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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of **HARDING ADVISORY LLC and** **WING F. CHAU,** **Respondents.**	Administrative Proceeding File No. 3-15574

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RESPONDENTS' OPPOSITION TO DIVISION'S APPEAL OF THE INITIAL DECISION

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<u>**OCTANS**</u>

I. INTRODUCTION.

The Division's claim that the ALJ erred by not finding liability for failure to disclose Magnetar's participation in the Warehouse Agreement ("WA") is meritless. Most fundamentally, the OIP simply does not charge failure to disclose Magnetar's participation in the warehouse as a stand-alone violation. Rather, the OIP charged that failure to disclose Magnetar's participation in the warehouse was part of a scheme to hide the fact that Magnetar had a role in asset selection *and* had an economic incentive to choose bad assets. (*See* OIP at ¶¶ 2, 5, 25, 59; ID at 57 (*citing* Tr. 1086-88, 1111-12).) But the ALJ specifically found that there was no scheme of any kind (ID at 66, 78-80), that Magnetar's interests were aligned in relevant respects with those of other investors (*Id.* at 75-77 (*citing* Tr. 2225, 2333-39, 2390, 2483-84; RX 493), 89), that Magnetar did not exercise its WA rights even a single time, that is to say that Magnetar did not add or eliminate even one specific asset during the warehouse period (*See id.* at 78), and that the ABX Index trade was beneficial to the deal as a whole and was understood by Magnetar and Harding *at the time* to be so (*Id.* at 77). In other words, these specific findings (among others) demonstrate conclusively that the failure to disclose Magnetar's participation was immaterial as a matter of law. Indeed, even absent the ALJ's findings, under the Commission's own materiality analysis set forth in a proposed rule release relating to prohibiting certain conflicts of interests in connection with securitizations, it is clear that there was nothing material about Magnetar's involvement. *See generally* Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. 60320, 60339 (Sept. 28, 2011) (to be codified at 17 C.F.R. pt. 230), available at http://www.gpo.gov/fdsys/pkg/FR-2011-09-28/pdf/2011-24404.pdf (hereinafter, the "Rule 127B Release"). It was also immaterial as a matter of proof: all investors who provided testimony in this case uniformly agreed that Magnetar's participation in the warehouse was not material to them. *See infra* at 13-16.

II. THE OIP ALLEGATIONS DO NOT SUPPORT A FRAUD CHARGE.

The OIP alleges that Harding put its own interests in securing business from Magnetar and Merrill ahead of the interests of Octans' investors and that, to accommodate Magnetar, Harding compromised its asset-review standards. (*See* OIP ¶¶ 6, 8.)[1] Failing to do its usual review and analysis rendered false certain representations about its asset selection practices and comportment with the industry standard of care. (*See* OIP ¶¶ 6, 58.) The reason these allegedly false statements were material and constituted a fraud, according to the OIP, was that Magnetar was planning to take short positions on certain of Octans tranches and, therefore, Magnetar's motivation for asset selection did not align with the interests of other investors. Here is the relevant materiality allegation:

> These misrepresentations and omissions [about asset review processes and comportment with the industry standard of care] were material. Investors in the securities of Octans I *would have considered it important* that an *undisclosed* party with *interests not aligned* with those of the other investors had influence over or rights regarding collateral selection.

(OIP ¶ 59) (emphasis added.)

This allegation fails as a matter of law. First, a mere misalignment of interests among investors in a CDO is unexceptional and is a natural result of the economic differences among

[1] In one paragraph of his decision, the ALJ states that "[t]here is evidence that Harding compromised its standards to accommodate Merrill" (ID at 74 (relying on DX 224)). Division seizes on this sentence for dear life to attempt to show that Harding was conflicted. But as Division well knows, the exhibit as to which the ALJ made that observation has nothing to do with Harding's credit review process. In fact, as Division also knows, the ALJ plainly misread the import of the relevant email exchanges. (DX 224.) This email exchange dates from late April 2007, long after Octans closed and several months after Harding selected the Norma bonds (DX 224.) The entire email chain is about Moody's requiring certain changes in the composition of the portfolio of assets for Jupiter 6. (*Id.* at 2-3). The rest of the email is Harding employees expressing their opinion about Merrill's solution to this issue, *i.e.* removing certain assets versus others that had been previously selected by Harding in order to meet the new WARF. (*Id.*) This email has nothing to do with Harding compromising its credit process.

the different tranches of the CDO. *See* Rule 127B Release at 60328 ("multi-tranche structures commonly used in ABS offering . . . may involve conflicts between the interests of various classes of investors in the offering by virtue of the different risks and rewards associated with such tranches."). Indeed, as we have argued elsewhere,[2] and as Harding's lawyer on the Octans transaction testified,[3] a collateral manager may not be a fiduciary of the holders of several classes of CDO investors – or of the CDO itself – because of this misalignment and potential divergence of interests. *See Goldstein v. SEC*, 451 F.3d 873, 881 (D.C. Cir. 2006) ("If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest.").[4] The OIP's allegation that Magnetar's interests were "not aligned" is unremarkable and cannot serve as a predicate to a fraud charge.

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2 Respondents' Pre-Hearing Brief ("Resp'ts Pre-Hearing Br.") at 30-31 (Mar. 26, 2015); Respondents' Post-Hearing Memorandum of Points and Authorities ("Resp'ts Post-Hearing Mem.") at 143-145 (Aug. 20, 2014); Respondents' Opening Brief in Support of Their Petition for Review ("Resp'ts Br.") at 29-30 (Apr. 1, 2015).

3 (Suh 3053:13-3054:21; 3048:2-3049:6.)

4 As we have argued repeatedly, to the extent the theory of liability here is predicated on misalignment of interests, as opposed to a conflict of interests, it is also inconsistent with the Commission's position in *SEC v. Tourre* where the Commission argued to the jury and the federal district court that the participation of the hedge fund (Paulson & Co.) in the creation of a CDO, ABACUS 2007-AC1, was material because its interests were *adverse* to – as opposed to being merely misaligned with – the interests of the other investors. (*See, e.g.*, RX 128 at Tr. 2564:14-24; 2744:24-2745:19 (SEC's Summation and Rebuttal Summation in *SEC v. Tourre*); RX 858 at ¶¶ 22-26, 35, 38-40 (Initial Expert Report of Ira Wagner in *SEC v. Tourre*). As we argued before, Division should be judicially estopped from propounding this inconsistent theory. (*See, e.g.*, Respondents' Reply Brief in Support of Motion for a More Definite Statement ("Resp'ts Reply Br.") at 3-16 (Feb. 3, 2014); Resp'ts Post-Hearing Mem. at 291-292, 337.) Note that the Commission's conclusion that conflicts among tranches of CDOs are not prohibited despite their misalignment of interests was made with the *Tourre* case in mind; the transaction at issue in that case was specifically referenced as an impetus to the prohibitions contained in the Rule 127B Release (*see* Rule 127B Release at 60323, 60324 n. 38).

It is further notable that in the *Tourre* case, Wagner, as Commission's expert, took the position that, under virtually the same circumstances, Magnetar's rights in another warehouse for a deal similar to Octans did not have to be disclosed. Briefly, in *Tourre*, the defense argued that Paulson's role in the Abacus warehouse was unexceptional because the Abacus collateral manager, ACA Management LLC, did a deal with Magnetar, ACA Aquarius 2006-1 Ltd., in which Magnetar had warehouse veto rights. (*See* RX 858 at 14-16.) Wagner responded, in part, by noting that having risk in the warehouse gave the party with a veto the economic incentive to veto the accumulation of risky assets. (*Id.* at 15-16 ¶ 24.) He then added that "Magnetar, like UBS [the Merrill equivalent in that deal] at most had veto rights and that [the relevant witness] could not recall any exercise of those rights by either Magnetar or UBS, or any other specific input Magnetar had on the portfolio." (*Id.*) If having rights in the warehouse is a material fact that must be disclosed regardless of whether those rights had been exercised, Wagner's observation quoted

Second, this allegation falls well short of alleging materiality, because it states only that investors in Octans would have found the representations *important*. As the Division of Enforcement should be aware, the fully-articulated materiality standard is whether there was "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See In the Matter of Feeley & Willcox Asset Mgmt. Corp.*, Advisers Act Release No. 2143, 2003 WL 22680907, *9 (July 10, 2003) (citing the standard articulated by the Supreme Court in *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (*quoting TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). In other words, even if Division proved that Octans' investors would have found the omitted information merely important, it would not have proven fraud.

III. MAGNETAR'S PARTICIPATION IN THE WAREHOUSE WAS NOT MATERIAL UNDER THE COMMISSION'S OWN ANALYSIS.

Applying the correct standard, the Commission's own analysis of conflicts under similar circumstances leads to the conclusion that Magnetar's participation in Octans was immaterial. As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), the Securities Act of 1933 was amended to include Section 27B, which generally prohibits certain persons involved in the structuring, creation, and distribution of an asset-backed security ("ABS") from engaging in transactions within one year after the date of the closing of the ABS that would involve or result in a material conflict of interest with respect to any investor in such ABS. *See* Rule 127B Release at 60320. However, Section 27B also provides exceptions from this prohibition for certain risk mitigating hedging activities, among other things. *Id.*

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above was a misleading *non sequitur*. In other words, it was the position of Division and the SEC in *Tourre* that, at a minimum, no warehouse rights needed to be disclosed if, as here, they were not exercised.

In 2011, the Commission released a proposed rule implementing this new section ("Proposed Rule 127B"). Along with Proposed Rule 127B, the SEC provided certain pre-rulemaking comments. Among these comments, the Commission opined that it had determined preliminarily that a situation in which a third party (such as Magnetar) to an ABS deal (such as Octans) had selected assets for the ABS transaction, purchased one or more securities in that transaction, and also hedged its securities purchases by entering into a credit default swap on the relevant ABS to offset its exposure to the ABS, would not present a material conflict of interest where, as here, the third party would not profit more from its short position than it would from its long position. Rule 127B Release at 60339.

