17-761:10, 764:15 - 765:12 ("Q. And so, by 2006, did you have an understanding or a belief as to

---

managers knew about Magnetar; unsure about insurance companies, pension funds, and foreign banks), 2573:4-6 ("Might there be some that didn't know and some that did know? That wouldn't surprise me."). In any event, the degree to which Magnetar's investment strategy was known is irrelevant in light of Harding's overriding fiduciary duties.

[26] The context suggests that Huang (who is not a native English speaker and acknowledged that he "sometimes mix[es] up present and past tense," Tr. 810:3-7) intended the past tense here – "knew."

[27] Huang testified that, by "shorting the mezz," he meant establishing short positions on mezzanine debt issued by the CDO's in which Magnetar bought the equity, Huang Tr. 758:17-21 – exactly as Prusko explained.

[28] Huang elaborated: although in theory Magnetar could also short other things, shorting the mezzanine debt of the same CDO in which Magnetar invested equity would be ideal because it would enhance correlation, and Huang understood that ultimately Magnetar was "long correlation." Huang Tr. 745:12-15, 748:25-749:13, 750:10-22, 757:12-21. At the hearing, Prusko confirmed Huang's understanding. Prusko testified that in order to achieve "correlation," Magnetar wanted to hedge the liabilities of CDOs in which Magnetar had invested the equity. *See* Prusko Tr. 2364:8 – 2367:20 ("we were concerned about the risk of our hedges [*i.e.*, shorts] performing differently than our equity"; if shorts were on the same deal in which Magnetar had gone long equity, "everything will be perfectly correlated in the sense that it has the same underlying exposure."); *see also* Resp. Exs. 500, 501 (Prusko complaining to that a Sept. 28, 2006 Merrill-issued research report describing an "ABS correlation trade" was "kind of like a how-to manual for our competitors.").

whether Magnetar was using the returns from its equity to pay for shorts on mezz issued by the same deal? / A. Yes. . . . Yes, it is past tense. At that time I certainly assumed.").

Chau, too, plainly understood all of this. He has testified that:

- He understood that Magnetar was "market neutral" (Chau Tr. 1742:25-1744:8) (prior testimony).

- He understood that in mid- to late-2006, Magnetar intended to use the returns from its equity positions to pay for its short positions (Chau Tr. 4321:4-4324:13 & 1744:18-1746:7) (prior testimony).

- *"It has always been* that [Prusko] would go long equity of a CDO and then hedge that equity by buying protection on senior tranches of *that CDO*" (Chau Tr. 1753:4-25 (emphasis added) (prior testimony)).

- He understood at some unspecified point before the Tigris transaction (which closed March 15, 2007, *see infra*) that "Magnetar would be shorting CDOs in which it invested" (Chau Tr. 4318:5-4321:3 & 1749:5-1751:21 (prior testimony)).

- "I know from a general market neutral long/short strategy they had, if they went long equity in a CDO, they would try to effect a short in the debt tranches." (Chau Tr. 1757:6-21 & 4317:10-24 (prior testimony)).

- He would have expected that Magnetar would hedge its long investment "with potentially a CDO tranche of that same capital structure" and that "at the time the [Harding-Magnetar] CDOs were being issued," he "had a general understanding" that "Magnetar was going to short them" (Chau Tr. 1754:20-1755:11).

- "[E]veryone in the community knew" that Magnetar "would like to enter into a long/short strategy . . . on their own deals. They would go to every investment bank saying they would be the end investor in the equity and that they wanted to short the tranches of the same CDO as part of their hedging strategy" (Chau Tr. 1761:8-1764:3 (prior testimony)).

Nor is there any merit to Respondents' recent suggestion that Harding did not understand Magnetar's strategy until a meeting with Magnetar in September 2006. Chau's prior testimony (and even some of the hearing testimony) contains no such time limitation. Indeed, on August 31, 2006 Chau advised his co-workers that an unidentified party shorting Octans I was "prob[ably] Magnetar" because "they will buy pro[ection] on any deal 20 wide to cash." Div. Ex. 157; Chau Tr. 1757:24-1759:8. That is, even before the September 2006 meeting, Chau was aware that Magnetar was trying to short Octans I along with other CDOs, and knew the premium Magnetar was willing to pay to do so. Similarly, on May 31, 2006, Chau advised his co-workers that "Jim [Prusko] wants to buy protection from [*i.e.*, short against] the [Octans I] warehouse," Div. Ex. 48; Wang Tr. 445:9-446:5 – again showing Chau's early understanding that Magnetar intended to bet against Octans I.

In other words, Respondents clearly understood at the time they were ramping Octans I that Magnetar's strategy entailed simultaneously investing in, and betting against the performance of, the CDOs that Magnetar helped to create and the selection of whose collateral Magnetar helped to influence. Respondents thus understood that Magnetar's interests were distinctly different from those of arm's-length debt investors betting only on the CDO performing – in Chau's own words, Magnetar was "indifferent to the performance of the transaction." Chau Tr. 1777:8 – 1778:17 & 4314:11-4316:2 (prior testimony).[29]

B. Magnetar's Longs and Shorts on Octans I

At the hearing, Respondents made much of the fact that it is impossible to short a CDO tranche before the CDO has been priced. *E.g.*, Prusko Tr. 2396:14-21, 2403:19-25. But that is neither remarkable nor relevant. As discussed above, at the time Magnetar helped set up Octans I, it did so with the intent and objective of shorting it once that became possible. Sure enough, as soon as Octans I priced in August 2006 (and even before Magnetar purchased the equity, which was not until the September 2006 closing), Magnetar set about trying to short the debt tranches.[30]

---

[29] Respondents have recently implied that since hedging is commonplace, there was nothing out of the ordinary about Magnetar simultaneously (i) sponsoring a CDO by committing to buy its equity, and (ii) seeking to short its liabilities. This argument is directly refuted by Chau's prior testimony: "I think [Magnetar was] the only one that I know of that was actively buying equity and insuring [*i.e.*, shorting]. Most of the investors were just actually long investors." Chau Tr. 1775:11-1776:5.

[30] Resp. Exs. 866, 867 (Aug. 22, 2006 email from Prusko to Merrill Lynch: "Now that we are priced, if you can find anyone who wants to take exposure synthetically, we would like to buy protection on any of

Ultimately Magnetar shorted $48 million of Octans I's debt, compared to its initial $94 million long investment. Div. Ex. 248A; Smith Tr. 2224:9-2225:25; Prusko Tr. 2483:9-2484:2. Magnetar would have shorted more if it had been able to find the needed counterparties; the $48 million "was a[s] much as we could source on that." Prusko Tr. 2485:6-19.

Respondents also understood, before Octans I closed, that Magnetar wanted the ability to reduce its equity position by resecuritizing it into another vehicle, eventually known as Tigris. On September 18, 2006, Prusko told Chau that Prusko wanted to "max[imize] size of my rated equity piece," Div. Ex. 276 – in other words, to maximize the portion of the $94 million investment that would be rated by a rating agency and hence eligible for inclusion in a CDO of CDOs. *See* Huang Tr. 775:24-776:14 (explaining Magnetar's objective: "You take CDO tranches – equity tranches, get a portion of it rated so you can resecuritize them."); Chau Tr. 1781:16-1784:21; *see also* Div. Ex. 179. By the time Octans I closed on September 26, 2006, $64 million out of the $94 million was in fact rated and thus able to be re-securitized.[31] In March 2007, Magnetar sold the $64 million into Tigris, leaving it, on a notional basis, with an $18 million net short position on Octans I ($30 million long, $48 million short), along with certain indirect exposure via the Tigris transaction.[32]

---

the tranches. Would really help us out with our hedging."); Prusko Tr. 2755:21-2756:17 ("Q. With both of those e-mails in mind [*i.e.*, Resp. Exs. 866, 867], is it fair to say that as soon as Octans 1 priced, Magnetar was looking to hedge its long risk on it by obtaining shorts? / A. I think it's a fair reading of that, yes."); *see also* Div. Ex. 157 (August 31, 2006 comment by Chau that Prusko probably buying protection on Octans I).

[31] Smith Tr. 2219:14-2223:9; Resp. Ex. 59 at 5 (letter from S&P rating $64 million of Octans I equity); Resp. Ex. 4 at 101 (indenture clause conditioning closing on obtaining a rating for the higher tranche of equity); Div. Ex. 3 at i (offering circular showing tranching of equity).

[32] Div. Ex. 248A; Smith Tr. 2226:2-18, 2231:2-15, 2235:19-2236:23 (on March 15, 2007, equity sold into Tigris CDO of CDOs, in which Magnetar had an interest); Prusko Tr. 2477:22-2478:10.

Harding was a participant in the Tigris transaction.[33] The primary effect of the transaction was to dramatically *reduce* Magnetar's overall exposure to Octans I and other CDOs' equity. The relevant witnesses unanimously agreed that the sale of the rated equity tranches into Tigris *reduced* the notional size of Magnetar's equity exposure to Octans I. Huang Tr. 776:15-777:22 ("The overall size of the exposure, maximum size of the exposure would be reduced but the position would be more risky from their perspective."); Prusko Tr. 2757:5-19 (placing Octans I equity into Tigris "would decrease the notional size" of Magnetar's exposure to Octans I equity); Chau Tr. 1780:22 – 1781:6.

The Tigris vehicle took in approximately $1 billion in equity in various Magnetar-sponsored CDOs, pooled them, and issued securities to two stake-holders: the bank Mizuho, which took roughly the top half of the capital structure ($500 million worth of senior debt), and Magnetar, which took the remaining portion – about $500 million in more junior securities. Prusko Tr. 2475:23-2476:18, 2480:5-23. Mizuho bought its notes in cash, and the proceeds in substance went to pay Magnetar for the CDO equity it sold into the Tigris SPV.[34]

In other words, once Magnetar sold out its equity, *it had reduced its exposure from $1 billion to $500 million and received cash for the remainder.* The "financing" that Chau and Prusko referred to was *non-recourse* – if the pooled CDO equity (including the $64 million rated tranche of Octans I) failed, the most Magnetar could lose after Tigris was its approximately $500

[33] *Compare* Chau Tr. 1784:22-1785:9 (Harding was designated "collateral advisor") *with* Chau Tr. 4354:14-4355:21 (Chau could not recall Harding's designated role). Harding's management fees for its role in Tigris amounted to $712,628.68. Div. Ex. 240.

[34] Div. Ex. 248A (reflecting $64 million cash payment for Octans I equity on March 15, 2007); Resp. Ex. 755 (Tigris flow of funds), Sources & Uses tab (showing $500 million proceeds from sale of Tigris' Aaa notes); Chau 4359:14-21 (CDO equity sold to Tigris in exchange for payment); Prusko Tr. 2757:12-22 ("if we had sold a security to a warehouse, . . . we would then receive payment for the sale of that security. That would be typical.").

million investment in Tigris, *not* the $1 billion in underlying CDO equity that it had previously held. Chau Tr. 4357:25-4360:11, 4361:20-4362:10, 4362:24-4363:12.

Nor is it accurate to say that Tigris gave Magnetar any increase in reward or risk. Before Tigris, the income stream on the CDO equity belonged exclusively to Magnetar; after Tigris, a portion of that income stream had to be shared with and paid first to Mizuho at the top of the Tigris waterfall, and only then could Magnetar receive any portion of its previously exclusive income stream. Prusko attested to this point unambiguously, Tr. 2478:18-2479:23, 2776:23-2777:22 ("after moving the Octans securities and the other securities into the Tigris financing transaction, we are still eligible to receive all those cash flows [*i.e.*, from CDO equity], only now, after we pay the senior financing cost."), and Chau admitted it too. Chau Tr. 4370:13-4373:8. The substantive effect of Tigris was to cash Magnetar out of half of the equity portfolio, reducing both overall risk and reward along with the magnitude of Magnetar's long position.[35]

V. THE RAMP OF OCTANS I

A. Overview

Octans I was a $1.5 billion CDO. The collateral was primarily synthetic mezzanine subprime RMBS. Answer ¶ 3. Work on the CDO began in May 2006, with Harding partnering with Merrill and Magnetar to accumulate assets in a "warehouse" for the transaction. The CDO was marketed in July and August 2006, and closed on September 26, 2006. A timeline is provided in Appendix 1 to this brief. The marketing effort included a pitchbook describing Harding's process for selecting assets. Harding represented, for example, that it engaged in

[35] To be sure, the Tigris securitization "tranched" the CDO equity and left Magnetar invested in the "bottom" half of it, a stake that in isolation was riskier than (and had a higher yield than) the $1 billion collection of CDO equity that Magnetar had held before Tigris. That is very different, however, from saying that *Magnetar itself* was exposed to more (or the same amount of) risk before and after. By cashing out of the "top half" of the equity, Magnetar dramatically reduced its exposure to CDO equity – the long side of its CDO strategy.

"rigorous upfront credit and structural analysis" of each asset, that it "perform[ed] a thorough bottom/up credit and structural analysis to identify individual investments," and that it employed a "collaborative, methodical, and disciplined investment process."

At closing, among other things: (1) Harding entered into a CMA with a Cayman Islands SPV (the CDO's "Issuer"); (2) the Issuer, advised by Harding, acquired the warehoused assets, and (3) the Issuer issued securities to investors. Respondents represented in the CMA that Harding would discharge its duties as CDO manager "with reasonable care . . . and . . . in a manner consistent with the customary standards, policies and procedures followed by institutional managers of national standing." Div. Ex. 4 at 8. This representation was repeated to investors via offering circulars distributed in August and September 2006.

B. Engagement Letter and Warehouse Agreement

Chau, on behalf of Harding,[36] executed a May 26, 2006 engagement letter (Answer ¶ 24; Div. Ex. 24; *see also* Wang Tr. 395:2-5) with Merrill Lynch and Magnetar pursuant to which Harding agreed to manage, and Merrill Lynch agreed to structure and market, the CDO.[37] Magnetar committed to buy the CDO's equity. Div. Ex. 24 at 5. Engagement letters were usually between the manager and the underwriter; the one for Octans I was therefore unusual insofar as Magnetar was a party. Wang Tr. 391:10-21, 394:11-25.

Harding, Merrill, and Magnetar also entered into a May 26, 2006 warehouse agreement. Div. Ex. 5[38]; *see also* Answer ¶ 27. Harding's usual warehouse agreements were simply between

[36] In May 2006, Chau's group was still at Maxim. As discussed above (*see* section I.A.), this brief uses the term "Harding" to refer collectively to Maxim and Harding Advisory.

[37] Wang testified that the purpose of an engagement letter was to appoint Harding to select collateral for a CDO that would be formed. Wang Tr. 391:25-393:10.

[38] Though unsigned, Div. Ex. 5 represents the correct version of the warehouse agreement. *See* Tr. 409:10 – 410:15. The executed signature pages are contained in Resp. Ex. 124.

the manager and the arranger. Wang Tr. 395:17-24, 400:21 – 401:7.[39] This was the first time in Harding's experience that a party other than Harding and the underwriter had warehouse rights. Wang Tr. 407:24 – 408:10. The Octans I warehouse agreement gave Magnetar – which would bear 85% of the risk and potential reward associated with warehousing the assets – important control rights relating to the acquisition of assets, including the right to reject, *i.e.*, veto, assets selected by the manager for inclusion in the portfolio. Div. Ex. 5; Wang Tr. 404:6-405:19 (Magnetar was a "warehouser" for Octans I with exposure to risk and reward), 406:11 – 407:14 (prior testimony that in the Octans I warehouse, Magnetar "had the same role as the underwriter"), 407:15-23 (Magnetar had "the ability to veto selections" for Octans I).[40]

---

[39] For a general description of a CDO warehouse, see Wagner Report ¶ 25.

[40] Section 3(A) of that agreement sets forth Magnetar's veto right applicable to acquisition of synthetic assets (Div. Ex. 5 at 3 (emphasis added)):

> During the Accumulation Period, the Collateral Manager [*i.e.*, Harding] will identify Reference Obligations [*i.e.*, assets to be acquired synthetically] . . . for possible inclusion in the [Octans I] Portfolio and provide a list of each Reference Obligation . . . to Dealer and Magnetar. *Dealer [i.e., Merrill] will have the right* in its sole discretion *to enter into a Credit Default Swap . . . with respect to any Reference Obligation identified by the Collateral Manager, unless Magnetar notifies Dealer and the Collateral Manager within one Business Day after receiving such notice from the Collateral Manager that it objects to the inclusion of such Reference Obligation in the Warehouse Portfolio.*

This paragraph is clear: Harding selects RMBS, and then Merrill has the option to enter into a CDS on those RMBS, *unless* Magnetar registers its objection, in which case Merrill has no such option – plainly a right on the part of Magnetar to override the manager's selections. Wang, who actually advised Chau on the document, agreed that this paragraph "reflects Magnetar's veto right." Wang Tr. 411:4-9. (Section 2, on cash securities as opposed to synthetics, also unambiguously conditions Merrill's "obligation to acquire any [asset] for inclusion in the Warehouse Account" on Merrill "not hav[ing] received notice from Magnetar . . . . that Magnetar objects to the inclusion of such [asset] therein." Div. Ex. 5 at 2-3, § 2(D)(2)(ii).) Chau's relatively recent suggestion that the agreement gave Magnetar a right to "object" to, but not "veto," Harding's selections (although even Chau could not explain the difference or why it would matter, *see* Chau Tr. 1804:4-11) is contradicted by his own prior testimony (*see* Chau Tr. 1801:8-21), by three different witnesses who testified without contradiction that a party at risk on a warehouse would normally be expected to have a right to approve assets in the warehouse (Wagner Tr. 4640:20-4641:6; Huang Tr. 1269:5-16, 1271:6-10; Doiron Tr. 2038:9-16), and even by Respondents' Pre-Hearing Brief (page 11, first full paragraph).

Chau executed the warehouse agreement, Resp. Ex. 124, and has previously acknowledged reviewing it, Chau Tr. 1798:12-1799:3.[41] And yet he testified in 2008 that he would never have granted Magnetar a veto over collateral selection precisely because "we would be ceding our management authority to a third party" and "I pride myself as being a very independent asset management company . . ." Chau Tr. 1819:12 – 1821:20.[42] Similarly, Huang testified that a veto right gives a party influence over what goes into a warehouse. Huang Tr. 728:12-729:7, 735:25-737:4.

Magnetar's warehouse involvement and rights were never disclosed to investors. The pitchbook for Octans I disclosed that the warehoused assets "will be purchased from a portfolio of securities held by an affiliate of Merrill Lynch pursuant to *a warehousing agreement between such affiliate of Merrill Lynch and the Collateral Manager*." Div. Ex. 1 at 32 (emphasis added). In other words, the warehouse was mentioned, but one of the parties to it was omitted, leaving investors in the dark about the involvement of a party with a distinct set of tactical motivations. The offering memorandums contained a similar misstatement. Div. Ex. 3 at 66.

[41] Wang testified that her practice was to send Chau warehouse agreements for his review before he signed them, as well as to discuss warehouse agreements with him. Wang Tr. 395:25 – 397:23, 401:25 – 402:18; *see also* Wang Tr. 398:17- 400:7.

[42] Chau's attempt to avoid the implications of his previous testimony was unconvincing. After being confronted with the 2008 testimony, he later volunteered, after the questioning had moved on to a different topic, that "he made an error" in the 2008 testimony and that he had been referring exclusively to a veto post-closing, as opposed to pre-closing. Chau Tr. 1831:10-1833:11. Setting aside that the prior testimony has no such indication, it is undisputed that the bulk of a CDO portfolio is ramped pre-closing; impairment of a manager's independence would therefore have a far more significant impact on the portfolio pre-closing than post-closing.

C. Magnetar's Involvement

Magnetar was, according to Huang, more actively involved in the Octans I ramp than any other investor in any of Harding's CDOs. Huang Tr. 824:20-825:11, 995:20-996:18.[43] Huang acknowledged, too, that he was "maybe a little uncomfortable" with Magnetar's "amount of involvement," which Huang "just wasn't used to," Huang Tr. 1227:24-1228:15.

Consistent with the warehouse agreement, Prusko made sure that Harding ran by him its proposed acquisitions for Octans I – or "the Magnetar deal," as it was initially known. *See* Wang Tr. 419:2-5, 423:2-12, 425:13 – 426:7. On May 30, 2006 at 11:36 a.m., Wang asked Merrill Lynch's Sharon Eliran,[44] with a cc to Chau: "Are we ready to open the warehouse for the Magnetar deal? Sounded like Prusko wanted to see all the names first." Div. Ex. 25.[45] At about the same time, Wang wrote to Prusko, with a cc to Chau and Huang (Div. Ex. 28):

> Now that we have the documents signed up, we just wanted to touch base with you regarding process. It sounds like you want us to send you a copy of our bid lists for your review prior to sending it to the street. If so, should we send the lists to you or someone else at Magnetar?
>
> Please let me know how you would like this to work.

[43] Huang also testified that the Octans series was unusual in that he knew who the equity investor was. Huang Tr. 995:9-13.

[44] Eliran was a CDO banker. Lasch Tr. 163:6-9.

[45] Paragraph 1 of the parties' March 24, 2014 stipulation (the "Time Stamp Stip"), in conjunction with the Division's March 3, 2014 Exhibit List, identifies the correct time in Eastern Daylight Time (EDT) for the email headers in Div. Exs. 25 through 83. Many of the emails in this range were processed with a four-hour offset. For example, the time in the header of Div. Ex. 25 reads "3:36 p.m."; the actual time in EDT was 11:36 a.m. Unless otherwise specified, this brief relies on the Time Stamp Stip in citing the time of the top-most email in Division Exhibits 25 through 83.

Prusko replied, at 12:51 p.m., with a cc to Chau and Huang: "Yes, that would be great. Please send the lists to me. Also, would like to talk frequently so I'm up to date on your plan of action, how things are going, etc." Div. Ex. 28.[46]

Wang first sent Prusko a bidlist[47] on May 30, 2006 at 5:45 p.m. Cc'ing "MaximCDO,"[48] she wrote: "Attached please find a list of names we'd like to circulate . . . . Please let us know what you think." Div. Ex. 37 at 2. *See also* Wang Tr. 434:2-436:21. Prusko then asked questions about Harding's plans for circulating bidlists, which Wang answered. At 8:25 p.m. that night, Prusko instructed Wang, with a cc to Chau and Huang, to remove constituents of the ABX Index from the list: "We're going to do a big block trade of the index names, so please leave them off of any other lists you do." Div. Ex. 37 at 1; Div. Ex. 38 (spreadsheet with Index bonds highlighted by Prusko). In other words, the Index trade (discussed in detail below) was planned – without Wang's knowledge[49] – and since some of the bonds on Harding's list overlapped with the Index, Prusko wanted to avoid duplication. Wang complied with Prusko's request. Div. Ex. 42; Div. Ex. 50 at 1; Wang Tr. 446:25-447:10.

---

[46] Wang testified that to the extent Prusko was kept "up to date," it was by Chau or Huang, not herself. Wang Tr. 430:4-431:9.

[47] Because the instruments at issue were synthetic, to go long a particular RMBS, the Octans I CDO would *sell* "protection" on that asset under a CDS. In order to enter into such a CDS, Harding needed to find a counterparty who was willing to *buy* protection. Harding therefore circulated "BWIC" (short for Bids Wanted in Competition) lists in order to solicit bids for the purchase of protection. The opposite of a BWIC is an "OWIC" (Offers Wanted in Competition), which is circulated by a party who is willing to buy protection (*i.e.*, short), and which Harding could respond to in order to go "long" a bond. *See, e.g.*, Answer ¶ 17(iv), (v), (vi), (vii); Lasch Tr. 206:10-207:4; Lieu Tr. 3295:21-3296:6.

[48] Everyone in the CDO group at Maxim – including Chau, Huang, Wang, and the analysts – received emails sent to MaximCDO. Wang Tr. 432:17-433:10.

[49] *See also* Div. Ex. 50 at 1-2 (Wang misunderstands Prusko's reference at 10:51 a.m. on May 31, 2006 to "index names you want to exclude"); Div. Ex. 48 (Wang asks Chau and Huang at 10:56 a.m.: "What does this mean?"); Wang Tr. 444:14-25.

Wang shared with Prusko the results of the initial bidlist, and sent to him, obtained his approval for, and shared with him the results of, additional bidlists used to ramp Octans I. Div. Exs. 75, 85, 114, 115, 117, 118. Wang's emails were typically cc'ed to Chau and Huang, or to MaximCDO.

D. Magnetar Pushes for Index Exposure

Magnetar was seeking to have its CDOs acquire exposure to the ABX Index. Lasch Tr. 147:23 – 148:10, 163:20 – 164:4.[50] By way of background, investors generally did not want the Index included in a CDO's portfolio in part because they could source it directly, as Chau and Huang have explained.[51] In addition, the rating agencies, whose rating was needed to sell CDO securities, tended to prohibit CDO vehicles from buying the Index directly. Wagner Tr. 4708:3-6. Chau, moreover, has previously testified to an understanding that investors would prefer to see *fewer individual Index bonds* – not just the Index in a block – in a transaction. Chau Tr. 4401:5-4402:6 (explaining the email now marked Div. Ex. 275: "some investors would have some preferences of *not having too many index names or less index names*.").[52] Similarly, Huang acknowledged that the distinction between buying the Index in a block – *i.e.*, acquiring exposure

---

[50] *See also* Div Ex. 252 (Prusko urging Index in another Merrill-Magnetar CDO), Div. Ex. 131 (same).

[51] *See* Huang Tr. 795:9-19, 796:6-12, 797:15 – 798:22 (prior testimony: "no investor wants to pay asset managers of any type to buy index . . . people don't want you to buy it because they can buy it themselves"); Chau Tr. 2125:14-2129:15, 2135:9-2136:5 (prior testimony: "I think the general theme was, you know, why should we as an investor pay you to buy an index?", "if I am just buying the total index they could do that themselves so why pay me a management fee?"); Div. Ex. 275 (Chau's response to Prusko's suggestion to "buy the extra index": "need to check with the structurers and syndicate as to how much index before investors balk").

[52] Chau's testimony at the hearing that "investors do prefer exposure to individual names within that index," Chau Tr. 2133:8-9, is simply not credible. In addition to his prior testimony, there is also evidence that Chau wanted to – and did – "exclude index trades" from lists of Octans I and II trades shown to FGIC, Div. Ex. 158; Resp. Ex. 827, which was a potential investor in the super-senior tranche of Octans I, *see* Div. Ex. 258 at 2.

to all 20 constituent bonds – and buying exposure to *most* of the bonds (for example, 19) is simply "a question of degree," Huang Tr. 798:25-799:13.

Nevertheless, beginning in late May 2006, Magnetar's Prusko pushed Merrill Lynch and then Harding to buy the 2006-1 Index for Octans I. Initially, there was no discussion of excluding bonds – Magnetar clearly wanted the portfolio exposed to the entire Index.[53] On May 22, 2006, Prusko asked Merrill Lynch:

> With things soft would be great to really start ramping . . . . A question on ramping . . . with ABX BBB- pretty wide vs single name and cash, *can you put it [i.e., the Index itself] in warehouse directly* or will ML intermediate, sell ABX then buy single name from warehouse? . . . .seems like would be a good idea to get size quickly.

Div. Ex. 18 at 1 (emphasis added); *see also* Lasch Tr.165:9-13, 166:18-167:2. Early the next morning, Lasch informed Prusko that Merrill trader Charles Sorrentino "is ok to out [*i.e.*, put] *the index itself* in the warehouse." Div. Ex. 20 (emphasis added); Lasch Tr. 167:14-168:13. Later that day, Prusko boasted to his supervisor that a recent call with Merrill:

> will have gone well if they actually buy something, they seemed amenable to the idea. You would have laughed at me explaining to three senior wall street traders/structurers: "ML buys $400 ABX BBB-, ML then buys protection on $20 *each of the 20 underlying names* from warehouse . . . ."

Div. Ex. 19 at 1 (emphasis added). Prusko acknowledged that this email "is just referring to the mechanics of disassembling the index into its component parts" and does not refer to the manager excluding bonds. Prusko Tr. 2735:18-2736:4.

On May 23 and 24, Prusko kept up the pressure on Merrill Lynch: "Let's buy some index!" and "ABX opening weaker, lets do call, BUY!!!" Div. Ex. 21; *see also* Lasch Tr.169:22-

[53] The exact mechanism (*i.e.*, (a) putting the Index CDS in the warehouse directly, as opposed to (b) Merrill selling protection on the block Index CDS outside the warehouse and then buying protection on the 20 individual bonds from the warehouse, resulting in the warehouse being long all 20 bonds individually) had not been determined.

170:2. Harding was not party to these communications, and at no point in any of them did anyone acknowledge that asset selection was the *manager*'s prerogative, or that the manager might not want to buy the Index. Nevertheless, on May 25, Prusko apparently separately discussed his interest in the Index with Chau, who seems to have been willing to do what Prusko wanted: acquire the *entire* Index and disassemble it into the underlying components, all of which would go into Octans I. Div. Ex. 23 (May 26, 2006 email from Lasch to CDO co-head DeSilva: "[Prusko] said he talked to wing yesterday and in ramping, *they both would like to buy a chunk of the index and buy protection on the underlyings against it from the deal*." (emphasis added)).

E. <u>"We'll Push To Get Names They Have Issue With"</u>

On the afternoon of May 30, 2006, Prusko and representatives of Merrill Lynch had a telephone call to discuss the Index trade. Prusko again explained the mechanics, and then the participants conferenced in Huang. (Huang testified that Chau was aware of this call. Huang Tr. 843:18-844:6, 846:2-19, 847:16-848:10.) Prusko described the call to his supervisor in an email at or about 5:19 p.m.[54] titled "painful day":

> Remember last ML call I sent you email about how funny it was that I had to explain the index arb to everyone.
>
> Not as funny the second time. Had to go thru it from scratch. *Then we got Maxim on the phone to have them <u>check if they wanted to exclude any names</u>*, and I had to explain to this Charles guy [*i.e.*, Charles Sorrentino] how that would work. I need one of those cricket bats like the manager had in Spinal Tap.

[54] The time stamp reads 4:19 p.m., but Magnetar was based near Chicago, *see* Prusko Tr. 2371:2-7, *i.e.*, in the Central Time zone, and the context makes 5:19 more plausible.

Div. Ex. 31 (emphasis added). Prusko also wrote to Lasch at 5:23 p.m.: "Tony at Maxim will let us know *if any names he wants to exclude*, then we should be good to go. *Let's stay on top of this*." Div. Ex. 33 (emphasis added).[55]

The parties, in other words, discussed acquiring *all* of the Index *except* for any Index bonds that Harding might want to exclude. Huang Tr. 833:15-835:16, 848:19-849:15; Lasch Tr. 171:21-172:4. At 5:40 p.m., Lasch, who had listened in to the call, promised Prusko that Merrill would "*push to get names they [i.e., Harding] have issue with [i.e., want excluded from the Index exposure] tomorrow am*." Div. Ex. 33 (emphasis added); Lasch Tr. 173:3-9.

The next day, May 31, 2006, Prusko and Lasch kept pressing Huang and Chau to deliver the excluded names, and Huang said that Harding would report back soon. At 9:30 a.m., Prusko wrote to Lasch: "*Lets stay on top of ABX thing today, would like to get some off*." Div. Ex. 45 (emphasis added). Four minutes later, Lasch replied: "was Tony going to come back to you on the names he had issue with?" Div. Ex. 45; *see also* Lasch Tr. 174:23-175:8, 176:4- 177:10. Seven minutes after that, Prusko emailed Huang, with a cc to Chau: "you have abx names that you want out, ready to trade?" Div. Ex. 46; Huang Tr. 877:22-878:8. At 10:51 a.m., Prusko wrote to Wang, with a cc to Chau and Huang: "We good on the index names you want to exclude? Div. Ex. 50 at 2. At 11:24 a.m., Prusko repeated and clarified: "For our block index trade, u guys were going to let us know *if there were any* of the 20 index names you wanted to exclude, we had a call w tony and charles from ml last nite." Div. Ex. 50 at 1 (emphasis added). At 11:40 a.m., Huang assured Prusko, cc'ing Chau and Wang: "Yes, we should have these names

[55] Prusko added: "I still don't have spreadsheet with current warehouse assets, would really like that tonite." Div. Ex. 33. Three minutes later, Prusko wrote to Huang: "T, u have spreadsheet with current warehouse/trade log? thanks, Jim." Div. Ex. 32.

to you and Charles soon. Wing and I just got back from a meeting away from the office this morning." Div. Ex. 50 at 1.

As the hours passed, Merrill and Magnetar continued to demand the list of exclusions. At 1:07 p.m., Lasch followed up with Prusko: "did you hear back from Tony?" and Prusko responded: "Yes, but he hasn't given us names yet, still waiting. Have to go to meeting, *please stay in front of Tony and Charles for me on this. Would really like to get started at least today.*" Div. Ex. 51 (emphasis added); *see also* Lasch Tr. 178:22-179:5. Lasch then asked banker Eliran: "hey, can we nudge tony for the names he doesnt want in? seemed like it should be pretty easy to identify. Jim [Prusko] and [Magnetar partner] Dave [Snyderman] will be totally psyched to get some done today." Div. Ex. 55; Lasch Tr. 179:25-180:20, 181:2-11. At some point, possibly right after these messages,[56] Eliran sent a Bloomberg message to Huang: "Regarding Magnetar, *are there names* that you don't want in the deal? *Magnetar is looking to get some of the CDS done today.*" Resp. Ex. 343 (emphasis added). The urgency of these communications is obvious, then and now.[57]

F. Harding Delivers the ABX Exclusions

At issue were two different rating levels of the 2006-1 version of the Index: Baa2 (BBB) and Baa3 (BBB-), making 40 assets in all (20 at each of the two rating levels). It is clear that Magnetar wanted as many components from the Index as possible to be included in (*i.e.*, as few as possible to be excluded from) its CDOs, even though Magnetar did not care about the quality

[56] The parties agreed that the 8:38 time stamp on Resp. Ex. 343 should be 4:38 p.m., Tr. 869:12-13, but that time stamp is for Huang's reply to Eliran. The exhibit does not specify when Eliran sent the initial message to Huang.

[57] *E.g.*, Lasch Tr. 203:20-23 (agreeing that the emails "reflected a certain urgency"); Huang Tr. 1049:16-21 ("as you can see from those emails and Bloomberg messages, they [*i.e.*, Magnetar] were very active, very involved, they wanted to push this thing").

of any of them. Prusko essentially acknowledged this at the hearing. Prusko Tr. 2446:10-17, 2465:16-2466:4. This approach is to be contrasted with that of investors counting on the manager to use its judgment to vet bonds and include only those of the highest quality, subject to the transaction criteria. At one point Prusko even wrote to Merrill Lynch, in connection with the Norma transaction: "Need to be aggressive in doing the index arb trades on ABX 1 and 2 right out of the gate. *Have to push the managers to use as many bonds as possible out of the indices.*" Div. Ex. 131 (emphasis added); *see also* Prusko Tr. 2746:16-21.

Respondents understood that Magnetar wanted to maximize the number of Index bonds. Huang has previously testified that "ideally they [*i.e.*, Magnetar] want Harding analysts to be okay with all the names in the index," and "if you are asking whether Magnetar wants more [Index] names, yes. They would prefer more names." Huang Tr. 786:7-21, 787:14-788:3; *see also id.* at 781:18-782:10. As analyst Moy later wrote to her co-workers: "we had to pick the lesser of evils when we were looking at the index." Div. Ex. 156 at 2; *see also id.* at 1 ("we knew we had to pick the less worse.").

Respondents also understood that Magnetar saw the Index as a way of ramping quickly. Huang Tr. 830:9-831:10 (prior testimony: "at that time, frankly, I thought they wanted the index because you can ramp up the deal faster."), 1267:2-3 ("ABX certainly provided – allowed us to ramp up the deal more quickly."). Respondents were right: in Prusko's own words, the Index was a way "to get size quickly," Div. Ex. 18 at 1. As Respondents' counsel put it at the hearing: "Magnetar wanted to do an index trade to ramp quickly so [Harding] looked to the index assets and they chose some." Tr. 3524:1-3. Huang testified that a fast ramp would be in the interest of the pre-committed parties – Magnetar, Merrill Lynch, and Harding – although not necessarily in the interest of other investors. Huang Tr. 825:16-826:24. Chau boasted to Prusko how quickly

Harding ramped its transactions, Resp. Ex. 861 (Chau to Prusko, disparaging a competitor: "Slow rampers. Stick w/Harding, we get the job done right!"), even though ordinary debt investors had nothing to gain from Harding forgoing the type of deliberate and methodical asset selection promised in its marketing materials.

