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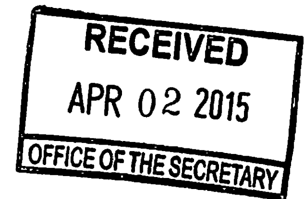
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



ADMINISTRATIVE PROCEEDING
File No. 3-15574

In the Matter of

HARDING ADVISORY LLC and

WING F. CHAU,

Respondents.

APPEAL OF THE DIVISION OF ENFORCEMENT

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The Division of Enforcement ("Division") respectfully submits this Appeal of the January 12, 2015 Initial Decision ("Initial Decision" or "ID") by Administrative Law Judge Cameron Elliot with respect to the charges against Harding Advisory LLC ("Harding") and its principal, Wing F. Chau ("Chau").

BACKGROUND

This case involved violations of the federal securities laws – in particular, Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a), and Sections 206(1) and (2) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. § 80b-6 – in connection with Respondents' selection of assets for certain collateralized debt obligations ("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, as well as to honor the representations made to investors about Harding's investment and management processes. The relevant documents included the Collateral Management Agreements ("CMAs") between Harding and the various CDO issuing entities, as well as certain marketing materials describing Harding's asset selection process that were sent to prospective and actual investors, such as Pitch Books[1] and Offering Circulars.[2]

The CDOs at issue in the proceeding included Octans I CDO Ltd. ("Octans I"), and several other CDOs for which Harding wrongfully purchased several tranches of another CDO

[1] A pitch book was the initial disclosure concerning a proposed CDO transaction, providing both an overview of the CDO as well describing the collateral manager and the processes they would use to assemble the CDO's collateral.

[2] Where terms or documents are not otherwise specifically defined, the Division relies on the description set out in the ALJ's Initial Decision.

called Norma CDO I ("Norma")[3]. Harding marketed Octans I with a Pitch Book, a document distributed to potential investors which described not only the CDO but also contained a section about Harding that was created by Harding (and reviewed by Chau). Wang Tr. 368:13- 370:21, 372:19-373:6, 386:14-387:22; Chau Tr. 1824:9-1825:9.[4] Harding commonly tracked the Pitch Book in investor meetings. Huang Tr. 1043:11-13. The Pitch Book represented that Harding's investment process included the following:

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

Div. Ex. 1 at 43.

[3] Harding placed Norma securities into four of its CDOs: Lexington Capital Funding V Ltd. ("Lexington V"), Jupiter High-Grade CDO VI, Ltd. ("Jupiter VI"), Neo CDO 2007-1, Ltd. ("Neo"), and 888 Tactical Fund, Ltd. ("888 Tactical") (collectively the "Norma Recipients"). The CMAs and offering circulars for these CDOs contained similar language as to the standard of care to be employed by Harding. Div. Ex. 504 at 7 (888 Tactical CMA); *see also* Div. Ex. 506 at 7 (Lexington V CMA) (same language); Div. Ex. 510 at 8 (Neo CMA) (same language); Div. Ex. at 512 at 7 (Jupiter VI CMA – "requiring reasonable care . . . in a manner consistent with the efforts, practices and procedures followed by prudent institutional investment managers of national standing"); Div. Ex. 503 at 97 (888 Tactical offering circular); Div. Ex. 513 at 173-74 (Jupiter VI offering circular); Div. Ex. 507 at 155-56 (Lexington V offering circular); Div. Ex. 509 at 158-59 (Neo offering circular).

[4] This brief generally cites witness testimony by referring to the last name of the witness (except in some cases when totally clear from context), together with the page and line of the hearing transcript. The witnesses cited include Respondent Wing Chau, Tony Huang, Chau's and Harding's second in command, Alison Wang, a lawyer and jack-of-all trades at Harding, Jung Lieu, a Harding credit analyst, James Suh, Harding's outside counsel, and James Prusko, from Magnetar Capital ("Magnetar").

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

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

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

Harding also represented that it would "take all action required, as Collateral Manager for the Issuer, to be taken by it under the Investment Advisers Act of 1940, as amended." *Id.* at 6. Harding's representation in the CMA that it would discharge its duties as CDO manager "with reasonable care . . . and . . . in a manner consistent with the customary standards, policies and procedures followed by institutional managers of national standing" (Div. Ex. 4 at 8) was repeated to investors via Offering Circulars distributed in August and September 2006. *See, e.g.*, Div. Ex. 3 at 66.

As a fiduciary, and pursuant to the governing CDO documents and the marketing materials sent to investors, Harding was required to exercise due diligence and independently determine whether or not it was appropriate for the issuers for which it served as collateral manager to acquire certain assets. However, while Harding was supposed to act as a disinterested

gatekeeper, in too many instances it acted as a turnstile instead, and failed to undertake the rigorous analysis it promised it would employ in selecting assets.

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. In doing so, Harding made a mockery of representations as to the supposedly unbiased and rigorous processes and analysis that it would employ in selecting assets.

Second, Respondents made a series of indefensible purchases of Norma bonds, accepting the notes issued by Norma without doing the requisite analysis thereof and then, after that analysis, purchasing Norma bonds despite Respondents' unfavorable view of the investment. This conduct not only was contrary to representations made toward investors, it also violated Respondents' 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.

LEGAL ARGUMENT

I.

ERRORS WITH RESPECT TO THE OCTANS I TRANSACTION

A. The ALJ Erred In Holding that Respondents Did Not Violate Section 17(a)(3) of the Securities Act.

The ALJ held that Harding misrepresented its investment analysis process in Pitch Books sent to investors (actual and prospective) (ID 66) in describing it as "collaborative, methodical and disciplined" and involving a "thorough rigorous upfront credit and structural analysis" and a "thorough bottom/up credit and structural analysis." (ID 65.) (*See also* Div. Ex. 1.) The ALJ

further held that Respondents misrepresented the standard of care to be followed, in both the Offering Circulars, and in the collateral manager agreements. (ID 70; citing Div. Ex. 4 at 8, 3 at 197).

However, the ALJ held that Respondents' misrepresentations did not constitute violations of Section 17(a)(3) of the Securities Act. *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, for several reasons.

First, it rested on a misapplication of the Commission's recent decision in *John P. Flannery*, Securities Act Release No. 9689, 2014 WL 7145625 (Dec. 15, 2014). The ALJ's determination that distribution to "multiple investors" (ID 67 & 70) was insufficient ignores the facts of *Flannery*. There, respondent Flannery edited two letters to investors in August 2007, letters that contained misstatements as to the portfolios' risk profile, encouraging investors to retain their investments. *Flannery*, at 40. This "negligent conduct spanned a critical two-week period . . . and encompassed more than one materially misleading communication." *Id.* at 49. Yet compared to *Flannery*, the case at bar presents a far more compelling factual situation, given that the conduct at issue persisted over a much longer period of time. If two letters to existing investors over a short period of two weeks– who had already made their investment decisions – were found to be a sufficient practice or course of business, then the distribution of Pitch Books, Offering Circulars, and CMA's over many months to numerous investors– prospective and actual— and the issuer should be as well. *See, e.g.*, Chau Tr. 1485:10-13, Wang Tr. 343:9-22 (Pitch Book designed to be sent to all potential and actual investors).

