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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.**

**REPLY IN FURTHER SUPPORT OF THE APPEAL OF**

**THE DIVISION OF ENFORCEMENT**

DIVISION OF ENFORCEMENT
Howard A. Fischer
New York Regional Office
Securities and Exchange Commission
Brookfield Place, 200 Vesey Street, Suite 400
New York, NY 10281
Tel. (212)-336-0589
[redacted]
Attorney for the Division of Enforcement

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The Division of Enforcement ("Division") respectfully submits this reply in further support of its appeal of certain aspects of the ALJ's January 12, 2015 Initial Decision ("ID").

## ARGUMENT

### I. THE ALJ'S ERRORS ON OCTANS I

The Division argued that ALJ committed the following errors with respect to Octans I:

- failing to find a violation of Section 17(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77q(a) ("Securities Act").
- failing to find Respondents' failure to disclose, in either the Pitch Book or the Offering Circular, that Magnetar was a party to the warehouse agreement and thus played a role in asset selection, constituted a violation of any subsection of Section 17(a) of the Securities Act.
- erroneously concluding that the evidence was "insufficient to conclude that Harding possessed a conflict of interest" because there was "insufficient evidence of pressure by Magnetar to corrupt Harding's credit process." (ID 73).
- failing to find a violation of Section 17(a)(1) of the Securities Act.

Rather than respond to these arguments, Respondents instead present a scattershot array of arguments largely untethered to the Division's points[1] in an attempt to show that there was no violation. While Respondents' failure in their brief[2] to track the arguments actually made by the Division complicates any response thereto, the Division will address those points that bear on the specific arguments made in the Division's cross-appeal.

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[1] Rather than responding to the specific issues raised in the Division's Appeal, Respondents have shoehorned into their opposing brief discussions of issues on which only ***they*** are appealing. Respondents have ignored the Commission's March 9, 2015 Order denying leave to file oversize briefs by appending to their opposition large chunks of what must have originally been in their moving brief. For this deliberate flouting of the Commission's Order, much of Respondents' arguments should be stricken as unrelated to the Division's appeal.

[2] For ease of reference, this brief will refer to the Division's April 1, 2015 Appeal as "Div. App."; to the Respondents' May 8, 2015 Opposition as "Resp. Opp. Br."; to Respondents' April 1, 2015 Appeal as "Resp. App."; and to the Division's May 8, 2015 opposition thereto as "Div. Opp. Br."

## A. <u>Respondents Violated Subsection 17(a)(3) of the Securities Act</u>

The Division previously showed it satisfied whatever "multiplicity" requirement the Commission's decision in *John P. Flannery*, Securities Act Release No. 9689, 2014 WL 7145625 (Dec. 15, 2014) recognized, and that the ALJ erroneously mischaracterized the violation as related solely to "a misrepresentation about a single subject in a single document." To the contrary: the 17(a)(3) violation was predicated on, *inter alia*, misrepresentations in numerous documents, including the Pitch Books, Offering Circulars, and the Collateral Management Agreement ("CMA"). Div. App. 5-7.

Respondents halfheartedly attempt to distinguish *Flannery* by asserting that it involved two or three misstatements sent in two letters, while the case at bar involved only "a single misstatement" "about Harding's credit review process." Resp. Opp. Br. 20. That it was sent to at least a hundred recipients is claimed to be irrelevant. *Id.* This argument fails.

First, it ignores that there were multiple misrepresentations in these documents, including the Pitch Book's promises that as part of its investment process Harding 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.
- 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. The Pitch Book included additional misstatements, including claiming Harding utilized "Individual Asset Selection Employing a Disciplined Bottom/Up Credit and Structural Analysis" *Id.* at 45. It also misrepresented 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.

Moreover, Harding misrepresented the standard of care it would follow, in both the CMA (Div. Ex. 4 at 8), and in the Offering Circulars, which referenced the CMA or its standard of care language. *See, e.g..*, Div. Ex. 3 at 66, 197; *see also id.* at 175-77, 257, 259. It is respectfully submitted that these multiple misstatements in numerous documents satisfy *Flannery's* requirements.

The policy implications of Respondents' position are stark, and would, if accepted, pose enormous risk to investors. Respondents would have the Commission immunize from liability those who obtain money or property through materially misleading materials, over a period of several months, as long as it is characterized as just one lie – no matter the number of victims, or the length of time. For example, a deliberate and material misstatement about an issuer's revenues in a private placement memorandum would not create liability under subsection 17(a)(3), even if sent to hundreds, or thousands of investors. The Commission should not accept such a straitened view of the statute's reach.

