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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15574

In the Matter of

HARDING ADVISORY LLC and
WING F. CHAU,

Respondents.

PREHEARING BRIEF OF THE DIVISION OF ENFORCEMENT

DIVISION OF ENFORCEMENT
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PRELIMINARY STATEMENT

Harding Advisory LLC ("Harding Advisory," and, together with its predecessor, "Harding") and its owner Wing F. Chau (collectively, "Respondents") made misrepresentations to investors and breached their obligations to act in the best interests of the Collateralized Debt Obligation (CDO) vehicles for which Harding was collateral manager and investment adviser. Respondents' desire to please an undisclosed third party, the hedge fund Magnetar, as well as Merrill Lynch – the investment bank responsible for much of Harding's business – led Respondents to corrupt their asset-selection process, including by selecting assets that they disfavored. This compromised decision-making rendered materially untrue statements that Respondents made both to investors in the CDOs and to their advisory clients concerning the methods and standards that Harding would apply in selecting collateral. Respondents, in other words, placed their interests in keeping Magnetar and Merrill Lynch happy ahead of their obligations to the CDO vehicles and their investors.

Specifically, with respect to a CDO named Octans I CDO Ltd. ("Octans I"), Harding fulfilled Magnetar's wish to load up the portfolio with the constituents of a benchmark known as the ABX Index, even though Harding's internal analysis and review did not support many of these purchases. Referring later to another Magnetar-driven review of the ABX Index bonds, a Harding analyst commented that "we had to pick the lesser of evils." And for other vehicles advised by Harding, Chau made a series of indefensible purchases, accepting notes issued by a troubled Merrill-underwritten CDO known as Norma, despite Respondents' unfavorable view of the investment. Chau was apparently trying to return favors and show that he was a "team player" who "never forget[s] my true friends."

Respondents had represented in advisory agreements known as Collateral Management Agreements ("CMAs") that Harding would discharge its duties as manager of the CDOs "in a manner consistent with the customary standards, policies and procedures followed by institutional managers of national standing." These representations were repeated to CDO investors in the offering memorandums for the CDOs. They were materially untrue.

Also untrue were Harding's representations, in the marketing books for its CDOs, concerning its process for selecting assets. Harding represented, for example, that it would engage in "rigorous upfront credit and structural analysis" of each asset, that it would "perform a thorough bottom/up credit and structural analysis to identify individual investments," and that it employed a "collaborative, methodical, and disciplined investment process." These were not empty phrases but language with a clear meaning and import to industry participants – a meaning and import that Respondents knew to be inaccurate. On top of all this, the marketing book and offering memorandum for Octans I made a misrepresentation in the "conflicts of interest" section, omitting, from a description of the "warehouse" arrangement through which collateral was accumulated prior to closing, all mention of contractual rights relating to the acquisition of collateral that had been granted to Magnetar.

For these reasons, Respondents violated Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a), and Sections 206(1) and (2) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. § 80b-6. Chau also aided and abetted and caused Harding's primary violations of both of those statutes.

CONTENTIONS OF FACT

Respondents

Harding Advisory is a registered investment adviser whose principal is Wing Chau. ¶ 9.[1] Chau started Harding Advisory in or about July 2006 as the successor to Maxim Advisory LLC ("Maxim"), *see id.*, a CDO-management group headed by Chau within a larger company known as Maxim Group. Harding's entire business was managing CDOs. In total, Harding served as the manager to twenty-one CDOs. At its peak in 2007, Harding had approximately $20 billion in assets under management (AUM). *Id.*

Wing Chau, 47, has served since 2006 as Harding Advisory's CEO and Chief Compliance Officer. ¶ 10. Chau is the 99% owner of Harding Advisory; his wife owns the remaining one percent.[2]

Market Background[3]

A CDO is a special purpose vehicle that issues securities, including debt securities, to investors and uses the proceeds to invest in fixed income securities or loans. The debt normally is issued in different tranches that feature varying levels of risks and returns. The senior tranche is the highest rated, is first in the priority of repayment through what is called the CDO's waterfall and has the lowest risk of default. Because of the lower risk of default and the priority

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[1] Where undisputed facts are alleged in a given paragraph of the OIP and admitted in the corresponding paragraph of the Answer, this brief uses the notation "¶ __" to refer to the paragraph number in both documents.

[2] While Respondents' January 10, 2014 Answer (at ¶ 10) states that Chau is a resident of Basking Ridge, New Jersey, Respondents represented in a filing in federal district court that Chau resides in Miami-Dade County, Florida, and that Harding Advisory's principal place of business is in Boca Raton, Florida. Complaint, *Wing F. Chau and Harding Advisory LLC v. SEC*, at ¶ 10, No. 14 Civ. 1903 (S.D.N.Y. Mar. 18, 2013).

