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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15574

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In the Matter of

HARDING ADVISORY LLC
and WING F. CHAU,

Respondents.

Division of Enforcement's Opposition to Respondents' Motion to Stay Sanctions

Respondents Harding Advisory LLC and Wing F. Chau seek a stay of the Commission's January 6, 2017 Order Imposing Remedial Sanctions, Securities Act Rel. No. 10277, 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." Mot. 1. The Commission's consideration of stay requests is "governed by the traditional, four-factor standard—namely, '(1) whether the stay applicant has made a strong showing that he is likely to succeed on the merits; (2) whether the applicant will be irreparably injured absent a stay; (3) whether issuance of the stay will substantially injure the other parties interested in the proceeding; and (4) where the public interest lies.'" *Raymond J. Lucia Companies Inc. and Raymond J. Lucia, Sr.*, Exchange Act Release No. 76241, at 1 (Oct. 22, 2015) (quoting *Nken v. Holder*, 556 U.S. 418, 434 (2009)). As the parties seeking relief, Respondents carry "the burden of demonstrating that a stay is justified." *Id.* "Because the first two factors are the most critical, an applicant's failure to demonstrate the requisite likelihood of success or irreparable harm ordinarily will be dispositive of the stay inquiry." *Id.* at 1-2. Respondents fall far short of meeting any of the four factors. Their stay request should therefore be denied.

In light of the Commission's decision not to seek further review of the D.C. Circuit's recent decision in *Bartko v. SEC*, 845 F.3d 1217 (D.C. Cir. 2017), in which the Court vacated collateral bars based on misconduct that predated the July 22, 2010, effective date of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), the Division does not oppose granting Chau, who was associated with an investment adviser at the time of his misconduct, such relief from the collateral bars the Commission imposed in this case. Accordingly, the Commission should vacate the portion of the Commission's order that bars Chau from association with a broker, dealer, municipal securities dealer, or transfer agent. This action, however, has no bearing on Respondents' request for a stay, which, as demonstrated below, should be denied in all respects.

I. RESPONDENTS HAVE NOT MADE THE REQUISITE SHOWING OF A LIKELIHOOD OF SUCCESS ON THE MERITS.

Respondents contend (Mot. 1, 6) that the Commission must grant a stay if it agrees that they have raised "serious, substantial, difficult, and doubtful legal questions as to which reasonable jurists may disagree.". But that bare showing is sufficient only if the other three factors strongly favor a stay. *See Sherley v. Sebelius*, 644 F.3d 388, 398 (D.C. Cir. 2011); *Davis v. Pension Benefit Guar. Corp.*, 571 F.3d 1288, 1292 (D.C. Cir. 2009). As explained below, those factors counsel *against* a stay here. Respondents' burden is thus to establish that their arguments are likely to prevail on appeal. Because they cannot do so, a stay is unwarranted. *See Lucia*, *supra*, at 2 & n.5.

A. Respondents are not likely to succeed on their Appointments Clause claim.

The Commission correctly held that its ALJs are employees, not officers of the United States, and thus their manner of appointment is not subject to the requirements of the

Appointments Clause. January 6, 2017 Order, *supra*, at 26-27. Respondents argue that "reasonable and intelligent jurists may disagree," pointing to a Tenth Circuit ruling that the Commission's ALJs are inferior officers subject to the Appointments Clause. Mot. 7-8 (citing *SEC v. Bandimere* 844 F.3d 1168 (10th Cir. 2016)). The fact that a divided panel in one circuit disagreed with the Commission's position, however, does not establish that Respondents are likely to prevail on appeal in this case.

