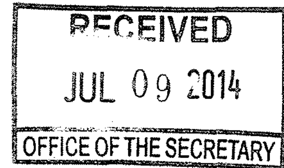
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



In the Matter of

HARDING ADVISORY LLC and

WING F. CHAU,

Respondents.

File No. 3-15574

ALJ Cameron Elliot

RESPONDENTS' POST HEARING MEMORANDUM OF POINTS AND AUTHORITIES [CORRECTED]

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Respondents, Harding Advisory LLC ("Harding") and Wing F. Chau, by and through their counsel, Nixon Peabody LLP, respectfully submit this Post Hearing Memorandum of Points and Authorities. On October 18, 2013, the Securities and Exchange Commission's ("SEC") Division of Enforcement ("Division") filed an Order Instituting Proceedings (the "OIP") against Respondents alleging that they willfully violated Section 17(a) of the Securities Act of 1933 and Sections 206(1) and (2) of the Investment Advisers Act of 1940.

PRELIMINARY STATEMENT

The Division failed to carry its burden of proving the allegations in the OIP.

OCTANS I

The primary allegation in the OIP (and the topic of most of what was covered at the Hearing) is that Respondents, Harding, and its principal, Mr. Wing Chau, committed fraud in connection with the creation and marketing of a single collateralized debt obligation ("CDO") named Octans I CDO ("Octans I") by including in the collateral of that deal certain constituent assets of an index, ABX Index HE-2006-1 ("ABX Index") as an accommodation to Magnetar Capital LLC ("Magnetar"), a hedge fund that invested $94 million in Octans I equity. The OIP alleges that Respondents included the relevant ABX Index assets in the Octans I portfolio despite the fact that two of Harding's analysts, Ms. Jung Lieu and Ms. Jamie Moy, "disfavored" them.

Evidence at the Hearing established conclusively that Harding did not "disfavor" these assets. In fact, Ms. Moy and Ms. Lieu approved the same assets for other Harding deals not involving Magnetar while the Octans I portfolio was being ramped. Further, evidence at the Hearing established that these were not bad assets, however they were selected. There was zero proof that there was anything wrong with a single one of them. A few days before the Hearing, in a *Brady* letter, the Division disclosed to the Respondents one of its expert's findings, admitting that the ABX Index assets were not worse than any other assets Harding picked for any of its

other deals or any other assets available in the market. The expert confirmed in his testimony that he found no adverse selection by Harding. Evidence at the Hearing also established that Harding's inclusion of the ABX Index assets in the Octans I portfolio benefitted the deal by generating supplementary cash flow.

Nonetheless, the Division tried to prove fraud predicated on two notions: (1) that Magnetar had certain rights to reject or veto assets and also influenced portfolio selection, and (2) these rights and this influence had to be disclosed because Magnetar's interests were not aligned with the interest of certain other Octans I investors. The proof at the Hearing established beyond any serious doubt that Magnetar's interests were aligned in all material respects with the interests of all other Octans I investors. To begin, Magnetar had a $94 million long position in Octans I equity. Magnetar's hedges (or short positions on other parts of the Octans I capital structure, the basis for the Division's claim of a misalignment of interests) were $48 million at their high water mark. The Commission itself found in a rulemaking release that, in cases where a deal participant had the same economic interests that Magnetar had in Octans I, its participation in asset selection would not be material to a reasonable investor. The Court must rule for the Respondents for this reason alone.

As to Magnetar's objection and veto rights, there was no evidence at the Hearing that Magnetar exercised either one of these rights, not even a single time. In any event, these rights related to a Warehouse Agreement pursuant to which assets for Octans I were being assembled. Magnetar's rights terminated with the termination of the Warehouse Agreement when Octans I closed. One of the Division's experts also opined that in light of the fact that Magnetar took 85% of the risk of loss during the warehousing period, it was not unusual or alarming for Magnetar to have had such rights. Investors who testified at the Hearing agreed.

There was no fraud for another separate reason. The investors in Octans I received the exact bundle of rights they expected. This bundle of rights was reflected in the Offering Circular for Octans I, dated September 20, 2006 (the "Offering Circular"). There was no evidence—none at all—that any investor was deceived about the assets that went into the Octans I portfolio. There was no evidence—none at all—that any investor was deceived about the notes themselves, their order of payment, or interest. There was no evidence—none at all—that any investor was deceived about the price of the notes. There was no evidence—none at all—that any investor was harmed in any way whatsoever. There was no evidence—none at all—that Harding did not perform its post-closing duties, during the period it managed Octans I. There was also no evidence—none at all—that Octans I's eventual failure had anything to do with the asset selection relating to the ABX Index assets or to Harding's asset selection generally; Octans I's performance was consistent with that of other mezzanine (*i.e.*, backed primarily by BBB and BBB- tranches of residential mortgage backed securities ("RMBS")) CDOs of a similar vintage.

Importantly, the bundle of rights the Octans I investors received did not include the right to have the portfolio assets selected in any particular manner. The Offering Circular specifically disclosed that Octans I investors were not getting any representations about the quality of the portfolio assets and had to rely on their own analysis of all individual assets in the collateral pool. A finding of fraud cannot rest on a failure to disclose the manner of asset selection for a collateral pool when the relevant disclosure explicitly stated that it provided "no information on the credit quality" of the assets in that pool and explicitly told prospective investors to analyze each asset before investing. The Court must rule for the Respondents for this reason alone.

A finding of fraud also cannot rest on any statements in a Pitch Book for Octans I (the "Pitch Book"). The Pitch Book was replete with disclaimers, cautioning that it was not an

offering document, that it should not be relied on, that it was subject to change, and that the actual offering would be made by means of the Offering Circular. If that were not sufficient, the Pitch Book, like the Offering Circular, also explicitly told prospective investors that they were not getting any representations about the quality of the pool collateral and also told potential investors to conduct their own investigation of each of the assets in the pool.

Consistent with the above, all investors, including the Division's sole "victim" witness, did extensive analysis of the portfolio and made their investment decisions on the basis of their analyses. All investors were highly sophisticated—most of them were other collateral managers —and capable of doing their own analysis. All investors represented and warranted to Harding that they were sophisticated, capable of doing their own analysis, and had received all information necessary to make their own independent decision to purchase Octans I notes.

Also consistent with the above, none of the investors who testified at the Hearing said that they used the Pitch Book to inform their assessment of the collateral manager and its asset selection processes and competence. The Division's only "victim" witness agreed that it would have been "absurd" to do so and he never did. Instead, all investors testified that they did their own extensive due diligence on the collateral manager and its asset selection processes and capabilities. The Division's expert agreed that he did not rely on pitch books during his time in the industry and always conducted detailed due diligence of every collateral manager. In other words, none of the investors received actionable information from the Pitch Book. All of the investors set aside the Pitch Book and acted on the basis of the due diligence they performed.

In any event, neither the Offering Circular nor the Pitch Book was Harding's statement. They were the statements of the special purpose vehicle created by Merrill Lynch, Pierce, Fenner & Smith ("Merrill Lynch") to effectuate the Octans I transaction (the "Issuer") and of Merrill

Lynch, respectively. The Issuer and Merrill Lynch knew as much as Respondents did about Magnetar's role in Octans I. The same legal counsel represented the Issuer and Merrill Lynch in the transaction. Merrill Lynch, the Issuer, and their counsel knew that, as the owner of the preferred shares, Magnetar was the co-owner of the Issuer. The Issuer's counsel reviewed the Warehouse Agreement containing Magnetar's rejection and veto rights. Respondents in good faith relied on all the parties who were actually making the relevant representations to make sure that the relevant disclosures did not materially omit or misstate anything. The Issuer represented to Harding that the Offering Circular was true and complete in all material respects. Respondents cannot be held liable for any failure to disclose Magnetar's role in Octans I or its rights in the warehouse for this reason alone.

The Division also failed to prove that there was a departure from the relevant standard of care. To begin, the standard of care applied only prospectively after the deal closed and related to Harding's management of the deal post-closing. The reason is simple and also self-evident: one is not bound by the terms of an agreement until one enters into that agreement. On September 26, 2006, Harding entered into a collateral management agreement (the "CMA") with the Issuer. That was the date Octans I closed and Harding's obligations to act for the Issuer began. There was no proof at the Hearing that there was anything wrong with how the Respondents managed Octans I post-closing.

Even if one were to take the position, as the Division does, that the Issuer's purchase of the collateral at closing, on September 26, 2006, was covered by the CMA, that "selection" was made long **after** May 31, 2006 (the day on which the ABX Index assets were selected). Immediately before closing, Harding re-analyzed the portfolio assets and confirmed that they met all relevant criteria. There was no proof at the Hearing and no allegation in the OIP that

there was anything deficient or improper with the certification process or the certification itself. Were there any problems with the asset selection during the warehousing stage, the pre-closing certification fixed all that by giving the Respondents an independent basis (after any alleged prior mistakes) for including the relevant assets in the deal and making all relevant representations. The Court must rule for the Respondents for this reason alone. -

In addition, to accept the Division's reading of the CMA—which is based on the CMA provision stating that "the collateral manager will undertake to select all collateral to be purchased by the Issuer on the Closing Date"—one must also give effect to how the CMA defines "selection." The "selection" provision expressly directed Harding to select collateral to be acquired by the Issuer in accordance with the eligibility and investment criteria set forth in the transaction documents, and nothing more. In other words, Harding met all its obligations, including comportment with the standard of care when and as required. The Court cannot find liability for any alleged misstatements about compliance with the standard of care for this reason alone.

Finally, this is not a case about negligent selection of assets, which is where the Division is heading. In the face of the various proof failures mentioned above and detailed in the remainder of this brief, shortly before the Hearing was to begin, the Division tried to make this into a case about negligent failure to do proper vetting of ABX Index assets by Harding on May 31, 2006. This theory is largely predicated on two things: (1) a set of junior-analyst-run spreadsheets that everyone, including one of the Division's two experts, Ira Wagner, agrees made no sense on their face; and (2) Mr. Wagner's speculative, unsupportable assertion that—contrary to Ms. Lieu's testimony that she would not have relied on a facially defective analysis

and would not have approved any assets without getting comfortable with them—Ms. Lieu did not have adequate time to reanalyze the relevant assets.

As discussed in exceptional detail below, Harding did have an effective asset selection process that met the relevant industry standards. The fact that Harding kept getting hired by the world's most sophisticated investment banks to manage their deals is proof enough. Be that as it may, there is a big divide between negligent selection of assets **on a given day** and making material misrepresentations about asset selection **processes** in disclosure documents.

The OIP alleges fraudulent misrepresentations and omissions in disclosure and deal documents and it alleges knowing or reckless conduct. The Division failed to prove the allegations in the OIP.

NORMA PURCHASES

The second set of allegations relates to the inclusion of bonds issued by a CDO called Norma CDO I, Ltd. ("Norma") in two other deals managed by the Respondents, Neo CDO 2007-1, Ltd. ("Neo") and Lexington Capital Funding V Ltd. CDO ("Lexington V"). Undisputed evidence at the Hearing established that the relevant Norma bonds constituted approximately 1.6% percent of each of these deals. There was no evidence that the placement of the Norma bonds in these deals by Harding adversely affected either one of these deals in any way. In fact, according to the Division's other testifying expert, Norma's performance was in line with that of other CDOs of the same type and vintage. The credit characteristics of the Norma bonds were consistent with other similar bonds purchased by Harding at the time.

The theory of materiality here too was that these purchases were made to accommodate Magnetar and Merrill Lynch. Again, the Division failed to prove its case. The evidence is clear and uncontroverted that Respondents did not accommodate anyone. Not a single witness to the

relevant events testified that there was any accommodation or that they thought at the time that Norma bonds were bad investments at the price and spread at which they were purchased. The Division cannot meet its burden of proof by relying on rank hearsay consisting of one-line e-mails between people who did not testify at the Hearing. The Division cannot meet its burden of proof by relying on seven-year-old flippant e-mails that no witness remembers.

In any event, the timeline of the negotiation between Harding and Merrill Lynch leaves no doubt that Respondents did not agree to buy the relevant Norma bonds until they were able to secure a price at which the investment made sense. Were they in the business of accommodating Merrill Lynch and Magnetar, Respondents would have agreed to whatever terms were being offered right away. It is uncontested that an early bid from Harding would have been very beneficial to both Magnetar and Merrill Lynch. Instead, Respondents delayed their purchases and negotiated better terms, which benefited investors in both Neo and Lexington V at the expense of Magnetar and Merrill Lynch. The Division failed to prove the Norma allegations.

Critically, the Division also failed to prove that any of the Issuers were deceived or defrauded. As a start, as was the case with Octans I, there was no proof at the Hearing that the Respondents did not fully and appropriately discharge their post-closing obligations to each of the relevant Issuers. The Issuers were not defrauded, in other words, for the same reasons the investors were not: there was nothing wrong with the collateral, the bonds, the price of the bonds, or the manner in which Harding managed them post-closing. All Issuers entered into virtually identical collateral management agreements with Harding. All of those agreements limited Harding's asset selection obligations to choosing assets that met the relevant eligibility criteria and nothing else. There is no evidence whatsoever that any of the Issuers even knew about any of the statements about asset selection in any Pitch Book.

But more fundamentally, the Issuers were created to receive whatever assets Merrill Lynch decided to capitalize them with; they had no choice and no independent interests in what assets they would receive, let alone the manner in which those assets would have been selected. They were hired to say yes. They also were not hurt in any way as a result of asset selection, good or bad. Asset selection process was wholly immaterial to them. The Court cannot find liability for any alleged misstatements to the Issuers for this reason alone.

BACKGROUND

I. BACKGROUND ON COLLATERALIZED DEBT OBLIGATIONS (CDOS).

Generally, what is colloquially referred to as a "CDO" is a type of structured asset-backed vehicle created for the purpose of issuing securities backed by a pool of bonds, loans, and other assets. (Lasch 113:16-24.) Very broadly, a CDO security is a bond or note (debt) that entitles its owner to cash payments (obligations) derived from cash generated by a portfolio of other securities (collateral) that are pooled together. (*See* Resp. Ex. 2 at 2, 12, 27-28 (OC).) The structure of the CDO—its cash payment obligations (sometimes referred to as coupon payments), its credit ratings, and its risk profile (*i.e.*, the risk that it will not be able to meet its coupon payment obligations)—is entirely controlled by its structurer, in this case, Merrill Lynch, and is based solely on market demand. (Huang 727:11-18; Wagner 4615:21-4616:18.) The key terms, of course, are the amount of cash payments, the credit profile of the deal, and the price of the notes. (Resp. Ex. 2 at 1-17 (OC).) The notes are usually sold in tranches, with the more senior tranches having priority of cash payments over the more junior ones. (*Id.* at 1.) Typically, a CDO would issue notes that entitled the note purchasers (or investors in the notes) to receive payments based on the cash flows generated by the collateral assets pooled in the CDO. (*See* Resp. Ex. 2 at 27-28, 76-104 (OC).)

The CDO itself would normally be a newly created Special Purpose Vehicle ("SPV"),

whose sole purpose would be the issuance of the relevant securities. The CDO would typically be created by the originator of the transaction, usually an investment bank. The investment bank often worked with a law firm to create the SPV (typically a trust incorporated in the Cayman Islands). The investment bank that either already owned the assets or acquired them for this specific transaction would then transfer the assets to the SPV. (Resp. Ex. 2 at 68, 131-133 (OC).)

To establish a priority of payments, the CDO usually would issue notes in tranches; the more senior tranches would be paid before the more junior ones. (Div. Ex. 8001 at ¶ 20.) As a result, notes representing the more junior tranches would carry more risk that the CDO would not make payments according to the terms of those notes. (*Id.*; Prusko 2778:25-2780:8.) This is referred to as the "Cash Flow Waterfall." Any losses would be allocated in a reverse order of priority, with the most junior tranches bearing the first risk of loss. (Prusko 2778:25-2780:8.) Senior tranches were typically rated AAA or AA by the rating agencies. The mezzanine tranches were typically rated A and BBB because they carried more risk. The equity or first loss position carried the highest risk and earned the biggest reward in the form of a residual profit after all other tranches had been paid their stated coupon.[1] (Prusko 2778:25-2780:8; 2781:18-2785:15.) In 2006 and 2007, equity tranches often had a rated and non-rated piece. (Prusko 2352:22-2353:16.) As Ira Wagner set forth in his report:

> This technique, known as "tranching," allocates payments of interests and principal to senior Notes before Paying subordinate Notes. The senior Notes will therefore have the highest ratings and the lowest interest costs. There may be multiple classes of subordinate Notes, with each with a different priority of payment, lower ratings and increasing interest rates as their ranking becomes junior. Finally, the Equity will receive payments if all other obligations on the Notes have been paid. Conversely, if the CDO Issuer suffers losses on its investments, such losses will be borne first by the Equity and then by subordinate Notes, in reverse order of priority. The expectation of the investors in CDOs is that the yield on the CDO Issuer's assets will exceed the average cost on its Notes, thus

[1] (*See* Resp. Ex. 2 at 1 (OC) for securities that were offered in Octans I; Resp. Ex. 2 at 5-7 for the spread or coupon of the securities.)

generating a profit for the CDO Issuer, which would be paid to the holders of the CDO Issuer's Equity.

(Div. Ex. 8001 at ¶ 20; *see also* Chau 4163:19-4165:2.)

In addition to splicing the liability structure into tranches, the CDO would invest in a diverse set of assets. (Wagner 4898:18-4899:15.) By subordinating the liability structure and by including a diverse set of assets, the rating agencies could give AAA ratings to the top tranche of the CDO and so forth, even though the CDO was backed by mezzanine, *i.e.*, BBB and BBB- tranches of Residential Mortgage Backed Securities ("RMBS") backed by subprime mortgages. (*Id.* ("The driver is the perception that if you do that, if you diversify these assets and then credit tranche the interest in them, that some amount of that—some amount of those liabilities are very high quality. They are AAA.").)

CDOs could also have been static or managed. With the former, the collateral was known and fixed for the life of the CDO. With a managed CDO, a portfolio or collateral manager was appointed by the CDO Issuer or SPV at the closing of the transaction to manage the underlying collateral of the CDO pursuant to a Collateral Management Agreement. In the latter scenario, "there would be a period of time where you could buy and sell assets in and out of the pool, and you could reinvest principal that amortized into the deal." (Edman 2560:17-25.)[2] Octans I, of course, was a managed deal.

A. Mezzanine CDOs Are Debt Securities Whose Interest Payments Are Derived From BBB/BBB- Tranches Of RMBS & CDOs And Credit Default Swaps That Reference BBB/BBB- Tranches Of RMBS

In Octans I, the collateral consisted of asset-backed securities, such as Residential

[2] (*See* Resp. Ex. 2 at 8 (OC) ("Until the end of the Reinvestment Period, the Collateral Manager may reinvest Principal Proceeds in additional Cash Collateral Debt Securities and Defeased Synthetic Securities and may apply CDS Principal Proceeds to Acquire Credit Default Swaps. See 'Description of Notes-Reinvestment Period,' 'Security for the Notes-Eligibility Criteria' and 'Dispositions of Collateral Debt Securities.'"); *see also* Resp. Ex. 2 at 13, 42 (OC).)

Mortgage Backed Securities ("RMBS"), Credit Default Swaps ("CDS") referencing RMBS, and tranches of other CDOs. (Resp. Ex. 2 at 26-37 (OC).)

1. RMBS ("Collateral Obligations").

In an RMBS, the collateral consisted of subprime mortgages or loans that were bundled together,[3] such that the periodic payments by the borrowers on those mortgages or loans constituted the source of cash payments made by the RMBS trustee to its note holders. (Div. Ex. 8001 at ¶ 11; Resp. Ex. 2 at 30-32 (OC).) In a typical RMBS, all cash generated from the subprime mortgages and loans would be combined and paid out to the investors according to a priority set forth in the offering documents. (*See* Div. Ex. 8001 at ¶ 12.) Like with CDOs, the RMBS issued notes in tranches; again, the more senior tranches would be paid before the more junior ones. Correspondingly, the RMBS allocated any losses due to foreclosure or defaults on the underlying loans to the most junior tranche first after any available credit enhancement. (*Id.*) Losses were then "allocated among the tranches in reverse order of priority." (*Id.*)

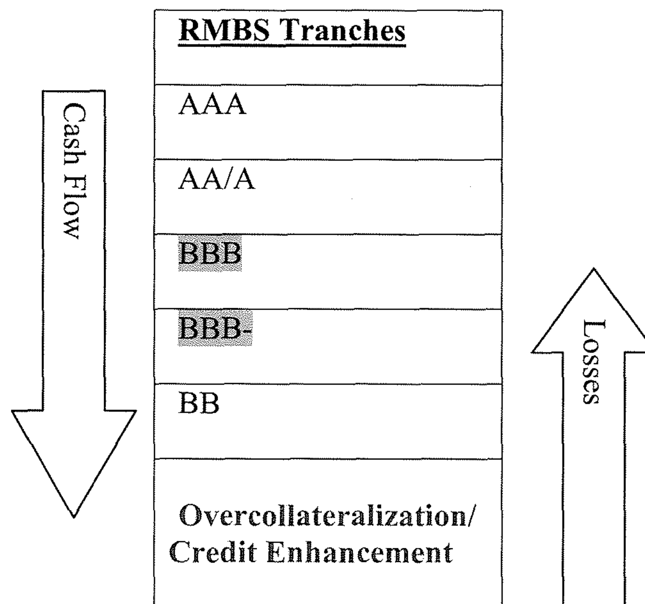
Below the most junior tranche was what was sometimes referred to as the "overcollateralization," which basically means that the principal amount of the issued debt for the RMBS may be $100 million while the principal value of the mortgages underlying the RMBS may be equal to $120 million. (*See* Chau 4070:3-13; Div. Ex. 8001 at ¶ 12.) Overcollateralization resulted in credit enhancement for the RMBS, because the RMBS, in this example, had to experience $20 million in losses before the investors in the most junior tranche started to lose money. (*See* Chau 4070:3-13; Edman 2523:9-2524:5.) However, this amount of cushion or credit enhancement grew over the life of the RMBS deal. The excess cash or loan payments made during the life of the deal increased the credit enhancement cushion. (Chau

[3] Securities firms purchased the underlying loans and pooled them. "For investors in this pool of loan, they would earn their pro rata share of income and their pro rata share of losses." (*See* Chau 4068:9-4069:9.)

4073:4-18.) How it worked mechanically was that any residual income—or income left after all of the note holders had been paid according to their priority of payments—was used to pay down more of the AAA or senior notes, which in turn reduced the debt of the CDO and created additional credit enhancement. (Chau 4070:18-4071:4; 4073:4-18.)

Furthermore, because the underlying assets are pools of subprime mortgages, everyone expected a certain number of defaults or losses to accrue over some period of time. (Chau 4074:9-4075:12.) The credit enhancement or overcollateralization was designed to absorb those losses over time. (Chau 4076:10-25.)

A rough diagram of an RMBS tranches follows:



2. Credit Default Swaps Referencing RMBS ("Reference Obligations").

In a synthetic mezzanine CDO like Octans I, the collateral consisted primarily of contracts each of which mimicked the performance of a specific existing asset-based reference RMBS. (Lasch 114:4-21.) The contracts themselves took the form of CDS, whereby the "seller

of protection" (the Octans I CDO itself, after it was capitalized) was entitled to receive periodic payments of premiums from a counterparty in exchange for agreeing to bear the risk of loss, should the underlying reference obligation experience a default or some other agreed-upon credit event. (Lasch 114:25-116:7; Wagner 4614:15-4615:20.) In other words, the CDS counterparty paid premiums to purchase an insurance policy that would pay if the credit quality of the reference CDO deteriorated. (*Id.*)

Put more simply, the counterparties agree to pay the CDO if A, B, and C happened, but if X, Y, and Z happened, the CDO had to make payments to the counterparties. The idea of a synthetic RMBS then is to bet that A, B, and C were more likely than X, Y, and Z. In the specific case of Octans I, the counterparties were undertaking to make payments to the Octans I CDO that generally mirrored the payments that Octans I CDO would have received had it bought tranches of specifically identified RMBS. Because the CDO generally received premium payments from the counterparties while the reference asset was performing but suffered a principal loss if the reference asset defaulted, the CDO was considered to have a **long position**. (Wagner 4611:8-4613:17; Lasch 114:25-116:7.) By contrast, because the counterparty received payments when the reference asset experienced a credit event, and thus declined in value, the counterparty was considered to have a **short position**. (*Id.*)

Significantly, in Octans I there had to be (and there was) a **short counterparty for every single synthetic asset in the deal**, which constituted 90% of the assets. (*See* Resp. Ex. 2 at 47 (OC).) In addition, with a mezzanine CDO such as Octans I, the synthetic asset had to reference primarily BBB/BBB- tranches of RMBS securities. (Resp. Ex. 2 (OC).)

3. CDO Bucket.

A CDO bucket, which Octans I had, is a small percentage of the portfolio of the CDO

that is backed by tranches of BBB/BBB- CDOs. (*See* Resp. Ex. 2 at 35-36 (OC).) Those CDOs, in which Octans I invested, in turn were exposed to underlying RMBS securitizations. (Chau 4145:4-4146:13; *see also* Resp. Ex. 2 at 36 (OC).) Octans I, therefore, had an indirect exposure to the underlying RMBS that collateralized the CDOs in the bucket, and a further indirect exposure to the subprime mortgages or loans that collateralized the RMBS. (Chau 4145:4-4146:13; *see also* Resp. Ex. 2 at 36 (OC).)

In sum, the collateral for a mezzanine CDO, such as Octans I, consisted primarily of BBB/BBB- tranches of RMBS backed by subprime real estate, CDS that referenced BBB and BBB- tranches of RMBS, or BBB/BBB- tranches of CDOs backed by RMBS. (*Id.*)

B. The Collateral Manager Selects The Referenced Obligations Based On A Pre-Determined Set Of Criteria And Then Sources The Assets Through BWICs, OWICs, Or Direct Negotiation With A Counterparty.

When putting together a CDO, the investment bank or structurer sets forth the credit profile of the deal based on actual and expected market demand. (Wagner 4615:21-4616:18.) For example, the structurer sets forth certain criteria, such as the Weighted Average Rating Factor ("WARF"), or a numerical score representing the credit risk of the portfolio (*see* Wagner 4616:19-4617:11); the Weighted Average Spread ("WAS"), or the average of the premiums to be paid by the counterparties on the CDS that will buy in the collateral pool (*see* Wagner 4617:12-4617:23), and a host of other concentrations and limits. (Wagner 4617:24-4619:4; *see also* Huang 904:24-905:13.)

The investment bank did not set these criteria in isolation, but rather did so through an iterative process wherein the originator used the rating agency models to analyze the collateral assumptions, developed a "rough cut" of the collateral assumptions and criteria, and then ran those numbers by "traders and salespeople and others" to see what market demand there was for

the proposed CDO notes and where those notes likely could be placed. (Wagner 4619:5-4620:13.) Put differently, the investment bank spoke with prospective investors to determine the structure and the collateral profile of the proposed CDO.

The investment bank also had a host of individuals working on the transaction before close, such as: (1) a structuring team, which would model the assumptions and set the initial and then final terms of the deal; (2) an investment banking team, which would manage or captain the deal by working with the rating agencies, the collateral manager, and transaction counsel and which also commented on and supervised the creation of deal documents; (3) a trading desk, which would actually source or obtain the assets for the deal; and (4) a syndicate desk, which would market the deal and talk to investors. (Wagner 4659:17-4660:23; Huang 727:11-18.)

The investment bank may have also engaged a collateral management firm, such as Harding Advisory, UOB Asset Management, or Maxim, to assist in selecting assets that met those pre-determined collateral assumptions. During this time, the investment bank agreed to purchase the collateral and place the collateral in a segregated account on its books, referred to as the "Warehouse." (*See* Lasch 116:4-7.) The investment bank, and here the equity purchaser (Magnetar), then shared the risk of loss on this collateral prior to closing of the deal when the collateral was transferred to the SPV created for the purpose of issuing the CDO. As such, the investment bank or anyone who took risk in the warehouse typically retained certain rights over what assets were being added to the CDO because of the significant financial risk that this party would face in the event the market changed and the deal did not close. (Wagner 4634:3-8; 4640:17-4641:11; Huang 727:19-728:19.) These rights were set forth in a Warehouse Agreement.

During the portfolio selection process, a collateral manager typically chose collateral

assets and reference obligations based on a defined set of Eligibility Criteria or Investment Guidelines, which were typically set forth in a Warehouse Agreement and were later described in the Offering Documents. (*See* Wagner 4637:15-4638:24.) Put differently, the collateral manager "selected" those assets and referenced securities **available in the market** based on a pre-determined set of criteria.

As most relevant to this case, there were three ways that the collateral manager could have identified synthetic collateral during the warehousing phase. First, the collateral manager could have conducted a "BWIC" (Bids Wanted in Competition), which was a competitive bidding process in which the manager distributed a list of reference obligations on which it wished to sell protection. (Lasch at 206:12-25.) Interested parties provided their bids (*i.e.*, the widest spread they were willing to offer for protection), and the manager would then typically have the investment bank execute the trade with the highest bidder. (*See* Huang 737:9-19.) Second, the collateral manager could respond to an "OWIC" (Offers Wanted in Competition), which is when a dealer distributed a list of reference obligations on which it wished to buy protection and the collateral manager would then provide its bids. Third, the collateral manager could source synthetic collateral by directly negotiating with a counterparty, such as a dealer who the manager knew had an "axe," or mandate to trade, on a specific asset or type of assets. (Lasch 206:12-25.) When dealing directly with a counterparty, the collateral manager generally verified that the price at which the trade was done was fair and reasonable by comparing it with other contemporaneous trades in the market for the same or similar securities. There were economic benefits to sourcing bonds in a private negotiation (Lasch 207:7-15), because a BWIC could drive down the price or increase spread of the reference obligation by alerting the market to the existence of a buyer looking to source a large number or assets.

Notably, it is the trading desk at the investment bank or structurer who actually sourced the assets and entered into the initial contracts with counterparties. (Wagner 4659:17-4660:23; Lasch 207:16-25.)

II. INVESTORS IN CDOS BACKED BY SUBPRIME REAL ESTATE UNDERSTOOD THAT THESE CDOS WERE RELATIVELY RISKY INVESTMENTS AND DEMANDED HIGHER RETURNS TO MATCH THE ADDITIONAL RISK.

Due to the complex nature of these securities, the offering documents of CDOs expressly limited the prospective and actual investors to those sophisticated investors who could understand the various risks associated with investing in CDOs backed by RMBS, CDS, and CDOs. These risks—including as to the "Nature of Collateral"—were typically detailed in the offering circulars. (*See* Resp. Ex. 2 at 18-75 (OC).) In return, the investors demanded higher returns in the form of higher interest (or coupon) payments to match the additional risk. (*See id.* at 27-29, 150.)

At the same time, as in any insurance contract, there was a price quality relationship; it was cheaper to buy insurance on better quality collateral than on collateral whose credit quality was worse. (*See id.*) Because the insurance premiums were lower on less risky collateral and because those premiums funded the coupon payments to the investors (*see* Resp. Ex. 2 (OC) at 27-29, 150), there was always a tension between the desire to maximize the quality of the collateral and the ability to generate the size of the coupon payments demanded by the investors. (*See* Jones 2868:15-21; Wagner 4620:21-4621:2.)

In other words, the object of the Octans I CDO exercise was not to build the safest portfolio for everyday investors. If that were the object, the collateral would have consisted of T-Bills. (*See* Huang 1263:10-1264:9; Chau 4116:18-4117:25.) Instead, the object was to build a portfolio that generated attractive yields for sophisticated institutions, given the risk profile of the

portfolio that those sophisticated institutions understood and were willing to tolerate. (*See* Chau 4163:19-4165:2; Chau 4258:19-23; Jones 2807:4-7; Jones 2818:15-2819:5; Wagner 4615:3-4620:17.) By demanding higher yields, the note purchasers were, in effect, trading away some credit quality. (Chau 4258:2-6 ("as spread increases, there is more risk. As spreads decrease, there is less risk").) As Mr. Chau further testified,

> As I said before, participants in the CDO industry, every investor comes in with their eyes wide open. They understand that buying into a CDO transaction, each if you're buying the AAA senior tranche, is not the same as buying the AAA government rated security. Even though they carry the same ratings, the risk/return are substantially different. And it applies for every tranche in the CDO structure.
>
> So investors that participate in the CDO industry know that they will need to have risk in the portfolio to generate the necessary spread or income to pay all of the various stakeholders in the CDO trust. And each of these stakeholders [has] different interest for that's all going to be reconciled during the CDO construction process.
>
> But a deal driver for the mezzanine CDOs, to create the necessary income to pay the super senior investor its LIBOR plus 50 interest demands, to pay the BBB investor its LIBOR plus 400 interest rate demands, to pay the equity investors 20 percent yield demands, you need to create a portfolio that can generate enough income to pay all those various stakeholders. In the mezzanine CDO industry, that asset class was the subprime residential mortgage-backed securities that were rated BBB/BBB-.

(Chau 4257:2-4257:25.)

By logical extension, in order to achieve the necessary balance of credit and coupon payments, Harding had to go through an iterative process of adding new assets and assessing how each new asset or group of assets changed the characteristics of the portfolio as a whole. (*See* Wagner 4631:6-4634:8; Chau 4347:16-4349:1.) When a portfolio was large, it was easier to source (or "ramp up") at the beginning of the ramp-up period before the portfolio achieved a certain critical mass and started taking shape in terms of overall credit and overall return. (*See* Wagner 4631:6-4634:8.) Once the portfolio started taking shape, every new addition had to be made with an eye on how that addition would facilitate achieving the desired overall portfolio price/quality target and other applicable portfolio constraints. (*See id.*) In other words, by

changing the characteristics of the pool, every new addition also changed the requirements for what type of assets could and should be added next. When discussing how he selected assets or CDOs for inclusion in the **high grade** CDOs he ramped, Douglas Jones explained this very point:

> Well, when we were building each deal, it required—in order to come out with a final yield that we would need to be able to generate all the different returns for all the different tranches that we would be selling, we needed to hit out at a certain amount of spread. And so in order to do that, we built basically a model of all the different types of assets that we would put in our deal—some fixed rate, some CDOs and some RMBS, and how many Aas we would need to be, how many Single A rated assets or Aaa rated, pretty elaborate model. But each time we would buy a security, we would book it in this program and then recalculate what our running spread was for the assets we had acquired, because we ultimately needed to tie out to a number in order to hit all the targets that we had been shooting for.

(Jones 2811:4-22; *see also* 2820:1-10.) Finally, sourcing a large portfolio could take weeks or even months, if investor demand were to change—if, for example, investors were to begin to demand higher coupon payments—any additions thereafter to the portfolio would have to reflect changes in demand.

III. OCTANS I WAS A MEZZANINE CDO BACKED PRIMARILY BY SYNTHETIC SUBPRIME RMBS THAT WAS STRUCTURED AND MARKETED BY MERRILL LYNCH AND MANAGED BY HARDING.[4]

Maxim Advisory LLC ("Maxim")[5] was engaged pursuant to a Warehouse Agreement and an Engagement Letter executed by Maxim, Merrill Lynch and Magnetar on May 26, 2006, to act as collateral manager for a contemplated $1.5 billion CDO in which Merrill Lynch would act as underwriter and Magnetar would purchase the equity. (Resp. Answer, *Harding Advisory LLP*, Admin. Proc. File No. 3-15574 (January 10, 2014) ("Answer") at ¶¶ 3-4; Resp. Exs. 118 (Engagement Letter), 123-124 (Warehouse Agreement with signature pages)[6].) Alison Wang, a vice president at Maxim and, later Harding's Chief Operating Officer and a lawyer by trade

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4 The Division attached a purported timeline, which contained inaccurate information, as Appendix 1 to its brief. (*See* Div. Br. at 30, App'x 1.) As an example, the Division quoted language from one of its exhibits that makes it appear as though Maxim was contacted about the Octans I transaction on May 3. Specifically, the Division's timeline entry for May 3, 2006 reads:

> 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.**"

(*Id.* (emphasis added).) The Division then cites to Division Exhibit 12 and Respondents Exhibit 760 for support. The actual language of Division Exhibit 12 reads:

> "We have agreed to a short list of managers, have engagement letter to **them for first deal (Maxim as manager) and their counsel sending us proposed docs today**."

(Div. Ex. 12 (emphasis added).) The evidence demonstrates that Maxim did not receive any documentation until May 17, 2006 (*see* Resp. Ex. 133), and that the author of the e-mail is referring to **Magnetar** not Maxim when he says "letter to them. . . ." (Resp. Ex. 760.) In addition, the timeline (1) omits many details, including the extensive negotiations between counsel over the deal documents, Merrill Lynch's drafting of the Pitch Book, and additional ramping of portfolio assets; and (2) mischaracterizes evidence (*see, e.g.*, the first May 25, 2006 entry characterizing, with no supporting testimony from the author of the e-mail, that Mr. Prusko wanted to put the entire Index in the deal, when the actual language suggests no such thing).

5 Harding Advisory, Maxim's successor, was formed in July 2006. (*See* Answer ¶ 9.)

6 The Division incorrectly states that Division Exhibit 5 "represents the correct version of the warehouse agreement." (Div. Br. at 23 n.38.) Its exhibit actually omits approximately 10 key pages of definitions. For example, "Termination Date" is a defined term referenced approximately 13 times in the Warehouse Agreement; however, the Division's exhibit omits the definition of Termination Date (which was the closing date). (*Compare* Div. Ex. 5 (definitions section ends at page "Exhibit A-3" and the last defined term is "Code") *with* Resp. Ex. 123 (definitions section ends at page "Exhibit A-13," includes a definition for "Termination Date," and the last defined term is "Zero Coupon Bond").)

(Wang 210:1-20, 215:3-24), received the draft documents from Merrill Lynch on May 17, 2006, and negotiations ensued between Merrill Lynch, Maxim, Magnetar, and their respective counsel through the date of signing on May 26, 2006. (*See* Resp. Exs. 133-146, 149-159.)

Pursuant to the Engagement Letter, Merrill Lynch was solely responsible for establishing the Issuer[7] "for the purpose of acquiring a portfolio consisting predominantly of BBB-rated asset-backed securities (or equivalently-rated asset-backed securities) to be selected and managed by" Maxim. (Resp. Ex. 118 at 1.) In addition, Merrill Lynch was solely responsible for offering the notes and shares issued by the Issuer. (*Id.*) The initial acquisition by Maxim of the CDO portfolio was governed solely by the Warehouse Agreement. (*Id.*) Magnetar agreed, in the Engagement Letter, to purchase the equity of Octans I. (*Id.* at 5.) The Engagement Letter expired on the date Octans I closed. (*See id.* at 3.)

Pursuant to the Warehouse Agreement, Maxim selected each asset, whether a cash bond or a reference obligation (such as a CDS), for inclusion in the warehouse during the "Accumulation Period," which was the period between May 26, 2006 and the closing of Octans I.(*See* Resp. Ex. 123 ¶ 2(A); *Id.* at Exhibit A-1 (defining "Accumulation Period").) In accumulating the collateral, Maxim's choices were limited to assets that fit within the Eligibility Criteria, a comprehensive list spanning 4 annexes and 12 pages. (*Id.* at Annex A-D.) Magnetar agreed to take 85% of the warehouse risk on the portfolio, with Merrill Lynch retaining the remaining 15% of the warehouse risk. (*See id.* at ¶¶ 5(A)(2)(A), 6(B)(1)(A), 6(D)(1)(A).) As the parties taking the financial risk for the warehouse, Merrill Lynch and Magnetar retained certain rights to receive notice of and object to inclusion of the assets selected by Maxim. Specifically,

[7] In addition, Merrill Lynch was empowered to establish a Co-Issuer, organized under Delaware law, that would "be a wholly owned subsidiary of the Issuer." (*See* Resp. Ex. 118 at 1.) Merrill Lynch, in fact, established Octans I CDO Ltd., the Delaware-organized co-issuer. (*See* Resp. Ex. 2 at 131.)

Maxim agreed to provide one business day's notice to Merrill Lynch and Magnetar of the assets that Maxim had selected. (*See id.* at ¶ 2(A).) Magnetar could also veto assets, but only on the grounds that the relevant asset did not meet the eligibility criteria. (*Id.* at ¶ 4(c).) In addition, Maxim was required to obtain Merrill Lynch's consent, which Merrill Lynch could give "in its sole discretion," prior to the inclusion of the proposed asset. (*See id.* at ¶¶ 2(D)(2), 3(A).) Magnetar was able to object to the inclusion of the proposed asset. (*See id.*) The Warehouse Agreement terminated on the date that Octans I closed. (*See id.* ¶ 11, Annex A-12.)

Ramping the portfolio began promptly.[8] On May 31, 2006, Maxim purchased, via a BWIC, 25 assets over 31 trades, representing a total notional value of $275 million. (*See* Div. Ex. 6; *see also* Resp. Exs. 317-321, 327 (E-mails regarding May 31 BWIC).) The next day, via another BWIC, Maxim purchased 20 assets over 28 trades, representing a total notional value of $225 million. (*See* Div. Ex. 6; *see also* Resp. Exs. 347-348, 351, Div. Ex. 118.) Between June 2 and June 7 (prior to the Index trade), Maxim acquired approximately an additional $395 million in total notional value.[9] (*See* Div. Ex. 6; *see also* Div. Ex. 118.) In other words, prior to June 8, 2006, the date that the Warehouse actually purchased the ABX Index assets that are the focus of this case,[10] Maxim had already ramped approximately $1.05 billion total notional value, or 70%,

[8] According to the trade blotter, 22 synthetic RMBS assets, representing a total notional value of $156.5 million or approximately 10% of the portfolio, were traded into the Octans I portfolio, but the trade dates occur prior to the May 26 signing of the Engagement Letter and Warehouse Agreement. (*See* Div. Ex. 6; *see also* Div. Ex. 118 (Octans 1 portfolio showing trades through June 8, 2006).) It appears that Maxim purchased these assets with the intention to place them into one of its CDOs at a later date. At the time, besides Octans I, Maxim was also ramping Lexington III.

[9] It appears that the June 2 and June 6 trades occurred via BWIC. (*See* Resp. Exs. 356 (E-mail from Sharon Eliran to James Prusko noting that Wing Chau was "working on a CDS list."), 357-366.)

[10] The review, approval, and trades regarding the ABX Index assets (which had a total notional value of $220 million) are discussed in Section XII.

of the Octans I portfolio.[11] On June 8, Maxim engaged in two other non-ABX Index trades for a total notional value of $13 million. (*See* Div. Ex. 6.) After June 8, and through July 17, 2006 (prior to the July 18 distribution of the Pitch Book), approximately $98 million total notional was added to the Octans I warehouse. (*See id.*) In other words, prior to Merrill Lynch taking any significant steps to contact investors about Octans I, Maxim had already ramped into the warehouse $1.3825 billion total notional, or 92%, of the Octans I portfolio. (*See id.*) For the remainder of July through the August 18 pricing of Octans I, the Octans I warehouse acquired approximately an additional $44 million total notional, bringing the ramped portfolio up to 95% of the total value. (*See id.*) From mid-August to closing on September 26, 2006, the Octans I warehouse had acquired approximately $47.5 million in total notional, bringing the portfolio up to 98% ramped. (*See id.*) The remaining portfolio was acquired post-closing. (*See id.*)

There is no allegation or suggestion that any of the $1 billion plus assets acquired during the same time period as the ABX Index assets, by the same team at Maxim, were acquired pursuant to anything less than a thorough, rigorous, and collaborative credit review, or traded in order to appease Magnetar or Merrill Lynch.[12]

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[11] On June 2, 2006, Wing Chau was estimating that, with the ABX Index trades, the ramped portfolio would have a notional value of $1.15 billion. (*See* Resp. Ex. 784.)

[12] As discussed in Section IX, while the Division put forth allegations of impropriety regarding the trade involving the ABX Index, the Division also failed to prove that the ABX Index assets were disfavored, acquired without meaningful review, and traded in order to appease Magnetar and Merrill Lynch.

The simple fact is that Octans I did not fail because of Harding's approval of the so-called "disfavored" ABX Index assets. In *SEC v. Tourre*, Mr. Wagner opined that the "relevant performance comparison" to determine whether there was something wrong with a CDO deal was to compare "the exposure of each CDO to downgraded assets as of February 4, 2008." (Resp. Ex. 858 at ¶¶ 41-42.) He then relied on a Wachovia report (Resp. Ex. 856 (CDO Exposure to Assets Downgraded by Moody's and S&P (7/1/07-2/4/08) Wachovia Securities, February 4, 2008 ("the "Wachovia Report"))) to show that ABACUS significantly underperformed other CDOS within nine months of issuance." (*Id.*; *see also* Wagner 4872:3-22.) That report demonstrates that Octans I performed, on average, the same as other CDOs of the same vintage and make-up. (Resp. Ex. 856 (Wachovia Report); Wagner 4886:13-4890:8 (testifying that Octans I was middle of the pack).)

Octans I also outperformed the Division's "lodestar." The Division went to great efforts to compare HIMCO's credit processes with that of Harding. (*See* Posthearing Brief of the Division of Enforcement at 77-80,

(Footnote continued on next page)

THE DIVISION FAILED TO PROVE FRAUD AS TO OCTANS I

IV. MAGNETAR'S INTERESTS WERE ALIGNED WITH THE INTERESTS OF OTHER INVESTORS IN ALL MATERIAL RESPECTS.

A. Each Allegation In The OIP Is Premised Upon Magnetar's Interests Being Adverse Or "Not Aligned" With The Other Note Holders.

Magnetar paid $94 million for Octans I equity.[13] Magnetar expected a 20% return on its equity investment each year for the life of the deal, which was projected in early 2006 to be six years.[14] That is to say that Magnetar hoped to earn approximately another $113 million had the deal performed as anticipated at the time of asset selection. Magnetar's hedge position never exceeded $48 million; indeed, Magnetar's hedge position could have been higher by another $5 million, but Magnetar reduced its hedges by that amount at one point during the relevant period.[15] Magnetar's hedges in Octans I would have needed to be twice the notional size of its long investments in order for Magnetar to have been fully hedged,[16] *i.e.*, Magnetar's own contemporaneous view—and the only logical view—was that it was net long Octans I.[17] Even

Harding Advisory LLC, Admin. Proc. File No. 3-15574 (Jul. 13, 2014) (hereinafter "Div. Br."); Doiron 1864:11-1865:7.) Wadsworth, HIMCO's sole deal, was a high-grade CDO, which meant that, unlike Octans I, it was backed by AAA/AA/A assets. (Doiron 2023:22-23.) However, Wadsworth, which also closed in September 2006, failed in February 2008, two months **before** Octans I. (*See* Doiron 2025:3-18.) Thus, Octans I could not have caused Wadsworth to fail as it outlasted Wadsworth.

[13] (*See* Resp. Ex. 2 at 132 (Final Offering Circular, dated September 20, 2006 (hereinafter "Offering Circular") (Total Equity listed as $94,000,000); Resp. Ex. 750 (Initial Investor List for Octans I) (noted that Magnetar invested $94,000,000 in Preferred Class A and B shares).)

[14] (Prusko 2335:15-2336:3 ("[T]he characteristics of the equity and CDOs we were investing in was that you received considerable cash flow coupon each year, 20 some percent from the long equity, and you could expect that if you didn't call the deal, that the life of the assets would be somewhere out as long as, you know, eight years."); Resp. Ex. 530 (Octans I Preliminary Term Sheet) (Listing the expected Weighted Average life as 6.0 years).)

[15] (*See* Div. Ex. 248A.)

[16] (Prusko 2338:19-2341:5 (testifying: (i) "When I said 2 to 1, I mean that for $1 of cash equity investment, we would have a notional hedge of $2;" and (ii) "from a sensitivity standpoint, you need more notional dollars of the hedge short for every dollar of equity you're long, because your equity is much more sensitive to changes in value in the [RMBS] market than the hedges are, so they'll have the same sensitivity or they'll have the same payout profile in good and bad markets. You need to have those in a ratio similar to if you were trading equity options versus stocks.").)

[17] (Prusko 2484:17-2485:5.)

taking its hedges into account, Magnetar was the second largest long investor in Octans I.[18] Even after Magnetar transferred a portion of its Octans I equity into Tigris, Magnetar's economic exposure to Octans I remained almost the same.[19] In sum, it cannot be seriously disputed that, in all relevant respects, Magnetar's economic interests in Octans I were always the same as those of all other investors: like other investors, Magnetar had a strong economic interest in the deal performing well. With the exception of Morgan Stanley, the super senior investor with almost $1 billion at stake, Magnetar wanted more than other investors for the deal to succeed.

Because it was making a $94 million equity investment and was also taking 85% of the risk of loss in the warehouse during the ramp-up period, Magnetar had certain limited rights in the Warehouse Agreement that allowed it to veto, under certain circumstances, or object to assets going into the Octans I portfolio.[20] Magnetar never exercised these rights, not even one time. Not a single asset had been vetoed or objected to by Magnetar. Aside from three cash assets that Harding chose from a list of 24 cash assets Magnetar offered to Harding for inclusion in Octans I (and the Division does not claim any improprieties with regard to these cash assets), only the ABX Index assets were included at Magnetar's suggestion.[21] At the time Magnetar made this suggestion, Magnetar had no ability to discern good RMBS assets from bad.[22] Contemporaneous e-mails confirm that Magnetar's motivation for recommending an ABX Index trade was its contemporaneous belief that there was an arbitrage opportunity to acquire ABX Index assets at

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18 (Resp. Ex. 750 (Initial Investor List for Octans I).)

19 (*See* Section IV.C.4.; *see also* Prusko 2484:21-2485:5.)

20 (*See* Resp. Ex. 123 at ¶¶ 2(A), 2(D)(2), 3(A), 5(A)(2)(A), 6(B)(1)(A), 6(D)(1)(A).)

21 On May 30, 2006, Magnetar offered Harding 24 cash bonds at cost for Octans I. Mr. Chau responded that he would have "credit run it through their underwriting process." After Harding ran it through their credit process, Jamie Moy sent Tony Huang the credit decisions on those 24, ultimately approving 14 of those assets. However, Harding ended up selecting only three of the 14 approved assets for inclusion in Octans I. (*See* Resp. Exs. 309-312, 314-316, 337, 355, 781-782, 787-791.)

22 (Prusko 2330:7-2331:7.)

better spreads than the same assets could have been acquired directly.[23] Contemporaneous e-mails confirm that Magnetar determined immediately after the ABX Index trade was executed that the arbitrage worked and the assets were in fact acquired at better spreads.[24] Contemporaneous e-mails confirm that Magnetar did not benefit from the ABX Index trade in any way other than as a long investor in Octans I.[25] There is no evidence that Magnetar dictated or even suggested which specific ABX Index assets should be included for Octans I.[26] There is no evidence that Magnetar dictated or even suggested how many of the ABX Index assets should have been included in Octans I.[27] Harding alone chose which ABX Index assets were included in Octans I and how many. There is no evidence, direct or circumstantial, that contradicts this simple and fundamental fact.

But there is plenty of evidence that there was nothing wrong with the ABX Index assets in Octans I. The Division tried but failed to find proof that the ABX Index assets were adversely selected, *i.e.*, that at the time of their selection, based on then current information, these assets were worse that other assets picked by Harding for other deals. That effort resulted in a *Brady* letter to the Respondents admitting that the Division's expert, Dr. Richard Ellson, tried but could not show that, at the time they were selected by Harding, the ABX Index assets were worse than other RMBS in Octans I, other RMBS picked by Harding for its other deals, or other RMBS in

23 (*See, e.g.*, Div. Ex. 18; Div. Ex. 21.)

24 (*See, e.g.*, Resp. Ex. 889.)

25 (*See, e.g.*, Resp. Ex. 384.)

26 (*See, e.g.*, Lasch 201:21-202:8; Prusko 2430:18-2431:3.)

27 (*Id.*)

the market at the time.[28] There is no evidence that ABX Index assets had anything to do with Octans I eventual failure.

There is evidence that they performed at least as well as the other Octans I portfolio assets.[29] A spread comparison of ABX Index assets on an apples-to-apples basis (comparing BBB assets in the ABX Index basket with the BBB assets in the remainder of the Octans I portfolio, and similarly BBB- with BBB-) shows that the ABX Index assets were, indeed, acquired at better spreads and produced more cash for the deal.[30]

This background, which, as the Court is aware, we raised in pre-hearing motions, is the primary reason why the Division tried to make this case about **negligent** selection of assets or Harding's overall asset-selection processes instead of what the Commission actually alleged.[31] The specific allegations in the OIP as they relate to Octans I have nothing to do with whether the Respondents chose assets for Octans I in a negligent manner that was a departure from the relevant standard of care. The specific allegations—the only allegations the Commission made in its OIP—are that the Respondents **knew or were reckless in not knowing** that deal document disclosures were misleading **because they did not disclose Magnetar's role in the deal or the Respondents' alleged accommodation of Magnetar's preferences**, despite the Respondents' alleged negative view of the relevant assets.[32] Be that as it may, as discussed more fully below, the Division failed to prove even negligence.

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[28] (Resp. Ex. 884 (March 27, 2014 Brady Letter from Division re: Statements from Richard Ellson, Imran Khan, and Douglas Jones).)

[29] (*See* Exhibit F; *see also* Exhibit A (methodology.)

[30] (*See* Exhibit F; *see also* Exhibit A (methodology.)

[31] (*See, e.g.*, Mem. of Law in Support of Mtn. to Exclude Evid. of Uncharged Acts and to Limit Proof to the Bounds of the OIP at 1-6, In the Matter of Harding Advisory LLC, et. al., File No. 3-15574 (Mar. 21, 2014).)

[32] (OIP ¶¶ 54-59, 70-73.)

B. Octans I-Related OIP Allegations.

We start with the specific allegations in the OIP. Paragraph 2 of the OIP introduces the concepts of Magnetar's undisclosed **rights** and **undue influence** and Harding's' acquiescence:

> Unbeknownst to investors and in conflict with the marketing materials and offering circular for Octans I, a third party named **Magnetar** Capital LLC (together with affiliates, "Magnetar")—a hedge fund firm whose interests were not aligned with those of the debt investors in Octans I—**had undisclosed rights over the selection of collateral** for Octans I. **Magnetar's influence led Harding to select assets for Octans I that Harding's own personnel disfavored**.

(OIP ¶ 2 (emphasis added).)

Paragraph 4 then focuses on failure to disclose Magnetar's **rights** with respect to the Warehouse Agreement:

> The warehouse agreement governing the process of accumulating collateral prior to the closing of the Octans I transaction was actually a three-way agreement among Harding, Merrill, and Magnetar. **The agreement gave Magnetar important rights, chief of which was the right to veto Harding's selection of collateral for the Octans I portfolio**. Consistent with the agreement, Magnetar exercised significant control over the composition of the portfolio, but ***this right, among the others granted to Magnetar*****, was not disclosed to the debt investors in Octans I.**

(OIP ¶ 4 (emphasis added).)

Paragraph 5 focuses on the Pitch Book and the Offering Circular disclosures relating to asset selection and, again, failure to disclose Magnetar's Warehouse Agreement **rights** and **influence** over collateral selection:

> The so-called "Pitch Book" and offering circular used to market Octans I, the relevant portions of which were drafted or reviewed by Harding, described Harding's credit-selection processes and represented that the collateral would be selected by Harding and housed at Merrill in accordance with a warehouse agreement between Merrill and Harding. **These representations were materially misleading because they did not disclose Magnetar's rights in and influence over the collateral selection process.**

(OIP ¶ 5 (emphasis added).)

Paragraph 6 then alleges that the Respondents made representations in the Offering Circular and the CMA about comportment with the standard of care set forth in the CMA but

that, the Respondents **knew or recklessly disregarded** the fact that these representations were materially misleading because the Respondents compromised their standards to accommodate Magnetar-requested trades, to wit:

> The offering circular and a Collateral Management Agreement with the Octans I Issuer executed by Chau also represented that Harding, in selecting collateral for the CDO, would perform its obligations as collateral manager:
>
> with reasonable care (i) using a degree of skill and attention no less than that which [Harding] 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 [Octans I collateral].
>
> This was a material misrepresentation that Harding and Chau, **as they knew or at least recklessly disregarded**, compromised their standards to accommodate trades requested by Magnetar.

(OIP ¶ 6 (emphasis added).)

In other words, the OIP does not allege that Harding did not have standards or that its standards were subpar. It does not allege that Harding negligently, recklessly, or knowingly selected assets thereby departing from the standard of care set forth in the CMA. It alleges, instead—and solely—that the **purported relaxation of Harding's standards to accommodate Magnetar was a material fact because Magnetar's interests were not aligned with those of the other Octans I investors**, and that the Respondents **either knowingly or recklessly** failed to disclose this fact in the Pitch Book and the Offering Circular. Again, here is the summary of the Octans I-related disclosure-failure allegations in the OIP:

> <u>Misrepresentations and Omissions Regarding Collateral Selection for Octans I</u>
>
> 54. Magnetar's rights regarding, and role in, the selection of collateral for Octans I were not disclosed.
>
> 55. **The Pitch Book** used to solicit investors in the transaction, the relevant portions of which were drafted by Harding and had been reviewed by Chau, described Harding's investment approach and credit processes, but **said nothing about Magnetar's control rights and actual influence over the Octans I portfolio**.

56. Similarly, **the offering circular**, which Harding had reviewed, represented that the collateral acquired by the Issuer from the warehouse on closing was "selected by [Harding] and held by [Merrill] pursuant to warehousing agreements between [Merrill] and [Harding]." This disclosure **omitted any mention of Magnetar's involvement in the warehouse phase. Harding and Chau knew or were reckless in not knowing of this representation and the reasons why it was false or misleading.** Harding and Chau failed to ensure the accurate disclosure of Magnetar's warehouse rights.

57. In the Collateral Management Agreement (CMA), which Chau executed at closing on behalf of Harding, Harding represented to the Issuer that Harding in relevant part would "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 [Harding] would exercise with respect to comparable assets that it manages for itself and (ii) without limiting the foregoing, in a manner consistent with customary standards, policies and procedures followed by institutional managers of national standing relating to assets of the nature and character of the Collateral." In the CMA, Harding further represented as relevant here that all collateral acquired on closing—that is, the warehoused collateral—would satisfy the applicable terms and conditions of the CMA.

58. **The offering circular described the CMA, and repeated the standard of care representation quoted above. These representations to the Issuer and investors were materially false or misleading in that Chau and Harding, in order to accommodate Magnetar's preferences, caused Octans I to acquire collateral that Harding's personnel disfavored. Harding and Chau knew the standard of care representation in the CMA and knew or were reckless in not knowing that it was repeated in the offering circular and was false or misleading.**

59. These misrepresentations and omissions were **material. Investors in the securities of Octans I would have considered it important that an undisclosed party with interests not aligned with those of the other investors had influence** over or rights regarding collateral selection.

(OIP ¶¶ 54-59 (emphasis added).)

C. Magnetar's Interests.

Note the explanation of materiality in Paragraph 59 of the OIP; it is predicated on the allegation that Magnetar's interests were not aligned with those of other investors. (*See also* OIP ¶¶ 2, 25.) As discussed more fully at Section IV.C.8 below, the interests of all investors in a CDO were never perfectly aligned because investors in different tranches of a CDO had different appetites for risk and different resulting preferences for the composition of the collateral pool.

(*See* Wagner 4643:21-4644:22; *see also* Suh 3055:23-3056:20; Edman 2529:19-2530; Jones 2811:4-22; Jones 2820:1-10.) All investors were aware of this. All investors were also aware that despite not being perfectly aligned, they all shared an economic interest in seeing the overall CDO perform well enough so that they received their expected coupon payments and the repayment of their principal. (Wagner 4643:21-4644:3.) As also discussed more fully below, it was common and expected that investors could have had opinions on the composition of the collateral and may have insisted on certain assets being included in the collateral pool as a condition of making their investment. (*See* Section VIII.B.2.) The key issue, therefore, is not whether Magnetar's interests were **misaligned** with those of other investors in Octans I; the key issue is **only** whether Magnetar had an interest in the deal performing poorly. Put differently, unless Magnetar's interests somehow gave it an incentive to spike the deal in a way that would endanger the other investors' ability to obtain their expected returns, Magnetar's misalignment of interests was irrelevant.

The Division failed to prove the allegations in the OIP as to Octans I for the simple reason that it failed to prove that Magnetar's participation, in whatever form, was material; the reason the Division failed to prove that Magnetar's interests in Octans I were adverse to the interests of the other Octans I investors, including those who were only long. The Court should rule for the Respondents for this reason alone.

1. Magnetar expected to receive approximately $16 million dollars a year for six years for a total expected return of approximately $96 million on its $94 million investment in Octans I.

Magnetar paid $94 million for the equity of Octans I. Equity investors were at the bottom of the waterfall, the stream of payments generated by the collateral pool; they got paid only after all other bondholders were paid their full coupon. As the SEC argued to the jury in the *SEC v.*

Tourre case, it is self-evident that a $94 million equity investor's interests were materially aligned with those of the other bondholders.[33] But that fact alone does not sufficiently convey Magnetar's long economic interest in Octans I because it does not take into account the returns that Magnetar expected on that investment.

In the spring of 2006, Magnetar expected to earn approximately a 20% return on its long CDO investments over an eight-year period. (*See* Resp. Ex. 493 ("We will have a massively positive carry axe (24% irr) for the next 8 years."); Prusko 2335:15-2338:18.)[34] Magnetar expected the cost of its hedges to reduce that return by approximately 3%, leaving Magnetar with an expected return of 17% a year, each year for that entire period of time. (*Id.*) Specifically, in the case of Octans I, which was expected to have a life of approximately six years, therefore, Magnetar expected to earn just shy of $96 million net of the cost of its hedges. ($94 million x .17 x 6 = $95,880,000.)[35] Magnetar hedged its $94 million long position by shorting certain tranches of Octans I capital structure. These hedges never exceeded $48 million in notional value and were accumulated over time. (*See* Div. Ex. 248A.) In sum, Magnetar had approximately $190,000,000 at risk on its long position in Octans I ($94 million out-of-pocket equity purchase expense plus approximately $96 million representing expected return over the life of the deal net of the cost of its hedges).

[33] (Resp. Ex. 128 at 2564:14-24, 2744:07-2744:13, 2744:24-2745:19 (SEC's Summation and Rebuttal Summation in *SEC v. Tourre*).)

[34] The length of the investment was based on the expected average life of the CDO in which Magnetar bought equity. Because Mr. Prusko stated that they expected "20 some percent" return on its long equity investment rather than the 24% from the contemporaneous e-mail, we are using the more conservative number of 20% in our calculations.

[35] The cost of Magnetar's hedges assumes the 2-to-1 hedge ratio that Magnetar expected to have in place with respect to its long investments. Given that Magnetar's hedging position for its Octans I equity never exceeded $48 million, *i.e.*, .5 to 1 (*see* Div. Ex. 248A), the cost of those hedges would be lower than Magnetar's typical hedging cost and the resulting return would be higher by that amount.

2. Magnetar's hedges never exceeded $48 million.

On the other side of the ledger, as of the end of December 2006, Magnetar's hedges on Octans I were at their high water mark of $48 million. In other words, Magnetar stood to gain $48 million if Octans I defaulted almost entirely. To make the Division's misalignment of interest theory work, one has to believe that Magnetar was willing to lose $94 million and forgo up to another $96 million to earn no more than $48 million.

Moreover, these hedges would not pay all at once: Magnetar could have lost its entire $94 million equity investment and not collected a single dollar on its hedges. Specifically, these hedges were in the form of short positions on different tranches of Octans I: three hedges with a notional value of $25 million on the Class D tranche, one $8 million hedge on the Class E tranche, two hedges with a notional value of $15 million on the Class F tranche that were reduced by $2.5 million for a net short notional position of $12.5 million, and a net $2.5 million notional short position on the Class G tranche. (*See* Div. Ex. 248A.)

Because shorts start paying only after the entire capital structure below the tranche that was shorted had been written down and the tranche that was being shorted had become impaired, Magnetar's shorts on Octans I would pay as follows:

- $2.5 million when Magnetar's entire equity position had been written down and the G tranche had become impaired;[36]
- Another $12.5 million if Magnetar's entire equity position and the entire $39 million G tranche had been written down, and the $31 million F tranche had become impaired;
- Another $8 million if Magnetar's entire equity position, the entire $39 million G tranche, and the entire $31 million F tranche had been written down, and the $60 million E tranche had become impaired; and

[36] For example, if Magnetar had a $5 dollar short position on the G tranche and the G tranche experienced a $1 dollar loss, Magnetar would earn $1 dollar on its short position.

- Another $25 million if Magnetar's entire equity position, the entire $39 million G tranche, the entire $31 million F tranche, and the entire $60 million E tranche had been written down, and the $15 million D tranche had become impaired.

Put differently, these hedges were out of the money and because of tranching and the resulting subordination, they were expected to pay only in extreme negative scenarios and not all at once. (Prusko 2336:16-2338:5.)[37]

There was also no evidence during this Hearing that in early 2006 anyone—not Magnetar, not Merrill Lynch, not Harding, and not the Division's expert, then head of the Bear Stearns CDO business, Ira Wagner, expected the market to crash.[38] Indeed, even in the spring of 2007 when the market deteriorated and the value of Magnetar's equity holdings went down, Magnetar still did not anticipate a market crash and maintained its market neutral position by **reducing** its hedges to reflect the diminution of the value of its equity holdings. (Prusko 2359:4-2360:9.) The economic impact of reducing hedges, of course, is reduction of payouts in case of a further deterioration of the market.

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[37] To the extent that Magnetar's hedges were CDS (*i.e.*, insurance contracts that paid when certain credit events occurred), their mark-to-market value (*i.e.*, the price at which Magnetar could exit those CDS positions) would increase and the value of Magnetar's equity holdings would decrease if the market deteriorated. But as Mr. Prusko explained, Magnetar was long volatility. (Prusko 2354:10-2357:19.) Being long volatility reflects the reality that, over a period of six to eight years, markets are likely to fluctuate in response to varying economic conditions. (*Id.*) Therefore, Magnetar expected that it might be able to realize gains on the value of its hedges in a down market, but it also expected (and hoped) that the value of its equity positions would recover. (*See id.*) (Such market value fluctuations would have no impact on the other note holders because their coupon payments were predetermined.) Again, Magnetar's multi-year investment strategy critically depended on the strength of the portfolio underlying Magnetar's long investments; the portfolios would have had to be strong enough to weather varying economic conditions over the life of the deal and recover every time. (*Id.*) As Mr. Prusko testified: "[Magnetar's] strategy was first and foremost based on the attractiveness of the long investment, and then the hedge was just to create the most optimal payout profile." (Prusko 2358:7-10.)

[38] (*See, e.g.*, Resp. 856 (Bear Stearns closed the following deals in the 2006 to 2007 timeframe: Neptune CDO V, ACA ABS 2006-1, Coda CDO 2007-1, ACA ABS 2006-2, Liberates Preferred Funding II, Tahoma CDO, Ischus Synthetic ABS 2006-1, Ischus Synthetic ABS 2006-2, Term CDO 2007-1, IXIS ABS CDO 3, Tahoma CDO II, Mayflower CDO I, Tallships Funding, Sorin CDO VI, Tahoma CDO III, BFC Genese CDO, HG-Coll 2007-1, Buchanan 2006-12, Brushfield CDO 2007-1, and Parapet 2006.)

3. Magnetar was always long Octans I.

Furthermore, as Mr. Prusko explained, Magnetar generally thought that the right ratio of shorts to longs would have to be 2-to-1 in order for Magnetar to be market neutral. (Prusko 2338:19-2339:18.) The reason, as he explained, was that equity was much more sensitive to small changes in the market than the more senior tranches because the senior tranches would only experience losses when their subordinate tranches were impaired. (Prusko 2340:6-2341:5.) To account for this difference in sensitivity, therefore, Magnetar had to put on hedges on different tranches of the capital structure with the optimal overall ratio being 2-to-1. (Prusko 2336:16-2343:7.) Magnetar's high water mark $48 million hedge on its Octans I equity investment was only .5-to-1 instead of the 2-to-1 needed to be fully hedged. In other words, Magnetar did not consider itself to be fully hedged on its Octans I equity investment; it considered itself to be long. (Prusko 2353:21-2354:9.)[39]

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[39] Apparently attempting to cast doubt on the idea that Magnetar cared that its long equity investment in Octans I performed well, the Division notes that Magnetar would have shorted more if it had been able, citing Mr. Prusko's testimony. (Div. Br. at 20.) In answering the Court's question about why, contrary to Magnetar's general approach to hedging, Magnetar's hedges on Octans I were only .5-to-1 instead of 2-to-1, Mr. Prusko stated that his only recollection was that that was as much as they could source. (Prusko 2485:6-19.) If anything, the fact that Magnetar could not be sure that it could fully hedge its long position in a deal in which it bought equity, gave Magnetar an added incentive to hope that its equity investment would perform well. If Octans I were a bad deal, such that it were at risk of deteriorating in value for idiosyncratic reasons stemming from a bad asset pool, Magnetar would be exposed to that idiosyncratic risk unless it were able to fully hedge out that risk by shorting enough of the Octans I capital structure. The fact that Magnetar could never be sure that it could hedge by shorting the same deal is one reason that Magnetar had to evaluate each long position on its own merits and had to take a holistic view of its overall strategy. (*See* Prusko 2396:7-21; 2389:12-2390:7.) As Mr. Prusko testified, Magnetar was attempting to hedge its entire long position, *i.e.*, it attempted to hedge the sum of its long positions in selecting its hedges. (Prusko 2389:12-2390:7.) Note too that Mr. Prusko's immediate recollection that Magnetar could not source any more shorts may be in error; as discussed above, Magnetar's trade blotter indicates that Magnetar had reduced its Octans I-related shorts at one point during the relevant time. (*See* Div. Ex. 248A.)

Be that as it may, assuming that Magnetar obtained a 2-to-1 ratio with its Octans I hedges and maintained it over the life of the deal, it still would not have earned more from its hedges than it would lose by losing its equity investment and forgoing its expected returns.

4. Tigris financing did not materially change Magnetar's long exposure to Octans I.

Faced with the inescapable fact that Magnetar's long position in Octans I undermines its assertion that Magnetar stood to gain if the deal did not perform, the Division tried to show that Magnetar had sold most of its equity in Octans I, thereby becoming net short. Indeed, despite the Court's clear indication that it found this argument to be specious,[40] the Division persists by claiming again in its Post Hearing Brief that Magnetar was $18 million net short after the $64 million portion of its Octans I equity was moved to Tigris. (Div. Br. at 20.)

It is undisputed that Tigris was a financing transaction between Mizuho and Magnetar that was structured as a CDO. (Div. Br. at 21.) Magnetar contributed approximately $1 billion worth of its CDO equity securities into Tigris. (*Id.*) There were two tranches in Tigris of approximately equal size; Mizuho took the top tranche for approximately $500 million and Magnetar retained the Tigris equity of approximately $500 million. (*Id.*) Because the financing was non-recourse, the Division claims that the $500 million that Magnetar took out of this transaction reduced Magnetar's equity position in Octans I by half, with the corresponding reduction in its long economic risk. (*Id.* at 20-21.)

Assuming *arguendo* that the Division is right that Magnetar's long economic risk had been halved (it was not as we will show immediately below), Magnetar was still net long and well short of its 2-to-1 hedging ratio. If, as the Division claims, Magnetar cashed out half of its $64 million equity in Octans I, it also retained half, *i.e.*, it retained $32 million. (*See id.* at 20.) $32 million retained as part of Tigris plus the $30 million that remained after the $64 million portion was moved to Tigris is equal to $62 million. Given a short position of $48 million,

40 (*See* Tr. 4368:6-4369:4; 4372:11-18; 4378:5-16.)

Magnetar was net long $14 million ($62 million–$48 million), not net short $18 million. The Division knows that. This is the Division's own math.

The Division also explains that, as Mr. Prusko and Mr. Chau testified, because Mizuho was the senior note holder in Tigris, a portion of the income stream from the Octans I equity in Tigris would be diverted to Mizuho. (*Id.* at 21.) Yet, somehow, the Division claims that this fact shows that Magnetar's overall risk and reward were reduced. (*Id.*) The Division has it exactly backwards.

A financing is not a gift. Magnetar effectively took a loan from Mizuho and agreed to repay Mizuho by redirecting the cash flow from its $1 billion in equity holdings (including the $64 million Octans I portion) to Mizuho in the form of coupon payments. (*See* Prusko 2475:25-2480:23.) Had the cash flow from the Octans I equity contributed into Tigris diminished, the obligation to pay Mizuho would have been unaffected, but the residual cash paid to Magnetar as the Tigris equity holder would have been decreased. Put more simply, before the Tigris transaction, if the cash received by Octans I equity were reduced by $1, Magnetar would have lost $1. After the Tigris transaction, Magnetar would have effectively paid Mizuho its full coupon first, in addition to losing $1. (*See* Prusko 2479:1-2480:23.) And because the cost of senior financing was relatively small compared to the yield on the equity investments, Magnetar's exposure to the incremental performance of the Octans I equity was virtually the same. (*Id.*) Furthermore, for the same reasons, if the Octans I equity stopped producing cash completely, but the other assets in Tigris continued to generate cash, Magnetar would have borne the full brunt of that loss. Only if Tigris defaulted entirely before the coupon payments to Mizuho approached $500 million that Magnetar effectively borrowed would Magnetar have come out ahead. But that scenario would involve a market crash and, as noted, neither Magnetar

nor anyone else involved in these transactions predicted a market crash at the time of Tigris or Octans I.

5. The Division's expert agrees that Magnetar's 85% risk exposure to the warehouse also aligned its interests with other investors.

Another independent reason for the alignment of interest between Magnetar and the other investors in Octans I was the fact that Magnetar bore 85% of the warehouse risk. (Resp. Ex. 123 at ¶¶ 5(A)(2)(A), 6(B)(1)(A), 6(D)(1)(A).) As the party bearing 85% of the risk, Magnetar stood to gain 85% of any amount earned by the warehoused assets prior to the closing of the deal and stood to lose up to 85% of any losses suffered by the warehouse. (*Id.*) Indeed, had Harding picked bad assets and investors—all of whom as we show in Section VII.D.3. below had done their own analysis of the assets pool prior to investing—balked, Magnetar would have been stuck with the ownership risk attendant to having 85% of a bad pool of assets. (*Id.*)

There is no doubt that Magnetar understood this to be a very real risk. At the same time as the selection of the ABX Index assets was made, an internal Magnetar e-mail exchange between Mr. Prusko and his boss, Mr. David Snyderman, dated June 4, 2006, expressed concern that the risk of warehousing assets could cause liquidations and attendant losses to Magnetar in case of market deterioration. (*See* Resp. Ex. 493; Prusko 2418:14-2420:11.) As Mr. Prusko explained, Magnetar owned its equity investments in CDOs outright, meaning that in case of a negative market event, Magnetar would get less cash flow, but it could not be forced to sell the equity. (*Id.*) Magnetar's exposure in the warehouse was different because under certain conditions—if, for example, the CDO could not be created or the warehoused securities declined in price—Merrill Lynch would have had the right to liquidate the warehouse, which would then have imposed losses on Magnetar equal to 85% of any losses realized as a result of the liquidation. (*See id.*) To suggest, as the Division repeatedly does, that despite this

contemporaneous documented evidence of concern about losses in the warehouse, Magnetar was unconcerned about the quality of assets being warehoused or had an interest in Harding buying weak assets simply stands logic on its head.

In fact, ownership of equity and risk in the warehouse are precisely the factors that point to the **alignment** of interest between Magnetar as the equity investor and the other note holders. It is very instructive to look at what Mr. Wagner said—in writing—in the rebuttal report he submitted in the *Tourre* case. (Resp. Ex. 858.) As discussed elsewhere in this brief and at length in the Respondents' Reply in Further Support of Their Motion for a More Definite Statement, one of Mr. Tourre's arguments was that the fact that the hedge fund in that case, Paulson & Co., had a role in asset selection that was immaterial and unexceptional. (*Id.*; *see generally* Resp. Ex. 857 (Initial Wagner Report in *SEC v. Tourre*).) To support this position, Mr. Tourre pointed to the deal the ABACUS 2007-AC1 ("ABACUS") collateral manager, ACA Management, LLC ("ACA"), did with Magnetar, ACA Aquarius 2006-1 ("Aquarius"), in which Magnetar had a role in the selection of assets and also hedged its equity position by shorting some of the capital structure. (*See* Resp. Ex. 858 ¶¶ 22-26.)[41] Here is one of the arguments Mr. Wagner offered in response to that assertion by Mr. Tourre:

> Further, a review of the Engagement Letter and Warehouse Agreement for Aquarius shows that Magnetar was obligated to purchase 100% of the equity of the transaction and would bear risk of loss in certain circumstances if the transaction failed to close and the warehouse was [sic] liquidated. In the CDO market, it was reasonable and customary for a party bearing the risk of loss on the warehousing of assets prior to the issuance of the CDO to have some rights with respect to the assets that were being accumulated during the warehouse period. Further, a **party that had such risk would be economically motivated to minimize its risk by using its veto to minimize the accumulation of risky assets in the warehouse**.

[41] ABACUS 2007-AC1was the name of the deal at issue in *Tourre*.

(Resp. Ex. 858 at ¶ 24 (emphasis added).) We agree with Mr. Wagner: Magnetar's interests were aligned with the interests of the other investors in Octans I for two independent reasons: it bought 100% of the Octans I equity and it bore 85% of the warehouse risk.[42]

6. The Commission agrees that Magnetar's interest were aligned and its role in the deal was not material.

The Commission also agrees that Magnetar's interest were aligned with those of the other investors because Magnetar invested in the equity of Octans I and was net long. Specifically, in a rulemaking release, the Commission stated its belief that a party's participation in a transaction like the Octans I would not present a conflict of interest unless that party stood to gain more on its hedges than it did on its investments in the equity.

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[42] It is also important to point out here that in Aquarius, as in Octans I, ACA agreed to do an ABX Index trade at Magnetar's suggestion—the same ABX Index HE-2006-1 at the same time, May 22, 2006—and the Division saw no problem with that. (*See* Resp. Ex. 514; *see also* Resp. Ex. 979.) Indeed, despite the fact that Magnetar suggested the ABX Index trade for Aquarius, Mr. Wagner pointed out in his *Tourre* report that the Aquarius "record shows that no **specific** assets were either suggested or vetoed by Magnetar during the Aquarius asset selection process." (Resp. Ex. 858 at ¶ 25 (emphasis added).) That is true about Octans I as well. There is simply no evidence that, aside from certain cash assets that even the Division does not take issue with, there were any specific assets that were either vetoed or suggested by Magnetar.

The Division tries to sidestep this basic fact by arguing for the first time in its Post Hearing Brief that Magnetar's suggestion of the ABX Index trade for Octans I was the equivalent of giving Harding a pre-selected list. (*See, e.g.*, Div. Br. at 56.) This is just silly. There is no dispute that all investors had views on the portfolio assets and all investors were free to express their preferences, sometimes as a condition of making their investment. (*See* Section VIII.B.2.) Each suggestion or request then could be viewed as a pre-selected list. There is simply no evidence of any agreement that Harding would accept all, most, or any specific number of the ABX Index assets. And the Division cannot point to any. The e-mails in which Mr. Prusko asked whether Harding would want to exclude any assets (Div. Exs. 31, 46, 50) cannot be fairly read to lead to a different conclusion. Other e-mails from the same time period are clear about everyone's understanding that only assets chosen by Harding would be accepted. (*See* Div. Exs. 33, 45, 51; Resp. Ex. 343, 786; *see also* Resp. Ex. 383 (E-mail from Mr. Prusko explaining to another collateral manager that the names the manager liked went into the deal).)

The very fact that there were repeated e-mails expressing that Magnetar was impatiently waiting to get a list from Harding is definitive proof that: (1) it was Harding's decision alone to identify how many assets would go in and which ones, and (2) Magnetar understood that and accepted it. Not a single e-mail suggests that the outcome of the ABX Index asset selection was preordained by virtue of some explicit or implicit understanding. The fact that the trade would work better—*i.e.*, produce more cash flow for the deal if the number of ABX Index assets were higher—does not change the fact that Magnetar was waiting for Harding to identify the assets Harding did not want in the deal. Magnetar's communication with ACA about the ABX Index trade for the Aquarius deal further corroborates this point. There too Magnetar expressed a desire to move quickly and was looking for ACA to decide for itself which assets to exclude. (*See* Resp. Ex. 514.) There too Magnetar expressed its understanding and acceptance of the fact that the collateral manager gets to choose the subset of ABX Index that would go into the portfolio. (*Id.*)

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), the Securities Act of 1933 was amended to include Section 27B, which generally prohibits certain persons involved in the structuring, creation, and distribution of an asset-backed security ("ABS") from engaging in transactions within one year after the date of the closing of the ABS that would involve or result in a material conflict of interest with respect to any investor in such ABS. *See* Prohibition Against Conflicts of Interest in Certain Securitizations at 3, 76 Fed. Reg. 60,320 (proposed Sept. 19, 2011) (to be codified at 17 C.F.R. pt. 230), *available at* http://www.sec.gov/rules/proposed/2011/34-65355.pdf (hereinafter, the "Rule 127B Release"). However, Section 27B also provides exceptions from this prohibition for certain risk-mitigating hedging activities, among other things.

In 2011, the Commission released a proposed rule implementing this new section ("Proposed Rule 127B"). Along with Proposed Rule 127B, the SEC provided certain pre-rulemaking comments. Among these comments, the Commission opined that it had determined preliminarily that a situation in which a third party (such as Magnetar) to an ABS deal (such as Octans I) had selected assets for the ABS transaction, purchased one or more securities in that transaction, and also hedged its securities purchases by entering into a credit default swap on the relevant ABS to offset its exposure to the ABS, would not present a material conflict of interest unless the third party stood to profit more from its short position than it did from its long position. Rule 127B Release at 75-76.

To be clear, the purpose of the Rule 127B Release was to identify material conflicts of interest and the Commission predicated its materiality analysis on the materiality formulation set forth in *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988) and *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), that a conflict is material if there exists a "substantial likelihood"

that a "reasonable" investor would consider the conflict important to his or her investment decision. Rule 127B Release at 37-38. With that in mind, the Commission considered under what circumstances risk-mitigating hedging activities would or would not be material, such that they could be allowed by the Proposed Rule. *Id.* at 53.

Noting that the risk-mitigating activities must be *bona fide*, *i.e.*, that they have to be tied to a specific risk exposure and should adjust over time so that the overall position remains delta neutral, *id.* at 52, 54, 69, the Commission considered a specific example in which an investor who was allowed "to select the composition of the assets that underlie an ABS" also purchased CDS protection on the relevant assets "to reduce or hedge their exposure" to these assets. *Id.* at 73, 75. In this example, the Commission stated that its preliminary view was that this type of risk-mitigating hedging did not present a material conflict of interest, unless the relevant investor would gain more from its short positions on the relevant deal than it would lose from its long position in the deal. *Id.* at 75-76.[43] Significantly, if this situation did not present a material conflict within the framework of *Basic v. Levinson* and *TSC*, not only would the hedging be permitted, but there would be no need to make any disclosures.[44]

As discussed above, Magnetar was never net short in Octans I. Magnetar was also not even fully hedged. It was never in a position to gain more from its shorts on Octans I than it did on its equity investment. Mr. Prusko's testimony is uncontroverted that Magnetar sought to remain market neutral (he also described the investment strategy as being delta neutral (Prusko

[43] The Commission contrasted *bona fide* hedging with a situation in which a hedge fund purchases equity "**in order to** influence the selection of **riskier** assets and implement an arbitrage strategy" designed to capitalize on market failure. *See* Rule 127B Release at 76 (emphasis added). For all of the reasons discussed in this brief, there is no hint in this case that Magnetar had an appetite for riskier assets in connection with Octans I or sought to do anything other than remain market neutral while collecting its 17% coupon for many years.

[44] It should go without saying that if the Commission determined that there would be no conflict, a Respondent in an enforcement proceeding cannot be held liable for holding the same view, even if the Commission's expressed view was qualified as preliminary.

2338:19-2339:4) and that Magnetar pulled back some of its hedges in Octans I in the fall of 2006 and also all of its hedges in 2007 in response to the softening of the market. (*See* Div. Ex. 248A; Prusko 2359:4-2360:9).) There can be no dispute that the record in this case supports but one conclusion: Magnetar's hedging of Octans I was *bona fide* and, therefore, its participation in asset selection, in whatever form, was not material and did not have to be disclosed.

7. The Octans I investors agree with the Commission that Magnetar's role did not need to be disclosed.

The Commission's analysis is consistent with the testimony in this case. The evidence shows that it simply did not matter to the investors whether Magnetar or any other equity purchaser: (1) invested in the equity of Octans I, (2) took on some of the warehouse risk, and (3) had certain rights during the warehouse period as a result. (Edman 2536:5-2539:3; 2544:6-16; *see also* Resp. Ex. 884 at 2 (Mr. Imran Khan (UOB) told the Division that "[i]t is not important to disclose the identity of a party to a warehouse agreement if that party is merely providing warehouse funding, and its only involvement is the right to veto assets.").) The answer again does not change even if that same equity investor was employing a hedging strategy that involved shorting the capital structure of the same deal.[45] (Edman 2536:5-2539:3; 2544:6-16.) What did matter to the investors was the structure of the deal, their rights and liabilities as detailed in the Offering Circular, and their view on the underlying collateral.

As Mr. Edman, whose institution, Morgan Stanley, stood to lose the largest amount of money, testified:

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[45] The OIP alleges that Magnetar's interests were not aligned with the purely long investors. (OIP ¶ 25.) However, the record is silent as to whether any of these investors were purely long. What we do know from the exhibits is that some of the other investors also hedged their long positions by taking some short positions, including for some on Octans I. (*See, e.g.*, Resp. Ex. 724 (Internal Merrill Lynch e-mail indicating that Tricadia wanted to go long BBB/BBB- CDOs and short some of the A tranches) (Dec. 1, 2006); Resp. Ex. 573 (Internal Merrill Lynch e-mail confirming Solent's $50 million long investment in Octans I and $30 million purchase of protection or short position).)

Q. What did you know about [Magnetar's] strategy?

A. Our understanding was that their general strategy was to be long equity and short mezzanine in some form or fashion.

Q. **What relevance, if any, did that have to you in making your decision about whether to invest in deals in which they were the equity**?

A. **Very little**.

Q. Why?

A. Because we had information—we had the information we needed. If we could see what the assets were that were going into the deal, we would do our own underwriting on those assets, and the structure.

Q. Okay. **Would it have mattered to you, if not only was Magnetar the equity, Magnetar also had helped take some of the risk on the warehouse while the deal was being ramped**?

A. **That would not have mattered**.

Q. Why not?

A. Well, I don't think that would have been terribly unusual if they had committed to buy the equity. It might be natural for the equity buyer to assume some of the risk in the warehouse because they were effectively going to take that deal once the deal priced, and that's a risk they wanted to take, and the fact that they were taking some kind of warehouse risk wasn't going to change our view of what the performance of the bonds were going to be.

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Q. And if not only they had some involvement in the warehouse, **if they had, in fact, been communicating with the underwriter and the collateral manager, and had some notice of the bonds that were going into the warehouse that you might not have had at the time, would that have made a difference to you in your investment decision**?