Specifically, the purpose of the Rule 127B Release was to identify material conflicts of interest, and the Commission predicated its materiality analysis on the formulation set forth in *Basic*, 485 U.S. at 231-32 and *TSC Industries*, 426 U.S. at 449 that a conflict is material if there exists a "'substantial likelihood' that a 'reasonable' investor would consider the conflict important to his or her investment decision . . . ." Rule 127B Release at 60329. With that in mind, the Commission considered under what circumstances risk-mitigating hedging activities would or would not be material, such that they could be allowed by the Proposed Rule. *Id.* at 60333-34.

Noting that the risk-mitigating activities must be *bona fide*, *i.e.*, that they have to be tied to a specific risk exposure and should adjust over time so that the overall position remains delta neutral (*id.* at 60334, 60337-39), the Commission considered a specific example in which an investor who was allowed "to select the composition of the assets that underlie an ABS" also purchased credit default swap ("CDS") protection on the relevant assets "to reduce or hedge their exposure" to these assets. *Id.* at 60339. In this example, the Commission stated that its preliminary view was that this type of risk-mitigating hedging did not present a material conflict of interest, unless the relevant investor would gain more from its short positions on the relevant deal than it would lose from its long position in the deal. *Id.* Significantly, if this situation did not present a material conflict within the framework of *Basic* and *TSC*, not only would the hedging be permitted, but there would be no need to make any disclosures.

As discussed above, the ALJ specifically found that Magnetar was never net short in Octans. (ID at 76-77.) In fact, as noted, the ALJ found that Magnetar's participation in asset selection was not improper, inured to the benefit of all investors, and fit perfectly within what the Rule 127B Release deems not to be material. Here is a summary of his findings:

> The OIP alleges that Magnetar's interests in Octans I "were not aligned" with those of the debt investors of Octans I, but the OIP does not specify how those interests were misaligned. OIP at 2. The Division specifies in its post-hearing brief that "Respondents clearly understood . . . that Magnetar's strategy entailed simultaneously investing in, and *betting against* the performance of, the CDOs that Magnetar helped to create." Div. Br. at 19 (emphasis added). The evidence does not support this contention.
>
> (ID at 75.)

He found that Magnetar was not even fully hedged. (*Id.*) It was never in a position to gain more from its shorts on Octans than it did on its equity investment. (*Id.*) Magnetar sought to remain market neutral (or delta neutral) (*Id.*) (*See also* Prusko 2338:19-2339:4). Magnetar also adjusted some of its hedges in Octans in the fall of 2006 and also all of its hedges in 2007 in response to the softening of the market. (*See* DX 248A; Prusko 2359:4-2360:9.)[5] There can be no

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[5] In the spring of 2006, Magnetar expected to earn approximately a 20% return on its long CDO investments over an eight-year period. (*See* RX 493 ("We will have a massively positive carry axe (24% irr) for the next 8 years."); Prusko 2335:15-2338:18.) (The length of the investment was based on the expected average life of the CDO in which Magnetar bought equity. Because Prusko testified that they expected "20 some percent" return on its long equity investment rather than the 24% from the contemporaneous e-mail, we are using the more conservative number of 20% in our calculations.) Magnetar expected the cost of its hedges to reduce that return by approximately 3%, leaving Magnetar with an expected return of 17% a year, each year for that entire period of time. (Prusko 2335:15-2338:18.) Specifically in the case of Octans, which was expected to have a life of approximately six years, therefore, Magnetar expected to earn just shy of $96 million net of the cost of its hedges. ($94 million x .17 x 6 =

dispute that the record in this case supports but one conclusion: as the ALJ found, Magnetar's hedging of Octans was *bona fide* and, therefore, its participation in asset selection, in whatever form, was not material and did not have to be disclosed. (*See* ID at 75-77.) In other words, even if, contrary to the evidence and ALJ's findings, Magnetar actually selected some of the assets for Octans, its participation in the deal did not create a material conflict of interest because it never stood to gain more from Octans failure than it did from its expected performance.[6]

IV. CONTRARY TO DIVISION'S ARGUMENTS, THE RECORD DOES NOT SUPPORT EVEN A FINDING THAT RESPONDENTS THOUGHT MAGNETAR'S INTERESTS WERE MATERIAL.

Division does not challenge the ALJ's factual findings described above, and thus, the inquiry should end here. However, Division, in its opening brief, invites the Commission to overturn the ALJ's findings based on a tortured reading of other parts of the record and the law. Namely, Division argues, in turn, that: (1) Harding accommodated Magnetar's interests; (2) Chau understood that Magnetar's influence created a conflict of interest and (3) Respondents were ultimately responsible for the statements in the Pitch Book ("PB") and the Offering

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$95,880,000.) In sum, Magnetar had approximately $190,000,000 at risk on its long position in Octans ($94 million out-of-pocket equity purchase expense plus approximately $96 million representing expected return over the life of the deal net of the cost of its hedges). Magnetar hedged its long position by shorting certain tranches of Octans' capital structure. These hedges never exceeded $48 million in notional value and were accumulated over time. (*See* DX 248A.)

6 The ALJ, in another section of the ID, stated that "[t]he omission of Magnetar's involvement in the warehouse was inaccurate" and "that a third party had the ability to interfere with Harding's selection of collateral for Octans is surely something that would have been material to a reasonable investor." (ID at 68-69.) However, in light of the other ALJ's findings about Magnetar's participation, his finding of materiality is incongruent. The only seeming explanation for this materiality finding–at odds with the rest of the decision–is that the ALJ, as an employee of the SEC, felt compelled to find materiality in light of the Commission's earlier findings in the settled order *In the Matter of Merrill, Pierce, Fenner & Smith Incorporated*, Release No. 71051, File No. 3-15642, Order Instituting Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-And-Desist Order at ¶¶ 38-39, 41 (Dec. 12, 2013) (RX 129). One hopes that consistent with the statement in the settled order that the "findings herein . . . are not binding on any other person or entity in this or any other proceeding," the Commission has not prejudged this matter and does not itself feel constrained by the findings in that Order. (*See id.* at 2, n. 1).

Circular ("OC") about the WA. None of these assertions stand up. We address these in order below:

A. Harding Did Not Think It Was Giving Into Magnetar.

Division asserts that, "[t]he evidence showed that Magnetar had special rights and privileges that no other investor had, and that Harding acted to accommodate Magnetar's desires." (Appeal of the Division of Enforcement ("Div. Br.") at 16 (April 1, 2015).) In light of the discussion above, this observation is immaterial, even if true. But it is not true: Division misstates the record. Division predicates this argument largely on its claim that Lieu conceded that Magnetar controlled the ABX Index trade. This is a desperate reach that fully exposes Division's utter failure of proof on this issue.

As background, and as Division is well aware, the execution of the ABX Index trade was novel and complex and required multiple explanations by Magnetar. (*See, e.g.*, DX 19; Prusko 2441:14-2442:3; Chau 4285:11-18; Lasch 150:7-151:5.) It entailed a multi-step trade whereby the warehouse would go long the entire index itself and would short out the assets the manager did not like. (*Id.*) The net effect of the trade would be that the warehouse would be long only the remaining component assets of the index. With this as backdrop, contrary to Division's assertion, Lieu did not testify that Magnetar "had control" with regards to the ABX Index. (Tr. 3355:2-13.) Here testimony related to *the execution* of the ABX Index trade, not the choice of the component assets of the index to which the deal would be exposed. (*Id.*) The passage Division points to here – as Division well knows because it has tried this legerdemain repeatedly with this and other examples and Respondents repeatedly have had to address it – is *about the mechanics* of executing the trade, not about Harding's selection of the assets. In her investigative testimony, improperly cited by Division as evidence in the Hearing, Lieu testified that Magnetar had some control over how the ABX Index trade would be ***executed*** after Harding had selected the relevant ABX Index assets. (Tr. Lieu 3354:16-3355:13 ("Q. Was it your understanding that Magnetar had some control over the ***execution of trades*** involving the ABX index? A. Yes.").

Likewise, in another attempt to convert innocuous evidence into something sinister, Division misstates Chau's prior investigative testimony that "debt investors were never told about the index trade . . ." (Div. Br. at 17.) This is yet another misleading canard born out of absence of actual evidence of misconduct. Throughout the Hearing, Division tried to insinuate that Harding hid the ABX Index trade and that investors did not want to see the Index in the deal. In light of the ALJ's finding that the ABX Index trade was beneficial to the deal (ID at 56-57, 92) and the assets were not adversely selected (ID at 57 (citing Tr. 1086-88, 1111-12), no disclosure was required; investors did not need to be warned about something that was good for them. *See* Rule 127B Release. In any event, the relevant issue is that investors did not want to see collateral managers populate their deals with the *entire* index on the theory that if they wanted exposure to the entire index, they could get that exposure directly without the intermediate step of buying CDO bonds. (Chau 4291:17-4294:9) Where, as here, collateral managers chose some subset of the index and obtained exposure to the bonds at better spreads because they obtained that exposure though an index trade, the market perceived that as very beneficial. (*Id.*)

With this as context, Chau's actual prior testimony was that he did not recall any specific discussions about the ABX Index. (Tr. 2158:14-2160:5.) Failure to recall a discussion years prior does not mean it did not happen. But there was no reason and no way for Chau to hide the ABX Index either; and he did not. The evidence demonstrated that the investors: (1) received a copy of the portfolio prior to investing, which included the ABX Index assets;[7] (2) were familiar with the ABX Index and its constituent assets;[8] (3) conducted their own due diligence or credit review on these assets;[9] and (4) did not view the ABX Index assets as anything different than the rest of the subprime universe of mezzanine bonds.[10]

B. Chau Did Not Admit That Magnetar's Alleged Influence Created a Conflict of Interest.

In yet another attempt to make it sound like something bad happened here, Division asserts that Chau testified that he understood that Magnetar's role had to be disclosed. (Div. Br. at 9 arguing that 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".) Again, even if true, this testimony would be irrelevant. And again, it is not true.