And Respondents understood that the liquidity of the Index would likely assist Magnetar with its hedging. Huang Tr. 781:6-12 ("if you have the strategy that I suspect they had, then liquidity is one of the most important factors.").[58] In any event, Huang understood that to a "correlation" trader like Magnetar (as opposed to ordinary debt investors), the credit quality of any particular Index bond was irrelevant.[59] Magnetar's only interest, in other words, was in having the CDOs acquiring significant exposure to the Index; the exact exclusions were unimportant, so long as there were not too many of them.[60]

At Harding, the task of identifying the exclusions was given to analyst Lieu, who testified that Chau had discussed the trade with her. Lieu Tr. 3355:14-22, 3402:11-3403:25. The evening of May 30, at 5:49 p.m. (after the three-way telephone call), Huang forwarded to Lieu the full list of bonds in the Index. Div. Ex. 36; Huang Tr. 853:19-855:15. Less than 23 hours later, at 4:23

[58] According to Huang, CDS on individual Index-constituent bonds are more liquid, Tr. 794:17-795:2, but the Division's expert Richard Ellson disputed that. Ellson Tr. 1185:19-1186:9.

[59] Huang Tr. 1202:24-1203:8 ("My personal view, this is more of a correlation trade. The credit quality is not the key issue from anybody."), 1410:15-1411:4 ("Let me correct that. . . . I meant to say yesterday the credit quality shouldn't be relevant to Magnetar."), 1411:5-12 (credit quality would matter to other investors).

[60] Prusko testified that Magnetar wanted Index exposure in order to obtain the benefits of an "arbitrage" between (i) the more advantageous price, or spread, of the block Index and (ii) the average of the various prices or spreads of its 20 component bonds. Prusko Tr. 2438:14-2439:23. However, this "arbitrage" was clearly not the driver of Magnetar's interest in Index exposure, as shown, for example, by the fact that *Prusko specifically wanted Index bonds in Octans III, even though by that time the price arbitrage was concededly no longer available*. Compare Div. Ex. 152 (Prusko asking Chau and Huang for their Index selections, and then orchestrating trading in Index bonds for Octans III) *with* Chau Tr. 4293:16-4294:2 ("Index arbitrage" not available by the time of Octans III). In any event, regardless of *Magnetar's* true motives, the "Index arbitrage" cannot possibly have been a valid basis for *Harding's* selections, as discussed further in section V.I. below.

p.m. on May 31, Lieu delivered back to Huang a list of twelve "ABX Index rejections" from the 40 – four rejections at the Baa2 (BBB) level and eight at the Baa3 (BBB-) level. Div. Exs. 70, 71, 72; Huang Tr. 852:12-853:12. Fifteen minutes later, Huang, without review, forwarded the twelve exclusions to Merrill's Eliran. Resp. Ex. 343 & Tr. 869:12-13 (stipulation on time); Huang Tr. 870:17-872:18.[61]

The subtraction of twelve represented a decision to commit the Octans I CDO to invest in the remaining 28 bonds (sixteen at the higher level, twelve at the lower level) – ultimately a $220 million purchase accounting for 15% of the Octans I portfolio. Huang Tr. 872:19-873:5, 878:4-13. As Respondents wrote in a "white paper" provided to the Division before this case was filed: "Jung Lieu's May 31, 2006 'ABX index rejections' list . . . perfectly conforms to the trade as it was executed a week later . . . . *Harding's ultimate purchase decision[] . . . was finalized as of the evening of May 31.*" Div. Ex. 5001 (Respondents' white paper)[62] at 39 (emphasis added); Chau Tr. 4443:15-22.

G. <u>**"We are less comfortable with some of these index names . . ."**</u>

Lieu's review is discussed in section VI. below. Harding's communications the next morning make clear that Lieu was not entirely comfortable with all of the 28 bonds, and that Chau and Huang knew it. On June 1, 2006, Huang wrote to Chau and Wang in an email titled "Magnetar index trade": "we should push them [meaning Merrill or Magnetar] to short the Baa2's [*i.e.*, cause the deal to go long] since *we are less comfortable with some of these index names at the Baa3 level.*" Div. Ex. 81 (emphasis added); Huang Tr. 900:6-903:15. Later that morning, Huang wrote to Prusko: "Sent Sharon the list yesterday. Don't know if you've got it, so

[61] At 4:58 p.m., Eliran copied Huang's message over to Prusko and Lasch. *See* Div. Ex. 74.

[62] Chau testified that he reviewed the white paper before it was submitted. Chau Tr. 2144:19-2146:20.

here it is again. We can do $15mm each issuer (Baa2 and Baa3 together) *and prefer the Baa2's.*" Div. Ex. 82 (emphasis added). Huang testified unambiguously that these emails reflected the views of Lieu, since he did no analysis of his own. Huang Tr. 881:4-882:7, 1337:22-1338:11, 1341:6-8. There is no evidence that Chau raised concerns about investing in bonds with which his analyst was "less comfortable."

Harding's investment decision is troubling in other ways (in addition to those relating to Lieu's work, discussed in detail below). For instance, neither Huang nor any other portfolio manager meaningfully reviewed Lieu's selections. Huang Tr. 872:15-18, 882:8-11, 882:19-20 ("as you can tell, I just passed that list along.").[63] In addition, Huang knew that Lieu's selections included many bonds in a category that he himself believed to be inferior, namely "dealer shelves." Dealer shelves are RMBS issued by an entity affiliated with an investment bank. The Index consisted predominantly of them. Huang Tr. 799:15-802:7, 804:20-805:6, 806:20-808:3 (prior testimony: "If you look at the index it is basically bank shelves."). Huang disfavored dealer shelves (Tr. 812:24-814:16):

> *Based on my experience, dealer shelves are a little worse. . . . [B]ack then the dealer shelves it is my view and I am sure other people's views, that the dealer shelves are worse* because they tend to get a little bit worse collaterals from the underwriters. They extract certain other things from these deals – *I mean everything else being equal, personally I would prefer non-dealer shelf than dealer shelf.*

[63] Chau has previously testified: "I imagine Tony and Jung Lieu would discuss her decisions" and "Tony Huang must have sat down with her. . . . They decided that this was the appropriate list." Chau Tr. 4413:1-2, 4419:16-19. This testimony cannot be taken at face value. Huang essentially testified that meaningful review (as opposed to rubber-stamping) of RMBS selections was not part of his job description. *See* footnote 64, *infra*. Chau cannot possibly have thought that Huang and Lieu actually had a substantive conversation about the selections. Rather, the prior testimony shows that Chau knew what *should* have happened – namely, the portfolio manager should have had a substantive discussion with the analyst. *See* Wagner Report at 3 (Ops. II(a)(vi), (vii)); section VIII.C. below.

And yet, Huang gave no thought to the fact that the 28 bonds selected by Lieu included many dealer shelves. Huang Tr. 882:12-17, 882:23-883:3, 883:13-885:4.[64]

H. Execution of the Index Trade

Prusko kept up the pressure on June 1.[65] That afternoon, he prodded Eliran: "So what's up?" He then suggested a phone call with Chau and Sorrentino, and complained privately to Snyderman: "Really in the hand holding business! . . . I have to initiate each baby step of the process [for the index trade]. Hope I don't have to explain trade again." Div. Ex. 83. At 3:40 p.m. (19:40 GMT), Prusko complained to Lasch: "trying to get Charles [Sorrentino] to do index trade, slow going." Div. Ex. 86. At 4:14 p.m.,[66] Eliran sent Prusko, Chau, and Huang dial-in information for a 4:15 p.m. call. Div. Ex. 87.

On June 2, Merrill asked Prusko to authorize the Index trade. Without copying anyone at Harding, Lasch wrote to Prusko: "I think we are all set to go in terms of the index. . . . You are ok for us to move on that and start buying some index correct? . . . . just let us know if all sounds good to you to go ahead." Prusko replied "Sounds good" and added, referring to the anticipated purchase of Baa3 (BBB-) Index, that he would "want to move some of mine over." Div. Ex. 89.

---

[64] Despite being held out as Harding's number-two portfolio manager, and despite the fact that most of the collateral in Octans I and other Harding CDOs consisted of RMBS, and despite the fact that Huang actually had well-thought-out views and preferences regarding RMBS, Huang's job description apparently did not include meaningful review of RMBS selections. *E.g.*, Huang Tr. 862:5-18, 863:9-16, 980:14-18, 981:2-4, 1047:22 – 1048:6 ("I am not the one selecting any names. *I may have certain views, I prefer certain things, but I wasn't involved in that market at that time.*"), 1421:2-14, 1256:23-1257:9. This was a clear breach of the standard of care, as discussed below in section VIII.A.

[65] Chau had clearly been in the office May 31, *see, e.g.*, Div. Ex. 50, and was also at work June 1. At 9:35 a.m., he wrote to Prusko: "Hi Jim, back in the saddle, Lets chat this am when u r free." Div. Ex. 88. (This exhibit is not covered by the Time Stamp Stip, but the content of the messages makes clear that it was sent before 10 a.m. – that is, at 9:35 a.m. rather than 1:35 p.m.) *See also* Div. Ex. 83 at 1 (Eliran on June 1, 2006: "I saw Wing today in our office").

[66] This email is not covered by the Time Stamp Stip, but the content makes plain that the correct time is 4:14 p.m., not 8:14 p.m.

Only later that day did Prusko advise Chau: "Would like to pass over my BBB- index if u have any left to do." Resp. Ex. 785 at 1.

The Index trading took place on or about June 8, 2006. When it was finished, the Octans I warehouse had acquired $10 million of exposure to each of the sixteen non-rejected Baa2 bonds ($160 million in total exposure) and $5 million of exposure to the twelve non-rejected Baa3 bonds ($60 million in total exposure).[67]

The mechanics were as follows: Merrill, outside the warehouse, acquired $200 million of block Baa2 Index and bought protection from the Octans I warehouse on $10 million of each of the sixteen non-rejected Baa2 bonds. Similarly, Merrill, outside the warehouse, went long $100 million of block Baa3 Index – $70 million of which came from Magnetar, as Prusko had wanted[68] – and bought protection from the Octans I warehouse on $5 million of each of the twelve non-rejected Baa3 bonds. The warehouse was thus left long 28 Index bonds. Separately, Merrill itself "hedge[d] the other names out," in other words neutralized its exposure to the Harding-rejected bonds by shorting them elsewhere in separate transactions. Resp. Ex. 384 (Prusko describing mechanics in June 15, 2006 8:11 p.m. email); Div. Ex. 6A; Div. Ex. 95. As Chau has admitted, Magnetar controlled the execution of the trade. Chau Tr. 2158:21-2159:5 (prior testimony: "everyone agreed that Magnetar would execute the ABX index").

---

[67] *See* Div. Ex. 6A (extract from Harding trade blotter); Smith Tr. 2201:10-2203:21; Div. Ex. 186A; Smith Tr. 2204:10-2206:21.

[68] *See* Div. Ex. 273 (June 6, 2006 email from Lasch to Prusko: "they will take your 70mm Baa3 into the deal . . ."; Prusko's reply: "very good, apprec[iate] that."); Div. Ex. 274 (June 6, 2006 email from Lasch to Snyderman: "We took jim's 70mm baa3 into the deal today and with everything else we've ramped ...we're at 1.15b.") & Lasch Tr. 185:3-23, 204:22-25; Prusko Tr. 2451:4-12, 2463:21-25 (explaining novation); Div. Exs. 107, 108, 109 (trade confirmations for $70 million total novations); Smith Tr. 2207:22-2212:12; *see also* Div. Ex. 5001 at 40 (Respondents' white paper: "Magnetar acted as the counterparty in the trade.").

Prusko reported to Snyderman on the Index trading in a June 6, 2006 email titled "ML Index thing went so well I can't take it." Resp. Ex. 889. (At that time Prusko believed Octans I would be priced in the "next 2-3 weeks." *Id.*) In a June 15 email to another collateral manager, Prusko left no doubt who had driven the entire process: "Last deal [*i.e.*, Octans I], _we had ML_ buy Baa3 and Baa2 ABX and then simultaneously buy protection from deal on names that the manager liked." Resp. Ex. 384 (emphasis added).

I. **The Claim of Enhanced Spread**

Respondents have argued that the Index trade conferred spread (income) benefit on the deal because the Index was trading wider than its constituent names – the so-called "Index arbitrage." *See, e.g.*, Chau Tr. 2142:3-2143:16. Not only is this claim not valid, it is irrelevant. As to validity: the Index may have been trading wider (cheaper) than individual Index bonds, and the 28 individual CDS may well have gone into the CDO at a spread that, for many or most of them, was facially above-market. *E.g.*, Wagner Tr. 4712:20-24, 4718:2-6. However, as the Division's expert Richard Ellson showed – and he was never rebutted – the CDO was forced to reimburse Merrill for an "upfront premium" associated with the long Index exposure, destroying any economic advantage to the Index trading, and actually *decreasing* the spread otherwise in the CDO. *See* Div. Ex. 8002 (Ellson Report); Div. Ex. 174 (Octans I closing flow of funds report); *see also* footnote 60, *supra*.

More important is the irrelevance of the claim. Respondents have repeatedly insisted that the so-called "arbitrage" method of execution has nothing to do with the investment decision, which is supposed to be independent of it. In their February 2013 "white paper," Respondents argued: "As Mr. Chau explained, *the arbitrage was merely an execution strategy for acquiring assets that the analysts had already determined were appropriate for the portfolio*." Div. Ex.

5001, at 32 (emphasis added). In support, Respondents cited the following prior testimony from Chau: "[T]he ABX arbitrage is an execution discussion. It is not a question of selection discussion." and "***Once we identified the securities that we like,*** the ABX arbitrage is a way we execute that trade . . . ." *Id.* (emphasis Respondents'); Chau Tr. 2144:10-2149:6.

Chau has also previously testified (although at the hearing he claimed not to recall it) that even without the Index "arbitrage," the CDO would likely have acquired the same 28 bonds:

> The ABX arbitrage, the only focus of that is how we executed it, how we source those assets. *So regardless of whether we did the ABX arbitrage or not, we probably would have bought the same names underlying that . . . even if we did not do the ABX arbitrage.* The ABX arbitrage itself was just execution strategy that allowed for an efficient way to get scale.

Chau Tr. 4398:18-4400:3. More telling still, Chau has conceded (although at the hearing he initially claimed not to recall) that *Harding did not analyze the economics of the "arbitrage" before selecting the Index bonds.* Chau Tr. 2151:18-21, 2156:18-2158:13.

The issue in this case is not whether any particular Index component bond could be acquired more cheaply through the more complex block method than on its own, but rather whether Harding, in the first place, properly analyzed and then selected the component bonds in question. Respondents cannot have it both ways: if the selection took place without regard to the so-called arbitrage method of execution, then the latter cannot be used to justify the former. If, on the other hand, the arbitrage benefit really was a motivation for acquiring these particular bonds, then: (i) Chau's prior testimony and written submissions would be false to the extent they claim otherwise; and (ii) Respondents would be conceding that they abdicated to Magnetar their responsibility to independently judge what collateral was best for the transaction, and in what amounts. The idea of ramping with the Index and harvesting any so-called "arbitrage" was obviously Magnetar's, and Magnetar's alone. Harding did not even analyze the economics to see if they justified the trade, let alone compensated for the problematic results of Lieu's review.

J. More Evidence of Compromise: Octans II and III

Respondents had a pattern and practice of pressuring credit analysts to accept more Index bonds, and overruling them when they accepted too few. At Prusko's request, Harding did another Index trade for Octans II.[69] Referring to that trade later, analyst Moy remarked: "due to the fact *we had to pick the lesser of evils when we were looking at the index* we said 'Y' to" a bond known as FFMLT 2006-4. Div. Ex. 156 at 2 (emphasis added). Moy also wrote, after Lieu mentioned a "No" decision on a bond named GSAMP 2006-HE3 M8: "We had it on the index for a 'Maybe' because *we knew we had to pick the less worse.*" *Id.* at 1 (emphasis added). Octans II acquired FFMLT 2006-4 and GSAMP 2006-HE M8 despite the analysts' views. Div. Ex. 214A; Smith Tr. 2212:13-2215:8.

According to Lieu's previous testimony, these emails are a reflection that the analysts were overruled in connection with an Index trade. Lieu nevertheless felt it was important that the records reflect the original credit decision. *See* Lieu Tr. 3360:1 – 3363:5, 3364:17-3373:12. According to Lieu, the credit work should not be any different for an Index bond. Lieu Tr. 3360:1-4, 3369:19-24. Lieu has also testified that she would be concerned about, and strongly oppose, the purchase of a bond that had been rejected on credit, Tr. 3274:9-3275:22, 3276:13-23, even though Chau did in fact sometimes buy bonds rejected by his analysts, Lieu Tr. 3272:11-24.

Prusko also had Harding buy a set of Index bonds in connection with Octans III. Div. Ex. 152 (email chain among Prusko, Huang, Chau re Octans III Index trade); Huang Tr. 938:4-14.

[69] *See* Div. Ex. 127 & Huang Tr. 930:14-19; Div. Ex. 128 (July 28, 2006 email from Prusko to Chau and others: "would like to start [Octans II] with 'index arb' trades"); Div. Ex. 129; Div. Ex. 130.

Prusko completely dominated the execution, making the decision that he would source – in other words, short against the CDO or assign an existing long position on – individual Index bonds, as opposed to the Index being initially acquired in a block. *See* Div. Ex. 152; Huang Tr. 939:18-24, 941:13-942:16, 1412:4-21.[70] The trading included at least three bonds rejected by Harding's chagrined analysts: SAIL 05-HE3 M8,[71] FFML 2006-FF4 M8,[72] and BSABS 2005-HE11 M8.[73] *See also* Div. Ex. 219A; Smith Tr. 2215:21-2218:9 (showing the three bonds in Octans III).[74]

* * *

The evidence shows overwhelmingly that Respondents bought so many Index bonds because that is what Magnetar wanted, and for that reason alone. Huang admitted to his discomfort with Magnetar's approach to the Index bonds (Tr. 954:23-955:24):

> THE COURT: Let me ask you this way. To what extent, if at all, were you troubled by the way Magnetar was approaching the incorporation of the ABX bonds or index into the Octans 1, Octans 2 and Octans 3 CDO's?

---

[70] Chau testified that by this time the "Index arbitrage" was no longer available – which if true means that Magnetar must have had some other reason for wanting to buy Index bonds in quantity. *See* footnote 60, *supra*.

[71] *See* Div. Ex. 164 (Moy to Chau, Chen, Lieu: "We were actually not okay with the collateral in this deal," *i.e.*, SAIL 05-HE3), Div. Ex. 160 (Chen to Chau, Moy, Lieu: "I checked with credit, we're not good on credit, and it's already in Octans 3 as per Prusko trades"), Div. Ex. 162 (Lieu instructing junior analyst to note that the mezzanine tranches of the SAIL deal are "N" and that the comment refers to the deal having "high 90+ LTV," *i.e.*, problematic collateral); Lieu Tr. 3379:17-3380:14.

[72] Div. Ex. 163 (Lieu to Chen and Moy: "Not as bad as I thought. 2 rejected bonds traded with Prusko from the index [*i.e.*, FFML 2006-FF4 M8 and SAIL 2005-HE3 M8]. . . . Xi, to the extent that you can control it, please refrain from letting any index trades happen for Oct 3 AND Lex 3."); Lieu Tr. 3381:21-3383:20.

[73] Div. Ex. 165 (Prusko informing Respondents: "I'm going to assign this [BSABS 2005-HE11 M8]," and deciding price); *id.* (Wang to Lieu: "IS THIS OKAY?"); *id.* (Lieu to Wang: "NO on credit. We passed coz mostly 2 and 3 yr IO terms," *i.e.*, the collateral consisted mostly of interest-only loans); Div. Ex. 166 (Lieu to Chen: "Are we SHORTING these [*i.e.*, the BSABS bond]? It's a rejected bond from the index."); *id.* (Lieu to Chen: "Already told [Chau] our credit stance on this."); Lieu Tr. 3387:18-3391:10.

[74] Respondents have suggested that because Octans III started off as a bespoke trade, Chau was entitled to buy whatever Magnetar and Citi wanted. That argument is meritless, as explained below in section VIII.B.

THE WITNESS: They were certainly a lot more active. Maybe – there is some discomfort in the back of my mind.
THE COURT: And why? Why did you feel that discomfort?
THE WITNESS: Maybe they were just being too active. . . . Some of these things, emails or Bloomberg messages or whatever they are, certainly looking back, does come across as being, you know, sort of a, you know, a little bit too – I am trying to think of the right word to use.
THE COURT: To[o] aggressive? Too invasive[?]
THE WITNESS: A little too – I mean, usually, I would prefer – I would prefer they not ask these things, that there is no – I would prefer they not ask those things or maybe even suggest some of these things.

VI. HARDING'S REVIEW OF THE INDEX SECURITIES FOR OCTANS I

Respondents' behavior in selecting the Index assets is flatly inconsistent with representations that Harding made to investors and the Octans I Issuer about its processes and standards for selecting collateral. At a fundamental level, Respondents had *no basis for buying many of the bonds*. Harding, among other things:

- bought many bonds despite very negative credit analysis;
- did only rudimentary analysis or none at all on a significant volume of bonds;
- rushed through its work; and
- ignored the views of Jamie Moy, who specifically advised against Harding's purchase of some of the bonds that went into Octans I.

In sum, Harding came nowhere close to the methodical, rigorous, disciplined, industry-standard approach that Harding claimed it followed in representations to investors and advisory clients.

A. Jung Lieu Was Not Credible

As a threshold matter, Jung Lieu's lack of credibility was nothing short of astonishing.[75] She was so unreliable that at times, her version of events – and, therefore, Respondents'

[75] She was also biased. Whether from defensiveness because her work is at issue in the case, or from loyalty to Chau (to whom she had been close, *see* Huang Tr. 1036:17-19, 1038:20-21), she consistently displayed inordinate hostility to the Division (with which she refused to meet in preparation for the hearing, Lieu Tr. 3235:13-17) and friendliness towards Respondents' counsel (with whom she

substantive defense of the case[76] – changed literally question by question. That is Lieu's M.O. Huang has testified that when Harding's CDOs were being marketed, Lieu was sometimes "too definitive" in answering investors' questions – to the point that Huang "would kind of like roll my eyes." Huang Tr. 1037:13 – 1039:4. In fact, Lieu's willingness to exaggerate and, when necessary, make things up, was clearly one of the qualities that impressed Chau, who, Huang observed, "kind of liked Jung's aggressive style" and "put her in front of the investors a lot more often" than he did Jamie Moy. Huang Tr. 1038:19 – 20, 1039:4-6. Attached as Appendix 2 is a sampling of points large and small on which Lieu has blatantly contradicted herself – it could easily have been many times longer.

B. <u>Analysis of RMBS – Overview</u>

Lieu testified that Harding's analysis of RMBS entailed a review of collateral characteristics, *i.e.*, the actual characteristics of the loans inside the RMBS trust; surveillance, *i.e.*, reviewing the performance of the loans since the issuance of the RMBS; and cash flows, *i.e.*, testing to see whether securities at a given level in the RMBS capital structure would be impaired under certain assumptions about losses and prepayments in the underlying portfolios of loans.[77] If the bond had been reviewed before, the analysis was supposed to be updated with new performance information and cash flows. Lieu Tr. 3296:10-3297:2; Chau Tr. 2172:22-2173:5.

---

communicated extensively before the hearing, Tr. 3236:25-3237:20). That should be compared to Huang and Wang, whose level of candor and cooperativeness did not vary depending on who was questioning them (and who made themselves equally available to both sides (Wang Tr. 225:24-227:15; Huang Tr. 710:4-10)).

[76] Respondents' counsel, referring to Steven Hilfer's *first* expert report: "Your Honor, I would submit to you that this is probably the most important evidence in this case for the defense." Tr. 37:21-38:4. The first Hilfer report rested on a version of events that Lieu initially supplied the defense but then retracted, resulting also in the de facto retraction of Hilfer's first report. *See* Hilfer Tr. 4950:12-4951:17.

[77] Cash flows are introduced and explained at paragraphs 50 through 53 of Wagner's report.

Lieu's description of the process is generally consistent with industry standards. *Compare* Doiron Tr. 1870:15-1871:8 (explaining HIMCO's analysis of RMBS).[78] To comply with industry standards, moreover, it was necessary, in running cash flows, to apply not just a single "base case," but also "stress cases" using more severe assumptions about losses on the underlying loans. This point was agreed by both sides' fact and expert witnesses.[79] (There is an absolute lack of evidence that more than one case was ever run for the Index bonds.) According to Lieu, if the cash flows projected any write downs, the bond was supposed to be rejected. Lieu Tr. 3335:14-3336:3 (prior testimony).[80] (Thirteen of the 28 accepted Index bonds showed writedowns in the base case. *See* Div. Ex. 53.)

As the evidence repeatedly showed, analysis of RMBS takes time – time that Lieu obviously did not have on May 31. Lieu has previously testified that it would "take about a day to review [a single RMBS bond] in full including collateral plus the cash flow analysis." Tr. 3287:13-3288:14. At the hearing she testified that it could be shorter *provided* she was "already familiar with the originator and servicer and I have all the collateral information that I need from having looked at the deal before." In that case she would simply need to "refresh the

[78] HIMCO is an actual example of an "institutional manager of national standing" – the lodestar for the represented standard of care. *See* Wagner Tr. 4919:4-23 (explaining that "institutional manager of national standing" includes "large insurance companies"); Doiron Tr. 1857:4-1858:8 (describing amount of HIMCO's AUM and size of Hartford Insurance group). Accordingly, Doiron's testimony regarding HIMCO's practices supplements Wagner's testimony regarding what the standard of care required.

[79] Wagner Tr. 4911:11-4914:23 (explaining concepts of base case and stress case), 4583:12-18 (industry-standard RMBS analysis requires "running more than one cash flow"), 4918:6-10 ("there should be stress cases run as part of the standard of care"); Hilfer Tr. 4948:20-24 ("I would start with the collateral loss, and again, I would run some stresses on it. Often investors want to see where bonds break."); Doiron Tr. 1871:17-1872:18, 1873:17-20, 1888:21-1889:4, 1953:22-1954:8 (explaining concepts of base case and stressing; HIMCO ran multiple scenarios and Doiron expected other managers to do the same); Chau Tr. 2174:16-2175:5.

[80] *Compare* Doiron Tr. 1872:19-1873:16 (HIMCO's practice was to reject any bonds that experienced losses in the base case).

performance information . . . plus refresh the cash flow analysis." Tr. 3286:6-3287:1. Lieu testified that this shorter version of review "could be 30 minutes or it could be three hours depending on the bond." Tr. 3287:2-10. Chau has previously testified that if an analyst is unfamiliar with the bond issue, "it could take days," but for RMBS "that are very similar to previous securitizations and originators that they are very familiar with, it could take a matter of hours." Chau Tr. 2168:6-2172:21.[81] (According to Lieu's 2:49 p.m. email on May 31, Harding had previously reviewed 29 of the 40 Index bonds, meaning eleven still required a full review and twenty-nine required at least the shorter version. Div. Ex. 65.)

The lower-rated an RMBS tranche, the more rigorous the credit work should have been. Lieu has previously testified: "if we were reviewing securities at the bottom of the capital structure, which is the BBB and below, we would review a lot more facts." At the hearing she initially refused to acknowledge the truth or plain import of her prior testimony, and, when pressed, testified that "for BBB securities, we might run more cash flow analysis," Tr. 3284:6-3285:18. (Again, there is no evidence that this actually happened.) On May 30, 2006, at 1:02

[81] For comparison, HIMCO's Ken Doiron estimated that HIMCO used between eight and sixteen man hours to analyze each RMBS bond considered for acquisition. Doiron Tr. 1873:21-1874:5. And Wagner opined: "As a general matter, after reviewing the Harding credit process for making investment decisions as stated in the Marketing Book and as elaborated in Chau's testimony, I find it would be impossible for one analyst to carry out the process to review 40 securities from 20 transactions within 24 hours." Wagner Report ¶ 67; Wagner Tr. 4938:22-23 ("I don't think she had enough time."). At the hearing, Wagner at one point mused that, if he was not doing anything else, "I could do it in a day I think," but the surrounding context leaves entirely unclear exactly what Wagner meant by "it": "I think the question is 'it.' It depends on what is required. That is what I tried to say. It depends on what is required. If it is some limited amount of work it would be more able to be done in a day. If it is more extensive work and depending on what has been looked at before it might or might not be done in a day. *It is also, is that the only thing you are asked to do in a day.*" Wagner Tr. 4757:13-25. The examination never clarified just what Wagner thought he could accomplish in a day, and how that compares to the various steps that Chau and Lieu held out to investors and testified about. For instance, Wagner specifically indicated that while *he* would not expect an RMBS's collateral characteristics to change meaningfully month to month, Harding's witnesses testified that the collateral characteristics were re-reviewed – so as to explain the otherwise inexplicable changes from "no" based on collateral characteristics on May 22 to "yes" on May 31, *see* section VI.E. below – and that would take more time. Wagner Tr. 4755:24-4756:11.

p.m., Moy wrote to the "MaximCDO" list, referring to a list of bonds being circulated for possible investment: "Given these are Baa3 bonds, we would need to do the full credit analysis." Div. Ex. 26. (Recall the sentiment that Huang relayed from Lieu to Chau and Wang on June 1: "we are less comfortable with some of these index names at the Baa3 level." Div. Ex. 81.)

Octans I was Harding's first CDO containing synthetic, as opposed to cash, RMBS. *See* Div. Ex. 239. According to Lieu, Chau explained at the outset that synthetics made it possible to buy the best bonds in the universe of RMBS – the limited supply of cash bonds was no longer a constraint. Lieu Tr. 3294:16-3295:3. Huang testified much the same way, explaining that synthetics allow "a greater degree of selection in a sense because then you can go back in history, look at whatever [RMBS] deals you want to source rather than just take a snapshot looking at what is currently available in the market." Huang Tr. 957:12-17. Huang explained, too, that it is preferable for a manager to consider a broader universe of bonds because that provides a greater "opportunity to pick the better bonds." By contrast, being required to work off the Index "would be a severe constraint." Huang Tr. 815:1-18, 818:2-6, 818:22-819:7. In Lieu's telling, Chau made clear there was no constraint on the vintages in Octans I – the analysts could pick whatever they wanted, even bonds from earlier (*i.e.*, generally less risky) vintages. Lieu Tr. 3354:7-3355:1. (All of the bonds in the 2006-1 Index had been issued in the second half of 2005. *See* section II. above.)

C. <u>"No Quick Way"</u>

Potential investors in a CDO, and Harding's analysts themselves, were interested in Harding's acceptance ratio, or "hit rate" – the percentage of bonds that the analysts accepted out of the total they analyzed. A lower ratio meant more discriminating analysts. At the time, Harding's acceptance rate for mezzanine RMBS was about 20%,[82] and this is the number that Harding used in marketing CDOs to investors. Lieu Tr. 3571:22-3572:8. By contrast, the acceptance ratio on the 40 Index bonds for Octans I was 80% at the BBB level and 60% at the BBB- level.

In late May 2006, the volume of OWICs (lists of bonds available for synthetic acquisition, *see, e.g.*, footnote 47, *supra*) reaching Harding was quite heavy. Lieu Tr. 3302:2-13. On May 30 at 12:14 p.m., Lieu wrote to Moy: "oh my god . . .I'm getting mad now . . . we said we'd get back to them by the end of today already, why does everyone keep bugging us? We're working on so many synthetic lists already!!" Div. Ex. 27. Moy agreed, and Lieu added: "they don't understand that there is no 'quick way.'" Div. Ex. 27.

It is not clear who "they" referred to. What is clear is that Lieu was uncomfortable with the volume of bonds she was being asked to process. In this regard it is worth noting another reason that Huang discerned for Chau's preference for Lieu over Moy: "I think the other reason Wing likes Jung a little bit better, maybe a lot better, I don't know, *she is a little quicker in terms of Wing may want: I need ten names, Jung would come up with ten.* Jamie would take longer." Huang Tr. 1037:6-7, 1040:6-1041:19.[83]

---

[82] Div. Ex. 26 (Moy to MaximCDO on May 30 at 12:02 p.m. "On prior lists and on whole, at max, our hit rate has been 20%."); Div. Ex. 29 (Moy to Lieu, on May 30 at 3:28 p.m.: "very interesting how our hit ratio is once again 20%."; Lieu's immediate response: "I know! that's our magic number . . ."); Lieu Tr. 3309:4-11 ("we approved about one fifth, as in 20 percent of the universe.").

[83] At the hearing, Lieu even seemed to concede at one point that she had been forced to make the Index selections under time constraints: "I did my credit work [on the Index] based on all the information and knowledge I had at the time I was doing the credit work, and *I did the best I could with the time I was given*." Tr. 3612:25-3614:3.

D. <u>Harding Relaxes Its Assumptions To Facilitate the Ramp of Octans I</u>

Harding made it easier for bonds to pass its cash flow tests just when Prusko discussed the Index with Chau. Cash flow analysis is commonly performed with a software and database system known as Intex. The key inputs, or assumptions, for RMBS are prepayment rate, default rate (the percentage of the loans inside the RMBS trust that are assumed to go bad), and severity (when a loan defaults, how much value is lost in the foreclosure). "Cumulative losses" on a pool of mortgages are the total losses, computed as defaults multiplied by severity. Wagner Report ¶¶ 50 n.15, 51; Wagner Supp. Report (Div. Ex. 8003) ¶ 2; Lieu 3313:23-3314:11. The lower the cumulative loss projection, the less stressful the scenario. In late May 2006, Harding was projecting 6% cumulative losses, arrived at by applying a 15% default rate with 40% severity. *E.g.*, Wagner Supp. Report ¶¶ 14-21; Lieu Tr. 3624:1-10, 3973:10-21, 3979:4-15.

Six percent represented a dramatic relaxation of the analysts' previous standards, one obviously driven by Chau's desire to ramp Octans I more quickly. On May 19, 2006, Moy noted Harding's cumulative loss assumptions: "if it's baa2 – 13%, baa3 – 9%. and sometimes we play around with the stresses and loss numbers."[84] Div. Ex. 15. On May 26, 2006, Lieu emailed Wang: "jamie and i already decided yesterday" – the same day that Prusko discussed the Index with Chau, *see* Div. Ex. 23 – "that everything will be run at 6% loss curve. . ." Resp. Ex. 767. And on May 31, 2006, at 1:52 p.m., Lieu wrote to Moy and Wang: "I will be re-running the old deals that we rejected based on old high losses curves (9, 11, 13% runs). If those pass the 6% we're using now, I'm going to change those to 'Y.'" Div. Ex. 56.

---

[84] Lieu testified that Moy made a mistake here. Tr. 3630:23-3631:18. Lieu was wrong. As Wagner explained, it is normal to subject higher-rated bonds to more stressful scenarios (and lower-rated bonds to less stressful scenarios), not the other way around. Wagner Tr. 4534:20-4536:18, 4698:23-4699:25. Hilfer agreed. Tr. 4982:10-14 ("you would expect a less stressful scenario to cause losses for a lower-rated bond."). Higher-rated bonds are *designed* to withstand more stress.

The differences among these percentage levels are highly significant. Wagner explained that mezzanine RMBS bonds are sensitive even to a couple of percentage points of losses,[85] and Lieu acknowledged: "Would I expect to see different results if I ran a 6 percent cum loss versus 8 percent cum loss when it comes to principal writedowns? Yes, I would expect to see different results." Tr. 3455:7-11.

The loss assumptions are supposed to reflect the bond manager's outlook on the economy.[86] Chau's view in 2006 of subprime loan performance, according to testimony he gave in October 2008: "My personal view was that *we would be in a mild recession and that the delinquencies and losses would be within a range of 6 to 8 percent*, and that based on those expectations, these securities survive." Chau Tr. 4379:25-4380:10.[87] The earlier, higher percentage levels cleared the threshold of Chau's stated expectations; the 6% number was at their low end.

The impetus to lower the percentage could not have come from anyone other than Chau. Lieu admitted that Chau sometimes instructed the analysts to run cash flows at a lower loss level.

---

[85] Wagner Tr. 4537:17-4538:21 ("these pieces themselves [*i.e.*, an individual RMBS tranche] are really smaller than the change in the losses that you are talking about. So a 2 percent difference or 2 percentage point difference in cumulative losses could be the difference between completely wiping out the tranche and having the tranche have no losses at all.").

[86] *See, e.g.*, Wagner Tr. 4593:6-4594:6, 4603:12-16, 4838:15-4839:4, 4911:14-4912:3.

