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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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ADMINISTRATIVE PROCEEDING
File No. 3-15574

In the Matter of

HARDING ADVISORY LLC and
WING F. CHAU,

Respondents.

POSTHEARING REPLY BRIEF OF THE DIVISION OF ENFORCEMENT

DIVISION OF ENFORCEMENT
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PRELIMINARY STATEMENT

The Division's brief is unrebutted. Respondents have instead offered a self-contradicting (and highly repetitive) grab bag of arguments in which Respondents, among other things:

- argue with a straight face that Harding was not an investment adviser to the CDO Issuers,[1] that the Issuers were not Harding's clients, and that the CMAs were not advisory agreements, Resp. Br. 105, 144, 145 & n.156, 242 n.284, 334 n.317 – and then turn around and admit, in effect, that this is nonsense because Harding *was* an investment adviser to the Issuers, who *were* their advisory clients, and that the CMAs created the advisory relationship, Resp. Br. 104, 339;

- create a false picture of corroboration for Chau's testimony about Kaplan's negative Norma write-up by grievously mis-citing the record, attributing an extensive series of transcript citations and testimony excerpts to Wagner – when in fact the transcript in question was of Chau, whose far-fetched testimony on the point at issue received ***no*** corroboration whatsoever from Wagner or any other quarter. *See* Resp. Br. 264-67 (attributing to Wagner five citations of and excerpts from Transcript pages 4382-4386); *contra* Transcript pages 4382-4386 (Chau, not Wagner, on the stand);

- engage in many other serious mischaracterizations of the record, including as to Ken Doiron, who simply *did not testify* that it would be "absurd" to factor a pitchbook's discussion of the manager's approach into an investment decision, or that an *underwriter's* warehouse involvement and hedging (to say nothing of a third party's) did not need to be disclosed – in fact his testimony was the opposite;

- complain that the Division's proof and argument are outside the OIP, when in fact they fall squarely within it;

- implicitly acknowledge that the Backfill Documents were created after the fact and effectively abandon any pretense of having credibly identified an "error" in the 1:13 Cash

[1] Capitalized terms or abbreviations used in this brief have the meanings assigned to them in the Division's Post-hearing Brief, which will be referred to as the Division's "Opening Brief" and cited as "Div. Br." Respondents' Brief will be cited as "Resp. Br." On July 8 (eleven days after the already extended date for filing their brief), Respondents filed a purported "corrected" version of their 349-page submission that contains, according to their document-comparison software, on the order of 600 changes. Many of these result from tinkering with trivial punctuation issues, but some appear to be potentially substantive. This filing is plainly improper, and an unnecessary nuisance. The Division's references to Respondents' Brief are keyed to the timely filed original.

Flows, leaving Respondents with *no* coherent defense of Lieu's May 31, 2006 selections in the face of negative credit work;

- rely heavily on cases involving only private parties, addressed to the reliance element, even though reliance, like injury, is not an element here;

- focus on issues that are either beside the point or unhelpful to their case, such as whether "all of the witnesses testified, uniformly, that they . . . worked hard." Resp. Br. 67; *accord id.* at 194, 207.[2]

There is much in Respondents' Brief that does not merit a response or that was already anticipated and refuted in the Division's Opening Brief (typically without serious rejoinder in Respondents' Brief). The following pages are generally limited to a discussion of Respondents' more significant internal contradictions and mis-statements of fact and law.

I. THE DIVISION'S DISCUSSION OF THE BACKDROP AND OF MAGNETAR'S STRATEGY IS UNREBUTTED

Nothing in Respondents' verbiage changes the fact that, as alleged in the OIP and discussed in the Opening Brief, Magnetar always intended to be, as Chau put it, "indifferent to the performance of the transaction," which situated Magnetar differently from the other investors.[3] Assuming that the particulars of Magnetar's positions even matter, nothing Respondents have said alters the reality detailed in the Opening Brief that Magnetar ended up

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[2] In fact, certain witnesses have admitted that they did not always work hard, namely number-two employee Huang, who apologized on the stand because after a certain point he "took it easy," Tr. 1195:4, and CEO Chau, who argues that the birth of his second child was a valid excuse for washing his hands of a nine-figure investment decision made five days after the birth, but not acted on for another week after that, decisions that could easily have waited were it not for the pressure from Magnetar. Resp. Br. 170 & n.185, 281-82. Note that of the two different birth dates that Chau offers for his child, *see* Resp. Br. 170 (baby born on May 26), 282 (baby born on May 30), the correct date is May 26. *See* Resp. Ex. 852 (Tuesday, May 30 email noting that the baby "was born on Friday").

[3] Respondents' arguments based on Proposed Rule 127B are irrelevant. "Proposed [SEC] rules do not have the force of law." *Union Commerce Corp. v. Huntington Bancshares Inc.*, 556 F. Supp. 374, 380 (N.D. Ohio 1982); *see also Mayer v. Chesapeake Ins. Co.*, 877 F.2d 1154, 1162 (2d Cir. 1989) ("the proposed [SEC] rule does not govern the present case"). *See also* Tr. 663:2-664:21.

with a net $18 million short position on Octans I, together with certain indirect long exposure through Tigris. And Respondents have said nothing to change the fact that, as alleged in the OIP and discussed in the Opening Brief, Magnetar pushed Harding to include Index assets for reasons having nothing to do with their long-term credit quality, which Magnetar did not care about.

II. THE DIVISION'S DISCUSSION OF THE RAMP OF OCTANS I AND THE REVIEW OF INDEX SECURITIES REMAINS UNREBUTTED

A. The Supposed "Arbitrage" Benefit Remains Irrelevant and Unproven

Respondents argue "that there was an arbitrage opportunity to acquire ABX Index assets at better spreads than the same assets could have been acquired directly." Resp. Br. 26-27, 50-54, 166-170. Maybe so, particularly if one ignores the upfront premium discussed by Ellson. But as explained in the Division's Opening Brief (at 39-41), that is irrelevant, because this case is about asset selection, not best execution. Again, the question is whether Harding validly selected the 28 Index assets, not what was the cheapest way to acquire those assets.[4] Respondents proceed from the premise that (as Chau has previously testified) Harding was interested in acquiring those 28 assets independently of the arbitrage – in which case, the arbitrage logically cannot be a justification for the selections. *See* Div. Br. 39-40. In addition, the record established that *no one at Harding ever analyzed the supposed arbitrage* to figure out whether it compensated for the negative credit work, or indeed made any economic sense at all.[5] Div. Br. 40-41; Chau Tr.

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[4] Respondents' argument is something like that of a retail shopper who, when asked why he bought a particular item of dubious or unknown quality, says: "Because it was on sale."

[5] Respondents, for example, say that "[t]he difference in spread would more than cover the cost to buy protection on the individual names." Resp. Br. 166. That is an entirely unsupported assertion. Suppose Harding had simply stuck with the ten Index assets that the analysts had approved before Magnetar entered the picture. Merrill or the CDO vehicle would have had to pay protection premiums as the short party on 30 CDS contracts (forty minus ten), and it is far from obvious that any arbitrage benefit on the 10 would have compensated for the ongoing carrying costs on the 30. In any case, this is all beside the point because Harding never did the analysis to find out. And let there be no mistake: such an analysis was

2151:18-21, 2156:18-2158:13 (admitting no analysis of economics); Lieu Tr. 3359:22-3360:4 (admitting no analysis of price); Huang Tr. 872:15-18 (admitting no analysis, period). The discussion of arbitrage is nothing more than a post-hoc justification.[6]

In addition, Ellson showed that the Index trade detracted from the spread of the overall portfolio due to the upfront premium associated with the trade. Div. Ex. 8002; Div. Br. 39. Respondents have never rebutted Ellson. At the hearing they criticized the supposed lack of an apples-to-apples approach, and attempted to introduce an elaborate calculation, designated RX 882A-G, that they claimed refuted him. Tr. 1142:4-1154:8. The Court excluded RX 882A-G (also known as "composite Exhibit 882") as an untimely expert-less expert report. Tr. 1154:9-1156:24, 1158:12-1161:10.

Respondents' Brief relies heavily on the very analysis that the Court excluded. Respondents' Appendix F[7] *is* RX 882B-G, with some columns removed and some Excel formulas displayed. Appendix A purports to explain the calculations. Respondents' Brief (at 28 & nn.29-30, 53-54 & nn.51-54) relies heavily on Appendix F – in other words, on the excluded exhibit. The Court's ruling made eminent sense at the time, and it still does: Appendix A's do-it-yourself instructions are no substitute for an expert witness. Tr. 1154:15-16 (Court: "This is complicated enough that it would require an expert."). Respondents' attempt to circumvent the Court's evidentiary ruling should be rejected.

Harding's responsibility, not Merrill's or Magnetar's. *See, e.g.*, Div. Ex. 5, clause 3(A) (under warehouse agreement, manager selects CDS and "pricing terms thereof"); *contra* Resp. Br. 167 n.181.

[6] The third-party research reports that Respondents cite (at 166-67) are no substitute for Harding's analysis, particularly when there is no indication that Chau or anyone else at Harding ever received, possessed, or reviewed the reports. *See* Resps. Exs. 294 (no Bates code), 295 (Merrill Bates code).

[7] Respondents' Brief appends "Exhibits." To avoid confusion with hearing exhibits, we will refer to these appended "Exhibits" as "Appendices."

B. Harding's Asset-Selection Process for Octans I Was Compromised by Magnetar's Involvement, and Respondents Have Not Shown Otherwise

Respondents complain that the Division has not shown that Harding's asset-selection process was corrupted by Magnetar's involvement.[8] But the Division proved what is alleged in the OIP. A wealth of compelling evidence shows that with Octans I, as with other Magnetar CDOs, Harding followed a practice of accepting "the lesser of evils" from the Index. That evidence, much of it expressly previewed in the OIP, includes, among other things:

- significant write-downs for 16 of the 28 accepted bonds in the cash flows circulated May 30 and 31;[9]
- Lieu's sentiment, relayed by Huang to Chau and Wang the morning after the selections, that "we are less comfortable" with some of the assets (*see* Div. Br. 35-36);
- Moy's dissenting views (*see* Div. Br. 56-57);
- inexplicable flips from "No" based on individual loan (*i.e.*, collateral) characteristics to "Yes" when there was no time for a review of the collateral to get comfortable with it (*see* Div. Br. 52);
- the aberrational "hit rate" (*see* Div. Br. 47-48);
- the relaxation of assumptions for no discernible reason other than to accelerate the ramp and facilitate the Index trade (*see* Div. Br. 49-51);

Respondents' attempt to defend the Index selections is addressed below.

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[8] Lacking any evidence of competent, uncorrupted asset selection for the Octans I Index trade, Respondents contend that a valid asset-selection process was in place at Harding as a general matter and was followed before and after the Index trade for Octans I. If accurate, that would serve only to highlight that, as alleged in the OIP, Harding specifically compromised its process to accommodate Magnetar.

[9] Thirteen of those write-downs are in the 1:13 Cash Flows. Another three are in the Moy Spreadsheets, which Respondents insist should be considered here as evidence of Harding's credit work. *See* Div. Br. 52-56 & Appendix 3 (columns E, G-J); Resp. Br. 175-77 & Appendix D. The Division does not concede that Lieu had access to the Moy Spreadsheets, but Respondents cannot have it both ways: either (1) as Wagner assumed and made clear he assumed (*see, e.g.*, Wagner Tr. 4741:19-4742:21), Lieu did not see the Moy Spreadsheets, in which case she accepted eleven bonds for which she reviewed *no* cash flows at the time of her decision, *see* Div. Br. 54, a very serious violation of the standard of care; or (2) Lieu *did* have access to the Moy Spreadsheets, in which case Respondents should be impugned for accepting three bonds with write-downs in those spreadsheets. *See* Div. Br. 55.

1. *It Was Chau's Idea To Violate the Standard of Care by Relaxing the Loss Assumptions – and His Contrary Argument Contradicts His Testimony*

According to Respondents, Lieu and Moy "decided on their own in late May to adjust their assumption to 6 percent cumulative losses." Resp. Br. 281 (relying on RX 767, incorrectly cited as RX 267); *accord id.* at 180, 218 (citing RX 767). The Division's Opening Brief explained that the impetus to relax the assumptions, and thus get more bonds to pass, had to have come from Chau, even if the details were left to Lieu and Moy. Div. Br. 50-51 & n.88. Moreover, the timing is important. Moy and Lieu conferred about lowering the loss levels on May 25. That is the same day that Prusko discussed the Index with Chau, *see* Div. Br. 49 – which no doubt prompted Chau to ask the analysts to figure out a way to get more bonds to pass.

In any case, Respondents' version of events conflicts with Chau's testimony, elicited by his own counsel (Tr. 4244:12-17):

> Q. Let me ask you this. How does one determine whether to use 6 percent cumulative loss or 13 percent or 3 percent?
> A. *Those assumptions are generated at the senior level of Harding Advisory, so it would be myself, Tony Huang, Alison Wang.*[10]

To accept the narrative in Chau's brief is to reject Chau's credibility as a witness; and vice-versa.

Respondents find it notable, too, that, according to third-party research reports, certain other firms used loss numbers below 6 percent. Resp. Br. 219 n.247. These reports are beside the point. *See* Wagner Tr. 4929:3-25 (Harding's assumptions more relevant than industry research reports in assessing compliance with the standard of care). As Respondents note (at 180 n.207), Harding was not required in the abstract to use a specific loss level. *See* Wagner Tr. 4734:25-4735:2 ("I have never said that everyone has to use the same default rate."). What Respondents

[10] As explained in the Opening Brief, the suggestion that Huang or Wang ever generated loss assumptions is not credible. Div. Br. 51 n.88.

were required to do (and this is not disputed either, *see* Resp. Br. 217-18) was to independently develop considered assumptions consistent with their own macroeconomic views, and then to apply those assumptions in a regular and defensible manner. *See* Wagner Tr. 4928:4-9 ("I presume that they would come up with some method of looking at these cash flows that was based on, again, the top-down view of the economy and other factors and then the bottom-up type analysis, applying it to individual securities.").