A little background is in order here, too. CDO deals often closed only partially ramped, *i.e.*, even after the CDO closed, the collateral manager would continue buying securities until the pool reached its expected total capitalization. (*See, e.g.*, RX 2 at 35-37; Chau 4145:4-4146:13.) This is standard. (*Id.*) In addition, mezzanine CDO deals often had a CDO bucket, meaning that, in addition to RMBS, some relatively small portion of the portfolio consisted of other CDOs. (Chau 4145:5-4146:13; *see also* RX 2 at 36) The CDO bucket was often filled after closing. This

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7 (*See, e.g.*, RX 548-56, 820-82, 815-819, 538-539, 811-814, 559-562, 578-579, 604-606, 743, 737, 688-689, 636, 643-645.)

8 (*See, e.g.*, Doiron 1961:9-1962:10; Edman 2542:2-9; Jones 2830:13-25.)

9 (*See, e.g.*, Doiron 1961:9-1962:10.) In fact, the deal documents spelled out that the investors had to do their own analysis of the synthetic collateral, by among other things, reviewing the deal documents for that collateral as well as the performance results for each Reference Obligation. (RX 2 at iv, 18, 26-27, 50, 52; Suh 3039:9-3040:20.)

10 (*See, e.g.*, Edman 2542:10-20.)

is the context of the prior testimony Division trotted out as evidence of Chau admitting that allowing Magnetar to have a role in the warehouse was a conflict.

At first blush, Chau's prior testimony[11] appears inconsistent on its face, with him testifying on one page that it is okay for Magnetar to express an opinion on asset selection (DX 1009 at 127:9-19) and on the next page that it would violate his independence if Magnetar expressed an opinion on asset selection (DX 1009 at 128:8-129:5). Chau explained the apparent inconsistency at the Hearing, however. (Tr. 1831:10-1833:5.) The two pieces of testimony address different time periods. (*Id.*) His testimony was that there was nothing wrong with talking to Magnetar about assets during the warehouse period; however, as he testified, it would violate his independence to cede control or influence to Magnetar after the deal closes. (*Id.*) This explanation is supported by the record. The questions that led to his prior testimony that ceding control to Magnetar would violate his independence related to an exhibit that focused, in relevant parts, on sourcing CDOs post-closing. (DX 140 (for example, in one email, Chau discussed "waiting til [sic] we price" or close to source CDOs, which would constitute "4-5%" of the portfolio).) [12]

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11 Division cited the Hearing transcripts (Tr. 1819:12-1821:20); however, this part of the transcript refers directly back to Chau's prior investigative testimony (DX 1009 at 128:8-129:5.)

12 Division's reliance on Huang's testimony to make it sound as if he too had a problem with Magnetar's involvement does not withstand scrutiny either. (Div. Br. at 17.) Huang, who asked Lieu to review the ABX Index assets, testified that he was at all times comfortable with his interactions with Magnetar regarding the ABX Index assets for Octans and that they were ordinary, routine, and normal. (Tr. 1230:11-15, 1231:16-22, 1284:4-1286:10, 1288:23-1289:9, 1290:3-19, 1295:14-20, 1296:21-1297:3.) Put differently, Huang testified that Harding–and nobody else–selected the assets free of any influence, pressure, or third-party control. (Tr. 1274:6-12.) The rest of Division's citations relate to other deals, hypotheticals, Magnetar's sourcing of some of the assets (as opposed to Harding's selection of the assets), and Huang's point that it would be problematic to trade directly with Magnetar if there was not a fair mechanism to establish a price (he did not, in fact, testify that there was not such a mechanism). (*Id.*; *see also* Tr. 909:4-920:5, 947:10-955:24.)

As for Huang's general musings about his views of the market and Magnetar, Division grossly overstated his testimony. Huang did not testify, for example, that that there was an "imbalance between Magnetar's powers and those of other investors" (Div. Br. at 17 (*citing* Tr. 725:12-726:4). Rather, when asked in prior investigative testimony about the back and forth between Harding and Magnetar, Huang expressed his personal opinion that

V. MAGNETAR WAS NOT INDIFFERENT TO OCTANS' PERFORMANCE, NOT THAT THAT MATTERS.

Faced with problems with its theory that Magnetar's interests were misaligned, Division reaches in yet another direction. It claims that Magnetar was indifferent to the performance of Octans and that Chau understood that. (Div. Br. at 9-10). Again, this is irrelevant, even if true, as the Commission contemplated in its Proposed Rule 127B analysis that some participants in CDOs may be "delta neutral" and that a "delta neutral" position did not create a conflict, only a situation where a participant stood to earn more on failure of the deal would a conflict present itself. (Rule 127B Release at 60337-38.)

In any event, Division failed to address Magnetar's actual positions, the Commission's Proposed Rule 127B, or Wagner's prior expert report,[13] but yet again (unburdened by any record citation) points to Chau's investigative testimony for support. (Div. Br. at 9-10 "Chau . . . 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 point here is that unlike other investors, Magnetar did not care about the quality of Octans' assets. Note that Division failed to provide a record citation. (*Id.*).[14] The actual testimony in no way supports this contention:

> Q. . . . In the CDOs you did where Magnetar was an equity investor, how did you balance the interest of Magnetar with the interest of the other noteholders?

Magnetar was too involved, without defining what that involvement was or exactly why he felt that. (Tr. 725:12-726:5.) Regardless, he is not an expert in this case, and his personal feelings are irrelevant, especially when they conflict with the Commission's own observation that third-party involvement is not by itself problematic, even when the third party actually picks assets for the CDO.

13 As Wagner stated in the *Tourre* matter, if Magnetar were not looking to do anything that would hurt other investors, or if, as is the case here, Magnetar proposed something that would benefit all, there would be no reason to think that failure to disclose Magnetar's involvement in the deal could be material to any reasonable investor. (*See* RX 858 at ¶¶ 22-26.)

14 The quotation is from investigative testimony. (*See* Div. 1003 at 477:5-478:10.) Prior investigative testimony was not admitted into evidence. (*See, e.g.,* Tr. 11:20-14:7.)

A. There was no need. ***There was no conflict interest.***
Q. But weren't Magnetar's interests unique because of their long/short strategy?
A. No. The hedging of an investment is indifferent to the capitalization of that investment.
Q. So, you didn't think there was any difference between Magnetar's interest and the interests of the other – of the noteholders in other CDOs that you did where Magnetar was an equity investor?
A. No. Again, ***they bought the equity tranche, and they hedged that equity tranche.*** They were indifferent to the performance of the transaction. It was a – as they say, market neutral transaction. . . . For example, ***if equity was yielding 20 percent and the triple-B tranche was yielding 3 percent, they would earn a risk-free return of 17 percent.***

(DX 1003 at 477:5-478:10 (Counsel's objections omitted) (emphasis added)); *see also*, Chau 1776:24-1777:7 (disagreeing that Magnetar was indifferent to the transaction because "[t]hey would want the equity tranche to perform"), 4313:22-4316:16 (Chau testifying, during Respondents' case-in-chief as to his entire answer in prior investigative testimony.)[15]

VI. DIVISION INVITED ERROR BY MISSTATING THE MATERIALITY STANDARD

The Division could not find a single investor who would agree that Magnetar's participation in the Octans warehouse significantly altered the total mix of available information. In fact, the Division called only one investor to testify at trial, Doiron. As discussed below, even he did not agree that Magnetar's participation was material. Two other investors were called by the Respondent to rebut any notion of materiality of Magnetar's participation, Edman and Jones.[16] One other investor did not testify (Khan); his testimony came in the form of a *Brady* letter also disclaiming materiality, among other things.

[15] This is just one instance out of many where the ALJ allowed Division, over Respondents' objections, to read into the record prior investigative testimony under the guise that it was a prior inconsistent statement, when, in fact, the prior statement was consistent. One wonders what the point is of holding a Hearing, if the Division may be allowed to offer its investigative testimony as substantive evidence. None of the investigative testimony was admitted as substantive evidence in this case.

[16] Note that Edman refused to meet with Respondents' counsel before his testimony at the Hearing.

To get around this pesky proof problem, Division resorted to misstating the materiality standard. (*See* Div. Post-Hearing Br. at 81; Div. Reply Post-Hearing Br. at 36.) Division claims that *Feeley & Willcox* holds that "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." (Div. Br. at 15). However, *Feeley & Willcox* actually holds, citing the well-established standard articulated in *Basic*, that in order to fulfill the materiality requirement, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the ***reasonable investor*** as having significantly ***altered the 'total mix' of information made available***." 2003 WL 2268097 at *9 (emphasis added).

Division also cites *Feeley & Willcox* for the proposition that the standard of materiality is met if an investor "would want to know" a particular fact. (Div. Br. at 17.) *Feeley & Willcox* stands for no such proposition. *See generally*, 2003 WL 22680907. The fact that someone is curious about a piece of information does not make it material. *SEC v. Wyly*, No. 10-cv-5760 (S.D.N.Y. July 10, 2014) ("The SEC is right that investors would probably 'want to know if the chairman and vice chairman . . . of a company had agreed they were going to try and sell it.' But a fact is not material 'merely because a reasonable investor would very much like to know [it].'") (internal citations omitted).