[87] At the hearing Chau tried to backtrack, revising the "6 to 8 percent" to "6 percent." *E.g.*, Tr. 4247:6-9 ("I mean, I was quoting from memory in my previous testimony of 6 to 8 percent but I think as we sit here now and look at all the documents, let's see if 6 percent cum loss makes sense in this environment[.]"). His attempt, in 2014, to revise the 2008 testimony should be rejected. In trying to explain the backtracking, he said: "The 6 to 8 percent cum. loss assumptions is assuming that we have some type of event . . . . [I]t was *only in the 2000-2001 mild recession* that we had *that caused that pickup in delinquencies and losses*" to cumulative losses of 6 to 8 percent. Tr. 4379:17-24; *see also* Chau Tr. 4076:16-18 (in 2000-2001 recession, cum losses reached 6 to 8 percent), 4247:10-12 ("The peak losses in 2000-2001 was 6 to 8 percent."). Chau's whole point in the 2008 testimony was that his "personal view" was that there *would* be a mild recession – which, by Chau's own account at the hearing, would have caused 6 to 8 percent cumulative losses.

Tr. 3345:9-17.[88] Lowering the losses would cause more bonds (including more Index bonds) to pass, and thereby facilitate the rapid ramp of Octans I. However, given the increasingly poor performance of subprime RMBS in the spring of 2006, it is impossible to square Respondents' decision with the standard of care applicable to them. *See* Wagner Report ¶ 90.

E. Decisions Flipped from "No" to "Yes" – "Bit Too Much of a Coincidence"

Lieu's final decision reflected many switches from "no" to "yes" and none in the other direction. Before May 31, 2006, Harding had reviewed 29 of the 40 Index bonds, and rejected 19 of them. At 2:49 p.m. on May 31, Lieu wrote: "Out of the 40 bonds in this list" – Lieu was referring to the 4 p.m. OWIC, but the OWIC simply consisted of the Index bonds at the BBB and BBB- levels[89] – "we have already looked at 29 bonds. Out of those, 10 have been approved, and 19 have been rejected. These are the approved deals: [listing 10 bonds]." Div. Ex. 65. A Harding bidlist from June 5, which was apparently intended to synthesize previous decisions,[90] corroborates Lieu's email, reflecting review of 29 Index bonds, acceptance of the same 10 listed by Lieu, and rejection of 19. *See* Div. 93 (bidlist), 94 (metadata for bidlist); Appendix 3, *infra* &

[88] Lieu's suggestion that it may have been Huang or Wang who wanted to lower the loss level, Tr. 3343:8-3345:8, is not credible. Huang and Wang each testified unambiguously that they did not get involved in generating Intex assumptions. Huang Tr. 980:14-18; Wang Tr. 601:3-19. Also not credible is Lieu's testimony based on Resp. Ex. 767 to the effect that the idea came from herself and Moy, rather than senior management. Tr. 3624:15-3625:21, 3635:19-3636:5. Lieu backtracked on redirect, admitting that the impetus might have been Chau. *See* Tr. 3944:2-3946:10. Also, compare her testimony to Chau's: "Q. How does one determine whether to use 6 percent cumulative loss or 13 percent or 3 percent? / A. *Those assumptions are generated at the senior level of Harding Advisory, so it would be myself, Tony Huang, Alison Wang.*" Chau Tr. 4244:12-17.

[89] *Compare* Div. Ex. 58 (attached to Div. Ex. 57) *with* Div. Ex. 36 (list of Index bonds).

[90] The so-called "master bidlist" distributed by Lieu the night before, Div. Exs. 39, 40, was mistake-ridden and unreliable. *See* Div. Ex. 56 (1:52 p.m. email from Lieu noting mistakes in the master bidlist); *see also* Wagner Report ¶ 79.

Wagner Report Appendix 6 (compiling decisions from Div. Ex. 93, *i.e.*, "corrected bid list").[91] Note that this ratio – the pre-Magnetar ratio – is still low, at 34%.

Of the 19 rejected bonds, Lieu accepted nine for the Octans I Index trade. *See* Appendix 3, *infra*; Wagner Report Appendix 9. Instructive in this regard is a bidlist dated May 22, 2006, which includes decisions on 32 bonds, with seven marked "Y" – an acceptance rate of 22%. Div. Ex. 16; Lieu Tr. 3422:13-25. Of the 25 bonds noted as rejected on May 22, five made it into Octans I despite the rejection on May 22, and all were Index bonds[92] – a pattern that Lieu has previously described as "a bit too much of a coincidence." Lieu Tr. 3426:2-22. Moreover, three of those five bonds had been rejected because of "collateral attributes." Div. Ex. 16; Wagner Report ¶ 98. The characteristics of the mortgage loans backing an RMBS would not be expected to change meaningfully from May 22 to May 31. Wagner Tr. 4532:22-4534:14. In other words, there is *no good explanation* why those three bonds made it into the Octans I portfolio.

F. <u>Lieu Approves Many Index Bonds with No Basis and Despite Red Flags</u>

At 12:51 p.m. on May 31, Lieu sent junior analyst Kaplan an email listing 24 Index securities and asking him to "run loss curves on these too and send me the file." Div. Ex. 52. At 1:13 p.m., Kaplan responded, *id.*, attaching an Excel file named "jung.xls." (Division Exhibit 53, or the "1:13 Cash Flows.") On May 30 and 31, Lieu received cash flow information on four other Index bonds,[93] bringing to 28 the total number of bonds with cash flow results sent to her.

---

[91] The citations in Wagner's main report are based on Bates numbers and investigative testimony designations. The Division's March 3, 2014 exhibit list contains columns that map the older designations to the Div. Ex. designation.

[92] The five were SAIL 2005-HE3 M8; AMSI 2005-R11 M8; CWL 2005-BC5 M8; NCHET 2005-4 M8; and SAIL 2005-HE3 M9. *Compare* Div. Ex. 16 at 2 *with* Div. Ex. 186 (trustee report listing collateral); Wagner Report ¶ 96 (analyzing Div. Ex. 16).

[93] The four are FFML 2005-FF12 B2; SABR 205-HE1 B3; SVHE 2005-4 M8; and GSAMP 2005-HE4. The first three of these are discussed in Wagner's Report, at ¶ 81(a) & nn. 51 and 52 (citing documents

Appendix 3 to this Brief, like paragraph 94 of Wagner's main report, compiles the writedown percentages and investment decisions for these 28 bonds.

The only analyses Lieu received showed writedowns on all but six of the bonds. (Note that six out of 28 is about 21% – roughly the pre-Magnetar acceptance ratio.) Some of the writedowns were extremely heavy. Referring to the 1:13 Cash Flows, Lieu testified, consistent with industry norms, that "I would not purchase a bond with principal writedowns." Lieu Tr. 3430:16-17. *And yet, thirteen bonds with writedowns were purchased anyway.* Lieu has variously testified that:

- There was a mistake and she realized it and fixed it, even though no one has been able to find the "corrected" runs.
- Even if there was no mistake, she may have *thought* there was and intentionally ignored the results without redoing them.[94]
- Even if there was no mistake, she may have inadvertently overlooked the results.[95]

None of these scenarios is especially credible. (Also, at the end of the day, none does Harding much credit, since these scenarios at best bespeak serious violations of the standard of

---

now known as Div. Exs. 267 & 268, 269 & 270, 271 & 272); *see also* Wagner Supp. Report ¶ 39 (correcting citations in footnotes 51 and 52 of main report). The fourth should have been included in the chart in Wagner's paragraph 94, since Wagner intended to tally all bonds for which cash flow results were sent to Lieu on May 30 or 31, and results for GSAMP 2005-HE4 B2 (with a writedown percentage of 0%) were sent to Lieu on May 30. Div. Exs. 267, 268. The GSAMP bond was one of the 12 exclusions from the Octans I Index trade, so Wagner's omission is of limited significance.

[94] Tr. 3804:16-19 ("Again, as I said, in my mind I was thinking [one] of two things, *either* it was a mistake *or that this was unrealistic and we thought it was a mistake* ***and decided to ignore it***"), 3804:22-3805:2 ("I would have come to the conclusion that it was run incorrectly and would have actually tried to rerun, ***or*** *that I thought it was run under unrealistic expectations* ***and would not have considered that to be true and part of my analysis at the end.***"). This is all nonsense. At the time, Lieu would not have been surprised to see writedowns. *See* Div. Ex. 56 (Lieu at 1:52 p.m. on May 31, 2006: "I will be re-running the old deals that we rejected based on old high losses curves (9, 11, 13% runs). ***If*** *those pass the 6% we're using now*" – *if*, not when, those pass at 6% – "I'm going to change those to 'Y.'").

[95] Tr. 3964:9-11 ("*Whether or not these cash flow runs were correct, if I had seen* such high principal writedowns, I would not have said yes to the bonds at the time.").

care, and at worst present prima facie evidence of recklessness regarding picking subpar bonds.) Neither Lieu nor Respondents have been able to credibly explain what the supposed mistake was. (More on this below.) And the purchases follow a clear pattern: bonds with writedowns below 50% were generally accepted; bonds with writedowns above 50% were rejected.[96]

Of the 28 bonds Lieu accepted, cash flow results were sent to her for 17. *See* Appendix 3, *infra*. For the remaining eleven (two of which had been previously accepted[97]), there is *no* evidence of *any* cash flows sent to, requested by, or reviewed by her on May 30 and May 31. Nor is the idea that Lieu accepted bonds without running cash flows especially far-fetched. Apparently Harding had had problems in the past whereby bonds were accepted without review, including without being run through Intex. Wang has testified (Wang Tr. 338:4-22):

> Q. You just referred to procedures, what were the procedures that you asked that would satisfy you that were being followed properly in determining how to make a purchase?
>
> A. For the RMBS securities I think *I wanted to make sure that deals were being reviewed. That somebody – they were running the bonds on Intex[] and doing the proper analysis, that they were, you know, documenting their work.*

In examining Wagner, Respondents made an issue out of two spreadsheets (the "Moy Spreadsheets"), Respondents' Exhibits ("RX") 774 and 325, attached respectively to a May 30 email from *Moy* to *Huang* (Resp. Ex. 772) and a May 31 10:15 a.m.[98] email sent by Kaplan to *Moy* (Resp. Ex. 324).[99] As Wagner explained, it is impossible to know what to make of the Moy

---

[96] The exceptions are that Lieu also rejected: (1) the Long Beach (LBMLT) bonds, which had writedowns of 0% and 41.03%, but Long Beach was a disfavored originator at Harding, Lieu Tr. 3563:13-21; (2) the MLMI 2005-AR1, class B-3, but it had a writedown percentage very close to 50% and was at the Baa3 level; and (3) the GSAMP issue at both rating levels, suggesting a concern about the collateral characteristics. *See also* Wagner Tr. 4527:25-4529:4, 4905:20-4906:9.

[97] The two are MABS 2005-NC2 M9 and RASC 2005-KS11 M9. *See* Div. Ex. 65 (Lieu 2:49 p.m. email).

[98] Resp. Ex. 324 was produced with a MAXIM-EMAIL- prefix. The headers of all such emails were rendered in GMT, as reflected by the set of stipulated times.

[99] RX 774 was named "ABS Bespoke - Portfolio 2006-5-22 Results.xls."

Spreadsheets. Wagner Tr. 4777:13-4778:21. Both are extremely lengthy – three hundred entries in the case of RX 325 – meaning that nowhere close to all the bonds could have been substantively reviewed.[100] Also, there is a good deal of overlap between the Index bonds in the Moy Spreadsheets and the bonds in Div. Ex. 53.[101]

However, even if one were to grant that Lieu somehow had access to and relied on the Moy Spreadsheets, it would not come close to redeeming her work. One of the bonds that Lieu accepted for Octans I that did *not* have results in the 1:13 Cash Flows but *did* in the Moy Spreadsheets – the MABS bond at Baa3 – showed a gigantic writedown of 59.46% and 60% in the Moy Spreadsheets. *See* Resp. Ex. 325, Excel row 175; Resp. Ex. 774, Excel row 67. Two others also had writedowns in the Moy Spreadsheets, of 6.83%/7% and 4.83%.[102] Giving Lieu "credit" for the Moy Spreadsheets still would mean that she accepted 16 bonds (the 13 in Div. Ex. 53 plus the additional three referred to in this paragraph) with significant write downs.[103]

---

[100] In questioning Wagner, Respondents' counsel tried to equate running a cash flow with a credit decision. The latter includes much more than the former. Wagner Tr. 4782:18-4783:14, 4789:18-4790:15. There is no evidence of any prior *decision* – any substantive review beyond a writedown percentage on large spreadsheets – for the 11 bonds in Wagner's Appendix 7, which are also the 11 left over when the 29 that Harding had previously looked at (see Lieu's 2:49 p.m. email, Div. Ex. 65) are subtracted from the total 40.

[101] In Appendix 3, *infra*, compare columns I and J to column G.

[102] The bonds are FFML 2005-FF12 B3 (*see* Resp. Ex. 325, Excel row 118; Resp Ex. 774, Excel row 36) and SVHE 2005-4 M9 (*see* Resp Ex. 325, Excel row 294). *See* Wagner Tr. 4787:4-11 ("If [Lieu] did see" bonds written down in the Moy Spreadsheets, "then it is another bond that I would question what her decision was based on.").

[103] If one includes the Moy Spreadsheets in the universe of applicable cash flow runs, then the number of Index bonds with acceptable cash flow results, *i.e.*, zero writedowns, is 14 (the five in Wagner's paragraph 94 plus nine of the previously-unreviewed 11, *see* Appendix 3, *infra*) out of 39 with results – a ratio of 36% that, while low, still leaves plenty of room, after some rejections for collateral attributes, for a hit rate of roughly 20%. In other words, including the Moy Spreadsheets would just help to show that the cash flow results for the bonds overall really were business as usual, and what was *not* usual was Lieu's decision to accept so many of them.

The idea that Lieu actually used the 1:13 Cash Flows to make decisions also is not far-fetched. Again, Harding's approach to the Index was to accept the "lesser of evils." Chau himself was not particularly concerned about the write-downs, judging from his prior testimony. *See* section VI.J. below. And the Octans I ABX review assignment (which effectively was to identify the worst bonds in the Index for rejection, not to independently analyze each of the bonds in "bottom/up" fashion) should be compared to what happened in August 2006 when Citigroup gave Harding a list of bonds and asked Harding to select from the list. In that case, Harding, as Wang noted in an email insisting on appropriate disclosures (Resp. Ex. 457):

> in selecting these 80 names . . . did not apply its customary methodology or standard of care for selecting individual RMBS names (e.g. Harding used generic cash flow and surveillance runs to eliminate identify [sic] the worst-performing bonds and did not review term sheets, prospectuses or specific collateral information); and [] Harding may not have selected such names for its own accounts or accounts that it manages for others.

Harding clearly knew how, when asked, to do a "quick and dirty" elimination of the worst bonds from a pre-selected list. Due to Harding's desire to accommodate Magnetar and Merrill Lynch, that is precisely what happened with the Octans I Index bonds.

G. Moy's Conflicting Opinions

The credit decisions on the Octans I Index bonds were not unanimous. At 2 p.m. on May 31, Harding trader Michael Giasi circulated an OWIC: "Here is an OWIC due at 4 pm today. Maybe we can see if there are any names we've done the work on already to see if there is a fit for us." Div. Ex. 57. By "a fit for us," Giasi must have meant a fit for Octans I, the main synthetic RMBS CDO that Harding was ramping at this time.[104] *See also* Lieu Tr. 3723:23-3725:1 (the May 31 OWIC "would have been part of the ramping for Octans I"). The bonds on

[104] Harding's second synthetic RMBS CDO was Octans II, *see* Div. Ex. 239, the ramping for which did not start until late July. *See* Div. Ex. 128.

the OWIC exactly matched the ABX Index at the Baa2 and Baa3 levels. *See* Div. Ex. 58. At 2:18 p.m., Moy asked junior analyst Lee "to do anohter [sic] surveillance template on this owic," listing 21 of the 40 Index bonds. Div. Ex. 61. Lee returned the requested templates to Moy (and Lieu) at 2:29 p.m. Div. Ex. 63.

At 3:04 p.m., Moy sent to MaximCDO "the results for the 4 pm owic." Div. Ex. 65. Moy now had 15 bonds approved – eight of the 10 previously approved per Lieu's 2:49 p.m. email, and another seven bonds.[105] Div. Ex. 66. Moy's list conflicts with Lieu's on 13 bonds. Moy excluded the two MABS bonds (which were on Lieu's 2:49 p.m. list of 10 previously approved bonds), noting in her email: "there is a correction. *we are not okay on the MABS deal.* that is a 100% IO loan deal. some we have already seen as jung mentioned below." Div. Ex. 65 (emphasis added). IO, or interest-only, loans[106] were riskier, and Harding claimed in marketing presentations to give extra scrutiny to them. *See* Div. Ex. 1 at 45. Harding's analysts disfavored bonds with mainly IO loans. *E.g.*, Div. Ex. 167 (Sept. 18, 2006 email from Lieu: "we passed [on an Index bond included in Octans III] coz mostly 2 and 3 yr IO terms."); Resp. Ex. 446 (Feb. 6, 2007 email noting that analysts had "filtered," from the list of "bonds we can trade for Octans4," "100% IO" RMBS).

Moy's views were ignored. Both MABS bonds went into Octans I, as did all the other ones that Moy was not ready or willing to approve. There is no credible evidence of any effort to reconcile the differing views. First of all, it stands to reason that if there was any discussion at all about the conflicts on MABS, it was more likely *before*, not after, Moy wrote to the entire firm

[105] Approving the seven did not necessarily require much additional work. Five were the *higher*-rated classes of bonds previously approved at the *lower* rating level. Two were the lower-rated classes of bonds previously approved at the higher level. *See* Appendix 3 (comparison of Excel columns F and K), *infra*.

[106] Interest-only loans were mortgages set up with payments only sufficient to cover interest for a period of time, such as two years. Wagner Report ¶ 102.

"*we* are not okay."[107] And while Lieu claimed at the hearing to have an actual recollection of a discussion with Moy on May 31, 2006 to resolve their differences, Tr. 3400:16-3401:6, when she tried to explain what triggered the memory, her testimony veered into the absurd.

Lieu has previously testified unambiguously that she does not remember May 31, 2006 – at all.[108] At the hearing, she initially claimed that being shown documents in prep sessions triggered recollection of discussions with Moy. Tr. 3396:11-3402:2. Lieu was unable to identify or even intelligently describe any of the documents that supposedly triggered her newfound recollection, *except* for the 1:13 Cash Flows Excel file. Tr. 3409:23-3414:19. *But Lieu had received, and reviewed, the 1:13 Cash Flows three days before the SEC investigative testimony in which she maintained that she did not recall anything about May 31, 2006.* Tr. 3414:20-3420:13. Lieu's testimony that she and Moy worked out their differences on May 31 can be safely dismissed as a manufactured memory.

H. <u>There Was No Time for a Proper Review</u>

There is no evidence that Lieu began work on the Index bonds on May 30 – to the contrary, she was apparently working on pulling the first master bidlist together until 8:47 p.m. that night. Div. Ex. 39. On May 31, at 8:54 and 8:56 a.m., she requested other employees' help converting the Index from .pdf to Excel format. Div. Exs. 43, 44. The request to Kaplan did not come until 12:51 p.m., and the supposedly faulty results were returned at 1:13 p.m., allowing just

[107] Lieu is of no help in interpreting "we are not okay." Her testimony varied from "I assume that means she is no" to "I can't recall," to "I can't tell from this e-mail who she is talking about when she said we." Lieu Tr. 3550:21-3551:1, 3708:21-3709:6.

[108] Lieu Tr. 3397:12-3398:22 (July 2012 investigative testimony: "I don't remember this day [May 31, 2006] at all"; "Q. And again, you don't recall anything specifically about what you did on that day [May 31, 2006]? / A. No.").

over three hours to supposedly resolve the alleged problems with the cash flows and come to a decision on all the bonds.

Lieu was, moreover, engaged in a series of other attention-consuming tasks besides the Index review. *See* Lieu Tr. 3692:12-3693:1. At 9:36 a.m., she asked Kaplan for cash flows on four bonds, none of them on the Index. Resp. Ex. 322. At 1:52 p.m. she commented on the various discrepancies she had noticed on the master bidlist, saying that she would re-run all the previously rejected bonds at 6%. Div. Ex. 56. At 2:12 p.m. she sent a new cash flow request to Kaplan for 35 non-Index bonds. Div. Ex. 60. At 2:49 p.m. and again at 3:22 p.m., she commented on the 4 p.m. OWIC and on Moy's results. Div. Exs. 65, 69. And, if Lieu's own account is to be believed, she had substantive discussion with Moy, *after* Moy's "results" were sent at 3:04 p.m., about 13 different bonds (including MABS) as to which the two of them had reached different decisions.

It is impossible to square all of this with Lieu's testimony (much less Chau's) about the amount of time it takes to properly review an RMBS bond. That is particularly so when eleven bonds had no decision and required review basically from scratch, and a number of the bonds had been rejected for collateral characteristics, requiring that the underlying loans be closely re-examined to justify acceptance.[109]

I. <u>There Were No Stress or Customized Cases</u>

Again, the fact and expert witnesses for both sides agreed on the importance of running more than one case, or scenario. No evidence has emerged – none – that on May 31 or at any other time (such as during the backfill project in subsequent months and years), Lieu or anyone

[109] *See also* Wagner Tr. 4944:14-4945:2 ("I don't think it is very likely" that Lieu reviewed and analyzed all the information that Respondents now contend she did, for all the securities in the Index); *id.* at 4938:20-4939:6 ("I don't think she had enough time" given everything else going on).

else ran any stress or other customized scenarios for the Index bonds beyond the 6% losses that Harding began using across the board to ramp Octans I.[110] See Lieu Tr. 3997:1-8.

J. Chau's Admissions Seriously Undermine His Defense

Chau testified that he does not have a recollection of May 31, 2006. But in November of 2012, he was refreshed with emails from that day and then testified about it. Chau Tr. 4402:25-4403:15. In trying to explain how Lieu came out with different decisions from Moy, Chau made a series of statements that are flatly inconsistent with Lieu's testimony – and with the theory of his defense. He testified that the write downs in the 1:13 Cash Flows, far from a mistake or cause for alarm, were a valid basis for decision-making. He then proceeded to say that the numbers were "meaningless," that he was "comfort[able]" with them, and that they were merely a starting point for additional analysis – which Chau insisted would and did take more than three hours.

Chau testified that, between 2 p.m. (when Giasi circulated the OWIC) and 3:04 p.m. (when Moy delivered her results), there was insufficient time for Moy to do all the analysis that would have been required. According to Chau, knowing Harding's investment process, including how long it takes to do loss curve analysis, it would be physically impossible for Moy to do the requisite analysis. He testified: "I'm not sure what the Commission is trying to say. Are you trying to say that two hours is all we need to analyze 40 securities?" (That, of course, is not so far from what Lieu and Respondents are now saying.) Chau Tr. 4404:22-4407:15.

He went on: unlike Moy, Lieu had the benefit of the cash flows sent by Kaplan. Having reviewed the emails from May 31 with his counsel beforehand, he testified: "I believe there is an

[110] Spreadsheets for three bonds discussed in the Hilfer report used two different loss scenarios, 100 * BASE LOSS, and 117 * BASE LOSS, which is presumably more stressful. *See* Resp. Exs. 972, 973, 974; Hilfer Supp. Report ¶ 41(vi). None of these three bonds is in the Index, and two of the bonds (the ones analyzed in Resp. Exs. 972 and 973) were not purchased for Octans I at all. Also, Harding sometimes ran scenarios with different interest rates, but all used the same default, severity, and prepay assumptions, which are the most important. *See* Wagner Report ¶ 50; Lieu Tr. 3956:1-4.

email out there from one analyst to Jung Lieu with loss curve analysis right around this time. And with that information, I would say she would then be able to conduct the analysis and make a decision." Tr. 4407:24-4413:14. He continued (Tr. 4418:14-4420:3):

> Q. . . . So if Jamie Moy doesn't have enough information to your satisfaction to be able to opine yes or no when she is making this decision, okay, what enables Harding to be able to make the decision that [of] all the bonds on ABX Index, there are only these ones we don't want?
>
> A. The records clearly show[] that the work was done for Jung to make that determination. The loss curve analysis was provided to her by Brett Kaplan, which allowed her cash flows and the like.

That is, according to Chau, the 1:13 Cash Flows were not a cause for alarm, or a sign that something was wrong with the analysis, but rather a valid basis for decision-making.

Chau was then shown the loss curves. He was asked: why are there such heavy writedowns? He answered that this was the result of applying *standard assumptions*. Tr. 4420:4-20. Pressed as to why Harding would invest in securities showing writedowns even under the standard assumptions, Chau did *not* say, as Lieu did, that he was surprised to see those numbers and that there must have been a mistake. Instead, having by now backed himself into a corner, *he testified that the writedown percentages are "meaningless" and that "a host of reasons" gave him "comfort" with the writedowns*. Tr. 4420:21-4426:12.

What is more, after describing all the additional work that would be needed to justify investing in a bond with writedowns even in the initial run, Chau was asked: All in three hours? (*i.e.*, from 1:13 p.m. to 4:23 p.m.). His answer: *This happened in more than three hours*. Tr. 4426:13-4428:2. At the hearing, he was forced to acknowledge his previous admission:

> Q. But your inference based on those emails [the ones from May 31 presented to him at the investigative testimony] was that all of this analysis that would have had to be done to get comfortable with 40 bonds as to which your initial assumption showed heavy write downs for many of them, your inference was that that would take more than three hours. Don't you remember that?

A. Yes, that's my interpretation at the time. You're correct.

Tr. 4428:4-12.

Accepting Chau's prior testimony means accepting (i) that Respondents *were* willing to buy bonds for which write downs were projected in a base case (since Chau had no problem with the write downs), and (ii) that Lieu did *not* have enough time (since the work that Chau testified had to be done to justify the purchase would, he said, have taken, and did take, more than three hours). Accepting Chau's testimony, in other words, requires rejecting Lieu's testimony (and with it, Respondents' defense) – and vice versa. In reality, neither of them is credible.

VII. THE DEFENSE CASE ON OCTANS I: DIFFERENT ASSUMPTIONS AND BACKFILLED ANALYSIS

Respondents offered essentially two counter-narratives. The first, unveiled one business day before trial, is that the 1:13 Cash Flows had a "latent defect," Tr. 39, 44, 46, prompting Lieu to do additional cash flow runs with different assumptions that showed positive results but were never saved. (Lieu insisted that her practice and Harding's was to save cash flow runs. Tr. 3441:23-25, 3444:11-12, 3664:5-9, 3878:17-18.) The second, which debuted in the third week of trial, is that a series of purported "Credit Committee Bond Evaluation" reports and other cash flow runs somehow reflect Lieu's work on May 31, 2006. In fact, these documents were created months or a year or more later as part of a "backfill" project.

A. The "Latent Defect" Theory

The latent defect theory requires placing faith in Lieu's uncorroborated assertions about the assumptions or settings that she would have or should have or did use in Intex. But Lieu obviously no longer has any idea what *any* of those inputs were. In February 2012 investigative testimony, she generally recalled (incorrectly) that while at Maxim (*i.e.*, up until the summer of

2006), the base case was 8% cumulative losses and the stress case 10%. Tr. 3333:12-16. On March 20, 2014, she advised defense counsel that Harding intended to apply a 6% constant default rate (CDR) – a very different methodology from projecting cumulative losses. *See* Wagner Supp. Report ¶¶ 9, 13.[111] Then, at the outset of her testimony on April 21, she initially could not recall whether, in May and June 2006, Maxim was using a CDR methodology or a methodology based on a given level of cumulative losses. Tr. 3315:8-3316:9, 3326:17-19.

By the *middle of the afternoon of her third full day of her testimony, after she had been shown all of the evidence concerning the Index trade by both sides*, Lieu was steadfastly maintaining that the supposed "mistake" on May 31, 2006 was a failure to use 6% cumulative losses.[112] Then the Division threatened to prove to Lieu, and did prove to her, that (as is now undisputed) the 1:13 Cash Flows in Div. Ex. 53 actually *did* use 6% cumulative losses.[113] At that

---

[111] Having spoken with Lieu on March 20, 2014, Respondents asserted, on March 28, that "6% CDR and 40% severity" were "the assumptions that all of the evidence demonstrates were the assumptions that Harding intended to use at the time." March 28, 2014 Haran Affidavit ¶¶ 7, 11. That led to Steven Hilfer's first report: "I have performed the analysis I believe Harding intended to run on May 31, 2006. I used a 6 CDR, 40% severity rate . . . ." March 28, 2014 Hilfer Report (Resp. Ex. 976). Hilfer has effectively retracted the first report. Hilfer Tr. 4950:12-4951:17.

[112] The pertinent exchange is at Lieu Tr. 3951:19-3952:18, 3954:3-9, and culminates as follows:

> Q. And so that's what you believe is the mistake. You believe that the May 31, 2006 runs were not done at 6 percent cumulative losses after severity, is that correct?
> A. Yes.
> . . .
> Q. . . . You're not changing your testimony from a few minutes ago that you believe that the mistake on May 31, 2006 was not to apply after severity 6 percent cumulative losses. You're not changing your testimony as to your belief about what the mistake was, correct?
> A. That's correct.

[113] Lieu Tr. 3952:19-3953:7, 3973:10-3979:15 (acknowledging that Kaplan's 1:13 p.m. cash flows had to have been run using 6 percent cumulative losses); *see also* Wagner Supp. Report ¶ 23 ("I found that the assumptions utilized in [Div. Ex. 53] resulted in a 6% level of cumulative losses."). It was not until the emergence of the "Collat Tranches" – the spreadsheets showing the application of Harding's granular timing curves to the pools of mortgages, which Harding usually did not include in the cash flow output – that it became possible to verify the cumulative losses being projected in any given run. *See* Wagner Supp. Report ¶¶ 15-21. In any event, that the Intex runs projected 6% cumulative losses is no longer

point, Lieu suddenly shifted, insisting that something else, such as the prepay settings, must have been wrong. Tr. 3953:8-3954:15, 3957:2-3958:2, 3959:8-18, 3979:16-3980:10.[114] It should be clear that Lieu's testimony on the assumptions is hopelessly compromised and unreliable.

Respondents, meanwhile, settled on two sets of inputs that they claim were somehow mistaken in the 1:13 Cash Flows: (1) the default timing curve (also known as the "ramp" or "vector") and severity assumptions; and (2) the prepay setting, *i.e.*, "unscheduled balance reduction rate" versus "prepay rate." The default timing curve is a series of assumptions about how the defaults are distributed over time. *E.g.*, Wagner Supp. Report ¶ 14. It is true that at a certain point Harding began using a different set of assumptions and settings.

However, *all the documents around the time that Lieu was doing her analysis* use the earlier default and severity assumptions and prepay setting. The timing curve used in the 1:13 Cash Flows is represented with the notation "150 * Ba3 (4%)." The severity is 40%. The prepayment vector is "100 * JamieCombo," and the setting for applying the prepay vector is "Unscheduled Balance Reduction Rate."[115] These are *exactly the same assumptions and settings*

---

seriously disputed by Respondents, *see, e.g.*, Hilfer Supp. Report, at 5 n. 4, who have shifted to a focus on the timing curve and prepay setting.

[114] Eventually Lieu settled on this: *there should not have been writedowns because the bonds were trading at par*. Tr. 3959:19-3963:25. This explanation (and a substantive defense based on it) is extremely troubling: the whole point of having a bond manager is to vet the bonds' credit risk, not check their current price on a Bloomberg terminal. The reason to run cash flows is to *find out* whether bonds will experience losses under relevant assumptions. A daily trading price is not a substitute for credit analysis. Wagner Report at 3-4 (Ops. II(a)(iii), II(b)), ¶ 105; Wagner Tr. 4734:21-24 ("I mean the fact that it trades at par I think has nothing to do with the individual evaluations of the credit."), 4923:6-20. Lieu's logic takes the credit-worthiness of the bonds as a given, and on that basis impugns the analysis, changing it until she gets no write downs – an upside-down, faith-based approach that represents a serious violation of the standard of care. In any case, the explanation should be given no credence at all, since Lieu believed *at the time* that the 6% cumulative loss projection might well impair the bonds. *See* Div. Ex. 56; footnote 94 above.

[115] In the 1:13 Cash Flows (Div. Ex. 53), using as an example the tab named Portf CF 03072SV85, which are the cash flow runs for the AMSI 2005-R11 M8 (Baa2) Index bond, the name of the default curve appears in cell D8, next to the label "Default Rate" in cell C8. The label "Default Severity" and the entry

used in eight other analyses sent to Lieu and Moy before, during, and after May 31.[116] On top of that, these analyses reflect writedowns for a significant percentage of the securities. If Lieu really did catch an error on May 31, presumably she would have asked Kaplan to make a correction and use different assumptions going forward. But instead Lieu analyzed another 88 securities using the same assumptions on June 1.[117]

Respondents have pointed to cash flow runs from September 2006 showing no writedowns for the 2006-1 Index bonds at the BBB level. (These runs do not analyze the BBB- bonds.) Resp. Exs. 429, 430, 431, 432. But these runs were performed with different, more relaxed assumptions. The entry for default rate reads "100 * BASE LOSS," and this time the severity is 100%. (Also, the prepay setting is "prepay rate" instead of "unscheduled balance reduction rate.")[118] Wagner was able to verify – this too is not disputed – that the "100 * BASE

"40 Percent" appear in cells E8 and F8. The prepay vector "100 * JamieCombo" appears in D7, next to the label "Unsch Bal Redctn Rate." *See also* Wagner Supp. Report ¶ 15, Appendix 2.

[116] The eight are compiled in the chart in paragraph 23 of Wagner's Supplemental Report: Div. Exs. 267, 268; Div. Exs. 269, 270; Resp. Exs. 322, 323; Div. Exs. 271, 272; Div. Exs. 290, 291; Div. Exs. 288, 289; Div. Exs. 286, 287; Div. Exs. 281, 282. In addition, RX 942, which was created June 6, 2006, uses the same default timing curve, severity, and prepay setting (albeit with a different prepayment vector). To confirm that RX 942 was created June 6, 2006, one can open the file in Excel, click the "File" tab, and note the "Created" date in the right-hand pane. *See also* Div. Ex. 9015 (Concordance metadata for RX 942; Concordance metadata is explained in footnote 129 below).

[117] Also noteworthy in this regard are the May 30 and 31 Moy Spreadsheets (RX 325 and 774), discussed above in section VI.F. First of all, the Moy Spreadsheets largely track the 1:13 Cash Flows to the extent there is overlap (*see* Appendix 3, *infra*), suggesting that the 1:13 Cash Flows were *not* aberrational. Second, in the Moy Spreadsheets, a very healthy percentage of the bonds showed writedowns. If that bothered Moy or struck her as odd, there is no evidence of it.

[118] In Resp. Ex. 432, these assumptions can be seen, for example, in any of the tabs with a label beginning with "PortfCF 004421UK7." In cells G7 and H7 (next to the label "default rate" is the entry "100 * BASE LOSS"), cells A8 and B8 (Default Severity of "100 Percent"), and E6 and F6 ("Prepay Rate" of "100 * JamieCombo"). The analysis was done under six different scenarios with different assumptions about interest rates, but the default, severity, and prepay assumptions are the same in all six. *See* Wagner Supp. Report ¶ 27 n.18.

LOSS" default curve with 100% severity also generates 6% cumulative losses, but *with losses spread over about ten years rather than five*. Wagner Supp. Report ¶¶ 26-34.

As Wagner explained, this is a *less stressful* (and less realistic) analysis. First, RMBS are designed to absorb a certain amount of losses over time, so spreading the losses out makes the scenario less stringent. Second, the later curve uses 6% defaults and 100% severity (as opposed to 15% defaults and 40% severity), which means that a *much smaller portion of the loans is assumed to fall out of the pool*, that is, more of the loans are still generating income. Wagner Supp. Report ¶¶ 35-37; Wagner Tr. 4545:23-4547:17. Third, the 100% severity assumption (in other words, that when a loan defaults, nothing is recovered in foreclosure), presumably required to arrive at the 6% cumulative loss number at the lower default rate, ignores the reality that "mortgages generally have a recovery." Wagner Tr. 4557:6-16.

