INITIAL DECISION RELEASE NO. 734
ADMINISTRATIVE PROCEEDING
FILE NO. 3-15574

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of	:	
	:	INITIAL DECISION
HARDING ADVISORY LLC and	:	January 12, 2015
WING F. CHAU	:	
	:	

APPEARANCES: Howard A. Fischer, Daniel R. Walfish, Brenda W.M. Chang, and Elisabeth L. Goot, Division of Enforcement, Securities and Exchange Commission

Alex Lipman, Sean T. Haran, David Feldman, Ashley Baynham, and Ronaldo Rauseo-Ricupero, Nixon Peabody LLP, representing Respondents Harding Advisory LLC and Wing F. Chau

Nicole Rabner and Bradford Hardin, Jr., Wilmer Cutler Pickering Hale and Dorr LLP, representing Magnetar Capital LLC[1]

BEFORE: Cameron Elliot, Administrative Law Judge

SUMMARY

This Initial Decision (ID) finds that Respondents Harding Advisory LLC (Harding) and Wing F. Chau (Chau) violated Section 17(a) of the Securities Act of 1933 (Securities Act) and Section 206 of the Investment Advisers Act of 1940 (Advisers Act). The ID: orders Harding and Chau to cease and desist from violations of Section 17(a) of the Securities Act and Section 206 of the Advisers Act, and to jointly and severally pay $1,003,216 in disgorgement and prejudgment interest; revokes Harding's investment adviser registration and orders it to pay a civil penalty of $1.7 million; and bars Chau from association with the securities industry and orders him to pay a civil penalty of $340,000.

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[1] Magnetar Capital LLC (Magnetar) and its counsel were admitted as parties for the limited purpose of obtaining a protective order covering certain exhibits and testimony concerning Magnetar.

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I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission (Commission) issued its Order Instituting Administrative and Cease-and-Desist Proceedings (OIP) on October 18, 2013, pursuant to Section 8A of the Securities Act, Sections 203(e), 203(f), and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act of 1940 (Investment Company Act). Harding and Chau filed a joint Answer on January 10, 2014.

A hearing was held on March 31, 2014, April 1-4, 7-11, 21-25, and 29-30, 2014, in New York City and at the Commission's headquarters in Washington, D.C. The admitted exhibits are listed in the Record Index issued by the Secretary of the Commission on December 23, 2014.[2] The Division of Enforcement (Division) and Respondents thereafter filed post-hearing briefs by July 14, 2014.[3]

B. Summary of Allegations

This proceeding concerns allegations of fraudulent misrepresentation involving the purchase of assets for collateralized debt obligations (CDOs) directed by Maxim Group LLP (Maxim) and Harding (collectively referred to as Harding, unless specified otherwise), which acted as collateral manager to the CDOs. Chau, as the majority owner, chief executive officer, managing member, and chief compliance officer of Harding, is alleged to have committed primary violations and to have aided and abetted and caused Harding's violations.

The OIP alleges that Harding acted as collateral manager to Octans I CDO Ltd. (Octans I), a $1.5 billion CDO structured and marketed by subsidiaries of Merrill Lynch & Co., Inc. (Merrill). OIP at 2. During the structuring of the CDO, Merrill, Harding, and Magnetar, a hedge fund that invested in all of the equity of Octans I, entered into a warehouse agreement to accumulate collateral prior to the closing of Octans I. OIP at 2. Pursuant to the warehouse agreement, Merrill kept the collateral on its balance sheet before purchase, and Magnetar had the right to review the collateral before purchase. OIP at 2. According to the OIP, the fact that Magnetar was a party to the warehouse agreement and had, in essence, a "veto" right over the collateral, was never disclosed to debt investors in the CDO. OIP at 2.

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[2] The descriptions of Respondents' Exhibits 286-88 submitted by Respondents do not match the exhibits submitted. These three exhibits are described as attachments to Respondents' Exhibit 285. The copies of the exhibits submitted by Respondents are, however, single pages, each stating, "This Document Produced in Native Format." Accordingly, I have not relied on Respondents' Exhibits 286-88.

[3] Citations to the transcript of the hearing are noted as "Tr. ___." Citations to exhibits offered by the Division and Respondents are noted as "Div. Ex. ___" and "Resp. Ex. ___", respectively. The Division's and Respondents' post-hearing briefs are noted as "Div. Br. ___," "Resp. Br. ___," and "Div. Reply Br. ___," respectively.

During the warehouse phase of Octans I, Harding allegedly deferred to Magnetar's suggestions to select collateral that was favorable to Magnetar, but not to the performance of the CDO. Specifically, Harding is alleged to have acquired for Octans I exposure to Residential Mortgage Backed Securities (RMBS) referenced in an investment product known as the ABX Index. OIP at 7-8. According to the OIP, Harding, at the behest of Magnetar, acquired long positions in the RMBS despite negative opinions of those RMBS by Harding's credit department. OIP at 9-10. Harding allegedly failed to disclose these facts to the co-issuers of Octans I, Harding's client, and to debt investors in Octans I, and thus to have failed to act within both industry standards of care and standards of care explicitly required in the Octans I collateral management agreement (CMA). OIP at 11. According to the OIP, descriptions of these standards in the Octans I pitch book and offering circular were misrepresentations. OIP at 11.

Harding is further alleged to have acquired tranches of a CDO called Norma CDO I (Norma), for CDOs that Harding managed, as a favor to Merrill, which structured Norma, and to Magnetar, which was the sole equity investor in Norma, to the detriment of debt investors in the Harding-managed CDOs. OIP at 12-13. The OIP alleges that Harding had been reluctant to acquire mezzanine-level tranches of Norma, but purchased them after pressure from Merrill and Magnetar, and without any analysis of Norma's creditworthiness. OIP at 12-13. Following the selection of mezzanine tranches of Norma, but before Norma closed, Harding allegedly received a negative analysis of Norma by one of Harding's credit analysts, but nevertheless acquired the Norma bonds and allocated them to Harding-managed CDOs. OIP at 12-13. Harding allegedly breached the standard of care provisions in the CMAs for the CDOs in which the Norma bonds were placed, without disclosing the breach of its advisory obligations to investors or to Harding's clients. OIP at 12-13.

II. FINDINGS OF FACT

The findings and conclusions herein are based on the entire record. I applied preponderance of the evidence as the standard of proof. *See Steadman v. SEC*, 450 U.S. 91, 102 (1981). I have considered and rejected all arguments, proposed findings, and conclusions that are inconsistent with this ID.

A. <u>Background</u>

A CDO is a special-purpose vehicle (SPV) that issues debt securities and uses the investment proceeds to obtain collateral in the form of, as relevant to this proceeding, securities of hundreds of RMBS, and in some cases other CDOs. Tr. 113, 972 4071-72. After RMBS tranches and tranches from the other CDOs are acquired, they are pooled, and re-tranched into classes of CDO notes. Tr. 2345. Income from the RMBS and outside CDOs are redirected to the CDO tranches through a "waterfall" payment structure, paying first to the highest-rated CDO tranche notes and then to the lower-rated tranches, in order of seniority. Tr. 2341, 2345-47, 4070-71. The inverse is true for the rates of return paid to investors in the CDOs; the rates of return are highest for the least senior tranches, and are lowest for the most senior tranches. Tr. 2796, 4072-74, 4093. The lower tranches bear risk of first loss by virtue of their subordination. Tr. 2508-09. The lowest tranche is commonly referred to as the equity, receives the residual cash flows, and carries the highest risk of default. Tr. 739, 2346, 4088. The equity tranche is usually not rated, but can be carved up into rated and unrated pieces. Tr. 4152-53.

RMBS are investment vehicles that pool thousands or tens of thousands of individual residential mortgage loans as collateral into a trust that redirects the interest payments to investors in the RMBS. Tr. 4067, 4088. As with CDOs, the trust issues debt securities in tranches of varying subordination and risk level, and RMBS investors receive income in accordance with a waterfall structure, from the highest-rated tranches, typically rated AAA or Aaa, to the lowest-rated tranches, typically rated BBB- or Baa3.[4] Tr. 4070. As relevant here, RMBS were collateralized by subprime mortgages, which are mortgages that have a credit defect, making them ineligible for sale to quasi-governmental agencies Fannie Mae or Freddie Mac; thus, the subprime mortgages at issue are sometimes referred to as "non-agency" mortgages. Tr. 2345, 4073-74, 4901. Subprime borrowers typically pay higher interest rates than prime borrowers, making the subprime mortgages attractive to investors. Tr. 4074. Because subprime mortgage loans are risky, however, securitizers pool them into RMBS to mitigate risk, and tranche the RMBS to generate different asset classes. Tr. 4068-69, 4074.

CDOs that collateralize with RMBS can purchase either actual, "cash" RMBS notes, or "synthetic" RMBS by contracting for credit default swaps (CDS) with counterparties. Tr. 109-10, 114, 2517, 2345. A CDS is a derivative, a contract that obligates a transfer of payments between counterparties based upon the performance of a reference entity; as relevant here, the reference entity was typically RMBS. Tr. 109; Div. Ex. 44. The party to the CDS that is "long" on the reference RMBS is the party selling protection on the reference RMBS and collecting premiums from the counterparty. Tr. 115, 2337. The party to the CDS that is "short" is the party buying protection on the reference RMBS and paying premiums to the long counterparty. Tr. 115, 2337. "Protection" refers to protection against a negative credit event on the reference RMBS. Tr. 114; Div. Ex. 8001 at 9-11. In the instance of a specified credit event, the long party pays a specified amount to the short party, and the long party accordingly bears the risk of loss, much like a purchaser of the underlying asset does. Tr. 114; Div. Ex. 8001 at 9-11. The long party in such a case is said to have "exposure" to the bond. *See* Tr. 2391, 2457. A fully synthetic CDO solely acquires CDSs as constituent assets; a hybrid CDO acquires both cash assets and synthetic assets. Tr. 114.

A CDO investment mandate is the specification of collateral and criteria for the CDO, and is usually the result of collaboration between the CDO's collateral manager and the CDO's investment bank. Tr. 1487. A mezzanine CDO refers to a CDO that is collateralized by primarily mezzanine-rated tranches of RMBS, which are the tranches between the senior notes and the equity; the mezzanine tranches are typically rated, as relevant in this case, between BBB and BBB-, or between Baa2 and Baa3. Tr. 127-28, 740, 2345-46, 4080, 4083-84. Similarly, the mezzanine tranches of a CDO are those that are rated between BBB and BBB- or Baa2 and Baa3. Tr. 4070.

[4] The rating conventions differ according to the rating agency. Moody's rates securities from Aaa to C, and Standard and Poor's rates securities from AAA to D. Tr. 873-74. BBB is akin to Baa2 and BBB- is akin to Baa3; BBB is higher (less risky) than BBB- and is sometimes referred to as "BBB flat." Tr. 874, 885. This ID refers mainly to the Moody's designations.

Although a mezzanine CDO is backed by less-than-investment grade securities, its structure can provide returns to debt investors even if a portion of the underlying assets default or suffer write-downs. *See* Tr. 127-28, 740, 4898-99. For example, the principal balance sold to CDO investors may be smaller than the principal underlying the CDO's assets, so that losses or write-downs to the underlying principal do not immediately result in a loss of CDO principal; this is referred to as overcollateralization. Tr. 4070-76. Also, as noted, the debt tranches are protected by subordination, which refers to the lower tranches' absorption of losses before any losses are absorbed by more senior tranches. Tr. 2509, 2785. Additionally, varying mechanisms in the waterfall can disrupt or divert cash flows based upon "triggers" or "tests," to mitigate risk to senior tranches. Tr. 717-18, 2509, 2785, 4092. For example, a decrease in payments from the RMBS could shut off interest payments to lower-rated tranches, while maintaining payments to higher-rated tranches, until cash flows again rise above the test level. Tr. 717-18.

Underwriters, sometimes referred to as dealers, are investment banks that structure and syndicate CDOs. Tr. 727, 732, 4263. After a CDO investment mandate is conceived, but prior to creation of the CDO, the collateral manager (if it is a managed CDO) selects assets for the CDO and requests that the party warehousing the assets acquire the assets and hold them. Tr. 115-16, 727, 4205. This collateral aggregation phase is known either as the warehouse phase or the "ramp." Tr. 115-16, 395-96, 1894-95. Prior to the ramp, the collateral manager and underwriter enter into an engagement letter and a warehouse agreement, and the warehouse agreement designates what party will warehouse the assets until the CDO closes, and what party will assume liability for losses suffered from those assets during the ramp. Tr. 389, 3616. The underwriter usually provides the warehouse and, consequently, assumes at least some liability for losses. Tr. 727. To mitigate risks associated with acting as the warehouse during the ramp, the warehouse party maintains rights to approve or veto assets selected by the collateral manager. Tr. 728, 733.

CDOs can be either managed or unmanaged, and underwriters select the managers prior to the ramp. Tr. 4263. For managed CDOs, investors base their decision to invest in the CDO at least in part on the quality of the manager, that is, the collateral manager. Tr. 4354. Managed CDOs are either statically or actively managed, meaning the collateral is either fixed or variable. Tr. 1979, 2560. As relevant here, CDOs are collateralized with cash RMBS, synthetic RMBS, or other CDOs. Tr. 113-14, 972, 2344. After selection, exposure to synthetic bonds is gained by submitting bids wanted in competition (BWIC) or answering offers wanted in competition (OWIC). Tr. 206, 208.

The ABX Index is an index of RMBS, reflecting the twenty most liquid RMBS in the market at each credit level, and offered by a joint venture of banks. Tr. 147, 855, 2438-39. The ABX Index includes bonds rated Baa2 and Baa3. Tr. 160. It is re-indexed semiannually, offering new series for each credit level, and the ABX Index itself is traded as a single CDS with its own price and spread.[5] Tr. 147, 2438-39. Thus, an investor may gain exposure to both the

[5] The term "spread" means different things in different contexts. It sometimes means simply payments. *E.g.*, Div. Ex. 8001 at 10-11. Throughout this ID, however, unless indicated otherwise, it means the difference between a particular interest rate and the London Interbank

ABX Index itself, and to one or more of the bonds comprising the ABX Index. Tr. 2438-39. The twenty bonds chosen for each credit level are a subset of the universe of bonds in the market, and serve as a proxy for the market as a whole. Tr. 2542.

B. Relevant Entities and Lay Witnesses

1. Harding Advisory LLC

Harding began as Maxim, a department within Maxim Group, and Chau led Maxim prior to establishing Harding. Tr. 135-36; Answer at 3. Chau established Harding as a Delaware LLC and registered it as an investment adviser pursuant to the Advisers Act, and in July 2006, eight to ten Maxim employees left Maxim to join Harding.[6] Tr. 239, 270, 2163; Resp. Ex. 145 at 2. Employees that left Maxim for Harding included: Tony Huang (Huang), managing director, considered Harding's number two; Alyson Wang (Wang), vice president and chief operating officer, considered Harding's number three; Xilun Chen (Chen); Jamie Moy (Moy), a director and credit analyst; Jung Lieu (Lieu), assistant vice president and a credit analyst; Brett Kaplan (Kaplan), a credit analyst; and Ken Lee (Lee), a credit analyst. Tr. 234, 263-64, 361, 387-88, 694; Div. Ex. 1 at 40. Chau is a 99% owner of Harding, and his wife owns the remaining 1%. Tr. 1448-49.

Three departments at Harding reported to Chau: Portfolio Management/CDO Structuring/Trading, Credit/Research, and Surveillance/Monitoring. Div. Ex. 1 at 40. There were no clear, defined roles at Harding, but the only three employees who could approve investments were Chau, Huang, and Wang. Tr. 964-65. The credit department reviewed whole loan portfolios of RMBS and performed cash flow analyses to determine the creditworthiness of the RMBS. Tr. 4095.

At Maxim some employees had individual offices, but at Harding the staff occupied a single open room. Tr. 510-11, 1252. Harding staff used email to communicate, but often spoke with each other informally in person and across desks. Tr. 511-13. Infrequently, formal meetings were held in a separate conference room. Tr. 513. Harding had several informal committees, including an investment committee and a credit committee. Tr. 324; Div. Ex. 9. Harding staff testified that the committees rarely met formally, but members frequently spoke across their desks within the one-room office. Tr. 326-327, 966, 970. It was not clear whether a credit committee existed in May 2006. Tr. 3268. Lieu testified that there was no established, regularly meeting committee, but that credit analysts did discuss bonds and credit issues with each other. Tr. 3267-68.

Between December 2004 and October 2007, Harding acted as collateral manager to twenty-one CDOs, eight of which were mezzanine deals. Tr. 1453; Div. Ex. 239. Octans I was

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Offered Rate (LIBOR). *E.g.*, Div. Ex. 3 at 46, 191, 277; Div. Ex. 219A at 2 ("Index Spread" column).

[6] Harding was, at the time of the events at issue, located in New York. Div. Ex. 4 at Exhibit B. Harding has since relocated to the Boca Raton area of Florida. Tr. 2163.

Harding's first synthetic mezzanine CDO. Tr. 935. Prior to Octans I, Harding had mainly acted as manager to high-grade (i.e., non-mezzanine) CDOs. Div. Ex. 239. In addition to Octans I, Harding acted as manager to two other Octans deals, Octans II and Octans III. Tr. 255. Harding made no money unless and until its CDOs closed, and if a CDO failed, it stopped receiving fees. *See* Tr. 255, 1473-75.

a. Wing Chau

Chau received a bachelor's degree in economics from the University of Rhode Island and a master's degree in finance from Babson College. Div. Ex. 1 at 57. At the time that the CDO products in question were created and sold, he was domiciled in New Jersey. 2162. He recently moved to Florida, and he is in the process of domiciling himself there. Tr. 2161-62.

Chau "was responsible for everything at Harding"; everybody reported to him. Tr. 258, 261. Chau had a hand in every major decision at Harding. Tr. 262. Chau, along with Wang and Huang, made all investment decisions for Harding. Tr. 261. Chau was a signatory to all of Harding's significant agreements. Tr. 395; *see, e.g.*, Div. Exs. 4, 504, 506, 510, 512; Resp. Exs. 123, 124. Chau was Harding's chief compliance officer. Tr. 270; Div. Ex. 122 at 47 (of 87). He was responsible for reviewing all marketing materials on Harding's behalf, and was responsible for ensuring that Harding's materials did not violate the antifraud sections of the securities acts. Tr. 1451-52; Div. Ex. 122, Harding Investment Adviser Policies and Procedures Manual at 4-5. Chau was also responsible for ensuring that none of Harding's employees violated the antifraud sections of the securities acts. Tr. 1452-53; Div. Ex. 122 at 4, 6-7, 11, 28, 38 (of 87).

One of Chau's children was born on May 26, 2006, and he was out of the office on May 30, 2006, one of the days focused upon in this case. Tr. 2191, 4280. He was available by email and phone that day, and corresponded with others from Harding that day. *See, e.g.*, Resp. Exs. 309, 852. The morning of May 31, 2006, Chau attended some meetings out of the office, but was in Harding's office at least part of that day. Tr. 4438; Div. Ex. 50 at 1.

Although I credit much of Chau's testimony, at times he was not believable. The Division repeatedly impeached him. *E.g.*, Tr. 1543-44, 1546-48, 4341-43, 4398-4400. Chau also offered farfetched explanations on some matters. For example, a Bloomberg message between Chau and an acquaintance at New York Life Investment shows that Chau attempted to unload poorly performing Norma bonds at one point, and the acquaintance mocked him with a parody of the song "Candle in the Wind," quite obviously disparaging Norma due to its sinking market position at the time. *See* Div. Ex. 226. Chau attempted to downplay his acquaintance's parody, claiming it was merely humorous banter, and not indicative of his acquaintance's opinion of the Norma bonds; Chau's response was that the song lyrics did not "say anything about opinion of Norma . . . it is a song parody. I don't know what [he] was saying when he wrote that song, the meaning behind the words."[7] Tr. 1700-01.

[7] Lyrics include,

Good-bye Norma Jean Though I Never Knew You At All
The Hedge Funds Are Shorting You Betting That You Fall

Chau's histrionics also eroded his overall credibility. At one point, Chau lashed out at Division counsel during his direct examination, exclaiming "shame on you, Mr. Walfish," referring to co-counsel for the Division who was not questioning Chau at the time. Tr. 1534. Chau's outburst at Mr. Walfish, Chau explained, pertained to Mr. Walfish's questioning of Wang the prior day. Tr. 1534.

Chau also deflected questions by the Division on rudimentary issues. For example, when asked a simple question whether it was consistent with industry practice for a collateral manager of national repute to perform diligence on underlying assets of a CDO, Chau stated, "I don't know how to respond to that question." Tr. 1551-58. When pressed on similar, common-sense concepts, Chau sometimes gave long-winded answers when a simple yes or no would have sufficed. *E.g.*, Tr. 1559-1565 (answer lasting over five transcript pages). After one of Chau's long, evasive answers, I cautioned Chau's counsel that Chau's inability to answer simple, direct questions harmed his credibility. Tr. 1565-66. Following the warning, Chau answered questions more directly, although he remained conspicuously less willing to answer questions by the Division compared to questions from his own counsel. *Compare*, *e.g.*, Tr. 4067-331 (direct examination by Respondents' counsel) *with* Tr. 4337-444 (cross examination by Division).

b. Tony Huang

Huang received his bachelor's degree in physics from the California Institute of Technology, and a master's degree in physics from Cornell University. Tr. 696-97. He became involved in the financial industry in 1993 or 1994, working first at J.P. Morgan in the credit derivatives area, including CDSs. Tr. 697-98. Huang then worked at Centre Solutions, part of Zurich Insurance (Zurich), as a portfolio manager, on early versions of securitized risk, a precursor to CDOs. Tr. 698-700. In 2003 or 2004, Huang left Zurich for Highland Capital, a collateralized loan obligation manager with some hedge fund activities. Tr. 700-03. Huang joined Highland Capital to build up its asset backed securities group and trade synthetic bonds. Tr. 703-04. Before he left, Huang started the process for a couple of CDO deals, although he left before any of them closed. Tr. 704-05. Huang then joined Harding as managing director in late 2005 or early 2006. Tr. 705, 709. Chau hired Huang to "do the math" on loss expectations of mezzanine securities and their default probabilities, which required high-level quantitative calculations.[8] Tr. 4096. Huang reported to Chau. Tr. 963.

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And It Seems To Me You Lived Your Life Like A Candle In the Wind
Never Knowing Who to Cling To When Defaults Set In
You went Long Too Much Long Beach And You Know That's A Sin

Div. Ex. 226 (formatting altered).

[8] Chau also hired Chen to perform high-level quantitative loss projections on deals that Harding managed. Tr. 4096. Chen did not testify at the hearing.

Huang was a portfolio manager at Harding and had authority to approve purchases. Tr. 3937. Primarily, Huang reviewed potential investments in CDOs managed by others, for potential inclusion in Harding-managed CDOs. Tr. 972-73. He was not typically involved in any credit decision making for RMBS bonds, and he usually did not express any opinion on them. Tr. 862-63, 980-81. He deferred to the credit analysts' expertise regarding analysis of RMBS collateral. Tr. 986, 998. Huang did, however, make decisions on specific RMBS bonds when Chau was not in the office, which was true on May 30, 2006. Tr. 862, 1204. Huang frequently assigned bonds to the credit department for review prior to taking action on OWICs and BWICs. Tr. 863.

Huang began to have misgivings with the way Harding was run by Chau, and he believes that led to his gradually diminished responsibilities at Harding before he left in 2008. Tr. 695, 974. Huang did not, however, believe that he was ever asked to do anything that would compromise his or Harding's standards, nor did he ever do anything that would sacrifice his or Harding's integrity. Tr. 1197, 1207-12. Similarly, he never asked anyone else to put another entity's interest above Harding's. Tr. 1197, 1209-11. Huang believed that Chau was qualified and capable in his position and that he strove to make sure tasks were performed correctly. Tr. 1255-56. He also believed that Moy and Lieu were qualified and reliable. Tr. 1256-57, 1261.

c. Alyson Wang

Wang received a bachelor's degree from the University of Pennsylvania, a law degree from Columbia University, and an LLM degree from New York University. Tr. 215. After receiving her bachelor's degree, she worked as an accountant, and after law school, she worked for two law firms in their respective tax departments. Tr. 216-17. She joined Maxim in 2005, and then Harding in 2006, after meeting Chau through his wife, a friend of Wang's. Tr. 221-22, 224-25. Wang left Harding in 2009, and went to a hedge fund where she was the chief operating officer and oversaw compliance. Tr. 216-17, 278-79. She is currently attending school toward a graduate degree in computer science. Tr. 278.

Prior to joining Harding, Wang had not worked on any CDO deals. Tr. 221. Nor did she have any experience working for a financial institution or asset manager. Tr. 222-23. Her relevant experience came from her training in reviewing legal contracts, and her relevant skills included attention to detail and organization. Tr. 509-10.