The ALJ erroneously adopted Division's incorrect standard in finding that Magnetar's role was material. Specifically, the ALJ stated that "that a third party had the ability to interfere with Harding's selection of collateral for Octans is surely something that would have been material to a reasonable investor." (ID at 68-69.) As support, the ALJ cited a portion of Doiron's redirect, wherein he testified that he would have wanted to know "if there were another party to the Octans [WA] that was not only providing warehouse financing but was also somehow hedging on the other side." (Id. (citing Tr. 2063:3-8).) To get that answer, Division asked the wrong question ("isn't that something you'd want to know about") because merely wanting to know something does not meet the standard of materiality. (Tr. 2063:3-7.) When asked the right series of questions about whether Morgan Stanley's involvement in the warehouse of a CDO Doiron managed, the Wadsworth, had to be disclosed in the PB and OC, given that Morgan Stanley suggested certain assets, had certain veto rights, and hedged its warehouse risk, Doiron testified "no." (Tr. 1997:2-11; *see also* 1997:12-2002:23.) He testified this way because such a disclosure would not have altered the total mix of information, or, in his own words, "because we still selected, you know, the assets that were put in the CDO. Morgan Stanley may have had some control, but it was still the assets we selected." (Tr. 1997:8-11)

Of course, Doiron's opinion is just an isolated opinion of one person and not conclusory proof of what would have been viewed by the reasonable investor as having significantly altered the total mix of information, but his testimony is echoed by the other investors. When the investor witnesses were asked the right questions, the testimony was unequivocal that Magnetar's unexercised rights in the warehouse did not alter the total mix of information. It did not matter to the investors whether Magnetar or any other third-party: (1) invested in the equity of Octans, (2) took on some of the warehouse risk, and (3) and had certain rights during the warehouse period as a result. (*See, e.g.*, Edman 2536:5-2539:3, 2544:6-16; Jones 2832:6-2842:7;[17] *see also*, RX 884 at 2 (Khan (an investor from UOB) told Division that "[i]t is not important to disclose the identity of a party to a [WA] if that party is merely providing warehouse funding, and its only involvement is the right to veto assets.").) The answer does not

[17] As just explained, Doiron testified consistently with Edman and Jones when asked about whether Morgan Stanley's role in the warehouse had to be disclosed as to a CDO Doiron managed.

change even if that same equity investor was employing a hedging strategy that involved shorting the capital structure of the same deal. (Edman 2536:5-2539:3, 2544:6-16.) What did matter to the investors was the structure of the deal, their rights and liabilities as detailed in the OC, and their view of the underlying collateral. (Edman 2536:17-2539:3; Jones 2832:6-22; 2849:2-2850:15.)

In sum, it is unanimous from all investor witnesses that the fact that another party, even one who had taken some short positions, had "some control" over the selection of assets during the warehouse period did not mean that the collateral manager had not selected the assets. The investors, therefore, did not expect a disclosure on this issue, and even if they had known of these facts, it would not have changed significantly the total mix of information available to them.

VII. THE ALJ CORRECTLY FOUND THAT RESPONDENTS WERE NOT LIABLE FOR THE RELEVANT STATEMENTS IN THE OC AND PB.

Assuming arguendo that Division gets over the hurdles above, Respondents were not liable for the relevant statements in the PB and OC. The ALJ correctly found that "Respondents did not act with scienter, or even negligently.[18] There is no evidence that Respondents' conduct was intentional. The sections of the [PB] and [OC] at issuer were drafted by Merrill, not Harding." (ID at 69 (citing Tr. 369-71, 1829-30, DX 4 at 19).)

Division seeks to upset that ruling by obscuring the record on two points. First, Division cherry-picked testimony in order to argue that Chau was "ultimately responsible" for the entire PB. (*See, e.g.*, Div. Br. at 11). This is patently false and directly contradicted by Chau's testimony. Chau testified, in reference to Harding's internal policies and procedures, that he was

[18] Contrary to Division's argument, the evidence does not establish violations of Sections 17(a)(1), (2), or (3), or 206(1), (2) for either the Octans-related or Norma-related claims.

ultimately responsible for Harding's marketing materials. (Tr. 1828:18-1829:19). However, when Division tried to extend Chau's responsibility to the Octans PB, he explained that the PB "[was] not Harding's marketing materials." (Tr. 1829:22-1830:9).

Second, Division argues that the fact that Suh, Harding's deal counsel, reviewed the OC and commented in a section not relevant here that Magnetar's name should be disclosed somehow means that Respondents committed a securities law violation. (Div. Br. at 14.) In fact, Suh's review, combined with that of other experienced and informed counsel, shows exactly the opposite. *See In The Matter of John P. Flannery and James D. Hopkins*, Securities Act Release No. 9689, 2014 WL 7145625, *33 (Dec. 15, 2014) (establishing that a Respondent may lack scienter when he has a "good faith" belief in the accuracy of a disclosure, based on the involvement of counsel).

Respondents knew that: (1) the Issuer's and Merrill's counsel knew that Magnetar was a party to the WA and had certain rights under the agreement (RX 143-44),[19] (2) Merrill's counsel reviewed the Octans PB (Wang 567:21-568:7, RX 178), and (3) the Issuer's and Merrill's counsel drafted, edited, and finalized the OC (DX 138, RX 185, 198-203, 237-239). Respondents also knew and relied upon the fact that the Issuer's and Merrill's counsel issued a 10b-5 Opinion, where it advised that the issuance of the notes did not violate any laws. (RX 75 at ¶ 6.)

Respondents also knew that their counsel, Suh, knew about the WA (RX 140, 166, 172, 176) and that he reviewed and provided comments on the OC (RX 189-193, 196-197). Respondents retained Suh and his firm because they had experience representing Collateral Managers; and Respondents relied heavily upon Suh to correct any relevant issues in the deal

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[19] This is also why the ALJ found that "the issuer knew of Magnetar's involvement [in the WA] independently of Harding . . . because its attorneys (who were also attorneys for Merrill) knew of it," and therefore any failure to disclose Magnetar's involvement in the warehouse was "immaterial because it did not change the total mix of information available to the issuer." (ID at 80-81.) Division does not even address this point.

documents. (Wang 354:17-355:19, 398:21-399:6, 513:24-514:25.) Even Chau's certification that he reviewed the OC was done in collaboration with Suh. (Tr. 3018:7-3019:2, RX 53 at ¶ 1.) Suh, in fact, issued a negative assurance opinion, where he also advised, on behalf of his law firm, that nothing came to his attention to suggest that the disclosures in the OC misstated or omitted any material facts. (RX 80 at 1.)

Respondents also knew that Suh had suggested that Magnetar's name be disclosed in the OC. (RX 196-197, Wang 583:15-584:13.) While Suh was overruled by counsel for the Issuer on this point (RX 196-197), Suh explained that his comment related to disclosing that there was a concentrated voting power at the equity level and not a general comment that Magnetar's name specifically had to be disclosed (Tr. 2954:21-2955:19, 2957:6-17.)

VIII. THE ALJ DID NOT ERR IN FAILING TO FIND A 17(A)(1) VIOLATION ON THE BASIS OF HOW HE EVALUATED LIEU'S CREDIBILITY.

There is no reason to upset the ALJ's conclusion that there was no violation of Section 17(a)(1) of the Securities Act. Again we start with the basics: if the ALJ did not find Lieu credible, he could have disregarded her testimony, but that would not change the fact that the Division failed to meet its burden of proof through other evidence. Regardless, Division argues that the ALJ should have found Lieu was not credible, which was one of the reasons he did not find scienter. Despite Division's blanket assertion that the ALJ improperly credited Lieu's testimony, Division fails to explain what specific testimony was improperly credited. This leaves us to assume that Division takes issue with the finding that that there was no deliberate scheme to defraud investors. However, it is clear that the ALJ accorded the proper weight to Lieu's testimony because, as Division acknowledges, the ALJ took into account Lieu's hostility to Division when he made his findings. (*See* ID at 10.) Additionally, as discussed in more depth in Respondents' Opening Brief, Lieu credibly testified that although she is unable to remember precisely what happened on May 30, 2006, she would not have approved the assets if she had not done her due diligence and determined that the assets were creditworthy. (*See* Resp'ts Br. at 8-9 (*citing* Tr. 4046:9-12).)[20] Therefore, the evidence presented, at best, amounts to a failure of one analyst to properly document the review of assets on a single day, and is insufficient to find liability under Section 17(a)(1), as well as Sections 17(a)(2).

IX. THE ALJ CORRECTLY FOUND THAT RESPONDENTS DID NOT VIOLATE SECTION 17(A)(3).

While we disagree that any securities violation can be premised upon the lack of documentation of Lieu's credit work on just one day, that the PB was an offering document, or that the standard of care provision in the OC governed conduct during the warehouse period, we do agree with the ALJ that the Division did not make out a Section 17(a)(3) claim.

Section 17(a)(3) "proscribes transactions, practices, and courses of business that operate or would operate as a fraud, and proscribes misrepresentations only if they constitute transactions, practices, or courses of business." (ID at 60.) A single misstatement in two different documents does not operate as a course of conduct. In arguing the opposite, Division misapplied the standard enunciated in *Flannery*. There, the Commission held:

> we read Section 17(a)(3) to be narrower . . . whereas Rule 10b-5(a) and (c) and Section 17(a)(1) all would proscribe *even a single act* of making or drafting a material misstatement to investors, Section 17(a)(3) is not susceptible to a similar reading. Of course, one who ***repeatedly makes or drafts such misstatements over a period of time***

[20] Division attacks Lieu's credibility based on her hostility to Division without acknowledging that Lieu voluntarily cooperated and testified during Division's investigation, and that it was Division's behavior that led to her hostility. When Lieu told Division during the investigation that she believed there were additional documents that would provide information about the circumstances under which she reviewed the relevant bonds, Division did not provide those documents and instead tried to get her to say that she was overruled.(*See* ID at 37 (*citing* Tr. 3659-60)). For example, Division never showed Lieu the documentation that demonstrated that another credit analyst had approved the same ABX assets for other deals. (*See* ID at 46 (*citing* Tr. 3803-04).) Her hostility, in other words, was a direct result of her clear perception that the Division was less interested in the truth than it was in getting her to say whatever was helpful to its case.