Second, the evidence adduced at trial satisfied whatever repetition requirement *Flannery* recognized under Section 17(a)(3). The record demonstrated that, for example, the Pitch Book was sent out over a hundred times to numerous prospective and actual investors. *See, e.g.*, Resp. Ex. 511 (8.15.2006 transmission of Pitch Book and Offering Circular to over 75 recipients, including over 20 separate investor firms); Resp. Ex. 544 (8.16.2006 email circulation of Pitch Book to almost 100 recipients at numerous investor firms); Resp. Exs. 529, 540 (7.19.2006 blast emails of Pitch Book to undisclosed list of potential investors); Div. Ex. 135 (8.3.2006 email transmitting Pitch Book to several recipients at HIMCO, an investor); Div. Ex. 141 (8.15.2006 email transmitting Offering Circular to HIMCO); Div. Exs. 142 and 249 (8.16.2006 transmission of materials to several recipients at another investor); Div. Ex. 187 (8.3.2006 email transmitting Pitch Book to NIR, another investor); *see also* Resp. Ex. 525.

At a minimum, all of these materials went to the over 20 firms that ultimately invested in Octans I (*see* Resp. Ex. 750). Whether one counts the more than 20 recipients who ultimately invested, or the over a hundred potential investors who received the materials in question, the Division respectfully requests that this kind of broad-based distribution more than suffices to meet whatever multiplicity requirement Section 17(a)(3) may impose.

B. The ALJ Erred In Holding 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.

The ALJ erroneously found that Respondents' failure to disclose, in either the Pitch Book or the Offering Circular, that Magnetar was a party to the warehouse agreement and thus played a role in asset selection, did not establish a violation of any subsection of Section 17(a) of the Securities Act, ***even though he held that this disclosure was material and misleading***. The Division had argued that the Pitch Book's and Offering Circular's erroneous description of the

warehouse agreement as an agreement solely between Merrill Lynch and Harding (Div. Ex. 1 at 32) left investors unaware of a participant with significant rights which had been heavily involved in collateral selection.

The Warehouse Agreement for Octans provided Magnetar with numerous significant rights, among them the right to veto the acquisition of certain collateral by the collateral manager. Div. Ex. 5 at 3 (Section 3(A) of the Warehouse Agreement). The ALJ ruled:

> The omission of Magnetar's involvement in the warehouse was inaccurate, and therefore misleading, because the particular language at issue suggested that Merrill and Harding were the only parties to the warehouse agreement. Tr. 415, 1844. Also, that a third party had the ability to interfere with Harding's selection of collateral for Octans I is surely something that would have been material to a reasonable investor. *See, e.g.*, Tr. 2063. As with Harding's misrepresentations regarding its investment analysis process, its "use" of the pitch book resulted in Harding obtaining money, within the meaning of Section 17(a)(2).

ID at 68-69.[5]

Yet the ALJ found that there was no evidence that Respondents acted intentionally, or even negligently. The ALJ held that, as the purportedly relevant sections of the Pitch Book and Offering Circular were drafted by Merrill, not Harding, Respondents' testimony that they were completely unaware of the misleading language was credible, which thus precluded liability under any provision of 17(a). ID at 69. This determination was erroneous for several reasons.

1. <u>Respondents Should Be Held Liable for the Pitch Book Misrepresentation</u>

   a. *Respondents' Conduct Violated Section 17(a)(1) of the Securities Act*

The Division respectfully submits that Respondents' conduct violated Section 17(a)(1) of the Securities Act. Section 17(a) may be satisfied with recklessness. *SEC v. Chester Holdings, Ltd.*, 41 F. Supp. 2d 505, 522 (D.N.J. 1999). Recklessness constitutes "highly unreasonable

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[5] *See also* Chau Tr. 1531:23 – 1532:2 (agreed warehouse agreement "was a very important document"); 1535:12-17 (warehouse agreement was "central and important").

conduct...an extreme departure from standards of ordinary care." *Id.* at 523. Furthermore, "ignorance provides no defense to recklessness where a reasonable investigation would have revealed the truth" and "good faith is no shield to liability." *SEC v. Infinity Group Co.*, 212 F.3d 180, 193 (3rd Cir. 2000).

The record amply demonstrates Respondents' reckless conduct in violation of Section 17(a)(1). First, Chau knew that the involvement of other parties in asset selection would compromise Harding's independence, having testified in 2008 that he would never have granted Magnetar a veto over collateral selection precisely because he knew that in doing so "we would be ceding our management authority to a third party" and "I pride myself as being a very independent asset management company . . ." Chau Tr. 1819:12 – 1821:20. Chau also was fully aware of the terms of the warehouse agreement, as he was a signatory thereto (Resp. Ex. 124) and had reviewed it. Chau Tr. 1798:12-1799:3. As an experienced investment professional, Chau understood that any extrinsic limitation on the manager's discretion was important and had to realize that it had to be disclosed. *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 198 (1963)("[S]uppression of information material to an evaluation of the disinterestedness of investment advice 'operate[s] as a deceit[.]'").

Indeed, Alison Wang testified that it would be important for the Pitch Book to contain a full disclosure of conflicts of interest and not to be inaccurate, even for the content not supplied by Harding. Wang Tr. 384:16-21, 612:16-613:25. The misrepresentation at issue fell clearly in the section of the Pitch Book concerning Harding's and Merrill's conflicts of interest. *See* Div. Ex. 1 at 31-32; Wang Tr. 385:20-386:9. And Chau, who executed the warehouse agreement – Harding's first tripartite warehouse agreement – understood that Magnetar's involvement

presented a conflict of interest, because Magnetar, unlike the debt investors, planned to be "indifferent to the performance of the transaction."

The record established beyond peradventure that Respondents reviewed the Pitch Book in its entirety. Chau admitted that while Harding concentrated primarily on the section of the Pitch Book concerning Harding (Div. Ex. 1 at 37-59), "we would review or scan through the rest of the pages." Chau Tr. 1837:25-1838:15. Others at Harding did as well. *See, e.g.*, Wang Tr. 606:5 – 607:5 (Harding did not simply review sections of Pitch Book regarding Harding); Wang Tr. 609:9-24; 610:16-23 (Wang reviewed and commented on non-Harding sections of Pitch Book).

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

But it is not just that Respondents read the Pitch Book. It is not just that Respondents knew that the involvement of other parties, like Magnetar, would compromise Harding's independence. It is not just that Respondents reviewed and commented on the very pages of the

Pitch Book containing the misrepresentation in question. Respondents – Chau in particular – were specifically charged with reviewing materials sent to investors and ensuring their accuracy. Their failure to do so is manifestly reckless, especially in the fact of all the unusual aspects of the Octans I transaction.