Here, the lowering to 6 percent cannot be squared with Chau's own testimony on his macroeconomic view, coupled with the increasingly poor performance of subprime in the spring of 2006. *See* Div. Br. 50-51. *Nor does the record contain a single credible rationale for the relaxation.* The obvious inference is that any "top-down" analysis at Harding was compromised or abandoned once Magnetar asked Chau to ramp Octans I quickly and with Index bonds. *See* Resp. Br. 212 n.243, 217 (explaining "top-down" analysis). Finally, and perhaps most importantly, accepting bonds with write-downs in the 6 percent base case was a clear violation of the standard of care, regardless of how other firms were projecting losses.

2. *That the Analysts Had Already Reviewed Most of the Index Bonds Is Undisputed – <u>but the Analysts Had Rejected Two-Thirds of What They Had Reviewed</u>*

The sections of Respondents' Brief (XII.D., at 171-75, Appendix C) that purport to demonstrate "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," Resp. Br. 173, need to be read in conjunction with section VI.E. of the Opening Brief and column F of its Appendix 3. Of course the analysts had reviewed many Index assets before May 31, 2006 – 29 out of 40 of them, to be precise, *and almost two-thirds of those were rejected before Magnetar started demanding the exclusions*. Div. Br. 51-52. To date no good explanation has emerged for how and why Lieu reversed the "No" decision on nine of those, since all showed very large write-downs on May 31, 2006, *see* Div. Br. Appendix 3 (column G), and three had been rejected for collateral characteristics that there simply was not time to re-review. Div. Br. 52 & 46 n.81.[11]

As for the eleven bonds that had not been previously reviewed, there simply was not time for a proper review. *See* section II.B.3 below. It is no answer to say that the "credit team" (Resp. Br. 171-75) may have already reviewed a portion of the information that factors into a credit decision. For one thing, the "credit team" could mean Moy rather than Lieu. *See* Resp. Br. 211 (acknowledging that the analysts generally "divided up the bonds"). For another, even if Respondents were right that tranche-specific (as opposed to deal-specific or servicer- and originator-specific) analysis can be done in "30 minutes or so," Resp. Br. 171 – and that is *not* the evidence[12] – still review of the eleven would have required *at a bare minimum five and a half hours of work*. And that is apart from the substantial investment of time needed to justify nine reversals from "No" to "Yes," as well as all the time to do the cash flow and surveillance work on all forty and to do all the *non*-Index work that Lieu did that day (to say nothing of the many Index-related tasks that Lieu *claims* to have done). It does not add up.

3. *Respondents Marshal No Credible Evidence That There Was Enough Time*

The evidence shows clearly and convincingly that Lieu did not have enough time to properly review all of the Index bonds – which Chau had to have known given his own

[11] Respondents assert (at 184) that Lieu "did not know about Magnetar." But the undisputed evidence is that she did. *See, e.g.*, Resp. Ex. 353 (June 1, 2006 email from Lieu to MaximCDO referring repeatedly to "Megnatar"). Moreover, Huang and Lieu each testified that Chau informed them of the Index trade. Div. Br. 30, 34; Huang Tr. 846:6-7. Chau was in the office on May 31 and looped in to the Index trade and Magnetar's relentless push to get the exclusions that day. Div. Br. 111. There is more than enough circumstantial evidence to conclude that, whether through Chau or Huang, Lieu was made to understand that her role on May 31 was to identify a limited number of exclusions.

[12] *See* Div. Br. 45-46 (reviewing Lieu's hearing testimony that the shorter version of review "could be 30 minutes or it could be three hours depending on the bond," and Lieu's and Chau's prior testimony that review took a day or more per bond); *see also* Lieu Tr. 4001:2-7 (agreeing that, "if one is already familiar with the [bond] or has more to work with," review can be "much quicker[,] as in a few hours").

testimony on how long it took to review RMBS bonds in general, and how long it took Lieu in this instance. Div. Br. 45-46, 48, 58-59, 60-62. Respondents' rejoinder includes RX 514,[13] an email in which collateral manager ACA promised to report back to Prusko on the Index assets in a day's time. Resp. Br. 280. RX 514 has no probative value. A third-party email without context,[14] it says nothing about how much work ACA had already done on the Index assets (except to imply that it was a lot), how recently the work had been done, how many people would be looking at the assets, how many other things those people would be busy with, and a host of other variables. *See, e.g.*, Wagner Tr. 4765:11-4766:7. Also, despite what Respondents say, the Division has never held out ACA as exemplifying a standard of care.

4. *Respondents' Discussion of Approvals and Rejections Before and After May 31 2006 Are a Series of "Heads I Win, Tails You Lose" Arguments*

In their discussions of supposed approvals and rejections of the Index bonds at *other* times for *other* transactions, Respondents repeatedly talk out of both sides of their mouth. Under

[13] Respondents also point out that Huang and Lieu say there was enough time. Resp. Br. 68, 280. But Lieu is not credible on this subject, and Huang (even setting aside the fact that he testified that Harding generally did *not* spend enough time on its analysis, *see* Div. Br. 81 n.144) was basically disengaged from whatever Lieu was doing. *E.g.*, Div. Br. 37 n.64.

[14] *See Joseph Abbondante*, Exchange Act Rel. No. 53066, 2006 WL 42393, at *7 (Jan. 6, 2006). Note that despite Respondents' complaints (at 8, 196, 215, 243 n.285) about the Division's supposed use of "rank hearsay," much of the Division's documentary evidence is in the form of emails by Chau and others at Harding that would not even qualify as hearsay under traditional evidence principles because they are party admissions. *See* Fed. R. Evid. 801(d)(2)(A), (D). Traditionally, the "theory behind admitting [party] admissions" was "that they are reliable, or at least it is fair to admit them, and they can often easily be answered if required, by the party, who is, after all, a party in the lawsuit and ought to be made responsible for the statement[.]" Paul F. Rothstein, Federal Rules of Evidence Rule 801 cmt. III n.20 (3d ed. 2013); *see also* 2 McCormick on Evid. § 759 (7th ed. 2013) ("responsibility for statements of one's employee is consistent with" adversary system). Accordingly, under *Abbondante* and other Commission precedent, Chau's and other Harding employees' emails (even Moy's on "the lesser of evils") have tremendous probative value and reliability, and present no unfairness. *See Wheat, First Sec., Inc.*, Exchange Act Rel. No. 48378, 2003 WL 21990950, at *12 & n.55 (Aug. 20, 2003) ("Even if the Federal Rules of Evidence applied, the law judge properly admitted the evidence as non-hearsay." (citing Fed. R. Evid. 801(d)(2)(A), (D))).

their "heads I win, tails you lose" system, Lieu's acceptances on May 31 would be *validated* by *acceptances* at other times, but would not be *invalidated* by *rejections* at other times.

First of all, it is undisputed that all previous decisions were supposed to be refreshed before Lieu made the selections on May 31, 2006. Div. Br. 44; Resp. Br. 159, 189, 207, 226. Accordingly, insofar as four of the previously approved Index bonds showed write-downs when Lieu re-analyzed them on May 31 (*see* Div. Br. Appendix 3, columns E-G), those should not have been included in the Octans I warehouse.

Similarly, even if were true that "the MABS bonds . . . had been approved by both analysts on other occasions" before May 31,[15] it would be irrelevant. On May 31, 2006, Moy registered a clear view about the MABS bonds based on the collateral, and those views were not reflected in the investment decision made later that day. There is no evidence that Moy had previously independently reviewed the MABS bonds. Again, it is not disputed that the two analysts "divided up the bonds," Resp. Br. 211, and even Respondents concede elsewhere that the prior approval was attributable to Lieu alone. Resp. Br. 178.

Next, Respondents find it significant that Moy included the MABS bonds (and other Index bonds that she was not willing or ready to approve on May 31) in lists sent out after May 31. Resp. Br. 159-62, Appendix B. But that does not mean that Moy ever changed her opinion of MABS or anything else. Rather, as Respondents elsewhere explain, "Generally, if a portfolio manager, like Mr. Huang, requested from the Harding credit team a list of approved deals, the credit analyst [such as Moy] would review the master list of credit decisions" – after May 31, this would include the "yes" for MABS – "and run *cash flow or surveillance analysis* in order to

[15] Resp. Br. 158; *see also* Resp. Br. 160 (asserting that one of the MABS bonds "was approved on May 22, 2006 by the Harding credit team"); Resp. Exs. 298A, 299A (demonstrative implying that Moy and Lieu jointly agreed on MABS around May 22, 2006).

refresh the credit decision." Resp. Br. 159 (emphasis added). In other words, any subsequent "approval" of MABS by Moy is simply a reflection that MABS was recorded in the master list as a "yes" in the face of her negative views on the collateral in the deal – in other words, it is a reflection of Harding's violation of the standard of care.

There is, however, a much larger problem with Respondents' reliance on decisions made for other transactions at other times to excuse the events of May 31, 2006. Start with the fact that a number – at least six – of the Index assets included in Octans I on the basis of the May 31 selections had actually become *expressly rejected* by the time Octans I closed.[16] In an effort to deal with that, Respondents turn around and argue that a later rejection does not invalidate a prior approval.[17] Respondents cannot possibly be allowed to have it both ways. Either (A) the validity of a credit decision at time X (say, May 31, 2006) is independent of decisions on the same bond made later than X (in which case supposed re-approvals at later times are irrelevant) or (B) the validity of a credit decision on May 31, 2006 can indeed be judged based on what the analysts do afterwards (in which case Respondents violated the Advisers Act for the additional reason that they caused the Octans I Issuer to accept a number of assets that the analysts had expressly rejected by the time the CMA was signed). It cannot be both.

[16] Resp. Ex. 435 is a September 18, 2006 email from Lieu to Chau listing ABX 2006-1 approvals and rejections at the Baa2 level only following a full re-review. RX 435 lists as rejected six ABX bonds at the Baa2 level that went into Octans I at closing. *Compare* Div. Br. Appendix 3. However, arguably the number is really ten, not six. If the *Baa2 assets* were rejected following full review, then the *Baa3 counterparts* could no longer have passed muster, either. Of the six Baa2 Index bonds in Octans I that had become rejected by September 18, four had Baa3 counterparts in Octans I – a total of at least 10 bonds without supporting credit approval by the time of closing.

[17] *E.g.*, Resp. Br. 199 ("The fact that Harding's credit team changed its decision at some point in time later does not render the prior decision incorrect."), 226 ("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."), 227 ("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.").

5. *Respondents Have Not Shown That Lieu Relied on Non-Existent Cash Flow Runs as Opposed to the Existent Ones*

Nowhere in their 350-plus pages of argument do Respondents identify a single error, "latent defect," or "incorrect [or] unintended assumption" (Resp. Br. 179) in the 1:13 Cash Flows. Not one. (The closest they come is to baldly speculate about the prepay setting, Resp. Br. 188, Appendix J at 4.[18]) In fact, Respondents admit that "determining the cause of the strange cash flow results was difficult and it took an expert . . . to figure out the problem" – or rather to speculate about "the *most likely problem*." Resp. Br. Appendix J at 4 (emphasis Respondents').[19] Which raises an important point: Respondents would have the Court believe that, in between 1:13 p.m. and 4:23 p.m. on May 31, 2006, Jung Lieu accomplished something so "difficult" that a team of Navigant consultants[20] has been unable to achieve it despite trying mightily since March 24 of this year (*see* March 28, 2014 Haran Affidavit ¶ 9), namely identify an actual mistake in the assumptions underlying the 1:13 Cash Flows.

They have been unable to do it because there was no mistake with the 1:13 Cash Flows, and there are no missing runs. *The idea of additional cash flow runs is a fiction invented for the litigation.* Lieu did not have time on May 31 to devise a new curve that would make all of the bonds pass (that came later), and instead, in an extreme departure from the standard of care, she

[18] In their attempt to catalogue supposed "facial irregularities," Resp. Br. 183, with the 1:13 Cash Flows, Respondents claim (at 182-83) that it was a sign of a defect (a) for two tranches of the same deal to have the same write-down, and (b) for a higher tranche to experience any write-down before a lower tranche experienced a 100 percent write down. These arguments have no evidentiary support – because they are wrong. Hilfer obtained almost the same results when he inputted the same assumptions that Harding was using in late May 2006. *See* Hilfer Supp. Report Table 2.

[19] Respondents actually go even further and *finally concede* that the 1:13 Cash Flows were indeed run according to the "method" that "the Harding credit team" used at the relevant time until it was "scrapped" at some later point, Resp. Br. Appendix J at 5 – probably because it showed write-downs for bonds that Harding had already decided to invested in.

[20] *See* Hilfer Supp. Report ¶ 12.

selected, and Harding caused an advised portfolio to invest in, bonds that showed significant write-downs under Harding's own analysis.[21] It bears repeating, too (*see* Resp. Br. 164, 182, 202), that the fact that a bond is trading at par does not license a manager to forgo credit work or ignore the results of it – both are serious violations of the standard of care. *See* Div. Br. 64 n.114.

C. <u>Respondents Have Basically Thrown in the Towel on the Backfill Documents</u>

Respondents are no longer seriously trying to argue that the Backfill Documents were created contemporaneously with the investment decision. *See* Resp. Br. 228-35. Nor have Respondents furnished any basis for believing that the Backfill Documents accurately reflect what Lieu did on May 31. Respondents argue that the bond evaluations were updated – as if to suggest (albeit half-heartedly) that contemporaneous documentation might have been superseded or modified. Resp. Br. 231-33. For one thing, that is inconsistent with the title and format of the Backfilled Bond Analyses, which (falsely) suggest presentation to a (non-existent) committee for an investment decision as opposed to ongoing updating. Div. Br. 67-68. Also, this is another "heads I win, tails you lose" argument – Respondents write off compelling evidence of later creation as evidence merely of modification, but *utterly fail to show that anything was created at the time the investment decision was made.*

D. <u>The Point about Constraints Increasing as the Ramp Progresses Is Irrelevant</u>

Respondents (at 19-20, 210) talk about the manager being increasingly constrained as a ramp progresses.[22] This is irrelevant. The undisputed testimony is that *the constraints, whatever*

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[21] Respondents at one point argue without support or elaboration that "even if [Lieu] had not re-run the analysis that day, the [1:13 Cash Flows] did provide a basis for decision." Resp. Br. 180. A basis for distinguishing among the "lesser of evils," perhaps, but not a basis for investment consistent with the standard of care and other representations. Lieu was emphatic, and Doiron, Huang, and Wagner agreed, that a credit analyst should not recommend bonds with projected write-downs in the base case. Div. Br. 45 & n.80, 77-78, 84; Wagner Report ¶¶ 92-93.

