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February 2, 2015

VIA FACSIMILE AND FEDERAL EXPRESS

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549
Fax: 202-772-9324

RE: In the Matter of Harding Advisory LLC, et al.
Administrative Proceeding – File No. 3-15574

Dear Ms. Murphy:

We represent Respondents Harding Advisory LLC and Wing F. Chau in the above-referenced matter. Enclosed for filing, please find the Respondents' Petition for Review of the Initial Decision.

Thank you for your attention to this matter.

Sincerely,

Ashley Baynham

Enclosures
cc: Hon. Cameron Elliot (via e-email)
Howard Fischer, Esq. (via e-mail)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

HARDING ADVISORY LLC and

WING F. CHAU,

Respondents.

Administrative Proceeding
File No. 3-15574

RESPONDENTS' PETITION
FOR REVIEW OF THE INITIAL DECISION

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INTRODUCTION

Pursuant to Commission Rule of Practice 410(b), Harding Advisory LLC ("Harding") and Wing F. Chau (collectively, "Respondents"), by and through their counsel, Nixon Peabody LLP, hereby petition the Securities and Exchange Commission ("SEC" or "Commission") for review of the Initial Decision ("ID") rendered by Administrative Law Judge Cameron Elliot ("ALJ") on January 12, 2015. In his Initial Decision, the ALJ found that Harding committed the following violations:

a. negligently misrepresenting to Octans I investors, in the pitch book, Harding's investment analysis process, in violation of Section 17(a)(2);

b. negligently misrepresenting to the Octans I issuer, in the Collateral Management Agreement ("CMA"), the standard of care Harding followed in selecting collateral, in violation of Section 206(2) and Section 17(a)(2);

c. negligently failing to follow the correct standard of care, with respect to the Octans I issuer, in violation of Section 206(2) and Section 17(a)(3);

d. negligently misrepresenting to Octans I investors, in the offering circular ("OC"), the standard of care Harding followed in selecting collateral, in violation of Section 17(a)(2);

e. failing to follow the correct standard of care, with respect to two CDO Issuers which received Norma mezzanine bonds, in violation of Section 206(1) and Section 17(a)(1); and

f. misrepresenting to two CDO Issuers, in the CMAs, the standard of care Harding followed in selecting Norma mezzanine bonds for each Issuer's portfolio, in violation of Section 206(1) and Section 17(a)(1).

In addition, the ALJ found that Mr. Chau was "primarily liable for, and aided and abetted and caused, Harding's Norma-related violations." (ID at 90-91.)

Respondents take exception to many of the findings in the ID, including, among other things, finding liability for conduct that was not alleged in the Order Instituting Proceedings ("OIP"). For all of the reasons set forth below, among others, certain of the ALJ's legal conclusions are not supported by his own factual findings, certain conclusions are contrary to governing law and are in conflict with the relevant deal and disclosure documents, and certain other findings are not supported by the record or the applicable law. When properly analyzed and weighed, the evidence and the law dictate a finding that the ALJ's findings of violations are clearly erroneous. In any event, the disgorgement and penalties assessed by the ALJ cannot be supported by the evidence or the applicable law, even if his findings of liability were correct.

Specifically, among other things, Respondents seek review under Rule of Practice 411(b)(2)(ii) of the findings that Respondents violated Section 17(a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. § 77q(a)] and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act") [15 U.S.C. § 80-b(6)(1), (2)]. Respondent Wing F. Chau seeks review under Rule of Practice 411(b)(2)(ii) of the findings that he aided and abetted Respondent Harding Advisory LLC's violations of Sections 17(a) of the Securities Act and Section 206(1) of the Advisers Act. Respondents also seek review under Rule of Practice 411(b)(2)(ii) of the findings that Respondents are liable for disgorgement and civil penalties and subject to a lifetime bar, as well as the imposition of a cease-and-desist order. Finally, Respondents seek review under Rule of Practice 411(b)(2)(ii) of the findings that Respondents' affirmative defenses and violations of their constitutional rights were inapplicable.

OCTANS I-RELATED ERRORS

I. THE FINDINGS AND RECORD CONCLUSIVELY DEMONSTRATED THAT HARDING ADVISORY DID NOT DEVIATE FROM ANY STANDARD OF CARE.

The primary allegations in the OIP in this case describe a *deliberate* fraud by Harding , a collateral manager principally of collateral debt obligations ("CDOs"), and Mr. Chau, Harding's principal owner, whereby, in sourcing assets for a mezzanine CDO named Octans I CDO Ltd.

("Octans I"),[1] the Respondents succumbed to pressure from a hedge fund, Magnetar Capital LLC ("Magnetar"), and included in the Octans I portfolio assets Harding's own analysts "disfavored".[2] What made this a fraud, according to the OIP, was that Magnetar's interests were not aligned with those of other investors in the deal because, unlike other investors, it stood to profit from the failure of Octans I. More specifically, the OIP alleged that Magnetar wanted Harding to place an index trade involving the ABX Index 2006-1 ("ABX Index") – or as many ABX Index 2006-1 component assets as Harding would take – for its own advantage and at the expense of other investors, and that Harding acquiesced to this demand in order to curry favor with Magnetar and Merrill Lynch, the deal underwriter.[3]

In his initial decision, the ALJ found that *none* of those allegations were true. In fact, he concluded that "*in order to find an intent to defraud, I would have to disbelieve every single lay witness who testified on the subject.*" (ID at 66 (emphasis added)). Specifically, the ALJ found:

- that Harding's analysts did not disfavor the relevant assets (ID at 79);
- that the assets at issue were not bad and did not contribute to any CDO failure (ID at 47, 92);
- that there was no proof of adverse selection (ID at 57); indeed this was a finding by one of Division's own experts and was disclosed pre-hearing as *Brady* material;[4]

[1] In May 2006, Merrill Lynch hired Respondents to select collateral for Octans I backed principally by the BBB and BBB- tranches of RMBS. Octans I was structured and marketed by Merrill Lynch. The $1.5 billion deal closed on September 26, 2006.