> may well have engaged in a fraudulent "practice" or "course of business," ***but not every isolated act will qualify.***

Flannery, 2014 WL 7145625, at *18 (emphasis added).

Flannery's facts reveal Division's error. There, Respondent Flannery, former Fixed Income Chief Investment Officer of State Street Global Advisors ("SSgA"), was found to have violated Section 17(a)(3) for his role in drafting and editing two letters dated August 2, 2007 and August 14, 2007. (*Id.* at *8-9). The August 2nd letter to investors about the effects of the subprime mortgage crisis on SSgA's trading strategies was found to be misleading because it asserted that SSgA reduced risk in part by selling its AAA-rated cash positions. (*Id.* at *29). The August 14th letter regarding Limited Duration Bond Fund's ("LBDF) poor performance was determined to be misleading because it advised investors to hold their LDBF investments and forecasted greater liquidity in the months to come. (*Id.* at *30). The two letters in *Flannery*, unlike here, conveyed multiple misstatements to investors regarding LDBF's and SSgA's viability.

Here, the ALJ found the same misrepresentation about Harding's credit review process in both the PB and OC, meaning that there was one single misstatement. (ID at 60, 67.) The fact that the statement appears in two documents does not change the analysis, especially when the second statement is made and used by a different party. The Commission in *Flannery* makes clear that "a single act of making or drafting a material misstatement to investors" does not constitute a course of business for the purposes of Section 17(a)(3). (*Flannery*, 2014 WL 7145625, at *18). Nor does the *Flannery* repetition requirement turn on the breadth of circulation, as Division would have it.[21]

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[21] Respondents did not draft, prepare, or circulate the PB or OC. In fact, all of Division's citations to the distributions of these documents show that Merrill, not Harding, circulated these materials.

X. THE ALJ PROPERLY CONCLUDED THAT CHAU WAS NOT LIABLE FOR CAUSING OR AIDING AND ABETTING ANY OCTANS VIOLATIONS.

The ALJ properly evaluated the evidence and concluded that Chau was not liable for causing or aiding and abetting the Octans related violations based on the ABX Index trade. (ID at 87.) Division seeks to hold Chau primarily and secondarily responsible for, in the words of the ALJ, the "slapdash" actions of one analyst on a day in which Chau was out of the office and on a transaction that had been delegated to another senior member of the team.

However, in seeking to overturn this finding, Division does not contest the actual evidence underlying the ALJ's conclusion, which demonstrates that Chau could not have caused nor aided and abetted the Octans-related violations:

- Chau was out of the office on May 30, 2006 (ID at 35);
- Tony Huang, a portfolio manager at Harding, was therefore in charge of overseeing the ABX Index trade for Octans (ID at 8, 35);
- Though Chau was available by email and telephone on May 30, 2006, there was no evidence that he was privy to the discussions surrounding Octans (ID at 35);
- There was insufficient evidence that Chau was aware that the ABX Index trade analysis was negligent (ID at 87);
- Despite being aware of Harding's investment analysis process in general, there was insufficient evidence that Chau was aware of Lieu's "slapdash" process for the Octans ABX trade specifically (ID at 87); and
- Chau's description of Harding's investment analysis process suggested that if he had been aware of it, he would have considered Lieu's work on the ABX Index trade to be substandard. (*Id.*)

NORMA

I. DIVISION IMPROPERLY SEEKS TO EXPAND ITS CLAIMS.

With Norma, as with Octans, Division misleads about the OIP allegations. As a starting point, Division makes several mentions of investors in the deals into which the Norma bonds were placed. Let's be clear: the OIP does not allege any violations relating to any investors in any of the deals into which the Norma bonds were placed. (*See*, *e.g.*, OIP ¶ 69.) Division is well aware of this: Division did not call a single investor in any of these deals and did not place a single PB for any of these deals in evidence. Any stray references to investors in these deals are a red herring. This simply reflects Division's concerns about its theory of the case: given the interests and the function of the SPVs and their directors in these deals, they could not have been defrauded by means of misrepresentations about asset selection. (*See* Resp'ts Br. at 22-30.) And so Division tries to salvage its case, post Hearing, by pretending that this case was about misrepresentations to investors.

Next, Division challenges the ALJ's finding that the OIP did not charge any violations with respect to the purchase of the Single-A Norma bonds. (Div. Br. at 19-23) Here again, assuming Division's allegations, Division knows that Merrill was the fiduciary of the Issuers of the deals into which the BBB bonds were placed,[22] and that Merrill, as the structurer, knew everything Harding knew about the Norma bonds and the circumstances of their purchase. And since disclosure to a fiduciary is disclosure to its principal, Harding is deemed to have made full disclosure to the Issuers of all relevant facts. (*Alioto v. Hoiles*, 531 F. App'x 842, 853 (10th Cir. 2013) (*quoting Chapman Coll. v. Wagener*, 45 Cal.2d 796, 291 P.2d 445, 448 (1955)), *cert. denied*, 134 S. Ct. 1561 (2014) ("notice to or knowledge possessed by an agent is imputable to the principal"); Resp'ts Br. at 26-27.)[23] Indeed, as the ALJ observed with respect to Octans, disclosure to their fiduciary facts that their fiduciary already knew would not have significantly altered the total mix of information available to the CDOs. To fix this problem with its case,

[22] *See In re Parmalat*, 684 F. Supp. 2d 453, 475-76 (S.D.N.Y. 2010), *aff'd sub nom, Food Holdings, Ltd. v. Bank of Am. Corp.*, 423 F. App'x 73 (2d Cir. 2011) (holding that creator of SPVs, as promoter and *de facto* controller, had fiduciary duty to its creation); *see also* DX 509 at second to last page (Neo OC) (Merrill and Issuer had same counsel); DX 507 at second to last page (Lexington OC) (Merrill and Issuer had same counsel).

[23] In addition, as we argued in our opening brief, Division's theory on the BBB bonds is irrational. Harding agreed to buy the Single-A notes before any pressure was applied. (*See, e.g.*, ID at 82; Chau 4184:14-4185:18.) It received the portfolio, the PB, and the term sheet, had time to review these materials, and volunteered to buy the Single-A bonds. (*See* Chau 4184:14-4185:18.) As we previously explained, if Harding had a good faith basis to purchase the Single-A bonds, it had a good faith basis to purchase the BBB bonds. The portfolio analysis is the same for both tranches.

therefore, Division now claims that the OIP covered the Single-A purchases, one of which was for a Citi deal. (Div. Br. at 19-23.)[24]

Division did not press the Single-A theory at the Hearing. As a starting point, the fact that there can even be an argument about whether the OIP charged the Single-As in addition to the BBBs proves that this allegation did not allege fraud with sufficient particularity. *See* Fed. R. Civ. P. 9(b) (In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally.). Deprived of the ability to file a motion to dismiss, Respondents filed a motion for a more definite statement asking for clarification. Division opposed, claimed that the allegations were clear, and refused to specify anything. The ALJ denied the motion. (*See* Order Denying Respondent's Motion for a More Definite Statement (Feb. 12, 2014).)[25]

As the ALJ noted in the ID, the thrust of the OIP allegations is that Harding caved to pressure from Merrill and Magnetar to buy the Norma bonds. (ID at 86.) Because there was no evidence of pressure to buy the Single-As from anyone, the ALJ agreed that the OIP did not charge the Single-A purchases. (*Id.*) That Respondents proceeded on this understanding is clear from their pre-Hearing brief. In it, Respondents specifically referenced only the BBB bonds and clearly stated their understanding that the bonds in question constituted 1.6% of the deals into which they were placed (Resp'ts Pre-Hearing Br. at 12-13), which is true only as to the BBB bonds. (*See* Ex. A.) And, as the ALJ points out, when the topic came up at the Hearing,

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[24] Similarly, there is no basis to consider the factual circumstances surrounding the Single-A bonds in imposing any remedy.

[25] One indication that these allegations were not clear is the ALJ's apparent confusion in his order denying the motion for a more definite statement that Harding was the collateral manager for Norma. (Order Denying Respondent's Motion for a More Definite Statement (Feb. 12, 2014); see also Tr. 1500:19-1501:5.) The collateral manager of that deal was someone else.

Respondents' counsel made clear his understanding that only the BBB bonds were charged and Division did not object or say anything to clarify what it now claims to be a misunderstanding by both Respondents' counsel and the ALJ.

In a shocking attempt to twist the record and rewrite history, Division now claims that the relevant discussion at the Hearing was not a waiver or an abandonment of the issue by Division but a mere miscommunication among counsel for the Respondents about how many transactions were charged. (Div. Br. at 22.) Here is the entire relevant colloquy:

> Q. Now, do you recall which CDOs the BBB flat went into? The BBB flat Norma bonds.
> A. I recall it going to two deals. The names escape me at this point.
>
> ***
>
> Q. Does this refresh your memory?
> A. Yes.
> Q. What is it?
> A. The two CDOs that went into the Neo transaction and the Lexington transaction.
> Q Can we pull up Division Exhibit 507, please?
> JUDGE ELLIOT: Wait, I thought there were three. Wasn't there a Jupiter?
> MR. LIPMAN: Your Honor?
> JUDGE ELLIOT: Yes.
> MR. LIPMAN: May I address that?
> JUDGE ELLIOT: Yes, go ahead.
> MR. LIPMAN: There were three but there are only two charged in the OIP.
> MS. BAYNHAM: Four.
> JUDGE ELLIOT: Oh, there are four. I'm sorry.
> MR. LIPMAN: Only the BBBs are charged in the OIP.

(Tr. 4236:18-4237:19.)