The Commission acknowledged *Bandimere* in its January 6, 2017 Order, but appropriately declined to follow it. Noting that Respondents here may appeal to the D.C. Circuit but not the Tenth Circuit, the Commission adhered to its previous holdings and to the D.C. Circuit's decision in *Lucia v. SEC*, 832 F.3d 277 (D.C. Cir. 2016), which adopted the Commission's view. Although the D.C. Circuit recently granted rehearing en banc in *Lucia*, thereby vacating the panel decision, that fact sheds no light on how the en banc Court is likely to rule on the merits, and thus whether a stay is warranted here. *See* Fed. R. App. P. 35(a) (establishing two criteria for granting rehearing en banc—when "necessary to secure or maintain uniformity of the court's decisions" or "the proceeding involves a question of exceptional importance"—neither of which considers likelihood of success). Nor does it obligate the Commission to follow *Bandimere*. *See Johnson v. U.S. R.R. Ret. Bd.*, 969 F.2d 1082, 1093 (D.C. Cir. 1992) (recognizing that when an agency's "position is rejected in one circuit, . . . it should have a reasonable opportunity to persuade other circuits to reach a contrary conclusion.").[1]

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1 Respondents erroneously claim that the Commission cannot invoke nonacquiescence because it has requested a 30-day extension of time to file a petition for rehearing en banc in *Bandimere*, which, they claim, shows the Commission is "not seeking review" of that decision in the Supreme Court. Mot. 8 (citing *Heartland Plymouth Court MI, LLC v. NLRB*, 838 F.3d 16 (D.C. Cir. 2016)). It is not clear how this argument bears on Respondents' likelihood of success, but in any event it is meritless. *Heartland* confirmed that an agency may preserve its opportunity to seek Supreme Court review by first filing

B. Respondents are not likely to succeed in demonstrating that the Commission's findings on the merits are arbitrary, capricious, an abuse of discretion, or unsupported by substantial evidence.

Respondents challenge the Commission's liability findings on four grounds: (1) that they did not owe any fiduciary duty to Lexington Capital Funding V Ltd. CDO ("Lexington") and Neo CDO 2007-1 ("Neo"), (2) that the Commission misunderstood the nature of the Norma CDO I ("Norma") turbo, (3) that Lexington and Neo could not have been defrauded because their directors were also Norma's directors, and (4) that any departure from the applicable standard of care was not material. None of these arguments is likely to succeed on appeal.

1. The Commission did not err in finding that Respondents owed a fiduciary duty to Lexington and Neo.

Sections 206(1) and 206(2) of the Advisers Act impose fiduciary duties on investment advisers. *See* January 6, 2017 Order, *supra*, at 7, 15 (citing *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) and *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-94 (1963)). As the Commission noted, these fiduciary duties require an investment adviser to act with "utmost good faith," *Capital Gains*, 375 U.S. at 194, and "at all times in the best interest of the fund [it advises]," *SEC v. Tambone*, 550 F.3d 106, 146 (1st Cir. 2008), *withdrawn*, 573 F.3d 54 (2009), *reinstated in relevant part*, 597 F.3d 436 (2010)).

The Commission found that Harding, a registered investment adviser under the Advisers Act, owed a fiduciary duty to its clients, including issuers of CDOs it managed. January 6, 2017 Order, *supra*, at 7.[2] The Commission further found that "Harding breached its fiduciary duty to

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a petition for en banc review in the circuit court. 838 F.3d at 22 n.5. Moreover, unlike the NLRB in that case, the Commission has not demonstrated a "steadfast refusal to seek *certiorari*" of adverse decisions "for a quarter of a century" during which a circuit split had already "engulf[ed] most circuits." *Id.* at 24-25.

2 Respondents do not appear to dispute that Harding was an investment adviser to Lexington and Neo. *See* Respondents' Opening Brief in Support of their Petition for

select only assets it believed were best for its clients in violation of Sections 206(1) and Section 206(2) when Chau purchased Norma BBB bonds as a favor to Magnetar and Merrill and Harding allocated those assets to Lexington and Neo without regard for those clients' interests." *Id.* at 17.