With delinquencies and foreclosures increasing throughout 2006, and again, given Chau's stated view of a coming recession, Harding had *no basis* consistent with applicable standards of care to relax the assumptions this way. Wagner Supp. Report ¶ 37; Wagner Tr. 4862:12-16. Accordingly, the September 2006 runs are evidence not that the Index bonds should have, or somehow did, pass when Lieu reviewed them on May 31, 2006, but rather of Harding's pattern of relaxing assumptions to get more bonds to pass.

B. The "Credit Committee" Reports and Related Materials Are Probative Only of Harding's Intent To Mislead Investors

On the morning of the final day of Lieu's testimony, Respondents suddenly introduced a series of spreadsheets that they claim are, or represent, work Lieu did on May 31, 2006.[119] The

[119] Respondents insist that they did not know about these documents any sooner. This claim should be given no credence. To take one example, if Respondents are to be believed, they first discovered Resp. Ex. 958, a spreadsheet marked HA00748574, on April 22, 2013. Tr. 3862:3-24. They then listed the document on an April 23, 2014 exhibit list – with the date marked "unknown." *See* Respondents' Fifth

spreadsheets in question include single-bond analyses marked RX 940, 941, and 943 through 962 (the "Backfilled Bond Analyses") and portfolio-wide cash flow runs marked RX 966 through 971 (together with the Backfilled Bond Analyses, the "Backfill Documents").[120] In actual fact, these documents were all created long after May 31, 2006.

First of all, the very title and format (and arguably existence) of these documents is deeply misleading. The Backfilled Bond Analyses are generally titled "Credit Committee Bond Evaluation Document," which would signal to investors, as Wagner put it, "that there is a credit committee that would review this document. . . . [T]his would suggest it is material prepared and presented to a credit committee for their evaluation, and . . . that the credit committee then signed off on that particular security." Wagner Tr. 4547:20-4548:11. Needless to say, nothing remotely close to that happened, at least not in the case of the Index bonds. Not only is there no evidence

---

Amended Exhibit List. But *Respondents had previously listed and marked <u>the exact same document</u> (HA00748574) on March 19, 2014*, as Resp. Ex. 805 – *and there noted the date as July 6, 2007*. See Sixth Amended Exhibit List, entries for Resp. Ex. 805 and Resp. Ex. 958. To repeat: as Lieu's testimony turned sour for Respondents, they re-marked and re-listed a backfilled spreadsheet, with the acknowledged date going from July 6, 2007 to "unknown." That is not all. Respondents have known for a very long time about these documents and exactly where to find them. In a November 19, 2012 testimony session, the Division showed Chau the 1:13 Cash Flows and asked him about a particular bond with high writedowns, the AMSI 2005-R11 M8. ("AMSI" is Ameriquest, one of Lieu's disfavored originators. Lieu Tr. 3563:10-12, 22-24.) As discussed above, Chau argued that the writedowns are meaningless. Then, after a short break in the testimony, he suddenly "recalled" that there was a document showing that at some point after May 31, 2006, additional analysis showing no writedowns was done to supposedly justify the purchase of the AMSI bond. When the Division asked for a citation, Respondents' (former) counsel specifically identified HA00748574 – which is none other than Resp. Ex. 805/958. *See* Div. Ex. 1008 (Nov. 19, 2012 Tr.) 370:7 - 372:21. In other words, Respondents' former counsel were so familiar with the backfilled spreadsheets that they were able, during a 12-minute break in proceedings, (a) to locate the Bates code for the particular bond that the Division had chosen to ask about, and (b) to prepare Chau to testify about the document.

[120] Appendix 4 to this Brief tallies information about the Backfill Documents. Not included in the defined "Backfill Documents" universe is RX 942, which is the "collat tranche" for a non-Index bond. It is worth noting, however, that RX 942 was created June 6, 2006 and uses the same default timing curve and severity as the 1:13 Cash Flows as well as the "Unsch Bal Redctn Rate" setting, albeit with a different prepay vector. *See* footnote 116, *supra*. Also not included in the definition of "Backfill Documents" are RX 972, 973, and 974; those are discussed below in section VII.C. concerning the Hilfer report.

that Harding *had* a functioning credit committee in May 2006,[121] but also, as Lieu put it, "I made the decisions" as to which Index bonds went into Octans I. Lieu Tr. 3697:7-9; *see also* Lieu Tr. 3934:10-14 ("I was the one making the decisions."). There is simply no evidence that some sort of multi-person committee received 28 separate bond evaluation documents and then, on the basis of those documents, made a considered decision on May 31 to invest in the 28 Index bonds. *See also* Wagner Tr. 4548:12-19.

Harding, moreover, had a clear practice of "backfilling" documentation of investment decisions so it would have something to show investors when they asked. On June 6, 2006, Wang noted the need to "backfill credit committee reports . . . so we can be ready to market the Magnetar deal quickly." Resp. Ex. 367; *see also* Wang Tr. 500:7-505:20. Lieu's explanation of the "backfilling" was that the analysts' notes were saved in various locations, including their notebooks[122]: "So we made a conscious decision and created a project so we could go back and make sure that [the files] were more organized." Lieu Tr. 3730:5-11.[123] Yet Lieu also testified that bond write-ups were normally prepared "after hours or the next day" following review of a bond. Lieu Tr. 3810:22-3811:4. She furthermore insisted in the strongest possible terms that there was no reason in 2007 to go back and document work done in 2006, and that she would have resigned if anyone had asked that of her.[124]

[121] *See* Lieu Tr. 3264:6-3269:7.

[122] Lieu's notebook from May 2006 is uninformative. Following a page dated "5/30," there is what appears to be a tally of the number of acceptances and rejections on the Index: "24 N," "5 Y," "11 unknown" – totaling 40 bonds – and other attempts at tallies that could relate to the Index or classes of it. Otherwise the notations are unclear. *See* Div. Ex. 241, at 59-60 (HA02072319-20); Lieu Tr. 3290:11-3293:9.

[123] *Cf.* Wang Tr. 501:5-15 ("backfilling" "just refers to the process of cleaning up . . . and organizing all the documents that [the analysts] might have used or produced during the process.").

[124] Her testimony, which was elicited by *Respondents*, may be worth quoting at some length (Tr. 3824:4-3825:3, 3869:19-3870:1):

Lieu was either lying or extraordinarily forgetful. In *July of 2007* – more than a year after the Index trade and ten months after the close of Octans I – the backfill project for Octans I was in full swing. On July 18, 2007 Harding official Richard Chin[125] emailed the analysts (including Lieu), with a cc to Chau, about a call scheduled for July 24, 2007 to discuss Octans I with investor HIMCO:

> In preparation for the HIMCO call, let's focus first on the 24 RMBS bonds in Octans I that have had a ratings action *as **<u>we are back-filling our credit templates and credit comments</u>**, as well as forming our forward-looking views. . . . **<u>We should have about a couple of detailed write-ups completed should HIMCO ask for them</u>**. These write-ups should incorporate our qualitative thoughts* on the originators and servicers, . . . *and anything else that would demonstrate the depth of our research.*

Div. Ex. 233 (emphasis added).

Q. Would you have any reason in 2007 to go back and create a cash flow run from May 31st for SAIL 2005-HE3 M9 and did you take any steps to make it look like it was from that time period in May of 2006?
A. No, I don't know why we would do that. If we have most recent information, we would be running cash flows from that day.
. . .
Q. Did anyone ever ask you in any time during 2007 to go back and try to mimic documents from 2006?
A. No, absolutely not.
Q. Did anyone ever suggest to you at any point, go back a year or two and create some documents to try to substantiate what you did a year ago or more?
A. No.
Q. If someone had suggested that, what would you have done?
A. I would have left.
Q. When you say you would have left, what do you mean by that?
A. I would have quit my job.
Q. Why?
A. Because that's against my own integrity.
. . .
Q. Did you ever have any reason that you might want to go back months or years later to try to recreate some of this stuff?
A. No.
Q. Did you ever do that?
A. No.
Q. Did you ever learn that someone might do that?
A. No.

[125] Chin was hired as a Director in August 2006. *See* Div. Ex. 1 at 40; Div. Ex. 3 at 193-94.

1. RX 941 – "settle date" of May 31, 2006

Respondents questioned Lieu about RX 941, a purported "Credit Committee Bond Evaluation Document" for SAIL 2005-HE3 M9. RX 941 was created in approximately July of 2007. (This SAIL bond went into Octans I despite a writedown of 48.83% in the 1:13 Cash Flows. In RX 941, there are no writedowns, but, like virtually all the Backfill Documents, RX 941 was run with the later, more relaxed default and severity assumptions.)

The first tab of RX 941, which purports to be an overview, is not dated.[126] The title, however, contains a strong clue as to when the analysis was *not* done: "Harding Advisory LLC, Credit Committee Bond Evaluation document." Respondents were still at *Maxim* in May 2006.[127] The cash flows in RX 941 (contained in tabs titled "Cash Flow to Call" and "Cash Flow to Maturity") each have a "Settle Date" of May 31, 2006. Here is Lieu's initial testimony on that entry (Lieu Tr. 3814:14-20):

> JUDGE ELLIOT: Can you tell when this document was created? And I'm referring now to proposed Respondents' Exhibit 941.
> THE WITNESS: On this specific tab, cash flow to call, **the settlement date shown in C-2 is 2006 May 31st. So I can tell that this was run right around that time.**

This testimony was outrageous. The "settle date" in Intex is *just another assumption* – it is the hypothetical date *as of which* the analysis is done, not the date on which the analysis is actually requested from Intex. *E.g.*, Wagner Tr. 4541:12-4542:24. In fact, Lieu was forced to

[126] Many of the Backfilled Bond Analyses are dated, although not always accurately. In Appendix 4, see the column "Date noted in doc."

[127] Lest Respondents argue that the document titles could have changed from Maxim to Harding as part of an update (although it is hard to see how that would help to convince investors that the spreadsheet authentically documents an investment decision that took place at Maxim), note that two of the documents in this series *are* titled "Maxim Advisory LLC, Credit Committee Bond Evaluation Document", and the dates noted *inside* the files are July 2006. *See* Resp. Exs. 944, 950. (As discussed in section I.A. above, the switch from Maxim to Harding happened in July.) *See also* Appendix 4, entries for Resp. Ex. 944, 950.

acknowledge under questioning from the Division that *even the runs she performed at home in March or April of 2014 had a "settle date" of May 31, 2006* (Tr. 4028:13-4030:3):

> **Q. Does that entry of May 31, 2006 [referring to cell C-2 in Respondents' Exhibit 941] reflect the date that this analysis was run through Intex or does it reflect the date as of which the analysis was done, even if it was actually done later, it looked at it as though it were May 31, 2006? Which of those is true?**
> **A. The latter.**
> Q. It's as of May 31, 2006, right?
> A. That is correct.
> Q. In fact, you testified that . . . you went home and ran Intex yourself for some of the bonds, right?
> A. That is correct.
> Q. And you asked Intex, tell me what those results would look like as of May 31, 2006, right?
> A. That is correct.
> Q. Did you tell Intex to use a settle date of May 31, 2006?
> A. Yes, I did.
> Q. That didn't mean that the analysis was done on May 31, 2006. The analysis was done in March or April of 2014, right?
> A. That is correct.
> **Q. So there is no significance that we can assign in terms of when this analysis was actually performed to the fact that it says settle date, May 31, 2006, wouldn't you agree with me?**
> **A. Yes.**

In RX 941, the "Performance Info" tab contains "historical data" through June 2007. These are not projections, but actual performance information that did not exist until June or July 2007, prompting Wagner to testify that this tab "certainly suggests to me that [RX 941] was done after the date of the . . . updated historical data." Tr. 4543:7-21. Respondents also introduced RX 941-B, which derived from the "Collateral Compare" tab in RX 941. But in the actual RX 941, the cells are all filled with "vlookups," essentially a call to pull information from different electronic locations with addresses generally based on this string: "Database Project**Holdings Back-fill\[RMBS DB BACK-FILL_FINAL**.xls]."[128]

[128] In order to create RX 941-B, Respondents needed to find the RMBS DB BACK-FILL_FINAL.xls spreadsheet, and, in effect, "hook it back up" to RX 941. What they recreated was how RX 941's

On top of all this, the "metadata" inside and outside the document give no reason to believe that it was created near in time to May 31, 2006. Inside the Excel file itself, in the "File" tab under Related Dates, are the following:

- Created: March 31, 2006 (this is obviously just the date that the original template was created; most of the spreadsheets in the Backfill Documents have the same "Created" date. *See* Appendix 4.)
- "Last Printed": February 28, 2007 (again, this is likely carried forward from a template)
- "Last Modified" date: August 28, 2007

All of this matches the Concordance metadata for RX 941, which is contained in Division Exhibit 9004.[129]

2. *Other Purported Evaluations of Index Bonds – Later "Settle Dates"*

Respondents have introduced Backfilled Bond Analyses for 19 out of the 28 Index bonds selected on May 31. In other words, there is *no* write-up for nine of the Index bonds in which Octans I invested.

After RX 941, the Backfilled Bond Analyses for the other Index bonds actually hurt Respondents even more because *the cash flow runs in nearly all of them were done with settle dates much later than May 31, 2006.* One of the reports, RX 948, was run to May 25, 2006, but the "creation" metadata inside the file and the database show irrefutably that that file was created in August 2006.[130] Apart from that, the settle dates for Index bonds are all later – generally in

---

"Collateral Compare" tab must have looked in the heyday of the backfill project – which has nothing to do with Lieu's work on May 31, 2006, when neither RX 941 nor the backfill project existed yet.

[129] The Concordance metadata is information about each file that Respondents produced along with the files themselves and that is now in the Concordance database. Appendix 4 matches each of the Backfill Documents up with the Division Exhibit that contains a printout of the Concordance metadata for that RX. In this case, Div. Ex. 9004 shows a PRINTDATE that matches the "Last Printed" date in RX 941 (2/28/07). Div. Ex. 9004 also has identical dates for "DATECREATED" and "MODDATE" – 8/28/07, the same "Last Modified" date noted inside the file. In the Concordance metadata for the Backfill Documents, the DATECREATED field in the database always matches the MODDATE. *See* Appendix 4.

[130] Resp. Ex. 948; Div. Ex. 9021; Appendix 4, *infra* (RX 948 created 8/30/2006).

November 2006 but also December 2006, July 2006, and in one case July 2007.[131] While it is possible to run cash flows as of a particular settle date in the past, it would be nonsensical to (and there is no evidence Harding ever tried to) enter a settle date far off into the *future*. On the contrary, the settle date was *supposed* to correspond to the time of the investment decision. *See* Lieu Tr. 4037:21-4038:4. These analyses, therefore, had to have been created long after May 2006.

There are other indications that the documents were prepared much later, including (as reviewed above in connection with RX 941), the title (generally "Harding Advisory LLC" as opposed to "Maxim Advisory LLC"), the date of the latest performance information, and the metadata. Moreover, some of the Backfill Documents have dates noted in the document – these are frequently long after May 31. Also, one of the documents bears the initials "JL/YC," but Yuna Cho had not yet joined Harding in May of 2006, or, for that matter, in August 2006.[132]

3. *Octans I Portfolio Runs (RX 966 & 967)*

Respondents have also featured RX 966 and 967, which are *portfolio-wide* cash flow runs for *all* the bonds in Octans I as of the run date. These were created in July 2007.

The Excel filenames of RX 966 and RX 967 were: "Octans I Cash Flow Detail Part 1 (May 2006 Assumptions).xls" and "Octans I Cash Flow Detail Part 2 (May 2006 Assumptions).xls." Div. Exs. 9005, 9006.[133] According to the "Related Dates" in the File tab, the spreadsheets were created on July 13, 2007. The assumptions and settings used for defaults,

---

[131] Included in the Backfill Documents is RX 940, which also uses a settle date of May 31, 2006, but which analyzes a *non-Index bond*, OOMLT 2003-5 M6, and hence is irrelevant for assessing what work Lieu did on the Index bonds. All indications are that RX 940 was created in July 2007.

[132] *See* Div. Ex. 1 at 40 (no mention of Cho in August 2006 pitchbook listing Harding personnel).

[133] Compare this to RX 968 and 969, whose original names were "Octans 2 & 3 Cash Flow Detail Part 1 (August 2006 Assumptions).xls" and "Octans 2 & 3 Cash Flow Detail Part 2 (August 2006 Assumptions).xls." Div. Exs. 9007, 9008.

severity, and prepay were the later set. The bonds were run with a "settle date" of May 31, 2006, but again, this is meaningless because one can always go back and produce cash flows with an older settle date (as Lieu did at home).

It is essential, moreover, to understand that, being "portfolio runs," RX 966 and RX 967 were created *as a whole and all at once*. Just as with the 1:13 Cash Flows in Div. Ex. 53, Intex ran a set of bonds through a common set of assumptions, producing cash flows for all of them simultaneously. *E.g.*, Wagner Tr. 4549:16-22; Lieu Tr. 3845:19-23. And, because RX 966 and RX 967 analyze *all* the bonds in the Octans I portfolio as of the run date, *they cannot possibly have been created in May 2006, when the portfolio had not finished ramping.*

When the "settle date" in Intex is set before a bond actually comes into being, Intex generates an error message. Wagner Tr. 4550:25-4552:12; Lieu Tr. 4032:4-10. Using these error messages, as well as Harding's actual trading activity for Octans I (as shown by Harding's trade blotter, Div. Ex. 6), Wagner determined that RX 966 and 967 were created *no earlier than June 2007.* Wagner Tr. 4549:23-4550:15, 4552:19-4553:3. Here are a few examples for illustration, identified by CUSIP:

- **00441VAM0**. Harding purchased this bond for Octans I with a trade date of August 3, 2006 and a settle date of August 25, 2006. Div. Ex. 6, Excel row 1467. In RX 966, the tabs for this bond have an error message: "Portfolio Totals Accumulation Failed: . . . cannot add security to portfolio because deal settle date (20060825) differs from portfolio settle date (20060531)." In other words, the bond did not exist in the marketplace before August 25.

- **40431JAN3**. Harding bought this bond for Octans I in April 2007. Div. Ex. 6, Excel row 3016. In RX 966, the tabs for this bond have a similar error message: "deal settle date (20070130) differs from portfolio settle date (20060531)."

- **93935KAL4**. Harding bought this bond for Octans I ***<u>in late June 2007</u>***. *See* Div. Ex. 6, Excel row 3255. In RX 967, the tabs for the bond have a similar error message: "deal settle date (20070116) differs from portfolio settle date (20060531)."

Because these portfolio runs include bonds purchased as late as April and June 2007, *they could not have been created any earlier than late June 2007*. And, since RX 966 and 967 do *not* include runs for three bonds added to Octans I in late July 2007,[134] they have to have been created in between late June and late July – which is consistent with the July 13, 2007 creation date shown in the Excel files.

C. Hilfer's Second Report Does Not Help, Not Least Because It Repeatedly Shows Writedowns Even Under the "Corrected" Assumptions

It was not entirely clear what Respondents were trying to accomplish with the second Hilfer report.[135] Hilfer's first point seems to be that Harding used a "non-standard industry prepayment convention." Hilfer Supp. Report ¶ 26; Hilfer Tr. 4977:16-4978:8. It is hard to see how this helps Respondents, since if valid,[136] it would be an admission that Respondents used Intex in *violation* of industry standards even as they made representations about their *compliance* with industry standards. Hilfer's second point seems to be that if the "prepay rate" setting had been used (and there is no evidence it was), fewer bonds would have shown writedowns. Hilfer Supp. Report ¶¶ 32-34 & Table 3. But fewer is not the same as none, and even with the supposedly standard prepayment setting, four bonds showed writedowns.[137]

---

[134] The three bonds' CUSIPs are 00076BAK0, 00076BAL8, and 00076BAM6. *See* Div. Ex. 6.

[135] Hilfer conceded that his second report contained "some additional information" beyond rebutting Wagner, Tr. 4952:6-25 – in other words, analysis in violation of the Court's ruling that Respondents could only rebut the Division's experts, not offer direct expert analysis of their own. *See* March 18, 2014 Order; *see also* March 14, 2014 Tr. 24 ("I am not going to consider it unless it really is rebuttal evidence. It's going to have to fall within the scope of the Division's expert evidence.").

[136] The premise is extremely questionable. There must be a reason why Intex offers five different prepayment "conventions" (the very word implies some kind of general acceptance), four of which, according to Hilfer, would have produced similar results. *See* Hilfer Supp. Report at 10 n.14.

[137] This discredits Lieu even more, if that is possible; she insisted that, *without* a mistake: "I would expect anything really above 10 percent to be unusual and uncommon." Tr. 3661:17-18; *see also* Tr. 3950:10-16. The SAIL Index bond at the Baa3 level that Lieu said yes to showed 18.72% writedowns even under Hilfer's supposedly corrected settings. Hilfer Supp. Report Table 3.

Hilfer also reviewed RX 972, 973, and 974, but *these are cash flows for bonds that were not in the Index and, in two cases, were not even purchased for Octans I.* Hilfer Tr. 4957:9-15. They have nothing to do with Lieu's review of the Index bonds. What is more, despite Hilfer's statement (in ¶ 43) that "[t]he projected principal write downs for all three RMBS contained in [RX 972, 973, and 974] for all four different scenarios are zero," in actual fact, *two of the bonds did show major write downs under the very assumptions that the defense seems to be arguing Lieu intended to use. See* RX 973, 974.[138] Hilfer essentially conceded that this was a major error in his report. Tr. 4966:25-4970:17. Finally, Hilfer's unelaborated assertion that the later set of assumptions is "consistent with industry standards" (¶ 46) is irrelevant, because it is impossible to show that those assumptions were used to make the investment decisions at issue.

* * *

To recap, Respondents have no credible support for their post-hoc version of reality. There is no evidence to support the "latent defect" theory apart from Lieu's patently incredible say-so. Respondents have produced analyses for 19 of the 28 Index bonds (the other nine are still unaccounted for); they are easily shown to have been created long after May 31, 2006. Among other things, all have a "settle date" well after May 31, except for RX 941 (the one Backfilled Bond Analysis used at the hearing) and 948 (which the metadata show was created August 30, 2006). The portfolio runs (RX 966 and 967) were generated in July 2007, when the backfill project was in high gear. Hilfer's attempt to change the prepay setting, besides being irrelevant, *also* shows significant writedowns in one of the BBB- Index bonds purchased for Octans I, and

[138] To use the example of RX 973, scenario 3 shows a principal writedown of $654,081.51. The entire tranche balance was 6,017,000, making for a writedown percentage of nearly 11%.

of the three *non-Index bonds* that he reviewed, two reflect (contrary to his report) significant writedowns even under the different sets of assumptions.

VIII. HARDING'S ACQUISITION OF RMBS AT MAGNETAR'S BEHEST WAS AN EXTREME DEPARTURE FROM THE STANDARD OF CARE – AND RESPONDENTS KNEW IT

Wagner's exposition of the applicable standard of care, including the "customary standards, policies and procedures followed by institutional managers of national standing," was not only never *rebutted*, it was forcefully *corroborated* by the testimony of Ken Doiron. Doiron's firm, HIMCO, is an actual example of an institutional manager of national standing (*see* footnote 78, *supra*), and his understanding of industry standards is informed by "how we ran our group" as well as conversations with other industry participants, industry publications, and conferences. Doiron Tr. 1883:10-1884:23. In Wagner's explanation, the standard of care requires a "standardized, consistent, rigorous, thorough, and independent investment process." Wagner Tr. 4579:16-4582:19; *see also* Wagner Report at 3-4 (Op. II(b)). Harding had no such thing, at least not with respect to the Index bonds.

A. Octans I

Harding had no basis consistent with the standard of care for approving many of the Index bonds for Octans I, and its desire to please Magnetar corrupted the independence that anchors a manager's standard of care. The analysis itself was frequently negative or non-existent, and in all events "limited and rudimentary" insofar as "stress testing outside of a standardized [cash flow] run was lacking." Wagner Report at 3-4 (Ops. II(a)(i), (viii), II(b)), ¶ 81; Wagner Tr. 4922:18-4923:2.[139] Doiron testified that he would not expect a CDO manager to run just one base case, let alone no cash flows at all, nor would he ever expect a manager to accept bonds that

[139] *See also* footnote 79, *supra*. Hilfer agreed on the importance of running stress cases.

showed heavy write downs even in the base case. Doiron Tr. 1888:11-1890:7, 1920:7-14, 1923:22-1925:17.

Doiron testified as well that he would never expect a CDO manager to buy bonds that the portfolio manager and the firm were not comfortable with. Doiron Tr. 1882:25-1883:9, 1920:21-1921:9. Yet Harding bought Baa3-rated bonds that it was "less comfortable" with, Div. Ex. 81, as well as many dealer shelves in the Index despite Huang's unfavorable view of them, *see* section V.G., *supra*.

The Backfill Documents only compound the violations. Wagner opined that Harding's "[l]imited documentation" of its credit decisions violated the standard of care. Wagner Report at 3-4 (Ops. II(a)(ix), II(b)). He further testified that it would be a violation to document an investment decision using assumptions different from those actually in place at the time of the investment decision, including by reverse-engineering the assumptions until the results came back positive. Wagner Tr. 4934:12-4935:12. Yet that is what produced the Backfill Documents.

The standard of care was also violated by the rushed nature of the analysis. Wagner Report at 3-4 (Op. II(a)(iv), II(b)), ¶ 67; Wagner Tr. 4923:21-4924:5. As discussed above (*see* sections VI.B., VI.H.), Lieu simply did not have enough time. Doiron agreed, testifying that he would not expect a CDO manager, consistent with industry standards, to be able to analyze 30 or 40 bonds in an afternoon or a day. Doiron Tr. 1902:15-24, 1921:10-24, 1953:22-1954:8.

Yet another violation was the failure to reconcile the analysts' differing views. The industry standard requires collaboration and consensus, not unilateral review by a relatively junior employee. Wagner Report at 3-4 (Op. II(a)(v), II(b)), ¶¶ 103, 106, 131, 132; Doiron Tr. 1878:8-1879:9, 1886:6-1887:5, 1888:3-10, 1993:24-1994:4; *see also* Jones Tr. 2846:13-16, 2847:5-7 ("Everything got discussed. There was nobody that was in our group that was just allowed to buy whatever they wanted without talking to everybody."); Lieu Tr. 3553:18-3554:3 (credit committees at other places Lieu worked operated by consensus). Doiron was insistent that if a credit analyst does not like a bond, the bond should not be bought, and analysts should never be pressured to relax their standards. Tr. 1885:9-1886:5, 1909:15-1910:7, 1921:25-1923:21.

Relatedly, there was no meaningful oversight of the analysts' decisions; instead, in the case of the Index trade, Huang simply rubber-stamped Lieu's hasty selections – another violation. *See* Wagner Report at 3-4 (Op. II(a)(v), (vi), II(b)), ¶¶ 99, 112, 117, 119, 131, 132; Wagner Tr. 4805:16-4806:2, 4924:16-4925:9; Doiron Tr. 2033:19-2035:15. In fact, Harding *never* had a functioning system of oversight.[140]

B. Octans II and III

As further evidence of a practice of disregarding the standard of care to accommodate Magnetar, Chau pressured the analysts to accept the "lesser of evils" for Octans II and baldly overrode their views for Octans III. *See* section V.J. above. Wagner and Doiron explained that this is inconsistent with industry standards. Wagner Report at 3-4 (Ops. II(a)(ii), II(b)), ¶¶ 108-111; Wagner Tr. 4813:19-4816:14; Doiron Tr. 1885:9-1886:5, 1923:5-21. Respondents argued at the hearing that because Octans III was initially set up as a "bespoke" trade involving Magnetar

[140] At some point after the move from Maxim to Harding Advisory there existed an "investment committee" consisting of Chau, Huang, and Wang. Wang. Tr. 326:12-15; Huang Tr. 965:19-966:2. However, this was not a bona fide committee that met to consider proposed investments, but rather three people who each had separate authority to sign off on investments proposed by more junior employees. *See* Wang Tr. 328:10-330:12; Huang Tr. 966:3-971:20; Wagner Report ¶ 121. Two of the three testified that they had limited or no involvement in reviewing RMBS investment decisions. Wang Tr. 332:9 – 334:4, 339:16 – 342:2; *see* footnote 64 above on Huang. (In fact, Wang, given her background as a tax lawyer, probably was not qualified to make investment decisions. *See* Wang Tr. 219:12 – 224:7; Huang Tr. 975:19-25.) As for Respondents' suggestion that Wagner and the Division are contradicting themselves by simultaneously complaining about rubber-stamping *and* overruling, *see* Tr. 4816:15-21, there is no inconsistency. The industry standard calls for *substantive review and discussion*. If views differ, they must be reconciled. Even if views are the same, there should be meaningful review to confirm it. Wagner Tr. 4814:21-4815:16, 4816:22-4817:6. Nothing of the sort took place at Harding, at least not where the Index bonds were concerned.

and Citigroup's proprietary "correlation" desk in London, Chau was entitled to ignore his analysts' views in favor of Magnetar's and Citigroup's judgment. *E.g.*, Tr. 4819:17-4820:8. This argument is profoundly wrong-headed.

Octans III was designed to be syndicated to investors beyond Citigroup – and in fact *was* sold to investors beyond Citigroup.[141] (Prusko's testimony in substance was that Citigroup need not, *but very well might*, sell the liabilities.[142]) There was a 239-page offering circular for the transaction expressly addressed to potential outside investors (not Citigroup). Resp. Ex. 891 at 1. As Huang explained: "*usually bespoke, there are only two parties involved* . . . . Eventually both parties would agree on a set of names on that basis to do a transaction." Huang Tr. 1417:23-1418:6. That is, Citigroup and Magnetar could have simply agreed between themselves on the collateral. The reason for involving Harding was obviously to convey the appearance of independent selection by a professional asset manager, and thereby make it easier for Citigroup to sell the notes. Indeed, the engagement letter for Octans III not only contemplated that, at Citigroup's option, Octans III's liabilities could be sold to outside investors at a future point, but also required Harding to "make itself available to facilitate such placement," in other words to participate in the marketing effort. Resp. Ex. 865 at 1-2.

Sure enough, the offering circular for Octans III (i) contains a description of Harding, (ii) specifically says *Harding* (not Citigroup or Magnetar) will select the portfolio for the Issuer, and (iii) represents that Harding will perform its obligations "with reasonable care . . . and . . . in a manner consistent with the customary standards, policies and procedures followed by

---

[141] This is not news to Respondents. The investors in Octans III included Harding's own 888 Tactical CDO. *See* Div. Ex. 6, Excel row 2956.

[142] Prusko Tr. 2489:8-17 ("the structure was set up *such that they could create and distribute cash liabilities*, but they weren't *necessarily* intent on [dis]tributing *the entire capital structure*"), 2629:7-9, 2767:17-2768:2.

institutional managers of national standing." Resp. Ex. 891 at 118, 121, 122. All this would have been irrelevant if the only thing that mattered was Citigroup's and Magnetar's approval of the assets. As Wagner explained, it is no answer to say that "the deal was different" or that Magnetar and Citigroup had approval rights – the manager was involved, and its processes and duties still mattered. Wagner Tr. 4824:17-4825:16, 4826:19-4827:9, 4828:16-21; *see also* Doiron Tr. 1919:2-24 (compromising investment and credit processes to accommodate a third party violates industry standards). Huang testified that Harding should *not* have compromised its credit standards for Octans III if there were other investors beyond Citigroup and Magnetar, and that, if Harding *had* compromised, other investors would have wanted to know.[143]

C. Respondents Knew That the Index Purchases Were an Extreme Departure from the Standard of Care

Chau and others at Harding knew exactly what was supposed to be done.[144] Harding maintained written "Investment and Surveillance Procedures" that set out "best practices" for review of RMBS and CDO investments. *See* Div. Ex. 7 (December 1, 2005 version); Div. Ex.

---

[143] Huang Tr. 1414:16-1415:5; *see also id.* at 1221:21-24 ("To me, the process [for Octans III] is exactly the same. We went through the same process for the index names that we went through for Octans 1 and Octans 2.").

[144] Tellingly, Huang admitted that Harding (along with others in the marketplace) routinely departed from the level of diligence that *he* was comfortable with, and that these issues were magnified by Magnetar's involvement (Tr. 1049:23-1050:2, 1050:15-1051:23, 1194:13-1195:6):

> at that time everything was kind of on an accelerated basis. And from my personal view is nobody has enough time, frankly, to do the necessary amount of work.
>
> * * *
>
> based on the way I wanted to [review assets], it is just not – physically impossible. . . . That is part of the reason why we had the mess we had, you know, in '07, '08. . . . Magnetar, do they make the problem worse? Maybe. They certainly more involved, they wanted the thing done, you know, whatever, from their perspective, I guess I can understand it. It was a universal problem.
>
> * * *
>
> I could have done better. . . . I probably worked harder in the beginning. Later as I testified yesterday, I was kind of a – took it easy. I didn't do whatever – I was a little – frankly, I was detached from the business.

225 (April 13, 2007 email from Wang to Chau and Huang attaching updated version of Div. Ex. 7). These written procedures bear no recognizable relation to the corrupted process for selecting RMBS for the Octans transactions. Here are just a few examples:

- "All RMBS deals should be reviewed by at least three members of the Maxim Advisory portfolio management team." Div. Ex. 7 at 5; *see also* Div. Ex. 225 at 8 (similar wording, but with reference to credit committee).

- "After performing the initial screening and in-depth review of the potential investment, the members of the portfolio management team (which will consist of at least two people) analyzing each deal will summarize the relevant deal characteristics and stress run results and present the transaction to a senior portfolio manager." Div. Ex. 7 at 8; *see also* Div. Ex. 225 at 11 (similar wording, but with reference to committees).

- "Regardless of whether Maxim Advisory participates in a deal, the analyst will create a folder for the transaction and save the term sheet, the prospectus, any collateral information or other material provided by the dealer, the Maxim-created summary and the Maxim stress runs." Div. Ex. 7 at 8-9; *see also* Div. Ex. 225 at 12 (similar).

What is more, Harding knew how to spot when its investment process departed so far from the standard of care that disclosure was warranted. As discussed above (section VI.F.), Harding was asked by Citigroup in August 2006 to assemble a portfolio by kicking the worst names out from a list pre-selected by Citigroup. Before Harding proceeded, Wang emailed Citigroup (cc Chau) to note that the cursory review would not be representative of Harding's "customary methodology or standard of care for selecting individual RMBS names," and to insist on appropriate disclosure. Resp. Ex. 457. (Wang was unaware of the Index trade for Octans I at the time it was happening. *See* footnote 49 above and accompanying text.)

Respondents, in other words, understood full well that having one analyst single-handedly bang out decisions on a few dozen pre-selected bonds in one day on the basis of limited cash flow and surveillance work did not comport with the standard of care, or Harding's own best practices – to the point that it called for disclosure. *See* Wang Tr. 486:9-493:13.

IX. THE CDO MANAGER'S INTEGRITY, PROCESSES, AND ANALYSIS WOULD AND DID MATTER TO REASONABLE INVESTORS

Respondents contend that, because the relevant collateral was disclosed, no investor can have been defrauded or misled by its inclusion in Octans I. This argument is a non-starter. Many CDO investors, despite conducting their own review of the collateral, were extremely focused on the manager's review of it and would have considered it important if the manager's selection process was (i) corrupted by other parties, (ii) not as represented in the marketing materials, or (iii) otherwise inconsistent with prevailing standards of care. This is why potential investors (including at times Harding) often asked CDO managers about their credit processes and reasons for selecting specific bonds.[145] As Doiron explained (Tr. 2063:17-2064:2):

> Q. . . . If HIMCO can independently diligence the RMBS assets that had been ramped in the Octans 1 CDO, why bother asking the manager for its comments?
> A. Because you relied on their expertise, you know, as a manager, and their experience and staff in addition to your own analysis.
> Q. How about also their diligence and level of care?
> A. Yes.

Further support for the importance of the collateral manager's role comes from each witness with experience investing in CDOs:

<u>Wing Chau</u>

Chau has previously testified that investing in a CDO means "you're betting the manager." Tr. 4353:14-4354:14. Chau acknowledged not just that investors in *his* CDOs wanted

---

[145] *E.g.*, Lieu Tr. 3570:3-3571:8 ("[investors] want to understand what is the process that the manager goes through every day to look at the securities in order to make the decision on whether or not they're doing their job."), 3572:14-3574:10 ("they wanted to know what the manager's views are" on bonds already acquired for the portfolio); Jones Tr. 2836:14-19 (potential investors in Jones' CDOs "would frequently say, 'Let me see your work on this,' or 'Let me see your work on that' for a lot of different reasons."). Respondents' theme that Octans I investors could not have been deceived because they had the opportunity to ask questions of Harding barely warrants discussion. The people doing the answering included Wing Chau and Jung Lieu (who embellished so much that Huang sometimes "kind of like roll[ed] my eyes"). There is no reason to think that Harding truthfully answered investors' questions.

to understand Harding's "investment philosophy and style," Chau Tr. 1827:12-21, but that *he too* relied on the expertise of other managers in deciding whether to invest in *their* CDOs. Chau Tr. 1537:23-1538:5, 1539:23-1540:4. Chau agreed that, at least in the case of an actively managed CDO, the name and identity of the manager were an important selling point. Chau Tr. 1826:3-11. (There is no dispute that Octans I was a managed CDO. *E.g.*, Chau Tr. 2104:15-17 ("It's an active deal."); Tr. 2563:13-25 (Respondents' counsel: "we'll agree it was a managed [CDO]."))