A. **No, I don't think so**.

Q. Why not?

A. Same reason, but also, I don't think we would have—I don't know when we would have committed to the deal. I think that probably would have been—the majority of the assets would have been on the warehouse line.

(Edman 2536:17-2539:3 (emphasis added); *see also* 2541:4-20.)

Another investor witness, Mr. Jones' testimony is identical:

Q. Okay. Well, let's put it this way: **Did the fact that Magnetar might be the equity have any relevance at all in whether you wanted to invest in that deal**?

A. **I don't think so**.

Q. Why not?

A. You know, for one, I didn't really know a ton about them, so–you know, a lot of these funds are more famous now than they were then. Really, the answer is that I took what was given to me and I did my work on it, and I ran through what I was buying, and once I kind of was comfortable with what I was buying, then I would buy it. And I don't really care if it was Sam or Bob or anybody else who was selling it. . . .

***

Q. **Did you or did you not say that you would not have regarded it as a big deal, an equity investor's right to kick out collateral that it did not like**?

A. I don't think that, being higher up the capital stack, **I would take that as a public service to everybody in the dea**l. Typically that's the way it's expressed in CMBS deals where you have a B piece buyer and since he's taken the riskiest piece, he gets a chance to kick out stuff he doesn't want. That to some extent gives people comfort when they buy further up the capital stack, if they know that that B piece buyer is a good B piece buyer.

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Q. **Did you tell the SEC previously that knowing that a hedge fund may be hedging its equity investment probably would have not changed your investment decision**?

A. No, no. That's what a hedge fund does. They buy stuff and then they hedge it.

Q. **Why wouldn't that make any difference to you in your investment decision**?

A. Well, I'm just buying one thing, and I'm not buying the whole package. **I'm buying one thing, and if I like what I'm buying and I think it's the right price, then what do I care what everybody else is doing?** People go long and short stuff all day long in the markets. I buy stock, and people are selling options and doing all kinds of stuff. It doesn't change what I think is right.

(Jones 2832:6-22; 2849:22-2850:15 (emphasis added); *see also* 2852:3-19; 2840:22-2842:7.)

When asked about Morgan Stanley's role in the warehousing of the assets for Wadsworth, a HIMCO managed high-grade CDO, and its corresponding ability to control the

asset selection for Wadsworth, a HIMCO witness, Kenneth Doiron, testified that there was nothing unusual about these facts and that he did not expect the Wadsworth pitch book or offering circular to disclose Morgan Stanley's role. (Doiron 1988:15-1989:9; 1991:13-18; 1993:11-20; 1994:15-18; 1997:2-2002:18; 2009:24-2010:21; 2056:3-24; Resp. Ex. 720 (Oct. 6, 2006 Wadsworth Offering Circular).)

Mr. Doiron agreed that the fact that Morgan Stanley, as the warehouse provided, had to approve each asset that went into Wadsworth and proposed certain assets for inclusion in the CDO, did not change the fundamental truth that HIMCO still selected the assets (and thus, no disclosure of Morgan Stanley's role had to be made). To wit:

> Q. When you and your team prepared the marketing materials for Wadsworth, you didn't—you said that you selected the assets. You didn't mention Morgan Stanley's control. Right?
>
> A. Correct.
>
> Q. Did that make that statement false?
>
> A. No, because we still selected, you know, the assets that were put in the CDO. Morgan Stanley may have had some control, but it was still the assets we selected.

(Doiron 1997:2-12.)

In addition, even though Mr. Doiron expected Morgan Stanley (as the originator for Wadsworth) to protect itself during the warehouse period by putting on significant hedges or short positions, that fact did not change his view on whether a disclosure about Morgan Stanley's role had to be included in the offering documents. (Doiron 1989:18-1991:12; 2009:21-2010:21.)

In sum, it is unanimous from all investor witnesses that the fact that another party, even one who had taken some short positions, had "some control" over the selection of assets during the warehouse period, did not mean that the collateral manager had not selected the assets. The investors therefore did not expect a disclosure on this issue; and even if they had known of these facts, it would not have changed their decision to invest in Octans I.

8. All investors understood that their interests were not fully aligned.

In fact, the Division's entire theory that Magnetar's participation had to be disclosed because its interests **were not aligned** does not make sense in light of the Rule 127B Release. The Rule 127B Release acknowledges that certain conflicts of interest are inherent in the securitization process. Rule 127B Release at 36.

Ira Wagner made the same point in his supplemental report in *SEC v. Tourre,* as well as his testimony in this case. (Resp. Ex. 858 at ¶ 38; Wagner 4635:15-4637:3 (super senior investors prefer less correlation among the collateral pool (reflected in the offering circular) and equity investors prefer higher correlation).) While every investor wanted the deal to perform, there were fundamental differences between the various classes of notes in CDOs, *i.e.*, "the most senior noteholder will want to—especially in a bad market—they'll want to receive their returns —their principal back as quickly as possible, whereas the equity holders would prefer to continue to earn their high interest for a longer period of time." (Suh 3055:23-3056:20; *see also* Edman 2529:19-2530:7 (if a sequential pay test (detailed in the Offering Circular) had been triggered, it would benefit the super senior tranche the most); Chau 4118:20-4119:20; 4121:19-4122:12; 4163:19-4165:2 (mezzanine and equity investors are looking for a different risk/return profile than super senior investors).)

These differences were not only apparent to anyone familiar with the structure of CDOs (as these investors were), but also set forth in the Offering Circular. (*See, e.g.*, Resp. Ex. 2 at 26 (OC) (one of the risk disclosures in the Octans I Offering Circular was that, "The Voter Rights Afforded to the Holders of Preferred Securities [Magnetar] may be Adverse to Holders of Notes.").) Everyone therefore understood that each tranche had its own interests, which may or

may not have aligned with the interests of the other tranches. (*See, e.g.*, Edman 2507:2-11.)[46] The only thing that all investors agreed on was that they did not want the deal to default or to fail to pay the note holders their expected returns. Magnetar's interest in Octans I was exactly the same.

D. <u>There Was No Adverse Selection of the ABX Index Assets.</u>

It is also true—and cannot be seriously disputed despite the Division's unsupported arguments to the contrary—that the ABX Index trade was beneficial to the deal. To begin, as mentioned previously, the Division hired Dr. Ellson to see if he could prove that the ABX Index assets were adversely selected. (*See* Resp. Ex. 884 at 1-2.)[47] Dr. Ellson then used historical loan level data to look at the likelihood—as of the time Harding analyzed these assets for inclusion in Octans I—of projected defaults and losses experienced by the ABX Index assets in question. (Ellson 1106:9-1107:3; 1112:22-1113:11.) His conclusion was that he could not show adverse selection; the ABX Index assets were no worse than the other assets Harding picked and no worse than the bonds then available in the market. (*Id.* at 1112:6-10.)

The fact that Dr. Ellson performed a loan level analysis is by itself very significant. In effect, he re-ran the ABX Index assets using credit analysis analytics, which is what Harding did using Intex. But in order to be able to compare meaningfully the ABX Index bonds with other bonds available in the market, Dr. Ellson had to have used a set of assumptions and the type of analytics that were customary for collateral managers at the time. In other words, he looked at

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[46] For example, all investors in a CDO other than equity received a stated coupon. What that meant, of course, was that none of the tranches of a CDO aside from equity were sensitive to small variations in market conditions. So long as the first losses were absorbed by the equity tranche, tranches above equity could tolerate more risk.

[47] At the Hearing the Division raised a hearsay objection with regard to Resp. Ex. 884. (Tr. 1095:16-1096:10.) This exhibit is a *Brady* letter from the Division to the Respondents setting forth certain facts. We will assume for all purposes that the contents of the letter are true and therefore admitted as such. In any event, the letter represents admissions of a party opponent. Fed. R. Evid. 801(d)(2).

the analysis Harding and other collateral managers would have been looking at in May 2006 and he had to make a judgment about what was reasonable and customary. Therefore, his analysis showed that neither Harding nor anyone else would have had any reason to think that the ABX Index assets were any worse than any other Harding-selected assets or any other assets available in the market. (*See id.* at 1112:22-1113:11.)[48]

Separately, it is beyond cavil that Magnetar and other deal participants **thought**, at the time, that the ABX Index trade **would** produce more cash for the deal. In a May 22, 2006 e-mail to several people at Merrill Lynch, Mr. Prusko noted that ABX BBB- was pretty wide to cash. (Div. Ex. 18.) Dr. Ellson confirmed that this e-mail indicates that people at Merrill Lynch and Magnetar "thought there was an arbitrage opportunity." (Ellson 1137:5-1138:9.) On May 24, 2006, Mr. Prusko e-mailed Mr. Lasch at Merrill Lynch, stating: "ABX opening weaker, let's do call, BUY!!!"[49] (Div. Ex. 21.) Here again, Dr. Ellson agreed that this e-mail also indicated that the people on the e-mail thought there was an arbitrage opportunity at that time and wanted to move quickly to take advantage of it. (Ellson 1138:10-1139:4.)

At the very same time, on May 22, 2006, Mr. Prusko received an e-mail from Ms. Laura Schwartz at ACA with the following sentence referring to the ABX Index trade proposed by Magnetar for the Aquarius deal: "I realize the spreads are wider today so we plan on getting back to you tomorrow afternoon with the outcome of our review." (*See* Resp. Ex. 514.) Mr. Prusko

[48] It is curious to say the least that, having asked Dr. Ellson to re-run the bond analyses, the Division did not introduce the results of those analyses, relying instead on Mr. Wagner's suppositions about how Harding ran its bonds and what assumptions it must have used. One can only conclude that Dr. Ellson's analysis showed that (1) the analysis reflected in Div. Ex. 53 was very obviously incorrect and unreliable, and (2) that run properly, using reasonable assumptions at the time, the bonds at issue were credit worthy. This is exactly what Mr. Steven Hilfer, the Respondents' expert, also confirmed. (Resp. Ex. 976 (Hilfer Rebuttal Report); Resp. Ex. 977 (Hilfer Supplemental Expert Report).)

[49] The Division asserts that this and other e-mails demonstrated Magnetar's desire for mangers to buy the full Index. That argument is addressed in Section XII.B. at n.179.

responded: "Eager to get a chunk done while spreads are wider as long as you are OK with everything that goes into the portfolio." (*Id.*; *see also* Resp. Ex. 384 (Prusko e-mail to yet **another** collateral manager ramping a deal in which Magnetar would want to buy equity, dated June 15, 2006, stating: "[W]ould love to open warehouse tomorrow and start buying **before index rips all the way back above 101**. Last deal, we had ML buy Baa3 and Baa2 ABX and then simultaneously buy protection from deal **on names that the manager likes. You know which index names your [sic] are ok with** at Baa3 and Baa2 level?") (emphasis added).)[50]

It is also beyond cavil that Magnetar, as well as Merrill Lynch and Harding, believed that the ABX trade **did in fact** produce more cash flow for the deal. In a June 6, 2006 internal Magnetar e-mail with a subject line, "ML Index thing went so well I can't take it," Mr. Prusko boasted to his boss, Mr. Snyderman, that despite the premium for the trade and the Merrill Lynch intermediation fee, the assets acquired as a result of the ABX Index trade generated higher spreads than the spreads that were available in the market on a single-name basis. (*See* Prusko

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[50] Note that all these e-mails are consistent with each other in that Magnetar unfailingly left the choice of assets as well as the number of assets to be included to the collateral manager. There is evidence in this case that contradicts that. Here is what the Division's own Merrill Lynch witness, Richard Lasch, had to say on the topic:

> Q. As far as you know, was anyone other than Harding deciding what specific assets would go into Octans 1?
>
> A. Not as far as I know, no.
>
> Q. As far as you know, was anyone other than Harding deciding what specific assets on the ABX index would go into Octans 1?
>
> A. No, not as far as I know.
>
> Q. As far as you know, was anyone other than Harding deciding how many of the ABX index assets would go into Octans 1?
>
> A. No, not as far as I know.

(Lasch 201:21-202:8.)

The suggestion that Magnetar was not really interested in the extra spread but was only interested in getting the deal done quickly does not deserve much attention and is obviously inconsistent with this contemporaneous evidence. Suffice it to say that one can be interested in both; one can want to ramp quickly to shorten the life of the warehouse in order to reduce one's risk there, and one can simultaneously want to move quickly to take advantage of the arbitrage.

2457:23-2460:8; Resp. Ex. 889.) Another contemporaneous document, a Merrill Lynch internal document summarizing the trade, shows that the spread on the BBB ABX Index was 154 and the spread on the BBB- was 267. (Div. Ex. 169.) The same exhibit shows that the ABX Index constituent assets that were shorted away from the deal into the market were traded at an average spread of 127.25 for BBB and 228 for BBB-. Harding would, of course, have had the same information at the time. It is clear, therefore, that Magnetar, Merrill Lynch, and Harding, as the collateral manager, all saw the same trading information showing that the ABX Index trade was beneficial to the deal because the assets acquired as part of that trade were acquired at higher spreads.

But lest there be any doubt that the ABX Index did in fact produce more cash for Octans I, here is the calculation comparing, on an apples-to-apples basis, the weighted average spread ("WAS") of the ABX Index assets in Octans I, net of upfront premiums spread over the expected life of the deal:

For the BBB- RMBS[51]

	Notional / Upfront Payment	# of Securities	WAS
SYNTHETIC - INDEX	$60,000,000	12	267.0
Upfront Payment (5 yrs)	$1,062,500		231.6
Upfront Payment (7 yrs)	$1,062,500		237.5[52]
Upfront Payment (7 yrs)	$1,062,500		241.7
OTHER BBB- SYNTHETIC	$522,500,000	59	234.3

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For the BBB RMBS[53]

	Notional / Upfront Payment	# of Securities	WAS
SYNTHETIC - INDEX	$160,000,000	16	154.0
Upfront Payment (5 yrs)	$1,461,720		135.7
Upfront Payment (7 yrs)	$1,461,720		140.9
OTHER BBB SYNTHETIC	$620,700,000	78	124.8

The Division, of course, offered Dr. Ellson's calculation in an attempt to show that the ABX Index trade actually produced less money for the deal; but as the Court itself observed almost immediately, Dr. Ellson's calculation makes little sense because he failed to take into account the fact that the mix of BBB to BBB- assets in the ABX Index basket was materially different from the mix of the BBB to BBB- in the rest of the portfolio. (*See* Tr. 1113:21-1115:15.) The BBB- constituted only about 27% of the ABX Index basket, with the remaining 73% consisting of the BBB. In the rest of the portfolio, the BBB- and the BBB represented 45%

51 Source: Div. Ex. 169; Div. Ex. 6 (Harding Trade Blotter); Resp. Ex. 444 (Octans I Trustee Report), Div. Ex. 8002 (Ellson Expert Report); Exhibit A (methodology); Exhibit F (Ellson calculation of WAS).

52 Source: Div. Ex. 169; Div. Ex. 6 (Harding Trade Blotter); Resp. Ex. 444 (Octans I Trustee Report), Div. Ex. 8002 (Ellson Expert Report); Exhibit A (methodology); Exhibit F (Ellson calculation of WAS).

As noted, Octans I expected life at close was six years. Assuming a six year life, there is an ABX Index premium for BBB- as well.

53 Source: Div. Ex. 169; Div. Ex. 6 (Harding Trade Blotter); Resp. Ex. 444 (Octans I Trustee Report), Div. Ex. 8002 (Ellson Expert Report); Exhibit A (methodology); Exhibit F (Ellson calculation of WAS).

and 53% of the portfolio, respectively.[54] Given that the huge spread differential between the BBB and BBB- of more than 100 bps, a comparison that does not take account of the difference in the mix is skewed and meaningless. Mr. Ellson himself admitted on the stand that a comparison of two baskets on the basis of spread only, without taking account of the differences in the composition of those baskets, is meaningless. (*See* Ellson 1126:12-1132:19.) Of course, Division Exhibit 169, as well as Respondents Exhibit 889, makes clear that in their contemporaneous analysis of the benefits of the trade, the parties considered the benefit on the BBBs separately from that on the BBB-s.

As the calculation above also shows, Dr. Ellson gave an answer to the Court that was simply false. When the Court asked him: "Is it possible that the deficit [that Dr. Ellson claimed in his report resulted from the ABX Index trade], I think you call it in your report, is attributable to maybe that the index bonds were more heavily concentrated in, say, the Bbb?", Dr. Ellson said: "No, your Honor. The deficit results from the premium that was paid on the transaction to Merrill Lynch." (Ellson 1115:8-14.) There can be no serious debate that, indeed, the so-called deficit in Dr. Ellson's report stemmed from the fact that the ABX Index basket was more heavily concentrated in the BBBs.

We think it was no accident that the Division had Dr. Ellson do the analysis that the Court immediately flagged as incorrect. (*See* Ellson 1114:8-1115:14.) The Division was well aware that Magnetar's economic interests were aligned in all material respects with those of the

54 Source: Div. Ex. 169; Div. Ex. 6 (Harding Trade Blotter); Resp. Ex. 444 (Octans I Trustee Report), Div. Ex. 8002 (Ellson Expert Report); Exhibit F (Ellson calculation of WAS). Dr. Ellson's comparison also did not control for any changes in spreads attendant to any price movements during the ramp-up period.

other investors.[55] As Mr. Wagner stated in his reports in *SEC v. Tourre* and as the Proposed Rule 127B Release makes clear, motivation matters. As discussed above, if Magnetar were not looking to do anything that would hurt other investors, or if, as is the case here, Magnetar proposed something that would benefit all, there would be no reason to think that failure to disclose Magnetar's involvement in the deal could be material to any reasonable investor. In fact, any "accommodation" of Magnetar in that situation would be unexceptional, done in good faith, for the right reasons, and consistent with normal market practices. (Wagner 4653:5-4656:7.)

As discussed more fully at Section IX.B below, the failure to mention that there was a third party to the warehouse agreement was entirely unintentional. The lawyers for all parties, Merrill Lynch, the Co-Issuers, Harding, and Magnetar, knew that Magnetar had rights in the Warehouse Agreement and were so unconcerned about it that they all missed the fact that the description of the Warehouse Agreement in the Offering Circular omitted any mention of Magnetar, one of the parties to the agreement. Something similar had to have happened in the Aquarius deal and for the same reasons.

To eliminate any lingering doubt that Magnetar did not benefit from the ABX Index trade in any way other than as a long in investor in Octans I, consider that when Mr. Prusko was asked in June 2006 by another collateral manager about whether Magnetar realized a profit on the ABX Index trade, his answer was simple, unequivocal, and consistent with all other evidence about Magnetar's motivation that has been introduced in this case. He wrote: "Actually we do not. ML buys the index and then buys protection from the deal on names you like at the spread which

[55] Note, for example, that in its pre-hearing brief, the Division threw caution to the wind and baldly asserted that Harding committed a violation regardless of Magnetar's true economic interests. (Pre-Hearing Brief of the Division of Enforcement at 20-21, *Harding Advisory LLC*, Admin. Proc. File No. 3-15574 (Mar. 24, 2014).)

they bought the index less a few bp admin fee. They then hedge the other names out. **All the benefit of the 'arb' goes into the deal.**" (Resp. Ex. 384 (emphasis added).)

The Division makes a big deal of the exchanges between Magnetar and Merrill Lynch about portfolio composition. (Div. Br. at 9-11.) But the evidence is clear and unambiguous, "portfolio composition" did not refer to specific RMBS assets, it referred solely to asset-class allocation in the portfolio. (Prusko 2412:17-2414:7.) As Mr. Prusko explained, as the equity investor, Magnetar wanted to understand what the portfolio would look like. (*Id.*) There is nothing peculiar about that; all investors wanted to know what was in the asset pool. (*See* Section VII.D.3.) One difference for Magnetar was that it was committing to buy the equity, the riskiest tranche, **before** the assets had been selected. It is unsurprising then that before committing $94 million, Magnetar would have wanted to make sure that it understood in general terms what would be in the portfolio. (*See* Prusko 2412:17-2414:7.) For example, Magnetar wanted to invest in mezzanine deals. (*Id.*) Naturally, it wanted to make sure upfront that the asset portfolio would primarily consist of BBB and BBB- securities, as opposed to AAAs. (*See id.*) Once again, as Mr. Prusko explained, to effectuate its hedging strategy, Magnetar needed to make sure that its hedging positions lined up with its long investments. (*Id.*) If the portfolio included corporate bonds, for example, but Magnetar was hedging subprime risk, there could be a mismatch and the effectiveness of the hedges could have been at risk. (*Id.*)

Again contemporaneous e-mail correspondence fully corroborates Mr. Prusko's testimony. In the run up to the agreement between Merrill Lynch and Magnetar to embark on the Octans I project, a Merrill Lynch banker asked Mr. Prusko: "can you give us a sense of what collateral works for you in broad brush strokes (max Baa3, BB bucket, WAL, etc.) so we can start running some numbers." (Resp. Ex. 761.) Mr. Prusko responded: "Generally, want clean

subprime deal, 5% Ba1, 10% CDO (only subprime deals)." (*Id.*) In other words, Magnetar wanted a portfolio of all subprime risk. (Prusko 2414:11-2415:6.)[56]

1. Magnetar had neither the economic motivation nor the means to pick bad assets.

Magnetar's involvement in the Octans I deal was irrelevant for another independent reason: Magnetar could not pick a bad asset even if it wanted to because during the warehouse phase for Octans I, Magnetar did not have the capability to discern good RMBS assets from bad. (Prusko 2330:7-2331:7.) It also did not want to. As another contemporaneous e-mail, dated July 7, 2006, illustrates, when asked whether he was looking for weak deals to short, Mr. Prusko answered that while he would love a list of short candidates, sourcing weak deals was not really what mattered to Magnetar's strategy, to wit: "It's really a combo of delta hedging and supply-demand. Very hard to get off sizable CDO CDS trades unless they're done against a deal, and this is a natural delta hedge against our equity even if they are the best names. Our gig is really more macro anyway, not a security selection play." (Resp. Ex. 398.) In other words, Magnetar did not have an economic motivation to create or short bad assets. (Resp. Ex. 493.) It expected a net 17% return every year for eight years on its equity holdings! It needed hedges that best correlated with its equity investments; it was not buying equity in weak deals to hedge.

The Division spends a good portion of its brief trying to show that Magnetar was indifferent to the performance of Octans I.[57] (*See, e.g.*, Div. Br. at 16-22, 114.) That argument is

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[56] Incidentally, while Magnetar expressed a preference for Baa1 in this e-mail and in a subsequent e-mail to Mr. Chau, Octans I exposure to Baa1 was minimal. (*See* Resp. Ex. 785; Div. Ex. 6.)

[57] This assertion is not borne out by the evidence. But if it were, we are not sure how that would help the Division's case. Indifference is the absence of conflict by definition. It is also not entirely clear to us why someone who was indifferent to the performance of the deal would have had opinions about the assets that influenced the performance of the deal. Magnetar did not need a CDO to have long exposure to the ABX Index; the evidence in this case is that it was long the ABX Index already. (Prusko 2444:24-2446:8; 2450:16-2451:12.) It also did not need a CDO to short the ABX Index if that was its want; it could have done so directly in the market. As discussed above, only a conflicting motivation could make Magnetar's participation material.

predicated on a mischaracterization of the relevant testimony. The Division has a section in its brief under a heading "Indifferent to the Performance of the Transaction." (Div. Br. at 16-19.) The point of that section is that Magnetar's interests were different from the interests of other Octans I investors because it had a market neutral strategy and so it did not care how the deal performed. The section ends with a quote from Mr. Chau's investigative testimony: "[Magnetar was] indifferent to the performance of the transaction." Over our objection, the Division used this quote to impeach Mr. Chau, who said at the Hearing that "Magnetar would want the equity tranche to perform." (Chau 1776:6-1778:17.) Here is the entire relevant investigative Q and A:

Q. Okay. There were CDOs that you did that Magnetar invested in, correct?

A. Yes.

Q. And you understood in connection with those CDOs, that Magnetar had a long/short strategy, correct?

A. A market neutral long/short strategy, yes.

Q. And that was a strategy which the noteholders didn't necessarily have?

A. I've seen noteholders execute the same strategies, where they would go long the triple-B tranche, debt tranche, and short the single-A tranche above it.

Q. So the noteholders in those CDOs might or might not have had a long/short strategy?

A. Each investor has their own criteria.

Q. Okay. So, did you—how did you balance the—In the CDOs you did where Magnetar was an equity investor, how did you balance the interest of Magnetar with the interest of the other noteholders?

MS. DALEY: Objection.

A. There was no need. There was no conflict of interest.

Q. But weren't Magnetar's interests unique because of their long/short strategy?

MS. DALEY: Objection.

A. No. The hedging of an investment is indifferent to the capitalization of that investment.

Q. So, you didn't think there was any difference between Magnetar's interest and the interests of the other—of the noteholders in the other CDOs that you did where Magnetar was an equity investor?

MS. DALEY: Objection.

A. No. Again, they bought the equity tranche, and they hedged that equity tranche. They were indifferent to the performance of the transaction. It was a—as they say, market neutral transaction. **To the extent that the market stayed the same, Magnetar—and certain yield components. For example, if equity was yielding 20 percent and the triple-B tranche was yielding 3 percent, they would earn a risk-free return of 17 percent.**

Q. But you knew that Magnetar was buying protection on some of the assets in those CDOs, correct?

MS. DALEY: Objection.

A. I believe their objective, as you said, was to short CDO transactions against their equity investments.

Q. And didn't that put them in a different position than the other noteholders?

MS. DALEY: Objection.

A. No. It just made—it's that they were hedged. You know, there was no inherent conflict.

(Chau 4313:22-4716:16; Div. Ex. 1003 at 29 (emphasis added).)

In context, it is clear that what Mr. Chau was saying was that Magnetar's hedging strategy did not depend on its equity investment being weak. "This hedging of an investment is indifferent to the capitalization of that investment," means that hedges have to correlate with the long position regardless of whether the long position references a strong or weak pool of assets. This is the same point Mr. Prusko made in the July 7, 2006, e-mail discussed above (Resp. Ex. 398) where he said "this is the natural delta hedge against our equity even if they are the best names."

Not much more need be said. Delta-neutral, perfectly hedged, market neutral, long/short, indifferent—are all ways to describe a strategy that protects an investor in down markets. As Mr. Chau understood, Magnetar stood to earn almost 20% in risk free profit if the equity performed as anticipated. He also understood that Magnetar would hedge by shorting the triple-B tranche, *i.e.*, he knew that, for the reasons described above, the shorts would pay only in extreme market conditions.

2. Mr. Chau could not and did not know exactly how Magnetar hedged.

This brings us to the Division's allegation that we speak out of both sides of our mouths when we say that Mr. Chau did not know exactly how Magnetar would hedge. (Div. Br. at 16 n.25.) We start with the most fundamental point: Magnetar's short position was never more than $48 million and it did not reach that level until December 21, 2006. (Div. Ex. 248A.) It was not net short. Even if, however, Mr. Chau knew that or, alternatively, if he knew that Magnetar managed to get to a delta-neutral 2-to-1 hedge ratio in Octans I, all that would have told him would have been that given its $94 million equity investment, Magnetar's interest were aligned with those of other Octans I investors. Magnetar had skin in the game (*see* Resp. Ex. 858 at ¶ 24; Resp. Ex. 128 at 2564; 14-18) (Mr. Tourre "misled" ACA into believing that Paulson was a long investor, an equity investor, that it had skin in the game) and it did not stand to profit more from the Octans I demise than it stood to profit from its long position. *See generally*, Proposed Rule 127B Release.

In any event, Magnetar was a hedge fund and, in the SEC's own words in its summation in *SEC v. Tourre*, "hedge funds hedge." (Resp. Ex. 128 at 2744:5-10.) The long equity/short other portions of the capital structure hedging was not something Magnetar invented; it is a variation on using options to hedge investments in stocks, whereby investors go long equities

and buy put options to hedge their equity positions. (*See* Resp. Ex. 501 at 1, 3 (Merrill Lynch Report, Long ABS Correlation Trade Ignites Mezz SF CBO Market (Sept. 28, 2006).) Knowing generally that Magnetar would hedge is not the same, in other words, as knowing exactly what instruments they would use and the sizes of the relevant hedge positions. As Mr. Chau and Mr. Prusko testified, they did not really know each other before the Octans I transaction. (Chau 4279:10-25; Prusko 2398:12-2399:3.) Of course, Mr. Chau learned more about Magnetar and its investment strategy over the course of 2006 as they worked on several deals together. It cannot be seriously disputed, however, that at the time of the ABX Index trade for Octans I in May 2006, Mr. Chau's and Harding's understanding of Magnetar's strategy was rudimentary.

For example, an internal Magnetar e-mail, dated June 4, 2006, illustrates that even Magnetar did not have a clear idea about how it would hedge its equity purchases in CDOs. (*See* Resp. Ex. 493 ("We should brainstorm on the most convex instruments in the credit world to help establish our hedges."); Prusko 2367:25:2368:18.) Surely, Mr. Chau cannot be found to have known what Magnetar itself did not know about its own hedging strategy. This is worth reemphasizing, Mr. Chau **could not have known** exactly what Magnetar was going to do to hedge its Octans I equity **on May 31, 2006**, given that, as noted above, **that question was not resolved at Magnetar as of June 4, 2006**. In fact, as late as September 2006, Magnetar was soliciting views, including from Mr. Chau, about hedging opportunities. (Resp. Exs. 860-861.) Furthermore, Magnetar was hedging its entire long position; what may have been optimal with respect to hedging each deal separately may not have been optimal for its overall long position. (*See* Prusko 2389:12-2390:7.) Mr. Chau could not have known—and there is no evidence that he did—Magnetar's entire long position. There was also no certainty that Magnetar would be able

to source hedges on the same deal in which it bought equity. That depended on finding a willing counterparty. (Prusko 2390:8-2391:13.)

The Division cites its Exhibit 157 as proof that Mr. Chau understood Magnetar's investment strategy. A close look at that exhibit proves that he did not. Division Exhibit 157 is an August 31, 2006, e-mail exchange between Ms. Wang and Mr. Chau. In it, Ms. Wang informed Mr. Chau that she had been told that someone "sold protection on the A2s today—20bps wide of where we priced." Mr. Chau responded: "Yes, prob to Magnetar, they will buy protection on any deal 20 wide to cash." It is self-evident that by saying "probably," Mr. Chau was indicating that he did not know. (*See* Chau 4275:22-4278:1.) It is also self-evident that saying that Magnetar would buy protection on "any deal" indicates that Mr. Chau did not connect the sale of protection on Octans I to Magnetar as a hedge of its equity position in Octans I. Had he done so, Mr. Chau would have said something like: "Yes, to Magnetar. They will buy protection on **their** deal 20 wide to cash," or even "Yes, to Magnetar. They will buy protection on **any of their** deals 20 wide to cash." But Mr. Chau did not say that because he could not have known. Indeed, as Mr. Chau testified, he did not learn that Magnetar in fact hedged its long position in Octans I by shorting its capital structure until the investigation that led to this proceeding and he did not learn the full extent of their hedges on Octans I until shortly before the Hearing. (*See* Chau 4274:16-4275:21.) There was no proof offered at this Hearing that contradicts that basic fact.

E. Magnetar's Objection And Veto Rights In The Warehouse Agreement Did Not Need To Be Disclosed.

The Division made much of the fact that Magnetar's rights in the Warehouse Agreement, including a right to object to assets and a veto right, were not disclosed. It is undisputed that Magnetar had never exercised its veto or objection rights. (Prusko 2430:18-2431:3.) It is also an

undisputed fact that whatever warehouse rights Magnetar had terminated with the termination of the Warehouse Agreement once Merrill transferred warehoused assets to the Issuer. (Resp. Ex. 123 at Ex. A-12; Suh 3031:22-3032:17.) It is therefore irrelevant, let alone immaterial, that those rights were not disclosed in the offering documents or the Pitch Book. Again, Mr. Wagner and the SEC agree. In the *Tourre* case, Mr. Tourre also raised the fact that Magnetar had veto rights in the Aquarius warehouse. (*See* Resp. Ex. 858 at 14-16.) As discussed above, Mr. Wagner responded in part by noting that having risk in the warehouse gave the party with a veto the economic incentive to veto the accumulation of risky assets. (*Id.* at ¶ 24.) He then added that "Magnetar, like UBS [the Merrill Lynch equivalent in that deal] at most had veto rights and that [witnesses] could not recall any exercise of those rights by either Magnetar or UBS, or any other specific input Magnetar had on the portfolio" (*Id.* at 15 ¶ 24.)[58] If having rights in the Warehouse Agreement is a material fact that must be disclosed regardless of whether those rights had been exercised, Mr. Wagner's observation quoted above was a misleading *non sequitur*. In other words, it was the position of the Division and the SEC in *Tourre* that, at a minimum, no warehouse rights needed to be disclosed if they were not exercised. Importantly, while the Aquarius pitch book mentioned the warehouse agreement, it did not disclose that it was a three-party agreement or that Magnetar had certain rights under the Agreement. (Resp. Ex. 979 at 83.) The Aquarius offering circular was silent as to the warehouse agreement and as to Magnetar. (*See* Resp. Ex. 804.)[59]

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[58] As noted, at Magnetar's suggestion, the collateral manager in that deal did an ABX Index trade.

[59] For all of the reasons set forth here, Magnetar's involvement in Octans I was irrelevant. That said, there is zero evidence that there was any scheme or attempt to hide Magnetar's involvement in Octans I. It is uncontroverted that the investors were told repeatedly that the Preferred Securities had been privately placed prior to the marketing of Octans I. For example, the pricing announcements for Octans I noted that the preferred shares of $94 million dollars were not being offered. (Resp. Ex. 529 (E-mail chain ending with e-mail from Catherine Chao to undisclosed recipients re: **NEW ISSUE: Dorado CDO—Deal Announcement**); *see also* Resp. Ex. 2 at 2 (OC) ("The Preferred Securities are not being offered hereby. The Preferred Securities are being offered by the Issuer in a
(Footnote continued on next page)

V. HARDING'S MOTIVATION WAS TO BUILD DEALS THAT WOULD PERFORM WELL.

The Division attempted to prove Harding had nefarious motivations by arguing that Harding had "no meaningful 'skin in the game'" because it had not invested capital in Octans I. (*See* Div. Br. at 12-13.) This is the functional equivalent of saying that no investment professional who manages money on behalf of others cares about the returns on clients' investments because all the professional earns is success fees. Harding's primary source of income was the fees it generated from managing CDOs for the life of the deals. It is

privately negotiated transaction to an investment fund (the 'Initial Holder of Preferred Securities')."').)These investors therefore knew that an investor fund had been involved in the transaction prior to the marketing of the CDO; and as explained more fully below, these investors expected anyone investing in Octans I to express opinions on the collateral pool and did not expect to informed of each investors' suggestions. At minimum, no effort was made to hide the fact that an equity investor had been involved in the deal prior to the pricing announcement.

Second, like Harding, several of the Octans I investors had met with Magnetar in the summer of 2006 regarding putting together other CDOs. (*See, e.g.*, Resp. Ex. 523 (E-mail chain between Morgan Stanley and Magnetar individuals re: GSC-Magnetar structure (June 15, 2006)); Resp. Ex. 527 (E-mail chain ending with e-mail from Richard Lasch to James Prusko re: Meeting between Magnetar and Chotin) (July 19, 2006)); Resp. Ex. 547 (E-mail from Zach Smith re: Lunch with Declaration and Magnetar (July 20, 2006)); Resp. Ex. 698 (E-mail chain ending with e-mail from Jim Finkel (Petra) to Harin De Silva re: Magnetar) (August 22, 2006)); Resp. Ex. 617 (E-mail chain ending with e-mail from Cecilia Pan to James Prusko re: Meeting with Tricadia) (August 4, 2006).) Certainly, these investors had the same knowledge that Harding had on or about September 26, 2006.

Third, the evidence also shows that all but one investor likely knew that Magnetar generally had a market neutral strategy. (*See, e.g.*, Jones 2852:3-19; Edman 2536:5-2539:3; Edman 2544:6-16; Resp. Ex. 546 (E-mail chain re: Trade Proposal (July 20, 2006)); Resp. Ex. 880 at 1-2 (August 14, 2006 Article in Derivatives Week on Magnetar's CDO Strategy) ("Market participants speculate the fund is shorting other parts of the capital structure against its long equity positions.").) In fact, the Division cites to Mr. Edman's testimony that investment banks, proprietary desks, and CDO managers knew about Magnetar's general strategy of hedging its long position (Div. Br. at 25), which would be all but one of the investors, HIMCO. However, even had they not been aware that Magnetar employed a capital arbitrage strategy, it was well known in the industry that investors in the CDO space employed this strategy. (*See, e.g.*, Resp. Ex. 501 at 1, 3 (Merrill Lynch Report, Long ABS Correlation Trade Ignites Mess SF CBO Market (Sept. 28, 2006)) ("Arguably the most significant CDO strategy in 2006 is the ABS correlation trade, which is . . . [to long] Mezz SF CBO equity and short the junior debt of similar risk.").)

Finally, investors in this industry also knew that Magnetar took the equity piece of CDOs named after constellations. (*See, e.g.*, Huang 990:13-16, 991:19-23; 992:9-15; Chau 1609:6-11; Edman 2505:23-2506:3; 2536:5-21; Resp. Ex. 880 at 1-2 (August 14, 2006 Article in Derivatives Week on Magnetar's CDO Strategy).) Octans I is a constellation name. Even if the investors were not aware that Octans was a constellation, at minimum, no effort was made to hide that Magnetar was involved; if there had been such an effort surely they would not have used a consistent naming convention that connected deals to Magnetar. The Division's point that Octans I is not a well-known constellation is fatuous. The world of CDO investors, as the Hearing made plain, was inhabited by highly educated professionals with MBAs, JDs and PhDs. Surely at least some of them knew what Octans was or were curious and had access to Google.

uncontroverted that Harding was compensated in Octans I in part on non-defaulting assets under management (senior fees) and in part based on the performance of those assets over time (subordinated fees). (Wagner 4661:24-4662:19; *see also* Resp. Ex. 2 at 200, 290, 293 (OC); Resp. Ex. 5 at 5, 16 (CMA).) If any assets defaulted, Harding's senior fees would have been reduced. (Wagner 4661:24-4662:19.) If any asset performed poorly, Harding's subordinated fees would have been reduced. (*Id.*) If the CDO were liquidated due to an event of default, Harding would have lost all future fees. That is to say that, like the Octans I bond holders and equity, Harding expected a future stream of payments as a return on its sweat equity investment. In fact, the split of fees into senior and subordinate aligned Harding's interest with the interests of all investors across the entire capital structure of Octans I. (Wagner 4661:20-4663:4.)

Had the CDOs it managed failed, Harding would have lost a significant source of future income. (*See* Div. Ex. 240 (fees collected by Harding).) For example, Harding's initial fee of $1 million on Octans I was dwarfed by the $3.5 million in management fees Harding earned over the life of that deal, despite the fact that Octans I fees stopped in early 2008, well short of the deal's initially expected six-year life. (*See* Div. Ex. 240A.) Assuming the same fees for each of the remaining five years, Octans I represented an income stream over its expected life of approximately $21 million. That may not be enough skin in the game for the Division of Enforcement, but it was for the Respondents. (*See* Huang 1262:7-1263:20 (Harding's economic interest in Octans I was in the pool assets performing well for as long as possible, so that Harding could collect its fees over the entire expected life of the deal.))

It is also important to note that Harding did not receive upfront fees on any of the Magnetar deals aside from a $1 million upfront fee for Octans I. (*See, e.g.*, Div. Ex. 240.) The effect of not having upfront fees was to align even more strongly the interests of the collateral

manager with those of the investors in the deal by conditioning all future income on deal performance. This feature is yet another factor that undermines that Division's theory that Harding would have had an incentive to accommodate Magnetar at the expense of other deal investors. This is an obvious point. Of course, Harding was interested in more deals with Magnetar so it could earn more fees. The absence of upfront fees in Magnetar deals predicated Harding's ability to earn fees solely on asset performance.

Most importantly, Harding's ability to be selected as the collateral manager on future deals rested on its reputation in the market, especially with prospective investors and originators, for building deals that performed well for the CDO investors. (Wagner 4663:5-14.) Investment banks originating CDOs did not select collateral managers for prospective deals **unless** they were satisfied that the collateral manager built deals that performed as expected or better for the CDO investors. (Wagner 4597:21-4599:22; 4665:7-4668:11.) As part of their due diligence on potential collateral managers, those investment banks looked at the performance of the collateral in the Harding deals and at the overall performance of those deals. (Wagner 4665:7-4668:11.) Specifically, prospective investors on any future deals evaluated the overcollateralization ratios, rating transitions, trading activity post-closing, as well as how the underlying collateral was performing. (Wagner 4665:7-4668:11.) They also determined how Harding ran its credit analysis on RMBS bonds, including what macro and micro assumptions, it used. (Wagner 4591:15-4594:20; 4595:5-4596:22; 4597:21-4599:22.)

One should not lose sight of the fact that the CDO market was populated by very sophisticated, discerning players. Had a collateral manager stuffed a CDO with disfavored assets, which impacted the performance of the deal, no investment bank would have chosen the collateral manager for future deals. As Mr. Wagner testified, it would become "very hard [for the

investment bank] to market a new deal," if one of the collateral manager's previous deals was perceived as a bad deal by the market. (Wagner 4663:15-24.) That Harding did not select "disfavored assets" for Octans I (*see* Section XI), is corroborated by the fact that other originators, including Citi, Wachovia, and Credit Suisse, selected Harding as their collateral manager for CDOs after Octans I closed and after they were able to assess its performance. (*See* Wagner 4597:21-4598:22; Resp. Ex. 239 (CDOs Managed Since Inception).)

In sum, Harding's sole economic motivation was to build a collateral pool that met the expectations of the CDO investors and performed well. Including disfavored assets would have harmed Harding by jeopardizing future income streams and future business opportunities. It certainly would not have resulted in Harding being chosen as a collateral manager by Merrill Lynch or Magnetar on future deals.

VI. THERE IS NO EVIDENCE OF ANY SCHEME.

Simply put, all of the witnesses who testified about their work in connection with the ramping, closing and management of Octans I confirmed that there was no scheme within Harding to defraud anyone. To the contrary, all of the witnesses testified, uniformly, that they acted in good faith, worked hard, and did their best to act with integrity. Not only that, each testified that his or her coworkers at Harding were professional, qualified, and competent to perform the jobs assigned to them. No witness testified that he or she was aware of anyone at Harding engaging in any misconduct, deception, fraud, or questionable ethical conduct. The testimony of those witnesses was credible and was uncontradicted. The testimony is also heavily corroborated by all of the other evidence in the case and by a commonsense view of the various actors' economic motives and incentives.

A. **Jung Lieu Testified There Was No Scheme And She Was Corroborated.**

Jung Lieu testified that she acted in good faith in connection with the selection of ABX Index assets for the Octans I warehouse: "I did my credit work 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." (Lieu 3612:20-3613:3.) She testified that she "had enough time to come up with the credit decisions" and would have asked Tony Huang for more time if she felt that she had needed it. She also testified that she would not have rendered a credit decision if she had felt that she needed more time. (Lieu 3693:15-3694:20.)

Ms. Lieu testified that nobody gave her a specific number of ABX Index assets that she had to pick, that she was the person who made the decision to select the ABX Index assets on May 31, 2006, that nobody had overruled her or ordered her to select any of the assets, and that there was nothing unusual about Mr. Huang's request that she review the ABX Index to determine whether to select any assets from it. (Lieu 3696:8-3697:9.) She testified that there was no particular pressure on her on May 31, 2006, and characterized that day as "just another day at the office." (Lieu 3696:21-22.) She testified that she never felt that there was anything strange, suspicious, or problematic about being asked to review the ABX Index for Octans I or the manner in which she was assigned the task. (Lieu 3723:3-3723:16.) Finally, she testified that, during late May and early June 2006, during the ramping of Octans I, none of the six or seven other people at Harding who were also working with her on the ramping of Octans I ever "raise[d] a problem or suggest[ed] that there was something strange, out of the ordinary or otherwise improper about an ABX Index trade" or "the way the assets had been selected." (Lieu 3732:10-3733:7.) In short, she testified that she picked the assets, based on her own honest

views, without being pressured or asked to sacrifice her integrity and without lowering her standards or accommodating anyone.

All of the other witnesses testified, credibly, to the same truths.

B. Tony Huang Testified There Was No Scheme And He Was Corroborated.

Tony Huang, whose credibility the Division does not question, made clear that he believed that Harding was a "good place," that he never suggested to anyone at Harding, or pressured anyone at Harding, to do anything that was "wrong," "misleading," or "fraudulent," and that he did ***not*** "compromise his standards in connection with Octans I to accommodate trades requested by Magnetar," or ask anyone else to compromise their standards. (Huang 1198:14-22; 1196:22-1197-15; 1207:18-21.) He testified that he guards his integrity and he never sacrificed it while at Harding, including in connection with the Octans I and Octans II transactions. (Huang 1208:4-1212:2.) Mr. Huang confirmed that he never saw anything indicating that Harding might have put Magnetar's or Merrill's interests ahead of Harding's interests and that he himself never engaged in that kind of conduct. (Huang 1209:12-1210:2.) He testified that he was at all times comfortable with his interactions with Magnetar and that they were ordinary, routine, and normal. (Huang 1230:11-15; 1231:16-18.) In short, Mr. Huang flat out denied each and every one of the allegations in the OIP concerning Harding's interactions with Magnetar and Merrill, and concerning his work, and his supervision of Ms. Lieu's work, in connection with the ABX Index selection process for the Octans I, II, and III transactions.

Mr. Huang testified that Harding, in the ordinary course of business, had already approved a number of ABX Index assets for Octans I, prior to May 31, 2006. (Huang 1289:10-1290-19; Div. Ex. 49.) This was not surprising given that, in Huang's words (and in the words of

other witnesses), the "Index components are everywhere," and are "the biggest part, the most liquid" part of the market. (Huang 1290:3-19.)

Mr. Huang confirmed that neither Magnetar nor anyone else ever indicated that Harding had to select any set minimum number of ABX Index assets (Huang 1276:6-1277:6), but that no matter what, "we are going to end up probably, most likely, [with] some ABX bonds" as, according to Mr. Huang, "I personally haven't seen a deal without any names on it." (Huang 1277:19-1278:5.)

In fact, even though Mr. Huang was the main point of contact at Harding for Magnetar in connection with the ABX Index asset selection, Mr. Huang had no idea that Magnetar even had any warehouse rights, such as a right to object or a veto right, until the Division informed him during investigative testimony years later! (Huang 1267:22-1269:18; 1271:6-10; 1271:17-1273:18.) That evidence is critical: the allegation is that Magnetar pressured, exerted influence, and controlled asset selection, but neither of the Harding employees who actually selected the assets had any idea that Magnetar even had a say in asset selection.[60]

Mr. Huang made clear that Harding—and nobody else—selected the assets free of any influence, pressure, or third-party control. He testified that there was no doubt in his mind on that point. (Huang 1274:6-12.)

Mr. Huang makes this clear when he testifies about the lack of any direction from any person or party concerning identifying any particular number of ABX Index assets for the warehouse. He testified:

> ...I understand that if our analyst came back, says they don't like any of those ABX bonds, and I probably would hear something *from Merrill.* If I say hey, we don't like any of those bonds. They probably—how can you not like any bonds in the ABX? That is

60. There is no evidence that Ms. Lieu had any idea that Magnetar had warehouse rights.

what I would expect. Other than that, the amount, how much we approve and not approve, I thought it was just part of selecting bonds in the process.

(Huang 1266:13-25 (emphasis added).) In short, Mr. Huang had no idea that Magnetar had any warehouse rights or, indeed, any particular interest in Harding selecting any particular number of ABX Index assets. While the Division makes much of his testimony that he thought Magnetar might *prefer* more ABX Index assets because of liquidity, he had no sense that Magnetar would have complained, or more important, would have had any right to complain, if in fact Harding had not selected any ABX Index assets for the warehouse.

Mr. Huang testified that, although he thought Mr. Prusko was "anxious," he never felt any pressure or "stress" from Magnetar's requests that Harding move expeditiously when reviewing the ABX Index assets.[61] To the contrary, Mr. Huang characterized his interactions and Harding's interactions with Mr. Prusko as "routine stuff," "run of the mill," "normal," and "ordinary." (Huang 1284:4-1286:10; 1288:23-1289:9; 1295:14-20; 1296:21-1297:3.)

In sum, Mr. Huang testified that he was "puzzled" and "surprised" by the Division's "focus on that particular thing," referring to the events of May 31 and the ABX Index issues. (Huang 1265:19-1266:6.) In his mind, "most deals would have some ABX bonds. It is hard to avoid." (Huang 1267:8-16.)

The other witnesses testified similarly.

C. **All Of The Other Witnesses Testified There Was No Scheme.**

Alison Wang testified that she did not do anything wrong and was unaware of any misconduct. (Wang 539:19-540:12; 541:12-17.) Wing Chau testified that he acted in good faith, sees now that there was a mistake in the Offering Circular regarding listing Magnetar as a party

[61] Indeed, given that Magnetar was taking 85% of the warehouse risk on a $1 billion plus transaction, it makes perfect sense that Mr. Prusko was paying attention.

to the Warehouse, and would have fixed it back then if he had noticed it. (Chau 2113:11-2114:15.) Prusko testified that he did not particularly care how many ABX Index assets were in the deal and never pressured anyone or demanded any set number and never exercised veto rights. (Prusko 2465:16-2466:17, *see e.g.*, 2488:6-21.)

D. The Witnesses Who Handled The ABX Index Trade And Asset Selection Were Motivated To Testify Truthfully.

For the Division's alleged scheme to have existed, a number of people would have had to have been in on it. Many of these witnesses, like Ms. Lieu, have no ongoing relationship with Mr. Chau, no particular incentive to protect him or Harding, and no reason to testify falsely. Ms. Lieu has not spoken to Mr. Chau for years and has no relationship with him. She estimates that she spent six (6) full eight (8) hour days answering questions about her work at Harding in investigative testimony and in civil depositions before this Hearing started. As Ms. Lieu testified at the Hearing, there were other instances in which she recalls that her credit decision, or the decision of Ms. Moy, was overruled by Mr. Chau. (*See*, *e.g.*, Lieu 3883:20-3884:12.) She was questioned extensively about instances of being overruled and made clear that, in those instances, she would speak to Mr. Chau and he would explain to her his reasons for over-ruling her:

> For example, I could say no or yes and Wing thought otherwise and usually he would give me his reasons on why he thought the loans were better or worse or the originator was better or worse. There were also conversations revolving around the actual price of the bond and actually putting more relative value analysis.

(Lieu 3889:1-7.)

She characterized those interactions as professional and testified that Mr. Chau had reasonable explanations in those instances when he disagreed with her analysis. (Lieu 3889:8-19.) Finally, she testified that Mr. Chau, as the boss at Harding, always had the authority and the prerogative to overrule her, whenever he saw fit. (Lieu 3891:7-23.)

Given that she freely testified about other instances in which Mr. Chau had overruled her, including in connection with Octans 3, there is only one reason why Ms. Lieu continues to insist that she alone made the credit decisions on May 31, 2006, in connection with Octans I: because it is the truth. Given the way the Division attacked her during her investigative testimony and at the Hearing, she certainly had a motive to point her finger at Mr. Chau or Mr. Huang, shift the blame to either or both of them, and claim that she simply picked the assets that she was told to pick. The only conceivable reason she did not do so is because nothing like that happened.

Similarly, Mr. Huang took full responsibility at the Hearing for handling the ABX Index trade on behalf of Harding, knowing also that the Division's case centers on Harding's conduct on that trade. Mr. Huang, like Ms. Lieu, had no incentive to falsely insist that he handled that trade. To the contrary, he had every incentive, if he wanted to protect himself, to blame everything on Mr. Chau. He did not do that; he took full responsibility for Harding's conduct on May 31, 2006. Indeed, the Division elicited testimony from Mr. Huang that once Mr. Chau authorized Mr. Huang to handle the ABX Index trade on behalf of Harding, Mr. Chau "*left it alone to me. I don't recall I have any follow-on discussion with Wing on this subject* [the ABX Index trade in late May and early June 2006]." (Huang 846:2-19 (emphasis added).) The Division also elicited testimony from Mr. Huang that, "In this case, yes... I was the one who did all this [forwarding the list of ABX assets to Ms. Lieu without informing Mr. Chau]. I don't think Mr. Chau was involved in that." (Huang 857:2-7.) And it elicited testimony from Mr. Huang to the effect that, "When we were doing Octans I, the index, I [Mr. Huang] was more involved with that than Mr. Chau." (Huang 858:14-16.)

Mr. Huang testified, truthfully and like all of the other witnesses, that May 31, 2006 was just like any other day and that there was no scheme, no conspiracy, and no plan to give

Magnetar anything other than his, Ms. Lieu's, and Harding's honest services. There can be no serious doubt that Mr. Huang testified truthfully. He volunteered information during the Hearing that was not especially helpful to himself, to Mr. Chau, or to Harding. Indeed, he went so far as to express regret that neither he, nor virtually anyone else in the market in 2005 through 2007, had been able to see that they were in a housing bubble and eventually a lot of people lost a lot of money. (Huang 1192:1-1193:13.) In short, he told the truth as he knew it.

Had there been any scheme at Harding to select assets for an improper purpose, Mr. Huang would have been aware of it—indeed he oversaw all of Harding's interactions with Magnetar and Merrill in connection with selecting ABX index assets for the Octans deals—and he would not have hesitated to tell the Court about it at the Hearing. There was no scheme.

1. The other evidence also demonstrates there was no scheme.

a. Magnetar's economic interests.

First, as we discuss elsewhere, the evidence demonstrates that Magnetar's only economic motivation or "preference" was that Harding do its job properly and select assets for Octans I in good faith and in a timely enough manner to take advantage of the arbitrage opportunity that Magnetar and others perceived at the time and which would put *more money into the deal* for all investors. Magnetar invested almost $94 million in the riskiest portion of Octans I and was taking a significantly higher amount of warehouse risk. While it may have had a general strategy of hedging its investments and taking a "market neutral" position, it had absolutely no desire, plan, or hope to lose its equity investment in Octans I or to incur warehouse losses during the ramp period. It therefore neither had, nor ever expressed, any economic desire that Harding lower its standards, abdicate its responsibility, or otherwise choose assets that Harding otherwise "disfavored" or did not genuinely approve. In short, the proof is clear that Magnetar had absolutely **no economic interest** in Respondents compromising or lowering their standards.

Because Magnetar had no economic interest in being "accommodated" in the manner alleged in the OIP, the allegations make no sense.

b. *Harding's and Mr. Chau's economic interests.*

Second, all of the evidence also demonstrates that it was also against Respondents' economic interests to lower their standards. Harding and Mr. Chau knew and understood at all times that the longer the contemplated CDO performed as planned, the longer Respondents would be paid and the more money they would make. They also knew and understood that, in the event the contemplated CDO underperformed, Harding and Mr. Chau could lose future business as a result. The better the deal performed, the more money they stood to make. While the Division suggests that Harding wanted to "keep" Magnetar "happy" so that it might get more business, all businesspeople have similar incentives every day, whenever they are working with other parties who might hire them in the future or refer additional business to them in the future. The standard desire for profit and continued success in business is not evidence of motive to commit fraud. *See Kalnit v. Eichler*, 264 F.3d 131, 140 (2d Cir. 2001); *In re Adelphia Communications Corp. Secs. and Deriv. Litig.*, 03 MD 1529 (LMM), 2007 U.S. Dist. LEXIS 66911, at *10 (S.D.N.Y. Sept. 10, 2007); *see also Key Equity Investors Inc.*, 246 Fed. App'x 780, 786 n.10 (3d Cir. 2007).

c. *The theory of "concealed accommodation."*

Third, putting to the side that no witness testified that Harding "accommodated" Magnetar or Merrill, the Division conceded prior to Hearing that neither Magnetar nor Merrill ever learned or became aware of Respondents' alleged "accommodation" of them. (Div. Response to Motion for More Definite Statement.) The Division's theory just makes no sense.

Given Magnetar's undisputed long position in Octans I, the Division's theory would require Respondents to be mistaken about what Magnetar wanted, act on that mistaken

impression with the goal of trying to make Magnetar "happy," and then conceal that accommodation from Magnetar. Of course, the more sensible explanation for all of this is the one that is demonstrated by the evidence: none of it ever happened.

d. *The non-existent set of "disfavored" assets.*

Fourth, the OIP repeatedly alleges that, due to Magnetar's alleged "influence," Harding selected an (as yet still unidentified) number of "disfavored" assets from the ABX Index. (*See* generally, OIP ¶¶ 2, 34, 41, 50, 51, 58.) But again, none of the witnesses testified that they "disfavored" any of the ABX Index assets that were selected for Octans I and that testimony was overwhelmingly corroborated by the undisputed facts that all of those assets were approved and selected by Harding for a variety of other deals, for other underwriters, having nothing to do with Magnetar, both before and during the ramp of Octans I. No matter how hard the Division tries to suggest that any of the assets at issue were "disfavored" by Harding, the evidence proves the opposite. In short, there was no scheme to select assets that were "disfavored" by Harding personnel in order to accommodate Magnetar because none of them were "disfavored" and, the evidence proves, would have been—and were—selected routinely and regularly by Harding in its ordinary course of business.

e. *Magnetar's agnosticism on the number and names of ABX Index assets.*

Fifth, while the OIP alleges that a central part of Harding's misconduct involved "accommodating *trades requested by* Magnetar," (OIP ¶ 8 (emphasis added)), there is no evidence that Magnetar requested any particular "trades." While Magnetar (like others in the industry), Merrill, and Harding believed in late May 2006 that there was an arbitrage opportunity with the ABX Index assets, Magnetar never asked that Harding pick any particular assets from the ABX Index or any particular minimum number of assets. And the evidence shows that

Magnetar did not even have the capability to evaluate individual assets for itself. It had no analysts at the time, and was not running cash flows or doing credit reviews. It therefore had no preferences.

The evidence is overwhelming that Magnetar's only request, consistent with what it and everyone else believed was in the best interests of the CDO, was that Harding determine whether there were any ABX Index assets that it "liked" for the deal. The evidence demonstrates that this was a reasonable and ordinary request and that there was nothing wrong with Magnetar's request or Harding's (and Merrill's) agreement to review the ABX Index and work out the mechanics if any of those assets were deemed eligible for the warehouse. And, as shown elsewhere, Harding was already well on its way to selecting a number of ABX Index assets for the warehouse anyway, and there were pronounced ***benefits*** to the deal in having ABX Index component names.

Even under the Division's latest theory of the case, it is clear that Harding *excluded* the assets that it *did not like*.

f. *The Harding credit team had no idea Magnetar had any rights.*

Sixth, as noted above, Mr. Huang and Ms. Lieu did not even know, at the time, that Magnetar had any rights in the Warehouse Agreement. This is consistent with their perception at the time, which was that Magnetar was just like another equity investor that had no particular rights, influence, or control over the ramping process.

All of these six reasons corroborate and support the credible testimony of the witnesses that there was no scheme within Harding to improperly accommodate Magnetar. The Division cites *SEC v. Garber*, 959 F. Supp. 2d 374 (S.D.N.Y. 2013), *see* Div. Br. at 116, but has flouted that case's admonition that the SEC cannot bypass the elements necessary to impose misstatement liability "by labeling the alleged misconduct a 'scheme.'" *Id.* at 380-81.

VII. THE NOTE PURCHASERS RECEIVED EXACTLY THE BUNDLE OF RIGHTS THEY EXPECTED FROM THE OFFERING DOCUMENTS.

The investors in Octans I paid a fair price for a specifically defined, carefully cabined bundle of rights to ownership of a collateral pool that met certain specific characteristics. That limited bundle of rights did not include the right to have the collateral selected or sourced in any particular way. In fact, investors were specifically told that their bundle of rights did not include any representations about the quality of the synthetic collateral. Therefore, they were told, they had to rely on their own analysis of each of the synthetic RMBS in the assets pool as well as all other aspects of their investment. (*See* Resp. Ex. 2 at 18, 52 (Final Offering Circular, dated September 20, 2006 (hereinafter "OC")). No one can seriously debate that an investor who is explicitly told that it would get no representations about asset quality, cannot reasonably expect to be told how the quality of those assets was determined. There is also no allegation, let alone proof, that description of the collateral in the Offering Circular or the list of the collateral given to the investors was false or misleading in any way. There is no allegation or proof that **any** of the assets in the asset pool were bad. There is no allegation or proof that the Respondents did not properly manage Octans I post-closing. In other words, the investors in Octans I received exactly what they were promised. As such, the investors were neither deceived nor defrauded.

All investors in Octans I understood the exact bundle of rights they had received. The investors who purchased Octans I notes were all highly sophisticated institutions, each of whom attested to its sophistication as **a condition of receiving** the Offering Circular. They represented and warranted that they were sophisticated, able to bear the risks of their investments, and obtained all necessary information needed to make **their own independent decisions** to purchase the notes. (*See* Resp. Ex. 2 at 221, 222, 225 (OC).)

Let us be clear: we are not making a reliance argument. As discussed more fully below at Section XXII.A.3., fraud, at its core, is deprivation of the benefit of the bargain though falsity. The deception on which fraud may be predicated, therefore, has to go to the core of the bargain itself not to anything extraneous. For these reasons, in order to establish a violation of any of the anti-fraud provisions, the SEC must prove, among other things, a "stringent connection" between the alleged fraud and the offer or sale of securities. *See Chem. Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984). As the Second Circuit specified, unless the alleged fraud concerns the value of the securities bought or sold, or the consideration received in return, such fraud is not "in connection with" or "material to" the purchase or sale of a security. *Id.* As demonstrated below, there was no falsity in this case; asset selection was consistent with the relevant standards and representations. But even if there were misrepresentations or omissions relating to asset selection, there would be no fraud here because any such misrepresentations would have been entirely collateral and would have had nothing to do with **the value** of the Octans I notes, *i.e.*, with the question of whether the investors received the benefit of their bargain.

Separately, it is well settled that no duty to complete a statement arises unless the speaker makes a statement that would be misleading if not completed. In other words, the duty to complete a disclosure is only triggered when the defendant chooses to speak on a given topic, and then the duty relates only to the topic at issue. *See In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 366 (2d Cir. 2010) (holding that when a defendant "makes a disclosure about a particular topic," it must be complete and accurate but that defendant is not required "to disclose the entire corpus of [its] knowledge" (emphasis added)); *In re Sanofi-Aventis Sec. Litig.*, 774 F. Supp. 2d 549, 561 (S.D.N.Y. 2011) (same and collecting cases). Because the Offering

Circular did not address either the process of selection or the process of sourcing the collateral that was in the deal at closing, the Offering Circular did not need to say anything about Harding's manner of asset selection or asset acquisition.

In sum, there can be no fraud and no investors could have been misled because each investor bargained for a bundle of rights that consisted of the rights spelled out in explicit detail in the Offering Circular and nothing more. The Offering Circular gave no investor the right to know anything about how Respondents selected a particular security (so long as the security itself and the entire asset pool met all eligibility and investment criteria set forth in the Offering Circular), and no reasonable investor who received the Offering Circular could have expected to know how Respondents selected particular assets.

A. Note Holders' Rights Were Spelled Out In The Final Offering Circular.

The Offering Circular was the sole offering document for the sale of Octans I securities. The Pitch Book was not an offering document. (*See* Section VIII.B.) The Offering Circular made all that evident in *haec verba*:

> In addition, a prospective investor may have received a prospective investor presentation or other similar materials from the Initial Purchaser or the Placement Agent. Such a presentation may have contained a summary of certain proposed terms of a hypothetical offering of securities as contemplated at the time of preparation of such presentation in connection with preliminary discussions with prospective investors in the Securities. However, as indicated therein, no such presentation was an offering of securities for sale, and any offering is being made only pursuant to this Offering Circular. **Given the foregoing and the fact that information contained in any such presentation was preliminary in nature and has been superseded and may no longer be accurate, neither any such presentation nor any information contained therein may be relied upon in connection with a prospective investment in the Securities.**

(Resp. Ex. 2 at 68 (OC).) Prospective investor presentations include the Pitch Book and the term sheet. Clearly, therefore, no offer or sale of the notes was made by means of the Pitch Book or

any other similar materials circulated by Merrill Lynch before it distributed the final Offering Circular.[62]

The Offering Circular also contained **the entire** set of rights received by and representations made to the investors. It said, in relevant part:

> **NO PERSON IS AUTHORIZED IN CONNECTION WITH ANY OFFERING MADE HEREBY TO GIVE ANY INFORMATION OR MAKE ANY REPRESENTATION OTHER THAN AS CONTAINED HEREIN AND, IF GIVEN OR MADE, SUCH INFORMATION OR REPRESENTATION MUST NOT BE RELIED UPON** AS HAVING BEEN AUTHORIZED BY THE ISSUER, THE CO-ISSUER, THE INITIAL PURCHASER, THE PLACEMENT AGENT, THE COLLATERAL MANAGER, THE HEDGE COUNTERPARTIES OR ANY OF THEIR RESPECTIVE AFFILIATES.

(Resp. Ex. 2 at ii (OC) (emphasis added).)

B. The Bundle Of Rights.

The Offering Circular said **absolutely nothing** about how Harding had gone about selecting and sourcing the collateral that was in the deal at closing. Instead, after a lengthy enumeration of the various risk factors attendant to investing in the Notes, the Offering Circular focused first on the terms of the Notes, the Preferred Securities, and the Indenture (the primary agreement that fixed the bundle of property rights that each tranche of notes represented). (*See* Resp. Ex. 2 at 76-127 (OC).) Here the Offering Circular covered items like: the structure of the Notes, the interest, the repayment of principal, redemption, cancellation, priority of payments, and events of default and remedies. (*Id.*) The Offering Circular next focused on the ratings of the Notes. (*See id.* at 128-30.) It then focused, of course, on the security for the Notes, including describing the CDS and the reference obligations. (*See id.* at 134-91.)

[62] The first page of the **Preliminary** Offering Circular, dated August 14, 2006, cautioned that: "The Offering Circular is subject to completion and amendment. The securities offered herein may not be sold nor may offers to buy such securities be accepted prior to the time that a final offering circular is completed." (Resp. Ex. 1 at Cover Page (Preliminary Offering Circular).)

The Offering Circular next devoted over ten pages to specifying what criteria the collateral had to have met as a condition of the deal closing. (Resp. Ex. 2 (OC) at 137-148.) These Eligibility Criteria "are critical restrictions on what this CDO can purchase." (Suh 3022:15-3025:4; 3026:5-11.)

Among other things, as disclosed in the Offering Circular, no less than 10% of the portfolio was to be rated lower that Baa3 by Moody's and BBB- by Standard & Poor's ("S&P") (*id.* at 138); there could be no Defaulted Securities, Credit Risk Securities, Equity Securities, or Written Down Securities (*id.* at 139); and there were additional limits, such as on single issuer concentrations (*Id.* at 144). Pausing for a second on Credit Risk Securities, this meant that Harding believed that no security had a significant risk of declining in credit quality or value or becoming a defaulted security.[63] There was no allegation and is no evidence that any of the collateral securities were "Credit Risk Securities." As Mr. Suh explained, "it is very important that these securities not be impaired when they're acquired by the issuer. So you can't have a security that is likely to become a defaulted security. You can't have [an] equity security for, among other things, tax reasons. And you can't have what's called a written down security, which basically is an impaired security in the RMBS, CMBS context." (Suh 2991:5-2992:6.)

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[63] As defined in the Indenture, as well as the Offering Circular, a "'Credit Risk Security' means any Collateral Debt Security that the Collateral Manager believes, subject to the Standard of Care in the Collateral Management Agreement (as of the date of the Collateral Manager's determination based upon currently available information), has, since such Collateral Debt Security was purchased by the Issuer, a significant risk of declining in credit quality or value (or, there has occurred, or is expected to occur, a deterioration in the quality of the underlying pool of assets) or, with a lapse of time, a significant risk of becoming a Defaulted Security; *provided* that, during any Limited Discretion Period a Collateral Debt Security shall not be a Credit Risk Security unless either (a) such Collateral Debt Security has been downgraded by Moody's at least one or more rating subcategories since it was acquired by the Issuer or placed by Moody's on a watch list with negative implications since the date on which such Collateral Debt Security was purchased by the Issuer or (b) such Collateral Debt Security has experienced an increase in credit spread of 10% or more of the credit spread at which such Collateral Debt Security was purchased by the Issuer, determined by reference to an applicable index selected by the Collateral Manager." (Resp. Ex. 2 at 257 (OC); Resp. Ex. 4 at 19 (Indenture).)

There was no allegation and there is no evidence that any of the collateral securities were "Credit Risk Securities."

Further, the collateral also had to meet the following collateral quality tests as a condition of closing the deal: "Moody's Asset Correlation Test, the Moody's Maximum Rating Distribution Test, the Moody's Minimum Weighted Average Recovery Rate Test, the Weighted Average Spread Test, the Weighted Average Coupon Test, the Weighted Average Life Test, the Standard & Poor's Minimum Recovery Rate Test . . . [and] Standard & Poor's CDO Monitor Test" all of which were described in detail in the Offering Circular. (*See id.* at 169-70, 174.) These tests measure the performance of the collateral pool. For example:

> The Standard & Poor's CDO Monitor calculates the cumulative default rate of a pool of Collateral Debt Securities consistent with a specified benchmark rating level based upon Standard & Poor's proprietary corporate debt default studies. In calculating the Class Scenario Default Rate, the Standard & Poor's CDO Monitor considers each obligor's most senior unsecured debt rating, the number of obligors in the portfolio, the obligor and industry concentration in the portfolio and the remaining weighted average maturity of the Collateral Debt Securities and calculates a cumulative default rate based on the statistical probability of distributions of defaults on the Collateral Debt Securities.

(*Id.* at 175.)[64]

Consistent with the rest of the Offering Circular, in the section dealing with portfolio acquisition at closing, the portfolio description is limited to, again, the Investment Guidelines and nothing else:

> _Acquisition of Collateral Debt Securities._ All or most of the Collateral Debt Securities Acquired by the Issuer on the Closing Date will be Acquired from a portfolio of Collateral Debt Securities selected by the Collateral Manager and held by MLI, an affiliate of MLPFS, pursuant to warehousing agreements between MLI and the Collateral Manager. Some of the Collateral Debt Securities subject to such warehousing agreement may have been originally acquired by MLPFS from the Collateral Manager or one of its affiliates or clients and some of the Collateral Debt Securities subject to such warehousing agreements may include securities issued by a fund or other entity owned, managed or serviced by the Collateral Manager or its

[64] These criteria and demands—specifically outlined in the Offering Circular—severely restricted what Harding could select for Octans I. (*See* Section I.B.)

affiliates. **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.** The Acquire price payable by the Issuer for such Collateral Debt Securities will be based on the purchase price paid when such Collateral Debt Securities were Acquired under the warehousing agreements, accrued and unpaid interest on such Collateral Debt Securities as of the Closing Date and gains or losses incurred in connection with hedging arrangements entered into with respect to such Collateral Debt Securities. Accordingly, the Issuer will bear the risk of market changes subsequent to the Acquisition of such Collateral Debt Securities and related hedging arrangements as if it had Acquired such Collateral Debt Securities directly at the time of purchase by MLI of such Collateral Debt Securities and not the Closing Date.

(Resp. Ex. 2 at 66 (OC) (emphasis added).)[65]

C. Note Holders Received What They Were Promised.

All of the investment criteria and strict tests were met and all ratings were achieved.[66] There is no evidence to the contrary, nor could there be. Neither is there any evidence that the credit ratings were incorrect or obtained by means of incomplete or incorrect information. It is uncontested that, regardless of what occurred on May 31, 2006, Mr. Chau and Harding certified (as did others), at the closing of Octans I, that they understood the Eligibility Criteria and

[65] As discussed more fully at Section IX.C., the failure to mention that there was a third party to the warehouse was entirely unintentional; it was an oversight by the relevant lawyers. Regardless, the Warehouse Agreement had expired at closing. (Resp. Ex. 123 at A-12; Resp. Ex. 124 (signatures pages for Warehouse Agreement).) There was, therefore, no requirement to mention the Warehouse Agreement. (As noted, in fact, the Aquarius offering circular made no mention of a warehouse.) The mention of the warehouse here was provided merely as background. Specifically, this disclosure dealt with the nature of the securities placed in the deal, meaning it informed the reader that the initial collateral portfolio had been accumulated prior to closing and would be transferred to the CDO but only if each of the transferred assets and the portfolio as a whole met all Eligibility Criteria. It also informed the reader that any asset transfer would be made at the purchase price at which the asset was acquired while the portfolio was being accumulated pre-closing, such that any diminution in value would be borne by the deal. (Suh 2987:4-2988:10; *see also* Resp. Ex. 2 at 66 (OC).) Note that in the last two sentences, the relevant information is conveyed without mentioning the word "warehouse." It is therefore completely immaterial, indeed irrelevant, who all the parties to the Warehouse Agreement had been or what rights they may have had in the warehouse, so long as the portfolio met all Eligibility Criteria. With this as context, it is very understandable how Magnetar's name would be omitted from this disclosure; Magnetar's role in the warehouse had nothing to do with its purpose and intent. (*See* Suh 2988:11-2988:25; *see also* Resp. Ex. 2 at 66 (OC).) Note too that the disclosure alternatively mentions "warehouse agreements" (plural, but there was only one) and "warehouse agreement" (singular), further suggesting that no one looked at it very carefully. In any event, this is not the portion of the Offering Circular for which Harding had disclosure responsibility. *See* Section IX.B.

[66] (*See* Resp. Ex. 59 (S&P's ratings of Notes); Resp. Ex. 58 (S&P rating of Super Senior Swap); Resp. Ex. 60 (Moody's Rating Letter).)

reviewed each of the Collateral Debt Securities, and that, among other things, each security met the Eligibility Criteria, including that it was not a Credit Risk Security. Mr. Chau and Harding certified as follows:

> By his signature below, **Wing Chau, the president of Harding Advisory hereby certifies that** (i) the information set forth in Schedule A to the Indenture [the list of assets at closing] is correct in all material respects, (ii) he has reviewed and understands the definition of a Collateral Debt Security and the Eligibility Criteria, (iii) **he has reviewed each of the Collateral Debt Securities acquired by the Issuer on the Closing Date and confirmed that each satisfies all of the requirements in the definition of a Collateral Debt Security and the Eligibility Criteria** and (iv) he confirms that, in acquiring the Collateral Debt Securities, Harding has observed and complied with, and will continue to observe and comply with, the guidelines attached as Exhibit A [Investment Guidelines] to the Collateral Management Agreement.

(Resp. Ex. 53 at 1(Collateral Manager's Certificate).)[67] Because Credit Risk or Defaulted Securities would not have met the Eligibility Criteria, in effect, Harding and Mr. Chau certified that Harding reviewed each security for Octans I and did not believe that there was "a significant risk of declining in credit quality or value (or, there has occurred, or is expected to occur, a deterioration in the quality of the underlying pool of assets) or, with a lapse of time, a significant risk of becoming a Defaulted Security" for each security. (Resp. Ex. 2 at 257 (OC); Resp. Ex. 4 at 19 (Indenture).)[68]

This work involved a thorough review of each asset by several members of Harding. Mr. Chau explained:

> Yes, a lot of work was done. I and the CDO team, which consisted of Xi Chen and myself and Theo Pan and probably Brett Kaplan[,] would run all the bonds through to

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[67] The Division actually cites this document in its brief; however, it skips over the section dealing with Harding's certification that Harding and Mr. Chau independently reviewed and approved each asset as part of the certification process prior to the Closing. Rather, the Division offers a tortured reading of the Certificate to assert only that Mr. Chau reviewed the entire Offering Circular. (Div. Br. at 123) It again skipped an important part of that document, wherein Mr. Chau **only** certified that the information in the four sections of the Offering Circular that contained information on Harding did not include any untrue statement of a material fact or omit a material fact. (Resp. Ex. 53 at ¶ 1.) Those sections of the Offering Circular are not at issue.

[68] (*See* note 63 (definition of Credit Risk Security).)

make sure that the collateral within the warehouse meets the eligibility criteria of the new CDO that's being created. And to the extent that any of those assets that don't meet that criteria, we need to flag it and show it to the investment bank. But the process would be we would get the portfolio, rerun all our criteria assessments. We would then tie out with the investment bank, the underwriting bank, because they need to verify our computations that all these securities meet the various eligibility criteria tests, the weighted average rating factors, the weighted average spread tests. There are 20 pages of eligibility criteria that we need to certify to so we could run all those analyses. And then the structuring agent, in this case Merrill Lynch, would also have to—would parallel processing it but would also reconcile with us. And, ultimately, the rating agencies, before they give us the rating agency confirmation later, would also validate that the eligibility criteria is met.

So there [are] a lot of checks and balances that go through it but we would need to reconcile all those with the investment bank, with the trustee, with the rating agencies.

(Chau 4252:19-4253:25.) If any asset failed or caused the portfolio to fail, Harding would flag it for the investment bank, Merrill Lynch. (Chau 4252:19-4253:25.) Again, there is not a shred of evidence contesting that every single one of the assets in Octans I met the Eligibility Criteria. Moreover, the Division has not challenged or contested that Harding re-evaluated and analyzed each asset in the Octans I portfolio, including its credit worthiness, as part of this closing certification.[69] In sum, the evidence is clear, consistent, and uncontroverted that Harding and Mr. Chau reviewed and approved each asset at closing, and that they had a good faith basis for doing so. (*Id.*)[70]

Other parties, who undertook their own analysis and review, came to the same conclusion and certified that each asset in the ramped portfolio at closing met each of the Eligibility Criteria

[69] The Division makes much ado about the fact that Mr. Huang may not have reviewed Ms. Lieu's credit decision on the ABX Index assets on May 31, 2006, and thus concludes that Harding failed to have a portfolio manager review the asset. Mr. Huang, Ms. Wang, and Mr. Chau all testified that on or around the credit review of an asset, someone in management also reviewed the asset to make sure that it met the Eligibility Criteria. (Wang 524:10-17; Huang 1262:7-25; Chau 4471:22-4473:25.)

[70] The Court can rule for the Respondents on this basis alone because even if there were some defect in the selection of assets that took place earlier in the ramp-up period, any such defect had been fixed as part of the process of certification. One useful way to think about that is that the certification process is a break in causation; every decision made during the warehousing to include an asset in the collateral pool is either ratified or overruled as part of this process. That is the entire point of this certification. (*See* Suh 3022:15-3025:4.)

and collateral quality tests. For example, the Issuer, independent of anything having to do with Harding and in conjunction with the accountants for the deal, Deloitte & Touche LLP,[71] certified the following:

> On the date hereof, the Issuer has acquired or entered into commitments to purchase Collateral Debt Securities having an aggregate par amount of not less than U.S. $1,350,000,000. A Director of the Issuer and the Independent Manager of the Co-Issuer each hereby certifies that (a) he has reviewed the definition of a Collateral Debt Security in the Indenture, (b) he has reviewed the offering documents for the Collateral Debt Securities acquired by the Issuer on the Closing Date (including, to the extent applicable, by the entry into commitments to purchase Collateral Debt Securities) and confirmed that (i) each satisfies the requirements in the definition of a Collateral Debt Security in the Indenture and (ii) each satisfies or will satisfy, as the case may be, all terms and conditions applicable to such purchases as set forth in the Collateral Management Agreement or in the Indenture as of the date of purchase or commitment to purchase (if earlier) and (c) such Collateral Debt Securities have been delivered or pledged to the Trustee on behalf of the Secured Parties pursuant to the terms of the Indenture.

(Resp. Ex. 55 at 2 (Co-Issuers' Certificate) (emphasis added).)

D. The Offering Circular Specified That The Note Holders Were Not Receiving Any Representations About The Quality Of The Collateral.

What is most significant, however, is that the Offering Circular **specifically stated that the note purchasers were not getting any representations about the quality of the synthetic collateral** in the pool and had to rely on their own analysis of the collateral before deciding to invest. This case is about asset selection, meaning it is about whether Harding thought it was selecting "disfavored" assets for Octans I to accommodate Magnetar. Setting aside the fact that the Division **is not even claiming** that the relevant so-called "disfavored" assets were of lower quality than other assets that were considered for the deal (*see* Section XVI), a fraud theory cannot be based on inclusion of any such "disfavored" assets for the simple reason that the Offering Circular specifically told potential investors that they were not getting any representations about the quality of the collateral. We cannot repeat this often enough: the bundle

[71] (*See* Resp. Ex. 56 (Independent Accountant's Report dated Sept. 25, 2006).)

of rights received by the investors could not include the right to have assets chosen in any particular manner when (1) the Offering Circular stated that that no representations about asset quality were being made in connection with the offering, and (2) the investors were specifically told that they had to determine the quality of **each of the pool assets by themselves**. (Resp. Ex. 2 at 52 (OC).)

All investors received a list of assets (which was included as Schedule A to the Indenture).[72] All of them, as set forth in more detail below, were capable of determining for themselves (and agreed to do so as a condition to purchasing the Octans I Notes—also see below) whether the collateral assets were right for them. Here is what the Offering Circular listed among the Risk Factors:

> Limited Information Regarding Reference Obligations. ***No information on the credit quality of the Reference Obligations is provided herein.*** **The holders of Securities will *not* have the right to obtain** from the Synthetic Security Counterparty, the Issuer, the Collateral Manager, the Placement Agent, the Initial Purchaser or the Trustee **information on the Reference Obligations or information regarding any obligation of any Reference Obligor (other than the limited information set forth in the monthly reports delivered pursuant to the Indenture).** The Synthetic Security Counterparty will have no obligation to keep the Issuer, the Trustee or the holders of Securities informed as to matters arising in relation to any Reference Obligation, including whether or not circumstances exist under which there is a possibility of the occurrence of a Credit Event or a Floating Amount Event. None of the Issuer, the Trustee, the Noteholders or the Holders of Preferred Securities will have the right to inspect any records of the Synthetic Security Counterparty relating to the Reference Obligations.
>
> **None of** the Issuer, the Trustee, the Preferred Security Paying and Transfer Agent, the Collateral Manager or **the holders of the Securities will have the right to inspect** any records of the Credit Default Swap Counterparty or any other Synthetic Security Counterparty or **the Reference Obligations,** and the Credit Default Swap Counterparty and other **Synthetic Security Counterparties will be under no**

[72] (Resp. Ex. 4 at Schedule A (Indenture); *see also* Resp. Ex. 2 (OC) at 13 ("An investor or prospective investor in Securities may request from the Trustee a list of the Collateral Debt Securities which the Issuer has acquired."); Suh 2968:24-2969:6 (testifying that this provision is "an invitation to any investor or prospective investor in the securities that are being offered to get from the trustee a list of the assets that the issuer has obtained.").)

obligation to disclose any further information or evidence regarding the existence or terms of any obligation of any Reference Obligation or any matters arising in relation thereto or otherwise regarding any Reference Obligation, any guarantor or any other person, unless and until, in the case of a Long Credit Default Swap, a Credit Event has occurred and the Credit Default Swap Counterparty or other Synthetic Security Counterparty in its capacity as buyer of protection provides a Notice of Publicly Available Information to the Issuer evidencing the occurrence of such Credit Event as required under the terms of the related CDS Credit Default Swap or other Synthetic Security. **A prospective investor should *review the prospectus, prospectus supplement or other offering materials* (and any servicer or trustee reports) *for each Reference Obligation* prior to making a decision to invest in the Securities.**

(Resp. Ex. 2 at 52 (OC) (emphasis added).)

What this means in plain English is that (1) unless there was a default or other specifically defined deterioration in credit of an underlying security, the prospective note purchasers would have no right to get information from anyone involved in the creation or maintenance of Octans I, including Harding, about the quality of the synthetic collateral and (2) prospective investors had to do their own analysis of the synthetic collateral by, among other things, reviewing the deal documents as well as performance results for **each** Reference Obligation. (*See* Suh 3039:9-3040:20.)

Another important aspect of this disclosure is it highlights the difference between what the investors could review before closing and what would be available to them after. Before closing, investors received the list of the reference obligations and they were expected to do their own analysis of the pool assets in connection with making their investment decision. After the closing, on the other hand, investors would get no information about assets in the portfolio, aside from the limited information contained in the periodic trustee reports. To the extent information about the collateral manager is included in the Offering Circular, therefore, it is there to describe collateral manager's **capabilities** for managing the deal **after** closing when the information available to the investors would be very limited. (*See* Suh 3048:18-3049:6.)

This was not the only place in the Offering Circular where prospective purchasers were told that they had to do their own review of the collateral; the Offering Circular is replete with such warnings. The first Risk Factor disclosure in the Offering Circular related to investor suitability. It stated:

> Investor Suitability. An investment in the Securities will not be appropriate for all investors. **Structured investment products, like the Securities,** are complex instruments, and typically involve a high degree of risk and **are intended for sale only to sophisticated investors who are capable of understanding and assuming the risks involved. Any investor interested in purchasing Securities should conduct its own investigation and analysis of the product** and consult its own professional advisers as to the risks involved in making such a purchase.

(Resp. Ex. 2 at 18 (OC) (emphasis added).)[73]

Another Risk Factor relating to the collateral also specifically informed potential investors that they had to do their own analysis of the credit risks of the collateral assets:

> Nature of Collateral. **The Collateral is subject to credit, liquidity, interest rate, market, operations, fraud and structural risks.** A portion of the Collateral will be Acquired by the Issuer after the Closing Date, and, accordingly, the financial performance of the Issuer may be affected by the price and availability of Collateral to be purchased. The amount and nature of the Collateral have been established to withstand certain assumed deficiencies in payment occasioned by defaults in respect of the Collateral Debt Securities. See "Ratings of the Securities." If any deficiencies exceed such assumed levels, however, payment of the Notes and distributions on the Preferred Securities could be adversely affected. To the extent that a default occurs with respect to any Collateral Debt Security and the Issuer sells or otherwise disposes of such Collateral Debt Security, it is not likely that the proceeds of such sale or Disposition will be equal to the amount of principal and interest owing to the Issuer in respect of such Collateral Debt Security.
>
> **Reliable sources of statistical information do not exist with respect to the default rates for many of the types of Collateral Debt Securities eligible to be purchased by the Issuer. In addition, historical economic performance of a particular type of Collateral Debt Securities is not necessarily indicative of its future performance.** ***Prospective purchasers of the Securities should consider and determine for themselves***

[73] (*See also* Suh 2970:16-2971:6 (testifying that this provision means that "any investor that is interested in these securities should conduct their own investigation and analysis and consult professional advisors about the risk of the investment.").)

the likely level of defaults and the level of recoveries on the Collateral Debt Securities and the resulting consequences on their investment in the Securities.

