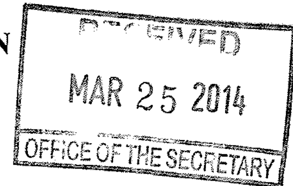
ORIGINAL

HARD COPY

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



In the Matter of

HARDING ADVISORY LLC and

WING F. CHAU,

Respondents.

File No. 3-15574
ALJ Cameron Elliot

RESPONDENTS' PRE-HEARING BRIEF

NIXON PEABODY LLP
Attorneys for Respondents
Harding Advisory LLC
and Wing Chau
437 Madison Avenue
New York, New York 10022
(212) 940-3000

Table of Contents

Page

PRELIMINARY STATEMENT 2

OVERVIEW 4

I. THE EVIDENCE AT TRIAL WILL DEMONSTRATE THAT THE ALLEGATIONS IN THE OIP ARE MERITLESS 4

A. The Evidence Proves Respondents' Conduct Concerning Octans I Was Proper 4

1. Respondents Did Not "Comprise Their Standards" Or Improperly Accompdate Anyone 4

2. Magnetar's Interests Were Aligned With Those Of Octans I Noteholders 7

3. Teven If The Court Determines That Magnetar Had Conflicting Interests With Those Of Octans I Noteholders, There Is No Eivdence Respondents Would Or Could Have Known That At The Time 8

4. Trespondents Cannot Be Held Responsible For Errors In The Offering Circular Concerning The Number Of Parties In The Warehouse Agreement 9

5. No Investor Could Have Been Defrauded By Merrill Lynch's Failure To Disclose That Magnetar Had Rights In The Warehouse Agreeement That It Did Not Exercise 10

6. Respondents Cannot And Should Not Be Held Resopnsible For Error Or Omission In The Offering Ciruclar Concerning The Warehouse Agreeement 11

B. The Evidence Will Provide That The Allegations Concerning The Norma Purchases Must Also Fail 12

II. THE OCTANS I OFFERING CIRCULAR AND DEAL DOCUMENTS WERE NOT MISLEADING: THE NOTE PURCHASERS RECEIVED EXACTLY WHAT THEY WERE TOLD TO EXPECT 13

A. Description Of The Collateral And Risks Of Investment 14

B. The Octans I Pitch Book Cannot Serve As The Basis For A Fraud Claim 23

C. The Collateral Management Agreement Cannot Serve As The Basis For A Fraud Claim 26

D. Harding Communicated With Magnetar About The Selection Of Assets For Octans I In The Normal Course; There Was No Need For Disclosure Of This Fact 31

CONCLUSION 32

TABLE OF AUTHORITIES

Page(s)

FEDERAL CASES

AUSA Life Ins. Co. v. Ernst & Young,
39 Fed. App'x 667 (2d Cir. 2002)..22

Banco Espirito Santo de Investimento, S.A. v. Citibank N.A.,
No. 03 Civ. 1537 (MBM), 2003 U.S. Dist. LEXIS 23062 (S.D.N.Y. Dec. 29, 2003)...........24

Chem. Bank v. Arthur Andersen & Co.,
726 F.2d 930 (2d Cir. 1984), cert. denied, 469 U.S. 884 (1984)..22

In re Flannery,
SEC Release No. 438, 2011 SEC LEXIS 3835, at *105-106 (Oct. 28, 2011)..................11, 12

In re Morgan Stanley Info. Fund Sec. Litig.,
592 F.3d 347 (2d Cir. 2010)..23

In re Sanofi-Aventis Sec. Litig.,
774 F. Supp. 2d 549 (S.D.N.Y. 2011)..23

Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc.,
157 F.3d 933 (2d Cir. 1998)..14, 24

SEC v. Stoker,
865 F. Supp 2d 457 (S.D.N.Y. 2012)..12

U.S. v. Regent Office Supply Co.,
421 F.2d 1174 (2d Cir. 1970)..23

U.S. v. Starr,
816 F.2d 94 (2d Cir. 1987)..22

RULES

Fed. R. Evid. 404(b)..12

PRELIMINARY STATEMENT

The evidence at the trial will demonstrate that the Division is proceeding on a theory that has no support in either the law or in the reasonable inferences that can be drawn from the evidence. In short, the Division's case consists of a theory in search of proof.

The trial will demonstrate that the defects in the Division's case are manifold. When taken in isolation, many of these flaws are, by themselves, fatal. When taken together, the cumulative number and quality of the flaws is overwhelming and will show that this matter should never have been brought in the first place.

As shown below and as will become overwhelming clear once the hearing commences:

- The Division alleges a scheme, but no one will testify that such a scheme existed, because it did not.
- In order to become a member of the Division's alleged scheme, each member of it would have had to knowingly put aside his or her own economic interests and act against them.
- Because all of the percipient witnesses from Harding Advisory LLC ("Harding"), Magnetar Capital LLC ("Magnetar") and Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") will, we expect, deny that there was any scheme or intention to engage in improper conduct, the Division will be left arguing to this Court after trial that, in one form or another, all of those witnesses are not credible.
  - We expect the Harding, Merrill and Magnetar witnesses will testify truthfully that they were at all times motivated, economically and otherwise, to ensure that assets selected would both perform and fit within the relevant eligibility criteria, and that they acted in good faith in pursuit of these interests.
- In any event, even if everything the Division alleges in the Order Instituting Proceedings ("OIP") were true – which is absolutely not the case – nobody could have been defrauded given the controlling contracts and transaction documents and the rights and duties that they proscribe.
- The specific conduct that is at the crux of this case relates to transactions that were and are, even with the benefit of hindsight and by every objective measure, profoundly immaterial.

- Thus, the Division's case centers on the selection of 11 assets in Octans I that were allegedly "disfavored," yet there is no allegation or, we expect, proof that those 11 assets performed any worse as a group than the other assets in the portfolio. Thus,
    - The 11 assets represent approximately **7%** of the value of the Octans I portfolio at closing. Given that the assets at issues comprise a virtually immaterial portion of the deal, and given the lack of any allegation that those assets underperformed or otherwise caused any particular harm to the transaction, it is unclear why this case needed to be brought at all.
- The other allegation relates to the purchase of certain Norma bonds and the placement of those bonds in other CDOs. Yet, again, there is no allegation that those Norma bonds – ***which themselves represented 1.6% or less of the value of the CDO portfolios that they were placed into*** – materially affected, in any negative manner, those CDO portfolios.
- Perhaps most importantly, the Octans I Offering Circular ("Offering Circular") and the deal documents for the other transactions make clear that no party was making any promises or representations about the quality of the assets or the manner in which they were selected. Further, the binding contract terms directed every investor to perform its own independent analysis of the assets.

- Put simply, this action focuses on the manner of selection of assets that, it appears, never caused anyone harm.
- Respondents and each of Respondents' relevant employees acted at all times in good faith and in accordance with ethical standards.
- None of the Respondents or their representatives lowered, diminished or otherwise sacrificed their standards in connection with the transactions at issue.
- The Division seeks to hold Respondents liable for statements that:
    - Respondents never made and cannot be legally held responsible for;
    - A multitude of other parties, individuals and lawyers were actually responsible for and drafted, reviewed and approved with full awareness of the relevant facts and circumstances; and
    - Are true or, to the extent they are incomplete, contain mere oversights that could not have mattered, would not have mattered, and did not matter to any reasonable sophisticated investor or relevant party at any time.

After all of the evidence is in, the Court will see that this action is misguided and should be promptly brought to an end so that both the Respondents and the Division can move on to more worthwhile pursuits.

OVERVIEW

This brief is divided into two parts. First, we set out why the Division will be unable to prove their allegations. Second, we demonstrate why, based on the controlling and binding terms of the relevant contracts and as a matter of law, the Division's case must fail in any event.