Chau, as Chief Compliance Officer at Harding (Chau Tr. 1449:17-22; Wang Tr. 270:11-17), was responsible for "reviewing all advertising and marketing materials." Chau Tr. 1451:17-23; Div. Ex. 122 at 4. *See also* Wang Tr. 296:17 – 297:6; id. at 297:7 – 298:16. Chau knew he was ultimately responsible for the accuracy of all marketing materials sent out. Chau Tr. 1829:8-21. Chau also understood that he was "responsible for ensuring that all Harding materials complied with the Advisers Act prohibition from . . . [e]ngaging in fraudulent, deceptive or manipulative activities. Chau Tr. 1452:15-22; Div. Ex. 122. *See also* Wang Tr. 295:7 – 296:11. Furthermore, Harding's compliance manual required "full and fair disclosure of all material facts, in particular information as to any potential and/or actual conflicts of interest." Div. Ex. 122, at p 3; Wang Tr. 275:16 – 276:18.

Respondents reviewed the offending material. They knew accurate disclosure was important. They were responsible for ensuring that accuracy. On this record, based on admissions from Respondents, it was error for the ALJ not to conclude that this conduct was reckless at a minimum. If this kind of conduct is not found at least reckless, the Commission risks establishing a precedent that an adviser can recognize the important and distinguishing features of a proposed investment, review the materials that fail to disclose that feature, admit responsible for ensuring accuracy for those materials, yet evade liability merely by claiming an "oversight." The Division respectfully submits that the Commission establish a clear standard for

this kind of misconduct, and find that the ALJ erred in not holding this conduct a violation of the Securities Act.

b. Respondents' Conduct Violated Sections 17(a)(2) and (3) of the Securities Act

At the very least, Respondents were negligent, in violation of Sections 17(a)(2) and (3) of the Securities Act, in obtaining money and property through use of the Pitch Book, based on the conduct set forth immediately above. If it was not reckless to know something was important to disclose and review the materials, including the very page, on which such a misrepresentation was included, it was negligent. Respondents conceded that such disclosure was important, and that it should have been made: "I think it was probably just an oversight in terms of Magnetar's name not being on that Offering Circular as a party to that warehouse agreement." Chau Tr. 4333:11-14; *see also* Chau Tr. 4333:23 – 4334:18 ("I think it was a simple mistake . . . there is no reason why it shouldn't be on there . . . ultimately I think it should have been disclosed. You know, I think it was an accident.") This is the very definition of negligence. *See, e.g., Gregg G. Lorenzo*, Initial Decision Release No. 544, 2013 WL 6858820 (Dec. 13, 2013) (not reading contents of misleading materials sent out is negligent, even if others were responsible for their content).

2. <u>Respondents Should Be Held Liable for Misrepresentations in the Offering Circulars</u>

The Offering Circulars also misrepresented the parties to the warehouse agreement, and thus, inaccurately described which parties would play roles in collateral selection:

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

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

a. Respondents' Conduct Violated Section 17(a)(1) of the Securities Act

Respondents' conduct with respect to the accuracy of the Offering Circular was similarly reckless, in violation of Section 17(a)(1) of the Securities Act. Not only did Chau concede that the Offering Circular description of warehouse agreement was inaccurate, Chau Tr. 2107:5-18, he admitted that he "carefully examined" the Offering Circular and so certified that he did. Chau Tr.1851:24 – 1852:19 and Div. Ex. 501. Others at Harding testified similarly. *See, e.g.*, Wang Tr. 344:23-25 (Harding reviewed preliminary and final Offering Circulars); Wang Tr. 345:10-22 (numerous people at Harding were involved in this process).

And it was not merely the sections regarding Harding that were subject to Respondents' review. Wang Tr. 612:15-23 (Harding reviewed non-Harding sections as well); Wang Tr. 612:24 – 613:16 (Harding wanted all sections to be accurate); *see also* Wang Tr. 616:21 – 618:22 and Div. Ex. 138.

Not only did Respondents review the entire document, comments made on drafts indicated that Harding's counsel wanted to identify Magnetar, recognizing the importance of such disclosure. Wang Tr. 619:4-24. Consequently, under the same rationale set forth with respect to the Pitch Books, Respondents' conduct with respect to the disclosures in the Offering Circular was reckless, establishing liability under Section 17(a)(1) of the Securities Act.

b. Respondents' Conduct Violated Sections 17(a)(2) and (3) of the Securities Act

At a minimum, Respondents were negligent.

First, Chau certified in a "Collateral Manager's Certificate" that he had "carefully examined the Offering Circular" – not simply the portions nominally attributed to Harding, but the entire document. Div. Ex. 501. Chau, Wang, and Huang were on the "working group list" for Octans I, meaning they received drafts of the Offering Circulars. Resp. Exs. 161, 162; Wang Tr. 347:2 – 352:11.

Second, Chau, Wang, Huang, and Harding's outside counsel reviewed the drafts, and not just the sections strictly limited to describing Harding. Wang Tr. 346:2-4, 346:13-25, 356:6-357:4, 619:11-19, 623:22 – 625:24. Finally, Harding was put on the clearest notice possible that Magnetar was *not* mentioned by name in the Offering Circular: Harding's counsel suggested a disclosure that named Magnetar, and was overruled by Merrill and Magnetar, whose counsel insisted that the reference be generic to the holders of the "preference shares," *i.e.*, equity. *See* Resp. Ex. 196; Wang Tr. 635:7-15, 636:4-21, 640:6-11. The Division respectfully submits that this evidence establishes, at a minimum, violations of Sections 17(a)(2) and (3) of the Securities Act for the relevant nondisclosures in the Offering Circular.

C. The ALJ Erred In Failing to Find a Violation Based on Harding's Conflict Between Its Duty to the Issuer and Its Influence By Magnetar.

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" because there was "insufficient evidence of pressure by Magnetar to corrupt Harding's credit process." Initial Decision at 73. The ALJ further held that while there was "evidence that Harding compromised its standards to accommodate Merrill" (ID at 74) similar evidence was lacking that "Harding compromised its standards to accommodate Magnetar specifically." Consequently, since there was no conflict, the ALJ held, there could be no duty to disclose that (purportedly non-existent) conflict.

The ALJ's finding that no conflict existed rested upon his factual determination that there was insufficient evidence that Harding "compromised its standards just to please Magnetar." ID at 74. But this misconstrues the problematic nature of Harding's conduct. Harding need not have completely subordinated its will to that of Magnetar for it to have breached the Advisers Act for failing to disclose a conflict of interest. It is sufficient that it took actions it never would have otherwise done simply because of Magnetar's influence, and that it undertook a course of conduct in deference to Magnetar. In holding that its conduct did not violate the Advisers Act, the ALJ understated the requirements imposed on advisers, and imposed a burden higher than the law requires to show a breach thereunder, as set forth below.