(Resp. Ex. 2 at 26-27 (OC) (emphasis added).)[74]

Similarly, here is the Risk Factor disclosure relating to possible credit events for the collateral:

> Adverse Effect of Credit Events and Floating Amount Events. **Payments on the Notes and distributions on the Preferred Securities will be adversely affected by the occurrence of Credit Events or Floating Amount Events under the Synthetic Securities.** If a Floating Amount Event occurs, the Synthetic Security Counterparty will have a contingent obligation to reimburse the Issuer for the amount paid in the event of an Interest Reimbursement or Principal Reimbursement by the Reference Obligor. However, there is no guarantee that a reimbursement of payments in respect of such Floating Amount Event will occur or that reimbursement will fully compensate the Issuer, particularly because the Synthetic Security Counterparty will not pay interest on such amount to the Issuer. This will reduce the Interest Proceeds available to pay expenses of the Issuer, interest on the Notes and distributions on the Preferred Securities on each Quarterly Distribution Date.
>
> Whether and when to declare a Credit Event and to deliver any notice that a Credit Event or a Floating Amount Event has occurred under a Long Credit Default Swap will be in the sole discretion of the Credit Default Swap Counterparty, and none of the Credit Default Swap Counterparty or any of its affiliates will have any liability to any Noteholder, any Holder of Preferred Securities or any other person as a result of giving (or not giving) any such notice under any Long Credit Default Swap. If a "Writedown," "Failure to Pay Principal" or (solely with respect to a Credit Event under a CDO PAUG Credit Default Swap) "Failure to Pay Interest" occurs, the Credit Default Counterparty may elect to require the Issuer to pay the Floating Amount or to treat it as a Credit Event and require the Issuer to pay the Physical Settlement Amount under such Long Credit Default Swap.
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> There is no guarantee as to the ability of the Issuer to sell or the timing of the sale of Deliverable Obligations delivered to the Issuer under Unhedged Long Credit Default Swaps, or whether the amount of Disposition Proceeds received by the Issuer upon the sale of such Deliverable Obligations will equal the Physical Settlement Amounts paid by the Issuer following the occurrence of the related Credit Events. Principal Proceeds available to pay the principal amount of the Notes and the Preferred Securities on any Redemption Date, at Stated Maturity or on the Accelerated Maturity Date also will be reduced by each Floating Amount (other than in respect of an Interest Shortfall) and

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[74] (*See also* Suh 2975:5-2976:12 (testifying that this provision informs the investors that "it is important for you to know how the collateral performance is going to affect your returns pursuant to a very complex set of prior payments terms. So it is very important that the investors know about the underlying assets.").)

each Physical Settlement Amount paid by the Issuer under Unhedged Long Credit Default Swaps.

The concentration of Reference Obligations in any one industry or geographic region, in any one originator or servicer or in any one Specified Type of Asset-Backed Security will subject the Securities to a greater degree of risk of loss resulting from defaults within such industry or geographic region, defaults by such originator or servicer or defaults among that Specified Type of Asset-Backed Security.

Prospective purchasers of the Securities should consider and determine for themselves the likely levels of Credit Events and Floating Amount Events during the term of the Securities and the impact of such Credit Events and Floating Amount Events on their investment.

(Resp. Ex. 2 at 50 (OC) (emphasis added).)[75]

Finally, again in the Disclaimer portion of the Offering Circular, in all capital letters, the following statement appears:

FOR THESE REASONS, AMONG OTHERS, **AN INVESTMENT IN THE SECURITIES IS NOT SUITABLE FOR ALL INVESTORS AND IS APPROPRIATE ONLY FOR AN INVESTOR CAPABLE OF (A) ANALYZING AND ASSESSING THE RISKS ASSOCIATED WITH DEFAULTS, LOSSES AND RECOVERIES ON, REINVESTMENT OF PROCEEDS OF AND OTHER CHARACTERISTICS OF ASSETS SUCH AS THOSE INCLUDED IN THE COLLATERAL** AND (B) BEARING SUCH RISKS AND THE FINANCIAL CONSEQUENCES THEREOF AS THEY RELATE TO AN INVESTMENT IN THE SECURITIES.

IT IS EXPECTED THAT PROSPECTIVE INVESTORS INTERESTED IN PARTICIPATING IN THIS OFFERING ARE WILLING AND ABLE TO CONDUCT AN INDEPENDENT INVESTIGATION OF THE RISKS POSED BY AN INVESTMENT IN THE SECURITIES.

(Resp. Ex. 2 at iv (OC) (emphasis added).)

The testimony at the Hearing established that investors expected to receive the rights spelled out in the Offering Circular and nothing else. (*See* Doiron 1958:15-1965:13; 1966:11-20; 1968:3-1971:2 (testifying that the collateral and the structure of Octans I was central to the

[75] (*See also* Suh 2970:16-2971:6 (testifying that this provision informs the investors that they "need to understand for themselves that—about the likely levels of credit events and other floating amount events under these derivatives during the term of the CDO notes and equity.").)

investment decision); Edman at 2504:17-25 (testifying that the underlying assets of the CDO, the structure of the CDO, and the waterfall were what was important in making an investment decision); Edman at 2560:17-2563:7) (testifying that he did not feel the need to conduct due diligence on the CDO manager even if it was a managed deal, because Morgan Stanley assumed that the deal "was managed to its minimum requirements in terms of collateral quality," which were spelled out in the Offering Circular); Jones at 2864:14-2865:19 (testifying that the structure, terms, and Maxim's analysis of the underlying collateral informed the investment decision); *see also* (Chau 1849:15-1850:3 (testifying that price of the securities, the collateral structure, and the credit ratings were material).)[76]

Even Mr. Wagner agreed that the bundle of rights the prospective investors received was in the Offering Circular. (Wagner 4644:23-4645:8 (Q: Right. It is in the offering circular. Everybody knows what rights they are getting and not getting? A: Yes.).)

1. In order to buy Octans I notes, prospective investors had to certify that they were sophisticated institutions who understood the risks.

Octans I was a Rule 144A offering; all prospective investors had to certify that they met the definition of a Qualified Institutional Buyer or Accredited Investor in order to be eligible **just to view** the Offering Circular:

> **In order to be eligible to view this e-mail and/or access the Offering Circular or make an investment decision with respect to the securities described therein, you must either (i) be a Qualified Purchaser who is also (1) a "Qualified Institutional Buyer" within the meaning of Rule 144A under the Securities Act of 1933, as amended, or (2) an "accredited investor" within the meaning of Rule 501(a) under the Securities Act** or (ii) not be a "U.S. person" within the meaning of Regulation S under the Securities Act. A "Qualified Purchaser" is (i) a "qualified purchaser" as defined in the United States Investment Company Act of 1940, as amended, (ii) a "knowledgeable employee" with respect to the Issuer within the meaning of Rule 3c-5 under the United States Investment Company Act of 1940, as amended, or (iii) a company beneficially owned exclusively by one or more Qualified

[76] (*See* Section VII.B.; Exhibit G.)

Purchasers and/or "knowledgeable employees" with respect to the Issuer within the meaning of Rule 3c-5 under the United States Investment Company Act of 1940, as amended.

By opening the attached documents and accessing the Offering Circular, you agree to accept the provisions of this page and consent to the electronic transmission of the Offering Circular.

(Resp. Ex. 2 at Cover Page (OC) (emphasis added); *see also* Suh 2970:16-2971:6.)

The Offering Circular required the investors **to represent and warrant** that they: (1) were sophisticated, (2) understood the risks of the investment, (3) had conducted their own analysis of the collateral pool, (4) were capable of sustaining any losses, and (5) would not transfer their notes to anyone else who was not similarly sophisticated (Suh 3013:13-3015:11), to wit:

> Investor Representations on Initial Purchase. **Each Original Purchaser** of Notes (or any beneficial interest therein) **will be deemed to acknowledge, represent and warrant** to and agree with the Co-Issuers, the Placement Agent and the Initial Purchaser, and each Original Purchaser of Preferred Securities (or any beneficial interest therein) will be required in an Investor Application Form to acknowledge, represent and warrant to and agree with the Issuer as follows:
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> * * *
>
> Purchaser Sophistication; Non-Reliance; Suitability; Access to Information. **The purchaser** (a) has such knowledge and experience in financial and business matters that the purchaser **is capable of evaluating the merits and risks** (including for tax, legal, regulatory, accounting and other financial purposes) of its prospective investment in Securities, (b) **is financially able to bear such risk**, (c) in making such investment is not relying on the advice or recommendations of any of the Initial Purchaser, the Placement Agent, the Issuer, the Co-Issuer, the Collateral Manager or any of their respective affiliates (or any representative of any of the foregoing) and (d) **has determined that an investment in Securities is suitable and appropriate for it. The purchaser has received, and has had an adequate opportunity to review the contents of, this Offering Circular. The purchaser has had access to such financial and other information concerning the Issuer and the Securities as it has deemed necessary to *make its own independent decision to purchase Securities*, including the opportunity, at a reasonable time prior to its purchase of Securities, to ask questions and receive answers concerning the Issuer and the terms and conditions of the offering of the Securities.**
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> * * *

> Reliance on Representations, etc. **The purchaser acknowledges that** the Issuer, the Placement Agent, the Initial Purchaser, the Trustee, the Preferred Security Paying Agent, **the Collateral Manager** and others **will rely upon the truth and accuracy of the foregoing acknowledgments, representations, warranties and agreements** and agrees that, if any of the acknowledgments, representations or warranties made or deemed to have been made by it in connection with its purchase of the Securities are no longer accurate, the purchaser will promptly notify the Issuer, the Placement Agent and the Initial Purchaser.

(Resp. Ex. 2 at 222 (OC).)

In sum, these provisions:

> [M]ake it very clear that because of the complicated nature of CDO securities and the potential for loss from those investments, the investors in CDOs must be sophisticated, must understand the risks of investments, not only the transaction structure, transaction terms, but also must have enough sophistication and knowledge about the underlying assets before they can make an investment decision to invest in the CDO securities.

(Suh 2938:11-2939:3; *see also* Suh 2970:16-2971:6.)[77]

Given these representations and warranties, Harding understood and expected that the investors conducted their own analysis on the underlying collateral pool for Octans I. (*See, e.g.*, Lieu 3893:25-3894:13; Chau 1842:8-20; *see also* Resp. Ex. 118 at 4 (Engagement Letter) ("Each purchaser of the Securities will be required to complete a representation letter as to certain matters in the form provided by Merrill Lynch and only prospective purchasers who make the representations set forth in such representation letter will be permitted to purchase Securities.").) Mr. Suh's unchallenged testimony was also that deal participants, including Harding, and their counsel, relied on the representations of the investors that they were sophisticated, had received whatever they needed to make their investment decisions, and had done their own analysis. (Suh 3078:23-3080:4; 3124:16-3125:17.) He explained further that one reason deal participants rely

[77] (*See* Chau 4258:24-4261:2 (testifying that all of the investors were sophisticated); Wagner 4621:7-4622:8 (testifying that these investors needed to know what they were doing in order to invest in CDOs, that the collateral managers and investment banks who invested in CDOs were sophisticated, and that all of these investors do some form of analysis on the underlying bonds).)

on those representations is that deal terms can change materially from the preliminary to the final Offering Circular. (*Id.*)[78]

2. The investors were, in fact, sophisticated and based their investment decisions on their own analysis of the collateral.

Of the twenty-two mezzanine investors who purchased Octans I Notes, twenty-one were other CDO collateral managers[79] and one was a very large commercial bank in Taiwan.[80]

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[78] To the degree that investors did not agree with the Eligibility Criteria or the deal terms, the investors themselves could and did negotiate with Merrill Lynch to change those criteria before they invested. (*See* Chau 4249:8-20 ("[T]he input of the super senior investor, the input of the mezzanine investors, the input of the equity investors all are going to drive what the ultimate eligibility criteria will be for that CDO transaction"); Wagner 4646:6-4647:11; 4654:4-4656:7 (testifying that the investor would work with the structurer if it wanted changes in the deal terms); Doiron 1985:12-1986:22; 1986:12-1988:3 (HIMCO requested changes to Octans I and expected that other prospective investors did the same).)

[79] (Resp. Ex. 750 (Octans I CDO Initial Investor List)). **Bear Stearns Asset Management ("BSAM")**: (Chau 4259:14-16 ("That's a hedge fund, sophisticated hedge fund and CDO manager that was one of the larger players in the CDO industry.")); **Basis Capital Fund Management ("Basis")**: (Chau 4260:25-4261:5 (CDO manager)); **Chotin Group Corporation ("Chotin")**: (Chau 4620:25-4261:5 (CDO manager)); **Cohen Bros. ("Cohen")**: (Resp. Ex. 517 at 3 ("Cohen Bros. was the #1 ranked CDO asset manager from 2004-2005 with over $9.9bn in transaction originated.")); **Credit Suisse Asset Management ("CSAM")**: (Chau 4191:12-19 (CSAM is a CDO manager)); **Declaration Management & Research LLC ("Declaration")**: (Resp. Ex. 518 at 4 ("$13 Billion in assets under management" and "Declaration has completed over $6.9 billion in actively managed structured finance transactions.")); **Deutsche Asset Management ("DEAM")**: (Chau 4260:25-4261:5 (CDO manager)); **Dynamic Credit Partners, LLC ("Dynamic")**: (Resp. Ex. 519 at 4 ("Both principals have long been involved in the CDO and ABS markets.")); **Fortis Investment Management ("Fortis")**: (Chau 4260:25-4261:5 (CDO manager)); **Hartford Investment Management Company ("HIMCO")**: (Doiron 1863:8-13 (HIMCO managed a CDO called Wadsworth)); **Ivy Asset Management ("Ivy")**: (Chau 4260:25-4261:5 (CDO manager)); **Lion Capital Management ("Lion")**: (*See* Resp. Ex. 614 (CDO manager)); **Maxim Advisory LLC ("Maxim")**: (Jones 2798:25-2799:23; 2800:20-2801:23 (CDO manager)); **NIR Capital Management, LLC ("NIR")**: (Resp. Ex. 520 at 8 (NIR's "Managing partners Joe Parish and Scott Shannon have over 25 years of combined experience in managing and structuring investment vehicles backed by diversified portfolios of structured product fixed income investments.")); **Petra Capital Management LLC ("Petra")**: (Jones 2853:10-2854:2 (CDO manager)); **Seneca Capital ("Seneca")**: (Chau 4259:22-24 (Seneca "is a West Coast-based CDO manager and they've been involved in the CDO industry pretty much since the outset of this industry.")); **Solent Capital Manager ("Solent")**: (Chau 4260:25-4261:5 (CDO manager)); **Terwin Money Management LLC ("Terwin")**: (Chau 4260:18-22 (CDO manager. ")); **Tricadia CDO Management ("Tricadia")**: (Resp. Ex. 634 (CDO manager)); **United Overseas Bank Assess Management Limited ("UOB")**: (Resp. Ex. 714 at 4 (UOB "has managed or acted as a co-adviser in 19 CDO transactions, making one of the most experienced CDO manager in Asia.")); **Vanderbilt Capital Advisors ("Vanderbilt")**: (Chau 4260:7-8 (CDO manager).)

[80] (Resp. Ex. 750 (Octans I CDO Initial Investor List); Chau 4261:18-23 (**Cathay United Bank ("CUB")** is "a subsidiary of the banking arm for Cathay Financial Holdings and Lucky Bank based in Taiwan, and I believe they began investing in CDOs at that point in time and have I believe roughly $2 trillion of assets. Actually, I'm mistaken. It says 2 NTM but basically it's a very large bank in Taiwan.").)

Morgan Stanley, one of the world's leading investment banks,[81] entered into a transaction that exposed it synthetically to the super senior risk in Octans I, which comprised the largest investment in Octans I at $975,000,000.[82] Magnetar, as discussed earlier, took the equity position —it purchased the Octans I preferred shares—and was the second largest investor in Octans I with its $94,000,000 long position.[83]

In an effort to present these sophisticated investors as naïfs and dupes who knew nothing about Magnetar, the Division contorts logic and facts. First, the Division argues that the sophistication of the investors did not matter (Div. Br. at 10, 127), which is odd given that this was a Rule 144A offering in which investors were specifically told to rely on their own analysis of the portfolio in making their investment decisions, which all of these investors did.

Second, the Division implied both during its examination of witnesses and in its brief that the investors mainly consisted of pension funds and foreign banks. (*See, e.g.*, Div. Br. at n.25; Test. at 2570:11; 2572:2-3; 2572:18-23; 2573:13-14; 2689:9.) Not a single investor was a pension fund.[84] It is reasonable to think, however, that any pension fund that participated in the CDO market employed sophisticated, knowledgeable professionals who could make informed investment decisions.

The focus on foreign investors reflects more than a hint of condescension; as if distance from New York or the SEC headquarters in Washington, DC, equates to a lack of sophistication

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81 (*See, e.g.*, Edman 2500:15-2501:7 (**Morgan Stanley** invested in the super senior tranche); Chau 4267:5-18 (testifying that Morgan Stanley was "one of the most sophisticated investors in the marketplace"); Edman 2504:2-8 ("I think anybody would have considered [Morgan Stanley] a sophisticated investor."); Edman 2566:19-21 (testifying that Morgan Stanley was one of the world's leading investment banks).)

82 (*See, e.g.*, Resp. Ex. 58 (S&P rating of Super Senior Swap).)

83 (*See* Resp. Exs. 2; 750.)

84 At the Hearing, the Division persisted with this legerdemain until Mr. Prusko testified that he had informal discussions with foreign banks who invested in CDOs from time to time. (Prusko at 2689:9-22.) Magnetar's investors, in fact, included both pension funds and foreign banks. (Prusko 2777:23-2778:13.)

or an inability or relinquishment of responsibility to read an offering document and understand its contents. One of the investors was a foreign bank, Cathay United Bank, which again was an extremely large bank in Taiwan that invested in other CDOs.[85] There were two other foreign investors, Lion and UOB, but both of those entities had extensive experience managing CDOs backed by RMBS and CDOs.[86] In fact, the Division planned to use Mr. Imran Khan from UOB as one of its witnesses at the Hearing. The Division used taxpayer funds to fly him all the way to New York, and had him cool his heels for three days before disclosing that he would not be testifying. (Tr. at 3596:17-3597:8.) Mr. Khan had not spoken with the Respondents' counsel, so we had to learn what he would have said by reading a *Brady* letter according to which, among other things, he would have testified that a compromised investment or credit process would be less important or even unimportant with respect to collateral that had been ramped, presumably because UOB was fully capable of analyzing the portfolio itself and would not have invested unless it did so.[87]

In any event, what all of these investors have in common is that they all manage money on behalf of others or do that and also provide financial advice. That is to say, they employ financial industry professionals bound by fiduciary duties and equipped with professional training to understand the investments they are making on behalf of their firms, even when those

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[85] (*See* note 80; *see also* Resp. Ex. 963 (News Briefs, Taiwan Business News regarding Cathy United Bank and Cathay Financial Holding Co.) (used to refresh Mr. Chau).)

[86] The evidence, in fact, shows that they did analyze the collateral. (Resp. Ex. 580 (UOB receiving the collateral portfolio and rating agency runs); Resp. Ex. 744 (Mr. Khan noting that Octans I "is similar to the ACA Aquarius deal"); Resp. Ex. 743 (UOB's summary analysis of deal and collateral, including "Portfolio is clean with no Neg Am of Fixed Rate assets—very consistent.").) (*See, e.g.*, Resp. Ex. 714 at 28 (UOB "has managed or acted as a co-adviser in 19 CDO transactions, making one of the most experienced CDO managers in Asia."); *HSBC and Lion Capital team up for managed synthetic CDO*, Dow Jones Factiva (Oct. 31, 2006) (Lion is "a portfolio manager based in Singapore with extensive experience in managing CDOs).)

[87] The Division may have refrained from calling Mr. Khan because his testimony would have damaged its case. (*See, e.g.*, Resp. Ex. 884 at 2 (March 27, 2014 Brady Letter from Division re: Statements from Richard Ellson, Imran Khan, and Douglas Jones).)

firms happen to reside in Asia. At a minimum, therefore, these investment professionals were equipped to understand that the Offering Circular was the relevant disclosure document and that the Pitch Book was not.

3. The investors requested and analyzed the underlying collateral in Octans I prior to making their investment decision.

The investors understood that they had to conduct their own independent investigation of the securities and of Octans I itself. (*See, e.g.*, Doiron 1973:3-1974:12; 1976:5-20; Edman 2536:5-2539:3; Jones 2832:6-22; 2849:2-2850:15.) Shortly after receiving the pricing announcement for Octans I on July 19, 2006, the prospective investors asked for the list of the current collateral.[88] For example, one day after receiving the pricing announcement, Ivy, one of the mezzanine note holders, asked Merrill Lynch for (1) the full rating agency analysis, (2) **ramped portfolio**, (3) offering memorandum, and (4) price talk and status on all tranches.[89] And as the deal progressed, but before closing, the investors requested updated lists of the ramped portfolio.[90] Indeed, it is uncontested that investors routinely asked Merrill Lynch for the collateral portfolio for Octans I, which Harding then sent to Merrill Lynch.

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88 (*See, e.g.*, Doiron 1955:21-1956:21 (The HIMCO analyst requested detailed collateral information on Octans I so that he could do his own analysis of the collateral in Intex); Resp. Ex. 524 (Bloomberg message chain between Alison Wang and Joshua Laurito re: hey Alison—who should I ask for the Dorado portfolio? (7/17/2006); Resp. Ex. 809-811 (Ken Lee e-mailed Merrill Lynch the Octans I portfolio in response to requests from Fortis Investments and Solent); Resp. Ex. 538-39; 811-814 (Solent's July 19, 2006 request to Merrill Lynch for the portfolio and Merrill Lynch's response); Resp. Ex. 548, 570-71 (Fortis' July 19, 2006 request to Merrill Lynch for the portfolio and Merrill Lynch's response); Resp. Ex. 815 (Basis Capital's July 20, 2006 request for the portfolio and Merrill Lynch's response); Resp. Ex. 559-562 (HIMCO's July 25, 2006 request for the portfolio and Merrill Lynch's response); Resp. Ex. 688-689 (Merrill Lynch sending the portfolio to Cohen Bros. on August 18, 2006); Resp. Ex. 636, 643-645 (DEAM's August 2006 requests for the collateral and structural information and Merrill Lynch's response); Resp. Ex. 604-606 (HIMCO's August 3, 2006 request for an updated list of collateral and Merrill Lynch's response); Resp. Ex. 596-598 (Lion's August 2006 request for the collateral and Merrill Lynch's response); Resp. Ex. 580-581 (UOB's July 2006 request for the collateral and Merrill Lynch's response).)

89 (Resp. Ex. 820-823 (Ivy's July 20, 2006 request to Merrill Lynch and Merrill Lynch's response) (emphasis added).)

90 (*See, e.g.*, Resp. Exs. 604-606 (HIMCO's August 3, 2006 request for an updated list of collateral and Merrill Lynch's response); Resp. Ex. 746 (August 4, 2006 E-mail from Merrill Lynch to UOB re: Dorado Marketing

(Footnote continued on next page)

Once they had the list of the ramped portfolio, the investors conducted their own credit analysis or independent investigation of the collateral portfolio,[91] which informed the investor's decision to invest.[92] For example, Mr. Doiron explained that HIMCO performed a credit analysis of each RMBS asset in Octans I and on the portfolio as a whole before deciding to invest. (*See* Doiron 1874:11-21; 1875:2-14; 1958:15-1965:13; 1966:11-20; 1968:3-1971:2.) This is the same investor who took over a year instead of the more typical three months to select the RMBS assets and CDOs for its CDO Wadsworth (which was a high-grade CDO originated by Morgan Stanley), stuck to its guns in disputes with Morgan Stanley about which assets to include in the CDO, and invested in fewer CDOs than it planned because other CDOs did not meet its standards. (Doiron 1863:1-1864:10; 1865:8-1868:4; 1876:10-21.) HIMCO engaged in as thorough of a review as a prospective investor could of the underlying collateral of Octans I, and decided that the underlying assets and the portfolio passed its credit analysis. In short, HIMCO, like Harding, did not view the ABX Index assets or indeed any assets in Octans I as disfavored.

More importantly, as the allegations in this case are confined to certain of the ABX Index

Book – Revised (sent updated portfolio); Resp. Exs. 629-630 (August 8, 2006 E-mail from Merrill Lynch to DEAM with updated information, including an updated Octans I Portfolio).)

91 (*See, e.g.*, Doiron 1874:11-21 ("we'd do a quantitative analysis, a base case scenario and stress case scenarios" on the underlying portfolio); 1875:11-14 (HIMCO analyzed the RMBS names in a CDO in which it invested); 1941:2-19 (The HIMCO analysts prided themselves on their individual review of the assets); Jones 2821:2-11 (Maxim reviewed the "loan tape and [tried] to figure out the quality of that entire pool of assets"); Resp. Ex. 743 (UOB AM's analysis and conclusions on the Octans I collateral); Resp. Ex. 728 (HIMCO's analysis of the Octans I deal); Resp. Ex. 614 (Internal Merrill Lynch e-mail, where they discussed that "Lion is comfortable with the collateral/structure.") (August 4, 2006)); Resp. Ex. 611-613 (containing HIMCO's detailed analysis on the underlying bonds in Octans I).)

In fact, the collateral manager investors also had to undergo this analysis of the collateral in order to make certain that the Octans I CDO met the eligibility criteria of the CDO deals in which they placed Octans I. (*See, e.g.*, Jones at 2824:3-2825:13)

92 (*See, e.g.*, Wagner 4601:23-4603:21 (testifying that the investors in CDOs analyzed the underlying collateral before making a decision to invest); Doiron 1944:3-21 (The analysts at HIMCO did not just rely on the Pitch Book, but they did their own analysis of the RMBS assets, including running their own stresses, and defaults); Doiron 2035:25-2036:6 (HIMCO's analyst's conclusion that Harding's knowledge of the collateral was strong came both from his discussions with Harding and his analysis of the underlying collateral); Edman 2521:15-23 (Morgan Stanley rigorously analyzed the underlying assets in Octans I before making an investment).)

assets, investors did not view the ABX Index assets as anything different than the rest of the subprime universe of mezzanine bonds.[93] (Edman at 2542:16-20; Jones at 2830:13-25.) There was no evidence that any investor in Octans I : (1) expressed concerns about the inclusion of ABX Index names or the prices or spreads at which they were included; or (2) noted any credit issues with those assets when they performed their own credit analysis of the portfolio. It is also undisputed that the prospective investors: (1) received a list of the ABX index assets Harding selected;[94] (2) were familiar with the ABX Index and the constituent assets on that index;[95] and (3) conducted their own due diligence or credit review on these assets.[96]

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[93] Any investor push back on the inclusion of the ABX Index was about including the Index as whole; and thus, a perception that the manager was not earning its fees by selecting specific constituent names in the ABX Index that made sense for the CDO. (Chau 2133:3-18.) More fundamentally, there was no evidence that a prospective or actual investor in Octans I even expressed this concern.

[94] As the ABX Index assets at issue were added to the Octans I warehouse in early June 2006 and the lists of the ramped portfolio were circulated in July and August of 2006, these lists included the ABX Index assets. (*See, e.g.*, Resp. Exs. 548-56 (Fortis); 820-823 (Ivy); 815-819 (Basis); 538-39; 811-814 (Solent); 559-562, 578-579, 604-606 (HIMCO); 743, 737 (UOB); 688-689 (Cohen Bros.); 636, 643-645 (DEAM).)

There was one exception (which is the only one cited by the Division) where the ABX-Index-related trading **volume** for Octans I and Octans II was left off a list provided to a prospective (and never actual) super senior investor in Octans I . (Div. Ex. 158 (Internal Harding August 31, 2006 e-mail).) **However**, as is clear from the face of that e-mail, the purpose of the list was not to disclose portfolio assets for Octans I. Rather, the purpose was to demonstrate to the potential investor that Harding did not favor one broker/dealer over another in any of its deals. (*Id.*) In that context, a single ABX Index trade would have skewed the presentation—and, in fact, might have misled —because the execution of a single ABX Index trade involved multiple short trades. The Octans I and Octans II ABX Index trades would have shown trading volume with Merrill Lynch and Wachovia, respectively, that would have overrepresented the normal volume of trading with those two broker/dealers. Knowing that, when asked by Mr. Chau to prepare a spreadsheet showing trading **volume** with different dealers, Mr. Chen suggested excluding the ABX Index trades. (*See id.*)

[95] (*See, e.g.*, Doiron 1961:9-1962:10; Edman 2542:2-9; Jones at 2830:13-25.) In fact, some of the investors worked on and invested in other deals, which included the ABX Index as a whole or the constituent assets. (*See, e.g.*, Edman 2542:10-13; Lasch 153:7-19)

[96] (*See, e.g.*, Doiron 1961:9-1962:10; Edman 2542:16-20.) Two things follow from Mr. Chau's and Harding's understanding that investors were analyzing the portfolio assets in a granular fashion: (1) investors' review provided an independent sanity check that there was nothing wrong with the assets, and (2) Harding understood that its asset selection competence was on display to be assessed by investors, many of whom were their competitors. Harding's reputation, therefore, was on the line. (*See* Section V.)

4. **The Standard of Care provision in the Collateral Management Agreement had nothing to do with how the collateral had been selected during the warehousing period.**

Given the various disclosures in the Offering Circular and the fact that Magnetar's interests were aligned in all material respects with those of the other investors, the Division pivoted and asserted that Respondents were liable because they failed to comply with the standard of care provision in the Octans I Collateral Management Agreement and its summary in the Offering Circular. Essentially, the Division asserted at the Hearing and in pre-hearing filings that (1) the standard of care provision in the CMA required Respondents to select assets during the warehousing phase in a manner consistent with asset selection by other, similarly situated collateral managers, and (2) that any departure from that standard rendered disclosures about comportment with the standard of care misleading. According to this new theory, the Division claims that Respondents would be liable if their conduct consisted of nothing more than negligent selection of assets, regardless of whether there was any accommodation of Magnetar. That was essentially the thrust of the Wagner Report.[97]

Setting aside the merits of this claim, as discussed in Section IV.B., this theory appears nowhere in the OIP. The allegations in the OIP are not merely that Harding promised and failed to comply with the relevant standard of care, but that Harding did so deliberately to "accommodate trades requested by Magnetar," which "Harding's personnel disfavored." (OIP ¶¶ 6, 58) In other words, the OIP did not charge failure to comport with a standard of care in a vacuum. The OIP alleged that the representations about comportment with the standard of care were materially false and misleading **because** the Respondents departed from the standard of care **to accommodate** Magnetar, **whose interests were not aligned with those of other**

97 (*See* note 31.)

investors. Moreover, this disclosure failure was knowing or reckless, according to the OIP. The OIP did not charge any such disclosure failure to be a product of negligence. (*See* Section IV.B.)

That said, the Division also failed to prove that the Respondents were obligated to ramp up the deal during the warehouse stage in accordance with the standard of care set forth in the CMA and the Offering Circular. The standard of care provisions on which this claim is based did not become effective until the CMA became effective on September 26, 2006, long **after** the May 31, 2006, ABX Index asset selection. It governed **prospective** conduct. *i.e.*, it set forth the rules and regulations for Harding's management of the deal **post-closing**. It is a promise of future performance, not a representation about past conduct. During the warehouse period, Harding was bound by the terms of the Warehouse Agreement and the Engagement Letter and nothing else.

In any event, to the extent the CMA imposed an obligation to act in accordance with an industry standard of care in selecting assets, that obligation was limited by the terms of the CMA itself. The **only** thing the CMA required in that regard was that Harding's determination that assets bought for the Octans I portfolio met all Eligibility Criteria and Investment Guidelines had to be made in accordance with the standard of care set forth in the CMA. Of course, as discussed above, any Credit Risk Security, a Defaulted Security, or a Written Down Security (as those terms were defined in the Offering Circular and the Indenture) would not have met Eligibility Criteria. Even then, the Standard of Care provision was not meant to impose an affirmative obligation, it was a defensive provision; it protected Harding from liability if a bad security made it into the portfolio **despite** an asset selection process that comported with the standard of care.

a. ***The Collateral Management Agreement did not specify how Harding had to select collateral for Octans I.***

Harding did not have any contractual or advisory relationship to the Issuer **until** the CMA was executed on September 26, 2006. (*See* Resp. Ex. 490, Minutes of a Meeting of the Board of Directors of Octans I CDO Ltd. (Sept. 25, 2006) ("The portfolio **will be** managed by Harding Advisory as collateral manager . . . pursuant to the Collateral Management Agreement referred to below.").) The very first sentence of the summary of the CMA in the Offering Circular informs the investors that the CMA will cover **prospective** conduct only, to wit:

> **On or prior to the Closing Date**, the Issuer **will** enter into a Collateral Management Agreement (the "Collateral Management Agreement") Harding Advisory LLC (the "Collateral Manager" or "Harding Advisory") whereby the Issuer **will** appoint the Collateral Manager and the Collateral Manager **will** undertake to select all Collateral Debt Securities **to be purchased by the Issuer on the Closing Date** and until the end of the Reinvestment Period and make Hedge Rebalancing Purchases after the Reinvestment Period and to perform certain other advisory and administrative tasks for or on behalf of the Issuer.

(Resp. Ex. 2 at 196 (OC) (emphasis added).)[98] According to this disclosure, no contractual relationship existed during the warehouse period, when the ABX Index assets were selected and when the Warehouse Agreement applied.

A textual analysis of the CMA is necessary because contractual obligations reside in the contract itself. Here is the appointment paragraph:

> Appointment of Collateral Manager. The Issuer **hereby** appoints the Collateral Manager as its investment advisor and manager with respect to the Collateral **on the terms set forth herein** and authorizes the Collateral Manager to perform such services and take such actions on its behalf **as are contemplated hereby** and to exercise such other powers **as are delegated** to the Collateral Manager hereby, in each case, together with such authority and powers as are reasonably incidental thereto.

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[98] Note that while the Offering Circular contains a summary of the CMA, the Offering Circular also states that: "The summaries do not purport to be complete and are qualified in their entirety by reference to such documents, copies of which will be made available to offerees upon request and are available at the office of the Trustee." (*See* Resp. Ex. 2 at v (OC).)

(Resp. Ex. 5 at 3 (CMA) (emphasis added).) It is clear from this provision that Harding was hired as of the effective day of the CMA, September 26, 2006, and that its obligations and powers were cabined by the terms of the CMA. (Suh 3042:11-3044:20.) Again, this is a contract governing future performance only; it is a promise to do something, rather than a representation that something had been done.

That Harding had limited obligations and duties is also reflected in the section of the CMA entitled "Limited Duties and Obligations," it states:

> <u>Limited Duties and Obligations; No Partnership or Joint Venture</u>. **The Collateral Manager shall not have any duties or obligations except those expressly set forth herein or that have been specifically delegated to the Collateral Manager in the Transaction Documents.** Without limiting the generality of the foregoing, (i) the Collateral Manager shall not be subject to any fiduciary or other implied duties, (ii) **the Collateral Manager shall not have any duty to take any discretionary action or exercise any discretionary powers, except discretionary rights and powers expressly contemplated hereby and in the Transaction Documents**, and (iii) except as expressly set forth herein or in the Transaction Documents, the Collateral Manager shall not have any duty to disclose, and shall not be liable for the failure to disclose, any information relating to any issuer of any Collateral Debt Security or any of its Affiliates that is communicated to or obtained by the Collateral Manager or any of its Affiliates. **The Issuer agrees that the Collateral Manager is an independent contractor and not a general agent of the Issuer and that, except as expressly provided herein, neither the Collateral Manager nor any of its Affiliates shall have authority to act for or represent the Issuer in any way and shall not otherwise be deemed to be the Issuer's agent when undertaking any other activities.** Nothing contained herein shall create or constitute the Issuer and the Collateral Manager as members of any partnership, joint venture, association, syndicate, unincorporated business or other separate entity, nor shall be deemed to confer on any of them any express, implied, or apparent authority to incur any obligation or liability on behalf of any other such entity.

(Resp. Ex. 5 at 8-9 (CMA) (emphasis added); *see also* Chau 1510:19-1513:9-15 (testifying that the Issuer was not an "advisory client" because Harding's duties were strictly circumscribed by the CMA).)

As discussed at Section IV.C.8. above, the misalignment of the interest of the different tranches of notes translated into different preferences for the types of collateral, the specific risk

profile of each asset added to the portfolio, and the concentration of risk in the asset pool. Reflecting that reality, under the CMA, Harding's obligations with respect to asset selection were limited to selecting collateral in accordance with the Eligibility Criteria and other defined Investment Guidelines, and nothing else. It stands to reason: the Eligibility Criteria and the Investment Guidelines described in the Offering Circular and the Indenture represented the common denominator that all investors agreed on and expected. For that reason alone, the CMA did not and could not obligate Harding to choose certain assets over others, assuming all assets being considered (and the asset pool overall) met all investment parameters. Here is how "selection" is defined in the CMA:

> Selection. **The Collateral Manager shall select all Collateral to be Acquired by the Issuer in accordance with Eligibility Criteria, the other investment criteria set forth herein and in the Indenture and the Investment Guidelines.** The Collateral Manager shall not cause the Issuer to negotiate the principal terms of loans (including substantial non-periodic payments to a counterparty on a swap agreement) or to hold itself out (and the Collateral Manager will not hold itself out on behalf of the Issuer) as being a lender, broker, dealer, trader or a person otherwise willing to make loans, enter into, assume, offset, assign or otherwise terminate derivative contracts or perform services with or for customers in the ordinary course of business.

Resp. Ex. 5 at 4 (CMA) (emphasis added).)[99]

b. *Harding was to select assets as it saw fit so long as they produced enough cash flow to pay all investors, including equity investors.*

A look at the Investment Objectives provision of the CMA further illustrates these points. Under this provision too, Harding was not required and indeed prohibited from serving the interests of investors who were only long or serving one class of notes over another. It was required, rather, to make sure that the assets it selected were of the type that would produce sufficient cash flow to pay the note holders their expected returns. This provision states:

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99 (*See also* Resp. Ex. 5 at 19 (CMA) (Harding represented that the Collateral Debt Securities complied with the Investment Criteria); Suh 3043:6-3044:12.).)

> Investment Objectives. In performing its duties hereunder, the Collateral Manager shall manage the Collateral with the objective that **Interest Proceeds and Principal Proceeds are sufficient to permit the Issuer**, in accordance with the Priority of Payments, (i) on each Distribution Date or Quarterly Distribution Date, as applicable, **to pay the Interest Distribution Amount with respect to each Class of Notes and principal on the Notes and Class A-1 Swap Availability Fee to the Class A-1 Swap Counterparty in a timely manner and (ii) subject to clause (i), to provide for returns to the Preferred Security holders**; provided, that the Collateral Manager does not guarantee, and shall in no event be liable for, the timely or ultimate performance of any payment obligations of the Issuer (including any payments with respect of the Notes or the Preferred Securities) **and the Collateral Manager's decisions and actions in connection with the pursuit of such objective shall be in accordance with the standard of care set forth herein.**

(Resp. Ex. 5 (CMA) at 7-8 (emphasis added).)[100] In other words, Harding was required to select assets (as it saw fit) that would produce enough cash flow to pay **all** investors, including equity investors, regardless of which class of notes they owned and without any regard to their overall investment objectives. Mr. Wagner made this point as well in his report:

> As a general matter, the Collateral Manager is working in the interest of the CDO's Note and Equity investors, although there may be times that the interests of the various investors may diverge and the Collateral Manager will have to balance those interests as it sees fit within the constraints of each individual CDO's terms.

(Div. Ex. 8001 (Wagner's Report) at ¶ 13(emphasis added); *see also* Wagner 4643:21-4645:8).)

For all these reasons, Division's assertion that Harding was required to use its discretion to add the "best" assets during the warehouse period makes little sense. In this context, there were no "best" assets. That is also why on cross-examination, Mr. Chau testified that while the collateral manager has some discretion in selecting assets, as more than one portfolio of assets

[100] Note the reference to the standard of care. It states that Harding would not be liable for poor performance of the asset pool, unless Harding's decisions and actions in connection with discharging its duties fail to meet the relevant standard of care. This is consistent with how the standard of care is applied throughout these agreements; compliance with the standard of care is a defense against liability. It is there for Harding's benefit. There is a recognition here that the asset pool consists of risky assets backed by subprime loans and a concomitant underlying assumption that some of those assets may default or turn out to be impaired in some way. There is also a tacit recognition of the fact that different investors may have different risk preferences for portfolio assets and some of those may blame the manager for picking weak assets should the more risky assets become impaired. Should that have been the case, Harding would not have been liable if it could have shown that it acted reasonably and in comportment with the standard of care.

will fit Eligibility Criteria, that does not mean that the manager is seeking to add the "best" assets or those with the least credit risk. (Chau 4345:10-4346:13 ("There really isn't a concept of best portfolio in the CDO because bear in mind we have to take into account all the competing interests of the super senior class and the mezzanine class and equity class."); 4348:11-21 ("I think descriptive terms as best, better, greatest, that doesn't weigh into our decision process. The decision process is to look at securities, look at the weighted average rating or the rating factor, look at the spread component at that time, and when you make that decision to add to the portfolio, it has to be accretive to the portfolio. . . . It has added benefit to the CDO trust.");[101] 4121:19-4122:12 ("For the mezzanine investors and the equity investors, they're looking for a higher return on their investment and they need to have exposure to lower rated securities to generate that income to compensate them for that risk/return exposure that they are seeking.)); *see also* Section II).)

c. ***The Standard of Care Provision Did Not Address How Collateral Was Selected Pre-Closing.***

The standard of care provision provided relevant part:

> (n) Standard of Care. The Collateral Manager shall, **subject to the terms and conditions hereof and of the Indenture**, 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. **The Collateral Manager shall comply with all the terms and conditions of the Indenture affecting the duties and functions that have been expressly delegated to it thereunder and hereunder,**

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[101] Although Ms. Wang testified that the Standard of Care provision applied to the manner in which Harding would select assets, she also testified first that: "I am not sure what the documents technically require" and "I don't remember if I had a full understanding of this provision even with the advice of counsel at the time." (Wang 591:13-594:25.) Even then, her answer is consistent with the provision applying to Harding's obligations as defined by the "selection" clause in the Collateral Management Agreement. (*Id.*)

and the Collateral Manager shall have no liability for its acts or omissions hereunder except as provided in Section 5(b) or 5(d).

(Resp. Ex. 5 at 8 (CMA) (emphasis added).) Again, by its terms, this provision is expressly limited to the Collateral Manager's obligations under the Collateral Management Agreement, which commenced on September 26, 2006. Specifically:

Q. When does the standard of care that's in the Collateral Management Agreement, when does it begin to apply?

A. It starts from the closing date.

Q. Of the Collateral Management Agreement?

A. Yes. That agreement—and the indenture, which—the two documents work very closely together, so neither of those documents are affected until the closing date.

Q. In fact, you wouldn't know what to do without the indenture; right?

A. That's right, because all of the eligibility criteria, key definitions, debt collateral, debt securities, [are in the] indenture.

(Suh 3121:21-3122:11; *see also* 3051:4-3052:16.)[102]

For emphasis: nowhere does this provision use the word "selection," "select," "credit review," "credit analysis," "Intex," or "cash flows." Rather, it refers only to the "obligations" that Harding had **under** the Collateral Management Agreement.[103] Moreover, this

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102 Q. What is your understanding of this provision?

A. This is a provision regarding what the standard of care that the collateral manager needs to exercise in connection with the performance of its obligations of the Collateral Management Agreement, as well as the performance of duties that he may have under the indenture. . . .

Q. Exactly what is it that the collateral manager is obligated to do? Because this says: "The collateral manager shall, subject to the terms, perform its obligations hereunder." What is your understanding of what that means, "hereunder?"

A. Hereunder means under the Collateral Management Agreement.

(Suh 3051:16-3052:16.)

103 As discussed elsewhere, Harding had limited agency agreement with the Issuer and had no responsibilities beyond what was in the CMA or the other transaction documents: "The Collateral Manager shall not have any duties or obligations except those expressly set forth herein or that have been specifically delegated to the Collateral Manager in the Transaction Documents." (Resp. Ex. 5 at 8-9 (CMA).)

requirement would be inconsistent with any requirement to select assets in a particular manner. Presumably, asset selection procedures may vary from manager to manager and may change as industry standards evolve. (Jones 2876:18-24.) ("I would state that unequivocally, that not every single person takes the same amount of time to do the same amount of work, and I would say that not everybody looks at things the same way, and I would say that a lot of people look at the exact same evidence and come to different conclusions.").)

In fact, the only specific reference to both the standard of care and asset selection has to do with Credit Risk Securities and Defaulted Securities, and even then, the application of the standard of care is defensive inasmuch as Harding would not be at risk for failing to exclude a weak security unless it **actually believed**, based on then available information and in the exercise of due care, that there was **a significant risk** of a decline in credit quality or value (or, there has occurred, or was expected to occur, a deterioration in the quality of the underlying pool of assets) or, with a lapse of time, **a significant risk of becoming** a Defaulted Security presented itself.[104]

This provision, however, by its own terms, did not apply until after the Issuer purchased the security at issue, *i.e.*, after the deal closed, post-asset selection during the warehouse period. (Resp. Ex. 2 (OC) at 175-177 (discussion of Dispositions of Collateral Debt Securities); Resp. Ex. 4 at 19 (Indenture).) In other words, the issue was never whether some securities were stronger than others; the only issue was whether Harding actually believed at the time of

[104] This fact is inescapable when one reviews the summary of the same provision in the Offering Circular. There, the standard of care provision appears alongside the provision on the "limitations on liability" of the collateral manager. (Resp. Ex. 2 at 196-197 (OC).)

selection that the relevant security presented a significant risk of decline in credit quality or value. It is uncontroverted that there were no such securities.[105]

The manner in which other provisions in the Offering Circular refer to this standard of care corroborates this basic point. These provisions discuss the collateral manager's duties, in disposing of Collateral Debt Securities, post-closing:

> <u>**Dispositions of Collateral Debt Securities**</u>
>
> **The Collateral Debt Securities may be retired** prior to their respective final maturities due to, among other things, the existence and frequency of exercise of any optional or mandatory redemption features of such Collateral Debt Securities. In addition, **pursuant to the Indenture**, **the Issuer may Dispose** of Collateral Debt Securities (including termination, assignment or hedging of Synthetic Securities) in the following circumstances:
>
> (i) **The Issuer may, at the direction of the Collateral Manager**, **Dispose** of (or, in the case of any Synthetic Security, exercise its right, if any, to terminate, hedge or assign) any . . . Credit Risk Security, Credit Improved Security . . . at any time; provided that Disposition of a Credit Improved Security or Credit Risk Security may occur only if the Collateral Manager determines, taking into account any factors it deems relevant, that . . . **Disposition of a Credit Improved Security or Credit Risk Security** may occur only if the Collateral Manager determines, taking into account any factors it deems relevant, that such Dispositions and any related purchases or substitutions will, in the judgment of the Collateral Manager (**exercised in accordance with the standard of care set forth in the Collateral Management Agreement**), benefit the Issuer in one or more of the following manners: an improvement in one or more of the Collateral Quality Tests or (solely for a Credit Improved Security) the Standard & Poor's CDO Monitor Test, an improvement in the credit quality of the portfolio, a narrowing of interest rate mismatches or any other improvement which, in the judgment of the Collateral Manager (**exercised in accordance with the standard of care set forth in the Collateral Management Agreement**), would result in a benefit to the Issuer. . . .
>
> ***
>
> (v) **The Issuer may Dispose** of (or, in the case of a Synthetic Security, exercise its right, if any, to terminate, hedge or assign such Synthetic Security) any Collateral Debt Security that is not a Credit Improved Security, Defaulted Security, Deferred Interest PIK Bond, Equity Security, Credit Risk Security or Written-Down Security **at any time after the Closing Date and prior to the end of the Reinvestment Period** (any such Disposition, termination or assignment, a "Discretionary Disposition"); provided that . . .

[105] (*See* Section VII.C.)

> (II) a Discretionary Disposition may occur only if: . . . (b) the Collateral Manager determines, taking into account any factors it deems relevant, that such Dispositions and any related purchases or substitutions will, in the judgment of the Collateral Manager (**exercised in accordance with the standard of care set forth in the Collateral Management Agreement**), benefit the Issuer in one or more of the following manners. . . .

(Resp. Ex. 2 at 175-177 (OC) (emphasis added).) These provisions presuppose that the closing has occurred—when the indenture and collateral management agreement have already been executed—and now the collateral manager, as part of its management duties, is advising the Issuer to dispose of certain assets.

d. *The investors understood that the Standard of Care provision did not address how collateral was selected pre-closing.*

Because this was a managed deal (discussed in more depth below), the investors focused not on the "discretion" the collateral manager had in selecting the assets during the warehouse phase, but rather the "discretion" the collateral manager had post-closing when the individual investors had no mechanism for opining on the manager's decisions. (*See, e.g.*, Resp. Ex. 642 at 3 (On July 27, 2006, DEAM, a collateral manager investor asked Merrill Lynch as one of its first questions on the deal terms, "How much discretionary trading is allowed?").) Thus, Morgan Stanley sought to change the deal terms in order to limit the discretion Harding would have in managing the deal post-closing and increase the control Morgan Stanley would have. (Edman 2557:20-2559:14; 2578:8-16.) In case this point had been lost, the Division elicited crystal clear testimony on this point during its cross-examination:

> Q And so my question to you, sir, is: Based on what you do recall, does it seem consistent or inconsistent with Morgan Stanley's overall approach that Morgan Stanley might have cared about the manager in connection with Octans 1?
>
> A. Based on this e-mail from the sales guy at Merrill to his colleagues, he seems to think that we cared about the manager if it was a managed deal. Yes, that would make sense. We would care more about the manager if it were a managed deal than if it were a static deal.

Q. Please elaborate on why, if you could.

A. Because we wouldn't know what the assets were going to be on a going-forward basis after the deal closed.

Q. I'm sorry?

A. Potentially we wouldn't know what the assets were going to be after the deal closed in a managed deal.

(Edman at 2582:2-21.)[106] When asked the follow-up question about whether the process Harding used to select assets pre-closing mattered to Morgan Stanley as an investor in Octans I, Mr. Edman testified that Morgan Stanley would not have cared even if Harding had been "reckless" in how it selected assets because again Morgan Stanley "would have looked at the bonds and had their own opinion on them." (Edman at 2598:3-17.)[107]

VIII. THE OCTANS I PITCH BOOK CANNOT SERVE AS THE BASIS FOR A FRAUD CLAIM.

A. Summary.

First and foremost, the Commission's allegations as to the Pitch Book have nothing to do with whether Harding failed to follow the procedures described in the Pitch Book. The OIP allegations are limited to failure to disclose Magnetar's alleged influence over the asset and rights in the Warehouse Agreement, and nothing else. For all the reasons described in Section IV above, the Division failed to prove its case on this issue and the Court must rule for the Respondents on that basis alone.[108]

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[106] (*See also* Doiron 1980:11-16 (testifying that the collateral manager is important post-close because at that point the investor is subject to their discretion.).)

[107] It should be noted that Mr. Edman has no connection to Harding or Mr. Chau, and refused to meet with Respondents' counsel prior to his testimony.

[108] (OIP ¶ 2 (Magnetar's interests "were not aligned" with the debt investors, that Magnetar had "undisclosed rights over the selection of collateral" for Octans I , and that therefore the so-called statements about Harding's credit selection processes and the warehouse agreement were "in conflict" with the Pitch Book); *see also* ¶ 5 ("These representations were materially misleading because they did not disclose Magnetar's rights in and influence over the collateral selection process."); ¶ 55 ("The Pitch Book used to solicit investors in the transaction . . . described Harding's investment approach and credit processes, but said nothing about Magnetar's control rights and actual influence over the Octans I portfolio.") (emphasis added).)

The Division failed to prove even its new theory that the representations in the Pitch Book were false and misleading because Harding allegedly did not follow the procedures for selecting assets described in the OIP. (Div. Br. at 108-116.) As a starting point, as demonstrated in Sections XII and XVI below, Harding's process for asset selection generally and the selection of the ABX Index assets in particular comported in all material respects with the descriptions of Harding processes contained in the Pitch Book. But even if they did not, proof at the Hearing established beyond any serious doubt that the Pitch Book statements the Division points to were so general and vague that they cannot be a predicate to a finding of fraud. None of the investors testified that they based their investment decision on the description of the collateral manager's process in the Pitch Book. Every investor testified that he did due diligence on Harding **regardless** of the contents of the Pitch Book. That includes Mr. Doiron and HIMCO, who did extensive due diligence on Harding. That also includes, Mr. Wagner who testified that he would not rely on a Pitch Book alone, but would do his own substantial and substantive due diligence on the collateral manager and would expect all investors to do so.[109]

This is another break in causation: even if the Pitch Book were defective, every investor made its own independent assessment of Harding, regardless of what the Pitch Book said. That independent assessment fixed any problems with the Pitch Book. Again, this is not a reliance point. The only investor the Division called to testify at the Hearing, Mr. Doiron, testified that it would be "absurd" to base an investment decision on bullets in the Pitch Book about the collateral manager (Doiron 1893:11-19; 1943:20-1944:21.) One struggles to understand then how the Pitch Book's general descriptions of Harding's processes could have significantly altered the total mix of information made available to the investors, when the investors had the

[109] (*See* Section V.)

ability and did, in fact, do significant due diligence on Harding. One also struggles to understand how Harding could have thought or even suspected that someone might have been misled about its processes when it made itself available for due diligence to every investor and answered all of their questions to their satisfaction. Put another way, Harding cannot be said to have obtained money or property by means of a general statement or an omission when (1) that statement has been superseded by a later more specific statement by the same person, and (2) the speaker knows that the purported victim is ignoring the first statement in favor of the later, more specific one.

And even if that were not true, the statements in the Pitch Book do not go to the benefit of ownership of Octans I securities that investors could have reasonably expected. There is not even a hint of an allegation, let alone proof at the Hearing, that any of the Pitch Book statements about the deal terms or description of securities were false or misleading in any way whatsoever. There is also no hint of allegation, let alone proof at the Hearing, that Harding did not manage Octans I post-closing in a manner consistent with what was described in the Pitch Book. Again, the Pitch Book is not an offering document, but even if it were, the investors received exactly what they could expect: they received the securities they expected to receive, the asset portfolio they expected to receive, and management of the assets post-closing they expected to receive. They received the benefit of their bargain; they were neither deceived nor defrauded.

Most significantly, perhaps, fraud **in connection with an offer or sale** of securities under Section 17(a) cannot be predicated on a document that expressly stated that it was **not an offering document and was subject to change**. *See, e.g., Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 939 (2d Cir. 1998); *see also Banco Espirito Santo de Investimento, S.A. v. Citibank N.A.*, No. 03 Civ. 1537 (MBM), 2003 U.S. Dist. LEXIS 23062,

at *14-15 (S.D.N.Y. Dec. 29, 2003) (holding, in breach of contract case, that disclaimers in "marketing presentations, the Offering Memoranda, and the letter of intent constitute objective signs of [defendant's] expressed intentions not to be bound by any statement outside the Offering Memoranda" (internal quotation marks and citation omitted)).

In sum, the Division's fraud case predicated on the statements in the Pitch Book failed logic, law, and fact.

B. The Pitch Book Is Not An Offering Document.

The Pitch Book, initially circulated by Merrill Lynch,[110] on July 18, 2006, provided **preliminary** information about the proposed structure and terms for Octans I.[111] It did not

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[110] The Division asserts that Wing Chau was responsible for the Pitch Book because Harding's compliance manual stated that he was responsible for all Harding advertising. (*See* Div. Br. at 108.) The Pitch Book, however, was not Harding's advertisement. The policy itself defined advertisement as "any written communication . . . directed to more than one person **concerning advice or recommendations about the purchase or sale of securities or any other advisory service**." (Div. Ex. 122 at 4.) The Pitch Book did not contain Harding's advice or recommendations about purchasing or selling securities, and the Pitch Book did not concern Harding's "advisory service." The Pitch Book, which was drafted, controlled, and disseminated by Merrill Lynch, was a marketing piece about Octans I. (*See* Section IX.A.) The policy clearly contemplated advertisements of Harding itself and not the portfolios that it managed. Wing Chau confirmed this understanding. (*See* Chau 1829:8-1830:7.)

[111] (*See, e.g.*, Resp. Ex. 529-530 (E-mails from Merrill Lynch re: New Issue: Dorado CDO—Deal Announcement." (July 18 and 19, 2006)).) The Term Sheet, like the Pitch Book, stated that it contained "preliminary information, subject to completion and amendment," such as the Expected Maximum Weighted Average Rating Factor and the expected Break Even Default Rates for Octans I. (Resp. Ex. 530 (Term Sheet).) The Pitch Book contained the following sections or chapters:

- Notice Section, which informed the prospective investors that the Pitch Book was "not an offer to sell, or a solicitation of an offer to buy, the Offered Securities" and was subject to change (discussed in more detail above). (Div. Ex. 2 at 2-3.)
- Transaction Summary, which provided a high-level summary including that: "It is anticipated that the portfolio will consist of approximately [90]% Structured Finance Securities and [10]% CDO Securities." (*Id.* at 5-10.)
- Asset Class Selection, which provided, among other things, historical default rates for BBB-rated structured finance securities and historical recovery rates of the same, a representative portfolio composition (*i.e.,* how many BBBs, BBBs-, AAs, etc.), transaction highlights (*i.e.*, Maximum Correlation Score, Expected Weighted Average Spread, Maximum Weighted Average Rating Factor, etc.), structuring assumptions (*i.e.*, the reinvestment period in which the manager could trade out and in certain securities), the waterfall structure, and the break even default rates. (*Id.* at 11-25.)
- The Risk Factors, including as to the Nature of Collateral and Certain Conflicts of Interest. (*Id.* at 26-34.)

(Footnote continued on next page)

contain the terms and conditions of the Notes or even the Eligibility Criteria for the Notes, which were detailed in the Offering Circular.

1. The Pitch Book specifically stated that it was not an offer to sell, or a solicitation of an offer to buy.

The Pitch Book, to state the obvious, was a marketing book, not an offering document. As discussed above, the Final Offering Circular expressly stated that the investors may only look to the Offering Circular and their own investigation when making an investment decision and warned the prospective investors that any presentations or materials previously sent by Merrill Lynch were not an offer of securities, had been superseded, may no longer have been accurate, and, in any event, should not have been relied on. The Pitch Book was also replete with warnings that it was not an offering document, that it was subject to change, and that the offering would be made pursuant only to the Final Offering Circular. It stated right at the beginning:

> **This Material is not an offer to sell, or a solicitation of an offer to buy, the Offered Securities or any other investment**. Any such offering of the Offered Securities will only be made pursuant to a final Offering Circular relating to the Offered Securities (the "Offering Circular"), which will contain material information not contained herein and to which the prospective purchasers are directed. In the event of any such offering, this Material will be superceded [sic], amended and supplemented in its entirety by the Offering Circular.

(Div. Ex. 2 at 2 (Pitch Book).) These points are repeated consistently and constantly:

- "No person has been authorized to give any information or make any representations other than the information contained herein, **as amended and**

- Tax Considerations, which provided a general discussion of the U.S. Federal income tax consequences of this investment. (*Id.* at 35-36.)
- About Collateral Manager, which is discussed below in greater depth, but essentially provided platitudes about Harding's investment philosophy. (*Id.* at 37-48.)
- Portfolio Surveillance/Monitoring, which included, for example, a sample of the monthly performance data that would be issued to the Note holders. (*Id.* at 49-55.)
- Key Executives and Investment Professionals, which included biographies of certain individuals at Harding. (*Id.* at 56-59.)

superseded by the information contained in the Offering Circular relating to the eventual offering, if any, of the Offered Securities" (*id.* at 3);

- "This transaction is in a structuring phase and **there may be material changes** to the structure, terms and assets prior to the offering of any securities" (*id.* at 6, 16);

- "**All information in these materials is for illustrative purposes only**. The actual structure of the final transaction, including the composition of the collateral to be acquired, will be determined at or around the time of pricing the Offered Securities based upon market conditions and other factors applicable at that time (*id.* at 18, 22);

- "On the Closing Date, a portion of the gross proceeds from the offering will be used to pay various fees and expenses, . . . For information about the amount of such fees and expenses, please review the final Offering Circular before investing" (*id.* at 20); and

- "In addition to the risk factors presented above, potential investors in the securities should review carefully the complete presentation of risk factors in the final Offering Circular" (*id.* at 27-34).

And it specifically directed the reader not to make any investment decisions based on the information in the Pitch Book:

> Any historical investment results of any person or entity described in this Material are not indicative of the Issuer's future investment results. Such results are intended only to give potential investors information concerning the general experience of the relevant person or entity as a collateral manager or adviser and are not intended as a representation or warranty by Merrill Lynch, the Collateral Manager, or any other person or entity as to the actual composition of or performance of any future investments that would be made by the Issuer. The nature of, and risks associated with, the Issuer's future investments may differ substantially from (and will be subject to constraints that were not applicable to) those investments and strategies undertaken historically by such persons and entities. There can be no assurance that the Issuer's investments will perform as well as, or in a manner similar to, the past investments of any such persons or entities. For these reasons, there are limitations on the value of the hypothetical illustrations contained herein. **This Material is provided to you on the understanding that as a sophisticated investor, you will understand and accept its inherent limitations, and will use it only for the purpose of discussing with Merrill Lynch your preliminary interest in investing in a transaction of the type described.**

(*Id.* at 3; *see also id.* at 27 ("An investor should not make any decision to invest in the Offered Securities until after such investor has had an opportunity to read and review carefully the Offering Circular").) In short, the SEC cannot premise a failure to disclose case on a document

provided to sophisticated potential investors that expressly stated that it was not complete and was provided for the sole purpose of assisting interested parties in determining whether they would want to obtain more information. *See Hunt v. Alliance North Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 730 n.4 (2d. Cir. 1998) (holding that no investor could have been misled where challenged marketing brochure stated that "complete information" was contained in the prospectus).

2. The Pitch Book was not final and was subject to change.

As to pool assets, the Pitch Book warned that any information about the collateral composition were assumptions with inherent limitations, may materially change, and should not be relied upon in making an investment decision; to wit:

> **The structuring assumptions are mathematical simplifications designed to approximate the effects of the composition of the collateral and the interests rates at which the collateral accrues interests, and none of such assumptions are meant to be historical descriptions or predictors of future performance**. Because they are simplifying assumptions, they have certain inherent limitations, are not conclusive, or exhaustive and alternative modeling techniques may produce significantly different results. Furthermore, **because the collateral purchased by the Issuer may be different from the model portfolio assumed during the structuring phase, the actual characteristics of the investment portfolio may be different from those assumed**; even if they are the same on a weighted average basis, the use of individual securities in the actual CDO structure may substantially change the results indicated. Because this transaction is in a structuring phase, there may be material changes to the structure, terms and assets prior to the offering of any securities. **This information is provided to you on the understanding that, as a sophisticated investor, you will understand and accept its inherent limitations, will review each assumption carefully and make your own determination as to its accuracy or reasonableness, and will use it only for the purpose of discussing with Merrill Lynch your preliminary interest in investing in a transaction of the type described. An investor should rely only upon the final offering materials for the definitive conditions and terms of the offering**.

(Div. Ex. 2 at 19 (Pitch Book).)

The Pitch Book warnings that it was subject to change were not mere legalese. Merrill Lynch first circulated the pricing announcement, term sheet, and Pitch Book for the Octans I deal

on July 19, 2006;[112] however, the deal did not close until September 26, 2006. During that time, prospective investors did request changes to the terms of the deal, as well as to the actual collateral.[113] This basic premise is uncontested. The Division's own expert, Mr. Wagner, testified that as potential investors reviewed the initial terms, structure, and collateral of the deal, they would provide feedback to Merrill Lynch, including asking for certain changes to be made to the deal. (Wagner 4653:5-20.) For example, he testified that prospective investors could change the collateral characteristics in order to increase the spread or expected return to the prospective investors, and at that point, Merrill Lynch and other deal participants would discuss whether the change could be made and if it could, it would be made. (Wagner 4653:21-4655:9.) Harding and its employees too understood for the same reasons that the information in the Pitch Book did not contain the final terms and conditions of the offer of securities. (*See* Wang 345:17-25.)

Furthermore, the uncontroverted evidence demonstrates that the investors: (1) appreciated that other prospective investors requested changes to the deal terms and to the assets in the portfolio; and (2) did not expect Merrill Lynch to inform them of those communications and requests. (*See, e.g.*, Doiron 1985:12-1986:22, 1986:12-1988:14; Edman 2536:5-2539:3; 2544:6-16; Jones 2832:6-22; 2849:2-2850:15.) In other words, before the Final Offering Circular was

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112 (Resp. Ex. 529 (E-mail chain ending with e-mail from Catherine Chao to undisclosed recipients re: **NEW ISSUE: Dorado CDO—Deal Announcement**).)

113 (*See, e.g.*, Resp. Ex. 697 (August 3, 2006 E-mail from Thomas Reese (HIMCO) re: Dorado CDO (noting, "[b]efore the deal was reinvesting defaults on recoveries; however they are now taking away that option and all recoveries from defaults are used to pay down the notes.); Resp. Ex. 696 (August 21, 2006 E-mail from Thomas Reese re: Request that Merrill Lynch add a requirement that there is a minimum number of cash securities); Resp. Ex. 746 (August 4, 2006 E-mail from Merrill Lynch to UOB re: Dorado Marketing Book—Revised (noting that there is a revised structure for Octans I)); Resp. Ex. 917 (August 16, 2006 Internal E-mail Chain re: Morgan Stanley's Requirements for taking the Super Senior position); Resp. Ex. 532 (July 19, 2006 E-mail from Fortis to Merrill Lynch re: Fortis Investments Requests (asked for a "[s]tipulation that all CDS in this deal, if any, are/will be standard ISDA fixed cap, step-up applicable, no upfront exchange"); Resp. Ex. 633 (August 2, 2006 E-mail from ACA, a prospective collateral manager investor re: Stipulations for Dorado (ACA provided a list of stipulations of changes to the deal in order to take the super senior position; at Merrill's request, Harding agreed to trade out 5% of the securities in the current portfolio).)

issued, the prospective investors understood that the material previously provided, including the Pitch Book, were not an offer of securities, were subject to change, and would be affected by the input of the prospective investors who asked for certain changes in the deal terms and collateral composition.

Investors used the Pitch Book "as a quick summary of what the structure of the deal was," as the section on the structure of the deal "would have been the most relevant thing in the marketing books" for investors.[114] That is where the Pitch Book provided specific, if preliminary, information. (*See, e.g.*, Div. Ex. 2 at 16-23.) This information, in conjunction with the list of the collateral, allowed the prospective investors to start their independent investigation.

C. **The Statements About Harding's Investment Philosophy Were Too General To Be Actionable.**

To be sure, the Pitch Book did have information supplied by Harding about Harding and its investment philosophy and post-closing surveillance and monitoring processes, but it did not make any representations about **how** the **initial** portfolio of Octans I would be or had been selected.[115] (*See* Wang 490:13-22 (who would not have wanted "disclosures about specific

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[114] (Edman 2551:13-22; *see also* at 2606:3-2607:6; Doiron 1893:11-19; 1943:20-1944:21 (testifying that while he only did a "cursory review" of the Pitch Book, HIMCO focused on certain things in the Pitch Book more than others, such as the structure of the deal, and that it would be absurd to base an investment decision on bullets in the Pitch Book about the collateral manager); *see also* Chau 1841:9-13; 4114:16-4115:24 (Reviewed pitch books to see the structure of the deal, such as the capital structure and overcollateralization assumptions, and if the collateral manager had the experience to manage the CDO going forward).) Mr. Jones testified that he did his own analysis and did not testify that he focused on any sections of the Pitch Book.

[115] The only reference in Section Six of the Pitch Book to "Octans," as opposed to general statements about Harding's investment philosophy and objectives appears on page 42 of the Pitch Book. (Div. Ex. 2 at 42.) Even on this page, it only notes that the Top/Down Economic Analysis in "Octans" would include "Research" and "Sector Allocation" and that the Bottom/Up Credit Analysis, includes "Compliance & Structuring," "Credit Review & Relative Value," and "Individual Credit Selection." Compare that with an earlier page, for which Harding did not provide information, that provides the Collateral Assumptions for Octans I. (*Id.* at 19.) Understanding the inherent limitations in such general, non-specific statements, the Division points to Harding's internal policy for how it performed its credit analysis. (*See, e.g.*, Div. Br. at 81-82.) Beyond the fact Harding's internal policy was not shown to the investors, the very fact that the Division has to point to that document rather than the Pitch Book demonstrates the simple point that the Pitch Book did not contain any information about how Harding analyzed the assets in Octans I.

(Footnote continued on next page)

investment practices or analyses").) In fact, although it was subject to change at the time, the Pitch Book also, like the Offering Circular, stated that it was not making any representations about the quality of the synthetic collateral in Octans I. All that the Pitch Book did say was that Harding generally performed a top-to-bottom analysis, *i.e.*, an analysis of the market, the economy and other relevant macroeconomic factors; and bottom-to-top analysis, *i.e.*, an asset level analysis of the assets chosen for the pool. (Div. Ex. 2 at 42-48 (Pitch Book); Wagner 4603:12-21.)

Section Six of the Pitch Book only described in **general terms** Harding's investment philosophy. The language in the Pitch Book about top/down and bottom/up analysis was boilerplate and did not communicate what the collateral manager actually did to analyze the assets. As apparent from the face of the documents and the Division's own brief, the statements at issue were mere platitudes: "rigorous upfront credit and structural analysis," "complete an in-depth credit review," employ a "disciplined bottom/up Credit and Structural analysis," and "collaborative, methodical and disciplined investment process." (Div. Br. at 109, Div. Ex. 2 at 43, 47-48.) In other words, the section was heavy on adjectives[116] and empty on facts.[117] That is

Moreover, the manual was clearly aspirational, and strict adherence to its provisions was not necessary in order to comport with the standard of care. Indeed, the Division cited no case law requiring strict adherence to an aspirational document, and the Division's own expert noted that comportment with the standard of care was not evaluated in light of the policies and procedures, but that the actual work conducted by the collateral manager "met the objectives and ends of such policies and procedures—the design and implementation of a standardized, consistent, rigorous, thorough, and independent investment process **designed to meet the objectives of the funds or vehicle under management, including risk and return targets.**" (Div. Ex. 8001 at ¶ 38.)

[116] (*See, e.g.*, Wagner 4580:6-13 ("I tried to summarize what I think the standard of care is with a number of adjectives, and I try and say that it is not the question of the particular policies or procedures, *per se*, whether they are formal or informal, but that there would be a standardized, consistent, rigorous, thorough and independent investment process.").)

[117] The most specific statement in this section is that Harding would "stratify[] the higher risk categories of the collateral pool (high LTVs, low credit scores, investment properties, IO loans) to further assess the ability of borrowers to repay debt." (*Id.* at 45) The only relevance of this sentence to the assets and the credit review at issue in the OIP is whether Harding further assessed or employed additional tests to the MABS bond on the ABX Index 2006-1, which was an Interest Only loan. The evidence clearly showed that Harding did. *See* Section XII.F.

precisely why, Mr. Wagner testified, he would need to speak with the manager to get the granular information necessary to understand what specific top/down and bottom/up analyses the manager thought necessary and how the manager performed those analyses. (Wagner 4589:13-4599:21.)

The Pitch Book provided no information on what cumulative loss curves, default rates, and loss severity Harding would use to analyze the assets.

- It said nothing about any hit rate of assets picked from among those suggested by other parties.
- It said nothing about how long it took to review an asset or bond.
- It said nothing about getting a consensus from all the credit analysts as to a credit decision.
- It said nothing about reviewing a credit decision.
- It said nothing about how many people would review a credit decision before making a decision.
- It said nothing about how many cash flow runs Harding would do.
- It said nothing about the assumptions Harding would use to run its cash flow analysis in Intex.
- It said nothing about whether Harding would only select assets with certain write-downs on the cash flow runs.
- It said nothing about a credit or investment committee.
- It said nothing about how Harding would maintain a contemporaneous record of its credit review.

For this very reason, the prospective investors viewed the sections of the Pitch Books on the collateral manager as "fluff," to which they paid "very little" attention. (Edman 2551:19-2552:4; Jones 2893:20-2894:7 (testifying that the sections on the collateral manager in the pitch books

were "cookie cutter"); Doiron 1942:21-1943:13 (testifying that much of the information in the pitch books were "boiler plate")[118].)[119]

Mr. Wagner, the Division's own expert, agreed with all three investor witnesses when he testified that when he worked at the CDO group at Bear Stearns, they had to "investigate the managers to a greater extent than what was summarized in the pitch book certainly." (Wagner 4589:13-4594:21.) In conducting this due diligence, Mr. Wagner would speak with the CDO managers' analysts in order to understand the analytics and assumptions they used, such as what cumulative loss and cumulative default rate they used, what their assumptions were in general, what their competence was, and what their view on the market was, such as their expectation of interest rates and general economic matters. (*Id.*) Mr. Wagner had to conduct these due diligence meetings for the very reason that this information was not conveyed or even hinted at in the Pitch Books. (*See id.*)

D. A Representation About How Harding Selected The Assets Would Have Been In Conflict With Other Statements In The Pitch Book.

In fact, any disclosure or discussion about how the assets would actually be selected would be in conflict with the other statements in the Pitch Book, including that the Pitch Book made no representations about the quality of the reference obligations. It is black letter law that

[118] It is true that Mr. Doiron, who incidentally was not the analyst who reviewed Octans I for HIMCO, testified that they reviewed the Pitch Book, considered it to be an important document, and relied on the accuracy of the Pitch Book. (Doiron 1877:2-15.) However, the testimony—in isolation—ignores the clarifying answers he gave on cross-examination (*See* Exhibit G.)

[119] (*See also* Edman 2609:22-24 (also testifying that the statements are "just stating the obvious. General things that you would do when you're looking at bonds."); Jones 2873:15-20 (testifying that he could "not recall that much differentiation between an awful lot of [the] managers" in the description of collateral managers' investment philosophy in the pitch books for CDOs); Jones 2875:21-2876:4 (testifying that every single CDO Pitch Book he has seen contains statements about how the collateral manager will be careful, thorough, and disciplined); Huang 1016:1-12 ("A lot of marketing books looked similar. Everybody is basically saying pretty much the same thing."); Huang 1020:10-25 ("Every manager, every pitch book, they say the same thing. . . . Everybody says they are thorough, they are going top down, bottom up, every single thing you can think of in the world.").)

in interpreting language in a document, a Court must give reasonable meaning to all parts of the document and avoid rendering portions of the document meaningless.[120]

This Court must give full and reasonable meaning to the express statements in the Pitch Book that no information on the credit quality of the assets will be provided to the prospective Note holders, to wit:

> **No information on the credit quality of the Reference Obligations is provided herein. The Noteholders will not have the right to obtain from the Credit Default Swap Counterparty, the Issuer, the Collateral Manager or the Trustee information on the Reference Obligations** or information regarding any obligation of any Reference Entity (other than the information set forth in the monthly reports delivered pursuant to the Indenture). Neither the Credit Default Swap Counterparty nor the Collateral Manager will have any obligation to keep the Issuer, the Trustee or the Holders of the Securities informed as to matters arising in relation to any Reference Obligation, including whether or not circumstances exist under which there is a possibility of the occurrence of a Credit Event. None of the Issuer, the Trustee or the Holders of the Securities will have the right to inspect any records of the Credit Default Swap Counterparty relating to the Reference Obligations.
>
> A prospective investor should review the prospectus, prospectus supplement or other offering materials (and any servicer or trustee reports) for each Reference Obligation prior to making a decision to invest in the Securities.

(Div. Ex. 2 at 30 (Pitch Book) (emphasis added).) For this reason, the Pitch Book—again in line with the Offering Circular—informed the prospective investors to conduct their own investigation regarding the merits of the transaction prior to making any investment decision, namely:

> The information contained herein does not purport to contain all of the information that may be required to evaluate the Offered Securities and any recipient is urged to read the Offering Circular relating to the Offered Securities and **should conduct its own independent analysis of the data referred to herein**.

[120] *Gould, Inc. v. United States*, 935 F.2d 1271, 1274 (Fed. Cir. 1991) ("Contract interpretation begins with the plain language of the agreement. '[P]rovisions of a contract must be so construed as to effectuate its spirit and purpose . . . an interpretation which gives a reasonable meaning to all of its parts will be preferred to one which leaves a portion of it useless, inexplicable, inoperative, void, insignificant, meaningless, superfluous, or achieves a weird and whimsical result.'" (quoting *Arizona v. United States*, 575 F.2d 855, 863 (Ct. Cl. 1978)) (internal citations omitted)).

(Div. Ex. 2 at 2 (Pitch Book).) It would be incongruous for the Pitch Book to tout Harding's asset selection for the original asset pool while also disclaiming any representations as to its quality.

And again, logic does not permit a document that specifically stated that it made no representations about the quality of the selected assets to serve as the basis of a fraud finding grounded in the premise that general representations in the same document about asset selection processes were incomplete and, therefore, misleading.

E. Harding's Qualifications Were Relevant to Post-Closing Management of the Deal Only.

Because Octans I was a managed deal, Harding would have been obligated to monitor the portfolio and make purchase and sell decisions on an ongoing basis.[121] (Chau 1825:18-1826:2; Edman 2560:17-2561:13.) After the deal closed, investors would have no say into what assets Harding would trade in or out. (Resp. Ex. 2 at 13 (OC).) At that point, their only information on the portfolio would consist of monthly trustee reports and their only recourse, if they did not like the assets Harding was selecting, would be to sell their positions, which could be difficult. (*See* Edman 2560:22-25.)

Thus, the Offering Circular in the opening pages discussed Harding's management role, while remaining silent on its role in the warehouse period. Specifically:

> Harding Advisory LLC **will perform certain advisory functions and assist the Collateral Administrator** with certain administrative functions with respect to the

[121] That is why Mr. Chau agreed during the Division's examination that investors wanted to know the manager's investment philosophy and style or why he testified that the investor in a CDO is "betting" the manager. (Chau 1827:12-21; 4353:13-19.) It is also why Mr. Chau agreed that certain pages of the Octans I Pitch Book, which described Harding's investment philosophy "would be important to investors." (Chau 1835:25-1836:8; 1836:24-1837:19.) Notably, these questions, while covering whether something would be important, did not address **why** or **when** it would be important. In fact, in an answer to one of the questions, Mr. Chau explained that it is important because of the Collateral Manager's "**future managing of the CDO**." (Chau 1837:9-19 (emphasis added).) This defect peppers the Division's examination of all of the investor witnesses, eliciting that the collateral manager was important to them, but not why it was important. (*See, e.g.*, Doiron 1874:22-25; 1893:11-19; 1918:9-25.)

Collateral pursuant to a collateral management agreement to be dated as of the Closing Date (the "Collateral Management Agreement") between the Issuer and Harding Advisory LLC (in such capacity, the "Collateral Manager"). See "The Collateral Manager" and "The Collateral Management Agreement." Under the Collateral Management Agreement, **the Collateral Manager will manage the Acquisition and Disposition of the Collateral Debt Securities**, including exercising rights and remedies associated with the Collateral Debt Securities, Disposing of the Collateral Debt Securities and certain related functions.

(Resp. Ex. 2 at 4 (OC) (emphasis added).)[122] And for this reason, the Offering Circular listed reliance on Harding as one of the deal Risk Factors, stating:

> Dependence on the Collateral Manager and Key Personnel. The performance of the portfolio of Collateral Debt Securities depends heavily on the skills of the Collateral Manager in analyzing and selecting the Collateral Debt Securities. As a result, the Issuer will be highly dependent on the financial and managerial experience of the Collateral Manager and certain of the officers and employees of the Collateral Manager to whom the task of selecting and monitoring the Collateral has been assigned or delegated.

(Resp. Ex. 2 at 66-67 (OC).) That is also why the Offering Circular included a "key man" provision, stating that should something happen to Mr. Chau, the Issuer or certain investors in the CDO would have the right to call for the removal of Harding as the collateral manager. (Resp. Ex. 2 at 198-199 (OC).) There would be no need for these Risk Factors and provisions, if the Octans I portfolio was static.

Mr. Jones explained that, in addition to the structure and terms spelled out in the Offering Circular and Maxim's analysis of the underlying collateral, the import of the collateral manager had to do with whether the manager had sufficient experience to manage the collateral post-closing. (Jones at 2864:14-2865:19.) In other words, the manager could not just be a two guys and a Bloomberg:

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[122] Similarly, the May 26, 2006 Engagement Letter stated that Harding agreed: "(1) to act as manager in connection with the initial acquisition of the Collateral prior to the Closing Date pursuant to a warehouse agreement acceptable to the Manager and Merrill Lynch (the 'Warehouse Agreement') and (2) to act as collateral manager for the Issuer with respect to the Collateral following the Closing Date pursuant to a collateral management agreement acceptable to the Manager and Merrill Lynch (the 'Management Agreement')." (Resp. Ex. 118 at 2 (Engagement Letter).)

> Q. You have the transparency for the collateral and you already know that you don't like [to] pay option ARMs, using that one example, so I come back to the question, who cares who the manager is?
>
> A. Well, there's two parts to it: **You buy the deal, but then the deal has to be managed. So if it's two guys and a Bloomberg and one of them tells me he's going to retire in three months, whose going to manage the deal? Right?** So I can look at it and say it's great collateral, it's really good, but it's going to not be managed correctly going forward. These are eight-year deals.
>
> ***
>
> A. It's like two parts. I see what you're saying. It's somewhat true. I've been saying that I would only look at that collateral, but **the deal had to be taken care of and baby-sat for eight years, and that's why the manager was getting paid. I wanted to make sure they were committed to the business.**

(*Id.*)

To assess the manager's ability to manage the portfolio post-closing, the majority of the prospective investors met with Harding as part of their due diligence.[123] (Jones 2824:3-2825:13; Doiron 1967:2-1967:8; Lieu 3930:9-3931:13.)[124] For example, UOB reached out to Merrill Lynch to have a call with Harding after they had received the ramped portfolio and the cash runs on the portfolio that Merrill Lynch had prepared. (Resp. Ex. 824 (E-mail chain ending in e-mail from Mark Kim to Sharon Eliran et al. re: UOB Conf call) (August 8, 2006).) Similarly, HIMCO's analyst Tom Reese, after his call with Harding, asked Merrill Lynch to have Harding

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[123] That is also why in addition to asking for a list of the collateral, prospective investors requested from Merrill Lynch information on Harding's past management of CDOs, including: "Upgrade/Downgrade history for all CDOs that have been managed by this manager since deal inception. Please include watch list actions if any." (*See, e.g.*, Resp. Ex. 548, 571-572 (Fortis' July 19, 2006 request to Merrill Lynch for the portfolio and Merrill Lynch's response); Resp. Ex. 815 (July 20, 2006 request for the portfolio and Merrill Lynch's response) (Basis Capital requested, "Performance history on previous deals managed by [Harding when the principals where at Maxim].").)

[124] (*See also* Resp. Ex. 596 (August 3, 2006 Internal Merrill Lynch E-mail re: Friday Morning Call with Lion Capital and Harding); Resp. Ex. 601 (August 3, 2006 Internal Merrill Lynch E-mail re: Call with NIR and Harding); (*See, e.g.*, Lieu 3893:25-3894:13; Resp. Ex. 627 (E-mail chain ending with e-mail from Laura Zwak to Thomas Reese and David Weigert re: HIMCO question) (August 7, 2006).)

Others, such as Morgan Stanley, did not feel the need to conduct due diligence on the manager even if it was a managed deal, because they would just assume that the deal "was managed to its minimum requirements in terms of collateral quality;" or in other words, they would just look to the protections and the Eligibility Criteria in the Offering Circular. (Edman 2560:17-2563:7)

provide "color" on four bonds and asked more generally for more detailed collateral information, such as on interest-only loans and California concentration.[125] The only reason for these calls and e-mails was to learn and test how Harding actually did its credit review; or in other words, to satisfy themselves that Harding could manage the portfolio.

It is only in these meetings, as opposed to the information contained in the Offering Circular or Pitch Book, where the prospective investors obtained meaningful information about how Harding selected assets for Octans I. (*See* Doiron 1967:2-1967:8; Lieu 3930:9-3931:13.) There and only there, did the investor delve into Harding's and its analysts' (1) macroeconomic views, such as what Harding thought the interests rates would be for the next year or what the likely default rates on subprime loans would be for the next couple of years, and (2) processes for conducting credit reviews, such as what assumptions it used in Intex to generate the cash flow reports. (*See id.*)

For example, HIMCO concluded after reviewing the assets selected by Harding and gathering specific information from Harding that:

- "Sound collateral manager. While CDO experience is limited, knowledge of the collateral is strong."
- "Solid collateral and surveillance technology."
- "Well diversified assets, both among types and grades."

(Resp. Ex. 612 (HIMCO's analysis on Octans I); Resp. Ex. 728 (HIMCO's deal summary of Octans I).) Of note, the deal summary drafted by Mr. Reese included information from the Pitch Book, such as certain structural information and break-even yields, but the only information

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[125] (*See, e.g.*, Resp. Ex. 604 (HIMCO's and Merrill Lynch's E-mail re: HIMCO's call with Harding and HIMCO's follow-up items); Resp. Ex. 627 (HIMCO's August 3, 2006 request for color on four bonds); Lieu 3926:12-3928:12 (in response to investor requests for information, Ms. Lieu would "review the most recent performance of the bonds" and provide that information and any other relevant information to the investor).)

cited as to Harding from the Pitch Book was about Harding's experience in managing previous CDOs. (*Compare* Resp. Ex. 728 *with* Div. Ex. 2 at 39). HIMCO cited nothing from the Pitch Book about Harding's investment philosophy. Rather after HIMCO's review and analysis of the underlying collateral,[126] calls with Harding, and receipt of additional information from Merrill Lynch, Mr. Reese focused on the specifics: the fact that Harding had good surveillance technology, its knowledge of the collateral was strong, and it had included well-diversified assets.

There is no hint in the evidence that Harding did not answer those questions fully and honestly. More importantly, these sophisticated investors, after conducting their due diligence on Harding's processes and selection of bonds, concluded that Harding was a good manager with good processes; or more simply, they were satisfied that they had the capability and experience to manage Octans I. (*See, e.g.*, Jones 2825:14-2826:15.)

IX. MERRILL LYNCH, NOT HARDING OR ANY OF ITS EMPLOYEES, DRAFTED, CIRCULATED, AND CONTROLLED THE USE OF THE PITCH BOOK AND OFFERING CIRCULAR.

The Division seeks to hold Respondents liable for statements made by Merrill Lynch and the Issuers in the offer and sale of securities, when they exercised no authority over how or where these statements would be made or used. This is contrary to established law, as detailed in the argument section. (*See* Section XXII.B.)

Merrill Lynch, as the structurer of the deal, drafted, prepared, and circulated the Octans I Pitch Book and Offering Circular. In fact, the May 26, 2006 Engagement Letter for Octans I explicitly stated that Merrill Lynch was the only authorized party to circulate materials about Octans I and to solicit offer and sales of securities; to wit:

[126] (Resp. Exs. 611; 728 (HIMCO's analysis of the underlying collateral and portfolio as a whole).)

6. Manner of Sales/Purchase of Securities

> **Offers and sales of Securities may be made only by the Issuer (or, if applicable, the Co-Issuers) and only through Merrill Lynch; the Manager is not authorized to, and may not, approach any person for the purpose of soliciting or recommending purchases of Securities**. Each purchaser of the Securities will be required to complete a representation letter as to certain matters in the form provided by Merrill Lynch and only prospective purchasers who make the representations set forth in such representation letter will be permitted to purchase Securities. Without limiting the foregoing, in the case of persons identified by the Manager as prospective investors, the Manager will provide Merrill Lynch with the information necessary to permit Merrill Lynch to contact such prospective investors, **and all offers and sales of Securities will be made solely by Merrill Lynch which will contact such prospective investors directly and provide them with copies of the applicable the offering documentation prepared in connection with the Offering**.