Finally, Respondents can be liable based not only on their transmission of misleading statements in various documents, but also upon their conduct in selecting assets. Section 17(a)(3) prohibits any person from "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." As the Commission has repeatedly recognized, negligent conduct suffices to establish liability. *Aaron v. SEC*, 446 U.S. 680, 701-02 (1980). "Negligence is the failure to exercise reasonable care or competence." *Byron G. Borgardt*, 56 S.E.C. 999, 1021, 2003 WL 22016313, at *10 (2003). Thus, in addition to their disclosure failures, Respondents' negligent (at least) failure to adhere to the represented standard of care set out in the Offering Circulars and CMA, as well as to the investment processes outlined in the Pitch Books, also establishes a violation of this subsection. By selecting assets in violation of these standards and processes, Respondents engaged in transactions, practices, and a course of business which operated as a fraud and deceit. *SEC v. Stoker*, 865 F.Supp.2d 457 (S.D.N.Y. 2012) is instructive on this point. There, under analogous circumstances, Judge Rakoff held that allegations that defendant negligently structured a CDO by wrongfully including inappropriate assets set out a claim under subsection 17(a)(3).. *Stoker*, 865 F.Supp.2d at 467-68.[3] The same reasoning applies here.

**B. Respondents Violated Section 17(a) By Failing to Disclose Magnetar's Being A <u>Party to the Warehouse Agreement and Its Role in Asset Selection</u>**

The ALJ held that the failure to disclose Magnetar's warehouse involvement in various materials was both material and misleading, yet did not find Harding liable due to its purportedly being unaware of the error. In its moving brief, the Division established that Harding's conduct was reckless, and thus constituted a violation of subsection 17(a)(1) of the Securities Act, as well as, at the very least, subsections 17(a)(2) and (a)(3). Div. App. 7-14.

In response, Harding effectively concedes the Division's arguments by ignoring them, instead asserting a plethora of mostly non-responsive claims, including that: (1) Magnetar's warehouse participation was not material, based on commentary to a proposed regulation that was not in effect during the acts at issue and which has not been enacted (Resp. Opp. Br. 4-7); (2) Magnetar was not indifferent to the performance of Octans I (*id.* at 12-13); and (3) the ALJ correctly found Respondents not liable for misstatements in the Pitch Books and Offering Circulars (*id.* at 16-18). None of these non-responses suffice to rebut the Division's argument.

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[3] *See also Anthony Fields, CPA.*, Release No. 4028, 2015 WL 728005, at 17-18, & n.58 (Feb. 20, 2015).

### 1. <u>Commentary to a Proposed and Unenacted Rule Has No Legal Effect</u>

Respondents lead by arguing the omission at issue was not material based on the commentary to a regulation – Proposed Rule 127B – that was not only proposed ***after*** the facts at issue, but which has never been adopted. "Proposed [SEC] rules do not have the force of law." *Union Commerce Corp. v. Huntington Bancshares Inc.*, 556 F. Supp. 374, 380 (N.D. Ohio 1982). Indeed, to the contrary: that a rule is proposed that would "accomplish the same results" urged by its proponent "supports the position that the existing law does not support [that party's] legal theory in this case." *Id.* That is, the fact that a rule was proposed to render conduct at issue legal strongly implies that it was not legal previously – why else would a rule be necessary? *See also Mayer v. Chesapeake Ins. Co.*, 877 F.2d 1154, 1162 (2d Cir. 1989) ("the proposed [SEC] rule does not govern the present case").

### 2. Harding Knew or Recklessly Disregarded Magnetar's Indifference to the <u>Performance of Octans I in Violation of Section 17(a)</u>

As the Division pointed out, Chau conceded that Magnetar was indifferent to the performance of Octans I, having hedged its exposure and would profit regardless of how Octans I performed. Div. App.9-10.[4] This indifference created a potential conflict with the debt investors, whose interest was in the CDO performing well. Yet not only did Magnetar have a different interest than long-only debt investors, Magnetar also had significant rights that no other

[4] According to Prusko, Magnetar's goal was to remain "market neutral," *i.e.*, to profit from good performance or bad, which required betting against two dollars of mezzanine CDO debt for every dollar invested long in CDO equity. Prusko Tr. 2681:4-2682:9, 2336:22-2341:5, 2363:22-2364:3. Consequently, Magnetar sought to go short on Octans I as rapidly as it could. Prusko Tr. 2755:21-2756:17 ("Q. With both of those e-mails in mind [*i.e.*, Resp. Exs. 866, 867], is it fair to say that as soon as Octans 1 priced, Magnetar was looking to hedge its long risk on it by obtaining shorts? / A. I think it's a fair reading of that, yes."); *see also* Div. Ex. 157 (August 31, 2006 comment by Chau that Prusko probably buying protection on Octans I).
Prusko acknowledged that CDO failure was extremely profitable for Magnetar. Prusko Tr. 2682:10-16.

investor had ***or even knew of***, including rights with respect to choosing which assets to select and how to execute that selection. Chau knew full well of, or recklessly disregarded, or negligently disregarded, this potential conflict. For these reasons, among others, the Division argued that the failure to disclose Magnetar's role in asset selection violated Section 17(a) of the Securities Act.