Section "206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers." *Transamerica Mortg. Advisors v. Lewis*, 444 U.S. 11, 17 (1979) (*quoting Santa Fe Indus. v. Green*, 430 U.S. 462, 471 n.11 (1977)). Investment advisers must therefore fully disclose all material facts and "employ reasonable care to avoid misleading [their] clients." *Montford & Co.*, Investment Advisers Act Release No. 3829, 2014 WL 1744130, at *50 (May 2, 2014) (relevant sections of the Advisers Act are designed to "eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested.").

Whether a conflict of interest exists turns on whether there is a "substantial likelihood" the client will find a fact important, not whether it actually impacted the investment adviser's decision. *Feeley & Willcox Asset Mgmt. Corp.*, Advisers Act Release No. 2143, Securities Act Release No. 8249, 80 S.E.C. Docket 1730, 2003 WL 22680907, at *13 (July 10, 2003). ("It is the client, not the adviser, who is entitled to make the determination whether to waive the adviser's conflict").

Furthermore, because the investment adviser is a fiduciary, courts have granted an extremely flexible interpretation of Section 206 violations, so that even the appearance of or potential for a conflict of interest is a violation under Section 206. *Steadman Security Corporation*, Admin. Proc. File No. 3-3101, 1974 SEC LEXIS 3639, at 103-104 (Dec. 20, 1974) (appearance of a conflict of interest is a violation); *Montford and Co., Inc., supra* (the potential for a conflict of interest is a violation).[6] "All that need be shown is that there is a 'non-disclosure of material facts.'" *SEC v. Wall Street Pub*, 591 F. Supp. 1070, 1083, 1084 (D.D.C 1984), *quoting, Capital Gains* 375 U.S. at 186 (holding that defendants violated Section 206 because they did not disclose to readers of their magazine that the defendants received benefits through writing positive articles about certain companies – "failure to disclose an economic self-interest constitutes a breach of the adviser's fiduciary duty in violation of Section 206.")

The record amply demonstrated that, under this legal standard, there was a conflict of interest that should have been disclosed. The evidence showed Magnetar had special rights and privileges that no other investor had, and that Harding acted to accommodate Magnetar's desires. Among other things, when Chau, Harding's principal, gave no "specific guidance" as to what assets to acquire for the Octans I portfolio (Lieu Tr. 3354:16 – 3355:4), Magnetar stepped into the breach and consequently "had control" "with regards to the ABX index." Lieu Tr. 3355:2-13.

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[6] In *Steadman Security Corporation*, defendants used their custodial accounts as bargaining chips with certain banks with whom they wanted to build relationships with. *Steadman*, 1974 SEC LEXIS at *109-110. Instead of assigning custodianship to the best possible bank, defendants gave false explanations to their clients for the assignments, and did not disclose their interests with the banks. *Id.* The administrative proceeding found a violation of Section 206. It further held, "An investment adviser should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, *conscious or unconscious*; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect." *Id.* at *106-107, *quoting, Capital Gains* 375 U.S. at 188.

See also Chau Tr. 2159:6 – 2160:5 (debt investors were never told about index trade since the benefits thereof flowed to Magnetar, as equity investor).

Harding's own personnel attested to this conflict of interest between Magnetar and debt investors. Huang, Harding's second in command, not only testified extensively as to the imbalance between Magnetar's powers and those of other investors (Huang Tr. 725:12 – 726:4), but conceded that Magnetar's involvement in the Octans I ramp gave him "discomfort" because they were "too active." Huang Tr. 954:23 – 955:24. Harding's purchase of ABX index came from Magnetar's books. Div. Ex. 273; Chau Tr. 2153:14-22. Huang testified that in his view this was improper. Huang Tr. 909:4-19. The reason is that such an arrangement lacks "a fair mechanism to establish a price." Huang Tr. 919:21-25.

Huang further explained that the ability "to reject or requirement to approve give[s] that person with that ability influence on what goes into the CDO." Huang Tr. 728:20 – 729:7. Magnetar got advance notice of proposed securities purchases and Chau made sure that Harding gave them this advance notice. Chau Tr. 1815:10 – 1817:7. Chau instructed his staff to give Magnetar advance notice of bid lists. Chau Tr. 1817:14-18. Magnetar insisted on this as it was in the warehouse agreement (undisclosed to debt investors). Chau Tr. 1818:5 – 1819:11. Huang also testified that if he was a debt investor in Octans I he would have wanted to know of Magnetar's involvement since "the interest of debt and equities are not necessarily aligned. In most cases, they are misaligned. So that is something I want to know." Huang Tr. 997:13 – 998:9.

Huang's admission that an investor would want to know of this possible conflict of interest satisfies the requirement set out under *Feeley & Wilcox*, supra. Nor was Huang the only person to think as much. Suh, Harding's counsel on Octans I, testified that he thought Magnetar

should have been disclosed due to its having rights other investors lacked. Suh Tr. 2593:14 – 2597:17.

Respondents' failure to make this disclosure warrants liability under the Advisers Act.

D. **The ALJ Erred In Not Finding A Violation of Section 17(a)(1) of the Securities <u>Act Based On An Overly Generous Assessment of Lieu's Credibility</u>.**

The ALJ held that as there was "insufficient evidence that Chau, Lieu, or anyone else intended to mislead investors by, in essence, exaggerating the rigor and thoroughness of Harding's investment analysis." ID at 66. The ALJ further held that no section 17(a)(1) claim could be predicated on the failure to disclose Magnetar's participation in the warehouse agreement in the Pitch Book and Offering Circular. (ID at 68-69).

As set forth above, Respondents' conduct was at least reckless, which satisfies the scienter requirement of 17(a)(1). But the ALJ's determination was also erroneous to the extent it was predicated on, among other things, the excess weight given to the testimony of Lieu. The weight of the evidence suggested, however, that Lieu was incredible.

First, it was error for the ALJ to credit Lieu's testimony to the extent he did, given her hostility to the Division, which the ALJ noted. *See* Lieu Tr. 3520; 3528-29 (noting Lieu's hostility to the SEC and describing getting information from her as akin to "tooth extraction"); Tr. 3253:15-21 (ALJ remarking that he's "frankly baffled as to why she's resistant to even testifying here . . . I don't think I've ever seen a witness who was so reluctant to come and testify. So she's definitely hostile.") *See also* Tr. 3474:17 – 3475:1.

Second, there was a stark contrast between Lieu's miraculously refreshed trial testimony and her prior investigative testimony, years earlier. This shocking reversal occurred only after Lieu met with Respondents' counsel for several days and had several phone conferences with

them (Lieu Tr. 3236:25 – 3237:20) yet refused to meet with the Division. Lieu Tr. 3235:8 – 3236:4.

Had the ALJ not credited Lieu's testimony it would have further supported a finding of liability under Section 17(a)(1).

II.