[2] After a multi-year investigation into the structuring and marketing of CDOs, the Commission issued its OIP on October 18, 2013, based on allegations by the Division of Enforcement ("Division"). A hearing commenced on March 31, 2014 and lasted 17 days.

[3] An ABX Index trade involved a simultaneous long position in the index and a short position in the components of the index that the collateral manager did not like. The net effect is long exposure to the component assets of the Index that the manager did like. The purpose of the trade is to take advantage of an arbitrage opportunity, which, in plain English, permits the purchase of constituent assets on more advantageous terms even when the cost of the trade is taken into account.

[4] Note that this disclosure, which, given the allegations, goes to the very core of what is in dispute, was made only four days before the start of the Hearing despite the fact that, according to the Division expert who did the

(Footnote continued on next page)

- that "[t]he evidence does not show that Harding employees schemed to accept bonds over the objection of a senior analyst, nor did analysts cave in to pressure to relax standards to ensure that the bonds would pass review" (ID at 79);

- that there was no evidence of Mr. Chau pressuring Harding analysts to relax standards of review to accommodate Magnetar or Merrill Lynch (ID at 80);

- that Harding approved the same assets for other deals, unrelated to Magnetar or Merrill Lynch, at other times both before and after the day on which these assets were selected for Octans I (*see* ID at 46, 66);

- that "there is insufficient evidence of pressure by Magnetar to corrupt Harding's credit process" (ID at 73);

- that Magnetar did not suggest a minimum number of ABX Index assets (ID at 78);

- that Magnetar was not betting on Octans I to fail because its long equity position was bigger than its short position 2 to 1, *i.e.*, Magnetar's interest were aligned with those of other long investors (ID at 75-77);

- that there was no *quid pro quo* whereby Harding would get more business if it allowed certain assets into the CDO (*id.*);

- that Harding's incentives were also aligned with those of the investors in Octans I (ID at 75);

- that the relevant parties believed at the relevant time that the ABX trade was beneficial to the Octans I deal (ID at 77);

- that, according to one of Division's own experts, "the performance of Harding-managed CDOs was generally consistent with the performance of several other managers' deals in the market at the time[,]" and that "with the recession beginning in 2008, everyone in the financial industry failed to predict the crash of non-agency bonds[;]" (ID at 56);

- that no one at Harding was ever asked to do anything unethical or anything that he or she was uncomfortable doing (ID at 8-10);

- that there was no direct evidence that Respondents' conduct contributed to any CDO's failure, and there was insufficient evidence of harm to investors or the marketplace resulting from Respondents' conduct (ID at 92); and

analysis, he had given his finding to the Division at least six weeks before that. Note too that the time from the service of process to the hearing was only approximately 20 weeks and that the investigative file in this case consisted of approximately 11 terabytes of data, which is equivalent to 22 million documents or the entire contents of the Library of Congress.

- that "[t]he evidence is insufficient to conclude that Harding possessed a conflict of interest with respect to Octans I" (ID at 73).[5]

In other words, there was no deliberate fraud, the relevant assets were fine, and Harding deals, including Octans I, performed in a manner consistent with the performance of deals managed by other comparable managers.

Despite these factual findings – all of which are consistent with the evidence in the case and with the arguments the Respondents presented in their post-Hearing brief – the ALJ found fraud. He found that the relevant analyst was negligent in selecting assets on the relevant day. Note that the ALJ found that this analyst's conduct did not rise to the level of an extreme departure from the relevant standard of care or even an extreme departure from the description of Harding's asset selection process described in the Pitch Book for Octans I (the only document that actually described in any manner Harding's asset selection process). The ALJ found, however, that because this analyst was negligent on that one day, her conduct rendered Pitch Book representations as well as representations about comportment with a standard of care contained in the Collateral Management Agreement and described in the Offering Circular materially misleading and therefore constituted negligent fraud.

As noted, these findings are inconsistent with what is actually alleged in the OIP. Indeed, Respondents did not understand that the Division would rely on a negligence theory – or what that theory might be – until the Division submitted its expert reports very shortly before the start of the Hearing. Prior to that, Respondents filed a motion for a more definite statement. Their motion was denied, despite the fact that the OIP did not even recite which subsections of Section

[5] There was also no evidence that any investors relied on what were alleged to be misrepresentations. (ID at 92.) While the Division does not have to prove reliance, this finding makes it clear that any such alleged misrepresentations were not material.

17(a) of the Securities Act and which subsections of Section 206 of the Advisers Act the Division claimed had been violated.

The submission of the Ira Wagner expert report was the first hint that the Division may try to prove negligence, but even that report did not make it clear because it contained various allegations – found to be baseless by the ALJ – about Harding lowering its asset review standards in response to pressure from Magnetar.[6] The ALJ's finding of liability predicated on negligence is inconsistent with, and is at variance from, the allegations in the OIP and, therefore, a reversible error. Plainly stated: the Division failed to prove the allegations in the OIP relating to Octans I for that reason alone.