Wang did "whatever was necessary" for Harding, which included reviewing documents, such as engagement letters, offering memorandums, and circulars. Tr. 214, 353. She believed that she reviewed the Octans I offering circular and the pitch book, though she has no independent memory of doing so.[9] Tr. 371. She also participated in drafting and reviewing

[9] Wang was an extremely reluctant witness. She was visibly anxious, had trouble answering basic questions, even from Respondents' counsel, and answered "I don't recall," or some variation thereof, dozens of times. Tr. 284, 507-08; *see generally* Tr. 209-308, 324-644. Some of her answers were so bizarre, and her demeanor when giving them so strange, that I eventually

Harding's compliance manual. Tr. 270-71. When reviewing offering circulars for Harding-involved deals, she sought to make sure that the sections regarding Harding were consistent with her understanding of what they should be; her review included subsections regarding investment criteria and descriptions of the CMA. Tr. 353-54. If there were "issues," she "raise[d] them with the appropriate people." Tr. 355, 501. Her determinations of accuracy were formed in part by information received from Chau or Huang. *See* Tr. 518.

Wang had no responsibility for credit research, surveillance of bonds, or diligence on other CDO managers. Tr. 338-39. The extent of her oversight of credit department decisions was to ensure that cash flow analysis had been performed on bonds being purchased. Tr. 337-38. Additionally, credit analysts, including Lieu, sometimes ran decisions by Wang. Tr. 522. Wang did not recall being aware of any credit analysts compromising their standards, nor does she believe she ever compromised her own standards. Tr. 539-41. She did not believe that she was ever asked to perform any unethical duties. Tr. 541.

d. Jung Lieu

Lieu received a bachelor's degree in finance from Washington University in St. Louis, Missouri. Tr. 3232. After graduating, she worked at MetLife Investments, in the asset backed securities department, performing surveillance on asset backed securities for non-agency loan mortgage products for a year, followed by a year as a credit research analyst, evaluating financial institutions. Tr. 3232-33. Lieu then worked at Fitch Ratings, starting in the residential mortgage department, and then moving to the ratings group, which rated new issue RMBS. Tr. 3233. Lieu joined Harding in 2005. Tr. 3231. She first joined Harding's surveillance group, and then became involved in credit analysis, reviewing RMBS bonds for purchase. Tr. 3247-48. In 2008 she joined T. Rowe Price as a mortgage credit analyst. Tr. 3230. In 2013, Lieu joined Five Bridges Advisors as a senior advisor to clients for mortgage portfolios and valuations. Tr. 3230.

Lieu reported to Chau at Harding. Tr. 3247. Moy was senior to Lieu, but the two credit analysts performed similar functions analyzing RMBS.[10] Tr. 267, 363, 3250, 3254. Moy and Lieu sometimes worked collaboratively, but other times, especially if there were time constraints, worked independently of one another. Tr. 3259-60, 3268. Often, if they were both in the office, Moy and Lieu would split projects, and, if there was time to do so, would review and discuss each other's work, seeking to reach a single opinion. Tr. 3269. Huang testified that Chau favored Lieu's opinion over Moy's and that Lieu was more influential than Moy at Harding. Tr. 1037, 1039-40.

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allowed direct examination by leading questions. Tr. 284, 288. However, she displayed no obvious bias, and appeared to make an effort to testify truthfully.

[10] Moy, prior to joining Harding, had ten years' experience in structured finance and fixed income, and was previously employed at Credit Suisse, Fitch Ratings, and Donaldson, Lufkin, & Jenrette. Div. Ex. 1 at 58. Moy and Huang knew each other before joining Harding, and it was at Huang's recommendation that Moy joined Harding. Tr. 1197. Moy did not testify at the hearing.

Lieu frequently fielded and answered questions of potential investors in Harding-managed CDOs regarding Harding's credit processes and the creditworthiness of specific bonds. Tr. 3926-29; *see, e.g.*, Resp. Ex. 627. She joined Chau on some of the roadshows marketing Octans I, answering investor questions on the credit review processes and standards at Harding. Tr. 3567, 3570. Some of the questions that Lieu answered for investors involved specific questions pertaining to single bonds that Harding invested in as part of its CDOs. Tr. 3567-73.

Lieu does not believe that she did anything to deceive investors. Tr. 3930. She testified that she never did anything unethical to accommodate other parties, such as Magnetar, nor did anyone ever ask her to do anything inconsistent with her ethics, such as "rubber-stamp" bonds. Tr. 3932. She never felt pressured to accept more ABX Index bonds, nor did she witness anyone else being pressured to do so. Tr. 3360.

Lieu displayed overt and unnecessary animosity toward the Division. Early in her direct examination, I declared her a hostile witness and permitted leading questions, due to her resistance to answering basic, foundational questions by the Division, sometimes by answering questions with questions.[11] Tr. 3251-54. The contrast between her resistance to answering Division questions and her avidity in answering questions from Respondents' counsel was striking, and clearly demonstrated bias in favor of Respondents.[12] Also, much of her testimony was confusing and inconsistent, in large part because she changed her story over time, as explained *infra*. Nonetheless, her most problematic testimony pertained to tangential issues, and I credit much of her testimony on the more important points.

2. James Suh

James Suh (Suh) was Harding's attorney for several of its CDO deals. Tr. 2917-18. Suh graduated from Cornell University in 1991 and from Fordham Law School in 1994. Tr. 2913. He worked for Rogers and Wells (now known as Clifford Chance), Morrison and Foerster, and McDermott, Will & Emery (McDermott), and from 2006 to the present has been a partner at Schulte Roth & Zabel (Schulte), in the derivatives, structured finance, and investment

[11] For example, the Division asked whether, regarding Lieu and Moy, "at Harding, one of you was senior to the other?" Tr. 3250. Lieu responded, "[w]hat is your definition of senior." Tr. 3250.

[12] Shortly before testifying at the hearing, Lieu provided a new explanation of credit evaluation processes conducted on May 30 and May 31, 2006, which differed substantially from testimony she provided consistently throughout investigative testimony and at a deposition in a related civil case. Lieu testified that her change in testimony was based upon being shown documents while meeting with counsel for Respondents approximately one week before her hearing testimony. Tr. 3461-62. When asked by the Division what documents she reviewed the prior week that caused her to change her testimony, she was not able to name or describe any of the documents. Tr. 3464-65. By contrast, when questioned by Respondents' counsel regarding the same files reviewed during Lieu's meeting with them, Lieu was much more responsive and forthcoming. Tr. 3679-80, 3683.

management groups. Tr. 2913-14, 2934. While at McDermott, nearly all of his work was on behalf of collateral managers in asset backed securities deals. Tr. 2916.

As Harding's counsel in 2006, Suh reviewed and marked up the formative contracts, including the CMA and the offering circular for Octans I. Tr. 2918, 2941-42; *see e.g.*, Resp. Ex. 197. He did not typically review pitch books. Tr. 3073, 3122-23. Suh focused his review of the Octans I's offering circular in sections pertaining to Harding, but he performed a general review of the document in its entirety, and made some comments throughout. Tr. 2941, 3119-20; Resp. Exs. 196-97.

3. Merrill

Merrill collaborated with Harding to create at least eleven CDOs, including Octans I, and acted as underwriter to Chau's and Harding's first CDO, Jupiter High-Grade CDO I. Tr. 1472, 1480; Div. Ex. 239. Prior to June 2006, all of Harding's management fees were earned from CDOs structured by Merrill, and in the second half of 2006 and 2007, Merrill continued to be underwriter for many of Harding's CDOs. Tr. 1482-83; Div. Ex. 239. The Merrill CDO group was co-headed by Ken Margolis (Margolis) and Harin De Silva (De Silva), while Andy Phelps (Phelps) headed the syndication team, Sharon Eliran (Eliran) was a banker, and Charles Sorrentino (Sorrentino) was a trader. Tr. 117, 120, 163, 1479.

Chau maintained friendships with individuals at Merrill, including Margolis. Tr. 1470, 1481. Chau met Margolis in the mid-1990s, prior to Margolis' leadership role in the CDO group at Merrill, and in 2007, Chau hired Margolis to work at Harding. Tr. 1481, 1483-84. Merrill and Margolis were strategic partners in Harding's CDO business: Chau wrote to Margolis in July 2006, "[h]ere's the game plan, we price dorado[13] in july/august, I price dorado II in sept while you are busy with other deals, and we come back to ml for dorado III in oct/nov, you don't miss a beat, and we maximize my deal flow." Tr. 1470, 4274; Div. Ex. 125. Additionally, Harding and Merrill developed an entity in 2007 intended to direct investment in warehouse facilities of CDOs, with Merrill raising capital for the project. Tr. 1485-86; Div. Ex. 213. Harding received approximately $42.5 million in fees from Merrill-structured CDO deals, which includes the approximately $4.5 million that Harding received for managing Octans I. Div. Exs. 240, 240A.[14] Chau agreed that Harding's relationship with Merrill was important, but testified that he was not beholden to it, and, moreover, that Chau had similarly important relationships with other investment banks, including Citigroup. Tr. 4305-07.

Magnetar also had an important relationship with Merrill. In July 2006, Richard Lasch (Lasch),[15] a Merrill employee, told Dave Snyderman (Snyderman), a partner at Magnetar,

[13] Octans I, II, and II were named Dorado early in the structuring process. Tr. 1890.

[14] Division Exhibit 240A is a demonstrative created by Douglas Smith (Smith), a staff accountant in the Division of Enforcement, who testified as a summary witness. Tr. 2196.

[15] Lasch worked at Merrill from 1997 to 2009, first as a derivative documentation specialist, and ultimately in sales, with responsibilities for a large group of institutional investors. Tr. 108-11. In early 2006, Lasch was part of a CDO group that originated, structured, syndicated, and sold

"[e]xtremely important to us that you know this partnership is the top priority of the cdo group (top to bottom) . . . [the Merrill CDO group] view[s] you as an issuer rather than a [counterparty]. Their ultimate goal is to maximize your return with the best structure possible" and "[Merrill's] hope is to do a lot of business with you . . . so that relationship is important." Tr. 187-89; Div. Ex. 121. Lasch updated Merrill's Director of Investor Client Coverage Group that

> [c]ontinuing to institutionalize the [Magnetar] account is paramount as they will be very loyal to those that help them early. A great example of a very sophist[ica]ted and nimble client that will be heavily involved in a multiple of products . . . if approached correctly, they should prove to be an extremely valued and profitable Merrill Lynch partner for years to come.

Tr. 194-95, 197; Div. Ex. 181. Margolis wrote to Snyderman on August 18, 2006, following release of the pricing for Octans I, "[w]e view our relationship as a partnership and will do whatever it takes to make this(/future) transaction(s) successful and are committed to helping your platform in every way possible." Div. Ex. 147. Magnetar's importance to Merrill was largely due to its willingness to purchase equity in CDOs, which was a rarity in the CDO market. Tr. 144-46, 186. Lasch testified that equity investors sometimes had considerable influence in the structuring of CDOs. Tr. 144-45. Chau, too, agreed that equity purchasers had considerable leverage in the industry, at one point stating that "underwriters were lining up at the door" to do CDOs with Magnetar. Tr. 1792.

Magnetar and Merrill began meeting in the spring of 2006 to set up a series of CDOs in which Magnetar would purchase the equity and Merrill would structure the CDOs; these CDOs included, among others, Octans I, II, and III, and many were managed by Harding. Tr. 116-19; Div. Exs. 11-12, 274. On April 18, 2006, Lasch wrote to James Prusko (Prusko) of Magnetar: "[P]helps is coming back to me on cdo meeting. . . . [I]dea would be to have you as a partner early in [t]he construction of deal and portfolio. Then we can talk [a]bout equity investment. U agree with that approach [r]ight?" Div. Ex. 11.

4. <u>Magnetar</u>

Magnetar is a hedge fund, founded by Alex Litowitz and launched in September 2005. Tr. 197, 2328; Resp. Ex. 880 at 2. In 2006, Magnetar had a fixed income mandate, and Prusko[16]

CDO notes to investors, and in that capacity he communicated with Prusko frequently. Tr. 116-18. Lasch considered Magnetar his group's second-most-important client. Tr. 112. Lasch currently works at SunTrust in Boston as a corporate bond salesman. Tr. 198.

[16] Prusko is a portfolio manager at Magnetar. Tr. 112, 2327-28. He received bachelor's and master's degrees from the Massachusetts Institute of Technology in chemical engineering, and an MBA from Dartmouth. Tr. 2325-26. After earning his MBA, Prusko worked for Putnam Investments for eleven years until 2003, after which he worked at two hedge funds before joining Magnetar at its launch in September 2005. Tr. 2325-26. At Putnam Investments, Prusko led the investment grade credit group. Tr. 2326.

and Snyderman, Prusko's supervisor, started a fixed income group to satisfy the mandate. Tr. 2326-27. In 2006, Magnetar was actively investing in equity tranches of CDOs and working with the underwriters of those CDOs, which were all named after astronomical constellations. Tr. 139-40, 1490, 1577; *See* Resp. Ex. 785. Magnetar had no ability to analyze RMBS securities in early 2006, having no one with a background in credit analysis or any tools, such as Intex, to perform cash flow evaluations. Tr. 2330-31.

5. <u>Octans I Co-issuers</u>

Octans I had two co-issuers, Octans I CDO Ltd. (the issuer) and Octans I CDO LLC (the co-issuer).[17] Div. Ex. 3 at 4, 131-33. The issuer was a Cayman Islands SPV formed on June 19, 2006, for the purpose of executing the closing documents, including the CMA, purchasing the collateral from the warehouse, and issuing the debt securities of Octans I. Tr. 3146; Div. Ex. 3 at 4, 131-33. The issuer was self-liquidating, following maturity of the notes. Div. Ex. 3 at 131. The co-issuer was a Delaware SPV formed on June 23, 2006, for the sole purpose of executing the closing documents and acting as issuer for U.S.-based sales. Tr. 3144, 3146; Div. Ex. 3 at 131. The co-issuer's role was more limited than the issuer's; the co-issuer owned no assets, was not a party to the CMA, and had no employees. Tr. 3147. The issuer and co-issuer had no physical locations; instead, they were administered and received correspondence at the issuer's independent administrator's office in the Cayman Islands and the co-issuer's independent manager's office in Delaware. Div. Ex. 3 at 131-32. According to the engagement agreement between Merrill, Magnetar, and Harding, Merrill had responsibility for establishing the issuer and co-issuer. Div. Ex. 24 at 1. The issuer and co-issuer were formed by Merrill and Schulte. Tr. 2961, 3133-34. The issuer and co-issuer and their representatives had no independent involvement in the deal during the ramp. Tr. 2960.

The indenture governed the administration of payments by the trustee to investors, and governed what credit events triggered a default. Div. Ex. 3 at 105-09. The indenture named JPMorgan Chase Bank, National Association as trustee for the CDO. *Id*. at 114. Any trades made by Harding after the creation of Octans I were required to be communicated to the trustee, and according to Chau, Harding fulfilled that responsibility. Tr. 4338. Trades were not communicated to either the issuer or co-issuer. Tr. 4337.

Donald Puglisi (Puglisi)[18] was the independent manager of the co-issuer. Tr. 3132. Puglisi and his firm, Puglisi and Associates, served as independent manager to between 1,800 and 2,100 CDOs and collateralized loan obligations (CLOs) in 2006. Tr. 3128, 3131.

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[17] An issuer typically has no role in preparing the pitch book, determining eligibility criteria, or answering questions from investors. Tr. 4264. The issuer is typically established after the engagement letter is signed and shortly before the closing of the CDO. Tr. 4265. CDO closings typically occur at the underwriter's offices or at counsel for the underwriter's offices. Tr. 4266.

[18] Puglisi earned a bachelor's degree and MBA from Michigan State University, and a Ph.D. from Indiana University in accounting and finance, after which he taught at the University of Delaware until retirement in 2001. Tr. 3128.

Puglisi was contacted by lawyers from Schulte, which acted as counsel both for Merrill and for the Octans I co-issuers. Tr. 3133-34, 3137-38; Div. Ex. 3 at 238; Resp. Ex. 933. All of his interactions regarding Octans I were with Schulte. Tr. 3143. Puglisi has no specific recollection of the Octans I CDO closing; he may have attended the closing in person at Schulte's office, which he often did because he had power of attorney from issuer SPVs, and could sign documents on their behalf, though the power of attorney for Octans I also granted an attorney from Schulte the ability to execute documents on behalf of the issuer. Tr. 3138-39; Resp. Ex. 46. On rare occasions, Puglisi had comments about offering circulars, which he forwarded to the appropriate lawyers, although he has no specific recollection whether he had any comments regarding the Octans I circular. Tr. 3142-43. Puglisi did not execute the offering memorandum, but the co-issuers authorized it by corporate resolution. Tr. 3141. He was never involved in the marketing or structuring of the CDO, and he did not review any pitch books or marketing materials. Tr. 3153-54. Puglisi had little concern for the structure of the CDO or who the investors were. Tr. 3150-51. For instance, Puglisi had heard of Magnetar and that it was alleged to have purchased the "preferred" shares in Octans I, but he had no actual knowledge of that fact. Tr. 3149-50.

6. Octans I Investors

a. Doug Jones

Doug Jones (Jones)[19] was brought in by Maxim in July 2006 to replace Chau after Chau moved his business to Harding, and to build the new group Maxim Capital Management (Maxim Capital). Tr. 2808. Maxim Capital, with underwriters, created its own CDOs and served as manager, and Jones' team selected the collateral. Tr. 2812. Its first CDO, Maxim 1, which was priced in December 2006, was a high-grade deal, comprised mostly of Aaa-rated RMBS. Tr. 2814-16. Maxim 1 had a CDO bucket, and it invested $7 million in the "B" tranche of Octans I, which were AA-rated, and $5 million in the "E tranche," which were A-rated. Tr. 2821-24; Resp. Ex. 750. Jones originally sought $15 million of Octans I securities for Maxim 1, but was limited to purchasing $12 million by Merrill, which acted as the warehouse for Maxim 1. Tr. 2825.

Jones testified that in deciding which CDOs to invest in, Maxim Capital performed some diligence on managers to determine their level of experience, their resources, and their ratings, and to ensure that they were not just "two guys and a Bloomberg," a pejorative term for managers. Tr. 2836-37, 2874-76, 2882. Jones never had reason to doubt Harding's abilities. Tr. 2838. Most important to Jones, however, was the underlying collateral in the CDOs. Tr. 2839, 2875, 2906. Maxim Capital performed its own diligence on the underlying collateral of the CDOs in which it invested. Tr. 2844, 2893-94.

[19] Jones started his finance career in 1985 at Salomon Brothers in its mortgage fixed income department, and then earned an MBA at Columbia Business School. Tr. 2807-08. After earning his MBA, he worked at MetLife as a mortgage trader, then went to Bear Stearns, where he was a portfolio manager for twelve years before starting at Maxim Capital. Tr. 2808. After leaving Maxim Capital in 2011, Jones started his own hedge fund, Candlewood Investment, dealing with structured credit bonds. Tr. 2870.

b. Ken Doiron

Ken Doiron (Doiron)[20] works for the Hartford Investment Management Company (HIMCO), an affiliate of The Hartford Financial Services Group, Inc., which maintains approximately $100 billion in assets, averages $20 billion in revenue, and has approximately 20,000 employees.[21] Tr. 1857-58. Since 2008, Doiron has led HIMCO's asset management group for private placements. Tr. 1858. HIMCO, with Doiron as lead portfolio manager, created a $1.2 billion CDO in 2006 called Wadsworth, and served as its collateral manager. Tr. 1863-64; Resp. Ex. 720. Wadsworth's underlying assets included RMBS and CDOs. Tr. 1870, 1876. As part of HIMCO's due diligence for Wadsworth assets, Doiron and his team reviewed marketing presentations for the CDOs, including sections regarding the collateral manager, and performed analysis on the collateral underlying the CDOs in the same manner that they would for the RMBS. Tr. 1874-77. Though Doiron and his team performed their own analysis on the collateral, Doiron expected that disclosures in the marketing materials would be accurate, and relied on the collateral managers' expertise on their CDOs' underlying assets. Tr. 1875-77, 1883, 2063. Members of Doiron's team spoke with Chau, and concluded that Harding was a "sound collateral manager," and his "knowledge of the collateral [was] strong." Tr. 1965-69; Resp. Ex. 612. Wadsworth invested $6 million in Octans I in two tranches, rated AA- and A (Standard & Poor's). Tr. 1927-29, 2022; Div. Ex. 177 at A-8. HIMCO's Octans I investment comprised about one-half of one percent of Wadsworth's capitalization. Tr. 2022-23; Div. Ex. 177.

Doiron and his team at HIMCO reviewed assets by examining qualitative factors, such as the geography and FICO scores of the underlying collateral, and quantitative factors, such as loss curves, prepayment analyses, and historical information. Tr. 1870-71. HIMCO used cash flow analysis software called Intex, and ran multiple analyses using base case and stress case scenarios. Tr. 1871-72. For assets to be placed in HIMCO CDOs, there had to be consensus among the credit committee. Tr. 1878. HIMCO reviewed the assets underlying Octans I, and performed cash flow runs, using Intex, of Octans I's underlying RMBS. Resp. Ex. 611.

Doiron testified that he expected collateral managers to perform due diligence on prospective collateral beyond reliance on credit ratings and marketing materials, and he expected CDO managers to pick only assets with which the manager was comfortable. Tr. 1882-83. He expected that managers would follow credit analysis procedures consistent with industry practice, and that credit analysts would make "yes" or "no" decisions on assets by consensus. Tr. 1885-88. Doiron expected that Harding based its Octans I asset purchase decisions on the standards set forth by Harding in the Octans I pitch book. Tr. 1898-99; *cf.* Div. Ex. 1 at 43.

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[20] Doiron received a bachelor's degree in management from Bentley University, and has worked at HIMCO since 1995, first in the accounting department, then in the structured finance department. Tr. 1859. In 2005 and 2006, Doiron headed the structured finance department at HIMCO responsible for asset backed securities, including RMBS and commercial mortgage backed securities. Tr. 1860.

[21] Doiron testified only as a lay witness. Div. Reply at 16 n.23; *cf.* Resp. Br. at 203.

c. Michael Edman

In 2006, Michael Edman (Edman)[22] was a managing director on Morgan Stanley's proprietary trading desk, investing Morgan Stanley capital in, among other things, CDOs. Tr. 2498-2500. Edman's group took both long and short positions in CDOs, and many of the positions, including a stake taken in Octans I, were part of its long/short strategy. Tr. 2566-68. Morgan Stanley took a $975 million long position in Octans I super-senior, Aaa-rated securities by selling protection on the tranche to Merrill. Tr. 2500-01, 2532; Resp. Ex. 916.

The Morgan Stanley proprietary trading desk was a sophisticated investor and was able to rigorously analyze assets before purchase. Tr. 2504, 2521. Edman and his team considered the underlying assets and the structure of a CDO to be among the most important components of an investment decision. Tr. 2504. Someone in Edman's group normally reviewed the offering circular of a CDO as part of the investment decision process. Tr. 2507. Additionally, Morgan Stanley negotiated for strong protections, including low collateral tests, high subordination, and stipulations regarding collateral managers' positions in the CDOs. Tr. 2549-50, 2553-54; Div. Ex. 258; Resp. Ex. 918. Despite all of the representations made by collateral managers regarding their selection of assets, Edman always assumed that the managers would perform at the lowest possible quality level, and would underwrite the assets to the worst-case scenario. Tr. 2561-62.

Edman was aware that Magnetar was purchasing equity and shorting tranches in the CDO market in 2006, based upon his general market knowledge, and he believed that other market participants would have been aware of Magnetar's presence and strategy. Tr. 2536, 2602. Magnetar's presence in deals that Morgan Stanley invested in was of little concern to Edman because Morgan Stanley would have all the information on the assets it needed and would perform its own underwriting on those assets. Tr. 2536-37. Edman did not find it unusual that Magnetar was a party to the Octans I warehouse agreement, because, as the equity purchaser, he expected Magnetar to take some risk in the warehouse. Tr. 2537. Edman did not believe that Magnetar's role in the warehouse or Magnetar's prior notice by Merrill and Harding of assets selected for Octans I would have influenced his investment decisions. Tr. 2538.

Octans I closed on September 26, 2006. Div. Ex. 239. The "SUPER SENIOR INVESTOR," presumably Morgan Stanley, inquired on the day of closing about Harding's ability to short out collateral without triggering a particular test, and Merrill forwarded Morgan Stanley's concern to Harding, with some "proposed solutions." Div. Ex. 258. Chen reacted negatively to Merrill's proposals, and sent an email to Chau, Huang, and Wang, complaining about "Another merrill jam job," and another email about twenty minutes later, stating that "If we give in to this we are truly a subsidiary of merrill." *Id.* Chau responded very early the following morning with "Emails are retained for 5yrs." *Id.* When questioned about this exchange, Chau was evasive, initially claimed not to know what Chen meant, and eventually characterized the email string – incredibly – as "idle banter." Tr. 1439-44.