I. THE EVIDENCE AT TRIAL WILL DEMONSTRATE THAT THE ALLEGATIONS IN THE OIP ARE MERITLESS

A. The Evidence Proves Respondents' Conduct Concerning Octans I Was Proper

1. *Respondents Did Not "Compromise Their Standards" Or Improperly Accommodate Anyone*

The OIP asserts that Respondents, in selecting assets for Octans I, "compromised their standards to accommodate trades requested by Magnetar." OIP ¶ 6.

This allegation fails for myriad reasons. The Division's theory is that Respondents, as a result of Magnetar's "influence," were led to select assets that Respondents' "own personnel disfavored." OIP ¶ 2.

First, no witness with personal knowledge of the events has testified – or, we expect, will testify at trial – that he or she "compromised" his or her standards or is aware of anyone else at Harding compromising his or her standards. To the contrary, all of the witnesses to the events at issue will, we expect, testify credibly and truthfully that they each acted in good faith.

Second, there will be no evidence at trial that any person at Harding was ever pressured by Magnetar to do anything. Indeed, the evidence will show that, but for the Division's manic

and unrelenting focus on the events of May 30 and May 31, 2006, the selection of the thirteen assets at issue was in all respects a non-event for the relevant witnesses.

Third, while the entire thrust of the OIP suggests that Harding somehow deceived investors by stating, expressly or otherwise, that Harding "select[ed the] collateral" in Octans I, the undisputed proof is that Harding did, in fact, select the assets (including the thirteen assets at issue). OIP at ¶ 2.

Fourth, the evidence will NOT show that Respondents "disfavored" the thirteen assets at issue. OIP at ¶ 2. To the contrary, the evidence will show that a Harding analyst, Ms. Jung Lieu, recommended approval of the thirteen assets in the normal course, of her own accord, under no pressure or special influence and that a Harding portfolio manager, Mr. Tony Huang, similarly approved selection of those assets. Indeed, the evidence will establish that most, if not all, of these assets were approved on credit by the same analysts at other times for other deals, having nothing to do with Magnetar, Merrill, or the ABX Index. In short, the evidence will show that the assets were perfectly acceptable.

Fifth, because both Ms. Lieu, the analyst responsible for recommending selection of the thirteen assets, and Mr. Huang, the portfolio manager who approved the selection, acted voluntarily and in the normal and good faith execution of their duties, and because the Division refuses to accept the truth for what it is, the Division is left with creating an alternative narrative to suit its theory. It will rely at trial on two types of evidence: certain pieces of credit analysis circulated on or about May 30-31, 2006, and emails suggesting that a second analyst – who did not take responsibility for the selection – might have made different recommended selections. Putting aside that it is irrelevant that a different analyst ***might have*** held a different view of certain of the thirteen assets, the evidence that the Division relies upon will crumble at trial.

Seventh, there will be no evidence that Magnetar ever cared which of the constituent assets of the ABX Index Harding selected for inclusion, or even how many. To be sure, there will be evidence – and we do not dispute – that Magnetar was anxious to get a trade based on component parts of the ABX done. But the urgency was the availability of the arbitrage opportunity; the evidence will show Magnetar wanted to make sure a trade was able to take place before the amount of arbitrage diminished in order to maximize the extra cash flow that it expected the trade to generate *for the deal*. The evidence will show that that all Magnetar wanted from Harding was a list of assets that Harding did not like, whatever that list might be.[1] Separately and independently, Harding already was looking at the same set of assets that were ABX Index constituents at the very same time. The evidence will show, therefore, that some or all of the same assets might have been included in the Octans I portfolio with or without Magnetar's suggestion to do the Index trade.

Eighth, and moreover, the evidence will show that selecting component parts of the ABX Index in the manner Respondents did in late May 2006 made economic sense for the deal. At the time, many ABS CDO market specialists believed that an arbitrage opportunity existed based on the difference between the spread at which one could go long the ABX Index and the spreads at which its constituent assets were trading. Such a trade was, therefore, one way to improve both the quality and the spread of the underlying portfolio because, in effect, that trade allowed a

[1] Indeed, the evidence will show that Magnetar was making the same request of another collateral manager working on another deal during the same period and, likewise, expressed no preference about which ABX Index assets or how many. The set of assets that the other manager liked was different from the set of assets Harding selected and the number of assets the other Manager chose to include was also different; it was smaller. In short, Magnetar was agnostic about which assets Harding wanted to include or how many. As discussed in more detail below, Magnetar was also not looking for weaker assets; weaker assets did not help its investment strategy.

collateral manager to get assets at spreads that were better than what the quality of the relevant assets would dictate.[2]

Ninth, the evidence will show that, as noted above, the entire sum of all so-called disfavored assets was approximately **7%** of the entire portfolio, which is less than the amount of equity Magnetar purchased. In short, assuming the assets were selected because they were more likely to default – there is not one scintilla of evidence that this was so – the first party to have been harmed by such an event would be Magnetar.

Tenth, and finally, the evidence will show that Respondents and Mr. Chau, in particular, did not show any special preference for assets suggested by Magnetar. Indeed, at about the same time that the ABX trade was being executed, Magnetar suggested to Mr. Chau a list of some 24 cash assets for inclusion in Octans I. Mr. Chau responded by stating that he would have credit look them over and see if any of them fit. The credit analysis that Mr. Chau received showed approval of several assets, but he chose **only three of the twenty-four** for inclusion in the deal.

For all of these reasons and more, the allegations in the OIP that Respondents "compromised their standards" with respect to Octans I will not be proven at trial. OIP at ¶ 6.

2. *Magnetar's Interests Were Aligned With Those of Octans I Noteholders*

Paragraph 25 of the OIP alleges (emphasis added):

> Chau understood that Magnetar was interested in investing as the equity buyer in a series of potential CDO transactions. Chau also understood that Magnetar's strategy included "hedging" its equity positions in CDOs, **potentially** by taking short positions on RMBS or certain tranches of CDOs, including the CDOs it was investing in. Chau therefore understood that, because Magnetar stood to profit if the CDOs failed to perform, Magnetar's interests were not aligned with those of

[2] The ABX Index itself was composed of a basket of the most liquid securities that were perceived to be widely representative of the RMBS market for the relevant period. The relative liquidity of the ABX constituent assets, therefore, assured that their spreads fairly accurately represented the market's perception of the assets' credit quality. In other words, the market understood the benefit of the trade and that there was an incrementally higher compensation for the same risk.

> potential investors in the debt tranches of Octans I, whose investment depended solely on the CDO performing well.

This allegation contains a variety of logical flaws and misstatements and will not be proven at trial.

The evidence will demonstrate that Magnetar committed to invest, and did invest, $94 million in Octans I. It took the first loss position. Thus, no other investor stood to lose a dime of his or her investment until Magnetar's $94 million investment disappeared. Similarly, Magnetar would not receive a return on its equity investment until after more senior noteholders were paid first.

In addition, the evidence will prove that investors in the debt tranches also – get ready for this – could and did hedge their investments by taking short positions on RMBS and/or on various tranches of the CDOs they invested in.

Perhaps most importantly, Magnetar was not only interested in Octans I performing well, it also insisted that Harding's interests be equally aligned with the positive performance of the deal. Thus, Magnetar negotiated for certain terms in the transaction that (a) lowered the amount of fees payable from the deal to Merrill Lynch and Harding so that there would be more cash available to pay investors (including themselves); and (b) resulted in Harding being compensated, in part, through a Subordinated Management Fee that, like Magnetar's first loss position, was only paid after interest and principal proceeds were paid to other investors.