More specifically, the ALJ's finding of negligence is predicated on three primary factors: that there does not seem to be contemporaneous documentary evidence memorializing the exact analysis the relevant analyst claims she had done on that one day; that her testimony on the matter is confused and contradictory; and that the Division's expert opined that her review (as evidenced by the documents given to him by the Division) was substandard. However, her testimony is essentially that she would not have approved assets for inclusion in the deal had she not done the requisite work.

Indeed, the document that the Division offered as proof that the relevant analyst approved assets she should not have approved is so problematic on its face, that the Division's expert agreed that he too would not have approved assets on the basis of that document without further analysis. That, in a nutshell, is her position. Her inability to remember precisely what she did on

[6] These and many other allegations in the Wagner expert report were predicated on his review of the investigatory record given to him by the Division. Of course, Respondents made a motion to exclude his testimony, in large part because he was opining on the ultimate issues in the case and because, in a similar case in federal court. similar testimony by the Division was precluded by a district court judge for the reasons set forth in the Respondents motion papers. (*See* discussion at Section V, *infra*; *see also* Resps.' Mot. to Exclude the Expert Testimony of Ira Wagner at 7, *Harding Advisory LLC*, Admin. Proc. No. 3-15574 (Mar. 21, 2014) (citing *SEC v. Tourre*, 950 F. Supp. 2d 666 (S.D.N.Y. 2013).)

a random day eight years before she testified at the Hearing is not surprising. Indeed, given (a) the absence of proof that anything untoward had taken place on that day, (b) her testimony that she was never asked to do anything unethical, and (c) the ALJ's finding that she was very busy on the day she analyzed the ABX Index bonds, it would be surprising if she did remember exactly what she did that day. At most, the ALJ's factual findings show that the Division proved that Harding's record keeping was inadequate, rather than that she was negligent in asset selection.[7] To repeat, there was nothing wrong with the assets she selected, and those same assets were selected by her and another analyst for other deals at other times.[8]

In effect, the ALJ's findings represent an improper burden shifting from the Division to the Respondents. He erroneously found that the absence of dispositive, documentary evidence that there was adequate review was evidence that there was absence of review. (*See, e.g.*, ID at 65.) Even if the ALJ disbelieved the relevant analyst's testimony about what she did that day, he should have found for the Respondents. In other words, if he disbelieved her and there was no other reliable evidence of what happened, he should have found that the Division failed to meet its burden of proof: again, absence of evidence is not evidence of absence.

The ALJ's finding is also erroneous because he accepted the expert's opinion on the ultimate issue. The ALJ f●und that the Division's expert, Ira Wagner, "did not identify exactly what 'industry standards' entail for collateral managers[.]" (ID at 55) Nevertheless, the ALJ accepted Wagner's opinion that the analysis of ABX Index assets for Octans I failed to meet

[7] Similarly, the ALJ found that the Harding analyst acted on her own without speaking to the other senior RMBS analyst at Harding. A more likely inference is that they did speak and reconcile their different opinions, given the ALJ's other finding that they sat in the same room at the same desk and both were present that day. The other analyst was not called by the Division and did not testify.

[8] Indeed, the ALJ made specific findings that the ABX Index assets at issue had been analyzed at various times both before and after May 31, 2006, including for deals not involving Merrill or Magnetar. He found that these reviews showed nothing wrong with the ABX Index assets that were selected for Octans I. (*See* ID at 35-36, 42-47.)

industry standards of care and the asset review procedures described in the Pitch Book. (ID at 55, 65, 66, 70, 73.)

There is another, independent, reason that the ALJ's finding that Harding's review of ABX Index assets was negligent was in error: there was uncontroverted testimony that prior to the closing of Octans I, Harding and Mr. Chau certified that the assets in the deal met all of the eligibility criteria for the deal and that Harding performed an analysis of deal assets in connection with this certification prior to closing. (ID at 20-21.)[9] In other words, even if there had been something wrong with the initial analysis performed on May 31, any problem had been fixed in connection with the pre-closing review and certification. Note too, that the ALJ found that a September 18, 2006 analysis of the same bonds showed no problems with any of the bonds; the deal closed eight days later on September 26. (ID at 56.)

Even assuming that the relevant analyst was negligent in her review of assets on a given day, her random negligence could not be the basis for a finding of negligent fraud. To begin, there are only eleven assets at issue here, representing approximately six percent of the Octans I portfolio. That is to say that all representations about asset selection processes and comportment with the relevant standard of care are true and correct in all *material* respects. Note here that the ALJ found that "Harding and [the relevant analyst] generally complied" with what was expected based on the asset review description set forth in the Pitch Book. (ID at 66). This is why the ALJ found that the representations in the Pitch Book and the reality of asset review were not "so clear and distinct" that there was an "extreme departure" from the standard of care. (*Id.*)

The implications of the ALJ's decision, should it be allowed to stand, are as profound as they are frightening. In effect, any employer can find itself liable for fraud if one of its

[9] Contrary to the ALJ's finding (*see* ID at 72 n.61), that review did involve credit quality review, as one of the eligibility criteria was that an asset could not be a credit risk or a defaulted asset. (*See* Resp. Br. at 84-86.)

employees has a bad day at the office, even if there is no evidence of collusion or bad faith, no investors were hurt as a result, the assets selected were no worse than any other assets, and the conduct in question is an aberration. This is not fraud.