[3] The Division also respectfully refers the Court to the expert report of Ira Wagner, including paragraphs 6-34, for relevant market background.

of repayment in the CDO's waterfall, the holders of the senior tranche have lower rates of return. The inverse is true for the lowest-rated tranche in the CDO. ¶ 15.

The investment manager of a CDO's portfolio is referred to as the collateral manager. Not all CDOs have collateral managers, ¶ 19, but where a CDO does have a collateral manager, the Division will establish that the manager is expected to exercise its independent judgment and to act in the best interests of the CDO. Another key participant in a CDO transaction is the investment bank, or dealer, that structures the transaction and brings it to market, which the Division will sometimes refer to as the "arranger" or "arranging bank."[4] Most of the CDOs relevant to this case were arranged by the now-defunct investment bank consisting of Merrill Lynch, Pierce, Fenner & Smith Inc. and its affiliates (collectively, "Merrill Lynch" or "Merrill").

A credit default swap (CDS) is a type of derivative through which two parties transfer the risk of ownership of a particular "reference obligation." As relevant to this case, the reference obligations were generally subprime residential mortgage-backed securities ("RMBS"). ¶¶ 3, 16. A CDS essentially mimics the performance of the referenced asset. Thus, an investor can gain exposure to an asset, such as an RMBS, by entering into a CDS that references the asset instead of by purchasing the asset itself.

More specifically, a CDS's protection buyer (who is "short" the reference obligation) pays to purchase "protection" upon the occurrence of certain events, such as an event of default, failure to pay interest, writedowns or substantial credit ratings downgrade of the reference obligation (collectively, "Credit Events"). The protection seller (who is "long" the reference obligation) sells that protection and assumes the risk of a Credit Event on the reference obligation. In 2006, the protection buyer normally paid the protection seller a premium or spread

[4] The arranging bank is sometimes referred to as the "underwriter" of the transaction. Many of the witnesses are expected to use this terminology at the hearing. The distinction is not relevant here.

(analogous to the coupon payments on a bond).[5] ¶ 16. Being exposed to an asset as the "long" party in a CDS is sometimes referred to as owning that asset "synthetically."[6]

A CDO can be backed by bonds (a "cash CDO") or by CDS (a "synthetic CDO"). A CDO backed by both bonds and CDS is called a "hybrid CDO." ¶ 17.

Also relevant to this proceeding is the ABX index ("ABX", "ABX Index," or the "Index"), which was a standardized CDS referencing a benchmark basket of 20 RMBS. The ABX Index was available at various levels of credit rating. The relevant levels in this case were BBB and BBB-. New ABX Indices became available twice per year, and in each case referenced RMBS issued in the preceding six months. Thus, for example, ABX 2006-1 referenced a basket of 20 RMBS issued in the second half of 2005. ¶ 33.

The Octans I Transaction

Octans I was a $1.5 billion hybrid CDO that closed on September 26, 2006. ¶ 3. Work on the CDO began in late May 2006, with Harding entering into a May 26, 2006 engagement letter (Div. Ex. 24) with Merrill Lynch and a unit of Magnetar pursuant to which Harding agreed to manage, and Merrill Lynch agreed to structure and market, the CDO. Magnetar committed to buy the equity, or junior-most tranche, of the CDO. *Id.*; *see also* ¶¶ 20, 24. In the intervening three months, known as the "warehouse" phase, Harding and Merrill Lynch – with involvement from Magnetar – worked to acquire a portfolio of assets initially housed in an account at Merrill Lynch.

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[5] For example, a protection buyer may agree to pay a protection seller 150 basis points to purchase protection against default on $10 million of a designated reference obligation, or $150,000 per annum, paid periodically.

[6] During the hearing, the parties and witnesses may sometimes use language that treats synthetic and actual cash ownership interchangeably, e.g. "Octans I owned XYZ number of RMBS." In reality, Octans I owned *CDS referencing XYZ number of RMBS*. For many purposes, the distinction is not relevant, precisely because synthetic ownership mimics actual cash ownership.

At closing, among other things: (1) Harding entered into a CMA with a special-purpose Cayman Islands entity (the CDO's "Issuer"); (2) the Issuer, advised by Harding, acquired the warehoused assets; and (3) the Issuer issued securities to the CDO's investors. As in any CDO, the securities were backed by the Issuer's pooled assets, which are referred to as the CDO's collateral. Approximately 90% of the collateral in Octans I consisted of synthetic subprime RMBS; the remaining 10% (known as a "CDO bucket") consisted of securities in turn issued in other CDO transactions.

For its role as Collateral Manager of Octans I, Harding earned approximately $4.5 million. By April 3, 2008, Octans I had begun to fail. *See* ¶ 3.