In response, Respondents assert Magnetar was not indifferent (Resp. Opp. Br. 12-13), yet their argument on this point is curious, to say the least. First, Respondents claim that proposed but never enacted Rule 127B negates this claim; as set forth above, that argument fails. Next, Respondents rely on a large block quotation from the transcript, but in that excerpt Chau accepts that Magnetar was "indifferent to the performance of the transaction." It is respectfully submitted that, if Respondents were trying to prove the contrary, Chau's embrace of the Division's position demonstrates their failure to do so.

**3. Respondents Should Be Held Liable for Misstatements in the Pitch Books and Offering Circulars**

In response to the Division's argument that Respondents should be liable under Section 17(a) for misrepresentations in the Pitch Books and Offering Circulars (Div. App. 8-14), Respondents simply ignore the vast majority of the Division's arguments. Instead, Respondents make two claims: that Harding was not responsible for the Pitch Book (Resp. Opp. Br. 16-17,20 & n.21), and that the review by various counsel of the Offering Circular immunizes Respondents from liability. *Id.* 17-18.

The first point is easily disposed of. There is no serious dispute that Harding created – and had full control over – the section of the Pitch Book about itself and its investment processes. Div. Ex.1 at 38-59; *see also* Wang Tr. 368:13- 370:21, 372:19-373:6, 386:14-387:22; Chau Tr. 1824:9-1825:9. Indeed, the section of the Pitch Book entitled "About Collateral

Manager" and which contains the misrepresentations at issue regarding Harding's processes declares on its first page that: "All information in section 6 has been supplied herein by Harding Advisory LLC." Div. Ex. 1 at 37.

Second, Harding also worked jointly with Merrill in drafting the Pitch Book section on conflicts of interest (Chau Tr. 1837:25-1838:7;Wang Tr. 384:16-21, 612:16-613:25), including reviewing and commenting on the pages with the misleading warehouse disclosure. Div. Ex. 124 at 2-3, Div. Ex. 124 at 1.

Third, Harding often tracked the Pitch Book in investor discussions, *see* Huang Tr. 1043:11-13 – a further indication that its contents were meaningful, and that Harding's oral presentations to investors were informed by its disclosures, misleading though they were.

Finally, a Section 17(a) claim does not require authorship; only that the violator "engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit." Respondents' argument that authorship is required under the Securities Act has been repeatedly rejected. *SEC v. Monterosso*, 557 Fed.Appx. 917, 2014 WL 815403, at *5 (11th Cir. Mar. 3, 2014); *SEC v. Garber*, 959 F. Supp. 2d 374, 380 (S.D.N.Y. 2013); *see also Flannery*, at *17. Section 17(a), again, is "expansive enough to encompass the entire selling process," *U.S. v. Naftalin*, 441 U.S. 768, 773 (1979).

Respondents' arguments with respect to the Offering Circular are even weaker. Respondents do not contest the factual or legal analysis showing Harding's reckless conduct with respect to the Offering Circular violated Section17(a)(1) of the Securities Act (Div. App. 12-13); rather, they appear to be arguing that the review of the Offering Circular by various counsel negates Respondents' requisite state of mind under Section 17(a)(1). Resp. Opp. Br. 17-18. At no point do Respondents challenge the Division's argument that this conduct violated subsections 17(a)(2) and (3).

Respondents are not entitled to any form of a good-faith reliance-on-counsel defense. It is black-letter law that "a party who intends to rely at trial on the advice of counsel must make a full disclosure during discovery; *failure to do so constitutes a waiver of the advice-of-counsel defense*." *Arista Records LLC v. Lime Grp. LLC*, 2011 WL 1642434, at *2 (S.D.N.Y. Apr. 20, 2011) (emphasis in original; internal quotation marks omitted); *U.S. v. Bilzerian*, 926 F.2d 1285, 1292 (2d Cir. 1991).

In this case, Respondents have never tried to make a full disclosure of their communications with counsel concerning this issue. They refused to allow their attorney to be questioned about his communications with his clients, if any, surrounding the disclosure of the warehouse in the offering circular. Tr. 3107:5-23. When Respondents *did* allow Alison Wang to be questioned on this subject, she negated every single element of an advice-of-counsel defense. Wang Tr. 459:11-481:5.

But that is far from the only problem with Respondents' attempt to invoke reliance on counsel. "To invoke this principle, [a securities defendant] has to show that he made complete disclosure to counsel, sought advice as to the legality of his conduct, received advice that his conduct, was legal, and relied on that advice in good faith." *Markowski v. SEC*, 34 F.3d 99, 104-05 (2d Cir. 1994).