There is also no fraud because, as the Respondents argued in their post-Hearing brief, all investors received the benefit of their bargain. Octans I was placed as a Rule 144A private offering with extremely sophisticated investors -- other investment and collateral managers. (*See* Resp. Br. at 93-99.) There is no allegation or proof that any of them did not get the exact securities they expected at the price they expected to pay. There is no allegation or proof that any of the assets in the Octans I portfolio did not comport with all eligibility and investment criteria. There is no dispute that all these sophisticated investors were given the entire portfolio before they invested and that they all reviewed and re-analyzed that portfolio before investing. (*See* Resp. Br. at 98 nn.86-87, 99-101; *see also* Resp. Ex. 884 at 2 (statements of Imran Khan, investor in Octans I).)

The ALJ gives short shrift to the fact that both the Pitch Book and the OC for Octans I explicitly stated that neither was making any representations about the quality of the collateral in the deal. (ID at 65.) But to say, as the ALJ does, that this disclaimer is irrelevant because the representations he found wanting relate to the process of selecting the collateral rather than the collateral itself stands logic on its head. (*See id.*) It is the equivalent of saying that the investors in Octans I would care more about how Harding selected assets than about the assets Harding selected.

On the contrary, the description of Harding's process and the disclaimer of the quality of the assets must be read together, not in conflict. Read together, these two provisions make clear that Harding's asset selection process was relevant only in very general terms primarily because

Octans I was a managed deal with a six-year life expectancy, *i.e.*, Harding's capabilities were relevant *after* the deal closed, when investors would be dependent on Harding's skill to maximize deal performance.

This was essentially the testimony of every investor in the deal, including the only investor called by the Division. None said that they relied on the Pitch Book alone for ascertaining the collateral manager's capabilities and processes. All said that they did their own asset analysis and spoke with Harding employees to satisfy themselves that Harding was capable and its employees knowledgeable. Again, to the extent the statements in the Pitch Book about Harding's process were relevant at all, the ALJ's findings show that they were materially true, given its entire contents and the role Harding played in the process.[10]

II. THE ISSUER WAS NOT, AND COULD NOT HAVE BEEN, DEFRAUDED.

Many of the same arguments apply with equal force to the allegations relating to the Octans I Issuer, especially given the ALJ's explicit finding that there was no conflict with respect to Octans I. (*See* ID at 73.) In addition, the ALJ misperceives the relationship between Harding and the Issuer.

Among other things, the relevant asset selection took place before the Issuer was even created, at a time when Harding had absolutely no obligations to it. (ID at 13.) The Issuer was created for the specific purpose of receiving the assets that Merrill Lynch decided to contribute to it for this transaction; it had no choice and no independence. There was also no evidence that the Issuer cared. (*See* ID at 14.) Indeed, given the explicit disclaimer about the quality of collateral mentioned above, which is a representation that technically protects the Issuer, one

[10] At most, the statements in the Pitch Book are also mere puffery given how general they were. The fact that each investor saw fit to speak with Harding before investing is definitive proof of that.

struggles to understand why the Issuer would care how the assets had been selected prior to closing or even prior to its creation. In short, for these reasons, among others, the ALJ's analysis is erroneous as to Harding's obligations and responsibilities before it become engaged by the Issuer.

In addition, the ALJ's analysis is erroneous both as a matter of law and as a matter of the operative documents as to the Respondents' obligations and liability after they did become so engaged. The Issuer also received exactly what it was promised; it was not deceived about the bundle of rights it could expect under the CMA, and, as a result, it was not defrauded. For example, as noted, any deviation from the standard of care on a random day by an analyst was fixed by the time the Issuer purchased the assets because the pre-closing certification served as a quality check on asset selection.

III. AN ISOLATED INCIDENT IS INSUFFICIENT AS A MATTER OF LAW TO FIND A SECTION 17(a)(3) VIOLATION.

The ALJ found that Harding violated Section 17(a)(3) by "negligently failing to follow the correct standard of care, with respect to the Octans I issuer." (ID at 90.) However, this conclusion is contradicted by the ALJ's findings that the only deviation in Harding's investment process occurred on one day for a particular set of assets. As the Commission has recently explained, one isolated incident is insufficient to establish a violation of Section 17(a)(3). In addition, as noted above, the ABX Index asset selection process was not a negligent deviation from Harding's stated process or standard of care, and Harding complied with its standard of care in all material respects.

* * *

In sum, Respondents maintain that these and other erroneous conclusions of law and fact resulted in the clearly erroneous findings that Respondents violated Section 17(a) of the Securities Act and Section 206(2) of the Advisers Act, as it relates to Octans I.[11]

NORMA-RELATED ERRORS

IV. THE ALJ ERRED IN FINDING THAT RESPONDENTS VIOLATED SECTION 17(a)(1) OF THE SECURITIES ACT AND SECTION 206(1) OF THE ADVISERS ACT AS TO THE NORMA CDO BBB BONDS

The second set of claims relates to Harding's role as collateral manager for two other CDOs, Neo CDO 2007-1 ("Neo") and Lexington Capital Funding V Ltd. CDO ("Lexington V"), which were both also structured and marketed by Merrill Lynch. In January 2007, Mr. Chau negotiated a discount to purchase the BBB-rated tranches of a CDO named Norma CDO I, Ltd ("Norma") for Neo and Lexington V. Harding was not involved in the structuring, marketing, or asset selection for Norma; it simply selected Norma BBB bonds for inclusion in two CDOs it managed. The ALJ concluded that Respondents operated under an undisclosed conflict of interest with respect to the purchase of these Norma bonds for Neo and Lexington V and materially misrepresented and failed to follow a standard of care in selecting the Norma BBB bonds for these two transactions. He found violations of Section 17(a)(1) of the Securities Act and Section 206(1) of the Advisers Act based on Harding's relationship with and representations made to the special purpose vehicles created by Merrill Lynch for these transactions, in other words, their Issuers. These findings were in error as a matter of both fact and law.

