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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.

CROSS-PETITION FOR REVIEW OF THE DIVISION OF ENFORCEMENT

DIVISION OF ENFORCEMENT
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February 12, 2015

Pursuant to the Commission's Rule of Practice 410(b), the Division of Enforcement ("Division") hereby cross-petitions the Commission for review of the Initial Decision issued by Administrative Law Judge Cameron Elliot on January 12, 2015. That Initial Decision determined that Respondents Harding Advisory LLC ("Harding") and Wing F. Chau ("Chau") violated Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 206 of the Investment Advisers Act of 1940 ("Advisers Act") in connection with various collateralized debt obligations ("CDOs") for which Harding served as collateral manager.

The Division cross-petitions for review, under Rules of Practice 411(b)(2)(i) and (ii), of certain rulings, findings and conclusions, and certain evidentiary rulings, as set forth more fully below, as well as of the disgorgement and civil monetary penalties that were jointly and severally ordered against Harding and Chau, both of whom petitioned the Commission for review of the Initial Decision on various grounds on February 2, 2015.

BACKGROUND

This case involved violations of the federal securities laws in connection with Respondents' selection of assets for certain CDOs for which Harding served as the collateral manager. As collateral manager, Harding was tasked with selecting, acquiring and monitoring the assets of various CDOs. In exercising its duties, both to investors and to the issuers of the CDOs in question, Respondents were required to adhere to the standard of care established not only under the Advisers Act but also under the governing documents. These documents included, among others, the Collateral Management Agreements ("CMAs") between Harding and the various CDO issuing entities, the Pitch Books describing Harding's asset selection process that were sent to prospective investors, and the Offering Circulars sent to investors in the CDOs.

The CDOs at issue in the proceeding included Octans I CDO Ltd. ("Octans I"), and several other CDO's for which Harding purchased several tranches of another CDO called Norma CDO I ("Norma"). In the broadest sense, Harding's violations consisted, first, of its purchase of certain assets for Octans I in violation of its duty of care toward investors and the CDO, in particular, in purchasing for Octans I constituents of a benchmark known as the ABX Index, even though Harding's internal analysis and review did not support many of these purchases.

Second, Respondents made a series of indefensible purchases of Norma bonds, accepting the notes issued by Norma despite Respondents' unfavorable view of the investment, in violation of its advisory obligations toward the CDOs for which it acquired Norma bonds. This compromised decision-making rendered materially untrue statements that Respondents made both to investors in the CDOs and to their advisory clients concerning the methods and standards that Harding would apply in selecting collateral.

THE HOLDINGS OF THE INITIAL DECISION

In the Initial Decision the ALJ ruled that, with respect to the Octans I CDO:

- the misrepresentations in the Pitch Books regarding Harding's asset selection process violated Section 17(a)(2), but not Sections 17(a)(1) or 17(a)(3), of the Securities Act (Initial Decision at 64-68);

- the failure to identify Magnetar's participation in the warehouse in the Pitch Book and Offering Circular did not violate any subsection of Section 17(a) of the Securities Act (*Id.* at 68-69);

- the misrepresentation in the Offering Circular about the standard of care exercised by Harding violated Section 17(a)(2) but not Sections 17(a)(1) or 17(a)(3) of the Securities Act (*Id.* at 70);

- the misrepresentation about the standard of care in the CMA, and Harding's breach of that standard of care, both violated Section 206(2) of the Advisers Act but not Section 206(1) (*Id.* at 72-73);

- Harding's two violations of Section 206(2) of the Advisers Act also violated Sections 17(a)(2) and (3) of the Securities Act (*Id.* at 81); and

- there was no conflict of interest, in violation of Section 206 of the Advisers Act, between Harding's duty to the issuer and its desire to please Magnetar. *Id.* at 78-80/

The ALJ further ruled, with respect to the Norma purchases, that

- Harding's purchases of the lower tranches of Norma bonds constituted a failure to follow the appropriate standard of care, in violation of Section 206(1) of the Advisers Act and Section 17(a)(1) of the Securities Act (*Id.* at 81-86);

- Harding misrepresented to its advisory clients in the CMA the standard of care it would utilize in selecting Norma's lower rated bonds, in violation of Section 206(1) of the Advisers Act and Section 17(a)(1) of the Securities Act (*Id*); and that

- Although there was evidence that Harding's purchase of the higher rated tranche of Norma bonds was at least negligent, the OIP did not sufficiently plead this as a violation. *Id.* at 86.

THE DIVISION'S CROSS-PETITION FOR REVIEW

A. Errors Related To Octans I

The Division takes exception to certain aspects of the ALJ's holdings and rulings relating to Octans I.

First, the Division takes exception to the ALJ's holding that Respondents did not violate Section 17(a)(3) of the Securities Act with respect to misrepresentations regarding Harding's investment analysis processes. *See* Initial Decision at 67 (with respect to Harding's investment analysis processes) and 70 (with respect to Harding's adherence to the standard of care.) The ALJ's decision relied on a finding that a "misrepresentation about a single subject in a single document is not the kind of transaction, practice, or course of business actionable under Section 17(a)(3)." Initial Decision at 67. This was reversible error, because (i) it rested on a misapplication of the Commission's recent decision in *John P. Flannery*, Securities Act Release No. 9689 (Dec. 15, 2014); and (ii) the evidence adduced at trial satisfied whatever repetition requirement *Flannery* imposed under Section 17(a)(3). This evidence included numerous instances of distributing the Pitch Book and Offering Circular for Octans I, which distinguishes this case from the sort of single-meeting fact pattern that the Commission said in *Flannery* did not satisfy Section 17(a)(3).