[22] Edman graduated from the University of Pennsylvania in 1992, and then went to work at Morgan Stanley, where he remained until 2007. Tr. 2497.

C. <u>Harding's Standard of Care</u>

Chau agreed that Harding, as a registered investment adviser, owed a fiduciary duty to clients. Tr. 1494. Harding maintained a compliance manual and code of ethics, and the compliance manual described the firm's fiduciary obligations. Div. Ex. 122 at 4, 25 (of 87). The compliance manual states, in relevant part,

> As a registered adviser, and as a fiduciary to our advisory clients, our firm has a duty of loyalty and to always act in utmost good faith, place our clients' interests first and foremost and to make full and fair disclosure of all material facts and in particular, information as to any potential and/or actual conflicts of interest.
>
> *   *   *
>
> Every fiduciary has the duty and a responsibility to act in the utmost good faith and in the best interests of the client and to always place the client's interests first and foremost.
>
> As part of this duty, a fiduciary or an adviser with such duties, must eliminate conflicts of interest, whether actual or potential, or make a full and fair disclosure of all material facts of any conflicts so a client, or prospective client, may make an informed decision in each particular circumstance.

Id. at 3, 24.

The Octans I CMA states:

> 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 . . . (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.

Div. Ex. 4 at 8. The Octans I warehouse agreements provides similar language, requiring Harding to use "a degree of skill and attention no less than that which [Harding] exercises with respect to comparable assets that it manages . . . [and] in accordance with . . . reasonable and prudent institutional money managers of national standing." Div. Ex. 5 at 15-16.

The Octans I offering circular provides:

> The Collateral Manager shall, subject to the terms and conditions of the Collateral Management Agreement and the Indenture, perform its obligations thereunder . . . with reasonable care (i) using a degree of skill and attention no less than that which the Collateral Manager exercises with respect to comparable assets, if any, 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 that have been expressly delegated to it thereunder and under the Collateral Management Agreement.

Div. Ex. 3 at 197. The offering circular provides a disclaimer of liability as well:

> The Collateral Manager . . . will not be liable to the Co-Issuers, the Trustee, the Preferred Security Paying Agent, the Noteholders, the Holders of Preferred Securities, any Hedge Counterparty, the Credit Default Swap Counterparty or any other person for any losses, claims, damages, judgments, assessments, costs or other liabilities incurred by the Co-Issuers, Trustee, the Preferred Security Paying Agent, the Noteholders, the Holders of Preferred Securities, any Hedge Counterparty, the Credit Default Swap Counterparty or any other person for any action taken or omitted to be taken or omitted to be taken by any of them under the Collateral Management Agreement or in connection therewith; *provided, however*, that the Collateral Manager may incur liability to the Issuer under the Collateral Management Agreement by reason of (i) any act or omission constituting bad faith, willful misconduct, gross negligence or reckless disregard in the performance of the Collateral Manager's obligations under the Collateral Management Agreement and (ii) the information concerning the Collateral Manager provided by it in writing for inclusion in this Offering Circular under the heading "The Collateral Manager" and the subsections of Risk Factors entitled "Conflicts of Interest Involving the Collateral Manager," "Dependence on the Collateral Manager and Key Personnel" and "Relation to Prior Investment Results" containing any untrue statement of material fact or omitting to state a material fact necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading. The Collateral Manager will not be liable for any actions taken or omitted to be taken at the express direction of the Issuer, the Trustee or other person entitled under the Indenture to give such direction.

Id. Similar representations and disclaimers exist in the offering memoranda for Jupiter High Grade CDO VI, Ltd. (Jupiter VI), Lexington Capital Funding V Ltd. (Lexington), 888 Tactical Fund, Ltd. (888 Tactical Fund), and NEO CDO 2007-1 (NEO), into which Harding placed Norma bonds. *See* Div. Ex. 503 at 97-98; 507 at 156; Div. Ex. 509 at 159; Div. Ex. 513 at 174.

D. <u>Harding's Credit Processes and Standards</u>

1. <u>Bond Selection Options</u>

There were several ways Harding credit analysts "selected" synthetic bonds to ramp CDOs. One way was by answering OWICs, which were lists put out in the market inviting other participants to bid on selling protection on referenced RMBS assets. Tr. 3724. Upon receipt of an OWIC, the credit department would first determine whether it had already performed credit analysis on any of the bonds in the OWIC, in which case it merely updated performance and cash flow analyses. *See* Tr. 4024-25.

Another selection method involved sifting through the universe of RMBS bonds; the bonds that survived credit review were then submitted to the market through a BWIC, soliciting bids to serve as counterparty. Tr. 3715-16, 3725-26. Another selection method involved purchasing the ABX Index and shorting the names that credit analysts rejected. Div. Ex. 152; Resp. Ex. 384.

After securing CDO deals for Harding management, Chau informed Lieu that Harding would select synthetic bonds using its normal credit process, but gave no guidance on the "vintage" of the bonds. Tr. 3354. Among the universe of mezzanine bonds, Harding's credit analysts approved around 20% for inclusion in Harding-managed CDOs, but that percentage was not required, it was simply a result of Harding's credit review process. Tr. 3309, 3572, 3735-36; *see* Div. Exs. 26, 29.

2. <u>Harding Credit Standards</u>

The Octans I pitch book represented that Harding took a fundamental approach to portfolio management as its investment philosophy. Div. Ex. 1 at 43. As investment objectives, Harding represented that it would invest in high quality assets with stable returns and superior capital preservation profiles, and maximize returns and minimize losses through rigorous upfront credit and structural analysis, as well as ongoing monitoring of asset quality and performance. *Id.* Harding represented that its approach to investing employed top/down economic analysis to determine sector allocation, bottom/up credit and structural analysis to identify individual investments, analysis of historical spreads to optimize relative value, in-depth credit review to determine the suitability of each potential transaction in the context of the CDO, and active monitoring of delinquency and loss trends. *Id.*

For sector allocation, Harding represented that it would analyze: corporate and consumer credit cycles; commercial and residential real estate market fundamentals, trends, and valuations; interest rate environment and expectations; and regional and global economic conditions. Div. Ex. 1 at 44. It also represented that it would monitor industry fundamentals, such as: industry loss curves, delinquencies, and recoveries; issuer-specific delinquency, loss, and prepayment trades; performance data from third-party vendors, trustee reports, and rating agencies; regulatory and legal issues and trends; and competitive pressures and growth constraints. *Id.*

For individual asset selection, Harding represented that it would employ a disciplined bottom/up credit and structural analysis that would include focus on key drivers of credit performance, such as: credit enhancement and structural protection based on expected loss scenarios relevant for the particular asset class and collateral profile; stress testing of each transaction under extreme interest rate and prepayment rate assumptions to capture the tolerance for losses of the underlying collateral pool; and determining the overall creditworthiness of investments coupled with a broad-based understanding of originator performances and quality of servicing platforms. Div. Ex. 1 at 45. Harding further represented that it would: perform a detailed loan-level analysis on loan-to-value statistics, credit scores, debt-to-income ratios, lien status, geographic concentration, loan purpose, interest-only loan concentrations, occupancy status, and documentation level to assess the credit risk of the underlying asset pool; stratify higher risk categories of the collateral pool to assess the ability of borrowers to repay debt; and evaluate the embedded prepayment options inherent in mortgage-related assets to determine the average life variability and duration drift of the securities under review. *Id.*

Harding's credit reviews were represented as involving "in-depth analysis of the collateral pool and the deal structure," including review of the collateral and the deal structure, and stress testing of the bonds. Div. Ex. 7 at 6-8. Harding's December 1, 2005, Investment and Surveillance Procedures manual states, "the members of the portfolio management team (which will consist of at least two people) analyzing each deal will summarize the relevant deal characteristics and stress run results and present the transaction to a senior portfolio manager." *Id.* at 8.

Lieu's testimony regarding the actual practices of the credit team at Harding was confusing and inconsistent. On the one hand, Lieu testified that consensus among credit analysts was a goal; if credit decisions were unanimous, the credit analysts could sometimes make the decision to purchase bonds for the ramp without further approval. Tr. 3269-70, 3555-56. If she and Moy had different credit opinions, they would discuss the differences and come to a unified decision; if they could not reach consensus, the decision was brought to a portfolio manager, namely, Chau or Huang. Tr. 3259, 3263, 3269-70, 3553, 3556, 3938-39. Lieu testified that the only times that she or Moy made unilateral decisions were when one or the other was out of the office. Tr. 3262, 3268. On the other hand, Lieu testified that she and Moy did not need to check each other's work, and that it was not necessary to reach unanimous decisions on bonds, because the portfolio manager made the final decision. Tr. 3259-61. She stated that "[t]here were no set rules saying that both of [them] had to review the bonds." Tr. 3269. Lieu believed that there were occasions that she or Moy were overruled. Tr. 3372-73. During the investigation of this case and in depositions in another case, Lieu learned that she, herself, had been overruled. Tr. 3371-72, 3390-91, 3393-94.

The contemporaneous evidence shows that Lieu and Moy did not always coordinate decisions, and that at least several decisions were at odds with one another, yet those bonds were approved without intervention by a portfolio manager. *See, e.g.*, Tr. 3400-01, 3554-56; *compare* Div. Exs. 70-71 *with* Div. Ex. 65-66. Lieu agreed that it was not unusual for her to have differences of opinion with Moy on credit decisions for OWIC or BWIC lists. Tr. 3558-59, 3561. Lieu made the credit decisions for the ABX Index bonds on May 31, 2006, alone, and those decisions were accepted by Huang, who simply forwarded the names to Merrill.[23] Tr. 3697, 3934; Div. Exs. 70-71, 82; Resp. Ex. 491.

Prior to closing CDOs, Chau certified that the assets being purchased by the CDOs met all of the eligibility and investment criteria of the CDO. Tr. 4252-53. Chau represented that the certification process offered "checks and balances," including by the underwriter and the ratings agencies, to ensure that the assets met all of the criteria. Tr. 4253; *see* Div. Ex. 501. Before the

[23] Lieu testified that the portfolio manager did not make any actual decision until the warehouse was fully stocked. Tr. 3937.

CDO closed and the assets in the warehouse were purchased, Harding could change its mind about any of the bonds. Tr. 3937.

Credit decisions by the analysts at Harding changed over time. Tr. 3614. Though the structural characteristics of an RMBS or CDO did not change, the collateral characteristics evolved as individual loans left the bond. Tr. 3377-78. Performance metrics of the bond also changed over time. Tr. 3378.

3. Credit Review Factors

The credit analysts at Harding reviewed several factors when deciding to purchase bonds. Tr. 3282. First, they analyzed the actual loans that were in the pool backing the RMBS, including particularly risky and mitigating factors (collateral attributes). Tr. 3283. Second, they reviewed the performance records of previously issued bonds. Tr. 3283. Third, they ran cash flow analyses using Intex, which performed multiple iterations of cash flow projections, using multiple variables and inputs, and produced a spreadsheet with aggregate and individualized projections. Tr. 3283.

For the collateral attributes, credit analysts at Harding reviewed, among other things, collateral stratification, issuer and mortgage servicer quality, FICO scores, loan-to-value ratios, and credit enhancement. Tr. 3838, 4077, 4243-44. The credit analysts would also focus on whether the security was performing worse than its benchmark, and determine if there were any other risk factors associated with the bond. 3832. They created what were known as either a "deal compare" or "collateral compare"; these files allowed the credit analysts to view the idiosyncrasies among bonds in the same series from the same dealer shelf. Tr. 3835-39. The analysts wanted to be mindful of trends regarding changes in originator, lessening of underwriting standards, loan-to-value, and percentages of second liens. Tr. 3836-39. For example, a collateral compare for a bond in a series known as SAIL compared one bond to two earlier bonds by the same originator. Tr. 3837; Resp. Ex. 941-B.

Credit analysts used Intex by inputting assumptions and the data for the bond; the most critical assumptions were the default rate, the default severity rate, and the cumulative loss rate.[24] Tr. 3299, 3314-15, 3955-56. Two predominant metrics were used to forecast principal write-downs through cash flow analysis in Intex: cumulative losses, the cumulative amount of losses that the pool of loans will experience during the lifetime of the underlying mortgages, and cumulative default rate, also referred to as conditional or constant default rate (CDR), the (annualized) monthly default rate. Tr. 3313-14. Harding credit analysts used both metrics at different times, and use of both metrics required assumptions about loss severity, the percentage loss on a foreclosure. Tr. 3314-16, 3670 ("Cumulative loss equation is default rate times loss severity."); Div. Ex. 8001 at 21 n.15. Cumulative loss projections were usually run using a "base case" and a "stress case"; the former represented expected losses based upon market forecasts at the time and the latter represented losses in a stressed market. Tr. 1874, 3327. Lieu testified that bonds projected to experience principal write-downs were rejected. Tr. 3335-36. If bonds had

[24] Lieu has run cash flow projections thousands of times in her career as a credit analyst. Tr. 3610-11.

been previously reviewed by Harding's credit department, the analysis had to be updated with new performance information and cash flow runs. Tr. 3296-97; *see also* Tr. 2172-73.

After receiving feedback from other managers reviewing the same types of securities, Harding lowered its cumulative loss assumptions in the spring of 2006 because they were too conservative.[25] Tr. 3343-45, 3635-36; *see* Tr. 4244-45. Lieu testified that the decision to lower the cumulative loss curve assumptions was prompted organically, not by Chau individually, though Lieu acknowledged that a senior officer of Harding would have to approve those changes.[26] Tr. 3948-49.

4. Credit Review Timing

According to Lieu, the amount of time Harding credit analysts needed to evaluate each bond depended on the analysts' familiarity with the loan originator, servicer, and deal. Tr. 3286-87. If she was already familiar with the originator and servicer and had previously reviewed all the collateral information, she only had to refresh the performance information and cash flow analysis, which took between thirty minutes and three hours, depending on the bond; if she had not previously analyzed the security, or she was unfamiliar with the servicer or originator, her analysis might take as long as one day.[27] Tr. 3286-87. If starting from scratch, it could take hours to run a loss curve on a security, but if the analyst had already seen or reviewed the bond before, it would take significantly less time.[28] Tr. 2169-71, 3287.

Lieu always felt as though she had adequate time to review bonds before making a credit decision, including the forty ABX Index bonds she reviewed on May 30 and 31, 2006. Tr. 3303, 3686-87, 3693-94. Lieu testified that she specifically had ample time to review the eleven ABX Index bonds that she had not seen before, and refresh data on the other twenty-nine ABX Index bonds, so that she could make informed decisions; despite their being "new bonds," she was familiar with the bond series and bond names, as they represented some of the most liquid bonds in the market. Tr. 3999-4001, 4024-25.

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[25] Harding's Investment and Surveillance Procedures as of December 1, 2005, required stress testing for all bonds prior to purchasing for a Harding-advised portfolio and stress testing for sub-prime bonds with 20% delinquency and 40% loss severity; accordingly, at that time, the stress case cumulative loss percentage for the bonds was 8% (20% times 40%). Div. Ex. 7 at 7.

[26] Chau testified that cumulative loss assumption levels were decided by senior management at Harding, either Chau himself, Huang, or Wang, in conjunction with Harding credit staff. Tr. 4244.

[27] Adding to the difficulty of evaluating a new deal is that it lacks performance history, and the only evaluative criteria are original loan characteristics. Tr. 3740-41.

[28] In contrast, Doiron testified that it took his group between eight and sixteen man hours to fully review one RMBS. Tr. 1873-74.

Chau testified that the time necessary to review the forty ABX Index bonds would have been shorter than for most bonds, because the ABX Index includes the same twenty bonds at each credit level, and bonds surviving Harding's credit tests at the Baa3 level would, according to Chau, survive at the Baa2 level and higher, and thus did not need additional review. Tr. 4250-51. Chau added that the credit analysts already had a lot of knowledge of the bonds in the ABX Index prior to reviewing them in May 2006, because the bonds represented the most liquid deals in the market. Tr. 4252. Huang was comfortable with the ABX Index block trade and did not feel that he was forced into it by any party. Tr. 1267.

In May 2006, Harding's credit department was busy and could not review all OWICs. Tr. 3302-03. On May 31, 2006, and June 1, 2006, Harding selected approximately $500 million in total assets to warehouse for Octans I. Div. Ex. 6; Resp. Exs. 317-21, 327. Thus, including the ABX Index trade, Harding selected a substantial fraction of the entire assets for Octans I on and around May 31, 2006. At one point, Lieu expressed frustration with the volume, noting, after being pressed for names of bonds from an OWIC, that there was no "quick way" to analyze bonds. Tr. 3302-06; Div. Ex. 27; *see* Div. Ex. 26.

5. <u>CDO Review Process</u>

For CDOs, Harding's policy was to employ a three-step process: (i) review the collateral manager; (ii) review and analyze the collateral; and (iii) review and analyze the deal structure.[29] Div. Ex. 7 at 10. Review of the CDO manager included analyzing the manager's experience and performance, the alignment of interest in the CDO, the manager's commitment to the CDO business, the manager's investment philosophy and process, and the manager's portfolio management style, including the trading pattern for the manager's prior CDOs. *Id.* at 10-11. The collateral review required an aggregate portfolio review, an asset-by-asset review, and a market value analysis. *Id.* at 11. The deal structure review included review of the structural features and hedges; static cash flow analysis, including review of scenario analysis on Intex and relative value analysis; and possibly a "dynamic analysis" involving a "[s]imulation based approach to tranche pricing and risk analysis." *Id.* at 11-12.

At Harding, third-party CDOs were reviewed primarily by Chen, Huang, and Chau. Tr. 4095. Chau relied upon Huang's and Chen's mathematical skills to go through the CDO collateral, create standard deviations, determine default probabilities, and evaluate how those potential defaults could affect the tranches Harding considered selecting. Tr. 4113. Credit analysts, including Moy and Lieu, reviewed the underlying CDO collateral but not the CDO itself. Tr. 4094-95.

Chau testified that review of CDOs is different from review of RMBS because of the indirect relationship between the RMBS and the CDO, and because losses at the RMBS level are muted by the capital structure of the CDO. Tr. 4147. Chau explained, "As that loss curve shape goes into the CDO structure, that shape, again, would get retransformed, and I get a different loss

[29] Chau testified that the analysis proceeded in the reverse order: initially focusing on the capital structure of the CDO and its collateral assumptions; secondly on the collateral underlying the CDO; and thirdly on the collateral manager. Tr. 4114-15.

curve structure. What we're looking at is we can't figure out that relationship because it's very difficult to figure out all these transformations, so now, we're just looking at the CDO BBB investment itself, and we're looking at the probability of default, in this case for Norma, for example, we just went through that process." Tr. 4150.

Harding also analyzed RMBS for the purpose of looking at collateral being selected by other investors and to gauge market interest in those assets; Chau testified that it was valuable for him to ascertain what investments make sense to market participants. Tr. 4142. Accordingly, it was not concerning to Chau that a significant portion of underlying RMBS in CDOs Harding selected were either rejected or would be rejected by Harding credit analysts. Tr. 4145-46.

The level of analysis on the collateral within CDOs depended upon the CDO manager. Tr. 4391. For managers that Harding was comfortable with, Harding analysts performed less rigorous analysis, though the credit analysts would still gather and review the same stratifications. Tr. 4391. In some instances, with larger CDO managers, Harding relied heavily on the marketing materials, because "worrying about eligibility criteria is probably not on the highest order of input variables we need to make a decision." Tr. 4391-92.

Octans I

A. Octans I Structure

Approximately $1.5 billion of Octans I notes were offered to investors, in ten tranches, collateralized by 183 RMBS at the time Octans I closed. Div. Ex. 3 at i; Resp. Ex. 4 at Schedule A. Each of the assets in Octans I was disclosed to investors in the indenture. *See* Resp. Ex. 4 at Schedule A. Harding did not invest in Octans I, which collateral managers sometimes do to have "skin in the game." Tr. 2709. Octans I investors were all sophisticated; they included mainly other CDO managers that placed Octans I into their managed CDOs, as well at least one institutional investor, Cathay United Bank.[30] Tr. 4259; Resp. Ex. 750.

1. Engagement and Warehouse Agreements

Harding (then Maxim) was engaged as collateral manager by Merrill on May 26, 2006, for a private placement offering of a CDO with original aggregate principal of $1 billion to $1.5 billion, with multiple tranches rated Aaa through Baa2. Div. Ex. 24 at 1. Pursuant to the engagement agreement, Harding would receive fees equal to .1% per annum of the average aggregate outstanding principal balance of the collateral, and subordinated management fees

[30] Chau testified "participants in the CDO industry . . . come[] in with their eyes wide open. They understand that buying into a CDO transaction, each if you're buying the AAA senior tranche, is not the same as buying the AAA government rated security. Even though they carry the same ratings, the risk/return are substantially different. And it applies for every tranche in the CDO structure." Tr. 4257. According to Chau, investors that participate in CDOs are aware of the level of risk associated with CDOs, and they are willing to assume that risk in order to earn high interest, because they understand that as the spread increases, there is more risk involved. Tr. 4257-58.

equal to .05% per annum of the aggregate outstanding principal balance of the collateral. *Id.* at 4. Chau signed the engagement letter on behalf of Maxim. *Id.* at S-1.

Harding, Merrill, and Magnetar all executed the warehouse agreement around May 26, 2006. Div. Ex. 5 at 1. Merrill was obligated to hold the CDO collateral assets as they were accumulated prior to the CDO closing. *Id.* at 2. Magnetar was a party to the warehouse agreement, and took, in essence, 85% of the warehouse risk and warehouse earnings. Tr. 2417, 2448-49; Div. Ex. 5 at 5-7.

Harding was obligated to "select each Collateral Obligation" for the warehouse, and to promptly notify Merrill and Magnetar of its selections. Div. Ex. 5 at 2. Similarly, it could "identify Reference Obligations . . . for possible inclusion" in the warehouse, as to which Merrill could contract with the issuer for credit default swaps. *Id.* at 3. However, if Magnetar objected to a particular collateral or reference obligation, Merrill was not required to acquire the collateral and was not permitted to contract for a CDS on the reference obligation. *Id.* at 2-3. It was not unusual for a party like Magnetar, which was assuming a substantial portion of the warehouse risk, to have the ability to object to assets. Tr. 2436, 2448-49, 2541. Prusko and Chau agreed that Magnetar never vetoed or objected to any collateral or reference obligations during the Octans I ramp. Tr. 1807; 2431.

Chau believed at the time that Magnetar's right to object was, as a practical matter, a "veto" right.[31] Tr. 1802-09. He also believed that such veto rights compromised Magnetar's independence. Tr. 1819-21.

Harding was required to promptly notify Merrill and Magnetar if a warehouse security, or the warehouse portfolio itself, failed to meet eligibility criteria. Div. Ex. 5 at 5. However, if Merrill consequently designated a security for removal from the warehouse, Magnetar had the right to veto such designation. *Id.* That provision provided protection for Magnetar, as Prusko explained:

> Under certain market conditions, that CDO won't be able to be created; or there could be losses in the warehouse . . . [a]nd certain permutation of any of those events could give Merrill, as the holder of the total warehouse, the right to liquidate that warehouse into the market, which would then cause the calculation of losses to be imposed upon whoever was taking the first loss, which was Magnetar.

Tr. 2419-20. Magnetar also had the right to seek collateral at the same time as the dealer, the right to see pricing terms of the collateral before it went into the deal, and the right to agree on the pricing before it went into the warehouse. Tr. 1809-10; Div. Ex. 5 at 2.

[31] Chau testified, once in investigative testimony and once in a civil deposition, that he understood at the time that Magnetar's right to object was in effect a right to veto, although at the hearing he explained that his understanding at the time was mistaken. Tr. 1802-09.

Chau instructed Harding staff to send the trade lists to Magnetar. Tr. 1815-17. Harding also provided Magnetar with lists of bonds on which Harding was offering to buy protection, pursuant to Magnetar's request and the warehouse agreement. Tr. 1817-19.

2. Octans I Pitch Book

The pitch book was primarily drafted by Merrill; however, Harding provided information for the sections of the pitch book describing Harding, and Chau and Wang reviewed them for accuracy. Tr. 367, 385, 1824; *see* Div. Ex. 1 at 37-59. Lieu contributed some content for the pitch book sections discussing credit and structural review for bonds, although the content she wrote usually went through many edits. Tr. 3565-66. Chau was ultimately responsible for the contents of the pitch book as it pertained to Harding. Tr. 1829. He did not recall reviewing the pitch book in its entirety, but agreed that he would have mentioned errors to appropriate parties if he became aware of them. Tr. 1838.