[22] Respondents' point is not clear, and even if it were right, it is hard to understand which way

they may be at whatever stage of the ramp, are not an excuse to relax credit standards or ignore credit work. Wagner Tr. 4639:12-22 ("In general, I think the bonds have to pass muster from a credit perspective and then you can evaluate whether you can put them into the CDO. . . . I just don't think that you buy bonds just to fit the CDO."); Jones Tr. 2820:20-25 ("Q. Did you relax your standards at all because it was early in the ramp? / A. No. Not at all. I mean, we would always buy what we wanted to buy, or try to buy what we wanted to buy."). In addition, there is no evidence that Lieu's Index selections had anything to do with portfolio constraints or that she considered them at all. *See* Huang Tr. 1042:9-20 (focus of RMBS analysts limited to "the credit side of the underlying bonds"); Lieu Tr. 3271:5-3272:10 (in general, the only constraints Lieu was ever informed of were rating and quantity of bond); Div. Ex. 81 (showing that Lieu made the Index selections independent of rating and quantity).

E. Chau's Certification of Compliance with the Eligibility Criteria <u>Does Not Mean That Respondents Did Their Jobs</u>

According to Respondents, their closing certification proves that they complied with their obligation to assess the credit-worthiness of the assets in Octans I. *E.g.*, Resp. Br. 86 ("Harding re-evaluated and analyzed each asset in the Octans I portfolio, *including its credit worthiness*, as part of th[e] closing certification." (emphasis added)); *see also id.* at 6, 142. There is simply no evidence for that. What is more, as discussed above in section II.B.4., Respondents had determined by September 18, 2006 (eight days before the certification) that at least six (*see* footnote 16) of the Index assets going into Octans I were now rejected on credit. If Respondents

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Respondents mean for it to cut and which way it should cut. Are Respondents saying that they were entitled to pick any old ABX assets on May 31, 2006 because at that early stage (just a day after Wang asked if the warehouse could be opened, *see* Div. Ex. 25), they were still relatively unconstrained by the portfolio targets? Or are Respondents saying that on May 31, 2006, they were basically forced to select many Index assets for unspecified reasons because unspecified portfolio constraints had begun to kick in?

really were trying to satisfy themselves at closing of the credit-worthiness of the bonds in Octans I, they would have done something about those rejected bonds.

In any case, the certification was merely one of compliance with the eligibility criteria, *see* Div. Ex. 501 at 1, which, with one notable exception, is an entirely separate matter from the manager's credit work. *See* section III below. The exception is the requirement that an asset *not* be a "Credit Risk Security." According to Respondents, the fact that they impliedly certified "no credit risk securities" means that they re-checked the bonds' credit quality just before closing. *See* Resp. Br. 82 & n.63, 85; Resp. Ex. 2 (OC) at 139.

There are at least three problems with that defense. First, just because Respondents signed a certification does not mean that the certification was accurate. Second, the definition of "Credit Risk Security" *incorporates the standard of care*, which there is no credible evidence Harding satisfied. Resp. Ex. 2 at 257; Resp. Ex. 4 at 19. Third, the definition of Credit Risk Security in the transaction documents presupposes that the asset has already been bought by the Issuer. Resp. Ex. 2 at 257; Resp. Ex. 4 at 19. In other words, as Respondents appear to concede in a different portion of their brief, the criterion "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. Br. 110 (emphasis added). Thus, the certification *at* closing of compliance with all the eligibility criteria is meaningless in relation to the "not a Credit Risk Security" criterion, since that exclusion could be triggered only *after* closing. The certification has still less bearing on whether Harding did proper credit work.

III. RESPONDENTS CONCEDE CONSCIOUS VIOLATION OF THE STANDARD OF CARE[23]

Respondents' reliance on the rating agencies' various requirements and other eligibility criteria as an excuse for ignoring or not doing their own credit work (*e.g.*, Resp. Br. 84-87, 103, 106, 141, 199, 227 n.258, 280, 296-99, 305-06) proves the Division's point: Respondents knowingly violated the standard of care. *See* Div. Br. 77-82, 99-102. The eligibility criteria for Octans I are set forth at pages 137 through 146 of the FOC (Resp. Ex. 2). *They are generally mechanical rules and rating-agency-imposed requirements; they have nothing to do with the manager's own views of the credit-worthiness of the assets.*[24] Wagner Report at 4-5 (Ops. III(a)(v), (b)), ¶¶ 105, 165; Wagner Tr. 4639:12-22. A CDO manager who does no investigation of assets beyond confirming that they meet the eligibility criteria set forth in an offering circular and indenture is no manager at all.[25]

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[23] Respondents complain (at 203-05) about the Division's use of fact witness Doiron's testimony to help illustrate the standard of care. This is allowed, as Respondents themselves have previously argued. Letter from Alex Lipman to Judge Elliot, at 2 n.1 (Mar. 6, 2014) ("[T]he relevant standard of care in this case can best be established by fact witnesses, rather than an expert."); *see also Harding Advisory LLC*, A.P. Rulings Rel. No. 1256, at 2 (Feb. 24, 2014) (Although standard of care "best established by expert evidence," "[t]he actual practices or opinions of particular lay witnesses . . . might be relevant"). Also meritless is the suggestion (at Resp. Br. 204-05) that Doiron has managed too few CDOs for his testimony about HIMCO's practices to be pertinent to the customary standards of institutional managers of national standing. *See* Wagner Tr. 4581:25-4582:15 ("I don't think the standard of care calls for it only being measured against CDO managers. . . . You wouldn't do [RMBS-specific analysis] if you were looking at the film securitization for DreamWorks, but you would try and understand the factors that impacted the cash flows, analyze them, stress them, look at structures, examine how they were put together. It is really the same approach across asset classes and really across asset managers."). Finally, Respondents suggest (at 205-06) that Doiron has managed too few CDOs for his testimony to be representative of the hypothetical reasonable CDO *purchaser* (as opposed to CDO manager). But that makes sense only if the reasonable CDO purchaser has to be a CDO manager, or in other words only if the point of issuing CDO securities is to place them in the portfolios of other CDOs. And that is not the case at all. *See generally* Wagner Tr. 4898:11-4901:2.

[24] The major exception is the criterion that an asset not be a "Credit Risk Security" – but that does not help Respondents. *See* section II.E. above.

[25] Consider a rough analogy: the manager of an actively managed mutual fund that invests in large-cap domestic stocks. If the manager were to select stocks without reading companies' financial statements, or after reading them and concluding that the companies are bad investments, it would be no answer for the

Respondents' arguments make a mockery of the role of an asset manager. If the CDO manager's only job was to satisfy the eligibility criteria, then there would be no reason for Harding to have its own credit analysts, no reason to bring those analysts to marketing presentations, no reason for investors to ask, and those analysts to answer, questions about Harding's own views of the assets and why they were selected (*see* Div. Br. 83 & n.145), no reason for Chau to inflate the depth of his credit department in marketing materials (Div. Br. 112-13), and, for that matter, probably no need for a standard of care, let alone for Wang to demand disclosure when Harding's conduct *during a ramp* did not comply with it, *see* RX 457. Indeed, there would likely be no need for Harding at all, let alone for it to obtain millions in fees for performing what, in Respondents' telling, were its relatively limited, if not ministerial, duties.

The CDO manager's job (Chau's idiosyncratic theorizing notwithstanding[26]) is to select the best bonds it can find that fit within the portfolio given the constraints.[27] The standard of care required Harding to investigate and confirm the credit quality of RMBS and CDO securities before acquiring them. Wagner Report ¶ 165; Wagner Tr. 4628:6-9 ("If the weighted average spread that makes the transaction work is too high for the manager to pick bonds they think are reasonable to put into a CDO, then they shouldn't be buying the bonds."), 4638:25-4639:22;

manager to defend himself by saying that the stocks were a permissible investment because they had a large market capitalization and were U.S. companies.

[26] *See* Resp. Br. 107-08 (no such thing as "best" assets); *but cf.* Chau Tr. 1494:25-1495:9 ("That is my intention personally. . . . I will try to buy the best securities at the best levels.").

[27] Wagner Tr. 4638:25-4639:11 (manager's job "is to pick the best bonds that fit within the CDO"); Doiron Tr. 1881:21-1882:2 (expected CDO managers to "choose the best assets they could find"); *see also* Jones Tr. 2818:20-22 ("we were just trying to buy what we considered the highest quality stuff with the highest yield"), 2827:19-23 ("ultimately we thought we were buying really good stuff, and our intention was to build a very nice deal that we would be happy to own ourselves and happy to sell to friends and family of the firm, and that's what we did").

Doiron Tr. 1882:3-24; Div. Br. 101. Respondents understood these responsibilities, and disregarded them.

IV. RESPONDENTS SERIOUSLY MISCHARACTERIZE THE INVESTOR TESTIMONY

The investor testimony (*see* Div. Br. 16 n.25, 83-86, 110-111 & n.183, 113-114 & n.187) showed overwhelmingly that the marketplace was interested not just in which assets had been ramped into the warehouse at the time of marketing, but in the manager's processes, diligence, its own credit work *for already ramped collateral*, and its independence. The Division furthermore showed that a reasonable investor would have found the omission of Magnetar's role in asset selection material.

Respondents have pointed to no actual testimony to undermine that; instead they have grossly mischaracterized the record, most seriously (although not only) with respect to Doiron. First of all, Doiron did *not* say that it would be "absurd" (Resp. Br. 4, 114, 121 n.114, 315) for an investor to take into account a CDO manager's discussion of its investment process in a pitchbook. On the contrary, Doiron – like Jones, Tony Huang, and Wing Chau, which is to say everyone except for Edman[28] – testified that this was important information to his group, even if not the only thing they reviewed. *See* Div. Br. 110-111 & n.183 (citing testimony). The "absurd" sequence actually reads as follows (Tr. 1954:25-1955:20):

> Q. Again, would you have been happy if ***all [your analyst] did*** was say, "Look at the collateral manager section of this pitchbook. Do you see how beautiful this is? They have a top-down/bottom-up approach." Would that ***have been sufficient*** for you to say, "I think that is the way to go. I think we should invest in Octans 1"?
> A. No, ***it would not have been sufficient.***

[28] Even Edman conceded that it would not be "ridiculous" for an investor to rely on the pitchbook in conjunction with other information and that "it doesn't sound crazy" that investors might rely on the manager's discretion and expertise. Tr. 2589:3-7, 2595:5-11.

> Q. Forgive me for being a little flip, but I am being flip because you would agree ***that*** would be ridiculous?
> A. Yes.
> Q. ***It*** would be absurd; right?
> A. Yes.
> Q. It would be absurd to base an investment decision on the bullet points in the collateral manager's section of a pitch book; right?
> A. Yes.

It is obvious that Doiron was simply saying that it would be "absurd" to base an investment decision *exclusively* on the collateral manager section of a pitchbook.[29] In case there is any doubt, here is the redirect (Tr. 2027:21-2029:2):

> Q. At one point Mr. Haran asked you – and I want to make sure we are totally clear on how you understood his question. At one point I think he asked something like: Wouldn't it be absurd to base your investment on the marketing presentation. Do you remember that?
> A. Yes.
> Q. Let's distinguish between two different things to be totally clear. Thing one is all we will do is read the marketing book and then close our eyes and not look at anything else. Thing number two is we are going to read the marketing book and do other kinds of work and diligence. Following me so far?
> A. Yes.
> Q. Would thing number one, read the marketing book, close your eyes and invest, would that be absurd?
> A. That would be absurd.
> Q. Would thing two, read the marketing book along with other things, other diligence-type work[] and then invest, would that be absurd?
> A. That would be reasonable.
> Q. If in that process it turned out that there were inaccuracies in the marketing book, is that something that would matter to you?
> A. Yes.

Respondents also claim (at 46-47, 286-89, Appendix G) that Doiron testified that *not even the underwriter's* warehouse role and hedging needed to be disclosed. Doiron said no such

[29] The materiality criterion, of course, does not require that misrepresented information be the *sole* thing a reasonable investor cares about, just that it be viewed as having importance in the "total mix" of information. *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988); *see also Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2413 (U.S. June 23, 2014) (reiterating *Basic v. Levinson*'s formulation of materiality); Div. Br. 103. Manager processes as depicted in a CDO pitchbook more than meet this standard. Div. Br. 83-86, 110-111 & nn. 183, 184; section VIII.B. below; *see also* footnote 46 below.

thing. In the portion of his testimony cited by Respondents (*see* Doiron Tr. 1988-2002, 2009-2010, 2056), the only thing he said about disclosure was that statements about HIMCO's own selection of and control over the Wadsworth portfolio were truthful even though Morgan Stanley, the underwriter, had approval rights. This is a red herring: *Morgan Stanley's involvement in the Wadsworth warehouse, like Merrill Lynch's in Octans I, was disclosed.*[30] Magnetar's involvement was not. And Doiron testified that he would expect *all* parties financing a warehouse (including the underwriter) to be disclosed, and that he would not have invested if he had known about Magnetar's warehouse involvement. Tr. 1929:14-1935:5, 2038:5-2043:7.