[11] Other errors include, but are not limited to: finding of liability for statements that were not made or used by the Respondents; failure to establish a causal connection between the alleged misstatements and obtaining of money or property; erroneous finding that conduct at issue operated as a fraud; erroneous finding that the same conduct was violative of both subsection (a)(2) and subsection (a)(3) of Secti●n 17 of the Securities Act; erroneous findings related to the analysis of fiduciary duties of CDO collateral managers; and erroneous findings as to the disclosure obligations under the Advisers Act and Section 17(a) of the Securities Act.

The ALJ found that the Norma bonds constituted approximately 1.6% of each of Neo and Lexington V. (ID at 52.) In other words, the ALJ also found that there was nothing wrong with the other 98.4% of the collateral in those two deals. (*See* ID at 48-54; 81-87.) Put differently, he found that all representations about the asset selection process were true and correct in all material respects. Put yet another way, he found that the asset selection process followed by Harding in connection with Neo and Lexington V resulted in those deals being 98.4% free of any conflict or taint. The last point is very significant because the very fact that these deals were found by the ALJ to be (at worst) 98.4% conflict free belies the entire notion that Harding or Mr. Chau was conflicted at all. One would expect more problems in these Merrill Lynch deals if Harding were laboring under a conflict, yet none other was proved and none other was even alleged. Given also the explicit finding that there was no *quid pro quo* in Octans I either, *i.e.*, the ALJ's finding that a desire to do business with a party does not by itself create a conflict of interest, one has to wonder why Harding would debase itself with respect to Norma and nothing else.

The short answer is that Harding did no such thing. To begin, there was nothing wrong with Norma bonds *per se*. As the Respondents were able to demonstrate at the Hearing, Norma's performance was consistent with that of other similar deals of the same vintage; this was based on a document submitted by the Division's expert, Ira Wagner, in another Commission CDO litigation, *SEC v. Tourre*. (Resp. Ex. 858 at ¶¶ 41-42 (Ira Wagner Rebuttal Report in *Tourre* case); Resp. Ex. 856 at 5 (CDO Exposure to Assets Downgraded by Moody's and S&P (7/1/07-2/4/08) Wachovia Securities, February 4, 2008); Tr. 4886:13-4890:8.) The ALJ ignored this exhibit and that was erroneous because, as all investors know, there is no such thing as a bad bond, only a bad price. That is to say, that there is a price quality relationship whereby a higher return is expected from a bond of a lower quality. Moreover, even Ira Wagner had to agree that in assembling collateral for a CDO, the collateral manager has to balance credit quality against producing attractive returns, meaning that some bonds in the deal would be worse than others if their spread is sufficiently attractive and was needed to make the overall deal returns attractive to investors. (Tr. 4620:21-4621:2.) That balancing act is what a collateral manager is hired to achieve.[12]

But the reason the ALJ walked away with the wrong impression about Norma is that the Division offered rank, unsubstantiated hearsay and misled the ALJ about Harding's internal analysis of Norma.[13] Specifically, one of the hearsay documents offered by the Division was a Norma analysis by a junior Harding analyst. The analyst did not testify at the Hearing and so did not explain this document. His analysis, however, was on its face riddled with indicia of unreliability. Among other basic errors, it misidentified Norma's collateral manager.

The Division argued that the document showed that, at the time of purchase by Neo and Lexington V, Norma BBB bonds were already substantially impaired. Mr. Chau explained at the Hearing and Respondents argued post-Hearing that the document showed no such thing, nor could it because the BBB bonds at issue would not have been investment grade had they been impaired when they were issued and bought.[14] The Division persisted, even in its post-hearing briefing. (*See, e.g.*, Tr. 1559:18-24; Div. Br. at 95.)

[12] The ALJ also specifically found that there was "no direct evidence that Respondents' failure to follow the appropriate standard of care contributed to any CDO's failure, particularly as to the Norma-related violations." (ID at 92.)

[13] This error infected all of the ALJ's legal and factual findings on Norma because his theory rested on Harding selecting Norma when it was of "poor quality" and "did not perform well" as compared to CDOs of similar vintage (ID at 54, 85-86.)