The Octans I pitch book, which was prepared and distributed prior to the CDO's closing, described: the structure of the proposed CDO, including the rating and approximate amount of each tranche; an overview of the expected portfolio composition; the collateral assumptions, including the expected coverage tests; and the risk factors. Div. Ex. 1 at 6, 16-19, 27-34. Although the pitch book was apparently distributed to multiple investors, the exact number and identity of recipients is unclear, especially as to unconsummated sales. *See* Resp. Ex. 187 (Merrill distributed pitchbook to a prospective investor); Resp. Ex. 750 (listing actual investors). The pitch book provided background on Harding, including its investment philosophy and process and its portfolio surveillance and monitoring process. *See* Div. Ex. 1 at 37-55. The pitch book also provided introductions to Harding's management team, including an illustration of the firm's structure and a description of key individuals. *See id.* at 40, 57-59. According to Huang, Harding presentations typically tracked the pitch book in investor meetings. Tr. 1043.

The pitch book described potential conflicts of interests related to Merrill's control over the warehouse:

> *Conflicts relating to Purchase of Collateral Debt Securities.* It is anticipated that many of the securities that will be purchased by the Issuer on the date on which the Offered Securities are issued 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. The Issuer will purchase securities included in such warehouse portfolio 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 purchase price payable by the Issuer for such securities will be based on the purchase price paid when such securities were acquired under the warehousing agreement, accrued and unpaid interest on such securities as of the date they are acquired by the Issuer and gains or losses incurred in connection with hedging arrangements entered into with respect to such securities. Accordingly, it is likely that the Issuer will bear the risk of market changes subsequent to the acquisition of such securities and related hedging arrangements

> pursuant to the warehousing agreement as if it had acquired such securities directly.

Id. at 32. However, the pitch book did not describe Magnetar's rights in the Octans I warehouse – indeed, it did not mention Magnetar by name at all. Tr. 1821, 1844; *see generally* Div. Ex. 1.

Chau agreed that the first sentence from the pitch book, quoted immediately *supra*, was not accurate. Tr. 1844. He explained that the failure to disclose Magnetar's involvement in the warehouse agreement was an oversight, that he relied upon counsel to ensure that the proper level of disclosure was made, and that he would have notified Merrill's counsel if he had noticed the error. Tr. 1847-49. In July 2006, after Eliran sent Chau and Wang a draft of the pitchbook, Wang commented on a paragraph entitled "Conflicts of Interests of Collateral Manager," a paragraph for which Harding was responsible. Tr. 377-78; Div. Ex. 124 at 1. Suh did not review the pitchbook. Tr. 3072-73, 3115.

B. Collateral Management Agreement

The CMA, which became effective on the date that the CDO closed, appointed Harding as collateral manager to Octans I and authorized Harding to perform the services set forth in the agreement, including supervising and directing the disposition and acquisition of assets. Div. Ex. 4 at 3; Tr. 3126. The CMA provided that Harding would take all actions required under the Advisers Act.[32] Div. Ex. 4 at 6-7. Another paragraph of the CMA authorized Harding to "require the Trustee" to take certain actions "in the best interests of the Preferred Securityholders and Noteholders (and, to the extent that the interests of the Noteholders and the Preferred Securityholders conflict, in the best interests of the Noteholders)." Div. Ex. 4 at 5. However, this provision was "[s]ubject to . . . the provisions of the Indenture," and applied to Harding "as agent of the Issuer." Div. Ex. 4 at 4.

C. Offering Circular

The Octans I offering circular, dated September 20, 2006, described the offering amounts and classes, and the ratings assigned to each tranche. Div. Ex. 3 at i. The first page prominently mentioned that Harding was the collateral manager, and the same page listed Merrill as the underwriter. *Id.* The co-issuers, described on the first page, took responsibility for all representations in the offering circular, except for a few sections:

> The Co-Issuers accept responsibility for the information contained in this document. . . . Neither the Initial Purchaser nor any of its affiliates makes any representation or warranty as to, has independently verified or assumes any responsibility for, the accuracy or completeness of the information contained herein. Neither the Collateral Manager nor any of its affiliates makes any representation or warranty as to, has independently verified or assumes any

[32] CMAs are ordinarily between the collateral manager and the issuer or co-issuers, but the investment bank, not the issuer, selects the collateral manager in the early stages of structuring the CDO. Tr. 4262-63.

> responsibility for, the accuracy or completeness of the information contained herein (other than the information set forth herein under "The Collateral Manager," "Risk Factors-Conflicts of Interest Involving the Collateral Manager," "Risk Factors-Dependence on the Collateral Manager and Key Personnel").

Div. Ex. 3 at v. The offering circular also stated, in pertinent part, that the CDO's securities would be acquired "from a portfolio of Collateral Debt Securities selected by the Collateral Manager and held by [Merrill] pursuant to warehousing agreements between [Merrill] and the Collateral Manager." Div. Ex. 3 at 66. It also stated that some of the CDO's securities "subject to such warehousing agreement may have been originally acquired by [Merrill] from the Collateral Manager or one of its affiliates or clients." *Id.*

The offering circular defined the warehouse agreement as the "May 26, 2006 [agreement] between Merrill Lynch International and the Collateral Manager." Div. Ex. 3 at 299. Magnetar's role in the warehouse agreement was not otherwise disclosed in the offering circular, and, like the pitch book, it did not mention Magnetar by name at all. Tr. 4332-33; *see* Div. Ex. 3 at 66; *see generally* Div. Ex. 3. Chau agreed that the definition and disclosures in the offering circular were inaccurate because they failed to disclose Magnetar's role in the warehouse agreement. Tr. 2107.

According to Suh, the offering circular was generally the final offering document in a CDO deal. Tr. 3124. Pitch books and marketing materials provide material information to potential investors, but many disclosures and deal terms change as the deal evolves between the initial engagement and the deal closing. Tr. 3124-25. During the latter stages of the ramp, a "red" offering circular, with cautionary language in red warning that the circular is subject to change, is circulated to potential investors, and is updated as the deal changes. *See* Tr. 3078. As the CDO nears closing, a "black" offering circular, the final version, is circulated to investors who expressed interest in purchasing classes of securities in the CDO. Tr. 3076-78. According to Suh, the black circular is distributed with sufficient time for investors to review and decide whether to invest. Tr. 3076. Investors must certify that they relied upon the offering circular in making their investment decision. Tr. 3124-25.

Prior to circulating the offering circular to potential investors, representatives of Merrill and Harding, including Wang, reviewed and commented on it. Tr. 353, 2950; *see* Resp. Exs. 196-97. Chau certified that he had "carefully examined the Offering Circular," and that "the information *concerning Harding Advisory* . . . included in the sections 'The Collateral Manager,' 'Risk Factors-Conflicts of Interest Involving the Collateral Manager,' [and] 'Risk Factors-Dependence on the Collateral Manager and Key Personnel' . . . did not include any untrue statement of material fact." Div. Ex. 501 at 1 (emphasis added). Suh commented on the side of a page in the draft concerning risk factors, "Disclose Magnetar's control or insert reference to Magnetar risk factor on p. 25"; similar language was repeated on the next page. Tr. 3073, 3119; Div. Ex. 138; Resp. Ex. 197 at 23-24. According to Suh, that language was confined to a risk factor related to Magnetar's rights regarding redemptions, and had nothing to do with Magnetar's business as a hedge fund. Tr. 2953-55, 2957.

On September 26, 2006, Chau signed a collateral manager's certificate on behalf of Harding, certifying that he had carefully examined the offering circular, and in his opinion, the information concerning Harding in the offering circular sections labeled "The Collateral Manager," "Risk Factors-Conflicts of Interest Involving the Collateral Manager," and "Risk Factors-Dependence on the Collateral Manager and Key Personnel" did not include any untrue statement of material fact or omit to state any material fact. Tr. 1852-53; Div. Ex. 501. The certificate did not include any language regarding verification of the accuracy of information regarding the warehouse agreement. Div. Ex. 501.

Chau testified that he did not believe that a lack of disclosure of Magnetar's involvement in the warehouse agreement was important. Tr. 4333. He testified that it was "commonplace that warehouse agreements would have parties to it and warehouse providers would have rights as part of the warehouse agreement," and that "it wouldn't be critical to [an] investment decision because whether a hedge fund who has risks to the warehouse agreement or whether the investment bank has risks to the warehouse agreement had some type of approval rights or rejection rights, that would just be common sense." Tr. 4333. In Chau's view, Magnetar's involvement should have been disclosed in the offering circular, but the lack of disclosure was an "accident," a "simple mistake." Tr. 4333-34. He testified that he was not focused on the sections that would have disclosed Magnetar's involvement, and that he was only focused on the sections regarding Harding. Tr. 4333. According to Chau, he did not know that Magnetar's role was not disclosed in the offering circular, but had he known, he probably would have raised it with the lawyers drafting it. Tr. 4334-35.

D. Magnetar's Strategy and Octans I Positions

The fixed income mandate at Magnetar included a desire to establish long-term, sustainable investments, and Snyderman and Prusko devised, among others, a CDO investment hedging strategy intended to produce long term cash flow and high level base case returns, hedged to perform well in poor markets. Tr. 2328-29, 2331-32, 2335-36; Resp. Ex. 493. Magnetar chose to invest in CDO equity because the cash flow profile was "very stable" and high in the early years of the portfolio, so even if the portfolio deteriorated in later years, Magnetar expected to benefit. Tr. 2332. Magnetar expected its CDO equity investments in 2006 to run approximately four to seven or eight years and produce large returns throughout that period. Tr. 2333-36; Resp. Ex. 493. If the market deteriorated, the first tranche to take losses would be the equity, and the short positions taken by Magnetar would only begin paying when the higher tranches became impaired. Tr. 2355-56. Ultimately, Octans I, along with some other CDOs, failed. Tr. 1563-64; Div. Exs. 239, 240A. Generally speaking, Magnetar profited from its short positions in CDOs, although it is not clear if Magnetar profited from Octans I. Tr. 2682.

To hedge its long positions in CDOs, Magnetar used CDSs referencing liabilities correlated to assets in the CDOs it invested. Tr. 2336. Magnetar expected to earn around 20% or more per year from its long positions, and its short positions cost approximately 3% per year; accordingly, Magnetar expected to earn attractive returns, but in extreme market deterioration expected to receive an attractive payout. Tr. 2337-38. Magnetar usually sought to hedge its long investments two to one, in other words, $2 notional short for every $1 long, and it sourced as many CDSs as possible, but could only aggregate as many short positions as were available. Tr.

2337-39, 2390. It sourced its hedges by: taking short positions on oversubscribed cash bonds; taking short positions on synthetic bonds; and taking short positions on whatever transactions were in the market at the time. Tr. 2392-93. Magnetar faced a dealer in establishing its synthetic short positions, because a swap agreement with a dealer was necessary to take a position. Tr. 2393.

Magnetar sought short positions on assets strongly correlated with its equity investments.[33] Tr. 747, 2364-65. Magnetar often shorted mezzanine tranches of deals in which it invested, including Octans I, because it believed that those tranches were most directly correlated to its long equity position. Tr. 2363-66; Resp. Ex. 398. If hedges were not made on the same CDO deal in which Magnetar invested equity, risk would arise from the difference in performance between the equity and the hedged assets. Tr. 2364-65, 2390. The closest correlation for long positions in a CDO is short positions in the same CDO. Tr. 2365-66.

Magnetar had success sourcing hedges that referenced securities in its early equity investments. Tr. 2390. With later deals, including Octans I, Magnetar had difficulty sourcing hedges referencing the same deal. Tr. 2390. Magnetar was unable to source directly correlated hedges for a CDO during its ramp, because it could not transact in a CDS referencing CDO securities that had not been priced. Tr. 2403. Magnetar could nonetheless hedge risk during the ramp to some extent, but prior to closing, when it actually purchased the equity, it could not predict whether it could achieve its target hedge ratio, and it would have to wait to determine if there was oversubscription. Tr. 2724-25, 2395-96, 2406-08; *see* Resp. Exs. 866-67. For Octans I, Magnetar purchased $94 million in equity, but was only able to source $48 million in hedges against the D through G tranches. Tr. 2483-85; Div. Ex. 248; Div. Ex. 248A[34]; Resp. Ex. 911. This comprised an approximately $1 short to every $2 long position for Magnetar in Octans I, making Magnetar's position net long. Tr. 2483-85; Div. Ex. 248; Div. Ex. 248A; Resp. Ex. 911.

Magnetar put together Tigris, a CDO managed by Harding, which was a vehicle to finance approximately $1 billion of the least risky segments of Magnetar's CDO equity holdings. Tr. 2476. To secure some of the financing, which came from Mizuho Bank (Mizuho), Magnetar split apart its unrated equity position in Octans I and procured a Bbb- rating on the more creditworthy portion. Tr. 2222-23; Resp. Ex. 59. Specifically, Magnetar split its equity holding into a $64 million rated position and a $30 million unrated position, and sold the $64 million position into Tigris in March 2007. Tr. 2226, 2478, 4152-53; Div. Exs. 248, 248A. The unrated equity remained on Magnetar's books. Tr. 2478. After ramping nearly $1 billion in collateral into Tigris, Magnetar received a $500 million non-recourse loan from Mizuho. Tr. 2478, 4362.

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[33] Correlation refers to the alikeness of assets in deals; it is initially projected by a ratings agency in consultation with CDO investors and the investment bank for the CDO, but ultimately determined by the market. Tr. 748, 4119. According to Chau, the higher the tranche level, the lower correlation the investor would like, and vice versa. Tr. 4118-21. A super senior investor, for example, desires maximum diversity, because it mitigates risk. Tr. 4119-20. A lower tranche investor, like Magnetar, desires higher correlation, because it generates higher returns. Tr. 4121-22.

[34] Division Exhibit 248A is a demonstrative, not under seal, that Smith created. Tr. 2224.

Magnetar retained a $500 million first loss position in the CDO, and Mizuho assumed liability for the other $500 million. Tr. 2479-80, 3198. Prusko considered Magnetar's position in Tigris to constitute "the same long risk" with respect to Octans I that Magnetar had before Tigris was formed. Tr. 2479-80.

Pursuant to the Octans I warehouse agreement, Magnetar had the right to information on bonds being purchased during the ramp. Div. Ex. 5 at 2-5. Prusko reminded Harding to keep Magnetar apprised of Octans I asset selections, and Harding agreed to provide its OWIC bid lists for Magnetar's review prior sending them to the market. Div. Ex. 28. In accordance with that agreement, Prusko requested that Wang speak with him frequently so that he would be kept aware of Harding's progress and plans. *Id.*

A feature common to CDOs in which Magnetar invested in the equity – a feature for which Magnetar negotiated – was the lack of overcollateralization and interest coverage tests. Tr. 2380-2384. In a typical CDO, these tests, if triggered, shut off payment to the equity tranches and diverted cash flow to the more senior tranches. Tr. 2382. Rating agencies viewed such tests as a measure of security for the deal's debt tranches, and considered them in their ratings. Tr. 2383-84. However, it was difficult for Magnetar to predict a rating agency's decisions; for example, even if a deal lost small amounts, rating agencies might decide to downgrade the CDO, which would trigger the overcollateralization test and shut off payments to the equity tranches. Tr. 2382. But without a trigger, rating agencies expected some other form of security, which could come in the form of extra equity in the deal. Tr. 2383-84. Thus, for CDOs in which Magnetar invested, the equity tranches comprised approximately 6% of the CDOs, which was approximately double the amount in typical CDOs. Tr. 2383-87. Octans I was a triggerless CDO. Tr. 2760.

E. <u>Harding's Knowledge of Magnetar's Strategy</u>

Chau agreed that investors in debt tranches were not aware generally who invested in the equity tranche. Tr. 1772. Nevertheless, Prusko believed that many in the CDO industry were aware of Magnetar's market neutral strategy in 2006, and certainly by the end of 2006. Tr. 2369. An August 2006 article by Creditflux, an industry newsletter, reported that Harding was launching a CDO (Dorado) and that it was the first of four expected deals involving a "Chicago-based bank" that would be purchasing approximately 49% equity in each deal.[35] Tr. 2370; Resp. Ex. 637. Similarly, an August 2006 Derivatives Week article discussed Magnetar as "dominating the market for asset-backed securities collateralized debt obligations," noting that it was investing in several subprime RMBS deals and that market participants speculated the fund was "shorting other parts of the capital structure against its long equity positions." Tr. 2373; Resp. Ex. 880 at 1-2.

Chau was aware of Magnetar's general trading strategy no later than August 31, 2006. Tr. 1758-64; Div. Ex. 157. His understanding was that Magnetar generally hedged its positions, including shorting tranches in the same CDOs in which it invested. Tr. 1748, 1754. He testified that the first time he learned of Magnetar's actual positions in Octans I, however, was during the

[35] Magnetar is headquartered in Evanston, Illinois, a suburb of Chicago. Tr. 2371.

Commission's investigation. Tr. 4274-75. In particular, he testified that he first learned Magnetar had a $48 million short position at the hearing, and that he previously believed that Magnetar had shorted approximately $10 million of Octans I. Tr. 4274-75.

Magnetar informed banks and collateral managers of its overall strategy on several occasions. Tr. 2683-84. Magnetar informed Harding of its overall strategy by at least late summer or early fall 2006, and Prusko was sure that Harding at some point understood Magnetar's strategy. Tr. 2398, 2685, 2728; Resp. Ex. 860. There was language in some of Magnetar's equity purchase agreements regarding Magnetar's intent to hedge. Tr. 2404. No such language existed in the Octans I warehouse agreement, however. *See* Div. Ex. 5. Prusko does not recall discussing Magnetar's intention to hedge with Chau at early meetings with him and Merrill representatives. Tr. 2410-12. Magnetar's discussions regarding its strategy with other parties typically concerned its market neutral strategy as a whole; Magnetar did not, as a general practice, advertise its exact positions. Tr. 2700, 2776-78.

Admittedly, the only way Chau could have known of Magnetar's short positions was if Magnetar had told him. As Chau testified during the investigation, he was "not sure [what Magnetar's short positions were]. It's executed at [the] hedge fund level, but I wouldn't be privy to that information." Tr. 4323-24. There is no evidence Chau knew what Magnetar's specific positions were, or even which positions it intended to take, at least during the first half of 2006. Indeed, Magnetar was still trying to determine how best to hedge its positions in June 2006; as Prusko wrote in an email on June 4, 2006, "We should brainstorm on the most convex instruments in the credit world to help establish our hedges." Resp. Ex. 493; *see* Tr. 2367-68.

But Chau clearly knew Magnetar's general strategy to invest in equity of CDOs and hedge, including by shorting debt tranches of the same CDOs, before Octans I closed. He testified during the investigation that he knew of Magnetar's intention to go long and short on the same deals because "everyone in the community knew that was their strategy. They had gone to every investment bank and told them what their transaction was, that they would like to enter into a long/short strategy. . . . [o]n their own deals. . . . [and the investment banks] would tell us." Tr. 1761. Chau testified previously that he did not "remember any specific exchanges, but [knew] from a general market neutral long/short strategy they had, if they went long equity in a CDO, they would try to effect a short in the debt tranches." Tr. 4317. Chau knew that Magnetar's goal was to "make money in a market neutral manner," and that his knowledge was "similar to everybody else's knowledge . . . they had a long/short strategy, a market neutral strategy." Tr. 4317-18. Chau understood Magnetar would be shorting CDOs in which it invested to "protect against any downside but unfortunately give up any of the upside as well." Tr. 4322-4323. Furthermore, on August 31, 2006, Wang wrote to Chau, "so bf said he sold protection on [Octans I] A2s today – 20 bps wide of where we priced," and Chau responded, "Yes, prob to magnetar, they will buy prot[ection] on any deal 20 wide to cash." Div. Ex. 157; Tr. 1759.[36]

Huang was not specifically aware that Magnetar intended to short tranches of CDOs it invested in; he suspected it, but he had no actual knowledge. Tr. 743-44. Huang "thought

[36] Chau later agreed that Magnetar "most likely" did not buy that protection. *See* Tr. 4276-77.

[Magnetar] was shorting the mezz of the deal itself, frankly actually at that time, not necessarily on the individual names themselves," and he "assumed as a hedge fund they [would] use whatever they [got] from the long position to pay for the shorts." Tr. 756, 765. Huang inferred Magnetar's positions based upon his understanding that Magnetar, a market neutral hedge fund, would achieve correlation best by shorting the mezzanine tranches of the CDOs in which it invested, but he had no knowledge of Magnetar's actual positions or specific strategies in 2006 and 2007. Tr. 740, 745-50. He did not know for sure whether Magnetar shorted tranches of Octans I until he met with Respondents' counsel prior to testifying at the hearing. Tr. 765-67.

There is no evidence that other Harding employees had actual knowledge or awareness of Magnetar's strategies and positions.

F. Octans I Ramp and Purchase of the ABX Index

1. Motivation to Purchase the ABX Index

Magnetar wanted Harding to select bonds in the ABX Index to engage in an index arbitrage strategy. Tr. 2439. The strategy, according to Prusko, exploited the difference between the spread of the ABX Index and the average spread of the cash bonds referenced in the index. Tr. 2439; *see* Tr. 2457-69; Resp. Ex. 889; *see also* Tr. 2142. In 2006, the ABX Index spread was much wider than the spread on its twenty underlying cash bonds. Tr. 2439. Accordingly, purchasing the ABX Index (as opposed to purchasing its underlying cash bonds) achieved the same risk exposure, but with better spread. Tr. 2439. This strategy was particularly attractive after May 2006, when the spread difference between ABX Index bonds and non-ABX Index bonds tightened. *See* Div. Ex. 131 ("the recent massive spread tightening has made these deals marginal at best. I think we need to make some adjustments to make these deals viable . . . [n]eed to be aggressive in doing the index arb trades on ABX 1 and 2 right out of the gate. Have to push the managers to use as many bonds as possible out of the indices.").

Magnetar recognized this arbitrage opportunity and urged Merrill and Harding to take advantage of it. Tr. 2442; Resp. Ex. 139. The strategy was not very well known in early 2006, and Prusko had to explain it to several banks, including Merrill, during ramp phases of CDOs. Tr. 2729. He noted in an email to Snyderman on May 23, 2009, "You would have laughed at me explaining to three senior wall street traders/structures: 'ML buys $400 ABX BBB-, ML then buys protection on $20 each of the underlying names from warehouse . . ..'" Div. Ex. 19 (ellipsis in original); *cf.* Div. Ex. 31. Magnetar profited only indirectly from the index arbitrage strategy, because, as Prusko explained in connection with a different CDO, "[a]ll the benefit of the arb goes into the deal." Tr. 2462-63; Resp. Ex. 384. "[T]here's no involvement [by Magnetar] economically, other than as the ultimate purchaser of the equity." Tr. 2463.

Chau agreed that Magnetar pushed to purchase the ABX Index to exploit an "index arbitrage condition." Tr. 2142. He also agreed that investors did not favor index purchases in actively managed CDOs, because investors believed that a manager should be paid to manage rather than outsourcing management to indexes that the investors could purchase on their own. Tr. 4291-92.

But Chau characterized the Octans I ABX Index purchase as "merely an execution strategy for acquiring assets that the analysts had already determined" to purchase, which disingenuously downplayed the significance of the fact that the execution strategy coincided with Magnetar's interests. Tr. 2147; Div. Ex. 5001 at 32. Chau explained that there were at least three ways of acquiring assets for Octans I: (1) the CDO trust purchases the ABX Index and shorts any undesirable assets; (2) the warehouse purchases the ABX Index and shorts any undesirable assets (Chau called this method "intermediat[ing]"); or (3) either the CDO trust or the warehouse purchases "single name CDSs on an individual basis," without purchasing the ABX Index. Tr. 4285-86. Chau testified during the hearing that he disfavored the third method because it presented "liquidity" issues and was "inefficient" because "the single name CDSs were trading richer than the whole index." Tr. 4286. By contrast, he testified during the investigation that "we probably would have bought the same names underlying that reference for the underlying ABX securities, even if we did not do the ABX arbitrage." Tr. 4399. Notably, at neither time did he testify that the third method would not have been an arbitrage, and thus would not have satisfied Magnetar, because it would not have involved purchasing the ABX Index.[37] *See* Div. Ex. 19 (Prusko explaining Magnetar's ABX Index arbitrage strategy).

2. <u>Initiation, Review, and Execution of the Trades</u>

Prusko and Merrill began discussing purchase of the ABX Index by the Octans I warehouse by no later than May 22, 2006. Tr. 2442; Div. Ex. 18. Lasch sent an email to Prusko early on May 23, 2006, noting that Eliran had spoken with Sorrentino the night before, and Sorrentino was "ok to [put] the index itself in the warehouse." Div. Ex. 20. On May 23, 2006, Prusko sent an email to Lasch stating, "[l]et's buy some index," and the next morning, Prusko told Lasch "ABX opening weaker, let's do call, BUY!!!," to which Lasch responded, "hunting sharon [Eliran] down." Tr. 168-69; Div. Ex. 21. Prusko testified that his urgency reflected his opinion that it was an attractive time to buy due to the low price and wide spread. Tr. 2443. Magnetar did not have a preference for any particular tranche of the ABX Index, but it did prefer more constituent assets than fewer because it enhanced the spread. *See* Tr. 2450, 2465-66; Div. Exs. 89, 131.