Respondents cannot satisfy *any* of the four elements of the defense: There is no indication that Respondents ever made a disclosure to their counsel of the relevant facts, ever affirmatively sought advice as to the sufficiency of those disclosures, ever received any advice on those disclosures, or relied in good faith on that advice. The closest Respondents have come is to show that Respondents' counsel at one point had possession of the Warehouse Agreement – but not that counsel was ever asked to opine on whether it would be appropriate to mischaracterize that agreement, let alone whether it would be consistent with the securities laws to misrepresent to their advisory client and to investors the standard of care and their method of selecting collateral. This is the so-called "presence of lawyers" defense, which is not a valid defense at all, but rather a back-door effort to benefit from counsel's peripheral involvement without establishing any of the predicates for a genuine reliance on counsel defense. *See, e.g.*, *SEC v. Savoy Indus.*, 665 F.2d 1310, 1314 n.28 (D.C.Cir. 1981) ("Compliance with federal securities laws cannot be avoided simply by retaining outside counsel to prepare required documents.").

Nor can they rely on the review of the Offering Circular by Merrill's counsel. Respondents and their attorneys had extensive input into the *entire* offering circular, not just the parts expressly attributed to Harding. Harding reviewed and was aware of the relevant provisions of the Offering Circulars (Div. Ex. 501; Wang Tr. 346:2-4, 346:13-25, 354:21-355:12, 359:17-360:6, 365:3-23, 623:22 – 625:24; Chau Tr. 2121:19-2122:8), and Chau certified that he had "carefully examined" the entire document. *See* Div. App. 12-14.

**C. <u>Harding Is Liable for its Failure to Disclose a Conflict of Interest</u>.**

The ALJ's failure to find a conflict of interest that had to be disclosed was premised on his conclusion that there was an absence of evidence demonstrating Magnetar's pressure on Harding. The Division argued that this was error, and that it overstated what needed to be shown to demonstrate a violation of the Advisers Act. Div. App. 14-18. The response – that there was no error because Harding did not itself believe there to be a conflict – should be rejected.

Respondents claim that the record did not show that Respondents believed Magnetar's interests were material. Resp. Opp. Br. 7-11. Yet their record citations demonstrate the contrary.

Respondents concede that the ABX Index trade was not their idea, and that because it was so complex it required "multiple explanations by Magnetar." Resp. Opp. Br. 8. They further admitted that Magnetar had control over the execution of the trade. *Id.* at 8-9.

Respondents seek refuge in the fact that the identity of the assets ultimately selected were not hidden from investors. *Id.* at 8-10. But that misses the point completely: what no investor, or the issuer knew, was the role that Magnetar played in selecting those assets. No one was told that Magnetar selected a small subset of the total universe of available bonds and instructed Harding to choose as many of those as possible to constitute a substantial portion of the Octans I portfolio, or that, as conceded, Magnetar controlled the execution of this trade. No other investor played this role; no other investor suggested assets, controlled the execution strategy, and had to explain multiple times a trade so complicated that Harding could not come up with it on its own.[5] *See* Div. App. at 16-17. Investors have every right to believe that a given investment strategy is being faithfully executed by the adviser they selected, not an undisclosed shadow adviser with divergent interests.

Respondents also acknowledged that Chau's testimony and the record evidence suggests strongly (to say the least) that Respondents knew that Magnetar's influence was problematic. Resp. Opp. Br. 10-11. *See also* Div. App. at 17. Respondents now claim that this evidence only relates to post-closing transactions, not the selection of the collateral pre-closing. But this claim (*see* Chau 1831:10 – 1835:15) is illogical. First, the undisclosed rights derived largely from the warehouse agreement, which is inapplicable post-closing. Second, Harding almost never traded

[5] Nor did the ALJ hold, contrary to Respondents' assertion (Resp. Opp. Br. 9) that the ABX Index trade was beneficial to the Octans I deal; to the contrary, engaging in the transaction resulted in approximately \$1.65 and \$2.15 million less income. ID at 57 (citing expert report of Richard Ellson). In any event, there is no legal support for the proposition that an investment adviser can, with impunity, lie to investors, or violate its fiduciary duty, as long as there is no harm ultimately suffered; in fact, the law is to the contrary. *See* Div. Opp. Br. at 16, n.20, 25.

assets after closing (although Chau tried to dump Norma bonds cheaply), so it would make little sense for Chau to testify that a practice he rarely, if ever, engaged in was problematic. Finally, as Chau initially recognized (before recanting once he realized how damaging his earlier testimony was), giving one party rights undisclosed to every other investor was problematic, regardless of when it occurred.

Respondents' argument ultimately boils down to the claim that, as Octans I did not perform worse than other CDOs of similar vintage, and the assets they selected were not significantly worse than others, Magnetar's involvement in proposing the ABX Index trade and controlling its execution is not material, and could not be a conflict of interest. But, as the Division pointed out earlier, that is not the law under the Advisers Act. Div. App. 15-16.