(Resp. Ex. 118 at 4 (Engagement Letter).) Pursuant to this agreement, Harding also agreed that, "it will not, directly or indirectly, solicit investors, agents, investment bankers or any other person to negotiate or consummate the Transaction, during the term hereof, without Merrill Lynch's prior written consent. (*Id.* at 3.) Harding's role, in fact, and as spelled out in this letter, was expressly limited to providing information, "as Merrill Lynch reasonably may request in connection with its engagement hereunder and the Offering." (*Id.* at 2.) Even when it provided information, it did not control the context in which the statement was made or how it would be used.

Harding did not have the right, per the agreement or in practice, to draft, edit, control, or use those statements it did not expressly provide at Merrill Lynch's request, such as the statements about the Warehouse Agreement in the Pitch Book or Offering Circular. (Wang 585:6-19.) The Division, tacitly concedes this point, when it points to the evidence that Harding wanted—in good faith—to disclose Magnetar's name (in relation to other provisions) in the Offering Circular, but was overruled by Merrill Lynch: "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." (Div.

Br. at 123 (citing Resp. Ex. 196; Wang 635:7-15; 636:4-21; 640:6-11) (emphasis added).) This vignette demonstrates that while Harding and its counsel could offer edits to the language of the Offering Circular and could make suggestions on what should be disclosed, unless Harding's comments were to the section of the disclosures directly attributable to Harding, Merrill Lynch's counsel, who also represented the Issuer, ultimately determined what disclosures would be made and exactly how they would be made.[127]

The Division tries to side step this issue by asserting that Harding reviewed and provided comments in and around the statements dealing with the Warehouse Agreement. But as discussed more fully in Section XXII. below, the ability to make suggestions on a document does not make Harding liable for securities fraud, especially whereas here the drafting party, Merrill Lynch, was fully aware of the salient details: Magnetar's rights in the Warehouse Agreement and the fact that it hedged its long position in Octans I.

A. Merrill Lynch Alone Drafted And Controlled The Use Of The Pitch Book.

The Division does not even contest that Harding did not draft or control the use of the Pitch Book. Rather it points out that Harding provided the information for Section Six, which it did, and reviewed more generally other sections of the Pitch Book. Focusing on the specific allegation in the OIP relating to the failure to mention Magnetar in the description of the Warehouse Agreement, Respondents did not draft that section of the Pitch Book and were not

[127] The sections of the Offering Circular that Harding provided information on are: (i) the section titled "Collateral Manager" and the subsection of the risk factor section titled, (ii) "Conflicts of Interest Involving the Collateral Manager," (iii) "Dependence on the Collateral Manager and Key Personnel," and (iv) "Relation to Prior Investment Results." (Resp. Ex. 5 (CMA) at 19-20.)

The sections of the Pitch Book where Harding provided information are noted with a footnote, either "All information in Section Six has been supplied herein by Harding Advisory LLC. Except where otherwise indicated, information is as of [July] 2006" or "Harding Advisory, as of July 2006." (Div. Ex. 1 at 37-59.)

responsible for that section.[128] As to the statements Harding did provide to Merrill Lynch, Harding acted in good faith to make sure those statements were accurate, including by having the different employees familiar with the credit process review those parts of the Pitch Books. (Wang 550:22-552:5; 564:21-565:4; 569:17-25.) Even then, Harding could not edit the document directly, but had to provide any edits it had to Merrill Lynch. (Wang 551:19-552:5.)

Harding also did not control how the Pitch Book would be used, *i.e.*, what other statements, representations, and disclaimers would be made in or about the document, or even how it would be updated from one version to the next.[129] Further, Merrill Lynch, not Harding, circulated the Pitch Book to investors.[130] This is insufficient to establish liability under Section 17(a)(2), as discussed more fully in Section XXII.C.

B. On Behalf Of The Co-Issuers, Merrill Lynch Drafted And Controlled The Offering Circular.

Although Merrill Lynch controlled what went into the Offering Circular, all statements in the Offering Circular, aside from the sections provided by Harding (which is not at issue here),[131]

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128 (*See, e.g.*, Wang 369:20-371:4 (testifying that Harding reviewed and focused on the sections relating to Harding itself; and that she may or may not have read the other pages); Wang 384:5-15 (testifying that she did not remember reviewing the section in the Pitch Book that referred to the Warehouse Agreement); Chau 1829:8-1830:7 (testifying that the Octans I Pitch Book was not a Harding marketing material for which Mr. Chau or Harding were responsible).)

129 (*See* Resp. Ex. 163 (Internal Merrill Lynch e-mail about drafting the Pitch Book (June 9, 2006)); Resp. Ex. 164 (Internal Merrill Lynch e-mail about drafting the Pitch Book (June 19, 2006)); Resp. Ex. 180 (Internal Merrill Lynch e-mail about drafting the Pitch Book (July 18, 2006)); Resp. Ex. 178 (E-mail from Sharon Eliran to Alison Wang & Wing Chau, where she informed them that Merrill Lynch had its lawyers review the Pitch Book (July 17, 2006)); Resp. Ex. 213 (Internal Merrill Lynch e-mail about drafting the Pitch Book (July 12, 2006)).)

130 For example, the term sheet, which Merrill Lynch circulated with the Pitch Book,[130] stated on the first page that "for further information" the prospective investors should contact individuals in Merrill Lynch's "Global Structured Products," "CDO Marketing/Global Structured Products," or "ABS Trading and Syndicate" groups. No contact information was provided for Harding or any of its employees. (*See, e.g.*, Div. Ex. 133 (Octans I Term Sheet and Pitch Book).) Moreover, every instance of the Pitch Book being sent to investors in evidence shows that it was Merrill Lynch, not Harding and not Mr. Chau, who circulated the document. (*See, e.g.*, Resp. Ex. 187.)

131 Respondents provided information on four sections in the Offering Circular that are not at issue: (i) the section titled "Collateral Manager" and the subsection of the risk factor section titled, (ii) "Conflicts of Interest Involving the Collateral Manager," (iii) "Dependence on the Collateral Manager and Key Personnel," and (iv) "Relation to Prior Investment Results." (Resp. Ex. 5 (CMA) at 19-20.) Those were the only sections for which

(Footnote continued on next page)

are statements of the Co-Issuers, who used as their disclosure counsel the firm that also represented Merrill Lynch, Schulte Ruth & Zabel LLP. The Offering Circular states:

> **This Offering Circular has been prepared by the Co-Issuers solely for use in connection with the offering of the Notes described herein** (the "Offering") and for listing purposes. **The Co-Issuers have taken all reasonable care to confirm that the information contained in this Offering Circular is true and accurate in all material respects and is not misleading in any material respect and that there are no other facts relating to the Co-Issuers or the Securities, the omission of which makes this Offering Circular as a whole or any such information contained herein, in light of the circumstances under which it was made, misleading in any material respect.** The Co-Issuers accept responsibility for the information contained in this document. To the best knowledge and belief of the Co-Issuers the information contained in this document is in accordance with the facts and does not omit anything likely to affect the import of such information.

(Resp. Ex. 2 (OC) at v (emphasis added).)[132]

Schulte, as outside or deal counsel for the Co-Issuers and Merrill Lynch, actually drafted the Offering Circular.[133] In fact, when asked why Mr. Suh sent his early comments on the Offering Circular to individuals at Merrill Lynch and Harding, but not the Issuer, Mr. Suh

Harding took responsibility. (Resp. Ex. 80 at 1; Wang 352:12-24; Wang 355:10-16; Wang 577:23-578:5; Suh 2968:7-16.)

[132] (*See also* Resp. Ex. 490 at 6 (Minutes of a Meeting of the Board of Directors of Octans I CDO Ltd. (Sept. 25, 2006)) (approving the Offering Circular and the representations contained therein); Suh 2966:16-25; 2967:15-24 (testifying that the Co-Issuers "are accepting responsibility for the contents of the document, and that to their best knowledge and belief, that the information in the document are in accordance with the facts, and there's no omission of facts that would affect what's disclosed in the documents.").)

[133] (*See, e.g.*, Resp. Ex. 461 at 2 (E-mail from Adam Singer, Schulte Roth & Zabel, re: Dorado CDO (Offering Memorandum) (August 2, 2006) ("attached please find an initial draft of the Offering Memorandum. . . . In addition, this draft is simultaneously being distributed to ML and remains subject to their review."); Resp. Ex. 465 at 3 (Closing Agenda for Octans I CDO Ltd. (SRZ Draft as of 8/31/06)) (Schulte is listed as the "Responsible Party" for the Preliminary Offering Circular, Offering Circular, Indenture, and the Collateral Management Agreement, among other documents); Puglisi 3141:3-18; 3143:21-25 (Puglisi testified that deal counsel sent him the offering circulars for the deals he was involved in and that he consulted with deal counsel if he had a question about the offering circular).)

In fact, Mr. Puglisi, whose entity, the Co-Issuer, is a co-author of the Offering Circular, testified about the steps he took to ensure the accuracy of the Offering Circular: "I've reviewed the portions of documents that I thought were relevant, and I relied on the expertise of deal counsel, who I had worked with for a number of years, and their expertise in putting these documents together, plus the other review mechanisms that are used, such as accountants, counsel to the collateral manager, counsel to the underwriter, if they're separate counsel, the trustee, all the various parties that are reviewing the documents. I relied on the process that's used to put these documents together to have documents that have integrity." (Puglisi 3144:14-3145:13.) A process Harding itself relied upon to ensure the accuracy of the deal documents.

explained that during the early stages, "the issuer is not—doesn't have people that are reviewing things on its behalf. Certainly not at this stage, when the transaction are—a transaction is still being worked on," (Suh 2960:7-2961:3), and that "[t]hese are documents in contemplation of the formation of the issuer and so on." (Suh 2961:17-19.)

Similarly, Harding did not control the distribution of the Offering Circular. The CDO itself authorized only Merrill Lynch "to distribute copies of the final Offering Circular as it shall think fit and to offer the Offered Securities on behalf of the Company on the terms and conditions of the Offered Securities and/or the Indenture and any related Documents or Ancillary Documents." (Resp. Ex. 490 at 7 (Minutes of a Meeting of the Board of Directors of Octans I CDO Ltd. (Sept. 25, 2006)).) Harding could not and did not distribute the Offering Circular.

There was no evidence at the Hearing of any deliberate effort to hide the fact that there were three parties to the Warehouse Agreement. There was also no evidence at the Hearing of any deliberate effort to hide the fact that Magnetar suggested ABX Index assets for the Octans I deal, or that Magnetar hedged its equity position by shorting the capital structure of the deal. Schulte, as counsel for Merrill Lynch, knew that Magnetar was a party to the Warehouse Agreement and had certain rights under the Warehouse Agreement. The record demonstrates that lawyers for Merrill Lynch and the Co-Issuers were very experienced,[134] that they oversaw the drafting and preparation of the Octans I Offering Circular,[135] that, in particular, they oversaw the

[134] For example, the lead lawyer, Paul Watterson, Jr., is the current co-head of the Structured Product & Derivatives Group at Schulte. (Resp. Ex. 261 (Schulte website biography of Paul N. Watterson).)

[135] (Div. Ex. 138, (E-mail from Joseph Suh to Paul Watterson *et al.* re: Dorado CDO (Offering Memorandum) + attachment) Resp. Ex. 185 (E-mail from Adam Singer, associate at Schulte to Distribution, copying Paul Watterson re: Initial Draft of the Offering Memorandum (August 2, 2006)); Resp. Exs. 198-200 (Schulte circulating a revised version of the Offering Circular); Resp. Exs. 201-203 (Schulte circulating a revised version of the Offering Circular); Resp. Ex. 249 (E-mail chain ending with e-mail from Sharon Eliran to Paul Watterson, Prabu Soundararajan, and Malik Rashid re: Octans CDO I Indenture—Harding & McDermott Comments 051366.0199 [Redacted]); Resp. Exs. 237-239 (Schulte circulating the final Offering Circular).)

drafting of the relevant provisions, in particular, and were fully aware that Magnetar was a party to the Warehouse Agreement.[136] All counsel, including the Co-Issuers', missed the unintended error of not disclosing that the Initial Preference Shareholder was a party to that Warehouse Agreement.

C. **The Respondents Acted In Good Faith.**

Putting aside whether Magnetar's rights in the Warehouse Agreement had to be disclosed (which they did not (*see* Section IV.E)) and putting aside that the failure to mention Magnetar was an inadvertent, unintentional error made by the Issuer's counsel (see above), Respondents cannot be held to have acted knowingly and recklessly when they relied in **good faith** on experienced lawyers, who represented Merrill Lynch and the Co-Issuers, to review the disclosures, including those about the Warehouse Agreement, and advised them if anything else needed to be said.

Respondents relied in good faith on the fact that several very experienced lawyers, who knew the relevant facts, prepared or reviewed the relevant documents and found no material misstatements of fact or material omissions. Respondents knew that: (1) the Issuer's and Merrill Lynch's counsel knew that Magnetar was a party to the Warehouse Agreement and had certain rights under that agreement,[137] (2) Merrill Lynch's counsel reviewed the Octans I Pitch Book,[138]

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136 (*See* Resp. Exs. 143-144 (E-mail chain ending with e-mail from William Jacobsen to Paul Watterson re: Magnetar and the attached Warehouse Agreement (May 25, 2006)) (Bill Lee, internal counsel at Merrill Lynch, asked Bill Jacobsen at Mayer Brown to "forward a word file of the warehouse agreement doc" to Mr. Watterson, which was done.).)

137 (Resp. Ex. 145 (E-mail from Bill Lee (in-house counsel) to Alison Wang, Wing Chau, James Prusko, Susan Furman, and Bill Jacobsen (Mayer Brown) (May 25, 2006) (asking Bill Jacobson to forward the Warehouse Agreement to Paul Watterson at Schulte Roth & Zabel).)

138 (Wang 567:21-568:7 (testifying that Merrill Lynch's and the Issuer's counsel reviewed the Pitch Book) Shortly before Merrill Lynch sent the Pitch Book out to investors, Sharon Eliran (Merrill Lynch) informed Alison Wang and Wing Chau that Merrill Lynch was "integrating some minor comments from the lawyers now." (Resp. Ex. 178.)

and (3) the Co-Issuer's and Merrill Lynch's counsel drafted, edited, and finalized the Offering Circular.[139] Respondents also knew and relied upon the fact that Schulte Roth & Zabel issued a 10b-5 Opinion, where it advised that the deal was entirely legal:

> **The execution and delivery by the Issuer of the Issuer Documents and the Notes and by the Co-Issuer of the Co-Issuer Documents and the Notes and the performance by the Co-Issuers of their obligations thereunder** (i) do not require under the federal laws of the United States of America or the laws of the State of New York any filing or registration by the Co-Issuers with, or approval or consent of, any governmental agency or authority of the United States of America or the State of New York that has not been made or obtained other than any consents, approvals or filings as may be required under the securities or "blue sky" laws of any jurisdiction, (ii) **do not violate any present statute, or present regulation of any governmental agency or authority, of the State of New York or the United States of America applicable to the Co-Issuer or the Issuer** and (iii) do not contravene or violate any provision of the Co-Issuer's certificate of formation or Limited Liability Company Agreement.[140]

Moreover, Respondents also knew that: (1) their counsel, Mr. Suh, knew about the Warehouse Agreement[141] and (2) he reviewed and provided comments on the Offering Circular.[142] In fact, Respondents retained Mr. Suh and his firm because they had experience representing Collateral Managers; and Respondents relied heavily upon Mr. Suh to correct any

[139] (Div. Ex. 138 (E-mail from Joseph Suh to Paul Watterson *et al.* re: Dorado CDO (Offering Memorandum) + attachment); Resp. Ex. 185 (E-mail from Adam Singer, associate at Schulte to Distribution, copying Paul Watterson re: Initial Draft of the Offering Memorandum (August 2, 2006)); Resp. Exs. 198-200 (Schulte circulating a revised version of the Offering Circular); Resp. Exs. 201-203 (Schulte circulating a revised version of the Offering Circular); Resp. Ex. 249 (E-mail chain ending with e-mail from Sharon Eliran to Paul Watterson, Prabu Soundararajan, and Malik Rashid re: Octans CDO I Indenture—Harding & McDermott Comments 051366.0199 [Redacted]); Resp. Exs. 237-239 (Schulte circulating the final Offering Circular).)

[140] (Resp. Ex. 75 at ¶ 6.)

[141] On May 25, 2006, before the Warehouse Agreement was signed, Ms. Wang forwarded the Agreement to Mr. Suh, saying in the e-mail, "thanks for taking a look at this—we are supposed to talk to them at 4:30. You are welcome to join." (Resp. Ex. 140.) When they moved to Harding, Ms. Wang sent the Engagement Letters and Warehouse agreements to Mr. Suh again. (Resp. Ex. 166, 172, 176.)

[142] (*See, e.g.*, Resp. Exs. 189-193 (Mr. Suh's mark-up of the Offering Circular (August 7, 2006)); Resp. Exs. 196-97 (Mr. Suh's further mark-up of the Offering Circular).)

relevant issues in the deal documents.[143] Even Mr. Chau's certification that he reviewed the Offering Circular was done in collaboration with Mr. Suh.[144]

Respondents also knew that Mr. Suh had suggested that Magnetar's name be disclosed in the Offering Circular.[145] While Mr. Suh was overruled by counsel for the Co-Issuers,[146] Mr. Suh explained that his comment on the Offering Circular related to having a specific disclosure that there was a concentrated voting power at the equity level and not a general comment that Magnetar's specific name had to be disclosed.[147] In fact, he testified that he could not recall a single instance where a third-party investor's name was disclosed in an offering circular.[148] Moreover, he explained that the section in the Offering Circular that discussed the Warehouse Agreement was disclosing the risk that the Issuer would pay the acquisition price of the warehoused assets, even if the market had moved.[149] It did not deal with Merrill Lynch's rights or Harding's rights under the Warehouse Agreement.[150]

Mr. Suh also issued a negative assurance opinion, where he also advised, on behalf of his law firm, that nothing came to his attention to suggest that the disclosures in the Offering Circular misstated or omitted any material facts. First, this letter repeated that Merrill Lynch and

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143 (*See, e.g.*, Wang 354:21-355:8; 359:7-15 (relied on counsel to review the section in the Collateral Management Agreement and in the Offering Circular); 398:21-399:6 (relied on counsel to review legal documents); 459:10-460:19 (communicated with outside counsel on CDO related documents); 513:24-514:5 (retained outside counsel for Harding that had experience representing collateral managers); Suh 2906:7-10 (testifying that he first got involved in the Octans I transaction in May 2006).)

144 (Suh 3018:7-3019:2; *see also* Resp. Ex. 53 at ¶ 1.)

145 (Resp. Exs. 196-197; Wang 583:15-584:13.)

146 (*See, e.g.*, Resp. Ex. 197 (Adam Singer (Schulte and later holder of the Power of Attorney for the Issuer) agreed that Magnetar would not be mentioned by name in the Offering Circular).)

147 (Suh 2954:21-2955:19; 2957:6-17.)

148 (Suh 2958:16-2959:5.)

149 (Suh 2987:4-2988:10; *see also* Resp. Ex. 2 at 66 (OC).)

150 (Suh 2988:11-2988:25; *see also* Resp. Ex. 2 at 66 (OC).

the Co-Issuer's counsel, not Harding or its counsel, were responsible for the accuracy, completeness, and fairness of the Offering Circular.[151] Then, it stated that subject to that disclaimer:

> Nothing has come to our attention that would lead us to believe that the statements contained under the captions "The Collateral Manager," "Risk Factors-Conflicts of Interest Involving the Collateral Manager," "Risk Factors-Dependence on the Collateral Manager and Key Personnel" and "Risk Factors-Relation to Prior Investment Results" in the Offering Circular as of its date and the date hereof, contained or contain any untrue statement of a material fact or omitted or omit to state any material fact necessary in order to make the statements contained therein, in light of the circumstances under which they were made, not misleading.

(Resp. Ex. 80 at 1.) Notably, Mr. Suh asked Harding a set of due diligence questions before it made that representation; and he also testified that Harding never refused to provide any information that he requested.[152]

During this entire process, Respondents were aware that several very experienced securities lawyers were reviewing these documents and relied in good faith on those lawyers to make certain the statements in the Pitch Book and Offering Circular were correct.[153] Mr. Chau and Ms. Wang further testified that they did not remember seeing the statement in the Offering Circular about the Warehouse Agreement. (Wang 570:20-570:20; Chau 4334:19-4335:9.) Ms. Wang testified that she did not hide, and no one asked her or anyone else to hide, Magnetar's involvement. (Wang 578:20-579:20.) Mr. Chau testified that had he seen the statement, he would have raised it with counsel. (Chau 4334:19-4335:9.)

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[151] (Resp. Ex. 80 at 1; *see also* Suh 2941:6-2941:25; 2947:6-2955:19 (testifying that his primary functions were to provide an opinion on the sections of the Offering Circular that Harding provided, review those sections of the Offering Circular that related to deal terms that were related to the rights and obligations of Harding as collateral manager, and make certain his negotiations relating to other deal documents involving Harding were properly reflected in the Offering Circular).)

[152] (Suh 3006:4-3007:8.)

[153] (*See* Wang 578:20-580:11; Chau 1847:2-1848:5; Chau 1852:10-1855:20.)

X. THE CO-ISSUERS WERE NOT DEFRAUDED.[154]

The Issuer was a newly-created, bankruptcy-remote special purpose corporate entity (referred to as an "SPV"). Like all CDO SPVs, it was created for a limited purpose of issuing Octans I notes. As a newly-created entity set up for a specific purpose, the Issuer had no prior history and no independence from its originator, Merrill Lynch, until closing, when it was capitalized by Merrill Lynch. (*See* Section X.F.1.) Merrill Lynch decided what assets would be contributed into the Issuer on whatever terms Merrill Lynch decided to do so. The Issuer had no role in the selection of Harding. The Issuer had no role in the warehousing of assets. The Issuer was created on June 19, 2006, long after the Warehouse Agreement became effective. (Resp. Ex. 2 at 131 (OC).) The Issuer had no interests whatsoever until after it was capitalized, and the Indenture became effective, again at closing, on September 26, 2006.

As for the type and quality of assets in the pool, there is no evidence that there were any regulations or set principles pursuant to which the collateral had to be assembled or even what it should be; it could have been assembled even at random. The structure of CDO securities and the terms of the notes therefore varied widely depending on the type of collateral, investor interest, market conditions, and other factors. In other words, every CDO, including Octans I, was entirely the brainchild of its originator and would be confined only by its originator's view of market demand.

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[154] The Division's assertion that the statements in the Pitch Book serve as the basis for a violation of 206(1) and 206(2) of the Investment Advisers Act makes no sense. Not only was this not alleged in the OIP, but there is no evidence at all that the Issuers, to whom the 206 violations are addressed, ever saw, much less reviewed, the Pitch Book. (Wang 586:2-588:14 (testifying that she had no recollection of the Issuer ever receiving the Pitch Book, participating in any meetings, or even ever asking a question); Chau 4264:7-12 (testifying that the Co-Issuers had no role in the preparation of the Pitch Book or term sheet); Chau 4264:13-22 (testifying that he had never seen an Issuer at the marketing of a CDO transaction or in any other meeting in which investors would ask questions of the collateral manager or underwriter); Suh 2960:14-2961:19 (testifying that the Issuer typically does not have people reviewing things until shortly before closing); Wagner 4678:22-4682:5 (testifying that the Issuers have no active role).) No argument can be made that the Issuers read or were even aware of Harding's Investment Philosophy, as contained in the Octans I Pitch Book.

A. The CMA Governed Prospective Conduct Only.

It was only upon the execution of the Collateral Management Agreement, on September 26, 2006, that the Issuer appointed Harding to manage the collateral. For all of the reasons described in Section X.A. above, the CMA did not become effective and did not control Harding actions until then. It was an agreement governing **prospective** activity and by its own terms did not apply to the warehousing phase. Among many other things, the CMA could not have governed asset selection before closing because until the Indenture became effective at closing, there were no instructions for Harding to follow.

B. The Issuer Received What It Was Promised.

The ABX Index assets were not bad assets, however they had been selected. And the post-closing management of the deal is not at issue. Even if Harding were the Issuers fiduciary—which it was not, and could not be, for all of the reasons we discuss below—Harding discharged its forward-looking, post-closing obligations fairly and fully and there is no proof or allegation to the contrary. The Issuer got what it was owed under the CMA. It was neither deceived nor defrauded.

C. Harding Fairly And Fully Discharged Its Obligations Under The CMA In Connection With The Acquisition Of The Portfolio At Closing.

Ignoring all that, the Division's case as to the Issuer is predicated on the proposition that the acquisition of the initial portfolio at closing was covered by the CMA. This argument ignores two facts, each of which is dispositive by itself: (1) the only obligation under the CMA that related to collateral selection was limited to making sure the collateral met all Eligibility Criteria and Investment Guidelines, and it did, and (2) while Harding was under no obligation to select the collateral in any particular way even under the CMA, the Division does not challenge Harding's certification that the collateral met all investment criteria. (*See* Section VII.C.) Even

had Harding's asset selection on May 31, 2006 been defective, there was no proof at the Hearing that it was defective in any way that made those assets ineligible. Even if Harding's asset selection on May 31, 2006 did not comport with the standard of care, the analysis that led to the certification and the certification itself—neither of which was challenged at the Hearing—fixed that. That analysis and that certification formed an independent basis for the purchase of the portfolio well after May 31, 2006. In other words, the CMA obligated Harding to make sure the portfolio met all investment criteria. Harding did and the portfolio did. The Issuer, once again, was neither deceived nor defrauded.

D. Respondents Relied In Good Faith On The Issuer's Representation That The Offering Circular Did Not Contain Any Material Omissions Or Misstatements.

The Offering Circular was the Issuer's disclosure. The Issuer was responsible for its contents and if the manner of asset selection pre-closing were important to the investors, failure to include it was the Issuer's.

The Issuer represented to Harding in the CMA that the Offering Circular did not omit or misstate any material facts, to wit:

> Representations of the Issuer. The Issuer represents and warrants that:
>
> * * *
>
> Offering Circular. The Offering Circular as of the date thereof (including as of the date of any supplement thereto) and as of the Closing Date does not contain any untrue statement of a material fact and does not omit to state any material fact necessary in order to make the statements therein, in light of the circumstances in which they were made, not misleading. The preceding sentence does not apply to information provided by the Collateral Manager in the section of the Offering Circular entitled "The Collateral Manager" and the subsections of the Risk Factors section entitled "Conflicts of Interest Involving the Collateral Manager", "Dependence on the Collateral Manager and Key Personnel" and "Relation to Prior Investment Results".

(Resp. Ex. 5 at 19-20.)

At the time the Issuer made that representation, the Issuer's sponsor, Merrill Lynch, was fully aware of Magnetar's role in the deal. The Issuer's lawyers were aware of Magnetar's rights in the warehouse. Merrill Lynch's lawyers also represented the Issuer. It was fair for the Respondents to believe in good faith that the Issuer was aware of all the facts known to Merrill Lynch because, as its creator, Merrill Lynch was the Issuer's fiduciary. *See In re Parmalat*, 684 F. Supp. 2d 453, 475-76 (S.D.N.Y. 2010), *aff'd sub nom. Food Holdings, Ltd. v. Bank of Am. Corp.*, Nos. 10-1021-cv, 10-1298-cv, 2011 U.S. App. LEXIS 10749 (2d Cir. May 27, 2011) (holding that creator of SPVs, as promoter and de facto controller, had fiduciary duty to its creation).

In addition, Magnetar owned preferred equity shares of the Issuer. (Resp. Ex. 2 at 131 (OC).) It was one of the co-owners of the Issuer. Division's claim here is that despite their existence only on paper, the Issuers could be deemed not to have received adequate disclosures. If that is so, the Issuer should be deemed to have known the role of its co-owner in its creation and capitalization.[155]

In short, Respondents relied in good faith on the Issuer's Representation that the Offering Circular did not omit or misstate any material fact.

As to the Pitch Book, as noted, there is no evidence whatsoever that the Issuer had ever seen it or was aware of its contents.

E. Harding Was Not The Issuer's Fiduciary.

Harding was not the Issuer's fiduciary. Here is the relevant language from the CMA:

> Limited Duties and Obligations; No Partnership or Joint Venture. The Collateral Manager shall not have any duties or obligations except those expressly set forth herein or that

[155] The CMA specifically provided that Octans I would be managed for the benefit of the note holders and equity, unless those interest conflicted. (*See* Section VII.D.4.B.) As discussed in section IV.C, Magnetar's interests never conflicted with those of the other note holders.

> have been specifically delegated to the Collateral Manager in the Transaction Documents. Without limiting the generality of the foregoing, (i) the Collateral Manager shall not be subject to any fiduciary or other implied duties, (ii) the Collateral Manager shall not have any duty to take any discretionary action or exercise any discretionary powers, except discretionary rights and powers expressly contemplated hereby and in the Transaction Documents, and (iii) except as expressly set forth herein or in the Transaction Documents, the Collateral Manager shall not have any duty to disclose, and shall not be liable for the failure to disclose, any information relating to any issuer of any Collateral Debt Security or any of its Affiliates that is communicated to or obtained by the Collateral Manager or any of its Affiliates. The Issuer agrees that the Collateral Manager is an independent contractor and not a general agent of the Issuer and that, except as expressly provided herein, neither the Collateral Manager nor any of its Affiliates shall have authority to act for or represent the Issuer in any way and shall not otherwise be deemed to be the Issuer's agent when undertaking any other activities...

(Resp. Ex. 5 at 8-9 (CMA) (emphasis added); *see also* Chau 1510:19-24; 1511:3-14; 1513:9-15 (testified that the Issuers were not "advisory client[s]" because there was no investment advisor agreement).)

This provision specifically states that Harding was not subject to any fiduciary duties. This reflects the reality that, as discussed above, the interests of the different tranches of the CDO were never perfectly aligned. If Harding were to be a fiduciary of the equity, *i.e.*, the Issuer and Magnetar, it would be obligated to act in a manner that could be detrimental to the note holders. For this reason the CMA specifically required Harding, consistent with the terms of the Indenture, to act in the best interests of **both the note holders and preferred security holders** (equity) unless their interests conflicted. (Resp. Ex. 5 (CMA) at 5 (the Collateral Manager has to "exercise any other rights and or remedies with respect to such Collateral Debt Security or Eligible Investment as provided in the related Underlying Instruments or take any other action consistent with the terms of the Indenture which is in the best interests of the Preferred Securityholders and the Noteholders (and, to the extent that the interests of the Noteholders and the Preferred Securityholders conflict, in the best interests of the Noteholders)"); *see also* Suh 3060:24-3062:10.)

Mr. Suh, who negotiated, edited, and advised Harding on this agreement, specifically explained:

> Q. And then it says: "Without limiting the generality of the foregoing; 1, the collateral manager shall not be subject to any fiduciary or other implied duties." Do you see that?
>
> A. Yes.
>
> Q. What is your understanding of these provisions?
>
> A. This provision reflects the reality of a CDO transaction, which is that, as we discussed before, the collateral manager [does not have] unfettered rights with respect to the management of the issuer's portfolio. It's subject to a number of eligibility criteria for the assets that it can have the trustee purchase on behalf of the issuer. It also has very strict provisions regarding disposition of the assets. So it's reflecting that reality, that because the collateral manager is subject to a number of restrictions set forth in the transaction documents, that the collateral manager does not have duties or obligations other than those that are set forth in the transaction documents. And so the collateral manager is not subject to any fiduciary or other implied duties, because it would be unfair for the manager to be subject to duties when they are also subject to these restrictions in the transaction documents. So that's what this is trying to get at, the fact that there are—these are asset-backed deals, the issuer is not permitted to do, in certain investments, not permitted to even dispose of certain investments in certain circumstances. And because of that, those limitations also apply to the manager's ability to act on behalf of the issuer.

(Suh 3053:5-3054:21; *see also* Suh 3048:2-3049:6.)[156]

Mr. Chau also explained his understanding that Harding could not enter into an advisory relationship with CDO Issuers because:

> [E]ach stakeholder in the CDO liability structure could potentially have different interests. It could have different—it could have aligned interest, misalignment, but they could have potential conflicts of interest. . . . And since my role is to manage the CDO after this, once we sign the agreement, it is very difficult for me as manager to rep that I can be a fiduciary to both parties with inconsistent interests.

(Chau 1512:10-23; *see also* Section X.H (discussing the disclosed conflicts of interest in the Offering Circular).) This testimony—from both Mssrs. Suh and Chau—is uncontested.

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[156] In the section referencing the Investment Advisers Act, it expressly limits Harding's role as a "Collateral Manager" for the Issuer and not as an "investment adviser." (*Id.* at 6 ("The Collateral Manager shall take all action required, **as Collateral Manager for the Issuer**, to be taken by it under the Investment Advisers Act of 1940") (emphasis added).)

F. **The Co-Issuers For Octans I Were Engaged To Vote Yes To The Octans I Transaction.**

1. The Issuer was an empty shell and had no interests until Merrill Lynch capitalized it at closing.

Even if Harding had been its fiduciary, the Issuer did not care about the manner of asset selection. Not a single witness testified that it did. As discussed below, all witnesses testified that it did not or would not.

These CDO SPVs were created to receive the assets that Merrill Lynch chose for them; they had no choice. *See Parmalat*, 684 F. Supp. 2d at 459 ("[SPVs] have no past, no future, and no employees. They are creatures of the financial services companies that cause their creation. They are phantoms, endowed by law with legal personality but having no real existence. . . In short, they were engaged to vote 'yes.'") The Court in *Parmalat* found the following facts dispositive on the issue of whether the Companies' directors were just hired to vote yes: (a) the entity existed only on paper for the sole purpose of completing the transaction (*id.* at 458-59, 467); (b) the entity and its directors never considered the business merits of the deal (*id.* at 459, 467); (c) the entity and its directors did not do any due diligence or exercise any independent business judgment (*id.* at 468); and (d) the entity just appointed as attorneys in fact the representatives of the originating bank. (*Id.* at 468.)

As discussed below, every single one of those facts is present here. In fact, the Division failed to offer any proof whatsoever that the issues present in this case would have changed the Issuer directors' decision to approve the transaction.

2. The Co-Issuers existed only on paper for the sole purpose of completing the Octans I transaction.

As a newly-created entity set up for a specific purpose, the Co-Issuers had no history and no independence from its originator, Merrill Lynch, until it was capitalized, at the closing of the

deal. (*See* Resp. Ex. 2 at 131-133 (OC) (outlined that the sole purpose of the Issuer is to effectuate the Octans I transaction); Resp. Ex. 65, Funding Certificate pursuant to Section 3.2(e) of the Indenture (states the Issuer will be capitalized on September 26, 2006).)

In sum, the Co-Issuers existed for this deal and this deal only:

- The entire issued share capital of the Issuer consisted of the 1,000 ordinary shares and 94,000 preferred securities; and the Issuer did not "have any material assets other than the Collateral Debt Securities and other assets comprising the collateral." (Resp. Ex. 2 at 4 (OC).)

- The Issuer could not accept or issue any other debt or equities other than what was stated in the Offering Circular of Octans I. (*Id.*)

- The Offering Circular states in black and white, "[t]he Issuer has no prior operating experience." (Resp. Ex. 2 at 131.)

Furthermore, the Issuer's activities were specifically limited to:

> Article 3 of the Issuer Charter provides that the activities of the Issuer are limited to (i) the issuance of the Notes, the Preferred Securities and its ordinary securities, (ii) the Acquisition, Disposition of, and investment in, Collateral Debt Securities, Equity Securities (to a limited extent) and Eligible Investments for its own account, (iii) the entering into, and the performance of its obligations under the Indenture, the Notes, the Class A-I Swap, the Purchase Agreement, the Account Control Agreement, the Preferred Security Paying Agency Agreement, the Collateral Management Agreement, the Synthetic Securities, the Collateral Administration Agreement, the ISDA Master Agreement, the Administration Agreement and any Hedge Agreement, (iv) the pledge of the Collateral as security for its obligations in respect of (inter alia) the Notes, (v) the ownership of the Co-Issuer and (vi) certain activities conducted in connection with the payment of amounts in respect of the Securities, the management of the Collateral and other incidental activities.

(Resp. Ex. 2 at 133 (OC).) Likewise, the Co-Issuer "was formed for the sole purpose of co-issuing the Notes," and "[t]he entire undivided limited liability company interest of the Co-Issuer is owned by the Issuer." (*Id.* at 4, 131.)

The Co-Issuers also did not have any management, staff, offices, or operations. (*See, e.g.*, Resp. Ex. 2 at 132 (OC).) And typically the directors of these Issuers served simultaneously in

similar roles for hundreds of other special purpose vehicles. (Wagner 4680:18-22; Puglisi 3131:8-3132:8.)

The Issuer's interests were also solely derivative from the assets its originator contributed and the notes its originator, Merrill Lynch, caused it to issue. In the words of Mr. Puglisi, who has decades of experience in the financial industry and in serving as a director, officer, and manager of SPVs:

> Q. Do you know what the purpose of the Issuer is?
>
> A. I have an understanding what the purpose of the issuer is.
>
> Q. What is your understanding?
>
> A. The purpose of the issuer is to be the owner of the assets that are in the structured finance vehicle to be the co-issuer of notes of the rated notes, along with the co-issuer; to be the issuer of unrated notes; to be the issuer of the equity in the transaction; to be the sole shareholder, or, in this case, member of the issuer; to contract with the collateral manager under the Collateral Management Agreement. I'm sure I'm forgetting something, but off the top of my head that's what I recall right now.
>
> Q. Do you know whether the issuer had a purpose outside of Octans 1?
>
> A. I'm having a lot of trouble with that question, because the Octans 1 issuer was the issuer for that vehicle and no other vehicle. It can't be used twice. It's used once.

(Puglisi 3145:24-3146:23.)

The Division's own expert testified, as follows, about the Issuer:

> Q. Does it have employees other than directors who sign the papers?
>
> A. The special purpose entity?
>
> Q. Yes.
>
> A. No
>
> Q. It is created for that one particular reason, right?
>
> A. To be a special purpose entity.
>
> Q. For that one deal.

A. For that deal, yes.

Q. It doesn't exist before?

A. No, not long before, no.

Q. And it doesn't exist after?

A. Well, it exists for the 30 years or however long the CDO is going to be outstanding for.

Q. But it is not in the business of doing multiple CDO's?

A. No. Typically the next deal would be a new issuer.

(Wagner 4679:22-4680:17.) The Co-Issuers are simply creatures of Merrill Lynch, endowed by law with legal personality, but having no real existence.

3. The Co-Issuers never considered the business merits of Octans I.

It is therefore not surprising that not a single piece of evidence has been offered that the Co-Issuers considered the business merits of the deal. The evidence, in fact, is the opposite. For example, the meeting minutes of the Board of Directors for the Issuer are silent about the type of assets in the CDO, the experience of the Collateral Manager, or any other indicia that the Issuer did anything more than just sign-off on the deal it was hired to approve. (Resp. Ex. 490 at 5-6, Minutes of a Meeting of the Board of Directors of Octans I CDO Ltd. (Sept. 25, 2006).) And Mr. Puglisi, the independent manager of the Co-Issuer, who also had joint Power of Attorney with the Issuers' counsel to approve the Offering Circular, stated that he did not recall interacting with anybody besides deal counsel. (Puglisi 3138:7-10.) Nor is there any documentary or testimonial evidence that the directors of the Issuer asked a single question of anyone at Harding or Merrill Lynch.

4. The Co-Issuers did not do any due diligence or exercise any independent business judgment.

The evidence establishes that the directors of the Issuer did nothing of substance in connection with the execution of the deal and had no input into any deal terms or deal characteristics. Namely:

Q. Does the issuer choose the structurer of the deal?

A. No.

Q. Does it choose—does it choose the assets?

A. No.

Q. Does it choose—is it involved in the pricing?

A. No.

Q. Does it meet with investors?

A. No.

Q. Does it do due diligence on the bank or the collateral manager?

A. No.

***

Q. They don't negotiate the term of the collateral management agreement?

A. No.

Q. That is done between the bank and the collateral manager, right?

A. Yes. With input of those, but—primarily those, but there were other people that had input as well.

Q. They don't negotiate the indenture?

A. No.

Q. Right? They sign the papers or they have—they authorize somebody else to sign the papers on their behalf?

A. Correct.

***

THE COURT: Let me ask one question. Does the issuer, as opposed to some other participant, do they advertise at all or—you already were asked do they go on the road show, but do they do any kind of advertising?

THE WITNESS: The issuer? The special purpose entity? No. There might be a tombstone ad that says the issuer, but the issuer isn't placing the ad.

(Wagner 4679:8-21; 4681:4-4682:5.) Mr. Chau and Ms. Wang similarly testified that the Issuer had no role whatsoever (1) in deciding who the collateral manager would be, (2) what the structure of the CDO would be, (3) in negotiating the indenture, and (4) in determining the Eligibility Criteria of the Collateral Debt Securities. (Chau 4263:15-4264:12; Wang 586:2-588:14.) The evidence is also uncontroverted that "[t]he co-issuers[157] had no role in selecting the collateral manager." (Chau 4262:25-4263:6; *see also* Wagner 4678:24-4679:5.)

There is no evidence on the record that the Co-Issuers were even physically present for the Octans I closing, when many of the documents were executed. Rather, the only evidence was that the Issuers typically did not attend the closing. (*See* Puglisi 3139:1-13 ("the issuer is down in the Cayman Islands and they don't send people up to the closing"); Wagner 4680:23-4681:3 (agreeing that the directors of the Issuers usually do not attend the closing.).)

Moreover, had the directors wanted to inquire into their co-owner's, Magnetar's, role, nothing prevented them from doing so. No attempt was made to hide Magnetar's involvement in Octans I. For example, the directors received e-mails related to the transaction, including the Closing Agenda, in which the distribution list included individuals with a @magnetar.com e-mail address. (*See, e.g.*, Resp. Ex. 464, E-mail from Camille Perkins, Schulte Roth & Zabel, to

[157] Respondents are planning on seeking a correction to the record as it currently refers to the "co-issuer" and not the "co-issuers." The context of the question, which refers to the issuers, and the beginning of Mr. Chau's answer, which states "they had no role," make it clear that the singular reference is a typographical error.

Distribution[158] re Octans I CDO Ltd.—Closing Agenda (August 31, 2006); Resp. Ex. 259, E-mail from Nubia Cabrera to Distribution[159] re Octans I CDO (Sept. 26. 2006) (announcing that Octans I CDO Ltd. had closed).) There is no evidence, however, that a single director asked a single question about Magnetar or anything else related to Octans I. (*See* Puglisi 3153:6-22.)[160] At minimum, no effort was made to hide Magnetar's involvement in the deal—including receiving and commenting on the Offering Circular—from the Co-Issuers.

5. The Co-Issuers acted through attorneys in fact.

The Issuers, in words and deeds, handed the reigns over to Schulte. The Power of Attorney executed on behalf of the Issuer appointed Adam Singer and Donald Puglisi, jointly and severally, "to do, execute and perform all and any of the acts, deeds, matters and things hereinafter contained in connection with the issue by the Company of certain notes . . . and certain preferred shares." (Resp. Ex. 46 (Executed Power of Attorney (Sept. 25, 2006).)[161] The activities of the Issuer are expressly limited to what it authorized Adam Singer and Donald Puglisi to do; there are no activities or obligations that the Issuer can undertake that are not covered by the Power of Attorney. (*Compare* Resp. Ex. 2 (OC) at 132 *with* Resp. Ex. 46.)

[158] The "To" line of this e-mail included the directors of the Issuer, David Egglishaw & John Cullinane, as well as the following individuals from Magnetar, Susan.Furman@magnetar.com and james.prusko@magnetar.com.

[159] The "To" line of this e-mail included the directors of the Issuer, David Egglishaw & John Cullinane, and Donald Puglisi, the independent manager of the Co-Issuer, as well as the following individuals from Magnetar, Susan.Furman@magnetar.com and james.prusko@magnetar.com.

[160] Even if the directors of the Issuer somehow missed the recipients of those e-mails, the Closing Agenda provided a list of abbreviations for certain parties, including Magnetar Capital Master Fund, Ltd. No other investor was listed. (Resp. Ex. 465 at 2, Closing Agenda for Octans I CDO Ltd. (SRZ Draft as of 8/31/06).)

[161] Moreover, the Power of Attorney also details that the attorneys-in-fact had the "full power" to arrange the issuance of the final Offering Circular, to approve the Offering Circular, and "to do all acts, to execute all documents . . ., to give such undertakings and assurances and to take all other actions in relation to the issue of the Offered Securities . . . ." (Resp. Ex. 46, Executed Power of Attorney (Sept. 25, 2006); *see also* Puglisi 3139:3-13 (Mr. Puglisi testified that with the Power of Attorney he had the authority to sign all documents at the closing on behalf of the Issuer).)

G. The Respondents Could Not Have Committed A Violation Of 206(1) And 206(2) Of The Investment Advisers Act Because The Issuer's Counsel And Merrill Lynch Knew All The Relevant Facts.

Perhaps more significantly, Merrill Lynch was the Issuer's fiduciary because, as the structurer of the deal, Merrill formed the Issuer. *See Parmalat*, 684 F. Supp. at 475-76 (holding that creator of SPVs, as promoter and de facto controller, had a fiduciary duty to its creation).

It was fair for the Respondents therefore to assume that the Issuer knew everything its fiduciary knew (or even that the Issuer knew what its shareholder Magnetar knew). (*See* Section X.D; Resp. Ex. 2 at 116 (OC).) Merrill Lynch knew all of the salient (alleged) facts. It knew about Magnetar's alleged involvement in the selection of the ABX Index assets[162] and rights under the Warehouse Agreement;[163] and it also knew more than Harding knew about Magnetar's hedges or short positions on Octans I,[164] as the Division's brief makes clear.[165] Thus, it was reasonable for Respondents to assume fairly that, having created them, Merrill Lynch made all necessary disclosures.[166]

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[162] We do not agree with the Division's interpretation of these e-mails; however, if they stand for the principle that Magnetar was pushing a certain number of the ABX Index assets, they also stand for the principle that Merrill Lynch was well aware of that fact: Div. Ex. 11 (E-mail between Jim Prusko (Magnetar) and Richard Lasch (Merrill Lynch) re: initiation of Octans I), Div. Ex. 12 (E-mail from R. Lasch to H. De Silva, D. Mallach, K. Margolis, D. O'Donnell, J. Peck, A. Phelps, S. Sloane, and G. St. Pierre (all of Merrill Lynch) re: Magnetar Financial LLC: **Mezz ABS Mandate(s) **); Div. Ex. 18 (E-mail from J. Prusko to Merrill Lynch employees S. Eliran, H. De Silva, & R. Lasch); Div. Ex. 21 (E-mails between R. Lasch & J. Prusko); Div. Ex. 25 (E-mail from Alison Wang to Sharon Eliran (Merrill Lynch) re: Maxim Proposal); Div. Ex. 31 (Internal Magnetar E-mail referencing call with Harding and Merrill Lynch); Div. Ex. 33 (E-mail from R. Lasch to J. Prusko); Div. Ex. 45 (E-mails between R. Lasch & J. Prusko); Div. Ex. 51 (E-mail from J. Prusko to R. Lasch); Div. Ex. 55 (Internal Merrill Lynch e-mail about ABX Index and Magnetar.)

[163] (Resp. Ex. 123 at A-12 (Warehouse Agreement dated May 26, 2006); *see also* Section IV.A. (discussing Merrill Lynch and its counsel's knowledge of the Warehouse Agreement.)

[164] (Resp. Ex. 866 (E-mail about whether Merrill Lynch could source hedges), Resp. Ex. 867 (E-mail between Magnetar and Merrill Lynch about sourcing hedges).)

[165] (Div. Br. at 9-11, 19 n.30, 23-24, 26, 29-32.)

[166] Should the Division answer that Merrill Lynch did not know that Respondents "abdicated" their responsibility to select assets for Octans I that ignores again that the violations in the OIP are premised on Magnetar's alleged involvement in the deal and its rights under the Warehouse Agreement (which Merrill Lynch knew). Further, at minimum, even under the Division's theory, Merrill Lynch, and thus the Issuer, knew that a third-party whose interests were not aligned with the other Note holders had a say in the composition of the portfolio. If
(Footnote continued on next page)

In fact, as discussed earlier, Merrill Lynch and the Issuer were represented on Octans I by the same outside counsel who knew all about Magnetar's warehouse rights.[167] And, those same lawyers reviewed and approved representations from the Issuer to the Respondents—contained in the Collateral Management Agreement and the Offering Circular[168]—that the Offering Circular did not contain any untrue statements of or omissions of material fact.[169] The Respondents knew that the Issuer had a host of lawyers drafting the disclosures and statements in the Offering Circular; therefore, they had another reasonable basis to think that all relevant disclosures had been made. It would not have been reasonable for Respondents, who were not in charge of the Offering Circular, to second-guess Schulte Roth & Zabel LLP and Merrill Lynch as to whether further disclosures were required.

In sum, the fact that the fiduciary and the owner of the Issuer knew all of the relevant facts, and that counsel for the Issuer drafted the relevant alleged misrepresentations to the investors, dispels any theory that Respondents intentionally, recklessly, or negligently misled anyone about whether it selected the assets for Octans I or about Magnetar's warehouse rights.

H. The Offering Circular Informed The Prospective Investors That The Collateral Manager May Be Operating Under Certain Conflicts Of Interest.

The investors and the Issuer also knew that Harding had certain conflicts of interest, as that fact was disclosed in black and white in the Offering Circular. (Resp. Ex. 2 (OC) at 58-63.)

knowing that fact did not alter the Issuer's decision to approve the transaction, why would (alleged) facts about Harding's credit process change the calculation?

At bottom, whatever the Division's theory, there is no proof. The Division offered no proof that any of its past, current, or future allegations and theories would have changed the Issuer's decision. All that is before the Court is the testimony of five witnesses, including their expert, as well as all of the documents about the Issuer, which overwhelmingly establish that the Co-Issuers were created to say "yes" and that nothing would have changed their decision to approve the transaction.

167 (*See* Section IV.A.; Resp. Ex. 2 (OC) at 2nd to last page.)

168 (*Id.*; at v; Resp. Ex. 5 (CMA) at 19-20.)

169 (Resp. Ex. 5 at 19 (CMA).)

In fact, one of those disclosures spelled out that, "the Collateral Manager, its affiliates and their respective clients may invest in securities (or make loans) that are included among, rank *pari passu* with or senior to Collateral Debt Securities held by the Issuer, or have interests different from or adverse to those of the Issuer." (*Id.* at 60.) Mr. Suh explained this provision, as follows:

> So the securities that are included in the ABS CDOs include asset-backed securities, that just like the CDO securities themselves, they may have securities that are senior to them or junior to them, or maybe pari passu. So this is a risk factor disclosure saying that the collateral manager, its affiliates and/or its clients may be investing in securities that have different priorities within that issuer's securities offering. So there may be a conflict in the way that if there were workouts, for example, in respect of that issuer, if you're representing another client that has a more senior position, there is a conflict between that and this issuer, which may have a more junior position.

(Suh 2981:2-2982:4.) Mr. Suh further testified that with this disclosure, the Issuer is authorizing these types of client cross transactions or essentially waiving the conflict of interest. (Suh 2982:9-2983:10.)

Moreover, after detailing the services the Collateral Manager may render to other persons and entities, the Offering Circular disclosed: "Services of this kind may lead to conflicts of interest with the Collateral Manager, and may lead individual officers or employees of the Collateral Manager to act in a manner adverse to the Issuer." (Resp. Ex. 2 at 62 (OC).) Again, Mr. Suh testified that he understood this disclosure to mean, "the collateral manager and individual employees and officers could be in a position where they have to act in a manner that's adverse to the interest of the issuer, so it's a disclosure about those potential conflicts of interest." (Suh 2983:21-2984:18.)

These disclosures of the conflicts of interests between the Issuer and the Collateral Manager are then reiterated in the summary of the Collateral Management Agreement: "In certain circumstances, the interests of the Issuer and/or the holders of the Securities with respect to matters as to which the Collateral Manager is advising the Issuer may conflict with the

interests of the Collateral Manager and its Affiliates." (Resp. Ex. 2 (OC) at 194-95, 201; *see also* Suh 3008:25-3009:23.)

XI. THE ABX INDEX ASSETS AT ISSUE WERE NOT DISFAVORED.

With asset selection, as with the rest of its Hearing presentation, the Division tried a different case from what was charged in the OIP. The OIP does not complain about how Harding selected assets generally. There is nothing in the OIP—not a single word—about Harding's overall asset selection process as it related to RMBS. For example, the OIP does not charge that there were any problems with the selection of any of the non-ABX Index assets in Octans I. (*See* OIP at ¶¶ 8-11.) There were a total of **185** assets in Octans I at closing, but not a single non-ABX Index asset is even mentioned.

Instead, the OIP is focused precisely and solely on the selection of the 28 ABX Index assets on May 31, 2006.[170] Even more to the point, not all of the 28 ABX Index assets that were part of the index trade were challenged by the OIP. The OIP goes through a very detailed review of exchanges between Ms. Lieu and Ms. Moy on May 31, 2006. These exchanges, according to the OIP, are evidence that Harding's analysts had approved only a subset of the ABX Index bonds that were among the 28 that went into the deal and that the remainder of those bonds was placed in the deal over their objections.[171] Here are the relevant paragraphs from the OIP:

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[170] Of course, the evidence disproves any accommodation to Magnetar. The evidence also demonstrates that there was no accommodation in the other Magnetar deals. For example, On August 29, 2006, James Prusko e-mailed Wing Chau and Tony Huang a list of First Franklin 2006-vintage RMBS deals. (*See* Resp. Ex. 797.) Mr. Chau forwarded that e-mail to Harding's credit team and asked them to analyze it. (*See id.*) Jamie Moy responded that they had "recently passed on" one of the bonds, but noted that, historically, First Franklin deals have "performed well." (*Id.*) Mr. Chau wrote "if it doesn't fit, we should pass." (*Id.*)

[171] As part of its argument, the Division suggests, using e-mails taken out of context, that Harding's credit analysts had a rule of approving only approximately 1 out of every 5 RMBS bonds that they analyzed (their supposed "hit rate"). (*See* Div. Br. at 47-48.) This argument is irrelevant. First, there is no evidence that Harding's credit analysts were limited to approving only 20% of any list of assets they were given to approve. Each bond within any given list was analyzed independently of the list itself, with consideration given to any limitations imposed by the CDO's eligibility requirements. (*See* Lieu 3308:3-13 (testifying that hit rate percentage changed based on the list).) Second, as noted in Section VIII.C, there is no evidence that Harding ever made a representation

(Footnote continued on next page)

> 43. At or about 2:49 p.m., [Jung Lieu] wrote to the trader and the Group List (emphasis added): "Out of the 40 bonds in this list, 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 bonds]."
>
> 44. At or about 3:04 p.m., [Jamie Moy] wrote to the trader and the Group List: "here's the results for the 4 pm owic. Attached are the 40 bonds. [T]here is a correction. We are not okay on the MABS deal [*i.e.,* an RMBS named MABS]. Some we have already seen as [Jung Lieu] mentioned below." **The attached spreadsheet had a "Y" (signifying that Harding's credit team approved the bond) next to 15 of the bonds, and a "N" (signifying that Harding's credit team rejected the bond) next to the other 25** bonds, including the "MABS" RMBS at both rating levels.
>
> 45. As noted above, however, the e-mail from [Jung Lieu] at 4:22 p.m. reflected the selection of the 28 Accepted Index Bonds to which the Octans I portfolio ultimately became exposed. Those 28 accepted bonds included all of the 15 bonds marked "Y" at 3:04 p.m., and another 13 bonds that had been marked "N" in that e-mail (including the "MABS" bonds). The 28 acceptances and 12 exclusions, moreover, changed from the 2:49 p.m. e-mail in which [Jung Lieu] noted that previously "10 have been approved, and 19 have been rejected."
>
> 46. *There is no contemporaneous record of Harding's **reasons** for accepting many of these bonds.* The only relevant credit work on May 31 of which there is any record (apart from what is reviewed above) was circulated to [Jung Lieu] at or about 1:12 p.m., and it was largely negative. For most of the bonds analyzed (which included ten of the 13 bonds that [Jamie Moy] had marked "N"), the credit analysis indicated substantial write-downs.
>
> 47. Subsequent communications confirm that Harding **compromised**, allowing into the Octans I portfolio bonds that it **would have been unlikely to select but for Magnetar's desire for ABX Index bonds**.

(OIP at ¶¶ 9-10 (emphasis added).) In other words, Jung Lieu circulated a list of 10 approved ABX Index bonds at 2:49 p.m. (*Id.* ¶ 43.) At 3:04 p.m., Jamie Moy circulated another list expanding the approved total to 15 by adding six additional names to the list circulated by Ms. Lieu and also removing the MABS bond. (*Id.* ¶ 44.) But the final list sent at 4:22 p.m. by Ms.

to any investor that its credit team was limited to approving only 20% of any given list of assets. To the extent Harding did disclose its acceptance rate to investors, there is no evidence that Harding ever misrepresented that rate. Finally, the Division pointedly argues that Jung Lieu's use of trading information about RMBS bonds to inform her expectations about how a particular bond is likely to perform in the future is absurd, yet it fails to see the irony in imposing a requirement that Harding's credit must approve only 20% or less of RMBS bonds in any given random list of assets without due regard to any credit analysis. As long as Harding's credit team did the analysis, it is irrelevant how many bonds they actually approve. (*See, e.g.*, Doiron 2016:14-21.)

Lieu had 28 names on it and included some of the names that had an "N" [indicating rejection] next to them in Ms. Moy's 3:04 p.m. e-mail. (*Id.* ¶ 45.) There were no contemporaneous documents showing **the reasons for accepting the remaining 13 bonds**. (*Id.* ¶ 46.) The only available analysis [the Brett Kaplan cash flow runs (Div. Ex. 53)] showed substantial write-downs for the bonds that were not on the Jamie Moy's 3:04 p.m. list of 15. (*Id.*).

The OIP, therefore, does not take issue with 15 of the 28 bonds selected by Harding on May 31. The only allegation here is that 13 assets made it into Octans I without any contemporaneous evidence of approval. (*See* Resp. Ex. 874 (listing the 13 assets at issue).) And the inference that the OIP makes is that, in the absence of evidence of approval: (1) these 13 assets had to have been "disfavored" by Ms. Moy and Ms. Lieu, and (2) because they were disfavored by the analysts, the only way these 13 assets could have made it into Octans I was because someone had overruled the analysts to accommodate Magnetar.

With that as background, we argued in pre-hearing papers, that there actually were 11 assets at issue. As discussed below, the MABS bonds at the Baa2 and Baa3 levels had been approved by both analysts on other occasions including on May 31, 2006. These bonds were not "disfavored." At most the selection of these bonds reflects a disagreement between the analysts. More likely, Ms. Moy did not realize that the bonds had just recently been approved. Therefore, we argued, the only party that would be hurt if the value of all 11 of the so-called "disfavored" assets were reduced to zero would be Magnetar. (*See* Reply Br. in Further Support of Resp. Mot. for a More Definite Statement at 1-2, *Harding Advisory LLC*, Admin. Proc. File No. 3-15574 (Feb. 3, 2014); Resp. Pre-Hearing Br. (Corrected) at 3, 7, *Harding Advisory LLC*, Admin. Proc. File No. 3-15574 (Mar. 24, 2014).)

The proof at the Hearing also showed that all 13 of these assets were in fact analyzed, approved by Harding's analysts, and were not "disfavored." For example, the Division made much of the fact that Jamie Moy was the senior analyst at Harding and emphasized—at the Hearing, as well as in its Post Hearing Brief—that Jamie Moy appeared to have been overruled by someone with respect to her credit decision on the MABS bonds. (*See* Div. Br. at 57, 113.)[172] It was Jamie Moy, however, who sent Tony Huang an e-mail showing that Harding approved all but one of the ABX Index bonds for another deal (NOT INCLUDING Magnetar) only three weeks after May 31, 2006, on June 21, 2006. (*See* Resp. Exs. 385-388.) The purpose of that e-mail was to provide a list of approved bonds for a Deustche Bank bespoke deal. (*Id.*) Generally, if a portfolio manager, like Mr. Huang, requested from the Harding credit team a list of approved deals, the credit analyst would review the master list of credit decisions, filter by "Yes," and run cash flow or surveillance analysis in order to refresh the credit decision. (*See* Lieu 3799:7-18.) In sum, these assets were not "disfavored" and were not being included as an accommodation to Magnetar: they were approved for another deal very shortly after they were approved for Octans I.

Other evidence that these were not disfavored assets consisted of proof that the same assets were continually being approved for other deals at other times both before and after May 31.[173]

[172] Although Jamie Moy might have had a more senior title, there were issues with her use of Intex. (*See* Resp. Ex. 767; Lieu 3626:16-25 (testifying that Jamie Moy "was not very good at running cash flows on Intex.").)

[173] *See* Exhibit B (Approvals of ABX Index Bonds for Non-Magnetar CDOs) for a full list of approvals of ABX Index bonds both before and after May 31, 2006, including citations to the evidence.

1. **AMSI 2005-R11 M8** was approved on August 25, 2006 for a Citi bespoke deal by Jung Lieu and Jamie Moy. (Resp. Exs. 415-416; 419-422.)

2. **CWL 2005-BC5 M8** was approved on either May 24 or June 7, 2006 for a Barclays bespoke deal by Jamie Moy (Resp. Exs. 371-372), approved on June 21, 2006, by Jamie Moy (Resp. Exs. 385-388), and approved on August 25, 2006 for a Citi bespoke deal by Jung Lieu. (Resp. Exs. 419-422.)

3. **JPMAC 2005-OPT1 M9** was approved on either May 24 or June 7, 2006 for a Barclays bespoke deal by Jamie Moy (Resp. Exs. 371-372), and approved on June 21, 2006, by Jamie Moy. (Resp. Exs. 385-388.)

4. **MABS 2005-NC2 M8** was approved on June 21, 2006 by Jamie Moy (Resp. Exs. 385-388), and approved on August 25, 2006 for a Citi bespoke deal by Jung Lieu. (Resp. Exs. 419-422.)

5. **MABS 2005-NC2 M9** was approved on May 22, 2006 by the Harding credit team (Div. Ex. 16), approved on May 30, 2006, by Jung Lieu (Resp. Exs. 776-777; Div. Exs. 34-35), and approved on June 21, 2006 by Jamie Moy. (Resp. Exs. 385-388.)

6. **MLMI 2005-AR1 B2** was approved on either May 24 or June 7, 2006, for a Barclays bespoke deal by Jamie Moy (Resp. Exs. 371-372), approved on June 7 for a Cohen Bros. bespoke deal by Jamie Moy (Resp. Exs. 369-370), and approved on June 21, 2006 by Jamie Moy. (Resp. Exs. 385-388.)

7. **MSAC 2005-HE5 B2** was approved on either May 24 or June 7, 2006, for a Barclays bespoke deal by Jamie Moy (Resp. Exs. 371-372), approved on June 21, 2006 by Jamie Moy (Resp. Exs. 385-388), approved on August 25, 2006, by Jung Lieu (Resp. Exs. 419-422), was traded into the Lexington III CDO on October 10,

2006 (Div. Ex. 6), and traded into the Lexington V CDO on December 19, 2006. (Div. Ex. 6.)

8. **MSAC 2005-HE5 B3** was approved on May 22, 2006 by the Harding credit team (Resp. Exs. 298-99), approved on May 30, 2006 by Jung Lieu (Resp. Exs. 776-777; Div. Exs. 34-35), approved on either May 24 or June 7, 2006 for a Barclays bespoke deal by Jamie Moy (Resp. Exs. 371-372), approved on June 7 for a Cohen Bros. bespoke deal by Jamie Moy (Resp. Exs. 369-370), and approved on June 21, 2006 by Jamie Moy. (Resp. Exs. 385-388.)

9. **NCHET 2005-4 M8** was approved on either May 24 or June 7, 2006, for a Barclays bespoke deal by Jamie Moy (Resp. Exs. 371-372), approved on June 7 for a Cohen Bros. bespoke deal by Jamie Moy (Resp. Exs. 369-370), and approved on June 21, 2006 by Jamie Moy. (Resp. Exs. 385-388.)

10. **RAMP 2005-EFC4 M8** was approved on either May 24 or June 7, 2006, for a Barclays bespoke deal by Jamie Moy (Resp. Exs. 371-372), approved on June 21, 2006 by Jamie Moy (Resp. Exs. 385-388), and approved on August 25, 2006, by Jung Lieu. (Resp. Exs. 419-422.)

11. **RAMP 2005-EFC4 M9** was approved on either May 24 or June 7, 2006 for a Barclays bespoke deal by Jamie Moy (Resp. Exs. 371-372), approved on June 7 for a Cohen Bros. bespoke deal by Jamie Moy (Resp. Exs. 369-370), and approved on June 21, 2006 by Jamie Moy. (Resp. Exs. 385-388)

12. **SAIL 2005-HE3 M8** was approved on June 6, 2006 for an unknown deal by Jamie Moy (probably Lexington II, where it was traded a day later) (Resp. Ex. 363, Div. Ex. 6), approved on either May 24 or June 7, 2006 for a Barclays

bespoke deal by Jamie Moy (Resp. Exs. 371-372), approved on June 21, 2006 by Jamie Moy (Resp. Exs. 385-388), and approved on August 25, 2006 by Jung Lieu. (Resp. Exs. 419-422.)

13. **SAIL 2005-HE3 M9** was approved on June 21, 2006, by Jamie Moy. (Resp. Exs. 385-388.)

As to whether Ms. Lieu and Ms. Moy agreed on the final list sent by Ms. Lieu at 4:22 p.m. on May 31, 2006, note that the fact that Ms. Moy responded to Ms. Lieu's 2:49 p.m. list of 10 approved names confirms that the two of them were communicating about the ABX Index bonds. The only reasonable inference, in light of that and in light of the fact that she herself approved these bonds on other occasions, including on June 21 for the Deutsche Bank bespoke deal, is that they also communicated on May 31. Moreover, they sat within feet of each other and they were both analyzing the same bonds on May 31. Even as a simple matter of common courtesy and to maintain the professional relationship they shared, Ms. Lieu could not have simply ignored the fact that Ms. Moy was looking at the same bonds and that they had a disagreement about at least one of them. Of course, having set Ms. Moy as the senior most experienced analyst who had been overruled, the Division failed to call her as a witness. One can only conclude that if she were prepared to testify that she had been overruled or had not been consulted, the Division would have called her. The Division, therefore, failed to carry its burden of proving the assets at issue were "disfavored" by the Harding analysts or that they had been overruled or ignored.

XII. HARDING'S CREDIT ANALYSTS WHO PERFORMED THEIR STANDARD ANALYSIS FOR THE ABX INDEX WERE NOT PRESSURED OR OVERRULED.

A. There Was "No Real Distinction Between ABX And The Rest Of The Subprime Market."

To step back, the Division has predicated a fraud on the inclusion in Octans I of 28 bonds from 16 of the 20 largest, most liquid RMBS deals. To be clear, these deals were selected by 15 of the largest market participants in order to represent the broader RMBS market place; the RMBS deals within the ABX could be found in almost all CDOs issued around that time, which means almost all market participants were analyzing these deals; and countless articles were written about the Index itself and trading strategies. Every market participant was analyzing these bonds and reaching its own conclusions.

The ABX Index was first released on January 19, 2006, with the roll-out of ABX.HE 2006-1 ("ABX 06-1" or ABX Index"[174]), which contained 20 RMBS deals. (*See* Resp. Ex. 294 at 2; Huang 780:14-22; Prusko 2438:10-13.) Subsequent series were rolled out every six months. (*See* Resp. Ex. 294 at 2; Huang 928:19-929:12.) The ABX Index administrator, a company called Markit, compiled a list of the largest subprime RMBS issuance for a particular time period (limited by certain eligibility criteria), and submitted the list to a consortium of approximately 15 banks (known as "CDS IndexCo"), who then voted on which RMBS assets to include in the index. (*See* Resp. Ex. 294 at 2-3, 5; Resp. Ex. 295 at 12; Resp. Ex. 400 (Markit Press Release for ABX.HE 06-2); Huang 854:25-855:15; Wagner 4753:15-4755:4.) Each series of the ABX Index contained a "unique set of deals (and underlying loans)." (Resp. Ex. 400 (Markit Press Release

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[174] Although the ABX Index would roll-out a new series every six months and would not necessarily be similar in composition to the prior series (*e.g.*, ABX.HE 06-2 is different from 06-1, 07-1, and 07-2), this brief will refer to the constituent assets of the ABX.HE Index 06-1 as "ABX Index" bonds and refer to the ABX.HE 06-1 index itself as the "ABX Index." Should Respondents refer to any other series of the ABX Index, they will refer to them by their series number.

for ABX.HE 06-2).) The Index reflected "general market conditions, subprime issuance trends . . . and subprime borrower characteristics." (Resp. Ex. 294 at 5.) According to a January 17, 2006 UBS research paper, none of the deals in the 2006-1 series stood out "as being atypical of recent subprime issuance trends." (Resp. Ex. 294 at 2; *see also* Doiron 1961:9-1962:10 (testifying that knowledge of the ABX Index was widespread and nothing to suggest that there was anything different about the ABX assets from the rest of the RMBS universe); Edman 2542:2-20, 2574:20-23 (testifying that the ABX was a "reasonably large portion of the market[,]" there was "no real distinction between ABX and the rest of the subprime universe[,]" and the ABX bonds were interchangeable with other bonds, generally speaking).)[175] The ABX Index itself had five sub-indices, reflecting different credit-rated tranches, including AAA, AA, A, BBB, and BBB-. (*See* Resp. Ex. 294 at 2; Lasch 160:14-20.) During the relevant time period, in 2006, ABX Index assets were trading at par, similar to the universe of non-Index RMBS bonds. (Lieu 3670:20-3671:3; Wagner 4733:23-4734:6.) The index, as well as the underlying RMBS deals, was typically more liquid than non-ABX Index deals[176] (*see* Resp. Ex. 400 ("The underlying bonds that serve as reference obligations are selected through a polling process . . . in order to select the **most liquid** securities backed by home equity loans.")), and Tony Huang testified that he

[175] The Division attempted to elicit testimony that the ABX Index contained a substantial number of "dealer" shelves and that dealer shelves contained "worse" collateral than other RMBS deals. (*See* Huang 811:1-7.) No one testified that they perceived any difference between "dealer" shelves and other RMBS deals; in fact, the testimony elicited demonstrated that it made no difference whether an RMBS deal was a "dealer" shelf or not. (Huang 811:8-14, 884:15-885:4.) The Division, improperly using prior testimony, suggests that Mr. Huang "disfavored" dealer shelves. His statement was consistent with the testimony, which was that he did not recall Harding having any particular credit view on dealer shelves. (*Compare* Huang 812:17:19-23 (did not recall Harding having any particular view) *with* Huang 813:11-12 (prior testimony that he did not recall Harding having any particular view).) To the extent Mr. Huang noted in prior testimony that he felt that dealer shelves were "a little worse," he was expressing a personal opinion as of 2011 and did not say that he would not purchase dealer shelves.

[176] The Division disputes this contention, based on the testimony of Richard Ellson, one of its experts (*see* Div. Br. at 34 n.58), but Mr. Ellson's testimony is contradicted by documentary evidence and testimony. (*See* Resp. Ex. 400; Huang 781:9-10; Doiron 1961:17-18; Prusko 2438:10-13; Chau 4250: 11-12.) In addition, the Division's other expert, while not recalling specifically, believed that liquidity was one of the factors for choosing the constituent assets of the ABX Index. (*See* Wagner 4754:18-23.)

believed that most, if not all CDOs, would have contained some ABX Index bonds.[177] (Huang 794:17-795:2, 930:20-931:10.)

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[177] The Division also attempted to elicit testimony that suggested that investors, in general, had a negative view of ABX Index bonds. The testimony, clearly and without contradiction, established that investors generally did not like to see collateral managers purchase the **entire** ABX Index **itself** for inclusion in the CDO portfolio because they did not believe a manager was earning its fees by doing so. (*See* Huang 993:15-21; Chau 2133:6-18; Chau 4291:17-4292:2, 4292:16-4293:20.) In fact, investors analyzed ABX Index bonds the same as any other RMBS asset. (*See* Edman 2543:8-19; Chau 4291:17-4292:2, 4292:16-4293:20.) The Division's only recourse is to refer to prior testimony taken out of context and without the benefit of the full answer. (*See* Chau 4401:5-4402:6.) The complete answer in the prior testimony demonstrated that Mr. Chau was talking about the full index and not individual exposure; the reference to "index names" is either a transcription error or mistaken turn of phrase:

> Q. So what was your understanding of sort of, as you were having discussions with investors during the course of the Octans marketing, did you have any discussions with the investors about what their positions were, about how much index should be in a deal one way or another?
>
> A. Their only concern was not just buying the entire index. From their points of view, which I agree with, that if I'm just buying the total index, they could do that themselves so why pay me the management fee. They were fine with getting individual exposures.
>
> Q. And so do you recall specifically which investors told you that?
>
> A. Not specific investors, just in general.
>
> Q. Do you recall the types of investors that told you that, meaning were they insurance companies, or asset managers?
>
> A. Sure, money managers, other CDO managers.
>
> Q. So as far as making index purchases, that's something they could do themselves?
>
> A. Yeah. It wasn't a major issue for the most part. Every securitization had ABX index names in those CDOs.
>
> Q. But with these securitizations, you didn't represent to the investors that they occurred; is that right?
>
> A. Well, they would look at the portfolio names and see for themselves that there [were]was names that were within the ABX index. From our discussion, it was always—were just to buy the ABX index by itself and take all the 20 names that—although they weren't concerned about it as a credit risk, but it was more of why should I compensate you for you just buying an index.
>
> Q. How do you know they weren't concerned about it from a credit risk standpoint?
>
> A. They never mentioned that they were concerned about credit. It was always around, you know, we are paying you to select assets, not just buy an index.

(*See* Div. Ex. 1007 at 327:27-329:12.)

B. **The Index Itself Was Trading At A Premium, And So, Market Participants Realized A Benefit By Investing In The ABX Index And Shorting The Assets That Market Participants Did Not Want Exposure To.**

It was undisputed at the Hearing that Octans I utilized the ABX Index arbitrage strategy in order to source single-name CDS at higher spreads. Utilizing this strategy allowed investors to realize higher cash flows than if the CDO had invested in the assets referenced in the ABX Index on a single name basis. (*See* Chau 2160:6-2161:15, Wagner 4715:20-4716:11; *see also* Resp. Ex. 384 (E-mail from Prusko explaining to another collateral manager that the benefit goes to the CDO); Resp. Ex. 889; Prusko 2458:8-2460:8; Prusko 2461:20-2463:17.) During early-to-mid-2006, the ABX Index was trading at a premium to the single-name RMBS assets that the ABX Index referenced.[178] (*See, e.g.*, Resp. Ex. 294 at 11 (demonstrating spread premium as of February 7, 2006); Resp. Ex. 300 (May 22, 2006 e-mail between collateral manager and James Prusko noting the spread premium); Prusko 2441:4-13; Chau 2142:3-22; Chau 4284:11-13.) In other words, a comparison of the spread to purchase the ABX Index with the average spread to purchase the 20 RMBS assets demonstrated that a market participant could gain, at a better rate, the same exposure to the 20 RMBS assets referenced in the ABX Index by purchasing the ABX Index and not the individual names. (*See* Resp. Ex. 294 at 13-14; *see also* Prusko 2438:14-2439:23; Chau 4286:5-20 (testifying why it would be inefficient to source the names by purchasing them individually).) In addition, the difference between the spreads was great enough to make it economical to buy the Index and then short the individual names that the collateral manager had rejected. (*See id.*) The difference in spread would more than cover the cost to buy protection on the individual names. (*See id.*) This strategy was well-known in the marketplace by

[178] Even as late as August 2006, industry research was recommending that "investors sell protection through the ABX and buy protection on the same basket of bonds through single-name CDS. This basis trade is positive carry and makes sense **especially for accounts with a benign view of credit/housing**. . . ." (Resp. Ex. 405 at ML-SEC2E-017854679 (Lehman Bros. research report).)

the time that Harding agreed to review the ABX bonds in late May. (*See* Resp. Ex. 294 at 11-16 (UBS article describing the strategy in a February 7, 2006 article); Resp. Ex. 295 at 8 (Nomura article describing the strategy on March 7, 2006[179]); Resp. Exs. 300, 514 (e-mails from late May detailing the strategy with various collateral managers); Chau 4293:2-12.)

The concept behind the arbitrage opportunity was simple; its execution, however, was more complex. One method would have been to allow the CDO itself to purchase the Index and then short out the names that the manager had rejected.[180] (*See* Prusko 2441:14-2442:3; Chau 2142:22-2143:19; Chau 4285:11-18; Lasch 150:7-151:5.) Merrill Lynch believed,[181] and Harding agreed, that it would be more efficient for the warehouse provider (Merrill Lynch for Octans I) to purchase the ABX Index and then sell the individual names to the warehouse. (*See*

[179] The article itself has a date of March 7, 2005, but that is clearly a typographical error since it is describing historical ABX Index trading, which was not issued until January 19, 2006.

[180] The Division asserts that Magnetar wanted all twenty ABX Index assets in Octans I and uses e-mails that no employee from Harding was on to prove its point. (*See* Div. Br. at 28-30.) Those e-mails, however, do not say what the Division suggests. All of the relevant evidence demonstrates that the mechanics always included a component where the collateral manager would review and determine which assets, if any, it did not like. In order to effectuate the trade, either Merrill Lynch or the warehouse had to buy the entire index in the first step of the trade, and in the second step, short out the names the manger did not like. With this background, it is clear that references to buying the entire index related to explaining this mechanism of the trade, and not expressing an expectation that all 20 constituents would go into the CDO. On May 22, James Prusko e-mailed employees at Merrill Lynch asking a "**question on ramping**" and then specifying whether the warehouse would buy the index directly or whether Merrill would buy the index and sell it to the warehouse. (*See* Div. Ex. 18.) The next day, Merrill Lynch informed Mr. Prusko that the warehouse itself **could** buy the index. (*See* Div. Ex. 20.) Later that day, Mr. Prusko wrote to his supervisor that he had to explain the mechanics to Merrill Lynch and provide an example. (*See* Div. Ex. 19.) At no point in time does Mr. Prusko state a preference. He is trying to determine how Merrill Lynch intended to execute and source the Index arbitrage trade, which the Division concedes in a footnote. (*See* Div. Br. at 29 n.53 ("The exact mechanism . . . had not been determined.").) The only e-mail having anything to do with Harding was a second-hand report from Richard Lasch to Harin De Silva about a conversation that Mr. Prusko had with Mr. Chau. (*See* Div. Ex. 23.) The clear import of this e-mail is a suggestion by Magnetar and Harding that the execution proceed with Merrill buying the index itself and then buying protection from the Octans I warehouse, as opposed to having the warehouse buy the index and shorting out names that Harding had rejected. All subsequent discussions about the ABX Index trade include a discussion about Harding choosing assets that it wanted to exclude. (*See, e.g.*, Div. Ex. 31, 33.) The Division confirmed this, **with emphasis**, that the "parties, in other words, discussed acquiring **the entire** Index **except** any Index bonds that Harding might want to exclude." (Div. Br. at 31.) That is the entire point of the ABX Index trade. (*See* Resp. Ex. 294 at 11.)

[181] As the sole structuring agent for Octans I Merrill Lynch was responsible for analyzing the arbitrage opportunity and determining the strategy by which it could best execute the strategy. (Chau 4287:14-23.) Harding was responsible for determining which individual names would be approved on credit. (Chau 4284:16-24.)

Chau 4285:11-4286:4; *see also* Resp. Ex. 384; Prusko 2460:17-2461:19.) For the 28 names that Harding had approved for Octans I, Merrill Lynch would enter into CDS contracts with the Octans I warehouse where the warehouse sold protection (or went long) on the individual 28 names and Merrill Lynch bought that protection (or went short). (Chau 2143:9-13; *see also* Prusko 2441:14-2442:3.) The rate was the same rate at which Merrill had acquired the Index. (*Compare* Div. Ex. 6 (Trade blotter showing rate of 154 bps for BBB tranche and 267 bps for BBB- tranche) *with* Div. Exs. 91-92, 96-112 (Trade confirmations showing rates of 1.54 and 2.67 for BBB and BBB- tranches, respectively).) For the remaining 12 names that Harding had rejected, Merrill Lynch bought protection from other market participants so that Merrill's exposure to the ABX Index was now zero. (*See* Prusko 2456:7-2457:22; *see also* Div. Ex. 95.)

As noted earlier, Octans I, a $1.5 billion CDO, was limited to 1% in the amount of notional value it could be exposed to a single issuer. Accordingly, for every RMBS deal, Octans I was limited in going long by $15 million. Because Harding had a preference for the BBB-rated tranches of the ABX Index (*see* Div. Ex. 82),[182] Harding split the $15 million issuer cap into $10 million for the BBB-rated tranche and $5 million for the BBB(-)-rated tranche. (*See* Div. Ex. 6 (Trade Blotter).) With that guidance, Merrill Lynch went out into the market to purchase $200 million of the BBB-tranche of the ABX Index and $100 million of the BBB(-)-rated tranche of the ABX Index. Merrill was able to acquire from Magnetar, at a beneficial

[182] Tony Huang testified that he "assumed" the preference referred to the RMBS deals themselves (*see* Huang 881:4-882:2), but the documentary evidence established two ways that the Harding analysts "preferred" the BBB over the BBB-. First, the rejection list that Jung Lieu sent to Tony Huang contained more BBB- bonds than BBB bonds (meaning that Harding's credit team had rejected more BBB- bonds). (*See* Div. Exs. 71-72 (rejecting 8 BBB- bonds and 4 BBB bonds).) Second, the approved notional amount for BBB was higher than the approved notional amount for BBB- ($10 million notional for BBB and $5 million notional for BBB-). In addition, in order to execute a trade one has to find a willing counterparty. Knowing that, market participants always rank their preferences, *i.e.*, they may prefer A but would be willing to live with B if A were unavailable. In any event, whether the credit analysts preferred BBB or BBB- is irrelevant considering the uncontroverted evidence that all 28 of the ABX Index assets were reviewed and approved by Harding's credit team. (*See* Section XII.D.)

spread, $70 million of the BBB(-) tranche.[183] (*See* Div. Ex. 107-109; *see also* Div. Ex. 89; Div. Ex. 95; Resp. Ex. 491; Prusko 2444:24-2446:8, 2450:16-2451:12 (testifying that Magnetar had purchased the BBB- tranche of the ABX Index in order to protect against spreads decreasing and offering it to Merrill if it would be helpful).) The rest of the trade was sourced from other market participants.[184] All of the index trades occurred over a period of time from June 2, 2006 through June 7, 2006, with the bulk of the trades occurring between June 5 and June 7. The trades involving the single name assets that Harding approved did not take place until June 8, 2006 (more than a week after Jung Lieu submitted her rejection list). (*See* Div. Ex. 6 (Trade Blotter).) Contemporaneous e-mails at the time clearly established that Merrill Lynch was able to acquire exposure to underlying RMBS assets referenced in the ABX Index at a 25-30 percent premium over acquiring the same assets through single-name trades. (*See* Resp. Ex. 889; Prusko 2458:8-2460:8; Wagner 4717:23-4718:6.) The Division's own expert, Ira Wagner, confirmed that it would be better to obtain a credit-approved bond at a higher spread. (Wagner 4704:21-4705:4, 4708:11-21.)

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[183] Merrill acquired Magnetar's interest in the BBB- tranche of the ABX Index through a process called "novation." A novation is the "process by which a credit [de]fault swap contract is assigned from one counterparty to another counterparty." (Prusko 2463:21-25.) Magnetar had a pre-existing CDS contract with a short counterparty that gave it long exposure to the index. Magnetar then novated, *i.e.*, transferred its long interest in the CDS contract to Merrill, effectively stepping out of the contract. (Prusko 2464:2-14.) The Division attempted (unsuccessfully) to elicit testimony to suggest there was something nefarious about this trade. There was nothing. Assuming Harding and Merrill agreed to do the ABX arbitrage trade, Merrill had to get long exposure to the Index. Sourcing that exposure though Magnetar at market levels—which is what happened here when Magnetar novated its long exposure to Merrill Lynch—is no different than sourcing from someone else by going into the open market. As noted, Magnetar did not realize a profit on this novation. (*See* Resp. Ex. 761.)

[184] To be clear, Merrill would not have been able to source the full amount of the ABX Index in one transaction; it would not have been able to obtain a counterparty willing to short that much in notional value. Instead, over the course of several days, it sought protection buyers for smaller chunks of the ABX Index. (*See* Div. Exs. 91-92, 96-112 (Trade Confirmations).) The amounts of the trades ranged from $15 million to $30 million, and included a diverse group of counterparties, including The Royal Bank of Scotland, Deutsche Bank, Citibank, Morgan Stanley, and Goldman Sachs. (*Id.*)

The ABX Index arbitrage strategy also allowed a collateral manager to ramp assets into the warehouse quickly, which allowed the manager to lock in favorable spreads, as well as protect against the risk that the deal did not close. (*See* Resp. Ex. 295 at 8 ("Some CDO managers may use the indices to quickly ramp up CDO portfolios. It is unlikely that CDO managers will rely on the widely-traded indices to fill up their CDO portfolio, because they add value by picking specific bonds. However, collateral managers may use the index to manage risk and to take advantage of any temporary pricing discrepancies."); Huang 825:16-826:24, 827:9-12; Huang 1277:7-17, 1278:6-1280:5; Wagner 4760:16-4761:8; *see also* Div. Exs. 18, 21; Prusko 2442:4-16, 2443:12-25 (testifying that spreads were wider in late May and it was an attractive time to ramp assets into the warehouse quickly before the arbitrage opportunity disappeared).)

C. Mr. Huang Was In Charge Of The ABX Index Trade For Octans I.

As a preliminary matter, on the evening of May 30, 2006, Tony Huang sent Jung Lieu a PDF document listing all of the ABX Index bonds. (*See* Div. Ex. 43.) Mr. Huang sent the list because Wing Chau was out of the office tending to his wife, child, and newborn baby (who had been born on May 26, 2006.)[185] (Chau 2190:24-2191:9; Resp. Ex. 313.) Tony Huang was in charge of overseeing the ABX trade. (Huang 844:3-6, 846:6-10, 856:8-857:7, 858:10-16, 860:16-861:3, 862:9-18.) As discussed more fully below, after receiving the list from Mr. Huang, Ms. Lieu, set about reviewing the assets, refreshing prior analysis and arriving at a decision.

[185] Although it appears that Mr. Chau returned to work on May 31, it is not clear how much work he actually accomplished. (*See* Div. Ex. 50.) It was not until the following day that he e-mailed James Prusko and said he was "back in the saddle." (*See* Div. Ex. 88.)

D. Harding's Credit Team Had Analyzed And Performed The Bulk Of The Credit Review Process On The Majority, If Not All, Of The ABX Index Deals Prior To The Evening Of May 30, 2006, As Part Of The Credit Team's Normal Asset Review Process.[186]

As noted in Section XVI below, the bulk of the credit analysis is either deal specific (for example, reviewing structure and collateral) or not tied to any particular RMBS deal (for example, due diligence on originators and servicers). Once a credit analyst has reviewed a particular deal and become familiar with that deal, any additional tranche-specific analysis, including cash flow and surveillance runs, can be accomplished within 30 minutes or so. Prior to the evening of May 30, Harding's credit team had analyzed at least 17 of the 20 RMBS deals that make up the ABX Index. By the time Jung Lieu was tasked by Tony Huang with reviewing the ABX Index assets, she needed to only refresh cash flow runs in order to make a credit decision, and many of the cash flow runs had been done the day before.