Second, the ALJ erroneously found that Respondents' failure to disclose Magnetar's participation and role in asset selection failed to establish a violation of any section of Section 17(a) of the Securities Act.

Third, the ALJ erred in concluding that the evidence was "insufficient to conclude that Harding possessed a conflict of interest [between its duty to the issuer and its desire to please Magnetar] with respect to Octans I." Initial Decision at 73. This was error because it misconstrued the argument of the Division, which had stressed not that Magnetar's interests were exclusively opposed to the interests of debt investors, but that Harding committed fraud because it failed to disclose that it made selections in deference to Magnetar, a party with significant contractual rights with respect to asset selection, and which had interests not necessarily aligned with those of investors (in that Magnetar was simultaneously both long and short and stood to gain whether the transaction ultimately succeeded or failed). The finding that the Division "does not specify how those interests were misaligned" (Initial Decision at 75), and that no claim under Section 17 of the Securities Act and Section 206 of the Advisers Act was proven, was erroneous, and should be reversed.

Finally, the ALJ erroneously failed to find a violation of Section 17(a)(1) of the Securities Act, and this error was predicated on, among other things, the excess weight given to the testimony of Jung Lieu ("Lieu") as well as the exclusion of Chau's prior testimony on the same subject matters. It was error for the ALJ to credit Lieu's testimony to the extent he did, given (i) her hostility to the Division; (ii) the stark contrast between her miraculously refreshed trial testimony and her prior investigative testimony, years earlier; and (iii) the fact that she spent days prior to her trial testimony huddled with respondents' counsel before presenting her sharply differing testimony. Furthermore, it was error to exclude Chau's prior testimony on the same subject matters, and to allow it only for impeachment or to refresh recollection. As a result, the ALJ incorrectly credited statements at the hearing that were directly undermined by Chau's prior statements. Had the ALJ not made these errors, not only would it have supported a finding of liability under Section 17(a)(1), it would have also bolstered the Division's case on the other sections of the Securities Act.

B. Errors Related To Norma

The ALJ's determination that he could not impose liability arising out of Respondents' purchase of Norma's single-A rated tranche, even though the ALJ concluded that these purchases were "at least negligent" and could support liability (Initial Decision at 86), was erroneous. The ALJ held that the purchases of the single-rated tranche were not pleaded in the OIP. This was error because, *inter alia*, (i) it misconstrued the OIP, which fairly read alleged violations based on this conduct, (ii) the prior motion practice and prehearing briefing in these proceedings made clear that the Division's case extended to these purchases, and (iii) it rested on the ALJ's reading too much into the fact that the Division did not interrupt an assertion made by Respondents' counsel during the hearing during a colloquy with the Court, even though that colloquy was ambiguous, at best, and the Division was never asked by the ALJ to express the Division's opinion at that point (which should have been unnecessary, given that the Division had made its position clear in the OIP and in prior pleadings).

C. Errors Related To The Remedies Ordered

The Division takes exception to the ALJ's determination of both the disgorgement and penalty amounts.

With respect to disgorgement, the ALJ wrongly held that disgorgement was properly calculated as a pro rata percentage of collateral wrongfully placed into each CDO. *See* Initial Decision at 93-94. This was error because Harding, as a disloyal fiduciary, was not entitled to receive any of its management fees. A fiduciary that abdicates its responsibilities cannot be heard to argue that it is entitled to its fees on the basis that it wasn't violating its duties at every moment of every day. Furthermore, the ALJ erroneously omitted, in its disgorgement calculation, the fees earned by Harding on two additional CDOs for which it had purchased the single-A rated tranche of Norma bonds (the purchases that the ALJ erroneously ruled did not support liability).

With respect to the imposition of penalties, the ALJ erred in not imposing ***any*** penalties for the violations of Section 206(2) of the Advisers Act and Sections 17(a)(2) and (3) of the Securities Act. *See* Initial Decision at 95. The ALJ's determination was based on the fact that while the Division argued that this misconduct warranted third tier penalties, in the ALJ's analysis it only warranted first tier penalties. However, since the Division's brief explicitly referenced only third tier penalties, the ALJ wrongfully declined to impose any penalty at all for these violations.

This was error for two reasons. First, the fact that the Division argued for a higher level of penalty did not preclude the ALJ from ordering any lower penalty. Not imposing first-tier penalties that the ALJ believes are warranted simply because the Division did not specifically ask for them in the alternative was erroneous. Indeed, while Respondents argued that third-tier penalties were inappropriate, not only did they not argue that the failure to specifically request lower tier penalties precluded such an award, they argued that the conduct, if proven, would warrant first tier penalties at most.

Second, the evidence called for third tier penalties for these violations.

D. Other Error

The Division also takes exception to the ALJ's conclusion that Chau neither caused nor aided and abetted Harding's Octans I violations. *See* Initial Decision at 87. The ALJ's error rested upon the erroneous conclusion that Chau lacked sufficient knowledge of the underlying violations for aiding and abetting liability. Similarly, the ALJ erred in finding that the evidence failed to establish that Chau caused Harding's Octans I-related violations.

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For the above reasons, the Division respectfully requests that the Commission review the matters listed above. Due to the complexity of these issues, and the voluminous nature of the briefing, the Division respectfully requests that opening briefs on the petition for review and the cross-petition for review be scheduled for 8 weeks from the date that the Commission sets the briefing schedule, with oppositions thereto due 6 weeks thereafter, and replies in further support of the petition and cross-petition due three weeks thereafter.

Dated: February 12, 2015

Respectfully Submitted,

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