Harding's Incentives

Harding and Chau were strongly motivated to please Merrill Lynch. By May of 2006, Merrill Lynch had brought Maxim all six CDOs (total AUM: $7.3 billion) for which Maxim was serving, or would shortly begin serving, as collateral manager. In other words, at the time that Octans I was getting started – which was also the time that Chau was getting ready to spin off his business into an independent firm – Chau owed to Merrill Lynch literally 100% of his revenues, by then roughly $4 million. (A CDO manager does not get paid unless the CDO closes.) Merrill, moreover, was in a position to keep sending Chau business. After Octans I closed, even as the previous CDOs kept generating revenue, Harding became the manager of four additional Merrill CDOs; those four ultimately generated nearly $10 million in fees for Harding. *See generally* Div. Ex. 239 (chart of CDOs managed by Harding).

Keeping Magnetar happy was also important to Harding. Octans I was just one of a series of CDOs created pursuant to an arrangement between Merrill and Magnetar whereby Merrill would bring to market CDOs in which Magnetar would buy the equity layer and "play[] a significant role in the structure and composition of the portfolio," in the words of Richard Lasch, the Merrill Lynch salesperson who covered Magnetar.

As more than one witness is expected to explain, the equity portion of a CDO was typically the most difficult piece to sell, and without a buyer committed to purchase the equity tranche, closing a CDO transaction is impossible. Magnetar's willingness to purchase the equity in a series of transactions, including Octans I, thus gave it substantial leverage over the assembly and management of those transactions. Harding ultimately managed a total of four Magnetar CDOs, *see* ¶¶ 13, 26, including Octans I and two other "Octans" transactions that closed within a few months of Octans I.

As Chau and Tony Huang (Harding's other portfolio manager, and the closest thing at Harding to a "number two") understood, Magnetar was seeking not just to buy CDO equity, but also to enter into off-setting "hedges" – that is, short bets on the "mezzanine" tranches of CDOs (those just above the equity) that would pay off if the CDO began to experience defaults above a certain level. (Both Chau and Huang acknowledged their understanding of Magnetar's approach in investigative testimony and in civil depositions.[7]) In other words, Respondents understood that Magnetar's strategy entailed simultaneously investing in, and betting against the performance of, the CDOs that Magnetar helped to create and the selection of whose collateral Magnetar helped

[7] Harding's key personnel were all deposed extensively in *Chau v. Lewis et al.*, No. 11 Civ. 1333 (S.D.N.Y.), a defamation lawsuit filed in federal court by Chau and Harding against the author and publisher of a book about the financial crisis of 2008. Separately, Chau has given investigative testimony in connection with other SEC investigations in addition to this one. *See* Division Exhibit List (entries for Div. Ex. 1001 – 1012). Under traditional evidence principles, Chau's investigative and deposition testimony would not be hearsay when used by the Division in this proceeding, as they are the admissions of the Division's party-opponent. *See* Fed. R. Evid. 801(d)(2)(A). The same is true of investigative testimony and depositions given by certain individuals (Brett Kaplan and Jessica Hsieh) who were employed by Harding at the time of their testimony and testified about their work at Harding. *See id.* 801(d)(2)(D).

to influence. Respondents thus understood that Magnetar's interests were different from those of arm's-length debt investors betting only on the CDO performing.

The Octans I Warehouse Agreement

The Division will offer substantial proof focusing on the "ramp" – the acquisition of assets during the warehouse phase – of Octans I. Unlike Harding's previous warehouse agreements (which were simply between the manager and the arranger), the warehouse agreement for Octans I, dated May 26, 2006, was a three-way contract among Harding, Merrill, *and* Magnetar. Div. Ex. 5; *see also* ¶ 27. The agreement gave Magnetar – which also bore 85% of the risk and potential reward associated with warehousing the assets – important control rights relating to the acquisition of assets, including the right to veto assets selected by the manager for inclusion in the portfolio. Chau has previously testified that he would never grant Magnetar a veto over collateral selection, precisely because it would impair the collateral manager's independence.[8]

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[8] *See* Div. Ex. 1009 (transcript of Oct. 23, 2008 Chau Testimony), at 128:16 – 129:5:

> Q. Would you have given him [i.e. Magnetar's Prusko] veto rights on it if he asked for it? / A. No, we would not. / Q. Why not? / A. Well, we're an independent asset manager and I pride myself as being a very independent asset management company that wants to build an asset management business and we want to buy assets that fit the trust. / Q. And what would the problem be with giving them veto rights? / A. You know, we would be ceding our management authority to a third party. / Q. Why would that be a problem? / A. Again, it goes to independence. We're not an agent for anyone.

Chau has also acknowledged that the Octans I warehouse agreement in fact gave Magnetar a "veto." Div. Ex. 1006, at 20:22 - 21:1 (transcript of Nov. 16, 2011 Chau Testimony) ("Q. What's your understanding of Magnetar's right with respect to that provision [in the warehouse agreement]? / A. That they ***had the right to veto securities in the warehouse*** as they are taking the credit risk on those securities." (emphasis added)); Div. Ex. 1001, at 96:21 – 98:3 (transcript of Jan. 19, 2012 Chau testimony) ("Q. . . . [D]id Magnetar have the right to veto assets that the collateral manager suggested to go into the portfolio? . . . A. ***Yes***, as party to the warehouse agreement, Magnetar, having substantial risk in the warehouse agreement, it was – Merrill Lynch provided them a right to potentially object to collateral going into the warehouse. . . . Q. You're saying they didn't exercise that right? / A. They did not exercise any ***veto rights***, no.") (emphases added).