Respondents (at 46-47, 287-88) appear to find it significant that the Wadsworth materials do not spell out Morgan Stanley's control rights, but again – the Octans I materials do not spell out Merrill Lynch's control rights. Such rights would normally be assumed for a party financing a warehouse, as Doiron testified and other witnesses have agreed. *See* Doiron Tr. 2038:5-22, 2040:2-25; Div. Br. 24 n.40. The disclosure defect at issue here was mis-stating the *parties* to the warehouse agreement, *see* Div. Ex. 1 at 32; Resp. Ex. 2 at 66 – and thus signaling to investors that only two parties, not three, had warehouse-related rights. *Cf.* Resp. Br. 288 n.306.[31]

Respondents (at 47) also discuss Doiron's expectation that an underwriter might hedge. *See* Doiron Tr. 1989:18-1990:15. This is not remotely helpful to Respondents. Precisely because

[30] Resp. Ex. 720 at 33 (disclosing that Wadsworth warehouse financed by Morgan Stanley); Resp. Ex. 2 (OC) at 66 (disclosing that Merrill was party to Octans I warehouse).

[31] Respondents cite two Second Circuit decisions for the proposition that not all potentially interesting information needs to be disclosed. Resp. Br. 288. But these cases actually stand for a proposition that hurts Respondents: when one does choose to make "a disclosure about a particular topic, whether voluntary or required, the representation must be 'complete and accurate.'" *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 365-66 (2d Cir. 2010); *see also In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993) ("when a corporation is pursuing a specific business goal and announces that goal as well as an intended approach for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those approaches are under active and serious consideration."). That clearly did not happen here – the parties chose to speak about the warehouse, but in a way that was incomplete and inaccurate.

such hedging *was* a conflict of interest, the potential for Morgan Stanley to hedge with respect to Wadsworth was disclosed there (as Doiron expected it would and should be), just as the potential for Merrill Lynch to hedge with respect to Octans I was disclosed as a conflict of interest here.[32] What was *not* disclosed was *Magnetar's* involvement and intention to hedge. And that would have mattered to Doiron. Tr. 2063:3-8.

V. RESPONDENTS GET NO MILEAGE OUT OF RELITIGATING *TOURRE*

Respondents make a series of meritless arguments based on positions that the Division and Wagner supposedly took in the Fabrice Tourre case.[33] *Tourre*, of course, concerned not a manager's advisory obligations, but an underwriter's disclosure obligations where the manager, ACA, had collaborated with an undisclosed "short" (which ACA incorrectly thought was long equity) to select assets in a CDO called Abacus. Respondents assert, as though the *Tourre* facts are the only ones through which a CDO participant can violate the securities laws, 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." Resp. Br. 289

[32] Resp. Ex. 720 at 33; Doiron Tr. 2062:4-2063:8; Resp. Ex. (OC) 2 at 64-65 (Merrill "may from time to time enter into derivative transactions with third parties with respect to" the securities issued by Octans I or its collateral, and "may, in connection therewith, acquire (or establish long, short or derivative financial positions with respect to)" securities issued by Octans I or its collateral).

[33] The Division understands that the Court may be inclined to review the prior Wagner reports, *see* Tr. 4883:3-21, and the Division will not be troubled if that happens. However, it is respectfully submitted that the reports, in addition to not being especially illuminating here, are probably not a proper subject of substantive review. For one thing, the reports are the functional equivalent of written sworn statements. *See* Rule 235(a). Relatedly, Wagner's deposition transcript in *Tourre* was admitted as RX 859, but this may have been an oversight on the part of all involved, given the Court's practices regarding prior sworn statements. Tr. 11:20-12:2, 319:20-22 ("My practice with [any] prior sworn statements is to mark them as exhibits but not admit them."). Assuming the deposition should be off limits, it would be anomalous and somewhat unfair to consider the related reports. In any event, this section assumes that the reports are a proper subject of review.

(emphasis added).[34] Neither the *Tourre* judge, jury, Commission, Division, or Wagner has ever said anything of the kind. Respondents' other *Tourre*-related arguments fare no better.

A. Wagner Never Opined about the Disclosure of Any Warehouse Rights, Let Alone Said That It Is Acceptable To Mischaracterize a Warehouse Agreement

Respondents argue (at 63) that "it was the position of the Division and SEC in *Tourre* that, at a minimum, no warehouse rights needed to be disclosed if they were not exercised." That is not true. Neither the *Tourre* case nor Wagner's reports had anything to do with the disclosure of warehouse rights. Respondents are referring to a rebuttal report in which Wagner took aim at a defense expert (Bajaj) who tried to use ACA's separate Aquarius transaction, a Magnetar deal, to *speculate that ACA would have behaved no differently* in Abacus even if it had known of Paulson's true interest. Resp. Ex. 858 ¶ 22.

Wagner's response explained why, in his view, Bajaj was wrong and *from the standpoint of ACA* Magnetar's role in Aquarius (equity buyer and warehouser) would seem different from Paulson's role in Abacus (pure short). Resp. Ex. 858 ¶¶ 22-24.[35] Wagner's point regarding the Aquarius warehouse was that, since Magnetar bore warehouse risk, Magnetar (i) would be expected to have warehouse veto rights, and (ii) if anything, would be incentivized to use its veto

[34] This unsupported assertion is a reprise of an argument Respondents have made unsuccessfully in five previous applications to this Court, the Commission, and the U.S. District Court. This time it has been supplemented with incorrect or misleading citations to the record. To take just one example, the Wagner transcript pages cited on page 55 of Respondents' Brief say nothing relevant to the *Tourre*-related points about Magnetar that Respondents are trying to establish on page 55.

[35] In other words, this discussion was a side-show in which two experts debated the significance, to a non-party witness, of the differences between a transaction not at issue in that case and a transaction at issue in that case but not at issue here. (Bajaj's opinion was excluded, mooting Wagner's. *SEC v. Tourre*, 950 F. Supp. 2d 666, 678 (S.D.N.Y. 2013).) As noted (*see* footnote 33): This is not a useful exercise. As observed elsewhere, the Commission has never held up ACA as a model collateral manager; the Commission's basic point about ACA in *Tourre* was that the falsehood told to ACA about Paulson's true interest was *material*. *See* Mar. 28, 2014 Division's Opposition to Respondents' Motions in Limine, at 6-7. Relatedly, Wagner, *contra* Respondents, has never said that an equity investment would automatically align Magnetar's interests with those of the debt investors for all purposes, only that, from ACA's standpoint, an equity investment could make a difference as compared with a pure short.

to exclude risky assets. *Id.* ¶ 24. (Point (i) is uncontroversial. Point (ii) is discussed below.) *Wagner did not opine on whether Magnetar's warehouse rights needed to be disclosed to investors, much less whether it would be acceptable to misrepresent the parties to a warehouse.*

Later in their brief (at 291) Respondents distort the prior report even more. By way of background, a different defense expert (Cox) sought to excuse *the non-disclosure to investors* of Paulson's role as the economic short opposite Abacus by listing 24 other CDOs in which a CDO's CDS counter-party was not disclosed.[36] That is a different issue from disclosure of warehouse rights, a subject with which Cox – and therefore Wagner's rebuttal to Cox – was not concerned at all. *See* Resp. Ex. 858 at 3-4 (Op. (d)). And yet, the wording of the fourth bullet point on page 291 of Respondents' Brief implies unmistakably, but incorrectly, that Wagner opined on warehouse disclosures in connection with Cox's 24 CDOs. Again, he did not.[37]

B. Wagner Clarified that a Warehouse Provider's Incentives <u>Pertain to the Short Run, Not the Long Run</u>

Respondents (at 39-41, 291) argue that Magnetar's warehouse exposure aligned its interests with those of other investors. In that connection Respondents try to make hay of the fact that, in *Tourre*, Wagner wrote that a warehouser "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 ¶ 24. At the hearing, Wagner acknowledged an alignment of interests between a warehousing party and other investors, "assuming just that position," that is, focusing

[36] *See* Resp. Ex. 858 ¶¶ 19-21 (rebutting Cox Report, Dkt. Entry 196-1, *SEC v. Tourre*, No. 10 Civ. 3229 (S.D.NY.), at ¶ 69 & Ex. AG). Cox, too, was excluded. 950 F. Supp. 2d at 672 n.1.

[37] Yet another mis-citation appears in the third bullet point on page 291 of Respondents' Brief, according to which Wagner wrote: "[I]t was [a] common hedge fund strategy to invest in the equity tranche of [a] CDO and use the proceeds to simultaneously fund a short position on the same or another CDO." Here is Wagner's actual sentence: "***Dr. Bajaj himself notes*** that it was a common hedge fund strategy to invest in the equity tranche of a CDO and use the proceeds to simultaneously fund a short position on the same or another CDO." Resp. Ex. 858 ¶ 35.

only on the "long" warehouse risk, and "ignoring anything else [the party taking warehouse risk is] doing," Wagner Tr. 4644:4-22 – such as shorting. Wagner did *not* say, in *Tourre* or here, that Magnetar's warehouse risk automatically aligned it, for all purposes, with the other investors.

What is more, as Wagner noted, a warehouser is *not* necessarily motivated to maximize the *long-term credit quality* of the assets in a warehouse. Tr. 4661:13-16 ("you know, to some extent they" – the warehousing bank – "care about having good assets, but their horizon of caring is less than the CDO investors"), 4674:10-12 (warehouse trader's "perspective might be different than a long-term investor in the transaction"). Huang made this point too. Huang Tr. 897:3-24 (warehousers are motivated to take more risk in exchange for a higher spread).

C. It Was Not Customary for Investors To Suggest Assets for Inclusion

Respondents claim that "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.*" Resp. Br. 32 (emphasis added); *see also id.* at 41 n.42, 120 & n.113, 209 & n.241, 292. There is no evidence for the italicized portion of this assertion. All of the evidence is that investors, beyond negotiating over deal economics and sometimes investment criteria, on occasion asked for assets to be kicked *out* but did *not* suggest specific assets for inclusion. And this makes sense – asset selection was the manager's job.

In this case, although Magnetar's formalized right was only to exclude, exclusion and inclusion were two sides of the same coin. Prusko used the equivalent of a veto to prevent Harding from sourcing several Index assets on a piecemeal basis, thereby paving the way for the huge block trade through which he wanted to expose Octans I to as many Index assets as possible. Div. Br. 26-27; Div. Ex. 37 at 1 (May 30 email from Prusko to Wang instructing her to remove Index names from bidlist). This is also one answer to Respondents' oft-repeated point that Magnetar never exercised its veto rights. Of course it did, for all practical purposes. It was pursuant to the warehouse agreement, and precisely to make sure that he did not object, that Wang sent Prusko the lists of bonds Harding was planning to acquire. Div. Br. 26-27; Wang Tr. 419:2-5, 423:2-12, 425:3-426:7. The one time that Prusko is known to have objected was to prevent Harding from undermining his plans to acquire Index assets.[38]

The Division has never said (at least not anywhere identified by Respondents or known to the undersigned) that it is "common" for an investor to affirmatively suggest assets. Respondents have previously pointed to a post-trial brief in *Tourre* in which the Commission attorneys wrote: "Equity investors *occasionally* had input *on ACA's portfolios* because they were the first long investor to lose money if an asset in the portfolio failed. [citing trial transcript]." Resp. Ex. 515 at 11 (emphasis added). Far from a pronouncement about accepted market practice, this was a statement about trial testimony concerning what *ACA* had "occasionally" done in the past – and it was entirely unspecific about the nature and extent of the "input."

Respondents have not actually identified any evidence that *any* investor other than Magnetar (and, of course, Paulson in *Tourre*) *ever* suggested specific assets to a CDO manager. Jones testified that while he had heard of an equity buyer kicking assets out, he had never heard of an investor actively suggesting assets for inclusion. Jones Tr. 2849:2-20, 2886:5-2887:9.

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[38] This is no technicality. In the Norma CDO, where Magnetar was not party to a formal warehouse agreement and was not being kept up to date about what manager NIR was doing, there were competing purchases – Prusko's giant block Index trades and the manager's individual purchases. The result of the confusion (namely, Prusko's trades prevailing over the manager's) was sufficiently problematic that Merrill Lynch and NIR's principals agreed to settle charges based on it. *Merrill Lynch, Pierce, Fenner & Smith Inc.*, Securities Act Rel. No. 9493, at ¶¶ 64-73 (Dec. 12, 2013); *Joseph G. Parish III*, Advisers Act Rel. No. 3735, at ¶¶ 37-49 (Dec. 12, 2013). The Court need not accord evidentiary significance to these Commission findings to appreciate that Prusko's override of Wang in connection with the warehouse arrangement cleared the way for the Index trade Magnetar wanted.

Respondents' other investor witness, Edman, said essentially the same thing. Edman Tr. 2614:17-2615:25.[39] Finally, Respondents say (at 41 n.42) "that in Aquarius, as in Octans I, ACA agreed to do an ABX Index trade at Magnetar's suggestion," which may well be true, *see* RX 514, "and the Division saw no problem with that," which is emphatically not true. The Division has never passed judgment on any Magnetar-instigated Index trade in Aquarius, and neither, for that matter, has Wagner.[40]

In sum, contrary to the impression Respondents have sought to create, the evidence is that it was *not* normal market practice for investors to urge or even suggest specific assets to CDO managers, as Prusko did here with the Index trade.

VI. THE DIVISION HAS NOT GONE BEYOND THE OIP

Respondents claim that the Division is improperly seeking to hold them liable based on misconduct not alleged in the OIP. *E.g.*, Resp. Br. 28-31, 102, 113, 237-38, 282, 311-13, 338, 340. But each of the theories discussed in the Opening Brief was contained within the OIP. For example, the OIP alleged that the pitchbook's description of "Harding's investment approach and credit processes" omitted "Magnetar's control rights" and Magnetar's "actual influence over the Octans I portfolio." OIP ¶¶ 5, 55-56. The hearing and Opening Brief discuss the faulty warehouse disclosure in the pitchbook, and show that Harding's Index selections at the behest of

[39] Respondents imply (at 209 n.241) that RX 825 and 826 show a potential investor (as it happens, ACA) suggesting specific RMBS assets for inclusion in Octans I. That is not what these exhibits show. They show ACA only (i) going so far as to suggest a list of *issuers*, a much broader category, whose bonds could serve as replacements for ones ACA wanted to kick out, and (ii) seeming conscious all the while that the procedure was unusual.