ERRORS WITH RESPECT TO THE NORMA TRANSACTION

Harding bought both the single-A and triple-B tranches of the Norma CDO. The Initial Decision held that, because there was "no documentation of any Norma analysis predating February 2007, and Kaplan's commentary suggests that any such analysis would have revealed problems even with the A-rated tranche" that "there is evidence that the purchase of its a-rated tranche was at least negligent." (Initial Decision at 86). However, the ALJ held that he could not impose liability arising out of Respondents' purchase of Norma's single-A rated tranche, because those purchases were not "sufficiently" pleaded in the OIP. *Id.* Although the ALJ allowed that it was "a close question" (*id.*), he predicated his determination almost entirely upon the fact that the Division did not interrupt an assertion made by one of Respondents' counsel during the hearing during a colloquy with the Court.

This was error because, *inter alia*, (i) it misconstrued the OIP, which fairly read alleged violations based on this conduct, (ii) the entirety of the proceedings demonstrated 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 a statement made by Respondents' counsel during a colloquy with the Court.

First, the OIP fairly read states a claim related to the single-A tranches of Norma. The section regarding Norma is entitled "The Norma Purchases" in the plural to indicate that multiple tranches are referenced. Indeed, the purchase of Norma's A-rated tranche is the first mentioned.

OIP ¶ 61. The OIP also notes that since Norma did not close until March 1, 2007, Harding's orders that were placed in January were not effective until that close. *See* OIP ¶ 66 (referring to "Harding's orders for Norma [] placed in January 2007" – the plural includes both tranches); *see also* OIP ¶ 67 (complaining that "Harding nevertheless proceeded with the Norma purchases"); ¶ 69 (stating that the best interests of the portfolio "were not served by the Norma bonds"). Each of these references is in the plural. In finding that this charge was not adequately pleaded, the ALJ committed reversible error. *See, e.g., In the Matter of C. James Padgett Stuart et al.* Release No. 38423, 64 S.E.C. Docket 272, 1997 WL 126716 (Mar. 20, 1997) (reversing ALJ's overly narrow reading of OIP).[7]

Second, throughout the proceedings the Division consistently adduced evidence regarding the single-A purchases, almost always without objection from Respondents. Chau testified extensively about all four CDOs into which both the single-A and triple-B Norma bonds were placed. *See, e.g.*:

- Chau Tr. 1498:3 – 1499:18; 1501:9-22 ; Div. Exs. 504 (888 Tactical Fund collateral management agreement), 506 (Lexington Capital collateral management agreement), 510 (Neo collateral management agreement); 512 (Jupiter collateral management agreement):
- Chau Tr. 1520:16 – 1521:10 (relating to selecting assets for all four CDOs);

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[7] Illustrating that they recognized from the beginning that the OIP encompassed both tranches, Respondents' March 24, 2014 Pre-Hearing Brief describes the OIP as alleging "that the Respondents bought certain tranches of a Merrill CDO called Norma as an accommodation." (Respondents' Pre-Hearing Brief at 12.) Indeed, even ***before*** the institution of the OIP is was clear to Respondents that Harding's purchase of single-A rated Norma bonds was under question. Harding's March 15, 2013 White Paper Submission (Div. Ex. 5002) addressed "Harding's decision to invest in ***two*** tranches of the Norma CDO in January 2007." (White Paper at 1) (emphasis supplied). This White Paper went on to justify Harding's purchase of both tranches – the single A, and the triple BBB (id. at 2-6) and quite clearly and repeatedly referred to both throughout.

- Chau Tr. 1582:14 – 1590:18; 1590:20 – 1593:22 (Div. Exs. 188-192, 196) (asked about decision to buy Norma for all four CDOs, including single-A bonds);
- Chau Tr. 1593:23 – 1596:13 ; Div. Ex. 197) (showing no in-depth analysis had been done into Norma before the purchase of *any* tranche);
- Chau Tr. 1597:4-19 (testimony about purchase of single-A tranche);
- Chau Tr. 1642:14-21 ; Div. Ex. 212 (testimony relating to purchase of single-A tranche);
- Chau Tr. 1667:9-1668:14, 1670:10-21(testifying that single-A tranche was bought before Harding conducted internal analysis);
- Chau Tr. 1676:7 – 1677:21 (testimony relating to purchase of all tranches, including single-A);
- Chau Tr. 1688:16 – 1690:25, Div. Ex. 226 (relating to Harding's efforts, only a few months after purchase, to sell off Norma bonds, including single-A bonds);
- Chau Tr. 2117:10-23, 2119:23 – 2121:24; Div. Exs. 507, 508 509, 513 (Chau testifying about Offering Circulars for 888 Tactical, Lexington, Neo and Jupiter, the "four CDOs into which Harding placed the Norma CDOs"); and
- Chau Tr. 2121:19 – 2122:8 (Chau testifying that he reviewed standard of care sections for each of these four CDOs).

There is no obstacle to considering this evidence in crafting a remedy, since the proceedings, taken as a whole, gave the parties fair notice of what was being adjudicated. *Richard G. Cody*, Release No. 64565 at *19, n.76, 2011 WL 2098202 (May 27, 2011); *Aloha Airlines, Inc. v. Civil Aeronautics Bd.*, 598 F.2d 250, 262 (D.C. Cir. 1979) (noting that, in administrative proceedings, "[i]t is sufficient if the respondent 'understood the issue' and 'was afforded full opportunity' to justify its conduct during the course of the litigation"). In general, "administrative pleadings are very liberally construed," and courts accord agencies considerable latitude to interpret charging documents. *National Realty & Construction Co. v. ASHRC*, 489

F.2d 1257, 1264 (D.C. Cir. 1973). Thus, the "question on review is not the adequacy of the pleadings ... but is the fairness of the entire procedure." *Aloha Airlines*, 598 F.2d at 262 (quoting 2 K. Davis, Administrative Law Treatise, § 8.04 (1958)).

Moreover, the ALJ's determination apparently rested on a misreading of the hearing transcript from April 24, 2014, at p. 4237. This involved a brief colloquy between the Court, and two lawyers for Respondents: Mr. Lipman and Ms. Baynham after the Court asked how many Norma transactions were at issue. Mr. Lipman replied that "There were three but there are only two charged in the OIP." Tr. 4237 l. 14-15. At which point Ms. Baynham corrected him and said there were four. *Id.* at line 15. The ALJ then said "Oh there are four. I'm sorry." *Id.* at l. 17. To which Mr. Lipman said "Only the BBB's are charged in the OIP." At most, this reflects an ambiguity in the colloquy that indicates that at least one counsel thought that four bonds (which included the single A's) were being charged, and it was error to allow this ambiguity to circumscribe the allegations of the OIP.