Consistent with the warehouse agreement, Prusko made sure that Harding ran by him its proposed acquisitions for Octans I. On May 30, 2006, Prusko indicated to Harding employee Alison Wang that he wanted "to talk frequently so I'm up to date on your plan of action, how things are going, etc." Later that night, he instructed Wang to remove certain bonds from a Harding "bid list"[9] of potential acquisitions for Octans I. The reason is that the so-called "index trade" (discussed in more detail below) was planned (with Prusko's knowledge but evidently not Wang's), and some of the bonds on Wang's list overlapped with the Index.

Magnetar's warehouse involvement and rights were never disclosed to investors. The marketing book disclosed that the warehoused assets "will be purchased from a portfolio of securities held by an affiliate of Merrill Lynch pursuant to *a warehousing agreement between such affiliate of Merrill Lynch and the Collateral Manager*." Div. Ex. 1 at 32 (emphasis added). In other words, the warehouse was mentioned, but one of the parties to it was omitted. The offering memorandums contained a similar disclosure. Div. Ex. 3 at 66.

The Index Trade

Magnetar was seeking to have its various CDOs acquire exposure to the ABX Index. As a threshold matter, there is an incongruity in having a CDO of RMBS invest in a published index of RMBS. The CDO manager in theory was being paid for exercising its judgment and discretion, not for buying an off-the-shelf benchmark. Put differently, an investor could have bought the ABX Index directly without paying a CDO manager. For these reasons, investors generally did not want the Index to be included in a CDO's portfolio. In addition, the rating

[9] Again, the instruments at issue were synthetic, meaning that, to go long a particular RMBS, the CDO would *sell* "protection" on that asset under a CDS. In order to enter into such a CDS, Harding needed to find a counterparty who was willing to *buy* protection. The usual mechanism for doing so was to circulate in the marketplace a "BWIC" (short for Bids Wanted in Competition) list in order to solicit bids for the purchase of protection.

agencies whose blessing was needed to sell CDO securities tended to prohibit the vehicles from buying the index directly. Chau and Huang understood all of this.

Nevertheless, once the warehouse agreement and engagement letter were finalized in late May 2006, Magnetar's Prusko pushed Merrill Lynch and then Harding[10] to buy the Index for Octans I. Before actually purchasing the Index, Magnetar and Merrill Lynch seem to have recognized that it was supposed to be the manager's prerogative, not Magnetar's, to make investment selections for the CDO, and that a CDO manager might disfavor some of the bonds in the index. The parties discussed having the Octans I warehouse first buy the index in a block and then exclude (via offsetting "short" positions on individual RMBS bonds) any bonds that Harding disfavored.

More specifically, in a telephone conversation on the afternoon of May 30, 2006 initially between Magnetar and Merrill Lynch, the participants conferenced in Tony Huang to ask which bonds, if any, Harding wanted to exclude from Octans I's exposure to the index. Lasch promised Prusko that Merrill would "push [Harding] to get names [i.e. RMBS bonds] they have issue with [*i.e.* want excluded from the index exposure] tomorrow am." The next day, May 31, 2006, Prusko and Lasch kept pressing Huang and Chau to deliver the excluded names, and Huang said that Harding would report back soon.

<u>Harding's Selections</u>

The process by which Harding actually arrived at its decision is not defensible. At issue were two different rating levels of the index: Baa2 (BBB) and Baa3 (BBB-), making 40 assets in all (20 at each of the two rating levels). Huang understood that Magnetar would like as few

[10] At the outset of the Octans I ramp, Respondents' business was still housed at Maxim, not Harding Advisory. As indicated on page 1, this memorandum uses the term "Harding" to refer collectively to Maxim Advisory and Harding Advisory. By the time of the relevant misrepresentations, the operative entity was Harding Advisory, not Maxim Advisory.

deletions from the index as possible. The evening of May 30, at 5:49 p.m.[11], Huang forwarded to Harding credit analyst Jung Lieu the list of bonds in the index. There is no evidence that she began review of these names before around 1 p.m. on May 31. Yet less than 3.5 hours later, at 4:22 p.m. on May 31, Lieu delivered back to Huang – and he, at 4:38 p.m., then forwarded on to Merrill Lynch – a list of twelve "ABX Index rejections" from the 40.

The subtraction of 12 represented a decision to commit the Octans I CDO to invest in the remaining 28 bonds, a $220 million purchase that accounted for nearly 15% of the portfolio. [12] When Octans I actually acquired its exposure to these bonds, a portion of the block long exposure to the index came from Magnetar's books.