3. *Even If The Court Determines That Magnetar Had Conflicting Interests With Those of Octans I Noteholders, There Is No Evidence Respondents Would or Could Have Known That At The Time*

To the extent the evidence at trial shows that Mr. Chau knew, at the time relevant to the events at issue, that Magnetar, being a hedge fund, might well hedge all or certain of its investments, that is a far cry from proving that (a) Magnetar's interests were not aligned with the

interests of other investors or that (b) Mr. Chau knew and understood this was the case. Indeed, the OIP makes plain that Magnetar's plan with Merrill Lynch was to "**retain[] the equity**." OIP at ¶ 22.

Thus, other than recognizing the obvious – that Magnetar is a hedge fund and might hedge – Mr. Chau did not know the specifics of Magnetar's investment strategy.

Even now, with the evidence about Magnetar's actual strategy available in discovery, it is clear that Magnetar had an interest in Octans I performing well. Indeed, the evidence will show that, compared with Magnetar's $94 million equity investment, Magnetar only took two $5 million short positions on more senior tranches of Octans I, two weeks *after the closing of the deal*. Nobody from Harding, including Mr. Chau, knew in advance that Magnetar was going to take those positions. Thus, there will be no evidence upon which to find that Mr. Chau or Harding somehow knew that Magnetar's interests conflicted with a genuine and bona fide asset selection process – because Magnetar did not have such a conflict.

4. *Respondents Cannot Be Held Responsible For Errors In the Offering Circular Concerning the Number of Parties In The Warehouse Agreement*

It is apparent that the Octans I Offering Circular contained an error. It described the Octans I Warehouse Agreement ("Warehouse Agreement") as a two party agreement when, in fact, there were three parties to the agreement: Merrill Lynch, Harding and Magnetar. Offering Circular at 299. This is the only actual error in the Offering Circular that the Division has been able to identify. But the error is immaterial.

First, the evidence will prove that Harding was diligent in ensuring that the material terms of all deal documents were accurate.

Second, the people who were responsible for drafting and reviewing the Offering Circular have testified and, we expect, will testify that the error relating to the number of parties

who signed the agreement was just that: an error. The evidence will show that the only plausible explanation for the oversight – given the evidence that much attention was paid to more important parts of the deal documents – was that the language concerning the Warehouse Agreement was not something that people at the time thought was worth focusing on.

Finally, as described more fully below, Respondents cannot and should not be liable for any mistakes in the Offering Circular, including the error concerning the number of parties who signed the Warehouse Agreement.

5. *No Investor Could Have Been Defrauded By Merrill Lynch's Failure to Disclose That Magnetar Had Rights in the Warehouse Agreement That it Did Not Exercise*

The Warehouse Agreement gave Magnetar – the party taking 85% of the risk on the warehouse in exchange for 85% of any profits received from it – certain rights, but the Offering Circular did not mention or describe those rights.

In Part II of this brief, we set out in painstaking detail the controlling provisions of the relevant documents. For numerous reasons described above and for the reasons set out more fully below in Part II, *see* 13-31, no investor could have been defrauded in the manner the OIP alleges and there was no need for any mention whatsoever of the Warehouse Agreement, never mind a more expansive description of its terms.

In any event, the evidence will show that the Warehouse Agreement and the rights that were given to Magnetar in it were not a secret. To the contrary, the Warehouse Agreement was negotiated between the three parties and their counsel. In addition, the Offering Circular was fully negotiated between the parties and their respective counsel, over the course of multiple rounds of comments, suggested edits and revisions. Indeed, the evidence will show that Harding and its counsel requested additional disclosure concerning Magnetar's identity. The evidence will demonstrate that Magnetar's warehouse rights were not described in the Offering Circular

because none of the people responsible for drafting the Offering Circular thought it was important or necessary or, just as likely, nobody even thought about it (given how unimportant it was).

Indeed, the evidence will show that Magnetar did not exercise its veto rights under the Warehouse Agreement: it did not veto, disapprove, or insert any asset into the warehouse – meaning that there was nothing to disclose about those rights. Note in this regard that while Merrill's and Harding's participation in the Warehouse Agreement was disclosed, there was no disclosure about the nature of those rights or about whether any such rights were actually exercised, by whom, or how. The point of that disclosure in the Offering Circular was not who the parties were or their rights; the only point was that assets assembled in the warehouse would be transferred to the deal at the price paid when they were bought for the warehouse, such that the deal (and investors) would bear the risk of any diminution in value. The evidence will also show that other similar deals did not even mention the warehouse in the offering circular, even under the same circumstances when the parties (including equity purchaser) enjoyed the same rights.

6. *Respondents Cannot and Should Not Be Held Responsible For Errors or Omissions in the Offering Circular Concerning the Warehouse Agreement*

It is clear that the provisions and statements in the Offering Circular concerning the Warehouse Agreement were not drafted by Respondents. Because Respondents did not "make" those statements, did not have "control," much less "ultimate control" over those statements, and could "merely suggest what to say, [but] not 'make' [the] statement in its own right," Respondents cannot be liable for any materially false or misleading statements or omissions in those portions of the Offering Circular. *In the Matter of Flannery*, SEC Release No. 438, 2011 SEC LEXIS 3835, at *105-106 (Oct. 28, 2011) (quoting *Janus Capital Group, Inc. v. First*

Derivative Traders, 131 U.S. 2296, 2301-2302 (2011)). *But see SEC v. Stoker*, 865 F. Supp. 2d 457, 466 (S.D.N.Y. 2012). Nor were Respondents "sufficiently responsible for the statement – in effect, caus[ing] the statement to be made," to be liable for the statements at issue. *Id.* (quoting *SEC v. KPMG LLP,* 412 F. Supp. 2d 349, 375 (S.D.N.Y. 2006)).

The evidence will demonstrate that Merrill Lynch made and controlled the statements at issue, caused the statements at issue to be made, was the seller of the securities at issue, and made the relevant statements while in possession of all of the relevant facts. As Chief Administrative Law Judge Murray held in *Flannery*, "with respect to allegations involving documentary evidence, the Division must establish that Respondents had ultimate authority and control over such documents." *In the Matter of Flannery*, SEC Release No. 438, 2011 SEC LEXIS 3835, at *110 (Oct. 28, 2011). The Division cannot come close to meeting this standard.

B. The Evidence Will Prove That the Allegations Concerning the Norma Purchases Must Also Fail

Separate and apart from the Octans I allegations discussed above (and below), the OIP also alleges that the Respondents bought certain tranches of a Merrill CDO called Norma as an accommodation to Merrill and Magnetar while "basically having an unfavorable view" of those securities. This, the Division claims, was an independent securities law violation and a breach of duties to the CDOs into which these Norma bonds were placed. These allegations, which appear to be nothing more than traditionally inadmissible evidence of propensity, see Fed. R. Evid. 404(b), are also meritless and cannot support a finding of fraud.

First, as noted above, the Norma bonds that were placed into other deals constituted approximately 1.6% of the notional dollar value of those portfolios. The analysis, respectfully, should end there.

Second, there is no allegation, and we expect no proof at trial, that those bonds had any negligible (never mind material) negative effect on the performance of the CDOs that they were placed into.

The CDOs that they were placed into, just like Octans I and *every other similarly structured CDO at the time, failed as a result of unprecedented and unexpected market conditions.* In short, there is no allegation that the inclusion of the Norma bonds caused anyone any economic harm.

In any event, the evidence at trial will show that Mr. Chau, when negotiating for a better price on the Norma bonds at issue, bargained by expressing dissatisfaction with the structure of the deal. In doing so, Mr. Chau was able to obtain the Norma BBB notes at an ***improved coupon rate***. OIP at ¶ 64.

The evidence will show that Mr. Chau decided to purchase the Norma BBB notes for a simple reason: he believed they were an appropriate bond ***that would fit within the eligibility criteria of the CDOs into which they were placed.*** The controlling contracts with investors made it clear that investors would not be receiving, and were not entitled to, any information whatsoever about the "credit quality" of the underlying assets that were in the CDO portfolios.