[40] As if to suggest that Magnetar's urging the Index trade on Harding was not tantamount to suggesting 40 assets, Respondents point out that Wagner opined in *Tourre* that the limited record on Aquarius made available to him "shows no specific assets that were either suggested or vetoed by Magnetar during the Aquarius portfolio selection process," Resp. Ex. 858 ¶¶ 24-25 (quoted at Resp. Br. 41 n.42). But Wagner did not know about the Index trade in Aquarius. He was engaged to opine on Abacus, not Aquarius, and there is no indication anywhere in his reports that he saw RX 514 or anything like it. *See* Resp. Ex. 857 at 2-4 & Ex. 1; Resp. Ex. 858 Ex. 1.

Magnetar rendered the pitchbook's depiction of Harding's investment approach and credit process misleading. Similarly, the OIP alleged that the standard of care representations were misleading because Respondents "compromised their standards to accommodate trades requested by Magnetar." OIP ¶¶ 6, 57, 58 68, 69. This too was the subject of ample evidence and briefing.

Finally, on Norma, the OIP clearly accused Respondents of violations based on *both* the single-As *and* the BBBs. OIP ¶ 7 (referring to Respondents' "basically unfavorable view of" "*tens of millions* of dollars' worth of notes from Norma"; alleging that Chau made purchases in part to show he was a "team player"[41]; "For *each of the CDOs* into which Harding placed *the Norma notes*, the [CMAs] contained standard of care representations . . ."), ¶¶ 67-68 (similar), ¶¶ 60-62, 66 (reviewing evidence related to violations as to single-As); *see also* March 24, 2014 Division Prehearing Brief, at 15-16 (noting that Respondents placed Norma into "four CDOs").

Rule 200(b)(3) requires only a "short and plain statement of the matters of fact and law to be considered and determined" in sufficient detail so as to "permit a specific response thereto." That requirement was more than satisfied here. To the extent Respondents are complaining about the level of *detail* in the OIP, they were "not entitled to a disclosure of evidence in advance of the hearing. This has been called the 'distinction between allegations and evidence.'" *Harding Advisory LLC*, A.P. Rulings Rel. No. 1239, at 3 (Feb. 12, 2014) (citations omitted).[42]

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[41] *See* Div. Ex. 200 ("Did ML tell u I am in for 40mm single-As in Norma – team player!!!").

[42] Even if some of the misconduct discussed in the brief – for example, depicting Wang as a member of the "credit/research" department, buying Orion and other CDOs in the face of negative or no analysis, and so on, *see, e.g.*, Div. Br. 99 & n.175, 134 n.204 – falls outside the four corners of the OIP charges, it still can be taken into account in assessing sanctions. *E.g.*, *Gateway Int'l Holdings, Inc.*, Exchange Act Rel. No. 53907, 2006 WL 1506286, at *5 n.30 (May 31, 2006) ("Although we are not finding violations based on those failures, we may consider them, and other matters that fall outside the OIP, in assessing appropriate sanctions."); *Robert Bruce Lohmann*, Exchange Act Rel. No. 48092, 2003 WL 21468604, at *5 n.20 (June 26, 2003) (matters "not charged in the OIP" may nevertheless be considered "in assessing sanctions").

VII. RELIANCE AND HARM ARE IRRELEVANT – ALTHOUGH ESTABLISHED

Continuing their campaign to convert an SEC enforcement action into a private breach of contract or tort case, Respondents devote a significant portion of their submission to legally inapposite arguments about reliance and harm based mainly on cases involving private parties.[43]

First, Respondents' focus on performance is misplaced. Harm is not an element of a Section 206 or Section 17(a) claim. Div. Br. 103, 104, 127. The issue here is whether Respondents discharged their obligations, not how long Octans I lasted as the subprime market spiraled down. Respondents find it significant that Ellson did not find that the Magnetar-tainted selections performed worse than others. *That does not mean that Respondents did their jobs, or that their representations about asset selection were truthful.*[44] In any event, had Respondents not violated the securities laws, the entire transaction likely would not have taken place, avoiding a roughly $1.5 billion loss.[45] As to Norma, again, Respondents must have been worried about its impact on their portfolios, since Chau tried to rid himself of Norma notes at a steep discount. Div. Br. 98.

Second, Respondents' focus on the contract-law concept of "the benefit of the bargain" as well as "the value of the Octans I notes" (*e.g.*, Resp. Br. 3, 79, 303, 342) gets them nowhere. As the Division (and the investor witnesses) have noted, Harding was *getting paid by the CDO*

[43] Respondents say "we are not making a reliance argument" (Resp. Br. 79, 114), but of course that is exactly what they are doing.

[44] *See* Wagner Tr. 4890:9-24 (ultimate performance is not "necessarily reflective of the questions that are involved here"); Doiron Tr. 2061:10-21 (that Octans I may have lasted longer than Wadsworth does not mean that Harding did its job).

[45] Recall that synthetic assets create risk out of whole cloth – it is not as if the CDS in the Octans I portfolio would even have existed, let alone declined in value, but for Harding's activities.

vehicle and ultimately the investors to do an important job, and not just post-closing.[46] Harding did not do its job (and lied about it), depriving its advisory clients and investors of the "benefit" of any supposed "bargain." Respondents argue that, because investors received no representations about credit quality, investors had no "right to have the portfolio assets selected in any particular manner." Resp. Br. 3, 78. But this case is not about investors' "rights."[47]

Respondents (at 298-99) cite *SEC v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007) for the proposition that the offering circular's cautionary language made any representations about the manner of asset selection immaterial. *Merchant Capital* was concerned with the "bespeaks caution" doctrine applicable to forward-looking statements about performance. *Id.* at 767. Even in that regard "boilerplate will not suffice"; "the disclaimer must be meaningful and tailored to the risks" at issue. *Id.* This case does not deal with forward-looking statements, or statements about performance, and anyway Respondents have *not* identified a meaningful or tailored disclaimer advising of the risk that Harding might flout a represented standard of care or compromise its independence to accommodate an undisclosed party. *Merchant Capital* also partially ruled *for the SEC* because "general cautionary language [did] *not* render omission of specific adverse historical facts immaterial." *Id.* at 768-69 (emphasis added). Here, general disclaimers notwithstanding, the offering materials chose to speak on the

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[46] Div. Br. 2, 83-86, 127; Doiron Tr. 1895:12-1897:6, 2029:23-2030:4; Edman Tr. 2582:22-2584:6. Respondents' insistence that investors cared about the manager's processes and integrity *only because of* its post-closing discretion and not as regards pre-closing assets, apart from being wrong on the evidence, would not defeat materiality even if true. It would surely assume significance to the reasonable investor deciding whether to participate in a CDO that the *same manager* entrusted with post-closing control had accommodated Magnetar by making a mockery of the standard of care during the ramp.

[47] Equally meaningless are Respondents' references to "a break in causation" (Resp. Br. 86 n.70, 114); there are no causation requirements in an SEC enforcement case. *E.g.*, *SEC v. Apuzzo*, 689 F.3d 204, 212-13 (2d Cir. 2012).

warehouse agreement and standard of care, but omitted important historical or existing facts that made those representations misleading – which calls for liability under *Merchant Capital.*

As for the Section 206 claims, it is not a defense that the Issuers were shells "engaged to vote yes" or that no one "affiliated with" the four Norma Recipients testified. *E.g.*, Resp. Br. 140, 143, 146-54, 240, 242 & n.284, 332, 335. These are just additional "blame the victim"-style reliance and causation arguments. "Section 206 of the Advisers Act focuses upon the investment adviser and his or her actions. Clients and prospective clients are mentioned only in relation to the advisors." *Raymond J. Lucia Cos.*, Initial Dec. Rel. No. 540, 2013 WL 6384274, at *44 (Dec. 6, 2013) (citing *SEC v. Gruss*, 859 F. Supp. 2d 653, 662-63 (S.D.N.Y. 2012)). That the client may be a dupe, dummy, or shell has nothing to do with whether the *adviser* fulfilled its obligations and made the requisite disclosures.[48] Also irrelevant are Merrill's and Magnetar's supposed knowledge – Harding had independent advisory duties running to the client.[49]

Nor is there any basis for the contention (*e.g.*, Resp. Br. 146, 151, 339-40) that there would have been no consequences if Harding had made the necessary disclosures to the advisory clients. One mechanism for doing so was in the course of hashing out the language of the CMA

[48] There are excellent policy reasons why the adviser's obligations should not hinge on the wherewithal of the client, which after all by definition reposes trust in the adviser. *See, e.g.*, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (fundamental purpose of Advisers Act "was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry").

[49] Respondents' *Parmalat* case (*see* Resp. Br. 143, 146, 153) simply held that the bank that created two Cayman SPVs owed them state-law fiduciary duties. 684 F. Supp. 2d 453, 475-76 (S.D.N.Y. 2010). In *Parmalat, there was no separate investment manager; instead, the sponsoring bank signed management agreements with the SPVs and committed them to the challenged transactions. Id.* at 469-70. Yet even granting for argument's sake that Merrill owed the Issuer fiduciary duties as a *non*-manager sponsor, and further granting the (totally unproven) proposition that Merrill had full knowledge of Harding's abdication of its duties, and granting further still the (highly dubious) proposition that Merrill's knowledge should be imputed to the Issuer, it is still hard to see how this is relevant. An entity can have more than one fiduciary, each with its own independent duties of loyalty, care, and candor. *See, e.g*, Chau Tr. 4337:17-4338:13 (Issuers reposed separate authority in trustee and collateral manager). Merrill's duties, if they existed, would not nullify Harding's.

with the underwriter's counsel. *See* Suh Tr. 3110:4-22. Once Harding had revealed to the underwriter the need for additional disclosure *to the client or prospective client*, the same disclosure would have had to be included in the *offering circular*'s description of the CMA.[50] It is doubtful that any arm's-length investor, whether Doiron, Edman, or anyone else, would have invested in a CDO knowing that the manager had willfully violated the standard of care and compromised its independence to accommodate an undisclosed third party. Edman Tr. 2592:10-20; Doiron Tr. 1917:6-1920:3.

VIII. <u>THE PITCHBOOK IS ACTIONABLE</u>

Respondents' contention that the Octans I pitchbook is not actionable is meritless. To the extent that their arguments can be read to apply also to the preliminary offering circular (POC), as distinct from the final (FOC), the Division's response should be as well.

A. <u>The Misrepresentations in the Pitchbooks Were "In the Offer or Sale"</u>

Respondents argue (at 115-119, 310-11) that the pitchbook is not actionable because "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." Respondents have not cited, nor are we aware of, any authority for this assertion.[51]

Section 17(a) prohibits fraud "in the offer or sale of any securities." These "terms, which Congress *expressly intended to define broadly* . . . are expansive enough to encompass *the entire selling process*[.]" *United States v. Naftalin*, 441 U.S. 768, 773 (1979) (emphasis added, citations

[50] *See* Suh Tr. 3007:11-3008:21, 3121:4-16 (underwriter's and manager's counsel work to ensure that CMA's material terms, including standard of care, are disclosed in offering circular); *see also* Div. Ex. 500, at 4-7 (board of directors' resolution for Octans I Issuer approving CMA and offering circular only after the documents "were considered in detail by the Board").

[51] A District Judge in a case against a different CDO manager has already rejected these arguments made by the same counsel citing the same inapposite cases. *See Steffelin* Argument and Bench Ruling; Div. Br. 111 n.184.

omitted). The term "offer" is statutorily defined to include "every attempt or offer to dispose of, or ***solicitation of an offer to buy***, a security." Securities Act § 2(a)(3), 15 U.S.C. § 77b(a)(3) (emphasis added). "This language does not require that the fraud occur in any particular phase of the selling transaction." 441 U.S. at 773. "Solicit[ing] an offer to buy" from potential investors was precisely the point of the pitchbook and indeed the entire "roadshow," or marketing process. *E.g.*, Wagner Report ¶¶ 31, 32; Div. Exs. 188, 190, 207 (Chau placed offer to buy Norma securities following Merrill solicitation using Norma pitchbook).

The pitchbook was used in a process intended to induce investors to place orders for the CDO's securities – in other words, squarely in the "offer or sale." As noted in the Opening Brief without real rejoinder, Div. Br. 128, the cases hold that pitchbooks, pitchbook-equivalents, and other sales communications outside what Respondents call "the sole offering document," Resp. Br. 80, are fair game for a Section 17(a) claim. Citations are in the margin.[52]

In support of their argument, Respondents cite two breach of contract cases.[53] But this proceeding obviously does not involve *contract* rights based on the pitchbook. To the extent that Respondents are trying to use these cases anomalously to define the contours of an "offer," it is black-letter law that the definition of an "offer" in the Securities Act "extends beyond the common law contract concept of an offer." *SEC v. Cavanagh*, 155 F.3d 129, 135 (2d Cir. 1998).

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[52] *SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 151-52, 154, 165-66 (S.D.N.Y. 2011) (CDO marketing materials, including "flip book" and email communications, were "in the offer or sale" and actionable under Section 17(a)); *Steffelin* Argument and Bench Ruling, at 38 (sustaining Section 17(a)(2) claim based on CDO pitchbook); *SEC v. Quan*, 2013 WL 5566252, at *8 (D. Minn. Oct. 8, 2013) (flipbook actionable under Section 17(a) even though investors signed subscription agreements stating they had relied solely on a private placement memorandum); *SEC v. True North Finance Corp.*, 909 F. Supp. 2d 1073, 1096-97 (D. Minn. 2012) (rejecting argument that non-reliance clauses in subscription agreements rendered marketing materials outside offering memorandum immaterial as a matter of law).