[14] The Division caused this error. It argued that the document at issue demonstrated that the BBB Norma bonds were impaired at the time of purchase since the document noted a "write-down %" of 10.17%. (Div. Ex. 217.) Specifically, the Division asserted that the 10.17% figure referred to the RMBS collateral and, argued that, because this number was higher than the 6.79% subordination below the BBB tranche of Norma, the BBB

(Footnote continued on next page)

Unfortunately, this legerdemain succeeded. The ALJ found that a mezzanine CDO was backed by bonds that were *not* investment grade. (ID at 4, 53-54) In other words, he disbelieved Respondents when they said that the relevant Norma bonds could not have had a BBB rating – which means that they were investment grade by definition -- had they been impaired when issued. (Tr. 1559:25-1562:10; 4077:14-4078:14; Tr. 4089:12-4090:24; 4100:09-4112:03; 4147:1-4150:20; 4382:5-4383:3.)[15] In sum, in interpreting this hearsay document, the ALJ accepted the Division's false explanation because he was misled by the Division about the nature of these assets and their relevant metrics.[16]

bonds had been impaired. (*See, e.g.*, Div. Br. at 95.) Mr. Chau testified that the document referred to losses in the underlying pools of loans, which did not translate directly into losses by the RMBS backed by those pools of loans because of the various credit enhancements imbedded in the securitization of those RMBS. Respondents made the same point in their post-Hearing brief. (*See* Resp. Br. at 264-267.)

[15] Investment grade refers to bonds rated BBB- and above. *See* Investopedia, Definition of Investment Grade, available at http://www.investopedia.com/terms/i/investmentgrade.asp (last visited on Feb. 2, 2014); *see also*, Wikipedia, Bond Credit Rating, available at http://en.wikipedia.org/wiki/Bond_credit_rating#Investment_grade (last visited on Feb. 2, 2014).

[16] This was not the only instance of the ALJ being misled by the Division. Among other things, the ALJ was initially apparently misled into believing that the fraud here was that the RMBS underlying the CDOs in question were supposed to be AAA and that Harding placed lower-rated securities into these deals unbeknownst to investors and others. It was not until Mr. Chau was testifying in Respondents case that the ALJ understood that the AAA-rated tranches of CDOs were not backed by AAA-rated RMBS. At that point, the ALJ noted that he had to rethink many things about this case, given his new, correct understanding. (Tr. 4080:11-4081:18; 4161:12-4161:14.)

The Division never bothered to lay a proper foundation early in the case. As a result, when Mr. Chau and others testified in the Division's case early in the Hearing, the ALJ had trouble with their testimony, as he noted in the ID. (*See* ID at 5-14.) When he admonished counsel about how Mr. Chau testified, counsel responded that Mr. Chau's answers would have made more sense to the ALJ had the Division explained the transactions at issue. (Tr. 1565:15-1569:21.) In fact, when Mr. Chau testified, in response to a question from the ALJ, that it would help to step back and explain how CDOs work, the ALJ interrupted him and stated that he would get that chance during Respondents' case. (Tr. 1511:18-1512:5.) That is exactly what happened. As noted, after Respondents explained the transactions, the ALJ had to rethink and re-evaluate everything he had heard up to then. (Tr. 4080:6-4088:17; 4160:12-4161:14.) Of course, by then the damage was done.

This is one of the reasons Respondents wanted to have this case tried in a federal district court where the Division would have been forced to lay a proper foundation and explain the context before the trier of fact had formed any credibility judgments. In this regard, the Commission may be aware that in the *Stoker* case, which involved the same subject matter, Judge Rakoff upbraided both sides early in the trial for not explaining to the jury in plain terms the background and context of the relevant transactions.

Other hearsay relied upon by the ALJ was just as unreliable. Among other things, the Division introduced, as a key piece of its evidence, an internal Merrill Lynch email that purported to indicate that Mr. Chau had agreed to buy Norma bonds in a conversation with a Merrill Lynch banker. Suffice it to say, this email is subject to multiple interpretations and none of the Merrill Lynch people on that email testified at the Hearing. (*See, e.g.*, Resp. Br. at 255-257.) Nonetheless, at the Hearing, Mr. Chau was subjected to the spectacle of having to testify about its meaning. (Tr. 1623:21-1627:13.) In the ID, the ALJ found Mr. Chau's explanations of the meaning of this and other similar emails to be wanting. (*See. e.g.*, ID at 6, 51, 83-84.) The ALJ's finding of willfulness is predicated almost entirely on Mr. Chau's testimony about these hearsay emails. (ID at 81-87, 95.) In other words, Mr. Chau's inability to decipher hearsay authored by others was held against him both substantively and with respect to the assessment of his credibility.

Similar problems exist in connection with the "candle in the wind" parody email which figures prominently in the ID and in the ALJ conclusion that Harding did not like the BBB Norma bonds. The author of that email did not testify about its meaning either. It is a parody and it is written in verse. (Div. Ex. 226.) It is clever, but there is no reason to think that its contents were meant to be taken seriously. Had the original song not been about Norma Jean and contained different words, the same parodist may have written the same thing about another deal whose name happened to rhyme. In fact, the parody mentions that Norma was too long Long Beach, when Norma's exposure to Long Beach was actually relatively modest. (*See* Resp. Ex. 270.)

In other words, the ALJ relied almost exclusively on a series of unreliable hearsay emails sent by representatives of Merrill Lynch, Harding, and Magnetar in late 2006 and early 2007 for his finding of scienter. (ID at 48-54.) This hearsay lacked any indicia of reliability. The practical consequence of his reliance on hearsay was to shift the burden of proof to the Respondents. This was another error. In the absence of reliable evidence, the ALJ should have found that the Division failed to meet its burden of proof even if he did not trust conflicting testimony. Instead, the ALJ again converted absence of evidence into evidence of absence.