Nor are Respondents' efforts to distinguish that law (Resp. Opp. Br. 13-16) successful. Respondents ignore the law cited at Div. App. 16 providing that failure to disclose even an appearance of a conflict of interest violates the Advisers Act, and needs to be disclosed. Instead, Respondents focus their fire on *Feeley & Willcox Asset Mgmt. Corp.*, Advisers Act Release No. 2143, Securities Act Release No. 8249, 80 S.E.C. Docket 1730, 2003 WL 22680907 (July 10, 2003), arguing that the materiality standard is not whether a client would want to know a fact, but whether a reasonable investor would want to know. Resp. Opp. Br. 14-15.[6] However, Respondents have missed the point. The language they cite relates to violations of the Securities and the Exchange Acts (*see id.* at * 9), while the section upon which the Division relied related to the Advisers Act, and provided that investment advisers owed a "special duty of disclosure to

[6] Although as Respondents allow, at least one investor testified at length that he would have wanted to know about the conflict in this case. Resp. Opp. Br. 15. Somehow, Respondents dismiss this as "just an isolated opinion of one person and not conclusory proof of what would have been viewed by the reasonable investor" as material, even though they accept that "his testimony is echoed by the other investors." *Id.*

advisory clients" such that all potential conflicts should be disclosed. *Id.* at *12-13. As the Commission ruled in *Feeley & Willcox*, it is no defense for the adviser to claim that he had weighed the various interests and determined there was an alignment, such that no disclosure had to be made. If the potential for conflict exists, it must be disclosed.[7]

### D. Harding's 17(a)(1) Violations and Lieu's Credibility

In its moving brief, the Division argued that Harding should be held liable under Section 17(a) for several reasons, including the ALJ's erroneous determination regarding the credibility of Jung Lieu. Div. App. 8-12, 13, 18-19. Respondents ignore the arguments regarding Harding's recklessness, and the response to the argument based on Lieu's credibility mostly ignores the record cites adduced by the Division. Respondents' argument hinges on the counterfactual claim that, notwithstanding the evidence of what she did do, Lieu must have done something else; it should be rejected, and the Division's appeal on this ground granted.

## II. THE ALJ'S ERRORS ON NORMA

The Division argued that the ALJ erred in failing to find a violation related to the purchase of single-A Norma bonds. Div. App. 19-23. The Division's argument focused (i) on the language of the OIP (Div. App. 19-20), (ii) the evidence adduced during the hearing (*id.* 20-22), (iii) the ALJ's misreading of the hearing transcript (*id.* 22) and (iv) the law permitting matters outside the scope of the OIP to be considered in assessing sanctions. *Id.* 22-23. These

[7] *See also SEC v. DiBella* 587 F.3d 553, 567 (2d Cir. 2009) (noting also that for violations of Section 206(2) intent need not be shown); *Monetta Fin. Servs. v. SEC*, 390 F.3d 952, 955-56 (7th Cir. 2004) ("violation of the Advisers Act requires neither injury nor intent to injure"); *Vernazza v. SEC*, 327 F.3d 851, 858-59 (9th Cir. 2003) (potential conflicts must be disclosed); *SEC v. Slocum, Gordon & Co.*, 334 F.Supp.2d 144, 182, (D.R.I 2004) ("Potential conflicts of interest are always material"); *In re O'Brien Partners, Inc.*, Advisers Act Release No. 1772, 1998 WL 744085*8-9 & n.19 (Oct. 27, 1998)("even potential conflicts of interest are material and must be disclosed" even if adviser concluded that its conduct had not been influenced improperly).

arguments, which turn solely on a claim related to the single-A purchase are the sum total of the Division's appeal on Norma. Yet rather than focus on this narrow issue, Respondents either repeat the arguments made in their appeal or attempt to cram those that they neglected to address in the first go-round.

Thus, Respondents, by failing to respond to any of the arguments set out in the first two points and the last point, effectively concede them. Respondents only parry to the Division's third point is that one of its counsel "misspoke." Resp. Opp. Br. 24. In light of their failure to respond to the Division's other arguments, it is respectfully submitted that, if the only basis for Respondents' argument is a claim that they misspoke at the hearing, the Division has carried the day on this appeal point.

Notwithstanding the amount of ink spilled asserting arguments that bear no relationship to the Division's appeal (and which the Commission should strike as nonresponsive), none of them provide any relief to Respondents.

First, Respondents gain no traction from the assertion that, as a matter of law, the CDO issuers could not have been misled since Merrill Lynch, the structurer of the CDOs, knew everything about the Norma bonds and the circumstances of their purchase (Resp. Opp. Br. 22-23). This merely restates arguments from Respondents' own appeal (*see* Resp. App. 26-28). Rather than repeat what has already been briefed extensively, the Division relies on its response thereto in its Opposing Brief. *See* Div. Opp. Br. 32 & n.33; *see also* ID at 73 (rejecting this argument).

Similarly, the claim that there was no pressure from Merrill to buy the single-A Norma bonds so there could be no violation (Resp. Opp. Br. 23-24) is merely a rehash of a prior argument (Resp. App. 17-18) and has been rebutted. Div. Opp. Br. 25-26 & n.29. *See also* ID at 86.