[53] *Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 937-40 (2d Cir. 1988) and *Banco Espirito Santo de Investimento, S.A. v. Citibank, N.A.*, 2003 WL 23018888, at *4-14 (S.D.N.Y. Dec. 22, 2003), cited at Resp. Br. 115, 301-03, 310.

Respondents argue, relatedly, that various caveats in the pitchbook and FOC render anything outside the FOC inactionable. Resp. Br. 80-81, 115-19. Set aside that *Respondents themselves* relied on other CDOs' pitchbooks, and acknowledged understanding that investors would rely on Harding's pitchbooks. *See* Chau Tr. 1822:17-1823:15, 4129:1-5 ("typically, one would look at the marketing book to familiarize yourself with the deal, with the deal terms, the deal structure, *the collateral manager*" as prelude to further inquiry); Huang Tr. 1014:16-1015:12, 1016:16-23. Indeed, the market practice was to commit before distribution of the final offering circular, as Chau admitted.[54] The effect of Respondents' argument is that a securities professional can lie with abandon in a marketing presentation or other preliminary document – so long as there were suitable caveats and a final offering document existed (even one circulated only after investors had made their decision), he will have complete immunity.

That is not the law, which is why Respondents have cited no authority for this non-proposition. Their only other case, *Hunt v. Alliance North America Gov't Income Trust*, 159 F.3d 723 (2d Cir. 1998), is a reliance opinion. The private plaintiffs there complained that sales materials did not disclose certain risks which *were* adequately disclosed in separate prospectuses. *Id.* at 727.[55] The sales materials not only directed potential investors to the prospectuses but were "authorized for distribution *only when accompanied or preceded by a prospectus*," *id.* at 730 n.4 (emphasis added) – also not the case here, as most of the pitchbooks were distributed well before the FOC. On these facts, the Second Circuit found the reliance element lacking: "'*An investor*

[54] *E.g.*, Chau Tr. 2122:11-2123:12 (orders are based on POC because FOC comes out at closing); Chau Tr. 4206:16-4208:7 (orders for CDO securities cannot be broken unless security issued at closing is materially different from what was previewed in preliminary documents); Div. Br. 86-92 (reviewing chronology in which Chau committed to Norma long before FOC); *cf.* Suh Tr. 3075:22-3078:20 (admitting no knowledge of market practice regarding investor decision-making).

[55] In this case, of course, the Octans I FOC did not disclose what the pitchbook obscured.

may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth.' Minimal diligence in this case would have included consulting the prospectuses[.]" *Id.* at 730 (citations omitted, emphasis added). On top of that, the sales material actually *did* contain adequate disclosure, *id.* at 730 – again not this case.

Finally, even if *Hunt* were converted from the realm of private litigation to that of regulatory enforcement, and read to address materiality (as distinct from reasonable reliance), at most it suggests that a reasonable investor should have consulted the Octans I offering circular *together* with the pitchbook (a precept that the Division has no quarrel with but that Chau violated in relation to Norma, *see* Div. Br. 86-89, 99), *not* that the reasonable investor was required to ignore the latter entirely in favor of the former.

B. <u>The Description of the Investment Process Was Material</u>

Effectively conceding that the pitchbook was misleading, or as Respondents put it, "hyperbolic," Resp. Br. 319, Respondents nevertheless argue that the description of Harding's investment process is immaterial "boilerplate," "platitudes," and "puffery." Resp. Br. 121-24, 317-22. Respondents find it significant that CDO pitchbooks tend to contain similar representations about how the manager will vet and select bonds. True, because those representations are the industry standard.[56] As discussed elsewhere (section IV above; Div. Br.

[56] In Wagner's unrebutted explanation (Tr. 4580:6-4581:15):

> I tried to summarize what I think the standard of care is with a number of adjectives . . . . [T]here [sh]ould be a standardized, consistent, rigorous, thorough and independent investment process. Now, I think that – I think you could see that participants in this market would generally agree with what the standard of care is because it's basically what is in everybody's marketing book. . . . I read Harding's marketing book and how they went about – at least how they said in the marketing book they went about the investment process. And I thought that if they, in fact, carried that out, that would meet the standard of care. There was testimony in this trial, I think, where people said, "Gee, all these marketing books look the same. It is all boilerplate." Well, why is that? It is because that is the standard of care. They all say about the same thing, because that is what people expect managers of assets to do.

110-11 & n.183), investors (again, other than Edman, who was the dissenter, *but see* footnote 28) generally paid attention to the manager's description of its investment process – *even if* those sections tended to look alike.[57]

Harding's description of its investment process, far from immaterial "puffery," was language with clear meaning and import to industry participants. *See* Div. Br. 109-110. To take one example, there is a shared understanding of "top-down," "bottom-up analysis," even if the precise way it is implemented varies by manager. *E.g.*, Wagner Tr. 4927:21-4928:9; *see also id.* at 4589:16-4590:4; Doiron Tr. 1898:20-1901:6. That is why the trio of shareholder class action suits under Exchange Act Section 10(b) (one of them non-precedential) that Respondents cite (at 317-20) is off point. There is a world of difference between a giant financial-services company making vague statements in annual reports about its "reputation for integrity"[58] and a specialized CDO manager mis-describing its core activities using lingo that intentionally telegraphs compliance with industry-standard methods of credit selection.

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[57] *See, e.g.*, Jones Tr. 2873:9-20 ("Q. When you went through the pitchbook, was the section on the manager of any interest to you? / A. Yes, I mean, it was. I mean, wasn't the only thing, but it's – everything mattered to some extent. / Q. Including the manager's description of its own investment philosophy and approach to asset selection? / A. Yes, I mean, I guess. It's not that I can recall that much differentiation between an awful lot of managers in that sense, though."); Huang Tr. 1021:2-8 ("Q. . . . [I]f it turned out in reality someone was not doing those things that everybody says they do in the pitchbook, is that something that would concern you in reviewing that potential investment? / A. Yes.").

[58] *ECA v. JP Morgan Chase Co.*, 553 F.3d 187, 205-06 (2d Cir. 2009); *accord City of Pontiac Policemen's & Firemen's Retirement Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014) (vague statements about bank's reputation and integrity were inactionable puffery); *see also Boca Raton Firefighters & Police Pension Fund v. Bahash*, 506 Fed. Appx. 32, *37 (2d Cir. Dec. 20, 2012) (vague statements regarding S&P's parent's "transparent and independent decision-making process" were inactionable puffery). The *JP Morgan* and *UBS* rulings are not without controversy. *See Richman v. Goldman Sachs Group*, 868 F. Supp. 2d 261, 277 & n.8 (S.D.N.Y. 2013), *adhered to on reconsideration*, 2014 WL 2815571 (S.D.N.Y. June 23, 2014) (statements by Goldman Sachs about avoiding conflicts of interest with clients, including "We have extensive procedures and controls that are designed to . . . address conflicts of interest" and "Integrity and honesty are at the heart of our business," were actionable).

Materiality must be assessed in light of the evidence and all relevant circumstances.[59] In this case, the strong consensus from the fact witnesses and an unrebutted expert is that the pitchbook's discussion of the manager's approach *mattered* in the market. Despite his arguments now, Chau conceded precisely this point (Tr. 1835:16-1836:17):

> Q. You understand that investors would rely on [the description of Harding's investment approach in the pitchbook]. Correct?
> A. [after objection overruled] I am not sure if they would rely on it but ***it would be important to the investor, yes.***
> Q. ***It would be a factor in their investment decision, wouldn't it?***
> A. ***Yes.***[60]

IX. RESPONDENTS' QUASI-*JANUS* ARGUMENTS DO NOT ABSOLVE THEM OF SECTION 17(a) LIABILITY

Respondents essentially concede that *Janus* does not apply, Resp. Br. 309 – and then try to apply it anyway. *Id.* at 309-310. Similarly, Respondents expressly disclaim the defense of advice of counsel, *id.* at 336 n.318 – and at the same time assert it at length. Resp. Br. 136-39,

[59] *E.g.*, *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976); *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000); *Kas v. Fin. Gen. Bankshares, Inc.*, 796 F.2d 508, 514 (D.C. Cir. 1986).

[60] Respondents (*e.g.*, Resp. Br. 114-15, 128-30) insist that the pitchbook should be disregarded in favor of oral discussions between Harding and potential investors. This argument does not deserve serious consideration. S*ee* Div. Br. 83 n.145. First of all, investors' opportunity to ask questions does not excuse a CDO manager from its obligations of truthfulness in written materials. (Chau himself, in reviewing Norma, never asked NIR questions about its asset-selection processes. Instead he relied on the Norma pitchbook.) Second, Harding often tracked the pitchbook in investor discussions, *see* Huang Tr. 1043:11-15 – a further indication that the contents of the pitchbook were meaningful. Beyond this, the evidence is that Harding never disclosed its compromised approach to asset selection at the behest of Magnetar. Huang Tr. 1044:5-1045:11, 1046:19-1048:6, 1052:6-1053:6, 1054:9-21; Lieu Tr. 3585:15-3589:17. Respondents point out that investors were free to ask about specifics missing from the pitchbook. Resp. Br. 123, 129. But if any investor asked, for example, about the Index bonds, Harding surely did not say: "We rushed that one through and bought it in the face of negative credit work that made our own analysts uncomfortable." If any investor asked about loss assumptions, Harding surely did not say: "We relaxed those with no macroeconomic basis so we could get more bonds, including Index bonds, to pass and thereby please Magnetar." And if any investor asked for written credit work, Harding surely did not inform it that there was no credit committee behind the "Credit Committee Bond Evaluation Documents," and that one analyst made the decisions on the Index bonds all by herself one afternoon in the face of dissent from a more experienced analyst. Respondents say "[t]here is no hint in the evidence that Harding did not answer [investors'] questions fully and honestly," Resp. Br. 130, which is true only if one does not count as "hints" Lieu's staggering unreliability, Chau's propensity to make things up on the stand, Harding's willingness to show investors basically falsified credit work, and so on.

322-25.[61] Respondents seem to be arguing (*see id.* at 130-35) that they: (1) did not create relevant content in the pitchbook; (2) did not create relevant content in the offering circular; and (3) were not the ones physically circulating these materials. These are not obstacles to Section 17(a) liability. (Note, too, that none of this has any bearing on the Section 17(a) claims premised on defrauding the five Issuers (*see* Div. Br. 121, 125), which Respondents effectively ignore.[62])

First, the suggestion that only Merrill created the pitchbook (*see* Resp. Br. 5 & 116 n.110; *but see* Resp. Br. 132 & n.127) should be dismissed out of hand. It was plainly a collaboration. There is no serious dispute that *Harding* created – and had full control over – the section of the pitchbook about itself. It is of no moment that Harding emailed its slides to Merrill to be added to a larger slide deck – the market understood this as Harding's content. *See* Div. Ex. 1 at 37 ("All information in section 6 has been supplied herein by Harding Advisory LLC."). Harding also jointly created the section on its own and Merrill's conflicts of interest. Div. Br. 114-15.

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[61] Respondents are not entitled to any form of a good-faith reliance-on-counsel defense. They refused to allow their attorney to be questioned about his communications with his clients, if any, surrounding the disclosure of the warehouse in the offering circular. Tr. 3107:5-23. As explained in the Division's March 21 motions in limine ("Motion") (the arguments in which the Division incorporates by reference here) and never disputed, Respondents have continued to this day to withhold communications with their counsel concerning the preparation of marketing and other transaction documents for Octans I and related transactions. (Oddly, Respondents *did* allow Alison Wang to be asked questions relevant to an advice of counsel defense – and she negated every element of it. Tr. 459:11-481:5.) Respondents are really trying to assert a "presence of lawyers" defense, which, as explained in the Motion, is not a defense at all. Respondents' cases (Resp. Br. 322-25) appear to have involved genuine waiver of the privilege, making the advice-of-counsel defense available. In any case, a good-faith reliance-on-counsel theory would be especially ill-suited to this case because Respondents' attorney did not even review the pitchbook, nor was he told about Harding's violation of the standard of care. Wang Tr. 459:11-481:5; Suh Tr. 3072:23-3074:5, 3115:3-18.

[62] Respondents' Brief contains (at 242 n.283, 335) extremely cursory references to the Section 17(a) claims relating to the four Norma Recipients.

Next, that Merrill's lawyers initially drew up the offering circular, including the faulty warehouse disclosure,[63] does not give Respondents a free pass. Respondents and their attorneys had extensive input into the *entire* offering circular, not just the parts expressly attributed to Harding. Chau certified that he had "carefully examined" the entire document. Div. Br. 123. And the description of the warehouse agreement had to have been on Respondents' radar screens because they, and only they, repeated the misrepresentation about the warehouse agreement to their advisory client – *with the additional detail of the date of the agreement*. Div. Br. 119-20.

As relevant here, Section 17(a)(2) is far broader than the *Janus*-limited Rule 10b-5(b). It covers anyone who, in the process of selling securities, intentionally, recklessly, or negligently "obtains money or property by means of" any material misrepresentation. Section 17(a), again, is "expansive enough to encompass the entire selling process," *Naftalin*, 441 U.S. at 773, and liability under it emphatically does *not* depend on the defendant having "made" any statement at issue, in the *Janus* sense or any other. *SEC v. Tambone*, 550 F.3d 106, 125-29 (1st Cir. 2008), *withdrawn panel opinion reinstated in relevant part*, 597 F.3d 436, 450 (1st Cir. 2010) (en banc); *SEC v. Stoker*, 865 F. Supp. 2d 457, 465 (S.D.N.Y. 2012).