Further, the ALJ's interpretations of the hearsay emails were not supported by witness testimony. Not a single witness to the relevant events testified that there was any accommodation to Merrill Lynch or Magnetar or that he or she thought at the time that the Norma bonds were bad investments at the price and spread at which they were purchased. In sum, the evidence presented at the Hearing should have precluded any finding of fraud, either intentional or negligent.[17] Respondents, meanwhile, offered a reasonable explanation of what transpired based on a current reading of the documents by the witnesses at the Hearing.[18]

Perhaps more fundamentally, the ALJ again misunderstood the import of the relevant deal documents and misapplied the relevant law. As was the case with Octans I, Harding was not, nor could it have been, a fiduciary of Neo and Lexington V because (a) the relevant CMAs specifically said so and (b) because that would have put Harding in immediate conflict with the

[17] To be clear, the ALJ made no specific finding that Harding was a fiduciary of either the Lexington V Issuer or the Neo Issuer; however, to the degree he rested on his earlier finding that Harding was the Octans I Issuer's fiduciary and relied on similar but unstated reasoning in concluding that a 206(1) violation had occurred, he committed clear error.

[18] In particular, uncontested testimony established:

(1) Harding and in particular, Mr. Chau, engaged in price negotiations with Merrill Lynch and ultimately obtained the Norma BBB bonds at a spread and price that made sense (Resp. Br. at 245-258);

(2) the price at which Harding received the Norma BBB bonds represented a benefit for the investors and Issuers, at the expense of Merrill Lynch and Magnetar (Resp. Br. 258, 260-263);

(3) Harding analyzed the Norma bonds prior to purchase, including but not limited to evaluating the information contained in the term sheet, pitch book, collateral stratifications (information on the underlying collateral in Norma), and offering circular (Resp. Br. at 245-258); and

(4) a Harding junior analyst's CDO commentary did not indicate that Harding had an "unfavorable view" of Norma at the time it purchased the BBB rated securities (Resp. Br. at 263-271).

actual investors in those deals. As was the case with Octans I, Harding had no obligations to the Issuers of those deals during the ramp period. None. As was the case with Octans I, Merrill Lynch, as the structurer, could have capitalized those Issuers with whatever assets it chose because it created the Issuers to receive whatever assets it decided to place there. Again, even if there had been some obligation at closing, there was pre-closing certification and attendant asset review that had cured any deficiencies in the initial selection of the Norma bonds. Again, as with Octans I, there was no allegation let alone proof that the Issuers did not know that Norma was in the collateral pool before the pool was used to capitalize them, or that the bonds sold were not as described, or that anyone was deceived about the price, or that the assets did not in any way meet all eligibility and investment criteria.

Moreover, Merrill Lynch was the creator and a fiduciary of the Issuers of Neo and Lexington V. By definition, it knew all about Norma, which was another Merrill Lynch-structured CDO. Harding did not know anything that Merrill Lynch did not know. Harding could reasonably be deemed to have made all relevant disclosure to the Issuers because it did not hide anything from its fiduciary and creator. (The ALJ effectively found as much in another part of the ID relating to Octans I. (ID at 80-81.)) Not a single witness testified about what the Neo and Lexington V Issuers were told or not told. In fact, *the directors of the Issuer for Norma were the exact same three directors* for the Issuers of Neo and Lexington V. (Div. Ex. 280 at 136; Div. Ex. 507 at 103; Div. Ex. 509 at 110.) There is no evidence in this case that the Norma Directors were not fully aware of Norma's quality, its structural features, or its asset composition. Indeed, because they were the same directors for all three deals, one can assume the directors to be familiar with Norma at the time it was purchased by them for Neo and Lexington V.

The disclosure for Neo and Lexington V also disclaimed any representations about the quality of the collateral. (Div. Ex. 507 at 49; Div. Ex. 509 at 49.) There is therefore no reason to believe that the Issuers cared how the initial portfolio was selected since they were making no promises about its quality and, as in Octans I, specifically told potential investors to rely on their own analyses of the initial portfolio.

As for the finding that the selection of Norma did not comport with the relevant standard of care, again, at most, Harding's failure to maintain good records has been converted into a finding that the review was inadequate. (ID at 86.) Note that Harding also bought single A-rated Norma bonds that the Division did not charge, as the ALJ found. (*Id.*) There is only one reason the Division would not have charged that purchase: it thought that Harding did have a good faith basis for recommending those bonds and there was no evidence of any pressure from anyone to buy the single-As. But the relevant analysis is the same for the BBB as for the single-As: it entails understanding the deal structure and the deal portfolio. In other words, if Harding had a good faith basis for purchasing the single-As, it *a fortiori* had a good faith basis to buy the BBBs when the price was lowered to the acceptable level.[19]

* * *

For the reasons stated above, among others, Respondents maintain that these and other erroneous conclusions of law and fact resulted in the clearly erroneous findings that Respondents violated Section 17(a)(1) of the Securities Act and Section 206(1) of the Advisers Act, as it relates to the Norma bonds.

[19] Here too, the ALJ erroneously accepted Ira Wagner's ultimate conclusion that the selection of Norma BBB bonds did not comport with the relevant standard of care.