The third argument – that the CDOs at issue could not be defrauded – is equally baseless. *See* Opp. Br. 25-26. Harding relies entirely on dicta from the introductory paragraphs of *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 Fed.Appx. 73 (2d Cir. 2011), for the proposition that, since the issuer was a special purpose entity ("SPE") created for the purpose of closing the deal, as a matter of law it could not be defrauded since it had no choice in the matter. Under this concocted precedent, it is legally impossible for an investment adviser to commit fraud and violate the Advisers Act, as long as the client is a SPE. This case is far too slender a reed to support the weight of Harding's arguments.

*Parmalat* involved state law claims (not federal securities laws claims). Cayman SPEs connected with Parmalat sued the bank which created and used them for investment in a fraudulent scheme involving the overstatement of assets. The SPE's existed only to borrow $300 million from investors and buy the stock of a Brazilian subsidiary, with a put right to sell the shares to a Parmalat affiliate (guaranteed by Parmalat). When Parmalat collapsed and was unable to satisfy its obligations, the SPE's sued for fraud, arguing they would never have entered into the transaction had Parmalat fully disclosed its parlous financial condition. The Court dismissed the fraud claim on the ground that, as the SPE's had no choice but to close the deal (since that was the only reason they were created), no fraud claim under state law could lie.

But there is a clear distinction between a fraud claim under New York state law, which requires reliance, and an enforcement claim under the federal securities laws, which does not. Nor is there any part of the *Parmalat* decision on fraud that hinged upon the nature of the SPEs –

the fraud claim was dismissed for the failure to establish scienter under the "clear and convincing standard." 684 F.Supp.2d at 475. In fact, the *Parmalat* court actually ***upheld*** the existence of a breach of fiduciary duty claim – which is analogous in many respects to a claim under the Advisers Act. 684 F.Supp.2d at 475-81. (This claim was ultimately dismissed for failure to show damages resulting from the breach, but damages are not an element of an Advisers Act claim. Div. Opp. Br. at 16 &n.20.)[8]

Accepting Respondents' theory would mean that, in almost every instance, there could be no breach of the Advisers Act or any other securities law in any case involving a structured product, or a host of investment funds, since they all involve special purpose vehicles of one sort or another. These are just additional "blame the victim"-style reliance and causation arguments. "Section 206 of the Advisers Act focuses upon the investment adviser and his or her actions. Clients and prospective clients are mentioned only in relation to the advisors." *Raymond J. Lucia Cos.*, Initial Dec. Rel. No. 540, 2013 WL 6384274, at *44 (Dec. 6, 2013) (citing *SEC v. Gruss*, 859 F. Supp. 2d 653, 662-63 (S.D.N.Y. 2012)). That the client may be a dupe, dummy, or shell has nothing to do with whether the *adviser* fulfilled its obligations and made the requisite disclosures.[9]

Respondents' fourth argument – that the ALJ misinterpreted the purpose and goal of asset selection – not only ignores the appeal brief to which it is supposed to be responding, it presents

[8] Interestingly, the *Parmalat* court also rejected a claim made by Harding that it could not owe fiduciary duties since there were various parties with different interests: "if ... [an] entity conducts itself with respect to one party to a transaction in a manner that gives rise to a fiduciary duty, it is no answer to say that the bank owed a conflicting duty to another. That makes matters worse, not better." 684 F.Supp.2d at 478.

[9] There are excellent policy reasons why the adviser's obligations should not hinge on the wherewithal of the client, which after all by definition reposes trust in the adviser. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963) (discerning legislative interest in protecting "unsophisticated" clients).

a topsy-turvy alternate universe in which an investment adviser can purchase assets either without any analysis whatsoever or do so even in the face of harshly negative analysis. By claiming that the only thing that matters is the portfolio as a whole, Respondents seek to excuse disregard of their duty to select assets only after performing a rigorous examination in accordance with the appropriate standard of care. Regardless of whether or not certain levels of risk had to be assumed in order to obtain a desired rate of return, Harding certainly could not add assets without either doing the required analysis, or notwithstanding an analysis that the asset should not be acquired, even if done under pressure from other parties. The problem is not that Harding had to employ a risk/return balancing that would entail selection of some riskier assets with a higher level of return, but that there was absolutely no analysis that the risk profile of the Norma bonds was justified by the returns. There was no analysis for the single-A purchase, and the analysis of the triple-B bonds established that they were not worthy for purchase at all.

Furthermore, although Harding now claims (for the first time in this proceeding, at that) that it selected Norma because it somehow fit within some analysis of the relevant CDO portfolios as a whole, there is absolutely no evidence that this kind of far-reaching and integrative research was ever conducted, and no testimony from anyone at Harding that it is what they did. No one at Harding ever made a determination that the four CDOs at issue had a need that Norma filled; instead, they merely reacted to pressure from Merrill.[10]

[10] Respondents also assert, yet again, that Norma's fitting into the definition of "eligible" securities satisfied whatever obligation Harding had. Opp. Br. 28-29. This argument, which has no place in a response to the Division's appeal, has already been conclusively rebutted. *See* Div. Opp. Br. at 14-15, 29, 32.

## III. THE ALJ'S REMAINING ERRORS

### A. Failure to Find Causing and Aiding and Abetting Liability

The Division established Chau is liable for causing and aiding and abetting Harding's Octans I violations. Div. App. 23-27. In response, Harding does not dispute a single record citation or legal argument of the Division's but instead weakly puts forth two arguments: (1) that Chau was out of the office on May 30, 2006, and was not "privy to the discussions surrounding Octans"; and (2) that there was insufficient evidence that Chau was aware of his subordinates' violations. Opp. Br. 21. Both claims – which are varieties of Chau's attempts to wash his hands of the failings of his firm – fall short.

First, whether or not Chau was out of the office May 30, 2006, there is overwhelming evidence of his involvement with and understanding of the details of the Octans I transactions. (See the lengthy recitation of his involvement in the Division's moving brief. Div. App. at 23-27; *see also* Div. Ex. 68 (May 31, 2006 email from Chau to Lieu asking about the very Index assets "bought ... for Magnetar.") In any event, Chau was in the office May 31, *see, e.g.*, Div. Ex. 50, and was also at work June 1. At 9:35 a.m., he wrote to Prusko: "Hi Jim, back in the saddle, Lets chat this am when u r free." Div. Ex. 88. *See also* Div. Ex. 83 at 1 (Eliran on June 1, 2006: "I saw Wing today in our office"). Furthermore, Chau was a recipient of most of the May 30 and 31 Harding-Magnetar emails on ramping,[11] and was otherwise deeply involved in the ABX Index trade.[12]

[11] *See, e.g.*, Div. Exs. 25 (May 30, 2006 email referring to Octans I as a "Magnetar deal"); 28; 37, at 1; 46; 48 (May 31, 2006 email wherein Chau advised co-workers that "Jim [Prusko] wants to buy protection from [*i.e.*, short against] the [Octans I] warehouse"); 50; 81; *see also* Div. Ex. 23 (May 26 email stating that Prusko discussed his interest in the Index with Chau, who seems to have been willing to do what Prusko wanted: acquire the *entire* Index and disassemble it into the underlying components, all of which would go into Octans I; Huang Tr. 843:18-844:6, 846:2-19,

Second, as set forth in great detail previously, it was Chau's responsibility to ensure Harding's compliance with its represented processes. Div. App. 23-25. It is no excuse for Chau to seek refuge in his own failures to comply with his responsibility as Harding's principal, chief compliance officer and primary portfolio manager by claiming that he simply wasn't paying attention to what his personnel were doing, even though that was his job. Further demonstrating Chau's recognition that Harding cut corners is his boasting to Magnetar how quickly Harding ramped its transactions, Resp. Ex. 861 (Chau disparaging a competitor: "Slow rampers. Stick w/Harding, we get the job done right!"), even though ordinary debt investors had nothing to gain from Harding forgoing the deliberate and methodical asset selection promised in its marketing materials.

### B. Errors With Respect to Remedies

The Division argued ALJ should have ordered all of Harding's management fees disgorged, and not just a *pro rata* portion thereof based on the proportion of wrongfully chosen assets to the entire asset pool. App. Br. 27-30. The Division also asserted that the ALJ erred in his penalty assessment. App. Br. 30-33. Respondents ignore the arguments actually put forth.

#### 1. Disgorgement

The Division argued (Div. App. 27-30) that the ALJ erred in not ordering the disgorgement of all of Harding's management fees, under the "faithless agent" doctrine. Respondents seem to argue that the doctrine does not apply because there is no showing that

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847:16-848:10 (Chau was aware of May 30, 2006 call with Merrill and Magnetar to discuss trade).

[12] Chau knew, too, that the Index trade was highly unusual. He knew that investors did not like to see either the Index, or too many Index bonds, in a CDO, even making a point to "exclude index trades" from a trade blotter shown to a potential investor. Div. Ex. 158; Resp. Ex. 827; Div. Ex. 258 at 2. *See also* Div. Ex. 275 (Chau's response to Prusko's suggestion to "buy the extra index": "need to check with the structurers and syndicate as to how much index before investors balk").

Chau owed Harding a duty. Resp. Opp. Br. 35 & n.28. This misapprehends the argument; the Division never claimed that disgorgement should be based on Chau's disloyalty to Harding, but on Harding's disregard of its duties towards investors and advisory clients.

Respondents' other defenses – that the management fees were earned legitimately and that any violations were found not to have caused harm to investors or to the marketplace – fail as well. Resp. Opp. Br. 33-35. In the first place, these are not responses to the Division's arguments. These are points that should have been raised in Respondents' own challenge to the ALJ's ruling, and it is inappropriate for Respondents to pretend that these are in response to the Division's appeal. Second, any finding of violations of the securities laws during Harding's tenure presumes that at least a portion of its fees were wrongfully earned. Third, unlike in a private action, the measure of disgorgement is not harm to investors or the market at large, but the sums wrongfully obtained by Respondent.

### 2. Penalties

Respondents ignore the Division's appeal on this issue (Div. App. 30-33), arguing only briefly in passing that penalties were inappropriate because there were no securities violations and no pecuniary gain. The Division concedes that if, ultimately, no securities violations were deemed to have occurred, then penalties would be inappropriate; however, given the lack of response to the Division's moving brief on this issue it is respectfully submitted that, should such violations be found, the Division's position on penalties should prevail.

### 3. Respondents' General Attack On the Remedies Ordered Fails

Respondents never appealed the remedies imposed by the ALJ. Large sections of the Response Brief bear no relation to the Division's Appeal, and should be rejected for that reason alone. *See* Resp. Opp. Br. 30-32, 36-39.

Moreover, Respondents depend largely on arguing that sanctions (including a cease and desist order, Resp. Opp. Br. 36-37, and revoking Harding's adviser registration and awarding a permanent bar against Chau, *id.* at 37-39) were inappropriate because the ALJ erred in finding violations. There is no claim that the ALJ's findings do not support the sanctions awarded; rather, Respondents rely on a counterfactual reality in which they did nothing wrong and are the victims of an unjust crusade. However, Respondents' invented reality is not a basis on which remedies should be assessed.

Finally, regardless of whether Respondents should have raised this argument in their appeal, the sanctions awarded were entirely appropriate. Respondents' violations of their statutory duties were serious, repeated, and generally committed with a high degree of scienter. There is no assurance against future misconduct, as Chau refused to acknowledge that anything he did was in the least bit problematic, and repeatedly invented far-fetched, self-serving, unconvincing justifications for his conduct, as the Division has detailed. He also denied that he or Harding had any fiduciary duties to advisory clients. Opportunities to commit violations will persist as Chau is in his 40's and has given no indication he intends to leave the securities industry and, as the ALJ found, still manages assets. *See generally* ID 96.

An industry bar is particularly important in this case given the importance to the investment adviser industry of maintaining honest fiduciary relations. *See Steadman v. SEC*, 603 F.2d 1126, 1142 (5th Cir. 197() (Commission considers "violations occurring in the context of a fiduciary relationship to be more serious than they otherwise might be"); *James C. Dawson*, Advisers Act Rel. No. 3057, 2010 WL 2886183, at *4 (July 23, 2010) ("We have consistently viewed misconduct involving a breach of fiduciary duty or dishonest conduct on the part of a fiduciary … as egregious.") (rejecting argument that minimal harm to the adviser's to clients justified a less severe bar: the "nature of the violation itself, not solely . . . [the] calculation of financial harm" that underpins a bar determination." *Id.* at *3.)

Permanent bars are appropriate here. This case has certain commonalities with *ZPR Inv. Mgmt.,* ID. Rel. No. 602, 2014 WL 2191006 (May 27, 2014), which involved an investment adviser that misrepresented its adherence to a generally accepted set of standards and an individual who, in addition to misleading clients and prospective clients, "refused to accept responsibility for the abdication of his fiduciary duty." 2014 WL 2191006, at *58. The heavy sanction of permanent bars was imposed even though no investors were purportedly harmed. Similarly, in *Raymond J. Lucia Cos.*, ID Rel. No. 540, 2013 WL 6384274, at *57 (Dec. 6, 2013), a permanent bar was imposed on an individual who, like Chau, departed from standards of ordinary care, and "refused to accept responsibility for the abdication of his fiduciary duty." And in *Michael R. Pelosi*, Initial Dec. Rel. No. 448, 2012 WL 681582, at *18 (Jan. 5, 2012), *dismissed on other grounds*, Advisers Act Rel. No. 30997, 2014 WL 1247415 (Mar. 27, 2014), the reasons for a permanent bar included respondent's sophistication and the fact that his justifications for his misconduct were "unpersuasive, inconsistent, ad hoc, ex post facto, and, at times, incoherent" – which would also describe much of Chau's testimony. See also *Donald L. Koch*, Exchange Act Rel. No. 3836, 2014 WL 1998524, *21(May 16, 2014) (even violations lasting brief period of time can result in a lengthy bar).

## CONCLUSION

The Division respectfully requests that the Commission enter relief in favor of the Division on those points identified in the Division's April 1, 2015 Appeal.

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Respectfully Submitted,

Howard A. Fischer

New York Regional Office
Securities and Exchange Commission
Brookfield Place, 200 Vesey Street, Suite 400
New York, NY 10281
Tel. (212)-336-0589
[redacted]
Attorney for the Division of Enforcement

[redacted]

[redacted]

[redacted]