Wing Chau and Tony Huang testified that, because the ABX Index assets had been issued during the second half of 2005 and were ubiquitous in the market, Harding's credit team would have analyzed them as individual assets prior to Jung Lieu having received the e-mail from Tony Huang listing the ABX Index assets. (*See* Huang 1283:21-1284:3 (testifying that the ABX Index assets were common in the marketplace and assumed that Jung Lieu had reviewed "most" of them), 1290:3-19 (testifying that the ABX Index was a big "part of the market" and Harding had already put together bidlists that included these assets); Chau 4251:23-4252:13 (testifying that the ABX Index represented the largest RMBS issued in the second half of 2005 and Harding would have reviewed them in the normal course of business as it tried to determine whether to purchase these as cash assets).) The uncontroverted evidence corroborated the testimony.

186 *See* Exhibit C for a full list of the ABX Index deals analyzed prior to the evening of May 30.

1. By April 2006, Harding had analyzed five of the twenty RMBS deals that comprised the ABX Index.

Harding's trade blotter noted that five ABX Index deals were traded into the Jupiter IV and Lexington II CDO warehouses in 2005. (*See* Div. Ex. 6 (NCHET 2005-4 M1 traded into Jupiter IV CDO as a cash bond on August 11, 2005; GSAMP 2005-HE4 M4 and **SAIL 2005-HE3 M2** (AA-rated) traded into Jupiter IV as cash bonds on August 17, 2005; SVHE 2005-4 M6 and **SVHE 2005-4 M8** (BBB-rated) traded into Jupiter IV and Lexington II CDOs, respectively, as cash bonds on December 14, 2005).)[187] The ABX Index asset SVHE 2005-4 M8 was one of the ABX assets traded into Octans I. In addition, Jung Lieu's notebook from the time period September 2005 through February 2006 contains an entry analyzing SAIL 2005-HE3 on a deal-level basis.[188] (*See* Div. Ex. 244 at HA02072079.) Given the Division's concession that there was nothing improper about Harding's process prior to Octans I, the only conclusion that can be drawn from this evidence is that Harding followed its credit review process for these 5 bonds.

2. By the time Jung Lieu received the list of ABX assets from Tony Huang on the evening of May 30, 2006, Harding's credit team had performed the bulk of the credit analysis and rendered credit decisions on seventeen of the twenty RMBS deals that comprise the ABX Index.

In addition to the evidence demonstrating analysis of ABX Index deals in late 2005 and early 2006, several e-mails demonstrate that Harding had analyzed the majority of the ABX Index deals prior to Jung Lieu's assignment from Tony Huang to create a list of ABX assets to

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[187] Only two of the five names are actually part of the ABX Index (bolded and italicized). The ABX had five sub-indices (AAA, AA, A, BBB, and BBB-). (*See* Resp. Ex. 294 at 2.) However, the deals that comprised the ABX Index had additional tranches that were not part of the ABX Index. *See, e.g.*, Soundview Home Loan Trust [SVHE] 2005-4, Asset-Backed Certificates, Series 2005-4, Preliminary Prospectus Supplement (Form 424B3), at S-12 (Dec. 15, 2005) (detailing the ratings of 15 different tranches), *available at* http://www.sec.gov/Archives/edgar/data/1347120/000089109205002518/0000891092-05-002518-index.htm. This would not have changed the analysis, however, for the deal-level processes, since all the tranches would be subject to the same deal structure and collateral attributes.

[188] The page itself is undated; however, the next page to have a date, HA02072092, is dated February 8.

exclude from Octans I. First, on May 2, 2006, Jamie Moy forwarded to Brett Kaplan a surveillance report run by Ken Lee for a Deutsche Bank bespoke deal. (*See* Resp. Ex. 756.) She informed Mr. Kaplan that she and Tony Huang would like Mr. Kaplan to "get involved with these CDO ABS portfolios" and asked that he "continue the process on this bespoke." (*Id.*) The surveillance report included GSAMP 2005-HE4 B3 and RAMP 2005-EFC4 M9. (*See* Resp. Ex. 758.) On May 16, 2006, Jamie Moy forwarded to the MaximCDO e-mail distribution list "bonds Jung and I were okay with." (Resp. Ex. 297.) That list included FFML 2005-FF12 B2 and SVHE 2005-4 M8. (*See id.*) The following week, on May 22, Brett Kaplan forwarded to Jamie Moy and Jung Lieu a spreadsheet containing credit decisions. (*See* Div. Ex. 16.) The spreadsheet included analysis and decisions for 15 ABX index bonds (totaling 13 separate deals).[189] (*Id.*) **Accordingly, by May 22, 2006, Harding's credit team had analyzed 16 out of the 20 ABX Index deals.**[190] Finally, in response to a Merrill Lynch proposal, on May 30, 2006, at 3:23 p.m., Jung Lieu submitted credit comments on ten bonds after "running CF's [cash flow] and looking at credit." (Div. Ex. 29.) The analysis and credit comments included SABR 2005-HE1 B3.[191] (*Id.*) While the Division harped on the supposed "impossibility" of analyzing 40 bonds in less than 24 hours, **the evidence clearly established that the majority of the work on the ABX Index assets had occurred prior to Jung Lieu receiving the ABX Index list from Tony Huang**. Out of the three ABX Index deals of which no evidence has been located to date establishing a prior review, Ms. Lieu wholly rejected two of the deals, ARSI 2005-W2 and

[189] ACE 2005-HE7 M8, AMSI 2005-R11 M8, BSABS 2005-HE11 M8, CWL 2005-BC5 B, CWL 2005-BC5 M8, HEAT 2005-8 B1, JPMAC 2005-OPT1 M8, LBMLT 2005-WL2 M8, MABS 2005-NC2 M9, MSAC 2005-HE5 B3, NCHET 2005-4 M8, RASC 2005-KS11 M9, SAIL 2005-HE3 M8, SAIL 2005-HE3 M9, SVHE 2005-4 M8.

[190] It is possible that earlier analysis on the remaining ABX Index deals exists.

[191] SABR 2005-HE1 B3 was also included on the original list of names that Alison Wang submitted on May 30, 2006 to Merrill Lynch for approval for a proposed May 31 BWIC. (*See* Div. Ex. 42.)

SASC 2005-WF4, and Ms. Lieu rejected the third deal, MLMI 2005-AR1,[192] at the BBB- level. (*See* Div. Ex. 72.)

In short, the documentary evidence supports the testimony of Jung Lieu, Wing Chau, and Tony Huang that the ABX Index assets were reviewed prior to May 31, and, to the extent that Harding's credit team had not reviewed the ARSI or SASC deals prior to May 31, the wholesale rejection of those deals is consistent with either (1) a rejection of the deals based on credit analysis, or (2) a rejection of those deals because Ms. Lieu did not think she had enough time to render an accurate credit decision. (Lieu 3303:1-11; Lieu 3612:20-3613:3, 3693:15-3694:20.)

E. By The Time Ms. Lieu Sent Her E-mail To Mr. Huang, Harding Had Done Cash Flow Analyses For 39 Out Of 40 ABX Bonds.[193]

Because the Harding credit team had already performed the bulk of the credit analysis on the ABX Index assets when Ms. Lieu was tasked by Tony Huang to render a credit decision on the ABX Index assets for the ABX trade for Octans I,[194] all she had to do was refresh and review

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192 The evidence also likely establishes that MLMI 2005-AR1 had been analyzed prior to May 31, although it is less conclusive. Ira Wagner testified that MLMI 2005-AR1 B2 was one of the assets in which Jung Lieu updated the credit decision from No to Yes, based on his reading of a corrected Master bidlist. (*See* Div. Ex. 8001 at ¶ 79 & Appendix 6 ("By examining a later Master Bid List dated June 5, 2006, I found that there were 10 names that were **previously approved, 19 that were not approved and 11 that were not reviewed**.").) The Master Bidlist referred to by Mr. Wagner contained two entries for MLMI 2005-AR1 B2 (and two entries for the BBB- bond). (*See* Div. Ex. 93 (rows 523-524). In Column H ("Bid List"), the first noted "0531 OWIC" and the second noted "Barclay Bespoke PT A." (*See id.*) There is an "N" next to the Barclay Bespoke PT A entry in the "Credit Y/N" column. The "N" appears to be a typographical error. On June 7, 2006, Jamie Moy forwarded to Tony Huang a spreadsheet of credit decisions for "Barclay bespoke Pt A and B." (*See* Resp. Exs. 371-372.) The name of the spreadsheet is "Barclay Maxim tranches 05-24-2006." (*See* Resp. Ex. 371.) The spreadsheet itself shows MLMI 2005-AR1 B2 with a "Y" next to it and MLMI 2005-AR1 B3 with an "N" next to it, consistent with Jung Lieu's May 31 decision. (*See* Resp. Ex. 372 (Portfolio A).)

193 *See* Exhibit D for a full list of all the cash flow runs on ABX Index assets performed on May 30 and May 31.

194 The Division did not allege, and did not provide any evidence or elicit any testimony, that Harding's credit process prior to the Octans I deal was defective in any way. The uncontroverted evidence established that Harding had a credit process that Harding's credit team followed. (*See, e.g.*, Div. Ex. 244 at HA02072216-2217; *see generally* Div. Ex. 243 (late 2005–early 2006 Jung Lieu notebook containing processes for credit analysis).)

cash flow runs and surveillance. This process took minutes per bond. (Lieu 3287:2-12.)[195] On May 30, 2006, at 5:49 p.m., Tony Huang forwarded to Jung Lieu a list of the ABX Index assets. (*See* Div. Ex. 36.)[196]

Although, the Division elicited testimony from Mr. Wagner suggesting that there were no cash flow runs for 11 of the 40 assets, and that Jung Lieu had nonetheless approved 9 of them, (*see* Div. Ex. 8001 at App'x 7) that testimony was false. (Wagner 4574:8-10 (testifying that generally the Division provided him with documents); Wagner 4741:6-9 ("[T]here are bonds that there are no runs for at all.), 4741:19-4742:2 (repeating his assertion directly to the Court that there were no cash flow runs for some of the bonds), 4767:1-4797:6 (establishing that Appendix 7 in Division Exhibit 8001 is misleading because it failed to mention at all that cash flow runs were done on the 11 assets alleged by Mr. Wagner to not have any cash flow runs), 4797:21-4798:12.) In fact, all 40 of the ABX Index bonds had cash flow runs within the 24-hour period that the Division's expert, Ira Wagner, found to be acceptable.

On May 30, 2006, at 10:30 a.m., Jung Lieu asked Brett Kaplan to run cash flow analysis on certain RMBS bonds, including FFML 2005-FF12 B2 and GSAMP 2005-HE4 B2. (*See* Div. Ex. 267-268.) Approximately twenty minutes later, Mr. Kaplan provided the cash flow runs. (*See id.*) A couple of hours later, in a separate communication, Jamie Moy submitted cash flow results

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195 The Division's expert, Ira Wagner, testified that Jung Lieu was busy that day working on several different projects, so she could not have spent the time necessary to analyze the ABX Index assets. (*See* Wagner 4938:20-4939:6.) His testimony carries no weight because he admitted that he was not present in Harding's office that day, and he did not know what actually happened. (*See* Wagner 4766:17-4767:5.) In any event, Ms. Lieu testified, and Mr. Huang corroborated her testimony, that she had plenty of time to analyze and render credit decisions on the ABX Index bonds, and, if she had felt that she needed more time, she would have asked. (Lieu 3303:1-11; Lieu 3612:20-3613:3, 3693:15-3694:20; Huang 1283:21-1284:10.)

196 The actual time stamp on the e-mail shows 9:49 p.m., but the parties have stipulated that the correct time stamp is 5:49 p.m. (*See* Stipulations at ¶ 1.)

to Tony Huang for two "DB Bespokes."[197] In the first attachment, the spreadsheet listed cash flow results for two ABX Index bonds, GSAMP 2005-HE4 B3 and RAMP 2005-EFC4 M9.[198] (*See* Resp. Ex. 773.) The second spreadsheet shows cash flow results for twenty ABX Index bonds, including FFML 2005-FF12 B3, HEAT 2005-8 M8, RASC 2005-KS11 M8, and SABR 2005-HE1 B2.[199] (*See* Resp. Ex. 774.) Around the same time, Jung Lieu asked Brett Kaplan to run Intex analysis on four bonds, including SABR 2005-HE1 B3, which Mr. Kaplan provided shortly thereafter. (*See* Div. Ex. 269-270.) **Accordingly, on May 30, 2006, Harding's credit team had run cash flow analysis on 24 out of the 40 ABX Index bonds.**

On May 31, 2006, at 12:51 p.m., Jung Lieu asked Brett Kaplan to run cash flow analysis on 24 ABX Index bonds, which he provided approximately 20 minutes later.[200] (*See* Div. Exs. 52, 53, 54.) An hour later, Jung Lieu again asked Brett Kaplan to run cash flow analysis for several bonds, including five ABX Index bonds, which Mr. Kaplan provided approximately 10 minutes later. (*See* Div. Exs. 271-272.) Of the five ABX Index bonds, four had been requested by Jung Lieu earlier,[201] and one, SVHE 2005-4 M8, had been previously requested on May 30.

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[197] The names of the two spreadsheets attached suggest that the cash flow runs occurred earlier than May 30, 2006. (*See* Resp. Ex. 772 (attachments titled "ABS Bespoke—Portfolio MMR April 2006 Result 6% CF.xls" and "ABS Bespoke—Portfolio 2006-05-22 Results.xls").) However, other documents prove that the cash flow runs occurred on May 30, 2006. At 9:08 a.m. on May 30, Tony Huang forwarded to Jamie Moy a portfolio of names proposed by Deutsche Bank. (*See* Resp. Ex. 305.) Shortly thereafter, Jamie Moy forwarded that e-mail to Brett Kaplan, ostensibly to perform cash flow analysis. (*See id.*) The name of the attachment is "ABS Bespoke—Portfolio 2006-05-22.xls." (*See id.*) A comparison of the attachments (Respondents' Exhibits 308, 774) demonstrates that they are identical with the exception that Respondents' Exhibit 774 now includes writedown information from a cash flow run utilizing a 6% cumulative loss rate. (*Compare* Resp. Ex. 308 *with* Resp. Ex. 774.)

[198] The GSAMP 2005-HE4 B3 bond was on Mr. Wagner's list in Appendix 7.

[199] These four bonds were listed in Mr. Wagner's Appendix 7.

[200] There was an overlap of thirteen bonds from the cash flow analysis run the day before: ACE 2005-HE7 M8, AMSI 2005-R11 M9, ARSI 2005-W2 M8, BSABS 2005-HE11 M8, CWL 2005-BC5 B, JPMAC 2005-OPT1 M8, LBMLT 2005-WL2 M9, MLMI 2005-AR1 B2, MSAC 2005-HE5 B3, NCHET 2005-4 M8, RAMP 2005-EFC 4 M9, SAIL 2005-HE3 M8, SASC 2005-WF4 M8.

[201] Those four bonds were: ACE 2005-HE7 M8, AMSI 2005-R11 M8, MABS 2005-NC2 M8, NCHET 2005-4 M8.

Around the same time, Brett Kaplan also sent to Jamie Moy a "run from Intex." (Resp. Ex. 324-325.) The attachment shows the results of cash flow runs for RMBS bonds by their CUSIP numbers, including 23 ABX Index bonds. Among those bonds were ACE 2005-HE7 M9, BSABS 2005-HE11 M7, MSAC 2005-HE5 B2, RAMP 2005-EFC4 M8, and SVHE 2005-4 M9. (*See* Resp. Ex. 325.) **On May 31, therefore, Harding's credit team had cash flow analyses for 15 of the 16 bonds for which there were no cash flow runs the day before.**

In sum, by the time Mr. Lieu sent her e-mail to Mr. Huang, Harding had done cash flow analyses for 39 out of 40 ABX Index bonds. The one remaining bond, for which we have been unable to locate a cash flow run on May 30 or May 31, had been consistently approved by both Ms. Moy and Ms. Lieu, including for the 4:00 p.m., May 31, OWIC.[202]

On May 31, 2006, at approximately 4:22 p.m., after having analyzed the ABX Index bonds and conferring with Jamie Moy, Jung Lieu submitted to Tony Huang a list of ABX Index bonds that the Harding credit team had rejected. (*See* Div. Exs. 71-72; *see also* Lieu 3401:1-6; Lieu 3722:11-14.) Mr. Huang then forwarded that list to Sharon Eliran, a Merrill Lynch employee responsible for structuring Octans I. (*See* Resp. Ex. 343.) Ms. Eliran forwarded the list to James Prusko, the senior portfolio manager at Magnetar. (*See* Resp. Ex. 344.) The uncontroverted evidence established that it was Harding, and Harding alone, that selected the ABX Index assets that went into Octans I. (*See* Lasch 201:21-202:8; Huang 784:6-9; Huang 1274:6-15; Lieu 3697:7-9.)

[202] The only bond where no cash flow runs on May 30 or 31 could be located was RASC 2005-KS11 M9, but the evidence conclusively shows that this bond had been analyzed prior to this time and was consistently approved, even by Jamie Moy for the May 31 4:00 p.m. OWIC. (*See* Resp. Ex. 298-299 (May 22 approval); 371-372 (May 24 or June 7 approval); Div. Ex. 65-66 (Jamie Moy's May 31 approval for 4:00 p.m. OWIC).)

F. Harding's Credit Team Had Reviewed And Run Stress-Case Scenarios On MABS 2005-NC2 Prior To May 30 And Had Approved The Bond.

1. Harding gave extra scrutiny to MABS 2005-NC2.

The Division elicited testimony that Harding made representations that it gave "extra scrutiny" to RMBS deals containing interest-only ("IO") loans. (*See* Chau 4433:5-9; *see also* Div. Ex. 1 at 45; Div. Ex. 2 at 45.) An interest-only loan referred to a type of mortgage where the borrower's monthly payments were applied by the lender to the accrued interest but not the principal for a specific period of time. (*See* Div. Ex. 8001 at ¶ 102 (describing IO loans).) These loans were considered, in general, more risky because the principal was not being paid down.[203] (Lieu 3386:8-18.) Harding did not outright reject interest-only loans during the relevant time period,[204] but it would scrutinize them more in order to weigh the risk with any mitigating factors, such as higher FICO scores, lower LTV, performance information, and cash flow projections. (Lieu 3386:8-18; Lieu 3710:15-3711:9.) As part of its examination, the Division singled-out MABS 2005 NC-2, a deal backed by 100% interest-only loans that was approved for, and ultimately included in Octans I. (*See, e.g.*, Chau 4433:5-9; Lieu 3386:8-18.) On May 31, 2006, Jamie Moy, as part of her preliminary review of assets listed in an OWIC, disagreed with Jung Lieu's prior approval of the MABS deal for that same OWIC, noting that it was a 100% interest-only deal.[205] (*See* Div. Ex. 65.) It appears that the Division is attempting to prove, as part

[203] Jung Lieu's notebook from September 2005 to April 2006 contained notes from a Fitch conference call about IO loans, including that their "performance better than non-IO [loans] coz [sic] of higher FICO" and "IO borrowers particularly vulnerable to stressed market." (Div. Ex. 244 at HA02072194-2195.) This entry corroborated the testimony concerning Harding's practice of obtaining industry research.

[204] In February 2007, when the subprime mortgage market was experiencing distress, Harding employees compiled a list of approved RMBS assets for possible trading while ramping a CDO named Octans 4 (which never closed). (*See* Resp. Ex. 446; Chau 4434:24-4436:2.) That list specifically excluded RMBS backed solely by interest-only loans, but it is unclear whether this was a credit decision or a deal constraint specific to Octans 4. In any event, the fact that Harding's credit team would evaluate general RMBS characteristics based on current and up-to-date market conditions is, at best, commendable, and at worst, irrelevant.

[205] The events surrounding the May 31, 2006 4:00 p.m. OWIC are discussed in greater detail in Section XII.I.

of its general argument that Harding's credit team did not have time to review the ABX Index assets prior to submitting its rejection list, *i.e.*, that more time would have needed to have been spent on the MABS deal than other types of RMBS deals.

2. Harding's credit team had scrutinized MABS 2005-NC2 in a manner consistent with its statements in the Octans I Pitch Book.

As noted above, just one week earlier, on May 22, 2006, Harding's credit team analyzed and approved MABS 2005-NC2 M9 (the lower-rated BBB- tranche of the MABS deal). (*See* Div. Ex. 16; *see also* Lieu 3712:13-3713:6.) It is acknowledged by the Division and its expert that the cash flow runs for these deals were run at a higher cumulative loss (9%) than the run on May 31 (6%). (*See* Div. Ex. 8001 at ¶ 97.) The cash flow run for MABS 2005-NC2 M9 showed no writedowns. From this approval, MABS 2005-NC2 M9 was traded into the Lexington II warehouse, a Harding-managed CDO that did not involve Magnetar.[206] (*See* Div. Ex. 6.)

G. <u>The May 30 And 31 Cash Flow Runs On 27 ABX Index Bonds That Showed Writedowns Were Based On Incorrect And Unintended Assumptions, Which Jung Lieu Correctly Recognized.</u>

The May 30 and 31 cash flow runs highlighted by the Division's expert showed writedowns ranging from 4.69% to 62.31% on 22 of 27 bonds. (*See* Div. Exs. 53, 268, 270.) Five of the bonds showed writedowns of 0%. (*See id.*) The evidence adduced at the Hearing established (1) those bonds showing any writedowns would have been unusual at that time and was against expectation; (2) certain cash flow runs showed the same percentage of writedowns for the BBB- and BBB(-)-rated tranches, even though the structure of these bonds would have required that the lower-rated tranche experience a total loss before the higher-rated tranche would experience any writedowns; (3) when compared to the May 22 cash flow runs, some bonds showed higher writedowns on May 30 and May 31 even though those cash flow runs

[206] It was also approved and traded into the Octans III warehouse on August 30, 2006. (*See* Div. Ex. 6.)

utilized a lower cumulative loss assumption; (4) any credit analyst generally, and Jung Lieu specifically, would have questioned the results and investigated further; (5) Jung Lieu recalls that she did investigate and re-ran the analysis; and (6) even if she had not re-run the analysis that day, the cash flow runs did provide a basis for decision.

1. On May 26, 2006, Harding's credit team revised their cash flow assumptions to show 6% cumulative losses to reflect current market conditions and assumed future market performance.

On May 26, 2006, Jung Lieu sent Alison Wang an e-mail that cash flow runs would utilize a 6% cumulative loss curve. (Resp. Ex. 767.) Ms. Lieu testified that she and Ms. Moy made that decision together and then sought and received approval from senior management. (*See* Lieu 3624:15-3625:12.) Prior to that time, Harding's credit team was utilizing loss curves between 9% and 13%. (*See* Div. Exs. 15, 56.) One of the reasons for lowering the cumulative loss curve was because the percentages were too conservative, as confirmed by conversations Ms. Lieu had with other market participants.[207] (*See* Lieu 3343:2-6, 3635:10-3636:5; Lieu 3946:11-3947:8, 3948:6-12.) There is no evidence that the change to the 6% cumulative loss was made just for Octans I and therefore to accommodate Magnetar.

[207] The Division and its expert repeatedly assert that Harding "lowered" its assumptions and were utilizing "lenient" and "less stressful" loss curves. (*See* Wang 607:16-19; Lieu 3410:23-3411:1; Lieu 3942:25-3943:5; Wagner 4545:13-4546:8; Div. Ex. 8001 at ¶¶ 92 & n.59, 97; Div. Ex. 8003 at ¶¶ 5, 28, 37.) These assertions are irrelevant, as Mr. Wagner admitted, because each market participant is responsible for utilizing their own assumptions, and no industry standard existed as to what assumptions to use or how to use them. (Wagner 4734:7-4735:5 ("I have never said that everyone has to use the same default rate.").) The fact that Harding had its own assumptions and that it modified them as its view of the marketplace changed demonstrates that Harding had a reasonable process for analyzing RMBS assets. Market participants may quibble about the specifics, but that does not change the fact that it is the collateral manager that decides how to analyze the RMBS assets.

2. The May 30 and 31 cash flow runs were unreliable because BBB and BBB- RMBS bonds would not have shown writedowns during that time period.[208]

As an experienced RMBS analyst, Jung Lieu expected, in May 2006, that cash flow analysis utilizing a 6% cumulative loss curve and other, standard Intex assumptions would not have generated principal writedowns of the investment grade tranches of RMBS (those tranches rated BBB- and higher). (*See* Lieu 3445:10-14; Lieu 3661:1-18, 3662:12-21; Lieu 3959:23-3960:14; Lieu 3984:20-3985:4.) As Ms. Lieu testified, "If I looked at these cash flow results [Division Exhibit 53], I would have looked at it and thought that it was not a realistic reflection of what I expected of the bonds, these type of bonds, Baa2 and Baa3, in May of 2006 and either redone the analysis to reflect more realistic views or assume that something was done incorrectly in the input." (Lieu 3662:16-21.)

One of the reasons justifying this expectation was that RMBS deals were structured in a way that the lowest tranche (the "credit enhancement") would have grown sufficiently during the projected period of time to cover the losses. (*See* Lieu 3445:10-3447:7.) Specifically, the credit enhancement of an RMBS was approximately 2-4% when issued, but, because of assumed prepayments and excess interest, the credit enhancement grew over time (for example, it was expected to double during the first two years). (*See id.*) In addition, because the 6% cumulative loss is the expected loss over the life of the deal, the per-year losses would be smaller (for example, 1–2% cumulative losses within the first two years). (*See id.*) Accordingly, the 4–8% credit enhancement would more than cushion the higher rated tranches from the 1–2% losses expected to occur during those two years. (*See id.*) Using Respondents Exhibit 941, Ms. Lieu

[208] An alternative explanation for the May 30 and May 31 cash flow runs is that they, in fact, reflected a stress scenario. (*See* Wagner 4908:21-4910:12; *see also* Resp. Ex. 762 (E-mail from Jamie Moy stating that "both these bonds passed our **stress test at 6% cum loss**") (emphasis added).)

was able to demonstrate her explanation. In the "Performance Info" tab of Respondents Exhibit 941, cell D13 showed an actual cumulative loss of .05% as of May 25, 2006, and it showed an original credit enhancement of 3.35% (cell F13) and a current credit enhancement of 4.27% (cell E13). (Resp. Ex. 941; Lieu 3828:9-3829:16.) Accordingly, the .05% of losses would have been absorbed by the 4.27% of credit enhancement. (*See id.*)

Another reason that justified Ms. Lieu's expectation was that, in May 2006, the bonds were trading at par, meaning that it "was the consensus of the market that BBB securities [were] money good." (Lieu 3960:1-5.) In other words, **market participants would not have purchased bonds at par if there was an expectation of a substantial writedown.**[209] (*See* Wagner 4726:15-4727:15 (testifying that he would have expected an RMBS bond showing 50% writedowns to be trading at a price no higher than 50% of par.)

3. Two tranches of the same RMBS deal had identical writedown percentages, which was an indication of an error.

As noted in Section I.A.1. above, losses affect an RMBS deal starting from the lowest tranche (the credit enhancement) and moving up through the rated tranches. In other words, the BBB- tranche would be wiped out by losses before the BBB tranche suffered any losses. A quick glance at the results in Division 53 demonstrated that the cash flow analysis was run incorrectly because certain deals showed identical principal writedowns on both the BBB and BBB- tranches, and all of the deals where both tranches were run show the BBB- tranche receiving less than 100% writedown even though the BBB tranche is still experiencing a large principal writedown. (*See* Div. Ex. 53; Wagner 4743:11-4747:14.) In Division Exhibit 53, the MLMI

[209] The Division twists Jung Lieu's testimony in this regard to suggest that she was relying on the market place to perform her credit review. (*See* Div. Br. at 64 n.114.) Of course, that is not Ms. Lieu's testimony; she testified that the fact the bonds were trading at par **validated**, among other things, her **expectation** that writedowns should not occur. (Lieu 3960:1-5.) Even Mr. Wagner confirmed this. (Wagner 3726:15-4727:15.)

2005-AR1, SAIL 2005-HE3, and SASC 2005-WF4 deals show identical writedowns for the BBB and BBB- tranches (46.87%, 48.83%, and 54.63%, respectively). (*See* Div. Ex. 53.) In addition, the AMSI 2005-R11, ARSI 2005-W2, CWL 2005-BC5, and JPMAC 2005-OPT1 deals show the BBB tranche receiving principal writedowns even though the BBB- tranche has not experienced 100% principal writedowns. (*See id.*)

4. Comparing the May 31 cash flow run that utilized a 6% cumulative loss assumption with the May 22 run that utilized a higher cumulative loss assumption demonstrated that the May 31 analysis had errors.

There were 12 ABX Index assets that had cash flow runs on May 22, 2006, and May 31, 2006. (*Compare* Div. Ex. 16 *with* Div. Ex. 53.) Out of those 12, approximately half of them showed higher writedowns utilizing the May 31 6% cumulative loss assumption than the May 22, more stringent cumulative loss assumption. (*Id.*) For example, CWL 2005-BC5 B went from 9.04% on May 22 to 50.07% on May 31; in addition, SAIL 2005-HE3 M9, BSABS 2005-HE11 M8, HEAT 2005-8 B1, and MSAC 2005-HE5 B3 went from 0% writedowns on May 22 to 48.83%, 4.69%, 23.24%, and 20.03% respectively. (*Id.*)

5. Because of the facial irregularities, an RMBS credit analyst would have investigated to confirm that the cash flow analysis was run correctly.

When Ms. Lieu, an experienced analyst, was shown the May 31, 2006 Brett Kaplan analysis prior to the Hearing, she suspected that there was an issue with the cash flow runs. She was right. (*See* Section XII.G above.) Moreover, the Division's expert, Ira Wagner, testified that, if faced with similar results, he would have investigated further. (*See* Wagner 4738:19-4739:2 (testifying that he would have questioned the results in Division Exhibit 53), 4743:11-4747:8 (testifying that the identical writedowns on sequential tranches did not make any sense), 4750:3-4751:18 (testifying that he would have had "lots of questions" if the May 31 cash flow run showed higher writedown percentages than the more stringent May 22 cash flow run).)

6. Jung Lieu investigated in order to determine the issue and to run the correct assumptions providing reliable results.

In addition, as noted above, the transition to the 6% cumulative loss was not smooth, and Ms. Lieu frequently had to check a junior analyst's cash flow runs to see if they were run correctly. (Lieu 3633:22-3634:14; Lieu 4048:6-11.) In a May 26, 2006 e-mail, Ms. Lieu discussed with Ms. Wang the use of the 6% cumulative loss curve, and wrote, "[W]ith LACK OF INSTRUCTION, [B]rett [Kaplan] was going to run them all wrong . . . ." (Resp. Ex. 767.) Although Mr. Kaplan was usually tasked to run cash flows in Intex by either Ms. Lieu or Ms. Moy (Lieu 3689:12-16), he lacked the experience in analyzing RMBS assets to be able to identify any problems with the assumptions. (Lieu 3625:22-3626:15.) Simply, Ms. Lieu did what a credit analyst was supposed to do: she reviewed the work of a more junior analyst and would have made any necessary changes. The fact that she did not save her work is irrelevant.

No one remembers exactly what happened on May 31, 2006—a day almost 8 years ago—but Jung Lieu provided uncontested testimony of what she believes she would have done. There was no reason for her to deviate from her process. She did not know about Magnetar and no one pressured her to include certain assets or to do the analysis within a certain timeframe (*See* Section VI.A.) And she remembered having to check the cash flow runs and the results during the transition in order to make sure the analysis was being run correctly. (*Id.*)

Knowing that there appeared to be an issue with the cash flow runs, Ms. Lieu testified that she believes she would have investigated to determine the problem. (Lieu 3675:22-3676:9; Lieu 3984:20-3985:4; Lieu 3988:20-3989:10; Lieu 4009:8-17.) First, she believes she would have looked at the results to see if everything had been calculated correctly. (Lieu 3663:5-15; Lieu 3953:8-3954:2; Lieu 3985:5-3986:1.) Second, she believes she would have looked at the actual assumptions inputted into Intex to see that they were entered correctly, starting with the

default rate and prepay rate curves. (Lieu 3663:5-15; Lieu 3953:8-3954:2, 3985:5-3986:1.) Finally, if that had not yielded any answers, she believes she would have investigated within Intex even further.[210] (Lieu 3663:5-15; Lieu 3953:8-3954:2, 3985:5-3986:1.) In order to investigate, Ms. Lieu either would have done it herself or walked over to Mr. Kaplan's desk and look at his Intex settings.[211] (Lieu 3442:1-24; 3663:16-3664:1.) Once Ms. Lieu determined the issue, she would have corrected it and obtained reliable results. (Lieu 3989:11-19.) No evidence is established otherwise.

H. ABX Index Assets Were Not Disfavored: Contemporaneous Cash Flows Show Zero Percent Or Small Writedowns.

1. The fact that the May 30 and 31 cash flow runs were unreliable was corroborated by contemporaneous Harding cash flow runs.

Jung Lieu testified that she did not believe the cash flow runs on the ABX Index assets utilizing a 6% cumulative loss assumption would have resulted in any writedowns in May 2006. This expectation was confirmed by the evidence.

The evidence adduced in this proceeding established that Harding cash flow runs of ABX Index bonds both before and after May 31 showed writedowns of zero percent. On May 22, 2006, Harding's credit team performed cash flow analysis on several ABX Index bonds using a very strict cumulative loss assumption. (*See* Div. Ex. 16.) While some of those bonds showed

[210] Ms. Lieu could not recall exactly what she discovered to be the issue on May 31, but she believed that one possibility was the use of the "unscheduled balance reduction rate" instead of the "prepay rate" meant the prepay curve was run incorrectly. (Lieu 3985:22-3986:1.) Ultimately, though, Ms. Lieu could not presently testify what was the precise error in the cash flow runs because many of the assumptions were not noted on the spreadsheet and she did not have the actual Intex run. (Lieu 4050:12-4051:3.)

[211] Although it was her standard practice to save Intex runs, Ms. Lieu could not recall whether in fact she saved these particular runs. (Lieu 3664:2-18.) She did testify that she would not have necessarily e-mailed the revised runs. (*Id.*)

writedowns under that extreme scenario,[212] many of the bonds show zero percent writedowns, including many BBB- tranches.[213] (*Id.*) On September 18, 2006, Harding's credit team analyzed the BBB tranches of the ABX Index assets to refresh their analysis and make any corresponding changes to the credit decisions, if necessary. (*See* Resp. Exs. 429-432, 435.) The bonds were run under six different scenarios. (*See* Resp. Ex. 432 (different scenarios changed the Optional Redemption on and off, ran a LIBOR curve and a straight LIBOR rate, and shocked the LIBOR rate.) All six scenarios showed zero-percent writedowns for all the BBB-tranche of the ABX Index deals. These assets were also stressed.

Harding prepared and maintained two Excel spreadsheets called "Octans I Cash Flow Detail Part 1 (May 2006 Assumptions)" and "Octans I Cash Flow Detail Part 2 (May 2006 Assumptions)" containing cash flow runs for the assets added to the Octans I portfolio.[214] (*See* Resp. Exs. 966-967.) For each asset, there were two scenarios (one run with Optional Redemption on and one with it off). (*Id.*) All 28 of the ABX Index assets included in Octans I are included in these spreadsheets, and they all show zero writedowns. (*See id.*)

Finally, credit evaluation reports[215] for many of the ABX Index assets included in Octans I contain cash flow runs, and two bonds that were not included in Octans I (one, SASC

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[212] AMSI 2005-R11 M8 (100%), CWL 2005-BC5 M8 (100%), CWL 2005-BC5 B (9.04%), JPMAC 2005-OPT1 M8 (42.6%), NCHET 2005-4 M8 (100%), SAIL 2005-HE3 M8 (100%), SVHE 2005-4 M8 (60.05% and 60.47%).

[213] ACE 2005-HE7 M8, BSABS 2005-HE11 M8, HEAT 2005-8 B1, LBMLT 2005-WL2 M8, MABS 2005-NC2 M9, MSAC 2005-HE5 B3, RASC 2005-KS11 M9, SAIL 2005-HE3 M9.

[214] As noted in Section XVII.B, the evidence is unclear as to when (1) the cash flow runs were actually done, and (2) the results were compiled into the spreadsheet. The metadata is unreliable because that information only details when that particular spreadsheet was created and not whether the information was compiled from earlier sources. Regardless of when the spreadsheet was created, the cash flow runs support the conclusion that the May 31 cash flow runs from Brett Kaplan showing significant writedowns were incorrect and unreliable.

[215] Harding Advisory created "Credit Committee Bond Evaluation" reports in order to consolidate in one place the analysis for a particular deal or bond. (*See* Lieu 3809:5-3810:5.) These reports were generally created soon after the analysis and were updated to reflect current analysis. (*See* Lieu 3810:18-3811:17.) For these particular documents, the evidence is inconclusive as to when they were actually created. (*See* Section XVII.B.)

2005-WF4 M8 was later approved by Jung Lieu in September 2006). (*See* Resp. Exs. 439, 805, 941, 943-962 (credit evaluation reports for 15 ABX Index bonds).) The cash flow runs contained in these reports appear to have been run at various times, but they all show zero writedowns. (*See id.*)[216]

2. HIMCO's — the Division's lodestar — analysis showed 0% or low writedowns.

As further validation and corroboration, cash flow analyses conducted by sophisticated market participants, including an investor in Octans I, demonstrated that zero writedowns within the ABX Index bonds occurred under various scenarios and that writedowns would not begin to

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[216] In what can only be chalked up to desperation or paranoia, the Division now suggests that counsel's statements to the Court on April 23, 2014 (Tr. 3861:21-3862:24) about having only recently identified certain documents should be disbelieved. This allegation is baseless and professionally contemptible. (*See* Div. Br. at 66 n.119.) Here is the evidence that supports the Division's personalized attack: (a) of the twenty-four documents marked on the morning of April 23, 2014, while court was in session, the team inadvertently marked a single document that had already been marked just before the start of the Hearing as an exhibit (see Resp. First Supp. Ex. List (Mar. 19, 2014)); (b) prior counsel, with whom present counsel has not spoken, appears to have been familiar, two years ago, with that same document (the reference to that document was buried in one of the nine transcripts of sworn testimony that Mr. Chau had previously given). That document—like all of the other exculpatory documents proving that Harding performed Intex runs throughout 2006 and 2007 using standard assumptions showing zero or insignificant write-downs to the ABX Index—was never marked by the Division as an exhibit during its years of investigative testimony, was never shown by the Division to any witnesses so that it could be explained, and counsel was left to scramble to find it and others like it (once we received the Wagner Report weeks before the Hearing and began to understand how important cash flow runs would be to the Division's case.)

The Division, having investigated this case for years, knows more about the evidence and the documents than counsel, which was retained at the time that the OIP was served. As the Court knows, the Division refused to identify a single document as Brady material and took the position that its 22-million document data dump gave counsel everything we would need to be ready to defend the case within a matter of months. Counsel has worked diligently to understand the Division's allegations and evidence, as well as to craft defenses and identify exculpatory evidence.

If counsel already knew about and was familiar with the documents that were marked, in a rush, during the morning of April 23, 2014, then why didn't we show them to Ms. Lieu sooner? Why did we wait to only show them to her for the first time while she was on the stand at the Hearing at a time when we were not sure what she would say about them? If we already knew about those documents, why didn't we give them to our expert witness, Mr. Hilfer, to analyze sooner? Why, instead, waste his time, our time, and our client's money by sitting on the documents and not trying to understand what they were. If we already knew about those documents, why hold on to them, never show them to anyone, or ask anyone questions about them, and take the chance that the Court might exclude them for lateness? If we already knew about those documents, why would we risk jeopardizing our own careers by not telling the Court the truth about how we had located them?

As counsel made clear that day, we stand ready to answer questions under oath about how and when we found the documents. The Division's half-cocked and irresponsible accusations need to be put to an end.

occur except under extreme assumptions. First, HIMCO, an investor in Octans I, analyzed the Octans I portfolio prior to investing in Octans I. (*See* Resp. Exs. 611-612.) The cash flow runs showed zero writedowns for the ABX Index bonds, except SAIL 2005-HE3 M9, which showed only a 6.61% writedown.[217] (*See* Resp. Ex. 611.)

3. Contemporaneous market reports showed no writedowns.

In May and June 2006, JPMorgan released reports showing its cash flow analysis of the ABX Index. (*See* Resp. Exs. 934-935.) The reports showed that writedowns would not begin to occur until losses reached at least over 9%. (*See* Resp. Ex. 934 at 19-20; Resp. Ex. 935 at 20-21.)

4. Respondents' expert, Steven Hilfer, identified a possible error in the Kaplan May 31, 2006 cash flow runs.

Finally, Steven Hilfer, utilizing the loss curve derived from Division Exhibit 282 (referred to in the Wagner report as demonstrating Harding's 6% cumulative loss curve used in the May 30 and May 31 cash flow runs), was able to demonstrate that the writedowns would occur only when Intex was set to use a particular prepay methodology that was non-standard and, after June 2006, not used by Harding. (*See* Resp. Ex. 977 at ¶¶ 13-34.) Running the loss curve derived from Division Exhibit 282 with the non-standard prepay methodology achieved projected writedowns that were strikingly similar to the projected writedowns in the May 30 and May 31 Brett Kaplan cash flow runs. (*See id.* at Table 2.) By changing **one setting**, Mr. Hilfer was able to obtain cash flow runs showing no projected writedowns for all but four bonds. (*See id.* at Table 3.) Three of the four bonds were rejected by Harding's credit team, so that fact is of little significance. (*Cf.* Div. Br. at 52-53 n.93.)

[217] This fact apparently did not bother HIMCO since it decided to invest in Octans I anyway.

I. <u>The May 31 OWIC Is A Red-Herring: "Whether Ms. Moy Spent A Certain Amount Of Time Doing Her Analysis And Ms. Lieu Spent A Certain Amount Of Time Doing Her Analysis Are Two Separate Inquiries."</u>

While Jung Lieu was refreshing the analysis on the ABX Index assets, the Harding credit team received an e-mail from Michael Giasi, a Harding trader, regarding an OWIC in which bids were due at 4:00 p.m. (the "4 p.m. OWIC"). (*See* Div. Ex. 57-58.) Mr. Giasi asked the credit team to "see if there [were] any names [Harding has] done the work on already to see if there is a fit for [Harding]." (*Id.*) It was understood by the credit team that Mr. Giasi was asking them to determine on which bonds they had "already done [the] bulk of the credit work." (Lieu 3699:6-14.) The reason Mr. Giasi limited the work to those bonds already reviewed by the credit team was because the credit team would not have had "to spend as much time on reviewing those bonds." (*Id.*) All the credit team had to do was "refresh the performance and cash flow information." (Lieu 3699:19-23.) As a matter of coincidence, and not realized by the credit team until later, the 4 p.m. OWIC contained the same ABX Index assets that Tony Huang had tasked Jung Lieu to analyze for Octans I. Mr. Giasi's e-mail was sent at 2:00 p.m., giving the credit team less than two hours to see whether, based on the prior work, there were any assets in which Harding would be interested.

Approximately fifteen minutes after Mr. Giasi sent his e-mail, Jamie Moy asked Ken Lee, a Harding junior analyst, to run a surveillance report on twenty-one of the forty assets. (*See* Div. Ex. 61.) Less than fifteen minutes later, at 2:29 p.m., Ken Lee forwarded the surveillance report to Ms. Moy. (*See* Div. Ex. 63-64.) While Ms. Moy was asking for and receiving the surveillance reports, Jung Lieu was researching the past credit decisions by looking up the CUSIPs in an Excel file containing a master list of credit decisions. She did not focus on the names of the bonds or realize that the OWIC list duplicated the ABX Index. (*See* Lieu 3538:24-3539:11;

3701:10-3704:18.) At 2:49 p.m., Ms. Lieu e-mailed the results of her research to Michael Giasi and the MaximCDO distribution list. (*See* Div. Ex. 65.) She noted that the Harding credit team had conducted prior review of 29 of the bonds and that 10 had been approved and 19 had been rejected. (*See id.*) She then listed the ten previously approved bonds, including the BBB and BBB- tranches of MABS 2005-NC2, but still did not focus on the names or realize that they were ABX Index assets because she was simply "copying" and "pasting" CUSIP numbers and checking the CUSIP numbers. (*See id.*) This list represented her decision regarding the bonds based on past analysis alone. (*See* Lieu 3538:24-3539:11.) Fifteen minutes later, at 3:04 p.m., Ms. Moy responded to Ms. Lieu's e-mail. (*See* Div. Ex. 65.) She noted a disagreement about the MABS bonds, but otherwise agreed that the other eight bonds listed by Ms. Lieu were approved. She also approved seven other bonds. (*See* Div. Exs. 65-66.)

Out of the forty bonds, Ms. Moy noted that 15 were approved and 25 were rejected. (*See id.*) Ms. Moy, however, did not have enough time to render a final decision; it was likely that she rendered a preliminary decision in order to give the trader a sense as to whether to participate in the OWIC or not. (Lieu 3706:11-17 (testifying that the sixty minutes Ms. Moy had to render a decision was not enough time); *see also* Lieu 3704:17-18 ("I'm assuming . . . we're trying to gauge how much time we have.").)

To the extent that Ms. Moy's decisions conflicted with Ms. Lieu's work, they discussed their disagreements and rendered a final decision. (Lieu 3713:15-3714:8.) From the time Ms. Moy sent her e-mail with her preliminary decision on the 4:00 p.m. OWIC and the time Ms. Lieu submitted her rejection list to Mr. Huang, more than an hour had passed, giving them plenty of

time to discuss any issues with regard to the ABX Index assets. Moreover, Harding did not participate in the 4:00 p.m. OWIC.[218]

J. Again: These Assets Were Not Disfavored: Jung Lieu's Credit Decisions Were Corroborated By Approvals Both Before And After Of ABX Index Bonds For Harding-Managed Deals That Did Not Involve Magnetar.[219]

The evidence established that Jung Lieu's credit decisions rendered on May 31, 2006 for the 40 ABX Index assets were reasoned, and reasonable, decisions made after a thorough review by an experienced RMBS analysis. Prior to and subsequent to the May 31, 2006 decision, Harding's credit team rendered credit decisions approving, at one point or another, the same 28 ABX Index bonds that Ms. Lieu approved on May 31. The approvals were made for deals not involving Magnetar.

- On May 16, 2006, Jamie Moy and Jung Lieu approved two ABX Index bonds, FFML 2005-FF12 B2 and SVHE 2005-4 M8. (*See* Resp. Ex. 297.)
- On May 22, 2006, Harding's credit team approved seven ABX Index assets, after running cash flows with much higher cumulative loss assumptions. (*See* Div. Ex. 16.)[220]
- In early June, Jamie Moy submitted credit decisions approving ABX Index assets for various non-Magnetar deals.

[218] At the hearing, the Court acknowledged based on the evidence presented up until that point that Ms. Moy's work on May 31, 2006 was not probative or relevant to Ms. Lieu's separate assignment of selecting bonds for the Octans I warehouse. The Court stated that there were "two separate inquiries," and that "the analysis that Ms. Moy did was just for the purpose of an OWIC, not for the purpose of warehousing all these bonds into Octans I." The Court also noted that the evidence showed that "Ms. Moy didn't spend a lot of time on her [analysis]" and that "the most probative evidence of Harding's analysis of these bonds would pertain to Ms. Lieu's analysis because Ms. Lieu's analysis led to 28 of the 40 index bonds going into Octans I. And Ms. Moy's, I'm not so sure it had anything to do with anything except this OWIC." (Tr. 3788:6-19; 3790:2-7.)

[219] *See* Exhibit J (disputing the Division's unfounded attacks on Ms. Lieu's credibility.)

[220] Those seven bonds were ACE 2005-HE7 M8, BSABS 2005-HE11 M8, HEAT 2005-8 B1, JPMAC 2005-OPT1 M8, MABS 2005-NC2 M9, MSAC 2005-HE5 B3, and RASC 2005-KS11 M9. (*See* Div. Ex. 16.)

- On June 6, 2006, regarding a Merrill Lynch suggestion for an unnamed deal, Jamie Moy forwarded credit approvals for two bonds.[221] (*See* Resp. Ex. 363.)
- The next day,[222] Ms. Moy forwarded to Tony Huang credit approvals for 4 ABX Index bonds as part of a non-Magnetar deal.[223] (*See* Resp. Exs. 369-370.)
- That same day, Ms. Moy forwarded credit approvals for twenty-three ABX Index bonds across four possible portfolio configurations for a Barclays deal.[224] (*See* Resp. Exs. 371-372.)
- Finally, on June 21, 2006, Ms. Moy forwarded to Mr. Huang a list of "Maxim approved deals," for a Deutsche Bank deal. (*See* Resp. Exs. 385-388.) Ms. Moy's list of approved deals included twenty-seven of the twenty-eight ABX Index assets approved by Ms. Lieu on May 31.[225] (*See* Resp. Exs. 385-386.)
- In addition, on August 25, 2006, either Jung Lieu or both Jung Lieu and Jamie Moy approved 14 ABX Index bonds.[226] (*See* Resp. Exs. 415-416, 419-422.)

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221 Those two bonds were RASC 2005-KS11 M9 and SAIL 2005-HE3 M8. (*See* Resp. Ex. 363.)

222 It is also possible that these approvals were rendered on May 24, 2006. (*See* notes 190, 192.)

223 Those four bonds were MLMI 2005-AR1 B2, MSAC 2005-HE5 B3, NCHET 2005-4 M8, and RAMP 2005-EFC4 M9. (*See* Resp. Exs. 369-370.)

224 Those 23 bonds are ACE 2005-HE7 M8, ACE 2005-HE7 M9, BSABS 2005-HE11 M7, BSABS 2005-HE11 M8, CWL 2005-BC5 M8, FFML 2005-FF12 B2, FFML 2005-FF12 B3, HEAT 2005-8 B1, HEAT 2005-8 M8, JPMAC 2005-OPT1 M8, JPMAC 2005-OPT1 M9, MLMI 2005-AR1 B2, MSAC 2005-HE5 B2, MSAC 2005-HE5 B3, NCHET 2005-4 M8, RAMP 2005-EFC4 M8, RAMP 2005-EFC4 M9, RASC 2005-KS11 M8, RASC 2005-KS11 M9, SABR 2005-HE1 B2, SABR 2005-HE1 B3, SAIL 2005-HE3 M8, and SVHE 2005-4 M9. (*See* Resp. Exs. 371-372.)

225 The only bond missing from that list was AMSI 2005-R11 M8. (*See* Resp. Ex. 386.) This bond was approved for a Citi deal in August 2006. (*See* Resp. Ex. 415-416, 419-422.)

226 Those fourteen bonds were ACE 2005-HE7 M8, AMSI 2005-R11 M8, BSABS 2005-HE11 M7, CWL 2005-BC5 M8, FFML 2005-FF12 B2, HEAT 2005-8 M8, JPMAC 2005-OPT1 M8, MABS 2005-NC2 M8, MSAC 2005-HE5 B2, RAMP 2005-EFC4 M8, RASC 2005-KS11 M8, SABR 2005-HE1 B2, SAIL 2005-HE3 M8, SVHE 2005-4 M8.

In addition, on May 30, 2006, in preparation for submitting a BWIC the next day, Alison Wang submitted to Magnetar a list of fifty-four assets that Harding's credit team had approved that included 5 ABX Index names, separate and apart from the ABX Index trade.[227] (*See* Div. Ex. 34-35.)

Finally, the Harding trade blotter shows many trades of ABX Index assets into non-Magnetar CDO warehouses. First, as noted above, Harding purchased SVHE 2005-4 M8 for the Lexington II CDO, as a cash bond on December 14, 2005. (*See* Div. Ex. 6.) In May 2006, two ABX Index assets were traded into Lexington II (FFML 2005-FF12 B2 and MABS 2005-NC2 M9, on May 17 and May 23, respectively). (*See id.*) In addition, SAIL 2005-HE3 M8 was traded into Lexington II on June 7, 2006. (*See id.*) Prior to Octans I closing, three ABX Index bonds were traded into non-Magnetar CDO warehouses, two on September 18, 2006, and one on September 21, 2006.[228] (*See id.*) In October 2006, Harding purchased four ABX Index bonds that had been approved for Octans I for the Lexington III warehouse.[229] (*See id.*) In December 2006, Harding purchased six ABX Index bonds that had been approved for Octans I for the Lexington V warehouse.[230] (*See id.*)

In sum, the evidence demonstrates that Harding's credit team worked diligently and in good faith at all relevant times, regardless of the deal being analyzed. Harding and its credit team were not pressured at any time to lower their standards and never did lower their standards.

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227 Those five bonds were FFML 2005-FF12 B2, MABS 2005-NC2 M9, RASC 2005-KS11 M9, SABR 2005-HE1 B3, SVHE 2005-4 M8. (*See* Div. Ex. 34-35; *see also* Resp. Exs. 776-777.)

228 Those bonds were SABR 2005-HE1 B2 and SABR 2005-HE1 B3 (for Lexington III), and HEAT 2005-8 M8 (for Lexington III). (*See* Div. Ex. 6.) In addition, FFML 2005-FF12 B2 was traded into Octans I V (a deal that did not close) on August 10, 2006. (*See* Div. Ex. 6.)

229 Those bonds were HEAT 2005-8 M8, JPMAC 2005-OPT1 M8, MSAC 2005-HE5 B2, RASC 2005-KS11 M8. (*See* Div. Ex. 6.)

230 Those bonds were HEAT 2005-8 M8, JPMAC 2005-OPT1 M8, MSAC 2005-HE5 B2, RASC 2005-KS11 M8, SABR 2005-HE1 B2, SABR 2005-HE1 B3. (*See* Div. Ex. 6.)

Harding Advisory was a hard-working and diligent collateral manager looking to put together a CDO that would perform for all investors.

XIII. THE ALLEGATIONS IN THE OIP RELATED TO THE OCTANS II AND OCTANS III CDOS ARE IRRELEVANT TO THIS PROCEEDING.

A. The Division's Use Of An Ambiguous E-mail Regarding Octans II Fails to Demonstrate That Harding's Credit Team Was Overruled In Their Credit Decisions Regarding The ABX Index Trade For Octans I.

Unable to prove that anyone pressured or overruled the Harding credit team as it related to the ABX Index trade for Octans I, the Division attempts to bolster its case through the use of propensity evidence by misreading an ambiguous August 29, 2006 e-mail related to **Octans II** [231] as evidence that Harding's credit team was pressured and overruled by its portfolio managers regarding the ABX Index trade in **Octans I**. (*See* Div. Br. at 41, 79.) This e-mail, Division Exhibit 155, is irrelevant **because it does not prove any of the Division's allegations with respect to Octans I.**[232] Neither the FFML 2006-FF4 M8 bond nor the GSAMP 2006-HE3 M8 bond, the bonds referenced in the e-mail, were purchased for Octans I.

As background, on July 19, 2006, Markit rolled-out the latest series in the ABX Index, ABX 2006-2. (*See* Resp. Ex. 400.) Shortly thereafter, Tony Huang instructed Jamie Moy to analyze the new series to determine which bonds the credit committee approved. (*See* Huang 1345:24-1347:6; *see also* Div. Ex. 127 (Bloomberg message from Tony Huang to Wachovia stating "Our credit people are still working on the new ABX.HE.BBB.06-2 index").) Mr. Huang did not give Ms. Moy any special instructions other than to look at the bonds and provide her

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[231] Octans II was a broadly syndicated mezzanine CDO comprised mainly of synthetic CDS referencing RMBS bonds that was structured and marketed by Wachovia. (*See* Div. Ex. 239.)

[232] This e-mail is not even enough to show propensity because there is no evidence indicating what actually happened, and, therefore, it is unreliable hearsay. Because it has the burden of proof, if the Division seriously believed that this e-mail supported its case, it should have called Jamie Moy as a witness to explain her statements. She was on the Division's witness list.

credit decision. (Huang 1347:13-1348:17.) He certainly did not pressure her. (Huang 1202:9-23.) On Friday, July 28, 2006, at approximately 9:41 p.m., Ms. Moy e-mailed Messrs. Huang and Chau to inform them that she had done an initial review of the ABX 2006-2 assets and from "a collateral/structure (not cashflow) perspective[,] there are a few No and a few yes – most I have marked as Maybes." (Div. Ex. 129.) She wrote that she would finalize her analysis the following Monday, after performing cash flow analysis. (*Id.*) On Monday afternoon of July 31, 2006, Mr. Huang informed Wachovia that Harding would finalize discussions on the Index names that evening and provide the names to Wachovia the following day. (*See* Div. Ex. 130.) An August 2, 2006 Harding OWIC demonstrated that 9 out of the 20 2006-2 names were rejected by Harding's credit team at the BBB level. (*See* Resp. Ex. 587.) Absent from the OWIC (suggesting that Harding's credit team had approved them) were FFML 2006-FF4 M8 and GSAMP 2006-HE3 M8. (*See id.*)

Approximately three weeks later, on August 24, 2006, a junior analyst at Harding was reviewing Ms. Moy's credit decisions with regard to the 2006-2 series of the ABX and comparing it to previous decisions made by the credit team from the master bidlist. (*See* Div. Ex. 155.) The junior analyst noted a conflict with five of the bonds and asked for Ms. Moy's final decision. (*See id.*) The two bonds at issue, FFML 2006-FF4 M8 and GSAMP 2006-HE3 M8, had a "Yes" from Ms. Moy's recent analysis of the 2006-2 ABX Index and a "No" from prior decisions on the "Bidlist." (*See id.*) Ms. Moy told the junior analyst to keep her most recent credit decisions for all of the bonds except FFML 2006-FF4 M8, which had been listed as "Maybe" by Ms. Moy after her July 28 review of the structure and collateral, suggesting that after further review she could have decided either way. (*See id.*) The credit team decided to make the most recent credit decision a rejection. (*See id.*)

The next day, on August 25, 2006, Jung Lieu informed Jamie Moy that her credit comments with regard to another bond on the 2006-2 ABX Index, GSAMP 2006-HE3 M8, conflicted with Ms. Moy's approval. (*See id.*) Ms. Lieu wrote, "Let me know if you think it should be 'Y', and we can discuss and change the comments in the bidlist." (*Id.*) On August 28, 2006, Ms. Moy responded and noted that she had initially designated this bond as "Maybe," but approved it for Octans II. (*See id.*) They agreed to change it from approved to rejected. (*See id.*)

As noted above, this e-mail has nothing to do with the ABX Index trade involving Octans I. The e-mail is not even discussing the same assets. Moreover, Division Exhibit 155 cannot be used by the Division to show the propensity of Harding's portfolio managers to pressure or overrule its credit analysts because it is ambiguous. First, no one knows whether it was true that, for the 2006-2 ABX Index, Ms. Moy was picking the "lesser of evils." The e-mail itself is rank hearsay, and Ms. Lieu's testimony is nothing more than speculation (*see* Lieu 3363:18-3368:19, 3370:20-3372:22). Second, no one knows what Ms. Moy meant by "lesser of evils" or "less worse." Third, even if Ms. Moy was selecting the "less worse" bonds, no one knows for what reason. Ms. Moy was analyzing BBB bonds from the 2006-2 ABX Index, and it is possible that the "less worse" bonds provided substantial spread benefits. If anything, what is readily apparent from the e-mail, is that neither Ms. Moy nor Ms. Lieu expressed any concern about being pressured or being overruled or that anything nefarious was occurring at Harding.

If anything, this e-mail demonstrates that Ms. Moy and Ms. Lieu collaborated on the credit process as equals, asking for and providing advice on how to record credit decisions. It also demonstrates the independence of Harding's credit team. Without involving management or seeking permission afterward, Ms. Lieu and Ms. Moy agreed that if a credit decision is "No," then it should remain "No" whether the bond is part of an Index trade or not. (*See* Div. Ex. 155.)

Finally, documentary evidence completely refutes the Division's assertion that Harding's credit analysts were pressured or overruled in the **Octans II** transaction. Subsequent to the August 29, 2006 e-mail, Jung Lieu undertook a review of the BBB-rated tranches of both the 2006-1 and 2006-2 ABX Index. As a result of that review, the GSAMP bond was listed as approved. (*See* Resp. Ex. 435 ("All the INDEX bonds have been re-looked at for current CF runs, surveillance, interest shortfalls, and collateral characteristics.") In addition, after Harding's management became aware that the credit analysts had rejected the FFML bond, Wing Chau forwarded to James Prusko a list of ABX Index assets that had been rejected by Harding's credit team, which included FFML 2006-FF4 M8. (*See* Resp. Ex. 800-801.) The next day Harding bought protection on this bond for the Octans II warehouse. (*See* Div. Ex. 6.) There is no evidence that Harding's credit analysts were pressured or overruled based on this e-mail regarding Octans II or any evidence regarding Octans I.

B. The Division's Use Of E-mails Related To Octans III Fails To Demonstrate That Any Credit Analyst Was Pressure Or Overruled With Respect To The ABX Index Trade In Octans I.

In a second attempt to bolster its otherwise unsupported allegations that Harding purchased "disfavored" ABX Index assets for Octans I, the Division produced a string of e-mails from September 2006 showing that two ABX Index assets, BSABS 2005-HE11 M8 and SAIL 2005-HE3 M8, had been rejected by Harding's credit team but were still purchased for Octans III. (*See* Div. Exs. 160-167.) The Division is trying to push the inference that Harding's portfolio managers overruled Harding's credit analysts, but this inference is unwarranted in light of the full weight of evidence. Octans III, a Harding-managed CDO that closed on December 6,

2006 (*see* Div. Ex. 239), was a private transaction[233] between two highly-sophisticated investors: Magnetar and Citigroup's proprietary trading desk in London. (*See* Huang 1237:14-1238:5, 1239:5-14, 1242:13-19.) "The reference obligations to form a part of the Reference Portfolio will be agreed between the Parties **prior to the ramp up process**." (Ex. 864 at CITI 28660960.) In other words, as a requirement for the deal, **both Magnetar and Citigroup had to approve every asset that was proposed by Harding and the price at which to purchase it**.[234] (*See* Resp. Exs. 864 at CITI 28660960; Resp. Ex. 865 at CITI 28899630.) Harding's credit analysts would not have known about the structure of this trade or have seen the engagement letter. (Lieu 3892:16-3993:24.) Even assuming that Harding "overruled" its credit analysts, this fact would be irrelevant to this proceeding because Octans III was a completely different type of CDO.[235]

In addition, the fact that Harding's credit team changed their decision on **two** bonds months after they were approved for Octans I has no bearing on the asset selection process for Octans I. The uncontroverted evidence demonstrated that both Jung Lieu and Jamie Moy had approved the BSABS bonds on May 31 as part of the 4:00 p.m. OWIC (Div. Ex. 65-66), as well as on May 22, 2006 (Resp. Ex. 298-299). In addition, Ms. Moy approved it for two bespoke

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[233] The Division asserts that Octans III was broadly syndicated and supports that by noting that 888 Tactical CDO, a Harding-managed CDO, invested in Octans III. (*See* Div. Br. at 80 & n.141.) That 888 Tactical bought an Octans III bond is not evidence that Octans III was broadly marketed to outside investors. Typically, broadly syndicated CDOs used, as part of their marketing effort, a pitch book. (*See, e.g.*, Resp. Exs. 534 (Longstreet CDO), 908 (Wadsworth CDO), 979 (Aquarius CDO).) There was no pitch book for Octans III. The fact that Octans III **could** have been marketed does not prove that it actually **was** marketed. Because Harding was the collateral manager for Octans III, it was very familiar with the bonds and could buy them in a private sale, even in the absence of broad syndication.

[234] The Division asserts that Harding's role with Octans III was only a gloss to demonstrate to outside investors that the portfolio was independently selected by a collateral manager because the two parties could simply agree on the portfolio without the need for Harding. (*See* Div. Br. at 80.) Again, there is no evidence that Octans III was marketed to outside investors. In addition, Harding was often asked to select portfolios for private bespoke deals. (*See, e.g.*, Resp. Exs. 371-372 (Barclays bespoke), 385-388 (Deutsche Bank bespoke), 419-422 (Citi bespoke).)

[235] Moreover, e-mails and testimony suggest that Tony Huang forwarded to James Prusko the list of approved bonds on August 22, 2006, before he knew that the approval decision on the bonds had been changed. (*See* Resp. Ex. 413; Huang 944:19-945:3.)

deals, one on either May 24 or June 7 and one on June 21. (Resp. Exs. 371-372; 385-388.) Likewise, the SAIL bond had been approved several times around the May/June 2006 time period by Jamie Moy and was traded into the Lexington II warehouse on June 7, 2006, which evidences approval from Harding's credit team. (*See* Resp. Exs. 363, 371-372, 385-388; Div. Exs. 6.) In addition, Jung Lieu approved the SAIL bond for a non-Magnetar deal on August 25, 2006. (*See* Resp. Exs. 419-422.) The fact that Harding's credit team changed its decision at some point in time later does not render the prior decision incorrect. As noted in Section XVI.D below, once a bond is traded into a CDO warehouse, the only way to remove it is if it becomes an ineligible security. The uncontroverted evidence established that both of the bonds met the eligibility criteria at the time of closing. (*See* Resp. Ex. 53.)

XIV. THE DIVISION'S EXPERT, IRA WAGNER, IS NOT CREDIBLE AND HIS REPORT SHOULD BE GIVEN NO WEIGHT BECAUSE IT IS NOTHING MORE THAN SPECULATION ABOUT EVENTS THAT HE DID NOT WITNESS MASKED AS EXPERT TESTIMONY.

The Court should give the views of Division expert Ira Wagner little or no weight. Putting aside the opinions that he provided in the *Tourre* case—which are highly probative that there was nothing material **in this case** about Magnetar's warehouse rights here, given Magnetar's interests in the deal performing—the rest of Mr. Wagner's testimony and opinions here have no basis under *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993), confuse the issues, and are infected with a bias that goes beyond the typical bias that an expert shows to the party paying his fees. His reports and testimony are nothing more than the Division's attempt to invade the province of the fact-finder, as the Court has noted, (*see* Tr. 3192:23-3193:5), and he is not credible. He consistently made errors and took incorrect or false positions that benefitted the Division's theory of the case and prejudiced Respondents. Perhaps the most striking example is his stubborn insistence that "Credit" at Harding had not performed

any cash flow runs for the ABX bonds selected on May 31, 2006. He made no qualifications in his written report on the issue and made no qualifications on the issue when questioned by the Court. Thus, Mr. Wagner testified falsely in response to questions from the Court about whether there were "no runs" done:

> THE COURT: Hold on. Let me ask one thing on what you said. You said there were bonds for which there were no runs done?
>
> THE WITNESS: Yes, that I found.
>
> THE COURT: ABX index bonds or some other?
>
> THE WITNESS: Yes. This is 27. There are 13 others.

(Wagner 4741:19-4742:2.) This was false. Mr. Wagner asserted that there were no runs done for between 11 and 13 of the 40 ABX index assets.

But runs had, in fact, been done for all of the ABX Index assets, and he knew it because those runs were all included within the subset of documents he reviewed and relied upon in preparing his report and testimony. Thus, Mr. Wagner attached to his report a spreadsheet he labeled "Harding Decision on Bonds **Not Previously Reviewed by Credit**," which contained the entry "**No Analysis**" in a column labeled "Bond Analyzed and write downs," clearly indicating that **no cash flow runs had been performed** on eleven assets. (*See* Div. Ex. 8001 at App'x 7.) His report concluded that "**[w]ithout any cash flow runs** these approvals essentially have no meaningful analysis to support this decision." (*Id.* at ¶ 83.) He continued to insist that he was telling the truth, even as he was required to admit, one asset after another, that this was not true and that cash flow runs had indeed by performed for each and every asset (Wagner 4768:11-4797:6; 4797:5-6 (testifying that all eleven did, indeed have cash flow runs that had been performed).) Mr. Wagner's motive was clear: he wanted to leave the impression that Harding Credit analysts were not doing any work, so he ignored, overlooked or buried evidence that

undermined the position he wanted to take. That evidence was front and center in the material that he reviewed. Ultimately, despite his sweeping generalizations that no contemporaneous cash flow runs existed for these bonds, Mr. Wagner feebly took the position that what he had not meant what he said or what he wrote. (*Id.* 4776:6-24.)

This is the third instance that the Division has used expert or summary witnesses with no personal knowledge of the events underlying the Octans I transaction to provide false or misleading testimony. (*See* Section IV.D. (misleading testimony from expert Richard Ellson)); Section IV.C.4. (misleading testimony from SEC staff accountant Doug Smith).) The Division is alleging that the Respondents committed fraud. That is a serious accusation. The Division has taken years to assemble its evidence and has a remarkable storehouse of knowledge concerning details and documents when it suits its purposes. We fear that the Division is struggling too hard to justify positions that the facts do not support, perhaps in the hope that Respondents will not have enough time or resources to locate the exculpatory evidence.

Finally, Mr. Wagner makes sweeping factual and credibility decisions despite having no personal knowledge about the Octans I transaction (*see, e.g.*, Wagner 4779:4 ("I don't know what happened.")), reviewing only a limited set of documents handpicked by the Division (*see, e.g.*, *id.* 4574:8-10), and generally ignoring any testimony, admissible or not, that contradicted the positions he had been hired to take. He also asserted without any evidence that in the "spring of 2006, delinquencies on subprime mortgages were increasing." (Div. Ex. 8001 at ¶ 90.) The Division has seized on this statement to attack Harding's decision to modify it cumulative loss assumption. (*See* Div. Br. at 51.) Mr. Wagner also tied together rising mortgage delinquencies with declining performance in subprime RMBS, but **he cited to no evidence**. (*See* Div. Ex. 8001 at ¶ 90.) The documentary evidence suggests that, even if delinquencies were increasing, the

market believed RMBS assets were performing as expected. It is undisputed that the ABX Index, which represented the broader market, was trading at par during this time period. Despite the prominence of his opinions concerning Intex cash flow runs, Mr. Wagner admitted that he has no experience running Intex and that his opinion on the cash flow runs is based on his ability to "intuitively look at models and understand them." (Wagner 4561:23-25, 4562:25-4563:6.) In fact, his "intuitive" abilities failed him when he stated confidently in his initial report that the Brett Kaplan cash flow runs were run at a 2.4% cumulative loss rate—again, taking a wrong or mistaken position with the effect of prejudicing Respondents.[236] (Wagner 4565:6-4566:15.) As the Division's expert on Intex, Mr. Wagner wrote, authoritatively, in his first report: "Following the receipt of the requested runs, **all conducted at the same across the board 6% default rate and 40% severity rate** . . . " (Div. Ex. 8001 at ¶ 84.) He also wrote: "Although it appears that Harding intended to utilize an assumed projected level of cumulative losses of 6%, **in fact, the runs I examined for the Index trade utilized a 6% default rate and a 40% severity rate. As discussed in footnote 15, this produces cumulative losses of only 2.4%.** Therefore, many of these securities were approved with writedowns taking place even at an assumed level of cumulative losses dramatically below Harding's own expectations." (*Id.* at 34 n.59.) Mr. Wagner retracted portions of his report based on supposedly "new" evidence that he claimed to be Harding's intended assumptions. (*See* Div. Ex. 8003 at ¶¶ 17, 38.) In addition, Mr. Wagner

[236] The Division inexplicably asserts that Mr. Hilfer, Respondents' expert, retracted his initial report regarding cash flow runs. (*See* Div. Br. at 44 n.76, 63 n.111.) Mr. Hilfer did no such thing. The Division states that Mr. Hilfer's first report incorrectly utilized a 6% CDR based on Jung Lieu's representations; however, Mr. Hilfer's report clearly stated that he was relying on **Mr. Wagner's supposed expert testimony that Harding was in fact running a 6% CDR.** (*See* Resp. Ex. 976 at 3(ix) (noting review of the Wagner report).) Of course, Mr. Wagner, when presented with Mr. Hilfer's report showing that he was wrong about Harding's intended assumption, he submitted a supplemental report contradicting his own statements in his previous report: "Harding's analysts **did not apply a CDR** in their analysis, and **nowhere** in the Reviewed Material or Supplemental Material did I see a reference to running the securities at 6% (or any other) CDR. Rather, as stated previously, Harding analyzed RMBS securities by applying an assumed level of cumulative losses." (Div. Ex. 8003 at ¶ 13.)

opined on purported defects in Harding's credit process generally, in an effort to bolster the Division's weak case, but it is clear the Division provided him with a limited set of documents related to the review of the ABX Index assets, and Mr. Wagner did not request documents relating to Harding's other credit reviews.

XV. THE COURT SHOULD DENY THE DIVISION'S REQUEST TO DESIGNATE KENNETH DOIRON AS AN EXPERT BECAUSE THIS BELATED REQUEST WAS GIVEN WITHOUT PRIOR NOTICE TO THE RESPONDENTS AND BECAUSE HIS TESTIMONY, AS CHARACTERIZED BY THE DIVISION, IS INCONSISTENT ON KEY POINTS.

For the first time in its Post-Hearing Brief, **after the deadline for designating experts and submitting expert reports has long passed, after Mr. Doiron testified, and after the close of evidence**, the Division seeks to offer Kenneth Doiron as an expert on the standard of care as applied to CDO managers in 2006. (Div. Br. at 45 n.78 ("Doiron's testimony regarding HIMCO's practices supplements Wagner's testimony regarding what the standard of care required."); *see also* Div. Br. at 77-79, 83, 101 n.177.) This request must be denied.

First, the Division's late request to designate Mr. Doiron defies the Court's pre-hearing scheduling order and established legal precedent. (*See, e.g.*, General Pre-Hearing Order, *Harding Advisory LLC*, Admin. Proc. File No. 3-15574 (Nov. 21, 2013) (requiring expert witness disclosures before the Hearing); Order Setting Prehearing Schedule, *Harding Advisory LLC*, Admin. Proc. File No. 3-15574 (Nov. 22, 2013) (ordering that expert reports shall be filed March 3, 2014)); *Smith v. Hrynkiw*, No. 05 Civ. 1759, 2008 U.S. Dist. LEXIS 123427 at *33, 2008 WL 8700457 (N.D. Ala. Apr. 28, 2008) (striking expert testimony in an affidavit of a fact witness because the witness was not timely identified as an expert on the standard of care); *see also* *Heller v. Dist. of Columbia*, 952 F. Supp. 2d 133, 138 (D.D.C. 2013) (stating that if a party does not timely comply with Fed. R. Civ. P. 26 disclosure requirements for utilizing an expert at trial,

"the party is not allowed to use that . . . witness to supply evidence on a motion, at a hearing, or at a trial, unless the failure was substantially justified or is harmless."). The Division offers no reason justifying its request—nor could it—to violate the Court's previous orders and to substantially prejudice Respondents with a post-hearing request to designate a fact witness as an expert witness.

Second, the Court expressly limited Mr. Doiron's testimony to facts within his personal knowledge. When the Division asked Mr. Doiron if he had an "expectation" as to whether or not certain general facts about CDO mangers were true and to opine on whether a hypothetical set of facts would be "consistent or inconsistent with industry standards" (*see* Doiron 1880:7-1889:16), Respondents' counsel objected to this line of questioning as improper expert testimony disguised as fact testimony, as well as improper for other reasons, such as leading. (*See* Tr. 1880:10-1880:19; 1883:5; 1884:13-15; 1885:13-15; 1886:10-12; 1887:10-20; 1888:7-9; 1889:10-17.) The Court agreed, stating that the Division needed to "make it clear [Doiron] is talking about just his own views." (Tr. 1887:17-20 (emphasis added).) The Division clearly disregarded the Court's instructions and is now attempting to offer Mr. Doiron's answers to these questions as expert testimony. Respondents' counsel therefore request that all of Mr. Doiron's testimony that is not directly related to his factual knowledge of Octans I be stricken from the record.

Third, Kenneth Doiron is not an expert on the standard of care as applied to CDO managers because he lacks the requisite experience necessary to offer an expert opinion in this area. According to his own testimony, Mr. Doiron managed just one CDO prior to testifying at the Hearing. (Doiron 1863:8-13; 1972:9-11.) Moreover, this CDO, Wadsworth CDO, Ltd., which also closed in September 2006, failed in February 2008, two months earlier than Octans I, even though it was a high-grade CDO and therefore backed by A-rated securities. (Doiron 2025:3-18.)

Thus, most of Kenneth Doiron's "experience" with CDO management, as the Division is forced to point out in its Brief, consists of "conversations with other industry participants, industry publications, and conferences." (Div. Br. at 77 (citing Doiron 1883:10-1884:23).)

In sum, the Division's assertion that HIMCO was "an actual example of an 'institutional manager of national standing'—the lodestar for the represented standard of care," (Div. Br. at 45 n.78) is unsupported.

Thus, beyond failing to give Respondents due notice of its intent to use Mr. Doiron as an expert, the Division never laid a foundation that Mr. Doiron had the requisite experience to be such a witness. The Division's attempt to designate Mr. Doiron as an expert should be disregarded.

Fourth and most important, regardless of whether Mr. Doiron's testimony is accepted as establishing or supplementing a standard of care, he does not represent the proverbial "reasonable investor." To begin with, Mr. Doiron's experience pales in comparison against the other Octans I investors. For example:

- Imran Khan,[237] whom the Division interviewed and represented would testify at the Hearing, worked at UOB Asset Management, which in 2006, had managed or acted as a co-adviser in 19 CDO transactions, 9 of which it was still actively managing at the time. (Resp. Ex. 714 at 29.) The 10 CDOs, which UOB Asset Management was no longer actively managing in 2006, had all successfully been redeemed (*i.e.*, unlike the one CDO managed by Mr. Doiron, did not fail). (Resp. Ex. 714 at 29.)

- Michael Edman,[238] who testified at the Hearing, was the Managing Director of the Proprietary Trading Group at Morgan Stanley in 2006. His group invested in 10 to 20 CDOs. (Edman 2502:7-18.)

[237] Mr. Khan refused to meet with Respondents' counsel.

[238] Mr. Edman refused to meet with Respondents' counsel. (Edman 2496:12-18.)

- Douglas Jones,[239] who testified at the Hearing, was a portfolio manager at Maxim Capital from 2006 to 2011. During this time, Maxim Capital managed two high grade CDOs. (Jones 2801:25-2803:9.)

- The super majority of the remaining investors in Octans I were similarly collateral managers for CDO transactions. (*See* Section I.A.2.)

Therefore, should the Court entertain the Division's request to use Mr. Doiron's testimony as expert testimony, Respondents request that it also designate Mr. Khan's statements in Respondent's Exhibit 884, and Mssrs. Jones' and Edman's testimony as expert testimony on the appropriate standard of care.

XVI. HARDING DILIGENTLY ANALYZED RMBS BONDS, INCLUDING THE ABX INDEX BOND AT ISSUE, USING RIGOROUS, DISCIPLINED, INDUSTRY-STANDARD METHODS AND TECHNOLOGY.

Analyzing RMBS bonds is a multi-step process involving high-level review of originators and servicers of subprime mortgages, an initial review of the RMBS structure and underlying collateral for new issue bonds, surveillance of the performance of more-seasoned bonds, and an analysis of future cash flow and potential losses of particular tranches of an RMBS using manager-specific assumptions in a software program called Intex. By focusing on the activities of the credit analysts over a 24-hour period in late May, the Division ignores the overwhelming evidence that Harding's credit analysts had engaged in the analysis of the individual RMBS that comprised the ABX Index on multiple occasions over the course of prior weeks and months. The Division predicates its entire case related to Octans I on the premise that

[239] Mr. Jones met with both the Division and Respondents' counsel for approximately equal lengths of time. (Jones 2857:11-2858:6.)

Out of nowhere, the Division asserts that Mr. Jones, who never worked with Mr. Chau or the others who left Maxim for Harding, is biased because an "adverse ruling 'would not be good for' Maxim's reputation." (Div. Br. at 85 n.148.) This ignores what Mr. Jones actually said. First, he testified that should Harding be ultimately found liable, there was a chance, which he characterized as "rare," that a story on Harding may take a deep dive into the background and mention Maxim. (Jones 2861:13-22.) Second, in that rare circumstance, he testified that it "wouldn't help" Maxim, but that "I don't have anything to do with that [nor] do I care." (Jones 2862:3-5.) Mr. Jones, as the Division knows, no longer works at Maxim. This is not a sufficient basis to assert that Mr. Jones was biased.

Jung Lieu would not have started analyzing these 40 bonds until the evening of May 30, at the earliest. Contrary to the Division's conclusory remarks about the need to analyze 40 ABX Index bonds on May 31, Jung Lieu needed only to refresh her analysis on those bonds, while utilizing her past research and analysis to inform her credit decision for the ABX component of the Octans I portfolio.

Consistent with that, as we demonstrate below, by the time Jung Lieu was tasked by Tony Huang to review the Baa2 and Baa3 tranches of the underlying RMBS of the ABX Index (the "ABX Index Bonds"), Ms. Lieu was familiar with the deals, had previously analyzed many of the bonds, and simply needed to refresh cash flow projections using recently-modified market assumption. Ms. Lieu had plenty of time to perform the necessary analysis in order to make recommendations to Mr. Huang about which bonds should be included in Octans I.

A. Harding Employees Responsible For Analyzing And Approving The Purchase Of RMBS Assets Consisted Of Hard Working, Intelligent, And Experienced Individuals Who Worked Together To Ensure A Quality CDO Portfolio.

Harding's credit team consisted of two senior analysts and two junior analysts. Jung Lieu, who had approximately six years of experience analyzing RMBS assets by mid-2006 (Lieu 3233:24-3234:2) was a credit analyst at Maxim and Harding during the relevant time period, and she was involved in doing the credit analysis of RMBS bonds that Harding reviewed for purchase into the CDOs it managed. (Wang 268:9-13; Lieu 3248:7-11; Lieu 3798:3-4; *see also* Resp. Ex. 2 at 194 (providing a brief biography on Ms. Lieu in the Offering Circular).) Jamie Moy, with approximately ten years of experience in structured finance and fixed income was also a credit analyst at Maxim and Harding, involved in analyzing RMBS bonds. (Wang 268:9-13; Lieu 3250:13-14; Lieu 3797:25-3798:4; Resp. Ex. 2 at 194.) Brett Kaplan and Ken Lee were junior analysts at Maxim and Harding, and they usually ran the Intex cash flow reports and

surveillance reports for specific bonds at the request of either Ms. Lieu or Ms. Moy. (Lieu 3689:5-16.)

In addition, Harding had two portfolio managers who oversaw the asset selection process. Wing Chau was a portfolio manager for Maxim and Harding who ultimately had the final decision on whether to purchase a bond or not, especially if Ms. Lieu and Ms. Moy disagreed on a credit decision and could not reconcile their opinions. (Lieu 3263:21-3264:5; Lieu 3556:3-20; *see also* Resp. Ex. 2 at 194.) Tony Huang was also a portfolio manager for Maxim and Harding, and he had over twelve years of experience in the structured credit products area. (Huang 1200:12-14; Resp. Ex. 2 at 193.) He also had the authority to make a final decision on a bond if there was a disagreement between the credit analysts. (Lieu 3556:3-20.) Usually, he would make his decision if Mr. Chau was out of the office. (Huang 862:9-18; Lieu 3263:21-24.)

All of Harding's employees sat in close proximity to each other, so it was easy to discuss matters by simply talking to each other. (*See* Lieu 3630:5-9 (Ms. Lieu noting that she did not always e-mail with Ms. Moy because she could "just turn around and talk to her"); Lieu 3665:19-3666:4 ("It was a very small office. Everybody was less than six feet away.").)

B. Harding Reviewed RMBS Assets From Three Different Sources (New Issue Bonds, OWICs, And Dealer Axes), And Harding's Credit Team Would Divide Up The Work, Review The Credit Decisions, And Reconcile Any Disagreements.

As noted above, Ms. Lieu and Ms. Moy were responsible for analyzing RMBS bonds for purchase into a Harding-managed CDO. Ms. Lieu and Ms. Moy would receive names of potential RMBS bonds to purchase from three different sources: new issue announcements, OWICs, and dealer axes. When a new RMBS deal was being issued, the RMBS issuer would announce the bond, similar to a new CDO issuance. In addition, market participants who were looking to enter into a CDS contract with a long counterparty would send "OWICs" or "Offers-

Wanted-In-Competition."[240] A market participant sending out an OWIC is looking to buy protection on, or "short," a series of reference RMBS assets. Other market participants would then submit their offers to sell protection on some or all of the RMBS assets referenced in the OWIC. Generally, the market participant with the best offer would then be able to sell protection to the OWIC submitter. (*See* Lieu 3295:21-3296:9.) When OWICs were sent out, there was usually a hard deadline for others to submit their offers. Sometimes this deadline was 24 hours or less. (*See, e.g.*, Resp. Exs. 332-333 (Merrill Lynch OWIC giving less than 24 hours); Div. Ex. 15 (OWIC giving approximately 2 hours).) Finally, market participants could communicate with each other individually. One participant would let another participant know on which particular assets it was interested in buying protection, known in the marketplace as an "axe." The entities would then privately negotiate an acceptable spread. (*See* Lasch 207:7-208:18; *see also* Resp. Exs. 362-363.) Similarly, the underwriter to a CDO or potential investors in a CDO could suggest particular assets for inclusion in the CDO to the CDO's collateral manager.[241] The collateral manager would then review the assets and select those assets that it felt best fit the CDO portfolio.[242]

With synthetic CDOs, the portfolio is populated by CDS. Unlike with a cash bond, the universe of potential RMBS assets for a synthetic CDO is any RMBS deal still performing at that

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240 The flip-side of an OWIC is a "BWIC" or "Bid-Wanted-In-Competition." With a BWIC, a market participant sends out a list of reference RMBS assets on which it is looking to sell protection, or "go long." (*See* Lasch 206:12-18.) Harding submitted BWICs for Octans I on, at least, May 31, 2006, June 1, 2006, June 2, 2006 and June 6, 2006. (*See* Resp. Exs. 319, 351, 360-361, 364-366.)

241 In the ramping of Harding-managed CDOs, the underwriter, the equity investor, and potential investors all routinely suggested RMBS assets for Harding to analyze. (*See* Resp. Exs. 297 (Merrill Lynch suggestion); Resp. Exs. 782-783, 787-791 (Magnetar suggested, and Harding purchased 3 out of 24 assets); Resp. Exs. 825-826 (potential investor in the super senior suggesting RMBS assets).)

242 For example, Magnetar suggested 24 cash bonds for Octans I. Harding agreed to review the assets, and Jamie Moy sent to Tony Huang the credit decisions on those 24 bonds, ultimately approving 14 assets. Harding ended up purchasing 3 of the 14 approved assets. (*See* Resp. Exs. 309-312, 314-316, 337, 355, 782-783, 787-791.)

time, with one, major, insurmountable limitation: there had to be a willing counterparty on the other side of the deal that would pay an attractive price. For example, if a CDO had a weighted average life of 5 years, then counterparties would not likely purchase protection on a 2002 or 2001 CDO since it would almost be fully paid off. Accordingly, while it would appear in theory that the universe of RMBS from which a collateral manager could select was infinitely large, the reality was that it was much smaller. Richard Ellson, in his testimony concerning the fact that there was no adverse selection with respect to the ABX Index assets in Octans I, noted that the universe of viable deals at that time would have been less than 600. (*See* Ellson 1105:17-1106:08 (noting a reference pool of 590 assets); Ellson 1112:14-1113:11 (testifying that criteria used for the reference pool of 590 RMBS was based on a collateral manager's access to those deals at that time).) In addition, as noted above, the portfolio is an iterative process and the universe necessarily shrinks even further as the portfolio becomes constrained by the Eligibility Requirements and Investment Criteria.