ADDITIONAL ASSIGNMENTS OF ERROR

V. THE ALJ IMPROPERLY ADMITTED AND RELIED ON TESTIMONY BY THE DIVISION'S EXPERT, IRA WAGNER

The ALJ improperly denied Respondents' motion in limine to exclude the purported expert testimony of Ira Wagner, and improperly relied on Mr. Wagner's testimony, even though Mr. Wagner's purported opinions were demonstrably unreliable and irrelevant to the allegations in the OIP. The record demonstrates that, among other things, Mr. Wagner's opinion testimony was flawed, untestable, based on cherry-picked evidence; simply a ploy by the Division to introduce a purported expert to summarize its allegations as proof of a violation and to invite the ALJ to rely on otherwise inadmissible prior testimony; and an improper opinion on the ultimate issues and an opinion outside the scope of admissible expert testimony. The ALJ's reliance on Mr. Wagner's testimony in his conclusions was clear error. In addition, the ALJ erroneously and arbitrarily denied Respondents' request that the Division provide communications and other materials related to the expert opinions.

VI. THE ALJ IMPROPERLY ADMITTED AND RELIED ON PRIOR INVESTIGATIVE TESTIMONY AND MADE ADDITIONAL ERRONEOUS EVIDENTIARY AND OTHER RULINGS

At the onset of the trial, the ALJ, pursuant to Rule 1001 of the Rules of Practice, did not admit as evidence various transcripts of prior sworn testimony. (*See* Tr. 13:20-14:7.) However, throughout the trial, the ALJ allowed the Division to read into the record portions of the inadmissible testimony. Over Respondents' objections, he improperly allowed the Division to read into the record prior sworn testimony in order to refresh witness' recollections; admitting as prior inconsistent statements, statements that were either consistent with the witness's testimony or concerning a different topic than the subject matter to which the witness was testifying; and admitting as substantive evidence, prior sworn statements as prior recollection recorded, even though the requirements for such a finding were not met, among other things. Once made part of the transcript, these otherwise inadmissible statements were relied on, at least in part, by the ALJ when issuing his Initial Decision.

Moreover, the ALJ made several erroneous evidentiary rulings, substantially prejudicing Respondents in their attempt to defend against the Division's allegations. For example, the ALJ improperly denied Respondents' motion to amend the hearing transcript to insert the word "not" in a sentence from Ms. Jung Lieu's testimony. (*See* ID at 90.)

The ALJ clearly erred in denying Respondents' Motion for a More Definite Statement, causing substantial prejudice to Respondents who were forced, among other things, to litigate matters outside of that which was alleged in the OIP.

VII. THE ALJ IMPROPERLY IMPOSED DISGORGEMENT, CIVIL PENALTIES, A LIFETIME BAR, AND A CEASE-AND-DESIST ORDER

Even assuming that the ALJ's conclusions of law and fact were sufficient in order to find violations of Section 17(a) and Section 206, his remedies were vastly disproportionate to the actual conduct as described in his findings of facts.

A. Disgorgement Not Warranted

Disgorgement was imposed improperly on Respondents contrary to the overwhelming weight of the evidence and standards of law. For example, among other things, the ALJ's findings, and the overwhelming weight of the evidence, established that Harding generally provided the services it said it would and that no Investor or Issuer was harmed by the inclusion of the assets, among other factors weighing against any determination to impose disgorgement. Furthermore, it was inappropriate, given the findings of facts to subject Mr. Chau to joint and several liability with regard to disgorgement.

B. Civil Penalties N●t Warranted

The ALJ improperly, and without explanation, imposed four counts of Third Tier penalties on each Respondent. Among other things, the ALJ never made any findings with regard to the "substantial pecuniary gain" Respondents received due to the misconduct, a requirement under the statute. In addition, the ALJ incorrectly weighed the factors when determining whether imposition of civil penalties was in the public interest.

C. Lifetime Bar Not Warranted

Finally, the ALJ imposed a lifetime bar on Respondents due to his findings of misconduct related to the Norma transaction. His imposition of a lifetime bar is greatly disproportionate to the purported misconduct, given the ALJ's findings and the weight of the evidence, and was not supported by the facts or the law.

VIII. THE ALJ ERRED IN HIS CONCLUSIONS REGARDING THE STATUTE OF LIMITATIONS AND CONSTITUTIONAL CLAIMS

The ALJ found that the statute of limitations did not bar the Divisions claims regarding Octans I, contrary to the facts and the law. For example, among other things, the alleged deviation from the standard of care and related disclosures occurred months prior to the closing of the deal and outside the statute of limitations.

In addition, the ALJ found that Respondents' Equal Protection and Due Process rights were not violated. His conclusion was not supported by the record. Indeed, he failed to allow the Respondents to develop a full record in support of their constitutional claims. Nevertheless, among other things, the ALJ concluded that Respondents could not "point to [any] evidence supporting these allegations." (ID at 90.) The ALJ failed to note that Respondents were frustrated in their attempts to adduce that evidence by the SEC, the Division, and the ALJ himself. Respondents continue to press their claim that their constitutional rights were violated.

CONCLUSION

For the reasons stated above, Respondents request that the Commission grant their petition for review.

Dated: New York, New York
February 2, 2015

Respectfully Submitted,

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TO: **Elizabeth M. Murphy, Secretary**
U.S. Securities and Exchange Commission

FAX: (202) 772-9324

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RE: **In the Matter of Harding Advisory LLC, et al, Administrative Proceeding - File No. 3-15574**

FROM: Ashley Baynham

PHONE: 212-940-3188

DATE: February 2, 2015

NUMBER OF PAGES WITH COVER PAGE: 27

MESSAGE:

Please find for filing in the above-referenced matter Respondents Harding Advisory LLC and Wing Chau's Petition for Review of the Initial Decision.

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