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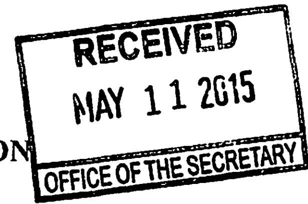

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15574

In the Matter of

HARDING ADVISORY LLC and

WING F. CHAU,

Respondents.

OPPOSITION OF THE DIVISION OF ENFORCEMENT TO RESPONDENTS' APPEAL

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May 8, 2015

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The Division of Enforcement ("Division") respectfully submits this opposition to the appeal by Harding Advisory LLC ("Harding") and Wing Chau ("Chau") (collectively, "Respondents") to limited aspects of the ALJ's January 12, 2015 Initial Decision ("ID").

None of Respondents' arguments have merit. The ALJ's determination should be upheld.

I.
PURPORTED OCTANS ERRORS

While often difficult to parse, the claimed errors with respect to Octans I CDO Limited ("Octans I") include:

- That all that was found was a negligent fraud, and that mere negligence on a simple, random day cannot render false general descriptions of asset selection processes unless those processes were "wholly abandoned" (Resp. Br. 5); and

- That a finding of negligent fraud is outside the scope of the Order Instituting Proceedings ("OIP") and was a new liability theory asserted for the first time over the objections of Respondents (Resp. Br. 5-8).

- That there was, in fact, no negligence in connection with the ramp of Octans I (8-11).[1]

Each argument must be rejected.

C. Background and the ALJ's Holding On Octans I

As collateral manager, Harding was tasked with selecting, acquiring and monitoring the assets of various CDOs. The CDOs at issue in the proceeding included Octans I, and several other CDOs for which Harding wrongfully purchased several tranches of another CDO called Norma CDO I ("Norma") (*see* Section II).

In exercising its duties, both to investors and to the issuers of the CDOs, Respondents had to adhere to the standard of care established not only under the Advisers Act but also under the

[1] Respondents cite no statutes but appear only to take exception to the rulings relating to Section 17 of the Securities Act of 1933, 15 U.S.C. § 77(q)(a) ("Securities Act") since nothing in Respondents' brief (which only addresses misrepresentations made to investors) appears to address the issues relating to the ALJ's determination of the claims under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 ("Advisers Act"). ID 71-81.

governing documents, and 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, which set out the standard of care, and marketing materials describing Harding's asset selection process that were sent to prospective and actual investors, such as Pitch Books[2] and Offering Circulars.[3]

The Pitch Book with which Harding marketed Octans I was distributed to potential investors, described the CDO, and 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. As the ID held, the "Octans I pitch book represented that Harding took a fundamental approach to portfolio management as its investment philosophy." (ID 19.) The Pitch Book represented that Harding's investment process would:

- 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.

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[2] 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.

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

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

- 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. *See also* ID 19.

Further, the Pitch Book referred to "Individual Asset Selection Employing a Disciplined Bottom/Up Credit and Structural Analysis" (Div. Ex. 1 at 45), and represented 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). *See also* ID 19-20.

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.

See also ID 17-18.

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." Div. Ex. 4 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; ID 17-18.

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 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.

Harding's purchases for Octans I included constituents of a benchmark known as the ABX Index, even though Harding's internal analysis 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. This compromised decision-making violated Harding's duty of care toward investors and the CDO, and rendered materially untrue statements Respondents made to investors in the CDOs and to their advisory clients concerning the methods and standards that Harding would apply in selecting collateral.

Consequently, the ALJ held[5] that:

- 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);

[5] By brief dated April 1, 2015 ("Div. App. Br.") the Division has appealed certain parts of the ALJ's determination related to Octans (Div. App. 5-19).

- 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.

D. <u>Respondents' Objections to the ALJ's Octans I Holdings Are Groundless</u>

None of Respondents' arguments pass muster.

4. Respondents Are Wrong That All The ALJ Found Was One Day Of <u>Sloppiness, And That This Would Not Establish A Claim</u>

Respondents assert that, at most, all the ALJ found was one day of "simple negligence" and that the ALJ "conflates negligent fraud with simple negligence [and that] mere negligence on a simple, random day cannot render false general descriptions of asset selection *processes* unless those processes were wholly abandoned." (Resp. Br. 5). Respondents' attempt to minimize the import of its conduct as just "one employee" who had "a bad day at the office" (Resp. Br. 15) ignores the substantial evidentiary record supporting the ALJ's determination.

First, the ALJ held that an undisclosed party, Magnetar, which had purchased the equity in the CDO, had substantial rights (which no other investor had) that were not disclosed to debt investors. These rights included:

- The right to effectively veto collateral selections (ID 25, citing Tr. 1802-09), even though Chau had conceded that giving such a right would compromise Harding's independence. ID 20, Tr. 189-21.

- The right to be notified promptly if a warehouse security failed to meet eligibility criteria. ID 25, Div. Ex. 5 at 5.

- The right to veto removals from the warehouse on eligibility grounds. ID 25.

- The right to see collateral prior to its going into the warehouse, the right to see pricing terms for collateral, and to agree on those terms before collateral went into the warehouse. Id. *See also* ID 31 (citing Div.Ex. 5 at 2-5, Div. Ex. 28).

- The right to see lists of bonds on which Harding was offering to buy protection. ID 26.

Chau acted vigorously to ensure that Magnetar's rights were protected, and made sure to instruct his staff to send trade lists to Magnetar. ID. 26. Yet, the Pitch Book describing the deal "did not describe Magnetar's rights in the Octans I warehouse – indeed, it did not mention Magnetar by name at all." ID 27. Chau conceded this was inaccurate (*Id.*, citing Tr. 1844), and said it was an oversight. *Id.* Nor did the Offering Circular disclose Magnetar's role; to the contrary, it mis-described the warehouse agreement as only including Merrill and Harding as parties. ID 28 (citing Div. Ex 3 at 299, Tr. 4332-33). As the ALJ found, Chau conceded the disclosures in the Offering Circular were inaccurate. *Id.* Harding's counsel had wanted to include additional disclosures regarding Magnetar. *Id.* (citing Tr. 3073, 3119, 2953-55, 2957, Div. Ex. 138, Resp. Ex. 197 at 23-24).

The ALJ found these rights and Magnetar's role were significant, and that Harding executed the ABX Index trade not because it independently ascertained these assets were ones it wanted to purchase, but because Magnetar wanted them in the CDO in order to pursue its own strategy:

- "Magnetar sought short positions on assets strongly correlated with its equity investments." ID 30.

- Chau conceded Magnetar pushed the index trade. ID 33.

- The ABX trade was spurred by Magnetar: "Magnetar wanted Harding to select bonds in the ABX Index to engage in an index arbitrage strategy." ID 33 (citing Tr. 2439).

- Because the strategy was Magnetar's, and not Harding's, Magnetar had to repeatedly explain it. ID 33 (citing Div. Exs. 19, 31). Further showing that the

trade was done as an accommodation and that Harding found it confusing, Harding personnel had to advise others that concentration limits restricted Harding to a ceiling of $15 million per bond class. ID 36.Ultimately, a significant portion ($70 million) of the Index came directly from Magnetar's own inventory. ID 36.

- That a substantial portion of the ABX Index assets came from the equity investor was never disclosed to the debt investors.

The ALJ further found that when Chau mischaracterized the ABX Index trade as "merely an execution strategy for acquiring assets that the analysts had already determined to purchase" he had "disingenuously downplayed the significance of the fact that the execution strategy coincided with Magnetar's interests." ID at 34 (citing Tr. 2147, Div. Ex. 5001 at 32). Furthermore, the ALJ found that Chau's explanation for the trade changed significantly between the investigation and the hearing. ID 34.

Second, the conduct the ALJ identified as the basis of his holding extended well beyond a day. While Magnetar and Merrill discussed the ABX Index trade no later than May 22, 2006 (ID 34) (showing the trade idea came from outside Harding) it was discussed by Magnetar with Chau no later than May 24. (*Id.*, citing Div. Ex. 23, Tr. 2151.)[6] Previously, neither Harding nor its predecessor had ever ramped a CDO with the ABX Index. *Id.*

Nor were the errors merely minor, simply a "bad day at the office." Although Respondents represented in Pitch Books that they employed a "collaborative, methodical and disciplined investment process" (ID 65), the evidence established, and the ALJ found, that Harding's personnel did not collaborate and in fact often worked at cross-purposes, did not check

[6] Shortly after Chau discussed the ABX Index trades with Prusko, he directed Harding to relax its assumptions significantly from 9%, 11% and 13% down to 6%, which made it far more likely that purchases would be approved. *See* Div. Ex. 15; Resp. Ex. 767; Div. Ex. 56 (Lieu wrote to Moy and Wang: "I will be re-running the old deals that we rejected based on old high losses curves (9, 11, 13% runs). If those pass the 6% we're using now, I'm going to change those to 'Y.'": *see also* Lieu Tr. 3624:1-10, 3973:10-21, 3979:4-15.

each other's work, and were neither methodical nor disciplined. *Id.* Nor, even though the Pitch Book represented that Harding would conduct stress case runs, was there any documentation of such work being done. ID 65.[7] Nor did Harding's conduct and processes comport with the standard of care representations in the Offering Circular or the CMA. ID 70.