All three cases cited by Respondents actually came out in favor of actionability under Section 17(a)(2). Respondents refer (at 309-10) to the need for "use" of a statement, but to the extent *Tambone* and *Stoker* used the word "used," they used the passive voice – it is the

[63] Respondents (at 309) say, confusingly, that Merrill had "ultimate control over . . . the statements" in the Offering Circular. The concept of "ultimate authority" or control comes from *Janus* – under which technically Merrill did *not* have control. Rather, per *Janus*, the Issuer and Co-Issuer are the attributed authors that, for Rule 10b-5(b) purposes only, "made" all statements in the offering circular not expressly attributed to the manager. *See* Suh Tr. 2966:16-2968:16; Resp. Ex. 2 at v ("This Offering Circular has been prepared by the Co-Issuers. . . . The Co-Issuers accept responsibility for the information contained in this document."). And yet no one suggests that *Merrill* could not be liable here under Section 17(a) for the faulty warehouse disclosure (*see, e.g.*, *Merrill Lynch, Pierce, Fenner & Smith Inc.*, Securities Act Rel. No. 9493 (Dec. 12, 2013) (charging Merrill under Sections 17(a)(2) and (a)(3) based on the faulty warehouse disclosure, *inter alia*)) – because "control" is not a sine qua non of Section 17(a) liability.

statement that must be used. *See* 550 F.3d at 127 ("Liability attaches so long as the statement is *used* 'to obtain money or property,' regardless of its source." (emphasis in original)); 865 F. Supp. 2d at 465 (defendant liable under Section 17(a)(2) if "he obtains money or property *by use* of a false statement, whether prepared by himself or another." (emphasis in original)).

Even less helpful to Respondents (*see* Resp. Br. 309) is *SEC v. Radius Capital Corp*, 2012 WL 695668 (M.D. Fla. Mar. 1, 2012). The defendant there, DiGiorgio, was the CEO of a mortgage lender and RMBS issuer[64] accused of falsely representing in contract documents submitted to Ginnie Mae that the loans that backed the RMBS were federally insured. *Id.* at *1-*2, *5. The SEC alleged that the *prospectuses* for the RMBS falsely represented that the underlying mortgages were federally insured, and that DiGiorgio knew the prospectuses were false. *Id.* at *7. The SEC asserted charges under Sections 10(b) and 17(a). The Complaint did "not explain the process by which prospectuses are issued and distributed," did "not identify who was ultimately responsible for the content of the prospectuses," and did not "explain the defendants' specific roles in this process. The SEC simply states that DiGiorgio made misrepresentations to Ginnie Mae in the contract documents and 'a prospectus was then issued and distributed.'" *Id.* at *7. These allegations left open "the possibility that a person other than DiGiorgio was responsible for the communication of the content of the prospectuses."[65] *Id.*

The court dismissed the section 10(b) claims under *Janus* but *upheld the Section 17(a)(2) claims*: "Although the Court declines to make any assumptions about who controlled the content, issuance and distribution of the prospectuses, the Court finds that these allegations are sufficient to demonstrate that DiGiorgio, at minimum, 'used' a statement he knew to be false to obtain

[64] The entity, Radius Capital, was an actual operating company, not an SPV like the CDO Issuers.

[65] Presumably the prospectus was distributed by a dealer, analogous to Merrill here.

money or property." *Id.* This case is similar: Harding knew about the Octans I offering circular and knew or recklessly (or in one respect at least negligently) disregarded that it contained misrepresentations relating to underlying contracts (the warehouse agreement and CMA) to which *Harding* was party. Div. Br. 111-13, 114-15, 122-23. And, of course, Harding knowingly obtained money from use of the offering circular. This was enough in *Radius Capital*,[66] and it is enough here.

Also instructive is *SEC v. Daifotis*, 2011 WL 2183314 (N.D. Cal. June 6, 2011). Daifotis was alleged to have "substantially participated" in the creation of statements not directly attributed to him in sales materials, SEC filings, press materials, and a web site. For instance, Daifotis "received, reviewed, and contributed to sales and marketing materials . . . put out by [his company] and made suggestions and edits to some of them." *Id.* at *4-*5. He also reviewed, but failed to correct, talking points containing misstatements. *Id.* at *5. Noting that "the alleged misstatements were all about the Fund Daifotis himself managed," the court, pre-*Janus*, held the allegations sufficient for liability under Section 10(b) and Section 17(a) even though the statements were attributed to others. *Id.* at *5-*6. Once *Janus* came out, the *Daifotis* court reconsidered, and dismissed the Section 10(b) claims to the extent Daifotis was not an attributed "maker" of the statements, but *adhered to its ruling upholding Section 17(a) charges without regard to attribution.* 2011 WL 3295139, at *5-*6 (N.D. Cal. Aug. 1, 2011).

The facts here fit comfortably within *Daifotis* and *Radius Capital*. To review: Harding contributed the description of itself and its investment process in the pitchbook, and reviewed and edited the section dealing with *its own conflicts of interest*. Harding and its counsel received,

[66] A jury eventually held DiGiorgio liable on all prongs of Section 17(a). *SEC v. Radius Capital Corp.*, Lit. Rel. No. 22974, 2014 SEC LEXIS 974 (Mar. 19, 2014).

reviewed, contributed to, and edited the offering circular, particularly as regards the standard of care and Harding's own conflicts of interest. The offering circular, which Chau "carefully examined" and which concerned an investment vehicle for which *Harding* was the manager, made misrepresentations concerning contracts to which *Harding* was party.

Harding then embarked on a selling process in which it was the *full collaborator* of the investment bank. Wagner's description of market practice is unrebutted and entirely consistent with the evidence in this case:

> the underwriter ***and Collateral Manager*** would conduct a roadshow, in which ***they*** would have group and one-on-one meetings with potential investors in a number of cities throughout the world. The underwriter ***and Collateral Manager*** would then have continuing dialogue with potential investors, responding to specific questions and requests for analysis. A number of investors also had questionnaires or other documents that they would request the underwriter ***and/or the Collateral Manager*** fill out.

Wagner Report ¶ 31 (emphasis added). The pitchbook and POC were an integral part of this process, since they were the written materials that investors for all practices purposes relied on in deciding whether to buy the CDO. Accordingly, when the CDO closed and Harding began to be paid, Harding and Chau unquestionably "obtain[ed] money . . . by means of" untruths in the sale of securities.

Respondents also "engage[d] in [a] practice [and] course of business which operated or would operate as a fraud or deceit upon the purchaser[s]" of Octans I's notes and employed "a device, scheme, or artifice to defraud" those purchasers. *See* Sections 17(a)(1), 17(a)(3). Respondents' challenges (at 276, 327-29) to the Section 17(a)(1) and (a)(3) claims are meritless. Our Opening Brief (at 115-16) discusses why Respondents are liable under Section 17(a)(1) and (a)(3) for deceptive conduct beyond pure misrepresentations.

X. RESPONDENTS STILL HAVE NOT OFFERED A GENUINE DEFENSE OF THE NORMA PURCHASES

Respondents' discussion of the Norma purchases draws mainly on very serious mischaracterizations of the evidence, the most bizarre of which concerns the "% Writedown" figure in Kaplan's highly negative February 27, 2007 report. Div. Ex. 217. As previously explained, this red flag had to have referred to projected losses on the RMBS tranches inside Norma, not (as Chau testified) to the loans underlying those RMBS. *See* Div. Br. 95-97. Respondents devote several pages (*see* Resp. Br. 264-267) to arguing that Wagner corroborated Chau's self-serving testimony on this statistic. *Respondents incorrectly attribute to Wagner what was in fact Chau's own cross-examination testimony.* This table shows via blackline the edits needed to make Respondents' Brief accurate[67]:

Page	Excerpt from Respondents' Brief
265	As Mr. Chau and **~~the Division's own expert~~** **Mr. Chau himself** agreed, however, the 10.17 was not the expected writedown on the Norma CDO. (Chau 4098:9-4111:6; **~~Wagner~~** **Chau** 4382:5-4383:3; **~~Wagner~~** **Chau** 4386:13-23.
265	The write-down number in question relates to the deterioration in the pools of loans underlying the RMBS that composed the Norma CDO. (**~~Wagner~~** **Chau** 4382:5-4383:3.)
265	**~~Ira Wagner~~** **Wing Chau** explained: [block quote from Chau's testimony omitted] (**~~Wagner~~** **Chau** 4382:5-4383:3 (emphasis added).) Mr. Chau concurred **with himself**: [block quote from Chau's testimony omitted]
266-267	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?

[67] None of the approximately 600 corrections in Respondents' July 8 filing, *see* footnote 1, fixed this.

	A. Yes. **That's why it's the second order effect**, yes. (~~**Wagner**~~ **Chau** 4386:13-23 (emphasis added).)
267	~~**The Division's own expert**~~ **Chau** confirmed as much during his testimony.

In reality, Wagner never corroborated Chau's contrived explanation (his report did the opposite, *see* Div. Br. 95), and neither did anyone else. Not that the stakes here are high, since even if the statistic meant what Chau alone says it means, it would still (a) have spelled trouble for Norma, and (b) be further evidence of Harding's recklessness because it would mean that Harding did not even *try* to project whether the Norma portfolio would be written down. *See* Div. Br. 96-97 & n.168.

More generally, Respondents *still have not offered an actual defense of the Norma purchases*. Despite Respondents' assertions (*e.g.*, Resp. Br. 239, 249, 250) and speculation about what its analysts "could" have done with the limited information they obtained from Merrill (*e.g.*, *id.* at 248), there remains *no evidence* that *any* analyst at Harding actually did (and plenty of evidence that they did not do) any work on Norma before Chau committed to the purchases. Div. Br. 88-89, 92-93, 124-25.

And despite Respondents' repeated references (*e.g.*, at 235-36, 244, 247, 250, 252-58) to Chau's supposed "bargaining" or holding out for a better price on the BBBs, there is *no evidence* that Harding ever did an analysis showing that the Norma securities were *worth buying at **any** price*. Respondents implicitly concede this when they say as a general matter that "[t]he same bond *may have been* unattractive at a certain spread but very attractive at a wider spread." Resp. Br. 235 (emphasis added). Regardless of whether it may have been, or may not have been, Harding never did the work to find out. And it is clear that from what little Chau had gleaned, Norma was "unattractive" to him even at +505. *See* Div. Br. 91-92 ("love is in the air," etc.).

It bears emphasis that claims about price are meaningless without a genuine understanding of the securities (Wagner Report ¶ 170) – which Chau did not even begin to obtain until February 27.[68] Like a boast about having gotten a great deal on a ticket on the *Titanic* (*see also* footnote 4 above), Chau's claims of price improvement are meaningless without taking into account the actual quality of the Norma bonds. And no one bothered to do that here, not least because the real reason for the purchase was Chau's admitted eagerness to build goodwill with Merrill and Magnetar.

Respondents insist that "[t]he fact that the Norma bonds met all eligibility criteria coupled with the fact that the relevant bonds had investment grade ratings proves beyond any doubt that there was nothing wrong with them." Resp. Br. 264; *see also id.* at 239, 272. This is an admission, because the unrebutted evidence concerning the requirements of the standard of care represented to the Norma Recipients (and knowingly violated by Chau) is that the manager must do its own credit work, *not* rely on eligibility criteria and rating agencies. *See* Section III above; Div. Br. 101. And, of course, there *was* "[some]thing wrong with" the Norma bonds – which is why Chau kept trying to avoid or unload them.

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[68] Respondents argue that "the Division tries to have it both ways" in arguing "that Harding did not do an analysis and also that Harding's analysis shows that Norma was a bad investment." Resp. Br. 264. There is no inconsistency. Chau bought the securities to be a "team player" for his "true friends" without doing proper review *but already having a negative view*: severe recklessness at a minimum, plus an incipient breach of fiduciary duty. He then waited several weeks, received a negative report that only strengthened his *scienter* as to Norma's problems, and weeks later than that, as investment adviser, *caused the Norma Recipients to buy Norma without proper disclosure.* Respondents contend that "not much could have been done at the time [Kaplan's] analysis was prepared," Resp. Br. 264, but their assertion is frivolous. One of several things that could have been done was to *disclose* to the client or prospective client the problems with Norma. *See* text accompanying footnote 50 above. Again, Harding did not have some sort of automatic right to close CDOs, *see* Div. Br. 102, and if a CDO such as a Norma Recipient could not get done (as a result of needed disclosures or for any other reason), it would have fallen to the underwriter and manager to dispose of the warehoused assets. *See* Wagner Tr. 4655:19-4656:7 (if ramped CDO cannot close, warehouse might have to sell bonds at a loss); *see also* Resp. Ex. 123 § 6 (provisions of Octans I warehouse agreement governing failure to close).

A few more observations about the Norma facts are in order. First, Respondents are simply wrong to argue (at 243-44, 260 n.298) that the Division rested mainly on uncorroborated hearsay and speculation. To the extent the Division rests on documentary evidence (as opposed to live testimony in which Chau variously acknowledged the plain import of the documents or offered ridiculous explanations for them), the narrative at its core draws on emails *from* Chau himself; emails *to* Chau not really being used for the truth of the matter asserted; emails written by *other* employees of Respondents (*see* Fed R. Evid. 801(d)(2)(A), (D); footnote 14 above); emails *from* Prusko, who testified about them at the request of Respondents; and one true third-party email, namely Margolis' report of his conversation with Chau ("Wing is in for $20 mm"), which not only relays *Chau's own statements* but is heavily *corroborated by other evidence.* Div. Ex. 204; Div. Br. 87-92.

Next, Respondents commit at least three major mischaracterizations of the price-related communications. One is that the January 9, 2007 email from Merrill (Div. Ex. 190) was not a "pricing email," Resp. Br. 245; *see also id.* at 258 (referring incorrectly to "original spread"). It was a transaction announcement that contained "*price guidance*" (Respondents acknowledge this in almost the same breath, *see id.* at 245), which is to say where *Merrill* hoped, at the time it began soliciting interest, that the tranches *might* price. *See* Chau Tr. 4124:8-4126:22. That is why the coupon levels in Div. Ex. 190 were expressed as an "area." Norma was not actually priced until January 26, 2007. *See* Div. Ex. 207; Div. Br. 91. The second mischaracterization is to argue that on January 19, 2006, Chau had not decided to buy the single-As. In fact, he had. *Compare* the citations in Div. Br. 89 n.154 *with* Resp. Br. 249-50.