II. THE OCTANS I OFFERING CIRCULAR AND DEAL DOCUMENTS WERE NOT MISLEADING: THE NOTE PURCHASERS RECEIVED EXACTLY WHAT THEY WERE TOLD TO EXPECT

The Offering Circular correctly described the assets but said nothing about how that collateral was or would be selected. It does not say anything, because it makes clear that investors are not entitled, and "will not have the right to obtain," any information on the "credit quality" of the assets. Offering Circular at 52. Moreover, the Offering Circular directs potential investors to "conduct [their] own investigation and analysis of the product and consult [their] own professional advisers as to the risks involved in making such a purchase." *Id.* at 18.

In short, there can be no fraud and no investors could have been misled because each investor bargained for a bundle of rights that consisted of the rights spelled out in explicit detail in the Offering Circular and nothing more. The Offering Circular gave no investor the right to know anything about how Respondents selected a particular security (so long as the security itself met certain characteristics consistent with the eligibility criteria), and no reasonable investor who received the Offering Circular would have expected to know how Respondents selected particular assets.

A. Description of the Collateral and Risks of Investment

The Offering Circular – the sole operative document pursuant to which the Notes were sold – said absolutely nothing about how the collateral that was in the deal at closing had been either selected or sourced.[3] Instead, after a lengthy enumeration of the various risk factors attendant to investing in the Notes, the Offering Circular focused first on the terms of the Notes, the Preferred Securities, and the Indenture (the primary agreement that fixed the bundle of property rights that each tranche of notes represented). *See* Offering Circular at 76-127. Here the Offering Circular covered items like: the structure of the Notes, the interest, the repayment of principal, redemption, cancellation, priority of payments, and events of default and remedies. The Offering Circular next focused on the ratings the Notes were assigned by the rating agencies. *See id.* at 128-30. It then focused, of course, on the security for the Notes, including describing the CDS and the reference obligations. *See id.* at 134-91.

Significantly, there the Offering Circular devoted *ten pages* to specifying what criteria the collateral had to have met as a condition of the deal closing. Among other things, as

---

3 As discussed more fully below, *infra* V.E.1, as a matter of law, the only document pursuant to which the Notes were sold was the Offering Circular. *See Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 939 (2d Cir. 1998) ("Thus, the Offering Circulars and Prospectuses, and not the Brochures, define the consummated buy-sell agreements between the parties.").

disclosed in the Offering Circular, 90% of the reference obligations had to be rated at least "Baa3" by Moody's Investors Services, Inc. ("Moody's") and at least "BBB-" by Standard & Poor's Ratings & Services ("S&P"), *id.* at 138; no security could be a Credit Risk or Defaulted Security, *id.* at 139;[4] the portfolio had to meet certain single servicer limitations, *id.* at 140-42; and the portfolio had to meet certain additional limits on single name concentrations. *Id.* at 144. Importantly, the collateral had to and did meet certain collateral quality tests as a condition of closing. *See id.* at 143.[5] All of these criteria and strict tests were met and all the ratings were achieved, and the OIP does not allege otherwise.

Of course, the OIP does not allege that the credit ratings were incorrect or were obtained by means of incomplete or incorrect information. There is also no allegation in the OIP that the note purchasers paid anything other than a fair market price for the Notes they bought, given the credit quality of those notes.

---

[4] As defined in the Indenture a "'Credit Risk Security' means any Collateral Debt Security that the Collateral Manager believes, subject to the Standard of Care in the Collateral Management Agreement (as of the date of the Collateral Manager's determination based upon currently available information), has, since such Collateral Debt Security was purchased by the Issuer, a significant risk of declining in credit quality or value (or, there has occurred, or is expected to occur, a deterioration in the quality of the underlying pool of assets) or, with a lapse of time, a significant risk of becoming a Defaulted Security; *provided* that, during any Limited Discretion Period a Collateral Debt Security shall not be a Credit Risk Security unless either (a) such Collateral Debt Security has been downgraded by Moody's at least one or more rating subcategories since it was acquired by the Issuer or placed by Moody's on a watch list with negative implications since the date on which such Collateral Debt Security was purchased by the Issuer or (b) such Collateral Debt Security has experienced an increase in credit spread of 10% or more of the credit spread at which such Collateral Debt Security was purchased by the Issuer, determined by reference to an applicable index selected by the Collateral Manager." Octans I Indenture ("Indenture") at 19. There is no allegation, nor could there be, in the OIP that any of the collateral securities were "Credit Risk Securities".

[5] The following collateral tests had to be met: "(A) on or prior to the Ramp-Up Completion Date, each of the Moody's Asset Correlation Test, the Weighted Average Spread Test, the Maximum Rating Distribution Test, and Minimum Weighted Average Recovery Rate Test, and is satisfied or, if immediately prior to such Acquisition one or more of the Moody's Asset Correlation Test or Moody's Minimum Weighted Average Recovery Rate Test was not satisfied, the extent of compliance with any such the Moody's Asset Correlation Test or Moody's Minimum Weighted Average Recovery Rate Test which was not satisfied is maintained or improved by such Acquisition and (B) after the Ramp-Up Completion Date, each of the applicable Collateral Quality Tests and (except in the case of reinvestment of Disposition Proceeds of a Credit Risk Security) the Standard & Poor's CDO Monitor Test is satisfied or, if immediately prior to such Acquisition one or more of such Collateral Quality Tests or the Standard & Poor's CDO Monitor Test was not satisfied, the extent of compliance with any such Collateral Quality Test or the Standard & Poor's CDO Monitor Test which was not satisfied is maintained or improved by such Acquisition." *See id.* at 143. All of these tests were painstakingly described in detail in the Offering Circular. *See id.* at 169-75.

Consistent with the rest of the Offering Circular, in the section of the Offering Circular dealing with portfolio acquisition at closing, the portfolio description is limited to, again, the investment guidelines and nothing else:

> *Acquisition of Collateral Debt Securities.* All or most of the Collateral Debt Securities Acquired by the Issuer on the Closing Date will be Acquired from a portfolio of Collateral Debt Securities selected by the Collateral Manager and held by MLI, an affiliate of MLPFS, pursuant to warehousing agreements between MLI and the Collateral Manager. Some of the Collateral Debt Securities subject to such warehousing agreement may have been originally acquired by MLPFS from the Collateral Manager or one of its affiliates or clients and some of the Collateral Debt Securities subject to such warehousing agreements may include securities issued by a fund or other entity owned, managed or serviced by the Collateral Manager or its affiliates. **The Issuer will Acquire Collateral Debt Securities included in such warehouse portfolios only to the extent that such purchases are consistent with the investment guidelines of the Issuer, the restrictions contained in the Indenture and the Collateral Management Agreement and applicable law.** The Acquire price payable by the Issuer for such Collateral Debt Securities will be based on the purchase price paid when such Collateral Debt Securities were Acquired under the warehousing agreements, accrued and unpaid interest on such Collateral Debt Securities as of the Closing Date and gains or losses incurred in connection with hedging arrangements entered into with respect to such Collateral Debt Securities. Accordingly, the Issuer will bear the risk of market changes subsequent to the Acquisition of such Collateral Debt Securities and related hedging arrangements as if it had Acquired such Collateral Debt Securities directly at the time of purchase by MLI of such Collateral Debt Securities and not the Closing Date.