It cannot be clearer that the ALJ was asking why the focus of questioning was on only two transactions when he had an understanding that the Norma bonds were placed into three deals. Counsel for Respondents immediately asked to speak to clarify that only two transactions were charged. In so doing, one of Respondents' lawyers misspoke and repeated the ALJ's mistaken understanding that there were three Norma-related deals in total. Another lawyer for the Respondents corrected him *and* the ALJ to make sure that the record correctly reflected the total number of deals into which Norma bonds were placed. The ALJ then acknowledged counsel's correction as to the total number of deals. The first lawyer for the Respondents' then clarified that regardless of the total number of deals, only the BBBs were charged. The ALJ's recollection of what happened is the same: "when Respondents' counsel asserted during the hearing that only the mezzanine [BBB] tranche was alleged in the OIP, Division did not object." (ID at 86.) At a minimum, therefore, having permitted the Respondents (to their detriment) and the ALJ to proceed on a mistaken understanding of what was charged, Division now tries to resurrect additional claims by misrepresenting its own actions.[26]

II. THE ISSUERS OF LEXINGTON AND NEO WERE NOT DEFRAUDED.

The substance of the Norma-related allegations does not make out a fraud for all of the reasons we have pointed out. (Resp'ts Br. at 15-30.) Even before one takes into account that the same individuals who acted as directors for Norma were also directors for Neo and Lexington, the idea that Merrill-created CDOs could be defrauded by inclusion of other Merrill-created deals in their portfolios strains common sense to the breaking point. All of these deals involve the same people working for the same organizations. Beyond that, CDO directors do nothing of substance. As one court observed, they are hired to say "yes." (*See In re Parmalat*, 684 F. Supp. 2d at 459 (These SPVs "are phantoms, endowed by law with legal personality but having no real existence. . . . In short, they were engaged to vote 'yes.'"); *see also* Puglisi 3145:24-3146:23; Wagner 4679:22-4680:17.) Beyond even that, the CDOs do not profit from the performance of the portfolio assets and, in this case, they specifically disclaimed any representations about the

[26] Given Division's duty of candor of court, we assumed that had Division's position then been that the Single A bonds were charged, it would have stood up and answered the ALJ's question about how many CDOs were at issue, or at a minimum, corrected Respondents' counsel's characterization. *See* Rule 3.3(a)(1) of the New York Rules of Professional Conduct ("A lawyer shall not knowingly: (1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer.")

quality of the portfolio assets and specifically advised investors that they must rely on their own analysis of the portfolios. (*See*, *e.g.*, DX 507 at iii, 11, 49; DX 509 at iv-v, 49-50.) In light of all this, it is simply not plausible that disclosure to the CDOs that one asset representing 1.6% of the portfolio was placed there as a result of pressure from the CDO's creator would have significantly altered the total mix of information available to a reasonable CDO.

And all of this is before one takes into account the fact that: (1) the assets were added after their spread was widened as a result of a price negotiation by Harding and that this widening of the spread benefitted the deals *at the expense of Merrill and Magnetar* (Resp'ts Br. at 15-20); or (2) Norma caused no harm and performed in a manner consistent with the performance of other similar deals of the same vintage. (ID at 92, 96-97.)

Finally, obsessive incantation without analysis that Harding was a fiduciary of the CDOs does not make it so, no matter how much Division wishes it to be. (*See*, *e.g.*, Div. Br. at 3, 15-16, 25 n. 8, 27-28.) For all of the reasons discussed here and in our opening brief, Harding was not and could not have been – as a matter of law – the CDOs' fiduciary. But Harding did, as it was required by the CMAs of these deals, do a pre-closing analysis of the asset pool to make sure that it could certify that all assets in the deal met all eligibility criteria, including criteria relating to their credit quality. (Chau 4252:15-4259:10.) None of these certifications or their predicate analyses has ever been challenged by Division.

III. DIVISION, AND INDEED THE ALJ, MISAPPREHENDS THE PURPOSE AND GOAL OF ASSET SELECTION FOR CDOS.

But even if none of the above were true, all of the Norma claims fail for an independent reason: Division misconstrues the object of the exercise. The object was not to recommend an individual asset. It was also not to pick the safest assets available for everyday investors. If that were the object, the collateral would have consisted of T-Bills. (*See* Huang 1263:10-1264:3;

Chau 4116: 18-4117:25.) Instead, the object was to build a *portfolio* that generated attractive yields for sophisticated institutions (who understood and were willing to tolerate the risk), given the risk profile of that *entire* portfolio. (*See* Chau 4163:19-4165:2, 4258:19-23; Jones 2807:4-7, 2818:15-2819:5; Wagner 4615:3-4620:17.) By demanding higher yields, the note purchasers were, in effect, trading away some credit quality. (Chau 4258:2-6 ("as spread increases, there is more risk. As spreads decrease, there is less risk"), 4257:2-4257:25 ("you need to create a portfolio that can generate enough income to pay all those various stakeholders.").

By logical extension, in order to achieve the necessary balance of credit and coupon payments, Harding had to go through an iterative process of adding new assets and assessing how each new asset or group of assets changed the characteristics of the portfolio as a whole. That is to say that Harding could not have added Norma, unless Norma fit the portfolio needs and criteria at the time it was added. (*See* Wagner 4631:6-4634:8; Chau 4347:16-4349:1; *see also* RX 870; Chau 4210:7-4211:6.) When discussing how he selected assets for inclusion in CDOs, Jones, who was also a collateral manager, explained this very point:

> Well, when we were building each deal, it required-in order to come out with a final yield that we would need to be able to generate all the different returns for all the different tranches that we would be selling, we needed to hit out at a certain amount of spread. And so in order to do that, we built basically a model of all the different types of assets that we would put in our deal-some fixed rate, some CDOs and some RMBS, and how many Aas we would need to be, how many Single A rated assets or Aaa rated, pretty elaborate model. But each time we would buy a security, we would book it in this program and then recalculate what our running spread was for the assets we had acquired, because we ultimately needed to tie out to a number in order to hit all the targets that we had been shooting for.

(Tr. 2811:4-22.) In other words, some relatively-more-risky assets had to be added to the portfolio in order to achieve a desired, market-driven, overall risk profile. And the collateral manager had very wide discretion about the choice of assets. (DX 8001 ¶ 13 (Wagner Expert Report); RX 857 ¶ 6 (Wagner Report in *Tourre*).) The only limitation of that discretion is in

Eligibility Criteria in the deal documents and the overall risk/return profile of the deal, which is determined in light of market conditions and credit ratings and is a product of the Eligibility Criteria. (RX 2 at 138-145.)

This is also why comportment with any standard of care is not about the creditworthiness or credit review of any individual asset in the portfolio; it is about the entire portfolio. For example, among other things, as disclosed in the Octans OC, no less than 10% of the portfolio was to be rated lower that Baa3 by Moody's and BBB-by Standard & Poor's ("S&P") (RX 2 at 138); there could be no Defaulted Securities, Credit Risk Securities, Equity Securities, or Written Down Securities (*Id.* at 139.); and there were additional limits, such as on single issuer concentrations (*Id.* at 144.). These Eligibility Criteria "are critical restrictions on what this CDO can purchase." (Suh 3022:15-3025:4, 3026:5-11.) Again, for this exact reason, Harding certified at closing that each asset and the portfolio as a whole, "satisfies all of the requirements in the definition of a Collateral Debt Security and the Eligibility Criteria." (DX 501 at 1; Chau 4252:15-4254:10.)

Put yet a different way, the CDOs were offering investors a specifically defined, carefully cabined bundle of rights to ownership of a collateral pool that met certain specific characteristics. (*See, e.g.,* Edman 2562:8-2563:7 (testifying that Morgan Stanley assumed that the deal "was managed to its minimum requirements in terms of collateral quality," which were spelled out in the OC); Wagner 4644:23-4645:8 (testifying as follows: (Q: Right. It is in the offering circular. Everybody knows what rights they are getting and not getting? A: Yes.).) There has neither been any allegation nor proof that the Octans, Lexington, and Neo portfolios met each and every Eligibility Criteria spelled out in the deal documents. There is also not even one allegation that any of the bonds in any of these deals were mispriced, given their portfolio characteristics.

For all these reasons, the ALJ erred in finding that Respondents obtained money or property based on alleged misstatements about the credit review of a single asset. Harding was not charged with selecting one asset. It selected and managed a *portfolio* of assets with varying characteristics and credit quality that together met all relevant Eligibility Criteria. In fact, the CMA language on which Division predicates its allegation that Harding made misrepresentations about asset selection cannot possibly be read to cover selection of individual assets because asset assembly takes months, and the selection referenced in the CMA, at best, was to take place on the day the deals closed. (*See*, *e.g.*, DX 509 at 158.) In short, again, even if Harding failed to do what it was supposed to do with respect to one asset amounting to 1.6% of a portfolio, its representations about the *asset pool* and the selection of the *asset pool* were materially true and correct.

As well, as discussed below at 34, Neo and Lexington would have closed with or without the Norma BBBs and Harding would have received its fees with or without the inclusion of Norma in Neo and Lexington portfolios. (Similarly, Octans probably would have received the same components of the ABX Index even if Lieu performed whatever analysis Wagner thinks she should have performed.) Therefore, in neither case did the Respondents obtain money or property as a result of their alleged misconduct, even if true. And, for the same reasons, to the extent liability is predicated on misstatements or omissions, the relevant disclosures were untethered from the offending conduct; no money or property was obtained because those disclosures were false, assuming them to be so. Put differently, Respondents did not need to make false statements to close deals and receive their fees.

REMEDIES

Even accepting the argument that Respondents violated securities laws, the remedies imposed by the ALJ were excessive and inappropriate. The ID ordered Harding and Chau to cease and desist from violations of Section 17(a) of the Securities Act and Section 206 of the Advisers Act, and to jointly and severally pay $1,003,216 in disgorgement and prejudgment interest; revoked Harding's investment adviser registration and ordered it to pay a civil monetary penalty of $1.7 million; barred Chau from association with a registered investment company and the securities industry; and ordered Chau to pay a civil penalty of $340,000. (*See* ID at 97.)

