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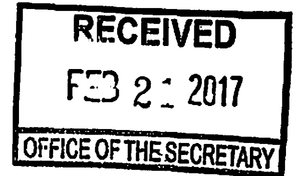


UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMISSION

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

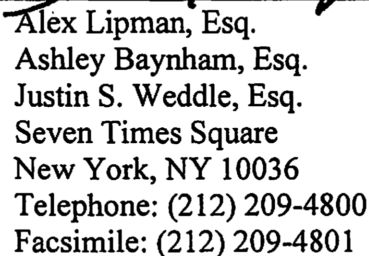
RESPONDENTS' MOTION TO STAY THE COMMISSION'S ORDER IMPOSING REMEDIAL SANCTIONS PENDING JUDICIAL REVIEW

Respondents Harding Advisory LLC and Wing F. Chau move under Rule of Practice 401 to stay the Commission's January 6, 2017 order ("**Order**") imposing remedial sanctions pending the filing of a petition for review with the appropriate United States Court of Appeals and, upon the timely filing of such a petition, pending the determination of that appeal. In support of their motion, Respondents submit the attached memorandum of points and authorities.

Dated: February 17, 2017

Respectfully submitted,

BROWN RUDNICK LLP



By: ________________
Alex Lipman, Esq.
Ashley Baynham, Esq.
Justin S. Weddle, Esq.
Seven Times Square
New York, NY 10036
Telephone: (212) 209-4800
Facsimile: (212) 209-4801

Attorneys for Respondents
Harding Advisory LLC and Wing F. Chau

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

MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF RESPONDENTS' MOTION TO STAY THE COMMISSION'S ORDER IMPOSING REMEDIAL SANCTIONS PENDING JUDICIAL REVIEW

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SUMMARY

Respondents, Harding Advisory LLC and Wing F. Chau, move to stay the Commission's January 6, 2017 Order imposing remedial sanctions pending the filing of a petition for review with the appropriate United States Court of Appeals and, upon the timely filing of such a petition, pending the determination of that appeal.[1] A Stay is warranted because the Respondents are likely to succeed on the merits; absent a stay, Respondents will be irreparably harmed, there will be no harm to others by maintaining the status quo, and the public interest favors a stay.[2]

To start, Respondents' appeal easily satisfies the "likelihood of success on the merits" factor, which is met whenever an appeal raises serious, substantial, difficult, and doubtful legal questions as to which reasonable jurists may disagree.[3] Respondents have raised a dispositive constitutional issue—the unconstitutional appointment of SEC ALJs—that unequivocally meets the likelihood of success factor.[4] One Circuit, the Tenth, has agreed with the Respondents' position. Another, the D.C. Circuit, having initially disagreed with the Respondents' position, has now vacated its decision and is taking up the issue *en banc*.[5] In other words, not only would reasonable jurists disagree on the outcome of this issue, they, in fact, have.

Moreover, the Commission liability finding rests on a legally and factually erroneous conclusion that the Respondents were in a fiduciary relationship with their alleged victims, and

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[1] Alternatively, Respondent respectfully seek a temporary stay to allow Respondents to apply for a stay to the appropriate Court of Appeals.

[2] *See, e.g.*, *In re Raymond J. Lucia Co.*, Exchange Act Release No. 76241, 2015 WL 6352089, at *1 (Oct. 22, 2015) (listing factors).

[3] *Florida v. U.S. Dep't of Health & Human Servs.*, 780 F. Supp. 2d 1307, 1317 (N.D. Fla. 2011).

[4] (Resp. Br. at 31-33; Resp. Reply Br. at 14-19; Resp. Supp. Brief at 1-4; Resp. Supp. Reply Br. at 1-4.)

[5] *Bandimere v. SEC*, 844 F.3d 1168, 1179 (10th Cir. 2016); *Raymond J. Lucia Co. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016).

thus this finding will be overturned on appeal.[6] As a predicate to finding Respondents liable, the SEC found that as collateral managers for two CDOs, Neo CDO 2007-1 ("**Neo**") and Lexington Capital Funding V Ltd. CDO ("**Lexington**"), Respondents breached their fiduciary duties to the Issuers of those CDOs by selecting for them certain BBB-rated bonds of another CDO, named Norma CDO I, ltd. ("**Norma**").[7] This finding directly conflicts with the relevant law because, as the D.C. Circuit made very plain, a collateral manager cannot be a fiduciary of the CDO it manages because such a fiduciary relationship would immediately create a conflict or potential conflict with the noteholders.[8] That legal conclusion makes eminent sense, as demonstrated by the record here. Respondents specifically disclaimed that they were fiduciaries of Neo and Lexington Issuers in the relevant collateral management agreements ("**CMAs**").[9] Their then-lawyer testified that this disclaimer was driven specifically by the need to avoid potential conflicts and, therefore, neither force Respondents to prefer certain classes of investors over others nor hold them liable should their decisions affect different classes differently.[10] The finding of a fiduciary relationship, thus, presents another doubtful and substantial legal question.

Even if a fiduciary relationship somehow existed despite the clear agreement of the parties to the contrary, the decision rests on another legal error because all relevant facts were fully disclosed to the Issuers. In short, liability here was premised Respondents' alleged failure to disclose to Neo and Lexington that Respondents described a certain feature of the Norma

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[6] The Circuit Court of Appeals will not accept factual findings "unsupported by substantial evidence," and will overturn any decision that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law" or "contrary to constitutional right, power, privilege, or immunity." 5U.S.C. § 706.