Finally, even if these allegations fall technically outside the four corners of the OIP, they can still legitimately serve as the basis for the remedies sought. It is well established that the ALJ can "consider . . . matters that fall outside the scope of the OIP, in assessing appropriate sanctions." *Gateway Int'l Holdings, Inc.*, Release No. 34-53907 (May 31, 2006), 88 SEC Docket 334 at n.30, 2006 WL 1506268 ("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."); *see also Armand R. Franquelin*, Release No. 698, Release No. ID - 698, 2014 WL 5383925, *3 & n2 (S.E.C. Release No. Oct. 22, 2014); *Herbert Steven Fouke*, ID Release No. 660, 2014 WL 4258244, *4 &n.7 (Aug. 29, 2014) ("In assessing sanctions, [ALJ] may consider matters outside the OIP"); *Don Warner Reinhard*, Exchange Act Release No. 63720 (Jan. 14,

2011), 100 SEC Docket 36940, 36947 & n.21, 2011 WL 121451, citing *Robert Bruce Lohmann*, Exchange Act Release No. 48092 (June 26, 2003), 56 S.E.C. 573, 583 n.20, 2003 WL 2146804 (finding that matters "not charged in the OIP" may nevertheless be considered "in assessing sanctions")); *see also Alero Odell Mack, Jr.*, Release No. 482, Release No. ID - 482, 2013 WL 550096 (Feb. 13, 2103); *Florin S. Ilovici*, Release No. 68285, Release No. 34-68285, 105 S.E.C. Docket 141, 2012 WL 5892998 (Nov. 23, 2012).

III.

THE ALJ ERRED IN NOT FINDING CHAU LIABLE FOR CAUSING AND AIDING AND ABETTING HARDING'S OCTANS I VIOLATIONS.

While the ALJ held that Chau was liable for causing and aiding and abetting Harding's Norma related violations, he held that, as Chau lacked sufficient knowledge of the underlying violations, he neither caused nor aided and abetted Harding's Octans I violations. ID at 87. This was error and should be reversed.

A. Chau Caused Harding's Octans-related Violations

Chau should be held liable for causing Harding's Octans I related violations of Sections 17(a)(2) and (3) of the Securities Act.

It is well-established that causing liability requires finding that: (1) a primary violation occurred; (2) an act or omission by the respondent caused the violation; and (3) the respondent knew, or should have known, that his or her conduct would contribute to the violation. *Robert M. Fuller*, 56 SEC 976, 2003 WL 22016309 (Aug. 25, 2003) (party who knew or was reckless in not knowing that omission would result in fraudulent non-disclosure is liable for causing violation).

The Commission has repeatedly held that negligence is sufficient to establish "causing" liability under Section 21C of the Exchange Act when a person is alleged to have caused a primary violation that does not require scienter. *KPMG Peat Marwick*, Exch. Act. Rel. No.

43862, 54 SEC 1135, (Jan. 19, 2001), *aff'd, KPMG v. SEC*, 289 F.3d 109 (D.C. Cir. 2002). *See also Joseph Vancook*, Release No. 61039, 97 S.E.C. Docket 777, 2009 WL 4005083, at *14 &n.65 (S.E.C. Release No.) (Nov. 20, 2009). Negligence is the failure to exercise reasonable care or competence. *Byron G. Borgardt*, Release No. 8274, 80 SEC Docket 3559, 3577 & n.35 2003 WL 22016313 (Aug. 25, 2003).

Chau had a responsibility to ensure that the marketing materials and other materials used by Harding were accurate in all material ways. Not only was he the person responsible for all of Harding's conduct, he was also the person responsible for ensuring the accuracy of materials sent out. Simply put, he "should have known" what his subordinates were doing – especially when others at his firm, such as Mr. Huang, were deeply troubled by the conduct at issue. "The phrase "should have known" used in Section 21C(a) is classic negligence language." *KPMG Peat Marwick*, at *20.

It was Chau's failure to adhere to his responsibility that caused Harding's violations. Yet under the ALJ's reasoning, the officer with the responsibility to ensure that disclosures to investors are accurate can escape liability through their own professed incompetence at supervising their firm. When a party is responsible, as a senior person, for performing a specific function, and they fail to do so, they are liable for negligently causing the violation that is the result of that failure if the underlying failure is negligent based. Having taken on the responsibility to ensure materials are accurate, Chau cannot evade responsibility for his failure. *See Gateway Int'l Holdings*, et al., Release No. 294, 86 S.E.C. Docket 201, Release No. ID - 294, 2005 WL 2000079 (SEC Release No. Aug 18, 2005) (President and CEO of company who was responsible for ensuring company's disclosure were timely was liable for causing its securities violations for failing to ensure that it did so). *See also Warren Lammert, et al.*, Release

No. 348, 93 SEC Docket 337, 93 SEC Docket 422, Release No. ID-348, 2008 WL 1867960 (SEC Release No.) (Apr. 28, 2008) (respondents who failed to monitor what their company was doing, or read fully disclosure materials in their possession, thus allowing a violation to occur, acted negligently and thus caused the underlying violation).

B. Chau Is Liable for Aiding and Abetting Harding's Octans-Related Violations

Chau should be held liable for aiding and abetting Harding Advisory's Octans-related primary violations of the Securities and Advisers Acts. Aiding and abetting liability requires: (1) a primary violation; (2) knowledge of the violation by the aider and abettor; and (3) substantial assistance by the aider and abettor in the primary violation. *SEC v. DiBella*, 587 F.3d 553, 566 (2d Cir. 2009); *see also SEC v. Apuzzo*, 689 F.3d 204, 212 (2d Cir. 2012).

Following *Howard v. SEC*, 376 F.3d 1136, 1142-43 (D.C. Cir. 2004), citing *Graham v. SEC*, 222 F.3d 994, 1006 (D.C. Cir. 2000), it is well established that recklessness is sufficient to satisfy the scienter requirement for aiding and abetting and causing liability. "A secondary violator may act recklessly, and thus aid and abet an offense, even if he is unaware that he is assisting illegal conduct." *Howard*, 376 F.3d at 1143.[8]

The record showed that Chau acted recklessly by failing to ensure Harding's compliance with the dictates of the Securities and Advisers Acts even though he should have known – based on the circumstances involved with the index trade for Octans – that there were significant risks involved. The record established that Harding had never acquired assets for a CDO in the fashion

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[8] *See also SEC v. Milan Group, Inc.*, 962 F.Supp.2d 182, 192 (D.D.C. 2013); *Warren Lammert, et al.*, Release No. 348, 93 SEC Docket 337, 93 SEC Docket 422, Release No. ID-348, 2008 WL 1867960 (SEC Release No.) (Apr. 28, 2008) (for aiding and abetting liability, "knowledge or awareness requirement can be satisfied by recklessness when the alleged aider and abettor is a fiduciary or active participant").

it employed here, by trading large portions of the ABX index.[9] Since the record was replete with evidence that most investors, other than equity investors like Magnetar, disfavored index purchases, this fact alone should have put Chau on notice that the Octans I transactions was ripe with potential pitfalls.[10] Nor had Harding ever managed a CDO in which the equity investor had such significant rights, or influence. Huang Tr. 824:20-825:11, 995:20-996:18.

As the testimony established, Chau gave no "specific guidance" to his staff as to what assets to acquire for the Octans I portfolio (Lieu Tr. 3354:16 – 3355:4), and that as a result Magnetar "had control" "with regards to the ABX index." Lieu Tr. 3355:2-1. Indeed, so complex was the trade, and so unused to doing something of this nature was Harding, that Magnetar had to walk Harding through the trade numerous times.[11] As Harding's second in command testified, this arrangement demonstrated an excessive level of involvement that left him uncomfortable. *See* Huang Tr. 725:3-726:2.