Offering Circular at 66 (emphasis added).[6]

---

[6] The context of this disclosure makes abundantly clear that the Division's allegation that this disclosure was misleading because it did not mention Magnetar as a party to the Warehouse Agreement is simply wrong. This disclosure dealt with the nature of the securities placed in the deal, meaning it informed the reader that the initial collateral portfolio would be transferred from the warehouse but only if each of the transferred assets and the portfolio as a whole met all eligibility criteria. It also informed the reader that any asset transfer would be made at the purchase price at which the asset was placed in the warehouse, such that any diminution in value would be borne by the deal. It is therefore completely immaterial, indeed irrelevant, who all the parties to the Warehouse Agreement had been or what rights they may have had in the warehouse, so long as the portfolio met all eligibility criteria. With this as context it is very understandable how Magnetar's name would be omitted from this disclosure; Magnetar's role in the warehouse had nothing to do with its purpose and intent. Note in this regard that we expect the evidence to show that there was no effort made by anyone to withhold Magnetar's involvement from this disclosure and that it was simple (and unsurprising under the circumstances) oversight that the relevant Merrill lawyer failed to mention Magnetar as a party to that agreement. In any event, this is not the portion of the Offering Circular for which Harding had disclosure responsibility.

What is most significant, however, is that the Offering Circular ***specifically stated that the note purchasers were not getting any representations about the quality of the synthetic collateral*** in the pool and had to rely on their own analysis of the collateral before deciding to invest. This point could not be overstated: this case is about asset selection, meaning it is about whether Harding selected the right quality assets or whether Harding allowed lower quality assets into the deal to accommodate Magnetar. Setting aside the fact that the Division is not even claiming that the relevant so-called "disfavored" assets were of lower quality than other assets that were considered for the deal (and we do not believe there will be any evidence of that at trial), a fraud theory cannot be based on inclusion of any such "disfavored" assets for the simple reason that the Offering Circular specifically told potential investors that they were not getting any representations about the quality of the synthetic collateral.

All these investors were sophisticated; all of them received a list of assets (which was included as Schedule A to the Indenture); and all them were capable of determining for themselves (and agreed to do so as a condition to purchasing the Octans I Notes – see below) whether the collateral assets were right for them. Here is what the Offering Circular listed among the Risk Factors:

> ***Limited Information Regarding Reference Obligations.*** **No information on the credit quality of the Reference Obligations is provided herein. The holders of Securities will not have the right to obtain from the Synthetic Security Counterparty, the Issuer, the Collateral Manager, the Placement Agent, the Initial Purchaser or the Trustee information on the Reference Obligations or information regarding any obligation of any Reference Obligor (other than the limited information set forth in the monthly reports delivered pursuant to the Indenture).** The Synthetic Security Counterparty will have no obligation to keep the Issuer, the Trustee or the holders of Securities informed as to matters arising in relation to any Reference Obligation, including whether or not circumstances exist under which there is a possibility of the occurrence of a Credit Event or a Floating Amount Event. None of the Issuer, the Trustee, the Noteholders or the

> Holders of Preferred Securities will have the right to inspect any records of the Synthetic Security Counterparty relating to the Reference Obligations.
>
> **None of the Issuer**, the Trustee, the Preferred Security Paying and Transfer Agent, the Collateral Manager or **the holders of the Securities will have the right to inspect any records of** the Credit Default Swap Counterparty or any other Synthetic Security Counterparty or **the Reference Obligations, and** the Credit Default Swap Counterparty and other **Synthetic Security Counterparties will be under no obligation to disclose any further information or evidence regarding the existence or terms of any obligation of any Reference Obligation or any matters arising in relation thereto or otherwise regarding any Reference Obligation**, any guarantor or any other person, unless and until, in the case of a Long Credit Default Swap, a Credit Event has occurred and the Credit Default Swap Counterparty or other Synthetic Security Counterparty in its capacity as buyer of protection provides a Notice of Publicly Available Information to the Issuer evidencing the occurrence of such Credit Event as required under the terms of the related CDS Credit Default Swap or other Synthetic Security. **A prospective investor should review the prospectus, prospectus supplement or other offering materials (and any servicer or trustee reports) for each Reference Obligation prior to making a decision to invest in the Securities.**

Offering Circular at 52 (emphasis added).

What this means in plain English is that (a) unless there was a default or other specifically defined deterioration in credit of an underlying security, the prospective note purchasers would have no right to get information from anyone involved in the creation or maintenance of Octans I, including Harding, about the quality of the synthetic collateral and (b) prospective investors had to do their own analysis of the synthetic collateral by, among other things, reviewing the deal documents as well as performance results for each Reference Obligation.

This was not the only place in the Offering Circular where prospective purchasers were told that they would have to rely on their own review of the collateral; the Offering Circular is replete with such warnings. The first Risk Factor disclosure in the Offering Circular related to investor suitability. It stated:

> *Investor Suitability.* An investment in the Securities will not be appropriate for all investors. **Structured investment products, like the Securities,** are complex instruments, and typically involve a high degree of risk and **are intended for sale only to sophisticated investors who are capable of understanding and assuming the risks involved. Any investor interested in purchasing Securities should conduct its own investigation and analysis of the product and consult its own professional advisers as to the risks involved in making such a purchase.**

Offering Circular at 18 (emphasis added). This Risk Factor was in addition to the Disclaimer on the front cover of the Offering Circular that stated:

> **In order to be eligible to view this e-mail and/or access the Offering Circular or make an investment decision with respect to the securities described therein**, you must either (i) be a Qualified Purchaser who is also (1) a "Qualified Institutional Buyer" within the meaning of Rule 144A under the Securities Act of 1933, as amended, or (2) an "accredited investor" within the meaning of Rule 501(a) under the Securities Act or (ii) not be a "U.S. person" within the meaning of Regulation S under the Securities Act. A "Qualified Purchaser" is (i) a "qualified purchaser" as defined in the United States Investment Company Act of 1940, as amended, (ii) a "knowledgeable employee" with respect to the Issuer within the meaning of Rule 3c-5 under the United States Investment Company Act of 1940, as amended, or (iii) a company beneficially owned exclusively by one or more Qualified Purchasers and/or "knowledgeable employees" with respect to the Issuer within the meaning of Rule 3c-5 under the United States Investment Company Act of 1940, as amended.
>
> **By opening the attached documents and accessing the Offering Circular, you agree to accept the provisions of this page and consent to the electronic transmission of the Offering Circular.**

Offering Circular at Cover Page (emphasis added). In other words, only the most sophisticated investors could even view the Offering Circular and these most sophisticated investors were told that they had to rely on their own investigation and analysis before making their investment decision.[7]

[7] Of the twenty-three investors who purchased Octans I notes, twenty-one were other collateral managers, one was a hedge fund, and another was the biggest commercial bank in Taiwan. Morgan Stanley entered into a transaction that exposed it synthetically to the super senior risk in Octans I. All of these investors understood the disclosures in the Offering Circular and all were required to and did certify that they understood the risks and were able to make their own investment decisions based on representations in the Offering Circular.