Prusko discussed purchasing the ABX Index with Chau no later than May 25, 2006. Div. Ex. 23; Tr. 2151. Prior to Octans I, Harding had never ramped a portfolio with the ABX Index. Tr. 2151, 3356. Sometime prior to May 31, 2006, Chau explained to Lieu that Harding would participate in Magnetar's proposed ABX Index trade, and he explained the mechanics of the trade to her. Tr. 3402-03.

Prusko was eager to commence the ABX trade, and he pushed to identify the names that Harding wanted excluded as quickly as possible. Tr. 173; Div. Ex. 33. Prusko testified that Magnetar was eager to ramp certain assets when market factors favored swift action, but Magnetar was not necessarily eager to ramp deals quickly as a general strategy. Tr. 2728, 2730-

[37] Chau favored the second method over the first method because it was "efficient" and gave Harding "flexibility"; there is no evidence that Magnetar favored one over the other. Tr. 4285-86.

32. In CDO deals like Octans I, in which Magnetar had an interest in the warehouse, the longer the ramp took, the more interest it could accrue. Tr. 2730-32.

The afternoon of May 30, 2006, Prusko, Sorrentino, and Huang discussed purchase of the ABX Index for the Octans I warehouse. Div. Ex. 33. During that May 30, 2006, telephone call, the participants decided that Harding would review the bonds represented in the ABX Index and determine what names it was comfortable accepting for Octans I and what names it would not accept. Div. Ex. 33. Typically, Chau handled RMBS trades for the CDOs, but on May 30, 2006, Chau was out of the office, and Huang stepped in to assist on the proposed ABX Index trades. Tr. 972-75, 1244-45; Resp. Ex. 852. Chau was available by email and telephone on May 30, 2006, but there is no evidence that he was privy to the discussions. *See* Div. Ex. 33.

Prusko emailed Lasch on May 30, 2006, at 5:23 p.m., asking Lasch to "stay on top of this," and Lasch responded that he would "push to get names they have issue with tomorrow am." Div. Ex. 33. On May 31, 2006, at 9:30 a.m., Prusko emailed Lasch "[l]ets stay on top of ABX thing today, would like to get some off." Div. Ex. 45. At 1:07 p.m. on May 31, 2006, Lasch emailed Prusko, asking, "did you hear back from [T]ony?" and Prusko responded three minutes later, "Yes, but he hasn't given us names yet, still waiting. . . . please stay in front of Tony and Charles for me on this. Would really like to get started at least today." Div. Ex. 51. Four minutes later, Lasch emailed Eliran, asking, "can we nudge [T]ony for the names he doesnt want in? seemed like it should be pretty easy to identify. Jim [Prusko] and Dave [Snyderman] will be totally psyched to get some done today." Tr. 180; Div. Ex. 55.

On May 30, 2006, at 5:49 p.m., Huang forwarded to Lieu a list of the bonds in the ABX Index at the Baa2 and Baa3 credit levels. Tr. 3406-07; Div. Ex. 36. Huang testified that he did not direct Lieu to review the ABX Index bonds any differently than normal, nor did he receive any instruction to so direct Lieu. *See* Tr. 1209, 1266-76, 1347. At 8:54 a.m. on May 31, 2006, Lieu sent an email to Michael Giasi (Giasi), a Harding employee, asking him to provide a spreadsheet with the ABX Index names at the Baa2 and Baa3 credit levels so that she could more easily search prior credit decisions by Harding to determine whether any of the ABX Index names had been evaluated already. Tr. 3688; Div. Ex. 43. At 8:56 a.m., Lieu forwarded a list of the ABX Index names to Lee. Div. Ex. 44.

At 12:51 p.m., Lieu sent Kaplan a list of twenty-four ABX Index bonds, asking him to run loss curves on the bonds and send her the file. Div. Ex. 52. At 1:12 or 1:13 p.m., Kaplan sent Lieu an email attaching a spreadsheet with cash flow figures for the twenty-four ABX Index bonds that Lieu had previously sent, after having run them through Intex (Kaplan spreadsheet). Tr. 3413; Div. Exs. 52-53. Of those twenty-four bonds, twenty-two showed expected principal write-downs. Div. Ex. 53.

There were forty ABX Index bonds at the Baa2 and Baa3 levels, and Harding analysts analyzed cash flow for at least thirty-nine within the ten days leading to Lieu's decisions on May 31, 2006, including the twenty-four that Lieu had Kaplan run on May 31, 2006. *See* Tr. 4741; Div. Exs. 52-54, 267-72; Resp. Exs. 324-25, 773-74. Lieu was not copied on every email for these runs, but all took place days and hours before her ABX Index review. *See, e.g.*, Resp. Exs. 324-35. For example, another ABX Index deal was reviewed for a proposed Merrill portfolio trade on May 30, 2006, and Lieu specifically stated that she had "run[] CF's and look[ed] at credit" for bonds not already in the master bidlist. *See* Div. Ex. 29; *see also* Div. Ex. 16. The fortieth bond, for which no cash flow run records have been located, was approved by both Moy and Lieu on May 31, 2006, and had been approved several times before that. *See* Div. Exs. 65-66; Resp. Exs. 298-99, 371-72.

On May 31, 2006, at 4:23 p.m., Lieu sent a list of names to Huang that she opined Harding should be unwilling to accept. Tr. 3407-08; Div. Exs. 70-71. The list of bonds that Harding was not willing to accept included four Baa2-level bonds and eight Baa-3 level bonds, leaving twenty-eight bonds out of the forty ABX Index bonds that Harding's credit department approved. Tr. 3408-09; Div. Ex. 71. As far as Lieu knew, the decision on these bonds was adopted as Harding's decision, without any overruling by portfolio managers. Tr. 3728. Lieu believed, based upon the emails in evidence, that she was the one who made the decisions on the ABX Index bonds that day. Tr. 3934. That is, she made the credit decisions, and the portfolio manager (Huang) adopted her decisions as Harding's own. *See* Tr. 3934.

At 4:58 p.m. that afternoon, Eliran forwarded Lieu's list to Prusko, letting him know which names Harding wanted excluded. Div. Ex. 74. Prusko responded to Eliran's email that Magnetar had some ABX Index at the Baa3 level that it could sell to the warehouse, and he asked whether Merrill would want to purchase both Baa2 and Baa3 at that point. Tr. 2444-46; Resp. Ex. 491. Eliran replied that the plan was to purchase both Baa2 and Baa3. Resp. Ex. 491. Prusko testified that Magnetar had no view on constituent assets it would prefer Harding to include or exclude. Tr. 2446.

The next day, June 1, 2006, at 6:05 a.m., Wang emailed Chau and Huang, noting that she did not believe Harding could recommend $15 million of exposure for each bond class in the ABX Index that Harding had approved the day before, because of concentration limits provided for in the Octans I warehouse agreement. Div. Ex. 81. Huang replied later that Wang was correct and that Harding should push shorts of the Baa2-level ABX Index bonds because Harding was "less comfortable with some of these index names at the Baa3 level." Tr. 899-902; Div. Ex. 81. Four hours after Wang's email, Huang emailed the list of acceptable ABX Index names to Prusko, informing Prusko that Harding could purchase $15 million of each of the twenty-eight issuers in the ABX Index. Div. Ex. 82.

Harding eventually agreed to purchase $10 million of exposure to each ABX Index name at the Baa2 level and $5 million at the Baa3 level. Tr. 2204-06; Div. Exs. 6, 6A, 186, 186A.[38] The ABX Index trades resulted in long positions of $160 million at the Baa2 level and $60 million at the Baa3 level, or $220 million combined. Div. Exs. 6, 6A, 186, 186A.

The Octans I warehouse purchased the ABX Index on June 6, 2006, from Magnetar, which had exposure to the index in its own inventory. Tr. 181-82; Div. Ex. 273. The names that Harding rejected were subsequently shorted. Tr. 4285. Magnetar transferred $70 million of exposure to the ABX Index through trade novations on June 6, 2006, so that Merrill became counterparty in place of Magnetar. Tr. 2208-12; Div. Exs. 107-109.

[38] Division Exhibits 6A and 186A are demonstratives created by Smith. Tr. 2200-02, 2205-06.

Magnetar had also purchased small amounts of cash RMBS that it expected would be placed in the warehouse. Tr. 2469-70. On May 30, 2006, Prusko emailed Chau, telling him that Magnetar had the bonds and would sell them at cost to the warehouse. Tr. 2469-70; Resp. Ex. 309. Chau replied, "[s]ure, why don't you email the names over, and I can have credit run it thru their underwriting process." Tr. 2470; Resp. Ex. 309. Prusko replied to Chau that he had included a spreadsheet with the names, but because Chau was reading his email on a BlackBerry, he could not view the spreadsheet, and Chau responded that Prusko should send the names to Huang. Tr. 2470; Resp. Ex. 309. After Prusko forwarded the twenty-four names to Huang on May 30, 2006, Huang let Prusko know on June 7, 2006, that Harding was willing to purchase three of the bonds. Resp. Exs. 770-71, 787.

3. Lieu's Testimony Regarding May 31, 2006, ABX Index Approvals

Lieu knew that Magnetar was involved in the trades relating to the ABX Index, and that Magnetar was the equity investor in Octans I. Tr. 3355-56. Lieu also understood that the warehouse would purchase the ABX Index, and Harding would select bonds to short that it did not like. Tr. 3355. However, none of the emails from Prusko urging Lasch to push for names included anyone from Harding. *See* Div. Exs. 33, 45, 55. Indeed, there is no evidence that Lieu or Moy were copied on any emails from Merrill or Magnetar regarding the ABX Index trades.

Lieu generally had little independent recollection of the ABX Index bond review on May 31, 2006. *E.g.*, Tr. 3273-74, 3460. She expressed confusion regarding how the bonds could have been approved, given the high write-downs in the Kaplan spreadsheet, and she initially agreed that there must have been a "mistake." *See* Tr. 3429, 3435-38, 3445. Shortly before the hearing, however, Lieu reviewed emails and records from 2006, and at the hearing, she testified that those records reminded her that she performed additional credit work on the ABX Index bonds before making a decision. Tr. 3445, 3453, 3661. Lieu testified, without corroboration, that she told the Division during the investigation that she believed there were spreadsheets that would provide information regarding the circumstances of the ABX Index cash flow runs and credit decisions on the bonds, and that she had performed additional analysis on the ABX Index. Tr. 3659-60.

Lieu's new recollection shortly before the hearing was that she had concluded on May 31, 2006, that the cash flow runs in the Kaplan spreadsheet were flawed, and that incorrect assumption inputs caused the flaws. Tr. 3427. Lieu believed the outputs were not reflective of Baa2 and Baa3 bonds in May 2006, because she would have expected no write-downs higher than 10%. Tr. 3661-62. She testified that if she had seen such high write-downs and understood the assumptions to be true, she would likely not have approved of the purchases. Tr. 3429, 3663. This led her to believe that she performed corrected cash flow runs for the ABX Index bonds, and those, not the Kaplan spreadsheet, formed the basis of her opinion that the approved bonds were creditworthy. Tr. 3427, 3663. She also noted that Baa2 and Baa3 RMBS traded at par in May 2006, which is another reason that Lieu called into question the accuracy of the Kaplan spreadsheet's high principal write-downs. Tr. 3670-71.

Lieu testified that after reviewing materials with Chau's counsel in preparation for the hearing, she recollected that she and Moy had a conversation on May 31, 2006, where they came to a final credit decision regarding which bonds Harding wanted to short. Tr. 3404, 3406. Lieu testified that she did not previously remember any communications with Moy that day in testimony before the Commission during several investigations leading up to this proceeding or in a deposition in a private civil case on a related matter. Tr. 3411-13. According to Lieu, reviewing emails with Respondents' counsel jogged her memory that she had, indeed, discussed the ABX Index bonds with Moy that day. [39] Tr. 3411-13. Lieu testified that she was not shown one such email during investigative testimony or in the civil deposition. Tr. 3415-21. Additionally, Lieu stated that the emails reminded her that there were multiple cash flow runs on the bonds, and that after she and Moy discussed why they came to different opinions on May 31, 2006, Lieu concluded that it was because they had used different cash flow assumptions. Tr. 3410, 3427.

Lieu testified that the absence of documentary evidence of her request to Kaplan to run further cash flows, or any resulting cash flow analyses, could be explained by the fact that her proximity to Kaplan in the office made it easy for her to stand with him as he ran the figures again. Tr. 3442. That is, she might have viewed the results on the screen in real time, rather than waiting for an email from him, because she would have wanted to see his Intex settings and to run some trials on the figures. Tr. 3442, 3663. In May 2006, Kaplan sat close to Lieu. Tr. 3665-66. Because cash flow analysis for all forty ABX Index bonds could be rerun through Intex at one time, she surmised that she could have reviewed a new run by Kaplan shortly after being asked to do so, and that she could have viewed the results on the computer screen while she stood with him. Tr. 3442. She did not have a specific recollection on this, however, and it was not ordinary practice at Harding to run assumptions through Intex without saving the output files. Tr. 3442-43, 3664. Lieu also recorded many credit evaluation facts in notebooks, but there were no entries in her notebooks for ABX Index bonds dated May 31, 2006. Tr. 3291-93; Div. Ex. 241; *see also* Div. Exs. 242-46.

a. Cumulative Loss Curves

Lieu's first explanation for high write-downs in the Kaplan spreadsheet was that it did not reflect a lowered cumulative loss rate assumption that Harding had recently implemented; variation of this rate could make a difference between write-downs and no write-downs.[40] Tr. 3456-57. During investigative testimony, Lieu told Division counsel that she believed that at the time, the base case cumulative loss assumption was 8% and the stress case was 10%. Tr. 3341,

[39] At least one of the emails that purportedly jogged Lieu's memory had been shown to her in 2012. Tr. 3418-20.

[40] Chau testified that Harding's decision to purchase exposure to a majority of bonds in the ABX Index was supported by the market and the structural protection of the bonds; however, during investigative testimony Chau said he was "surprised" that the credit analysts approved bonds based upon write-downs reported in the Kaplan spreadsheet. Tr. 4423. He testified during the investigation that the write-downs did not make sense, given a 6% cumulative loss curve assumption. Tr. 4423.

3457. At the hearing, Lieu testified that she had made a mistake in her prior investigative testimony, and that Harding had lowered its cumulative loss rate assumptions to 6% for the base case and 8% for the stress case, and that Kaplan must not have used the lower rate. Tr. 3457, 3647-48.

Lieu believed using a 6% cumulative loss would not produce principal write-downs in the ABX Index bonds because most of the bonds carried credit enhancement of between 2% and 4%, and credit enhancement tends to grow, in some cases doubling within two years. Tr. 3445-46. Thus it would be unlikely, according to Lieu, that a 6% cumulative loss would impact collateral in that time. Tr. 3445-47. The cumulative loss is also affected by a timing curve input, also known as a vector or ramp, and Lieu believed that a timing curve that spread cumulative losses over the thirty-year lives of the bonds would not cause write-downs. Tr. 3445-48. Lieu testified that she would not expect a 6% cumulative loss, with all losses in the first sixty-two months of the bonds' existence, as the runs preceding the Kaplan spreadsheet assumed, to cause principal write-downs for bonds in 2006. Tr. 3451.

Lieu pointed to an email from May 26, 2006, where Lieu wrote Wang, "good thing you jumped in about the loss curve… jamie and i already decided yesterday that everything will be run at 6% loss curve, and with LACK OF INSTRUCTION, brett [Kaplan] was going to run them all wrong…and of course, she would just use those number coz she doesn't even check the CF's..." Resp. Ex. 767 (ellipses in original). Lieu did not believe that Kaplan would have had the capability to identify problems with cash flow runs at that time because he was still fairly junior and inexperienced. Tr. 3626. Her last remarks in the email to Wang referred to Moy, whom Lieu did not believe ran cash flows through Intex well. Tr. 3626.

On May 19, 2006, Giasi asked Moy what Harding credit analysts used for base case cumulative losses for an OWIC that day, and Moy responded that the rates were 13% for Baa2 bonds and 9% for Baa3 bonds. Tr. 3336; Div. Ex. 15. At 1:52 p.m. on May 31, 2006, Lieu sent an email to Moy and Wang with the subject line "Bidlist corrections"; the body of the email stated, "After checking through all the bidlist tabs, I have found that 22 of the classes had the wrong Y/N in there. I'm going to update the master list with the correct comments. After that, I will be re-running the old deals that we rejected based on old high loss curves (9, 11, 13% runs). If those pass the 6% we're using now, I'm going to change those to 'Y.'" Div. Ex. 56. Lieu testified that she and Moy had agreed by that time that 6% was the more reasonable rate. Tr. 3631-34.

Lieu testified regarding a cash flow run file reporting results for over 100 bonds, including ABX Index bonds. *See* Resp. Ex. 966; Tr. 3866-67. The cash flows include many of the same bonds that were run as part of the Kaplan spreadsheet, and at least two bonds included in this cash flow report had no write-downs, but reported significant write-downs in the Kaplan spreadsheet. Tr. 3867-71; Resp. Ex. 966. The cash flow runs assumed a different loss curve than the one reported in the Kaplan spreadsheet. Tr. 3847; Resp. Ex. 966. However, it is clear that this cash flow analysis was performed after May 31, 2006. There are multiple bonds in the spreadsheet that were not purchased by Harding until August 2006, and notations in the spreadsheet shows that Intex could not process the cash flow run for multiple bonds because the settlement date assumption, May 31, 2006, was earlier than the settlement date for each bond.

Resp. Ex. 966, *passim*. Furthermore, the metadata for Respondent Exhibit 966 shows that the file was created in July 2007. *Id.*; Div. Ex. 9005. Also, in the Kaplan spreadsheet, losses were spread over an approximate six-year period, but in the 2007 run, losses were spread over a ten-year period, allowing the bond to absorb losses more slowly and avoid principal write-downs. *Compare* Div. Ex. 53, *with* Resp. Ex. 966.

During the meeting with Respondents' counsel that supposedly reminded her she had performed further credit analysis on the ABX Index bonds, Lieu also reviewed spreadsheets with information on the "collat" tranche, the mortgage loans underlying a particular RMBS tranche. Tr. 3461-62. The Kaplan spreadsheet only showed cash flows for specific bonds, rather than cash flows for the underlying mortgage loans, but to determine what assumptions were used for the cash flow runs, Lieu needed to see the results from the collat tranche, including the default rate and the cumulative loss amounts. Tr. 3466. A collat tranche for a bond not in the ABX Index, and analyzed approximately June 6, 2006, showed use of a 6% cumulative loss rate. Tr. 3682-84; Resp. Ex. 942.[41] Another collat tranche file for a non-ABX Index bond analyzed at approximately the same time also assumed a cumulative loss rate of 6%, with no principal write-downs. Div. Exs. 281-82. Lieu concluded from this that there had been a "mistake" on the ABX Index bonds. Tr. 3467.[42]

Nevertheless, Lieu eventually agreed that the Kaplan spreadsheet assumed a cumulative loss rate of 6%. The Division walked Lieu step by step through a calculation using the collateral principal balance as the denominator and total liquidation as the numerator, which Lieu confirmed were the correct figures and basic formula for determining cumulative loss, and showed her that the result of the calculation was 6%. Tr. 3972-79. Lieu also agreed that the 6% cumulative loss rate in the Kaplan spreadsheet represented the base case, not the stress case, and she agreed that she might not have asked for analysis of the stress case. Tr. 3997-4000.

b. Default Rate Anomaly

Even though Lieu accepted the Division's demonstration that the Kaplan spreadsheet used a 6% cumulative loss assumption, Lieu was adamant that there must have been another error in the Kaplan spreadsheet assumptions. Lieu identified in a Kaplan spreadsheet tab what she perceived as an incorrect assumption for the default rate, which was identified in the Kaplan spreadsheet as 150*BA3 (4%), the name of a formula created by Harding. Tr. 3433-35; Div. Ex. 53. That formula was 150% of a default curve that Harding would have entered into Intex, although Lieu could not identify the curve because the cell did not reveal the underlying formula, only the name of the formula. Tr. 3671-72. The actual numbers used in the formula were saved

[41] The cumulative default rate in the collat tranche was 15% and the severity rate was 40%, which Lieu testified resulted in a 6% cumulative loss rate. Tr. 3466-67.

[42] After seeing the Kaplan spreadsheet and collat tranche document, Lieu testified that she ran cash flow analyses on two ABX Index bonds on her own volition. Tr. 3544-45. No documents were introduced at the trial memorializing what assumptions she used, and the explanations she gave during testimony were completely unclear. *See, e.g.*, Tr. 3479-83, 3544-45. Accordingly, I have not given this any weight.

separately in a spreadsheet known as a "ramp" file at Harding. Tr. 3674. The 150% number represented the "ramp" used to shape the curve. Tr. 3672-73. Lieu asked to see the ramp files to determine what curve figures were used, but she has not seen them. Tr. 3676-77. She last saw the ramp files prior to leaving Harding in 2007. *See* Tr. 3674-76.

But at least seven other cash flow spreadsheets, pertaining to dozens of bonds, created on or around May 30 and 31, 2006, and June 1, 2006, and run by Kaplan at Lieu's request, show the same default curve: 150*Ba3 (4%).[43] *See* Div. Exs. 267-68, 269-70, 271-72, 286-87, 288-89, 290-91; Resp. Exs. 322-23. Many of the bonds included in these cash flow runs showed significant write-downs, just as the Kaplan spreadsheet did, but there is no contemporaneous evidence showing concern with any of the other cash flow spreadsheets from that period. *See* Div. Exs. 267-68, 269-70, 271-72, 286-87, 288-89, 290-91; Resp. Exs. 322-23.

c. Prepayment Assumption and Standard Option

Lieu identified another formula used in the Kaplan spreadsheet, 100*JamieCombo, that Moy had created as a prepayment rate assumption. Tr. 3642-43; Div. Ex. 53. The Kaplan spreadsheet, however, listed this formula in a tab indicating that it was the rate used for an assumption called "Unscheduled Balance Reduction Rate." Tr. 3985-86; Div. Ex. 53. She testified that it was not an assumption option that was used by Harding, and its use, Lieu believed, could have caused the erroneous write-downs. Tr. 3985-86. Cash flow analyses that purportedly occurred on or around May 31, 2006, indicated that the same formula was used as the "Prepay Rate," not the "Unsch Bal Redctn Rate." Tr. 3847-48; Resp. Ex. 966.[44]

The purportedly incorrect assumptions that Lieu pointed out in the Kaplan spreadsheets were not, however, anomalies in Harding's credit review process at the time. The same spreadsheets showing cash flow runs for dozens of bonds run on May 30 and 31, 2006, and June 1, 2006, that used the 150*Ba3 (4%) default rate listed the prepayment rate as an "Unsch Bal

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[43] On May 22, 2006, Kaplan sent Moy and Lieu a bid list with thirty-two names evaluated for an OWIC dated May 23, 2006, and of those names, twenty-five were rejected for credit reasons. Div. Ex. 16. Of those twenty-five rejected bonds, five were in the ABX Index and were later selected for Octans I. Div. Exs. 6, 6A, 16; Tr. 3423-25. During the hearing Lieu testified that the passage of one week (May 23 to May 30) could explain the disparate opinions on four bonds, but Lieu remarked during investigative testimony that the disparate opinions were "a bit too much of a coincidence." Tr. 3425-26.

[44] Respondent Exhibit 966 does not appear to have been created at or around the time the credit decision was made in May 2006. Its metadata identifies a creation date in 2007, yet lists the "settle date" as May 31, 2006 in the Intex output. Resp. Ex. 966. Any settle date can be entered into Intex to determine how a bond evaluation would look at that time. Tr. 4037. However, if the settle date predates the actual settle date of the bond, Intex reports an error message. Tr. 4032. For example, one of the bonds that was not purchased by Harding until August 25, 2006, displays an error message stating, "cannot add security to portfolio because settle date (20060825) differs from portfolio settle date (20060531)." Tr. 4038; Resp. Ex. 966 at tab Portf CF 00441VAM0.

Redctn Rate." *See, e.g.*, Div. Exs. 267-68, 269-70, 271-72, 286-87, 288-89, 290-91; Resp. Exs. 322-23.

One other explanation was that the practice at Harding was to use the standard CDR curve assumption option in Intex, as opposed to the non-standard option, and that the Kaplan spreadsheet might have used the non-standard option. Tr. 3668. The crux of the Respondent's rebuttal expert report was that the Kaplan spreadsheet was flawed, because it showed that had the non-standard option been used, there would have been many fewer write-downs. *See generally* Resp. Ex. 976.

d. <u>Credit Comment Templates and Collateral Compare</u>

As part of its record-keeping, Harding maintained credit comment files for each bond that it reviewed, including the credit decision for the bond and records of the review performed, such as cash flow analyses, and comments were recorded in a standardized template. Tr. 3809-12. Lieu testified that there were credit comment files for each bond reviewed. Tr. 3843.