Generally, within Harding, names of RMBS assets were communicated to Harding's portfolio managers, like Wing Chau, or traders, like Michael Giasi, who then forwarded the names to Harding's credit team for review. (*See, e.g.*, Resp. Exs. 297 (Chau forwarding Merrill Lynch suggestion), 303-304 (Giasi forwarding BWIC), 311 (Huang forwarding Magnetar suggestion), 332-333 (Giasi forwarding OWIC).) In addition, Harding's credit team reviewed RMBS assets on OWIC and BWIC lists even though Harding may not participate in the bidding process. (*See, e.g.*, Resp. Exs. 303-304, 764.) Harding implemented this process under the theory that collateral managers had done an extensive review prior to sending out their lists, so there was now a market view as to the suitability of the RMBS assets. (*Id.*) The fact that other collateral managers had reviewed the assets, however, did not mean that Harding automatically

viewed the assets as credit-worthy. It was simply another piece of information that could be used to inform a credit decision.

Ms. Lieu and Ms. Moy divided up the bonds to be analyzed and discussed their respective credit decisions. (Lieu 3269:8-18; Lieu 3798:18-3799:2.) As part of their analysis, Ms. Lieu and Ms. Moy initially looked at past credit decisions for that bond, if any, and then refreshed the information with additional performance data and cash flow analysis. (Lieu 3296:10-16.) If both Ms. Lieu and Ms. Moy approved a bond on credit that had a rating of Baa3 or higher (in other words, an investment grade bond), then the asset could be acquired without any further approval; although, ultimately, it was the portfolio manager's decision on whether to acquire the bond or not. (*See* Lieu 3259:2-3, 3270:14-3271:4.) If Ms. Lieu or Ms. Moy disagreed on any particular asset, they attempted to reconcile their disagreement and come to a consensus. (Huang 1335:11-1336:13; Lieu 3260:14-19.) Specifically, Ms. Lieu testified that she would explain to Ms. Moy why she "liked or disliked certain credit, show[ed] her the facts, discuss[ed] why [Ms. Lieu felt] like those [were] risky factors or good factors and [Ms. Moy] would explain to [Ms. Lieu] why she [thought that] actually those factors [were] not good or bad . . . ." (Lieu 3629:3-9.) Ms. Lieu and Ms. Moy then discussed the bonds and "come to a conclusion at the end about what [their] final decision should be." (*Id.*) If they were unable to find a consensus, then they presented their arguments to the portfolio manager (usually Mr. Chau but sometimes Mr. Huang). The portfolio manager made a final decision on whether to invest in the RMBS asset or not. (*See* Lieu 3259:17-21, 3263:21-24; Lieu 3556:3-20.)

The time it took for a credit analyst to review and render a credit decision on a particular RMBS bond depended on several factors, including the analyst's familiarity with the originators and servicers of the underlying mortgages, familiarity with the RMBS structure and collateral,

and any prior analysis done for that particular deal. (*See* Doiron 1951:24-1952:9; Chau 2168:6-2169:16; Lieu 3286:6-11; Lieu 3741:11-20.)

C. The Uncontroverted Evidence Demonstrates That Harding Employed A Comprehensive, Top-Down/Bottom-Up Analysis On RMBS Bonds.[243]

As detailed below, there were many factors that a credit analyst reviewed when deciding on whether to purchase an RMBS bond or not. First, the credit analysts conducted due diligence on servicers and originators of mortgages independent of a review of any particular RMBS bond. Second, when an RMBS deal was newly issued or was being reviewed for the first time, the credit analysts reviewed the offering documents to determine the RMBS structure and reviewed the underlying collateral. This review was done regardless of the particular tranche Harding may have wanted to purchase. Third, the credit analysts compared the collateral of the RMBS deal under review with previously reviewed, related RMBS deals in order to get an idea of how the RMBS deal under review is likely to perform. Again, this review was conducted on the deal itself and was not dependent on any particular tranche that Harding was interested in purchasing. Fourth, the credit analysts conducted cash flow analyses using industry-standard technologies and employing assumptions gleaned from market knowledge and expertise in order to predict how the bond might perform in the future. Finally, for more seasoned bonds, the credit analyst reviewed historical performance of the individual bonds within the deal utilizing a "surveillance" report. Cash flow analyses and surveillance reports involved tranche-specific analysis, but could have been created and reviewed within minutes. This process was utilized regardless of the credit rating of the bond being reviewed. (*See* Lieu 3283:13-20.)

243 "Top-down" analysis refers to a market participant reviewing macro-economic conditions in order to derive a point-of-view on the current state of the market place as well as an understanding of potential market trends. (*See* Div. Ex. 1 at 44.) "Bottom-up" analysis refers to a credit and structural review of a specific investment product, such as an RMBS bond. (*See* Lieu 3565:5-14.)

1. First, the uncontroverted evidence demonstrates that Harding did extensive due diligence on subprime mortgage originators and servicers.

As part of their responsibilities as credit analysts, the Harding team performed due diligence on originators and servicers of residential mortgages.[244] (*See* Chau 4243:24-4244:1 (process involves, among other things, looking "at the issuer and mortgage servicer quality"); Lieu 3614:15-20 ("Because every time we make a credit decision, we will be looking at the most recent performance, cash flow analysis or any additional information that we have regarding the deal, the originator or servicer. Those all have to come into account when making the decision at that time."); Lieu 3917:15-19 ("So if we have more performance information or any extra information about loans that we found out after talking to the originator or dealer, any of that would now be included in the new analysis."); *see also* Lieu 3286:6-18 (Ms. Lieu testifying about the length of time it took to review a bond, including an assumption of already being "familiar with the originator and servicer").) The review of originators and servicers was independent of any particular RMBS deal. From this due diligence, a Harding credit analyst could form an initial opinion about a specific bond based on its exposure to mortgages originated or serviced by particular entities. (*See* Lieu 3537:18-3538:6.)

The evidence adduced by the Division demonstrates that Harding did extensive due diligence on mortgage originators and servicers. For example, Division Exhibit 242 is a notebook comprised of approximately 140 pages of Jung Lieu notes, the vast majority of the pages dedicated to information on specific originators and servicers, including many that

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[244] An "originator" is a company that originates mortgages. (Chau 1656:17-20.) In other words, the originator is the entity that provides the financing to the individual seeking a mortgage. On the other hand, a "servicer" is a company that manages the mortgage after the funds have been disbursed. (*See* Resp. Ex. 2 at 290 (defining "Servicer" in the Offering Circular).)

originated or serviced mortgages that made up the portfolios of ABX Index Bonds.[245] The first few pages of Division Exhibit 242 enumerate detailed questions for originators (*see* Div. Ex. 242 at HA02071804-1806, 1811-1812) and for servicers. (*See id.* at HA02071816-1819.) In addition, the notebook contains a schedule of meetings with some of these entities. (*See id.* at HA02071814-1815.) As noted earlier, the vast majority of the notebook is dedicated to specific reviews of originators and servicers (including Option One, Fremont, Saxon, C-Bass, First Franklin (FFML deals), Impac, Bayview, Warehouse Mortgage Corp (owned by GE), Ameriquest/Argent (AMSI and ARSI deals), The Winter Group (HEAT deals), SURF, Emax/Mortgage Lending Network, Indymac, AMC Mortgage Services, Aegis, New Century (NCHET deals), Wilshire, MSAC/MSHEL, and Washington Mutual). (*See* Div. Ex. 242 at HA02071810, 1820-1873, 1877-1936.) These reviews have detailed analysis on their operations, policies and guidelines, types of loans, geographical distribution of mortgages, experience of the personnel, training, and legal issues. (*See id.*)

2. Second, the uncontroverted evidence demonstrates that Harding's credit team reviewed the underlying structure and collateral of RMBS.

The Harding credit team also analyzed the structure and underlying collateral of RMBS deals. Harding's credit team looked at the loan characteristics of the underlying mortgages backing the RMBS and looked for potentially riskier attributes (interest only, for example) and mitigating factors (credit enhancement, for example). (*See* Lieu 3283:2-6; Lieu 3386:8-18; Resp. Exs. 297-298 (A May 16, 2006 e-mail from Jung Lieu approving on credit SVHE 2005-4 M8 even though both Ms. Lieu and Ms. Moy believed it had "riskier attributes compared to the other

[245] Division Exhibit 242 is undated, and it is difficult to determine the time frame in which the notebook entries were made, but it appears that it was created in late 2005 or early 2006 and went through early 2007. For example, the first date is on HA02071896 and is either January 25 or July 25, 2006; the next dated page is HA02071911 and has 04/27/07, but page HA02071938 is dated 8/23/06.

bonds" because the credit enhancement "was there to compensate for it").) The review of an RMBS' structure and collateral was specific to the deal. Because it was independent of any analysis for a particular tranche of the RMBS, the analysis of the structure and collateral was used to inform a credit decision on any particular tranche.

3. Third, the Harding credit team used past research and analysis of RMBS bonds in order to efficiently review new RMBS assets by comparing RMBS bonds with similar structures, issuers, and collateral.

Harding credit analysts routinely compared the collateral characteristics of a new issue RMBS with the collateral characteristics of "the last two deals that have been issued from the same shelf."[246] (Lieu 3835:22-3836:13, 3843:22-25; *see, e.g.*, Resp. Exs. 941, 941B (example of a collateral compare).) This analysis was called a "collateral compare" or "deal compare." (Lieu 3835:22-23.) The purpose of the collateral compare analysis was to analyze any trends regarding the originators and servicers, to determine, for example, whether they were loosening their underwriting guidelines or if there was more risk in their loans. (Lieu 3836:22-3837:4.) The credit analysts expected that the specific RMBS being analyzed would perform consistently with the way other RMBS from the same shelf have performed. (*Id.* 3837:21-24.) The Harding credit team wanted to know this information "for future decisions on whether or not [Harding] wanted to continue buying the deal." (Lieu 3837:2-4.)

When performing a collateral compare, the credit analyst compared a variety of details of the mortgages that were pooled into the related shelves and the servicers and originators of those mortgages. (*See, e.g.*, Resp. Exs. 941, 941B.) For example, Respondents' Exhibit 941B details,

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[246] An RMBS "shelf" simply refers to a series of RMBS issued from the same issuer using the same guidelines for packaging the pool of loans backing the RMBS. For example, SAIL 2005-HE is a specific shelf issued by the Structured Asset Investment Loan Trust 2005-HE and underwritten by Lehman Bros. SAIL 2005-HE1, SAIL 2005-HE2, and SAIL 2005-HE3 each contain their own pools of mortgages that were packaged using the same guidelines. (*See* Lieu 3837:11-20.)

among other things, the collateral balance, the original number of loans, the FICO scores, percentage of interest only loans, percentage of second lien loans, and a list of the originators and servicers of the underlying loans for the SAIL 2005-HE1, SAIL 2005-HE2, and SAIL 2005-HE3 deals. (*See also* Lieu 3838:4-3839:14 (Ms. Lieu explaining the various pieces of information in Resp. Ex. 941B.) When Harding's credit team was analyzing several bonds at once, the team utilized a spreadsheet that provided the same type of information for various bonds horizontally across a spreadsheet. This format allowed the credit analyst to perform a more efficient review of the various bonds. (*See* Lieu 4025:9-17.)

As with the other types of analysis previously discussed, a collateral compare was deal specific, meaning that once a credit analyst had utilized and drawn certain initial conclusions about a deal from the collateral compare, those conclusions would be the same regardless of the tranche that Harding intended to purchase for one of its CDOs and the analyst would not have to do the work again.

4. Harding's credit team analyzed projected cash flows using industry-standard technologies and conservative assumptions that reflected Harding's view of the market based on the analysts and portfolio managers' expertise in the market, discussions with other market participants, review of industry research, and knowledge about historic market events.

In addition to reviewing originators and servicers generally and the structure and collateral of specific deals (and comparing that to similar deals), Harding's credit team used industry-standard technologies, using a program called Intex, to model the projected cash flows of a particular RMBS deal and/or tranche of an RMBS deal for a given period of time into the future. (*See* Lieu 3283:9-12 ("[W]e also did cash flow analysis **which meant putting in our own assumptions** and running and forecasting what the cash flows would be in Intex."); Lieu 3707:23-3708:4; Wagner 4720:17-18, 4735:12-15 (most people used Intex).) In order to run this

software, Harding's credit team developed a series of assumptions, including the rate at which the mortgage pool would experience pre-payments of those mortgages, the rate at which mortgages would default, the percentage of the defaulted mortgage balance that could expected to be recovered (through, for example, foreclosure proceedings), and the effect of changes to LIBOR. (*See* Resp. Exs. 756, 759 (May 2, 2006 e-mail from Jamie Moy to Brett-Kaplan attaching loss curves); Resp. Ex. 241 at HA02072329-2330 (undated Jung Lieu notebook page drafting a loss curve); Lieu 3846:3-3847:5 (explanation of the importance of the LIBOR assumptions).) These assumptions reflected a collateral manager's subjective view of the current state of the residential mortgage market (and the economy at large) and its expected performance in the future. (Wagner 4703:18-25 (testifying that cash flows were intended to reflect the market conditions and expectations of the person analyzing the bond), 4838:15-4840:2.) There was no industry standard about what assumptions to use when running cash flow analysis or how stringent or lenient an analyst's assumptions should be. (Wagner 4736:7-17 (testifying that market participants did not use the same assumptions).) In fact, market participants were expected to use their own knowledge, expertise, and research capabilities in order to develop their own assumptions (this is otherwise known as "top-down" analysis). (*See* Doiron 2029:12-22 (testifying that different managers used different assumptions and different managers would have different judgments about the same RMBS bonds).) Thus, a market participant who had a more negative view about the future performance of the residential market would be expected to have more stringent assumptions, while a market participant with a more positive view about the future performance of the residential mortgage market would be expected to have more lenient assumptions. It did not matter what the actual assumptions were as long as the resulting credit approvals and rejections reflected the market participant's own independent analysis and

judgment of the analyzed RMBS bonds. (*See* Lieu 3568:4-9 (a CDO manager was expected to exercise independent judgment in the selection of assets that would be included in the CDO); Wagner 4736:22-4737:2 (view of bonds was subjective), Wagner 4812:6-21 (many subjective factors in credit decision and reasonable people can disagree).)

Harding, like every other market participant, utilized its collective expertise of the market, knowledge of the practices and assumptions of other market participants based on due diligence and networking, and review of research reports authored by underwriters, managers, and rating agencies to develop its cash flow analysis assumptions. (*See* Lieu 3946:11-3947:8, 3948:6-12; Chau 4244:12-4245-1; Wagner 4851:3-14; *see also* Resp. Ex. 781 (E-mail from Jamie Moy to a former colleague at Fitch asking for information about the performance of deals backed by mortgages with mortgage insurance).)

More importantly, Harding's assumptions were continually modified and tweaked in response to changing market conditions and internal reviews. (Lieu 3299:20-22.) Indeed, a collateral manager would not be doing its job if it settled on a set of assumptions that remained static despite changes in market conditions. For example, on May 19, 2006, Jamie Moy informed Michael Giasi that the cash flow runs utilized 13% for BBB and 9% for BBB- bonds. (Div. Ex. 15.) On May 25, 2006, Ms. Moy informed the MaximCDO distribution e-mail list that the credit team approved two bonds that "passed our stress test at 6% cum loss." (Resp. Ex. 762.) The next day, Jung Lieu e-mailed Alison Wang confirming that all the cash flow runs would be run at 6% cumulative losses. (*See* Resp. Ex. 767; *see also* Lieu 3624:15-25 (testifying that, while Ms. Lieu and Ms. Moy decided to run cash flow analysis at 6% cumulative losses, that decision would have been approved by a portfolio manager).) Cash flow runs on May 31 showed the use of a ramp file called "Ba3 (4%)," but the use of this curve appeared to be limited to a three day

period. (*See* Div. Ex. 8003 at ¶ 23.) By June 8, 2006, the Harding credit team used a ramp file called "BASE LOSS." (*See* Resp. Exs. 972-974.) Jung Lieu confirmed in her testimony that sometime in 2006, there was a discussion among Harding employees, including Ms. Lieu, Wing Chau, and Alison Wang, about modifying the cumulative loss assumptions to be more in line with what other managers were using.[247] (*See* Lieu 3343:12-24; *see also* Lieu 3635:10-3636:5.)

Whenever Harding was analyzing an RMBS asset for purchase, the credit team ran cash flow analysis, even if the bond had been analyzed before. (Chau 2172:22-2173:2.) Cash flow analysis involves the interactions of a variety of very specific assumptions. Market participants, in general, used a service called "Intex" to run these assumptions against RMBS bonds to determine how the bond would perform under certain market conditions. Intex was an intricate modeling tool that aggregated the structural and collateral features, as well as the historical performance of, RMBS deals.[248] Market participants using Intex were able to tweak a variety of assumptions, including the ability to use various customized assumptions or built-in Intex assumptions, or a combination of both. (*See* Lieu 3953:16-3954:2; Resp. Ex. 977 at ¶ 20 (noting the five different prepay conventions); Resp. Ex. 966 (cells A5 through H90 listing a variety of assumptions).) The constant or conditional default rate ("CDR") was an assumption used within Intex that assumed a certain amount of mortgage defaults annualized and calculated monthly.

[247] In fact, a 6% cumulative loss projection would have been considered conservative. **For example, on May 19, 2006, JPMorgan was projecting cumulative loss percentages for the BBB- tranche of the ABX Index at between 2.36% and 4.13%**. (*See* Resp. Ex. 934 at 19-20 ("Proj" column); *see also* Wagner 4844:10-4845:25.) A month later, JPMorgan was projecting cumulative losses at **between 3.17% and 4.32%.** (*See* Resp. Ex. 935 at 20-21 (June 14, 2006 report).) In September 2006, Bear Stearns, where the Division's expert, Ira Wagner, was head of the CDO group during that time, was running a **10-year loss curve projecting cumulative losses at 4.5%**. (*See* Resp. Ex. 978 at 91; *see also* Wagner 4853:5-4855:5.) Even with the market turmoil during early 2007, Standard & Poor's, a rating agency, predicted that cumulative loss projections would not exceed 7.75% for 2006-vintage RMBS, considered to be backed by much riskier mortgages than other vintages. (*See* Resp. Ex. 936 at 2, 6; *see also* Wagner 4855:10-4859:5.)

[248] While Brett Kaplan or Ken Lee, as junior analysts, were usually tasked to run the Intex cash flow assumptions (Lieu 3689:5-16), all the members of the Harding credit team (including Ms. Moy and Ms. Lieu) had access to Intex. (*See* Lieu 3666:22-3667:7.)

(Lieu 3313:10-3314:2; Wagner 4848:3-10.) The rate could be straight-line (meaning the same percentage of defaults each month) or it could be curved (meaning varying rates of defaults each month and known alternately as a "loss timing curve" or "default timing curve"). (*See* Lieu 3321:17-20 ("The other way is a different type of forecasting tool where, for example, if we use CDR, we say just use 15 CDR every single month, regardless of at the end how much cum loss you're pushing through."); Lieu 3674:13-17; Lieu 4010:25-4011:9.) Market participants running cash flow analysis would also have an "assumed severity," which was the assumed percentage loss on a foreclosure. (*See* Div. Ex. 8001 at 21 n.15.) For example, a severity of 30% assumed that for every defaulting mortgage, the lender would not be able to recover 30% of the mortgage. (*See* Doiron 1959:9-12.) In other words, the assumed recovery on defaults would be 60%.[249] Cumulative losses refer to the aggregate amount of losses that a pool of loans was projected to experience over the life of the mortgages. (Lieu 3313:23-25; Lieu 3650:23-3651:6; Lieu 4010:25-4011:9.) While bonds could experience cumulative losses that affect the cash flow, it did not necessarily follow that because a bond experienced cumulative losses that it would have suffered a loss in principal (or "principal writedown"). (Lieu 3620:9-3621:18; Lieu 3828:9-3829:16 (Jung Lieu explaining that a bond experiencing cumulative losses may not experience a principal writedown because the losses were cushioned by the credit enhancement of the deal).) Finally, another important assumption was the constant or conditional prepay rate ("CPR"), which was the assumed percentage of the outstanding principal that would be paid prematurely, usually because the mortgages were refinanced. Like with the CDR, the prepay rates have been straight-line or based on a curve. (Lieu 3480:17-3481:1.) When a credit analyst chose to use a

[249] Another method in analyzing cash flows would have the severity set to 100%. The purpose for setting severity to 100% is to subject the cash flow to the loss curve itself. There is no evidence that there was anything improper about this method.

timing curve for the CDR and the CPR, that analyst created the curve in Excel and saved it as an Intex proprietary file, called a "ramp file." (Lieu 3674:9-3675:1.) When running the cash flow analysis, the fields for the default rate and the prepay rate would have included a reference to that external file. (*See, e.g.*, Resp. Ex. 972; Div. Ex. 53.)

For example, over a three-day period of time,[250] Brett Kaplan was using a specific Intex ramp file called "Ba3 (4%)" with a loss severity of 40%, and a prepay ramp file called "JamieCombo" (set to "Unscheduled Balance Reduction Rate").[251] (*See* Div. Exs. 267-272, 281-282, 286-291; Resp. Exs. 322-323.) Sometime during this period of time, Harding's credit analysts created an Intex ramp filed called "BASE LOSS."[252] (*See* Resp. Exs. 972-974 (Excel spreadsheets showing cash flow runs for three different bonds with created date of June 8, 2006); *see also* Div. Exs. 9010-9012 (Concordance metadata reports consistently showing creation date).) BASE LOSS utilized a 6% cumulative loss assumption.[253] (*See* Resp. Ex. 872; Div. Ex. 8003 at ¶ 31.) In addition, Harding credit analysts had other loss timing curves available to them. For example, on May 2, 2006, Jamie Moy e-mailed Brett Kaplan a spreadsheet containing a Base

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[250] The Division produced no evidence to show that this method was used before that time, and the evidence adduced by Respondents demonstrates that it was quickly abandoned as a method to project 6% cumulative losses on RMBS bonds.

[251] In addition, there is one cash flow run of one bond from June 6, 2006. (*See* Resp. Ex. 942.)

[252] The latest BASE LOSS could have been created is June 8, 2006, but it is possible that it was created earlier.

[253] The loss curve utilized in BASE LOSS is spread out over ten years. (*See* Resp. Ex. 872.) Although irrelevant, the Division repeatedly asserts that, because of this, the BASE LOSS curve was more "relaxed" than the Ba3 curve (*See, e.g.*, Div. Br. at 65), but this is far too simple an explanation. Initially, it should be noted that major market participants, such as JPMorgan and Bear Stearns, utilized 10-year loss curves when running cash flow analysis. (*See* Resp. Exs. 934-935, 978; Wagner 4850:3-6 (agreeing that JPMorgan believed a 10-year curve was reasonable); Wagner 4854:13-25 (same with Bear Stearns).) In addition, Harding itself had loss curves from early May that used a 10-year curve. (*See* Resp. Exs. 756, 759.) Second, as confirmed by Ira Wagner, the BASE LOSS curve is actually more severe through the first four months when compared to Ba3. (*See* Wagner 4833:5-4835:14; Div. Ex. 8003 at ¶ 33.) The Division conceded that higher losses experienced earlier in time are more severe because those losses affect the credit enhancement cushion before it has had time to build up more of a reserve. (*See* Div. Ex. 8003 at ¶ 35; Div. Br. at 66.)

curve of 6% and a "BBB Curve" of 8.79%.[254] (*See* Resp. Exs. 756, 759.) Also, given that the ramp file Brett Kaplan used on May 30–June 1 was labeled "Ba3" suggests that there were ramp files for other credit ratings. (*See also* Div. Ex. 15 (Jamie Moy noting the existence of loss curves for the BBB and BBB- tranches).) It appears that, at least from June 8, 2006, Harding's credit team utilized BASE LOSS as the standard curve and stressed it. (*See* Resp. Exs. 972-974 (running default rate at 100*BASE LOSS (6%) and 117*BASE LOSS (approximately 7%).) In other words, it appears that Brett Kaplan's use of the Ba3 (4%) ramp file was an aberration.[255]

There were many additional assumptions that could be utilized within Intex in order to derive cash flow analysis. The tweaking of any of these assumptions could have dramatic effects on the cash flow analysis. (*See* Resp. Ex. 977 at ¶¶ 25-34 & accompanying tables (demonstrating that changing one assumption, the prepay methodology, creates two scenarios, one with substantial writedowns and one without).) Of importance here, is the Optional Redemption and Prepayment Method (a series of settings within Intex that changed how the CPR would be applied to the collateral). "Optional Redemption" was a feature of RMBS where the mortgage servicer could "call" the deal if the collateral balance dipped below a certain threshold (for example, 10% of the original balance). (Lieu 3819:5-25.) The result was that all of the RMBS bonds would be paid off. (*Id.*) Within Intex, a credit analyst could have turned this setting on or off. When the setting was on, the cash flow would run until such time as the deal met the

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[254] Both of these curves are extended over 10 years.

[255] The Division and its expert, Ira Wagner, continually point out the **number** of RMBS bonds that were run using this ramp file (*see* Div. Br. 65 & n.117 (citing Wagner Supplemental Report)), but, running hundreds of bonds at once takes minutes. (*See* Wagner 4758:1-17.) The key fact is over what period of time, and the evidence shows a three day period, with one additional cash flow run on June 6. In addition, Mr. Wagner and the Division keep asserting that Ms. Lieu "analyzed another 88 securities using the same assumptions on June 1." (Div. Br. at 65.) The assertion incorrectly states the evidence. There are two e-mails where Brett Kaplan sent cash flow runs utilizing these assumptions to Jung Lieu, for a total of 25 assets. (*See* Div. Exs. 281-282 (one bond), 286-287 (24 bonds).) The rest of the cash flow runs were sent to Jamie Moy, about whom Jung Lieu had recently informed Alison Wang was failing to instruct Brett Kaplan and failing to check the numbers. (*See* Resp. Ex. 767.) There is also no evidence that Ms. Lieu actually relied on Brett Kaplan's cash flow runs in making her credit decisions. (*See* Section XII.G.)

optional redemption trigger. (*Id.*) When the setting was off, Intex would assume that the servicer would not call the deal and the cash flows run to the final legal maturity of the bonds. (*Id.*) A cash flow analysis where the Optional Redemption setting was on was called "Cash Flow to Call." (*Id.*) When the Optional Redemption setting was off, the analysis would be called "Cash Flow to Maturity." (*Id.*) The general market practice at the time was to assume that the deal would be called (Optional Redemption on); however, credit analysts wanting to run a stress case would turn Optional Redemption off. (*Id.*)

Another assumption that affected cash flow analysis was the method by which prepayments would be applied to the loan balance. (*See* Resp. Ex. 977 at ¶ 20.) Intex provided five different conventions: (1) Standard, where the prepay amount and default amount were applied to the loan independently; (2) Capped at Prepays, where Intex capped the balance reduction by applying the default amount up to the prepay amount; (3) Max(Prepay, Default), where Intex capped the balance reduction at the maximum of the prepay and default units; (4) Defaults before Sched, similar to Capped at Prepays; and (5) PSA,Max(Prepay, Default), which is similar to Max(Prepay, Default) except that it took into account defaults that occurred in the period. (*See id.*) When reviewing a cash flow Excel report, an analyst determined whether the Standard method or one of the other four methods were used by looking to see how the report named the row providing the CPR assumption. When the row was named "prepay rate," the Standard method was used. (*See id.* at ¶ 21.) When the row was named "unscheduled balance reduction rate," one of the other four methods was used. (*See id.*) The default Intex method was the Standard convention, which "has always been the industry practice . . . when projecting future performance for RMBS." (*See id.* at ¶¶ 21, 32.) In fact, Harding's practice was to use the

Standard prepay convention.[256] (Lieu 3668:3-12; Lieu 3970:6-19, 3979:24-3981-17 (testifying that Harding used standard prepay and not unscheduled balance reduction rate).)

When running cash flow analysis, market participants usually formulated a "base" case, which were the assumptions that the market participant believed were likely to occur. (*See* Wagner 4911:19-4912:6.) In addition, although not required in every instance, the market participant may have "stressed" those assumptions in order to determine how a bond might have performed under worse-than-likely scenarios. (*See* Wagner 4912:7-4913:6.) There were many ways to stress the base case within Intex. (*See, e.g.*, Wagner 4838:23-4840:13 (noting that stress cases could either be different scenarios or built into the curve); 4908:21-4909:12.) First, a credit analyst could run some or all of the timing curves (*i.e.*, the CDR or the CPR) at higher levels. This is denoted in Intex with a number greater than 100 that precedes an asterisk followed by the name of the ramp file. (*See, e.g.*, Resp. Ex. 972 at Tab "Cashflows M8 Scen 4" (noting 117*BASE LOSS); *see also* Lieu 3673:1-8 (testifying that multiplying a curve by 200 results in the curve being twice as high).) Increasing this number multiplied the underlying curve. If 6% cumulative losses were multiplied by 117, the resulting curve would have produced approximately 7% cumulative losses. In addition, a credit analyst could have "shocked" the interest rate assumptions. (*See, e.g.*, Resp. Ex. 972 at Tabs "Cashflows M8 Scen 2" and "Cashflows M8 Scen 3" (shocking interest rates at 50% and 100%, respectively); *see also* Resp. Ex. 976 (Hilfer's March 28, 2014 Expert Report) ("A shock to the interest rate curve is an increase or decrease to the interest rate by a set amount . . . .").) Another method to stress the base case was to turn optional redemption off. As noted above, with optional redemption off, the

[256] The Division suggests that, because Intex offered a variety of settings, those settings must have been used (*see* Div. Br. at 75 n.136), but it failed to provide any evidence rebutting Mr. Hilfer's contention or Ms. Lieu's testimony that she generally only used the standard prepay rate.

losses are calculated through the maturity of the bond. When Optional Redemption was on, the losses were calculated to a point in time where the collateral reached a certain benchmark at which it would be assumed that the servicer would "call" the bond and pay off the remaining balance. In other words, with optional redemption off, there was no point where a party would step in and pay off the balance due on the bond. The resulting cash flow run was, therefore, more onerous. (*See* Lieu 3819:5-25; Hilfer 4981:13-4982:3.) Because a credit analyst was simply stressing the base case, it took virtually no additional time to run stress scenarios when analyzing RMBS bonds. (Wagner 4758:7-25.)

5. Finally, Harding's credit team would use Intex to compile into a "surveillance report" the historical performance information on RMBS bonds being analyzed (if they were seasoned bonds) or on related RMBS bonds (if the bond being analyzed did not have performance information).

In addition to running cash flow projections, either to refresh previously analyzed RMBS bonds or to analyze new issue bonds with no performance history, Harding credit analysts also obtained historical performance information on particular bonds, which were then incorporated into "surveillance reports."[257] (*See* Lieu 3248:14-3249:5, 3283:7-9, 3296:22-25 (obtain performance information from Intex to determine if bond performing as expected); Lieu 3707:23-3708:4.) The main purpose for the surveillance reports was to determine whether the bonds were performing as expected, or, if the bonds were not, to then determine what additional risk factors existed. (*See id.*) In addition, when reviewing new issue RMBS bonds, Harding

[257] Harding credit analysts also ran surveillance reports on RMBS bonds owned by Harding-managed CDOs to determine if the current performance of the bond is concerning and to determine whether the bond should be sold. (Lieu 3248:25-3249:2.) This analysis, however, occurred during Harding's post-closing management of the CDO, when a collateral manager would have more discretion to manage the portfolio. (*See* Resp. Ex. 5 at 4-6 (the Collateral Management Agreement).) During the warehouse phase, a collateral manager cannot sell a bond it has purchased for the warehouse unless the bond is later deemed to have violated the eligibility criteria and the warehouse provider authorizes the sale. (*See* Resp. Ex. 123 at 5 (Warehouse Agreement) (paragraph 4(C) relating to "Ineligible Securities").)

credit analysts reviewed the surveillance reports of RMBS bonds from related deals. (*See* Lieu 3249:20-3250:2.) "[K]nowing from the surveillance and the experience of how the originators and servicers performed in their previous deals, [Harding's credit analysts could] make a good conclusion on how [they] expect[ed] them to perform going forward on new issued deals as well." (*Id.* at 3249:23-3250:2.)

D. **Credit Decisions Involving RMBS Bonds May Change Over Time Based On New Information About Historical Performance, Changes In Cash Flow Assumptions, And Changes In The Market Place, But A Subsequent Change In A Credit Decision Does Not Render The Prior Credit Decision Invalid Retrospectively.**

Every time Harding credit analysts reviewed an RMBS bond that had been previously reviewed, they approached their analysis by determining their view of the creditworthiness of the bond at the time it was being reviewed. Prior credit decisions provided a starting point in which to begin the review, but the analysts did additional work to see whether the prior decision was still valid. Accordingly, it was not unusual for a later credit decision to be different from an earlier decision. The fact that a credit decision on a particular bond changed at a later point in time did not render the prior decision invalid at the time that prior decision was made. The changed credit decision merely reflected Harding's credit team's current view of that particular bond.

As noted above, when reviewing an RMBS bond, Harding's credit team would first look to see whether a prior credit decision had been rendered. Then, the credit team would refresh cash flow analysis using their current assumptions and update the surveillance report to determine whether any changes had occurred either in Harding's projections or the actual performance of the bond. Finally, the credit team would determine whether there was any new information about the originators and servicers of the underlying mortgages or whether there was

any new information about the underlying credit profile. With this information, Harding's credit team could render a credit decision at that time. (*See* Lieu 3614:10-20; Lieu 3915:13-3917:25; *see also* Div. Ex. 56 (E-mail from Jung Lieu noting that she was going to re-run cash flow analysis using 6% cumulative loss assumptions and changing credit decisions on bonds that passed but had been previously rejected); Resp. Ex. 435 (E-mail from Jung Lieu re-running cash flow analysis and reviewing credit on ABX bonds in September 2006).)

If Harding's credit team changed a credit decision, that decision operated prospectively. In other words, if Harding's credit team had previously approved a bond that it was now rejecting, that rejection did not affect the prior approval. As Jung Lieu testified, the Harding credit team might scrutinize the performance of that bond that was previously purchased, but the new credit decision only meant that Harding would not take on additional exposure. (Lieu 3614:25-3616:3.) In addition, prior to the closing of the CDO, the collateral manager generally was not allowed to sell a bond that had been purchased for the warehouse. The decision to sell was the warehouse provider's. (*See, e.g.*, Resp. Ex. 123 at 5 (Warehouse Agreement) (paragraph 4(C) relating to "Ineligible Securities").)[258]

[258] In other words, at the time the collateral was transferred into the deal, some of the assets may well have become "disfavored", meaning they might not have been candidates for any future deals. This reflects yet another reality of the CDO business; there was no practical way to ramp-up a portfolio of $1.5 billion in a day or even a few days. The ramp-up took months and depended on finding counterparties from whom assets could be sourced, etc. This is one additional reason why Harding could not have been expected to populate the deal with the "best" bonds, whatever that means. In other words, the only reasonable representation about the collateral Harding could have made in the offering documents was that, at closing, the assets and the portfolio as a whole met all eligibility and investment criteria. This is also why Harding had to certify at closing that all assets did, including that none of the assets were Credit Risk or Defaulted Securities. In addition, this is one of the reasons for the disclosure about warehousing assets and the fact that any diminution in the value of the warehoused assets would be borne by the investors in the deal. All market participants in the CDO space understood this. (*See* Section VII.B.)

XVII. SPREADSHEETS AND REPORTS CONCERNING ABX INDEX ASSETS CORROBORATE THE EVIDENCE THAT HARDING'S CREDIT TEAM PERFORMED THE ANALYSIS AND THAT THE ABX INDEX BONDS WERE PROJECTED TO HAVE NO WRITEDOWNS UNDER REASONABLE ASSUMPTIONS, EVEN IF THEY DO NOT CONSTITUTE DIRECT PROOF.

This section of the brief deals with the metadata issue relating to the asset analyses that counsel found during the hearing. As discussed below, metadata evidence is mostly inconclusive because metadata changes when documents or information are transferred or re-saved. It appears that there is enough evidence to support the conclusion that the relevant analyses were performed in 2006, when the Octans I portfolio was being ramped, that the templates were created in early 2006, and that the Intex settings and the cumulative loss and loss severity assumptions are consistent with what all witnesses agreed were the standard industry assumptions Harding intended to use in late May/early June 2006.

But let us set all of that aside and step back. As we demonstrated above in great detail, Harding analysts performed numerous analyses on thousands of assets over a period of years. It is ludicrous to suggest, as the Division does, that Harding did not perform the correct analysis on any Octans I bonds until some backfill project in 2007 that was precipitated by nothing and had no purpose.[259]

The only reasonable conclusion, given all the work that Harding had done, is that the witnesses with actual knowledge were telling the truth. According to them, Harding did the analyses and later tried to collect and organize its analyses in one place when time permitted. In

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[259] The Division incorrectly asserts that the 2007 backfill was precipitated by an upcoming HIMCO investor call. The relevant e-mail actually references general backfilling and seeks to prioritize the assets relevant to the HIMCO meeting. Specifically, on July 18, 2007, Richard Chin sent an e-mail regarding an investor call with HIMCO. (*See* Div. Ex. 233.) The clear import of the e-mail is not, as the Division asserts, that Harding began a backfilling project in July 2007, but that it was an ongoing project, consistent with Ms. Wang's June 2006 e-mail. Richard Chin wrote, "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 we are back-filling** our credit templates and credit comments . . . ." (*See id.*) Tellingly, the Division failed to emphasize the "as" in its brief. (*See* Div. Br. at 69.) In addition, it does not say anything about the ABX Index bond.

fact, the Division's speculation that there was some nefarious backfill project in 2007 is belied by the fact that a "backfill" effort relating to Octans I is reflected in an e-mail dated June 6, 2006. (*See* Resp. Ex. 367.) In fact, that e-mail mentions backfilling "credit committee reports, one-pagers and other files we maintain so we can be ready to market [Octans I] quickly." (*Id.*) Note that this e-mail evidences the existence at Harding of "credit committee reports" and "other files [they] maintained" for gathering their credit analyses. (*See* Resp. Ex. 367; Wang 501:4-15 ("['Backfill'] just refers to the process of cleaning up after having done all the analysis and organizing all the documents that they might have used or produced" and including in her explanation organizing documents in 2007 relating to the work done a year earlier).)

This stands to reason. Harding's analysts worked hard, had many things to do each day, and had to respond to BWICs and OWICs with alacrity. There was nothing untoward about that; that was the nature of the business. (Resp. Ex. 884 at 2.) There was no requirement to document their credit analyses and no set way to file them. And so, like most extremely busy people, they documented their analyses by gathering them in one place from wherever they saved them as time permitted in slow periods.

July 2007, as the Division is well aware, was a slow period for the CDO business; it temporarily seized following the blow-up of two Bear Stearns hedge funds that invested in CDOs. They finally had a respite and so they organized their files because they thought the business would come back and they thought it would be good to have their ducks in order when that happened. (*See generally* Wang 501:5-15; Lieu 3729:23-3730:25; Huang 1342:24-1343:11, 1420:23-25.)

A. **These Documents Show That The Relevant Assets Have 0% Writedowns: The Division Does Not Contest That Point.**

It is undisputed that the cash flow runs, performed by Harding in the ordinary course of its business and prior to any investigation, show zero percent writedowns for the relevant assets utilizing at least two different scenarios. (*See, e.g.*, Resp. Ex. 945.) These documents also detail the **reasons** for approving a particular bond, further supporting that these bonds had been analyzed by the time Jung Lieu submitted her rejection list to Tony Huang on May 31st. Respondents' Exhibit 945, noted the following about RASC 2005-KS11 M8:

> Low 2nd lien %, mostly owner-occupied, and high full doc % for subprime deal. 60+ DQ of 6.7% of FC+REO of 3.5% is better than average subprime performance. Current CE of 5.02% is enough to cover potential pipeline losses. CF runs show no principal writedowns, and principal starts getting paid at stepdown date.

(*Id.*) This information corroborates Jung Lieu's testimony and other documentary evidence showing that Harding had a reasonable basis for selecting these assets. On this, the Division is silent.

B. **The Concordance Reports Are Unreliable.**

The Division's assertion in this case is that Harding corrupted its credit review process in order to please Magnetar. In support of its theory, the Division has argued that certain cash flow runs for ABX Index assets could not support a credit approval and that no cash flow runs had been performed on a subset of the ABX Index assets. Respondents' Exhibits 940-941, 943-962 (the "Bond Evaluation Reports") provide Harding's credit team's analysis of various bonds.

First, in most instances, the information contained in Division Exhibits 9004, 9014, 9016-9020, and 9022-9035 (the "Bond Evaluation Concordance Reports") conflict with the actual metadata contained in the native Excel spreadsheets provided to the Court. (*Compare* Column G ("Created", per Excel "File" tab) and Column L ("DATECREATED", "MODDATE" (metadata)) of Div. App'x 4.) The evidence demonstrates that Harding began using the model as

early as March 31, 2006, and it is uncontroverted that these reports were updated over time. (*See, e.g.*, Resp. Ex. 940[260] (Excel properties on File tab showing a creation date of March 31, 2006 and first tab of the spreadsheet showing updates from July 23, 2007); Lieu 4055:4-8.) The Division asserts that the March 31 date has to be the date in which the template was created, which may well be true. But this says nothing about when the Excel files were actually created.[261] Second, it is evident from the Division's exhibits that Concordance populated the DATECREATED field with the metadata from the "Last modified" date field. The Division essentially concedes this point when it noted that, in the Concordance Reports, "the DATECREATED field in the database always matches the MODDATE" even though, with a few exceptions, this is never true when comparing the metadata contained with the native Excel spreadsheet. (*Compare* Column G ("Created", per Excel "File" tab) and Column I ("Last modified", per Excel file tab) of Div. App'x 4.) In addition, the TIMECREATED field and the MODTIME field (which represent at what time the document was created and the time in which it was modified) are **exactly the same, down to the second**.

In order to demonstrate how unlikely this would be, Respondents reviewed and compiled the metadata from the native Excel spreadsheets produced by the Division as exhibits to this matter. (*See* Exhibit E (Metadata from Division Exhibits Showing Last Modified Date of 2014 and Last Modified Date By Division Employees).) With just a few exceptions, all of the Excel spreadsheets show a Last Modified Date of February and March **2014**, and show the Last

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[260] The Division dismisses this document as irrelevant and that "all indications are that [Respondents' Exhibit 940] was created in July 2007." (Div. Br. at 73 n.131.) While it does not show analysis related to an ABX Index bond, it demonstrates that this document was updated on July 23, 2007 by Jung Lieu. The created date within Excel itself is March 31, 2006. The last modified date is July 31, 2007. Division Exhibit 9014, the Concordance report for Resp. Ex. 940, shows both the Created and Modified dates as July 31, 2007.

[261] The fact that there was at least a template created as of March 31 actually demonstrates that Harding did compile its analysis in an easy to digest format starting in at least March 31, 2006.

Modified By field to be populated by Division of Enforcement attorneys. If Concordance had populated the DATECREATED field with the MODDATE metadata for the Division's exhibits, the results would have led a fact-finder to believe that the files themselves were not created until 2014, when, in fact, they had been created much earlier.

C. Respondents' Exhibit 941 (SAIL 2005-HE3 M9 Bond Evaluation Report) And Other Bond Evaluation Reports.

Harding's credit team created Bond Evaluation reports in order to compile the credit team's analysis and decision into an easily digestible format in order to be able to quickly reference the research. (*See* Lieu 3809:5-3812:22, 3823:25-3824:2; *see also* Resp. Exs. 940-941, 943-962.) Usually these files were created after the fact, but they represented the contemporaneous analysis performed by the credit team. (*See* Lieu 3809:5-3812:22, 3823:25-3824:2.) The Division takes issue with Respondents Exhibit 941 on four grounds: (1) the report says "Harding" but the company was Maxim in May 2006; (2) the settle date of May 31, 2006 is inconclusive; (3) the spreadsheet contained historical data through June 2007; and (4) the Concordance report shows a 2007 creation date. (*See* Div. Br. at 70-72.) Even taken together, this information is consistent with the report being updated, and it does not conclusively prove that the document was created in 2007. A reasonable inference is that this was created sometime after the initial analysis and updated later on to incorporate historical data. In addition, this argument is irrelevant since the weight of the evidence establishes that Harding reviewed and analyzed the ABX Index bonds.

First, the fact that the SAIL 2005-HE3 M9 Bond Evaluation Report has a heading of "Harding" as opposed to "Maxim" simply demonstrates that, at some time between March 31, 2006, when the Excel file was created, and August 28, 2007, when it was last modified, someone

changed the heading.[262] Second, while the May 31, 2006 settle date does not indicate the date on which the cash flow analysis was run, it provides for the possibility that it was run at or around that time.[263] (*See* Lieu 3682:13-3683:2.) Third, the fact that the document has historical data through June 2007 is also consistent with the information being updated.[264] In addition, it should be noted that the historical data is cut-and-pasted from some other source, meaning that the numbers are actually entered into the spreadsheet's cells and not referenced by an external file. There are four blank rows next to Months 24 through 27, suggesting that someone anticipated putting in that information at a later date. (*See* Resp. Ex. 941 (Performance Info tab, "2. Historical data").) Finally, the Division trots out its Concordance Reports to assert that this document could not have been created around May 31, 2006. (*See* Div. Br. 72.) Interestingly, and without explanation, the Division failed to note that the Concordance Report for this document shows a DATECREATED of August 28, 2007. (*See* Div. Ex. 9004.) In fact, reading

262 The Division, without a hint of irony, asserts that two of the documents are noted as "Maxim," but the last modified date is in 2006. (*See* Div. Br. 70 n.127.) The Division argues that this means that the other files could not have had their names changed from Maxim to Harding as part of an update. (*Id.*) Of course, this is absurd. Someone can update one file without making corresponding updates to another.

263 The Division savages Jung Lieu's testimony that it was possible that the cash flow analysis was run around that time. (*See* Div. Br. at 70-71.) The Division misconstrues her testimony because it does not like the fact that Ms. Lieu does not help its case. Earlier in her testimony, Ms. Lieu, in discussing Respondents Exhibit 942, explained that, regarding the settle date, "the industry standard is to use T [trade date] plus 2 [days] or T plus 3, **so I assume if I take out two or three days from the settle date**," that would provide the date of the run. (Lieu 3682:13-3683:2.) Without any other context to assist her, Ms. Lieu was relying on her assumption about when the cash flow analysis would have been run, but then quickly agreed that she was not able to tell.

264 The Division, showing its lack of knowledge about spreadsheets, insists that Respondents "needed to find" a specific spreadsheet that is referenced in one of the tabs of Respondents Exhibit 941. (*See* Div. Br. at 71 n.128.) This is actually incorrect, as the Division is well aware. When Respondents' Exhibit 941 itself was opened in Concordance, the data referenced by the external file was correctly referenced in the spreadsheet. When readying documents for production, including spreadsheets from the Initial Exhibit list, Respondents' counsel noticed that certain spreadsheets would lose that information when opened natively in Excel. Respondents' counsel was able to create PDF copies by printing the spreadsheet directly from Concordance. Respondents had the same issue with two other spreadsheets from its initial exhibit list, and so informed the Division at that time. (*See* E-mail from Ashley Baynham to the Division re: In re: Harding Advisory LLC & Wing F. Chau, File No. 3-15574, attached hereto as Exhibit I.) The same process to create the PDFs for the initial exhibit list was used to create the PDFs for the Bond Evaluation Reports. Lest there be any doubt, Respondents Exhibits 434 and 438 reference a file with the file path "C:\blp\api\dde\Blp.xla." Respondents have located neither this file nor the file referenced in Exhibit 941; although, it is possible that the files are contained in the 22 million documents produced to us by the Division.

the Division's argument leaves one with the impression that the Concordance Report noted a March 31, 2006 creation date. (*See id.* (noting that created date is "March 31, 2006" and stating that "[a]ll of this matches the Concordance metadata for RX 941, which is contained in Division Exhibit 9004.").) Of course, knowing that this is misleading, the Division pulls-back from that assertion **in a footnote** buried in a general explanation about the Concordance reports.

D. Octans I Portfolio Runs (Respondents Exhibits 966-967).

Harding maintained two documents that contained cash flow runs for the Octans I portfolio. The Division argues that these documents had to have been created in July 2007 and that all of the cash flow runs had to have been created at the same time because it was a portfolio run. Again, the Division fails to understand the relationship between a document and its metadata. First, within the native Excel spreadsheets, the date created is noted as July 13, 2007. The only thing that this proves is that **these two spreadsheets** were created on that date. It does not prove that the cash flow runs were performed on that date. There is no evidence to counter any inference that cash flow runs were cut and pasted from other sources. This would have provided the 2007 creation date, but would have provided historical analysis, which is consistent with Jung Lieu's testimony. In addition, the Division argued that the cash flow runs were performed "as a whole and all at once" because all of them were run using a "common set of assumptions, producing cash flows for all of them simultaneously." (Div. Br. at 74.) It is clear, however, that these cash flow runs were not run simultaneously. As the Division conceded, the settle date is an assumption that Intex uses. (*See* Div. Br. at 70.) Accordingly, a portfolio run in Intex could not have multiple settle dates, and yet, multiple settle dates are present in Respondents' Exhibit 966. (*See, e.g.*, Resp. Ex. 966 (Tab "Portf CF 17309LAM7 Sc..." (settle date of August 30, 2006).) In any event, whenever these cash flow runs were performed, they

corroborate the fact that these bonds were projected to have no writedowns, which is in line with Harding's own expectations and the market's.

THE DIVISION HAS NOT ESTABLISHED LIABILITY WITH RESPECT TO NORMA

The second set of allegations in the OIP relates to Harding's investment in Norma on behalf of two Harding-managed CDOs, which were ramping for launch in 2007. The Division's allegations concerning the Norma BBB-rated bonds purchased by Harding rest on the predicate that Harding purchased these securities, which it otherwise would not have selected, in order to curry favor with Magnetar and Merrill Lynch.[265] These allegations are predicated solely on flippant e-mails that Mr. Chau wrote and that the Division reads completely out of context and on rank hearsay e-mails, whose meanings are not clear and whose authors and recipients had not been called to testify.[266] When all of the evidence and testimony are considered in context, there can be no doubt that the Division failed to prove its case as to Norma also.

As an initial matter, the OIP does not allege that Harding's view of the Norma bonds was negative. It alleges only that Harding's view was "basically unfavorable," whatever that means. (OIP ¶ 7.) In fact, proof at the Hearing definitively showed that Harding agreed to buy the BBB Norma bonds only after the spread on those bonds increased to a level that rendered the bonds attractive.[267] This stands to reason because, as discussed elsewhere in this brief, there was a price/quality trade-off in investing in any CDO bonds.[268] The same bond may have been unattractive at a certain spread but very attractive at a wider spread. The Norma BBB notes were

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265 (OIP ¶ 69.)

266 (*See* Section XIX.A.)

267 (*Id.*)

268 (*See* Section II.)

offered initially to Harding at a spread of three-month LIBOR, plus an additional 3.85 percent.[269] Harding bought them at a spread of three-month LIBOR, plus an additional 5.05 percent.[270] Mr. Chau testified, without contradiction, that at the wider spread, the Norma bonds were in fact an attractive investment.[271]

Proof at the Hearing also definitively showed that the manner of Harding's negotiation with Merrill Lynch with respect to the BBB Norma bonds was inconsistent with the Division's theory that Harding bought the BBB notes to accommodate Merrill Lynch or Magnetar.[272] Among other things, there was undisputed testimony at the Hearing from different witnesses that the best time to have accommodated both Magnetar and Merrill Lynch would have been right when Merrill Lynch first solicited Harding to buy the BBB bonds.[273] Had Harding done so, Merrill Lynch would likely have been able to sell the remaining bonds from the same tranche to other investors on terms that would have been more favorable to both Merrill Lynch and Magnetar. Based on this undisputed evidence, Harding's delay in making its investment decision almost literally took money out the pockets of both Merrill Lynch and Magnetar.[274] There was also no evidence that Harding claimed credit for buying the BBB bonds from either Merrill Lynch or Magnetar.[275] Undisputed evidence at the Hearing proved that Mr. Chau specifically did

269 (Div. Ex. 190.)

270 (Div. Ex. 212.)

271 (*See* Section XIX.A.)

272 (*See* Section XIX.B.)

273 (*See* Section XIX.A.3.)

274 (*Id.*)

275 (*Id.*)

not even tell Magnetar that Harding had bought the BBB bonds because he knew that, by delaying Harding's purchase and by negotiating a discount, Harding cost Magnetar money.[276]

As is clear from the OIP quotes below, the relevant Norma allegations are predicated on the notion that Harding would not have bought the BBB notes had it not been pressured to do so, to wit:

> Harding and Chau also later breached their obligations by purchasing, for inclusion in several other CDOs managed by Harding, tens of millions of dollars' worth of notes from a troubled Magnetar-related CDO underwritten by Merrill known as Norma. Harding and Chau bought the Norma securities despite their basically unfavorable view of them, **adding lower-rated notes to their prior Norma commitment only after receiving pressure from Merrill and a direct request from Magnetar.** Chau was apparently trying to return a favor and show that he was a "team player" who "never forget[s] my true friends." For each of the CDOs into which Harding placed the Norma notes, the collateral management agreement contained standard of care representations similar to that in the collateral management agreement for Octans I.

(OIP ¶ 7 (emphasis added).) Here is the remainder of the allegations:

> 60. In January 2007, Merrill was in the process of marketing a Constellation CDO known as Norma. On January 9, Chau, after reviewing information about Norma, wrote to a Merrill salesperson: "Turbo structure is very weak." On January 16, 2007, Merrill's head of CDO syndication ("Syndicate Head") asked Chau in an electronic conversation: "ready to talk about your participation [in the Norma offering]?" Harding then requested from Merrill certain information about the loan pools backing the RMBS referenced in the Norma portfolio.
>
> 61. On January 19, 2007, after further conversation with Merrill's sales staff, Chau and Harding agreed to purchase $40 million worth of Norma's A-rated tranche for several CDOs managed by Harding.
>
> 62. **Chau at first did not agree to buy Norma's lower-rated tranches.** But on January 23, the Magnetar Representative e-mailed Chau with the subject heading "Pls buy some norma bbb." The e-mail continued: "Stop complaining about turbo. :) Remember who was there for u when u were a little guy." Shortly afterwards, Chau wrote: "Did ML tell u I am in for 40mm single-As in Norma – team player!!!"
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> 63. Also on January 23, the Syndicate Head wrote to Chau: "what's your level" – i.e. what coupon rate would make the bond acceptable – "on BBB or BBB- if we can't

276 (*See* Section XIX.)

change the turbo?" Chau responded: "ah-so . . . let me sharpen the pencil," to which the Syndicate Head replied: "sweet."

64. The next day, the Syndicate Head asked Chau if he had "'sharpened your pencil' on norma BBBs yet?" Chau replied: "I never forget my true friends," and subsequently agreed to acquire, at an improved coupon rate, $20 million worth of the Norma BBB notes.

65. **When a Merrill sales representative later asked Chau if he had heard the news that Merrill had decreased Harding's allocation of the Norma BBBs from $20 million to $15 million, Chau replied: "Now that's what I'm talking about, the love is in the air" – further suggesting that he had not wanted to purchase those notes in the first place.**

66. Although Harding's orders for Norma were placed in January 2007, Norma itself did not close, and its securities were not available for purchase, until March 1. Shortly before Norma's close, an analyst circulated within Harding, including to Chau, a highly critical credit report. The commentary noted that "[t]here's quite a large percentage of deals [i.e. RMBS to which the Norma portfolio was exposed] failing surveillance tests, on the watchlist and on the do not buy list. Also, there is almost 15% exposure to [two RMBS sponsors generally disfavored within Harding.]"

(OIP ¶¶ 60-66 (emphasis added and internal footnote omitted).) The fact that the OIP is only focused on the BBB notes is significant because it reflects a tacit admission by the Division that there was nothing wrong with Harding's decision to buy the Norma Single-As and, therefore, with Harding's process for making that decision.[277]

[277] Only post-hearing, in yet another variance from the OIP, the Division now claims violations in connection with the Single-A Norma purchases as well. In fact, counsel for the Respondents specifically told the Court during the Hearing that it was our understanding that the Single-A purchases were not covered by the OIP and the Division did not correct that statement:

JUDGE ELLIOT: Wait, I thought there were three. Wasn't there a Jupiter?

MR. LIPMAN: Your Honor?

JUDGE ELLIOT: Yes.

MR. LIPMAN: May I address that?

JUDGE ELLIOT: Yes, go ahead.

MR. LIPMAN: There were three but there are only two charged in the OIP.

MS. BAYNHAM: Four.

JUDGE ELLIOT: Oh, there are four. I'm sorry.

MR. LIPMAN: Only the BBBs are charged in the OIP.

(Footnote continued on next page)

In fact, the evidence is clear that Harding asked for and received all relevant information to analyze Norma, found the Single-A bonds attractive right away and came to a reasoned conclusion to buy the BBB bonds as well once the spread was increased to a level that made the purchase attractive.[278]

The Division relied on legerdemain to try to show that Harding's own analysis showed that Norma BBB bonds were impaired at the time Harding purchased them.[279] But the evidence is clear that Harding's analysis showed no such thing and that Harding's analysis was corroborated by the rating agencies. Undisputed evidence at the Hearing demonstrated that the rating agencies employed an analysis that was similar to the one Harding performed; and the BBB Norma bonds would never have received investment-grade ratings had they experienced the impairment that the Division claimed they did.[280]

(Tr. 4238:5-19.)

278 For the first time during this proceeding, the Division implied in its Post Hearing Brief that Respondents did not have enough time to sufficiently analyze the Single-A Norma notes prior to purchasing them on behalf of 888 Tactical and Jupiter VI. (Div. Br. at 88-89.) Putting aside that the Single-A Norma notes are not charged in the OIP, Mr. Chau testified at the Hearing that there was sufficient time to analyze these securities prior to making a decision to purchase them. (Chau 4184:14-22.) As discussed below, more than 48 hours passed between the time Harding received the relevant information from Merrill Lynch until the time it reached an internal decision to buy the Single-A notes. (*See* Section XIX.A.5.)

279 (Div. Br. at 95-97.)

280 Rating agencies analyzed the underlying mortgage collateral of a new issue CDO (subjecting it to various ranges of probabilities of default, stress cases involving stressing the interest rate curve, stressing the default curve, assessing the variability of the cash flows) in order to properly rate the capital structure of the CDO. (Chau 4223:21-4230:21; Resp. Ex. 890 at 2.) Unless the collateral met the various criteria examined by the rating agency, it would not rate the deal. (*Id.*) With Norma, Fitch issued its report on March 1, 2007, the date of closing. (Resp. Ex. 890.) Fitch asserted that:

> The ratings of the class A-1, A-2, B, and C notes address the likelihood that investors will receive full and timely payments of interest, as well as the stated balance of principal by the stated maturity date, pursuant to the governing documents. The ratings of the class D, E, and F notes address the likelihood that investors will receive ultimate interest payments and the stated balance of principal by the stated maturity date. The rating of the class G and H notes address only the likelihood that investors will receive the stated balance of principal by the stated maturity date, pursuant to the governing documents.

(Resp. Ex. 890 at 2.) Fitch would not have made these statements if the BBB tranche was already impaired or was expected to experience a 10 percent loss. (Chau 4223:21-4230:21.)

The Division failed to carry its burden for the independent reason that the relevant purchases were immaterial, whatever their merits. The BBB Norma purchases represented 1.6% of the notional size of each of the deals into which they were placed.[281] Even had Harding's process for selecting the BBB Norma bonds been defective, including these assets in those deals could not have made any difference to the deals' performance or overall credit quality. There was no evidence, none, in fact, that those deals suffered in any way because of the Norma bonds. There was evidence, based on an analysis Ira Wagner applied in the *Tourre* case, that Norma performed as well as, or better than, other similar deals of the same vintage.[282]

Finally, not a single person – not a single investor and not a single person affiliated with any of the CDOs into which Norma bonds were placed – testified at the Hearing. The Division did not even try to offer any evidence that the Norma purchases themselves or the manner of their selection mattered to anyone. That, by itself, is a fundamental failure of proof and the Division failed to carry its burden for that reason alone.

XVIII. BACKGROUND

A. <u>Overview Of Norma CDO I Ltd.</u>

Norma was a $1.5 billion mezzanine ABS CDO that closed on March 1, 2007. (Prusko 2629:20-22; Div. Ex. 218 at i.) The collateral manager for Norma was N.I.R. Capital Management, LLC ("NIR"); Merrill Lynch was the underwriter; and Magnetar Capital purchased

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281 The Single-As were 1% and 2% of the deals for which they were bought. (*See* Section XVIII.B.)

282 In *Tourre*, Mr. Wagner opined that the "relevant performance comparison" to determine whether there was something wrong with a CDO deal was to compare "the exposure of each CDO to downgraded assets as of February 4, 2008." (Resp. Ex. 858 at ¶¶ 41-42.) He relied on the Wachovia Report to show that ABACUS significantly underperformed other CDOs within nine months of issuance." (*Id.*; *see also* Wagner 4872:3-22.) That report demonstrates that Norma performed in line with other CDOs of the same vintage and make-up. (Resp. Ex. 856 (Wachovia Report); Wagner 4886:13-4890:8.)

Norma's equity tranche. (*Id.*) **Harding's only connection to Norma was that of an investor.** (Resp. Ex. 290; *see generally* Div. Ex. 218.)

B. Four Harding-Managed CDOs Invested In Norma. Only Two Of These Investments Are Charged In The OIP.

1. Harding purchased $35 million of Single A-rated Norma notes for inclusion in two Harding-managed CDOs that were ramping in early 2007: Jupiter High Grade CDO VI, Ltd. and 888 Tactical Fund, Ltd.

In February 2007, Harding purchased $35 million of Single A-rated Norma notes for inclusion in two Harding-managed CDOs: Jupiter High Grade CDO VI, Ltd. ("Jupiter VI") ($15 million) and 888 Tactical Fund, Ltd. ("888 Tactical") ($20 million). (Resp. Ex. 284-85.) Jupiter VI was a $1.5 billion ABS CDO that closed on May 3, 2007. (Div. Ex. 513 at i.) Jupiter VI was underwritten by Merrill Lynch. (*Id.*) 888 Tactical was a $1 billion ABS CDO that closed on March 15, 2007. (Div. Ex. 503 at 1-5.) 888 Tactical was underwritten by Citigroup. (*Id.*) Harding was the collateral manager for both 888 Tactical and Jupiter VI. (*Id.* at 1; Div. Ex. 513 at i.)

Again, the OIP contains **no allegations** related to Harding's purchase of Norma's Single A-rated notes. (Tr. 4237:8-19.) The arguments set forth here apply with equal force to the Single-A purchases as well.

2. Harding purchased $15 million of BBB-rated Norma notes for inclusion in two Harding-managed CDOs that were ramping in early 2007: Lexington Capital Funding V Ltd. and Neo CDO 2007-1, Ltd.

Following its purchase of Single A-rated Norma securities for Jupiter VI and 888 Tactical, Harding purchased $10 million of Norma's BBB-rated notes for Lexington Capital Funding V Ltd. ("Lexington V"), a $615 million mezzanine ABS CDO that closed on March 29, 2007; and $5 million of BBB-rated notes for Neo CDO 2007-1, Ltd. ("Neo"), a $300 million mezzanine ABS CDO that closed on April 5, 2007. (Chau 1644:10-14; Div. Ex. 507 at i; Div. Ex. 509 at i.) Merrill Lynch was the underwriter, and Harding was the collateral manager of both

Lexington V and Neo. (Div. Ex. 507 at i; Div. Ex. 509 at i.) At closing, Lexington V had a notional value of $615 million. (Resp. Ex. 879.) Of this, $10 million – or 1.63 percent – of the collateral in Lexington V was comprised of Norma BBB-rated notes. (*Id.*) Similarly, only $5 million of the $300 million of securities in the Neo portfolio – or 1.66 percent – was made up of the Norma BBB-rated notes at issue. (*Id.*)

The Division made no allegations as to the remaining 98.3% of these portfolios, presumably because it believed that these assets were purchased in good faith. Moreover, it did not introduce a single piece of evidence at the Hearing demonstrating that any investor[283] or director or managing member of the Co-Issuers[284] for any of these transactions found the fact that Respondents included these notes important, let alone that this fact significantly altered the total mix of information made available.

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[283] In addition, and apparently as an afterthought, the Division alleged that this conduct also violated Section 17(a) of the Securities Act. (Div. Br. at 125; *see also* OIP ¶ 68 (referencing representations in the Offering Circular).) For the same reasons outlined in the Octans I section, the Division's claims fail. (The collateral manager agreements for these transactions contained the same language. (Div. Ex. 504 at 4, 7; Div. Ex. 506 at 4, 7; Div. Ex. 510 at 4, 8; Div. Ex. 512 at 4, 7.).) The Offering Circulars for those deals also state that no representations about the quality of the portfolio were being made to investors and investors were told to conduct their own investigation of each collateral asset. The Division, in fact, offered zero evidence that the inclusion of one CDO, which represented 1.6% of the portfolio, was material to the investors. It did not call a single investor witness related to these CDOs. There is also no evidence that the inclusion of this one asset altered the total mix of information.

[284] The Division also offered no proof that the inclusion of the Norma BBB bonds made any difference to the Issuers of the CDOs. As was the case with Octans I, the Division did not call a single director of the issuers of these CDOs to testify at the Hearing. For the same reasons outlined in the Octans I section, these claims too fail. (*See* e.g., Div. Ex. 507 at 103-04 & Div. Ex. 509 at 110-11 (the Issuers sole purpose was to effectuate the 2007 transactions); Div. Ex. 507 at 104 & Div. Ex. 509 at 111 (the Issuer's activities were limited to certain actions defined in the Offering Circulars).); Div. Ex. 506 at 7-8 & Div. Ex. 510 at 8-9 & Chau 1510:19-24; 1511:3-14; 1513:9-15 (the Issuers were not advisory clients because there was no investment advisor agreement); Div. Ex. 507 at 2nd to last page & Div. Ex. 509 at 2nd to last page (Merrill Lynch is the "Initial Purchaser" who created the Issuers).)

XIX. THERE IS NO EVIDENCE THAT HARDING OR WING CHAU BOUGHT NORMA SECURITIES AS A FAVOR FOR MAGNETAR OR MERRILL LYNCH.

A. Mr. Chau Negotiated A Better Price And Spread On The Norma BBB Bonds Than Was Initially Offered By Merrill Lynch, To The Benefit Of The Harding-Managed CDOs And To The Detriment Of Merrill Lynch And Magnetar.

1. The Division is attempting to rely solely on speculation and uncorroborated hearsay evidence to prove its case.

The Division's case against Harding's purchase of Norma relied heavily on a series of e-mails sent by representatives of Merrill Lynch, Harding, and Magnetar in late 2006 and early 2007. (Div. Br. at 86-102.) As of the date of the Hearing, these e-mails were over seven years old. In many instances, the witnesses called at the Hearing did not recall these e-mails. (*See generally* Chau 4167:16-4230:21; Chau 1578:5-9; Chau 1598:25-1599:4; Chau 1673:10-13; Prusko 2636:23-2637:8.) In other instances, the Division did not bother to call the relevant parties on the e-mails, instead relying on hearsay and speculation to prove its case.[285] (*See e.g.*, Div. Br. at 91 (discussing Div. Ex. 204); Div. Br. at 94 n.164 (discussing Div. Ex. 203).)

In an administrative proceeding, the government cannot rely solely on uncorroborated hearsay evidence to satisfy its burden, especially in the face of contradicting evidence from the sworn testimony of the Respondent. *See Hoska v. U.S. Dept. of the Army*, 677 F.2d 131, 138-41 (D.C. Cir. 1982). Allegations that are as consistent with innocent conduct as they are with

[285] The majority of the e-mails used to support the Division's case with regard to the Norma issue were between parties who were either not called at the Hearing or did not recall the document. For example, the Division offered e-mails between Mr. Chau and the following individuals as evidence: Catherine Chao (Div. Exs. 189, 193, 207, 210, 212); Andrew Phelps (Div. Exs. 191, 198, 205); Xilun Chen (Div. Exs. 196, 207, 212); Theo Pan (*id.*); Timothy Hider (Div. Exs. 207, 212); and Tony Huang (*id.*). The Division did not call any of these witnesses at the Hearing, except Tony Huang whom it did not ask about these e-mails. The Division also introduced e-mails that Mr. Chau never received. (*See, e.g.*, Div. Ex. 190 (between Catherine Chao and Michael Doyle); Div. Exs. 194-95 (between Catherine Chao and Xilun Chen); Div. Ex. 201 (between Michael Doyle, Andrew Phelps, and Kenneth Margolis); Div. Ex. 204 (between Kenneth Margolis and Andrew Phelps, Cecilia Pan, Sharon Eliran, and Catherine Chao).) The Division did not call any of these witnesses at the Hearing. To the extent these e-mails are being offered for their truth, they are rank hearsay and the Division's interpretation of their meaning is pure speculation.

fraudulent conduct are never sufficient to establish liability under Sections 206(1) or (2). *United States v. Mulheren*, 938 F.2d 364, 372 (2d Cir. 1991).

Here, the Division's interpretations of these e-mails are not supported by witness testimony. Respondents, meanwhile, offered a reasonable explanation of what transpired based on a current reading of the documents by the witnesses at the Hearing. Where these two explanations are equally likely, Respondents' interpretation must prevail. 4-73 Modern Fed. Jury Instructions – Civil, ¶ 73.01 (Matthew Bender) (stating that, when the standard for determination of liability is "preponderance of evidence," then the party bearing this burden must prove more than equality of evidence and if the testimony of both parties is "in balance or equally probable," then the plaintiff has failed to sustain his burden).

The following timeline puts the e-mails and other evidence in context. (*See also* Exhibit H (Timeline of Events Related to Norma).) The basic and inescapable conclusion, which this timeline makes evident, is that Harding and Mr. Chau had multiple opportunities to say "yes" to Merrill Lynch and Magnetar, but Mr. Chau kept saying "no." And he did not say yes until the spread made the bonds attractive. This is not evidence of a breach of fiduciary duties. This is evidence of a collateral manager doing its job, in good faith, and in a way designed to benefit the deals it manages, even if doing so could harm the people with whom the manager wants to continue to do business.[286]

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[286] The Division alleged that United Capital, another CDO manager that invested in Norma, not Harding, actually negotiated the discount on Norma's BBB-rated bonds and Harding simply benefitted from it. (Div. Br. at 92.) The Division cannot prove these allegations. (*See* Div. Ex. 207 (Wing Chau states that Harding purchased the BBB-rated Norma notes at "full coupon" on January 26, 2007, five days before United Capital placed its order).) Mr. Chen testified that this e-mail communicated to Mr. Chen that the discount Harding negotiated would be reflected in a higher coupon pay out rather than a lower price. (Chen 4213:24-4214:13.) As the Court is aware, a buyer of a bond can increase the return earned by that bond in one or both of two ways: (1) it can buy the bond at a discount to par; and (2) it can pay par but negotiate a higher coupon. Mr. Chen appears to have been expecting a discount to par and expressed surprise that Harding was paying par for the bonds. Mr. Chau's response told Mr. Chen that the negotiated discount would be reflected in the coupon payments. More importantly, the fact that
(Footnote continued on next page)

2. January 9: Merrill Lynch released pricing and marketing information for Norma prompting Harding to request additional information in order to analyze the collateral and for Wing Chau to lay the groundwork for later price negotiations with Merrill Lynch.

On January 9, 2007, Merrill Lynch circulated the initial marketing materials for Norma – the Term Sheet and Pitch Book – as well as the price information. (Div. Ex. 190.) This was the first official announcement from Merrill Lynch that it was launching Norma and it included price guidance – the expected pricing of Norma's tranches – and preliminary marketing documents. (Chau 4124:8-4126:11.) Once market participants received this information, they would "look to see if they [had] room to invest at the BBB or A level and if these interest rates [made] sense as an investment choice. . . ." (Chau 4128:15-17.) Those who were interested in purchasing securities in Norma would contact Merrill Lynch to ask for additional information to inform their decision about whether to invest. (Chau 4125:23-4126:11.) Additionally, "one would look at the marketing book to familiarize yourself with the deal, with the deal terms, the deal structure, the collateral manager, so you can have a coherent discussion with the investment bank and the collateral manager should you choose to invest." (Chau 4129:1-5.)

The January 9 pricing e-mail listed the BBB-rated notes (Class E tranche) at "3mL + 385." (Div. Ex. 190.) This meant that the expected coupon payments (interest) that an investor would earn by investing in the Baa2/BBB tranche of Norma would be the three-month LIBOR interest-rate, plus an additional 3.85 percent interest. (Chau 4126:12-4127:9.)

Following the announcement by Merrill Lynch, Mr. Chau did not place an order or indicate any interest.[287] Instead, Mr. Chau requested the Norma collateral portfolio. (Chau

another investor also secured a discount on Norma is irrelevant. It does not negate the benefit of the discount received by Harding, or the detriment suffered by Magnetar and Merrill Lynch.

[287] The Division focuses on certain internal Merrill Lynch e-mails to suggest that even before Merrill Lynch began marketing Norma, Mr. Chau was already on board to buy Norma bonds. (Div. Br. at 86-87.) If that were so,
(Footnote continued on next page)

1578:20-1581:12; Div. Ex. 188.) Shortly thereafter, a Harding analyst, Xilun Chen, also requested the Norma portfolio from Merrill Lynch, providing Merrill Lynch with a Harding-created template to fill out. (Resp. Exs. 266-67.) This template included the specific information that Harding needed to run its analysis of the underlying assets in the Norma portfolio. (*Id.*) Mr. Chau described specifically what information the Harding template provided during his testimony:

> ...[T]he underlying residential mortgage-backed securities BBB rated bonds that would be sold into the Norma portfolio and it would be broken down by CUSIP, by its mnemonic ticker symbol and the relative deal sizes that would be sold into the Norma CDO along with when those securities were traded during the warehouse phase and the trading prices of those securities at the time it was purchased, trade date, settle dates, the various issuer names associated with those BBB rated securities as well as a host of descriptive information such as loan to balance, average loan size, rated average coupon, the relevant ratings for the rating agencies, where the average FICO scores which is the way to gauge the overall pool's creditworthiness of the individual borrowers, and also broken out by various buckets in terms of how many loans were below 550 FICO which is a threshold for a very subprime individual versus 620 which would be an average for a subprime person."

(Chau 4179:11-4180:4.)

There would be no need for all this information if Harding had already committed to buy anything or if Harding did not care what it was buying, so long as it was doing a favor to Merrill Lynch and Magnetar. Along the same lines, there would be no reason for Mr. Chau to complain about a Norma structural feature, its turbo.[288] But he did. Shortly after requesting the Norma portfolio, Mr. Chau e-mailed Merrill Lynch, to complain about Norma's turbo feature in order to create a wedge with which to later negotiate a discount. (Div. Ex. 189.)

there would have been no point to all the contemporaneous conversations about whether Harding would have an interest in any Norma bonds.

[288] A "turbo" feature is a CDO feature that diverts a percentage of the CDO's income from the equity tranche to other debt tranches to pay down the principal of that particular tranche. (Chau 1585:9-1588:5.) The turbo feature does not affect the credit of a particular debt tranche, nor does it serve as credit enhancement. (*Id.*) It only optimizes the Weighted Average Life ("WAL") of the security. (*Id.*)

3. January 16: Wing Chau contacted Merrill Lynch to determine the market's level of interest in Norma.

On January 16, 2007, Harding asked for the portfolio for the third time. (Chau 1590:20-1592:25; 4175:4-23; Div. Ex. 192; Resp. Ex. 886.) And it did so after Mr. Chau sent a message to Andrew Phelps, the syndicate manager for Merrill Lynch's CDO division, to gauge the market's level of interest in Norma. (Div. Ex. 191.) Mr. Chau hoped to gain additional bargaining leverage if interest was low. (*See* Chau 1625:19-1627:4.) Andrew Phelps replied to Mr. Chau's message: "proceeding alright - have about 25 percent of AA down thru BBB done (AA- is about 50 percent done) with BBB- open right now. ready to talk about your participation?" (Div. Ex. 191.) In his testimony, Mr. Chau explained his interpretation of this response:

> He is relaying to me the current – at the time, what the indications of interest were for the Norma CDO transaction. So for the Norma CDO transaction for AA rated securities down through the BBB tranche, they have roughly 25 percent of each of those tranches spoken for. The AA- tranche, there has been 50 percent interest spoken for at that point in time and the BBB- tranche currently is open which means that there is no indications of interest at the BBB- tranche. And he's asking me if I'm ready to provide him an indication of interest.

(Chau 4171:15-4173:3.) In other words, Andrew Phelps' response told Mr. Chau that he could get the Norma's BBB-rated bonds at a better spread.

As described in this e-mail, at this point, Mr. Chau did not say "yes." Had he done so, he would have been doing Merrill Lynch and Mr. Phelps a big favor because Mr. Chau could have given Mr. Phelps his lead order. As Mr. Chau explained during his testimony, a lead order at that stage of Norma's ramping process would have been extremely valuable to Merrill Lynch:

> Q. What's a lead order?
>
> A. A lead order is in the new issue process where an investor comes in early in the syndicate process. And so investment banks prefer to have as many lead orders as possible. The lead order allows the syndicate manager to then transmit that information to

> the marketplace to let market participants know that there is interest in this transaction and this is how much has been spoken for and this is the price that they've established.
>
> This gives them a very big leverage point to get investors that are looking at these securities to put in their orders of interest before they get locked out of the trade. . . .
>
> Q. And what is your understanding of whether having a lead order is valuable to an underwriter?
>
> A. Yes. As I said, it's extremely valuable to an underwriter because it helps with the marketing phase because it drives other investors into the order book. The typical new issue process, if a new issue languishes, people look at it as a barometer of weak interest from other market participants. To the extent that you have a lead order, you can now broadcast that information to the investment community and the investment community immediately reacts to that early order interest because if you want to participate, you need to really get on the bus, so to speak, before it leaves the station.

(Chau 4195:6-4196:21.) Instead of placing a lead order, however, Harding requested the information it needed for an analysis of Norma's collateral.

4. January 17: Harding ran the Norma portfolio through Intex, assessed the collateral risk and profiles, and made eligibility criteria determinations.

On January 17, 2007, Harding received a completed version of Harding's collateral stratification template ("strat template") from Merrill Lynch with the requested information for the Norma portfolio filled in. (Div. Exs. 194-95.) As described above, the strat template provided Harding the "top level information" it needed to quickly summarize the descriptive characteristics of the collateral backing the BBB-rated Norma securities. (Chau 4176:22-4181:15.) Once Harding received this collateral information from Merrill Lynch, its analysts could "upload the CUSIPs into the Intex" so that Harding could "generate and forecast cash flows" and "run a series of loan analyses." (*Id.*) Meanwhile, Mr. Chau continued his communications with Merrill Lynch, but still did not commit to purchasing any of Norma's BBB-rated securities. (Chau 4183:17-4184:3; Div. Ex. 193.)

5. January 19: Harding indicated its initial interest in purchasing the Single A-rated Norma securities.

On January 19, 2006, more than 48 hours after getting the portfolio information, Harding **internally** circulated its initial thoughts on Norma. (Div. Ex. 196.) The fact that this e-mail originated from someone other than Mr. Chau and was sent to someone else, with Mr. Chau listed only as a "CC" is significant in itself. It reflects the fact that Harding employees responsible for evaluating CDOs for potential investment had, in fact, done the necessary analysis and concluded that it would be appropriate for Harding to purchase $40 million of Norma's Single A-rated notes: $20 million for 888 Tactical, $15 million for Jupiter VI, and $5 million for Neo. (*Id.*) There is no evidence at all of any conversations or communications with any Harding employees directing them to approve these bonds.[289]

As mentioned, at this point, Harding had still not committed to buy any Norma securities.[290] Harding had only determined internally that $15, $20, and $5 million of Norma's A-rated notes satisfied the investment and eligibility criteria for the warehouses of 888 Tactical,

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[289] The Division has pointed to no evidence that demonstrates that Harding did not conduct the analysis it needed to, other than to assert that Harding **may not** have had the Preliminary Offering Circular for Norma at the time. (Div. Br. at 88-89.) Respondents had the Preliminary Offering Circular in their possession on January 24, 2007, meaning they received it at some point prior to this date. (Resp. Exs. 832-33 (Harding sent the Preliminary Offering Circular to Merrill Lynch).) The Division concedes this point (Div. Br. at 89, n.153), but cannot offer any evidence as to when Respondents first received this document. As the Division has the burden of proof, it cannot affirmatively state that Respondents did not review this document prior to purchasing the Single-A Notes without any actual evidence of this fact.

The Division also points to no evidence or information that was included in the Preliminary Offering Circular, but was missing from the Pitch Book, Term Sheet, and Collateral Stratifications that Harding had in its possession several days before expressing this initial interest in the Norma Single-A bonds. The Division could not make that assertion because the Preliminary Offering Circular is just that, preliminary, and does not contain the numbers and figures necessary to do any sort of calculation. (*See generally* Resp. Ex. 833.)

[290] The Division elicited testimony from Mr. Chau on this point that the January 19 e-mail reflected Harding's purchase of $40 million of cash bonds in Norma's Single-A tranche. (Chau 1570:20-1571:13.) However, shortly thereafter, Mr. Chau corrected the Division's mistaken impression:

> Q. Now, can we go back to Division Exhibit 196. Would it be fair to describe this as a commitment by Harding to purchase the assets listed therein?
>
> A. This is our **expectation of what we would like** to buy of Norma CDO. Yes.

(Chau 1593:10-16(emphasis added.).)

Jupiter VI, and Neo respectively. Harding now had to request and receive warehouse approval from the underwriters for each of these CDO warehouses. During his testimony, Mr. Chau explained that Merrill Lynch or the investment bank structuring the CDO had to approve each asset added to the Warehouse. (Chau 4205:20-4208:7 ("I would send a request of approval to Merrill Lynch and Merrill Lynch at that point would either – after it analyzed the security, they would then look to see if they would approve or deny it.").) Put differently, once the Norma bonds were added to the Warehouse for the CDOs it was ramping, Harding could not take the asset out of the portfolio unless something changed and the asset no longer met the Eligibility Criteria for the warehouse of the relevant CDO deal.

Harding subsequently requested and received warehouse approval from Citigroup and Merrill Lynch respectively to include Norma's Single A-rated notes in the portfolios for 888 Tactical and Jupiter VI. (Resp. Exs. 275-76.)

Notably, internal approval of Norma at the Single-A level reflects a familiarity with and analysis of Norma. This is the real reason the Division now claims a violation with respect to the Single-As. It finally occurred to the Division that its theory that Harding had a negative view of Norma runs counter to Harding's decision to buy the Single-As. Of course, Harding's initial decision to buy the Single-As but not the BBBs is consistent with the other evidence in this case, *i.e.*, that the BBBs were not attractive at their initial spread and Harding was unwilling to even consider buying them unless the spread became more favorable.

6. January 23: James Prusko e-mailed Wing Chau about Norma's BBB-rated notes. Wing Chau replied that Harding had purchased Single A-rated notes, but he did not commit to purchasing any additional Norma securities at this time.

The Division points to e-mail exchanges between Mr. Prusko and his boss and Mr. Prusko and Mr. Chau as evidence that Magnetar was pressuring Mr. Chau to buy BBB

Norma notes. (Div. Br. at 89 (discussing Div. Ex. 199.) If anything, these exchanges prove that Mr. Chau resisted any pressure and did not agree to do what Mr. Prusko was asking. Specifically, on January 23, 2006, in an e-mail exchange with David Snyderman, James Prusko wrote: "I will personally hammer Wing." (Div. Ex. 199.) The Division contends that this is a reference to the Norma BBB tranche. Mr. Prusko was not sure and thought that it could have been a reference to something else. (Prusko 2750:9-2752:10.) But even if this were a reference to the Norma BBBs, the e-mail that follows proves that Mr. Prusko did not get the commitment he wanted to get from Mr. Chau. In that e-mail, also on January 23, 2007, Mr. Prusko and Mr. Chau had the following exchange under the subject "Pls buy some norma bbb":

> Prusko: "Stop complaining about turbo. :) Remember who was there for u when u were a little guy. Also, if u ramp any killer deals, like the citi one, pls give me heads up so I can get in front of dealers on getting the equity."
>
> Chau: "I hear you, not me holding up the deals, only a small cog in the machine :)"
>
> Prusko: "Yes, u think will restart soon, maybe after afs everyone gets going gain [sic]?"
>
> Chau: "From the guys I talked to, everyone is trying to time the bottom in spreads, should pick up after AFS. Did ML tell u I am in for 40mm Single-As in Norma - team player!!! How did your call go w/alex at mizuho?"
>
> Prusko: "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.)[291]

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[291] In the January 23, 2006 exchange with Mr. Snyderman, Mr. Prusko wrote:

> I would say we do not yet have a report that accurately calcs first payment. However, I am on all the dealers about the daycount issue, cautiously optimistic we won't have it on newer deals (octans 1 same issue as cetus 1 had.)
>
> ***
>
> Sharon was quite whiny and down about norma bbb's, 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.
>
> I will personally hammer wing. he's getting too big for his britches. we left a lot of loot on the table there.

(Div. Ex. 199.) Mr. Prusko did not recall this e-mail and the Division did not offer any other witnesses to testify as to its meaning. After reviewing the e-mail on the stand and being asked what he meant by, "I will personally hammer Wing," Mr. Prusko testified that he did not think he was referring to Mr. Chau buying Norma's BBB-rated bonds. (Prusko 2750:9-2752:10.) He explained: "I think at the top I talk about some first payment day count problems and specifically mention Octans 1. First period payments were a sore spot with respect to – often they

(Footnote continued on next page)

At no point in this e-mail did Mr. Chau commit to purchasing BBB-rated notes; again, he did not say "yes." When asked about this e-mail at the Hearing, Mr. Chau explained: "As I say, I don't recall the general specifics. As I recall it, I was fine with the Single-A's. The Bbb's I was looking for more of a price concession, and so I was delaying putting my interest in to ascertain what the new issue order book would look like." (Chau 1611:16-21.) Mr. Chau confirmed that, at the time of these e-mails, he had not expressed any interest to Merrill Lynch in Norma's BBB-rated securities. (Chau 1611:22-1612:3; 4186:13-23.) Note that having received Mr. Chau's answer that Harding already expressed an interest in the Single-As, Mr. Prusko did not press further for Mr. Chau to purchase the Norma BBB bonds. Note also that if the Division's theory is right that Harding bought Norma BBBs to curry favor with Magnetar, this was another missed opportunity by Mr. Chau. In fact, both Mr. Chau and Mr. Prusko testified that Mr. Chau never told Mr. Prusko that Harding had purchased Norma's BBB-rated securities. (Prusko 2651:17-19; Chau 4235:20-4236:14.)

were smaller to the equity than were modeled because of sloppiness in timing and things like that, and it was a source of loss of money to the equity, so reading this – sitting here today, reading this, I think it's equally probable that the 'loot left on the table' referred to the first payment of Octans 1 as anything else." (Prusko 2751:8-19; see *also* Prusko 2751:20-2752:10 ("I don't know. Sitting here today, I think it's likely, as it was in the e-mail, but I think it's also quite plausible that it referred to some other topic that's not mentioned in this e-mail.").)