As will be demonstrated at the hearing, Harding's behavior in reaching this investment decision is flatly inconsistent with representations that Harding made about its process for selecting collateral. In fact, Harding's behavior is, in relation to the relevant standards, sufficiently outlandish that the only explanation for it is that Harding wanted to please Magnetar and Merrill Lynch badly enough that it was willing to abdicate its fiduciary responsibilities to do so. Among other things:

- Harding did only rudimentary analysis or none at all on a significant volume of bonds;

[11] As the Division indicated in its March 3, 2014 Exhibit List filing, there has been some confusion over the time stamps of emails because of the automated conversion in certain cases of times from Eastern Daylight Time (EDT) to Greenwich Mean Time (GMT), which is four hours later than EDT. The parties have stipulated to the correct time stamps for the Octans I index trade.

[12] This is not disputed. *See, e.g.*, Div. Ex. 5001 (white paper submitted by Respondents), at 39 ("Jung Lieu's May 31, 2006 'ABX index rejections' list . . . perfectly conforms to the trade as it was executed a week later on June 8. . . . When Harding purchased the ABX Index [on June 8], those same rejected securities were shorted from the Octans I warehouse. *Thus, . . . Harding's ultimate purchase decision . . . was finalized as of the evening of May 31.*"); *see also id.* at 30 ("Harding conducted two block Index trades in Octans I, both on June 8, 2006. . . . *Of the 40 bonds in the two Index blocks, Harding retained a long position in Octans I on 28 of the bonds and shorted out the remaining 12 bonds.*") (emphases added). Also undisputed is that Harding allowed Magnetar to control the execution of those trades. *See id.* at 40 ("Magnetar acted as the counterparty in the trade.").

- Such analysis that Harding did do could not possibly justify many of the purchases; and

- Harding seems to have ignored the views of a different credit analyst, named Jamie Moy, who specifically advised against Harding's purchase of some of the bonds that went into Octans I.

In sum, the methodical, rigorous, disciplined approach that Harding claimed it followed in representations to investors and to its advisory clients was simply not used.

Moreover, subsequent communications confirm that Harding compromised its independent judgment, allowing into the Octans I portfolio bonds that it would not have selected but for Magnetar's desire for ABX exposure. For instance, the following morning, in internal email traffic with Wang and Chau, as well as externally with Magnetar, Huang noted that Harding was "less comfortable" with some of the ABX bonds at the Baa3 (as opposed to higher-rated Baa2) level and would prefer that Octans I buy the higher-rated levels.

Nor was Octans I the only Magnetar-related CDO for which Harding allowed its asset-selection process to be corrupted. Harding did similar ABX trades for two more Magnetar-sponsored CDOs, known as Octans II and Octans III. The email traffic from August and September 2006 makes crystal clear that the analysts believed that "we had to pick the lesser of evils when we were looking at the index," and the Division will offer abundant evidence demonstrating that assets made it into Octans II and Octans III over the frustrated objections of the credit analysts assigned to vet the bonds.

<u>Marketing and Closing Octans I</u>

<u>Pitchbooks</u>: During the marketing of a CDO, marketing books, or "pitchbooks," jointly developed by the investment bank and the collateral manager are distributed to investors. The pitchbook for Octans I represented (in sections drafted by Harding and approved by Chau) that Harding's investment approach included, *inter alia*, the following (Div. Ex. 1 at 43):

- Maximize returns and minimize losses through rigorous upfront credit and structural analysis, as well as ongoing monitoring of asset quality and performance.
- Employ a top/down economic analysis to determine sector allocation.
- Perform a thorough bottom/up credit and structural analysis to identify individual investments.
- Complete an in-depth credit review to determine the suitability of each potential transaction in the context of the CDO.

Further, the pitchbook refers to "Individual Asset Selection Employing a Disciplined Bottom/Up Credit and Structural Analysis" (*id.* at 45), and represents, too, that Harding's "Investment Decision, Process and Execution has Been Built Around," among other things, "a collaborative, methodical and disciplined investment process." (*Id.* at 48).

These representations were materially untrue. Harding's approval of $220 million of ABX component collateral bore no recognizable relation to what an industry participant would have expected from the pitchbook. There was nothing "bottom/up," "rigorous," "disciplined," or "collaborative" about Harding proceeding with a massive purchase that Magnetar wanted despite negative credit results (or no results at all), internal dissent, and acknowledged discomfort from a lead portfolio manager.

Also misleading was the pitchbook's disclosure of the warehouse agreement. As discussed above, the "conflicts of interest" section of the pitchbook (which Respondents had reviewed) identified only two of the three parties to the agreement, leaving investors unaware of the influence of a significant participant in the transaction.