A description of the Risk Factor relating to the collateral specifically informed potential investors that they had to do their own analysis of the credit risks of the collateral assets:

> *Nature of Collateral.* **The Collateral is subject to credit, liquidity, interest rate, market, operations, fraud and structural risks.** A portion of the Collateral will be Acquired by the Issuer after the Closing Date, and, accordingly, the financial performance of the Issuer may be affected by the price and availability of Collateral to be purchased. The amount and nature of the Collateral have been established to withstand certain assumed deficiencies in payment occasioned by defaults in respect of the Collateral Debt Securities. See "Ratings of the Securities." If any deficiencies exceed such assumed levels, however, payment of the Notes and distributions on the Preferred Securities could be adversely affected. To the extent that a default occurs with respect to any Collateral Debt Security and the Issuer sells or otherwise Disposes of such Collateral Debt Security, it is not likely that the proceeds of such sale or Disposition will be equal to the amount of principal and interest owing to the Issuer in respect of such Collateral Debt Security.
>
> **Reliable sources of statistical information do not exist with respect to the default rates for many of the types of Collateral Debt Securities eligible to be purchased by the Issuer. In addition, historical economic performance of a particular type of Collateral Debt Securities is not necessarily indicative of its future performance.** ***Prospective purchasers of the Securities should consider and determine for themselves the likely level of defaults and the level of recoveries on the Collateral Debt Securities and the resulting consequences on their investment in the Securities.***

Offering Circular at 26-27 (emphasis added).[8]

Similarly, here is the Risk Factor disclosure relating to possible credit events for the collateral:

> *Adverse Effect of Credit Events and Floating Amount Events.* **Payments on the Notes and distributions on the Preferred Securities will be adversely affected by the occurrence of Credit Events or Floating Amount Events under the Synthetic Securities.** If a Floating Amount Event occurs, the Synthetic Security Counterparty will have a contingent obligation to reimburse

---

8 According to the Indenture, a "'**Collateral Debt Security**' means (i) any CDO Obligation, (ii) any Other ABS, (iii) any Synthetic Security (including a Credit Default Swap) each Reference Obligation of which, and each Deliverable Obligation under which, is a CDO Obligation or Other ABS or (iv) any Deliverable Obligation that is a CDO Obligation or Other ABS that would qualify to be included as a Collateral Debt Security hereunder if purchased directly by the Issuer." Indenture at 17.

the Issuer for the amount paid in the event of an Interest Reimbursement or Principal Reimbursement by the Reference Obligor. However, there is no guarantee that a reimbursement of payments in respect of such Floating Amount Event will occur or that reimbursement will fully compensate the Issuer, particularly because the Synthetic Security Counterparty will not pay interest on such amount to the Issuer. This will reduce the Interest Proceeds available to pay expenses of the Issuer, interest on the Notes and distributions on the Preferred Securities on each Quarterly Distribution Date.

Whether and when to declare a Credit Event and to deliver any notice that a Credit Event or a Floating Amount Event has occurred under a Long Credit Default Swap will be in the sole discretion of the Credit Default Swap Counterparty, and none of the Credit Default Swap Counterparty or any of its affiliates will have any liability to any Noteholder, any Holder of Preferred Securities or any other person as a result of giving (or not giving) any such notice under any Long Credit Default Swap. If a "Writedown," "Failure to Pay Principal" or (solely with respect to a Credit Event under a CDO PAUG Credit Default Swap) "Failure to Pay Interest" occurs, the Credit Default Counterparty may elect to require the Issuer to pay the Floating Amount or to treat it as a Credit Event and require the Issuer to pay the Physical Settlement Amount under such Long Credit Default Swap.

There is no guarantee as to the ability of the Issuer to sell or the timing of the sale of Deliverable Obligations delivered to the Issuer under Unhedged Long Credit Default Swaps, or whether the amount of Disposition Proceeds received by the Issuer upon the sale of such Deliverable Obligations will equal the Physical Settlement Amounts paid by the Issuer following the occurrence of the related Credit Events. Principal Proceeds available to pay the principal amount of the Notes and the Preferred Securities on any Redemption Date, at Stated Maturity or on the Accelerated Maturity Date also will be reduced by each Floating Amount (other than in respect of an Interest Shortfall) and each Physical Settlement Amount paid by the Issuer under Unhedged Long Credit Default Swaps.

The concentration of Reference Obligations in any one industry or geographic region, in any one originator or servicer or in any one Specified Type of Asset-Backed Security will subject the Securities to a greater degree of risk of loss resulting from defaults within such industry or geographic region, defaults by such originator or servicer or defaults among that Specified Type of Asset-Backed Security.

Prospective purchasers of the Securities should consider and determine for themselves the likely levels of Credit Events and Floating Amount Events during the term of the Securities and the impact of such Credit Events and Floating Amount Events on their investment.

Offering Circular at 50 (emphasis added).[9]

Finally, again in the Disclaimer portion of the Offering Circular, in all capital letters, the following statement appears:

> FOR THESE REASONS, AMONG OTHERS, **AN INVESTMENT IN THE SECURITIES IS NOT SUITABLE FOR ALL INVESTORS AND IS APPROPRIATE ONLY FOR AN INVESTOR CAPABLE OF (A) ANALYZING AND ASSESSING THE RISKS ASSOCIATED WITH DEFAULTS, LOSSES AND RECOVERIES ON, REINVESTMENT OF PROCEEDS OF AND OTHER CHARACTERISTICS OF ASSETS SUCH AS THOSE INCLUDED IN THE COLLATERAL** AND (B) BEARING SUCH RISKS AND THE FINANCIAL CONSEQUENCES THEREOF AS THEY RELATE TO AN INVESTMENT IN THE SECURITIES.
>
> **IT IS EXPECTED THAT PROSPECTIVE INVESTORS INTERESTED IN PARTICIPATING IN THIS OFFERING ARE WILLING AND ABLE TO CONDUCT AN INDEPENDENT INVESTIGATION OF THE RISKS POSED BY AN INVESTMENT IN THE SECURITIES.**

Offering Circular at iv (emphasis added).

Nothing more really needs to be said. The note purchasers received exactly what they bargained for at a fair price. They were not deceived about the quality of the portfolio and, therefore, they were not defrauded. *See AUSA Life Ins. Co. v. Ernst & Young*, 39 Fed. Appx. 667, 671 (2d Cir. 2002) ("[T]he purpose of the laws prohibiting securities fraud is to restore to a defrauded individual the 'benefit of the bargain.'"); *accord Chem. Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984) ("The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions – to make sure that the buyers of securities get what they think they are getting . . . ."), *cert. denied*, 469 U.S. 884 (1984); *see also U.S. v. Starr*, 816 F.2d 94, 98 (2d Cir. 1987) ("[In a fraud case,] the harm contemplated must affect the

[9] A "'**Credit Event**' means, with respect to any Synthetic Security, any event identified in the related Underlying Instruments as a 'credit event' for purposes of the Credit Derivatives Definitions incorporated by reference therein." Indenture at 18.

very nature of the bargain itself. Such harm is apparent where there exists a discrepancy between benefits reasonably anticipated . . . and actual benefits . . . delivered." (citation and internal quotation marks omitted)); *U.S. v. Regent Office Supply Co.*, 421 F.2d 1174, 1182 (2d Cir. 1970) (finding no scheme to defraud where the misrepresentation was collateral to the sale and did not concern the quality or nature of the goods being sold and there was no discrepancy between benefits reasonably anticipated and actual benefits received).

Thus, in the absence of any disclosures about how the collateral would be selected or sourced, the Respondents had no duty to complete any disclosure. As a related matter, of course, there was no duty on anyone's part, let alone the Respondents, to say anything at all about how the portfolio had been or would be either selected or sourced.

Separately, it is well settled that no duty to complete a statement arises unless the speaker makes a statement that would be misleading if not completed. In other words, the duty to complete a disclosure is only triggered when the defendant chooses to speak on a given topic, and then the duty relates only to the topic at issue. *See In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 366 (2d Cir. 2010) (holding that when a defendant "makes a disclosure about a *particular topic*," it must be complete and accurate but that defendant is not required "to disclose the entire corpus of [its] knowledge" (emphasis added)); *In re Sanofi-Aventis Sec. Litig.*, 774 F. Supp. 2d 549, 561 (S.D.N.Y. 2011) (same and collecting cases). Because the Offering Circular did not address either the process of selection or the process of sourcing the collateral that was in the deal at closing, the Offering Circular did not need to say anything about either topic.