Additionally, the record was replete with evidence of Harding's dislike of the assets they ultimately selected for Octans I, as well as of the haphazard selection process for them. Numerous bonds that had been rejected previously made it into Octans I despite the rejection on May 22, and all were Index bonds – a pattern that Lieu has previously described as "a bit too much of a coincidence." Lieu Tr. 3426:2-22.[8] Index bonds went into Octans I even though the evidence showed they had been rejected by a Harding analyst. *See* Div. Exs. 65, 167.[9] Additionally, many of Lieu's selections included "dealer shelves" (securities issued by an entity affiliated with an investment bank), securities Harding senior executives disfavored (Huang Tr. 812:24-814:16), but neither Huang nor any other portfolio manager meaningfully reviewed Lieu's selections. Huang Tr. 872:15-18, 882:8-11, 882:19-20 ("as you can tell, I just passed that list along.").

Furthermore, acts post-dating the purchase of securities for Octans I provide further evidence of a troubling pattern, in particular, in connection with two other CDOs, Octans II and III. As the evidence reflected and the ALJ found, even though with respect to some bonds "the

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[7] The ALJ also found that the failure to disclose Magnetar's participation in the warehouse agreement was inaccurate and misleading, but held that Respondents were not liable therefor because they did not draft the misleading disclosures at issue. ID 68-69. The Division has challenged that determination. *See* Div. App. at 7-14.

[8] Moreover, three of those five bonds had been rejected because of "collateral attributes." Div. Ex. 16; Wagner Report ¶ 98. The characteristics of the mortgage loans backing an RMBS would not be expected to change meaningfully from May 22 to May 31. Wagner Tr. 4532:22-4534:14.

[9] As Harding analyst Moy later wrote to her co-workers: "we had to pick the lesser of evils when we were looking at the index." Div. Ex. 156 at 2; *see also id.* at 1 ("we knew we had to pick the less worse.").

decision was an 'N,' yet 'due to the fact that we had to pick the lesser of evils when we were looking at the index we said 'Y.'" (ID 47 (citing Div. Ex. 156)).[10]

Finally, the ALJ's decision was bolstered by his credibility findings:

- The ALJ held that "at times [Chau] was unbelievable. The Division repeatedly impeached him." ID 6 (citing Tr. 1543-44, 1546, 4341-43, 4398-4400).

- "Chau also offered farfetched explanations on some matters." ID 6.

- "Chau's histrionics also eroded his overall credibility." ID 7. (citing Tr. 1534). Indeed, during the hearing, Chau refused to answer directly the Division's questions, went on numerous multi-page digressions instead of responding to examination, and at one point screamed "Shame on you" at Division trial counsel, requiring the ALJ to halt his testimony to warn Respondents' counsel. Chau Tr. 1565:15 – 1560:20.[11]

- "Chau also deflected questions by the Division on rudimentary issues. . . . When pressed on . . . common-sense concepts, Chau sometimes gave long-winded answers when a simple yes or no would have sufficed." ID 7, citing Tr. 1551-58, 1559-1565 (Chau "remained conspicuously less willing to answer questions by the Division compared to questions from his own counsel." (comparing Tr. 4067-331 to Tr. 4337-444).

See also ID. 16 (characterizing Chau's responses to questions about emails as "evasive" and "incredible") (citing Tr. 1399-44, DX. 258). Chau was not the only person whose testimony was

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[10] *See* Div. Ex. 164 (Moy to Chau, Chen, Lieu: "We were actually not okay with the collateral in this deal," *i.e.*, SAIL 05-HE3), Div. Ex. 160 (Chen to Chau, Moy, Lieu: "I checked with credit, we're not good on credit, and it's already in Octans 3 as per Prusko trades"), Div. Ex. 162 (Lieu instructing junior analyst to note that the mezzanine tranches of the SAIL deal are "N" and that the comment refers to the deal having "high 90+ LTV," *i.e.*, problematic collateral); Lieu Tr. 3379:17-3380:14. Div. Ex. 163 (Lieu to Chen and Moy: "Not as bad as I thought. 2 rejected bonds traded with Prusko from the index [*i.e.*, FFML 2006-FF4 M8 and SAIL 2005-HE3 M8]. . . . Xi, to the extent that you can control it, please refrain from letting any index trades happen for Oct 3 AND Lex 3."); Lieu Tr. 3381:21-3383:20.

[11] During one bizarre episode, Chau refused to answer a simple question and instead went on for several pages apparently justifying his behavior by reference to the "London Whale," the JPMorgan Chase trader whose unauthorized activity cost over $6 billion in losses in 2012. Chau Tr. 1555:0 – 1557:25; 1559:18 – 1565:10.

problematic. "Lieu's testimony regarding the actual practices of the credit team at Harding was confusing and inconsistent." ID 19. The ALJ held that "contemporaneous evidence shows that Lieu and Moy did not always coordinate decisions, and that at least several decisions were at odds with one another, yet those bonds were approved without intervention by a portfolio manager." *See* ID 20 and record citations therein.[12]

Finally, the claim that processes must be "wholly abandoned" in order to establish liability has no basis in the cases cited (Resp. Br. 5). Nor do any of them stand for the principle that "widespread systemic abandonment" is a necessary or required element of any claim, either based on negligence or otherwise; nor do they define what that term might include, or whether the conduct of Harding, even under the most straitened reading of it occurring during a short period of time, would satisfy it. The citing of these cases in the ID (*see* ID 64) was simply for the proposition that misrepresenting credit review standards is material.

5. <u>Negligent Fraud Was Within The Scope of the OIP</u>

Respondents have long known that the OIP sought relief for violations of all sections of 17(a) of the Securities Act, including negligent fraud.[13] While Respondents claimed, in a January 10, 2014 Motion for a More Definite Statement ("MDS Motion") that they did not understand whether the "conduct at issue was intentional or negligent" (MDS Motion 12), the Division's January 27, 2014 Opposition ("MDS Opp.") made clear that all sections of the Securities Act were alleged to have been violated. MDS Opp. 10 (citing OIP ¶ 70). The Division also made it

[12] Well after the events at issue Respondents concocted a new defense for the ABX Index purchases: that it was simply a strategy for purchasing assets they would otherwise have obtained, but at a better price. *See, e.g.*, Resp. Br. at 3 & n.3. This defense, which is borne out nowhere in Harding's contemporaneous records, fails for two additional reasons: (1) it is no defense to argue that one bought something improperly and in violation of their represented procedures, but at a good price, and (2) as the expert report of Ellson demonstrated, the index purchases had a net negative economic effect, albeit a slight one. Div. Ex 8002.

[13] And, although they do not appear to be contesting any determination with respect to the Advisers Act, both 206(1) and (2) of that statute as well.

clear how, in additional to intentional conduct under Section 17(a)(1), it intended to prove violations of 17(a)(2) and (3). MDS Opp. 10-11. The ALJ, in his February 12, 2014 Order denying the motion, found that it was clear that all subsections were allegedly violated, and held that violations of subsection 17(a)(3) were adequately alleged. Given this understanding early in the proceedings, Respondents could not have been prejudiced when the Division proceeded in this fashion. *See also* OIP ¶¶ 54-58.[14]

6. There Was More Than Sufficient Basis For a Negligence-Based Claim

Respondents' grab-bag of defenses that the evidence did not support a negligence-based fraud does not justify overturning the ALJ's decision.

a. The Case Was Not Predicated Wrongly On A Hearsay Document Or Wagner's Assertion that Lieu Failed to Review Eleven Assets

First, Respondents claim the ALJ erred by accepting the Division's expert's opinion on the ultimate issue, and in relying on a hearsay document (Div. Ex. 53). Resp. Br. 8-12. Respondents' defense rests largely on characterizing the Initial Decision as finding that there was a lack of documentation as to what actually happened, arguing that the inability to determine exactly what happened that day does not establish negligent fraud, and thus the ALJ's findings represent an improper burden shifting from Division to Respondents. Essentially, Respondents argue that their statement at the hearing that they "must" have done all the appropriate analysis,

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[14] While Respondents claim that they did not bother getting an expert on the standard of care because they did not understand that a negligence claim was being asserted (Resp. Br. 6-7), the ALJ's decision on the Motion for a More Definite Statement was dated February 12, 2014, the due date for identification of an expert was over a month later, and the hearing began two months later.

notwithstanding the lack of any evidence thereof,[15] should have been credited instead, and that the ALJ's decision relied almost entirely on Wagner's report and one exhibit.

However, as set forth in detail above, the ALJ's determination was more broadly based. Further, Harding also tried to justify the purchase of various bonds based on spreadsheets that the ALJ found were clearly created after the securities were purchased. ID 39. On that record, the ALJ's findings were warranted, even without reference to Wagner's report or Div. Ex. 53.