Respondents erroneously contend (Mot. 9-10) that the relevant collateral management agreements ("CMAs") effectively disclaimed any fiduciary duty under the Advisers Act. Section 215(a) of the Advisers Act expressly invalidates any contractual provision that purports "to waive compliance with any provision" of the Act. *See also Capital Gains*, 375 U.S. at 201 ("The [Advisers Act], in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested."); *Goldstein v. SEC*, 451 F.3d 873, 881 (D.C. Cir. 2006) (noting that Section 206 "create[s] a fiduciary duty of loyalty between an adviser and his client"). Consequently, an adviser cannot contract away the fiduciary duties it owes to clients under Section 206. Respondents' similar contention (Mot. 9-10) that because the CMAs "subject [Harding] to a number of restrictions" Harding therefore "does not and cannot have other duties or obligations" is likewise without merit. The fact that an agreement constrains an investment adviser's discretion in managing its client's portfolio in no way establishes that the general fiduciary duties of loyalty and good faith under the Advisers Act do not apply.

Nor does the D.C. Circuit's decision in *Goldstein* cast any doubt on the Commission's finding that Harding owed a fiduciary duty to Lexington and Neo. In *Goldstein*, the Court vacated a Commission rule regulating hedge funds. 451 F.3d at 884. The rule rested on the Commission's interpretation of the word "client" in an Advisers Act provision as extending not only to a client fund but also to the fund's investors. *Id.* at 877-78. The Court considered this

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Review at 22. In any event, substantial evidence supports that conclusion. *See, e.g.*, Div. Ex. 504 at 3 ("[Lexington] hereby appoints [Harding] as its investment advisor and manager with respect to the Collateral on the terms set forth herein . . . ."); Div. Ex. 506 at 3 (same as to Neo and Harding).

interpretation unreasonable in part because it would imply that the adviser owed a fiduciary duty both to the fund and the fund's investors, in which case the adviser would "inevitably face conflicts of interest." 541 F.3d at 881. Nothing about this holding establishes that "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," as Respondents claim (Mot. 2). If anything, *Goldstein* stands for the opposite conclusion—that an adviser *can* be a fiduciary of the CDO it manages; it simply admonishes that such an adviser cannot simultaneously be a fiduciary of the CDO's noteholders without creating conflicts of interest.

2. The Commission's liability findings do not rest on the nature of the Norma turbo.

Respondents argue (Mot. 10-11) that the Commission's liability findings were based on a misunderstanding of Norma's turbo and amortization schedule. But the Commission's findings did not rest on the precise mechanics of either. The Commission found that Harding breached its fiduciary duty by selecting Norma BBB bonds for Lexington and Neo as a favor to Merrill and Magnetar, even though Harding did not consider the bonds a prudent investment. January 6, 2017 Order, *supra*, at 15-16. Substantial evidence supports these key findings. *See id.* at 13-16.

For example, the Commission found that after studying Norma's term sheet and other materials, Chau determined that Norma's "turbo structure" was "very weak" and disfavored mezzanine noteholders, and that Chau was therefore reluctant to purchase Norma BBB bonds. *Id.* at 13. Chau agreed to acquire Norma BBB bonds only after receiving repeated overtures from Merrill and Magnetar. *Id.* Then, about a week before Norma closed, Chau received an in-depth internal assessment of the BBB bonds that "raised significant red flags and predicted that the investment would be hit with losses." *Id.* at 14. Harding nonetheless went ahead with the purchase and allocated the bonds to Lexington and Neo. *Id.* The Commission noted that there was no evidence Respondents ever disclosed to Lexington or Neo its negative assessment of the Norma BBB bonds or the fact it selected them as a favor to Merrill and Magnetar. *Id.* at 16.

Respondents' contention (Mot. 11) that they cannot be liable because the mechanics of the Norma turbo were disclosed in Merrill's offering circular ignores that the Commission's findings were *not* based on a failure to disclose how the turbo worked. Even if the turbo structure was disclosed, the Commission found Respondents breached their fiduciary duty because they "did not act in the best interest of Harding's clients when selecting the Norma BBBs for Lexington and Neo." January 6, 2017 Order, *supra*, at 15. Respondents provide no authority for the notion that Merrill's disclosure of the turbo structure absolved Harding of its obligation to act with utmost good faith and in the best interests of its clients.

3. The Commission correctly rejected Respondents' argument that fraud could not have occurred because Lexington, Neo, and Norma had the same directors.