Tony Huang

Huang testified that in evaluating CDOs for potential investment, it was important for Harding to understand the other manager's philosophy, expertise, investment process, and operational structure. Tr. 1014:16-21. Although Harding could analyze the collateral in the CDO as of the time of the marketing, "we don't know entirely what is going to go into the CDO. Only a portion of it was available at that time." Huang Tr. 1016:24-1017:13. (Usually CDOs are *not* fully ramped up at closing. Suh Tr. 3026:17-21; *see also* footnote 147 below.) According to Huang, "if you don't trust the manager, you don't buy." Tr. 1019:24-1020:4.[146]

Harding sometimes asked other managers questions about their purchase of specific assets. Huang Tr. 1022:4-6. Huang testified that despite the commonalities among pitchbooks, he would be concerned if a manager was not doing the things that every manager says it does. Tr. 1020:10-1021:8. If proper analysis was not done on RMBS bonds, or if it was done and the results were negative under the manager's *own* assumptions, but the manager bought the bonds anyway, Huang would be concerned. Tr. 1021:9-19, 1022:12-17. Also of concern to Huang would be a CDO manager taking in assets that one of its own analysts warned against, or rushing

[146] Huang testified that the *degree* of importance he attached to the manager varied depending on whether the CDO was actively managed as opposed to static. Huang termed Octans I a "quasi static" transaction. Tr. 1017:20-1019:18.

through its work without properly vetting collateral so as to please an undisclosed third party. Tr. 1023:6-22. All of these things could have affected Huang's interest in a CDO. Tr. 1024:7-11.

Ken Doiron / HIMCO

Doiron was emphatic that the manager of a CDO was important to him when he reviewed a CDO for potential investment. Tr. 1874:22-25. While HIMCO did its own analysis of the assets ramped into a CDO,[147] Doiron expected the manager to be more familiar than HIMCO with the assets in its own CDO, and to have done at least as much analysis on the underlying assets as HIMCO did in reviewing the CDO. Tr. 1875:11-25. According to Doiron, the manager is paid for its expertise and familiarity with the collateral in the CDO. Tr. 2029:23-2030:4.

Doug Jones

Jones was the lead portfolio manager at Maxim Capital Management ("MCM"), a CDO-management firm housed at Maxim Group after Chau left.[148] Jones Tr. 2796:7-24. Although he emphasized that MCM did its own analysis of the collateral in the CDOs it considered buying, he testified that the manager's identity, personnel, and capabilities were the *first* things MCM needed to get comfortable with in reviewing a CDO. Tr. 2824:3-2825:6, 2835:7-15; *see also* Tr. 2870:13-15. Further, MCM's own investors "would always ask" about MCM's work reviewing assets:

> We had rooms of fifty people from Asia that would come and we would give a presentation of our process from soup to nuts, and go through step by step what we did, what we looked for and what we liked, what we thought were good ways to build these deals. And then there were additional meetings that we had with people where we went

[147] HIMCO could not have known *everything* that would be included in Octans I: Its "CDO bucket" was not completed at the time of HIMCO's review. Tr. 1969:24-1970:2 (quoting internal HIMCO analysis of Octans I in Resp. Ex. 612: "completion of ramp will consist of CDOs").

[148] This was a source of bias for Jones. Maxim Group is not widely known (*see* Jones Tr. 2798:13-15), and Jones acknowledged that an adverse ruling for Chau here "would not be good for" its reputation. Tr. 2862:7-10. Jones spent five and a half years at Maxim Group. Tr. 2796:15-17, 2858:7-8, 2859:19-2860:2.

> through a pitchbook step by step. We talked about things that we were looking for, things we wanted to do.

Tr. 2868:22-2869:18.

Michael Edman

Edman worked in a proprietary trading group at Morgan Stanley. Tr. 2498:12-22. Despite his emphasis on Morgan Stanley's ability to analyze a CDO's structure and collateral, Edman acknowledged that investors are "relying on the manager" to the extent a portfolio is not fully ramped at the time an investor buys in, as well as with respect to investment decisions post-closing. Tr. 2577:9-2578:16. Edman testified that "we would care more about the manager if it were a managed deal than if it were a static deal." Tr. 2582:3-21; *see also* Resp. Ex. 917 at 1, 2. (Again, there is no dispute that Octans I was managed.) Edman acknowledged that the manager is paid for its work sourcing assets because "they're looking out for the investors in the CDO." Tr. 2582:22-2584:6. Edman testified that "it would concern me" if the manager of a managed CDO had not lived up to its obligations of diligence during the ramp. Tr. 2592:10-20.

X. RESPONDENTS BUY NORMA AS A FAVOR TO MERRILL AND MAGNETAR

Norma was another Merrill-Magnetar CDO. The collateral manager for Norma was NIR Capital Management ("NIR"). Lasch Tr. 153:20-154:9. Harding ultimately placed Norma securities into four of its CDOs: Lexington Capital Funding V Ltd. ("Lexington V"), Jupiter High-Grade CDO VI, Ltd. ("Jupiter VI"), Neo CDO 2007-1, Ltd. ("Neo"), and 888 Tactical Fund, Ltd. ("888 Tactical") (collectively the "Norma Recipients"). In so doing, Harding breached its fiduciary obligations.

A. Chau Buys Single-A Norma Notes Without Meaningful Analysis

Harding was such a high-volume buyer of Merrill-underwritten and other CDO securities that, well before Norma was marketed, Merrill assumed Harding would buy a significant quantity of it. Moreover, some market participants clearly regarded CDO buying as a form of currency, a favor to be swapped. On December 6, 2006, Prusko emailed NIR's portfolio manager Joseph Parish, as well as Phelps and Eliran of Merrill Lynch, concerning the contents of Norma's "CDO bucket."[149] Div. Ex. 184 at 2; Prusko Tr. 2631:6-10. Syndicate head Phelps then suggested to Parish and Prusko that they consider putting into Norma's CDO bucket tranches of Lexington III (another Merrill-Harding CDO) to reward Chau "given th[at] Wing has been a big buyer of Scorpius, Auriga,[150] *and very likely the Norma deal.*" Div. Ex. 184 (emphasis added). Prusko advised Parish that the two of them could indeed "support Wing" by buying Lexington III notes, albeit only at a discount. Div. Ex. 184 at 1; Prusko Tr. 2754:4-6.

The marketing of Norma began on January 8, 2007. Chau received the price guidance, pitchbook, and term sheet on January 9, 2007. Div. Exs. 188, 190; Chau Tr. 1578:20-1579:24, 1582:14-1583:18. Up to that point, Respondents had no idea what collateral was in Norma, and had not received any information on its structure, portfolio allocation, and the like. Chau Tr. 1580:24-1582:9, 1583:19-1585:8.

Chau's reaction to these materials was to write to Merrill sales representative Catherine Chao: "Turbo structure is very weak . . . we prefer the old style amortization." Div. Ex. 189; Chau Tr. 1580:16-18, 1585:12-16. Turbo is a feature of the waterfall structure by which income that would otherwise go to the equity is diverted to pay principal to more senior tranches. Here, the turbo structure was weak because it would send less income to repay the holders of notes above the equity tranche. Wagner Report ¶ 154; Chau 1585:22-1586:10. Chau admitted that the

[149] Magnetar was trading against Norma, buying protection from it on assets in its CDO bucket. *See* Div. Ex. 184 at 2 (Prusko referring to "me buying CDS protection").

[150] Scorpius and Auriga were two other Merrill-Magnetar CDOs. *See* Lasch Tr. 139:14-19.

"weak" turbo was better for the equity and worse for the debt tranches, and that all else being equal, he would have preferred a stronger turbo structure than Norma's. Tr. 1586:14-1588:5.

On January 16, 2007, at 9:34 a.m.[151] Phelps asked Chau via Bloomberg message: "Ready to talk about your participation [in Norma]?" Div. Ex. 191; Chau Tr. 1589:9-22. At this point, Harding had no information on Norma other than the pitchbook and term sheet. Later that day, Chen asked Kaplan to prepare "numbers" on several CDO portfolios, including Norma's, and both Kaplan and Chen asked Merrill for information on the Norma portfolio. Div. Ex. 197 at 2; Div. Ex. 192; Resp. Ex. 886.[152] Early on January 17, Merrill's Chao sent Harding the portfolio information. Div. Exs. 194 & 195. Later that day, Chao asked Chau in a Bloomberg message about the Norma BBB bonds, and Chau joked: "I thot her size was more in the single-A area. Just busting your chops. Talkin' to Phelps about it." Div. Ex. 193; Chau Tr. 4182:6-4183:11.

By January 19, Kaplan had not responded to Chen's request for "numbers" on Norma, nor, as Chau conceded, had Harding done any other in-depth analysis. Chau Tr. 1596:5-1597:5; *see also* Div. Ex. 197 (Jan. 22 email from Kaplan did not include numbers on Norma); Div. Ex. 216 & Chau Tr. 1600:4-14 (Chen asked Kaplan to "write up" Norma on Feb. 22). Nevertheless, on the basis of the pitchbook and term sheet – and without having received a preliminary

---

[151] The second line of the message makes clear the correct time, and that the time stamp in the header was rendered in GMT – five hours ahead of Eastern Standard Time (EST).

[152] Chen's email (Div. Ex. 192) requested "portfolio strats" (short for stratification), meaning the list of RMBS securities in the portfolio and a breakdown of certain information relating to the RMBS. Chau Tr. 1591:11-1592:8. Strats did not give the most granular information about the RMBS in the portfolio, or give any indication what Harding's own analysts thought of that collateral. Chau Tr. 1592:9-1593:9.

offering circular ("POC")[153] – Respondents decided to buy $40 million of Norma's single-A tranche for three CDOs being ramped by Harding.[154] Respondents did not buy the BBBs.

B. "Wing is in for $20mm" – Chau Accedes to Pressure To Buy BBB Norma Notes

On January 23, 2007, in a 7:33 a.m. email,[155] Prusko informed Snyderman: "Sharon [Eliran] was quite whiny and down about norma bbb's" – Prusko acknowledged at the hearing that this meant Merrill was having difficulty marketing the Norma BBBs (*see* Prusko Tr. 2639:2-18, 2653:3-13, 2747:9-14) – "but phelps to his credit was very aggressive, sounds like he will use his clout to stuff people with them, will stick Baa3's in cdo2's in their pipeline." Div. Ex. 199.[156] Prusko continued: "I will personally hammer wing, he's getting too big for his britches, we left a lot of loot on the table there." *Id.*

Two minutes later, Prusko wrote to Chau, in an email titled "Pls buy some norma bbb,": "Stop complaining about turbo. :) Remember who was there for u when u were a little guy." Div. Ex. 200; Chau Tr. 1600:25-1602:17; *see also* Prusko Tr. 2643:15-20. Chau deflected the request; at this point he still had not expressed any interest in the BBBs. Chau Tr. 1611:22-1612:3. At 8:08 a.m., Chau asked Prusko: "Did ML tell u I am in for 40mm single-As in Norma – team

[153] There is no evidence that Harding had the Norma POC before January 24. *See, e.g.*, Resp. Ex. 975 at 3 (conceding this).

[154] Div. Ex. 196 (email from Chen to trading assistant Theo Pan, cc Chau, specifying amounts, allocation, and price for Norma single-A); Resp. Ex. 975 at 2 (describing Div. Ex. 196 as "Harding's initial decision on Norma."); Chau Tr. 1570:20-1571:13, 1593:12-16, 1597:6-19 (testifying that Div. Ex. 196 represented an investment decision). Harding later tweaked which CDOs received how much of the $40 million in single-As, among other reasons because Lexington IV apparently never closed. *See* Div. Ex. 239. The final allocation is reflected in Div. Ex. 237 and Div. Ex. 6 (Excel rows 2805, 2806).

[155] The context indicates that the time in the top-most header in Div. Ex. 199 (identified as "12:33 p.m.") was probably GMT, such that the correct time in EST was 7:33 a.m.

[156] While some of the difficulty of selling Norma may have been due, as Prusko suggested, to market conditions in January 2007, some was certainly due to characteristics specific to Norma. The collateral was clearly undesirable, as discussed below (*see also* footnote 164), and, as Huang explained, Magnetar CDOs in particular contained structural features that made it "harder to sell the mezz." Huang Tr. 717:2-10, 747:6-8.

player!!!" Div. Ex. 200. Chau's testimony on this email was that he wanted Prusko to know that he had done something in Magnetar's interest: "I am trying to build goodwill." Chau Tr. 1603:5-1604:23, 1606:3-1607:13. Prusko replied: "No, they did not, *they were just bustin' on u about the bbb's, gave you no credit for A's, that's great, thank you*." Div. Ex. 200 (emphasis added); *see also* Prusko Tr. 2754:18-23. Chau testified as follows regarding Prusko's request that he purchase the Norma BBBs (Tr. 1610:4-21):

> Q. To be sure I understand, is it your testimony it might have benefitted Merrill, but it would definitely benefit Magnetar?
> A. Yes.
> Q. And you knew that at the time?
> A. Yes.

On January 23, within hours of the Prusko-Chau exchange,[157] Phelps asked Chau via Bloomberg message: "what's your level on BBB or BBB- if we can't change the turbo?" Chau responded: "ah-so, let me sharpen the pencil," to which Phelps replied: "sweet." Div. Ex. 198. Chau testified: "Q. You knew at this point keeping Merrill Lynch happy was important because they were such a large part of your income flow. Correct? / A. Yes." Chau Tr. 1613:13-16. Chau acknowledged, too, that Phelps' gratitude for Harding purchasing the Norma BBB notes would help Chau "in building goodwill." Chau Tr. 1618:2-19.

The next day, January 24, Phelps asked Chau: "so, have you 'sharpened your pencil' on norma BBBs yet? or has your citi mezz deal and bbb lists in the street taken up too much of your time?" Div. Ex. 205; Chau Tr. 1620:24-1621:10. Chau replied: "I never forget my true friends." Div. Ex. 205. Chau acknowledged in testimony that the "true friends" in question were Merrill Lynch and Magnetar. Chau Tr. 1622:14-20.

[157] The time stamp on Div. Ex. 198 says 2:42 p.m., but this is a Bloomberg exchange. As discussed elsewhere in this brief, the time in the header of other Bloomberg exchanges was rendered in GMT, meaning that the time of the last transmission in Div. Ex. 198 was likely 9:42 a.m. EST.

Later that day, Merrill CDO co-head Margolis spoke with Chau. Div. Ex. 204. Margolis and Chau had known one another for many years, and ultimately became close. *See* Chau Tr. 1479:16-20, 1481:18-21.[158] Margolis reported on the conversation in an email to Phelps and Eliran titled "Wing is in for $20mm": "*I told him we would try and sell him down to $15mm if we could . . . He wants to talk about the spread but he will be in.*" Div. Ex. 204 (emphasis added). In other words, Chau caved to the combined pressure from Prusko, Phelps, and Margolis, agreeing to buy the Norma BBB notes without even knowing the spread he would get.[159]

By January 26, 2007, Merrill had finally placed enough of Norma's liabilities that the deal priced. Div. Ex. 207. Merrill's Chao confirmed Harding's commitment to buy $40 million of Norma's single A (class D) and $20 million of Norma's BBB (class E) notes, the latter at par (not a discount). Div. Ex. 207. On February 1, Catherine Chao wrote to Chau: "u got the news on your decreased Norma BBB allocation, yes?" Div. Ex. 210; *see also* Chau Tr. 1628:11-14, 1633:9-12. One minute later,[160] Chau responded: "Now that's what I'm talking about, the love is in the air," *id.* – a sign as clear as can be that Chau had not wanted the BBB bonds in the first place. Merrill's revised confirmation on February 2 indicated that Harding would acquire only $15 million of the BBB (class E) notes, just as Margolis had discussed with Chau. Div. Ex. 212

[158] By the time of the Norma marketing, Margolis, on behalf of Merrill, was working with Chau on a potential new venture by which Harding would provide a platform to other CDO managers. Div. Ex. 213; Chau Tr. 1484:17-1486:18. Merrill agreed to invest significant capital in the venture. *See* Div. Ex. 182 (Nov. 7, 2006 email from Margolis to Chau: "We are also committing $30 million for your permanent equity vehicle."); Div. Exs. 183, 185, 187 (discussions from Nov. 2006 to Jan. 2007 about the project). Later in 2007 or early 2008, Margolis went to work for Harding. Chau Tr. 1483:12-17.

[159] There is no reason to take this email at anything other than face value. Chau himself attested that Margolis knew his business: "I had much respect for Mr. Margolis. He is very bright. One of the smartest and capable persons I have ever met on Wall Street." Tr. 1484:9-12.

[160] The "16:12:17" time stamp on the header is expressly indicated to be GMT. The time in EST was thus 11:12 a.m.

(10:18 a.m. email[161]); Chau Tr. 1642:14-1643:15. Also, on February 1, another buyer (not Harding, which had already agreed to acquire $20 million of the BBB at par) succeeded in bringing the price of the BBBs down (*i.e.*, increasing the spread).[162]

The "love is in the air" comment speaks for itself, and Chau has never offered a credible explanation for it. His explanations at the hearing were discursive to the point of incoherent, *see* Chau Tr. 1628:20-1631:22, and his suggestion that the email was "sarcastic" because he was actually upset with the decreased allocation (Tr. 1631:23-1632:9) was first supplied by his counsel during investigative testimony when Chau was otherwise unable to explain the email.[163]

C. Harding's Eventual Analysis of Norma Was Extremely Negative

Chau has admitted that there is no evidence of any analysis of Norma before Respondents committed to purchase it. Tr. 1642:8-13. He has also been consistently unable to explain why

---

[161] The 10:08 a.m. email in Div. Ex. 212 may have been a mistake by Catherine Chao.

[162] The revised confirmation to Harding on February 2 (Div. Ex. 212) indicates that the class Es would be sold at 97% of face value (as opposed to 100.00, or par), with a discount margin ("dm," equivalent to spread or coupon) of 505 basis points ("+505") above 3-month LIBOR ("3mL"). (Chau explained the notation at Tr. 1643:21-1644:2, 4126:23-4127:5.) That is to be compared to 440 basis points above 3-month LIBOR ("3mL+440"), which is where the Norma BBBs priced *and where Harding agreed to acquire them. See* Div. Exs. 212, 207. It was not Harding that brought the price down to 97 (*i.e.*, that increased dm from +440 to +505). Rather, a different firm, United Capital, or UCM, extracted that concession from Merrill through negotiations on January 31 and February 1. *See* Resp. Ex. 839 at 1 (Merrill email noting "DM for Norma is 505.3," following acceptance of UCM's bid at 97.00 on the BBBs). Also, as Wagner explained, the discounts at issue would not have been considered especially impressive, particularly in light of Respondents' failure to analyze whether the discount would compensate for the problems with Norma. Wagner Report ¶¶ 169-170.

[163] The attorney coaching was unusually obvious:

> CHAU: You know, I don't recall this chain. I am not sure if I was trying to be cute or what have you. . . . I should be angry, not that "love is in the air."
> Q. But you actually sound happy here; right?
> CHAU: I am not sure if I sound happy. I don't know why I made that comment.
> CHAU'S COUNSEL: *He could be sarcastic.*
> CHAU: *I could be sarcastic.* I don't recall the context in which I made the comment.

Tr. 1634:16-1636:11.

Respondents bought Norma, and at one point even seemed to concede that it was a favor to Merrill and Magnetar. Tr. 1676:7-22, 1677:13-21, 2190:16-23; Tr. 4123:8-13.

In late February 2007, Harding finally generated a written analysis of Norma. *See* Div. Ex. 216 (Chen asking Kaplan on February 22 to "writeup Norma"); Chau Tr. 1600:4-14. On February 27, Kaplan sent Chau, Huang, Chen, and others a two-page commentary, along with a cover email that highlighted portions of the commentary. Div. Ex. 217. Chau (even as he claimed, implausibly, that Harding's CDO write-ups or commentaries were "meant for education primarily") testified that he read CDO commentaries in the ordinary course, and that they were important and reflected "the key points" in Harding's analysis. Chau Tr. 1644:25-1645:23. Huang testified that the commentary was used in the investment decision and that he would expect it to be prepared *before* an investment decision was made. Tr. 1012:21-24, 1014:6-15.

The Norma writeup was extremely negative. Chau testified that Harding's analysis of a CDO entailed three elements: the structure; the collateral inside the CDO; and the manager. Chau Tr. 2179:19-2180:8, 2187:11-17. Norma scored poorly on all three. As to structure, Kaplan's cover email and attached writeup noted that the turbo was "not meaningful." Div. Ex. 217 at 1, 3. This was consistent with Chau's original complaint about the turbo, which Chau acknowledged would benefit Norma's equity at the expense of mezzanine debt investors. Chau Tr. 1648:23-25, 1650:5-25, 1651:25-1652:3, 1652:15-20. Nor did the manager have much to recommend it. Chau testified that NIR was "average," Tr. 2183:6-16, and indeed, both the firm and its management team had limited experience with CDOs and with the relevant types of collateral. As Wagner explained, the Norma pitchbook (*see* Div. Ex. 190) provided "very little to rely on in terms of manager experience." Wagner Report ¶ 162.

Most glaring of all were Harding's conclusions about the low quality of the collateral.[164] Kaplan wrote in his cover email and attachment: "There's quite a large percentage of deals failing surveillance tests, on the watchlist and on the do not buy list." Chau did not dispute that having a high percentage of RMBS failing surveillance tests is negative. Chau Tr. 1651:21-24, 1652:21-1653:6.[165] The watch list consisted of RMBS that Harding viewed negatively and "should be watched more carefully." Chau Tr. 1658:10-13, 1654:6-24. And the do-not-buy list consisted of RMBS that the credit staff had rejected. Chau Tr. 2165:2-2166:21 (prior testimony). Chau admitted that each of these factors was a reason to avoid buying a CDO.[166]

The writeup added: "Also, there is almost 15% exposure to Fremont and Ameriquest, combined." Div. Ex. 217. Fremont was at the top of Harding's list of "the worst 5 originators," Div. Ex. 215, and Lieu had negative views of both Fremont and Ameriquest. Lieu Tr. 3562:20-3563:22. On March 9, when Lieu finally reviewed the Norma portfolio, she could not believe what she was seeing. Div. Ex. 221 ("Who's the manager on NORMA? 31% NC [New Century] and 14% Fremont?!"); Chau Tr. 1671:14-1672:5. Chau testified that he would defer to his analysts' views on the worst originators, Chau Tr. 1657:2-4, 1658:24-1659:6, and he ultimately

[164] Harding was not alone. For example, on January 24, 2007, word reached Merrill Lynch that Bear Stearns Asset Management (BSAM) had determined that "Norma = WEAK!", with a BSAM analyst offering "a few stats to show how weak the collateral is." Div. Ex. 203.

[165] Chau did not dispute that the percentage of RMBS failing surveillance tests was high. *See* Chau Tr. 1664:6-23. The surveillance tests were "DQ", "60+ day DQ", and "OC," referring to delinquencies, 60-day-plus delinquencies, and overcollateralization. Depending on the performance of the collateral backing a given RMBS, the RMBS could pass or fail the test. The percentages reflected in the write-up were the percentages of RMBS securities in the Norma portfolio failing each test. *See, e.g.*, Div. Ex. 16; Div Ex. 197; Div. Ex. 203 (BSAM analysis of Norma: "Out of 116 names, 17 (15%) are currently failing DQ triggers"); Lieu Tr. 3926:22-3927:11. The analysis was performed on the Norma portfolio as it stood on January 17 (see footer in Div. Ex. 217).

[166] Chau Tr. 1651:10-14 ("it wouldn't be a general practice" to buy CDOs with large percentage of deals failing surveillance tests), 1654:19-24, 1658:14-18 (Chau would prefer that a CDO not have a high percentage of deals on watch list; "to the extent we could avoid it, yes, we would try to"), 1655:13-23 ("If I could, I would buy CDO's that had residential mortgage-backed securities that were not on the do not not buy list. That would be my preference.").

admitted that all the metrics for the collateral were negative. Tr. 2188:19-22, 2189:7-14 ("yes, the numbers were high.").

D. <u>More on the Analysis – The Writedown Percentage</u>

The writeup showed that Harding's analysts were projecting that Norma's portfolio would be written down 10.17% – which at a minimum should have been cause for alarm given that the subordination (credit cushion) at the BBB level was just 6.79%. Div. Ex. 217 at 3; Wagner Report at 4 (Op. III(a)(iii)), ¶¶ 150, 157, 158 (describing the statistic as a "red flag"). At the hearing Chau seemed to admit that the meaning of "% writedown" referred to Norma's portfolio of RMBS, Tr. 1665:15-1666:12, then obfuscated, Tr. 4098:19-23, 4123:14-4124:4, and ultimately claimed that it refers to the writedowns in the loans underlying the RMBS in Norma, as opposed to projected writedowns in the RMBS themselves. Tr. 4382:8-4383:3. The latter account, part of Chau's attempt to downplay the negative assessment, was simply untruthful.

Every metric in that portion of the chart plainly referred to the RMBS, not their underlying loan pools. *E.g.*, Div. Ex. 217 at 1, 3 (referring to the "large *percentage of deals* failing surveillance tests, on the watch list, and on the do not buy list."); *see also* footnote 165, *supra*; *see also* Div. Ex. 203. That is also how Wagner understood the statistic. *E.g.*, Wagner Report ¶¶ 150, 155, 156, 157 (percentage and other statistics referred to "RMBS underlying Norma"). As Prusko explained, one models a CDO's performance by analyzing its underlying RMBS, not the loans that in turn underlie the RMBS. Prusko Tr. 2342:7-2343:7, 2343:14-22, 2344:7-10. Similarly, the Norma pitchbook projected at what point the various Norma tranches would be "hit" as a function of losses in the collection of RMBS. Chau Tr. 4101:25-4103:12.

Chau agreed that the only way to model a CDO's performance is to analyze the RMBS underlying it:

> the way to truly gauge the relationship of your CDO investment is looking at the performance of the actual BBB [RMBS] securities that collateralized that CDO and not the thousands and thousands of loans that underlie the RMBS securities, which then impacts the RMBS securitization, which then impacts the CDO securitization.

Tr. 4156:8-14; *see also* Tr. 4385:24-4386:23. Indeed, Chau never offered a coherent explanation (as opposed to empty verbiage) why Harding would bother to do what he now claims it did, namely include in its brief CDO writeups a projection of something that Chau basically said he was entitled to disregard (projected losses on the aggregated loans underlying the RMBS), but *not* include what *did* matter (projected losses on the RMBS). *See* Chau Tr. 4155:9-4156:25.

What is more, Chau's lie on the meaning of this statistic led him into another, even more obvious, lie.[167] "Writedown" is simply another word for "losses." *See* Wagner Report ¶ 52. If the 10% writedown for Norma really referred to losses on all the loans underlying the RMBS, that would represent *cumulative losses on the mortgages of 10%.* (That is not disputed. *See* Chau Tr. 4090:7-16.) Harding's own assumptions, as discussed above, analyzed RMBS by projecting ***6%*** cumulative losses, and again, mezzanine RMBS bonds are highly sensitive even to a couple of percentage points of losses (see footnote 85 above).

Probably realizing the difficult position that his testimony on Kaplan's writeup had put himself in, Chau doubled down: "at the 10 percent loss at the home loan level, typically, the BBB/BBB- [RMBS] securities would not be impaired. . . . So *based on just the average cum losses, we would expect that the BBB/BBB- [RMBS] would not be impaired.*" Tr. 4090:7-16. The statement that 10% cumulative losses would not impair BBB and BBB- RMBS bonds – in other

[167] In evaluating Chau's sincerity and candor, it may be worth bearing in mind what Tony Huang said when asked about Chau: "Trustworthy? There are things I trust and maybe a few things that I don't trust if that is what you are asking, to be perfectly honest." Huang Tr. 1422:14-17.

words, would not cause losses to the securities actually in the Norma portfolio – is, for lack of a better term, hogwash.[168]

E. <u>Harding Causes Four Advisory Clients To Acquire Norma</u>

The Norma transaction closed on March 1, 2007. *E.g.*, Resp. Ex. 975 at 6. Respondents ultimately allocated the Norma notes to the Norma Recipients as follows[169]:

888 Tactical	$20 million single-As
Jupiter VI	$15 million single-As
Lexington V	$10 million BBBs
Neo	$5 million BBBs

Chau, on behalf of Harding, executed a CMA for each of these CDOs. These CMAs each contained standard of care provisions similar to the one in the Octans I CDO, requiring Harding to perform its obligations – including selecting, and committing the Issuer to buy, the collateral acquired at closing – "with reasonable care . . . in a manner consistent with the customary standards, policies and procedures followed by institutional managers of national standing."[170]

---

[168] Harding's own analysis at 6% cum losses showed significant writedowns on a variety of bonds, as reviewed extensively above. *See also* Wagner Tr. 4700:19-4701:9 (mezzanine RMBS would be expected to "break" at "mid to high single digits of cumulative losses"); Hilfer Supp. Report, Table 3 (showing writedowns for a portion of bonds at 6% cum losses even under Intex setting defense claims Lieu intended to use); Hilfer Tr. 4966:25-4975:16 (acknowledging, *contra* report, writedowns at 6% cum losses with the timing curve and prepay settings that defense now contends Lieu intended to or did use on May 31); *cf.* Lieu Tr. 3486:4-7 ("I did a trial and error" – at home, in the weeks before the hearing – "to see when that bond" – the BBB MABS Index bond – "would actually get a writedown and from my analysis, it looked it wouldn't unless it was closer to 10 percent cum losses.").

[169] Div. Ex. 237 at 1; Div. Ex. 6 (trade blotter, Excel rows 2805-2808).

[170] Div. Ex. 504 at 7 (888 Tactical); *see also* Div. Ex. 506 at 7 (Lexington V) (same language); Div. Ex. 510 at 8 (Neo) (same language); Div. Ex. at 512 at 7 (Jupiter VI – "requiring reasonable care . . . in a manner consistent with the efforts, practices and procedures followed by prudent institutional investment managers of national standing").

And for each of these CDO's, the offering circular described the CMA and the standard of care set forth within it.[171]

F. Respondents Try To Trade out of Norma

Throughout the spring of 2007, Harding tried to limit its advised portfolios' exposure to Norma. Chau testified that, even though it was quite rare for Harding to try to sell off securities inside its managed CDOs, "there was a point where I was looking to swap out Norma securities." Chau Tr. 1688:16-1689:17.[172] On April 27, 2007, referring to the single-A notes allocated to the Jupiter VI portfolio, Chen complained in an email to Chau and Wang about Merrill Lynch's behavior: "Ironically, *we initially wanted them to reduce*: *NORMA* [and a series of other CDOs]; all are likely to stay in." Div. Ex. 223 at 1 (emphasis added).[173] On May 22, Chau sent a Bloomberg message to Edward Fitzgerald in which Chau tried to sell Fitzgerald the single-A Norma notes. Div. Ex. 226. Chau acknowledged that a seller's opening ask is normally above where he expects to transact, yet Chau's *opening* ask was at 87%, a "substantial discount" from the purchase price. Div. Ex. 226; Chau 1690:19-1691:11, 1692:12-1694:8, 1695:20-22.[174]

---

171 Div. Ex. 503 at 97 (888 Tactical); Div. Ex. 513 at 173-74 (Jupiter VI); Div. Ex. 507 at 155-56 (Lexington V); Div. Ex. 509 at 158-59 (Neo).

172 This is one of several answers to Respondents' oft-repeated contention that the Norma investment was too small a portion of the portfolios at issue to be a violation. *Respondents* themselves clearly thought the Norma investment was significant enough to be concerned about.

173 By this time, the amount of Norma notes in Jupiter VI had already been decreased in the sense that the investment went from an expected $20 million in early February to $15 million at Norma's closing. Compare Div. Ex. 211 *with* Div. Ex. 237 & Div. Ex. 6 (Excel cells E2805, R2805).

174 Fitzgerald did not bite. Instead, reflecting what must have been widespread disdain for Norma, he responded with a parody of Elton John's "Candle in the Wind," Div. Ex. 226; Chau Tr. 1691:21-1692:8, which amused Chau enough for him to repeat it to Merrill's Catherine Chao. *See* Div. Ex. 228; Chau Tr. 1699:24-1700:2.

G. The Norma Purchases Were an Extreme Departure from Applicable Standards of Care

Measured against the customary standards, policies and procedures followed by institutional managers of national standing, the Norma investment was grossly deficient. Wagner identified a number of serious departures from the standard of care in Respondents' purchase of Norma and other CDO securities, with the result that many of these investments "could not be justified." Wagner Report at 4-5 (Ops. III(a)(iv), III(b)). His conclusions went unrebutted.

First, it would be inconsistent with industry standards to purchase a CDO security without first using the POC to conduct a thorough review of the structure. Wagner Report at 4 (Ops. III(a)(i), III(b)), ¶ 140. That is exactly what happened with Norma. As discussed above, there is no evidence that Harding even had possession of the Norma POC at the time Chau committed to buy the Norma single-As, or that Harding considered the POC in deciding to invest in the BBB notes. Next, "[f]or many CDO investments, credit write-ups were either not done at all or were completed only after the investment decision was made." Wagner Report at 4 (Ops. III(a)(ii), III(b)), ¶¶ 147, 152. That was obviously the case with Norma, as the chronology reviewed above demonstrates. It was also true of many other CDO securities, some of which went into the same portfolios as Norma.[175] Again, this was a violation of represented standards.

What is more, the "credit write-ups, when they were done, contained numerous red flags that Harding failed to analyze further, such as the amount of underlying collateral that Harding's

[175] For example, *compare* Resp. Exs. 892 & 893 (Silver Marlin ABS CDO I write-up distributed Feb. 27, 2007) *with* Div. Ex. 6 (Excel row 2725: traded and settled in January 2007); *compare* Resp. Ex. 894 (Adams Square Funding II write-up distributed Feb. 28, 2007) *with* Div. Ex. 6 (Excel rows 2822-2829: trade date Feb. 9, 2007; placed into all four Norma Recipients, among other CDOs); *compare* Resp. Exs. 895 & 896 (Maxim High Grade CDO II write-up distributed March 12, 2007) *with* Div. Ex. 6 (Excel row 2894: trade date Feb. 28, 2007; placed into Neo); *compare* Resp. Ex. 900 (Libertas Preferred Funding IV writeup circulated April 18, 2007) *with* Div. Ex. 6 (Excel rows 2899-2900: trade and settle date in March 2007; placed into Jupiter VI and Neo).

own RMBS credit analysts had rejected, and the level of write downs that might be expected on the underlying collateral." Wagner Report at 4 (Ops. III(a)(iii), III(b)). According to Wagner, this was "the greatest shortcoming" in Harding's analysis of Norma – the disregard for Harding's own analysts' review of the RMBS collateral. Wagner Report ¶¶ 150, 156-158. As Wagner explained, referring to the Norma investment:

> It makes no sense to invest in mezzanine or subordinate classes of a CDO, when the investor [*i.e.*, Harding] has a purported strong understanding of the underlying asset class, finds significant red flags in its analysis of that collateral and then fails to consider, with further analysis, how the CDO would likely perform based on that collateral.

Wagner Report ¶¶ 157-158.

Wagner also observed that Harding "failed to run or request stress cash flows [for CDOs] based on the RMBS analysts' view of the collateral" and also "failed to analyze the likelihood of a [CDO] transaction to hit various tests and triggers that would re-direct the cash flow or result in an event of default." Wagner Report at 4-5 (Ops. III(a)(vi, vii), III(b)), ¶¶ 141-143, 170. Again, there is no evidence, inside or outside Kaplan's write-up, that Harding conducted this kind of analysis for Norma.