Respondents gain no traction with the claim that Wagner's cross-examination undermined his report by showing that Respondents actually conducted cash flow analysis for every questionable asset. Resp. Br. 10-11. This argument relies on spreadsheets created by other analysts at Harding and there was no evidence Lieu had access to them. As Wagner testified (*see, e.g.* Wagner Tr. 4776), his report stated that Lieu, the person that authorized Harding's purchase, failed to conduct any analysis of many of the securities at issue. Even if Lieu somehow had access to and relied on these other spreadsheets, it would not redeem her work, because these other spreadsheets showed huge write-downs in the bonds that Lieu accepted. *See, e.g.*, Resp. Ex. 325, Excel row 175; Resp. Ex. 774, Excel row 67 (showing that the MABS bond at Baa3 had a gigantic write-down of 59.46% and 60%). Two other bonds also had write-downs in the other

[15] Moreover, the claim that the proper procedures "must have been followed" had no evidentiary basis. The vast majority of the purportedly exculpatory evidence consisted solely of Lieu's recollection of what "must have happened" that only came to light after she met with Respondents' counsel for several days prior to testimony, a recollection at odds with her prior testimony in both the investigative testimony as well as civil litigation, and which had no contemporaneous documentary corroboration. *See, e.g.*, ID at 38 (citing Tr. 3404, 3406, 3411-13). Although Lieu claimed her recollection was jogged by new materials shown to her in prep sessions by Harding's counsel, it turns out that she had seen these materials several years prior. ID 38 & n.39 (citing Tr. 3418-20). The evidence further showed, and the ALJ held, that this claim of what "must have happened" was belied by the fact that Harding's practice was to save the output of its analysis; furthermore, Lieu's notebooks, which "recorded many credit evaluations, ... [contained] no entries . . . for ABX Index bonds dated May 31, 2006." ID 38 (citing TR. 3291-93, Div. Exs. 241-46).

spreadsheets, of 6.83%/7% and 4.83%.[16] Giving Lieu "credit" for this analysis would mean that she accepted 16 bonds (the 13 in Div. Ex. 53 plus the additional three referred to in this paragraph) with significant write-downs.

Finally, there is no reversible error in the extent to which the ALJ credited either of these pieces of evidence. To the extent that the expert's opinion was based on investigative testimony, where Chau's hearing testimony differed the ALJ accepted the hearing testimony. ID 67 (citing Tr. 4094-96, 4114-15). Nor is there any basis for excluding Div. Ex. 53, a business record of Harding's[17] on the grounds of hearsay – as the Commission has held, "hearsay evidence is admissible in our administrative proceedings and 'in an appropriate case, may even form the sole basis for findings of fact.'" *Edgar B. Alacan*, Release No. 8436, 83 SEC Docket 723, 2004 WL 1496843 (July 6, 2004); *see also Guy P. Riordan,* Release No. 9085, 2009 WL 4731397 (Dec. 11, 2009) ("[h]earsay evidence is admissible in our administrative proceedings and 'can provide the basis for findings of violations, regardless of whether the declarants testify'"); *Wheat, First Securities, Inc.*, Exchange Act Rel. No. 48378, 2003 WL 21990950 (Aug. 20, 2003), 80 SEC Docket 3406, 3429; *Charles D. Tom*, 50 S.E.C. 1142, 1145, 1992 WL 213845 (1992).[18]

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[16] The bonds are FFML 2005-FF12 B3 (*see* Resp. Ex. 325, Excel row 118; Resp Ex. 774, Excel row 36) and SVHE 2005-4 M9 (*see* Resp Ex. 325, Excel row 294). *See* Wagner Tr. 4787:4-11 ("If [Lieu] did see" bonds written down in the Moy Spreadsheets, "then it is another bond that I would question what her decision was based on.").

[17] In any event, as a report made in the ordinary course of business, at or near the time of the transactions at issue, as part of Harding's regular practice, Div. Ex. 53 would have admissible under the business records exception of FRE 803(6). *See, e.g., United States v. Bonallo,* 858 F.2d 1427, 1435 (9th Cir. 1988); *United States v. Qualls*, 553 F. Supp. 2d 241, 245 (E.D.N.Y. 2008).

[18] Respondents' assertion that an administrative hearing "cannot rely solely on uncorroborated hearsay evidence" (Resp. Br. 9 &n9) cites cases that undermine its defense. One, *U.S. v. Mulheren*, 938 F.2d 364 (2d Cir. 1991), involves the standards of proof applicable to criminal convictions, and is thus inapplicable. *Hoska v. U.S.*, 677 F.2d 131 (D.C. Cir. 1982) provided that "hearsay is admissible in administrative proceedings" and "hearsay can constitute substantial evidence." *See also McKee v. U.S.*, 500 F.2d 525 (Ct. Cl. 1974) ("In an administrative hearing,

b. <u>A Certification of Eligibility Does Not Vitiate Harding's Fraud</u>

Respondents' defense that certifying the ABX Index assets as "eligible" investments for Octans I negates any failure to follow its represented procedures or the standard of care to which it was committed is meritless. The eligibility criteria set forth at pages 137 through 146 of the Final Offering Circular (Resp. Ex. 2) are generally mechanical rules and rating agency-imposed requirements; they have nothing to do with the manager's own views of the credit-worthiness of the assets. *See* Wagner Report at 4-5 (Ops. III(a)(v), (b)), ¶¶ 105, 165; Wagner Tr. 4639:12-22. A CDO manager who does no investigation beyond confirming assets meet the eligibility criteria set forth in an offering circular and indenture is no manager at all.

Respondents' position is akin to saying that a mutual fund specializing in midcap equities, for example, has no obligation to independently determine whether a specific equity is a good investment – or can review financial statements or other materials and determine the company is a bad investment and then disregard that analysis – as long as it is a security of a company in the midcap range. It also contradicts Chau's own testimony that each security had to be subjected to analysis. Chau Tr. 1651:10-14 ("it wouldn't be a general practice" to buy CDOs with large percentage of deals failing surveillance tests); 1654:19-24, 1658:14-18 (Chau would prefer that a CDO not have a high percentage of deals on watch list; "to the extent we could avoid it, yes, we would try to"); 1655:13-23 ("If I could, I would buy CDO's that had residential mortgage-backed securities that were not on the do not buy list. That would be my preference.").

'rank hearsay' not only is admissible, . . . but can constitute substantial evidence if sufficiently convincing to a reasonable mind.") *Compare Robinson v. DC Housing Auth.*, 660 F.Supp.2d 6, 12 (D.D.C. 2009) ("utilization of hearsay evidence in administrative proceedings is well ground")(citing cases); *Robin Bruce McNabb*, Release No. 43411, 73 SEC Docket 1094, 2000 WL 1472687, at * 5 &n.34 (Oct. 4, 2000) ("in appropriate circumstances, hearsay may constitute the sole basis for findings of fact"). Finally, the fact that the ID was based on a much broader base than "mere" hearsay evidence further warrants rejection of Respondents' efforts.

As Wagner explained, relying on the fact that the eligibility criteria of his CDOs permitted the investment, "fundamentally fails" to comport with Harding's represented "disciplined bottoms/up approach" and with the applicable standard of care requirements. Wagner Report ¶ 165. Chau's rationales have nothing to do with "fundamental credit analysis and stress testing based on a review of the characteristics of the RMBS underlying the CDOs," and would be unrecognizable to national-class asset managers. *Id.* Eligibility is the minimum required – it is a floor, not the ceiling, and is separate from assessing the credit quality of assets, let alone compliance with the represented processes or the standard of care.

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

c. Lieu's Purported "General Compliance" With <u>Review Standards Is No Defense</u>

Respondents assert that, even if Harding did not comply with its represented process and standards on one day, Harding's general compliance made this aberration immaterial. As noted above, the fact that Respondents' failures were far more than that negates this defense. Moreover, as the ALJ held (ID 63-64 and cases cited therein; ID 71), a collateral manager's abandonment and misrepresentation of its credit review standards is material. *See SEC v. Capital Gains Research Bureau, Inc.*, 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[.]'"). *See*

also Section II(B)(1), below. Unsurprisingly, Respondents cite no case law in support of this claim.

d. <u>That Investors Received The Benefit Of Their Bargain Is No Defense</u>

Respondents assert there can be no fraud toward investors because they were sophisticated parties who received the benefit of their bargain, since they received disclosure of the specific assets in the Octans I CDO. Resp. Br. at 14.[19] This argument fails.

First, a securities professional is not entitled to abdicate its responsibilities simply because sophisticated investors are involved. *See Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 641-42 (D.C. Cir. 2008) (underwriter's "duties do not disappear" simply because of investor sophistication); *Hanly v. SEC*, 415 F.2d 589, 595-96 (2d Cir. 1969) (broker's duty to investigate applies even if his "customers may be sophisticated and knowledgeable" enough to conduct their own analysis of a stock because "reliance is not an element of fraudulent misrepresentation.").