<u>Collateral Management Agreement</u>: On the closing date for Octans I, Harding became the Issuer's "investment advisor and manager" with respect to the CDO's collateral (Div. Ex. 4 at 3), entering into a CMA signed by Chau in which Harding represented that it would (*id.* at 8):

> perform its obligations hereunder (including with respect to any exercise of discretion) with reasonable care (i) using a degree of skill and attention no less than that which the Collateral Manager would exercise with respect to comparable assets that it manages for itself and (ii), without limiting the foregoing, in a manner consistent with the customary standards, policies and procedures followed by institutional managers of national standing relating to assets of the nature and character of the Collateral.

Harding also represented that it would "take all action required, as Collateral Manager for the Issuer, to be taken by it under the Investment Advisers Act of 1940, as amended." *Id.* at 6. The standard of care representation was misleading. As the Issuer's investment adviser, Harding caused the Issuer to acquire collateral without disclosing that Harding's review of it did not come remotely close to following the "customary standards, policies and procedures" of a national-class institutional asset manager.

Offering Memorandums: During the marketing of a CDO and shortly before its closing, investors also receive, respectively, a preliminary and final offering memorandum. In this case, the memorandums (as Respondents knew) repeated the standard of care language from the CMA (Div. Ex. 3 at 197), which was misleading for the reasons reviewed above. The memorandums also contained a faulty disclosure of the warehouse agreement, omitting mention of Magnetar.

The Norma Purchases

In January 2007, Merrill was having trouble selling another in-progress Magnetar CDO, known as Norma. On January 9, after reviewing information on Norma, Chau expressed his dissatisfaction with it in an email to Merrill. Merrill representatives Andy Phelps and Catherine Chao later pushed Chau, in electronic communications on January 16 and 17, to buy Norma. Chau agreed to buy $40 million of Norma's A-rated tranche, which he allocated to several of Harding's CDOs.

But Merrill and Magnetar still needed help selling the lower-rated BBB tranche of Norma. On the morning of January 23, Magnetar's Prusko emailed Chau, "[p]ls buy some norma bbb...Stop complaining about turbo. :) Remember who was there for u when u were a little guy." Chau tried to deflect the pressure: "Did ML tell u I am in for 40mm single-As in Norma – team player!!!" That same day, Merrill's Phelps asked Chau "what's your level", *i.e.*, what coupon rate would make Norma acceptable, "on BBB or BBB-." Chau replied that he would "sharpen the pencil," to which Phelps replied "sweet." *Id.*

The next day, Phelps emailed Chau asking if he had "sharpened his pencil." Chau replied, "I never forget my true friends," and, after a telephone call from Merrill's Ken Margolis, agreed to purchase $20 million in Norma BBB notes. Reporting on this conversation, Margolis wrote in an internal email titled "Wing is in for $20mm": "I told him we would try and sell him down to $15mm if we could." When Chau learned, about a week later, that his allocation of Norma BBB notes had in fact decreased from $20 million to $15 million, he wrote to Merrill's Chao: "Now that's what I'm talking about, the love is in the air" – further demonstrating that he had not wanted to purchase those notes in the first place.

Chau and Harding did very limited review of the Norma CDO before agreeing to buy into it. Nevertheless, on February 27 – more than a month *after* Chau had agreed to purchase the Norma notes – Brett Kaplan, a Harding analyst, circulated within Harding, including to Chau, a report on Norma. The report was exceptionally negative. It noted, for example, that "[t]here's quite a large percentage of deals failing surveillance tests, on the watchlist and on the do not buy list."

Despite all this, Harding placed Norma bonds into four CDOs managed by Harding, three of them arranged by Merrill Lynch. The CDOs were named Lexington V, Jupiter VI, Neo, and 888 Tactical. For each of these CDO's, Chau, on behalf of Harding, executed CMAs containing standard of care provisions similar to the one in the Octans I CDO. For each of these CDO's the offering circular for the transaction described the CMA and the standard of care set forth within it. Respondents made no disclosure to the Issuers of these CDOs (*i.e.* their advisory clients) or to the CDOs' investors that the purchase of the Norma bonds was done as a favor to Merrill and Magnetar, one that Harding did not believe was in the best interests of the CDO. Nor did Respondents disclose that their review of Norma came nowhere close to complying with industry standards.

<u>Investor and Expert Testimony</u>

The Division will introduce testimony of investor witnesses to establish that investors relied on the integrity of Harding's asset selection processes, and would have wanted to be informed if that process was corrupted by other parties.

The report of Ira Wagner demonstrates that Harding's selection of RMBS and CDO assets did not comply with industry standards and expectations, or with the customary standards, policies and procedures followed by institutional managers of national standing, or with the description of Harding's approach to investment and asset selection in Harding's marketing materials. Finally, the report of Richard Ellson shows that the Octans I "index trade" did not confer a net benefit on the Octans I CDO.