Separately, when asked how unusual it was for people in the CDO industry to say things like "team player" or "remember who was there for you when you were a little guy," Mr. Prusko explained that it was "reasonably common" for collateral managers to "use the importance of their overall relationship to try to get good treatment on a specific transaction." (Prusko 2645:11-2646:19.)

7. **January 23-24: Merrill Lynch contacted Wing Chau to determine at what price Harding would be interested in purchasing Norma's BBB-rated notes after Merrill Lynch had internally determined that Harding's CDOs had the capacity for additional A- and BBB-rated securities.**

On January 23, 2007, Andrew Phelps e-mailed Mr. Chau: "what's your level on BBB or BBB- if we can't change the turbo?" (Div. Ex. 198.) Mr. Chau testified that it appeared that Andrew Phelps was asking him at what price Harding would be interested in buying the BBB or BBB- tranche of Norma if Merrill Lynch did not alter the turbo feature that Mr. Chau had previously complained about. (Chau 4186:25-4188:7.) In response to Mr. Phelps' message, Mr. Chau replied: "ah-so . . . let me sharpen the pencil." (Div. Ex. 198.) Merrill Lynch had now opened the door and was offering to negotiate with Harding on the price of Norma's BBB and/or BBB- tranche. (Chau 4186:25-4188:7.) Mr. Chau's reply indicated to Merrill Lynch that he would now figure out a price at which it would be appropriate for Harding to invest in the security. (*Id.*) At no point in this discussion did Mr. Chau agree to purchase BBB-rated Norma notes; he still did not say "yes."

The next day, Mr. Phelps again e-mailed Mr. Chau, asking: "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.) Mr. Chau's "citi mezz deal" was a mezzanine CDO that Harding was ramping in early 2007, underwritten by Citigroup. (Chau 4193:13-4194:10.) Mr. Phelps also pointed out Harding's purchase of other (not Norma) BBB-rated securities from OWICs and BWICs that were routinely circulated to industry participants. (*Id.*) Mr. Chau testified that he believed that Andrew Phelps was "expressing some dissatisfaction" that Mr. Chau and Harding were "too busy for him." (*Id.*) In other words, here Mr. Phelps is asking

Mr. Chau whether Harding had been so busy with other activities that Wing Chau cannot find time to discuss Norma with Merrill Lynch.

Andrew Phelps also noted in his e-mail that the "bbb- [tranche of Norma] is done now fyi at 480."[292] (Div. Ex. 205.) This sentence alerted Mr. Chau that: "...[T]he Norma transaction is heating up, so to speak, the bus is leaving the station. The BBB- tranche, which is one of the tougher tranches to place above equity, was just – he had just gotten a subscription order for and that tranche is now no longer available for investors to invest in." (Chau 4194:11-4195:1.) Mr. Phelps also told Mr. Chau that the BBB- tranche priced at 480 basis points or the three-month LIBOR interest-rate, plus an additional 4.8 percent interest. (*Id.*) This information told Mr. Chau that "if I want to participate in the BBB bonds, I cannot bid any lower than 4.8 percent because the 4.8 percent threshold has been established by a BBB- investor for that tranche." (*Id.*) This e-mail exchange is evidence of a negotiation, not of an accommodation. There is no reason for Mr. Phelps to mention the BBB- level, unless he is giving an indication of where the BBB is likely to trade.

In response, Mr. Chau replied: "I never forget my true friends." (Div. Ex. 205.) Mr. Chau testified that he believed this was a flippant way of saying that he would look at Norma's BBB-rated notes; it was not a promise to do anything else.[293] (Chau 4197:9-4198:6.) Again, he did not commit to purchasing these securities at this time, even though, as described above, such a commitment would have been very valuable for Merrill Lynch: "Knowing the fact that they had that initial order of interest across the capital structure at 25 percent and still building as well as

[292] Note that the initial pricing for the BBB- tranche was LIBOR plus 4.4% interest. (Div. Ex. 190.)

[293] Separately, throughout its Post Hearing Brief, the Division makes much ado about the fact that Mr. Chau wanted to maintain good business relationships with Merrill Lynch and Magnetar; however, Mr. Chau, as an owner of a CDO management business, wanting to maintain good relationships with industry participants, including the other investors and investments banks he worked with is neither strange, unusual, or probative of anything.

the BBB- bonds now being purchased, if I came in at the price talk of LIBOR plus 385, it would have driven the process of the syndicate process much faster in terms of Merrill Lynch being able to price that transaction."[294] (*Id.*)

Lest there be any doubt that Mr. Chau had not yet said "yes," a January 23, 2006, Merrill Lynch internal e-mail regarding the status of its sale of Norma proves that. (Div. Ex. 201.) In it, Harding was listed as having purchased $40 million of Norma's A-rated notes and having "AAA through BBB capacity" in Jupiter VI, Neo, Octans IV, and Lexington V. (*Id.*)[295]

8. January 24-25: Harding indicated to Merrill Lynch that it was interested in purchasing Norma's BBB-rated notes if Merrill Lynch was willing to negotiate on the price.

On January 24, 2007, Kenneth Margolis, another Merrill Lynch banker, e-mailed Andrew Phelps and others at Merrill Lynch that Wing Chau was "in" for an additional $20 million of Norma notes. (Div. Ex. 204.) Mr. Margolis wrote: "I told [Mr. Chau] we could try and sell him down to $15mm if we could. . . He wants to talk about the spread but he will be in . . . ." (*Id.*) Neither Wing Chau nor any other Harding employee received a copy of this e-mail. The Division

[294] Harding eventually purchases $15 million of BBB-rated securities in Norma at a LIBOR plus a discount margin of 505, garnering a substantial discount for the investors in Neo and Lexington V. (Div. Ex. 212.)

[295] As the underwriter for these deals, Merrill Lynch would have been privy to the details of each CDO's warehouse, including their capacity for certain tranches of securities. (Chau 4174:2-17.) It is not unusual therefore that Merrill Lynch would include Harding on its list of CDO managers that it should reach out to when attempting to sell Norma. ". . . [T]hey're attempting to sell the Bbbs – which, of course, is the job of the syndicate desk, is to sell the liabilities of the CDOs. . . ." (Prusko 2639:12-18.)

Moreover, this e-mail included an extensive list of other CDO managers, besides Harding, who were likely to or had the capacity to participate in Norma. (Div. Ex. 201.) There are no allegations that these other managers were included on this list because they were willing to purchase Norma as a favor to Merrill Lynch. The other CDO managers on this list included: ACA Management LLC, Babcock & Brown Securities, Barclays Global Investors, Bear Sterns Asset Management Inc., Braddock Financial Corporation, Chotin Asset Management Corporation, Citi Alternative Investments, LLC, ING Clarion Capital, Cohen & Company Financial Management, LLC, D.B. Zwirn & Co., L.P., Declaration Management & Research, LLC, Deerfield Capital Management, LLC, Dillon Read Capital Management, Fischer Francis Trees & Watts, J.P. Morgan Investment Management, Inc., Liberty View Collateral Management, LLC, MFS Investment Management, Old Hill Partners, Petra Capital Management, Pacific Investment Management Company, LLC, Princeton Advisory Group, Robeco Group, Sailfish Structured Investment Management, LLC, TCW Asset Management Co., and 250 Capital, LLC. (*Id.*)

did not call any of the Merrill Lynch employees on this e-mail exchange at the Hearing. No one therefore provided direct, non-hearsay testimony about this e-mail. Yet, this is one of the key e-mails on which the Division bases its Norma case.

Contrary to the Division's reading of this e-mail, the line: "He wants to talk about the spread but he will be in," makes it clear that there was no agreement on what Mr. Chau might buy or at what price; price and quality are, after all, the two key terms that parties to a trade must reach before there is a trade. (*Id.*) At the Hearing, Mr. Chau offered his interpretation of this sentence: ". . . Harding, would like to talk about the price of the security – spread is equivalent to price – of the Norma transaction and if his price is met, he will probably be in." (Chau 4199:2-4200:14.)[296]

Having communicated to Merrill Lynch an interest in $20 million of Norma's BBB-rated notes if it could get them for an acceptable price, the next day Harding pulled back. On January 25, 2007, Mr. Chau e-mailed Mr. Phelps: "may have an issue with the Normas, we are subject at

[296] This e-mail is hearsay and subject to different interpretations. As noted, neither Mr. Phelps nor Mr. Margolis testified at the Hearing. The Division **speculates** that Mr. Margolis meant that he would reduce Harding allocation as an accommodation to Mr. Chau. There is no testimony from anyone to support this speculation. It is not even a reasonable inference. As Mr. Margolis and Mr. Phelps knew at the time, Harding was ramping deals for which it needed BBB securities. (Div. Ex. 201 (internal Merrill Lynch e-mail identifying Harding as a party with BBB needs); Div. Ex. 205 (e-mail from Mr. Phelps noting that Harding had BBB list out in the market).) They also knew that Mr. Chau had earlier expressed an interest in the Norma BBBs at the right spread, *i.e.*, "let me sharpen my pencil." They also knew that Harding had already done an analysis of Norma in connection with placing its Single-As order. They also appeared to have known that if he could get the right spread, Mr. Chau would be interested in a $20 million allocation. It is reasonable to conclude then that the "I told him we could try and sell him down to $15mm if we could," was indeed a threat that if Mr. Chau wanted $20 million, he would not get it, unless he stopped negotiating and agreed to their price.

As to "Wing is in for $20 mm," again, this is just as consistent with Mr. Margolis' expectation that the parties could come to an agreement on the acceptable spread, as it is with any other explanation. Mr. Chau did not remember the conversation with Mr. Margolis. It took place many years before his testimony and was uneventful. When asked for his understanding of the meaning of the e-mail, Mr. Chau testified that Mr. Margolis was telling Mr. Chau that unless Harding got on board right then, Harding would not be able to buy the full allocation it may have wanted. (Chau 4202:13-4203:13.) Both interpretations are plausible from the face of the e-mail. However, the only witness who testified about it and who has any relevant knowledge read the e-mail in a way not helpful to the Division. His reading controls. *See Hoska*, 677 F.2d at 138-41. There is no evidence that directly contradicts his testimony. Finally, the burden of proof is on the Division. It cannot carry its burden by relying on its own interpretation of hearsay evidence. It also cannot predicate liability on evidence that is subject to two interpretations, one of which is perfectly innocent. *See Mulheren*, 938 F.2d at 372.

this time, warehouse issues . . . will b back to you." (Resp. Ex. 870.) During the Hearing, Mr. Chau explained his recollection of this e-mail:

> I have yet – I have given Merrill Lynch an order of interest on the Norma transactions subject to the usual caveats of subject to warehouse approval and, as we said before, we can always break the trade up until the point at which I say the warehouse providers have approved the bonds. I am now telling Merrill Lynch that my order indication is no longer valid. It's now subject, so I'm no longer good for those acquisitions of securities. I'm citing warehouse issues and those warehouse issues, I don't recall the specifics, if it was warehouse issues within the Merrill Lynch warehouse provider or warehouse issues with the other underwriting banks that we were ramping deals for but I would get back to them once we resolved those issues.

(Chau 4210:7-4211:6.) Similar to Merrill Lynch's threat to cut Harding's allocation if it did not come to terms quickly, this e-mail reflects Mr. Chau's countermove to pull his order if Merrill Lynch did not negotiate. Again, this back and forth is inconsistent with an accommodation of Merrill Lynch, especially because, as noted above, it was Merrill Lynch deals where Harding had BBB capacity.

9. January 26: Harding committed to purchase $20 million of Norma's BBB-rated notes at a discounted price and increased spread.

On January 26, 2007, Merrill Lynch e-mailed Harding, confirming its purchase of $20 million of Norma's BBB-rated notes. (Div. Ex. 207; Div. Ex. 212.) As the e-mails indicate, there was some confusion regarding the price at which Harding purchased these notes. (*Id.*) The correct pricing information is as follows:

- January 26, 2007, 11:21 AM: Merrill Lynch confirmed Harding's Norma purchase: $20 million of Norma's BBB-rated notes at 100.00 / par (or no coupon). (*Id.*)
- January 26, 2007, 11:26 AM: Xilun Chen forwarded Merrill Lynch's e-mail to Wing Chau expressing his confusion that it listed their purchase price as par. (Div. Ex. 207.)
- January 26, 2007, 1:11 PM: Wing Chau replied to Xilun Chen that Harding had not purchased these notes at par, but at "full coupon." (*Id.*)
- February 2, 2007, 10:08 AM: Merrill Lynch e-mailed Harding a revised confirmation listing the correct price at which Harding purchased these Norma

securities: $20 million of Norma's BBB-rated notes at 97.00 / 505 discount margin (or full coupon).[297] (Div. Ex. 212.)

The original spread for Norma's BBB-rated tranche, as listed in the pricing information circulated by Merrill Lynch on January 9, 2007, was the three-month LIBOR interest-rate plus a discount margin of 385 (or an additional 3.85% interest). (Div. Ex. 190.) In late January/early February 2007, Harding purchased these securities on behalf of Neo and Lexington V at the three-month LIBOR interest-rate, plus a discount margin of 505 (or an additional 5.05 percent interest). (Chau 4213:24-4215:5; Div. Ex. 212.) This price was the full coupon rate, or the maximum return offered on this tranche of Norma. (Chau 4213:24-4215:5.) This price represented a benefit for the investors of Neo and Lexington V, at the expense of Merrill Lynch and Magnetar.

10. February 1: Merrill Lynch cut Harding's allocation of Norma BBB-rated notes from $20 million to $15 million, leaving Respondents with a $5 million gap to fill in the portfolios of Lexington V and/or Neo.

On February 1, 2007, Merrill Lynch informed Wing Chau that it had cut Harding's allocation of Norma BBB-rated notes by $5 million. (Div. Ex. 210.) Harding was now to receive

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[297] The Division claimed in its Post Hearing Brief that Respondents tried to "trade out of Norma" in the spring of 2007. (Div. Br. at 98.) Mr. Chau explained in his testimony that this was not the case. He was instead simply engaging in price discovery:

> Q. If you are offering Mr. Fitzgerald Norma at 87, isn't it fair to say you actually think its real value is worse than 87?
>
> A. No. I think you have heard the term, "No bad bonds, just bad prices." So I wouldn't sell my friend and my mentor in this business a bond that I didn't think had value. Yes, the market prices dropped. We don't know where the prices are trading. And I am saying, "Here is a great bond at this price." I say, "Come on value at these prices." I anticipate this bond could right back up to par at some point, or go back to 89. I don't think it is going to continue to drop. But I am trying to determine price. If I knew what the prices were, I probably wouldn't have – back then my general recollection was there was a lot of price volatility, and I am trying to ascertain market prices for where CDO's are trading.
>
> Q. You are not saying in the email you have a sense of where the market is at for this, are you?
>
> A. I have no sense. That is why I put the offer out, to see if we can find an actual transaction that would then signify to us what price would be executed.

(Chau 1692:21-1693:23.)

$15 million worth of these securities instead of the $20 million it had requested. (*Id.*) Wing Chau responded to this news by sarcastically stating: "Now that's what I'm talking about, the love is in the air." (*Id.*) During the Hearing, the Division elicited the following testimony from Mr. Chau about this exchange:

> Q. Fair to say that the decision here to decrease your Norma Bbb allocation was made by Merrill. Correct?
>
> A. Yes.
>
> Q. And you responded back to Ms. Chao, "Now that's what I'm talking about. The love is in the air." Do you see that?
>
> A. Yes.
>
> Q. Fair to say that that would indicate that you were happy to have 5 million less of the Bbb. Correct?
>
> A. No.
>
> Q. Well, "Now, that's what I'm talking about, the love is in the air," is that an expression of unhappiness?
>
> A. I don't know what I was thinking about when I wrote that. Reading it now and given what just the chronology of e-mails you went through, it would be my – unfortunately, sarcasm doesn't translate well in e-mails. We had – going through this negotiation process, because if I wanted just to buy less, I would have just said: Just sell me whatever you want at the beginning; right?
>
> I am negotiating at every turn. Everyone is pressuring me, which is expected. I expect to be pressured. Ultimately, I come to a price that made sense for me, and said yes, now risk/reward works for me. I want $20 million. I just can't buy $20 million of CDO's without understanding where I am going to put them. I need to go find all the other CDO's I am managing, look at those investment criteria, see if the Norma tranche would fit the investment criteria. Those are defined terms and criteria. I then look to see where I can allocate the 20 million bonds.
>
> Once I have done that, I can then give a legitimate indication of interest. And once we negotiate a price and a price that is favorable, that I like and I want, you get cutback on your allocation – typically in the process of syndication, if you have an order and you get cutback, it meant that there was demand away from you.
>
> And I really had a need for 20 million bonds. I wouldn't have put 20 million if I didn't have the places to put it. I had 20 million places to go with it. The fact I now only have 15, I have to now look for other bonds to fill the allocation I needed for the other CDO's. It meant more work for me.

(Chau 1627:14-1630:15.)[298]

11. **February 2: Merrill Lynch confirmed Harding's purchase of $15 million of Norma's BBB-rated notes at a discounted price and increased spread.**

On February 2, 2007, Merrill Lynch e-mailed Harding a revised purchase confirmation that reflected its new allocation of $15 million of Norma's BBB-rated notes. (Div. Ex. 212.) Norma closed on March 1, 2007. (Resp. Ex. 890.)

B. The Discount On Price And Spread Negotiated By Wing Chau Was Beneficial To The Harding CDOs That Invested In Norma, But Detrimental To The Interests Of Magnetar And Merrill Lynch.

The wider spread Harding secured on the BBB-rated Norma securities benefited the stakeholders of Neo and Lexington V. Wider spread in the context of CDOs refers to a higher interest payment for that tranche of the CDO. (Prusko 2636:3-2636:22.) For example, if Harding had purchased Norma's BBB-rated securities at the original spread, Lexington V and Neo would have earned the three-month LIBOR plus 3.85% in interest. Because Harding purchased these same securities at a wider spread, the stakeholders for Lexington V and Neo earned the three-month LIBOR plus 5.05% in interest. In other words, a wider spread on the BBB tranche of Norma added more income to the waterfalls in Lexington V and Neo, benefiting everyone in those deals. (*See* Prusko 2653:24-2654:24.)

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298 This is yet another example of the Division reading into hearsay whatever it wants. Again, hearsay alone is not enough to carry its burden. And, again, the only testimony at the Hearing contradicts the Division's reading. The Division argues that the idea that the "love is in the air" comment was sarcastic was "supplied" by Mr. Chau's counsel during his investigative testimony. (Div. Br. at 92 n.163.) It is clear beyond any doubt that Mr. Chau's previous, investigative testimony on this point is very consistent: He testified then as he testified at the Hearing that he did not remember the e-mail but that he was not pleased by the cut in Harding's allocation and that the e-mail would not be expressing happiness. That is the context in which Mr. Chau's counsel suggested that the e-mail could have been sarcasm – that is what Mr. Chau was conveying in his answers without using the word. (*See* Chau 1634:14-1639:22.) Wing Chau's sarcastic nature is clearly apparent in many of the e-mails introduced at the Hearing. So much so in fact, that even the Court took note: "I think actually it is clear that [Wing Chau] sends flippant e-e-mails . . . ." (Tr. 4219:25-4220:2.)

The Division did not introduce any evidence at the Hearing that the presence of Norma securities had a negative impact on either Lexington V or Neo. There is no evidence of any negative impact stemming from the inclusion of Norma BBBs in these deals. These CDOs did not experience an event of default any sooner than their peer CDOs as a result of investing less than two percent of their collateral in Norma. (*See* Resp. Exs. 585, 748.) In fact, Lexington V did not experience an event of default until July 2009. (Resp. Ex. 748.)

The wider spread Harding secured on the BBB-rated Norma securities had a negative economic impact on the equity investor in Norma: Magnetar. Wider spread in the context of CDOs refers to a higher interest payment for that tranche of the CDO. (Prusko 2636:2-22.) Accordingly, a wider spread means that less money is left in the waterfall for the residual payments to the equity note holder, who is generally the last investor to be paid from the waterfall. (*Id.*; Prusko 2638:2-20.) Wing Chau explained this concept during the Hearing:

> Now, to the extent that those prices drift to a discount price and margins drift to a wider margin, those economic losses come out of the … equity investor and it accrues to the benefit of the investor of those debt tranches because now the investors of the debt tranches are getting higher compensation than it would have gotten if Merrill Lynch was able to drive that pricing to par at LIBOR plus 3.85. That's opportunity cost.

(Chau 4234:4-12.) In other words, "[f]or every basis point increase in the CDO liability, it's a dollar-for-dollar decrease to the equity investor." (Chau 4235:11-13.) In the case of Norma, the additional 0.65% interest collected on the BBB tranche by the stakeholders for Lexington V and Neo, resulted in a reduction in the amount of money that flowed down to Magnetar. Mr. Chau explained at the Hearing that this was the reason why he never told James Prusko that he had purchased BBB-rated notes in Norma:

> Q. Did you ever tell Mr. Prusko that you bought the BBBs?
>
> A. No, I did not.
>
> Q. Why not?

A. Because of my bargaining for a wider spread. The original price talk for the BBB bond was 3-month LIBOR plus 3.85. I wouldn't commit unless the Harding CDOs that we were investing for would receive a coupon of roughly LIBOR plus 500 basis points. So that difference in spread means that is lost income to the equity investor.

So if I had agreed to LIBOR plus 3.85, then the cost of liabilities would be much lower in the Norma CDO. Every basis point wider that I negotiated for my clients for investing in the Norma CDO, every basis points that I have widened that security is a basis point of income loss to Magnetar. I don't think they would be too happy with me knowing that I was part of pushing the pricing of this BBB tranche from 3.85 percent to a defective DM of 500 basis points.

(Chau 4235:20-4236:14 (emphasis added).) This testimony is uncontested and fully corroborated by Mr. Prusko. (Prusko 2651:17-19.)

The discounted price that Harding secured on the BBB-rated Norma securities also had a negative economic impact on the underwriter in Norma: Merrill Lynch.[299] Wing Chau explained how CDO pricing worked at the Hearing:

So as we mentioned before, the warehouse is accumulating assets and the assets are being accumulated at the then historical market prices and, for the most part, these are assets that have been acquired at par at 100 cents on the dollar. And the underwriting bank has committed, what we call firm underwriting, which means that they will firmly underwrite the CDO, that they will represent to the issuer that if you hire Merrill Lynch, regardless of market conditions, we will issue those securities and to the extent that we can't sell those securities, Merrill Lynch will buy those securities. And that's what is considered firm underwriting.

So we know that we've accumulated – we're going to accumulate roughly a billion-5 in collateral and if the market prices are at par at the time they purchased it, they would need to come up with $1.5 billion in cash at the end of the day to buy from the warehouse and put it into the trust. So in the new issue process, if Merrill Lynch cannot raise enough capital by selling these debt tranches at par, so for example they're going to sell $1.5 billion of securities which consists of super senior tranches, mezzanine debt tranches and debt equity. So they need to sell all those securities at par to come up with $1.5 billion of cash that they can then use to buy that $1.5 million of warehouse portfolio for the CDO trust.

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299 There was some discussion at the Hearing about securities sold at a discount after the CDO had priced. (Prusko 2653:24-2664:5.) In that circumstance, the Special Purpose Vehicle (the CDO) borrows the money from the underwriter, and then pays back the loan from the interest that goes into the waterfall. (*Id.*) This point is not relevant here, however, because Harding purchased the Norma notes in question before Norma closed and the price difference was born by the underwriter, Merrill Lynch.

> To the extent that they cannot sell those liabilities at par, so for example they sell the super senior tranches at 90 cents on the dollar to a debt investor, they only raised – they've lost 10 percent of the value and they would have to come up and absorb those 10 percent losses because they still had to pay a billion-5 for that portfolio. Just because they only raise $1.4 billion in the capital raise doesn't mean that the deal is not going to get done. The deal will get done because Merrill Lynch will have to advance $100 million to the trust to buy that asset.
>
> So on Merrill Lynch's book, they'll have a debt tranche and their price base cost basis will be 90 cents on the dollar. . . . And so it's very important for the underwriting bank to sell these securities at new issue and as close to par as possible because any price below par would mean a loss to the investment bank in terms of underwriting those assets.

(Chau 4231:4-4233:11; *see also* Prusko 2659:18-2660:3.) In other words, "if they cannot sell the securitization at par, every dollar price below par is a loss to Merrill Lynch." (Chau 4233:10-20.) This is why the underwriter's goal in a CDO deal is to push all of the investors towards par pricing. (Chau 4233:15-4234:12.) If all of the investors purchase at par, the investment bank breaks even. (*Id.*) To the extent that prices drop to a discount price, those economic losses come out of the investment bank's profits. (*Id.*) Here, Harding purchased Norma's BBB-rated notes for 97.00 (vs. 100.00 or par). (Resp. Ex. 890.) As Merrill Lynch had already committed to selling these securities at par, the difference – Harding's discount – came out of Merrill Lynch's pocket.

C. <u>Brett Kaplan's CDO Commentary Did Not Indicate That Harding Had An "Unfavorable View" Of Norma At The Time That It Purchased The BBB-Rated Securities.</u>

After the Norma purchases were made, on February 22, 2007, Xilun Chen asked Brett Kaplan to prepare a CDO Commentary for several CDOs that Harding was considering investing in or had committed to purchasing securities from. (Div. Ex. 216.) On February 27, 2007, Brett Kaplan circulated his Commentary for Norma internally at Harding (the "Norma CDO Commentary"). (Div. Ex. 217.) The Division's argument that the Norma BBB bonds were disfavored at Harding is predicated largely on the Brett Kaplan write-up of Norma. (Div. Br. at 92-97.) Indeed, the OIP allegations relied almost exclusively on this document as evidence that

Harding's own analysts recommended against investment in Norma. (OIP ¶¶ 60-69.) The Division tries to have it both ways: it argues both that Harding did not do an analysis and also that Harding's analysis shows that Norma was a bad investment. (*Compare* Div. Br. at 88 *with* Div. Br. at 95-97.) The evidence at the Hearing was that Harding did an analysis of Norma and came to a reasoned conclusion that, given the spread eventually offered, the BBBs were a good investment. However, while Brett Kaplan's write-up is evidence that Harding had done an analysis of Norma, it was not the basis for Harding's investment decision. It could not have been; it post-dates that decision. In addition, as discussed in detail below, the Division's claims about the content of the Norma write-up are misleading. In fact, Norma's characteristics were consistent with those of other bonds Harding bought at the time for various deals. (Chau 4138:22-4140:20; Resp. Exs. 892-96; 898-900; 904-05.) In any event, as noted, even if Brett Kaplan's analysis turned out to be as bad as the Division claims, not much could have been done at the time the analysis was prepared because Harding could not have easily removed the Norma BBBs from the warehouses for Neo and Lexington V unless the Norma bonds failed to meet the eligibility criteria for those deals. The fact that the Norma bonds met all eligibility criteria coupled with the fact that the relevant bonds had investment grade credit ratings proves beyond any doubt that there was nothing wrong with them and, as Harding determined then, they were a good and well-reasoned investment at the time.

1. The Division and its expert misinterpreted the meaning of the "writedown %" provided in the Norma CDO Commentary.

At the Hearing, the Division tried to show that the Brett Kaplan analysis showed that the BBB Norma bonds were impaired at the time of purchase because in a section on Cash Flow / Stress Runs it showed "writedown %" listed as 10.17 percent. (Div. Ex. 217.) At the Hearing, the Division pointed to a table in the Kaplan write-up and asserted that because the 10.17% write-

down in the loan collateral underlying the RMBS was higher than the 6.79% subordination below the BBB tranche of Norma, the BBB bonds had been impaired. (Chau 1663:3-1666:12.) As Mr. Chau and the Division's own expert agreed, however, the 10.17 was not the expected write-down on the Norma CDO. (Chau 4098:9-4111:6; Wagner 4382:5-4383:3; Wagner 4386:13-23.) Mr. Chau also explained at the Hearing that the 6.7% subordination was not only unrelated to the 10.17% write-down of the loan pool, but it was also viewed at the time as highly unlikely to be reached. (Chau 4098:9-4112:13.) We, therefore, thought we had debunked the Division's falsehood at the Hearing, but the Division persists in its Post Hearing Brief, claiming that Mr. Kaplan's write-up "showed that Harding's analysts were projecting that Norma's **portfolio** would be written down 10.17% . . . ." (Div. Br. at 95 (emphasis added).) Let us repeat then. This statement is false: Norma was a CDO. Its portfolio consisted of RMBS. (Resp. Exs. 269-270.) The write-down number in question relates to the deterioration in the pools of loans underlying the RMBS that composed the Norma CDO. (Wagner 4382:5-4383:3.) There is no direct relationship between the expected deterioration in the pool of loans underlying RMBS and the deterioration of the value of the CDO bonds backed up by the RMBS because of the way credit enhancements and risk redistribution absorb and redirect losses. (Chau 4067:16-4076:25; *see also* Wagner 4835:5-9.) Norma bonds, including even the BBB-, which were below the BBBs that Harding bought, were not expected to be impaired at the time of purchase. Ira Wagner explained:

> That writedown represents the underlying loans that back the RMBS securities that are rated BBB/BBB minus that ultimately is in the Norma transaction ... [The writedown percentage] **represents the writedown at the whole loan pool level, not at the tranche level.**

(Wagner 4382:5-4383:3 (emphasis added).) Mr. Chau concurred:

> Q. And so the question for you is: Do you know what the relationship is between losses experienced by these underlying bonds and losses experienced by the CDO?

A. So the losses at the pool level of loans, which is the 10 percent we had previously described, that 10 percent has a relationship to the RMBS securitization and based on diversification in the capital structure of the RMBS securitization, those losses get retransmitted and transformed in the sense that it will not have a one-to-one relationship of losses. As the loan losses at pool level as it relates to the CDO itself, there is a nonlinear relationship which is very difficult to project because the underlying loan losses because the losses that have been redistributed at the RMBS securitization level no longer has a direct one-to-one relationship to the CDO losses. The CDO losses only are created by losses at the BBB/BBB- security level.

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THE WITNESS: So, for example, at the 10 percent loss at the home loan level, typically, the BBB/BBB- securities would not be impaired.

JUDGE ELLIOT: Oh, I see what you're saying. Okay.

THE WITNESS: So based on just the average cum losses, we would expect that the BBB/BBB- would not be impaired. Therefore, there would be no losses to the CDO because the CDO only experienced losses if the BBB/BBB-securities default.

JUDGE ELLIOT: Okay.

THE WITNESS: And historically, those BBB/BBB-securities only had a 1 percent annual default rate, so the rating agencies did a very good job in analyzing the whole loan portfolio creating these RMBS securitizations that could withstand those type of losses and be able to confidently give investment grade ratings to those RMBS debt tranches.

(Chau 4089:12-4090:24; Chau 4147:1-4150:20.)

In other words, the write-down percentage did not reflect write-downs on the RMBS tranches that were collateralizing Norma. Harding's analysts were **not** projecting that Norma's **portfolio** of **RMBS** would be written down 10.17 percent. Evaluating the creditworthiness of a tranche of Norma required a different calculation than that which is reflected in the Norma Commentary.

Q. So if you want to know how Norma is going to perform, one thing that you would need to understand is the collateral inside Norma, correct?

A. Yes. This is what we did.

Q. And that consists of tranches of RMBS, right?

A. Yes.

Q. Norma doesn't contain the underlying loans themselves, right?

A. Yes. **That's why it's the second order effect**, yes.

(Wagner 4386:13-23 (emphasis added).)

In sum: Nothing in the Pitch Book for Norma or its term sheet, in other words, would indicate that any of its bonds had been impaired or were likely to become so. The percent write-down in the Norma CDO Commentary reflects the underlying loss on the pool of loans, not the CDO itself. There is not a one-to-one correlation from the loss in the pool of loans to the loss in the CDO. This figure does not mean that there was an expected 10 percent loss in the CDO, such that the BBB tranche would be wiped out. The Division's own expert confirmed as much during his testimony.[300]

2. It is important for a CDO manager to have a diverse portfolio of assets in the CDOs it manages.

In his report, Ira Wagner, an expert witness for the Division, focused on Brett Kaplan's comment in the Norma CDO Commentary: "There's quite a large percentage of deals failing surveillance tests, on the watch list, and on the do not buy list. " (Div. Ex. 8001 at ¶ 155.) This comment is misleading if not presented in the proper context. It was important for a CDO manager to have a diverse portfolio.

Diversification in the context of CDOs means that the assets that are in a CDO managed by a particular CDO manager are not identical to the assets in other CDOs managed by that

[300] Incidentally, the only possible source for the 10.17% loan level write-downs was an Intex, loan level analysis of the RMBS, meaning that Harding did perform that analysis in connection with its evaluation of the Norma bonds. (Chau 4123:14-4124:7; *see also* Chau 1640:6-1641:7.) Harding's "typical process" was to: "[A]nalyze the securities and then memorialize in a commentary. It can happen – most times it would happen after, but you could also write the commentary simultaneously even – but I expect that we would look at the offering circulars, pitch books, do our analysis and ultimately memorialize it." (Chau 1647:6-1648:5; *see also* Chau 4176:22-4181:15; 4243:15-4244:11.)

portfolio manager. (*See* Jones 2821:2-2822:23.) Investors prefer a diverse pool of assets.[301] (*Id.*) In order to accomplish this, CDO managers often invested in CDO securities backed by collateral that their analysts may not recommend for individual purchase. Wing Chau explained this during the Hearing:

> Q. … What, if any, benefit is there to that CDO if some of the assets or some portion of the assets of RMBS that are included in that CDO are RMBS that your own analysts would not have put into a Harding managed CDO?
>
> A. There I'm looking for the benefit of diversification. The whole object of investing in CDOs is to obtain investment exposure to a diversified pool of assets. If we were to just invest in only the assets that my analysts or Harding's analysts would approve, we would create a de facto 100 percent correlation.
>
> So as a portfolio manager in the context of investing in CDOs, I'm looking for a diversified pool of assets, which by definition is going to be a lot of the assets that are in the CDOs that I'm investing in will have – will not map out to the same investments that my investment analysts would have approved as direct investments.
>
> So it's a diversification, as well as looking to see what other managers are looking at investing in and learning what more about the market viewpoints of various securitization issues and loss expectation profiles.

(Chau 4142:7-4144:11; *see also* Chau 4339:3-4340:25; Wagner at 1898:18-4899:17.) In other words, in order to achieve diversification, it is necessary to invest in a wide range of assets, including those a CDO manager's analysts may not individually recommend for inclusion in a deal. Logically this makes sense. If an analyst would recommend an individual security for inclusion in a deal, it was probably already included in one of the manager's CDOs. The manager then has to go outside of what its analysts would recommend to find securities with which to diversify its portfolio. Doug Jones reiterated this concept at the Hearing:

> There was also a concern about overlap, so you didn't want to go out and buy, for example, a deal that already – that had bought a lot of stuff that you already bought, so then you own it twice effectively, so we were kind of cognizant of that, checked that …

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301 Wing Chau explained each investor's preference for correlation during the Hearing. (Chau 4118:20-4121:18.)

> Everybody was doing this at the same time, so there was that fear that people were going to have duplicate things. If I bought it and then I bought 30 percent of my deal, has other people's deals and they bought the exact same thing, well, then I've got a lot of overlap, and there were investors that were voicing concerns ... that he's just got exposure to the exact same thing. So, you know, I think there's still somewhere in the portfolio theory that says diversification is good....

(Jones 2821:2-2822:23.)[302]

In sum, in order to achieve a diverse portfolio, it was necessary to purchase CDOs that included securities that the CDO manager typically would not purchase individually. As such, it makes perfect sense that some deals would have assets found on Harding's watch or do not buy lists, just as assets that Harding particularly liked were likely on the watch and/or do not buy lists of other collateral managers.

3. The Norma CDO Commentary was not intended to be a final credit decision on Norma.[303]

Harding's CDO Commentaries were not credit decisions. These Commentaries primarily served as a tool to educate junior analysts by having them summarize information from various marketing and deal documents. (Chau 1645:8-9.) Mr. Chau explained that he also used the Commentaries as a qualitative check or a quick comparison between the CDO he was looking at and the other CDOs Harding had invested in the past:

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302 Harding also ran overlap analysis. Wing Chau provided another explanation for this work: these figures provided validation of Harding's investment decision from the market.

> The purpose was to look at the collateral that's being purchased by other investors and more to check for myself to see what other investors are investing in directly in RMBS securities and to check to see what differences there are versus what my analysts are using as investment decisions as direct investments ... It's valuable to me as portfolio manager to ascertain, from the universe of assets that's available, what investments make sense for market participants. So access a market validation for the rated securities so, for example, if we're not investing in this specific RMBS securitization directly because my analysts have a viewpoint that doesn't allow us to invest in it, this other account manager has a different investment viewpoint has invested in this security. So it's valuable to me as a portfolio manager to try to understand those differences and factor those differences into my own calculus in terms of investments.

(Chau 4142:13-4143:9.)

303 At minimum, this credit commentary is unreliable hearsay for anything other than the fact that Harding conducted a loan-level analysis of the collateral pool for Norma. It has errors on its face, *i.e.*, it listed Sailfish as the CDO manager and not NIR. (Div. Ex. 217.)

> I would look at it as a qualitative check and what we've just seen demonstrated from all the other CDOs that we invested in, they have roughly the same loss writedowns. It is more of just looking in general at a 30,000 foot level and saying, okay, these pools generate 10 to 15 percent. Some generate 50 percent. Some generate zero.
>
> What's the – I made the qualitative assessment and said, okay, if I have a pool that has 10 percent pool losses versus another pool that might have, say, 12 percent losses, I would probably pay less for those debt secured tranches for improvement of that 12 percent loss.

(Chau 4155:9-4156:14.)

In addition, Harding's CDO Commentaries did not reflect other considerations that would have been relevant to Harding's decision to purchase Norma, such as credit, eligibility criteria, volume availability, and price. (Huang 1012:21-1013:22.) Tony Huang testified that he would look at different pieces of information before approving a CDO for purchase, only one of which was the CDO Commentary. (*Id.*; Huang 1014:16-1015:15.) Mr. Huang described the CDO Commentaries as: "Basically a summary, a summary of analyst, you know, information that they got from reading the book. Maybe the offering circular." (Huang 1013:11-14.)

4. Other CDO Commentaries prepared by Harding around the same time as the Norma CDO Commentary show that the Percent Write-down and Percent Failing DQ Tests for these CDOs were in line with Norma.

As described above, the write-down percent is run as a qualitative check on the CDOs purchased by Harding. In other words, all else being equal, CDOs from the same time period should have similar percent write-downs in their underlying pool. Other CDO Commentaries prepared by Harding during this period show that Norma is within a similar range.

CDO	DATE COMMENTARY PREPARED	% WRITE-DOWN	% FAILING DQ TEST	PLACED INTO (HARDING DEALS)
Summer Street 2007-1 CDO	April 12, 2007	9.83%	80.51%	Adrastea, Jupiter VII, 888 Tactical, Mizuho, and Jupiter V
Norma CDO I	**February 27, 2007**	**10.17 %**	**82.83%**	**Jupiter VI, 888 Tactical, Neo, and Lexington V**
Maxim High Grade CDO II	March 12, 2007	10.21%	1.10%	Neo
Adams Square Funding II	February 28, 2007	10.59%	40.00%	Jupiter VI, 888 Tactical, Lexington III, Lexington V, Octonion, and Neo
Plettenberg Bay CDO	April 27, 2007	10.59%	77.48%	Adrastea, Mizuho, and 888 Tactical
Libertas Preferred Funding IV	April 18, 2007	12.66%	71.75%	Jupiter VI and Neo
Silver Marlin ABS CDO I	February 27, 2007	12.91%	1.80%	Neo

(Chau 4138:22-4140:20; Resp. Exs. 892-96; 898-900; 904-05; *see also* Wagner 4874:5-21 (agreeing that Norma was "middle of the pack").) These figures show that the percentages reflected on the Norma CDO Commentary were in line with the same figures on other CDO Commentaries that Harding prepared in early 2007. Among other things, this fact demonstrates that Harding did not change its investment criteria in order to accommodate Merrill Lynch and Magnetar in connection with the Norma purchases.

D. The 2007 Offering Circulars Disclosed That The CDOs Had Exposure To The Originators New Century And Fremont.

The Division theorized that Harding "disfavored" Norma in part because of its concentration of two originators, Fremont and New Century. (Div. Br. at 94.) This theory is in part based on an e-mail sent by Jung Lieu in March 2007 that disparages the amount of New

Century and Fremont in Norma. (Div. Ex. 221.)[304] However, this e-mail is irrelevant for several reasons. First, it was sent two months after Harding's purchase of Norma. To the extent Norma was approved for, met the investment criteria for, and was placed into deal warehouses, it could not be easily removed unless it failed to meet the eligibility criteria.[305] The Division's observation that some analyses showed problems with Norma after it was purchased, therefore, is a red herring. There is no allegation anywhere and no proof that the Norma bonds did not fit the relevant investment and eligibility criteria. All of the deals that received Norma notes also were reviewed by Harding pre-close and received a Harding certification that all investment and eligibility criteria were met, including that none of the securities were Credit Risk or Defaulted Securities. (Chau 4252:15-4254:10.)

More importantly however, as we demonstrated at the Hearing, this exposure to Fremont and New Century was disclosed in each of the Offering Circulars for the relevant transactions. (Chau 4436:15-4243:7; Div. Ex. 507 at 27-29; Div. Ex. 509 at 30-32.) The investors in Neo and Lexington V were thus on notice that these CDOs contained certain assets originated and serviced by Fremont or New Century and were told about the relevant risks. The Issuers, who drafted the Offering Circulars, certainly were aware of the disclosures. (Div. Ex. 507 at iii; Div. Ex. 509 at iv.)

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304 The actual concentrations of New Century and Fremont in Norma were far lower than stated in Jung Lieu's e-mail. (*Compare* Div. Ex. 217 (approximately 20 percent New Century and less than 10 percent Fremont) *with* Div. Ex. 221 (31 percent New Century and 14 percent Fremont).)

305 If Merrill Lynch approved the inclusion of the asset into the warehouse, then Harding would tell the investment bank selling the CDO that it had approval, at which point the "trade is now what we call done. . . . So once we say done, the warehouse is committed to buying the security and they cannot break that trade unless that security did not meet – materially meet the transaction terms that [were] stipulated to." (Chau 4205:20-4208:7.)

LEGAL ARGUMENT

The Division alleges two sets of violations of Section 17(a) of the Securities Act and Sections 206(1) and 206(2) of the Investment Advisers Act. The first set of allegations, relating to Harding's role as collateral manager for the Octans I CDO, alleges generally that "Magnetar's rights regarding, and role in, the selection of collateral for Octans I, were not disclosed." (OIP ¶ 54.) The OIP alleges that this was material because "investors . . . would have considered it important that an undisclosed party with interests not aligned with those of the other investors had influence over or rights regarding collateral selection." (OIP ¶ 59.)

The second set of allegations relates to Harding's purchase of certain notes of the Norma CDO.

As shown below, none of the allegations in the OIP (and none of the Division's continually evolving theories of liability) have been proven, and the evidence demonstrates that neither Mr. Chau nor Harding engaged in any misconduct. Indeed, in most significant respects, the evidence demonstrates the exact opposite of what the Division alleges.

XX. THE LAW.

A. Section 17(a).

Section 17(a) of the Securities Act makes it "unlawful for any person in the offer or sale of any securities . . .:

> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

15 U.S.C. § 77q(a) (2010).

A violation of Section 17(a)(1) requires scienter. Scienter is shown by facts demonstrating "a mental state embracing intent to deceive, manipulate, or defraud." It may also be established by recklessness, which is:

> Highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.

SEC v. True North Finance Corp, 909 F. Supp. 2d 1073, 1101-2 (D. Minn 2012).

To prove a claim under Section 17(a)(2), the Division must prove: (1) a material misrepresentation or omission of a material fact, (2) in the offer or sale of a security, for which (3) money or property was obtained. *See SEC v. Espuelas*, 579 F. Supp. 2d 461, 472 n.6 (S.D.N.Y. 2008). Section 17(a)(2) requires a "stringent connection" between the alleged misrepresentation or omission and the offer or sale of securities. *Schwarz v. Duckett*, No. 88 Civ. 5395 (MBM), 1989 U.S. Dist. LEXIS 1569, at *6-7 (S.D.N.Y. Feb. 21, 1989); *see also Pross v. Katz*, 784 F.2d 455, 457 (2d Cir. 1986).

To prove a Section 17(a)(3) claim, the Division must prove: (1) the use of a deceptive or misleading transaction, practice, or course of business, (2) in the offer or sale of a security. *See United States v. Naftalin*, 441 U.S. 768, 774 (1979) (holding that the three subsections of Section 17(a) proscribe distinct categories of misconduct); *SEC v. Patel*, No. 07-cv-39-SM, 2009 U.S. Dist. LEXIS 90558, at *20-25, 65 (D.N.H. 2009) (holding that a plaintiff may not use claims of misrepresentations as a fraudulent scheme).

A violation of Section 17(a)(2) or (3) may be proven by showing intentional conduct, recklessness or negligence. To establish negligence, the Division must show that Respondents had no reasonable basis for their actions. "Negligence in this context is not a strict liability

standard." *SEC v. Morris*, No. H-04-3096, 2007 U.S. Dist. LEXIS 101761, at *8 (S.D. Tex. 2007) (granting defendant's motion to dismiss).

B. Sections 206(1) And 206(2).

To establish a violation of Sections 206(1) and 206(2) of the Investment Advisers Act, the Division must prove that an investment adviser: (1) employed "any device, scheme, or artifice to defraud any client or prospective client" or (2) engaged "in a transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." 15 U.S.C. § 80b-6(1), (2).

A Section 206(1) violation requires scienter; a violation of Section 206(2) can be proved based on negligence.

The same elements necessary to prove a violation of Section 17(a)(1) and (3) will prove a violation of Sections 206 (1) and (2), except that Section 206(1) and (2) require that the violation be committed by an investment adviser against a client or prospective client. *See SEC v. Seghers*, 298 Fed. Appx. 319, 327-28 (5th Cir. 2008) ("The language of the anti-fraud provisions of § 206 of the Investment Advisers Act is drawn from § 17(a)(1) and (3) the Exchange Act, and conduct falling within § 17(a)(1) and (3) will fall within the analogous provisions of § 206 when committed by an investment adviser against a client or prospective client."); *SEC v. PIMCO Advisers Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 470 (S.D.N.Y. 2004) (stating that Sections 206(1) and 206(2) of Investment Advisers Act have been interpreted as substantively indistinguishable from Section 17(a) of the Securities Act).

NONE OF THE DIVISION'S ALLEGATIONS CONCERNING OCTANS I WERE PROVEN.

The Division continues to stake out factual positions that have been disproven by the evidence, and legal positions that have been rejected by the courts and by the Commission itself.

In most instances, the evidence at the Hearing completely disproved the key allegations in the OIP. In the other instances, the Division suffers from a complete absence of proof. What is left over has no legal significance.

XXI. THE DIVISION HAS FAILED TO PROVE A VIOLATION OF SECTION 17(A)(1) OF THE SECURITIES ACT.

A. As A Matter Of Proof, Fact And Evidence, There Was No Device, Scheme, Or Artifice To Defraud Anyone.

Section 17(a)(1) liability is premised on proof of a "device, scheme or artifice to defraud." 15 U.S.C. § 77q(a)(1). Scheme liability is limited to conduct involving "sham" or "inherently deceptive" transactions. *SEC v. Lucent Techs., Inc.*, 610 F. Supp. 2d 342, 350 (D.N.J. 2009). The Division's theory is that the Respondents schemed to "accommodate Magnetar's preferences [by] caus[ing] Octans I to acquire collateral that Harding's personnel disfavored" and, presumably, to hide that conduct from investors.

As we have detailed, there is no evidence of a scheme. Multiple witnesses from Harding, Merrill Lynch and Magnetar testified at the hearing. Not one witness testified that he or she participated in, knew about, understood or was asked to do anything on May 31, 2006, or any other relevant date, that was out of the ordinary, deceptive, deceitful or wrong. To the contrary, each witness testified, under oath and subject to extensive cross-examination by the Division, that he or she acted in good faith, performed his or her assigned tasks while at Harding with the best interests of Harding and Harding's clients in mind, and never once sacrificed, was asked to sacrifice, or asked anyone else to sacrifice his or her integrity.

The evidence simply contradicted the scheme allegations. Thus, no witness testified that he or she took any steps to "acquire collateral that Harding's personnel disfavored." (OIP ¶ 58.) Indeed, the evidence proves that those witnesses were testifying truthfully, because the evidence proves that Harding never did, on May 31, 2006, or any time after, acquire "disfavored"

collateral. Not surprisingly, the Division has largely abandoned that allegation. Other evidence also corroborates all of the direct testimony that there was no scheme.

First, to the extent that a scheme to **defraud** requires evidence that there be some contemplated harm, Harding's and Mr. Chau's economic interests would have made it irrational for them to have schemed to select assets that Harding itself "disfavored." Harding and Mr. Chau earned fees and hoped to establish a reputation as a sound collateral manager based on how well the deal performed in the future. All of their rational interests were aligned with selecting appropriate assets and not abdicating their role, sacrificing their standards, or any of the like.

Second, Magnetar had no interest in having Harding select assets that Harding did not like and all of the e-mails that show Mr. Prusko following up with Harding prove one thing: Magnetar wanted Harding to select assets that Harding "liked."

Third, Harding's stated motive for the scheme was to keep Magnetar and Merrill Lynch "happy." But again, the evidence demonstrates that neither of these entities – who were in the business of making money – would have been happy to have Harding lower its standards in asset selection. Moreover, the Division's post-OIP contention that Respondents never told Magnetar or Merrill Lynch that it was "accommodating" them in this manner and, so the argument appears to go, Respondents hid or concealed that Respondents were working to make them happy, is no more than a phony justification for a complete and utter lack of proof and an illogical theory of the case.

Fourth, all of the evidences demonstrates, in crushing fashion, that (a) Magnetar's economic interests were aligned with other investors in the deal in all meaningful respects, and (b) all relevant parties agreed at the time that there was an economic benefit to the deal in executing an ABX index-related trade because of the then-present arbitrage opportunity. Given

those circumstances, the evidence demonstrates that a decision to select assets from the ABX Index at the time was proof only of a plan to **benefit** investors, not defraud them.

In short, the evidence proves that there was no scheme. No sham transactions, no inherent deception, no scheme.

B. There Is No Proof Of Scienter, Particularly With Respect To Mr. Chau.

The Division cannot prove scienter.

First, because there was no scheme to defraud, there is no way the Division can prove intent by either Respondent to "employ" such a scheme or device. If anything, there was a scheme to select ABX Index assets quickly while the arbitrage opportunity existed and they could be obtained for a better than usual relative value so that the deal could profit. Second, all of the testimony, and all of the reasonable inferences that can be drawn from the testimony, are that neither Mr. Chau nor Harding knowingly, intentionally or recklessly did anything wrong, much less engaged in a scheme to defraud. Nonetheless, a few additional points are in order.

1. Mr. Chau had no meaningful role in the selection of the ABX Index assets.

The Division's entire theory is centered upon the allegation that Harding compromised its independent judgment to accommodate trades, *i.e.*, ABX Index assets that were otherwise allegedly "disfavored" within Harding, because this had been requested by Magnetar.

But Mr. Chau had little if any involvement in the process of selecting ABX Index Assets for the Octans I warehouse on May 31, 2006.

2. All of the witnesses deny that Mr. Chau requested anyone to lower their standards.

There is no evidence at all indicating that Mr. Chau asked, requested, solicited or directed Mr. Huang, Ms. Lieu or anyone else to lower their standards or to otherwise approve any more ABX Index assets than they would normally approve. To the contrary, all of the evidence

demonstrates that he paid very little attention to what Mr. Huang, Ms. Lieu, Mr. Kaplan, Mr. Lee, Ms. Wang, Ms. Moy and the others at Harding were doing concerning the review and approval of ABX Index assets on May 31, 2006.

He had good faith reasons to trust others: he had hired these competent and qualified people to do their jobs, and he was justified in believing that they were doing the job that he had hired them to perform.

3. The assets were never "disfavored."

There was nothing about the assets that were selected that would have, or could have, indicated to Mr. Chau that anything was amiss at Harding. The ABX assets selected by Ms. Lieu on May 31, 2006 were among the most liquid and well known assets in the market, were assets that Harding was already reviewing anyway, and were repeatedly selected and approved by Harding credit before and after May 31, 2006 for other deals. This was not a sign of trouble; it was a sign of business as usual.

4. Mr. Chau never saw the Kaplan May 31, 2006 cash flow runs until years later.

There is no evidence, and it cannot seriously be contended, that Mr. Chau ever saw the Kaplan May 31, 2006 E-mails until the Division confronted him with them in his investigative testimony, four or more years after the events at issue. Indeed, Mr. Kaplan sent those May 31, 2006 e-mails, with the accompanying cash flow run spreadsheets, to Ms. Lieu alone, and not to Mr. Chau, Mr. Huang, or anyone else. There was no testimony that he ever saw them, or that anyone, including Mr. Kaplan, Ms. Lieu or Mr. Huang, ever showed them to him or discussed them with him.

Therefore, even if one were to accept what seems to be the Division's premise – that Ms. Lieu violated some industry standard by selecting certain of the ABX Index assets on May 31, 2006 given the Kaplan cash flow runs, Mr. Chau was unaware of it.

5. There was nothing "wrong" with the ABX Index assets.

The proof is undisputed that there was nothing "wrong," "bad," "subpar," or "inferior" about any of the ABX Index assets that were selected for the Octans I warehouse. In addition, there is no evidence that anyone ever suggested such a thing to Mr. Chau at any time, including on May 30 or May 31, 2006. There is, therefore, nothing about those assets themselves that should have or would have given him a basis for concern or suggested a need for him to pay extra attention, even assuming he had studied them at the time (which he did not, until he did the pre-closing work necessary to confirm that they fit the deal's Eligibility Criteria).

6. There is no evidence that anyone suggested to Mr. Chau that more time was needed.

As noted above, both Ms. Lieu and Mr. Huang testified that Ms. Lieu had sufficient time to review the ABX Index names during the almost 24 hour period covering May 30-31, 2006. The Division's expert, Mr. Wagner, conceded that one day would be sufficient to perform the analysis (Wagner 4756:16-17), and the evidence shows that other collateral managers (of "national standing") also promised Magnetar that they could review the ABX Index within a day and make selections. (Resp. Ex. 514.)

Notwithstanding the Division's insistence on this point, the actual evidence fails to show that Ms. Lieu, at the time, expressed a need for more time to review the ABX Index assets and make selections. Given that Mr. Huang was an experienced portfolio manager and he was supervising the project and had the discretion to grant Ms. Lieu more time if he or she believed she needed it, given that Ms. Lieu was a qualified analyst and did not ask for more time and has

always maintained that she had no need for more time, and given that the job could be done effectively in that amount of time, there is no evidence to support a finding that Mr. Chau somehow knew or should have known that there was something wrong with the way Mr. Huang and Ms. Lieu were performing their jobs.

7. The inferences that the Division suggests are contradicted by the evidence and implausible.

Nonetheless, the Division argues that the Court should draw "the obvious inference" that Mr. Chau, on May 31, 2006, "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," because "Magnetar was a critically important constituency for Chau and Chau was in charge of that relationship." (Div. Br. at 111.)

The Division's conclusory assertion would hardly merit further discussion, except that it is belied by the actual evidence. The Division suggests:

- Chau "knew" that the review's results on May 31, 2006 were "at least partially negative." (Div. Br. at 112.) That is false. As shown, there is no evidence that he saw any of the cash flow runs on May 31 suggesting "negative" results.
- "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 . . ." (Div. Br. at 112.) The actual evidence from the time, however, is an e-mail showing that Ms. Lieu and Ms. Moy *decided on their own* in late May to adjust their assumption to 6 percent cumulative losses. (*See* Resp. Ex. 267 (which reads, "Jamie and I [Jung Lieu] already decided yesterday that everything will be run at 6 percent . . ."); Lieu 3623:4-3625:21 and 3635:19-3636:5.) The e-mail does *not* say, "As Wing instructed us, we are now running at 6%." In any event, the evidence shows that the 6 percent assumption decided upon Ms. Lieu and Ms. Moy was conservative, not relaxed.

In sum, there is no evidence that Mr. Chau had any reason on May 31, 2006 to know or suspect that there was anything to be concerned about relating to Ms. Lieu's review of the ABX Index assets. In fact, the evidence shows that, while he may have sent and received some e-mails on May 31, he was not fully engaged with Harding business on that day. His wife had given birth

to their second child on May 26 and, on June 1, Mr. Chau wrote to Mr. Prusko, ". . .back in the saddle, let's chat this AM when you're free. . . ." (Div. Ex. 88; Chau 4439:4-25.)

XXII. THE EVIDENCE DOES NOT ESTABLISH A VIOLATION OF SECTION 17(A)(2) OF THE SECURITIES ACT.

To prove a claim under Section 17(a)(2), the Division must prove: (1) a material misrepresentation or omission of a material fact, (2) in the offer or sale of a security, for which (3) money or property was obtained. *See Espuelas*, 579 F. Supp. 2d at 472 n.6. Section 17(a)(2) requires a "stringent connection" between the alleged misrepresentation or omission and the offer or sale of securities. *Schwarz v. Duckett*, No. 88 Civ. 5395 (MBM), 1989 U.S. Dist. LEXIS 1569, at *6-7 (S.D.N.Y. Feb. 21, 1989); *see also Pross v. Katz*, 784 F.2d 455, 457 (2d Cir. 1986) (same).

There can be no Section 17(a)(2) liability here for a variety of reasons. First, there were no ***material*** omissions or misstatements in the Offering Circular or in the Pitch Book. Second, to the extent there were any omissions or misstatements made anywhere, they were not made "**in the offer or sale of a security**." Third, the Division alleges, but does not meet its burden of proof, that either of the Respondents "knew or were reckless in not knowing" of the alleged misstatements and omissions in the Offering Circular. To the contrary, all of the evidence makes clear that the misstatements at issue were immaterial and/or honest mistakes. Fourth, the Division's newly fashioned allegations concerning allegedly false statements in the Pitch Book, while meritless because the statements are not actionable, were in any event never approved by the Commission and should be ignored or rejected on that basis alone.

A. Neither Merrill's Misstatement About The Number Of Parties To The Warehouse Agreement, Merrill's Non-Disclosure Of Magnetar's Unexercised Warehouse Rights, Nor Any Of The Other Newly Alleged Misstatements Or Omissions Establishes A 17(A)(2) Violation.

The Division's alleged misstatements and omissions regarding collateral selection for Octans I are stated in the OIP at paragraphs 54 through 59. In short, the Division alleges two misstatements and one omission in the Offering Circular and an omission in the Pitch Book. As to the Pitch Book, it alleges "the Pitch Book . . . described Harding's investment approach and credit processes, but said nothing about Magnetar's control rights and actual influence over the Octans I portfolio." (OIP ¶ 55.)

As to the Offering Circular, it alleges, correctly, that the Offering Circular is incorrect when it describes the Warehouse Agreement as a contract between two parties: Harding and Merrill. The Warehouse Agreement, of course, was a three-party agreement among Merrill, Harding and Magnetar.

Next, the OIP also alleges, correctly, that the Offering Circular neglects to mention or describe any of Magnetar's rights under the Warehouse Agreement.

Finally, the OIP alleges that the standard of care representation in the Offering Circular was false because the Respondents, "in order to accommodate Magnetar's preferences, caused Octans I to acquire collateral that Harding's personnel disfavored." (OIP ¶ 58.) Again, according to the OIP, the only reason that any of the alleged misstatements and omissions should matter is because of the alleged corruption of Harding's processes by a party (Magnetar) that had different interests than other investors.

1. The evidence at the Hearing disproved the Division's basic premises.

The OIP sets forth the two key premises upon which the Division's materiality arguments are based. Because the evidence and facts actually *disprove* these two fundamental underpinnings, the Division's case is revealed for what it really is: much ado about nothing.

a. ***The Division failed to prove that the ABX Index assets were disfavored.***

The OIP's allegations relating to violations by Respondents of the standard of care in the CMA turn on whether Harding selected assets that it, in fact, "disfavored." Thus, the OIP specifically and expressly states that the "standard of care representations" in the CMA and Offering Circular "*were materially false and misleading in that* Chau and Harding, in order to accommodate Magnetar's preferences, *caused Octans I to acquire collateral that Harding's personnel disfavored*." (OIP ¶ 58 (emphasis added).)

But the evidence overwhelmingly proves the opposite. It demonstrates that Harding did not "disfavor" any of the assets that were selected for Octans I. The allegations contained in the OIP must therefore fail for the simple reason that the OIP's factual predicate – that the assets were "disfavored" – was conclusively disproved. In short, the evidence proved that Harding selected for Octans I the exact same types and names of assets, including the same types and names of ABX Index assets, that it would have and did select for other deals at the time.

Given those facts, it would have actually been *false* to tell investors in Octans I that "Harding . . . caused Octans I to acquire collateral that Harding's own personnel disfavored." (OIP ¶ 58.)

Because the thrust of the Division's case is that they were not getting a normal Harding deal with normal Harding assets and they had a right to be told about that, the evidence

demonstrating that Octans I was just like any other deal that Harding managed proves that there was nothing to disclose.

b. *Magnetar was long Octans I at all relevant times and had no material conflict of interest with other noteholders.*

The second basis for materiality in the OIP is the so-called "misalignment" between Magnetar's interests and the other investors. Thus, the OIP states specifically, "Investors in the securities of Octans I *would have considered it important that a party with interests not aligned with those of other investors* had influence over or rights regarding collateral selection." (OIP ¶ 59.) But again, the proof at the Hearing demonstrated that Magnetar's interests were fully aligned with every investor in all material respects. To the extent Magnetar had any economic interests in Octans I that was "not aligned" with the interests of other Octans I noteholders, it was only to the extent that the interests of investors who own notes that are in different tranches can *never* be aligned.

The Division suggests, however, that because Magnetar's *general strategy* was to be market neutral, it therefore had different interests in Octans I than other investors. But regardless of Magnetar's general strategy or overall world view, the facts and the evidence *in this case* prove plainly that Magnetar was a *net long investor in Octans I during the entire relevant period of time*. All else being equal, Magnetar would have no rational reason to lose its equity investment in Octans I any more than any other investor would have wanted to lose their investment.

As we describe elsewhere, the Commission has recognized that bona fide hedging strategies do not cause a material conflict of interest to arise. Because Magnetar did not have a material conflict of interest with other investors, and because any "misalignment" of interests was immaterial, the fact that it may have had certain rights to object during the selection of assets

– rights that it never exercised, by the way – could not have been a material fact that needed to be disclosed.

2. The evidence at the Hearing, the Commission's own public pronouncements, and the cases all demonstrate that normal everyday "non-alignment" is neither material nor sufficient to trigger any duty of disclosure.

A "non-alignment" of interests or "differing interests" between a party with warehouse rights and other investors is not sufficient to trigger a need to disclose the fact of that party's warehouse rights. The Division's own witness at the Hearing testified, consistent with common sense, that there is no need to disclose the participation of every party in the normal give-and-take of asset selection for a CDO.

Thus, it is industry practice for the underwriter of a CDO who takes the warehouse risk to have some role in the accumulation of assets because of the financial risks that party faces. Mr. Huang made this clear when he testified in response to questions from the Court and the parties that the "underwriter" "always" has a veto over assets going into the warehouse because "if it is a billion dollar deal, you could potentially lose a billion," "if the deal for some reason doesn't materialize and the market goes against you, you will take the losses because you are on risk," so "it's common because if you have the risk, you have the rights." (Huang 1269:7-1271:15.)

The evidence also demonstrated that there was no need to disclose, explain, specify or discuss the details of Merrill's warehouse rights in Octans I. This is because there is no need to spell out for investors all of the communications and back-and-forth that take place between the collateral manager, who is selecting the assets, and the party taking warehouse risk, even where that warehouse party has interests that are different from the investors.

Division witness Ken Doiron explained that in the Wadsworth CDO, for which he and his HIMCO team served as collateral manager, he felt no need to disclose anything to investors about his interactions with Morgan Stanley, the underwriter in that CDO. Indeed, Doiron explained that Morgan Stanley had different interests than the investors. It wanted to use the CDO to place some assets that were on its books, wanted to get the deal ramped and sold more quickly and regularly pushed HIMCO to move faster and to approve more assets more quickly. Morgan Stanley had the warehouse risk and stood to earn substantial fees for distributing the deal to investors. It wanted those fees and wanted them quickly, it wanted to push assets off of its books and into the deal and it also had control over portfolio, given its warehouse rights. Doiron testified that the discussions concerning asset selection were so contentious that, at the end of the deal, Morgan Stanley gave the HIMCO team a set of boxing gloves, as a symbol of the battles that the parties had waged between each other.

But notwithstanding that Morgan Stanley had an absolute veto over HIMCO's asset selection, notwithstanding that Morgan Stanley regularly suggested assets that it wanted (for its own selfish business reasons) in the deal and HIMCO regularly reviewed and selected from those assets, and notwithstanding that Morgan Stanley had interests that were "different" from and "not aligned" with the interests of investors in the CDO, Doiron testified that his statement in the Wadsworth pitch book that "HIMCO selected the assets" was true and there was no need to mention Morgan Stanley's control rights. Indeed, he testified Morgan Stanley's control rights did not need to be disclosed even though he knew and expected Morgan Stanley would be protecting itself by putting on significant hedges or short positions on the assets. (Doiron 1989:18-1991:16; 2009:21-2010:21.)

The only way to reconcile Division witness Ken Doiron's testimony that it was perfectly truthful to say that "HIMCO selected the assets" with the actual truth – which is that HIMCO and Morgan Stanley selected the assets – is to understand industry practices and materiality. There was no need to describe Morgan Stanley's rights so long as it did not have *adverse interests* from investors.

That is why investors Michael Edman and Doug Jones each testified that they might be interested in knowing who the equity owner was and they might be interested in knowing if the equity owner had warehouse rights, but it would not have been important to their investment decision. (Edman 2537:9-2539:3; Jones 2832:6-22.) *See In re Morgan Stanley Info Fund Sec. Litig.*, 592 F.3d 347, 366 (2d Cir. 2010); *quoting In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) ("[A] corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact.")

Indeed, Mr. Doiron's testimony is clear that he would only view information about another party's participation in asset selection as important if that other party had a "*different agenda*." (Doiron 1929:22-1930:7.) And given his own view that Morgan Stanley's control over asset selection did not need to be disclosed in Wadsworth, that "different agenda" would have to be more than a simple desire to ramp more quickly, reduce risk by hedging investments and select assets that can be more easily hedged or that the third party might prefer.

In short, Morgan Stanley's "differing" interests and "non-aligned" interests were not sufficient for Division witness Ken Doiron in the Wadsworth CDO to worry about disclosing as it pertained to asset selection.[306] This is consistent with the case law, with the evidence

[306] Indeed, Merrill Lynch also had warehouse rights in Octans I, including a right to veto assets, but the Division has never claimed that any of the disclosures in Octans I were misleading or incomplete because Merrill's warehouse rights and role in asset selection were not disclosed.

concerning the opinions that the Division hired Mr. Wagner to provide in the *Tourre* case, and with the positions the Commission has taken in other contexts, which make clear that if there is a duty to disclose, it is only triggered where there is an *actual conflict of interests.*

a. *The key to materiality in Tourre was that Paulson was betting the deal would fail.*

Remarkably, the Division cites *SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147 (S.D.N.Y. 2011) (the "*Fabrice Tourre* case" or "*Tourre*"), for the propositions that "a CDO manager's processes, analysis, independence and integrity matter" and that courts have held that "misrepresentations concerning the *process* of selecting CDO collateral were material." (Div. Br. at 111, n.184.)

Whatever else the *Fabrice Tourre* case may stand for, it most certainly does not stand for the propositions that statements in a *Pitch Book* about a collateral manager's "integrity" and "processes" are material. What the case actually stands for, along with all of the other authority on this point, is that the only way that a third party's role in asset selection might become material is when that third party is economically interested in the deal failing and therefore has "adverse" interests. Thus, in *Tourre*, Judge Jones repeatedly stressed that the key material fact that drove the analysis for the case was that Paulson – the hedge fund that actually selected the assets during give-and-take meetings and discussions with the collateral manager – was *not* purchasing the equity. Because Paulson was *not* purchasing the equity, it was selecting assets that it wanted to *bet against* and its economic interests were therefore *contrary, adverse and opposed* to the interests of the other investors in the deal, because Paulson was only interested in the deal *failing*. Thus, Judge Jones focuses on:

- "Goldman and Tourre knew . . . it would be hard to market and sell the liabilities of a synthetic CDO if they disclosed that a *short investor* (i.e., Paulson) played a significant role in selecting the portfolio." 790 F. Supp. 2d 147, 150. Here,

Magnetar was not a *short investor* and there is no allegation or proof that it ever occurred to anyone that it would be hard to market the deal if it was disclosed by Merrill that Magnetar had warehouse rights (that it never exercised) and planned to hedge its $94 million, first loss equity investment.

- "According to the SEC, Goldman and Tourre misled ACA into believing Paulson was *investing in the equity* of ABACUS and *thus shared a long interest with CDO investors.*" 790 F. Supp. 2d at 150. Here, not only did Harding believe Magnetar was investing in the equity, it was true, and Magnetar retained its long equity position.

- Over the course of two months, "through a series of e-mails and meetings, Paulson and ACA agreed . . . on a reference portfolio of 90 RMBS." Because it was not to be a managed deal, ACA was identified as the "Portfolio Selection Agent" and not the "Collateral Manager." Tourre told investors in terms sheets, marketing materials and the offering circular that ACA selected the assets, but wrote in internal Goldman e-mails that the portfolio was selected by "ACA/Paulson." 790 F. Supp. 2d at 150-52. Here, Harding selected the assets and the evidence at the Hearing showed that *none of the people responsible for asset selection at Harding (Ms. Lieu and Mr. Huang) were even aware that Magnetar had any rights or role in the warehouse agreement.* In addition, Harding did not prepare or use any of the marketing material containing statements concerning the warehouse agreement or asset selection.

- Specifically, on the issue of materiality, Judge Jones wrote: "the crux of the SEC's allegation is that rather than being financially interested in ABACUS's success, . . . Paulson, in fact, had financial interests and expectations that were diametrically opposed to ABACUS's success. Assuming the SEC can prove its allegations, if Goldman and Tourre *represented [to ACA] that Paulson was investing in . . . equity, the fact that Paulson was, in reality, taking a short position* is a fact that "if disclosed, would significantly alter the 'total mix' of available information." *Id.,* at 162. Here, Magnetar invested in equity. There is no other reality. The fact that Magnetar reasonably intended to hedge that position by trying to limit its losses to zero – but never did execute such a hedge on Octans I – does not change the analysis.

The *Tourre* opinion is rife with additional references to the only issue that mattered in that case: the fundamental significance of the fact that Goldman and Tourre knew and understood that Paulson was a *short investor*, whose only interest in the deal was that it should fail. This circumstance drove the court's analysis.

b. ***The opinions on materiality the Division hired Mr. Wagner to provide in Tourre demonstrate that there was no materiality here – and why the Division did not ask Mr. Wagner to opine on materiality in this case.***

The Division hired Ira Wagner in the *Tourre* case to provide the following opinions, each of which directly undermines the Division's position here:

- "In the CDO market, it was reasonable and customary for a party bearing the risk of loss on the warehousing of assets prior to the issuance of the CDO to have some rights with respect to the assets that were being accumulated during the warehouse period." (Resp. Ex. 858 at ¶ 24.)

- "Further, a party that had such risk would be economically motivated to minimize its risk by utilizing its veto rights to minimize the accumulation of risky assets in the warehouse." (Resp. Ex. 858 at ¶ 24.) That is exactly what Respondents have been arguing all along.

- "[I]t was common hedge fund strategy to invest in the equity tranche of CDO and use the proceeds to simultaneously fund a short position on the same or another CDO. *What is most relevant is what Paulson's intent was in the ABACUS CDO, not what Paulson may have been doing elsewhere in the markets*, and it was reasonable for ACA to conclude that Paulson was investing in the equity, just as Magnetar . . . did in [the Aquarius CDO]." (*Id.*, at ¶ 35.) Of course, there is no dispute that Magnetar invested in the equity in Octans I. Respondents have also been arguing precisely this point. Magnetar was always long in Octans I. Whatever else Magnetar may have been doing outside of Octans I is not the issue in determining what Harding may have known about Magnetar's incentives.

- Although the defense experts cited examples, including the Magnetar/Aquarius deal, of instances in which there was no disclosure to investors of the situation where an equity investor had warehouse rights over the selection of assets during the warehouse period, Wagner wrote that those "disclosure examples from the other 24 CDOs . . . are not relevant examples because . . . [I]t is not just the identity or economic interest of Paulson, *a purely short investor purchasing protection on the ABACUS reference portfolio* that gives rise to the need for complete and accurate disclosure concerning Paulson; rather, *it is the active involvement of Paulson, a purely short investor with interests opposite to those of long investors in ABACUS, in the selection of the portfolio, which was unique and could not have been anticipated by CDO investors without specific disclosure.* [The defense expert] has identified no other CDO transaction in which a *purely short investor in the CDO's reference portfolio participated in the asset selection process."* (*Id.*, at Summary Statement of Opinions (d), p. 3-4; emphasis supplied.)

- Finally, Mr. Wagner acknowledges that every equity investor, by its nature, has differing and non-aligned interests with senior noteholders. He wrote, "*equity and*

> *senior tranche holders have differing incentives based on their different risk profiles,*" . . . [but] [u]nderlying all these considerations, however is the fact that *both the senior note and equity investors would all prefer the resulting portfolio to perform well, with lower levels of defaults and losses, as opposed to a purely short investor that would profit when defaults and losses increase.*" (*Id.*, at ¶ 38-40.) Once more, this is precisely the point Respondents have been making from the start.

In short, the entire basis for Mr. Wagner's opinion in *Tourre* that there was a need for disclosure in that case – unlike in the ordinary case such as Aquarius (and Octans I), for that matter – was that it was "**unique**" that "Paulson's interests were **directly opposite** to those of investors" because Paulson was "purely short" and "was looking essentially for the RMBS that had the highest probability of loss and being written off, " yet Paulson "worked with" ACA "over [the course] of weeks to agree on a reference portfolio," and thereafter "had a continued active role in the selection of the portfolio, including vetoing names suggested by ACA and suggesting other names for inclusion in the final portfolio" that "Paulson thought would be the worst performing." (*Id.*, at ¶¶ Summary Statement (d), 13, 16 and 19.)

Wagner also makes clear that simple "misalignment" of interests is not material because, in his words "both the senior note and equity investors *would all prefer the resulting portfolio to perform well . . . as opposed to a purely short investor* that would profit when defaults and losses increase." (Resp. Ex. 858 at ¶ 40.)

c. ***At the Tourre trial, the Division made clear that hedging by an equity investor who participates in asset selection does not trigger materiality – it is only when the party selecting assets is short.***

At the *Tourre* trial, the Division closed the loop. There, the Division took the affirmative positions that (a) it was common for equity investors to have input into assets that went into a CDO portfolio, (b) it was common for equity investors to hedge their long equity position by shorting some portion of the capital structure of the same portfolio and (c) there was no need for

disclosure of the equity investor's role in asset selection, even where it hedged, unless that equity investor had economic interests that were adverse or opposed to the interests of other investors. *Tourre*, No. 10 Civ. 03229 (Apr. 16, 2010).

d. *The Commission's Proposed Rule 127B is precisely on point and also independently disproves materiality.*

Proposed Rule 127B also reflects the Commission's deliberate and studied view that only actual conflicts of interest that motivate adverse asset selection would be material to investors. The actual wording of Proposed Rule 127B could hardly be more germane to this case. It bears brief repeating: the Commission opined on the materiality issues that might arise in a situation in which a third party (like Magnetar) that invests in a deal (like Octans I) and also selects assets for the deal, but also hedges its long position by taking a short position on the same deal. The Commission wrote that this situation *does not present a material conflict of interest* under *Basic v. Levinson* and *TSC* and *does not require disclosures to investors*. Rule 127B Release at 73 – 75; *see also id.* 37-38.[307] The only way such a hedging strategy would become material, under the Proposed Rule, is if the third party (such as Magnetar) stands to profit more from its short position than it does from its long position or, in other words, has a net short position in the deal. The Proposed Rule is, of course, consistent with the Division's position in *Tourre* and in *Stoker* (discussed more fully below), even though in those cases the party with the role in asset selection was pure short, not net short.

The Commission's Proposed Rule makes good sense, is supported by the case law and by industry practice, and recognizes the fundamental difference between (a) hedging risk and trying to minimize exposure and (b) betting against a particular transaction. Because it draws a bright

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[307] It should go without saying that if the Commission determined that there would be no conflict, a Respondent in an enforcement proceeding cannot be held liable for intentionally, recklessly or negligently holding the same view, even if the Commission's expressed view was qualified as preliminary.

line, it is also eminently more fair and practical than the Division's tortured position in this case. Based on the Proposed Rule, the inquiry is simple: does the party with asset selection rights have a net long investment or a net short investment. If it is a net short investment, then the party's role in asset selection is a material fact that investors are entitled to the information. If it is a net long investment (like Magnetar's), there is no conflict of interest and the party's role in asset selection is immaterial.

e. ***The materiality analysis in Stoker was the same: Citigroup's $500 million naked short position and undisclosed role in asset selection made its undisclosed role material.***

The Division also cites *SEC v. Stoker*, 865 F. Supp. 2d 457 (S.D.N.Y. 2012) a number of times in its Brief. That case perfectly illustrates why an *actual conflict of interest* is required for a party's role in asset selection to be material and why the Division's ham-handed failure to prove that Magnetar was "net short" in Octans I is fatal to its case.

In *Stoker*, District Judge Jed S. Rakoff denied Mr. Stoker's motion for summary judgment and held that the Division had sufficient facts to raise a "triable issue" of material fact for the jury. (The jury ultimately found for Mr. Stoker on both of the Section 17(a) counts charged.)

- There, Mr. Stoker was the "lead structurer" or "deal manager" from Citigroup of a "CDO Squared," identified by Judge Rakoff as the "Fund"), that Citigroup *underwrote, structured, marketed and sold to investors*. 873 F. Supp. 2d at 606-608. Here, Respondents were the collateral manager that fulfilled none of those roles.

- There, Stoker was the person responsible for approving the Citigroup pitch book for distribution after reviewing it for accuracy. 873. F. Supp. 2d at 614. Here, it was Merrill's pitch book and Harding had no rights to approve for distribution.

- There, "Stoker personally made substantial edits to the Offering Circular" and was responsible at Citigroup for informing Citigroup's outside counsel if there was anything "interesting" about the CDO. 873 F. Supp. 2d at 610 and 614. Here, Harding was only responsible for the sections on the "Collateral Manager" and

had no other drafting rights. Indeed, when Harding suggested to Merrill and Merrill's counsel that the Offering Circular disclose additional facts about Magnetar's rights, that suggestion was rejected.

- There, Stoker personally *used* the pitch book, sending it to an investor with a note, "Here's a top-of-the-line CDO squared for you." 873 F. Supp. 2d at 613. Here, neither of the Respondents ever used the Pitch Book.

- There, Citigroup alternatively "selected" or "helped select" twenty-five synthetic assets for inclusion in the portfolio and took a $500 million "naked" short position on those twenty-five assets. The deal "also contained twenty-four synthetic assets that Citigroup did not select" and Citigroup did not take short positions on any of those other assets. 873 F. Supp. 605 at 609. Here, the evidence demonstrates that Harding selected all of the assets after "agree[ing] to the concepts of acquiring exposure to the ABX Index and excluding from that exposure" whatever bonds that Harding would decide to reject. (OIP at ¶ 35.) In any event, Magnetar was, at all times, net long in Octans I.

- There, Stoker was responsible for the portions of the Offering Circular that made "repeated references to CSAC's [the collateral manager] selecting the assets," but Stoker knew that was false and had written in internal Citigroup e-mails that "CSAC agreed to terms *even though they don't get to pick the assets.*" 873 F. Supp. 2d at 611-12. Here, again, Harding did "select" the assets (*see, e.g.*, Huang 1274:6-12; 1276:9-1277:7), and Respondents were *not* in any event responsible for the one statement in the Offering Circular that said that the assets were selected by Harding.

- There, Citigroup's trading desk had asked Stoker to put the deal together so that Citigroup could short assets in a proprietary trade (using its own money) and "Stoker understood that if Citigroup picked synthetic assets for inclusion in a CDO for the purpose of purchasing protection on [shorting] those assets, it was likely that Citigroup wanted those assets to perform poorly." 873 F. Supp. At 609. Here, to the extent Magnetar had any role or influence whatsoever in asset selection, it was that Harding reject assets that it did not like and move quickly on the ABX Index selection while the prices were right to make money for the deal.

- There, Stoker personally "prepared models showing the **potential profits to Citigroup from shorting specific assets** into the CDO squared" and "was actively involved in the discussions of which assets to include in the Fund and which **assets to short**." 873 F. Supp. 2d at 615. Here, although the Division takes issue with Harding's work on May 31, 2006, it is undisputed that Harding was still trying to pick good assets.

- There, Stoker actively hid from the collateral manager the fact that Citigroup **was betting that the assets would fail.**" 873 F. Supp. 2d at 615. There, the Division's expert testified that "the 25 assets that Citigroup selected and took naked short positions on were of a lower quality than the other assets in the Fund." 873 F.

Supp. 2d at 615. Here, of course, there has never been any such allegation or proof.

- There, the evidence proved a "statistical significance" in performance of the assets at issue: "on the date the Fund was declared to be in default, six of the 25 assets selected by Citigroup were declared in default; while only two of the other 102 assets proposed by CSAC were declared in default." 873 F. Supp. 2d at 610. Here, of course, the ABX Index assets performed just as well as any other assets under the variety of scenarios that the Division's expert concocted.

At the end of the day, like in *Tourre*, the contradictions between the Division's theory and proof in *Stoker* and in this case are striking.

f. *Given the silence in the deal documents about the way assets were selected, there was no duty by Merrill Lynch or anyone else to speak about Magnetar's warehouse rights and nothing about that topic could be material.*

The duty to complete a disclosure is only triggered when the party chooses to speak on a given topic, and then the duty relates only to the topic at issue. *See In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 366 (2d Cir. 2010) (when a defendant "makes a disclosure about a particular topic," it must be complete and accurate but the party has no obligation "to disclose the entire corpus of [its] knowledge" (emphasis added)); *In re Sanofi-Aventis Sec. Litig.*, 774 F. Supp. 2d 549, 561 (S.D.N.Y. 2011) (same and collecting cases).

The Offering Circular did not address the process of selection of collateral during the warehouse and made clear that the only guidelines for the assets were that they would meet the Eligibility Criteria, the Offering Circular therefore did not need to say anything about Harding's manner of, or process for, asset selection because the issue was never discussed. Indeed, given the other plain and specifically tailored provisions of the Offering Circular making clear that investors would ***not*** be receiving any information about how "good" the assets might be, the likely level of defaults they might suffer under varying cash flow assumptions, or anything else, for the matter, about the quality or creditworthiness of the assets, or about Harding's view of

them. "Silence, absent a duty to disclose, is not misleading." *Basic*, 485 U.S. at 239, n.17; *see Morgan Stanley*, 592 F.3d at 347.

A fact is material if there is a substantial likelihood that, under all the circumstances, the fact would have assumed actual significance in the deliberations of the reasonable investor; materiality is not judged in the abstract, but in light of the surrounding circumstances. *SEC v. Cuban*, No. 3:08-CV-2050-D, 2013 U.S. Dist. LEXIS 30324, at *36 (N.D. Tex. Mar. 5, 2013). There is no duty to disclose a fact merely because it is material; rather the duty arises only where there have been inaccurate, incomplete or misleading disclosures. *True North*, 909 F. Supp. 2d at 1101. The requirement is not to "dump all known information" but to provide non-misleading information with respect to the subjects "on which he undertakes to speak." *In re K-tel Int'l, Inc. Secs. Litig.*, 300 F.3d 881, 898 (8th Cir. 2002).

Thus, the first sentence of the "Limited Information Regarding Reference Obligations" section of the Offering Circular states plainly and succinctly, in easy to understand everyday language, that **"No information on the credit quality of the Reference Obligations is provided herein."** (Resp. Ex. 2 at 52 (OC).)

The other plain terms of the Offering Circular make clear that only the Eligibility Criteria at the time of closing matter, there will be no information about the likelihood of defaults, write downs, or recoveries from any of the assets and investors need to perform that analysis themselves:

- The Collateral Manager's Certificate, Resp. Ex. 53 at 1, provides that: "Wing Chau . . . hereby certifies that . . . **he has reviewed each of the Collateral Debt Securities acquired by the Issuer on the Closing Date and confirmed that each satisfies all of the requirements in the definition of a Collateral Debt Security and the Eligibility Criteria . . ."**
- The "Acquisition of Collateral Debt Securities" section of the Offering Circular, Resp. Ex. 2 at 66, provides in relevant part: **"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."

- The "Nature of Collateral" section of the Offering Circular provides that **"Prospective purchasers . . . should consider and determine for themselves the likely level of defaults and level of recoveries on the Collateral Debt Securities and the resulting consequences on their investment in the Securities."**

In short, given that the Offering Circular was completely silent about the process by which assets had been selected during the warehouse period and given that the terms of the Offering Circular made plain that the only representations and statements that were being made were that assets met the Eligibility Criteria and that investors needed to run their own cash flow projections to determine whether the investment was worthwhile for them, there was no need to provide any information about the methods for selection of the assets. Indeed, that information would have been out of place and in conflict with the other deal terms.

"When an offering document's projections are accompanied by meaningful cautionary statements and specific warnings of the risks involved, that language may be sufficient to render the alleged omissions or misrepresentations immaterial as a matter of law." *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 768 (11th Cir. 2007) (quoting *Saltzberg v. TM Sterling/Austin Assocs.*, 45 F.3d 399, 399 (11th Cir.1995)). Here, the specific warnings and cautionary language were meaningful and tailored to the risk that the Division has identified: that an investor might otherwise be misled into believing that he or she can count on the fact that there is something that is somehow "better" about the assets that goes above and beyond the Eligibility Criteria, because Harding's selection processes during the warehouse period must have been in conformity with a "standard of care" that was designed to and resulted in Harding identifying "the best" assets that fit the Eligibility Criteria and then only selecting them.

Of course, the specific cautionary language to the effect that "***no information about the credit quality of the Reference Obligations is provided herein***"—and the fact that the only representation at all from Harding about the assets is that Mr. Chau has used his best efforts to confirm that they all meet the Eligibility Criteria—immediately and specifically renders any discussion of the "process" by which the assets had been selected for the warehouse immaterial. "A statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law." *Merchant Capital*, 483 F.3d at 767; *quoting Kaufman v. Trump's Castle Funding (In re Donald J. Trump Casino Sec. Litig.)*, 7 F.3d 357, 364 (3d Cir. 1993).