Respondents contend (Mot. 12-13) that Lexington and Neo could not have been defrauded because Merrill had designated the same three people to serve as their and Norma's directors, and thus their directors would have understood the features of the Norma bonds that Respondents had selected. Contrary to Respondents' suggestion (Mot. 4, 13), the Commission did not ignore this argument; it addressed and appropriately rejected it. January 6, 2017 Order, *supra*, at 16.

As the Commission recognized, Lexington and Neo are legally distinct entities to whom Harding owed a fiduciary duty. *Id.* Moreover, regardless of whether Lexington and Neo's directors may have understood how the Norma BBB bonds worked, Harding had a fiduciary duty to act in its clients' best interest. *See Capital Gains*, 375 U.S. at 194, 201; *Tambone*, 550 F.3d at 146; *Goldstein*, 451 F.3d at 881. Harding breached that duty when it purchased the Norma BBB bonds for its clients as a favor to Merrill and Magnetar without regard to their creditworthiness.

January 6, 2017 Order, *supra*, at 14-15. As the Commission observed, "nothing in the record suggests that Respondents specifically disclosed to the Lexington or Neo issuers either that they believed that Norma had a very weak turbo structure . . . or that they had reluctantly purchased the BBB-rated bonds they had selected to include in the portfolios as a favor to Merrill and Magnetar." *Id.* at 16. Absent such evidence, the Commission reasonably rejected the contention that Lexington and Neo could not have been defrauded because they and Norma were all controlled by Merrill. *Id.*

4. There is no merit to Respondents' argument that their failure to comply with the applicable standard of care was not "material."

Respondents erroneously argue (Mot. 13-14) that any departure from the standard of care applicable to their selection of assets "taint[ed]" only 1.6% of Lexington and Neo's collateral and is thus not material. "A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision." *IMS/CPAs & Assocs.*, Exchange Act Release No. 45019, 2001 WL 1359521, at *8 (Nov. 5, 2001)), *aff'd sub nom.*, *Vernazza v. SEC*, 327 F.3d 851 (9th Cir. 2003); *accord Capital Gains*, 375 U.S. at 200-01. Respondents offer no compelling reason to second-guess the Commission's conclusion that "a reasonable investor would have wanted to know that instead of exercising reasonable care in selecting assets Harding selected assets based on its relationship with Magnetar and Merrill." January 6, 2017 Order, *supra*, at 17.

Moreover, it is well-established that an investment adviser's fiduciary breach or conflict of interest may be material even if it "never put[s] anyone at risk" (Mot. 13) or does not affect a threshold percentage of assets. *See, e.g.*, *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956 (7th Cir. 2004) ("*Capital Gains* made clear that a violation of the Advisers Act requires neither injury nor intent to injure."); *Vernazza*, 327 F.3d at 859 ("It is indisputable that potential conflicts of interest are 'material' facts with respect to clients and the Commission."); *Kingsley, Jennison, McNulty & Morse, Inc.*, Advisers Act Release No. 1396, 1993 WL 538935, at *4 ("[B]ecause of the fiduciary relationship between an adviser and its client, the percentage or absolute amount of commissions involved is not the sole test of materiality in a transaction between them."). Respondents cite no authority to the contrary.

C. Respondents are not likely to succeed in demonstrating that the sanctions imposed by the Commission are an abuse of discretion.

Respondents challenge the sanctions imposed by the Commission generally, as well as the amount of disgorgement and civil penalties ordered. But Respondents cannot demonstrate that "the Commission's choice of sanction" was "either 'unwarranted in law or . . . without justification in fact.'" *Wonsover v. SEC,* 205 F.3d 408, 413 (D.C. Cir. 2000) (quoting *Butz v. Glover Livestock Comm'n Co.,* 411 U.S. 182, 185-86 (1973)); *see also Horning v. SEC*, 570 F.3d 337, 343 (D.C. Cir. 2009) ("We therefore accord great deference to the SEC's remedial decisions.") (quotation marks omitted).