These excessive remedies were imposed despite the fact that the ALJ found no harm, the CDOs at issue performed as well as other CDOs of similar vintages, Respondents cooperated during the investigation, the violations occurred some time ago, there was no evidence of harm to investors or the marketplace resulting from the violations, and there was no evidence that Respondents contributed to any CDO's failure. (ID at 92, 96-97.)

I. THE *STEADMAN* PUBLIC INTEREST FACTORS DO NOT SUPPORT THE REMEDIES IMPOSED BY THE ALJ.

Proper consideration of the relevant public interest factors demonstrates that the harsh sanctions imposed by the ALJ should be reversed. These include: egregiousness of the Respondent's actions, isolated or recurrent nature of the infraction, degree of scienter involved, sincerity of the respondent's assurances against future violations, Respondent's recognition of the wrongful nature of his conduct, and likelihood that Respondent's occupation will present opportunities for future violations as well as the extent to which the sanction will have a deterrent effect. *Steadman v. SEC*, 603 F.2d 1126, 1140, 1142 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). Additional considerations include the age of the violation and the degree of harm to investors and the marketplace from the violation. (*See* ID at 91 (citing *Marshall E. Melton*, 56 S.E.C. 695, 698 (2003).)

First, the Respondents' actions were not egregious. The ALJ concluded that Respondents' Norma-related violations qualified as egregious, in part, because Respondents were paid "as a result of their violations" and were "oblivious" to their fiduciary duties. (ID at 92.) These findings were erroneous because they are premised on a misapplication of law and a misunderstanding of the relevant facts. Even if true, however, these findings are out of sync with what the Commission typically perceives to be egregious conduct. *See In re Ted Harold Westerfield*, Release No. 41226, 1999 WL 100954, at *3 (Mar. 1, 1999) (finding defendant's conduct egregious where he planned, executed, and concealed a fraudulent scheme with a friend to pay and receive kickbacks in disregard of the friend's fiduciary duties to his customers).

As discussed in detail above, unlike in *Westerfield,* Respondents did not owe any fiduciary duties to the CDO investors or the Issuers. Moreover, even if they did not act within the requisite standard of care, the ALJ admitted that there was "no direct evidence that Respondents' failure to follow the appropriate standard of care contributed to any CDO's failure, particularly as related to the Norma-related violations, where the fraction of Norma bonds in each CDO's collateral was very low." (ID at 92.) In fact, even as to the Norma BBB bonds, Chau's knowledge that the bonds represented only 1.6% of each of the relevant portfolios translates into his understanding that even in the worst case, those bonds could not materially harm the portfolio and the bond holders. And, finally, undoubtedly the ALJ's finding of egregiousness was influenced by his erroneous conclusion that the BBB Norma bonds were impaired at the time of their purchase. (*See* Resp'ts Br. at 17-22.)

Second, even if true, the OIP allegations as to Norma describe a single instance of caving to pressure to buy one asset after obtaining a discount. There is no proof of any *quid pro quo*; indeed there is no allegation at all that Harding or Chau received anything of value as a result of this single purchase. Coupled with an explicit finding that no one at Harding was ever asked to do anything unethical (ID at 8-10), including by Chau, the Norma episode is, at most, a single aberrant departure from otherwise lawful, unexceptional business practices.

Third, despite the ALJ's unsupported findings to the contrary, the violations were not recurrent. The alleged Norma-related violations stemmed from the *one* selection of the Norma BBB bonds. Additionally, the Octans-related violations were based on the negligent process by which Harding selected certain ABX index assets for Octans on one day in May 2006.

Fourth, the proof of scienter is weak or non-existent. The ALJ admitted that scienter for the Octans-related violations were "technically nonexistent." (ID at 92.) As for the Norma-related violations, Division's main "evidence" of scienter is based on inadmissible hearsay; for example, an internal Merrill email purportedly reflecting Chau's agreement to buy Norma BBBs. (*See* DX 204; ID at 48-54, 84.) Scienter simply cannot be derived from otherwise inadmissible evidence that Respondents never received or viewed. Further, the ALJ based his finding on a misunderstanding of the quality of the BBB bonds. (Resp'ts Br. at 20.)

Fifth, the Respondents voluntarily cooperated with Division throughout a three-year investigation and accepted a lengthy tolling agreement. (ID at 92.)

Sixth, the ALJ held, "the violations occurred some time ago, and there is little evidence of harm to investors or the marketplace directly resulting from the violations." (*See* ID at 92.)

Seventh, the ALJ based some of his credibility findings on a disagreement in interpreting ambiguous hearsay documents that Chau did not author and, in some cases, did not even see.

(*See* Resp'ts Br. at 20-21.) As discussed, Chau's interpretation of these emails is just as consistent with their words as any other interpretation. (*Id.*)

Finally, affirming the ALJ's imposition of these harsh sanctions sets a dangerous precedent. The law enforcement objective of remedies is to punish underlying conduct and deter, not pile on penalties, as "such racking up or stacking of fines [of each individual violation] . . . is most likely not appropriate or a wise exercise." *In re Briones-Coroy*, 481 B.R. 685, 712 (Bankr. D. Colo. 2012). All of the remedies imposed on Respondents should be reversed.

II. THE ALJ ERRED IN ORDERING DISGORGEMENT OF MANAGEMENT FEES.

The ALJ erred in requiring Harding to disgorge a portion of its management fees earned for Octans and the two "Norma Recipients" because: (1) the management fees were earned through legitimate activities, and (2) the ALJ specifically determined that the securities violations caused no harm to investors or the marketplace.

Disgorgement is intended to prevent unjust enrichment and is appropriate only in situations in which a defendant has benefitted from ill-gotten gains and *should not be used as punishment*. *See In re Reserve Fund Sec. & Derivative Litig.*, No. 09 Civ. 4346, 2013 WL 5432334, at *14 (S.D.N.Y. Sept. 30, 2013) (emphasis in original) (internal citations and quotations omitted); *see also SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989) ("[T]he SEC generally must distinguish between legally and illegally obtained profits."). Additionally, disgorgement must be causally connected to securities violations. *See First City Fin. Corp.*, 890 F.2d at 1231; *In the Matter of Gregory M. Dearlove, CPA*, Release No. 315, 88 S.E.C. Docket 1603, 2006 WL 2080012 at *185-94 (July 27, 2006). Disgorgement is especially improper here because the ALJ also specifically determined that despite the misrepresentations, there was "no evidence" of harm. (*See* ID at 92, 95); *In re David J. Montanino*, SEC Release No.

773, 2015 WL 1732106, at *39 (April 16, 2015) (declining to order disgorgement because Division failed to demonstrate that violations of securities laws harmed the marketplace or clients and had failed to point to evidence that respondent was enriched, unjustly or otherwise, as a result of the violation); *In re Ambassador Capital Mgmt.*, SEC Release No. 672, 2014 WL 4656408 at *1, *72-73, *81-82 (Sept. 19, 2014) (same).

Division did not establish that the Respondents received ill-gotten gains, or in fact, any gains, from the conduct alleged. As to Octans, evidence indicates that those same assets would likely have been previously selected for Octans, as they were for other Harding deals, even if Lieu did everything she was supposed to do on that fateful day in May 2006. (*See* ID at 46, 66; *see also*, RXs 385-86; Tr. 1289:10-1290:19, 3799-3803.) As to Norma-related allegations, Neo and Lexington would have closed and been sold to investors with or without the Norma bonds because, as is always the case, neither deal had to be fully ramped at close. (DX 507 at 1, 509 at 1). The inclusion of Norma bonds in those deals had nothing to do with whether Harding would be paid a fee or how much. And there is no evidence of Harding receiving any other money or property as compensation for buying those bonds.

In addition, Harding's primary source of income was from management fees it generated from managing CDOs for the life of the deals. Notably, Division made no allegations about Harding's conduct in managing the CDOs. Harding's fees as Collateral Manager were earned based upon its performance of the specific obligations set forth in detailed transaction documents. There were no allegations that Harding did not manage the CDOs according to each requirement in the deal documents. In fact, as discussed above, Harding managed the portfolio of assets—not individual assets—as part of its management obligations, which included trading assets in or out as requested by the terms of the indenture. Disgorgement here is punitive and not causally connected to ill-gotten gains.[27]

Division cited *SEC v. Conaway* for the proposition that notwithstanding that compensation is not causally related to fraud, disgorgement is warranted when management's tenure would have been shortened substantially if the fraudulent scheme had not allowed the company to stretch out its existence. (Div. Br. at 28); No. 2:05-CV-40263, 2009 WL 902063 (E.D. Mich. Mar. 31, 2009). The *Conaway* court, however, did not find that disgorgement of compensation was *warranted*, but merely held that the SEC *could seek* disgorgement, and the appropriate disgorgement would turn on facts presented at trial. *Conaway*, 2009 WL 902063 at *19.

Division was unable to demonstrate that but for the violative misrepresentations, Harding would not have received its management fees nor did it prove that management's tenure would have been shortened substantially but for a fraudulent scheme. *See SEC v. Wyly*, No. 10-CV-5760 SAS, 2014 WL 3739415, at *5 (S.D.N.Y. July 29, 2014) (holding that the SEC did not satisfy its "burden to establish *both* a reasonable approximation of profits *and* the causal connection between the approximation and the violations.") (emphasis in original).[28]

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[27] In any event, Division's calculation of disgorgement is improper.