Here, Chau was Harding's dominant actor,[12] primary portfolio manager, and the individual with responsibility for Harding's marketing materials and disclosures.[13] While Chau

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[9] Furthermore, no other deal Harding managed ever included anyone other than the collateral manager and the underwriting bank as signatories to the warehouse agreement or gave rights thereunder to anyone else. Wang Tr. 406:3-9.

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

[11] Div. Ex. 19 at 1; Div. Ex. 31 (Magnetar's Prusko expressing frustration that he had to explain the trade "from scratch" yet again).

[12] Wang Tr. 261:2-5 ("Chau was responsible for everything at Harding Advisory"); *see also* 261:6-14 (Chau directed the firm in all respects, made investment decisions, and had "ultimate authority on what took place at Harding").

understood that he was responsible for ensuring that Harding complied with all securities laws, (Chau Tr. 1452:15-22; Div. Ex. 122; Wang Tr. 295:7 – 296:11), he failed to uphold his responsibility for ensuring compliance with Harding's adherence to law, even though he should have known that Magnetar's involvement would complicate the process of asset selection, and potentially make Harding's disclosures to investors about its asset selection process misleading. This is exactly the kind of reckless conduct that aiding and abetting liability was designed to counteract.

IV.

ERRORS WITH RESPECT TO THE REMEDIES ORDERED

A. The ALJ Erred In Calculating Disgorgement

The ALJ's determination of disgorgement raises a significant policy issue that needs to be resolved: what amount of an asset manager's compensation should be disgorged when that manager has violated its fiduciary duty with respect to some, but not all, of the collateral selected for an investment vehicle? The Division urged that a fiduciary's disloyalty vitiates their entitlement to any management fees, and that there can be no such thing as a "minor" disloyalty. Harding was supposed to be the gatekeeper, not a turnstile, and it is no defense that its identifiable breaches "only" related to a subset of all assets selected.

The ALJ rejected this argument, holding instead that the proper amount of disgorgement was the sum of Harding's management fees multiplied by the percentage of the portfolio that the wrongfully selected assets represented. ID 93-94. The Division respectfully submits this decision was in error, for several reasons.

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[13] Chau Tr. 1449:17-22; Wang Tr. 270:11-17; Chau Tr. 1451:17-23; Div. Ex. 122 at 4; see also Wang Tr. 296:17 – 297:6; *id.* at 297:7 – 298:16; Chau Tr. 1829:8-21.

First, as a matter of policy this is dangerous. As a rule, the notion that an asset manager could violate its fiduciary duty and, as long as it only related to a portion of assets, only have to forego a proportional portion of its management fees, might perversely induce such behavior. When discounted by the possibility of such disloyalty being detected, this rule would incentivize corner-cutting and fiduciary breaches. Adhering to one's duties as an investment adviser is integral to the performance of those duties, and it should be no excuse for an adviser to assert that it only violated its fiduciary duties part of the time. Furthermore, such a rule would damage the integrity of the markets and, if investors knew their adviser was violating its duties, even if it was "only" part of the time, they might be far less likely to invest in a vehicle, damaging the smooth functioning of the market.

The Division's approach is supported by case law, especially where, as here, Harding's very position was in part premised on its violations. *See, e.g., also SEC v. Conaway*, 2009 WL 902063, *19-20 (E.D. Mich. 2009) (disgorgement of compensation held warranted, notwithstanding defense that it was not causally related to fraud, on the grounds that defendants' tenure in management would have been shortened substantially if fraudulent scheme had not allowed company to stretch out its existence).

Holding that Harding was not entitled to any of its compensation for a deal in which they compromised their duties is consistent with the vast body of case law regarding "faithless agents." As courts have repeatedly held, under the "faithless agent" doctrine,[14] an agent must

[14] "One who owes a duty of fidelity to a principal and who is faithless in the performance of his services is generally disentitled to recover his compensation, whether commissions or salary." *Feiger v. Iral Jewelry, Ltd.*, 41 N.Y.2d 928, 928, 394 N.Y.S.2d 626 (1977) (citing Restatement (Second) of Agency (1958), § 469) It does not "make any difference that the services were beneficial to the principal, or that the principal suffered no provable damage as a result of the breach of fidelity by the agent." *Feiger*, 41 N.Y.2d at 928-29, 394 N.Y.S.2d 626. *See also Tyco Int'l, Ltd. v. Kozlowski*, 756 F. Supp. 2d 553, 562 (S.D.N.Y. 2010). All the relevant

forfeit all compensation received after his first disloyal act. *Phansalkar v. Andersen Weinroth & Co., L.P.*, 344 F.3d 184, 188, 200-203 (2d Cir. 2003) ("faithless servant doctrine requires [agent] to forfeit all compensation received after his first disloyal act" even if some loyal services "beneficial to the principal" were rendered thereafter, and regardless of whether or not the "principal suffered . . . provable damage"); *Morgan Stanley v. Skowron*, 989 F.Supp.2d 356 (S.D.N.Y.2013). *See also Carco Group, Inc. v. Maconachy*, 644 F. Supp.2d 218, 244 (E.D.N.Y. 2009) (for fiduciary breaches, agent "is required to forfeit all compensation, including "commissions or salary," paid beginning with his first disloyal act"); *Cadet Funding, LLC v. Hooser*, 2012 WL 3642827, *3 (July 2, S.D.N.Y. 2012).[15]

These amounts are as follows (*see* Div. Ex. 240A; Div. Ex. 240):

Octans I	$4,563,733.94
Lexington V	$1,285,112.77
Neo	$4,490,522.84

Finally, should the Commission further find Respondents liable for the CDOs into which Respondents stuffed the Norma single-A bonds, then the advisory fees for those vehicles should be disgorged as well. The amounts are as follows (*see* Div. Ex. 240A; Div. Ex. 240):

Jupiter VI	$1,105,398.28
888 Tactical	$1,243,336.01

Should the Commission determine to follow the ALJ's lead in calculating disgorgement as a pro rata percentage of fees based on the portion of total assets represented by the securities in question,

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collateral management agreements were governed by New York law. *See, e.g.*, Div. Ex. 4 at 31 (Octans I CMA); Div. Ex. 504 at 28 (888 Tactical CMA); Div. Ex. 506 at 30 (Lexington V CMA); Div. Ex. 510 at 32 (Neo CMA); Div. Ex. 512 at 30 (Jupiter VI CMA).

[15] At the very least, Harding's compromise of its standards at the outset extended the time by which the breaches extended. *See SEC v. Church Extension of the Church of God, Inc. et al.*, 429 F. Supp.2d 1045, 1050 (S.D. Ind. 2005) (ordering defendants to disgorge half their compensation on grounds that their violations of securities laws enabled fraud to persist).

then it should order disgorged 2% of the fees for 888 Tactical Fund (or $24,866.72)[16], and 1% percent of the fees for Jupiter (or $11,053.98),[17] plus interest.