[7] (FD at 15-16.)

[8] *See Goldstein v. SEC*, 451 F.3d 873, 879-82 (D.C. Cir. 2006) ("If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest.")

[9] (DX 506 at 7-8, 510 at 8-9 (The CMAs read: "Limited Duties and Obligations; No Partnership or Joint Venture. . . . [T]he Collateral Manager shall not be subject to any fiduciary or other implied duties . . . .").)

[10] (Tr. 3053:5-3054:21; 3048:2-3049:6.)

waterfall (*i.e.*, the apportionment of payments to the various tranches of Norma) as weak, but recommended Norma BBBs anyway to accommodate Norma's bankers, Merrill Lynch ("**Merrill**"), and equity buyers, Magnetar Capital LLC ("**Magnetar**").[11] As background, to establish a priority of payments, a CDO issues notes in tranches; the more senior tranches are paid before the more junior ones and any losses are allocated in the reverse order with the most junior tranches bearing the first risk of loss.[12] The waterfall feature at issue here—commonly referred to as "turbo"—further redirected the Norma CDO waterfall from the equity tranche to certain mezzanine tranches, including the BBB tranche, and, as a result, shortened the expected weighted average life ("WAL") or duration of the BBB bonds.[13,14] Because turbo is a *mechanical* feature of the deal that can be quantified, whether it is strong or weak is not a matter of subjective judgment; it is an objective fact that can be measured. Because it is an objective fact, the turbo feature disclosure made it possible for investors to approximate its impact on the WAL, as did Mr. Chau. The expected WAL of the BBB bonds was also separately fully and correctly disclosed in the Norma Offering Circular ("Norma OC").

Even if that were not true, an independent basis for finding likelihood of success on the merits is that the directors of the Issuers were the same three people who were also the directors

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[11] (FD at 13.)

[12] (DX 8001 at ¶ 20; Tr. 2778:25-2780:8.)

[13] (*See* RX 280 at 8, 93-104, 135; Tr. 4133:13-4138:20.) Note that the Commission got the effect of the turbo completely backwards: contrary to fact, the Commission described the turbo as a feature that redirected cash flow away from the BBB bonds to the equity. (*Compare id. with* FD at 13.)

[14] (*See* RX 280 at 8, 93-104, 135.) WAL or duration, in this context, indicates the length of time it would take for the BBB bond holders to receive their expected payments and is also a measure of sensitivity of a bond price to interest rate changes. (*Id.*) It is measured in years. By diverting cash flow from the equity tranche to the BBB tranche, the Norma turbo shortened the duration of the BBB tranche. (Tr. 4133:13-4138:20.) As noted below, the appropriate response when one does not like the duration of a bond is to seek reduction of the purchase price or an increase in coupon thereby reducing the amount of time necessary to get back principal and reducing risk of reduction in value resulting from any increase in interest rates. (*See* Tr. 4133:13-4138:20.) Here, the record is clear: Respondents bought the BBB bonds at a higher coupon and at a reduced price after complaining about the turbo and after being asked by the Merrill bankers to come up with a bid that takes into account the fact that the turbo could not be changed. (*See* Resp. Post-Hearing Br. at 243-60.)

of Norma, *i.e.*, they were both the sellers *and* the buyers of the Norma BBBs. Even if one were to take the view that—despite their authorship of disclosure documents for Neo and Lexington—neither the directors of Neo and Lexington nor their bankers or lawyers had any obligation to learn the salient features of the bonds they were acquiring, the directors did not need to do so: they already knew everything there was to know about the Norma bonds because they were the people selling them. As Norma directors, these three individuals decided that Norma would have a turbo, what the effect of the turbo would be, and how it should be disclosed. As a legal matter, the directors of Neo and Lexington could not have been defrauded about the selection of the Norma BBBs because they did not need advice as to desirability of bonds they were selling in another vehicle. In addition, if, in fact, the Norma bonds were hard to sell, it was ultimately these same directors who were being accommodated and so these directors did not need to be told that Respondents bought Norma bonds as an accommodation. Had the Commission addressed any of these arguments, the Commission would have reached a different conclusion. Put differently, the very fact that the Commission completely failed to address these points despite their prominence in both Respondents' papers and at the oral argument[15] evidences that there are serious, substantial, difficult, and doubtful legal questions about:

- Whether it may be fairly assumed that the directors of the issuers of a CDO, who make disclosures for that CDO, are familiar with the disclosed features of the bonds they offer for sale;
- If so, whether these directors can be deemed to have that same knowledge when, acting as directors for another CDO, they buy the bonds they themselves are selling;
- If so, does a collateral manager have to make any additional disclosures to them when it recommends the bonds they are selling to another vehicle over which they preside as directors;
- Alternatively, could a collateral manager be found liable for failing to disclose a fact that the manager can only learn from disclosures made by the same directors;

[15] (*See, e.g.*, Resp. Pet. at 18; Resp. Br. at 26-27; Resp. Opp. at 25-26; Resp. Reply at 8; Transcript of Oral Argument on Cross-Petitions, No. 3-15574 (**"Transcript"**) at 5:8-6:12 (Aug. 3, 2016).)

- o Can, contrary to the Commission's opinion in this case, corporate formalities be ignored and directors' knowledge and access to information be deemed irrelevant; and
- o Can a CDO itself be deceived and defrauded if its directors are not.

Finally, Respondents raise serious legal questions about the appropriateness of the ordered remedies. For example, it appears that their severity and scope is driven substantially by conclusions about uncharged and unproven conduct. Specifically, the OIP in this case charged violations only with respect to fraud on Neo and Lexington Issuers—it did not charge a fraud on any investors in those deals.[16] At oral argument in this matter, counsel for Respondents made that explicit observation without drawing an objection from either the Commission or the Division.[17] Indeed, no Norma-related evidence about investors was offered by the Division. Not a single investor testified, for example, about what, if anything, Neo and Lexington investors understood the reasons for the Norma BBB purchases. There was also no evidence offered about whether investors would have cared about the strength of the turbo, given that all it did was shorten the WAL of one asset amounting to 1.6% of the collateral pool. In fact, common sense suggests that investors would not care about the means by which the fully disclosed WAL was obtained so long as the WAL disclosure was accurate. It was. Nonetheless, the disgorgement and penalty amounts, in particular, appear to be driven by considerations relating to money paid by these investors and the risk to investors that allegedly resulted from the purchase of the BBB bonds.[18] This is another legal error that meets the likelihood of success on the merits standard.

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[16] (*Compare* OIP ¶¶ 54-59 *with* ¶¶ 60-69.)

[17] Transcript at 5:8-19.

[18] (*See* FD at 18-19 (pointing to the "risk to investors" as the basis for the associational bar imposed on Mr. Chau, revocation of Harding's registration, and cease-and-desist order), 20-21 (finding depriving "Lexington's and Neo's investors" of the opportunity to withdraw from the deals as the basis for disgorgement order), 21 (pointing to its finding "Respondents' violations increased the risk that the debt investors . . . would lose their investments" as the basis for the civil penalties).

The remaining factors support a stay. For example, as discussed below, a stay would harm no one, but enforcement of the remedies would force Harding into bankruptcy and thus force the dismissal of its two junior employees. In addition, because no one would be harmed by a stay, no compelling public interest is served by the imposition of draconian remedies before all of these contentious issues are fully litigated, especially because some of the issues on appeal challenge the constitutional power of the Commission to impose these remedies.

I. RESPONDENTS ARE LIKELY TO SUCCEED ON THE MERITS

Respondents do not have to show that they will definitely prevail in order to show that they are likely to succeed on the merits, but rather "if the other elements are present (*i.e.*, the balance of hardships tips decidedly toward [Respondents]), it will ordinarily be enough that [Respondents have] raised questions going to the merits so serious, substantial, difficult and doubtful, as to make them a fair ground for litigation and thus for more deliberative investigation."[19] In other words, the Commission does not have to agree that it would lose on appeal; it is enough that the legal question is subject to serious disagreement.[20] Indeed, as the D.C. Circuit has explained:

> Prior recourse to the initial decision maker would hardly be required as a general matter if it could properly grant interim relief only on a prediction that it has rendered an erroneous decision. What is fairly contemplated is that tribunals may properly stay their own orders when they have ruled on an admittedly difficult legal question and when the equities of the case suggest that the status quo should be maintained.[21]

Such serious questions will be raised on the appeal.

[19] *Washington Metro. Area Transit Comm'n v. Holiday Tours, Inc.*, 559 F.2d 841, 844 (D.C. Cir. 1977) (citation omitted).

[20] *Florida v. U.S. Dep't of Health & Human Servs.*, 780 F. Supp. 2d 1307 (N.D. Fla. 2011) (finding that a party was likely to succeed on the merits where, although the court strongly believed its position was correct, the "individual mandate . . . raised some novel issues regarding the Constitutional role of the federal government about which reasonable and intelligent people (and reasonable and intelligent jurists) [could] disagree" and where it was "likely that the Court of Appeals [would] also reach divergent results").

[21] *ID* at 844-45.

A. Respondents' Appointments Clause Claim Raises Serious and Difficult Legal Questions.

Respondents have preserved and will raise serious legal questions regarding the constitutional infirmities of the proceeding on appeal, including that SEC ALJs, are "inferior officers" and therefore the manner of their appointment violated the Appointments Clause of the Constitution. The Commission rejected this argument by relying on its earlier holdings and the D.C. Circuit's decision in *Lucia,* which held that because SEC ALJs cannot render final decisions, they are not "inferior officers."[22] However, the D.C. Circuit has vacated *Lucia* and has set it for rehearing *en banc.*[23] Moreover, the Tenth Circuit specifically rejected the *Lucia* Court's reasoning regarding the importance of the SEC ALJs' ability to render final decisions to determining whether SEC ALJs were inferior officers.[24] The Tenth Circuit found also that SEC ALJs meet the three characteristics of inferior officers that were identified in the seminal Supreme Court case, *Freytag v. Commissioner*:[25] (i) "the position of the SEC ALJ was 'established by law,'" (ii) the "'duties, salary, and means of appointment . . . are specified by statute,'" and (iii) the "SEC ALJs 'exercise significant discretion' in 'carrying out . . . important functions.'"[26] The Tenth Circuit explained that the *Lucia* panel misread *Freytag*, and that the Supreme "Court did not make final decision-making power the essence of inferior officer status."[27]

[22] (FD at 26-27.) Note that the Commission has conceded that the ALJ's method of appointment would violate the Appointments Clause if the ALJs are found to be "inferior officers."

[23] Order Granting Petition for Rehearing En Banc, *Lucia v. SEC*, No. 15-1345 (D.C. Cir. Feb. 16, 2017) (Doc. No. 1661665).

[24] *Bandimere*, 844 F.3d at 1181.

[25] 501 U.S. 869 (1991).

[26] *Bandimere*, 844 F.3d at 1179 (quoting *Freytag*, 501 U.S. at 881-82).

[27] *Id.* at 1184.

Indeed, the Commission's own statements concede that reasonable and intelligent jurists may disagree on whether SEC ALJs were properly appointed. The SEC requested a 30-day extension to file a petition for rehearing *en banc* in the *Bandimere* case in order to allow the new acting solicitor general and more generally the new administration officials to review and analyze the Appointments Clause issue and decide whether to file a petition for rehearing *en banc* or even appeal to the Supreme Court, *i.e.*, whether to contest or accept the Tenth Circuit analysis.[28]

Respondents note, also, that the Commission's decision incorrectly invoked the non-acquiescence doctrine to apply *Lucia's* now-vacated decision and not *Bandimere*. *Lucia* has been vacated, so *Bandimere* is now the sole Circuit Court decision on point, and it would invalidate the Commission's order. Non-acquiescence does not permit the Commission to simply ignore decisions it does not like; it only permits the Commission to pursue a circuit split and further review to the Supreme Court.[29] Given the Commission's delay in *Bandimere*, the Commission is plainly not seeking review to the Supreme Court, and this cannot invoke non-acquiescence. Moreover, opposing a stay has no valid non-acquiescence purpose—that is, opposing a stay does not further additional review, it simply evades the effect of authority unfavorable to the Commission.

B. Respondents' Merits Claims Raise Serious and Difficult Legal Questions.

As background again, the Commission's sole finding of liability relates to Harding's role as collateral manager for Neo and Lexington. In January 2007, Mr. Chau (i) first selected the

[28] Unopposed Motion for 30-Day Extension of Time in Which to Petition for Rehearing En Banc, *SEC v. Bandimere*, No. 15-9586 (10th Cir. Jan. 31, 2017) (Document No. 01019758575).

[29] *See Heartland Plymouth Court MI, LLC v. NLRB*, 838 F.3d 16, 21-25 (D.C. Cir. 2016) ("Achieving judicial finality through national uniformity requires non-acquiescence to rest on certain conditions. First, as explained above, non-acquiescence depends upon the agency actually seeking Supreme Court review of adverse decisions. Second, non-acquiescence requires candor in its application. The agency should clearly assert its non-acquiescence, specifying its argument against adverse precedent to preserve them for Supreme Court review.").

Single-A-rated tranches of Norma for inclusion in two CDOs Harding managed, and (ii) then selected and negotiated a discount to purchase the BBB-rated tranches of Norma for Neo and Lexington. The Commission found that Respondents' selection of the BBB bonds violated Sections 206(1) and (2) of the Advisers Act and Section 17(a)(2) of the Securities Act.[30] These findings, however, are wrong as a matter of law and evidence.

1. **The Commission wrongly decided that Respondents were the Issuers' fiduciary.**

The Commission has no evidentiary or legal basis to conclude that Respondents owed fiduciary duties to the Issuers,[31] and thus the Commission's liability decision was arbitrary, capricious, an abuse of discretion, and otherwise not in accordance with the law. Harding was not, nor could it have been, a fiduciary of the Issuers because (i) the relevant agreements specifically said so and (ii) because that would have put Harding in immediate conflict with the investors in those deals. Here is the relevant language from the CMA: "Limited Duties and Obligations; No Partnership or Joint Venture. . . . [T]he Collateral Manager shall not be subject to any fiduciary or other implied duties . . . ."[32] The CMAs reflect the reality that because the collateral manager is subject to a number of restrictions set forth in the transaction documents, the collateral manager does not and cannot have other duties or obligations. Mr. Suh, who as Harding's outside counsel negotiated, edited, and advised Harding on this agreement, explained:

> This provision reflects the reality of a CDO transaction, which is that, as we discussed before, the collateral manager [does not have] unfettered rights with respect to the management of the issuer's portfolio. It's subject to a number of eligibility criteria for the assets that it can have the trustee purchase on behalf of the issuer. It also has very strict provisions regarding disposition of the assets. So it's reflecting that reality, that because the collateral manager is subject to a

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[30] (FD at 14-15.)

[31] (*See* FD at 15-16.)

[32] (DX 506 at 7, 510 at 8.)

> number of restrictions set forth in the transaction documents, that the collateral manager does not have duties or obligations other than those that are set forth in the transaction documents. And so the collateral manager is not subject to any fiduciary or other implied duties, because it would be unfair for the manager to be subject to duties when they are also subject to these restrictions in the transaction documents.[33]

This testimony is uncontested. The Commission gave no reason why the contract cannot or should not govern; instead, it ignored this point all together. Nor did it have a legal basis: its conclusion contradicts legal precedent set by the D.C. Circuit, which, in the context of reviewing how the SEC's hedge fund rule counted clients of a fund's advisor, found that "[i]f the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest."[34]

2. Even if Respondents did owe fiduciary duties to the Issuers, there can be no finding of liability because the Commission erred in its understanding of turbo.

The Commission wrongly decided that Respondents' failed to disclose that the turbo structure was weak.[35] To begin, the finding of liability was undoubtedly driven by the Commission's utter failure to understand how the Norma turbo worked. It found, contrary to all evidence that Norma's turbo was designed to divert cash flow *from* the debt investors, including the BBB tranche, to equity investors.[36] The turbo feature did the opposite; it diverted cash from the equity to the debt investors.[37] So, far from disadvantaging the BBB bondholders (as the Commission appears to have found), the turbo benefitted them. There is also simply no evidence in the record—zero—to support the Commission's findings that the Norma amortization

[33] (Tr. 3053:13-3054:12.)

[34] *See Goldstein*, 451 F.3d at 879-82.

[35] (FD at 16.)

[36] (*Id.* at 13.)

[37] (RX 280 at 8, 93-104 (Norma Offering Circular).)

schedule was less favorable than a traditional amortization structure.[38] They are clearly erroneous and arbitrary.

There was, in fact, nothing hidden or sinister about the Norma turbo. The effectiveness of the turbo can be approximated from its description in the offering circular; it is an objective, disclosed fact, not a subjective judgment. The Norma turbo diverted a percentage of Norma's cash flow from the equity tranche to certain mezzanine tranches, including the BBBs, to pay down the principal of those mezzanine tranches.[39] The turbo feature did not affect the credit of any debt tranche, nor did it serve as credit enhancement.[40] It only optimized the WAL of the security.[41] The turbo was disclosed in the Offering Circular,[42] as was the WAL or duration of the BBBs.[43] One could easily assess the strength of the turbo by, among other things, observing that the disclosed WAL of bonds that did not benefit from the turbo was not all that different from the WAL of the BBBs.[44] In sum, the Commission's finding that there was a failure to disclose Respondents' subjective view of the turbo is not supported by the evidence and is arbitrary.[45]

Note too that by complaining about the turbo, Mr. Chau was able to obtain a better return for Neo and Lexington. One way to "strengthen" a "weak" turbo is to negotiate for a lower price

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[38] (*See* FD at 15, 16.)

[39] (RX 280 at 8, 11, 93-104; Tr. 4133:13-4138:20.)

[40] (*Id.*)

[41] (*Id.*)

[42] (RX 280 at 8, 93-104.)

[43] (RX 280 at 135.)

[44] (*See* RX 280 at 8, 11, 93-104, 135.)

[45] Disclosure of the turbo is the only substantive issue left in this case. The Commission agreed with Respondents that their analysis of Norma's asset pool could not form the basis of a finding of fraud. The Commission ruled that there was no fraud of any kind—even rejecting the Enforcement Division's negligence theory—in connection with Respondents' purchases of the Single-A Norma bonds for other CDOs they managed. (*See* FD at 15 n.20.) The BBB Norma bonds were, of course, secured by the same pool of assets as the Single-A tranche. The primary differences between these tranches were the order of payments to which they were entitled and the turbo feature which benefitted the BBBs but not the As.

or a higher coupon. That is what happened here. As the OIP in this matter makes clear: Mr. Chau agreed to bid on the BBB Norma bonds only after a Merrill banker asked him what Respondents' bid would be if Merrill were unable to change the turbo.[46] Consistent with that exchange, Mr. Chau testified that he complained about Norma's turbo to help negotiate a price discount.[47] The Respondents eventually bought the BBBs at a discount to par and at a higher coupon than originally offered but only after they refused Merrill's offer to purchase the BBBs several times.[48] The Commission is silent as to those key uncontroverted facts.

3. It was the alleged victims who sold the BBB bonds and disclosed the Norma structural features to Respondents.

Putting everything else aside, there could be no fraud here because the directors of the Issuer for Norma were the exact same three directors for the alleged victims, the Issuers of Neo and Lexington.[49] These three individuals, in their roles as directors of the Norma Issuer, sold the BBB bonds to themselves as directors of Neo and Lexington.[50] These three individuals decided on having a turbo, determined its characteristics, and described its features to Respondents in the Norma OC.[51] They also determined the BBBs' WAL. To find then, as the Commission does, that Respondents committed securities fraud because they did not disclose to these same three individuals how the turbo feature affected the BBB bonds belies basic common sense. One would hope that if these directors knew enough about these Norma BBB bonds to offer them for sale, they knew enough to make an informed decision to buy them. Even if Respondents

[46] (OIP ¶ 63.)

[47] (Tr. 4169:5-11; 4187:23-4188:7.)

[48] (Resp. Post-Hearing Br. at 243-60.)

[49] (RX 280 at 136; DX 507 at 103; DX 509 at 110.)

[50] (RX 280.)

[51] The Norma Issuer (i) prepared the offering documents, (ii) represented that it took reasonable care to confirm that the information contained in the offering document was true and accurate in all material respects, and (iii) accepted all responsibility for the relevant information in the offering documents. (RX 280 at iv-v, 8, 93-104, 135.)

recommended the BBBs as a favor to Merrill and Magnetar, the Issuers could not have been defrauded because their directors knew exactly what they were buying. Alternatively, if these bonds were recommended as a favor, it was the directors of Neo and Lexington who, as the sellers of the bonds, were the recipients of the favor and so they knew that as well. To these damning and dispositive facts, the Commission was silent. It neither addressed nor rebutted this point in its opinion.

4. Any departure from the standard of care as to Norma bonds was not material.

Nor could there have been an offering fraud against the CDOs because the inclusion of the Norma bonds in Neo and Lexington never put anyone at risk and was not material.[52] It is axiomatic that minor departures from credit review standards fail the materiality standard.[53] Indeed, in another part of its decision dealing with the Octans-related allegations, the Commission recognized that Harding's role in asset selection was not limited to actions of a single person on a single day because

> [i]t is undisputed that, prior to closing, Harding and Chau reviewed each asset in the Octans portfolio to assure that all complied with the Eligibility Criteria and certified to that effect. The Division does not argue that this pre-closing asset review fell below the industry standard of care or that any of the assets in the Octans portfolio failed to comport with the eligibility and investment criteria.[54]

The same is true about Neo and Lexington: however they were originally selected, the BBB Norma bonds were re-reviewed in connection with the pre-closing analysis of each of the assets that went into each of those deals.[55] The Norma BBBs also met all eligibility and investment

[52] (*See* ID at 92.)

[53] *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[54] (FD at 12.)

[55] (*See, e.g.*, Tr. 4252:15-4254:10.)

criteria.[56] That means that even if those bonds were initially picked in a manner that did not comport with the relevant standard of care, the *entire* selection process for Neo and Lexington substantially conformed to the relevant standards. Simply put, if the two BBB bonds met the eligibility criteria—which they did—and Harding selected them over another bond as a favor to Merrill and Magnetar, it is not deviation from the standard of care because the BBB bonds still meet all of the eligibility criteria. The CMAs for Neo and Lexington obligated Respondents to do nothing more.

Put in stark mathematical terms, the Commission's liability findings and sanctions rest on the inclusion of two bonds that constituted only approximately 1.6% of the collateral of two CDOs into which they were placed.[57] At worst, therefore, even ignoring pre-closing certification review, the asset selection process followed by Harding in these deals resulted in those deals being 98.4% free of any conflict or taint, and the statements about Harding's asset selection process were 98.4% accurate. More practically, if the Issuers understood that pressure from the deal banker (who was their agent in all three of the relevant deals) about asset selection resulted in the inclusion of only one asset representing 1.6% of the portfolio, the Issuers would be reassured, rather than concerned. One would expect more problems in these Merrill deals if Harding was laboring under a conflict, yet none other was even alleged.

Of course, the point that the BBBs amounted to only 1.6% of the Neo and Lexington glosses over the fact that the strength of the turbo was disclosed and could not have mattered. As noted, a finding that failure to disclose the "weakness" of the turbo was material is tantamount to

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[56] (*See* RX 280 at 142-51.)

[57] (*See* ID at 52.)

concluding that investors cared more about how the waterfall worked than they did about what they would be paid and when. To repeat: the WAL was correctly disclosed.

C. The Commission's Finding on the Sanctions Raises Serious and Difficult Questions.

The findings as to the sanctions also raise serious issues on which reasonable jurists can differ. The Commission imposed severe and business-ending sanctions: (i) imposing a five-year industry bar on Mr. Chau, (ii) revoking the adviser registration of Harding, (iii) ordering disgorgement of $5,775,635.61, jointly and severally, plus prejudgment interest of $2,780,380.78, and (iv) requiring Mr. Chau to pay a civil penalty of $170,000 and Harding to pay $850,000.[58] The driver of the sanctions is not the alleged victims, the Issuers. Rather, in its opinion, *for the very first time in the case*, the Commission asserted that Respondents violated Section 17(a) of the Securities Act by misleading the Lexington and Neo investors.[59] However, Respondents were never charged with defrauding *investors* in Neo and Lexington. The alleged Norma violations relate solely to the *advisory clients*, the Neo and Lexington Issuers.[60] Investors in Neo and Lexington were not Respondents' advisory clients. Following on that, the Division did not offer the testimony of a single investor and did not offer any evidence regarding what these investors were told or whether the alleged omissions would have mattered to them. The ALJ, in turn, did not find any violations related to Neo or Lexington investors; instead, his findings were specifically limited to conduct relating to the Respondents "advisory clients."[61] In its Petition for Review, the Division did not claim this to be an error and did not appeal on this point.[62] At the oral argument before the Commission, Respondents' counsel explicitly confirmed

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[58] (Order at 1-2.)

[59] (FD at 18-21.)

[60] (*Compare* OIP ¶¶ 54-59 *with* ¶¶ 60-69.)

[61] (ID at 81-82, 91.)

[62] (Div. Pet. at 5, 19-23.)

that there were no allegations of misconduct as to the Neo and Lexington investors.[63] That statement went unchallenged by both the Commission and the Division. Basing severe, business and career ending sanctions on uncharged, unsubstantiated, and unproven conduct with no notice or opportunity to even object violates due process.[64] At a minimum, the resulting sanctions must be stayed pending their appeal.

Separately, the ordered remedies raise serious concerns about their applicability and legal basis. For example—accepting for the sake of argument that Respondents failed to disclose that they understood the Norma turbo to be weak but recommended the Norma BBBs anyway—to accept that Respondents should disgorge all of their management fees from Neo and Lexington, one would have to believe that the Neo and Lexington directors would have refused to pay *any* fees and would not have closed Neo or Lexington *despite* the following facts:

- That they themselves were the sellers of the BBB Norma bonds in question;
- That they themselves were responsible for the presence of the turbo and for its characteristics;
- That the turbo and its resulting WAL of BBBs were disclosed;
- That the turbo was a mechanical waterfall feature whose strength could be easily approximated by looking at the Norma OC;
- That all relevant disclosures about the BBBs and Norma were made by these directors in the Norma OC, which formed the Respondents' entire understanding of Norma's turbo;
- That the BBB bonds met all of the eligibility and investment criteria of Neo and Lexington;
- That there was nothing wrong with the Norma BBBs in any other respect;

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[63] (Transcript at 5:8-19.)

[64] *Mullane v. Cent. Hanover Bank & Tr. Co.*, 339 U.S. 306, 313 (1950) (holding that an essential principle of due process is that a deprivation of life, liberty, or property "be preceded by notice and opportunity for hearing appropriate to the nature of the case."). Indeed, remedial sanctions must be based on "a minimum quantity of evidence." *Steadman v. SEC*, 450 U.S. 91, 98 (1981) ("[N]o sanction shall be imposed . . . except as supported by relevant, reliable, and probative evidence.").

- That the BBB bonds only constituted approximately 1.6% of the portfolios for Neo and Lexington;
- That it was these directors who were having a difficult time selling Norma bonds and, therefore, they were the ultimate beneficiaries of any favor to Merrill; and
- That given the disclosures in the CMA, these directors could not have expected Respondents to act as their fiduciaries.

To put it bluntly, there is simply no logic to the conclusion that Neo and Lexington directors would have refused to close the deals or refused to pay Harding's management fees. Worse yet, not one of them testified that they would have done so; they were not called by the Division. At a minimum, therefore, there is no factual basis for the Commission's conclusion. In sum, the disgorgement is not supported by either logic or facts and is likely to be overturned on appeal.

Third-tier penalties are unwarranted because it was error to find that Harding's selection of one bond that constituted 1.6% of Neo or Lexington resulted in substantial losses or created a risk of substantial losses. As the ALJ found, there was "no direct evidence that Respondents' failure to follow the appropriate standard of care contributed to any CDO's failure, particularly as to the Norma-related violations, where the fraction of Norma bonds in each CDO's collateral was very low."[65] That "Norma eventually defaulted on the BBB-rated bonds," as the Commission pointed out,[66] proves nothing. Norma's performance was no different than the performance of any other similar CDO bond that failed in the wake of the financial crisis.[67]

Finally, given the paucity of evidence of any risk of future or present harm to anyone created by the allegedly violative conduct as well as significant questions about whether Respondents were fiduciaries, the order to revoke Harding's registration and Mr. Chau's association bar should also be stayed.

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[65] (ID at 92.)

[66] (FD at 14.)

[67] (RX 858 ¶¶ 41-42; RX 856 at 5; Tr. 4886:13-4890:24.)

II. RESPONDENTS WILL BE IRREPARABLY HARMED ABSENT A STAY

Absent a stay of all of the remedial sanctions, Harding will be forced into immediate financial ruin and possibly bankruptcy. It is settled law that financial ruin, bankruptcy, or insolvency constitutes irreparable injury.[68] Such financial ruin will occur here. While the Commission touted that Respondents have "current assets under management of about $1 billion,"[69] the Commission ignored other facts. The Commission left out that the CDOs under management is in "run-off" mode, and that Harding, itself, is in run-off mode, only managing to expiration those CDOs that survived the financial crisis.[70] In short, Harding has very limited resources, and those limited resources will evaporate in the event that the Order is imposed. Absent a stay, Harding will therefore be forced into bankruptcy and will have to fire its two junior employees.[71] In addition, there is a reasonable question as to whether the Commission has the constitutional authority to even order the remedies, given that, among other things, the SEC ALJ was appointed in violation of the Appointments Clause. Subjecting Respondents to constitutionally defective remedies is an irreparable injury by itself.[72]

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[68] Courts, in the preliminary injunction context, hold that the impending loss or financial ruin of a business constitutes irreparable injury. *See, e.g.*, *Doran v. Salem Inn, Inc.*, 422 U.S. 922, 932 (1975) (irreparable injury shown where business "would suffer a substantial loss of business and perhaps even bankruptcy" absent injunctive relief); *Minard Run Oil Co. v. U.S. Forest Serv.*, 670 F.3d 236, 255 (3rd Cir. 2011) (While "a purely economic injury, compensable in money, cannot satisfy the irreparable injury requirement, . . . an exception exists where the potential economic loss is so great as to threaten the existence of the movant's business." (citations omitted)).

[69] (FD at 18.)

[70] (*See* Tr. 4335:14-24.)

[71] Even if the revocation is stayed, the five-year bar imposed on Mr. Chau will result in Harding's immediate financial ruin and potentially bankruptcy. As established in the record, the CDOs that Harding manages include a "key man" provision, stating that should something happen to Mr. Chau that makes him unavailable, the Issuer or certain investors would have the right to call for the removal of Harding as the collateral manager. (*See, e.g.*, RX 2 at 198-99.)

[72] *See Duka v. SEC*, 124 F. Supp. 3d 287, 288 (S.D.N.Y. 2015) (finding that SEC administrative proceedings are unconstitutional and thus being subjected to such a proceeding amounts to irreparable harm), *vacated on other grounds*, No. 15-2732 (2d Cir. June 13, 2016); *see also United Church of the Med. Ctr. v. Med. Ctr. Comm'n*, 689 F.2d 693, 701 (7th Cir. 1982) ("Submission to a fatally biased decision making process is in itself a constitutional injury sufficient to warrant injunctive relief, where irreparable injury will follow in the due course of events, even though the party charged is to be deprived of nothing until the completion of the proceedings."). Respondents may

III. NO OTHER PARTY WILL BE HARMED BY A STAY

No harm will result should a stay be granted. Despite what the Commission found, the violations were not recurrent. At bottom, the Commission faulted the process by which Respondents selected one asset in February 2007. Even then, as discussed above, there is no evidence that these BBB bonds caused any harm. And aside from the finding as to the BBB bonds, which, as discussed above, suffer from serious legal and factual errors, Respondents have an unblemished record. The Commission did not find any misconduct before the BBB bonds were selected or in the ten years since. Moreover, Respondents are no longer in the same business. The portfolios of the CDOs that Harding manages are static, meaning that Harding is not actively selecting assets.[73] Thus, the Commission does not have an evidentiary basis for stating, as it did, that there is a risk of future harm.

IV. THE PUBLIC INTEREST FAVORS A STAY

It is always in the public interest to ensure that the Commission's power to impose these remedies is constitutionally valid before those remedies are imposed. As discussed above, Respondents will seek to invalidate the entire proceeding because the ALJ who presided over this case held his office unconstitutionally. On that issue, as detailed above, reasonable jurists differ, with, at minimum, the Tenth Circuit agreeing with Respondents' position. Given that the Commission is not even sure whether it will ultimately disagree with the Tenth Circuit, it serves

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suffer even further irreparable harm since they may be prevented under the doctrine of sovereign immunity from recovering monetary damages from the Commission for being subjected to an unconstitutional hearing. *Odebrechy Constr., Inc. v. Sec'y, Fla. Dep't of Transp.*, 715 F.3d 1268 (11th Cir. 2013) (holding that "the inability to recover monetary damages because of sovereign immunity renders the harm suffered irreparable").

[73] (Tr. 4335:14-24.)

no one, including the public, to impose draconian remedies while this important constitutional issue is resolved on appeal.[74]

Dated: February 17, 2017

Respectfully submitted,

BROWN RUDNICK LLP

By: ______________________

Alex Lipman, Esq.
Ashley L. Baynham, Esq.
Justin S. Weddle, Esq.
Seven Times Square
New York, NY 10036
Telephone: (212) 209-4800
Facsimile: (212) 209-4801

Attorneys for Respondents
Harding Advisory LLC and Wing F. Chau

[74] *Jones v. Caruso*, 569 F.3d 258, 278 (6th Cir. 2009) (holding that, in determining whether to grant injunctive relief, the public interest is advanced if the injunction enjoins the enforcement of a statute of "questionable constitutionality" so as to first determine that constitutional question).

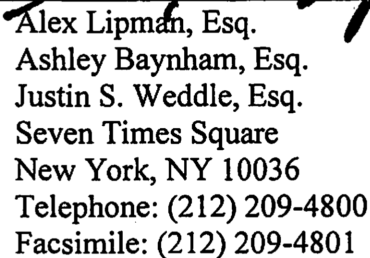
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMISSION

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

Pursuant to Commission Rule of Practice Rule 154(c), I hereby certify that the Respondents' Motion to Stay the Commission's Order Imposing Remedial Sanctions Pending Judicial Review complies with the length limitations set forth in Commission Rule of Practice 154(c). According to the Word Count function of Microsoft Word, this brief contains 6935 words, exclusive of table of contents, table of authorities, cover page, signature block, certificate of compliance, and certificate of service.

Dated: February 17, 2017

BROWN RUDNICK LLP



By: ______________________

Alex Lipman, Esq.
Ashley Baynham, Esq.
Justin S. Weddle, Esq.
Seven Times Square
New York, NY 10036
Telephone: (212) 209-4800
Facsimile: (212) 209-4801

Attorneys for Respondents
Harding Advisory LLC and Wing F. Chau

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMISSION

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

Pursuant to Commission Rule of Practice Rule 151(d), I hereby certify that on February 17, 2017, a true and correct copy of the Respondents' Motion to Stay the Commission's Order Imposing Remedial Sanctions Pending Judicial Review was served via electronic mail on:

Howard A. Fischer
Securities and Exchange Commission
New York Regional Office
200 Vesey Street, Suite 400
New York, NY 10281
Telephone: (212) 336-0589
Email: fischerh@sec.gov

Dated: February 17, 2017

BROWN RUDNICK LLP

By: ______________________
Alex Lipman, Esq.
Ashley Baynham, Esq.
Justin S. Weddle, Esq.
Seven Times Square
New York, NY 10036
Telephone: (212) 209-4800
Facsimile: (212) 209-4801

Attorneys for Respondents
Harding Advisory LLC and Wing F. Chau