Respondents mistakenly claim (Mot. 15-16) that the Commission's sanctions are premised on a finding that "Respondents violated Section 17(a) of the Securities Act by misleading the Lexington and Neo investors." The Commission made no such finding. The only Section 17(a) violation it found stemmed from Respondents' misrepresentations to Lexington and Neo regarding the standard of care Respondents would exercise in selecting assets for them. January 6, 2017 Order, *supra*, at 17. Respondents do not cite any specific passage in which the Commission found a violation, or justified a choice of sanction based on, misrepresentations to Lexington and Neo's investors. To the contrary, in justifying each sanction, the Commission referenced Respondents' breach of its fiduciary duty to Lexington and Neo. *See id.* at 18 (bar justified by fact that Chau's actions "served Harding's interests, rather than those of Harding's clients"); *id.* at 19 (applying same considerations to justify revocation of Harding's registration and imposition of cease-and-desist order); *id.* at 20 (disgorgement justified because "Respondents knowingly put their interests ahead of their clients"); *id.* at 22 (ordering separate civil penalties for "the violations with respect to Lexington" and "the violations with respect to . . . Neo").

Respondents also err in arguing (Mot. 16-17) that there is no logical or factual link between their violations and the approximately $5.78 million in fees they earned for managing Lexington and Neo that the Commission ordered disgorged. As the Commission explained, Harding received no fees unless and until the Lexington and Neo CDOs closed. January 6, 2017 Order, *supra*, at 21. If Respondents had disclosed that they acquired assets for Lexington and Neo "as a favor to outside parties without regard (and, indeed, in apparent opposition to) the interests of [their] clients," and that they "misrepresented in the offering documents for Lexington and Neo" the standard of care they would exercise in selecting assets, Lexington and Neo's investors might have had an opportunity to withdraw prior to closing. *Id.* at 20-21. The Commission ordered disgorgement of an amount that is a "reasonable approximation" of the amount of fees attributable to Respondents' failure to disclose that information. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231-32 (D.C. Cir. 1989). Respondents bear the consequence of any remaining uncertainty. January 6, 2017 Order, *supra*, at 21 (citing *First City Fin. Corp.*, 890 F.2d at 1232).

Nor have Respondents shown that the Commission abused its discretion in imposing third-tier civil penalties. The Commission concluded that Respondents' violations "involved fraud and created a significant risk of substantial losses to other persons." *Id.* at 21. Respondents object (Mot. 17) on the ground that Norma BBB bonds constituted only 1.6% of

Lexington and Neo's portfolio. But that fact does not invalidate the Commission's findings that those bonds "had an extremely high risk of default," and therefore that "including them in the Lexington and Neo portfolios increased the risk that the entire pool of assets would default." January 6, 2017 Order, *supra*, at 21. Moreover, the Commission counted "Respondents' scienter, their unjust enrichment, and the need for deterrence" as additional factors supporting third-tier sanctions. *Id.* The Commission also considered factors weighing against a third-tier penalty, including "the lack of losses or other harm directly caused by the violation." *Id.* Respondents are unlikely to prevail on a claim that the Commission abused its discretion in balancing these considerations. *See Kornman v. SEC*, 592 F.3d 173, 186 (D.C. Cir. 2010) ("Because of the Commission's accumulated experience and knowledge, its [remedial] judgment is entitled to the greatest weight." (alterations and quotation marks omitted)).

II. RESPONDENTS HAVE NOT DEMONSTRATED IRREPARABLE HARM.

Respondents have also failed to demonstrate irreparable harm. It is well established that "economic loss does not, in and of itself, constitute irreparable harm." *Wis. Gas Co. v. FERC*, 758 F.2d 669, 674 (D.C. Cir. 1985). Without support, Respondents' claim (Mot. 18) that "Harding will be forced into immediate financial ruin and possibly bankruptcy" if the Order is enforced. Mere speculation is insufficient to warrant a stay; the injury must be "certain," "actual," and "not theoretical." *Donald L. Koch and Koch Asset Mgmt., LLC*, Exchange Act Release No. 72443, at 3 (June 20, 2014) (quotation marks omitted); *see also Wis. Gas*, 758 F.2d at 674 (movant must "substantiate" claim that the existence of its business is threatened; "bare allegations . . . are of no value"). Respondents had the opportunity to provide the sworn financial statements necessary to support a claim that they are unable to pay disgorgement or civil penalties, but have failed to do so. *Cf.* 17 C.F.R. § 201.630.