B. The ALJ Erred In Calculating Penalties.

The Initial Decision imposed penalties on a per violation basis, imposing third-tier violations for four violations: two of Section 206(1) and two of Section 17(a)(1) (all related to Norma bonds). However, the ALJ declined to impose any penalties for certain post September 18, 2006 violations of Section 206(2) of the Advisers Act and Sections 17(a)(2) and (3) of the Securities Act related to Octans I. The ALJ determined 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. *See* Initial Decision at 95. The Division respectfully submits that the ALJ's calculation of penalties should be adjusted upwards.

Although the Initial Decision may not be pellucid in specifically identifying exactly which violations fit within this category of post-September 18, 2006 violations (see ID at 88) for which penalties were not assessed, it is apparent that they comprise the following:

- 206(2) violations occurring after September 18, 2006 include (a) the negligent misrepresentation to the Octans I issuer in the CMA regarding the standard of care Harding followed in selecting collateral (ID at 90); and (b) negligently failing to follow the correct standard of care, with respect to the Octans I issuer (*id.*);

- 17(a)(2) violations occurring after September 18, 2006 include (a) the negligent misrepresentation to the Octans I issuer in the CMA regarding the standard of care Harding followed in selecting collateral (ID at 90); (b) negligently failing to follow the correct standard of care, with respect to the Octans I issuer (*id.*); and (c) negligently

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16 $20 million worth of the single-A Norma bonds were purchased for this CDO, which represented 2% of that issuer's total portfolio. Resp. Ex. 879.

17 $15 million worth of the single-A Norma bonds were purchased for this CDO, which represented 1% of that issuer's total portfolio. Resp. Ex. 879.

misrepresenting to those Octans I investors who actually purchased bonds the standard of care Harding would apply in selecting collateral (*id.*); and

- 17(a)(3) violations occurring after September 18, 2006 include negligently failing to follow the correct standard of care, with respect to the Octans I issuer (ID at 90).

All in all, these comprise six additional violations for which the ALJ erroneously failed to impose any penalty. This was error for the following reasons.

First, the fact that the Division argued for a higher level of penalty did not preclude the ALJ from ordering any lower penalty he felt was warranted by the factual findings. 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. The Division sought the imposition of penalties, based on the conduct charged, and argued that the conduct warranted the most severe of sanctions. Having asked for such sanctions, the Division fulfilled its responsibility (and was not obligated to articulate a "fall-back request"), leaving the ALJ the discretion as to which tier penalties to impose, based upon his factual findings and conclusions of law. There is no basis in law (and none is cited in the Initial Decision) for the proposition that the Division is required to set out every possible range of sanctions just in case the ALJ failed to award the highest level sought. That would be equivalent to providing that, when seeking a specific monetary amount, the Division would have to say something like "the damages warranted are $100,000. And if not $100,000, then $99,999.99. And if not that, then $99,999.98." And so on.

In fact, the law is directly contrary to the approach taken by the ALJ. The Commission recently held as much in *Montford and Co., Inc.*, Release No. 3829, Release No. IA - 3829, 2014 WL 1744130, *25 (S.E.C. Release No.) (May 2, 2014). There, respondents argued that the ALJ improperly assessed third-tier penalties when the Division had requested only second-tier. The Commission rejected the notion that the ALJ is strictly bound by the specific tier requested by

the Division: "in determining the penalty necessary to protect the public interest, we are not bound by the amount the Division requested, and the record amply supports imposition of third-tier penalties."[18] Indeed, SEC Rules of Practice 111(i) and 360(b) provide the ALJ with discretion to determine the amount of the penalty.

Second, even if the Division did not argue for first-tier penalties, Respondents did. While Respondents argued that third-tier penalties were inappropriate, not only did they not claim 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. *See* Resp. Br. at 346. Given the ALJ's finding that the conduct alleged *was* proven, and Respondents seemed to concede that this conduct would warrant first-tier penalties, it was error for the ALJ to decline to award them.

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

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[18] ALJ Elliot had himself followed this approach earlier in *Ambassador Capital Management, LLC,* Release No. 672, Release No. ID - 672, 2014 WL 4656408, *78 (S.E.C. Release No.) (Sept. 19, 2014), in which he ordered the imposition of second tier penalties, even though the Division had asked for third tier penalties. There is no rationale for imposing a completely different standard in the case at bar.

fundamental level, Chau obviously did not care – at all – what went into his CDOs so long as the assets were allowed by the transaction documents. Nor did he care whether or not Harding followed the guidelines and procedures set out both in materials sent to investors and to the issuer.

Consequently, additional penalties should be imposed – both against Harding and against Chau – for these additional six violations, either at the first-tier level that the ALJ found was warranted but inexplicably failed to impose or, should the Commission find higher severity is warranted, on a second- or third-tier level.

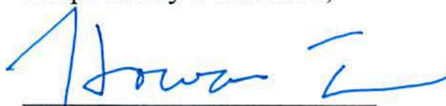
Finally, to the extent that the Commission holds that, as a result of the arguments set forth above, there are additional violations other than the ones found by the ALJ, penalties should be imposed for each of these. These include: (1) the multiple violations of Section 17(a)(3) related Offering Circulars, and collateral manager agreements for Octans 1 (point I(A) above); (2) the violations of Section 17(a) related to the failure to disclose Magnetar's being a party to the warehouse agreement in the Offering Circular (point I(B) above); (3) the Section 206 violation relating to Harding's undisclosed conflict of interest (point I(C) above); (4) violations of Section 17(a)(1) (point I(D) and (E) above); (5) violations related to the purchase of Norma's single-A rated securities (point II above); and (6) the causing and abetting violations of Chau (point III above).

CONCLUSION

The Division respectfully requests that the Commission find that the ALJ's determinations were in error, as set forth above, and order the relief sought by the Division in this appeal.

Dated: April 1, 2015

Respectfully Submitted,



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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15574

In the Matter of

HARDING ADVISORY LLC and
WING F. CHAU,

Respondents.

Certificate of Service

I hereby certify that, on April 1, 2015, I caused true and correct copies of the Division of Enforcement's April 1, 2015 Moving Brief in Support of its Appeal in the above-captioned matter to be served by UPS and/or email on the following:

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UNITED STATES OF AMERICA

Before the

SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15574

In the Matter of **HARDING ADVISORY LLC and** **WING F. CHAU,** **Respondents.**	**Certificate of Compliance with SEC Rule of Practice 450(d)**

I hereby certify that the Division of Enforcement's April 1, 2015 Moving Brief in Support of its Appeal in the above-captioned matter complies with SEC Rule of Practice 450(d) and that, as per the word counting program of the Word software, it contains approximately 10,800 words.

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April 1, 2015

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

Dear Mr. Fields

Enclosed/Attached please find an original and five copies of the Division's Appeal brief for filing in the above referenced action. Thank you.

Sincerely,

Howard Fischer
Attorney for the Division of Enforcement

HF:lw

cc: