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May 22, 2015

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VIA HAND DELIVERY

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

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' Reply Brief in Further Support of Their Petition for Review.

Thank you for your attention to this matter.

Sincerely,

BROWN RUDNICK LLP

Ashley Baynham/LNB

Ashley Baynham

Enclosures

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

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' REPLY BRIEF IN FURTHER SUPPORT OF THEIR PETITION FOR REVIEW

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<u>OCTANS</u>[1]

The ALJ found that Division failed to prove any of the predicate facts to the charge of intentional fraud. (Resp'ts Br. at 2-4.)[2] Division did not appeal a single one of these findings. (*Cf. id.*) Therefore, Division did not appeal that it failed to prove the fraud theory charged in the OIP.[3]

The ALJ improperly found uncharged, negligent fraud instead. (*Id.* at 4-5.) He found that one analyst on one day followed the relevant review standards only "to some extent, albeit untidily and incompletely." (*See* ID at 66.) Respondents argued that they were not on notice of this theory and the prejudice from this departure from the OIP was incalculable. (Resp'ts Br. at 4-8.)

In response, Division does not point to a place in the record where this uncharged theory is propounded. Instead, it claims that the mere fact that violations of Sections 17(a)(2) and (3)

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1 Where terms are not otherwise defined, Respondents rely on the descriptions set forth in their Opening and Opposition Briefs.

2 Division claims that Respondents did not contest Octans liability under Sections 206(2) of the Investment Advisers Act of 1940 ("IAA"). (Div. Opp. Br. at 10.) Respondents, however, asked the Commission to reverse all of the ALJ's findings of liability, including his findings regarding 206(2) of the IAA and Sections 17(a)(2) and 17(a)(3) of the Securities Act. (*See, e.g.*, Resp'ts Pet. Rev. at 2.) In fact, in a section dealing with IAA allegations as to the Norma-related transactions, Respondents stated that "the same problems and errors outlined in this section apply equally to the Octans transaction." (Resp'ts Br. at 25 n.24.) This is because all of Respondents' arguments about Harding's obligations under the IAA and relevant deal documents apply with equal force to Issuer-related IAA allegations for Octans and Norma-related transactions.

Separately, Division did not address Respondents' argument that the ALJ erred in finding a violation of Section 17(a)(3) based on the theory that Lieu allegedly failed to follow the correct standard of care with respect to the Issuer. (*See* Resp'ts Br. at 30 n.30.) Lieu's conduct on one day does not meet the repetition requirement enunciated in *In The Matter of John P. Flannery and James D. Hopkins*, Securities Act Release No. 9689, 2014 WL 7145625, 18 (Dec. 15, 2014).

3 Division only appealed that the ALJ erred in not finding Harding liable for failing to disclose in the PB and OC that Magnetar had certain rights in the WA. We have addressed elsewhere why this theory also fails. (*See* Resp'ts Opp. Br. at 1-3.) It also does not matter, although Division tries to have it otherwise, that Magnetar (a) received lists of the assets Harding had selected before the trades were executed, (b) suggested the ABX Index trade, or (c) sourced some of the ABX Index assets. (*Compare* Div. Opp. Br. at 6-9 *with* 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 ("Rule 127B Release").) The ALJ also did not find that these allegations contributed to any fraud. (ID at 58-81.)

were charged was notice enough. (*See* Div. Opp. Br. at 10-11.) The issue is not whether Respondents were on notice that Division would attempt to prove violations of Sections 17(a)(2) and (3), but whether Respondents had fair notice that Division would attempt to prove a negligent fraud theory that was inconsistent with its charged theory that Harding deliberately altered its review to accommodate Magnetar. (*See id.* at 6-8.)[4]

Division seeks to resuscitate its case by arguing that the ABX Index trade had a net negative impact on the deal. (Div. Opp. Br. at 10 n.12.) In doing so, Division asks the Commission to ignore the ALJ's findings: "the evidence demonstrates that all interested parties believed at the time that the ABX Index purchase would generate higher spread for Octans." (ID at 77.) In other words, Division's assertion, if true, is irrelevant for two independent reasons: it cannot negate the ALJ's finding that there was no scienter, and it does not alter the analysis that Magnetar's participation was not material, given its economic interests in Octans. (*See* Resp'ts Opp. Br. at 16-17.) This theory has also been found to be baseless. (*Id.*)

As background, Division retained Ellson "to determine whether the sub-set of synthetic RMBS positions relating to the ABX Index generated excess income when compared to the sub-set of synthetic RMBS positions not related to the ABX Index." (ID at 57.) Ellson concluded that the ABX Index trade had a net negative economic impact, but his opinion had a fatal flaw. In his calculation, Ellson compared apples to oranges. (ID at 77 n.66.) As the ALJ observed, Ellson's calculation makes little sense because he failed to take into account the fact that the mix of BBB to BBB- assets in the ABX Index basket was materially different from the mix of BBB to BBB- in the rest of the portfolio. (*See* 1113:21-1115:14.) BBB- constituted only about 27% of the ABX

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[4] Division's argument is akin to bringing murder charges based on a theory that the defendant pointed and pulled the trigger knowingly or at least negligently because he was brandishing a loaded gun, and then, at trial, pursuing a theory that the defendant was negligent because he left his gun locker open, which resulted in the gun being stolen and used in a murder by someone else.