Second, this is a misplaced reliance claim, and neither reliance nor investor injury is an element to an SEC enforcement action. *SEC v. Goble*, 682 F.3d 934, 942 (11th Cir. 2012); *SEC v. Pirate Investor LLC*, 580 F.3d 233, 239 & n.10 (4th Cir. 2009); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1363-64 & n.4 (9th Cir.1993); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985); *SEC v. Simpson Capital Mgmt., Inc.*, 586 F. Supp. 2d 196, 201 (S.D.N.Y. 2001).[20]

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[19] Respondents' argument (Resp. Br. 14 & n. 14) that fraud could not be predicated on the Pitch Book as a matter of law is also baseless. Unsurprisingly, Respondents cite only private fraud litigation cases, but this law is inapplicable to an SEC enforcement case. *See SEC v. Quan*, 2013 WL 5566252, at *8 (D. Minn. Oct. 8, 2013) (flipbook held actionable even though investors signed subscription agreements stating they had relied solely on a private placement memorandum); *SEC v. True North Finance Corp.*, 909 F. Supp. 2d 1073, 1096-97 (D. Minn. 2012) (rejecting argument that statements outside Offering Circular were not actionable because "reliance is not a required element of any of the SEC's claims").

[20] Nor is it an element in an Advisers Act claim. *Capital Gains*, 375 U.S. at 195; *SEC v. Wash. Inv. Network*, 475 F.3d 392, 404, 405 (D.C. Cir. 2007) (under Section 206, "the SEC does

e. Respondents Cannot Seek Refuge In Any Disclaimer

Respondents' assertion that any claim regarding the asset selection process is negated by the disclaimer as to the lack of representations as to the quality of the collateral (found in both Pitch Book and Offering Circular (RX 2 at 18, 52, DX 2 at 2, 30) (Resp. Br. at 14-15) also fails.

First, as the ALJ found, the fraud at issue related to the manner in which assets were selected, which was not the subject of the disclaimer. ID 65 (citing OIP at 3). The disclaimers do not address the subject matter actually at issue here (namely the manager's integrity, independence, and diligence), and the disclosures include a standard of conduct that Respondents knowingly violated. Their argument has been repeatedly rejected in private suits that, as far as the reliance argument, are on all fours with this one.[21]

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not need to prove reliance on the investment adviser's misleading statements, nor does the SEC need to prove injury"); *SEC v. Gruss*, 859 F. Supp. 2d 653, 669-70 (S.D.N.Y. 2012).

[21] *See Bayerische Landesbank, N.Y. Branch v. Aladdin Capital Mgmt. LLC*, 692 F.3d 42, 52, 58-59 (2d Cir. 2012) (sustaining CDO debt investor's claims against manager for failure to live up to representations that allegedly induced reliance, including that manager would act "in good faith using a degree of skill, care, diligence and attention consistent with the practice and procedures followed by reasonable and prudent institutional managers of national standing"); *Loreley Financing (Jersey) No. 28, Ltd. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 2014 WL 1810646, at *3-4 (N.Y. App. Div. 1st Dep't May 8, 2014) (sustaining claim that Merrill defrauded investor in a Magnetar CDO: "Under the circumstances, it cannot be said that the disclaimers and disclosures in the Offering Circulars preclude a claim of fraud . . . as to the specific matter, namely that the CDO's collateral had been carefully selected by an independent collateral manager, in the interests of the success of the deal and for the benefit of [the CDO's] long investors."); *Loreley Financing (Jersey) No. 3 Ltd. v. Citigroup Global Markets Inc.*, 2014 WL 1809781, at *6 (N.Y. App. Div. 1st Dep't May 8, 2014) (disclaimers and disclosures in Offering Circular did not preclude reasonable reliance by CDO investors alleging concealment of Magnetar's role in collateral selection; "[no]thing in the deal documents or elsewhere could have 'alerted' plaintiffs to the falsity" of representations about who selected the collateral and why).

Second, Respondents' argument is essentially that investors, having read a disclaimer as to asset quality, could not rely on representations as to asset selection process. As noted above, reliance is not an element of an SEC enforcement action.[22]

II.
PURPORTED NORMA ERRORS

C. Background and The ALJ's Holding On Norma

The evidence – which consisted in large part of Chau's own testimony and admissions – established that the purchases of Norma bonds for four CDOs[23] violated both the Advisers Act and the Securities Act.[24] ID 81-86. For each CDO, the respective CMA and Offering Circular represented that Harding would perform its obligations with "reasonable care . . . using a degree and skill and attention no less than which the Manager would exercise with respect for comparable assets . . . in a manner consistent with the customary standards, policies and

[22] Nor can Respondents gain mileage by claiming (Resp. Br. 15 &n.15) they cannot be liable for statements drafted by Merrill. First, the Pitch Book section describing Harding's processes was drafted by Harding. Wang Tr. 368:13- 370:21, 372:19-373:6, 386:14-387:22; Chau Tr. 1824:9-1825:9. Second, this defense, based on case law relating only to Exchange Act claims, does not apply to a claim under the Securities Act.

[23] 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).

[24] The ALJ held that, while Respondents' purchase of Norma's ingle-A Notes without any meaningful analysis was at least negligent, the Division failed to sufficiently charge those purchases in the OIP. ID 86. The Division has appealed this ruling (Div. App. 19-23).

procedures relating to assets of the nature and character of the Collateral." ID 82 (citing Div. Exs. 504 at 7; 506 at 7; 510 at 8; 512 at 7; 503 at 97-98; 507 at 156; 509 at 159; 513 at 174).

Respondents selected Norma bonds in violation of this standard of care, due to pressure from Magnetar and Merrill. ID 83. First, Chau caused Harding to purchase Norma's single-A bonds, without conducting the analysis Harding represented it would employ. Second, Harding's purchase of the triple-B bonds "illustrates Respondents' succumbing to pressure from Magnetar and Merrill, and statements made by Chau during the interactions evince scienter." ID 83. The ALJ held:

> The evidence demonstrates that . . . Respondents acted under a conflict of interest between their duty to their clients and their desire to please Merrill and Magnetar. Respondents' actions violated both the standards of care promised . . . and industry standards, including the fiduciary standard of care owed to CDOs as advisory clients. There is no evidence that Respondents disclosed their conflict of interest, and indeed, Respondents deny that one existed."

ID 82.

The record showed Merrill had significant trouble placing Norma securities. ID 49. A January 23, 2007 email demonstrated that Magnetar, concerned by these lackluster sales, planned to "hammer" Chau to buy Norma's lower rated tranches. ID 50 (citing Div. Ex. 199). Magnetar, through Prusko, followed through immediately and reached out to Chau to pressure him to buy the triple-B bonds. ID 50 (citing Div. Ex. 200). The record showed that over the next few days Magnetar and Merrill kept up the campaign, ID 50-51 (citing Div. Exs. 198, 201, 204, 205, 210) until on January 26, 2007, Chau agreed to buy $20 million of Norma's triple-B tranche. ID 51; Div. Ex. 212. To Chau's relief, that amount was reduced on or about February 1, 2007 to $15 million, prompting Chau to respond "Now that's what I'm talking about, the love is in the air." ID 51, Div. Ex. 210. The ALJ found Chau's explanations for the email correspondence

"laughably implausible" holding that 'in context, and taken at face value, Chau's statements plainly inculpate Respondents." ID 84.

The record showed that no prior analysis was performed with respect to any of the Norma purchases, ID 83, even though "Chau agreed that it 'would be irresponsible to buy something without actually looking at the assets.'" ID 52 (citing Tr. 1648). Yet Chau committed to purchasing Norma bonds without such analysis. ID 84. Chau conceded he made the investment decisions prior to reviewing any internal write-ups on Norma. ID 52 (citing Tr. 1670). When that internal write-up was concluded, it was starkly negative, with a "large percentage of deals failing surveillance tests, on the watch list, and on the do not buy list" plus a large exposure to disfavored originators. ID 53 (citing Div. Ex. 217). *See also* ID 84. Most glaring of all were Harding's conclusions about the low quality of the collateral. Chau did not dispute that having a high percentage of RMBS failing surveillance tests is negative. Chau Tr. 1651:21-24, 1652:21-1653:6.[25] The watch list consisted of RMBS that Harding viewed negatively and "should be watched more carefully." Chau Tr. 1658:10-13, 1654:6-24. The do-not-buy list consisted of RMBS that the credit staff had rejected. Chau Tr. 2165:2-2166:21 (prior testimony). Chau admitted each of these factors was a reason to avoid buying a CDO.[26]

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[25] Chau did not dispute that the percentage of RMBS failing surveillance tests was high. *See* Chau Tr. 1664:6-23. The surveillance tests were "DQ", "60+ day DQ", and "OC," referring to delinquencies, 60-day-plus delinquencies, and overcollateralization. Depending on the performance of the collateral backing a given RMBS, the RMBS could pass or fail the test. The percentages reflected in the write-up were the percentages of RMBS securities in the Norma portfolio failing each test. *See, e.g.*, Div. Ex. 16; Div Ex. 197; Div. Ex. 203 (BSAM analysis of Norma: "Out of 116 names, 17 (15%) are currently failing DQ triggers"); Lieu Tr. 3926:22-3927:11.