Lieu testified that a credit comment file for a bond named SAIL 2005-HE3 M9 (SAIL), which was selected for long exposure in the ABX Index and showed a projected write-down of 48.83% in the Kaplan spreadsheet, was further evidence that the Kaplan spreadsheet was flawed. The SAIL credit comment file listed a settle date of May 31, 2006, a prepayment rate of 100*JamieCombo, a default rate of 100*BASE LOSS, and a cumulative loss assumption of 6%. Tr. 3817-18; Resp. Ex. 941. Running the default curve BASE LOSS at 100% produced the 6% cumulative loss. Tr. 3820-21. The "cash flow to call" tab represented what would happen if the servicer exercised the bond's optional redemption feature, which allowed the servicer to pay it off if the loan principal dropped below 10%. Tr. 3819-20; Resp. Ex. 941. Conversely, the "cash flow to maturity" tab represented a scenario that assumed the servicer would not call the deal, meaning that the bond would run until final maturity. Tr. 3819-20; Resp. Ex. 941. Harding credit analysts analyzed both scenarios for each bond; cash flow to maturity is the more stressful scenario. Tr. 3819. Both scenarios showed no principal write-downs for the bond and no accumulated interest shortfall. Tr. 3823, 3825; Resp. Ex. 941. The cash flow to call and cash flow to maturity tabs both list "0605" as the "Latest Update," meaning the last update to these tabs was in May 2006. Tr. 3821; Resp. Ex. 941. A "Princ Writedown" column lists zero write-downs projected through 2019 as of the most recent update. Tr. 3822-23; Resp. Ex. 941. The historical performance information, which was updated over time, showed that as of May 25, 2007, there was .05% cumulative loss in the bond. Tr. 3828; Resp. Ex. 941. According to Lieu, that loss did not affect the tranche to which Octans I had long exposure, because the tranche's credit enhancement had grown from 3.35% to 4.27%. Tr. 3828-29; Resp. Ex. 941.

The credit comment files were not created on the date of the credit decision, and instead were created from anywhere between days after to as long as more than a year after Harding's initial review. Tr. 3810-11, 4029-30. The credit comment files were updated as Harding learned new details about the bonds. Tr. 3811. Indeed, the metadata for the SAIL credit comment file reflects a "Last Modified" date of August 28, 2007.[45] Div. Ex. 9004; Resp. Ex. 941. A tab in the SAIL credit comment file named "Performance Info" was "part of [Harding's] standard surveillance template." Tr. 3826; Resp. Ex. 941. Data under the surveillance template tab recorded a column showing dates and various performance metrics for the bond, including the current balance, the original balance, bankruptcies, foreclosures, overcollateralization levels, and delinquencies for each date. Div. Ex. 941. The last row with performance entries has an entry date of June 2007. *Id.* According to Lieu, the entries in the credit comment files regarding cash flow runs reflected information as of the time the analyses were run, though not necessarily input at that time. Tr. 3824, 3830. Lieu testified that there was no reason that she or anyone else would have gone back months or years later to try and recreate the templates. Tr. 3869-70.

On June 6, 2006, Wang wrote to Moy and Lieu, and copied Huang and Chau, asking if they could meet the next day to discuss items listed in the email, including: "Backfill credit committee reports, one-pagers, and other files we maintain so we can be ready to market the Magnetar deal quickly." Resp. Ex. 367. Lieu explained,

> [W]e maintained and saved a lot of the files supporting why we need certain credit decisions. We didn't have it all in one location that was easy to find. And also, we knew that the analysts had their own individual notes in their notebook. So we made a conscious decision and created a project so we could go back and make sure that they were more organized.

Tr. 3730. Lieu attributed this initiative to Wang's desire for files to be organized. Tr. 3729-30. Lieu did not think there was nefarious intent in backfilling the credit committee reports. Tr. 3730. Lieu denied that she or anyone had any reason to make it appear that the cash flow runs had been run in May 2006, if they had not actually been run then. Tr. 3824. She testified she would have quit had anyone suggested she do something like that. Tr. 3824-25.

Lieu denied that credit committee templates were recreated as long as months or years after the credit review had occurred. Tr. 3869. However, on July 18, 2007, Richard Chin, a Harding employee, emailed a number of Harding employees, including Lieu, Chau, and Wang, with the subject line "Octans I Call w/ HIMCO on 7/24 @ 11:00," stating, "In preparation for the HIMCO call, let's focus first on the 24 RMBS bonds in Octans I that have had a ratings action as we are back-filling our credit templates and credit comments, as well as forming our forward-

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[45] Lieu testified, looking at the spreadsheet in its native format, that the spreadsheet showed a "Created" date of March 31, 2006, a "Last Modified" date of the date of her testimony, and a "Last Printed" date of February 28, 2007. Tr. 3829-30; Resp. Ex. 941. These dates are confirmed by reviewing the "File" tab in the document. *See* Resp. Ex. 941. Metadata purportedly extracted by the Division indicates that the spreadsheet was created on August 28, 2007, last modified on August 28, 2007, and had a print date of February 28, 2007. Div. Ex. 9004. It is peculiar, to say the least, that the Division's metadata shows a print date prior to the creation date. Further, the metadata in the native file shows Maxim Group LLC as the licensee, thus, it is more likely that the file was created while Harding was still Maxim. Accordingly, I find that the native file's metadata, not the Division's metadata, represents the most accurate information.

looking views." Div. Ex. 233. Lieu explained that the backfilled credit committee templates reflected work that was done at the time shown in the document. Tr. 3730.

4. Other Cash Flow Runs and Analyses for ABX Index Bonds

Other cash flow runs for ABX Index bonds by Harding and other parties show varied results for the same bonds in the Kaplan spreadsheet, and led to decisions that varied from Lieu's decisions on the ABX Index bonds on May 31, 2006.

a. May 31 OWIC

At 2:00 p.m. on May 31, 2006, Giasi emailed the MaximCDO recipients, which included Lieu, attaching an OWIC due at 4:00 the same day. Div. Exs. 57-59. Giasi asked whether any bonds on the OWIC list matched bonds that had already been worked on by the credit analysts to see if there was a fit. Tr. 3506; Div. Exs. 57, 59. This OWIC was used to ramp Octans I. Tr. 3724. OWICs were forwarded to Harding credit analysts team nearly every day. Tr. 3724-25. They were sent to the credit analysts to determine whether Harding could purchase assets listed on them, and if the credit analysts were unable to complete the work on time, they would refuse to consider the OWIC. Tr. 3723-24. The OWIC Giasi emailed listed forty-one bonds, and forty of those bonds are the same as those listed in the Baa2 and Baa3 ABX Index. *See* Div. Exs. 36, 65. At 2:29 p.m., Lee sent Moy and Lieu a surveillance report on the bonds in the OWIC list. Div. Exs. 63-64. At 2:49 p.m., Lieu responded to Giasi and the MaximCDO address, informing Giasi that the credit analysts had previously reviewed twenty-nine of the forty bonds listed on the OWIC, and of those twenty-nine, ten were approved and nineteen were rejected. Div. Ex. 65. Lieu included a list of the ten approved deals.[46] *Id.* All ten of the approved bonds were also ABX Index bonds. *Id.* Of the ten, four showed principal write-downs in the Kaplan spreadsheet. *Compare* Div. Ex. 65 *with* Div. Ex. 53.

At 3:04 p.m., Moy responded to Giasi and the MaximCDO address, attaching credit results for the OWIC. Div. Ex. 65-66; Tr. 3511. Moy noted that there was a correction to the ten approved loans previously provided by Lieu; two of the bonds, the Baa2 and Baa3 tranches of a bond series titled MABS, were rejected by Moy because they were supported by interest-only mortgage collateral. Div. Ex. 65. Moy wrote, "we are not okay on the MABS deal. [T]hat is a 100% IO loan deal."[47] Div. Ex. 65. Moy's list accepted fifteen of the forty-one names and rejected twenty-six. Div. Ex. 66. All of the accepted bonds on Moy's list were also accepted on Lieu's acceptance list for the ABX Index, but thirteen of the bonds that Moy rejected for the OWIC were accepted by Lieu for the ABX Index. *Compare* Div. Ex. 66, *with* Div. Exs. 70-71. Lieu's decisions on the ABX Index bonds were sent only an hour and twenty minutes after the

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[46] Lieu always searched OWIC names through prior credit work using the CUSIP number, not the bond name, because names could be reported differently, but the CUSIP number stayed constant; accordingly, she was not aware at the time that the names on the May 31 OWIC were mostly ABX Index names. Tr. 3702, 3710.

[47] Moy had previously accepted one of these two MABS bonds in a BWIC prepared for May 23, 2006. Resp. Exs 298-99.

time Moy sent her list of approvals regarding the OWIC, a time when Lieu was busy reviewing the ABX Index bonds. Div. Ex. 65; Div. Ex. 70.

b. June 1 BWIC

At the same time that the ABX Index and May 31 OWIC analyses were occurring, Harding was preparing a BWIC for twenty-five synthetic bonds it intended to include in Octans I. Div. Ex. 42. The BWIC was a subset of fifty-four bonds that Harding had approved for its initial bidlist for Octans I. Div. Ex. 50 at 3-4. Wang forwarded the initial bidlist to Prusko for his review, and also forwarded a list of the proposed BWIC bonds to Merrill for its approval. Div. Exs. 42, 50. Prusko responded that he approved of the bidlist generally, but that he recognized bonds on the list that were also reference names in the ABX Index, and he asked Wang to remove them from the proposed BWIC. Div. Ex. 50 at 1-3. Wang responded that she would remove the ABX Index names from the BWIC list before it went "to the street." *Id.* at 3. Later in that same email chain, Huang told Prusko that Harding would be sending a list of the ABX Index names that Harding wanted excluded "soon." *Id.* at 1. At 5:15 p.m. on May 31, 2006, Wang sent the final May 31 BWIC list to Prusko, Huang, and Chau, which included twenty-one bond names, and in her email, told the recipients that Harding planned on circulating a list of approximately twenty more names for a BWIC the following day. Div. Exs. 75-76. At 7:03 p.m. that evening, Wang sent to Prusko, Huang, and Chau the proposed June 1 BWIC list, which included twenty bond names. Resp. Exs. 347-48.

c. Master Bid List

The credit analysts maintained a master bid list, which was a spreadsheet listing the bonds that the credit department had reviewed, each with a yes or no credit decision, indicating whether the credit department had approved or rejected the bond. Tr. 3345-46. The master bid list kept track of bonds for which Harding planned to submit BWICs; the ABX Index names were excluded.[48] Tr. 3716; Resp. Ex. 349. Lieu attempted to distill credit decisions made by the credit department into the master bid list. Tr. 3346-47. One such attempt was circulated on May 30, 2006, and included a list of four hundred ninety-four bonds previously reviewed by Harding analysts. Tr. 3346-49; Div. Exs. 39-40. The May 30, 2006, master bid list was the first attempt

[48] In the email sending the master list to the MaximCDO email, Lieu wrote,

> I have added all the deals we have looked at today and revised the approved deal list. As of today, EXCLUDING all deals (including today's trades) we already own in Magnetar and EXCLUDING names in the ABX Index, we have approved 58 Bonds. Going forward, we can use this master list to come up with 20 bonds for BWIC everyday. I will be updating this list everyday to reflect deals we have already done.

Resp. Ex. 349. According to Lieu, prior to the CDO being named Octans I, Harding employees called the deal Magnetar. Tr. 3717. Lieu explained that the ABX Index trades were excluded because Harding did not intend to trade the ABX Index the same way as the BWIC bonds. Tr. 3716.

by Lieu to pull together credit decisions from the group into one document, and prior to putting together this master bid list, Lieu had kept her own list of bonds. Tr. 3347-48. At 7:09 p.m. on May 31, 2006, Lieu circulated to the MaximCDO email list a master list of approved deals that could be used for BWICs, which did not include names from the ABX Index. Tr. 1328; Resp. Exs. 349-50. At 10:52 a.m. on June 1, 2006, Lieu circulated to the MaximCDO email list a revised approved BWIC list, urging that recipients should check the names against the deal's inventory, previous BWICs, and names on the ABX Index, and should ensure that the names on the list did not violate concentration provisions. Tr. 1334; Resp. Exs. 353-54.

On June 21, 2006, Moy emailed Huang with the subject line "Maxim Approved Deals," and attached a spreadsheet with the same name. Resp. Exs. 385-86. Lieu testified that the list Moy provided to Huang would likely have come from the master bid list that Lieu had put together a few weeks earlier. Tr. 3799-3801. Lieu believed that by Moy sending this list to Huang, Moy displayed agreement with Lieu on those bonds' approvals. Tr. 3801. She believed that she and Moy had previously made inconsistent credit decisions, but that Moy's June 21, 2006, list accurately reflected the credit department's conclusions. Tr. 3801-03. The list of approved deals included 228 bonds with Baa1, Baa2, and Baa3 credit ratings. Resp. Ex. 386. Twelve of the bonds marked with a "Y" credit decision in the spreadsheet provided by Moy were bonds approved by Lieu for the ABX Index trade, but rejected by Moy for the May 31 OWIC. *Compare* Resp. Ex. 386, *with* Div. Exs. 67, 71. Lieu was not shown the June 21, 2006, email and spreadsheet during her investigative testimony. Tr. 3803-04.

d. <u>September 18, 2006, ABX Index Bond Approvals</u>

On September 18, 2006, Lieu sent an email to Chau, copying Chen, informing him that "[a]ll the INDEX bonds have been re-looked at for current CF runs, surveillance, interest shortfalls, and collateral characteristics." Resp. Ex. 435. Lieu's email provided a list of the approved and rejected index bonds out of the 2006-1 and 2006-2 series of the ABX Index. *Id.* For the 2006-1 ABX Index series, the list showed twelve approvals and eight rejections. *Id.* Chen forwarded Lieu's email to Prusko the next day. *Id.*

Less than three hours after Lieu's email, Lee emailed Lieu, attaching a spreadsheet with cash flow analysis for twenty 2006-1 ABX Index series bonds at the Baa2 and Baa3 credit levels. Resp. Exs. 429-32. Five of the bonds in the spreadsheet were bonds that had previously been accepted by Lieu, but rejected by Moy, and showed principal write-downs in the Kaplan spreadsheet. *Compare* Resp. Ex. 432, *with* Div. Exs. 53 and 66. None of the twenty bonds in Lee's analysis showed principal write-downs. Resp. Exs. 429-30. Eleven bonds had positive credit decisions and nine were rejected. Resp. Ex. 430. Lee's spreadsheet showed a prepay assumption formula of 100*JamieCombo, a formula created by Moy, and a default rate of 100*BaseLoss. Tr. 3642-43; Resp. Ex. 432. Lee's analysis differed from the Kaplan spreadsheet assumptions by using a 100% default severity rate, as opposed to Kaplan's 40% default severity rate. *Compare* Resp. Ex. 432 *with* Div. Ex. 53.

Lieu's emailed list and Lee's spreadsheet were not entirely consistent. Lee had rejected two of Lieu's approved bonds, and had approved one of Lieu's rejected bonds; *Compare* Resp. Ex. 432, *with* Resp. Ex. 435. Of the twelve bonds that Lieu listed as accepted in the 2006-1 series, she had rejected two on May 31, 2006. *Compare* Resp. Ex. 435, *with* Div. Ex. 71. Of the eight bonds that Lieu listed as rejected in the 2006-1 series, she had accepted six on May 31, 2006. *Compare* Resp. Ex. 435, *with* Div. Ex. 71. Lieu explained that credit opinions on bonds changed over time as the analysts received updated information. Tr. 3917.

e. HIMCO Cash Flow Runs of Octans I

As part of its due diligence on Octans I, HIMCO ran cash flow analyses of RMBS in the Octans warehouse. *See* Resp. Ex. 611; Tr. 1957-58. An Intex output spreadsheet for these cash flows shows results for some ABX Index bonds, run using different assumptions, some of which use a lower severity rate than was used in the Kaplan spreadsheet. Tr. 1959-60. Several ABX Index bonds that had been approved by Lieu despite write-downs in the Kaplan spreadsheet were projected to incur no principal write-downs when run with a settle date of August 1, 2006, according to HIMCO's reviews.[49] *See* Resp. Ex. 611; Tr. 1963.

G. ABX Index in Octans II and III

Octans II was a $1.5 billion CDO with 222 assets, managed by Harding, structured by Wachovia, and invested in by Magnetar. Tr. 3923-24; Div. Ex. 214; Resp. Ex. 748. Magnetar pushed for Harding and Wachovia to select and purchase the ABX Index for Octans II and short the bonds that Harding did not approve, similar to what occurred with Octans I. *See* Div. Exs. 127, 128, 130.

On August 24, 2006, Lee sent an email to Moy and Lieu seeking guidance on how to reconcile two different credit decisions for five constituent ABX.HE 2006-2 series assets that were reviewed for Octans II. Div. Ex. 156. Moy and Lieu each wrote back, agreeing that the most recent decisions should stand, with the exception of a couple of bonds. *Id.* Moy noted that for one of the bonds, the decision was an "N," yet "due to the fact we had to pick the lesser of evils when we were looking at the index we said 'Y' to [it]." *Id.*

Octans III was a static "bespoke" CDO that Harding managed and a proprietary group at Citibank structured, and whose equity Magnetar purchased. Tr. 1412-13. A "bespoke" deal is one that is structured by a bank mostly for its own investment in the CDO, instead of structuring it and then syndicating it to other investors. Tr. 2779. As with Octans I and Octans II, Magnetar requested that Harding ramp with ABX Index bonds, although the mechanics were slightly different; Magnetar sourced the individual names that Harding approved, instead of purchasing the entire index and then shorting out the names Harding did not like. *See* Div. Ex. 152. Some bonds were purchased despite rejections from credit analysts. Div. Ex. 163.

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[49] On August 3, 2006, a representative from Merrill forwarded questions from HIMCO asking about overcollateralization deficiencies in four bonds in Octans I, two of which were ABX Index bonds. Resp. Ex. 627. The next day, Lieu emailed Chau a write up on all four bonds, explaining that each of them had sufficient credit enhancement to avoid potential losses. Tr. 3927, Resp. Ex. 627.

Lieu remarked on September 13, 2006, that the ABX Index trade for Octans III included two bonds that had been rejected by the credit department. Div. Ex. 163. BSABS 2005-HE11 M8, an ABX Index bond that had been rejected by the credit department, was selected for inclusion in the Octans III ramp after Prusko offered to assign it to the warehouse. Div. Exs. 166-67. SAIL 05-HE3 M8, an ABX Index bond that had been rejected by credit analysts, was also placed into Octans III. Div. Ex. 160. Moy wrote in August 2006 that she and Lieu had previously rejected a particular bond, but then had to "pick the lesser of evils when . . . looking at the index." Div. Ex. 156. Moy wrote later in the same email chain that she and Lieu had marked a bond as a "'[m]aybe' because we knew we had to pick the less worse" for the index. *Id.*; Tr. 3365-66.

Norma

A. Background

Norma was a mezzanine CDO managed by NIR Capital Management and structured by Merrill, and Magnetar purchased the equity. Tr. 153-54, 2629. It was collateralized with approximately $1.5 billion in collateral, predominantly RMBS. Div. Ex. 190 at 1, 3, 9. The A-rated tranche comprised approximately $74 million, of which Harding ultimately purchased $35 million to allocate between two of the CDOs it managed. Div. Exs. 190, 196, 237; Tr. 252, 1571. The Baa2-rated tranche comprised $65 million of the CDO, of which Harding purchased $20 million (later reduced to $15 million) for Harding-managed CDOs. Div. Exs. 190, 237; Tr. 1571, 4236-37. The Baa2-rated tranche was expected to pay interest at the three-month LIBOR plus 385 basis points (3.85%). Div. Ex. 190 at 1; Tr. 4126-27. Respondents purchased Baa2-rated Norma bonds with notional values of $10 million for Lexington and $5 million for NEO, two of four CDOs into which Harding allocated Norma bonds.[50] Div. Ex. 237 at 1; Resp. Ex. 879; Tr. 1644.

B. Chau's Testimony on Norma's Structural Attributes

According to Chau, Norma's structure made the Baa2-rated tranche a safe investment, with low probability of losses. For example, the Norma pitch book provided "Break Even Default Rates" for each tranche of securities, which represented the annualized rate of defaults that would yield the first dollar of loss at that tranche level. Tr. 4100-01; Div. Ex. 190 at 28. The pitch book listed the annual default rate for the Class E tranche, the Baa2-rated securities that Harding purchased, as 2.6% and the cumulative gross defaults as 14.3%; it also reported the break-even default rates at zero percent yield, meaning the point at which the investor would receive only its money back, as 4.9% annual default and 19% cumulative default. Div. Ex. 190 at 28; Tr. 4101-03. According to Chau, these losses applied to the underlying RMBS in the Norma CDO, not the underlying pools of loans. Tr. 4103. The Norma pitch book also listed "Historical Default Rates for BBB-Rated Finance Securities," including a one-year weighted average default rate for RMBS securities of approximately .1%. Div. Ex. 190 at 13. Additionally, historically, the ultimate recovery rate for BBB-rated RMBS was approximately

[50] Harding placed Norma "D" tranche, which were A-rated bonds, in 888 Tactical Fund and Jupiter VI. Div. Ex. 237 at 1.

52%, according to the Norma pitch book. Div. Ex. 190 at 14. The Norma pitch book listed the maximum weighted average rating factor (WARF), representing the loss expectations over a ten-year horizon, as 450, or a little less than .5% per year. Div. Ex. 190 at 22; Tr. 4110-4111. Chau maintained that the probability of reaching even a 2% default rate, based on the WARF, was very low. Tr. 4111-12.

C. Harding's Selection of Norma

On January 9, 2007, Catherine Chao (Chao), a sales representative at Merrill, forwarded price guidance for "NEW ISSUE" Norma to a list of potential purchasers that included Chau. Tr. 1580; Div. Exs. 188, 190. Chau then asked for the portfolio. Div. Ex. 188. About three minutes after asking Chao for the Norma portfolio, Chau wrote to Chao, "Turbo structure is very weak . . . we prefer the old style amortization." Div. Ex. 189. Turbo is excess interest that normally would be paid to the equity tranche, but is instead redirected to pay down principal to mezzanine or more senior tranches. Tr. 1585-86. Weak turbo redirects a relatively smaller amount of interest to pay down principal, and weaker turbo benefits the equity tranche at the expense of the more senior tranches. Tr. 1586-87. In the interest proceeds payment waterfall of Norma, a projected 40% of remaining interest proceeds above a 2.4% dividend to the equity tranche would be redirected to several mezzanine-level tranches to pay down principal. Div. Ex. 190 at 26; Tr. 4133-35. Chau preferred a traditional amortization structure, because the effect of Norma's turbo was minimal. Tr. 1587, 4134-35.

On January 16, 2007, Chau messaged Phelps, asking "how is norma doing?" Div. Ex. 191. Phelps responded "proceeding alright - have about 25% of AA down through BBB done (AA- is about 50% done) with BBB- open right now. ready to talk about your participation?" Div. Ex. 191. The same day, Chen emailed Chao, asking, "hey, can I get norma portfolio strat[ification]s pls?"[51] Div. Ex. 192. Also that same day, Chen emailed Kaplan, asking him to provide surveillance numbers on five CDOs, including Norma, which Kaplan did on January 22, 2007, with surveillance data on four of the five CDOs, but not Norma. Div. Ex. 197. By that time, Chau had reviewed preliminary documents, including the pitch book and term sheet, but Harding had not performed an in-depth review of Norma. Tr. 1596-97. On January 17, 2007, Chau messaged Chao about Norma, and Chao responded with a query as to Harding's interest in the BBB tranche. Tr. 4182-83; *see* Div. Ex. 193. On January 19, 2007, Chen emailed Theo Pan, proposing where A-rated Norma bonds could be placed once they were approved: $20 million into Citi CDO-squared; $15 million into Jupiter VI; and $5 million into NEO. Div. Ex. 196; Tr. 4184. That is, as of January 19, 2007, based on the pitch book and term sheet, and at least a preliminary credit analysis, Harding had decided to purchase A-rated Norma bonds. Tr. 1596-97; *see also* Tr. 1639-41, 1647 (Chau noting that Norma's turbo structure had been analyzed, but the commentary to the credit analysis was incomplete, which was a normal practice at Harding).