<u>CONTENTIONS OF LAW</u>

<u>I.</u> <u>Respondents Violated Section 17(a) of the Securities Act</u>

Section 17(a) of the Securities Act prohibits fraud in the offer or sale of securities. Section 17(a)(1) is violated when a defendant employs a device, scheme, or artifice to defraud in the offer or sale of a security. A violation of Section 17(a)(1) requires scienter, which can be satisfied by a showing of recklessness. *See Aaron v. SEC*, 446 U.S. 680, 697 (1980). Section 17(a)(2) prohibits any person from "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Section 17(a)(3) prohibits any person from "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." A violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act can be shown by negligent conduct. *Aaron*, 446 U.S. at 701-02. A fact is deemed material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. *Basic v. Levinson*, 485 U.S. 224, 231 (1988).

Here, Respondents violated Section 17(a)(2) by obtaining management fees through the use of materially misleading pitchbooks, offering circulars, and CMAs. Respondents violated Sections 17(a)(1) and (a)(3) by allowing their asset-selection processes to be corrupted by the influence of un undisclosed party with interests different from those of the debt investors, and by misrepresenting their asset-selection process. Respondents were fully aware of the representations they made to investors, and that they had not conducted the analysis or met the standards held out in the disclosure documents.

II. Respondents Violated Sections 206(1) and (2) of the Advisers Act

Sections 206(1) and (2) of the Advisers Act respectively prohibit an investment adviser from "employ[ing] any device, scheme, or artifice to defraud any client or prospective client," and from "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

As the Supreme Court has explained, Section 206 of the Advisers Act "establishes 'federal fiduciary standards' to govern the conduct of investment advisers." *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979). In recognition of the "delicate fiduciary nature of an investment advisory relationship," Section 206 places "an affirmative duty" on advisers of "utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963) (internal quotation marks omitted). An investment adviser has a duty under Section 206 to disclose, among other things, "all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested." *Id.* at 191-92.

Under Section 206 "it [is] not necessary . . . to establish all the elements of fraud that would be required in a suit against a party to an arm's length transaction." *Aaron*, 446 U.S. at 693. For instance, it is not necessary to show proof of actual injury to the client. *Capital Gains*, 375 U.S. at 195 ("Congress . . . did not intend to require proof of . . . actual injury to the client."). What Section 206 does require is that the adviser make full disclosure of "overlapping motivations," so that investors may assess whether the adviser "is serving 'two masters' or only one." *Id.* at 196.

A Section 206(1) violation requires scienter, whereas a violation of Section 206(2) can be shown with negligence. *See Steadman v. SEC*, 603 F.2d 1126, 1134 (5th Cir. 1979); *SEC v. DiBella*, 587 F.3d 553, 569 (2d Cir. 2009) ("any transaction that functions or otherwise results in a fraud is punishable under [Section 206(2)]. Thus, the Advisers Act holds liable negligent acts."). The scienter requirement can be satisfied with "recklessness," which is an "extreme departure from the standards of ordinary care." *SEC v. Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992) (internal quotation marks and citation omitted).

By causing the Octans I CDO Issuer to acquire collateral for which Respondents had *not* fulfilled the represented standard of care, Respondents defrauded their advisory client. Similarly, by permitting Magnetar to influence the composition of the Octans I portfolio, Respondents failed to disclose to their clients all material facts concerning conflicts of interest. Respondents also defrauded the Issuers of the CDOs into which they placed the Norma notes. Without disclosure, Respondents caused their advisory clients to acquire assets that Respondents plainly disfavored, and they did so purely as a favor to Merrill and Magnetar, important clients (though not Harding's advisory clients) who were pressuring Chau to help them sell the Norma notes. This was a violation of the standard of care representation to the advisory clients, and moreover represented a breach of Harding's fiduciary obligation to act in its advisory clients' (not its own) best interest.

III. Chau Aided And Abetted, and Caused, Harding Advisory's Violations

Chau can also be held liable for aiding and abetting Harding's primary violations of the Securities and Advisers Acts. The elements of aiding and abetting are: (1) a primary violation; (2) knowledge of the violation by the aider and abettor; and (3) substantial assistance by the aider and abettor in the primary violation. *DiBella*, 587 F.3d at 566; *see also SEC v. Apuzzo*, 689 F.3d 204, 212 (2d Cir. 2012).

Here, Chau was Harding's sole principal, primary portfolio manager, maker of the ultimate investment decisions for Harding, and the individual with responsibility for Harding's marketing materials and disclosures. Chau executed the CMAs on behalf of Harding, and approved the content concerning Harding in CDO pitchbooks. Chau knew and approved of the "index trade" for Octans I, and it was he who chose to buy Norma as a favor to Magnetar and Merrill. To the extent Harding committed violations, Chau's knowledge of and assistance with them is not open to serious question.

For the same reasons, Chau also was a "cause" of Harding's violations. "Causing" liability exists in a cease-and-desist proceeding when there is a primary violation; an act or omission by the respondent was a cause of the primary violation; and the respondent knew or should have known that his conduct would contribute to the violation. *See Robert M. Fuller*, Securities Act Rel. No. 8273, 2003 WL 22016309, at *4 (Aug. 25, 2003).