Respondents have implied that Norma was no worse than other CDOs on the market at the time, and that it was common for Respondents to invest in CDOs backed by a large portion of collateral rejected by their own staff. Chau Tr. 4145:18-4146:7. In support, Chau testified about Harding's CDO Deal Tracker, Div. Ex. 238. Tr. 4157:1-4159:18. Respondents also point out that Norma complied with the eligibility criteria for the four transactions – in other words, that the documents *allowed* the purchase.[176]

---

[176] *See* Respondents' March 26 Corrected Pre-Hearing Brief, at 13 ("The evidence will show that Mr. Chau decided to purchase the Norma BBB notes for a simple reason: he believed they were an appropriate bond ***that would fit within the eligibility criteria of the CDOs into which they were placed.***" (emphasis Respondents')).

These are not answers. As Wagner has explained, the Deal Tracker (Div. Ex. 238) is simply evidence that Harding had "a pattern of investing in CDOs that have similar red flags in the characteristics of their underlying collateral." Wagner Report ¶ 165. Chau's propensity to defend an investment by (i) comparing it to the overall market, (ii) pointing to its rating (*see, e.g.*, Tr. 4223:21-4225:23), and (iii) pointing to the fact that the eligibility criteria of his CDOs *permitted* the investment, "fundamentally fails" to comport with Harding's represented "disciplined bottoms/up approach" and with the applicable standard of care requirements. Wagner Report ¶ 165. Chau's rationales have nothing to do with "fundamental credit analysis and stress testing based on a review of the characteristics of the RMBS underlying the CDOs," and would be unrecognizable to national-class asset managers. *Id.*[177]

When all is said and done, even setting aside the undisclosed self-serving favor to Magnetar and Merrill Lynch, Respondents exhibited textbook recklessness – they invested in assets without properly investigating them and despite a host of warning signals. Chau has implied that he "needed" to buy shoddy assets in order to fill up his CDOs.[178] The only possible reason for this approach is that ramped CDOs equated to greater streams of advisory fees.

[177] Here is Doiron on this point (Tr. 1882:3-24):

> Q. Do you happen to have a view on whether or not the fact that an asset meets a CDO's rating and eligibility criteria is, in and of itself, a sufficient reason to accept that asset?
> A. No.
> Q. When you say no, are you saying you do have a view?
> A. I do have a view. The rating was taken into consideration, but also we did our own independent work to verify that.
> Q. If a CDO manager had come to you and said, "We didn't analyze these assets, but rest assured they all fit within the eligibility criteria and the rating requirements of my CDO," would that be good enough for you?
> A. No.
> Q. So is it fair to say that you did have an expectation that the CDO manager would go beyond the eligibility criteria and the rating requirements in reviewing assets?
> A. Yes.

[178] *See* the testimony quoted in footnote 166 above; *see also* Chau Tr. 1630:9-15.

Respondents were not being forced to put CDOs together (let alone to maximize their size), nor did they have some sort of fundamental right to serve as CDO managers. If the collateral available on the market had become so undesirable that Respondents, consistent with represented processes and applicable standards of care, could not complete a transaction or reach the desired size, *then they should not have continued to ramp and close the CDO. See* Wagner Report at 4-5 (Ops. III(a)(v), III(b)); Wagner Tr. 4638:25-4639:22, 4654:20-4655:25. For comparison, HIMCO's Wadsworth CDO, and especially its CDO bucket, was much smaller than originally contemplated because HIMCO could not find enough assets that met their standards – to the annoyance of the investment bank underwriting the CDO. Doiron Tr. 1863:14-1864:4, 1865:5-1868:4, 1876:10-21.[179]

LEGAL DISCUSSION

XI. LEGAL STANDARDS

A. Section 17(a) of the Securities Act

Section 17(a) of the Securities Act prohibits fraud in the offer or sale of securities. Section 17(a)(1) is violated when a defendant employs a device, scheme, or artifice to defraud in the offer or sale of a security. A violation of Section 17(a)(1) requires scienter, which can be satisfied by a showing of recklessness. *See Aaron v. SEC*, 446 U.S. 680, 697 (1980). Recklessness in the securities-fraud context means "an extreme departure from the standards of ordinary care" presenting "a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *SEC v. Steadman*, 967 F.2d

[179] Huang admitted that Harding's voraciousness for assets without regard to their fundamentally low quality – in other words, its recklessness – helped to perpetuate an asset bubble. Tr. 1052:6-23 ("you may have a view that this market was already, let's say, was a bubble, or maybe it is getting, now – the valuation was so high. . . . *You basically have to pick assets for whatever thing you manage*. . . . That is what happened in reality."), 1192:2-16 ("we kept the bubble going, I guess"); *see also* Huang Tr. 1050:15-1051:9-23.

636, 641-42 (D.C. Cir. 1992) (internal quotation marks and citation omitted); *see also S.W. Hatfield*, Exchange Act Rel. No. 69930, 2013 WL 3339647, at *21 (Jul. 3, 2013).

Section 17(a)(2) prohibits any person from "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Section 17(a)(3) prohibits any person from "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." A violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act can be shown by negligent conduct. *Aaron*, 446 U.S. at 701-02. "Negligence is the failure to exercise reasonable care or competence." *Byron G. Borgardt*, 56 S.E.C. 999, 1021, 2003 WL 22016313, at *10 (2003).

A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. *Basic v. Levinson*, 485 U.S. 224, 231 (1988). It is not necessary that a complete disclosure would have caused the reasonable investor to change its decision, only that the omitted fact would have assumed actual significance in its deliberations. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). "The information must be viewed from the perspective of a reasonable investor at the time the misrepresentation was made, not from the perspective of a reasonable investor with the benefit of hindsight." *SEC v. Quan*, 2013 WL 5566252, at *7 (D. Minn. Oct. 8, 2013) (citing *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 830-31 (8th Cir. 2003)).

Unlike private litigants, the SEC is not required to prove investor reliance or injury. *E.g., SEC v. Goble*, 682 F.3d 934, 942 (11th Cir. 2012); *SEC v. Pirate Investor LLC*, 580 F.3d 233, 239 & n.10 (4th Cir. 2009); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1363-64 & n.4 (9th Cir.1993); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985); *SEC v. Simpson Capital Mgmt.,* *Inc.*, 586 F. Supp. 2d 196, 201 (S.D.N.Y. 2001). Accordingly, whether or not any particular investor or client relied on any particular misrepresentation is not germane.

B. <u>Sections 206(1) and (2) of the Advisers Act</u>

Sections 206(1) and (2) of the Advisers Act respectively prohibit an investment adviser from "employ[ing] any device, scheme, or artifice to defraud any client or prospective client," and from "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

The Supreme Court has explained that Section 206 of the Advisers Act "establishes 'federal fiduciary standards' to govern the conduct of investment advisers." *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979). In recognition of the "delicate fiduciary nature of an investment advisory relationship," Section 206 places "an affirmative duty" on advisers of "utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963) (internal quotation marks omitted); *see also SEC v. Wash. Inv. Network*, 475 F.3d 392, 404 (D.C. Cir. 2007) ("Section 206 . . . prohibits failures to disclose material information.").

Under Section 206 it is unnecessary "to establish all the elements of fraud that would be required in a suit against a party to an arm's length transaction." *Aaron*, 446 U.S. at 693. For instance, it is not necessary to show reliance or injury. *Capital Gains*, 375 U.S. at 195; *Wash. Inv. Network*, 475 F.3d at 405 (under section 206, "the SEC does not need to prove reliance on the investment adviser's misleading statements, nor does the SEC need to prove injury"); *SEC v. Gruss*, 859 F. Supp. 2d 653, 669-70 (S.D.N.Y. 2012).

What Section 206 does require is that the adviser make full disclosure of "overlapping motivations," so that investors may assess whether the adviser "is serving 'two masters' or only one." 375 U.S. at 196. Additionally, an investment adviser has a "professional duty to investigate the information upon which his recommendations [are] based." *Blavin*, 760 F.2d at 712; *Raymond J. Lucia Cos.*, Initial Dec. Rel. No. 540, 2013 WL 6384274, at *40 (Dec. 6, 2013).

Because investment advisers are entrusted with the management of their clients' assets, they owe duties of care and loyalty. *E.g.*, *Bullmore v. Banc of Am. Secs., LLC*, 485 F. Supp. 2d 464, 470-71 (S.D.N.Y. 2007); *Pension Comm. of U. Montreal Pension Plan v. Banc of Am. Secs. LLC*, 716 F. Supp. 2d 236, 242 n.26 (S.D.N.Y. 2010). Moreover, the courts have recognized that, to commit fraud, a fiduciary need not make an affirmative misstatement; fraud can also be:

> conduct that is deceptive because it is inconsistent with a fiduciary duty. In claims of this kind, the fiduciary duty serves as a sort of standing false representation by the fraudster, who deceives the victim by violating the commitment associated with her fiduciary duty. Acceptance of a fiduciary duty creates an understanding that the fiduciary will behave in certain ways; if the fiduciary allows this understanding to continue while acting inconsistently with her obligations, she has deceived the victim.

In re Refco Capital Markets Ltd. Brokerage Customer Secs. Litig., 2007 WL 2694469, at *7 (S.D.N.Y. Sept. 13, 2007) (citing *SEC v. Zandford*, 535 U.S. 813, 821 (2002)).

A Section 206(1) violation requires scienter, which can be satisfied with recklessness; a violation of Section 206(2) can be shown with negligence. *Steadman v. SEC*, 603 F.2d 1126, 1134 (5th Cir. 1979); *Steadman*, 967 F.2d at 641; *SEC v. DiBella*, 587 F.3d 553, 569 (2d Cir. 2009).

C. *Janus* Is Not a Defense

Respondents have argued that *Janus Capital Group., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) bars some or all of the charges. *See* Respondents' Pre-Hearing Brief at 11-12.

Janus considered the private right of action under Exchange Act Rule 10b-5(b), which makes it unlawful to "make any untrue statement of a material fact." Its core holding:

> For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. . . . [I]n the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed.

131 S. Ct. at 2302. According to Respondents, Harding was not the *Janus* "maker" of statements regarding the warehouse agreement in the offering circular.

Respondents' reliance on *Janus* is misplaced. As an initial matter, Harding *was* the undisputed *Janus* maker of statements covered by the Section 17(a) claims, notably those in the pitchbook concerning its asset-selection process and in the CMAs concerning the level of care that Respondents would bring to bear on the selection process. Relatedly, the pitchbook *also* mischaracterized the warehouse agreement, and Respondents (as discussed below) had the requisite control over the pitchbook, which was jointly attributed to them and Merrill.

Beyond that, *Janus* is also no obstacle to the Division's Section 17(a) claims regarding the mischaracterization of the warehouse agreement. Unlike Rule 10b-5(b), which makes it unlawful to "***make*** any untrue statement of a material fact or to omit to state a material fact . . .", Section 17(a) of the Securities Act includes no reference to the "making" of a statement. Instead, it forbids any person "***to employ*** any device, scheme, or artifice to defraud"; "***to obtain*** money or property ***by means of any untrue statement of material fact or any omission***"; and "***to engage*** in any transaction, practice, or course of businesses which operates or would operate as a fraud or deceit." Consequently, the *Janus* ruling simply does not apply to a Section 17(a) claim.

This is overwhelmingly the dominant view.[180] Furthermore, courts have repeatedly recognized that the policy concern in *Janus* about the scope of private securities fraud actions is "inapplicable to a claim brought by the SEC under Section 17(a)," since there is no private right of action under Section 17(a). *Sentinel Mgmt.*, 2012 WL 1079961, at *15.[181] While one district court decision cited *Janus* as a basis for restricting Section 17(a) claims, *SEC v. Kelly*, 817 F. Supp. 2d 340, 345 (S.D.N.Y. 2011), it did so without analyzing the actual text of that statute, and for that reason has been criticized. *E.g., SEC v. Benger*, 931 F. Supp. 2d 904, 906 (N.D. Ill. 2013) (noting that the "vast majority of cases that have addressed this question have come to the same conclusion" and that "*Kelly* is clearly an outlier, even in its own district. It ignored the

---

[180] *E.g., SEC v. Monterosso*, 2014 WL 815403, at *5 (11th Cir. Mar. 3, 2014) ("*Janus* only discussed what it means to "make" a statement for purposes of Rule 10b–5(b), and did not concern section 17(a)(1) or (3) or Rule 10b–5(a) or (c). The operative language of section 17(a) does not require a defendant to "make" a statement in order to be liable." (citations omitted)); *SEC v. Geswein*, __ F. Supp. 2d __, 2014 WL 861317, at *4 (N.D. Ohio Mar. 5, 2014) ("The Court will not presume to extend *Janus* to violations of the Securities Act Section 17(a)."); *SEC v. Garber*, 959 F. Supp. 2d 374, 380 (S.D.N.Y. 2013); *SEC v. Pentagon Capital Mgmt. PLC*, 844 F. Supp. 2d 377, 422-23 (S.D.N.Y. 2012) ("Nor does *Janus* apply to SEC enforcement actions brought pursuant to Section 17(a) of the Securities Act" because of the absence of the word "make" from section 17(a)'s operative language), *aff'd in relevant part, vacated on other grounds*, 725 F.3d 279 (2d Cir. 2013); *SEC v. Stoker*, 865 F. Supp. 2d 457, 465 (S.D.N.Y. 2012) ("Although 'to make a statement' is the equivalent of 'to state,' to obtain money 'by means of' a statement plainly covers a broader range of activity. Thus, the emphasis of the *Janus* Court on the word 'make' serves, if anything, to highlight the importance of the difference in language between the two provisions."); *SEC v. Sentinel Mgmt. Group, Inc.*, 2012 WL 1079961, at *14 (N.D. Ill. Mar. 30, 2012); *SEC v. Sells*, 2012 WL 3242551, at *7 (N.D. Cal. Aug. 10, 2012) ("*Janus* does not apply to claims premised on § 17(a)"); *SEC v. Mercury Interactive, LLC*, 2011 WL 5871020, at *3 (N.D. Cal. Nov. 22, 2011) (*Janus* does not apply to Section 17(a) claims); *SEC v. Daifotis*, 2011 WL 3295139, at *5-6 (N.D. Cal. Aug. 1, 2011) ("*Janus* does not apply to claims brought under Section 17(a)").

[181] *Accord Daifotis*, 2011 WL 3295139, at *6 (N.D. Cal. Aug. 1, 2011) ("The same rationale does not apply in the context of Section 17(a) because there is already no implied private right of action for Section 17(a) claims"); *Stoker*, 865 F. Supp. 2d at 465 ("[T]here is no need to read Section 17(a) narrowly in light of concerns about the implied private cause of action, because there is no private right of action—implied or explicit—under Section 17(a).").

policy considerations that were important to the Court in *Janus*, and it has not been followed." (citing cases)).[182]

Finally, just one month ago, the Commission followed the dominant approach. In *Donald L. Koch*, Exchange Act Rel. No. 31047, 2014 WL 1998524, at *18 (May 16, 2014), it held that *Janus* does not apply where (as here with respect to the Section 17(a)(1) and 17(a)(3) charges), Respondents are charged "with engaging in manipulative and deceptive conduct" in addition to or apart from making statements. (The Commission relied in part on *Monterosso* and *Pentagon Capital*, both cited in footnote 180 above, which held that *Janus* does not apply to Section 17(a) claims.) Furthermore, the Commission squarely held that *Janus* "does not apply to violations of Advisers Act Sections 206(1) and 206(2), which lack any reference to making statements." *Id.*

XII. VIOLATIONS RELATING TO OCTANS I

A. Section 17(a) Violations Based on the Octans I Pitchbook

In the marketing of a CDO, "pitchbooks" jointly developed by the investment bank and the collateral manager are distributed to investors. Wang Tr. 342:10-22, 345:2-16, 368:9-12; Wagner Tr. 4645:14-20. The pitchbook for Octans I (Div. Ex. 1) displayed Harding's name prominently on the front and its logo on every page.

1. *Harding Section*

The pitchbook included a section about Harding. It was created by Harding, with review by Chau. Wang Tr. 368:13- 370:21, 372:19-373:6, 386:14-387:22; Chau Tr. 1824:9-1825:9. (Chau, per Harding's compliance manual, was responsible for all advertising.) Harding

[182] ALJ Murray applied *Janus* to Section 17(a) in *John P. Flannery*, Initial Dec. Rel. No. 438, 2011 WL 5130058, at *34-35 (Oct. 28, 2011), but she relied solely on *Kelly*. *See, e.g.*, *Stoker*, 865 F. Supp. 2d at 466 n.8 (criticizing *Flannery*'s treatment of the issue). *Flannery* is on review with the Commission, with oral argument scheduled for July 25, 2014. *See* Securities Act Rel. No. 9580 (Apr. 30, 2014).

commonly tracked the pitchbook in investor meetings. Huang Tr. 1043:11-13. The pitchbook represented that Harding's investment process included the following (Div. Ex. 1 at 43):

- Maximize returns and minimize losses through rigorous upfront credit and structural analysis, as well as ongoing monitoring of asset quality and performance.
- Employ a top/down economic analysis to determine sector allocation.
- Perform a thorough bottom/up credit and structural analysis to identify individual investments.
- Complete an in-depth credit review to determine the suitability of each potential transaction in the context of the CDO.

Further, the pitchbook referred to "Individual Asset Selection Employing a Disciplined Bottom/Up Credit and Structural Analysis" (*id.* at 45), and represented, too, that Harding's "Investment Decision, Process and Execution has Been Built Around," among other things, "a collaborative, methodical and disciplined investment process." (*Id.* at 48).

These representations were materially untrue. Harding's approval of $220 million of ABX component collateral in the Octans I transaction bore no recognizable relation to what an industry participant would have expected from the pitchbook. There was nothing "thorough," "rigorous," "disciplined," or "collaborative" about rushing through with a massive purchase that Magnetar wanted despite (i) rudimentary analysis by a single analyst that generated negative results, (ii) internal dissent, (iii) acknowledged discomfort, and (iv) a lack of meaningful review by a portfolio manager. Wagner opined that the language in the pitchbook on Harding's investment approach was consistent with comparable sections in other CDO pitchbooks and, if carried out, would meet industry standards of rigor and independence. Wagner concluded, however, the Index trade for Octans I did not comport with the description in the pitchbook or with industry standards. *E.g.*, Wagner Report at 3-4 (Op. II(a), (b), (c)), ¶¶ 39-45, 107; *see also* Wagner Tr. 4580:6-4582:19.

Doiron testified much the same way. To him, the description of Harding's investment approach signaled a thorough review of qualitative and quantitative factors, a variety of scenarios on Intex, and group discussion to review each investment. Tr. 1898:7-1901:6, 1903:11-17. Doiron estimated on the basis of the pitchbook that he would expect Harding to spend between four and eight man-hours reviewing a single RMBS. Tr. 1901:10-1902:14. Doiron testified that each of the following would be inconsistent with the description in the pitchbook:

- Having just one analyst do a quick review of 30 or 40 bonds in an afternoon or a day
- Doing just one cash flow run and no stress cases
- Accepting bonds that showed negative results from that one cash flow run
- Accepting bonds that the portfolio manager himself was not sure would be a good investment
- Accepting bonds without analyzing them
- Overruling an analyst's "no" decision
- Accepting bonds in the face of a disagreement between two analysts
- Pressuring analysts to relax their standards for certain types of assets
- Compromising the management company's investment approach or credit processes to accommodate the wishes of a third party.

Doiron testified that if any of these things had happened and he had become aware of them, he would not have invested in Octans I. Doiron Tr. 1902:15-1913:7.

Respondents made no disclosures to investors about the Index trade or about Magnetar and its influence on the portfolio. All of these misstatements and omissions were material. Witnesses generally agreed that a CDO pitchbook, including the manager's discussion of its investment process, is important, and that they would not want to invest if the manager misrepresented its process.[183] (Edman was the exception; he was uninterested in that section of

[183] Chau Tr. 1822:17-1823:8, 1827:12-1828:13, 1835:20-1836:17; Huang Tr. 1014:22-1015:12, 1016:16-23, 1019:20-1020:25; Doiron Tr. 1896:11-1898:19; Jones Tr. 2871:12-2874:10.

the pitchbook.) And as a general matter, as discussed above in section IX., a CDO manager's processes, analysis, independence, and integrity mattered to the reasonable investor.[184]

Respondents knew full well that the review of the Index securities had not comported with the rigorous, industry-standard approach depicted in the pitchbook. Start with Chau.[185] Several days before May 30, he acceded to Prusko's request to ramp the deal using Index assets, and it was he who brought Huang into the discussions on May 30. Chau was a recipient of most of the May 30 and 31 Harding-Magnetar emails on ramping. That includes Magnetar's emails on May 31 pressing for the list of excluded bonds, as well as Huang's email that morning promising them soon, which was sent after Chau and Huang returned together from a meeting outside the office. According to Lieu, Chau discussed the Index trade with her. Even without relying on her memory, the undisputed evidence is that Magnetar was a critically important constituency for Chau and that Chau was in charge of that relationship. The obvious inference is that he would have made sure that things were being handled in a way that would satisfy Magnetar – in other words, quickly, obediently, and with a limited number of rejections from the Index.

Chau knew, too, that the Index review was highly unusual. He knew that investors did not like to see either the Index, or too many Index bonds, in a CDO, even making a point to "exclude

---

[184] Courts have repeatedly concluded that misrepresentations concerning the *process* of selecting CDO collateral were material. *See SEC v. Stoker*, 865 F. Supp. 2d 457 (S.D.N.Y. 2012) (claim stated under Section 17(a) where Commission alleged that defendant and his investment bank employer represented "that an experienced, third-party investment adviser had selected the investment portfolio," even as the bank used the vehicle to dump assets hand-picked by the bank); *SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147 (S.D.N.Y. 2011) (upholding Section 17(a) claims based on, *inter alia*, misrepresentations that a portfolio whose contents were disclosed to investors "was selected by [the named selection agent] without disclosing [a third party hedge fund's] involvement"); Oct. 25, 2011 Tr. at 38, *SEC v. Steffelin*, No. 11 Civ. 4204 (MGC) (DE 29) ("*Steffelin* Argument and Bench Ruling") (sustaining Section 17(a)(2) claim where adviser allegedly obscured Magnetar's role in selecting a portfolio of collateral).

[185] Chau's scienter can be imputed to Harding Advisory, as can that of other Harding employees. *See, e.g*, *C.E. Carlson, Inc. v. SEC*, 859 F.2d 1429, 1435 (10th Cir. 1988); *SEC v. Manor Nursing, Inc.*, 458 F.2d 1082, 1096-97 nn.16-18 (2d Cir. 1972).

index trades" from a trade blotter shown to a potential investor (*see* footnote 52 above). He knew that Harding had never done this type of trade before, and that its usual approach was to source assets in the marketplace, not to kick out a certain number from a pre-selected list and then let Magnetar control the execution. He knew that the Index trade ran counter to one of the advantages of synthetics, which was that the manager could theoretically choose from the entire universe of RMBS.

Chau also knew that the review was hopelessly rushed, insufficiently rigorous, and its results at least partially negative. His prior testimony on the length of time it generally took to analyze a single RMBS – as well as on the amount of time that Lieu spent on May 31 – cannot be reconciled with the amount of time actually available that day. Chau had to have been aware of Harding's written "best practices" on RMBS review, which called for an extensive, multi-stage review process utterly unlike what took place on May 31. Chau sometimes instructed the analysts to relax their assumptions so that more bonds would pass, and the evidence is that exactly this happened in late May 2006, at the very moment that Prusko discussed with Chau ramping Octans I with the Index. On June 1, Chau received, but did nothing about, Huang's email relaying Lieu's sentiment that she was "less comfortable" with some of the Baa3 bonds.

Lieu, too, knew that the events of May 31 did not comport with the represented investment approach. She clearly understood the importance of having enough time: She had been complaining that there is "no quick way." She must have noticed that the "hit rate" on the Index was far out of line with the baseline 20% rate that the analysts were pleased with. And her testimony makes crystal clear that she knew that the write downs were a problem.

Harding's description of itself was misleading in other important ways. On page 40, in a clear effort to inflate the apparent depth of Harding's "Credit / Research" bench, the pitchbook depicts Alison Wang as a member of it (Div. Ex. 1 at 40), even though Wang testified unambiguously that she had no responsibilities for credit or research and could not explain why the pitchbook said she did. Wang Tr. 388:3-24. On the same page, the pitchbook depicted Jamie Moy (with a "D" for director next to her name) as the most senior credit analyst, even though Moy, along with her views on credit, had been marginalized despite being Harding's most experienced RMBS analyst. Wang Tr. 267:21-268:3, 389:4-390:9; Huang Tr. 1039:20-1049:5.[186] Nor were these issues inconsequential – the evidence is that investors cared about which individuals were behind the selection of assets for a CDO.[187]

2. Conflicts of Interest Section: Warehouse Disclosure

Also misleading was the pitchbook's disclosure of the warehouse agreement. Because the "conflicts of interest" section of the pitchbook identified only two of the three parties to the agreement, investors were left unaware of the influence of a significant participant in the transaction. Div. Ex. 1 at 32; Wang Tr. 416:6-13 (acknowledging that the sentence was inaccurate); Chau Tr. 1843:17-1844:24 (same).

This omission was material because it impacted the independence of the manager. Huang testified that a veto or rejection right gives its holder influence over what goes into a CDO. Tr. 728:12-729:7, 735:25-737:4. Doiron testified that it would matter to him if anyone beyond the manager and underwriter were party to the warehouse agreement, and that he would not have invested if he had known of it. Tr. 1929:22-1933:22 ("it could control the outcome of what securities ended up in the CDO, if somebody else had a different agenda."), 2038:5-2040:25,

---

[186] The Offering Circulars conveyed a similar misimpression. *E.g.*, Div Ex. 3 at 194; Wang Tr. 364:13-21.

[187] *E.g.*, Jones Tr. 2835:12-15 ("we would go and figure out who were the members of these teams and – to see the depth of experience and to figure out who the people were that were actually building the [CDO] deals.").

2062:6-2063:8. Even Jones attempted to track which CDOs Magnetar was involved in, clearly finding that fact significant. Tr. 2842:21-2843:10, 2853:6-9, 2854:14-16, 2856:10-24. Finally, Chau knew that this was a sensitive area; he testified in 2008 in a different investigation that he would never have allowed Prusko a veto over collateral selection because it would compromise Harding's independence.

Respondents at the very least were negligent in relation to this misrepresentation and quite possibly worse. Chau testified that while Harding concentrated primarily on the section of the pitchbook concerning Harding, "we would review or scan through the rest of the pages." Tr. 1837:25-1838:7. Wang testified that it would be important for the pitchbook to contain a full disclosure of conflicts of interest and not to be inaccurate, even for the content not supplied by Harding. Wang Tr. 384:16-21, 612:16-613:25. The misrepresentation at issue fell clearly in the section of the pitchbook concerning Harding's and Merrill's conflicts of interest. *See* Div. Ex. 1 at 31-32; Wang Tr. 385:20-386:9. And Chau, who executed the warehouse agreement – Harding's first three-way warehouse agreement – understood that Magnetar's involvement presented a conflict of interest, because Magnetar, unlike the debt investors, planned to be "indifferent to the performance of the transaction." As an experienced investment professional, Chau had to have grasped that any extrinsic limitation on the manager's discretion should be disclosed. *See Capital Gains*, 375 U.S. at 198 ("[S]uppression of information material to an evaluation of the disinterestedness of investment advice 'operate[s] as a deceit[.]'").

Perhaps most telling, when the pitchbook was still in draft form, Respondents twice commented on *the very page containing the faulty disclosure*. On July 17, 2006, Eliran emailed Chau and Wang a draft of the pitchbook. Resp. Exs. 178, 179; Wang Tr. 377:12 – 378:4; *see also* March 24 Stip. ¶ 2 (Dorado synonymous with Octans I). An hour later, Wang replied to Eliran, cc'ing Chau and Huang: "On ***page 29***, last paragraph of 'Conflicts of Interests of Collateral Manager,' – can we change as follows:" Div. Ex. 124 at 2-3 (emphasis added). Page 29 was the precise page of the draft containing the faulty warehouse disclosure. Resp. Ex. 179 at 29. After this email, Wang, Chau, and Huang further reviewed the pitchbook, culminating in a 1:18 p.m. email the next day from Wang to Merrill Lynch, cc'ing Chau and Huang. Div. Ex. 124 at 1 ("Some additional document comments. Tony and Wing are on the phone right now discussing other changes."). This email *once again offered comments on the Conflicts of Interest on page 29 without mentioning the faulty warehouse disclosure*.

* * *

To sum up: the pitchbook contained statements that Respondents knew, or were reckless in not knowing (or at a bare minimum with respect to the warehouse agreement, should have known), were untrue. Moreover, even if *Janus* properly applied here on the warehouse disclosure (and it does not), Respondents' authority to make changes to the section concerning *their own and Merrill's conflicts of interest* shows that they had enough control to satisfy *Janus*. As for attribution, the pitchbook on its face is presented as a joint document.

The pitchbook was used in a process of offering and selling securities through which Respondents obtained money – namely, management fees when the transaction closed.[188] Respondents are therefore liable under Section 17(a)(2) for the misstatements reviewed above. Respondents also violated Sections 17(a)(1) and 17(a)(3): They secretly allowed their asset-selection process to be compromised by the influence of an undisclosed party with interests

[188] To the extent there is any need to show use of the instrumentalities of interstate commerce, the record includes evidence of email and telephone solicitations from New York to investors in other states (such as Connecticut for HIMCO and Pennsylvania for Cohen & Co.) and countries (such as Taiwan and Singapore).

different from those of the debt investors, failed to disclose Magnetar's role and influence in the ramp, and then misrepresented their asset-selection process. *See, e.g.*, *Stoker*, 865 F. Supp. 2d at 467 ("defendant may be liable under both Section 17(a)(2) and Section 17(a)(3) . . . as long as the SEC alleges that the defendants 'undertook a deceptive scheme or course of conduct that went beyond the misrepresentations.'"); *Garber*, 959 F. Supp. 2d at 380-81 (Section 17(a)(1) liability available for misconduct beyond pure misstatements).

B. <u>Fraud on the Client: Violations of Section 206 and Section 17(a)</u>

On the closing date for Octans I, Harding became the Issuer's "investment advisor and manager" with respect to the CDO's collateral (Div. Ex. 4 at 3), entering into a CMA signed by Chau in which Harding undertook to "select all Collateral to be Acquired by the Issuer" (*id.* at 4). Harding represented that it would (*id.* at 8):

> perform its obligations hereunder (including with respect to any exercise of discretion) with reasonable care (i) using a degree of skill and attention no less than that which the Collateral Manager would exercise with respect to comparable assets that it manages for itself and (ii), without limiting the foregoing, in a manner consistent with the customary standards, policies and procedures followed by institutional managers of national standing relating to assets of the nature and character of the Collateral.

Harding also represented that it would "take all action required, as Collateral Manager for the Issuer, to be taken by it under the Investment Advisers Act of 1940, as amended." *Id.* at 6.

1. <u>Section 206</u>

As an initial matter, the representation that Harding would "select all Collateral" was materially misleading. It implied that Harding had independently identified all the components of the portfolio, when in fact, for a significant percentage of it, Harding had simply taken the Index (a block selected by Magnetar) and excluded the worst performers to the extent Lieu could identify them in a single rushed day.

Also materially misleading was the standard of care representation. Again, the manager's processes mattered to the marketplace. The standard of care language was one of the key points of negotiation in a CMA, Suh Tr. 3110:4-11, and the clause referring to institutional managers of national standing was not used in every transaction, Suh Tr. 3051:16-3052:3. Doiron testified that it was important to him that a CDO manager hold itself to this standard, Doiron Tr. 1917:23-1918:25. Chau acknowledged that the manager's standard of care is important "[f]or any investment decision." Chau Tr. 1508:12-19.

Harding did not comply with the specified standard of care in relation to the Index collateral, nor did it disclose that fact. Respondents have argued that the standard of care obligation covered only post-closing activities, but in fact it applied to *all* "obligations [under the CMA] (including with respect to any exercise of discretion)." Div. Ex. 4 at 8. One of those (discretionary) obligations was to "*select all Collateral to be Acquired by the Issuer*." Div. Ex. at 4. The offering circular even noted that the acquisition of the initial portfolio of collateral was subject to the CMA. Div. Ex. 3 at 66. On the closing date, having been appointed as Collateral Manager, and clothed in the status of investment advisor, Harding advised the Issuer to acquire the warehoused collateral, but without disclosing that its analysis had been grossly non-compliant with the standard of care.

This was a violation of Respondents' "affirmative duty" as fiduciaries of "full and fair disclosure of all material facts," *Capital Gains*, 375 U.S. at 194; *accord Wash. Inv. Network*, 475 F.3d at 404. Chau admitted that, if Harding had not complied with a specific standard of care, it would be important to disclose that fact to the advisory client. Tr. 1509:24-1510:9. It is no accident that Sections 206(1) and (2) apply not just to fraud on a client but to fraud on a "prospective client": before accepting the appointment as Collateral Manager, Respondents should have disclosed that the standard of care representation was not satisfied as to the warehoused assets.

Even outside the fiduciary context, Respondents, having chosen to speak on the standard of care, would have been obligated to make a *complete* disclosure – which would include the self-evidently important fact that the standard had been grossly violated in the ramp. As the Second Circuit has explained:

> When analyzing offering materials for compliance with the securities laws, we review the documents holistically and in their entirety. The literal truth of an isolated statement is insufficient; the proper inquiry requires an examination of defendants' representations, taken together and in context. Thus, when an offering participant makes a disclosure about a particular topic, whether voluntary or required, the representation must be "complete and accurate."

In re Morgan Stanley Info. Fund Secs. Litig., 592 F.3d 347, 365-66 (2d Cir. 2010) (internal quotation marks and citations omitted); *see also In re GLG Life Tech Corp. Secs. Litig.*, 2014 WL 464762, at *4 (S.D.N.Y. Feb. 3, 2014) ("'once a party chooses to speak, it has a "duty to be both accurate and complete."'" (quoting *Caiola v. Citibank, N.A.*, 295 F.3d 312, 331 (2d Cir. 2003))).

Moreover, there would have been a Section 206 violation even without the affirmative misstatement concerning the standard of care. Respondents were required to properly investigate the Index bonds before causing the Issuer to acquire them. Not unlike Raymond Lucia, Respondents here "departed from the standards of care in an extreme way." *Lucia*, 2013 WL 6384274, at *43. As discussed above, acceptance of a fiduciary relation creates an understanding that the fiduciary will behave in certain ways, *Refco*, 2007 WL 2694469, at *7, including that the fiduciary will fulfill its duty of care. The undisclosed failure to do so is itself a form of deception.

In addition, Respondents were required to act in their client's best interest, and were prohibited from putting their own interests ahead of those of their client. *E.g.*, *SEC v. Moran*, 922

F. Supp. 867, 895-96 (S.D.N.Y. 1996) (Section 206 requires "investment advisers to act for the benefit of their clients," and "to exercise the utmost good faith in dealing with" them). Respondents violated these obligations when, to please Magnetar and earn fees, they included $220 million in the portfolio without proper review.

Respondents acted with scienter. Chau testified that he read CMAs before signing them, Chau Tr. 1532:3-6, and was familiar with the standard of care language and its inclusion in Harding's CMAs as a general matter. Chau Tr. 1504:12-1505:20.[189] And as discussed above, Respondents understood the standard of care, knew that it had been violated, and knew that the industry-standard approach depicted in the pitchbook was untruthful. In addition, the standard of care for pre-closing conduct was very much on Respondents' minds as a disclosure item. Here is Wang's testimony after being refreshed on the August 24, 2006 email (Resp. Ex. 457) in which she called for disclosure concerning a selection process that ressembles the Index trade:

> Q. Is it fair to say that if Harding were given a list and told to select names from that list and Harding did not apply its customary methodology or standard of care to those names you would want that disclosed?
> A. I think that is fair, yes.
> Q. Likewise if Harding were given a list and told to select names and Harding used generic cash flow and surveillance runs to eliminate or identify the worst performing bonds but did not review term sheets, prospectuses or specific collateral information you would want that disclosed?
> A. I believe so, yes.

Tr. 492:24-493:13.

Separately, the CMA *also* mis-described the warehouse agreement. On page 8, in the paragraph following the "Standard of Care" paragraph comes this language: "any Acquisition of

[189] Chau's attempt to downplay his understanding of the language as well as his own sophistication ("I don't know if anyone can define an institutional manager of national standing . . . I don't need to understand that to let me know that I am going to do the right thing," Tr. 1509:11-19) was unconvincing. In any case, that testimony, if true, would be more *in*culpatory than *ex*culpatory since it would be severely reckless for Chau to represent, to an advisory client, compliance with a standard that he did not understand.