The Division argues that Respondents' arguments regarding disclaimers and disclosures in the final Offering Circular have been "repeatedly rejected" in three cases that "are on all fours with this one." (Div. Br. at 128 & n.198.) But all three of those cases applied a deferential standard applicable to motions to dismiss, none of them involved claims under the federal securities laws, and none remotely supports the Division's contention.

The first case, *Bayerische Landesbank, N.Y. Branch v. Aladdin Capital Mgmt. LLC*, 692 F.3d 42 (2d Cir. 2012) does not even address the effect that offering circular disclaimers may have on fraud claims. And for good reason: *The plaintiffs did not allege fraud*. What the Division obliquely calls "claims against manager for failure to live up to representations that allegedly induced reliance" (Div. Br. at 128 n.198) in fact consisted of two state-law claims by the CDO noteholders: (1) a claim in contract that the portfolio manager breached its obligations; and (2) a claim in tort alleging that the manager's conduct was grossly negligent. *Bayerische*, 692 F.3d at 48. In sustaining the two claims, the court specifically noted, "But this is not a claim for fraud, which pursuant to Federal Rule of Civil Procedure 9(b), would require [plaintiff] to plead with

particularity." *Bayerische*, 692 F.2d at 64. Moreover, in stark contrast to the Division's fraud claims based on conduct preceding the existence of the Issuer, the noteholders' claims in *Bayerische* were limited to the period *after* the CDO closed and the portfolio manager was appointed as investment adviser. In fact, the noteholders complained that the portfolio manager should have left the initial portfolio in place. *Id.* at 48.

The Division next cites two cases brought by affiliated plaintiffs, *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) ("*Merrill*") and *Loreley Financing (Jersey) No. 3 Ltd. v. Citigroup Global Markets Inc.*, 2014 WL 1809781 (N.Y. App. Div. 1st Dep't May 8, 2014) ("*Citibank*"), each of which alleged common-law fraud and other state-law claims. The decisions sustaining the pleadings in *Merrill* and *Citibank* highlight what is missing from the Division's case here. Among other things, the *Merrill* and *Citibank* courts found that plaintiffs alleged that (i) Magnetar actually took control of selecting assets for the investment vehicles at issue, (ii) defendants knowingly dumped toxic assets that they themselves originated into the investment vehicles, and (iii) defendants and Magnetar deliberately designed the vehicles to fail in order to reap a profit. *See Merrill*, 2014 WL 1810646, at *2-3; *Citibank*, 2014 WL 1809781, at *2-3.

Neither *Merrill* nor *Citibank* involved Harding or any of the CDOs at issue here. And neither decision analyzed claims against a collateral manager. By contrast, when the same plaintiffs brought a case against Harding and others relating to Octans II and other CDOs, their complaint was dismissed. *See Loreley Financing (Jersey) No. 3 Ltd. v. Wells Fargo Securities, LLC*, 2013 U.S. Dist. LEXIS 49665 (S.D.N.Y. March 28, 2013) ("*Wells Fargo*"). Unlike the complaints in *Merrill* and *Citibank*, the complaint in *Wells Fargo* did *not* allege that (i) Magnetar

actually gained unfettered "control" of selecting assets for the CDOs; (ii) defendants knew that even one asset selected for the CDOs was toxic; or (iii) defendants deliberately designed the CDOs to fail. With respect to Octans II, the complaint quoted from documents indicating that Magnetar (i) was looking to hedge the CDO's long bets by staking out short positions and (ii) was interested in the structure of the deal in which it was taking an equity position. *Wells Fargo*, 2013 U.S. Dist. LEXIS 49665, at *32-35. Those allegations, however, failed to plead fraudulent misrepresentations or omissions, resulting in dismissal of the complaint. *Id.*

3. The Note Purchasers' rights were cabined by the terms of the Offering Circular and the relevant deal agreements: Note Purchasers received exactly what they were told to expect.

a. *The Offering Circular correctly described the notes and the collateral but said nothing about how the collateral would be selected or sourced.*

Based on the detailed specific provisions in the Offering Circular, which the highly sophisticated investors agreed to, the Note Purchasers received exactly the benefit of their bargain and could not have been defrauded. *See Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 939 (2d Cir. 1998). *Independent Order of Foresters* dealt with the offer and sale of the same type of securities as in this case, collateralized mortgage obligation derivative securities. *Id.* at 936. The defendant in that case was alleged to have made negligent misrepresentations during negotiations, or what the SEC terms the "sales process," leading up to the sale. *Id.* at 935. Some of those alleged misrepresentations were contained in sales brochures and in what appears to have been a pitch book, a document containing the description of the underlying assets, called "Derivative Portfolio." *Id.* at 937-38. One of the core factual allegations was that the securities "did not perform as promised or as falsely represented by [the defendant] in the sales brochures and a 'Derivative Portfolio' that it used in marketing." *Id.* at 937. The Second Circuit explained at length the general process for marketing these

securities: a) the defendant would develop "a possible structure for the investment," and b) the defendant "gauged customer interest in the investment by preparing and circulating brochures to potential buyers." *Id.* at 938. Like the present case, "the brochures predated the actual creation of the securities," "[t]he fact that a brochure had been prepared for a security did not guarantee that the security would be created or that it would be created as described," and if the defendant "decided to go ahead and create the security, it produced an Offering Circular or Prospectus." *Id.* at 938. As such, the Second Circuit held:

> Viewing the negotiations as a whole, we conclude *as a matter of law* that the Offering Circulars and Prospectuses constituted the first communications between the parties having the requisite degree of specificity and definiteness to constitute valid offers . . . . Thus, the Offering Circulars and Prospectuses, and not the Brochures, define the consummated buy-sell agreements between the parties. The Offering Circulars and Prospectuses do not contain any warranties and expressly disavow any outside misrepresentations. Representations made in the Brochures and Portfolio, therefore, could not constitute enforceable warranties incident to contractual agreements between the parties.

Id. at 939 (emphasis added); *see also Banco Espirito Santo de Investimento, S.A. v. Citibank N.A.*, No. 03 Civ. 1537 (MBM), 2003 U.S. Dist. LEXIS 23062 (S.D.N.Y. Dec. 29, 2003).

Banco Espirito Santo was brought by a plaintiff who had invested in two structured-finance funds marketed and later managed by Citibank. *Id.* at *1. The plaintiff claimed that it had invested in both funds based on statements made orally by employees of Citibank during marketing meetings and in writing in two investor presentations. *Id.* at *5-6. The plaintiff sued, in part, based on breach of contract. *Id.* at *1. In his dismissal of this claim, Judge Mukasey concluded:

> The disclaimers in the marketing presentations, the Offering Memoranda, and the letter of intent "constitute objective signs" of Citibank's "expressed intentions" not to be bound by any statements outside the Offering Memoranda. Citibank gave BESI "forthright, reasonable signals that it meant to be bound only by a written agreement" and that the binding written agreement would be the Offering Memoranda for the Captiva funds. It is

> no proper exercise of authority for this court to frustrate that intent, particularly given the "level of investment and complexity" of the dealings at issue.

Id. at *15 (internal citations and quotation marks omitted).

The investors in Octans I received exactly what they bargained for. They bought and received notes, which entitled them to a future stream of payments based on the performance of certain collateral assets. The collateral assets were identified for the investors and investors were told that they were expected to determine for themselves whether such collateral assets meet their investment objectives. They paid a price that they believed was fair and which is not alleged to be unfair or unreasonable. They obtained the collateral management services of Harding and there is no allegation that Harding failed to execute its services after closing in a faithful and proper manner. Because the "manner" or "process" that Harding used to pick the collateral assets for the warehouse, before the deal closed, was not part of the consideration for the deal, there can be no fraud based on distinctions in how Harding picked the assets.

In other words, sophisticated investors paid a fair price for a specifically defined, carefully cabined bundle of rights to ownership of a collateral pool that met certain specific characteristics. They were given no representations in the Offering Circular about the process by which collateral had been selected. They were, therefore, neither deceived nor defrauded about what they were getting and they got exactly what they were told to expect. *See AUSA Life Ins. Co. v. Ernst & Young*, 39 Fed. App'x 667, 671 (2d Cir. 2002) ("[T]he purpose of the laws prohibiting securities fraud is to restore to a defrauded individual the 'benefit of the bargain.'"); *accord Chem. Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984) ("The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions – to make sure that the buyers of securities get what they think they are getting . . . ."), *cert. denied*, 469 U.S. 884 (1984); *see also United States v. Starr*, 816 F.2d 94, 98 (2d Cir. 1987) ("[In a fraud

case,] the harm contemplated must affect the very nature of the bargain itself. Such harm is apparent where there exists a discrepancy between benefits reasonably anticipated . . . and actual benefits [received.]" (citation and internal quotation marks omitted)); *U.S. v. Regent Office Supply Co.*, 421 F.2d 1174, 1182 (2d Cir. 1970) (finding no scheme to defraud where the misrepresentation was collateral to the sale and did not concern the quality or nature of the goods being sold and there was no discrepancy between benefits reasonably anticipated and actual benefits received).

b. *The Standard of Care provision contains only a promise – which Respondents met – to engage in future conduct.*

The Division suggests "the standard of care disclosure" in the Offering Circular was misleading because, in the Division's words, "it suggested to investors, during the ramping of the transaction, that the selection of the warehouse portfolio, and the decision to commit the CDO to acquire it, had been made in accordance with the standard of care, when that was not true." (Div. Br. at 122.)

Putting to the side that this argument fails because it flies in the face of all of the other deal terms described above, it fails for another reason as well: it is contradicted by the actual words of the provision, which came into effect on September 26, 2006 and which by its plain terms only governs what Harding would prospectively do ***in the future,*** after closing.

The Division relies specifically on the "Standard of Care and Limitation on Liability" provision at pages 196-197 of the Offering Circular, Respondents' Exhibit 2. That provision states in relevant part that: "The Collateral Manager ***shall***, subject to the terms of the Collateral Management Agreement and the Indenture, ***perform its obligations*** thereunder (including with respect to any exercise of discretion) with reasonable care . . ." (Resp. Ex. 2 at 197.) The rest of the provision also speaks in terms of future conduct by Harding.

Harding's obligations under the CMA, described generally in this Offering Circular provision, only came into existence months *after* the May 31, 2006, ABX Index asset selection and months *after* those assets were actually purchased for the warehouse on or about June 8, 2006. The plain and unambiguous reading of the provision is that it concerns Harding's management of the deal after September 26, 2006 and *post-closing*.[308]

The law concerning an alleged failure to carry out a promise, as opposed to a false statement of then-existing fact, is well-established: "*The failure to carry out a promise made in connection with a securities transaction is normally a breach of contract.* It does not constitute fraud unless, when the promise was made, the defendant secretly intended not to perform or knew that he could not perform." *In the Matter of OptionsXpress, Inc.*, AP File No. 3-14848, Release No. 490, 2013 SEC Lexis 1643, *232-33 (June 7, 2013) (Murray, ALJ) (emphasis added) (quoting *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993)).

The Division faces at least three factual circumstances that are fatal to its 17(a)(2) claims based on the standard care of provision in the Offering Circular. First, it bases its violation of the standard of care on a theory that the actual violation occurred on May 31, 2006, but the relevant standard of care provision was not in place at the time. Logically, one cannot violate a duty that does not exist. Second, even when the standard of care came into existence, it was not retroactive and only spoke in terms of future, post September 26, 2006 conduct. Again, the theory is that the conduct at issue took place in May 2006. Third, consistent with the rest of the CDO terms, the standard of care provision only required that Harding, when it was to perform its future collateral management duties, was to use its best efforts to ensure that the assets would meet the Eligibility Criteria for the deal – and nothing more. *See* Resp. Ex. 5 at 4 (CMA) ("The Collateral Manager

[308] During the warehouse period, Harding was bound only by the terms of the Warehouse Agreement and the Engagement Letter and nothing else. Of course, the Division makes no allegations about those agreements.

shall select all collateral to be Acquired by the Issuer **in accordance with the Eligibility Criteria, the other investment criteria set forth herein and in the Indenture and the Investment Guidelines**.)

It is undisputed that Harding, after September 26, 2006, satisfied its obligations under the CMA by ensuring that all of the collateral met the Eligibility Criteria and the other requirements spelled out in the CMA. And there is no proof or allegation that when Harding entered into the CMA and when the Offering Circular was finally executed, Respondents "*secretly intended* not to perform or knew that they could not perform" the future obligations spelled out in the CMA. *In the Matter of OptionsXpress*, at *232-33; *see also Pross v. Katz*, 784 F.2d 455, 457 (2d Cir. 1986) ("Making a specific promise to perform a particular act in the future while *secretly intending* not to perform may violate Section 10(b) . . . if the promise is part of the consideration for a sale of securities.") In cases involving nonperformance under a contract, "fraudulent intent may only be inferred 'when a defendant violates an agreement so maliciously and so soon after it is made that [its] desire to do so before [it] entered into the agreement is evident.'" *Campaniello Imports, Ltd. v. Saporiti Italia, S.p.A.*, 117 F.3d 655, 664 (2d Cir. 1997) *(quoting Powers v. British Vita, P.L.C.*, 57 F.3d 176, 185 (2d Cir. 1995)).

There is no proof or allegation that Harding "secretly intended not to perform" its obligations under the CMA, or indeed that it failed to perform those allegations. In short, the allegations concerning the "standard of care provision" in the Offering Circular must fail.[309]

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[309] The Division asserts, in conclusory fashion, that the Respondents "understood that the CDO's liabilities were being sold on the basis of a misleading description of the manager's standard of care." (Div. Br. 122) Given that the "standard of care" provision only consists of a promise that the Respondents follow a standard of care when managing the deal *in the future* and when making sure that the assets fit the Eligibility Criteria *in the future*, and given that there is no allegation or proof that Respondents did not exercise those activities properly, there is zero evidence supporting the Division's theory.

c. ***The Offering Circular contained an error when describing the Warehouse Agreement, but it was immaterial and Respondents, acting reasonably and with due care, nonetheless never caught the error.***

It is undisputed that the Warehouse Agreement was a tri-party agreement and that the Offering Circular's description of it incorrectly identified it as an agreement between two parties: "MLI and the Collateral Manager." (Resp. Ex. 2 at 66.)

The relevant provision states:

> _Acquisition of Collateral Debt Securities._ All or most of the Collateral Debt Securities Acquired by the Issuer on the Closing Date will be Acquired from a portfolio of Collateral Debt Securities selected by the Collateral Manager and held by MLI, an affiliate of MLPFS, pursuant to warehousing agreements between MLI and the Collateral Manager. Some of the Collateral Debt Securities subject to such warehousing agreement may have been originally acquired by MLPFS from the Collateral Manager or one of its affiliates or clients and some of the Collateral Debt Securities subject to such warehousing agreements may include securities issued by a fund or other entity owned, managed or serviced by the Collateral Manager or its affiliates. **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.** The Acquire price payable by the Issuer for such Collateral Debt Securities will be based on the purchase price paid when such Collateral Debt Securities were Acquired under the warehousing agreements, accrued and unpaid interest on such Collateral Debt Securities as of the Closing Date and gains or losses incurred in connection with hedging arrangements entered into with respect to such Collateral Debt Securities. Accordingly, the Issuer will bear the risk of market changes subsequent to the Acquisition of such Collateral Debt Securities and related hedging arrangements as if it had Acquired such Collateral Debt Securities directly at the time of purchase by MLI of such Collateral Debt Securities and not the Closing Date.

(Resp. Ex. 2 at 66 (OC) (emphasis added).)

The Division alleges that this provision was "untrue" in that (a) it "created the appearance that Harding had independently selected the entire portfolio" and (b) "Magnetar's warehouse rights gave it undisclosed influence."[310] (Div. Br. 122.)

The Division's arguments that Harding can be liable under Section 17(a)(2) based on this provision in the Offering Circular defy logic, the law, the facts, commonsense and the Division's own OIP.

First, the provision actually says "[a]ll or most of the Collateral Debt Securities Acquired by the Issuer on the Closing Date will be Acquired from a portfolio of Collateral Debt Securities selected by the Collateral Manager and held by MLI . . ." That statement is true. The portfolio was, in fact, "held by MLI [a Merrill entity]" and the portfolio was, in fact, "selected by Harding." (*See e.g.*, Huang 784:6-9; 1274:6-15) (testifying that there was no doubt that Harding selected all of the assets in Octans I); Doiron 1993:11-20; 1997:2-11 (testifying that statements in his own Wadsworth deal to the effect that "HIMCO selected the assets" were true, notwithstanding that, in fact, Morgan Stanley as warehouse provider had complete control over asset selection).)

Second, for all of the reasons already demonstrated, Magnetar's undisclosed rights or "influence" over the warehouse were immaterial and, if anything, good for the deal. (Jones 2849:2-15 (testifying that an equity investor that can kick out assets is a "public service" to the deal).)

[310] The Division also contends that the description of the Warehouse Agreement is also untrue because "it states that the acquisition of collateral will comport with the CMA and applicable law – including the standard of care and Respondents' Advisers Act obligations." (Div. Br. 122) We address that argument fully elsewhere.

B. Neither Of The Respondents Obtained Money "By Means Of" Or "Used" The Allegedly Untrue Statements Of Material Fact In The Offering Circular.

The Division spends four pages of its Brief arguing that *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) does not apply in this case. It (correctly) points out that the Commission recently held that *Janus* does not apply where Rule 17(a)(1) and Rule 17(a)(3) charges are alleged. (Div. Br. 105-108). We recognize that there are differing opinions in the courts concerning whether *Janus* applies to 17(a) claims and, more particularly to Rule 17(a)(2) charges.

In any event and regardless of whether *Janus* applies, Respondents cannot be liable for any violations of Rule 17(a)(2) because neither of the Respondents "used" any of the alleged misstatements or omissions or obtained money or property "by means of" any of the alleged misstatements or omissions.

Section 17(a)(2) makes it unlawful "to obtain money or property by means of any untrue statement of material fact." Thus, section 17(a)(2) prohibits the "use" of an untrue statement to obtain money or property. *Stoker*, 865 F. Supp. 2d at 465; *citing SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2009), *rehearing en banc granted, opinion withdrawn*, 573 F. 3d 54 (2009), *reinstated in relevant part*, 597 F.3d 436, 444 (2002); *see also SEC v. Radius Capital Corp.*, 2012 WL 695668, *4 (M.D. Fla. 2012) (adopting the *Tambone* "use" of the statement test).

Merrill made, had ultimate control over and decided how to *use* the statements in the Offering Circular that are the basis for the allegations in paragraphs 56 and 58 in the OIP.[311] Respondents did not distribute the Offering Circular, had no role in selling the securities in Octans I, and indeed, were prohibited from *using* the Offering Circular. Under the case law and

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[311] As the Supreme Court has said, "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. Without control, a person or entity can merely suggest what to say, not 'make' a statement in its own right." *Janus*, 131 S. Ct. at 2302.

the unambiguous language of Section 17(a)(2), Respondents cannot be liable under that statute for the alleged false statements or omissions in the Offering Circular that they never wrote, had no authority to use or to independently modify, and were not responsible for. *Compare Stoker*, 865 F. Supp. 2d at 465 ("Stoker may be held liable under 17(a)(2) if he obtains money *by use* of a false statement, whether prepared by himself or by another.") (emphasis added).

C. <u>Neither Of The Respondents Used The Allegedly Untrue Statements In The Pitch Book "In Connection With The Offer Or Sale Of Securities."</u>

It is also undisputed that Merrill was the party that had ultimate control over, distributed and "used" the Pitch Book. There is no evidence that Mr. Chau or Harding ever sent the Pitch Book to any prospective investor or "used" the Pitch Book in any way. *See Tambone* (Section 17(a)(2) liability attaches when "the statement is *used* to obtain money or property, regardless of its source").

In addition, given the glaring and specific cautionary language that is prominent both in the Pitch Book itself and in the Offering Circular, it is clear that it was not "used" "in connection with the offer or sale" of any securities.

The Pitch Book states:

> **This Material is provided to you on the understanding that as a sophisticated investor, you will understand and accept its inherent limitations, and will use it only for the purpose of discussing with Merrill Lynch your preliminary interest in investing in a transaction of the type described.**

(*Id.* at 3; *see also id.* at 27.)

The Pitch Book cautioned specifically that it was **not an offering document**. *See, e.g.*, *Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 939 (2d Cir. 1998); *see also Banco Espirito Santo de Investimento, S.A. v. Citibank N.A.*, No. 03 Civ. 1537 (MBM), 2003 U.S. Dist. LEXIS 23062, at *14-15 (S.D.N.Y. Dec. 29, 2003) (holding that disclaimers in "marketing presentations, the Offering Memoranda, and the letter of intent

constitute objective signs of [defendant's] expressed intentions not to be bound by any statement outside the Offering Memoranda" (internal quotation marks and citation omitted)); *see also Hunt v. Alliance North Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 730 n.4 (2d. Cir. 1998) (holding that no investor could have been misled where challenged marketing brochure stated that "complete information" was contained in prospectus).

D. The OIP Alleged Falsity In The Pitch Book Only Insofar As It Failed To Disclose Magnetar's "Control Rights" And "Influence" – It Did Not Allege Fraud Based Merely On A Failure To Follow The Pitch Book's Stated "Processes."

The Division's proof and allegations must remain within the "four corners" of the OIP. *See, e.g., In the Matter of Gregory M. Dearlove, CPA*, Initial Dec. Rel. No. 315, 2006 SEC LEXIS 1684, at *49-51 (July 27, 2006). Under Commission Rule of Practice 320, "[t]he Commission or hearing officer...shall exclude all evidence that is irrelevant, immaterial or unduly repetitious."

Respondents cannot be found liable based on theories of liability that were not alleged in the OIP. *Rita J. McConville*, 85 SEC Docket 3127, 3138-39 n.27 (June 30, 2005) ("We do not base our findings as to McConville's liability on the . . . press release. . . . The OIP did not charge misstatements in the press release."); *Russell Ponce*, 54 S.E.C. 804, 822 n.49 (Aug. 31, 2000) ("The Division contends that Ponce . . . was auditing some of his own work. . . . This conduct was not charged in the [OIP], however, and we do not consider it in assessing Ponce's conduct or the appropriate sanctions.").

Here, the plain English of paragraph 55 of the OIP is unambiguous: "The Pitch Book . . . described Harding's investment approach and credit processes, **but said nothing about Magnetar's control rights and actual influence over the portfolio**." Respondents understood, at the Hearing, that the Court permitted the Division to put on evidence of Respondents' failure

to comply with statements in the Pitch Book about Respondents' "top / down, bottom / up analysis" for the same reason the Court permitted Mr. Wagner to testify about his views of industry standards concerning the amount of time that should be spent reviewing an asset: to show that, if the Respondents did not meet the industry standards or the Pitch Book requirements on May 31, 2006, that failure would be relevant to demonstrate that Respondents must have been "*corrupted*" and failed to meet the standards *because they were part of the charged "scheme"* to "accommodate Magnetar and Merrill."

The Division's Post Hearing Brief makes clear, however, that what the Division really has wanted to do, all along, is to forget the OIP and seek liability against Respondents on the theory that they were simply negligent collateral managers. Two of the most blatant examples demonstrating that the Division has completely abandoned the "four corners" of the OIP can be found at pages 108 - 113 and pages 116 - 121 of the Division's Brief, in sections styled, respectively, "Section 17(a) Violations Based on the Octans I Pitch Book" and "Fraud on the Client: Violations of Section 206 and 17(a)." Throughout those two six page stretches of argument, the Division vehemently and repeatedly argues for liability based simply on (a) a failure to meet "industry standards" of rigor, discipline, collaboration, thoroughness and the like and (b) "non-compliance" with the "standard of care" coupled with a failure to disclose such non-compliance to the client (the "Issuer," a special purpose vehicle that was formed by Merrill and never reared its head either at the closing of Octans I or at the Hearing).

But if the Division had wanted to bring a "negligent manager" case or a breach of contract case, then it should have. It did not. After years of investigation, it recommended to the

Commission that proceedings sounding in fraud be instituted and that is what the Commission authorized.[312]

E. The Division Cannot Make Out A Section 17(A) Violation Based Simply On A Failure To Meet Industry Standards.

There is good reason why the Commission did not authorize the Division to bring a fraud case based solely on an allegation of a negligent failure to disclose negligent conduct (that, by the way, could not actually harm anyone, because the ABX Index assets selected were perfectly fine on their merits): because the law is clear that allegations of undisclosed mismanagement, errors, or mistakes do not make out a claim of securities fraud. Thus, the securities laws do not impose a duty of "self-flagellation." *Mo. Portland Cement Co. v. Cargill, Inc.*, 498 F.2d 851, 873 (2d Cir. 1974).

"It is well settled that section 10(b) was not designed to regulate corporate mismanagement nor to prohibit conduct which does not involve manipulation or deception." *Decker v. Massey Ferguson, Ltd.*, 681 F.2d 111, 115 (2d Cir. 1982) (*citing Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 473, 479 (1977) ("to bring within the ambit of the Rule [10b-5] all breaches of fiduciary duty in connection with a securities transaction . . . would . . . add a gloss to the operative language of the statute quite different from its ordinary meaning.") Any other rule

[312] The prejudice to Respondents in expanding the scope of the OIP is overwhelming. Respondents were never on notice that they could be liable simply for failing to live up to the Pitch Book's vague and general platitudes, or for simply failing to meet an unwritten, *ad hoc*, *ex post facto* formulation of the "standard of care" for picking assets on one day. Respondents tailored their strategy to the actual charges, by demonstrating that Magnetar's interests were aligned, that none of the assets at issue were ever disfavored, that there was no scheme and that Respondents' only true obligations were to follow industry standards in endeavoring to follow the binding agreements they had reached at the time: the warehouse agreement, the engagement letter and the CMA (which required that the assets selected by Harding meet stringent and detailed Eligibility Criteria). The Division stated in its Opposition to Respondents' Motion for Adjournment "[t]he OIP is clear. Respondents know the allegations...there should be little mystery about the identity and location of the core documents in this case." To premise liability on a theory that was not alleged in the OIP would be patently unfair.

would lead to the absurd result that a party's failure to disclose its own negligence would itself become the basis for an enforcement action under Rule 17(a).

But here, that is just what the Division seeks. The Division's theory of liability is Kafkaesque: Harding was slipshod on May 31, 2006 and negligently failed to disclose that fact on September 26, 2006.

But parties are under no duty to direct conclusory allegations at themselves or to characterize their own behavior in a pejorative manner. *Harrison v. Rubenstein*, No. 02 Civ. 9356 (DAB), 2007 WL 582955 (S.D.N.Y. 2007) (collecting cases). While the Division *alleges* that Harding failed to meet "industry standards" on May 31, 2006, Harding continues to disagree with that characterization on multiple levels and there is no evidence that anyone at Harding, on September 26, 2006, had any idea that somebody might second-guess the cash flow runs that Brett Kaplan e-mailed to Jung Lieu four months earlier, especially given that the bonds at issue were continuously re-analyzed for other deals and found to be acceptable and creditworthy. Because there is no proof or evidence that Mr. Chau (or anyone else at Harding) actually knew, understood or believed on September 26, 2006, at the time the CMA was signed, that Harding had somehow fallen short of industry standards on May 31, 2006, there can be no fraud, deception or scheme. The Division, creative as it is, cannot establish liability on a theory of "double negligence."

1. The Division's continually evolving theory of the case continues to fail.

Having arrived at the realization that it can't prove the case it charged, the Division's case has morphed so much that its best and first argument for a finding of a Section 17(a) violation is now that Harding made false statements in a host of generic, boilerplate, cookie cutter and vague marketing "fluff" and should be liable on that basis alone. As we note above,

the Division cannot switch horses midstream and seek liability on a basis never charged. In any event, their new theory holds just as little water as their first.

Thus, at pages 108 through 113 of its Post Hearing Brief, the Division forcefully argues that the following statements, *inter alia*, from the Pitch Book about Harding are false and materially misleading:

- Maximize returns and minimize losses through rigorous upfront credit and structural analysis . . .
- "Employ a top/down economic analysis to determine sector allocation."
- Perform a thorough bottom/up credit and structural analysis to identify potential investments.
- Complete an in-depth credit review . . .
- Investment Decision, Process and Execution has been built around . . . a collaborative, methodical and disciplined investment process."

(Div. Br. at 109 and 113.) There are more of them, but they are not worthy of repeating.

The testimony at the Hearing about these pages of the Pitch Book was a visit to the theatre of the inane. Thus, the Division's "lodestar" witness, Ken Doiron, could not even bring himself to agree that he focused on those portions of the Pitch Book. He testified that he only did a "cursory review" of the Pitch Book itself, that he and HIMCO focused on the things that actually matter in the Pitch Book more than others, such as the structure of the deal, and made clear that it would be absolutely "*absurd*" to base an investment decision on the bullets in the Pitch Book about the collateral manager. (Doiron 1893:11-19; 1943:20-1944:21; 1954:25-1955:20.)

As apparent from the Division's own brief, the statements are mere platitudes: "rigorous upfront credit and structural analysis," "complete an in-depth credit review," employ a

"disciplined bottom/up Credit and Structural analysis," and "collaborative, methodical and disciplined investment process." (Div. Br. at 109; Div. Ex. 2 at 43, 48.)

In other words, this marketing section was heavy on adjectives and light on specifics. For this very reason, the prospective investors testified that these sections of the Pitch Book constituted "fluff," to which they paid "very little" attention. (Edman at 2551:19-2552:25; Jones at 2893:25-2894:7 (testified that the sections on the collateral manager in the pitch books were "cookie cutter")); Doiron at 1942:21-1943:13 (testified that much of the information in the pitch books were "boilerplate").)[313]

Indeed, Mr. Edman testified that he affirmatively told his junior analysts that they should *not* look at the boilerplate and generic sections on Collateral Manager "Philosophy" and "Process." (*See* Edman 2609:22-24 (the Pitch Book statements about the manager are "just stating the obvious. General things that you would do when you're looking at bonds."); Jones 2873:15-20 (testified that he could "not recall that much differentiation between an awful lot of [the] managers" in the description of collateral managers' investment philosophy in the pitch books for CDOs); Jones 2875:21-2876:4 (testified that every single CDO pitch book he has seen contains statements about how the collateral manager will be careful, thorough, and disciplined); Huang 1016:3-12 ("A lot of marketing books ... looked similar. Everybody is basically saying pretty much the same thing."); Huang 1020:10-25 ("Every manager, every pitch book, they say

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[313] The Division made a lot of noise at the Hearing about "foreign bank" investors who might have been victimized. It had one on its witness list, a Mr. Imran Khan, but decided that it had better not call him. The *Brady* letter providing notice of some of his statements tells why. Here is what he would have testified:

- For UOB, it took an hour or two, or at least a half hour, to look at new-issue cash RMBS. In the relevant time, new-issue cash deals were coming very fast and sometimes it was not possible to spend more time. In some instances, people did not really know what they were buying; sometimes they had just 15 minutes to make a decision on cash bonds.

- According to Mr. Khan, an investment approach described in a Pitch Book can change over time and there is no universally accepted convention for analyzing assets.

the same thing. . . . Everybody says they are thorough, they are going top down, bottom up, every single thing you can think of in the world.").)

2. None of the alleged false and misleading statements in the Pitch Book were or could have been material to investors because they were all puffery.

As the witness testimony makes overwhelmingly clear, all of the broad, general and boilerplate statements in the Pitch Book are no more than "puffery," which cannot have misled a reasonable investor. *ECA & Local 134 v. JP Morgan Chase Co.*, 553 F.3d 187, 205-06 (2d Cir. 2009). The statements are too vague and general to be material. No reasonable investor could – and the evidence shows no investor did – take these statements seriously "for the simple fact that almost every [collateral manager] makes these statements." *ECA*, 553 F.3d at 206.

In *ECA*, the Second Circuit affirmed the district court's motion to dismiss for failure to state a claim. There, the complaint alleged that JP Morgan made a number of misrepresentations concerning its "'highly disciplined' risk management and standard-setting reputation for integrity."" JP Morgan had asserted that it had "risk management processes [that] are highly disciplined and designed to preserve the integrity of the risk management process," that it "set the standard for integrity," and would "continue to reposition and strengthen its franchises with a focus on financial discipline." *Id.*

The Court conceded that "while a bank's reputation is undeniably important, that does not render a particular statement by a bank regarding its integrity *per se* material." Rather, "finding that JP Morgan's statements constitute a material misrepresentation would bring within the sweep of the federal securities laws many routine representations made by investment institutions. We decline to broaden the scope of securities laws in that manner." *Id.*

Here, the Commission never authorized the Division to seek liability based on the falsity of statements in a Pitch Book concerning "bottom/up" analysis, "top/down" analysis, or anything of that sort. The Division argues that "Wagner opined that the language in the Pitch Book on Harding's investment approach was consistent with comparable sections in other CDO Pitch Books and, if carried out, would meet industry standards of rigor and independence." (Div. Br. at 109.) But the fact that the language is the same as comparable sections on "investment approach" in other Pitch Books does not mean that it demonstrates the standard of care; it only demonstrates that the statements in the Pitch Book are routine, are made by everyone in the industry, and are not actionable because "no investor would take such statements seriously . . . for the simple fact that almost every [collateral manager] makes these statements." *ECA*, 553 F.3d at 206. There is a reason the Commission did not authorize those type of charges – because those statements are so vague, general and meaningless to be not actionable.

3. The pitch book cases cited by the Division do not help them.

The Division argues that the statements that Harding prepared in the Pitch Book can be actionable and cites two cases in support of its position. Neither of those cases help the Division.

In the first, *SEC v. True North Finance Corp.*, 909 F. Supp. 2d 1073, 1097 (D. Minn. 2012), the entire thrust of the case is based on a series of Confidential Offering Memoranda ("COM") and Confidential Information Memoranda ("CIM") which accompanied the COMs. Hardly any of the allegations relate to statements that are made outside of the COMs and CIMs, but when they do, they relate only to marketing materials ("Update Letters" and a "Question and Answer ("Q&A") Sheet") that the defendants distributed to investors and prospective investors "*simultaneously to or after* the COMs." 909 F. Supp. 2d at 1086-87 and 1097. This is a critical and game ending distinction.

In the second case too, *SEC v. Quan*, 2013 WL 5566252 (D. Minn. 2013), there is nothing to suggest that the marketing materials contained any cautionary language, any disclaimers, or anything approaching the prominent and specific warnings drafted by Merrill and contained in the Octans I Pitch Book. For that reason, and that reason alone, *Quan* is distinguishable. But there is more.

The *Quan* defendants were hedge fund operators that were alleged to have made specific misrepresentations to investors in private placement memoranda and marketing materials that the defendants themselves used to solicit investors. There, unlike here, the alleged misrepresentations in the marketing materials were not puffery. They were easily specific enough to permit the district court to deny the defendants' motion for summary judgment. Here are the statements at issue in the *Quan* marketing documents:

- "*additional cash collateral is held in a segregated account.*" The evidence showed that there was such an account, but only up until a date in 2009.
- "Full Due Diligence on Borrower prior to commitment," including "an *inventory summary analysis*, *periodic asset appraisals of the borrower*, *on-site field examinations*, and an *accounts receivable aging summary analysis*." The evidence showed that, during the most recent five year period that investors invested and the flipbook was continuously used to solicit new investors, no on-site examinations ever occurred, no warehouse inspections were ever conducted, no third parties were ever contacted to confirm any transactions and no retailers were ever contacted to confirm the existence of any receivables.
- "*Major accounting firm has been retained to examine the books of intermediaries*," under a section titled "Borrower Risk Management." The evidence showed that an accounting firm had been retained, but only to audit the hedge fund's own books and not the books of the borrowers or the "intermediaries," who were described elsewhere in the flipbook as "borrowers."

Quan, 2013 WL 5566252, at *8-14.

These type of specific and detailed statements in the *Quan* case are fundamentally different from the generic, boilerplate, vague and hyperbolic statements in the Pitch Book about Harding's "Investment Philosophy and Process." (*See* Div. Br. 109: "maximize returns and

minimize losses through rigorous upfront credit analysis," "employ a top/down economic analysis to determine sector allocation," "perform a thorough bottom/up credit and structural analysis," "collaborative, methodical and disciplined investment process").)

While the Division may not have to establish reliance or injury, it must demonstrate materiality. To be material, the alleged misstatement must be "sufficiently specific for an investor to reasonably rely on that statement as a guarantee of some concrete fact or outcome which, when it proves false or does not occur," forms the basis for a fraud claim. *City of Pontiac v. UBS AG*, 2014 U.S. App. Lexis 8533, *31 (2d Cir. 2014). That statements that are "too general to cause a reasonable investor to rely upon" may have been "knowingly and verifiably false when made does not cure their generality, which is what prevents them from rising to the level of materiality required to form the basis for assessing a potential investment." *City of Pontiac*, 2014 U.S. App. Lexis 8533, *21.

In *Boca Raton Firefighters v. Bahash*, 506 Fed. Appx. 32, 37, 2012 WL 6621391 (2d Cir. 2012), the Second Circuit dismissed as puffery a McGraw Hill's assertion that a subsidiary's "recently posted code of practices and procedures 'underscores our dedication towards transparent and independent decision-making.'" The court explained that the "'puffery' designation . . . stems from the generic, indefinite nature of the statements at issue, not their scope." *Id.*; *citing City of Omaha, Neb. Civilian Emps.' Ret. Sys v. CBS Corp.*, 679 F.3d 64, 67 (2d Cir. 2012) (distinguishing "matters of objective fact" from "misstatements regarding opinion").

Here are some examples of statements that Respondents did *not* make in the Pitch Book or anywhere else:

- Harding only selects the 160 "best assets" that it can objectively and subjectively find for the portfolio.

- Harding independently decides, without communicating with anyone else, which assets it will review for inclusion in the portfolio.

- Harding has unilateral authority, regardless of the views or objections of any other party (including the parties who finance and take the risk during the warehouse and ramp period) to select only those assets that it desires.

- Harding spends a particular number of "man hours" reviewing each asset for inclusion in the portfolio on or about the date that the final credit decision is made by a Harding analyst.

- Every cash flow run for every asset in the portfolio, using varying assumptions, shows zero or insignificant projected write downs.

- Harding will not select any asset if it has a cash flow projection, using any set of Intex assumptions, that indicates any write-downs (or write-downs above any particular level).

- Every cash flow run performed by Harding personnel is performed using only industry standard Intex settings such as, for example, the default "prepay rate" setting instead of the non-standard "unscheduled balance reduction rate" setting.

- No Harding employee ever makes any mistakes, including when adjusting the Intex settings to be used for cash flow projections.

- No Harding analyst, when reviewing any of the assets in the portfolio at any time (including in connection with separate assignments), ever reaches a differing view about any of those assets.

- Every asset selected by Harding is backed up by proof, kept and maintained in writing, that every member of Harding's credit team has studied that asset and has unanimously and contemporaneously agreed with the decision to select that asset at the time.

- Harding employs a "hit rate" when it selects assets and the portfolios it selects must accord with the "hit rate."

- Harding employs a separate base case and stress case scenario when evaluating each asset and maintains pristine and contemporaneous records memorializing the results of those scenarios.

- Harding maintains contemporaneous records of "base case" and "stress case" scenarios for every asset selected for the portfolio, and all of these scenarios must show "positive results."

If Harding had indeed ever made any statements, representations or promises like these, we would understand the Division's misstatement theory. But that never happened. The Division is seeking to hold Respondents responsible for promises that they never made.

4. Respondents acted reasonably and with due care at all times.

Respondents cannot be held to have acted knowingly, recklessly or even negligently when they relied in **good faith** on their own experienced lawyers, as well as on the lawyers who represented Merrill Lynch and who actually drafted the materials that are now at issue (such as the disclosures about Magnetar's rights and participation in the Warehouse Agreement), to ensure that everything was in order and accurate.

In a factually analogous circumstance, the SEC alleged that John P. Flannery and James D. Hopkins, managers of funds advised by State Street Bank, were in violation of sections 17(a)(1),(2), and (3) of the Securities Act, for making inadequate disclosure to investors concerning portfolio holdings in an unregistered collective trust fund. *John P. Flannery,* Initial Dec. Rel. No. 438, 2011 WL 5130058 (Oct. 28, 2011). The SEC alleged that offering materials for the fund such as quarterly Fact Sheets, PowerPoint presentations to current and prospective investors, and responses to investor requests for proposal were misleading because they omitted integral information about the exposure of the fund to the sub-prime market. In-house counsel, as well as outside counsel, reviewed, edited and approved the materials. The SEC Chief Administrative Law Judge rejected the SEC's allegations and stated that because counsel was aware of all important information, good faith reliance on counsel by the defendant was proper. She went on to note that "a lawyer would not, or should not, approve a [document] if he was not familiar with its contents, and even if [in house counsel] did, that does not change the fact that [the defendant] acted reasonably in relying on Legal's opinion." *Id.* at *56-57.

As discussed above, Respondents relied in good faith on very experienced securities lawyers, who knew the relevant facts, prepared or reviewed the relevant documents, and found no material misstatements of fact or material omissions. The Issuer's and Merrill Lynch's counsel knew that Magnetar had certain rights under the Warehouse Agreement. Merrill Lynch's lawyers reviewed the Octans I Pitch Book. They drafted, edited, and finalized the Offering Circular. Respondents also knew and relied upon Schulte Roth's 10b-5 Opinion.

Respondents' counsel was aware of the Warehouse Agreement and reviewed and provided comments on the Offering Circular. Respondents relied in good faith on Mr. Suh to address relevant issues in the deal and disclosure documents. Respondents also knew that their counsel suggested that Magnetar's name be disclosed in the Offering Circular but was overruled by the Co-Issuers' counsel.

Mr. Suh also issued a negative assurance opinion that represented to the Respondents that nothing came to his attention to suggest that the disclosures in the Offering Circular were materially false or misleading. Respondents provided Mr. Suh all information he asked for so that he could give that opinion.

Respondents believed in good faith that all counsel would make sure that no material facts were omitted and no material facts were misstated. Mr. Chau is not a lawyer and there was no reason for him to second-guess experienced securities lawyers' judgment. He certainly did not have the wherewithal to substitute his judgment for theirs. Neither Mr. Chau nor Ms. Wang remembered reading the relevant disclosures in the Offering Circular. Ms. Wang testified that there was no deliberate effort to hide Magnetar's involvement. Mr. Chau testified the same way. There was no evidence that there was any such effort.

Other cases demonstrate that Mr. Chau and Harding cannot be liable for any of the alleged misstatements or omissions. *See, e.g.*, *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004) and *Scott G. Monson*, Initial Dec. Rel. No. ID -331, 2007 WL 172577 (June 15, 2007) (dismissing case alleging negligence based on theory of failure to "spot an issue").

As the Court of Appeals for the D.C. Circuit made clear in *Howard*:

> [R]eliance on counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter [citation omitted]. As a former SEC commissioner put it, "the reliance defense . . . is not really a defense at all but simply some evidence tending to support a defense based on due care or good faith." Bevis Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 Bus. Law. 1185, 1187 (1982) [footnote omitted]. The SEC itself recognized as much in *In re Charles C. Carlson*, 46 S.E.C. 1125, 1132-33 (1977) when it held that a broker reasonably relied on a lawyer's advice (which turned out to be mistaken) and added that although such a securities professional should have been familiar with the "rudiments" of securities law, he should not "be expected to display finished scholarship in all of the fine points."[314]

376 F.3d at 1147

In *Howard*:

- The law firm of Rogers & Wells, on behalf of Howard's company, had prepared all of the offering documents that contained the omissions that the SEC later found to be material. 376 F.3d at 1147. Here, Merrill Lynch and Merrill Lynch's outside counsel at Schulte Roth prepared all of the offering documents that contained the errors and omissions that the Division now claims were material. In addition, here, Merrill's internal counsel also had a role in preparing, or at least were responsible for ensuring the accuracy of, the documents at issue. Finally, here, Harding's outside counsel at McDermott Will & Emery, who Harding hired

[314] The defense "is known as a good faith defense or a due care defense" which can counter a finding of negligence. *Draney v. Wilson, Morton, Assaf & McElligott*, 592 F. Supp. 9, 11 (D. Ariz. 1984); *see Tannenbaum v. Zeller*, 399 F. Supp. 945 (S.D.N.Y. 1975); *see In re E.F. Hutton S.W. Properties II v. Union Planters Nat'l Bank*, 953 F.2d 963, 973 (5th Cir. 1992) (applying New York law and stating that "reliance on advice of counsel to resolve an open question of law is not negligent"); *see* Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 Va. L. Rev. 1, 9-19 (1976); *see Reliance on Advice of Counsel*, 70 Yale L.J. 987 (1960). Although the defense is not complete, it remains a strong factor for consideration. *SEC v. Enters. Solutions, Inc.*, 142 F. Supp. 2d 561, 576 (S.D.N.Y. 2001) (Cedarbaum, J.); *see, e.g.*; *In re Delphi Corp. Sec, Derivative & "ERISA" Litig.*, 602 F. Supp. 2d 810, 827 (E.D. Mich. 2009) (granting defendants' summary judgment motion in large part because defendant's relied on advice of counsel to override a provision in a trust agreement that plaintiff's contended was a breach of fiduciary duty). Importantly, "[counsel's] opinion as to the law (even [if] erroneous] should...protect the [defendants] acting in reliance upon it." *Spirit v. Bechtel*, 232 F.2d 241, 247 (2d Cir. 1956).

because of their special expertise in offerings of this type, reviewed the offering documents on behalf of Harding and worked with Alison Wang, a lawyer who was part of Harding's management team. Again, none of the disclosures that are at issue in the Offering Circular were drafted by Harding or were otherwise the responsibility of, or attributed to Harding. In addition, the incorrect description of the Warehouse Agreement in the Pitch Book was also in a Merrill section, not in a Harding section.

- Howard "voted in favor of the plan," only after he was told that "Rogers & Wells had been consulted and approved of the transaction." 376 F.3d at 1140. Here, Mr. Chau received a written certification at the closing from both Merrill's lawyers at Schulte Roth and Harding's lawyers at McDermott Will & Emery that there were no material misrepresentations or omissions in the offering documents.

- "Howard relied on [Rogers & Wells'] work product and believed the offering materials contained all the necessary disclosures." 376 F.3d at 1140. Here, Mr. Chau also relied on both Merrill's lawyers and Harding's lawyers.

- In *Howard*, the primary violation related to Rule 10b-9 of the Exchange Act, concerning whether purchases in a "part-or-none" offering were "bona fide." There was an "environment of uncertainty" and "vagueness" about the applicable law and it was "increasingly difficult for practitioners to define the circumstances in which Rule 10b-9 applied." 376 F.3d at 1145-46. Here, the Division's theory of materiality is, at best, based on an uncertain interpretation of the law. The Division's theory of materiality contradicts the Commission's own Proposed Rule 127B. Given that Magnetar was buying $94 million in equity in a first loss position and carried the bulk of the $1 billion+ warehouse risk, none of the lawyers from Merrill, Schulte Roth or McDermott Will & Emery believed that disclosure of Magnetar's warehouse rights, control or influence was material. Mr. Chau can have liability here only if he is held to a higher standard than the top notch lawyers who were hired and specifically tasked with ensuring compliance with the disclosure rules and only if he is held responsible for statements that he never made, had control over, or had authority to change.

- Howard "*skimmed through* but did not read closely" the final placement documents. 376 F.3d at 1139. Here, the Division acknowledges that Chau and Harding concentrated primarily on the sections concerning Harding – none of which, except for the puffery concerning Harding's philosophy and processes – are alleged to be problematic. Indeed, the Division acknowledged, Chau and Harding would only "review or *scan through* the rest of the pages" that were Merrill's responsibility. (Div. Br. at 114.)

In sum, here, as in *Howard*, "rather than red flags, [Chau] encountered green ones, as outside and inside counsel approved transactions" that the SEC is now subsequently scrutinizing. 376 F.3d at 1147.

The Division's arguments, that "respondents at the very least were negligent . . . and quite possibly worse" for failing to spot the mistake in Merrill's section of the Pitch Book concerning the number of parties to the Warehouse Agreement, deserve short shrift. They contend that, "as an experienced investment professional, Chau had to have grasped that any extrinsic limitation on the manager's discretion should be disclosed" and "when the Pitch Book was still in draft form, Respondents twice commented on the very page containing the faulty disclosure." (Div. Br. 114.)

First, the Division's own "lodestar" witness, Mr. Doiron of HIMCO, made clear there is no obligation to disclose "any extrinsic limitation on the manager's discretion." Mr. Doiron wrote, in the section of the Wadsworth section that he personally drafted and was responsible for, that "HIMCO selected the assets" for Wadsworth, even though Morgan Stanley actually controlled the warehouse, individually approved every asset that went into it, would have had to take short positions and hedges to protect itself, and often pushed assets towards the warehouse – that HIMCO might subsequently accept – for Morgan Stanley's own selfish business reasons.

Second, according to Mr. Wagner's prior opinions on behalf of the Division in *Tourre*, and according to Proposed Rule 127B, there is no need to disclose any influence on asset selection unless it is adverse. Here, again, Magnetar's economic interests were in line with other investors' interests.

Third, by arguing that a party's efforts to *help make a document more accurate* – by suggesting edits to it – is evidence that the party should be liable for *failing to spot an issue*, the Division is calling for absurd and irrational results. Industry participants who believe that they are more likely to be found liable for failing to spot an error in a document if there is evidence

that they commented on the document will, of course, be motivated *not* to comment on the document and *not* to try to help make it more accurate.

But the Division advances this illogical theory yet again. It argues Respondents "were at least negligent" for failing to find the mistake in the Offering Circular's description of the warehouse agreement because "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 holders of the preference shares." (Div. Br. at 123.) That Harding's counsel "suggested a disclosure that named Magnetar" and would disclose certain other rights that Magnetar would have, once the deal closed, is *not* evidence that is probative of Harding's failure to spot a mistake in a separate and non-material section of the Offering Circular. It is evidence that Harding and Harding's counsel were exercising reasonable care and competence and were trying in good faith and diligently to help make the entire document – not just Harding's sections – more accurate.[315]

XXIII. THE DIVISION HAS FAILED TO PROVE A CLAIM UNDER SECTION 17(A)(3) OF THE SECURITIES ACT BECAUSE THE DIVISION CANNOT DEMONSTRATE THAT RESPONDENTS ENGAGED IN A SEPARATE "TRANSACTION, PRACTICE, OR COURSE OF BUSINESS."

Under Section 17(a)(3), the Division must prove, separate from its 17(a)(2) allegations, the use of a deceptive or misleading transaction, practice, or course of business in the offer or sale of a security. *See United States. v. Naftalin*, 441 U.S. 768, 774 (1979); *SEC v. Patel*, Civil No. 07-cv-39-SM, 2009 U.S. Dist. LEXIS 90558, at *20-25, 65 (D.N.H. 2009).

[315] Perhaps the point that this Division argument proves most resoundingly is that, no matter what Mr. Chau or Harding do, it will figure out a way to hold it against them.

Because claims under Section 17(a)(3) are distinct from those under Section 17(a)(2) and proscribe different types of conduct, the Division may not bootstrap a 17(a)(3) course-of-business claim to a claim based solely on misstatements. *See Naftalin*, 441 U.S. at 774 (holding that each subsection of Section 17(a) "proscribes a distinct category of misconduct"); *Patel*, 2009 U.S. Dist. LEXIS 90558, at *20-25, 65 (holding that a plaintiff may not use claims of misrepresentations alone to plead a fraudulent scheme under 17(a)(3)).[316] Under either Rule 10b-5 or Section 17(a), a plaintiff may not hold a defendant liable for misleading statements under the scheme or course-of-business provisions by alleging only that "he or she was a participant in a scheme through which the statements were made." *In re Alstom SA Secs. Litig.*, 406 F. Supp. 2d 433, 475 (S.D.N.Y. 2005); *accord Patel*, 2009 U.S. Dist. LEXIS 90558, at *22. As such, the Division cannot establish liability for Section 17(a)(3) unless it proved that Respondents made misrepresentations *and* "undertook a deceptive scheme or course of conduct that *went beyond* the misrepresentations." *See Alstom*, 406 F. Supp. 2d at 475 (emphasis added).

The Division does not dispute this principle of law, *see* Div. Br. at 115-16, but fails to identify any deceptive course of business that went beyond the alleged omissions. Remarkably, the Division cites *SEC v. Stoker*, 865 F. Supp. 2d 457 (S.D.N.Y. 2012) in support of its Section 17(a)(3) claim. But *Stoker* sustained a complaint (before a jury found the defendant not liable for any securities law violations) based upon allegations that the defendant was involved in a scheme to include as many poorly performing CDOs in a portfolio as possible, so that Citigroup could profit by shorting certain CDOs for its own account. *Id.* 467. As discussed above, the allegedly "compromised" nature of Harding's asset selection is utterly counterfactual to *Stoker*. (*See*

316 Because it is well settled that the same elements are required to state a claim under the three subsections of either Rule 10b-5 or Section 17(a), how courts have analyzed the distinct subsections of Rule 10b-5 is relevant here. *See SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999) (except for scienter, "[e]ssentially same elements are required under Section 17(a)(1)-(3)" as with Section 10(b) and Rule 10b-5).

Section XXII.A.2.e.) A separate deceptive course of business cannot be predicated on such a thin basis.

A. In Any Event, There Was Nothing About Respondents' Conduct That Could Have Operated As A Fraud.

For all of the reasons previously discussed, nothing the Respondents did could have defrauded anyone:

1. The heart of the case is that Magnetar's Warehouse rights were not disclosed. But the evidence demonstrates that Magnetar's interests were aligned with other noteholders. As a result, nobody could be defrauded by not knowing about the role of someone who had the same economic interests in all meaningful respects.

2. The second alleged harm to investors was that investors received assets that Harding's personnel "disfavored" and that Harding would not otherwise have selected, absent Magnetar's influence. But the evidence demonstrated that the assets were not disfavored in any way and were regularly and routinely selected for other deals. As a result, nobody could be defrauded by receiving something that, all of the evidence demonstrates, they would have received anyway.

3. The Division earnestly criticizes the manner in which Harding selected assets on May 31, 2006 for the warehouse, but the evidence demonstrates that the assets selected were perfectly appropriate and just as good as other comparable available assets. As a result, although the Division is not required to prove injury, it is clear in this case that nobody was injured or could have been injured, given that the assets were just as good as any other similarly rated assets that were available at the time.

4. The Division alleges the "standard of care" provision in the Offering Circular was false, but the evidence shows that this provision only came into existence on September 26, 2006 and only governed Harding's future conduct. As a result, no reasonable investor could have been deceived into thinking that Harding had acted in a certain manner four months earlier, when that was not part of the plain language of the provision; and

5. The Division's theory is primarily based on omissions, but the controlling documents provide a multitude of discrete, specific, targeted and plain English cautions on the issue (to the effect that no information on the quality of the assets will be made available and that investors need to figure out for themselves the likelihood and severity of defaults on the assets). As a result, no reasonable investor could have entertained any concrete notions concerning how Harding went about selecting the assets.

B. **The Evidence Demonstrates Respondents Acted Reasonably And Prudently And Exercised Ordinary Care.**

For the reasons we have already discussed, the evidence demonstrates that the Respondents exercised reasonable and ordinary care. Mr. Chau, in particular, delegated responsibility for preparing and reviewing documents to Ms. Alison Wang, who was a meticulous person of integrity and a well-educated and well-pedigreed lawyer, as well as experienced outside counsel from a major New York law firm.

In addition, Mr. Chau and Harding appropriately left the preparation of deal documents and disclosures to Merrill Lynch, Merrill's internal lawyers and Merrill's outside lawyers. To the extent they did not see the need to provide investors with additional information, it was reasonable to believe that the lawyers were competent to make the right decision. Moreover, given that Division expert Ira Wagner in the *Tourre* case and the Commission in Proposed Rule 127B agree that an equity investor who has a role in asset selection does not present a material conflict of interest, it is inconceivable that Mr. Chau, a non-lawyer, should be held responsible for failing to see that such a situation might operate as a fraud on investors, especially when none of Merrill, Merrill's counsel or Harding's counsel identified it as an issue.

Finally, Mr. Chau and Harding acted reasonably in using marketing material that was similar to the marketing materials that virtually every other collateral manager used. Mr. Chau hired Tony Huang, an experienced and competent portfolio manager to assist in running Harding and Mr. Chau confirmed at the Hearing that Harding maintained industry standards in the way in which it conducted its collateral management business.

Mr. Chau delegated to Mr. Huang the supervision and the execution of the ABX Index trade and Mr. Huang was competent and qualified to handle that work. Other evidence in the case demonstrated that other collateral managers who worked with Magnetar also reviewed the

ABX Index within one day and provided selections of assets from Index names within that timeframe.

The evidence shows that Mr. Chau was never alerted to any issues at the time concerning the review of the ABX Index assets and, given that the assets selected were routinely selected for other deals, there is reason why he would have had reason for concern.

In short, there is no basis to impose Section 17(a)(3) liability on either of the Respondents.

XXIV. THE DIVISION FAILED TO PROVE ANY VIOLATION OF SECTION 206.

To prove a violation under Section 206(1) of the Investment Advisers Act, the Division must demonstrate that an investment adviser employed a "device, scheme, or artifice to defraud any client or prospective client." 15 U.S.C. § 80b-6(1). To prove a Section 206(2) violation, the Division must demonstrate that an investment adviser engaged "in a transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." 15 U.S.C. § 80b-6(2). Both provisions cover misconduct by an investment adviser against its "client or prospective client."

The elements necessary to prove a violation of Section 206(1) and (2) are substantively indistinguishable from those required for claims under Section 17(a)(1) and (3) of the Securities Act, except that the violation must be committed by an investment adviser against a client or prospective client, and need not occur in connection with the offer or sale of securities. *See SEC v. Seghers*, 298 Fed. Appx. 319, 327-28 (5th Cir. 2008); *SEC v. PIMCO Advisers Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 470 (S.D.N.Y. 2004). Here, the Division failed to prove a violation of Section 206(1) or (2) for the same reasons it failed to prove a violation of Section 17(a)(1) or (3).

The Division's Section 206 claims fail for the additional reason that the purported fraud defies all logic when one considers the identity of the "client." The Division does not attempt to argue that Harding was the investment adviser of any noteholder or prospective investor. Nor could it do so under the law. *See Goldstein v. SEC*, 451 F.3d 873, 879-82 (D.C. Cir. 2006). As a result, the Division must resort to arguing that the defrauded client was the **Issuer**. But the Issuer was an SPV that existed only on paper for the sole purpose of completing the Octans I transaction, and never considered any aspect of the business merits of Octans I, with respect to asset selection or otherwise.

Nobody from the Issuer testified at the Hearing. Nobody from the Issuer appeared at the closing. Nobody from the Issuer attended or participated in investor meetings or ever even saw the Pitch Book. Indeed, there is no evidence that the Issuer, or any of the nominee directors who operated the Issuer once it came into existence, gave a second thought to any of the matters that were at issue in the Hearing at the time of the closing. To the contrary, as described more fully above, the only evidence is that the Issuer was an entity that was created by Merrill for the purpose of doing whatever Merrill saw fit for it to do. In sum, there is a complete and utter failure of proof as to the Section 206 allegations (including that any of the alleged conduct was "material" to the Issuer).

The Division's theory of Section 206 liability is a multi-step abstraction that collapses under its own weight: (1) Merrill Lynch structured Octans I and created the Issuer; (2) Magnetar was a co-owner of the Issuer and an owner of Octans I; (3) the Issuer was created solely to accept CDO assets that met certain specified Eligibility Criteria, agreed upon by Merrill and Magnetar; (4) at closing on September 26, 2006, the Issuer was capitalized and, pursuant to the CMA, hired Harding to select assets that met those Eligibility Criteria; (5) Harding in fact

selected assets for Octans I at closing, and all of them met the Issuer's Eligibility Criteria; (6) four months earlier, pursuant to a Warehouse Agreement with the Issuer's creator and co-owner that required Harding to ensure that the assets it selected met the Eligibility Criteria, Harding had identified some of those assets in a manner that allegedly failed to comport with the industry standard of care but which met the Eligibility Criteria; (7) Harding had done so based on a desire to "accommodate" the Issuer's creator and co-owner; (8) Harding failed to inform the Issuer that it had identified assets in the way that it had in order to accommodate the Issuer's creator and co-owner; but (9) the Issuer's co-owner and creator nonetheless had ultimate control over whether to accept or reject the assets that Harding had selected for them.

A fiduciary's duty of "full and fair disclosure of all material facts" (Div. Br. at 117) is not so elastic as to reach omissions that were not material to anybody, much less the Issuer created by Merrill Lynch and co-owned by Magnetar. Equally baseless is the Division's contention that the representation that Harding would "select all collateral" at closing implied to the Issuer that Harding had initially identified every asset on its own, without any input from the Issuer's co-owner and equity investor. (Div. Br. at 116.) The CMA says nothing about the process by which Harding selected collateral during the warehouse period and certainly did not indicate that the process occurred without input from any investor.

The Division's argument that it can establish a Section 206 violation with no misstatement at all, based solely on the undisclosed failure to fulfill a fiduciary duty of care (Div. Br. at 118), must also fail. As an initial matter, the CMA expressly provided that Harding was not subject to fiduciary duties (Resp. Ex. 5 at 8 (CMA).) This provision is consistent with the fact that the very structure of a CDO, with interests of different tranches never perfectly aligned, makes it unreasonable for a collateral manager to assume fiduciary duties. The CMA thus

reflects the reality that because the collateral manager is subject to a number of restrictions set forth in the transaction documents, the collateral manager does not have other duties or obligations. (*See* Sections VII.D.4., X.E.) *See also Goldstein*, 451 F.3d at 881.[317]

More fundamentally, however, Respondents' purported failure to fulfill a standard of care under the CMAs does not equate to a violation of Section 206. As recognized in one of the cases cited by the Division (Div. Br. at 118), even when based on breach of duty, "the most basic element of all fraud claims is that the victim must be deceived by the perpetrator's words or actions." *In re Refco Capital Markets, Ltd. Brokerage Customer Secs. Litig.*, 2007 WL 2694469, at *7 (S.D.N.Y. Sept. 13, 2007) (dismissing claims that failed to coherently allege deceptive conduct).

Consistent with that principle, the conduct that the Court considered in *Raymond J. Lucia Cos.*, Initial Dec. Rel. No. 540, 2013 WL 6384274 (Dec. 6, 2013), included deliberate and repeated presentations of misleading promotional data to prospective clients, in circumstances where accurate data would have revealed that the highly touted investment strategy would fail. *Id.* at *40. Although the Court referenced the fact that one respondent "departed from the standards of care," the departure was "extreme" precisely because it related to the misleading calculations that were enthusiastically presented to the prospective investors. *Id.* at *43. The departure from standards of care and the prospective clients in *Lucia* cannot seriously be compared to the conduct in this case – which was consistent with the plain meaning of the

[317] The Division cites to Section 215(a) of the Advisers Act, which voids provisions "binding any person to waive compliance with any provision of this title or with any rule, regulation, or order thereunder." 15 U.S.C. § 80b-15. The disclaimer of fiduciary duties in the CMA is not such a provision; it does not waive compliance with the Advisers Act or any rule, regulation, or order. To the contrary, the CMA simply describes the nature of Harding's duties in a manner wholly consistent with the restricted role of a CDO collateral manager. CMAs cannot be transformed into advisory contracts subject to Section 215(a) based on documents, like Harding's compliance manual, that are unrelated to the CDO at issue. *See Valentini v. Citigroup, Inc.*, 837 F. Supp. 2d 304, 324 (S.D.N.Y. 2011); *cf.* Div. Br. at 129. The Division, unsurprisingly, does not cite any case that holds a collateral manager's disclaimer of fiduciary obligations to be void under Section 215(a).

governing contracts – and the Issuer. (Div. Br. at 118.) Unlike the prospective investors in *Lucia*, there was no evidence at all about the Issuer, much less that the Issuer (or anyone affiliated with the Issuer) considered the alleged omissions important such that the Issuer was or could have been deceived, or that anything at all that was contested in this case would have mattered in the least to it. The "most basic element of all fraud claims" is missing. *See Refco*, 2007 WL 2694469, at *7.

NONE OF THE DIVISION'S ALLEGATIONS CONCERNING NORMA WERE PROVEN.

As referenced above in Section XXI-XXIV, the Division failed to prove any basis for holding Harding or Mr. Chau liable under Section 17(a) of the Securities Act or Section 206 of the Advisers Act in connection with Harding's investment in Norma on behalf of Lexington V and Neo. (The Division's arguments regarding the Single A-rated Norma notes in Jupiter VI and 888 Tactical should be disregarded as extraneous to the OIP's allegations, but they present no basis for liability in all events.)

It is undisputed that Harding's only connection to Norma was that of an investor, and thus had nothing to do with selecting the assets that comprised Norma. Evidence at the Hearing demonstrated that Harding agreed to purchase Norma bonds for its CDOs once the spreads were sufficiently attractive. The Division countered with zero testimony to support the OIP's vague allegation that Harding's view of those bonds was "basically unfavorable" or that any client, prospective client, or CDO investor was harmed in any way by Harding's decision to purchase Norma bonds. No investor—and no other person affiliated with Lexington V or Neo—testified. Nor was there any other evidence to support the Division's contention that the 1.6% of those two CDOs that was comprised of Norma bonds were included based on a fraud or breach of duty.

(The same is true with respect to the 1%-2% of the Jupiter VI and 888 Tactical portfolios consisting of Norma Single A-rated notes.)

The speculative, uncorroborated interpretation of flippant e-mails cannot establish any liability under these circumstances. *See Hoska*, 677 F.2d at 138-41; *Mulheren*, 938 F.2d at 372. (*See also* Section XIX.A.10.)

XXV. AFFIRMATIVE DEFENSES.

The Division cannot prevail because of the following affirmative defenses.[318]

A. Charges Relating To Octans I Are Barred By The Applicable Statute Of Limitations.

A five-year limitations period applies to all actions for civil penalties, and the discovery rule does not apply to such actions. *See Gabelli v. SEC*, 133 S. Ct. 1216, 1221-24 (2013); *see also Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996) (28 U.S.C. § 2462 applies to administrative proceedings).

Although some courts have concluded that the limitations period does not apply to certain forms of equitable relief, *see, e.g., SEC v. Kelly*, 663 F. Supp. 2d 276, 286-87 (S.D.N.Y. 2009), the D.C. Circuit has held that some traditional equitable remedies that operate as punitive measures are effectively "penalties" and are therefore subject to the limitations period. *See Johnson*, 87 F.3d at 492. The D.C. Circuit, therefore, has held that disgorgement can be a penalty when it is not causally related to the wrongdoing. *Riordan v. SEC*, 627 F.3d 1230, 1234 (D.C. Cir. 2010) ("We have reasoned that disgorgement orders are not penalties, *at least so long as the disgorged amount is causally related to the wrongdoing*") (emphasis added).

Respondents entered into a series of tolling agreements that tolled the statute of limitations from August 31, 2006 until the filing of the OIP in this matter. Thus, Respondents

[318] Respondents are no longer asserting advice of counsel as an affirmative defense.

cannot be found liable based on conduct prior to August 31, 2006 and, as a consequence, charges based on disclosure violations and asset selection in connection with Octans I are time barred: The Pitch Book upon which the Division bases much of its claim as to Octans I was distributed by Merrill to potential investors before the limitations period. (*See* Section VIII.B.) Similarly, Harding's ABX Index trades in Octans I started and ended prior to August 31, 2006. (Resp. Ex. 125 ("Harding's Trade Blotter").)

Neither the "fraudulent concealment" doctrine nor the continuing violation doctrine brings this untimely conduct within the limitations period. The fraudulent concealment doctrine applies when a party participates in deceptive conduct purposely designed to hide a fraud, *SEC v. Jones*, 476 F.Supp. 2d, 374, 382 (S.D.N.Y. 2007), and no such conduct is alleged here. Decisions from the Southern District of New York and a number of other courts have also rejected the application of the continuing violation doctrine to securities actions. *See Stoll v. Ardizzone*, 2007 WL 2982250, at *2 (S.D.N.Y. Oct. 9, 2007); *SEC v. Harden*, 2006 WL 89864, at *2 (W.D. Mich. Jan. 12, 2006); *In re DVI, Inc. Sec. Litig.*, 2005 WL 1307959, at *11 (E.D. Pa. May 31, 2005).

B. <u>Charges Relating To Octans I Are Barred By Judicial Estoppel.</u>

We respectfully request that the Court reconsider its prior ruling on Respondents' motion to preclude the Division from taking positions in this matter that are flatly inconsistent with the positions it took in the *Tourre* case and with the position the Commission staked out for itself in Proposed Rule 127B (March 31, 2014 Tr. 65:5 – 66:25). *See New Hampshire v. Maine*, 532 U.S. 742, 749-51 (2001).

C. <u>The Administrative Proceeding Violated Respondents' Constitutional Rights.</u>

As the Court is aware, Respondents have argued that the Division and the Commission violated Respondents' constitutional rights to due process and equal protection by bringing this

matter as administrative proceeding. On December 20, 2013, the Respondents filed an expedited motion for an order (1) extending time and granting an adjournment; (2) providing that proceedings will be governed by certain Federal Rules of Civil Procedure; and (3) requiring the Division to provide or identify certain materials (the "Dec. 20 Motion"). On February 14, 2014, Respondents filed an emergency motion for reconsideration or to stay the Hearing and prehearing deadlines pending appeal to the Commission (the "Feb. 14 Motion"). On February 26, 2014, the Respondents filed a petition for interlocutory review and emergency motion to stay the Hearing and prehearing deadlines (the "Petition").

For the sake of economy, rather than repeating arguments previously made, Respondents incorporate by reference the arguments set forth in their moving and reply papers in support of the Dec. 20 Motion, the Feb. 14 Motion, and the Petition. Respondents respectfully request that, for the reasons set forth in those papers, the Court dismiss this administrative proceeding on the grounds that Respondents' due process, equal protection and other constitutional rights were violated by (1) holding an administrative hearing in strict conformity with the Rule 360(a)(2) timeline notwithstanding the volume of the Division's investigative file and the complexity of issues presented; and (2) denying procedural safeguards afforded to the similarly situated persons whose cases were either dismissed in federal court or proceeded to a jury trial.

XXVI. REMEDIES.

Even had the Division proven the case described in the OIP – the one based on a scheme to accommodate a hedge fund that used its influence over the Octans I portfolio to advance interests adverse to other investors – the relief it now seeks would have been remarkably overly aggressive. As explained above, the Division failed even to prove the severely watered-down case described in its Post Hearing Brief – the one where representations were supposedly

"rendered" false or misleading once Harding departed, unbeknownst to Magnetar or Merrill, from the standard of care set forth in the CMA. In all events, however, as explained below, the Division's request for harsh sanctions is inappropriate for the violations now claimed to have been committed and should be rejected.

A. **The Division Is Not Entitled To Disgorgement, Much Less Disgorgement Of 100% Of Harding's Management Fees.**

The Division requests disgorgement of more than $12 million, an amount equal to all management fees earned for Octans I and the four "Norma Recipients." (Div. Br. at 134.) In doing so, the Division makes no effort to demonstrate that the entirety of these fees represents a reasonable approximation of profits causally connected to the alleged violations. Instead, the Division merely asserts, in a single, sweeping sentence, that Respondents cannot retain any fees because they "did not do what they were engaged to do" and obtained their positions "through a series of misrepresentations." (Div. Br. at 134.) The Division then implies, in grossly misleading fashion, that the Court may order disgorgement even absent evidence of specific profits that were causally connected to the alleged violations. (Div. Br. at 135.) In reality, even putting aside the myriad flaws in the Division's theories of liability, there is no basis to disgorge management fees for any of the five CDOs.

The Division cannot dispute the fact that it elicited no testimony indicating that the Issuer, *i.e.*, Harding's lone client with respect to Octans I, would have withheld Harding's management fees or would not have acquired the assets and issued the Notes had it known every detail regarding Harding's asset selection processes. That alone demonstrates that disgorgement is inappropriate, and is further reinforced by the fact that the Division's purported evidence of faulty asset selection relates solely to ABX Index assets selected on a single day.

For similar reasons, the Division's request for disgorgement of management fees for the four "Norma Recipient" CDOs is even more baseless. Two of those CDOs, Jupiter VI and 888 Tactical, only invested in A-rated Norma notes, and are thus not covered by the OIP. The BBB-rated Norma notes in Lexington V and Neo represented only 1.6% of the collateral in those CDOs. The Division also did not elicit any testimony indicating that the Issuers for Lexington V and Neo would have withheld Harding's management fees or would not have acquired the assets and issued the Notes had they known every detail about Harding's purchase of the BBB Norma bonds.

Disgorgement is intended to prevent unjust enrichment and is appropriate only in situations in which a defendant has benefitted from ill-gotten gains and *should not be used as punishment*. *SEC v. Reserve Mgmt. Co.*, 09 Civ. 4346 (PGG), 2013 WL 5432334, at *14 (S.D.N.Y. Sept. 30, 2013) (emphasis in original) (quoting *SEC v. Norton*, 21 F.Supp. 2d 361, 365 (S.D.N.Y. 1998)). Accordingly, disgorgement cannot be ordered above the amount wrongfully acquired. *SEC v. Jones*, 476 F.Supp. 2d 374, 386 (S.D.N.Y. 2007). Any further sum would constitute a penalty assessment. *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978).

In asking for disgorgement here, the Division treats all management fees for five CDOs as "ill-gotten gains." While management fees may be gains, they are only "ill-gotten" – and therefore subject to disgorgement – if there is a direct causal link between them and a securities violation. As stated in *SEC v. First City Fin. Corp.*, "[s]ince disgorgement primarily serves to prevent unjust enrichment, the court may exercise its equitable power only over property causally related to the wrongdoing." 890 F.2d 1215, 1231 (D.C. Cir. 1989). Therefore, "the SEC generally must distinguish between legally and illegally obtained profits." *Id.* (emphasis added).

The Division relies on *First City Fin. Corp.*, but only for the proposition that the Division "need only offer a reasonable approximation of the profits from the violative conduct" before the burden shifts to the respondent to show that the approximation is inaccurate. (Div. Br. at 134.) Having glossed over its obligation to demonstrate that its disgorgement request is limited to amounts that were causally related to the alleged securities violations, the Division asserts that disgorgement may be ordered "without regard to whether or not the violator also claims to have performed 'legitimate' services." (Div. Br. at 135.)

But the Division has it exactly backwards. Management fees can be disgorged only to the extent they constitute ill-gotten gains earned during the course of fraudulent activities. The Commission distinguishes between amounts earned through legitimate activities and those connected to violative activities; it falls on the **Division** to show a reasonable approximation of the fees that constituted unjust enrichment. *Walter V. Gerasimowicz*, Initial Dec. Rel. No. 496, 2013 SEC LEXIS 2019, at *7 (July 12, 2013); *Joseph John VanCook*, Exchange Act Rel. No. 61039A, 2009 SEC LEXIS 3872, at *66-72 (Nov. 20, 2009) (aligning disgorgement amount with frequency of late trading in which respondents engaged). Thus, while the Division's disgorgement figure need only be a "reasonable approximation" rather than a precise figure, the Court must not include amounts that were earned through legitimate activities. *See Gregory O. Trautman*, Securities Act Rel. No. 9088, 2009 SEC LEXIS 4173, at *85 (Dec. 15, 2009) (rejecting entirety of respondent's compensation as reasonable measure of unjust enrichment causally connected to violations); *Jay T. Comeaux*, Initial Dec. Rel. No. 494, 2013 SEC LEXIS 1929, at *8 (July 2, 2013) (rejecting portion of disgorgement demand relating to legitimate activities because it lacked causal relationship to wrongdoing and thus would be punitive, not equitable). **No disgorgement** can be ordered when, as here, the Division fails to provide any

evidence of specific profits that were causally connected to a violation. *See Reserve Mgmt.*, 2013 WL 5432334, at *13; *Jones*, 476 F.Supp. 2d at 386; *Norton*, 21 F.Supp. 2d at 365; *Gregory M. Dearlove*, Initial Dec. Rel. No. 315, 2006 SEC LEXIS 1684, at *185-88 (July 27, 2006).

The amounts the Division seeks to disgorge in this case do not represent ill-gotten gains attributable to a fraud. They are the fees due Harding for legitimate collateral management services. Again, for emphasis, the Division has made no allegations about Harding's conduct **managing** these CDOs. The Division's flawed arguments that Harding's asset selection processes were subpar, even if accepted, do not establish any basis for disgorgement of management fees. Harding's fees as Collateral Manager were earned based upon performance of the specific obligations set forth in detailed transaction documents. Harding performed those obligations. The CMAs obligated Harding to select collateral to be acquired by the Issuer in accordance with specified criteria. Harding did so. Both the Issuer and the investors received the benefit of their bargain. The evidence demonstrates that any representations concerning the manner in which Harding selected eligible collateral would have had nothing to do with the value of the CDO notes, *i.e.*, with the question of whether investors received the benefit of their bargain. There is no basis for the Division's disgorgement request.

The Division does not even attempt to proffer evidence that might allow the Court to reasonably approximate an amount of Respondents' compensation that was causally connected to an alleged securities violation, and relies solely on its sweeping request relating to Harding's management fees. Accordingly, there is no basis for an order requiring accounting and disgorgement pursuant to the Securities Act, the Advisers Act or the Investment Company Act,

see 15 U.S.C. §§ 77h-1(e), 80b-3(j), 80b-3(k)(5), 80a-9(e), and the request for disgorgement should be denied in its entirety. [319]

B. The Division's Request For Third-Tier Penalties Is Unwarranted.

Having essentially abandoned the fraud case set forth in the OIP, the Division should also abandon any claim for penalties beyond the first tier. Even as it seeks to put Respondents' conduct in the worst possible light, the Division conclusively demonstrates that it is pressing nothing more than a negligence case. (Div. Br. at 136-37.)

The Division asserts that (1) Mr. Chau "did not care – at all – what went into his CDOs so long as the assets were allowed by the transaction documents"; and (2) it was the "height of irresponsibility" for Respondents to stuff CDOs with assets that they had "not properly investigated and knew had serious problems," resulting in a very significant "risk of harm to others." (*Id.*) Thus, the Division does not dispute, and implicitly concedes that (1) there is no evidence that Respondents ever intentionally selected weak assets for any CDO portfolio; and (2) all assets selected by Harding were specifically allowed by relevant transaction documents. Accordingly, even if the Division prevails on one or more of its claims, no second-tier or third-tier penalties would be warranted. *See* 15 U.S.C. § 80b-3(i)(2) (second-tier and third-tier penalties require fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement).[320] There exists an "unmistakable difference between conduct which negligently operates as a fraud when compared to conduct engaged in with the intent to defraud clients."

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[319] No disgorgement is appropriate as to either respondent. Additionally, Mr. Chau cannot properly be held jointly and severally liable for any disgorgement order relating to Octans I management fees because he was not present in the office or otherwise involved in the asset selection process upon which the Division bases the crux of its case.

[320] Third-tier penalties would not be appropriate in this case even upon a finding of intentional or reckless conduct, based on the other applicable factors.

SEC v. Moran, 944 F. Supp. 286, 297 (S.D.N.Y. 1996) (imposing first tier penalty on investment advisers for breach of duty to act in best interests of clients).

Third-tier penalties are also unwarranted because the Division cannot demonstrate that Harding's asset selection processes resulted in substantial losses or created a significant risk of substantial losses.[321] The evidence shows that the purportedly negligently selected assets performed no worse than rigorously selected assets. (*See* Section IV.C.5. (discussing Resp. Ex. 858 at ¶¶ 41-42); Resp. Ex. 856 (Wachovia Report); *see also* Resp. Ex. 884 (March 27, 2014 Brady Letter from Division re Statements from Richard Ellson, Imran Khan, and Doug Jones).) Moreover, for the same reasons that the Division has failed to establish that Harding's management fees were causally connected to a securities violation, the Division cannot rely on pecuniary gain as a basis for third-tier penalties.[322]

Moreover, penalties should not be assessed based on the purported existence of a separate violation for each of the five referenced CDOs. Again, two of those CDOs (Jupiter VI and 888 Tactical) are not even charged in the OIP, and thus all equitable remedies and penalties associated with those CDOs must be disregarded. And two others (Lexington V and Neo) involve identical alleged courses of conduct. Imposing penalties on the basis recommended by

[321] Mr. Huang's statements regarding the market's general failure to analyze CDO assets adequately (Div. Br. at 135) is no substitute for evidence that Harding's alleged violations caused substantial losses. Moreover, the Division's citation to his testimony is absurd and disingenuous. The actual testimony from Mr. Huang was that in hindsight he believed there was a "universal problem" with people in the industry not taking enough time: "At that time, if you put yourself in that situation, at that time everything was kind of on accelerated basis. And from my personal view is nobody has enough time, frankly to do the necessary amount of work." (Huang at 1049:22-1051:2; see also 1049:14-15 ("I think the problem, my personal view is the problem is universal."); 1050:21 ("nobody was doing it"); 1051:18 ("I am making a universal [point]."); 1051:22-23 ("It was a universal problem.") In other words, Mr. Huang was merely offering his opinion, not facts, that the entire CDO market was a little too exuberant. Furthermore, this point, taken to its logical conclusion, is that no one did their job, including Messrs. Doiron, Ellson, and Wagner – all of whom were involved in originating, structuring, or managing CDO deals that failed before and after Octans I failed. If Mr. Huang is correct and everyone in the industry analyzed RMBS assets too quickly, then that – quick analysis of RMBS assets – was the standard of care.

the Division would be "disproportionate and unreasonable." *See Raymond J. Lucia Cos., Inc.*, Initial Dec. Rel. No. 540, 2013 WL 6384274, at *59 (Dec. 6, 2013).

C. **Public Interest Factors Do Not Support The Harsh Sanctions Requested By The Division.**

Consideration of the relevant public interest factors demonstrates that the Division's requests for additional harsh sanctions should be rejected along with the requests for disgorgement and third-tier penalties. *See Steadman v.* SEC, 603 F.2d 1125, 1140 (5th Cir. 1979); 15 U.S.C. §§ 80b-3(e), (f), 80b-3(i)(3).

First, the Division's watered-down case of negligent asset selection cannot support a finding of "egregiousness" with respect to the violations alleged.

Second, while the Division halfheartedly references the "level of scienter" as a rationale for imposing harsh penalties (Div. Br. at 136), there is no escaping that a case centered on alleged negligent asset selection does not involve a degree of scienter sufficient to justify harsh sanctions.

Third, even as alleged by the Division, the violations were not recurrent. At bottom, the Division faults the process by which Harding selected certain ABX index assets for Octans I on a single day in May 2006. The Division's perfunctory attempts to pile on additional purported examples, *see*, *e.g.*, B. at 134 n.204, are unsupported by anything but conjecture.

Fourth, Respondents cooperated with the Division throughout a three-year investigation. That investigation resulted in the issuance of an OIP containing allegations that the Division implicitly concedes it was unable to prove. Respondents cannot be faulted for denying they should be held liable based on those allegations.

Finally, for the reasons set forth above, Respondents' asset selection did not result in losses, nor did it create substantial risk of loss.

For all of these reasons, the harsh sanctions requested by the Division are unwarranted. The nature of the violations alleged does not support a cease-and-desist order. *See KPMG Peat Marwick LLP*, Exchange Act Rel. No. 1374, 2001 WL 223378, at *7 (cease-and-desist order not "automatic" after finding of violation, traditional factors must be considered). To the extent any penalties are imposed, they should be first-tier penalties below the maximum amounts of $6,500 for natural persons and $65,000 for other persons. *See* 17 C.F.R. § 201.1003 & Pt. 201, Subpart E, Table III.[323]

In all events, no associational bars are appropriate, let alone the permanent bar requested by the Division. The Division's argument to the contrary rests on the flawed premise that Respondents breached a fiduciary duty, and the Division's attempt to mischaracterize the evidence as demonstrating "extreme" departures from standards of ordinary care. The Division does not cite any case in which a permanent bar was ordered based upon allegedly negligent selection of assets that were allowed by applicable transaction documents – it is unlikely that such a case exists. Instead, the Division cites three cases in which this Court ordered a permanent bar and claims that those cases share "certain commonalities" with this one. (Div. Br. at 139.) As the Court is aware, however, each of the three cases upon which the Division relies involved intentional misrepresentations to investors.

In *ZPR Investment Management, Inc.*, Initial Dec. Rel. No. 602, 2014 WL 2191006 (May 27, 2014), this Court considered a case in which an investment adviser, ZPRIM, and its president intentionally misrepresented its compliance with Global Investment Performance Standards (GIPS). Unlike the standard of care at issue here, GIPS is a set of specifically

[323] The expenses associated with the Division's three-year investigation and this administrative proceeding, combined with the harsh penalties requested by the Division, raise potential issues regarding Respondents' ability to pay. In the event that the Court is inclined to consider any substantial penalty, Respondents request an opportunity to provide information regarding ability to pay.

articulated standards and requirements for reporting investment performance results; they constitute a threshold factor for institutional investors considering money managers. *Id.* at *6-7, 50. Unlike the representations alleged here, the misrepresentations in *ZPR Investment Mgmt.* included false statements made with an intention to conceal poor performance from ZPRIM's investors. *Id.* at *56. Moreover, the respondents had disseminated false information in magazine advertisements, in newsletters, and in information submitted to Morningstar. *Id.* at *19-30, *45-50, *56. After weighing the *Steadman* factors, the Court found that censure was sufficient to vindicate the public interest as to ZPRIM and that a permanent bar was warranted as to the president who intentionally concealed ZPRIM's poor performance. *Id.* at *58.

The conduct that the Court considered in *Raymond J. Lucia Cos.*, Initial Dec. Rel. No. 540, 2013 WL 6384274 (Dec. 6, 2013) is similarly distinguishable. In that case, the respondents attracted investors with elaborate seminars, webinars, and slideshows touting the "Buckets of Money" strategy. *Id.* at *6-11. The capstone of the slideshows was a series of "backtest" slides that appeared to demonstrate that the efficacy of the investments was supported by historical data; in fact, however, the slides were based on unreasonable and misleading underlying data. *Id.* at *25-37. The respondents deliberately and repeatedly chose to present this misleading data to prospective clients because accurate data would have demonstrated that the touted strategy would fail. *Id.* at *40. The Court weighed the *Steadman* factors and found that it was in the public interest to permanently bar a respondent that intentionally misled thousands of clients and potential clients, but that the Division's request for maximum civil penalties was excessive. *Id.* at *57-59.

Finally, *Michael R. Pelosi*, Initial Dec. Rel. No. 448, 2012 WL 681582 (Jan. 5, 2012), involved a portfolio manager who prepared and sent letters to investment firm clients that falsely

inflated performance results. *Id.* at *8-9, *18. The extensive and distinct pattern of overstating investor returns in hundreds of letters demonstrated the respondent's intent to deceive clients. *Id.* at *19. Accordingly, based on the *Steadman* factors, the Court imposed a permanent associational bar but declined to impose the maximum second-tier penalties requested by the Division. *Id.* at *23-25.

CONCLUSION

Because there has been a failure of proof on the part of the Division, and because the great weight of evidence overwhelmingly favors Respondents, the Court should conclude that Respondents neither directly violated Section 17(a) of the Securities Act or Sections 206(1) or 206(2) of the Investment Advisers Act, that Mr. Chau did not aid or abet or cause Harding Advisory's violations of those sections, and dismiss the action.

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New York, New York

Respectfully Submitted,

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