B. The Octans I Pitch Book Cannot Serve As the Basis for a Fraud Claim

The OIP suggests that representations in the Octans I Pitch Book ("Pitch Book") about Harding and its asset selection were materially misleading. The main problem with this

assertion, again, is that fraud could not be predicated on the Pitch Book as a matter of law. *See, e.g., Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 939 (2d Cir. 1998); *see also Banco Espirito Santo de Investimento, S.A. v. Citibank N.A.*, No. 03 Civ. 1537 (MBM), 2003 U.S. Dist. LEXIS 23062, at *14-15 (S.D.N.Y. Dec. 29, 2003) (holding, in breach of contract case, that "disclaimers in marketing presentations, the Offering Memoranda, and the letter of intent constitute objective signs of [defendant's] expressed intentions not to be bound by any statement outside the Offering Memoranda" (citation omitted)).

In *Independent Order of Foresters*, the Second Circuit affirmed a district court's dismissal of most of plaintiff's state law claims arising from a sale of securities. *See id.* at 935. The court found that brochures giving only basic information about the securities could not be the basis for plaintiff's claims because the actual offer (from the offering circulars and prospectuses) controlled the deal, and the offering circular expressly disclaimed any outside representations. *Id.* at 938-39.

The relevant bundle of rights is set forth in the Offering Circular, not the Pitch Book. The Pitch Book is replete with warnings that it is not an offering document, that it is subject to change, and that the offering will be made pursuant to the Offering Circular. It states right at the beginning:

> This Material is not an offer to sell, or a solicitation of an offer to buy, the Offered Securities or any other investment. Any such offering of the Offered Securities will only be made pursuant to a final Offering Circular relating to the Offered Securities (the "Offering Circular"), which will contain material information not contained herein and to which the prospective purchasers are directed. In the event of any such offering, this Material will be superceded [sic], amended and supplemented in its entirety by the Offering Circular.

Pitch Book at 2; *see also* Pitch Book at 3, 6, 11, 18, 19, 20, 22, 27-36.

And it specifically directs the reader not to make any investment decisions based on the information in the Pitch Book, stating:

> An investor should not make any decision to invest in the Offered Securities until after such investor has had an opportunity to read and review carefully the Offering Circular.

Pitch Book at 27.

To be sure, the Pitch Book did have information supplied by Harding about Harding and its investment and asset monitoring processes, but it does not make any representations about how the initial portfolio of Octans I would be or had been selected. In fact, any such disclosure would be inconsistent with the other statements in the Pitch Book, including that the Pitch Book made no representations about the quality of the reference obligations:

> **No information on the credit quality of the Reference Obligations is provided herein. The Noteholders will not have the right to obtain from the Credit Default Swap Counterparty, the Issuer, the Collateral Manager or the Trustee information on the Reference Obligations** or information regarding any obligation of any Reference Entity (other than the information set forth in the monthly reports delivered pursuant to the Indenture). Neither the Credit Default Swap Counterparty nor the Collateral Manager will have any obligation to keep the Issuer, the Trustee or the Holders of the Securities informed as to matters arising in relation to any Reference Obligation, including whether or not circumstances exist under which there is a possibility of the occurrence of a Credit Event. None of the Issuer, the Trustee or the Holders of the Securities will have the right to inspect any records of the Credit Default Swap Counterparty relating to the Reference Obligations.
>
> A prospective investor should review the prospectus, prospectus supplement or other offering materials (and any servicer or trustee reports) for each Reference Obligation prior to making a decision to invest in the Securities.

Pitch Book at 30 (emphasis added).

It would be incongruous for the Pitch Book to tout asset selection for the original asset pool while also disclaiming any representations as to its quality.

That is not to say that the description of Harding in the Pitch Book was superfluous. Octans I was a managed deal, meaning the portfolio might not have remained constant and, after the initial portfolio was selected and the deal closed, Harding would have been obligated to monitor the portfolio and make purchase and sell decisions on an ongoing basis. The evidence

will show that, at the start, investors could get the asset portfolio and make their investment decisions based on their analysis of the assets that were in the portfolio; if they did not like the portfolio they could ask for changes (which was not uncommon) or they could walk away. But after the deal closed, investors would have no say into what assets Harding would trade in or out. At that point, their only information on the portfolio would consist of monthly trustee reports and their only recourse, if they did not like the assets Harding was selecting, would be to sell their positions, which could be difficult.

For this reason, the Offering Circular listed reliance on Harding as one of the deal Risk Factors, stating:

> *Dependence on the Collateral Manager and Key Personnel*. The performance of the portfolio of Collateral Debt Securities depends heavily on the skills of the Collateral Manager in analyzing and selecting the Collateral Debt Securities. As a result, the Issuer will be highly dependent on the financial and managerial experience of the Collateral Manager and certain of the officers and employees of the Collateral Manager to whom the task of selecting and monitoring the Collateral has been assigned or delegated.

Offering Circular at 66-67. There would be no need for this Risk Factor, if the Octans I portfolio was static.

C. The Collateral Management Agreement Cannot Serve As the Basis for a Fraud Action

Given these disclosures and admonitions in both the Offering Circular and the Pitch Book, the OIP tries to pivot away from the Offering Circular and asserts that the real problem here is that Respondents failed to comply with the terms of the Octans I Collateral Management Agreement ("CMA") that required them to act in a manner consistent with conduct of other similarly situated collateral managers.

The theory here, it seems, is that regardless of the disclosures in the Offering Circular, Respondents committed fraud because they said they would act in accordance with certain

standards and then failed to meet those. There are two main problems with this theory of liability. First, failure to meet standards of care is not fraud; it may be a breach of contract or negligence, but not fraud, unless the investors received something less than what they expected. Here, as shown above, investors received exactly what they could have expected under the Offering Circular, including a list of the portfolio assets on the basis of which they were making their investment decisions. Even if those assets were gathered in some way that did not comport with some standard of care, those performed as least as well as the other assets in the portfolio. Therefore, the investors were neither harmed nor defrauded.

The second problem with the failure to comport with the CMA theory is that it does violence to what the CMA actually requires. To begin, the CMA was described in the Offering Circular, but consistent with the rest of the Offering Circular, neither the summary of the CMA in the Offering Circular nor the CMA itself, imposes specific asset selection procedures on Harding. Instead, the CMA makes clear that Harding's only obligation was to use commercially reasonable efforts to ensure that the collateral met the eligibility criteria set forth in the Offering Circular and the other deal documents.

Again, a textual analysis of the CMA is helpful. In describing Harding's obligations under the CMA, the Offering Circular says nothing about how Harding would go about selecting collateral for Octans I, to wit:

> On or prior to the Closing Date, the Issuer will enter into a Collateral Management Agreement (the "Collateral Management Agreement") Harding Advisory LLC (the "Collateral Manager" or "Harding Advisory") whereby the Issuer will appoint the Collateral Manager and the Collateral Manager will undertake to select all Collateral Debt Securities to be purchased by the Issuer on the Closing Date and until the end of the Reinvestment Period and make Hedge Rebalancing Purchases after the Reinvestment Period and to perform certain other advisory and administrative tasks for or on behalf of the Issuer.

Offering Circular at 196. The only information about collateral selection that is provided in the Offering Circular has to do with eligibility criteria discussed above, nothing else. Similarly, in the CMA itself, selection was defined in terms of making sure that eligibility criteria were met and nothing else:

> Selection. **The Collateral Manager shall select all Collateral to be Acquired by the Issuer in accordance with Eligibility Criteria, the other investment criteria set forth herein and in the Indenture and the Investment Guidelines.** The Collateral Manager shall not cause the Issuer to negotiate the principal terms of loans (including substantial non-periodic payments to a counterparty on a swap agreement) or to hold itself out (and the Collateral Manager will not hold itself out on behalf of the Issuer) as being a lender, broker, dealer, trader or a person otherwise willing to make loans, enter into, assume, offset, assign or otherwise terminate derivative contracts or perform services with or for customers in the ordinary course of business.