Respondents' complaint that facing remedies from a "constitutionally defective" administrative proceeding itself constitutes irreparable harm is doubly flawed, as the Commission correctly rejected Respondents' constitutional claim. January 6, 2017 Order, *supra*, at 26-27. And in any event, abiding a proceeding one considers unconstitutional is not an irreparable injury. *See Tilton v. SEC*, 824 F.3d 276, 285 (2d Cir. 2016) ("The litigant's financial and emotional costs in litigating the [allegedly unconstitutional] initial proceedings are simply the price of participating in the American legal system, and not an irreparable injury that necessitates interlocutory review of the initial court's jurisdiction."); *Jarkesy v. SEC*, 803 F.3d 9, 28 (D.C. Cir. 2015) (noting that the "judicial system tolerates" such harms, which are no different from those incurred "by any respondent in an enforcement proceeding or any criminal defendant who must wait for vindication").

III. A STAY RISKS SUBSTANTIAL INJURY TO THIRD PARTIES.

Respondents cannot show that no other party would be likely to suffer substantial harm if the stay were granted. Respondents repeat (Mot. 19) their arguments that the violation concerned only one bond, that no one was harmed, and that they had an unblemished record. Respondents also suggest that they cannot harm the investing public because they "are no longer in the same business" in that they are "not actively selecting assets." *Id.* But the Commission has already rejected the argument that Respondents pose no future threat. Even if Chau is not currently responsible for selecting assets, the Commission explained that as long as he "remains an investment adviser," Chau will have "opportunities for violative conduct in the future," and so "a bar with a right to reapply after five years is necessary to protect the public." January 6, 2017 Order, *supra*, at 18. The Commission further recognized that "a finding of [a past] violation raises a sufficient risk of future violation, because evidence showing that a respondent violated the law once probably also shows a risk of repetition . . . ." *Id.* at 19 (quotation marks omitted); *see also Raymond J. Lucia Companies Inc. and Raymond J. Lucia, Sr.*, Exchange Act Release No. 75837, at 35 ("[B]ecause Lucia disregarded his fiduciary duties in the past in the manner shown here there is reason to believe that he will disregard them in the future."). In light of these findings, Respondents' request for relief should be rejected.

IV. THE PUBLIC INTEREST WEIGHS AGAINST A STAY.

Respondents have done nothing to demonstrate why a stay is in the public interest when the Commission has determined that the remedial sanctions it ordered were tailored to protect investors from Respondents' serious and knowing misconduct. As noted above, the Commission concluded that "a bar with a right to reapply after five years is necessary to protect the public" given that Chau violated his fiduciary obligations with scienter and that his continued association with an investment adviser "presents opportunities for violative conduct in the future." January 6, 2017 Order, *supra*, at 18. For the same reasons, the Commission also determined that revocation of Harding's registration is "necessary to protect the public interest." *Id.* at 19. And the Commission relied on the same public interest considerations in issuing a cease-and-desist order. *Id.* The civil penalties imposed likewise are "in the public interest" because Respondents' violations "involved fraud and created a significant risk of substantial losses to other persons," and in light of "Respondents scienter in committing the violations, their unjust enrichment, and the need for deterrence." Here again, Respondents' request to ignore these findings should be rejected.

* * * *

"[T]he imposition of a stay pending judicial review of an action by an administrative agency," the Commission has explained, "is an *extraordinary* remedy." *Richard L. Sacks*, Exchange Act Release No. 57028, at 3 (Dec. 21, 2007) (emphasis added). Respondents have failed to carry their burden of demonstrating that a stay is warranted—indeed, they cannot satisfy *any* of the four factors. Accordingly, their request for that extraordinary relief should be denied.

This 28th day of February, 2017.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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