[26] Chau Tr. 1651:10-14 ("it wouldn't be a general practice" to buy CDOs with large percentage of deals failing surveillance tests), 1654:19-24, 1658:14-18 (Chau would prefer that a CDO not have a high percentage of deals on watch list; "to the extent we could avoid it, yes, we would try to"), 1655:13-23 ("If I could, I would buy CDO's that had residential mortgage-backed securities that were not on the do not buy list. That would be my preference.").

Chau's excuse was that a typo in the report justified him "not [paying] any attention to this commentary." ID 54 (citing Tr. 4223). As the ALJ found, even if this is not merely a later created excuse by Chau, "it hurts him, because if Chau believed the commentary to be so flawed as to render it meaningless, then Chau never reviewed ***any*** in-depth Norma analysis. ID 84 (emphasis in original).[27] Chau also claimed that the fact that Norma was rated by Fitch justified Harding's purchase. ID 54 (citing Tr. 4227-29, Resp. Ex. 890 at 2, 5.)

The ALJ rejected Respondents' defenses. First, Chau claimed that he was waiting for the lead order to settle, which would provide some price guidance. ID 51-52. The ALJ did not find credible Chau's late concocted defense that he was trying to negotiate a discount, and there was no contemporary evidence supporting that defense. ID 51, 85. Furthermore, any attempts to negotiate a better spread "does not abrogate Respondents' failure to perform adequate diligence on the Norma bonds before committing to purchase them." ID 85. Second, Chau's argument that he was attempting to "add diversity" was also found incredible. "[T]he standard of care required independent, rigorous, and thorough diligence before approving bonds" ID 85. The ALJ also found "unconvincing" Respondents' effort to minimize the write-down projections in the commentary, ID 85. Finally, the ALJ found Chau's claims regarding Norma's quality negated by his attempts to unload the bonds shortly after they were placed in the CDOs. ID 85-86.

D. <u>Respondents' Claimed Defects</u>

Respondents assert that: (1) regardless of what transpired with the purchases of Norma bonds, the majority of the assets for the CDOs at issue were not purchased for improper reasons;

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[27] Others at Harding shared this negative view. On March 9, when Lieu finally reviewed the Norma portfolio, she could not believe what she was seeing. Div. Ex. 221 ("Who's the manager on NORMA? 31% NC [New Century] and 14% Fremont?!"). Under questioning, Chau was forced to concede that all the metrics for the collateral were negative. Tr. 2188:19-22, 2189:7-14 ("yes, the numbers were high.").

(2) the ALJ's findings rested on false premises; (3) the ALJ erred in finding a conflict of interest; and (4) the ALJ misunderstood the relevant deal documents and legal principles.

5. Respondents' Claim That They Only Committed Fraud Part of the Time <u>Misstates Harding's Obligations and Is No Defense</u>

Bizarrely, Respondents contend that, rather than pursue the best investments possible, or to adhere to the governing standard of care, or act as a fiduciary to advisory clients, the "role of the CM is, in part, to check the influence of the underwriter on the portfolio." Resp. Br. 16. Thus, Respondents imply, because Harding "only" subordinated their independence to Merrill and Magnetar for a minority of the CDOs' total assets, the CDOs were "98.4% free of any conflict or taint." Consequently, Respondents claim, any fraud is simply not material. Resp. Br. 16-17.

Respondents argue that the Norma purchases were not material since they represented between one and two percent of each of the Norma Recipients' assets. *See* Resp. Ex. 879 (tallying percentage of portfolios invested in Norma). But Respondents' claim that purportedly minor departures from the credit review standards fail the materiality test for a misstatement or omission (Resp. Br. 16) is not the law (and Respondents cite no case law in support of this claim that a purportedly "small" fraud is excusable). In recognition of the "delicate fiduciary nature of an investment advisory relationship," Section 206 places "an affirmative duty" on advisers of "utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963) (internal quotation marks omitted); *see also SEC v. Wash. Inv. Network*, 475 F.3d 392, 404 (D.C. Cir. 2007) ("Section 206 . . . prohibits failures to disclose material information.").

SEC v. DiBella, 587 F.3d 553 (2d Cir. 2009) further illustrates why the "small percentage" defense fails, particularly when it involves a breach of fiduciary duty. There, the

Connecticut state treasurer increased the state's pension fund's investment with his friend DiBella's firm from $50 million to $75 million. The pension fund's value was approximately $18 billion, *id.* at 558 –so the tainted $25 million increase represented just 0.14% of it. The Second Circuit nevertheless readily upheld the materiality finding for purposes of Section 10(b) (*id.* at 565-66 (emphasis added)):

> A reasonable investor . . . may have viewed the fee arrangement, *as it related to the level of Fund assets invested with Thayer*, as changing the total mix of information, because it tends to show that [the state treasurer] may have been motivated to increase the Fund investment with Thayer not because Thayer was a good investment but only to enrich DiBella.

So too here – a reasonable investor would want to know that Harding bought Norma not because Harding thought it was a good investment, but to benefit Magnetar and Merrill Lynch. As the Court held, in applying *Capital Gains*, "***any transaction** that functions [as] or otherwise results in a fraud is punishable under* Section 206." *Id.* at 569 (emphasis added). The percentages in *DiBella* were significantly smaller than the percentages in RX 879, as were the absolute dollar amounts – $25 million and $525,000 compared to a total of $50 million in client and investor funds that Harding improperly committed to Norma.

Commission precedent is to the same effect. In *Kingsley, Jennison, McNulty & Morse Inc.*, 51 S.E.C. 904, 1993 WL 538935, at *2-*4 (Dec. 23, 1993), an investment adviser's payments of just $31,960 in undisclosed "soft dollar" commissions were held material even though the $31,960 represented less than 1% of total commissions: "because of the fiduciary relationship between an adviser and its client, the percentage or absolute amount of commissions involved is not the sole test of materiality in a transaction between them." *See also Michael R. Pelosi*, Release No. 448, 102 SEC Docket 2808, 2012 WL 681582, at *21 (Jan. 5, 2012) (in proceeding against investment adviser who misrepresented his performance, the Court

"reject[ed] the 1% or 2% test Pelosi argues for, in favor of the more holistic, fact-specific approach adopted by the Supreme Court and Second Circuit." (citing *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162-63 (2d Cir. 2000)), *dismissed on other grounds*, 2014 WL 1247415. That goes for this case too – the Norma purchases represented serious breaches of fiduciary duty even if the other assets in the portfolios did not.

Furthermore, the record showed that *Respondents themselves* considered the Norma investment important – so important that they almost immediately tried to divest it even though Harding rarely traded out of a position. ID 54 (citing Div. Ex. 223, 226).

Further weakening this defense is that the evidence demonstrated Norma was far from the only violative investment in the Norma Recipients' portfolios. Respondents included in the Norma Recipients (and other vehicles) many other CDO securities either without analyzing them, or in disregard of negative analysis. One clear example is Orion, a Magnetar CDO that Respondents repeatedly purchased, and placed into the Norma Recipients (*see* Div. Ex. 6 (column C filtered for ORIN entries); Tr. 1407:6-20) despite Harding's conclusion that the CDO was a bad investment. Huang Tr. 1380:9-1381:3 ("I do recall that particular deal [Orion]. It is one of the deals I think we had a problem with. . . . We had a view, this Orion deal was – had a structure that was bad for investor[s]. . . . I wouldn't recommend it.").[28]

Finally, it is no defense to assert that there was no harm since Norma did not perform worse than CDOs of similar vintage. Resp. Br. 17. Unlike private litigants, the SEC is not

[28] *See also* Resp. Exs. 892 & 893 (Silver Marlin ABS CDO I write-up distributed Feb. 27, 2007) *with* Div. Ex. 6 (Excel row 2725: traded and settled in January 2007); *compare* Resp. Ex. 894 (Adams Square Funding II write-up distributed Feb. 28, 2007) *with* Div. Ex. 6 (Excel rows 2822-2829: trade date Feb. 9, 2007; placed into all four Norma Recipients, among other CDOs); *compare* Resp. Exs. 895 & 896 (Maxim High Grade CDO II write-up distributed March 12, 2007) *with* Div. Ex. 6 (Excel row 2894: trade date Feb. 28, 2007; placed into Neo); *compare* Resp. Ex. 900 (Libertas Preferred Funding IV write-up circulated April 18, 2007) *with* Div. Ex. 6 (Excel rows 2899-2900: trade and settle date in March 2007; placed into Jupiter VI and Neo).

required to prove investor reliance or injury. *E.g.*, *SEC v. Goble*, 682 F.3d 934, 942 (11th Cir. 2012); *SEC v. Pirate Investor LLC*, 580 F.3d 233, 239 & n.10 (4th Cir. 2009); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1363-64 & n.4 (9th Cir.1993); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985); *SEC v. Simpson Capital Mgmt., Inc.*, 586 F. Supp. 2d 196, 201 (S.D.N.Y. 2001).