Merrill had trouble placing Norma. Tr. 2639-40, 2747-48. On January 23, 2007, Prusko wrote in an email to Snyderman, "Sharon [Eliran] was quite whiny and down about norma bbb's, but phelps to his credit was very aggressive, sounds like he will use his clout to stuff people with

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[51] Stratifications provide a high-level look at the data, including the collateral type, loan to value ratios, and percentage of first-time home buyers and second-time home buyers. Tr. 1591-93.

them, will stick baa3's in cdo2's in their pipeline" and Prusko promised that he "will personally hammer wing, he's getting too big for his britches, we left a lot of loot on the table there." Div. Ex. 199. Oddly, Prusko – who on many other matters had a sharp memory – was able to recall little about this email: he could not remember what he meant by "too big for his britches," did not think that by "I will personally hammer wing," that Prusko meant that he would ask Chau to buy the Norma BBB tranche, and did not know what "use his clout to stuff people with them" meant. Tr. 2749-52. Chau explained that "loot on the table" likely referred to a prior CDO deal where Chau got a price discount for a mezzanine tranche, to Magnetar's disadvantage; Prusko did not recall what "loot on the table" meant. Tr. 1619-20, 2751-52.

In any event, two minutes later[52] Prusko wrote an email to Chau titled "Pls buy some norma bbb," and in the body of the email, wrote, "Stop complaining about Turbo :) . . . Remember who was there for u when u were a little guy." Div. Ex. 200. Chau responded five minutes later: "I hear you, not me holding up the deals, only a small cog in the machine :)." *Id.* After a response from Prusko to Chau,[53] Chau told Prusko: "Did ML tell u I am in for 40mm single-As in Norma - team player!!!" *Id.* Chau told Prusko he was a "team player" because he wanted Prusko to know that he was doing something that benefitted Prusko's economic interest and built goodwill with him. Tr. 1604-07, 1610. Chau had not expressed to Merrill any interest in buying Norma's lower-rated bonds, however. Tr. 1611-12. Prusko responded to Chau's email: "No, they did not, they were just bustin' on u about the bbb's, gave you no credit for A's, that's great, thank you." Div. Ex. 200.

Later that day, Phelps messaged Chau, asking, "what's your level on BBB or BBB- if we can't change the turbo?" to which Chau replied, "ah-so … let me sharpen the pencil." Div. Ex. 198. Phelps replied, "sweet." *Id.* Chau knew at this time that buying Norma bonds would benefit Merrill, and Chau was interested in keeping Merrill happy because it was a large source of Harding's revenue. Tr. 1613-15. Chau believed that he was "building goodwill" with Merrill, because purchasing mezzanine tranches of a CDO earns the associated investment banks' gratitude. Tr. 1615, 1618. According to Chau, he was looking for a price concession with the Norma BBBs, and he was delaying telling Merrill his interest in the bonds until he could ascertain what the "new issue order book" looked like. Tr. 1611. Late in the day on January 23, 2007, an internal Merrill email listing the Norma account status for Harding stated "40mm A, has AAA through BBB capacity (Jup VI, NEO, Octans IV, Lex)." Div. Ex. 201.

The next day, January 24, 2007, Phelps messaged Chau, asking, "so, have you 'sharpened your pencil' on norma BBBs yet? or has your citi mezz deal and bbb lists in the street taken up too much of your time? bbb- is done now fyi at 480." Div. Ex. 205; Tr. 1621. Chau replied "I never forget my true friends." Div. Ex. 205. Chau testified that his response was to Phelps'

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[52] Respondents do not dispute that the top email in the string in Div. Ex. 199 was transmitted at 7:33 a.m. Div. Br. at 89 n.155; Resp. Br. at 250-52.

[53] Prusko's initial email is time stamped at 7:35, and Prusko's response is time stamped at 7:55. Div. Ex. 200. Chau's intervening email, that is, his response to Prusko's initial email, although time stamped at 6:40, would most likely have been sent at 7:40 central time, or five minutes after Prusko sent his initial email and fifteen minutes before his responsive email. *Id.*

dissatisfaction with Chau being too busy for Phelps; Chau meant to tell Phelps that he had not forgotten about Phelps and would look at the securities, not that he was committing to buy. Tr. 4194, 4197. Chau also testified that his response was an example of his habit of writing flippant emails. Tr. 4219-20. By "true friends," Chau meant, in this case, Merrill and Magnetar. Tr. 1622.

Later on January 24, 2007, at 4:20 p.m., Margolis emailed Phelps and other Merrill representatives with the subject line "Wing is in for $20mm," writing "I told him we would try and sell him down to $15mm if we could. . . He wants to talk about the spread but he will be in." Div. Ex. 204. Chau was not on this email chain, and did not remember the conversation Margolis referenced, but testified that he did not tell Margolis that he would purchase at that point. Div. Ex. 204; Tr. 4200. In fact, Chau testified that Margolis' reference to selling Harding down to $15 million from $20 million was because Chau did not immediately commit to a purchase. Tr. 4203. Chau also testified that he was trying to negotiate a discount. Tr. 1625-27. I do not credit Chau's testimony on this point: sixty-seven minutes after Margolis' email to Phelps, without any documentation of further negotiations (on price or quantity), Pan requested approval from the Merrill warehouse group to purchase $10 million of Norma Baa2-rated bonds for Lexington, and attached a copy of Norma's preliminary offering circular. Resp. Exs. 832-33; Tr. 4203-05. As of January 24, 2007, Harding still had not completed its credit analysis of Norma. Tr. 1622-23.

On January 25, 2007, Chau messaged Phelps, informing him that Harding was having difficulty acquiring approval from warehouse providers for the purchase of Norma bonds. Resp. Ex. 870; Tr. 4210-11. Indications of interest to a bank for orders of CDO securities are subject to warehouse approval before Harding could commit to purchasing the securities. Tr. 4206-07. Before approval by the warehouse, Harding could back out of the trade. Tr. 4207.

The next day, January 26, 2007, Chao wrote to Chau, "ML Sells / Harding Buys: $40mm Class D @ 99.00 (+240DM) 20mm Class E @ 100.00 Thanks for the trades!"; Chau agreed that this message was confirmation of his intent to purchase $40 million of A-rated Norma bonds and $20 million of BBB/Baa2-rated Norma bonds. Div. Ex. 212 (formatting altered); Tr. 1642-43. Harding selected the Baa2-rated Norma bonds at par; the price was later discounted from par on February 2, 2007, after Harding's total purchase of the Baa2-rated bonds was lowered to $15 million. Div. Ex. 207, 212; Tr. 4214-15.

On February 1, 2007, Chao sent Chau a message, asking, "u got the news on your decreased Norma BBB allocation, yes?" Div. Ex. 210. Chao was referring to Merrill's reduction of Norma BBB-rated bond allocation from $20 million to $15 million, as Chau had requested previously. Tr. 1628; Div. Ex. 204. Chau responded to Chao, "Now that's what I'm talking about, the love is in the air." Div. Ex. 210. Chau testified that he could not recall exactly what he meant by his response to Chao, but that he believed it was sarcasm, and not an indication that he was actually happy Merrill cut back his allocation. Tr. 1628-29, 1631-34, 1638. Chao sent Chau updated trading information the next day reflecting the reduction in allocation. Div. Ex. 212.

The Norma A-rated bonds were allocated to Harding-managed 888 Tactical Fund and Jupiter VI, and the Baa2-rated bonds were allocated to Harding-managed NEO and Lexington. Div. Ex. 237; Resp. Ex. 879; Tr. 1644. Norma comprised approximately 1.6% of NEO and Lexington. Resp. Ex. 879; Tr. 4243. The Lexington offering circular provided a number of warnings, including that "[i]n recent months, delinquencies and losses with respect to residential mortgage loans generally have increased and may continue to increase, particularly in the subprime sector. This may affect the performance of RMBS Securities." Div. Ex. 507 at 27; *see also id.* at 29, 128. The NEO offering circular provided similar risk disclosures. *See* Div. Ex. 509 at 30. Both the NEO and Lexington offering circulars provided risk disclosures concerning exposure to originator New Century. Div. Exs. 507 at 29, 509 at 31-32.

Chau's explanation of his negotiating strategy for Norma was that he was waiting for the lead order, an early investor in the syndicate process, to settle. Tr. 4194-96. Once there is a lead order, the syndicate manager is able to transmit that order information to the market, letting participants know that an investor has committed to a certain amount and price of the securities being issued; procuring a lead order provides leverage to the syndicate group to get investors to commit before being locked out of the trade. Tr. 4195-96. Chau explained that in Phelps' January 24, 2007, email, Phelps conveyed to him that there was a lead order for Norma Baa3-rated securities at 480 basis points, and thus, 480 basis points became the threshold price for future investors. Div. Ex. 205; Tr. 4194. Chau opined that it would have been extremely valuable for Phelps to procure a lead order on the Baa2-rated securities. *See* Tr. 4197-98.

D. <u>Analysis of Norma</u>

Chau did not recall what analysis was performed on Norma. Tr. 1677, 4123. A spreadsheet labeled "CDO Credit Deal Tracker-Mezz Grade," that Chau testified was used to track CDOs that Harding purchased for inclusion in its managed CDOs, lists Norma with a January 17, 2007, "Date of Analysis." Div. Ex. 238; Tr. 4157. The spreadsheet included multiple columns for entries of the results of Harding's analyses, including the percentage of underlying collateral Harding's credit analysts had previously approved, rejected, or had not yet seen. Div. Ex. 238; Tr. 4158. Only a portion of Norma data was populated in the spreadsheet. Div. Ex. 238; *cf.* Tr. 4179-80.

Chau agreed that it "would be irresponsible to buy something without actually looking at the assets." Tr. 1648. A write-up by Kaplan (Kaplan commentary), Chau said, was the first formal write-up on Norma of which he was aware, but he and others at Harding had been reviewing and scrutinizing the materials for Norma prior to making a decision to purchase. Tr. 1640-42, 1644, 1647-48. According to Chau, the commentaries for CDOs were meant for "education primarily," providing the "key points" found by Harding. Tr. 1645. Nevertheless, Chau conceded that he "made the investment decisions without having [the Norma] commentary in hand." Tr. 1670.

Chau had "enough" time to make a decision on Norma. Tr. 4184-85. In addition to looking at the collateral structure, Chau needed to determine whether Norma fit the investment criteria for the CDOs to which Norma would be allocated. Tr. 4185. According to Chau, satisfaction of the investment criteria could be determined by reviewing the offering circular. Tr. 4204.

On January 16, 2007, Kaplan, who worked in both the RMBS and CDO departments at Harding, emailed Chao, seeking the collateral portfolio for Norma. Resp. Ex. 886; Tr. 4175. Chen asked Chao for Norma's stratifications, also on January 16, 2007. Div. Ex. 192. The next day, January 17, 2007, Chao forwarded the stratifications to Chen. Div. Ex. 194; Tr. 4177-79. The Norma stratifications included CUSIP numbers for the underlying collateral, which Harding's credit department could upload into Intex to run cash flow analyses. Tr. 4181.

On February 22, 2007, Kaplan distributed the Kaplan commentary to Chau and others at Harding. Div. Ex. 217. The Kaplan commentary was as of a portfolio date of January 17, 2007. *Id*. Kaplan wrote: "There's quite a large percentage of deals failing surveillance tests, on the watch list, and on the do not buy list. Also, there is almost 15% exposure to Fremont and Ameriquest, combined." *Id*. Harding considered Fremont one of the five worst originators at the time. *See* Div. Ex. 215; Tr. 1661-62. It was not general practice for Harding to purchase CDOs with a large percentage of deals failing surveillance tests. Tr. 1651. The watch list was an internal list at Harding for monitoring RMBS performance; bonds on the watch list had early warning indicators of problems. Tr. 1654. Similarly, the do-not-buy list reflected bonds that Harding had previously passed upon, and Chau preferred to buy CDOs without bonds on Harding's do-not-buy list. Tr. 1655. The Kaplan commentary also noted, "turbo not meaningful," which Chau interpreted to mean that the turbo was weak; weak turbo benefited the equity tranche of the deal, in this case owned by Magnetar, but detracted from the mezzanine tranches, which Harding was purchasing for inclusion in its managed CDOs. Tr. 1648-50; Div. Ex. 217.

Reporting on the cash flow and stress runs, the Kaplan commentary listed the write-down percentage as 10.17%, the shortfall percentage as 1.62%, the DQ test fail rate as 82.83%, and the sixty-day-plus DQ test fail rate as 46.02%, all percentages which Chau acknowledged were high. Div. Ex. 217; Tr. 1664. For write-down percentage in particular, tranches with subordination of less than 10.17% were expected to be "hit." Tr. 1666. As noted in the Kaplan commentary, the Norma BBB bonds had subordination of 6.79%, and Chau agreed that "it appears" that the Norma BBB bonds would be hit. Div. Ex. 217; Tr. 1666. Although Chau had no specific recollection, he testified that he "would have had the information" memorialized in the Kaplan commentary at the time he committed to purchasing Norma bonds. Tr. 1668.

Chau also downplayed the significance of the Kaplan commentary. Investing in a CDO whose underlying assets would have been rejected by Harding analysts is not the same as investing in the underlying assets themselves, and investing in the CDO can provide beneficial diversification. Tr. 4143-44. Chau testified that the writedown percentage focuses on "pool" losses – losses on loans collateralizing the underlying RMBS – and is merely a qualitative pricing point on the CDO from a "30,000 foot level." Tr. 4155-56. According to Chau, there is little value in pool loss figures because of the nonlinear relationship between those losses and performance of a CDO, and the more significant investment variables are the capital structure of the CDO, the ratings of the underlying collateral, and the collateral performance attributes. Tr. 4089-90, 4156. According to Chau, mezzanine RMBS securities had only a 1% default rate historically, and thus a CDO comprised of such RMBS securities would be able to withstand pool-level losses. Tr. 4089-90. He also claimed that he would not have paid much attention to the Kaplan commentary because it contained mistakes, including the fact that the collateral manager listed in the commentary was incorrect, and Chau was too busy to look at something with obvious mistakes. Tr. 4222-23. Chau testified, "if I get a commentary from an analyst that didn't bother to have the time to put in the correct collateral manager, I would not have paid any attention to this commentary. I would have most likely just closed the spreadsheet and moved on with the rest of my day." Tr. 4223. Chau also noted that Fitch Ratings provided "market validation" for Harding's analysis in a March 1, 2007, report on Norma. Tr. 4227-29; Resp. Ex. 890 at 2, 5.

Norma did not perform well. Chen wrote to Wang and Chau on April 27, 2007 regarding asset allocation in Jupiter VI: "In typically [Merrill] fashion, they called me yesterday to hold off on selecting BVILL vs. FSTF. They now want to just move the entire 20m of HRIDG and 15m of MARLN and be done. Having said that, still no confirmation. Feels like another last minute present. Ironically, we initially wanted them to reduce: NORMA, BVILL, Western Spring, FSTF and FORCE; all are likely to stay in." Div. Ex. 223. Although Chau's typical strategy was "buy and hold," in May 2007 he attempted to swap out Norma for other securities, offering \$.87 on the dollar, a "substantial discount" from its purchase price a few months before. Tr. 1688-91; Div. Ex. 226. As noted, a trader at New York Life responded to Chau's effort to exchange Norma securities with a parody of "Candle in the Wind," using lyrics insinuating that hedge funds were shorting Norma and that there were multiple defaults in the underlying collateral. Div. Ex. 226; Tr. 1690-91. Chau forwarded some of the parody lyrics to Chao the next day. Div. Ex. 228.

Expert Witnesses

A. Ira Wagner

Ira Wagner (Wagner) graduated from the University of Virginia with a bachelor's degree and from the Wharton School of the University of Pennsylvania with an MBA. Div. Ex. 8001 at 6, Appx. 2. Wagner worked at a series of investment banks in varying roles, concentrating on securitizations, including CDOs and RMBS. *Id.* at 5-6. Since leaving his last investment banking position at Bear Stearns in 2008, Wagner has served as an independent consultant in regulatory and litigation matters involving financial institutions and mortgage origination and securitization. *Id.*

The Division engaged Wagner to render opinions on whether Harding's processes for selecting RMBS and CDOs were consistent with: industry standards and expectations; standards, policies, and procedures followed by institutional managers of national standing relating to assets like those in Octans I; and the description of Harding's approach to investment and credit selection in the Octans I pitch book. Div. Ex. 8001 at 2. Wagner opined that Harding's investment process for RMBS in Octans I did not meet industry standards and expectations and that: credit approvals could not be justified by results of the analyses; Chau relied on credit rating and market reception over the judgment of Harding's analysts; insufficient time was given to credit analysts to carry out their work; there was limited oversight of decisions made by credit analysts; cash flow analysis of RMBS was limited and rudimentary; cash flow stress testing outside of a standardized run was lacking; and limited documentation was prepared to document credit decisions. *Id.* at 3. Wagner also opined that the CDO selection process would not meet industry standards and expectations and that: there was a lack of thorough review of structural features of a CDO beyond a cursory review of the marketing material and term sheet; credit write-ups were not done or were completed only after the investment decision was made for many CDO investments; the write-ups contained red flags that Harding failed to analyze further; Harding failed to run or request stress test cash flows based on credit analysts' view of the collateral; and Harding failed to analyze the likelihood of a triggering event that would re-direct cash flow. *Id.* at 4-5; Tr. 4596-98.

Wagner's expert report did not identify exactly what "industry standards" entail for collateral managers, but did state that they would require cash flow analysis for every security being considered and approved, that ABX Index bonds should be analyzed the same way as non-index bonds, and that the collateral manager should not allow investments outside of its established investment process. Div. Ex. 8001 at 31, 41-42, 53. Wagner opined that the analyses for Octans I and Norma, in addition to failing to meet industry standards, failed to meet the standards of care Harding set for itself. *Id.* at 15-16, 58. Wagner's report stated that long investors in the CDO market evaluate the collateral manager as an important component in the analysis of a potential CDO transaction, and that such an evaluation would include the manager's management capabilities and experience, investment philosophy, credit process, performance of managed CDOs, sourcing of the portfolio, and motivation for issuing the CDO. *Id.* at 15.

Wagner opined that the credit analysis leading to the May 31, 2006, decisions on the ABX Index bonds was inadequate and not in compliance with industry standards or Harding's own stated standards. Div. Ex. 8001 at 30-31. Specifically, Wagner noted that: Lieu requested cash flow runs on only twenty-four bonds in the ABX Index from Kaplan, and Wagner found evidence of cash flow analyses for only three other ABX Index bonds on May 30 and May 31, 2006; no requests for cash flow runs and no results were found for eleven bonds that had not been previously reviewed by Harding credit analysts, yet nine of those bonds were approved; only one set of cash flow analyses was run for the bonds that Wagner observed evidence for; all of the cash flow runs used the same default rate; and there was no further evidence of customized runs or stress tests. *Id.* Furthermore, though Lieu received the list of ABX Index bonds approximately twenty-four hours before she sent her list of approvals to Huang, Wagner noted that Lieu requested and received the cash flow results for the twenty-four bonds only three and a half hours before sending her decisions. *Id.* at 28, 30. Wagner agreed that cash flow analyses would not take a significant amount of time, and that familiarity with the bonds would cut the time necessary to review those bonds, and he agreed that it is possible that forty bonds could be evaluated in a day, but he did not believe that the work that Lieu performed was sufficient. Tr. 4755-58. Wagner did not perform any independent credit analysis of the bonds. *See* Tr. 4562.

Wagner testified that there was a "clear pattern" to Lieu's May 31, 2006, decision on ABX Index bonds as to twenty-seven of the bonds, twenty-four of which were bonds in the Kaplan spreadsheet. Tr. 4528. With the exception of two, all of the ABX Index bonds that had write-downs of less than 50% were approved, and those having write-downs of 50% or greater were rejected. Tr. 4528; *see also* Div. Ex. 8001 at 34-35. Wagner also noted that 20% of the bonds in the Kaplan spreadsheet had zero write-downs, the same percentage of bonds that he understood Harding had generally approved among the universe of mezzanine RMBS. Tr. 4531.

Wagner authored a supplemental expert report after learning of new issues arising during the hearing, but the supplemental report largely conveys Wagner's confirmation of his earlier opinions. Div. Ex. 8003 at 2. Wagner wrote in the supplemental report that Harding credit analysts did, indeed, use a 6% cumulative loss assumption in the cash flow runs around May 31, 2006, and that Lieu approved many ABX Index bonds run at 6% cumulative loss that projected high write-downs.[54] *Id.* at 4-6, 8-12. Additionally, Wagner reviewed a September 18, 2006, cash flow analysis report on twenty ABX Index bonds provided to Lieu by Lee, showing no write-downs for any of the bonds. *Id.* at 12-13; *see* Resp. Exs. 431-32. Wagner determined that the September 18, 2006, cash flow analysis had been run using more lenient assumptions than the Kaplan spreadsheet. *Id.* at 12; Tr. 4545-46. Wagner was able to determine that the cumulative loss assumption in the September 18, 2006, cash flow analysis was also 6%, but that the timing vector was nearly doubled, allowing significantly more time for losses to be absorbed than in the Kaplan spreadsheet assumptions. Div. Ex. 8003 at 12-17; Tr. 4545-47.

Wagner's supplemental report also responded to a rebuttal expert report submitted by Respondents, which opined that the write-downs recorded in the Wagner expert report, which were extracted from the Kaplan spreadsheet, did not reflect Harding's intended assumption of 6 CDR and 40% severity. Div. Ex. 8003 at 6-7. Wagner's supplemental report pointed out that the Kaplan spreadsheet was run with a 6% cumulative loss assumption, not a 6 CDR assumption, and that the write-downs accurately reflected that fact. *Id.* at 6-12.

Wagner agreed that the performance of Harding-managed CDOs was generally consistent with the performance of several other managers' deals in the market at the time. Tr. 4890. He also agreed that with the recession beginning in 2008, everyone in the financial industry failed to predict the crash of non-agency bonds. Tr. 4901.

B. Richard Ellson

Richard Ellson (Ellson) is the Director of the Enhanced Solutions Group at Andrew Davidson and Company in Raleigh, North Carolina (Andrew Davidson). Tr. 1075. Andrew Davidson develops quantitative models for credit, prepayments, valuation, and risk management; the Enhanced Solutions Group takes internally developed models regarding RMBS and creates applications to assist in, *inter alia*, stress testing. Tr. 1075-76. Ellson earned a bachelor's degree from Bucknell University and a Ph.D. in economics from the University of Florida. Tr. 1091-92. He was a tenured professor at the University of South Carolina from 1979 to 1987, and thereafter worked in the asset-backed securities industry at a variety of investment banks and brokerages before joining Andrew Davidson. Tr. 1091-93.

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[54] Wagner initially mistakenly concluded that the cumulative loss rate used was 2.4%. Div. Ex. 8001 at 34 n. 59. Although he later acknowledged that the 2.4% rate was an error and that the rate was actually 6%, he opined that even 2.4% produced high write-down projections. Tr. 4565.

Ellson was engaged by the Division to analyze the Octans I transaction to determine whether the sub-set of synthetic RMBS positions relating to the ABX Index generated excess income when compared to the sub-set of synthetic RMBS positions not related to the ABX Index. Div. Ex. 8002 at 1. Ellson opined that the answer to that question was no, and that the ABX Index positions generated in total between $1.65 and $2.15 million less income. *Id.* at 1, 4.

Ellson reached his conclusions by: (i) calculating the ongoing spread of the ABX Index bonds, which, when averaged, was 185 basis points; (ii) reviewing a flow of funds report for Octans I showing up-front premium paid for the bonds of $2,554,220; and (iii) amortizing the up-front premium over three expected lifespans of the bonds: three, five, and seven years. Div. Ex. 8002 at 2-4; Tr. 1083-85. The 185 basis-point ongoing premium was 6% higher than non-index bonds at the time, but subtracting the up-front premium paid for the bonds created the deficit. Div. Ex. 8002 at 2-4; Tr. 1084-85. Ellson's analysis was based strictly on pricing. Tr. 1123. He did not analyze whether the specific assets were traded at better spreads than they would otherwise command, because they were not put out for bid with other dealers. Tr. 1124. His analysis, accordingly, did not consider the arbitraging that Magnetar purportedly sought by trading the ABX Index long and shorting out the assets that Harding did not want. Tr. 1133, 1136.

Ellson was also engaged to determine whether there was adverse selection in approving the ABX Index bonds, but his analysis yielded no statistically significant results. Tr. 1086-88, 1111-12.

C. Steven Hilfer

Steven Hilfer (Hilfer) has a bachelor's degree from the State University of New York at Binghamton and an MBA in finance from New York University, and holds Series 7, 24, and 63 licenses. Resp. Ex. 976 at 2-3. Hilfer has worked in the securitization industry for approximately thirty years, specializing in structuring RMBS, CDOs, and CLOs; has managed numerous structuring and transaction management teams, and has reviewed hundreds of securitization documents; has marketed, sold, and financed positions for investors and issuers of RMBS and other structured finance securities; and has analyzed and valued numerous subprime RMBS bonds by projecting future performance using industry standard tools such as Bloomberg and Intex. *Id.* at 3-4. Hilfer has held positions at Moody's Investors Service, Donaldson, Lufkin and Jenrette, and Credit Suisse Securities (USA) LLC, and he is currently a director and principal at Navigant Consulting, Inc. *Id*. at 2-4, Appx. I. He has testified and submitted expert reports in other cases. *Id.* at 4, Appx. I.