Collateral by the Issuer from MLI [*i.e.*, Merrill Lynch International] pursuant to *the Warehouse Agreement dated as of May 26, 2006 between MLI and the Collateral Manager* shall be deemed to be at fair market value." Div. Ex. 4 at 8. This is a flat mischaracterization of the warehouse agreement, made by Harding (with Chau's signature) to the advisory client, and further obscuring Harding's compromised asset selection. Respondents were required to disclose all conflicts of interest, *Capital Gains*, 375 U.S. at 191-92 – this representation obscured one such conflict. Nor can this have been due to sloppy recycling of generic boilerplate, since the language refers, by date, to the specific warehouse agreement for Octans I.[190]

It is no answer to say, as Respondents repeatedly have, that the Issuer's counsel received (in its capacity as underwriter's counsel) the warehouse agreement. Chau understood that it was an important aspect of Harding's obligations to comply in full with the warehouse agreement; in fact, according to him, Harding expressly represented to the Issuer that it had done so. Chau Tr. 1514:14-1516:8, 1535:12-1536:3. And the warehouse agreement, as Chau conceded, demanded essentially the same standard of care as the CMA. Div. Ex. 5 at 15-16;[191] Chau Tr. 1537:14-22.

Respondents cannot have it both ways: either (i) the Issuer was on notice of the warehouse agreement, in which case it was defrauded by Harding's violations of the standard of care requirements contained in it, or (ii) the Issuer was not on notice of the warehouse agreement, in which case the CMA's faulty description of it withheld from the client important information bearing on the adviser's independence and conflicts of interest – and reasons for

[190] Harding's other CMAs in evidence do not mention a warehouse agreement at all. *See* Div. Ex. 504 at 7; Div. Ex. 506 at 7; Div. Ex. 510 at 8; Div. Ex. at 512 at 7.

[191] Clause 14(A): "The Collateral Manager shall discharge its duties under this Agreement, using a degree of skill and attention . . . no less than that which reasonable and prudent institutional money managers of national standing exercise with respect to comparable assets."

departing from the standard of care in the CMA. Either way Harding failed to make "full and fair disclosure of all material facts," *Capital Gains*, 375 U.S. at 194.

Primary Section 206 liability is appropriate for Harding Advisory and Chau. Given Chau's level of control and influence at Harding, he can be considered an investment adviser. *See John J. Kenney*, 56 S.E.C. 448, 485 n.54 (2003); *Alexander V. Stein*, 52 S.E.C. 296, 299 & n.10 (1995); *ZPR Inv. Mgmt.*, Initial Dec. Rel. No. 602, 2014 WL 2191006, at *54 (May 27, 2014).

2. *Section 17(a)*

The same facts that make out violations of Section 206 directed at the Octans I Issuer also violate Section 17(a) of the Securities Act. Respondents' deceptions and scienter are discussed above.[192] As for "the offer or sale" requirement, this conduct was in the context of closing the CDO, which included (i) the sale from the warehouse to the Issuer of the initial portfolio of collateral, which contained cash securities along with CDS[193]; as well as (ii) the Issuer's sale of securities to investors. *See United States v. Naftalin*, 441 U.S. 768, 773 (1979) ("The statutory terms [offer and sale], which Congress expressly intended to define broadly . . . are expansive enough to encompass the entire selling process[.]" (citations omitted)).

C. Section 17(a) Violations Based on the Offering Circular

During the marketing of a CDO and shortly before its closing, investors receive, respectively, a preliminary and final offering circular ("FOC"). *E.g.*, Wang Tr. 344:3-25, 345:17-

[192] Respondents' omissions along with their misstatements are actionable under Section 17(a). The fiduciary relationship creates a duty to disclose, the failure to fulfill which is fraud. *See, e.g., Chiarella v. United States*, 445 U.S. 222, 229-30 (1980); *SEC v. Zandford*, 535 U.S. 813, 823 (2002) ("any distinction between omissions and misrepresentations is illusory in the context of a broker who has a fiduciary duty to her clients.").

[193] *See* Div. Ex. 6 with column R filtered for "Octans I."

25, 346:7-12. The Octans I offering circulars discussed the CMA, repeating the standard of care language in it. Div. Ex. 3 at 196-97. The standard of care disclosure was misleading – it suggested to investors, *during the ramping of the transaction*, that the selection of the warehoused portfolio, and the decision to commit the CDO to acquire it, had been made in accordance with the represented standard of care, when that was not true.

Here Respondents acted with full knowledge or at the very least recklessness: They were acutely aware that the offering circulars described the CMA, and considered it important that the description be accurate. Wang Tr. 354:21-355:12, 359:17-360:6, 365:3-23; Chau Tr. 2121:19-2122:8; *see also* Suh Tr. 3008:4-10 (offering circular discloses provisions of CMA that are considered material). In other words, Respondents understood that the CDO's liabilities were being sold on the basis of a misleading description of the manager's standard of care.

The offering circulars also mis-disclosed the warehouse agreement:

> All or most of the [collateral] Acquired by the Issuer on the Closing Date will be Acquired from a portfolio of [collateral] *selected by the Collateral Manager and held by MLI*, an affiliate of MLPS, *pursuant to warehousing agreements between MLI and the Collateral Manager. . . . The Issuer will Acquire Collateral Debt Securities included in such warehouse portfolios only to the extent that such purchases are consistent with* the investment guidelines of the Issuer, the restrictions contained in the Indenture and *the Collateral Management Agreement and applicable law.*

Div. Ex. 3 at 66 (emphases added); Wang Tr. 417:2-25. This disclosure is part of a section beginning on page 58 of the FOC titled "Risk Factors Relating to Conflicts of Interest and Dependence on the Collateral Manager." Div. Ex. 3 at 58.

The warehouse disclosure was untrue in three respects that would have mattered to the reasonable investor. First, the offering circular created the appearance that Harding had independently selected the entire portfolio ("selected by . . ."), when in fact, for a significant percentage of it, Harding had simply taken the Index (a block selected by Magnetar) and excluded the worst performers to the extent Lieu could identify them in a single rushed day. Second, Magnetar's warehouse rights gave it undisclosed influence. Third, the passage states that the acquisition of warehoused collateral will comport with the CMA and applicable law – including the standard of care requirement and Respondents' Advisers Act obligations, when in fact these were violated.

Here Respondents were at least negligent. Chau certified in a "Collateral Manager's Certificate" that he had "carefully examined the Offering Circular" – not simply the portions nominally attributed to Harding, but the entire document. Div. Ex. 501. Chau, Wang, and Huang were on the "working group list" for Octans I, meaning they received drafts of the offering circulars. Resp. Exs. 161, 162; Wang Tr. 347:2 – 352:11. Chau, Wang, Huang, and Harding's outside counsel reviewed the drafts, and not just the sections strictly limited to describing Harding. Wang Tr. 346:2-4, 346:13-25, 356:6-357:4, 619:11-19, 623:22 – 625:24.[194] Finally, Harding was put on the clearest notice possible that Magnetar was *not* mentioned by name in the circular: Harding's counsel suggested a disclosure that named Magnetar, and was overruled by Merrill and Magnetar, whose counsel insisted that the reference be generic to the holders of the "preference shares," *i.e.*, equity. *See* Resp. Ex. 196; Wang Tr. 635:7-15, 636:4-21, 640:6-11.

In sum, the offering circulars contained a series of misrepresentations that Respondents knew, recklessly avoided knowing, or should have known were materially untrue. Like the pitchbook, the offering circulars were used in a process of offering and selling securities through which Respondents obtained money. Respondents are therefore liable under Section 17(a) for the faulty offering circulars.

[194] For comparison, Doiron testified that HIMCO "most likely" reviewed even the portions of the Wadsworth offering circular not attributed to the collateral manager. Doiron Tr. 2055:12-2056:2.

XIII. VIOLATIONS OF SECTIONS 206 AND 17(a) RELATING TO NORMA

Respondents clearly disliked Norma at both the single-A and BBB levels. Chau bought the single-A tranche to be a "team player," and, by his own admission, before doing any meaningful analysis of it. After the purchase, Respondents tried to reduce their CDOs' exposure to the single-A tranche. As for the BBBs, Chau bought them only in response to pressure by Magnetar and Merrill Lynch, and disliked them so much that he cheered when his allocation was reduced. Then, after Harding had placed its orders for Norma but before the four advisory clients acquired it, Kaplan's highly negative report was circulated.

At the hearing, Chau was evasive as to whether the analysis reflected in Kaplan's write-up – as opposed to the physical write-up itself – was (a) performed, and (b) known to him before he agreed to acquire the bonds in January. *See* Tr. 1647:18-1648:13, 1666:15-1669:6, 1670:2-21; Tr. 4123:8-13. It seems clear that the analysis was done only after Chau committed to purchase, but either way there would have been a serious violation of Respondents' fiduciary obligations: In one scenario they would have bought with full knowledge of the problems, and in another without fulfilling their obligation to their prospective client to investigate. Either way there was an extreme departure from standards of ordinary care. *Cf. Lucia*, 2013 WL 6384274, at *43.[195]

Whatever the case, Respondents clearly had become aware of Norma's red flags in late February 2007, which was still *before* they caused the advisory clients to acquire it. And yet

[195] The discursive, and not always intelligible, theoretical discussion that Chau offered under questioning from his own counsel does not come close to redeeming the investment decision. For one thing, there is no evidence that Harding ever performed the kind of analysis that could theoretically have justified the investment (for instance, modeling to see whether Norma's BBB tranches and single-A tranches could withstand the losses that Harding's own analysts were projecting on the underlying RMBS). For another, many of Chau's justifications, to the extent they are coherent, do not withstand scrutiny. Take Chau's claim that investing in CDOs backed by collateral rejected by his own staff is useful for diversification. Chau Tr. 4143:13-4146:13. This is as ridiculous as it sounds, and flatly inconsistent with applicable standards of care. Wagner Report ¶¶ 150, 157, 158.

Respondents made no disclosure to the clients of the problems with Norma. Nor did Respondents disclose that they did not believe Norma was a good investment, and that they had placed their own interest in pleasing Merrill Lynch and Magnetar (their "true friends") ahead of the best interests of the portfolios. *Cf. Capital Gains*, 375 U.S. at 191-92; *Moran*, 922 F. Supp. at 896.[196] Chau testified that selecting assets that he did not think were in a CDO's best interest as a favor to someone else would be "wrong" and require disclosure. Tr. 1519:11-23.

Moreover, the CMAs for all four Norma Recipients contained standard of care requirements like those in the Octans I CMA. This was materially misleading in that, as reviewed in section X.G. above, the acquisition of Norma was an extreme departure from the standard of care and Respondents knew it. As with Octans I, Respondents failed to disclose the non-compliance, which violated their duty to their clients, prospective or otherwise, to make full disclosure of all material facts. *See Capital Gains*, 375 U.S. at 194; *Wash. Inv. Network*, 475 F.3d at 404. Again, even outside the fiduciary context, this would have been actionable because Respondents chose to speak on the standard of care, but did so incompletely.

The deception aimed at the advisory clients also violated Section 17(a). The Norma bonds, and the notes issued by the Norma Recipients, were securities "in the . . . sale" of which Harding made the relevant misrepresentations and omissions. *See Naftalin*, 441 U.S. at 773.

XIV. CHAU AIDED AND ABETTED, AND CAUSED, HARDING ADVISORY'S VIOLATIONS

Chau can also be held liable for aiding and abetting Harding Advisory's primary violations of the Securities and Advisers Acts. Aiding and abetting entails: (1) a primary

[196] In the securities-fraud context, a fiduciary's favor to a friend or business associate is a well-recognized form of self-dealing. *See, e.g.*, *SEC v. Obus*, 693 F.3d 276, 291 (2d Cir. 2012); *SEC v. Cuban*, 620 F.3d 551, 557 n.38 (5th Cir. 2010); *SEC v. Rocklage*, 470 F.3d 1, 7 n.4 (1st Cir. 2006); *SEC v. Yun*, 327 F.3d 1263, 1280-81 (11th Cir. 2003).

violation; (2) knowledge of the violation by the aider and abettor; and (3) substantial assistance by the aider and abettor in the primary violation. *DiBella*, 587 F.3d at 566; *see also SEC v. Apuzzo*, 689 F.3d 204, 212 (2d Cir. 2012). Here, Chau was Harding's dominant actor, primary portfolio manager, and the individual with responsibility for Harding's marketing materials and disclosures. Chau executed all the CMAs on behalf of Harding, and approved the content concerning Harding in CDO pitchbooks. He knew and approved of the Index trade for Octans I, and involved both Huang and Lieu in it. It was he who chose to buy Norma as a favor to Magnetar and Merrill. To the extent Harding Advisory committed violations, Chau's knowledge of and assistance with them are not open to serious question.

For the same reasons, Chau also was a "cause" of Harding Advisory's violations. "Causing" liability exists when there is a primary violation; an act or omission by the respondent was a cause of the primary violation; and the respondent knew or should have known that his conduct would contribute to the violation. *See Robert M. Fuller*, 56 S.E.C. 976, 984 (Aug. 25, 2003). Those requirements are readily satisfied here.

XV. DEFENSES ADVANCED BY RESPONDENTS HAVE NO MERIT

A. Investor Reliance Is Not an Issue in the Case

According to Respondents, investors "got the benefit of their bargain." Tr. 3000:25. In Respondents' telling: (i) most of the collateral was disclosed in advance, (ii) investors were sophisticated and had the ability to analyze that collateral themselves, (iii) the pitchbook and preliminary offering circular were superseded by the final offering circular, (iv) the final offering circular contained pertinent disclaimers, and therefore (v) Respondents are not liable.

That is not the law. As discussed above, reliance and injury simply are not elements in an SEC enforcement case and therefore the lack of either is not a defense.[197] At best Respondents are arguing materiality – what the reasonable investor would care about. But the Division has proved what the reasonable investor would, should, and did care about, which is not just the collateral in the transaction, but also its selection by a diligent, unconflicted, independent, capable manager whose own analysis legitimately supports the decisions to acquire it.

It is no answer to say that the investors were sophisticated. HIMCO, MCM, and Morgan Stanley were all sophisticated – but all cared about the manager of the CDOs they invested in. Harding was sophisticated, too, but Chau and Huang testified that the manager of the CDOs Harding bought mattered. The evidence is overwhelming that even when investors like HIMCO could and did review the collateral in Octans I, they still wanted to understand the manager's own analysis of various assets, and expected that analysis to legitimately support the investment decision. In any case, a securities professional is not entitled to abdicate his responsibilities simply because investors or clients are sophisticated. *See Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 641-42 (D.C. Cir. 2008) (underwriter's "duties do not disappear" simply because of investor sophistication); *Hanly v. SEC*, 415 F.2d 589, 595-96 (2d Cir. 1969) (broker's duty to investigate applies even if his "customers may be sophisticated and knowledgeable" enough to conduct their own analysis of a stock because "reliance is not an element of fraudulent misrepresentation.").

[197] *E.g, Lucia*, 2013 WL 6384274, at *39; *Michael R. Pelosi*, Initial Dec. Rel. No. 448, 2012 WL 681582, at *18 (Jan. 5, 2012), *dismissed on other grounds*, Advisers Act Rel. No. 30997, 2014 WL 1247415 (Mar. 27, 2014). Respondents' pre-hearing brief rested entirely on private, not SEC cases, ignoring not just the principle that lack of reliance is not a defense to an SEC case, but also the actual cases in which representations pertaining to the manner in which CDO collateral was selected were held actionable – over defense arguments that, at least in the case of *Steffelin*, were identical to those Respondents make here. *See* footnote 184; *Steffelin* Argument and Bench Ruling at 3-4, 6-8.

Also extremely wide of the mark is Respondents' argument that "fraud could not be predicated on the Pitch Book as a matter of law," Resp. Corrected Pre-Hearing Brief 23-24. Respondents have thus far cited only state-law cases in support, and with good reason: That is not a correct statement of the law applicable to an SEC enforcement case. *See SEC v. Quan*, 2013 WL 5566252, at *8 (D. Minn. Oct. 8, 2013) (flipbook held actionable even though investors signed subscription agreements stating they had relied solely on a private placement memorandum); *SEC v. True North Finance Corp.*, 909 F. Supp. 2d 1073, 1096-97 (D. Minn. 2012) (rejecting argument that statements outside offering circular were not actionable because "reliance is not a required element of any of the SEC's claims").

Equally misplaced is Respondents' argument that the disclaimers and disclosures in the final offering circular insulate them from liability. The disclaimers do not address the subject matter actually at issue here (namely the manager's integrity, independence, and diligence), and the disclosures include a standard of conduct that Respondents knowingly violated. Their argument has been repeatedly rejected in private suits that, as far as the reliance argument, are on all fours with this one,[198] to say nothing of what should happen in an SEC case. *See, e.g.*, *Lucia*,

[198] *See Bayerische Landesbank, N.Y. Branch v. Aladdin Capital Mgmt. LLC*, 692 F.3d 42, 52, 58-59 (2d Cir. 2012) (sustaining CDO debt investor's claims against manager for failure to live up to representations that allegedly induced reliance, including that manager would act "in good faith using a degree of skill, care, diligence and attention consistent with the practice and procedures followed by reasonable and prudent institutional managers of national standing"); *Loreley Financing (Jersey) No. 28, Ltd. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 2014 WL 1810646, at *3-4 (N.Y. App. Div. 1st Dep't May 8, 2014) (sustaining claim that Merrill defrauded investor in a Magnetar CDO: "Under the circumstances, it cannot be said that the disclaimers and disclosures in the offering circulars preclude a claim of fraud . . . as to the specific matter, namely that the CDO's collateral had been carefully selected by an independent collateral manager, in the interests of the success of the deal and for the benefit of [the CDO's] long investors."); *Loreley Financing (Jersey) No. 3 Ltd. v. Citigroup Global Markets Inc.*, 2014 WL 1809781, at *6 (N.Y. App. Div. 1st Dep't May 8, 2014) (disclaimers and disclosures in offering circular did not preclude reasonable reliance by CDO investors alleging concealment of Magnetar's role in collateral selection; "[no]thing in the deal documents or elsewhere could have 'alerted' plaintiffs to the falsity" of representations about who selected the collateral and why).

2013 WL 6384274, at *49 ("general cautionary language does not render omission of a specific misleading historical fact immaterial.").

B. <u>The CMAs Did Not Disclaim Harding's Duties Under the Advisers Act</u>

Respondents have argued that they did not owe fiduciary duties to their advisory clients, pointing to a provision in the CMAs that "the Collateral Manager shall not be subject to any fiduciary or other *implied duties*," *e.g.*, Div. Ex 4 at 8 (emphasis added). That provision, to the extent it is enforceable at all, is simply a disclaimer of any *implied state-law* duties.[199] But Harding was the Issuers' investment adviser under the *federal* securities laws, which of course impose *federal* fiduciary duties.[200]

Each of the CMAs expressly "appoints the Collateral Manager as [the Issuer's] ***investment advisor*** and manager with respect to the Collateral on the terms set forth herein," *e.g.*, Div. Ex. 4 at 3, and there is (or should be) no serious dispute that the CMAs were advisory agreements. *See* Div. Ex. 122 at 6 ("Advisory Agreement" section of Harding compliance manual); Wang Tr. 301:3-17. Section 215(a) of the Advisers Act voids any contract provision that purports "to waive compliance with any provision of" the Advisers Act. Accordingly, even if Harding had tried to contractually disclaim duties imposed by the Advisers Act, such a disclaimer would be a nullity. But that is not what Harding tried to do: each of the CMAs expressly affirms that Harding as collateral manager is subject to the Advisers Act. *E.g.*, Div. Ex.

---

[199] *Cf. LBBW Luxembourg S.A. v. Wells Fargo Secs. LLC*, __F. Supp. 2d __, 2014 WL 1303133, at *15 (S.D.N.Y. Mar. 31, 2014); *BNP Paribas Mortg. Corp. v. Bank of Am., N.A.*, 866 F. Supp. 2d 257, 269 (S.D.N.Y. 2012); *Seippel v. Jenkens & Gilchrist, P.C.*, 341 F. Supp. 2d 363, 381-82 (S.D.N.Y. 2004) ("contractual disclaimers of fiduciary duty are effective in New York").

[200] *See, e.g.*, Div. Ex. at 122 at 4, 24 (Harding's compliance manual, citing *Capital Gains* and affirming that "[a]s a registered adviser, and as a fiduciary to our advisory clients, our firm has a duty of loyalty and to always act in utmost good faith, place our clients' interests first and foremost and to make full and fair disclosure of all material facts and in particular, information as to any potential and/or actual conflicts of interests.").

4 at 6 ("The Collateral Manager shall take all action required . . . to be taken by it under the Investment Advisers Act of 1940."). The CMAs' disclaimer of privately enforceable "implied duties" is not carte blanche for Harding to disregard its federal advisory obligations.

C. <u>The Percentage of the Advised Portfolios Invested in Norma Is Beside the Point</u>

Respondents have argued that the Norma purchases were not material because they represented between one and two percent of each of the Norma Recipients' assets. *See* Resp. Ex. 879 (tallying percentage of portfolios invested in Norma). But *Respondents themselves* clearly considered the Norma investment important – they kept trying to rid themselves of it even though it was rare for Harding ever to try to trade out of a position.

In any event, the small percentage is not a defense to securities fraud, particularly when it involves a breach of fiduciary duty. *SEC v. DiBella*, 587 F.3d 553 (2d Cir. 2009) illustrates why. That case arose out of a kickback-style arrangement in which the Connecticut state treasurer caused the state's pension fund to increase, from $50 million to $75 million, the size of its investment with an outside money management firm named Thayer Capital Partners. The treasurer's friend, DiBella, was to be compensated as a function of the amounts invested with Thayer. *Id.* at 558-60. The pension fund at the time was valued at approximately $18 billion, *id.* at 558 – an amount so vast that the tainted $25 million increase represented just 0.14% of it. The Second Circuit nevertheless readily upheld the materiality finding for purposes of Section 10(b) (*id.* at 565-66 (emphasis added)):

> A reasonable investor . . . may have viewed the fee arrangement, *as it related to the level of Fund assets invested with Thayer*, as changing the total mix of information, because it tends to show that [the state treasurer] may have been motivated to increase the Fund investment with Thayer not because Thayer was a good investment but only to enrich DiBella.

So too here – a reasonable investor would be interested to know that Harding bought Norma not because Harding thought it was a good investment, but only to benefit Magnetar and Merrill Lynch. And there is more: DiBella was also charged with aiding and abetting an Advisers Act Section 206 violation by Thayer, which improperly agreed to make payments to DiBella. *Id.* at 560, 568. The amount of the proposed quasi-kickback was $525,000 (of which $25,000 was actually paid), representing just 0.7% of the pension fund's anticipated $75,000,000 investment. The Circuit nevertheless faithfully applied *Capital Gains*, observing that "***any transaction** that functions [as] or otherwise results in a fraud is punishable under* Section 206." *Id.* at 569 (emphasis added). The percentages in *DiBella* were significantly smaller than the percentages in RX 879, as were the absolute dollar amounts – $25 million and $525,000 compared to a total of $50 million in client and investor funds that Harding improperly committed to Norma.

Commission precedent is to the same effect. In *Kingsley, Jennison, McNulty & Morse Inc.*, 51 S.E.C. 904, 1993 WL 538935, at *2-*4 (Dec. 23, 1993), an investment adviser's payments of just $31,960 in undisclosed "soft dollar" commissions were held material even though the $31,960 represented less than 1% of total commissions generated by the Respondents' advised accounts: "because of the fiduciary relationship between an adviser and its client, the percentage or absolute amount of commissions involved is not the sole test of materiality in a transaction between them." *See also Pelosi*, 2012 WL 681582, at *21 (in proceeding against investment adviser who misrepresented his performance, the Court "reject[ed] the 1% or 2% test Pelosi argues for, in favor of the more holistic, fact-specific approach adopted by the Supreme Court and Second Circuit." (citing *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162-63 (2d Cir. 2000)), *dismissed on other grounds*, 2014 WL 1247415. That goes for this case too – the Norma purchases represented serious breaches of fiduciary duty even if the other assets in the portfolios did not.[201]

XVI. REMEDIES

In determining whether the public interest requires sanctions, the following factors are to be considered: the egregiousness of the actions; the isolated or recurrent nature of the infractions; the degree of scienter involved; the sincerity of a respondent's assurances against future violations; a respondent's recognition of the wrongful nature of his or her conduct; and the likelihood that a respondent's occupation will present opportunities for future violations. *See Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979); *see also Michael T. Studer Castle Secs. Corp.*, Exchange Act Rel. No. 50411, 2004 WL 2104496, at *4 (Sept. 20, 2004). Other factors include the age of the violations and the degree of harm to investors and the marketplace, *see Marshall E. Melton*, Advisers Act Rel. No. 2151, 2003 WL 21729839, at *2 (July 25, 2003), as well as the extent to which a sanction will have a deterrent effect and the likelihood of future violations. *See ZPR Inv. Mgmt., Inc.*, Initial Dec. Rel. No. 602, 2014 WL 2191006, at *55 (May 27, 2014); *Mark Feathers*, Initial Dec. Rel. No. 605, 2014 WL 2418472, at *3 (May 30, 2014) (citing *Schield Mgmt. Co.*, Exchange Act Rel. No. 53253, 2006 WL 231642, at *8 & n.46 (Jan. 31, 2006)).

A. A Cease and Desist Order Should Issue

In determining whether a cease-and-desist order is appropriate in the public interest, in addition to the "*Steadman* factors" listed above, the Commission further considers: "whether there is a risk of future violations, whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the

[201] In reality, Norma was far from the only violative investment in the Norma Recipients' portfolios. *See* footnotes 175 and 204 above and below.

cease-and-desist order in the context of any other sanctions being sought in the same proceedings." *Steven E. Muth*, Initial Dec. Rel. No. 262, 2004 WL 2270299, at *39 (Oct. 8, 2004) (citing *KPMG Peat Marwick LLP*, Exchange Act Rel. No. 1360, 2001 WL 47245 (Jan. 19, 2001)). In applying these factors, the Commission has held that "although some risk of future violation is necessary, it need not be very great to warrant issuing a cease-and-desist order and ... in the ordinary case and absent evidence to the contrary, a finding of past violation raises a sufficient risk of future violation." *KPMG Peat Marwick LLP*, Exchange Act Rel. No. 1374, 2001 WL 223378, at *6 (Mar. 8, 2001) (internal quotation marks and citation omitted).

A cease-and-desist order is appropriate in this proceeding. Respondents' violations of their statutory duties were serious, repeated, and generally committed with a high degree of scienter. There is no assurance against future misconduct, as Chau refused to acknowledge that anything he did was in the least bit problematic. To the contrary: throughout his testimony, he repeatedly, almost compulsively, invented far-fetched, self-serving, unconvincing justifications for his conduct.[202] (He also routinely contradicted his own prior statements.) And opportunities to commit violations will persist inasmuch as Chau is in his 40's and has given no indication that he intends to leave the securities industry.

[202] To take just a few examples: Chau actually denied that Harding was the Octans I Issuer's investment adviser. Tr. 1513:9-15. He also resisted a straightforward question about whether he thought the standard of care required doing due diligence into the assets underlying a CDO. He changed the subject to the London Whale, eventually delivering a protracted monologue on the causes of the financial crisis. Tr. 1554:8-1565:12. And in trying to defend the Norma purchase, Chau speculated that he may not have read Kaplan's write-up at all because it contained an error. Tr. 4223:7-12 ("sitting here today, if I get a commentary from an analyst that didn't bother to have the time to put in the correct collateral manager, I would not have paid any attention to this commentary. I would have most likely just closed the spreadsheet and moved on with the rest of my day."). This testimony was inane: Many of the negative statistics in the write-up were *also* in the cover email (*see* Div. Ex. 217 at 1), which did not contain the mistake. In any case, a responsible investment adviser would not ignore the analysis prepared by his own staff.

B. Respondents Should Disgorge Their Advisory Fees

Section 8A(e) of the Securities Act and Sections 203(j) and 203(k)(5) of the Advisers Act authorize an order to disgorge ill-gotten gains. 15 U.S.C. §§ 77h-1(e), 80b-3(j), 80b-3(k)(5).[203] "[D]isgorgement's underlying purpose is to make lawbreaking unprofitable for the law-breaker[.]" *SEC v. Contorinis*, 743 F.3d 296, 301 (2d Cir. 2014). To determine the appropriate amount of disgorgement, the Division need only offer a reasonable approximation of the profits from the violative conduct. *See SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989). The burden then shifts to the respondent to show that the approximation is inaccurate. *Id.* at 1232. All doubts concerning the determination of the disgorgement figure are to be construed against Respondents. *E.g.*, *SEC v. Lorin*, 76 F.3d 458, 462 (2d Cir. 2006).

Respondents should disgorge their advisory fees for Octans I, as well as the Norma Recipients. The amounts are as follows (*see* Div. Ex. 240A; Div. Ex. 240):

Octans I	$4,563,733.94
Lexington V	$1,285,112.77
Jupiter VI	$1,105,398.28
Neo	$4,490,522.84
888 Tactical	$1,243,336.01

It is appropriate for Respondents to disgorge the entirety of these fees.[204] Respondents did not do what they were engaged to do, and instead obtained their fiduciary positions through a series of

[203] Authority for a disgorgement order here also stems from Section 9(e) of the Investment Company Act ("Company Act"), 15 U.S.C. § 80a-9(e). *See* OIP at 13.

[204] Although the proof regarding Respondents' purchases of RMBS focused on Octans I, and the proof on CDO securities focused on Norma, these were no isolated occurrences. On RMBS: the Division proved similar behavior as to Octans II and III. And on CDOs, as discussed above, *see* footnote 175 and section X.G., Respondents included in the Norma Recipients (and other vehicles) many other CDO securities either without analyzing them, or in disregard of negative analysis. One clear example is Orion, a Magnetar CDO that Respondents repeatedly purchased, and placed into the Norma Recipients (*see* Div. Ex. 6 (column C filtered for ORIN entries); Tr. 1407:6-20) despite Harding's conclusion that the CDO was a bad investment. Huang Tr. 1380:9-1381:3 ("I do recall that particular deal [Orion]. It is one of the

misrepresentations. One who obtains or continues in a fiduciary position by virtue of securities violations is not entitled in equity to retain compensation from that position, without regard to whether or not the violator also claims to have performed "legitimate" services.[205] Disgorgement, moreover, has a deterrent function. *E.g.*, *Contorinis*, 743 F.3d at 301; *SEC v. Teo*, 746 F.3d 90, 105 (3d Cir. 2014); *SEC v. Whittemore*, 659 F.3d 1, 11 (D.C. Cir. 2011). The requested disgorgement will vindicate the Commission's interest in deterring others from similar derelictions.

In addition, prejudgment interest must be ordered on any disgorgement. Commission Rule 600; *see also J.W. Barclay & Co.*, Initial Dec. Rel. No. 239, 2003 WL 22415736, at *42 (Oct. 23, 2003). Appendix 5 to this Brief presents a prejudgment interest computation.

Finally, under settled principles, the disgorgement order should be joint and several as to Harding Advisory and Chau in light of Chau's ownership and dominance of Harding and his extensive involvement in the misconduct.[206]

C. **Third-Tier Penalties Should Be Assessed**

Under Section 203(i) of the Advisers Act, the Commission may impose a civil money penalty on a respondent who willfully[207] violated (or aided and abetted a violation of) the

---

deals I think we had a problem with. . . . We had a view, this Orion deal was – had a structure that was bad for investor[s]. . . . I wouldn't recommend it.").

[205] *See, e.g.*, *SEC v. Conaway*, 2009 WL 902063, at *19-20 (E.D. Mich. 2009) (disgorgement of chairman and CEO's compensation would be warranted even if not causally related to his violations if the violations prevented the corporation from entering bankruptcy earlier); *SEC v. Church Extension of the Church of God, Inc.*, 429 F. Supp. 2d 1045, 1050 (S.D. Ind. 2005) (ordering company executives to disgorge half their compensation on grounds that their violations of securities laws prolonged company's existence and therefore their employment); *see also SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994), *aff'g SEC v. Drexel Burnham Lambert Inc.*, 837 F. Supp. 587 (S.D.N.Y. 1993) (defendants who used securities violations to assume control of a company were required to disgorge the entirety of the money paid to them as officers and directors of the company).

[206] *E.g.*, *SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1475-76 (2d Cir. 1996); *SEC v. First Pac. Bancorp.*, 142 F.3d 1186, 1191-92 (9th Cir. 1998); *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 455 (3d Cir. 1997); *Whittemore*, 659 F.3d at 10-12 ; *SEC v. Calvo*, 378 F.3d 1211, 1215-16 (11th Cir. 2004); *see also SEC v. Pentagon Capital Mgmt. PLC*, 725 F.3d 279, 288 (2d Cir. 2013).

Advisers Act or Securities Act, if the penalty is in the public interest.[208] The public interest is assessed with respect to these statutory factors: (1) deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) the need for deterrence; and (6) such other matters as justice may require. 15 U.S.C. § 80b-3(i)(3); *see also Hector Gallardo*, Exchange Act Rel. No. 65422, 2011 WL 4495006, at *10 (Sept. 28, 2011). "Not all factors may be relevant in a given case, and the factors need not all carry equal weight." *Robert G. Weeks*, Initial Dec. Rel. No. 199, 2002 WL 169185, at *58 (Feb. 4, 2002). *See also Richard P. Sandru*, Initial Dec. Rel. No. 3646, 2013 WL 4049928, at *9 (Aug. 12, 2013).

A three-tier system establishes the maximum per-violation penalty. 15 U.S.C. § 80b-3(i)(2). Second-tier penalties are imposed in cases involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. *Id.* Third-tier penalties are imposed in cases where such state of mind is present *and* where the conduct directly or indirectly (i) resulted in substantial losses, ***or*** (ii) created a significant risk of substantial losses to other persons, ***or*** (iii) resulted in substantial pecuniary gain to the violator. *Id.* During the time period at issue, the third tier penalties for each violation were $130,000 for a natural person, and $650,000 for an entity. See 17 C.F.R. § 201.1003 & Pt. 201, Subpart E, Table III.

The conduct here should be subject to third-tier penalties given the level of scienter and the tremendous pecuniary gains to Respondents, as reviewed above. In addition, Chau's callous disregard for his advisory obligations created a very significant risk of harm to others. At a fundamental level, Chau obviously did not care – at all – what went into his CDOs so long as the

---

[207] There is no serious question that Respondents' violative acts were willful within the meaning of *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000).

[208] Penalty authority here also derives from Section 9(d) of the Company Act, 15 U.S.C. § 80a-9(d).

assets were allowed by the transaction documents. Huang essentially acknowledged that the failure of Harding and others to properly analyze assets was "part of the reason why we had the mess we had, you know, in '07, '08," – in other words, a catastrophic financial crisis. Huang Tr. 1049-51. It was the height of irresponsibility for Respondents to stuff giant vehicles with assets that they had not properly investigated and knew had serious problems.

There are many ways to count the violations, and Respondents' potential exposure here is gigantic.[209] The Court could (i) impose a penalty on each of Harding and Chau for each of the various misrepresentations in the Octans I pitchbook, multiplied by each instance in which the pitchbook was sent to an investor or potential investor[210]; (ii) do the same for each iteration of the Octans I offering circular; and (iii) penalize each of Harding and Chau multiple times for each of the five CMAs at issue. The Division believes, however, that it is not necessary to go so far. A fair approach would be to assess a single maximum-size penalty on each respondent for each of the five CDOs in question, in other words five times $130,000 (or $650,000 in total) against Chau, and five times $650,000, or $3,250,000 against Harding. No matter how the penalty is computed, it should give due regard to the need to send a strong deterrent message that

[209] *See, e.g., Muth*, 2004 WL 2270299, at *41 ("each fraudulent misrepresentation to each investor constitutes a separate act or omission" since the "statutory maximum is not an overall limitation, but a limitation per violation."); *Mark David Anderson*, Securities Act Rel. No. 8265, 2003 WL 21953883, at *10 (Aug. 15, 2003) (imposing 96 penalties, one for each of 96 trades in which respondent charged customers an undisclosed markup or markdown); *Kevin H. Goldstein*, Initial Dec. Rel. No. 243, 2004 WL 69156, at *19 (Jan. 16, 2004) (in fraudulent offering of securities, each fraudulent misrepresentation to each investor counted as a separate act or omission); *J.W. Barclay*, 2003 WL 22415736, at *40 (each unauthorized trade and each unsuitable transaction constituted a separate act or omission); *Weeks*, 2002 WL 169185, at *59 ("Thus, a 'Dear Investor' letter containing one fraudulent misrepresentation, when mailed to 3,400 Dynamic American shareholders, constitutes 3,400 separate acts or omissions."); *SEC v. Ramoil Mgmt., Ltd.*, 2007 WL 3146943, at *13 (S.D.N.Y. Oct. 25, 2007) (penalizing defendant for each false document he filed with the Commission under each statute that the false filings violated).