6. The ALJ's Findings Did Not Rest On False Premises

Respondents' next argument – that the ALJ based his findings on "false premises" – (Resp. Br. 17-22) is also baseless.

First, the defense that not a single witness testified that there was any accommodation to Merrill or Magnetar or that the Norma bonds were bad investments at the time (Resp. Br. 17) is besides the point. Under this theory, unless the wrongdoer admits their guilt under questioning at the hearing, there can be no liability. Of course, reality is different, and most cases depend less on such Perry Mason-like moments and more on building a case through documents, prior testimony, and similar methods. In the case at bar, and as set forth above, liability was established through documentary evidence, including numerous emails, internal Harding documents and analyses, prior testimony, and credibility assessments by the ALJ. There was a more than sufficient basis for the ALJ's determination.

Second, Respondents seek refuge in Harding's agreement to buy A-rated Norma bonds even absent any pressure. Resp. Br. 17-18.Yet, as the ALJ held, this did not exculpate Harding; if anything, it demonstrated that Harding could have been held liable for those purchases in addition to those of the triple-B bonds. The ALJ held not only that the evidence clearly demonstrated that the purchase of the triple-B bonds was a result of pressure, and that Harding would never have purchased them otherwise, it did so even though Harding's own analysis was highly negative. *See, e.g.*, ID 82. That Harding committed to purchase the single-A bonds

without any analysis[29] whatsoever was also found to be problematic. ID 84. The ALJ determined that Harding committed to buying the single-A bonds without conducting any analysis, in violation of its duties as a fiduciary and contrary to representations in the relevant documents, and it purchased the triple-B bonds ***both*** in response to pressure from Merrill and Magnetar, ***and*** in the face of a strongly negative analysis by its own personnel.

Respondents then claim that the ALJ's determination relied upon "rank, unreliable hearsay," in particular, the report (Div. Ex. 217) with a harshly negative review of Norma.[30] This attack is well off-target.

Primarily, Respondents assert that an internal Harding analysis produced by it in the course of its business is unreliable as an indicator of Harding's view of Norma, since it contains a typo: at one point it lists another collateral manager, not NIR. The emphasis Respondents place on this is remarkable, especially considering the analysis was sent to Chau under cover of an email that declared, in its first line, that "Norma CDO I is managed by NIR," the very top of the report states that Norma is "managed by N.I.R. group" and, at the bottom, repeats that Norma was "managed by NIR." Clearly, this *post-hoc* rationalization is nothing but pretextual. Indeed, for all his claims that this analysis was irrelevant, Chau testified that he read CDO commentaries in the ordinary course, and that they were important and reflected "the key points" in Harding's analysis. Chau Tr. 1644:25-1645:23. Huang testified that such commentary was used in the investment decision and that he would expect it to be prepared *before* an investment decision was made. Tr. 1012:21-24, 1014:6-15.

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[29] Chau conceded there is no evidence of any analysis of Norma before Respondents committed to purchase it. Tr. 1642:8-13.

[30] Of course, as the ALJ pointed out, this defense necessarily implies that Harding purchased the collateral without doing ***any*** analysis, which would also be a violation. ID 84.

Next, isolating one datum out of the entire analysis (the figure of 10.17 write-down under the category cash flow/stress runs), Respondents assert that the write-up was misinterpreted to the extent that it was taken as evidence that the bonds were impaired at the time of Harding's decision, and claims instead that it refers to losses in the underlying pools of loans, not the RMBS backed by such loans. Otherwise, it is claimed, the Norma bonds could not have been rated. Resp. Br. 18-19. Yet at the Hearing Chau seemed to admit it referred to Norma's portfolio of RMBS, Tr. 1665:15-1666:12, before switching tack. Tr. 4098:19-23, 4123:14-4124:4. But the latter claim makes no sense, as every metric in that portion of the chart plainly referred to the RMBS, not their underlying loan pools. *E.g.*, Div. Ex. 217 at 1, 3 (referring to the "large *percentage of deals* failing surveillance tests, on the watch list, and on the do not buy list."); *see also* Div. Ex. 203. As the ALJ found, Chau himself said as much, conceding that the only way to analyze a CDO is to look at the actual RMBS securities of which it is comprised, not the thousands and thousands of individual loans underlying those RMBS securities. ID 85 (citing Tr. 4156); *see also* Tr. 4385:24-4386:23. Whether these bonds were rated is irrelevant to the issue of whether or not Harding's own analysis determined that Norma was a very bad buy.

Finally, Respondents' attempt to downplay the obvious import of Harding's email trail of disdain for Norma should also be rejected, in particular the attempt to excuse Chau's desperate effort to unload Norma bonds at a significant loss, only weeks after purchase. On May 22, Chau sent a Bloomberg message to Edward Fitzgerald offering Fitzgerald the single-A Norma notes. Div. Ex. 226. Chau acknowledged that a seller's opening ask is normally above where he expects to transact, yet Chau's *opening* ask was at 87%, a "substantial discount" from the purchase price. Div. Ex. 226; Chau 1690:19-1691:11, 1692:12-1694:8, 1695:20-22. Chau testified that, even

though it was quite rare for Harding to try to sell off securities inside its managed CDOs, "there was a point where I was looking to swap out Norma securities." Chau Tr. 1688:16-1689:17.

Chau has also been consistently unable to explain why Respondents bought Norma, and at one point even seemed to concede that it was a favor to Merrill and Magnetar. Tr. 1676:7-22, 1677:13-21, 2190:16-23; Tr. 4123:8-13. While Chau testified that Harding's analysis of a CDO examined three components, (i) the structure; (ii) the collateral inside the CDO; and (iii) the manager (Chau Tr. 2179:19-2180:8, 2187:11-17), Norma scored poorly on all three. As to structure, Kaplan's cover email and attached write-up noted that the turbo was "not meaningful." Div. Ex. 217 at 1, 3. This was consistent with Chau's original complaint about the turbo, which Chau acknowledged would benefit Norma's equity (owned by Magnetar) at the expense of mezzanine debt investors. Chau Tr. 1648:23-25, 1650:5-25, 1651:25-1652:3, 1652:15-20. Most glaring of all were Harding's conclusions about the low quality of the collateral. The Harding analyst wrote in his cover email and attachment: "There's quite a large percentage of deals failing surveillance tests, on the watchlist and on the do not buy list." As set forth above, Chau conceded these factors weighed against buying a CDO. Nor did the manager have much to recommend it. Chau testified that NIR was "average," Tr. 2183:6-16, and indeed, both the firm and its management team had limited experience managing CDOs and with the relevant types of collateral.

7. <u>The ALJ Did Not Err in Finding A Conflict of Interest</u>

The ALJ held that, *inter alia*, a "conflict of interest claim arose. . . [because] Harding, as a purportedly independent manager, compromised its own standards, i.e., overlooked its negative opinion of those originators to purchase Norma bonds as a favor to Merrill and Magnetar." ID 84 & n.72. Respondents contend that the ALJ erred in finding a conflict of interest that had to be

disclosed to the issuers of the CDOs. Respondents argue that there was no conflict to disclose when Harding was retained by the Issuers and that the findings did not support the existence of any conflict. Resp. Br. 22-25.

The first argument, which is set out without any legal support or reference to the record, asserts that any conflict was "extinguished or was superseded by subsequent events" such as the expiry of warehouse agreements, Harding's pre-closing certification, or Harding's recommendation at the close based on the eligibility criteria. Resp. Br. 23. Harding's failure – at any time – to ascertain the Norma bonds were worth purchasing at any price, especially in light of its own highly negative analysis, cannot be excused merely because Harding determined that the bonds fit within a definitional category, which is what the certification entails. *See* argument at 1(B)(3)(b), above.

The second argument is equally unconvincing, and is based on the claim that there was no evidence of Magnetar pressuring Harding, and that Chau obtained a discounted price for Norma. Neither argument succeeds. First, the record is replete with evidence of Magnetar's pressure. *See, e.g.*, Div. Ex. 199 (Magnetar's Prusko saying he "will personally hammer wing"); Div. Ex. 200; Chau Tr. 1600:25-1602:17; *see also* Prusko Tr. 2643:15-20. Chau conceded that his purchasing Norma's triple-B tranche in response to Prusko's request would benefit Magnetar, at Tr. 1610:4-21:

> Q. To be sure I understand, is it your testimony it might have benefitted Merrill, but it would definitely benefit Magnetar?
> A. Yes.
> Q. And you knew that at the time?
> A. Yes.