The third major distortion: *Harding did not, as Respondents claim (e.g., Resp. Br. 257-258, 260, 263), negotiate any discount from +385 DM to +505 DM; its order was at the market* *price of +440 DM.*[69] This can be seen from Div. Ex. 207: at the bottom of the string is Merrill's January 26 pricing announcement, indicating that the BBBs were being offered at +440; in the middle is Merrill's confirmation that Chau had ordered $20 million of the class E (*i.e.*, BBB) bonds *at par*, in other words, at +440; and at the top is Chau's own confirmation to a subordinate that Harding was indeed getting the BBBs at par – *i.e.*, +440. (Consider in this light Chau's testimony that "I wouldn't commit unless the Harding CDOs that we were investing for would receive a coupon of roughly LIBOR plus 500 basis points." Tr. 4236:1-3.) Examined closely, the evidence shows that the eventual discount from +440 to +505 (that is, from par to 97.00) was purely attributable to a different investor's *subsequent* negotiations with Merrill.[70]

In sum: Chau received guidance that Merrill hoped to be able to sell the BBBs at +385; then Merrill had tremendous difficulty selling the BBBs (its banker "was quite whiny and down" about them, Div. Ex. 199; Div. Br. 89); then the deal priced, with Chau committing to buy $20 million of the BBBs at +440, or in other words the highest price (lowest spread) the market would bear. Wagner Report ¶ 171.[71] That Chau's allocation later decreased and the spread increased (to $15 million at +505) were purely a result of Chau's good fortune that Merrill found another buyer and lowered the price for both of them. And, as already noted (Div. Br. 92 n.162), the increase from +385 to +505 – let alone +440 – would not have been considered meaningful,

[69] "DM" stands for discount margin, expressing the coupon in terms of the number of basis points above 3-month LIBOR. *See* Div. Br. 92 n.162.

[70] *See* Div. Br. 92 & n.162 (citing RX 839, reflecting Merrill agreeing on February 1, 2007 to give UCM "440 coupon, 97.0 price," in other words a 3% discount from par at the coupon level at which the BBBs had priced, which equated to a DM of +505.3); *compare* Resp. Br. 244 n.286 (incoherent discussion of the evidence referring to testimony from Xilun Chen, who was not a witness at the hearing).

[71] Wagner did not have access to a full record (for instance, he did not see RX 839, showing UCM extracting a discount after the BBBs priced at +440), and was responding in paragraphs 167-171 of his report to certain assertions in Respondents' Wells submission taken at face value. It is clear that his conclusions in those paragraphs would have applied *a fortiori* if he had reviewed the full record.

particularly given Harding's lack of analysis coupled with Chau's initial negative impression and the later negative report circulated by Kaplan. Wagner Report ¶¶ 169-170.

The last thing to note about Respondents' factual presentation is the sheer absurdity of the notion that Chau somehow "had a negative economic impact" on Magnetar and Merrill by supposedly "bargaining" for a better spread. *See* Resp. Br. 237, 261-63. According to Chau:

> Every basis point wider that I negotiated for my clients[72] for investing in the Norma CDO . . . 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 [an effective] DM of 500 basis points.

Tr. 4236:8-14. This is nonsensical. Magnetar and Merrill obviously wanted Norma's liabilities to be placed so the transaction could close, even if that meant granting investors modest discounts. Chau expressly agreed that his buying the BBBs "might have benefitted Merrill, but it would definitely benefit Magnetar" and that he "knew that at the time." Chau Tr. 1610:4-21.

In case there is any doubt about this point, note that on the single-As, unlike with the BBBs, Chau actually *did* place his order at a discount.[73] If every basis point wider that Chau negotiated for investing in the Norma CDO would be a basis point of income loss to Magnetar, then this discount would be a relationship-harming fact. But far from hiding his involvement in placing the Norma single-A's, Chau was eager for Prusko to know: "Did ML tell u I am in for 40 mm single-As in Norma – team player!!!" Div. Ex. 200. Chau testified as follows concerning this discount purchase that by his own logic was not in Magnetar's interest (Tr. 1606:3-21):

> Q. You were telling Mr. Prusko you had bought 40 million of the single A's because you wanted Mr. Prusko to know that you were doing something that would benefit his economic interest. Correct?
> A. Yes.

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[72] Chau apparently did regard the CDOs as his advisory clients after all. *See* page 1 above.

[73] *See* Div. Ex. 207 (confirming order at time of pricing with 99.0 discount to par on class D, and an effective discount margin 65 basis points above price guidance in Div. Ex. 190).

And then – if there were any question about whether Magnetar would be "[un]happy" knowing Chau was "part of pushing the pricing" to higher coupon levels – Prusko responded: "No, they did not, . . . gave you no credit for A's, ***that's great, thank you.***" Div. Ex. 200 (emphasis added).

XI. THE STATUTE OF LIMITATIONS IS INAPPLICABLE

The statute of limitations defense that Respondents perfunctorily assert (at 336-37) is not an obstacle to any relief the Division is seeking. Respondents entered into tolling agreements with the Division that by their terms "suspended" "the running of any statute of limitations" "for the period beginning on August 31, 2011 through September 30, 2013." Since this proceeding was instituted on October 18, 2013, a cause of action here would be time-barred if it accrued before September 18, 2006 – not, as Respondents state, August 31.[74]

As an initial matter, the applicable statute of limitations, 28 U.S.C. § 2462, governs only the Division's request for penalties and associational bars, not any other relief or issue in the case. *E.g.*, *David F. Bandimere*, Initial Dec. Rel. No. 507, 2013 WL 5553898, at *75 (Oct. 8, 2013) (citing *Gregory O. Trautman*, opinion at Securities Act Rel. No. 9088A, 2009 WL 6761741, at *20 (Dec. 15, 2009)); *Joseph P. Doxey*, Initial Dec. Rel. No. 598, 2014 WL 1943919, at *19-20 (May 15, 2014). Nor is there any suggestion that the statute of limitations has any bearing on the Norma-related claims; Respondents' argument is limited to Octans I.

For Section 17(a) violations, accrual is properly measured from the dates of the offer or sale of the securities. *See David F. Bandimere*, 2013 WL 5553898, at *74-*75; *Joseph P. Doxey*, 2014 WL 1943919, at *19 (claims for violations in connection with the sales of securities "could

[74] Purely for reference, we have appended the operative agreement as Reply Appendix A. Respondents' (somewhat semantically confusing) description of the tolling agreements (Resp. Br. 336) omits the expiration of the agreement and therefore sells Respondents short with regards to the 18 days that elapsed in between the expiration and the institution of proceedings. As will be seen, though, the distinction between August 31 and September 18 of 2006 is irrelevant – nothing of consequence to the statute of limitations happened in that interval.

not have accrued until the sale occurred"). With respect to the Section 17(a) violations based on misconduct directed at investors (as opposed to the Issuer), the sale date for investors was no earlier than September 26, 2006. *See, e.g.*, Resp. Ex. 7 (September 26, 2006 initial note purchase agreement providing that notes "are to be issued pursuant to an indenture, dated as of September 26, 2006"). Neither were the Section 17(a)(2) violations complete until Harding "obtain[ed] money," which could not happen until the September 26, 2006 CMA was executed, entitling Harding to management fees. *See* Div. Ex. 4 at 16-17.[75]

Respondents' focus (at 337) on the events of May 31, 2006 overlooks the fact that many of the misrepresentations at issue (as opposed to the underlying conduct that made the representations materially deceptive) were embodied in a final offering circular dated September 20, 2006. Similarly, Respondents' focus (*id.*) on the distribution of the pitchbook pertains exclusively to unaccepted "offers" of the Octans I securities and not their "sale," as discussed in the preceding footnote. Respondents ignore, too, the Division's Section 206 and Section 17(a) claims based on misconduct directed at the Issuer. *See* Div. Br. 121. Those could not accrue until closing, at which point: the advisory relationship was formed; the misrepresentations, omissions, and deceptive conduct directed at the Issuer were complete; the warehouse sold securities to the Issuer; and the Issuer sold securities to investors.

XII. FULL DISGORGEMENT IS APPROPRIATE

Respondents argue (at 339-42) that "[t]he amounts the Division seeks to disgorge in this case do not represent ill-gotten gains attributable to a fraud." But they do. Harding obtained its

[75] The Division acknowledges that offers took place before September 18, 2006 given that most of the pitchbooks and POCs were distributed before that date. To the extent some offers were unaccepted by prospective investors (and therefore never culminated in a September 26 "sale"), arguably *a subset of the Section 17(a)(1) and 17(a)(3) violations only* might not be a basis for penalties or a bar.

(highly profitable) fiduciary positions through a series of misrepresentations and deceptive activities aimed at its advisory clients. Equity does not entitle Harding to retain the fruits of those violations. *See* Div. Br. 134-35; *see also SEC v. Contorinis*, 743 F.3d 296, 301-02 (2d Cir. 2014) ("Disgorgement serves to remedy securities law violations by depriving violators of the *fruits of their illegal conduct*. . . . Disgorgement instantiates the equitable principle that *wrongdoers should not benefit from their misdeeds*, and thus should relinquish *any profits obtained from them*." (emphasis added)). In the circumstances, the Division's approximation of ill-gotten gains is reasonable. *E.g.*, *SEC v. Monterosso*, __ F.3d __, 2014 WL 2922670, at *8 (11th Cir. Jun. 30, 2014) ("[e]xactitude is not a requirement." (citation and internal quotation marks omitted)). The burden was on *Respondents* to counter the Division's calculation, but Respondents did not even attempt to carry that burden, much less succeed in doing so.

CONCLUSION

The Court should make the findings, draw the conclusions, and impose the remedies advanced in the Division's Opening Brief.

Dated July 14, 2014
New York, New York

DIVISION OF ENFORCEMENT

/s/ Howard A. Fischer

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REPLY APPENDIX A

SIXTH AMENDED TOLLING AGREEMENT

WHEREAS, the Division of Enforcement ("Division") of the United States Securities and Exchange Commission ("Commission") has notified Harding Advisory, LLC ("Harding"), through its counsel, that the Division is conducting the investigation entitled In the Matter of Harding Advisory, LLC (NY-08306) (the "Investigation") to determine whether there have been violations of certain provisions of the federal securities laws;

WHEREAS, the Division and Harding previously entered into and agreed upon a tolling agreement relating to the Investigation, dated September 9, 2011, with a tolling period beginning on August 31, 2011 through February 28, 2012;

WHEREAS, the Division and Harding also entered into an amended tolling agreement, dated June 5, 2012, which extended the tolling period relating to the Investigation to run from August 31, 2011 through July 17, 2012 (the "amended tolling agreement");

WHEREAS, the Division and Harding also entered into a second amended tolling agreement, dated July 13, 2012, which extended the tolling period relating to the Investigation to run from August 31, 2011 through September 30, 2012 (the "second amended tolling agreement");

WHEREAS, the Division and Harding also entered into a third amended tolling agreement, dated September 27, 2012, which extended the tolling period relating to the Investigation to run from August 31, 2011 through December 31, 2012 (the "third amended tolling agreement");

WHEREAS, the Division and Harding also entered into a fourth amended tolling agreement, dated September 27, 2012, which extended the tolling period relating to the Investigation to run from August 31, 2011 through March 31, 2013 (the "fourth amended tolling agreement");

WHEREAS, the Division and Harding also entered into a fifth amended tolling agreement, dated March 5, 2013, which extended the tolling period relating to the Investigation to run from August 31, 2011 through June 30, 2013 (the "fifth amended tolling agreement");

WHEREAS, the Division and Harding agree to extend the fifth amended tolling agreement;

ACCORDINGLY, IT IS HEREBY AGREED by and between the parties that:

1. the running of any statute of limitations applicable to any action or proceeding against Harding authorized, instituted, or brought by or on behalf of the Commission or to which the Commission is a party arising out of the Investigation ("any proceeding"), including any sanctions or relief that may be imposed therein, is tolled and suspended for the period beginning on August 31, 2011 through September 30, 2013 (the "tolling period");

2. Harding and any of its agents or attorneys shall not include the tolling period in the calculation of the running of any statute of limitations or for any other time-related defense applicable to any proceeding, including any sanctions or relief that may be imposed therein, in asserting or relying upon any such time-related defense;

3. nothing in this agreement shall affect any applicable statute of limitations defense or any other time-related defense that may be available to Harding before the commencement of the tolling period or be construed to revive any proceeding that may be barred by any applicable statute of limitations or any other time-related defense before the commencement of the tolling period;

4. the running of any statute of limitations applicable to any proceeding shall commence again after the end of the tolling period, unless there is an extension of the tolling period executed in writing by and on behalf of the parties hereto; and

5. nothing in this agreement shall be construed as an admission by the Commission or Division relating to the applicability of any statute of limitations to any proceeding, including any sanctions or relief that may be imposed therein, or to the length of any limitations period that may apply, or to the applicability of any other time-related defense.

This instrument contains the entire agreement of the parties, and may not be changed orally, but only by an agreement in writing. The parties may execute this agreement in counterparts, each of which is deemed an original and all of which only constitute one original.

SECURITIES AND EXCHANGE COMMISSION
DIVISION OF ENFORCEMENT

By: Steven G. Rawlings   Date: 4/29/13
Steven G. Rawlings
Assistant Regional Director

HARDING ADVISORY, LLC

By: ________   Date: 5/16/13

Approved as to Form:

By: Joseph J. Frank   Date: 5/21/13
Joseph J. Frank, Esq.
Orrick, Herrington & Sutcliffe, LLP
Counsel to Harding Advisory, LLC

CERTIFICATION

I. Wing Chau, the President of Harding Advisory, LLC, a corporation duly organized and existing under the laws of the State of Delaware hereby certify that I have reviewed the foregoing Sixth Amended Tolling Agreement; that Harding Advisory, LLC agrees to the tolling of any limitations period described therein; and that I am authorized to execute such documents in furtherance of that Agreement as are required, substantially in the form of the foregoing Agreement, on behalf of Harding Advisory, LLC.

Dated: 5/16/13

Wing Chau