[28] Division also cited a number of cases for the proposition that the "faithless servant" doctrine governs, and the ALJ erred in establishing a proportional scheme of disgorgement because Chau compromised his fiduciary duties and thus must forfeit all compensation received after his disloyal act. (*See* Div. Br. at 28-29.) This standard, however, is an employment and agency law theory. *See Phansalkar v. Andersen Weinroth & Co., L.P.*, 344 F.3d 184, 200 (2d Cir. 2003); *Feiger v. Iral Jewelry, Ltd.*, 41 N.Y.2d 928, 928 (1977). Division's assertion that Chau owed a duty of fidelity to a separate "principal," here, Harding, is ill-conceived and contradictory to Division's other arguments. (*See* Div. Br. at 24. (alleging Chau "should have known what his subordinates were doing.").) Indeed, the only SEC enforcement action cited by Division, *SEC v. Church Extension*, does not mention the faithless servant doctrine as the applicable standard for disgorgement. *See* (Div. Br. at 29); *SEC v. Church Extension of Church of Church, Inc.*, 429 F. Supp. 2d 1045, 1050 (S.D. Ind. 2005) (ordering defendants to disgorge only half of their compensation because the "amount of disgorgement need only be a reasonable approximation of profits causally connected to the violation.").

III. THE ALJ ERRED IN AWARDING CIVIL PENALTIES.

Civil monetary penalties are unwarranted because the ALJ erroneously found that Respondents violated securities laws. *See* 15 U.S.C. §§ 80b-3(i), 80b-3(i)(2); 17 C.F.R. § 201.1003. But even assuming there were violations, civil penalties are nevertheless inappropriate because there was no pecuniary gain and a civil penalty is not in the public interest.[29] Third-tier penalties are entirely unwarranted, as one of the elements of a third-tier civil penalty is that the "act or omission . . . directly or indirectly . . . resulted in substantial pecuniary gain to the person who committed the act or omission." *See* 15 U.S.C. § 80b-3(i). There was no pecuniary gain to Respondents because, as previously explained, Lexington and Neo could have closed even without Norma.

IV. THE CEASE-AND-DESIST ORDERS WERE UNWARRANTED.

Cease-and-desist orders were neither necessary nor appropriate. *See KPMG Peat Marwick LLP*, Exchange Act Release No. 1374, 2001 WL 223378, at *7 (Mar. 8, 2001) (finding cease-and-desist order not "automatic" after finding violation; traditional factors must be considered). The Commission may require any person who "is violating, has violated, or is about to violate" securities laws to cease and desist from committing or causing such violation and any future violation of the same provision. *See* 15 U.S.C. §§ 77h-1(a), 80b-3(k). Even assuming there was a violation of securities laws, the Commission must consider other factors to determine whether a cease-and-desist order is appropriate, including: whether future violations are reasonably likely, the seriousness of the violations at issue, whether the violations are isolated or recurrent, the respondents' state of mind, whether respondents recognize the wrongful nature of

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[29] As noted above, there was also no willful conduct, which is required for an award of civil penalties. *See* 15 U.S.C. §§ 80b-3(i), 80a-9(d)

their conduct, the recency of the violations, whether the violations caused harm to investors or the marketplace, whether respondents will have the opportunity to commit future violations, and the remedial function a cease-and-desist order would serve in the overall context of any other sanctions sought in the same proceeding. *See, e.g.*, *In the Matter of Gordon Brent Pierce*, Release No. 9555, 2014 WL 896757 at *1-2, *82-84 (Mar. 7, 2014).

A cease-and-desist order is inappropriate here, as Respondents' conduct was not egregious, the violations were not recurrent and occurred many years ago, and no harm was caused to investors or the marketplace. (*See* ID at 92.) Additionally, the ALJ incorrectly placed "particular weight" on Respondents' supposed lack of recognition of the wrongful nature of their conduct despite that there was no repeated wrongful conduct. (*See* ID at 92); *First City Fin. Corp.*, 890 F.2d at 1229 ("[Defendants] are not to be punished because they vigorously contest the government's accusations. . . . lack of remorse' is relevant only where defendants have previously violated court orders.") (citing *SEC v. Koenig*, 469 F.2d 198, 202 (2d Cir.1972).)

V. THE ALJ ERRED IN REVOKING HARDING'S INVESTMENT ADVISER REGISTRATION AND IN IMPOSING A PERMANENT AND ASSOCIATIONAL BAR AGAINST CHAU.

The ALJ also erred in revoking Harding's investment adviser registration and imposing permanent and associational bars against Chau. The ALJ relied upon the same conduct and treated it as multiple acts counted for multiple securities violations and failed to acknowledge that with respect to the Norma BBB bonds, there was only one alleged bad act in selecting the BBB bonds, which accounted for only 1.6% of two portfolios.

First, Harding's investment adviser registration should not have been revoked because the ALJ's findings of willfulness were based solely on hearsay evidence.

Second, permanent bars are appropriate only if the actions at issue involve intentional misrepresentation to investors. *See ZPR Inv. Mgmt., Inc.*, Initial Dec. Release No. 602, 2014 WL

2191006 (May 27, 2014); *Raymond J. Lucia*, Initial Dec. Release No. 540, 2013 WL 6384274 (Dec. 6, 2013); *Michael R. Pelosi*, Initial Dec. Release No. 448, 2012 WL 681583 (Jan. 5, 2012). Whether an industry-wide bar is appropriate should be considered in light of the Commission's obligation to "ensure honest securities markets, and thereby promote investor confidence." *See Ross Mandell*, Exchange Act Release No. 71668, 2014 WL 907416, at *5 (Mar. 7, 2014) (finding industry-wide ban appropriate where a former president, CEO, and majority shareholder defendant was convicted of securities fraud, wire fraud, mail fraud, and conspiracy). In determining that the public interest weighed in favor of a permanent bar, the ALJ found intent and willfulness based on hearsay and a misunderstanding of the CDOs and placed "particular weight on Chau's lack of recognition of wrongful conduct . . . and on the fact that Chau continues his employment as an investment adviser, with current assets under management of about $1 billion." (ID at 96 (emphasis added).) But, as noted above, the "recognition of wrongful conduct" was not an appropriate factor for the ALJ to consider.

Finally, "[c]ollateral bars are appropriate 'in cases where it is contrary to the public interest to allow someone to serve in any capacity in the securities industry.'" *In the Matter of Abraham & Sons Capital, Inc. & Brett G. Brubaker*, Release No. 135, 1999 WL 34891, at *31 (Jan. 28, 1999) (citing *Meyer Blinder*, 65 SEC Docket 1970, 1981 (Oct. 1, 1997)). In making this determination, it is important to consider whether the misconduct is the type that "by its nature, flows across various securities professions and poses a risk of harm to the investing public in any such profession" and "whether the egregiousness of the respondent's misconduct demonstrates the need for a comprehensive response in order to protect the public." *Id.* at *30 (internal citations and quotations omitted). Even assuming the ALJ did not err in finding there was some misconduct, the conduct was not egregious, there was no harm to the marketplace, and the Issuers were not defrauded. The associational bar against Chau was thus inappropriate.

The revocation of Harding's investment advisor registration and the permanent and associational bars against Chau should be reversed.

CONCLUSION

For the foregoing reasons, Division's appeal of the Initial Decision should be denied and Respondents' appeal should be granted in its entirety.

Dated: May 8, 2015

Respectfully submitted,

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[redacted]

EXHIBIT A

Percentage of Norma CDO I notes in
Neo CDO 2007-1, Lexington Capital Funding V, 888 Tactical Fund, and Jupiter High-Grade CDO VI

Harding-Managed CDOs that Purchased Norma Notes							
Name	**Notional Value[1]**	**Date of Issue[2]**	**Total Amount of Norma Notes in CDO[3]**	**Rating of Norma Notes in CDO[4]**	**Price of Norma Notes in CDO[5]**	**Gross Spread of Norma Notes in CDO[6]**	**Total Percentage of Portfolio Comprised by Norma Notes**
Neo CDO 2007-1	$301,036,263.41*	April 5, 2007	$5,000,000.00	BBB	97	3ml+440/505dm	1.66%
Lexington Capital Funding V	$615,251,911.00**	March 29, 2007	$10,000,000.00	BBB	97	3ml+440/505dm	1.63%
888 Tactical Fund	$1,000,128,743.96***	March 15, 2007	$20,000,000.00	Single-A	99	3ml + 220 / 240dm	2.00%
Jupiter High-Grade CDO VI	$1,499,323,547.00**	May 3, 2007	$15,000,000.00	Single-A	99	3ml + 220 / 240dm	1.00%

* Aggregate Principal Balance of Pledged Collateral Debt Securities and Eligible Investments purchased with Principal Proceeds on deposit in the Principal Collection Account plus the Excess Synthetic Security Counterparty Account Balance
** Original Face Value of Portfolio
*** Aggregate Principal Balance of Eligible Collateral Debt Securities

[1] Respondents' Exhibit 283 (Neo CDO 2007-1); R-282 (Lexington Capital Funding V); R-283 (888 Tactical Fund); R-289 (Jupiter High-Grade CDO VI)
[2] Respondents' Exhibit 748
[3] Respondents' Exhibit 125
[4] Respondents' Exhibit 125
[5] Respondents' Exhibit 125
[6] Respondents' Exhibit 125

Respondents' Exhibit 879

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of **HARDING ADVISORY LLC and** **WING F. CHAU,** **Respondents.**	Administrative Proceeding File No. 3-15574 **CERTIFICATE OF SERVICE**

Pursuant to Commission Rule of Practice 150, I hereby certify that on May 8, 2015, a true and correct copy of the RESPONDENTS' OPPOSITION TO DIVISION'S APPEAL OF THE INITIAL DECISION was served via electronic mail on:

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Howard A. Fischer
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Dated: May 8, 2015

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May 8, 2015

HARD COPY

VIA FACSIMILE AND FEDERAL EXPRESS

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RECEIVED
MAY 11 2015
OFFICE OF THE SECRETARY

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

Dear Mr. Fields:

This firm represents Respondents Harding Advisory LLC and Wing F. Chau in the above-referenced proceeding. Enclosed for filing, please find Respondents' Opposition to Division's Appeal of the Initial Decision.

Thank you for your attention to this matter.

Sincerely,

BROWN RUDNICK LLP

Alex Lipman

Enclosures

cc: Andrew M. Calamari, Esq. (via e-mail)
Howard A. Fischer, Esq. (via e-mail)