CMA at 4 (emphasis added). To reinforce this point, at closing, Harding and Mr. Chau were required to certify that they understood the Eligibility Criteria and that, at closing, all such Eligibility Criteria were met with respect to each asset in the deal:

> By his signature below, Wing Chau, the president of Harding Advisory hereby certifies that (i) the information set forth in Schedule A to the Indenture [the list of assets at closing] is correct in all material respects, (ii) he has reviewed and understands the definition of a Collateral Debt Security and the Eligibility Criteria, (iii) he has reviewed each of the Collateral Debt Securities acquired by the Issuer on the Closing Date and confirmed that each satisfies all of the requirements in the definition of a Collateral Debt Security and the Eligibility Criteria and (iv) he confirms that, in acquiring the Collateral Debt Securities, Harding has observed and complied with, and will continue to observe and comply with, the guidelines attached as Exhibit A [Investment Guidelines] to the Collateral Management Agreement.

Collateral Manager's Certificate at 1.

In addition to asset selection, among other things, under the CMA, Harding was authorized to monitor the performance of the collateral, determine what assets should be acquired or sold and the timing of such acquisitions or dispositions, consent to certain modifications or waivers with respect to the collateral, exercise remedies with respect to

defaulted collateral, participate in certain bankruptcy proceedings, and perform certain other acts in connection with managing Octans I and its collateral during the life of the deal. CMA at 4-5.

Harding was also not required and indeed prohibited from serving the interests of investors who were only long. Harding's obligations in terms of investment objectives were set forth in the CMA as follows:

> (m) Investment Objectives. In performing its duties hereunder, the Collateral Manager shall manage the Collateral with the objective that **Interest Proceeds and Principal Proceeds are sufficient to permit the Issuer**, in accordance with the Priority of Payments, (i) on each Distribution Date or Quarterly Distribution Date, as applicable, **to pay the Interest Distribution Amount with respect to each Class of Notes and principal on the Notes and Class A-1 Swap Availability Fee to the Class A-1 Swap Counterparty in a timely manner and (ii) subject to clause (i), to provide for returns to the Preferred Securityholders**; provided, that the Collateral Manager does not guarantee, and shall in no event be liable for, the timely or ultimate performance of any payment obligations of the Issuer (including any payments with respect of the Notes or the Preferred Securities) **and the Collateral Manager's decisions and actions in connection with the pursuit of such objective shall be in accordance with the standard of care set forth herein.**

CMA at 7 (emphasis added). In other words, Harding was required to select assets (as it saw fit) that would produce enough cash flow to pay all investors, including equity investors, regardless of which class of notes they owned and without any regard to their overall investment objectives.

As to the standard of care, again, it had nothing to do specifically with how collateral was selected; it covered all of the various responsibilities of Harding with respect to Octans I. The CMA provided in relevant part:

> (n) Standard of Care. The Collateral Manager shall, subject to the terms and conditions hereof and of the Indenture, 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. The Collateral Manager shall comply with all the terms and conditions of the Indenture affecting the duties and functions that have been

> expressly delegated to it thereunder and hereunder, and the Collateral Manager shall have no liability for its acts or omissions hereunder except as provided in Section 5(b) or 5(d).

CMA at 8 (emphasis added). Significantly, this requirement would be inconsistent with any requirement to select assets in a particular manner. Presumably, asset selection procedures may vary from manager to manager and may change as industry standards evolve.

In fact, as noted above, the only specific reference to both the standard of care and asset selection has to do with making sure that Credit Risk Securities were removed from the collateral, and even then, the application of the standard of care is defensive inasmuch as Harding would not be at risk for failing to exclude a weak security unless it ***actually believed***, based on then available information and in the exercise of due care, that there was ***a significant risk*** of a decline in credit quality or value (or, there has occurred, or was expected to occur, a deterioration in the quality of the underlying pool of assets) or, with a lapse of time, ***a significant risk of becoming*** a Defaulted Security presented itself. This provision, however, by its own terms, did not apply until after the Issuer purchased the security at issue, *i.e.*, after the deal closed, post-asset selection during the warehouse period. *See*, *supra*, note 3; Indenture at 19 (emphasis added). In other words, the issue was never whether some securities were stronger than others; the only issue was whether Harding actually believed that the relevant security presented a significant risk of decline in credit quality or value. The OIP does not allege, and we are aware of no evidence, that there were any such securities.

Finally, Harding had limited agency and had no responsibilities beyond what was in the CMA or the other transaction documents:

> (q) Limited Duties and Obligations; No Partnership or Joint Venture. **The Collateral Manager shall not have any duties or obligations except those expressly set forth herein or that have been specifically delegated to the Collateral Manager in the Transaction Documents. Without limiting the generality of the foregoing, (i) the Collateral Manager shall not be subject**

> **to any fiduciary or other implied duties,** (ii) the Collateral Manager shall not have any duty to take any discretionary action or exercise any discretionary powers, except discretionary rights and powers expressly contemplated hereby and in the Transaction Documents, and (iii) except as expressly set forth herein or in the Transaction Documents, the Collateral Manager shall not have any duty to disclose, and shall not be liable for the failure to disclose, any information relating to any issuer of any Collateral Debt Security or any of its Affiliates that is communicated to or obtained by the Collateral Manager or any of its Affiliates. **The Issuer agrees that the Collateral Manager is an independent contractor and not a general agent of the Issuer and that, except as expressly provided herein, neither the Collateral Manager nor any of its Affiliates shall have authority to act for or represent the Issuer in any way and shall not otherwise be deemed to be the Issuer's agent when undertaking any other activities.** Nothing contained herein shall create or constitute the Issuer and the Collateral Manager as members of any partnership, joint venture, association, syndicate, unincorporated business or other separate entity, nor shall be deemed to confer on any of them any express, implied, or apparent authority to incur any obligation or liability on behalf of any other such entity.

CMA at 8-9 (emphasis added).

D. Harding Communicated with Magnetar About the Selection of Assets for Octans I in the Normal Course; There Was No Need for Disclosure of This Fact

As noted, it was not unusual for long investors in CDO deals to ask the collateral manager to include certain assets in the portfolio as a condition of making their investment. The reason it was not unusual is that one would not think that someone who had an economic interest in the CDO performing well would propose assets that would be contrary to that economic interest. It was also not uncommon for collateral managers to acquiesce to these requests, assuming, of course, that the assets met all applicable investment criteria individually and as part of the portfolio. **In fact, in connection with Octans I, potential investors other than Magnetar suggested certain assets to be included in order to consider making their investment.**

In short, there would simply be no reason for Harding to think or even suspect that including assets proposed by an investor who had $94,000,000 reasons for the portfolio to do

well could be detrimental to the deal or other investors. And there will not even be any evidence that Magnetar had any appetite for any specific ABX assets or, for that matter, ever expressed any preference for any particular asset or number of assets to be included.

The Division alleges that Magnetar's interests were not aligned with the interests of investors who were only long. To begin, we do not know who such investors might be. ABS CDO's were very risky and very sophisticated instruments, as we explained above. Every investor who was long ABS CDOs would be expected to hedge its long position in some way or another. Not to do so would be negligent, especially for investment professionals who were investing on behalf of others. It was also not uncommon, indeed extremely rare, for investors to disclose their investment strategies to counterparties in the market. This too stands to reason: investors would be expected to lose bargaining ability if their counterparties knew their exact strategies and understood what assets they needed to execute them.

CONCLUSION

For the reasons set forth above, and because the evidence at trial will establish that Respondents acted at all times in accordance with the law and the terms that are described more specifically in the relevant and controlling contracts, the Court should rule at trial that the allegations in the OIP are unproven.

Dated: New York, New York
March 24, 2014

Respectfully Submitted,
HARDING ADVISORY LLC and
WING F. CHAU
By Their Attorneys,

Nixon Peabody LLP
437 Madison Avenue
New York, New York 10022
Tel: (212) 940-3000