Nor is there any evidence that Chau did any price negotiation,[31] and even if he did, the fact is that there is nothing in Harding's analysis to justify the purchase of Norma at ***any*** price – a fact demonstrated when, shortly after purchase, Harding couldn't even dump Norma at a substantial loss. *See* Chau Tr. 1688:16-1689:17. *See also* Div. Exs. 223, 226, 228, Chau 1690:19-1691:11, 1692:12-1694:8, 1695:20-22.[32]

8. The ALJ Did Not Misapprehend the Relevant Deal Documents

Finally, Respondents contend that the ALJ erred in interpreting the relevant deal documents. They assert that there was no misrepresentation to investors, and that the only issue was the standard of care set out in the collateral management agreement. They claim that the prospective nature of the CMA excluded the conduct at issue, and thus that there was no

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[31] The revised confirmation to Harding on February 2 (Div. Ex. 212) indicates that the class Es would be sold at 97% of face value (as opposed to 100.00, or par), with a discount margin ("dm," equivalent to spread or coupon) of 505 basis points ("+505") above 3-month LIBOR ("3mL"). (Chau explained the notation at Tr. 1643:21-1644:2, 4126:23-4127:5.) That is to be compared to 440 basis points above 3-month LIBOR ("3mL+440"), which is where the Norma BBBs priced *and where Harding agreed to acquire them. See* Div. Exs. 212, 207. It was not Harding that brought the price down to 97 (*i.e.*, that increased dm from +440 to +505). Rather, a different firm, United Capital, or UCM, extracted that concession from Merrill through negotiations on January 31 and February 1. *See* Resp. Ex. 839 at 1 (Merrill email noting "DM for Norma is 505.3," following acceptance of UCM's bid at 97.00 on the BBBs). Also, as Wagner explained, the discounts at issue would not have been considered especially impressive, particularly in light of Respondents' failure to analyze whether the discount would compensate for the problems with Norma. Wagner Report ¶¶ 169-170.

[32] Respondents attempt to bolster their claim that no conflict existed by referring to Division witness Ken Doiron, an Octans I investor who was a collateral manager for his firm, HIMCO. Relying on his example of not having to disclose to investors pressure from his CDO's underwriter, even though its interests differed from investors, Respondents claim they too had no obligation "simply because Merrill suggested and succeeded in getting one bond into two other deals that it structured." Resp. Br. 28. Yet there is one stark difference which makes this comparison inapplicable: unlike Harding, Doiron's firm ***resisted*** that pressure to select assets they disfavored, and Doiron confirmed that it was improper to act unless "you are doing the analysis that you say you are going to do." *See* Doiron Tr. 1991:21-1991:9; 1993:17-20; 1934:12-25 (HIMCO would not approve assets suggested by underwriter unless HIMCO's analysis supported the purchase); 1997:2-11.

obligation to the issuer during the warehouse period. Further, they contend that the issuer was fully apprised, and finally, that Harding complied with the CMA in that it selected eligible securities, and that nothing more was required.

First, there is no basis to the claim that the standard of care representation applied only after each respective CDO closed, and thus could not govern conduct during the warehouse period. (Resp. Br. 25-26). (It is telling that Respondents offer no case law in support of this contention.) The standard of care applied to *all* "obligations [under the CMA] (including with respect to any exercise of discretion)." Div. Exs. 504 at 7 (888 Tactical CMA); 506 at 7 (Lexington Capital CMA); 510 at 8 (Neo CMA); 512 at 7 (Jupiter CMA). One of those (discretionary) obligations was to "*select all Collateral to be Acquired by the Issuer.*" Div. Exs. 504 at 4; 506 at 4; 510 4; 512 at 4.

It is thus clear that Harding's obligations extended to the transfer of assets from the warehouse: indeed, the CMAs included as anticipated "services" of Harding "effecting the acquisition or disposition" of securities "to be purchased by the Issuer on the Closing Date." Div. Exs. 504 at 3; *see also* at 4-5 (stating that Harding, as agent of issuer, would determine "specific" securities "to be acquired"); 506 at 3-5; 510 at 4-6; 512 at 3-5. *See also* Div. Exs. 504 at 4 (requiring that asset selection be in accordance with the "investment criteria set forth herein"; 506 at 4; 510 at 4, 512 at 4. Accordingly, one of Respondents' first acts was advising the issuer on the transfer of the warehouse assets, and thus the standard of care section of the CMA applied to the issuer's purchase of warehouse assets, as well as assets purchased or disposed after the date of the CMA.

On the closing date, having been appointed as Collateral Manager, and clothed in the status of investment advisor, Harding advised the Issuer to acquire the warehoused collateral, but

without disclosing that its analysis had been grossly non-compliant with the standard of care, violating both the Securities and Advisers Acts.

Second, the defense that the issuers had all the relevant information about Norma (Resp. Br. 26-28) also fails. This is based on the claim that since Merrill, the creator of the CDOs, knew all relevant information, their creation, the CDOs, also had to know. Of course, this attempted end-run around Harding's fiduciary duty ignores the fact that Merrill had no knowledge of the most relevant fact – that Harding purchased the Norma assets either having done no analysis (the single-A bonds) or after having analyzed and found them severely wanting (the triple-B bonds), and in doing so, violated the applicable standard of care and its fiduciary duty.[33] *See also* ID 73.

Third, the claim that Harding's satisfaction of the relevant eligibility criteria satisfied its obligations under the CMA fails for the reasons set forth above at I(B)(3)(b).

Finally, the defense that Harding had no fiduciary duty to its advisory clients fails. (Resp. Br. 29-30). Leaving aside the fact that one cannot legally disclaim a fiduciary duty,[34] each of the CMAs expressly "appoints the Collateral Manager as [the Issuer's] ***investment advisor*** and manager with respect to the Collateral on the terms set forth herein," (*e.g.*, Div. Exs. 504 at 3, 17; 506 at 3, 18; 510 at 4, 19; 512 at 3, 18) and there is (or should be) no serious dispute that the CMAs were advisory agreements. *See* Div. Ex. 122 at 6 ("Advisory Agreement" section of Harding compliance manual); *see also id.* at 4, 24 (affirming that "[a]s a registered adviser, and as a fiduciary to our advisory clients, our firm has a duty of loyalty and to always act in utmost good faith, place our clients' interests first and foremost and to make full and fair disclosure of

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[33] Respondents' argument depends entirely on mischaracterizing the violation as relating solely to the quality of the Norma bonds, when instead it relates to Harding's failure to adhere to its internal standards and the standard of care in selecting the bonds without the requisite analysis. On the latter, there was no evidence that anyone outside Harding was aware of its failings.
[34] Section 215(a) of the Advisers Act voids any contract provision that purports "to waive compliance with any provision of" the Advisers Act.

all material facts and in particular, information as to any potential and/or actual conflicts of interests."); Wang Tr. 301:3-17. Further, each of the CMAs expressly affirms that Harding as collateral manager is subject to the Advisers Act. *E.g.*, Div. Exs. 504 at ; 506 at 6 ("The Collateral Manager shall take all action required . . . to be taken by it under the Investment Advisers Act of 1940.").[35]

III.

PURPORTED CONSTITUTIONAL AND STATUTORY VIOLATIONS

Respondents' challenges to the administrative process fail.

C. The ALJ Properly Presided Over the Hearing

Respondents argue (Br. 31-33) that the hearing was void because it was not held before an "officer ... of the Commission," *e.g.*, 15 U.S.C. § 77u, as required by the federal securities laws under which Respondents were charged. They maintain that the SEC has not treated ALJs as officers of the United States under the Constitution's Appointments Clause, U.S. Const. art. II, § 2, cl. 2, and, therefore, that the ALJs must not be "officers of the Commission" within the meaning of the federal securities laws.

Respondents' argument fails because there is no indication that Congress intended "officers of the Commission," 15 U.S.C. § 77u, to be synonymous with "Officers of the United States," U.S. Const. art. II, § 2, cl. 2. The Supreme Court has recognized that the category of

[35] Even outside the fiduciary context, Respondents, having chosen to speak on the standard of care, would have been obligated to make a *complete* disclosure – which would include the self-evidently important fact that the standard had been grossly violated in the ramp. *In re Morgan Stanley Info. Fund Secs. Litig.*, 592 F.3d 347, 365-66 (2d Cir. 2010); *In re GLG Life Tech Corp. Secs. Litig.*, 2014 WL 464762, at *4 (S.D.N.Y. Feb. 3, 2014) ("'once a party chooses to speak, it has a "duty to be both accurate and complete."'" (quoting *Caiola v. Citibank, N.A.*, 295 F.3d 312, 331 (2d Cir. 2003))). In addition, Respondents were required to act in their client's best interest, and were prohibited from putting their own interests ahead of those of their client. *E.g.*, *SEC v. Moran*, 922 F. Supp. 867, 895-96 (S.D.N.Y. 1996) (Section 206 requires "investment advisers to act for the benefit of their clients," and "to exercise the utmost good faith in dealing with" them).

"Officers of the United States" for Appointments Clause purposes is not coterminous with that of "officers" for statutory purposes. In *Free Enterprise Fund v. Public Company Accounting Oversight Bd.*, 561 U.S. 477 (2010), the Supreme Court held that the members of the PCAOB were inferior officers under the Appointments Clause, *see* 561 U.S. at 510, even though the Court acknowledged that Congress had expressly declared that Board members were "not considered Government 'officer[s] or employee[s]' for statutory purposes," *id.* at 484 (quoting 15 U.S.C. § 7211(b)).