[210] *See* Resp. Ex. 750 for a list of Octans I investors, which is a subset of those who were solicited.

investment advisers are *not* entitled to thumb their nose at their obligations as Chau repeatedly did here. *Schield Mgmt. Co.*, 2006 WL 231642, at *8 & n.46.

D. Associational Bars Are Appropriate

Sections 203(e) and (f) of the Advisers Act authorize the Commission to revoke the registration of a registered investment adviser, and to bar a person from association with an investment adviser, for willfully violating (or aiding and abetting a violation of) the federal securities laws. 15 U.S.C. § 80b-3(e), (f)[211]; *see John W. Lawton*, Advisers Act Rel. No. 3513, 2012 WL 6208750, at *7 (Dec. 13, 2012) (collateral bars may be imposed based on conduct pre-dating July 22, 2010). The selection of an appropriate sanction includes an assessment of the deterrent effect it may have in upholding and enforcing standards of conduct in the securities business.[212]

An industry bar is particularly important in this case given the importance to the investment adviser industry of maintaining honest fiduciary relations. *See Steadman*, 603 F.2d at 1142 (in determining appropriate sanction, Commission entitled to consider "violations occurring in the context of a fiduciary relationship to be more serious than they otherwise might be"); *James C. Dawson*, Advisers Act Rel. No. 3057, 2010 WL 2886183, at *4 (July 23, 2010) ("We have consistently viewed misconduct involving a breach of fiduciary duty or dishonest conduct on the part of a fiduciary ... as egregious."). In *Dawson*, the Commission rejected the

---

[211] Company Act Section 9(b), 15 U.S.C. § 80a-9(b), also authorizes bars relating to registered investment companies.

[212] *See Don Warner Reinhard*, Exchange Act Rel. No. 3139, 2011 WL 121451, at *8 (Jan. 14, 2011); *Mark S. Parnass*, Exchange Act Rel. No. 65261, 2011 WL 4101087, at *3 (Sept. 2, 2011) ("the function of a bar order is not limited to merely preventing future identical violations, but is more broadly designed to achieve the goals of deterrence, both specific and general, to address the risks of allowing a respondent to remain in the industry"); *see also Gary M. Kornman*, Exchange Act Rel. No. 59403, 2009 WL 367635, at *7 (Feb. 13, 2009) ("The securities industry presents continual opportunities for dishonesty and abuse and depends heavily on the integrity of its participants and on investors' confidence.").

argument that the purportedly minimal financial harm to the adviser's clients justified a less severe bar, ruling instead that it is the "nature of the violation itself, not solely . . . [the] calculation of financial harm" that underpins a bar determination." *Id.* at *3.

Permanent bars are appropriate here. This case has certain commonalities with *ZPR Investment Management*. Both involve an investment adviser that misrepresented its adherence to a generally accepted set of standards (there, Global Investment Performance Standards; here, the customary practices of national-class asset managers). Both involve an individual who, in addition to misleading clients and prospective clients, "refused to accept responsibility for the abdication of his fiduciary duty." 2014 WL 2191006, at *58. The heavy sanction of permanent bars was imposed even though no investors were purportedly harmed. Similarly, in *Raymond J. Lucia Cos.*, Initial Dec. Rel. No. 540, 2013 WL 6384274, at *57 (Dec. 6, 2013), a permanent bar was imposed on an individual who, like Chau, had engaged in extreme departures from standards of ordinary care, and "refused to accept responsibility for the abdication of his fiduciary duty." And in *Michael R. Pelosi*, Initial Dec. Rel. No. 448, 2012 WL 681582, at *18 (Jan. 5, 2012), *dismissed on other grounds*, Advisers Act Rel. No. 30997, 2014 WL 1247415 (Mar. 27, 2014), the reasons for a permanent bar included the Respondent's sophistication and the fact that his justifications for his misconduct were "unpersuasive, inconsistent, ad hoc, ex post facto, and, at times, incoherent" – which would also be an apt description of much of Chau's testimony here.

Also instructive is *Donald L. Koch*, Exchange Act Rel. No. 3836, 2014 WL 1998524 (May 16, 2014), where the Commission held that even violations lasting a brief period of time can result in a lengthy bar. Respondents there were found to have engaged in fraudulent and manipulative conduct by "marking the close." *Id.* at *9. Although the amount of wrongfully obtained gains was negligible, and the violations involved trading on only two days and in three securities, the Commission ordered a permanent bar. *Id.* at *21.

CONCLUSION

The Court should conclude that Respondents violated (or in the alternative that Chau aided and abetted or caused Harding Advisory's violations of) Section 17(a) of the Securities Act and Sections 206(1) and (2) of the Advisers Act, and impose the requested sanctions.

Dated June 13, 2014
New York, New York

DIVISION OF ENFORCEMENT

/s/ Howard A. Fischer

Howard A. Fischer
Daniel R. Walfish
Brenda W.M. Chang
Elisabeth L. Goot
Securities and Exchange Commission
New York Regional Office
Brookfield Place, 200 Vesey Street, Suite 400
New York, NY 10281
Tel: 212.336.0589
Fax: 212.336.1322
Email: fischerh@sec.gov

APPENDIX 1: OCTANS I TIMELINE

Date	Event	Citation(s)
April 18, 2006	Merrill Lynch emails Prusko: "idea would be to have you as a partner early in the construction of deal and portfolio. Then we can about equity investment. U agree with that approach right?" Prusko replies: "Sounds good."	Div. Ex. 11
May 3, 2006	Merrill meets with Prusko. According to internal Merrill report prepared the next week, they "discuss working together on Mezz ABS deals, whereby we pick mutually agreeable managers to work with, Magnetar plays a significant role in the structure and composition of the portfolio...and in return [Magnetar] retain[s] the equity class and we distribute the debt. . . . We have agreed to a short list of managers, have engagement letter to [Maxim] for first deal."	Div. Ex. 12, Resp. Ex. 760
May 22, 2006 (Monday)	Prusko emails Merrill Lynch: "A question on ramping . . . can you put [the index] in warehouse directly or will ML intermediate . . . seems like would be a good idea to get size quickly."	Div. Ex. 18
May 23, 2006 early a.m. (Tuesday)	Merrill informs Prusko that Merrill "is ok to [put] the index itself in warehouse."	Div. Ex. 20
May 23, 2006 a.m.	Prusko reports to Snyderman on call with Merrill Lynch: "You would have laughed at me explaining to three senior wall street traders/structurers [the mechanics for putting all 20 Index names in the warehouse]."	Div. Ex. 19
May 23, 2006 evening	Prusko to Merrill Lynch: "Let's buy some index!"	Div. Ex. 21
May 24, 2006 9:01 a.m. (Wednesday)	Prusko to Merrill Lynch: "ABX opening weaker, lets do call, BUY!!!"	Div. Ex. 21

May 25, 2006 (Thursday)	Prusko discusses with Chau putting entire Index in Octans I, according to internal Merrill email	Div. Ex. 23
May 25, 2006	Harding decides to relax assumptions for projecting losses on RMBS bonds	Resp. Ex. 767
May 26, 2006 (Friday)	Date of engagement letter and warehouse agreement	Div. Ex. 24, Div. Ex. 5
May 29, 2006 (Monday)	Memorial Day	
May 30, 2006 11:21 a.m. (Tuesday)	Wang to Prusko, cc Chau and Huang: "Now that we have the documents signed up, we just wanted to touch base with you regarding process. . . . Please let me know how you would like this to work."	Div. Ex. 28
May 30, 2006 11:36 a.m.	Wang to Merrill Lynch, cc Chau: "Are we ready to open the warehouse for the Magnetar deal? Sounded like Prusko wanted to see all names first."	Div. Ex. 25
May 30, 2006 call ended at approximately 5:15 p.m.	Prusko and Merrill have call to discuss Index; they conference in Huang to ask whether Maxim wants to exclude any bonds. Afterwards Prusko urges Merrill "Let's stay on top of this," [i.e. getting list of excluded names from Maxim]; Merrill promises Prusko "We'll push to get names they have issue with tomorrow am."	Div. Ex. 31 Div. Ex. 33
May 30, 2006 5:49 p.m.	Huang sends list of Index bonds to Lieu	Div. Ex. 36
May 30, 2006 8:25 p.m.	Prusko to Wang: "We're going to do a big block trade of the index names, so please leave them off of any other lists you do."	Div. Ex. 37
May 31, 2006 8:54 a.m., 8:56 a.m. (Wednesday)	Lieu asks co-workers to convert list of index bonds to Excel format	Div. Exs. 43, 44

May 31, 2006 9:30 a.m.	Prusko to Merrill: "Lets stay on top of ABX thing today, would like to get some off."	Div. Ex. 45
May 31, 2006 9:41 a.m.	Prusko emails Huang, cc Chau: "you have abx names that you want out, ready to trade?"	Div. Ex. 46
May 31, 2006 10:51 a.m.	Prusko to Wang, cc Chau and Huang: "We good on the index names you want to exclude?"	Div. Ex. 50
May 31, 2006 11:24 a.m.	Prusko to Wang, cc Chau and Huang: "For our block index trade, u guys were going to let us know if there were any of the 20 index names you wanted to exclude, we had a call w tony and charles from ml last nite."	Div. Ex. 50
May 31, 2006 11:40 a.m.	Huang promises Prusko, cc Chau and Wang: "Yes we should have these names to you and Charles soon. Wing and I just got back from a meeting away from the office this morning."	Div. Ex. 50
May 31, 2006 12:51 p.m.	Lieu requests cash flows from Kaplan for 24 Index bonds	Div. Ex. 52
May 31, 2006 1:10 p.m., 1:14 p.m.	Prusko to Merrill: "please stay in front of Tony and Charles for me on this. Would really like to get started at least today." Internal Merrill email: "hey can we nudge tony for the names he doesnt want in? . . . [Magnetar] will be totally psyched to get some done today . . . ."	Div. Ex. 55
May 31, 2006 exact time unknown	Merrill to Huang: "Regarding Magnetar, are there names that you don't want in the deal? Magnetar is looking to get some of the CDS done today . . ."	Resp. Ex. 343
May 31, 2006 1:13 p.m.	Kaplan sends cash flows to Lieu reflecting write downs on many Index bonds	Div. Ex .52, 53
May 31, 2006 2:49 p.m.	Lieu to MaximCDO: "we have already looked at 29 bonds" out of the 40 in the Index. "Out of those, 10 have been approved, and 19 have been rejected."	Div. Ex. 65

May 31, 2006 4:23 p.m.	Lieu sends Huang list of 12 exclusions from ABX. Investment decision "finalized."	Div. Ex. 70, 71; Div. Ex. 5001 (white paper) at 39
May 31, 2006 4:38 p.m.	Huang sends Merrill Lynch "the names we don't want," listing the 12 bonds identified by Lieu	Resp. Ex. 343
June 1, 2006 8:34 a.m. (Thursday)	Huang to Chau and Wang: "we are less comfortable with some of these index names at the Baa3 level."	Div. Ex. 81
June 1, 2006 9:35 a.m.	Chau to Prusko: "Hi Jim, back in the saddle, Lets chat this am when u r free . . ."	Div. Ex. 88
June 1, 2006 10:05 a.m.	Huang sends Prusko the list of 12 excluded bonds	Div. Ex. 82
June 1, 2006 3:08 p.m.	Prusko to Snyderman: "I have to initiate each baby step of the process [of acquiring Index]. Hope I don't have to explain trade again."	Div. Ex. 83
June 6-8, 2006	Magnetar, Merrill, and Harding cause the Octans I warehouse to acquire exposure to 28 Index names – a $220 million trade.	Div. Ex. 6A, Resp. Ex. 889
July and August 2006	Octans I is marketed to potential investors as Dorado. Pitchbooks are distributed.	*E.g.*, Resp. Exs. 529, 530, 692; Div. Exs. 139, 141, 142, 145, 146.
Aug. 10, 2006	*Creditflux* article on Harding Advisory appears – refers to Dorado CDO by name and describes lead equity investor as a "Chicago-based bank."	Resp. Ex. 637
Aug. 11, 2006	CDO's name is changed from Dorado to Octans	Compare Resp. Exs. 198-200 to 201-03
Aug. 14, 2006	*Derivatives Week* names Magnetar as equity investor in CDOs named after constellations. "Market participants speculate the fund is shorting other parts of the capital structure against its long equity positions." Mentions a series of Magnetar CDOs by name, but not Octans or Dorado. Identfies Merrill as	Resp. Ex. 880

	underwriter for one such CDO.	
Aug. 15, 2006	Transaction participants asked to certify they were not the source for the *Creditflux* article	Resp. Exs. 463, 650-654
Aug. 18, 2006	Octans I has garnered enough interest for the deal to price; investors commit	*E.g.*, Div. Ex. 147 (bottom email)
Sept. 20, 2006	Date of final offering circular	Div. Ex. 3 at i (bottom of page)
Sept. 26, 2006	Octans I closes	Answer ¶ 3.
Sept. 29, 2006	Prusko complains to Merrill "not sure how much I appreciate the publicity" – referring to a Merrill research article issued the day before that Prusko describes as "kind of like a how-to manual for our competitors!"	Resp. Exs. 500, 501

APPENDIX 2: JUNG LIEU'S CREDIBILITY

Whether credit decisions were supposed to reflect input from more than one analyst	
HEARING TESTIMONY Q. Was it important [for you and Moy] to be checking one another's work? A. Sometimes. . . . Q. Generally, should it be both of you weighing in? A. I don't see the need. Q. Generally, should you be checking one another's work? A. I don't think so. (Tr. 3260:6-8, 3260:21-3261:1)	FEB. 2012 INVESTIGATIVE TESTIMONY . . .We should both be checking each other's work. Q. I see. So is that how it generally should have worked, is that it should be both parties weighing in? A. Yes. (Tr. 3261:20-25)

Whether the May 30, 2006 master bid list was the first of its kind	
HEARING TESTIMONY Q. Was this [Div. Ex. 39] the first attempt that you made to pull all the credit decisions together in one master file? A. No. (Tr. 3347:11-14)	JULY 2012 INVESTIGATIVE TESTIMONY A. And just one more thing to add . . . So we had logged kind of securities we've reviewed and commented on in many different files and this [referring to the same document as Div. Ex. 39] was an attempt to pull everything together into one master file. Q. And it looks – was this the first attempt that you made to pull all of that into one file, the May 31 bid list? A. I think so. (Tr. 3348:13-3349:5)

Whether Lieu recalls discussion with Moy about being overruled on Index bonds	
HEARING TESTIMONY Q. Do you recall any discussions with Jamie Moy about being overruled on index trade credit judgments? A. I don't recall any specific conversations regarding the index trade.	JULY 2012 INVESTIGATIVE TESTIMONY Q. And do you recall having any discussions with Jamie about being overruled on index trade credit judgments? A. I do recall, yeah, I do recall specifically an index trade happening when I was out and I think the credit decision we had originally had

(Tr. 3360:21-24)	being overruled. (Tr. 3362:6-12)

Whether Lieu was concerned about her credit decisions being overruled	
HEARING TESTIMONY Q. Now, were you concerned about being overruled from a credit perspective by Mr. Chau? A. No, because he's ultimately the portfolio manager. He's going to weigh the relative value of the bond and how it fits in the CDO. (Tr. 3274:9-13)	JULY 2012 INVESTIGATIVE TESTIMONY, JAN. 2012 DEPOSITION Q. Were you ever concerned about being overruled from a credit perspective by Wing? A. Yes. (Tr. 3274:25-3275:2) Q. Was this transaction [i.e. buying an RMBS bond that the credit analysts had rejected] done despite the rejection of the credit committee? A. I would hope not. (Tr. 3390:17-21)

Whether Lieu rejected an Index bond traded into Octans III purely because it had interest-only terms	
APRIL 21, DIVISION'S QUESTIONING [Referring to Div. Ex. 167] Q. Do you recall whether or not it was the practice to reject bonds backed by pools containing mostly two and three-year interest only terms? A. No, it wasn't our general practice to reject it straight out. We would actually have to look into the loan and look at mitigating factors. Q. You wrote, "We passed because mostly two and three year interest only terms," correct? A. Yes. Q. And was it your general practice to be accurate or inaccurate in writing e-mails to Alison Wang? A. This is not the only thing that we review on a credit decision. Obviously I was not going to write her a full paragraph of the credit group decision so I summarized.	APRIL 23, RESPONDENTS' QUESTIONING [Referring to Div. Ex. 167] Q. . . . The question is, that bond, is there anything in particular other than your [m]ost[ly] two and three-year IO terms that gave you a sense that that might be a particularly bad bond or dangerous or might exhibit writedowns? A. No. Q. So two or three-year IO terms, you looked at it and you decided, eh, we'll pass, right? A. Yes. (Tr. 3890:1-10)

(Tr. 3386:13-3387:2)	

Whether it was the practice to reject bonds with writedowns	
HEARING TESTIMONY Q. Was it the practice to reject any bond that experienced a writedown? **A. That depends on the price of the bond.** (Tr. 3334:5-7)	FEB. 2012 INVESTIGATIVE TESTIMONY A. . . . So we applied the base and stress assumption to all the bonds. We rejected **everything** that actually experienced a loss. Q. Okay. So **anything** that experienced a principal writedown, you would reject? **A. That's correct.** (Tr. 3335:14-23)

Whether an RMBS's status as an Index bond matters to Lieu	
HEARING TESTIMONY Q. When you think about RMBS, do you care whether they're in the index or not? A. I would think so because being in the index, you would think would improve liquidity. (Tr. 3358:1-4)	JULY 2012 INVESTIGATIVE TESTIMONY Q. Do you recall having any concerns about any of the bonds that were included in the ABX index trade for Octans 1, any credit concerns? A. I don't remember. . . . Sorry, just to clarify. Q. No, sure. A. Because, to me, when I think about securities, they're just securities. I don't think about the fact that they're actually in the index or not. (Tr. 3358:14-3359:1)

Whether Lieu was familiar with a commonly used group email list	
HEARING TESTIMONY Q. Are you familiar with an email address at Maxim called MaximCDO? A. Yes. . . . Q. Have you ever said that you did not know what the Maxim CDO list is? A. No.	JAN. 2012 DEPOSITION TESTIMONY Q. . . . Do you know what MaximCDO refers to? A. No. Q. Was there a distribution list within Harding of people who were working on the MaximCDO? A. I'm not aware of this list.

(Tr. 3241:4-9, 3242:3-5)	(Tr. 3246:9-16)

Whether analyst consensus is valuable apart from the need to make a decision	
HEARING, APRIL 21, 2014 Q. . . . is it important that the analysts on a committee reach a unanimous view? A. Not necessarily. . . . Q. You said that it was important to reach consensus. Can you explain why it is important to reach consensus on a committee? A. I believe it is important to reach consensus on a committee is because you need to make a final decision. (Tr. 3259:5-21)	HEARING, APRIL 22, 2014 Q. Well, other than the fact that there has to be a decision, is it important that both analysts or, if there is three, all of them, or if there is four, all four of them, be on board with that decision? A. It was important to me. Q. That all analysts be on board with it, right? A. Yes. Q. And isn't it your experience in the industry generally that when there are credit committees or credit discussions, whether or not part of an established credit committee, that normally decisions are to be reached by consensus? That's your experience, correct? A. That's correct. (Tr. 3553:11-23)

APPENDIX 3:
HARDING'S REVIEW OF ABX BONDS FOR OCTANS I

	A	B	C	D	E	F	G	H	I	J	K
1	Name of bond (March 24 Stip.)	CUSIP (Stip.)	Class (Stip.)	Rating (Stip.)	Accepted into Octans I per Lieu 4:23 p.m. email (Div. Ex. 70, 71) (Y/N)	Prior decision as per Lieu's 2:49 p.m. email (Div. Ex. 65) & corrected bidlist (Div. Ex. 93 -- compiled in Wagner Appx 6) (Yes/No/O for not reviewed)	Writedown in 1:13 p.m. cash flows (Div. Ex. 53)	Writedown in miscellaneous analyses sent to Lieu May 30-31 (Div. Exs. 268, 270, 272)	Writedowns in May 30 Moy-Huang email attachment "2006-5-22 Results" (Resp. Ex. 774)	Writedowns in May 31 Kaplan-Moy email attachment (Resp. Ex. 325)	Jamie Moy decision for 4 PM OWIC (Div. Ex. 66)
2	ACE 05-HE7	004421UK7	M8	Baa2	Yes	Yes	0%		0%		Y
3	ACE 05-HE7	004421UL5	M9	Baa3	Yes	O				0%	Y
4	AMSI 05-R11	03072SV85	M8	Baa2	Yes	No	42.78%			42.31%	N
5	AMSI 05-R11	03072SV93	M9	Baa3	No	No	62.31%		62%	62.31%	N
6	ARSI 05-W2	040104NL1	M8	Baa2	No	No	51.48%		37%	51.41%	N
7	ARSI 05-W2	040104NM9	M9	Baa3	No	No	53.89%			53.89%	N
8	BSABS 05-HE11	0738793U0	M7	Baa2	Yes	O				0%	Y
9	BSABS 05-HE11	0738793V8	M8	Baa3	Yes	Yes	4.69%		0%		Y
10	CWL 05-BC5	126670NM6	M8	Baa2	Yes	No	16.06%				N
11	CWL 05-BC5	126670NN4	B	Baa3	No	No	50.07%		52%		N
12	FFML 05-FF12	32027NYD7	B2	Baa2	Yes	Yes		0%		0%	Y
13	FFML 05-FF12	32027NYE5	B3	Baa3	Yes	O			7%	6.83%	Y
14	GSAMP 05-HE4	362341KK4	B2	Baa2	No	O		0%		0%	N
15	GSAMP 05-HE4	362341KL2	B3	Baa3	No	O			0%	0%	N
16	HEAT 05-8	437084QG4	M8	Baa2	Yes	O			0%	0%	Y
17	HEAT 05-8	437084QH2	B1	Baa3	Yes	Yes	23.24%				Y
18	JPMAC 05-OPT1	46626LAM2	M8	Baa2	Yes	Yes	15.68%		15%		Y
19	JPMAC 05-OPT1	46626LAN0	M9	Baa3	Yes	No	44.73%			44.72%	N
20	LBMLT 05-WL2	542514NJ9	M8	Baa2	No	No	0%				N
21	LBMLT 05-WL2	542514NK6	M9	Baa3	No	No	41.03%		40%		N
22	MABS 05-NC2	57643LMX1	M8	Baa2	Yes	Yes	13.08%				N
23	MABS 05-NC2	57643LMY9	M9	Baa3	Yes	Yes			60%	59.46%	N
24	MLMI 05-AR1	59020UG58	B2	Baa2	Yes	No	46.87%		47%	46.87%	N
25	MLMI 05-AR1	59020UG66	B3	Baa3	No	No	46.87%			46.87%	N
26	MSAC 05-HE5	61744CUZ7	B2	Baa2	Yes	O				0%	N
27	MSAC 05-HE5	61744CVA1	B3	Baa3	Yes	No	20.03%		16%		N
28	NCHET 05-4	64352VNB3	M8	Baa2	Yes	No	35.38%		35%		N
29	NCHET 05-4	64352VNC1	M9	Baa3	No	No	52.01%				N
30	RAMP 05-EFC4	76112BD31	M8	Baa2	Yes	O				0%	N
31	RAMP 05-EFC4	76112BD49	M9	Baa3	Yes	No	15.63%		11%		N
32	RASC 05-KS11	76110W7L4	M8	Baa2	Yes	O			0%	0%	Y
33	RASC 05-KS11	76110W7M2	M9	Baa3	Yes	Yes					Y
34	SABR 05-HE1	81375WGK6	B2	Baa2	Yes	O			0%	0%	Y
35	SABR 05-HE1	81375WGL4	B3	Baa3	Yes	Yes		0%			Y
36	SAIL 05-HE3	86358EXE1	M8	Baa2	Yes	No	48.83%		50%		N
37	SAIL 05-HE3	86358EXF8	M9	Baa3	Yes	No	48.83%				N
38	SASC 05-WF4	863576DN1	M8	Baa2	No	No	54.63%		55%	54.63%	N
39	SASC 05-WF4	863576DP6	M9	Baa3	No	No	54.63%			54.63%	N
40	SVHE 05-4	83611MKM9	M8	Baa2	Yes	Yes		0%	0%	0%	Y
41	SVHE 05-4	83611MKN7	M9	Baa3	Yes	O				4.83%	Y

APPENDIX 4: BACKFILL DOCUMENTS

	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O
1	**RX**	**Bond**	**Settle Date used to Generate Cash Flows**	**Date noted in doc**	**Date of latest historical performance information in Performance Information file tab**	**Title of doc**	**"Created", per Excel "File" tab**	**"Last printed", per Excel "File" tab**	**"Last modified", per Excel file tab**	**Div. Ex. for metadata**	**Name of underlying Excel file, per metadata**	**"DATECREATED", "MODDATE" (metadata)**	**PRINTDATE (metadata)**	**Comments**	**Notes on default, severity, and prepayment assumptions (if different from 100 * BASE LOSS with 100% severity and 100*JamieCombo)**
2	940	OOMLT 2003-5 M6	5/31/2006	None -- 7/23/2007 given as date of "update" by "JL"	6/2007	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	2/28/2007	7/31/2007	9014	OOMLT 2003-5 M6 Credit Comments.xls	7/31/2007	2/28/2007	Not an Index bond	
3	941	SAIL 2005-HE3 M9	5/31/2006	None	6/2007	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	2/28/2007	8/28/2007	9004	SAIL 2005-HE3 M9 Credit Comments.xls	8/28/2007	2/28/2007	Used at hearing and in Hilfer report	
4	942	CARR 2006-NC2 ("collat tranche")	6/9/2006	N/A	N/A	N/A	6/6/2006	Never	6/6/2006	9015	Cash Flows.xls	6/6/2006		Authentic mortgage cash flows run June 6, 2006	Uses 150 * Ba3 (4%) default vector and 40% severity; "Unsch Bal Rdctn Rate" setting applied to 100 *Jamie228 prepay vector
5	943	RAMP 2005-EFC4 M9	7/7/2006	None	N/A	N/A	7/7/2006	Never	1/2/2008	9016	RAMP 2005-EFC4 M9 CFs.xls	1/2/2008		Goes with Rx 944	prepay vector is 100*Combo50
6	944	RAMP 2005-EFC4 M9	N/A (no CF)	7/7/2006	None	Maxim Advisory, LLC Credit Commitee Bond Evaluation Document	3/31/2006	4/4/2006	7/7/2006	9017	RAMP 2005-EFC4 Credit Document 070706.xls	7/7/2006	4/4/2006	Goes with Rx 943	
7	945	RASC 2005-KS11 M8	11/3/2006	10/10/2006	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	11/28/2006	7/6/2007	9018	RASC 2005-KS11 M8 Credit Committee Document.xls	7/6/2007	11/28/2006		
8	946	SABR 2005-HE1 B2 and B3	11/3/2006	6/8/2006	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	11/28/2006	7/6/2007	9019	SABR 2005-HE1 B2 & B3 Credit Committee Document.xls	7/6/2007	11/28/2006		
9	947	SAIL 2005-HE3 M8	11/20/2006	8/10/2006	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	11/27/2006	8/28/2007	9020	SAIL 2005-HE3 M8 Credit Comments.xls	8/28/2007	11/27/2006		
10	948	SASC 2005-WF4 M8	5/25/2006	N/A	N/A	N/A	8/30/2006	Never	8/30/2006	9021	SASC 2005-WF4 M8 updated CF.xls	8/30/2006			
11	949	SASC 2005-WF4 M8	11/20/2006	9/21/2006	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	11/27/2006	12/12/2006	9022	SASC 2005-WF4 M8 Credit Committee Document.xls	12/12/2006	11/27/2006		
12	950	HEAT 2005-8 B1	N/A (no CF)	7/27/2006	N/A	Maxim Advisory, LLC Credit Committee Bond Evaluation Document	7/6/2006	7/6/2006	9/1/2006	9023	HEAT 2005-8 Credit Committee Document Short 072706.xls	9/1/2006	7/6/2006		
13	951	HEAT 2005-8 M8	11/3/2006	4/20/2005	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	11/24/2006	7/9/2007	9024	HEAT 2005-8 M8 Credit Committee Document.xls	7/9/2007	11/24/2006		
14	952	GSAMP 2005-HE4 B2	11/3/2006	10/10/2006	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	11/13/2006	12/11/2006	9025	GSAMP 2005-HE4 Credit Committee Document.xls	12/11/2006	11/13/2006		
15	953	JPMAC 2005-OPT1 M8	11/3/2006	6/8/2006	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	11/27/2006	7/20/2007	9026	JPMAC 2005-OPT1 M8 Credit Comments.xls	7/20/2007	11/27/2006		

APPENDIX 4: BACKFILL DOCUMENTS

	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O
16	954	MABS 2005-NC2 M8	11/20/2006	8/10/2006	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	11/27/2006	8/28/2007	9027	MABS 2005-NC2 M8 Credit Comments.xls	8/28/2007	11/27/2006		
17	955	MSAC 2005-HE5 B2	11/3/2006	6/8/2006	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	11/28/2006	7/9/2007	9028	MSAC 2005-HE5 B2 Credit Committee Document.xls	7/9/2007	11/28/2006		
18	956	ACE 2005-HE7 M8	7/17/2007	None	6/2007	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	2/28/2007	7/17/2007	9029	ACE 2005-HE7 M8 Credit Comments.xls	7/17/2007	2/28/2007	Initials of analysts include "YC"; Yuna Cho not at Harding in May 2006	
19	957	ACE 2005-HE7 M9	12/31/2006	None	3/2007	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	2/28/2007	8/28/2007	9030	ACE 2005-HE7 M9 Credit Comments.xls	8/28/2007	2/28/2007		
20	958	AMSI 2005-R11 M8	11/3/2006	None	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	12/14/2006	7/6/2007	9031	AMSI 2005-R11 Credit Committee Document.xls	7/6/2007	12/14/2006		
21	959	BSABS 2005-HE11 M8	11/20/2006	6/8/2006	10/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	12/12/2006	12/12/2006	9032	BSABS 2005-HE11 Credit Committee Document.xls	12/12/2006	12/12/2006		
22	960	CWL 2005-BC5 M8	11/3/2006	10/10/2006 (vlookup to backfill spreadshhet)	10/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	12/14/2006	7/9/2007	9033	CWL 2005-BC5 Credit Committee Document.xls	7/9/2007	12/14/2006		
23	961	HEAT 2005-8 B1	7/28/2006	N/A	N/A	N/A	7/28/2006	Never	7/28/2006	9034	B1 CFs.xls	7/28/2006			
24	962	GSAMP 2005-HE4 B2	11/13/2006	10/10/2006 (vlookup to backfill spreadshhet)	11/1/2006	Harding Advisory LLC, Credit Committee Bond Evaluation Document	3/31/2006	12/12/2006	7/9/2007	9035	Credit Comments Template - GSAMP 2005-HE4 B2.xls	7/9/2007	12/12/2006		
25	966	Octans I portfolio -- part I	5/31/2006	N/A	N/A	N/A	7/13/2007	Never	7/20/2007	9005	Octans 1 Cash Flow Detail Part 1 (May 2006 Assumptions).xls	7/20/2007		Portfolio run -- contains bonds purchased long after May-June 2006	
26	967	Octans I portfolio -- part II	5/31/2006	N/A	N/A	N/A	7/13/2007	Never	7/13/2007	9006	Octans 1 Cash Flow Detail Part 2 (May 2006 Assumptions).xls	7/13/2007		Portfolio run -- contains bonds purchased long after May-June 2006	
27	968	Octans II & III portfolio -- part I	8/30/2006	N/A	N/A	N/A	7/16/2007	Never	7/17/2007	9007	Octans 2 & 3 Cash Flow Detail Part 1 (August 2006 Assumptions).xls	7/17/2007		Portfolio run	
28	969	Octans II & III portfolio -- part II	8/30/2006	N/A	N/A	N/A	7/16/2007	Never	7/17/2007	9008	Octans 2 & 3 Cash Flow Detail Part 2 (August 2006 Assumptions).xls	7/17/2007		Portfolio run	
29	971	Lexington III portfolio	10/31/2006, 11/30/2006	N/A	N/A	N/A	Never	Never	Never	9009	Lexington 3 Cash Flow Detail.xls	7/6/2007		Portfolio run	Default vector 117 * BASE LOSS
30	972	JPMAC 2006-WMC2 M8	6/13/2006	N/A	N/A	N/A	Never	Never	Never	9010	JPMAC 2006-WMC2 M11 CF.xls	6/8/2006		Used in Hilfer Report; not Index bond, not purchased for Octans 1	117 * BASE LOSS in one scenario
31	973	MABS 2006-HE2 M11	6/13/2006	N/A	N/A	N/A	Never	Never	Never	9011	MABS 2006-HE3 M11 CF.xls	6/8/2006		Used in Hilfer Report; not Index bond, not purchased for Octans 1; significant write downs in 3 out of 4 scenarios	117 * BASE LOSS in two scenarios
32	974	AMSI 2003-11 M5	6/13/2006	N/A	N/A	N/A	Never	Never	Never	9012	AMSI 2003-11 M5 CF flat LIBOR.xls	6/8/2006		Used in Hilfer Report; not Index bond, not purchased for Octans 1; significant writedowns in 2 out of 4 scenarios	117 * BASE LOSS in two scenarios
33															
34	(Note: to scroll in Rx 972, 973, and 974, it is necessary to click the "split" button in the "View" tab)														

Appendix 5: Prejudgment Interest Computations

	Octans I	Lexington V	Neo	Jupiter VI	888 Tactical	Total
2006 PJI ("Upfront Fee")	$ 391,287.44					$ 391,287.44
2007 PJI ("Upfront Fee")			$ 970,137.55			$ 970,137.55
2008 PJI ("Liquidation" Fee)	$ 137,306.58		$ 14,307.65			$ 151,614.23
Q1 2007 PJI	$ 232,204.77				$ 91,093.44	$ 323,298.21
Q2 2007 PJI	$ 190,004.81				$ 98,024.10	$ 288,028.91
Q3 2007 PJI	$ 175,671.60	$ 82,254.70	$ 136,938.48		$ 80,740.95	$ 475,605.73
Q4 2007 PJI	$ 164,261.64	$ 67,326.16	$ 112,153.36	$ 93,354.94	$ 72,459.22	$ 509,555.32
Q1 2008 PJI	$ 150,943.13	$ 62,154.09	$ 49,960.96	$ 41,301.24	$ 49,959.54	$ 354,318.96
Q2 2008 PJI		$ 47,351.38		$ 34,729.69		$ 82,081.07
Q3 2008 PJI		$ 25,792.80		$ 26,016.57		$ 51,809.37
Q4 2008 PJI		$ 21,958.83		$ 22,176.44		$ 44,135.27
Q1 2009 PJI		$ 16,862.13		$ 19,352.93		$ 36,215.06
Q2 2009 PJI		$ 4,882.68		$ 9,768.12		$ 14,650.80
Q3 2009 PJI		$ 2,294.47		$ 4,549.20		$ 6,843.67
Q4 2009 PJI		$ 1,023.13		$ 3,774.60		$ 4,797.73
Q1 2010 PJI		$ 669.45		$ 3,522.47		$ 4,191.92
Q2 2010 PJI		$ 336.90		$ 3,199.32		$ 3,536.22
Q3 2010 PJI				$ 1,648.75		$ 1,648.75
Total	$ 1,441,679.97	$ 332,906.72	$ 1,283,498.00	$ 263,394.27	$ 392,277.25	$ 3,713,756.21

These calculations are a result of applying the standard prejudgment interest (PJI) calculator available on the Division of Enforcement's intranet to the information in Division Exhibits 240 and 240A. The calculations used the last possible day in the relevant time period. That is, if a payment was made to Harding during the first quarter of 2007, the PJI was calculated on the assumption that it was made on March 31, 2007. In addition to quarterly payments, there were additional payments made to Harding, including certain upfront and liquidation fees. Those too were calculated on the assumption that payment was made on the last possible day within the time frame. That is, for a payment made during 2008, it was assumed it was made on December 31, 2008, and PJI calculated accordingly.