Index basket, with the remaining 73% consisting of BBB. In the rest of the portfolio, BBB- and BBB represented 45% and 53% of the portfolio, respectively.[5] Given the spread differential between BBB and BBB- of more than 100 bps, a comparison that does not take account of the difference in the mix, is skewed and meaningless. (Exhibit A of Resp'ts Opp. Br. ("Exhibit A") (apples-to-apples analysis using Ellson's formulation.) Ellson himself admitted on the stand that his comparison, based only on the total spread without taking account of the differences in the composition of BBB/BBB-, was "meaningless." (1126:12-1132:19.) In fact, in the post-Hearing memorandum, when Respondents took Ellson's formula and did the calculation comparing, on an apples-to-apples basis, the weighted average spread of the ABX Index assets in Octans, net of upfront premiums and spread over the expected life of the deal, the ABX Index produced more cash for Octans.[6] (*See* Resp'ts Post-Hearing Mem. at 50-56; *see also* Exhibit A.)

Contrary to Division's argument, there is no evidence that the ABX Index assets were adversely selected. (Div. Opp. Br. at 5-15.) Division retained Ellson to see if he could prove that the ABX Index assets were adversely selected. (*See* RX 884 at 1-2.) Ellson used historical loan level data to look at the likelihood, as of the time Harding analyzed these assets for inclusion in Octans, of projected defaults and losses experienced by the ABX Index assets in question. (1106:5-1107:3; 1112:22-1113:11.) He concluded that he could not show adverse selection; the ABX Index assets were no worse than the other assets Harding picked and no worse than the bonds then available in the market. (1112:6-10.) The fact that Ellson performed a loan level analysis is significant. In effect, he re-ran the ABX Index assets using credit analysis analytics,

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5 (DX 6, 169, 8002; RX 444; Exhibit F to Resp'ts Post-Hearing Mem.)

6 Ellson also conceded that contemporaneous emails showed that the relevant individuals "thought there was an arbitrage opportunity" to the trade. (1137:5-1139:4.) The evidence shows this point. (DX 18, 21, 169; RX 384, 514, 889; Prusko 2457:23-2460:8.)

which is what Harding did, using Intex, to run cash flow analysis on these bonds. But in order to meaningfully compare the ABX Index bonds with other bonds available in the market, Ellson had to have used a set of assumptions and analytics that were customary for CMs at the time. In other words, he looked at the analysis Harding and other CMs would have been looking at in May 2006 and made a judgment about what was reasonable and customary. Therefore, Ellson's analysis showed that neither Harding nor anyone else would have had any reason to think that the ABX Index assets were any worse than any other Harding-selected assets or any other assets available in the market. (1112:22-1113:11.)

Division willfully ignores this evidence. Instead, in its defense of the ALJ's finding that Lieu's "slapdash" and "untidy" work on one day (out of three months of credit review work) establishes negligent fraud, Division mischaracterizes (a) the fact that Harding changed one of its assumptions to 6%; (b) the evidence about dealer shelves; and (c) the evidence about other deals, Octans II and III.[7] (Div. Opp. Br. at 6-9.) These are all red herrings.

First, Harding did not lower its default rate assumptions as an accommodation. (*See id.* at 7 n.6.) Each market participant was responsible for setting their own assumptions and no industry standard existed as to what assumptions to use. (Wagner 4734:7-4735:5 ("I have never said that everyone has to use the same default rate.").) The evidence shows that Lieu and Moy lowered the assumption to 6% because they decided the higher percentages were too conservative, as confirmed by Lieu's conversations with market participants. (Lieu 3343:2-6, 3624:15-3636:5, 3946:11-3948:12.) The ALJ agreed. (ID at 80 ("There is no evidence that that change occurred in concert with Magnetar's participation in Octans I or the ABX Index trade.").)

[7] As has been the case from the beginning, Division's brief is polluted with half-truths, misleading statements, and falsehoods. We do not have the space to address each one. One more example: Division's footnote 15 states that Lieu was shown all relevant documents during her investigative testimony; however, the ALJ specifically found that she was not shown relevant documents.

Second, Division is disingenuous in claiming that "Harding senior executives disfavored" dealer shelves. (*See* Div. Opp. Br. at 8.) Division inappropriately cites a portion of Huang's investigative testimony to manufacture Hearing evidence that dealer shelves were disfavored. (*See id.* (*citing* 812:24-814:16) (Huang's prior testimony begins with the following statement "I don't participate [in the credit review on dealer shelves] but I have my personal view. I don't actually remember Harding's view.").)[8] At the Hearing, the only admitted evidence on the issue was Huang's testimony that he did not recall Harding having any particular credit view on dealer shelves. (812:17-23.)

Third, Division cannot, for the first time in its opposition paper, argue that conduct related to other CDOs, Octans II and III, prove that Respondents were negligent in their credit review for Octans I. (*See* Div. Opp. Br. at 8-9.) The ALJ already considered and rejected any notion that Octans II and III were relevant to asset selection for Octans I. (ID at 47-48, 80.)[9]

Moreover, Division has not pointed to evidence of wholesale abandonment of credit review processes. Evidence of deliberate departure from the normal credit analysis of a particular set of assets would be inconsistent with charges of wholesale abandonment of review because the normal review process must serve as a baseline against which any deliberate departure is then measured. For this reason, Division did not even offer evidence that all review was flawed; what it argued, consistently until post-Hearing briefing, was that Lieu had deliberately departed from her normal practice only in reviewing the ABX Index assets. This is insufficient to establish liability for misstatements about credit review processes. (*See* Resp'ts Br. at 13, 16-17.) Minor,

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8 To the extent Huang noted in prior testimony that he felt that dealer shelves were "a little worse," he was expressing a personal opinion as of 2011 and did not say that he would not purchase them. In any event, whether dealer shelves were a little worse or a little better is irrelevant. As discussed elsewhere, there is no such thing as a bad bond, only a bad price. If a bond's price is attractive, given its credit quality, the bond may be bought precisely because its spread was needed to achieve the right mix of credit quality and expected returns.

9 Note, for example, that the discussion in Division's footnote 9 dealt with these other CDOs.

i.e., non-wholesale departures are not material and cannot support a fraud charge. (*Id.*) Division's bald assertion that the relevant cases mean something else without any citations or discussion is empty rhetoric.

Division also argues that the evidence that the ALJ considered, DX 53 and Wagner's opinion, is sufficient to establish negligent fraud. Putting aside that mere negligence on one day does not constitute negligent fraud (*see* Resp'ts Br. at 5), Division does not contest the main problems with these pieces of so-called evidence.

Division does not contest that: (1) the ALJ improperly accepted Wagner's opinion on the ultimate issue (Resp'ts Br. at 10-11); (2) Wagner's report was false in its assertion that Harding did not review all of the relevant bonds at issue (*id.*); and (3) Wagner could not define the standard of care (*id.* at 11). As we explained, those are insurmountable problems. It also bears noting that much of Wagner's expert report was based on his interpretation of investigative testimony that was not admitted as evidence at the Hearing.

Other than arguing that it can rely on hearsay (Div. Opp. Br. at 11-13), Division did not address that DX 53 lacks any indicia of reliability and thus may not serve as the basis for finding liability. (*See* Resp'ts Br. at 8.) As we demonstrated, that spreadsheet was so problematic *on its face* that Wagner testified that he would not have approved assets on the basis of the document without further analysis. (*Id.*) Division also has no response to the fact that Lieu knew at the time that each of the relevant bonds was trading at par, indicating that DX 53 was wrong on its face; bonds with write-downs do not trade below par. (*Id.*) Division ignores Lieu's testimony that she would not have approved the assets on the basis of DX 53, but would have done additional work; a conclusion supported by the record. (*Id.* at 8-9.)

More fundamentally, Division cannot address head-on the fact that Respondents reviewed each asset pre-closing, including making sure that none of them presented a credit or default risk, and certifying that each asset met the deal's Eligibility Criteria. (*See* Resp'ts Br. at 12-13; *see also* Chau 4252:25-4254:10 ("[y]es, a lot of work was done . . . to make sure the collateral within the warehouse meets the eligibility criteria.").) That is to say, Respondents re-reviewed the asset portfolio, fixing any prior errors, and certified to the investors that they were getting the exact bundle of rights the investors were promised.

Division tries to downplay this basic fact by stating that the Eligibility Criteria were "mechanical rules and rating agency-imposed requirements" that had nothing to do with the manager's own views of the assets. (Div. Opp. Br. at 14.) Taking that statement at face value, Division is claiming that the criteria imposed by rating agencies, whose job is to determine what *credit rating* to assign, had nothing to do with the *credit quality* of the deal. As to the criteria being mechanical, they are mechanical only in the sense that there are mathematical formulas that are applied to determine whether the deal was in compliance with the various Eligibility Criteria. As Chau explained, it took a post-graduate level mathematician or physics professor to run those numbers. (Chau 4096:7-20.) If running complex mathematical formulas is mechanical, any analysis of an RMBS in the ABX Index is mechanical. Finally, as to Division's citation of Wagner in its attempt to denigrate the import of the Eligibility Criteria, on the very next page of the transcript, Wagner concedes that the deal spread drives the quality of the assets in the pool, which may lead to the inclusion of more risky assets. (4640:5-13.) He also concedes in the same section of the cross-examination that each bond must be assessed not only on its credit, but also on whether it fits the various eligibility buckets. (4632:3-4633:15.) It is astounding that the SEC

Division of Enforcement would argue in a brief it filed with the Commission that whether investors received the benefit of their bargain was irrelevant as to whether they were defrauded.

NORMA

Division attempts to muddy the water by raising irrelevant arguments, and even then, it remains silent on several dispositive issues. For the most part, we do not need to address these points, as they are amply covered in Respondents' briefs. (Resp'ts Br. at 15-30; Resp'ts Opp. Br. at 21-29.) We have addressed below the most acute misstatements.

First, Division does not offer any rejoinder—as there is none—to the fact that the Directors of the Issuers, who were the same for Norma, Neo, and Lexington, were fully aware of Norma's quality, structural features, and asset composition. (Resp'ts Br. at 27.) If they believed the bonds were good enough to sell, they certainly thought the bonds were good enough to buy. Thus, no information Harding had about Norma could have altered the total mix of information available to the Issuers. They were neither deceived nor defrauded as to Norma. The analysis ends there.

Division's response to the points that Merrill was Norma's, Neo's, and Lexington's fiduciary, and disclosure to a fiduciary is disclosure to its principal (*Id.* at 26-27), is that Merrill did not know that Harding did not analyze the BBB Norma bonds. (Div. Opp. Br. 32.) Division's theory here was that Harding caved to pressure in order to curry favor. (OIP ¶¶ 60-69.) It is uncontested that Chau did not tell Magnetar that he purchased the BBBs. (Chau 4235:20-4236:14; Prusko 2651:17-19.) If Merrill also did not know, as the Division concedes here, then Harding could not have been buying Norma to curry favor with Merrill. Failing to take credit for accommodating someone is irrational if the accommodation is for the purpose of currying favor. Division concedes, in other words, that it failed to prove a quid pro quo, without which its theory of liability makes no sense whatsoever. This is the primary reason Division's reliance on cases involving corruption and undisclosed fees is entirely misplaced. (Div. Opp. Br. 22-24.) A more reasonable explanation for why Merrill did not know is that Norma was not bought as an accommodation.

Second, Division cites Section 215(a) of the IAA, which voids provisions "binding any person to waive compliance with any provision of" the IAA. 15 U.S.C. § 80b-15. The disclaimer of fiduciary duties in the CMA is not such a provision; it does not waive compliance with the IAA. To the contrary, the CMA simply describes the nature of Harding's duties in a manner wholly consistent with the restricted role of a CM for a CDO in which the interests of investors in different tranches are not fully aligned. CMAs cannot be transformed into advisory contracts subject to Section 215(a) simply based on a reference to "investment advisor" in the CMA, lower case and undefined. Division, unsurprisingly, does not cite any case that holds a CM's disclaimer of fiduciary obligations to be void under Section 215(a). Taken to its logical conclusion, Division's position would mean that no person could ever contract out of being a fiduciary, which would immediately halt most structured finance involving tranching.

Third, Division's entire theory rests on Respondents violating a standard of care, but nowhere – not in documents, testimony, or law – does Division explain what that standard of care is. In fact, its own expert, who opined that the standard of care was violated, "did not [and could not] identify exactly what 'industry standards' entail for collateral managers." (Resp'ts Br. at 11 (*quoting* ID at 55).) That is because Division pushes a reading and obligation that does not exist in the CMA.

Nowhere does the standard of care provision use the words "selection," "select," "credit review," "credit analysis," "Intex," or "cash flows." (*See* DX 507 at 156.) Rather, it refers only to Harding's "obligations" under the CMA. (Suh 3051:8-3052:16.)

The only specific reference to both the standard of care and asset selection in the CMA has to do with Credit Risk Securities and Defaulted Securities, and even then, the application of the standard of care is defensive inasmuch as Harding would not be at risk for including a weak security unless *it actually believed,* based on then available information and subject to the standard of care provision, that there was a *significant risk* of a decline in credit quality or value (or, there has occurred, or was expected to occur, a deterioration in the quality of the underlying pool of assets) or, with a lapse of time, a *significant risk of becoming* a Defaulted Security presented itself. (*See, e.g.*, DX 507 at 209, 211-12.) In other words, there was no obligation to pick the most credit-worthy securities. Liability would attach only if Harding bought a security *knowing* that it was likely to default. There is no evidence that Harding believed or even suspected that Norma was at risk of default. It was not.[10] (*See* RX 856.)

Fourth, Division continues to push its theory that the BBB Norma bonds were substantially impaired at the time Harding selected them. Let us be clear, again: this assertion is predicated entirely on Division's willful misinterpretation of a hearsay document. (Resp'ts Br. at 18-22.)

Specifically, Division argues that DX 217 showed that the RMBS underlying Norma were significantly, if not completely, impaired at the time of purchase. (Div. Opp. Br. at 26-27.) Like Division's reliance on Ellson's opinion about the economic impact of the ABX Index, this

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[10] Note that these provisions, by their own terms, did not apply until after the Issuer purchased the security at issue, *i.e.*, after the deal closed, post-asset selection in the warehouse period. (Resp'ts Br. at 22-25.)

assertion has repeatedly been proven false. (Resp'ts Br. at 18-19.) The write-down number in DX 217 referred to the deterioration in the *pools of loans* underlying the RMBS that composed the Norma CDO. (Chau 4098:9-4116:11, 4382:5-4383:3, 4386:13-23.) As Chau explained, the 6.7% subordination for the BBB tranche was not only unrelated to the 10.17% write-down of the loan pool, but it was also viewed at the time as highly unlikely to be reached. (4098:9-4112:13.) To repeat: (1) Fitch could not have given an investment-grade rating to impaired bonds;[11] and (2) Harding would have become aware of any such write-downs in connection with its pre-closing certification analysis. (*See* Resp'ts Br. at 19, 23.)

Division tries to bolster this legerdemain by baldly asserting that "every metric in that portion of [DX 217] plainly referred to the RMBS, not their underlying loans pools." (Div. Opp. Br. at 27.) First, even if it were true that every other metric related to RMBS, the 10.17% write-down figure did not have to. But note that there is no record citation for this assertion; there is nothing in the record to support it. In fact, Division apparently could not even get Wagner to say so; his report does not say that Norma was experiencing this level of write-downs in its RMBS portfolio. (DX 8001 at ¶¶ 150-57.) Moreover, there are two lines referring to DQ tests: "% Failing DQ Test 82.83%" and "% Failing 60+ DQ Test 46.02%." (DX 217.) If Division's reading is correct, "DQ" and "60+ DQ" indicates that 82% of the RMBS in the Norma portfolio were delinquent, meaning they missed their last payment, and 46.02% were delinquent more than 60 days. And yet, even as of February 2008, as the credit crisis was beginning to take hold, Norma's exposure to downgraded RMBS was 69.92%. (RX 856 at 5.)

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[11] Rating Agencies analyzed the underlying mortgage collateral of a new issue CDO (subjecting it to various ranges of probabilities of default, stress cases involving stressing the interest rate curve, stressing the default curve, assessing the variability of the cash flows) in order to properly rate the CDO's capital structure. (Chau 4223:21-4230:21; RX 890 at 2.) Unless the collateral met the various criteria examined by the rating agency, it would not rate the deal or more specifically the BBB tranche. (RX 890 at 2 (ratings address the likelihood investors will receive "the stated balance of principal by the stated maturity date").)

Division ignores Chau's uncontested testimony that he looked at this number "as a qualitative check," or a quick comparison between the CDO he was looking at and the other CDOs Harding had invested in. (4155:9-4156:14.) In other words, all else being equal, CDOs from the same ~~time~~ period have similar percent write-downs in the underlying pool. Other CDO Commentaries prepared by Harding during this period show that Norma is within a similar range. (Exhibit A.) These figures show that the percentages reflected on the Norma CDO Commentary were consistent with those of other bonds Harding bought at the time for various deals. (*Id.*) Among other things, this fact demonstrates that Harding did not change its investment criteria in order to accommodate Merrill and Magnetar.[12,13]

Fifth, Division argues that because Chau did not consider DX 217 in his decision to select the BBB bonds, he therefore did not do any analysis and review of the BBB bonds.[14] Again, Division and the ALJ turned Respondents' inability to produce a piece of paper documenting its

12 In yet another attempt to expand its case after the Hearing, Division now argues that these other CDO commentaries, as well as the selection for another CDO, Orion, were also "violative." (Div. Opp. Br. at 24.) Division investigated for five years. Chau testified for six days. Other Harding employees were examined for ten days. After all that, Division brought a case charging violations only with respect to the placement of the ABX Index in Octans and the purchase of BBB Norma bonds. Facing the dispositive fact that Norma is not anomalous when compared with other CDOs bought by Harding for other deals unrelated to Magnetar and Merrill, Division now, for the first time, post-Hearing, claims that five other CDOs were purchased by Harding without "analyzing them, or in disregard of negative analysis." (*Id.*) How does Division know that? There is nothing in evidence about (1) the circumstances of Harding's purchase of these CDOs or how it made its purchasing decision; (2) the timing of these analyses in relation to their purchase; and (3) what information was analyzed and by whom. In fact, Division did not even raise any issues with any of these CDOs when Respondents introduced their write-ups at the Hearing specifically to show that these other CDOs' characteristics were very similar to Norma's. In other words, because these other CDO write-ups undermine Division's argument that Norma would not have been bought but for pressure from Merrill and Magnetar, Division now claims, without any support whatsoever, that they too were purchased in violation of law.

13 Contrary to Division's assertion (Div. Opp. Br. at 27-28), Harding engaged in post-closing price discovery not because it never liked Norma but because in late May 2007, the RMBS market had softened and therefore, it made sense for a CM to engage in price discovery. (Respt's Br. at 21.)

14 Notably, the only possible source of many of these numbers in DX 217 was an Intex loan level analysis of the RMBS, meaning that Harding performed an analysis of the underlying RMBS in connection with its evaluation of the Norma bonds. (Chau 4123:14-4124:7.)

exact review seven years ago as evidence that the review did not occur.[15] (Div. Opp. Br. at 20, 26 n.29) Respondents, however, do not have the burden of proof.[16]

There is one more distortion that warrants some attention because it, too, illustrates the absurdity of Division's position. Division asserts that there is no evidence that Chau did any price negotiation. (Div. Opp. Br. 30.) Division's own exhibits show that this assertion is false on its face. (*See, e.g.*, DX 198 (January 23, 2007 email in which Merrill and Chau discussed what level or price would work), 204 (January 24, 2007 internal Merrill email noting that Chau "wants to talk about spread").) In fact, the January 9 pricing e-mail listed BBB-rated notes (Class E tranche) at "3mL + 385." (DX 190.) This meant that the expected coupon payments (interest) that an investor would earn by investing in the BBB tranche would be the three-month LIBOR interest-rate, plus an additional 3.85 percent interest. (Chau 4126:12-4127:9.) Division admits that Harding did not agree until he received, at minimum, a price of 440 basis points above 3-month LIBOR ("3mL +440") on January 26, 2007. (Div. Opp. Br. at 30 n.31.) Chau's testimony is uncontroverted on this point. (Chau 4213:24-4215:5, 4235:20-4236:14 (testifying that he requested and received a discount); *see also* Exhibit A to Resp'ts Br. (Timeline of Events Related to Norma).)

Division ignores this evidence and points to the fact that another party, United Capital Management ("UCM") also negotiated a discount. (Div. Opp. Br. at 30 n.31.) Whether UCM *also* negotiated a discount is irrelevant. It does not negate the benefit of the discount received by

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15 Contrary to Division's assertion (Div. Opp. Br. at 20), Chau did not testify that he bought the Norma bonds without analysis. (*See, e.g.*, Chau 1670:2-21 (testifying that he would have had the analysis underlying DX 217 prior to making the investment decision).)

16 Respondents have detailed why the ALJ's findings as to Norma should be reversed and why Division's appeal to expand the Norma findings should be denied. (Resp'ts Br. 15-30; Resp'ts Opp. Br. at 21-29.)

Harding, or the detriment suffered by Magnetar or Merrill as a result of that discount. (*See* Resp'ts Br. at 24-25.)

STATUTORY AND CONSTITUTIONAL VIOLATIONS

Division evades Respondents' arguments about ALJ appointments by deliberately missing the point. Respondents argue that the ALJ was not properly appointed or designated as an "officer of the Commission," *as required by the securities laws*, separate and apart from whether they are also constitutional officers.[17] (Resp'ts Br. at 31-33.) Division has conceded that the Commission did not appoint ALJs as officers of the Commission. (Div. Opp. Br. at 37 n.38 ("[T]he Commission does not 'choose' the ALJ that presides over each enforcement proceeding; rather the Chief ALJ 'select[s] . . . the [ALJ] to preside' over each case.") (internal citations omitted).) Recently, the SEC admitted the same in federal district court. *See* Transcript of Oral Argument at 25-26, *Tilton v. SEC*, 15-cv-2472 (S.D.N.Y. May 11, 2015).[18]

In short, Division concedes that the Hearing did not comply with the statutory requirements,[19] which plainly make the Hearing void. *See Ryder v. United States*, 515 U.S. 177, 182-83, 187-88 (1995) (finding that an improperly constituted hearing is void and cannot be given *de facto* validity by a further review court or panel).

Note that until these admissions, Respondents, Division, witnesses, *and the ALJ* thought that the ALJ was a properly designated officer, as reflected in the subpoenas issued in connection

[17] The statutory provisions governing Cease-and-Desist hearings relating to federal securities laws uniformly require hearings to be conducted by the Commission or "an officer or officers of the Commission designated by it." Securities Act of 1933, 15 U.S.C. § 77u; Securities Exchange Act of 1934, 15 U.S.C. § 78v; Investment Advisers Act of 1940, 15 U.S.C. § 80b-12; Investment Company Act of 1940, 15 U.S.C. § 80a-40.

[18] "The Court: Can I ask you the factual question that I asked of Mr. Gunther? Who exactly appoints SEC ALJs? Can you tell me more about the appointment process? [for the SEC] Ms. Lin: Your Honor, those facts are not in the record here, ***but we acknowledge that the commissioners were not the ones who appointed, in this case, ALJ Foelk, who is the ALJ presiding.***") (emphasis added).

[19] *See Phlo Corp. v. Stevens*, 62 F. App'x. 377, 382 (2d. Cir. 2003) (holding an argument is waived even where the plaintiff made "only the briefest of speculative references to the question.").

with the Hearing. For example, after Respondents' *Subpoena Ad Testificandum* request, the ALJ demanded compliance as "*an officer designated by the Securities and Exchange Commission.*" (Exhibit B (emphasis added).) Division similarly requested that the ALJ compel a third party to produce documents as "*an officer designated by the Securities and Exchange Commission.*" (Exhibit C (emphasis added).) Put differently, the ALJ purported to wield executive, Commission officer powers without ever being appointed as an officer of the Commission and without ever being designated by the Commission to conduct the Hearing.

That brings us to Respondents' next, *independent* argument. One reason that SEC ALJs are required to be officers under the securities laws is that they exercise executive or sovereign power, such as compelling attendance and document production (like the subpoenas issued in this matter). This exercise of sovereign power also means that SEC ALJs are inferior officers under Article II of the Constitution. (*See, e.g.,* Resp'ts Br. at 33-34.) Division has already conceded that: (1) the Commission does not properly appoint the SEC ALJs as officers (*see above*); and (2) ALJs, in violation of Article II, are separated from the President by at least two layers of "for cause" tenure protection. (*See, e.g.*, Div. Opp. Br. at 33-35 (only addressing the question of whether ALJs are inferior officers); Transcript of Oral Argument at 29, *Tilton v. SEC*, 15-cv-2472 (S.D.N.Y. May 11, 2015) (acknowledging that they would lose a preliminary injunction motion if the Court found the ALJ to be an inferior officer).) Division only argues that SEC ALJs are employees, not inferior officers. (Div. Opp. Br. at 33-35.)

Supreme Court precedent, the considered opinion of the Office of Legal Counsel, and the facts show that SEC ALJs are inferior officers. *See, e.g.*, Office of Legal Counsel, Officers of the United States Within the Meaning of the Appointments Clause, 17-19, 39 (Apr. 16, 2007) (hereinafter "OLC Officers") (explaining that officials who administer oaths and affirmations were "no less officers of the United States."); *see also Freytag v. Comm'r*, 501 U.S. 868, 881-82 (1991) (finding that special trial judges, who take sworn testimony and enforce compliance with discovery orders, are inferior officers). As summed up by the Office of Legal Counsel, "a position, however labeled, is in fact a federal office if (1) it is invested by legal authority with a portion of the sovereign powers of the federal Government, and (2) it is 'continuing.'"[20] OLC Officers at 1.

Division countered that ALJs lack sufficient discretion to be deemed inferior officers because the Commission "conducts *de novo* review" of the ID. (Div. Opp. Br. at 33-37.) That position has been roundly rejected. The Office of Legal Counsel stated:

> *If it is not necessary to the existence of delegated sovereign authority* (and thus to the existence of an office) *that a position include the exercise of discretion*, all the more is it not necessary that a position include some sort of "independent" discretion in carrying out sovereign functions. *The question for purposes of this first element is simply whether a position possesses delegated sovereign authority to act in the first instance, whether or not that act may be subject to direction or review by superior officers*[.]

See OLC Officers at 19 (emphasis added).

In fact, the Supreme Court found in *Freytag* that special trial judges ("STJs") appointed by the Tax Court, who are indistinguishable from SEC ALJs in all material respects, qualified as inferior officers. 501 U.S. at 881. First, "the office of [STJ appointed by the Tax Court] is 'established by Law,'" making STJs inferior officers. *Id.* The law likewise establishes ALJs. *See* 5 U.S.C. §§ 556, 78d-1. Additionally, the Supreme Court stressed that STJs are inferior officers because "the duties, salary, and means of appointment for that office are specified by statute." *Freytag*, 501 U.S. at 881. ALJ appointments are equally established by statute. *See, e.g.*, 5

[20] Opinions by the Office of Legal Counsel are controlling. (Office of Legal Counsel, Memorandum for Attorneys of the Office: Best Practices for OLC Legal Advice and Written Opinions (July 16, 2010) (finding its "core function, pursuant to the Attorney General's delegation, is to provide controlling advice to Executive Branch officials on questions of law that are centrally important to the functioning of the Federal Government.")).

U.S.C. §§ 556(c), 557, 5311, 5372; 15 U.S.C. §§ 77u, 78v, 80b-12, 80a-40. Importantly, the Supreme Court found that the STJs are inferior officers because they executed sovereign power, such as taking sworn testimony, conducting trials, ruling on the admissibility of evidence, and enforcing compliance with discovery orders. *Freytag*, 501 U.S. at 881-82. ALJs likewise take testimony (5 U.S.C. §§ 556(c)(1), (4)), conduct trials (17 CFR § 201.111), rule on the admissibility of evidence (17 CFR § 201.320), and administer discovery efforts by issuing, quashing, or modifying subpoenas, and overseeing depositions (17 CFR §§ 201.230, 201.232, 201.233.) Lest there be any doubt, the Supreme Court explained, "the Commissioner reasons that [STJs] may be deemed employees . . . because they lack authority to enter a final decision. But this argument ignores the significance of the [STJs'] duties and discretion." *Freytag*, 501 U.S. at 881.

Contrary to Division's assertion, *Landry v. FDIC*, in fact, supports this point. *Compare* 204 F.3d 1125 (D.C. Cir. 2000) *with* Div. Opp. Br. at 35 n.36. The *Landry* court concluded that Federal Deposit Insurance Corporation ("FDIC") ALJs were not officers. 204 F.3d at 1134. However, special factors distinguish the FDIC ALJ regime from that of the SEC. First, the FDIC ALJs were not required to be officers by law, unlike the SEC ALJs. *See* 12 U.S.C. § 1818. Second, the *Landry* court held that the "Tax Court [in *Freytag*] was required to defer to STJs' factual and credibility findings unless they were clearly erroneous . . . . whereas here the FDIC Board makes its own factual findings" (*i.e.* conducts a *de novo* review). 204 F.3d at 1133. Third, FDIC ALJs "never render the decision of the FDIC." *Id.*

Here SEC ALJs' findings and orders can become final, without requiring any further review by the Commission. Under the relevant provisions of the APA, an ALJ is authorized to use an "initial decision" that "becomes the decision of [the Commission] without further proceedings" unless the Commission affirmatively decides to review the decision in question and takes action. 5 U.S.C. § 557(b). SEC's Rules of Practice also provide that the Commission is not required to review an ALJ's initial decision unless there is *clear error*, and if the Commission declines to do so, the initial decision will be promulgated by the Commission as the final decision. 17 CFR §§ 201.360(d)(1), 201.410, 201.411. In other words, should the Commission choose not to review the initial decision, its act to make the decision final is purely administrative. Once this process is complete, the actions of the ALJ "shall, for all purposes, including appeal or review therefore, be deemed the action of the Commission." 15 U.S.C. § 78d-1(c). That is why the ALJ, in this matter, did not recommend anything, but rather "ordered" the remedies, including the revocation of Harding's investment advisor registration and Chau's permanent bar from association with a registered investment company. (ID at 96-97.)

Division then uses *SEC v. Jones,* 12 F. Supp. 210 (S.D.N.Y. 1935) to argue that Congress intended ALJs[21] to be merely employees and not officers. (*See* Div. Opp. Br. at 34.) However, that case stands for the proposition that being an employee of the Commission does not preclude that person from also being properly appointed or acting in another capacity with proper delegation. *Jones*, 12 F. Supp. at 215 ("[n]othing on the face of the proceedings tends to establish disqualification, unless it be the bare fact that he is an employee of the commission.").

Division next attempts to use the 1934 definition of officer to mean that officers, as used in the securities laws, are merely ministers, and thus something different than "inferior officers." (Div. Br. at 34-35.) "Officer" means someone empowered to hold an office, or rather someone who has had duties, such as executive powers, delegated to him or her. *Webster's New*

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[21] Division states that the referenced "hearing examiner" in *Jones* is the precursor of an ALJ, and thus equivalent for our purposes. (Div. Opp. Br. at 34.)

International Dictionary, 1690-91 (2d ed. 1934) ("A person lawfully invested with an office, whether civil, military, or ecclesiastical, and whether under the state or a private corporation".) That definition has not changed since the time of the Constitution. *Webster's New International Dictionary of the English Language Based on the International Dictionary of 1890 and 1900*, 1433-34 (1913).

Finally, Division ignores Respondents' Equal Protection claim altogether, only arguing that Respondents' inability to develop the record on its constitutional claims can be cured through the "procedural safeguards built into the administrative enforcement scheme."[22] (Div. Opp. Br. at 37 n.7.) However, like with the Due Process claim, Respondents' "class of one" Equal Protection claim requires development of the record. (*See* Resp'ts Pet. for Interlocutory Review and Emer. Mot. to Stay the Hearing at 5-6 (Feb. 27, 2014).) Further, the denial of both Respondents' subpoena of Division personnel and a document request cannot be "cured by the Commission itself," nor by the other "procedural safeguards" detailed by Division. For example, Rule of Practice 452 states that the Commission may "allow the submission of additional evidence," *see* 17 CFR § 201.452, but this does not cure the denial of Respondents' request for additional information *from Division*. Moreover, requiring Respondent to wait for the Court of Appeals, "to reverse the Commission's decision and direct [it] to supplement the record as appropriate," is likewise inadequate. Respondent would suffer significant and irreparable injury by waiting for eventual Court of Appeals review and risk future deterioration of future witnesses' memories.

22 Division does not contest that the ALJ's finding of privilege was erroneous. (Resp'ts. Br. at 35.)

CONCLUSION

For the foregoing reasons and those outlined in Respondents' opening and opposition briefs, the ALJ's findings of liability and orders as to remedies in the ID should be reversed in their entirety.

Dated: May 22, 2015

Respectfully submitted,

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Attorneys for Respondents
Harding Advisory LLC and Wing F. Chau

EXHIBIT A

CDO	DATE COMMENTARY PREPARED	% WRITE-DOWN	% FAILING DQ TEST	PLACED INTO (HARDING DEALS)
Summer Street 2007-1 CDO	April 12, 2007	9.83%	80.51%	Adrastea, Jupiter VII, 888 Tactical, Mizuho, and Jupiter V
Norma CDO I	**February 27, 2007**	**10.17%**	**82.83%**	**Jupiter VI, 888 Tactical, Neo, and Lexington V**
Maxim High Grade CDO II	March 12, 2007	10.21%	1.10%	Neo
Adams Square Funding II	February 28, 2007	10.59%	40.00%	Jupiter VI, 888 Tactical, Lexington III, Lexington V, Octonion, and Neo
Plettenberg Bay CDO	April 27, 2007	10.59%	77.48%	Adrastea, Mizuho, and 888 Tactical
Libertas Preferred Funding IV	April 18, 2007	12.66%	71.75%	Jupiter VI and Neo
Silver Marlin ABS CDO I	February 27, 2007	12.91%	1.80%	Neo

EXHIBIT B

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.

SUBPOENA AD TESTIFICANDUM

To: [redacted]

YOU ARE HEREBY REQUIRED to appear before the Honorable Cameron Elliot, Administrative Law Judge of the Securities and Exchange Commission, at Room 238 of the Javits Federal Building, 26 Federal Plaza, New York, NY, on the 31st day of March 2014, or at any date thereafter, at 9:30 a.m., to provide testimony in the Matter of Harding Advisory LLC and Wing F. Chau, AP File No. 3-15574, a public administrative proceeding pursuant to the Section 8A of the Securities Act of 1933, Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940.

IN TESTIMONY WHEREOF, the undersigned, an officer designated by the Securities and Exchange Commission, has hereunto set his hand at Washington, D.C.

Date: 3-14-2014

Signed: [signature]
Honorable Cameron Elliot
Administrative Law Judge

EXHIBIT C

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.

Notice of Request for Issuance of Subpoena

Pursuant to Rule 232 of the Commission's Rules of Practice, the Division of Enforcement gives notice that it has requested that the Administrative Law Judge issue a Subpoena Duces Tecum to Cooley LLP in the form attached hereto.

Dated: February 6, 2014
New York, New York

DIVISION OF ENFORCEMENT

By: /s/ Howard A. Fischer

Howard A. Fischer
Daniel R. Walfish
Securities and Exchange Commission
New York Regional Office
Brookfield Place, 200 Vesey Street, Suite 400
New York, NY 10281-1022
Tel: 212.336.0589
Email: fischerh@sec.gov

SUBPOENA DUCES TECUM

UNITED STATES OF AMERICA
Securities and Exchange Commission

TO: Cooley LLP
c/o Celia Goldwag Barenholtz, Esq.
The Grace Building
1114 Avenue of the Americas
New York, NY 10036-7798

In connection with the Administrative Proceeding captioned Harding Advisory LLC and Wing F. Chau, A.P. File No. 3-15574:

You are hereby required to produce on the 13th day of February 2014, at 10:00 a.m., the documents described in Exhibit A appended hereto to: Howard A. Fischer, Senior Trial Counsel, New York Regional Office Division of Enforcement, Securities and Exchange Commission, 200 Vesey Street Suite 400, New York, New York 10281-1022.

In testimony whereof, the undersigned, an officer designated by the Securities and Exchange Commission, has hereunto set his hand at Washington, D. C. this __ day of February, 2014.

____
Honorable Cameron Elliot
Administrative Law Judge

EXHIBIT A TO SUBPOENA TO COOLEY LLP

Documents Requested

A disk or [redacted] New York).

[redacted]

[redacted]