Moreover, a dictionary in use when the Securities Act and the Exchange Act were enacted defined the term "officer" to mean "[o]ne charged with a duty; an agent; a minister" or "[o]ne who holds an office," specifically "[a] person lawfully invested with an office, whether civil, military, or ecclesiastical, and whether under the state or a private corporation or the like." *Webster's New International Dictionary* (2d ed. 1934). Consistent with these broad, functional definitions, a federal court decision involving an early challenge to a Commission proceeding under the Securities Act alternatively referred to the hearing examiner—the precursor of an ALJ—as "an employee of the commission," an "officer[] of the commission," and "one of [the Commission's] attorneys." *SEC v. Jones*, 12 F. Supp. 210, 215 (S.D.N.Y. 1935) (finding it "manifest" that use of an attorney to conduct a hearing was proper given that Congress directed the Commission "to perform a great mass of duties" and gave the Commission broad latitude in using various "agents" "to assist in the discharge of those duties"), *aff'd*, 79 F.2d 617 (2d Cir. 1935), *rev'd on other grounds*, 298 U.S. 1 (1936). Similarly, the Administrative Procedure Act "consistently uses the term 'officer' or the term 'officer, employee, or agent'" to "refer to [agency] staff members." Kenneth Culp Davis, *Separation of Functions in Administrative Agencies*, 61 Harv. L. Rev. 612, 615 & n.11 (1948) (citing Nathaniel L. Nathanson, *Some*

Comments on the Administrative Procedure Act, 41 Ill. L. Rev. 368, 390 (1946)). Therefore, it is plain that ALJs are "officers of the Commission" within the meaning of the federal securities laws, and there is no inconsistency in their also being government "employees" for purposes of Article II of the Constitution.[36]

D. The Commission's Administrative Enforcement Scheme Does Not Violate Due Process

Many administrative agencies, including the Commission, authorize enforcement proceedings and, after an evidentiary hearing and review of the complete record, determine whether the law has been violated. *See* Stephen G. Breyer et al., Administrative Law and Regulatory Policy 917 (5th ed. 2002) (noting that "most commissions both issue the complaint that initiates the hearing process and decide the resulting case on appeal"); *see also* 5 U.S.C. § 554(d)(2)(C) (contemplating that agency heads will perform both prosecutorial and adjudicatory functions). Respondents contend (Resp. Br. 33-34, 36) that the entire administrative proceeding is constitutionally infirm because "the Commission, directly and through its employees," performs these functions. But it is well established that this arrangement—pervasive among administrative agencies and commissions—does not violate due process.

The Supreme Court has long rejected "[t]he contention that the combination of investigative and adjudicative functions necessarily creates an unconstitutional risk of bias in

[36] There is no support for Respondents' bald assertion (Resp. Br. 33 n.31) that if ALJs are "officers of the Commission" under the federal securities laws for purposes of presiding over a Commission administrative proceeding, then they must also be "inferior officers for Constitutional purposes and their appointments would violate the Appointments Clause of Article II of the Constitution." *See Landry v. FDIC*, 204 F.3d 1125, 1132-34 (D.C. Cir. 2000) (holding that ALJs are employees, not constitutional "officers"); *Free Enterprise*, 561 U.S. at 507 n.10 (explaining that its decision that limitations on removal of PCAOB members violated Article II "does not address that subset of independent agency employees who serve as administrative law judges," as "unlike members of the [PCAOB] . . . [they] perform adjudicative rather than enforcement or policymaking functions . . . or possess purely recommendatory powers").

administrative adjudication." *Withrow v. Larkin*, 421 U.S. 35, 47 (1975); *see also Shaughnessy v. United States ex rel. Accardi*, 349 U.S. 280 (1955) (upholding deportation scheme in which agency head performs both prosecutorial and adjudicative functions); *Richardson v. Perales*, 402 U.S. 389, 410 (1971) (upholding Social Security Administration system in which ALJs both investigate and decide claims); *Cousin v. Office of Thrift Supervision*, 73 F.3d 1242, 1250 (2d Cir. 1996) ("the mixing of investigatory, prosecutorial, and adjudicative functions" in an agency does not violate due process); *Wright v. SEC*, 112 F.2d 89, 94 (2d Cir. 1940) (same).

Rather, as the Court has made clear, due process challenges to the blending of prosecutorial and adjudicative functions in administrative agencies "must overcome a presumption of honesty and integrity in those serving as adjudicators" and must "convince that, under a realistic appraisal of psychological tendencies and human weakness, conferring investigative and adjudicative powers on the same individuals poses . . . a risk of actual bias or prejudgment." *Withrow*, 421 U.S. at 47. The appropriate due process inquiry thus is not whether the Commission plays a role at multiple stages of this administrative proceeding but rather whether the Commissioners' minds are "irrevocably closed" to the evidence, *FTC v. Cement Institute*, 333 U.S. 683, 701 (1948), or "the risk of unfairness" in the proceeding is otherwise "intolerably high," *Greenberg v. Board of Governors of Federal Reserve System*, 968 F.2d 164, 167 (2d Cir. 1992) (internal quotation marks omitted).

Respondents have failed to make such a showing here. To the extent they complain about the supposed unfairness of the proceeding stemming from adverse determinations by the ALJ (*see* Resp. Br. 34-35 & n.33), Respondents ignore that the Commission conducts *de novo* review of the ALJ's initial decision and may reach different conclusions on the disputed issues. *See* 17

C.F.R §§ 201.360(d), 201.411, 201.452.[37] But even if all of the adverse determinations about which Respondents complain *could* be attributed to the Commission – on Respondents' theory that ALJs necessarily do the Commission's "bidding" (Resp. Br. 34)[38] – Respondents still have not overcome the "presumption of honesty and integrity" of the adjudicators. *Withrow*, 421 U.S. at 47. They cite none of the factors on which courts rely when finding due process violations, namely that decision-makers have unequivocally prejudged the issues, have a financial interest in the outcome, or have "been the target of personal abuse or criticism from [a] party." *See id.* at 47 & nn. 14, 15, 16.

Finally, to the extent Respondents' argument can be construed as a facial due process challenge to the structure of the Commission's administrative enforcement regime (and those of other agencies), such a claim also must fail. As noted above, the Supreme Court has specifically rejected such arguments and has never suggested, let alone held, that an adjudicatory regime may be deemed unconstitutional because its prosecutorial and adjudicatory functions were

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[37] In particular, Respondents contend that the ALJ precluded them from developing their constitutional claims by denying Respondents' request to issue, in the midst of the hearing, subpoenas to the Division's trial team regarding the team's reasons for bringing the enforcement action in an administrative forum. But such a complaint – regarding the denial of a subpoena request – is irrelevant to Respondents' claim that the agency head should not be permitted to both authorize and adjudicate an enforcement action. Moreover, even if Respondents were correct that the ALJ erred in denying their request, such error can be cured by the Commission itself, which may order additional record development. *See* 17 C.F.R. § 201.452; *In the Matter of John Thomas Capital Management Group LLC*, Exchange Act Release No. 74345, slip op. at 6 & n.22 (Order Denying Mot. to Stay Admin. Proceeding, Feb. 20, 2015), available at http://www.sec.gov/litigation/opinions/2015/33-9728.pdf (discussing application of Commission Rule of Practice 452). And, in any event, a court of appeals may reverse the Commission's decision and direct the Commission to supplement the record as appropriate. Respondents also ignore other procedural safeguards built into the administrative enforcement scheme. Most notably, employees engaged in investigative or prosecutorial functions in a given proceeding are prohibited from aiding the Commission in making its final decision in that or any related case. 5 U.S.C. § 554(d); 17 C.F.R. § 201.121.

[38] Contrary to Respondents' suggestion (Resp. Br. 33-34), the Commission does not "choose" the ALJ that presides over each enforcement proceeding; rather, the Chief ALJ "select[s] . . . the [ALJ] to preside" over each case. 17 C.F.R. § 201.110; *see also* 5 U.S.C. § 3105.

insufficiently separated. *See* Richard J. Pierce, Jr., 2 *Administrative Law Treatise* § 9.9 p. 889 (2010 5th ed.); *Withrow*, 421 U.S. at 47. Moreover, that the Court has sanctioned the structure of enforcement schemes like the Commission's is hardly surprising, as a contrary holding – *i.e.*, that it violates the Constitution for an agency head to both initiate and adjudicate enforcement proceedings – would potentially undermine the "incredible variety of administrative mechanisms in this country" that provide administrative agencies with the flexibility to perform their multiple functions. *Withrow*, 421 U.S. at 49-50, 52.[39]

CONCLUSION

The Division respectfully submits that the ALJ's determinations that were the subject of Respondents' appeal were correct, and should stand.

Dated: May 8, 2015

Respectfully Submitted,

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[39] Respondents allege that there were numerous "due process violations to which they were subjected in connection with the [pending enforcement action]," noting that the specifics of their complaints are "detailed in [their] filings in the related district court actions." Resp. Br. 37 n.34. The Division disputes that any such violations occurred but will wait to address the substance of these claims until they are further developed in the supplemental briefing ordered by the Commission on April 30, 2015.