REMEDIES REQUESTED

The Division seeks: a cease-and-desist order; disgorgement, pursuant to Section 8A(e) of the Securities Act and Section 203(j) of the Advisers Act, of the fees Harding obtained from Octans I and the four CDOs into which Chau placed Norma; civil penalties pursuant to Section 8A(g) of the Securities Act and Section 203(i) of the Advisers Act; and advisory and collateral bars pursuant to Sections 203(e)(5), 203(e)(6), and 203(f) of the Advisers Act.

RESPONDENTS' LIKELY DEFENSES

Respondents have signaled that they will mount certain defenses, including the following.

Collateral Disclosed

Respondents appear to find it important that much of the collateral selected for a CDO was disclosed to investors. That may be true, but it is beside the point. The manager was being paid for its judgment and expertise. Investors did diligence on the collateral, but they also relied to some extent on the manager, and were entitled to assume that the manager had selected the collateral in good faith and in accordance with the represented methods and standards.

Magnetar's Equity Investment

Respondents also appear to find it significant that Magnetar made a substantial investment in the equity of the CDO. But regardless of Magnetar's true economic interest in the performance of Octans I, it is clear (a) that Magnetar was situated differently from other investors in the CDO, and (b) that Harding departed from its represented standards and methods to accommodate Magnetar's wishes.[13]

Respondents appear to believe that if the collateral tainted by Magnetar's involvement failed, Magnetar would be the main victim, but that is not correct, either: To the extent that collateral in the CDO began to fail, *all* investors above Magnetar in the capital structure would suddenly find themselves that much closer to experiencing losses. Investors were relying on Harding's integrity *across* the portfolio it assembled.

<u>Motivation for Buying Index Collateral</u>

Chau (in testimony) and his attorneys (in written submissions) have offered certain justifications for the Index-related trades. One of them is that a so-called "arbitrage" was available, making it possible to buy index bonds more cheaply through the method of execution that was used (go long the index in a block, subtract out the disfavored bonds via off-setting shorts) than by buying the index bonds on a single-name basis. In this way, according to Chau, the transaction was able to achieve more "spread," analogous to a higher interest rate.

The Court should not be distracted by this explanation, because it literally makes no sense. The issue here is not whether any particular component bond could be acquired more cheaply through the more complex block method than on its own. The issue rather is whether Harding, in the first place, properly selected the component bonds in question. As Respondents themselves have admitted, the so-called "arbitrage" method of execution has nothing to do with

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[13] Respondents, given their previous submissions and exhibit list, are likely to make much of supposed inconsistencies between the Division's theories here and in the *Fabrice Tourre* case recently tried to a verdict in district court. Respondents' fixation with *Tourre* is misplaced. *Tourre* was a case against a CDO trader/structurer working at an investment bank, not a CDO manager, and involved very different facts to boot. Contrary to Respondents' implication, the Commission has never "trumpeted" the conduct of the CDO manager in *Tourre* as being consistent with relevant standards of care – or for that matter said it was inconsistent. That case simply was not about the CDO manager's conduct, let alone some sort of policy pronouncement by the Commission of what or would not be acceptable for a CDO manager to do.

the investment decision, which is supposed to be independent of it. Div. Ex. 5001 (white paper), at 32 ("As Mr. Chau explained, *the arbitrage was merely an execution strategy for acquiring assets that the analysts had already determined were appropriate for the portfolio*." (citing the following Nov. 19, 2012 Chau testimony: 294:5-7 ("[T]he ABX arbitrage is an execution discussion. It is not a question of selection discussion."), 294:8-10 ("*Once we've identified the securities that we like, the ABX arbitrage is a way we execute that trade* . . . ."))) (emphases added).

Beyond that: (1) Ellson's report shows that there was no spread benefit from the index assets, and (2) there is no contemporaneous evidence that Chau or anyone else at Harding ever actually computed the supposed "arbitrage" benefit and weighed it against the risk associated with accepting assets in the face of negative credit results (or no analysis at all).[14]

<u>Reliance on Counsel</u>

Respondents are likely to assert some sort of reliance-on-advice-of-counsel defense. The Division has addressed this through a motion in limine, and incorporates here the arguments in that motion.

[14] Respondents' exhibit list suggests that they intend to offer evidence that other collateral managers also were engaged in trades based on the index. This does not help Respondents, as the examples on the exhibit list, so far as we could determine, all pertain to Magnetar CDOs and reflect managers responding to Magnetar's urging. The fact that other collateral managers were *also* willing to accommodate Magnetar's wish for Index collateral says nothing about whether it was appropriate to do so – let alone about whether *those* managers did or did not comply with their own representations to their clients and investors.

CONCLUSION

The Division of Enforcement intends to demonstrate that Respondents committed the above-described violations of the Securities and Advisers Acts, and that the requested sanctions are appropriate.

Dated March 24, 2014
New York, New York

DIVISION OF ENFORCEMENT

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