Respondents engaged Hilfer as a rebuttal expert witness to provide opinions regarding cash flow analyses run on May 31, 2006, for ABX Index bonds, in response to findings in Wagner's expert report.[55] Resp. Ex. 976 at 2, 4-8. Hilfer ran his own cash flow analyses

[55] I did not permit Respondents to offer direct expert evidence because they did not comply with the prehearing deadline for filing expert reports. *Harding Advisory LLC*, Admin. Proc. Rulings Release No. 1312, 2014 SEC LEXIS 955 (Mar. 18, 2014).

through Intex and determined: the write-downs in the Wagner expert report do not reflect Harding's intended assumptions of 6 CDR and 40% severity; the default scenario was more severe than the intended assumption; the write-downs using Harding's intended assumptions of 6 CDR and 40% severity results in zero expected write-downs on all tranches; the resulting projected cumulative losses were approximately 7% for all tranches; the projected collateral cumulative losses using an assumption of 6 CDR and 40% severity was higher than the projected collateral cumulative losses from JP Morgan research in May and June of 2006; it was reasonable for Harding to intend to run a 6 CDR and 40% severity scenario; and the ABX Index Baa2 and Baa3 tranches were trading at or around par in May and June 2006, and therefore, during that time, there was a reasonable expectation by a majority of market participants that the bonds would not experience any write-downs. *Id.* at 4-8. During his testimony, Hilfer backtracked from the assumption in his rebuttal expert report that Harding intended to run its cash flow analyses using a 6 CDR and 40% severity scenario, because he had learned since writing his report that Respondents did not intend to use those assumptions. Tr. 4950-51.

Hilfer later submitted a supplemental rebuttal expert report describing his replication of cash flow projections for a SAIL bond, based upon a spreadsheet showing purported cash flow runs on June 1, 2006.[56] Resp. Ex. 977. According to Hilfer, he used the figures and assumptions laid out in the spreadsheet and ran them through Intex, but in order to replicate approximately the same outputs reported by Harding, it was necessary to choose a "non-standard industry" assumption in Intex called "max(prepay, default)." *Id.* at 4-8. According to Hilfer, when a non-standard industry assumption is selected in Intex, the prepayment assumption is automatically renamed "unscheduled balance reduction rate." *Id.* at 8. Hilfer ran the twenty-seven ABX Index bonds discussed in the Wagner expert report through Intex, once using the industry standard prepayment assumption and once using a non-standard prepayment assumption. *Id.* at 9-12. Using the non-standard prepayment assumption produced write-downs for many of the twenty-seven ABX Index bonds, many similar to the write-downs in Wagner's expert report and in the Kaplan spreadsheet, but using the industry standard prepayment assumption produced no write-downs for twenty-three of the ABX Index bonds. *Id.* at 10-12; Div. Ex. 53. Hilfer also replicated results from cash flow projections for four non-Octans I bonds, each of which used a "standard prepayment convention," and each showed no write-downs. *Id.* at 12-17.

III. CONCLUSIONS OF LAW

The OIP charges both Harding and Chau with violations of Securities Act Section 17(a) and Advisers Act Sections 206(1) and 206(2), and Chau with aiding and abetting and causing all of Harding's violations. OIP at 13. The Division contends that Harding and Chau:

(1) violated Section 17(a), subsections (1), (2), and (3), with respect to Octans I investors by misrepresenting, in the pitch book, Harding's investment analysis process (Div. Br. at 108-12, 115-16);

[56] The SAIL bond was not one of the ABX Index bonds that Lieu approved on May 31, 2006. *See* Div. Exs. 44, 70-71, 281-282.

(2) violated Section 17(a), subsections (1), (2), and (3), with respect to Octans I investors by misrepresenting, in the pitch book, Harding's investment analysis personnel (Div. Br. at 112-13, 115-16);

(3) violated Section 17(a), subsections (1), (2), and (3), with respect to Octans I investors by failing to identify, in the pitch book, Magnetar's participation in the warehouse agreement (Div. Br. at 116);

(4) violated Section 206, subsections (1) and/or (2), with respect to the Octans I issuer by misrepresenting, in the CMA, that Harding would select all collateral for the issuer (Div. Br. at 116);

(5) violated Section 206, subsections (1) and/or (2), with respect to the Octans I issuer by misrepresenting, in the CMA, the standard of care Harding followed in selecting the issuer's collateral (Div. Br. at 117-18);

(6) violated Section 206, subsections (1) and/or (2), with respect to the Octans I issuer by failing to follow the proper standard of care in selecting the issuer's collateral, independent of any affirmative misrepresentations (Div. Br. at 118);

(7) violated Section 206, subsections (1) and/or (2), with respect to the Octans I issuer by failing to disclose that Harding had a conflict of interest between its duty to its client and its desire to please Magnetar (Div. Br. at 118-19);

(8) violated Section 206, subsections (1) and/or (2), with respect to the Octans I issuer by failing to identify, in the CMA, Magnetar's participation in the warehouse agreement (Div. Br. at 119-20);

(9) violated Section 17(a) (with no subsections specified) with respect to the Octans I issuer, in connection with the sale of collateral from the warehouse to the issuer, by the same conduct identified *supra* as violating Section 206 (Div. Br. at 121);

(10) violated Section 17(a) (with no subsections specified) with respect to Octans I investors, by misrepresenting, in the offering circular, that Harding would select all collateral for the issuer (Div. Br. at 122-23);

(11) violated Section 17(a) (with no subsections specified) with respect to Octans I investors, by failing to identify, in the offering circular, Magnetar's participation in the warehouse agreement (Div. Br. at 123);

(12) violated Section 17(a) (with no subsections specified) with respect to Octans I investors, by misrepresenting, in the offering circular, the standard of care Harding intended to follow (Div. Br. at 123);

(13) violated Section 17(a) (with no subsections specified) and Section 206 by purchasing Norma bonds for clients, either without following the proper standard of care in selecting the clients' collateral, or knowing that the collateral was unsuitable for the clients (Div. Br. at 124-25); and

(14) violated Section 17(a) (with no subsections specified) and Section 206 by misrepresenting, in each client's CMA, the standard of care Harding followed in selecting Norma bonds for each client's portfolio (Div. Br. at 124).

A. Alleged Securities Act Section 17(a) Violations Against Octans I Investors

Securities Act Section 17(a) provides, in relevant part:

> It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly— (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain 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, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a).

To prove a violation of Securities Act Section 17(a)(1), a showing of scienter is required. *Aaron v. SEC*, 446 U.S. 680, 695-97 (1980). Scienter is defined as a "mental state embracing the intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976); *Aaron*, 446 U.S. at 686 n.5. A finding of "extreme recklessness" satisfies the scienter requirement. *John P. Flannery*, Securities Act Release No. 9689, slip op. at 32 (Dec. 15, 2014); *David Disner*, 52 S.E.C. 1217, 1222 & n.20 (1997); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (citing eleven circuits holding that recklessness satisfies scienter in Section 10(b) and Rule 10b-5 actions), *cert. denied*, 499 U.S. 976 (1991). Extreme recklessness, in the context of securities fraud, is "highly unreasonable" conduct, "which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Flannery*, at 13 n.24; *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1977) (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)); *see also S.W. Hatfield, CPA*, Securities Exchange Act of 1934 (Exchange Act) Release No. 69930, 2013 WL 3339647, at *21 (Jul. 3, 2013). To prove a violation of Securities Act Section 17(a)(2) or 17(a)(3), only a showing of negligence is required. *Flannery*, at 14. "Negligence is the failure to exercise reasonable care or competence." *Byron G. Borgardt*, 56 S.E.C. 999, 1021 (2003).

Each subsection of Section 17(a) has a different scope. Section 17(a)(1) "proscribes all scienter-based fraud," including making, drafting, and devising a material misstatement, and using a misstatement made by others, to defraud investors. *Flannery*, at 24-25. Section 17(a)(2) proscribes obtaining money or property by means of an untrue statement, that is, "the transfer of money or property from an investor to" a respondent. *Id.* at 14, 35. Section 17(a)(3) proscribes transactions, practices, and courses of business that operate or would operate as a fraud, and proscribes misrepresentations only if they constitute transactions, practices, or courses of business. *Id.* at 25-26. Thus, a single act of making a material misstatement, by itself, would not violate Section 17(a)(3), but repeatedly making material misstatements could constitute a fraudulent practice or course of business. *Id.* at 26.

Respondents' activities occurred through interstate commerce, including by electronic mail and telephone calls. *See, e.g.,* Div. Ex. 233, Resp. Ex. 627; *see also SEC v. Tourre*, No. 10 Civ. 3229, 2013 WL 2407172, at *11 (S.D.N.Y. June 4, 2013) ("[I]t is undisputed that Tourre and his colleagues . . . accomplished the alleged fraud in part through communications . . . via phone and email. The SEC is therefore entitled to summary judgment on the interstate commerce element . . . ."). The interstate commerce nexus is therefore satisfied.

1. Threshold Legal Issues Regarding Securities Act Section 17(a)

Before analyzing the Division's theories of liability under Securities Act Section 17(a), several threshold issues must be considered.

a. Applicability of Janus Capital Group, Inc. v. First Derivative Traders

First, to the extent that *Janus Capital Group, Inc. v. First Derivative Traders*, --- U.S. ---, 131 S. Ct. 2296 (2011) (*Janus*), holds that an actor must be the "maker" of an untrue statement, as under Exchange Act Rule 10b-5, *Janus* does not apply. *Flannery*, at 15, 24.

b. "Use" of Untrue Statements

Respondents contend that they cannot be held liable under Section 17(a)(2), regardless of whether *Janus* applies, because Harding did not "use" the statements at issue "to obtain money or property," as required by Securities Act Section 17(a). *See* 15 U.S.C. § 77q (Section 17(a)(2) makes it unlawful "to obtain money or property by means of any untrue statement of fact"). Respondents contend that Merrill "had ultimate control over and decided how to *use* the statements in the Offering Circular." Resp. Br. at 309. Respondents cite *SEC v. Tambone* in support of their argument, which, prior to *Janus*, highlighted differences between Exchange Act Section 10(b) and Securities Act Section 17(a), noting that the latter includes the requirement that defendant have "used" the statement "to obtain money or property." 550 F.3d 106, 127 (1st Cir. 2008), *reh'g en banc granted, opinion withdrawn*, 573 F.3d 54 (1st Cir. 2009), *reinstated in relevant part on reh'g*, 597 F.3d 436, 444 (1st Cir. 2010) (en banc); *see SEC v. Stoker*, 865 F. Supp. 2d 457, 465 (S.D.N.Y. 2012) (discussing differences between Exchange Act Section 10(b) and Securities Act Section 17(a) in light of *Tambone*).

A violation of Section 17(a)(2) requires a "causal link" between a misrepresentation and the acquisition of money or property. *Flannery*, at 35. That is, the misrepresentation must be "at least relevant to, if not the cause of, the transfer of money or property" to Respondents. *Id.* Under this standard, Respondents clearly "used" their own statements to obtain money or property. Respondents knew the pitch book and offering circular were used to solicit investors for Octans I and that both documents reflected content that Harding prepared, and Respondents reviewed. Respondents understood Merrill would distribute the documents to achieve the common goal of securing investors for Octans I. Tr. 353, 1824, 2950, 4264; Div. Ex. 1 at 37; Div. Exs. 196-97; *cf. Stoker*, 865 F. Supp. 2d at 466 (finding that the complaint in *Stoker* met an even higher standard than mere use because "Stoker did know that the statements would be disseminated to investors, because the statements were made in the marketing materials specifically prepared to send to investors to encourage them to invest in the Fund"). Harding employees, including Chau, participated in the marketing of Octans I, attending road shows and answering questions related to the pitch book regarding, among other things, the credit decision-making process. *See, e.g.*, Tr. 1043.[57] Additionally, Harding made no money until its CDOs closed.[58] *See* Tr. 255-56, 1473.

c. Actionability of The Octans I Pitch Book

Respondents argue that misrepresentations in the Octans I pitch book are not actionable pursuant to Securities Act Section 17(a) because it explicitly stated that it was "not an offering document and was subject to change," and because investors stated in subscription agreements that they relied solely on the offering circular. Resp. Br. at 115 (emphasis omitted). But the "in the offer or sale" language of Section 17(a) is construed broadly to encompass the entire selling process, and is not limited to any particular phase of the transaction. *See United States v. Naftalin*, 441 U.S. 768, 772-73 (1979) (quoting 15 U.S.C. § 77b(3), "the term . . . 'offer' shall include *every attempt* or offer *to dispose of . . . a security* or interest in a security, for value"); *see also Graham v. SEC*, 222 F.3d 994, 1002 (D.C. Cir. 2000); *SEC v. Goldsworthy*, No. 06-cv-10012, 2008 WL 8901272, at *9 (D. Mass. June 11, 2008); *SEC v. Shapiro*, No. 4:05-cv-364, 2007 WL 788335, at *5 (E.D. Tex. Mar. 14, 2007), *report and recommendation adopted*, 2007 WL 1002120 (E.D. Tex. Mar. 30, 2007); *SEC v. Durgarian*, 477 F. Supp. 2d 342, 356 (D. Mass. 2007). More specifically, pre-offering circular marketing materials, including pitch books with similar disclaimers, have been found actionable. *See, e.g.*, *SEC v. Quan*, No. 11-cv-723, 2013 WL 5566252, at *8, *15 (D. Minn. Oct. 8, 2013) ("whether Quan's depleting of the Blocked Account caused the flipbook statement to be misleading is a triable fact issue"); *SEC v. True North Finance Corp.*, 909 F. Supp. 2d 1073, 1096-97 (D. Minn. 2012) (rejecting argument that statements outside the offering circular were not actionable even though investors signed subscription agreements explicitly stating that they did not rely on statements beyond materials in the offering circular, because a showing of reliance is not a requirement in cases brought by the Commission).

None of the cases Respondents cite in support of their argument bar liability pursuant to Securities Act Section 17(a). Two of the cases limited only actions based on state law breach of contract and breach of warranty claims. *See Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 938-39 (2d Cir. 1998) (upholding denial of New York state common law breach of warranty claims for statements made in pre-offering circular brochures because the "statements were made before and never incorporated into any enforceable contract or sale"); *Banco Espirito Santo de Investimento, S.A. v. Citibank N.A.*, No. 03 Civ. 1537 (MBM), 2003 U.S. Dist. LEXIS 23062, at *11-15 (S.D.N.Y. Dec. 29, 2003) (dismissing claim under New York law of breach of contract based on statements made during marketing negotiations that conflicted with language "expressly disclaiming any intention to be bound other than by the Offering Memoranda"). A third case, *Hunt v. Alliance North American Government Income Trust, Inc.*, upheld a dismissal of claims by private investors that advertising materials were not

[57] According to Huang, Harding presentations typically tracked the pitch book in investor meetings. Tr. 1043.

[58] *Tambone* and cases adopting its reasoning have made clear that "[l]iability attaches so long as the statement is used to obtain money or property, regardless of its source." *Tambone*, 550 F.3d at 127 (internal quotations and emphasis omitted).

misleading if read in conjunction with warnings in the prospectuses the fund urged investors to consult. 159 F.3d 723, 730 & n.4 (2d Cir. 1998). *Hunt* held that private investors, who were required to show reliance, failed to plead a sufficient claim where "minimal diligence" would have led investors to discover the truth. *Id.* at 730. Minimal diligence in *Hunt* included "consulting the prospectus," which disclosed the appropriate risks lacking in the advertising materials. *Id.* *Hunt* did not hold that marketing materials outside of an offering circular or prospectus cannot be actionable, especially where, as here, the offering circular failed to supplement or correct information alleged to be misleading. Respondents point to no language in the offering circular that would have negated or clarified questionable representations in the pitch book.

2. Alleged Fraud With Respect to Octans I Investors

a. Materiality

A violation of Securities Act Section 17(a) requires a showing of materiality. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32, 240 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999). Materiality is proved by showing a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'" *SEC v. Ginsburg*, 362 F.3d 1292, 1302 (11th Cir. 2004) (quoting *TSC Indus.*, 426 U.S. at 449). Materiality does not require proof that accurate disclosure would have caused the reasonable investor to change her decision, but only that the omitted fact would have assumed actual significance in the deliberations of the reasonable investor. *TSC Indus.*, 426 U.S. at 449.

As a general matter, misrepresentations and omissions are material when they pertain to an independent professional on whose expertise investors rely. *See S.W. Hatfield, CPA*, Exchange Act Release No. 73763, 2014 SEC LEXIS 4691, at *21 (Dec. 5, 2014). That materiality extends to improper influence over credit processes by independent collateral managers on whose expertise investors rely. *See Bayerische Landesbank, N.Y. Branch v. Barclays Capital*, 902 F. Supp. 2d 471, 473 (S.D.N.Y. 2012) ("exert[ion] [of] control over the selection of collateral assets," and "us[ing] . . . control to structure a rigged bet that would pay off when the collateral assets failed" "qualifies as an untrue statement of material fact") (internal quotations and citations omitted); *Stoker*, 865 F. Supp. 2d at 464 ("[R]epresenting to investors that an experienced, third-party investment adviser had selected the investment portfolio would facilitate the placement of the CDO squared's liabilities . . . [is], in the Court's reading of Section 17(a)(2), more than sufficient to impose liability.") (internal quotations and citations omitted). Similarly, misrepresentations and omissions regarding third parties' negative interest in a CDO are material. *See SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 163 (S.D.N.Y. 2011) ("[R]ather than being financially interested in ABACUS'S success, as the SEC alleges Tourre represented to ACA, Paulson, in fact, had financial interests and expectations that were diametrically opposed to ABACUS's success. Assuming the SEC can prove its allegations, if Goldman and Tourre represented that Paulson was investing in ABACUS'S equity, the fact that Paulson was, in reality, taking a short position is a fact that, if disclosed, would significantly alter the 'total mix' of available information.") (internal quotations and citation omitted).

Misrepresentations of credit review standards are generally material. *See Genesee Cnty. Emps.' Ret. Sys. v. Thornburg Mortg. Secs. Trust 2006-3*, 825 F. Supp. 2d 1082, 1167-68, 1170 (D.N.M. 2011) (alleged failure to "follow[] the stated practices and the respective underwriting guidelines" considered material misrepresentations); *Emps.' Ret. Sys. of the Gov't of the V.I. v. J.P. Morgan Chase & Co.*, 804 F. Supp. 2d 141, 152, 154-55 (S.D.N.Y. 2011) ("[a]llegations that loan originators abandoned the underwriting standards that they professed to follow" constitute material violations) (internal quotations and alterations omitted). Abandonment of disclosed credit processes and underwriting standards is also material. *See Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762, 773 (1st Cir. 2011) ("wholesale abandonment of underwriting standards" deemed actionable); *W. & S. Life Ins. Co. v. JPMorgan Chase Bank, N.A.*, --- F. Supp. 3d ---, No. 1:11-cv-495, 2014 WL 5308422, at *15 (S.D. Ohio Oct. 16, 2014) ("Plaintiffs have pleaded sufficient facts suggesting a systematic abandonment of underwriting guidelines . . . Courts in many jurisdictions have joined the Sixth Circuit in allowing claims based on the wholesale abandonment of underwriting guidelines.").

b. The Investment Analysis Process

The Division contends that Respondents violated Section 17(a), subsections (1), (2), and (3), with respect to Octans I investors by misrepresenting, in the pitch book, Harding's investment analysis process. Div. Br. at 108-12, 115-16. In particular, the Division contends that the investment analysis process for the ABX Index bonds was inconsistent with the representations in the pitch book. Div. Br. at 108-12; *see* OIP at 7-10.

Moy and Lieu reviewed the same set of bonds on May 31, 2006, Lieu through the ABX Index review, and Moy through an OWIC that listed the same bonds. Div. Exs. 36, 52, 65. Ultimately, Lieu approved thirteen more bonds than Moy did in her OWIC review. Div. Exs. 65-66, 70-71. Technically, each reported to Chau, or another senior executive in Chau's absence. Tr. 258, 3246, 3263, 3691. However, Lieu and Moy made many credit decisions independently, especially on May 31, 2006, when Lieu and Moy were busy reviewing multiple sets of bonds for credit-worthiness. Div. Exs. 65-66, 70-71. There is no evidence of communications between Lieu and Moy regarding the ABX Index bonds on May 30 and 31, 2006, nor is there evidence that the two were even aware that they were reviewing the same bonds at the same time. Lieu's response on May 31, 2006, to Giasi's question of whether Harding had previously reviewed any of the bonds in the May 31 OWIC was based upon her quick copying and pasting of CUSIPs for the bonds into a search function in records for previously reviewed bonds. Tr. 3697-3703; Div. Exs. 57, 65. She did not look them up by name, and thus was unaware that she was looking at many of the same bonds that she would be looking at as part of the ABX Index review. Tr. 3701-02. Similarly, while Moy copied the MaximCDO list when she sent her OWIC approval list, which would have included Lieu, it is unlikely Lieu would have been able to review Moy's decisions. Div. Ex. 65. Lieu's decisions on the ABX Index bonds were sent only an hour and twenty minutes after the time Moy sent her list of approvals regarding the OWIC, a time when Lieu was busy reviewing the ABX Index bonds. *Id.*; Div. Ex. 70.

Similarly, there is no evidence that anyone more senior than Lieu or Moy, such as Chau or Huang, took notice of the disparity between Lieu's and Moy's decisions on the ABX Index bonds on May 31, 2006. Div. Br. at 112. Moy took on the task of reviewing bonds for that day's OWIC, and Lieu was assigned the task of reviewing the list of ABX Index bonds that Merrill forwarded to Harding. The two of them worked independently, Lieu forwarded her results directly to Huang, and Moy forwarded her results directly to Giasi. Huang simply forwarded Lieu's decisions to Merrill.

I agree with the Division that the process Lieu followed was inconsistent with the "collaborative, methodical and disciplined investment process" described in the pitch book. Div. Ex. 1 at 48; *see also* Tr. 1898-1903 (Doiron describing his understanding of the pitch book's representations). The decision on which ABX Index bonds to purchase, or gain exposure to, was made essentially just by Lieu, with no review by Huang or Chau. Lieu's analysis was inconsistent with Moy's analysis of the same bonds the same day, with no effort made to reconcile the two analyses. Lieu's analysis was not a "thorough rigorous upfront credit and structural analysis" or "thorough bottom/up credit and structural analysis," as the pitch book represented it to be. Div. Ex. 1 at 43. It was, instead, slapdash.

While vague and general statements can be considered mere puffery, and thus not actionable as fraudulent misstatements, the statements in the pitch book were not "vague and general statements of optimism." *See Key Equity Investors, Inc. v. Sel-Leb Mktg. Inc.*, 246 F. App'x 780, 785 (3rd Cir. 2007) (quoting *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 538 (3rd Cir. 1999), *abrogated on other grounds by Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007)) (internal quotations omitted). The language regarding the credit review process was specific to the industry, and would have created expectations for investors reading it. Respondents claim that any representations regarding how Harding selected Octans I assets would have been in conflict with statements elsewhere in the pitch book, including the disclaimers that no representations were being made on the credit quality of the reference obligations. Resp. Br. at 125. The allegations of the OIP deal with representations made regarding credit processes by Harding, not the underlying assets. *See, e.g.*, OIP at 3. Harding's credit and selection processes were not disclaimed in a similar manner.

There is no documentation of Lieu running stress case runs, which shows failure to comply with statements made in the pitch book that Harding would run stress case scenario cash flows.[59] Div. Ex. 1 at 45. The pitch book stated that Harding would "[s]tress[] each transaction under extreme interest rate and prepayment rate assumptions to capture the tolerance for losses of the underlying collateral pool." *Id.* Wagner testified that performing stress case cash flow runs was an industry standard, and should be performed for each bond. Div. Ex. 8001 at 51; Tr. 4911-18. Lieu agreed that she was supposed to review stress case cash flow runs for each bond that she reviewed, yet there is no evidence that Lieu, or anyone at her direction, performed stress

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[59] Respondents suggest that the Kaplan spreadsheet, like similar ones around the same time, was actually a stress case run. Resp. Br. at 181 n.208. But Lieu conceded after reviewing the Kaplan spreadsheet and other credit review documents during the hearing that there did not appear to be any evidence of stress case cash flow runs. Tr. 3997. Also, Lieu testified she believed the base case cumulative loss rate for the period around May 31, 2006, was 6% and that the stress case scenario was 8%, but the credit review materials reviewed at the hearing were all performed using a 6% cumulative loss rate. *See* Tr. 3457-58.

case cash flow runs for the ABX Index bonds as part of her review on May 31, 2006. *See* Tr. 3997. Lieu's failure to run the stress case cash flows demonstrates inadequacy in the ABX Index review, but was not, by itself, such a large deviation from the standard of care that it rose to the level of extreme recklessness. *Cf. Plumbers' Union Local No. 12*, 632 F.3d at 773 ("*wholesale* abandonment of underwriting standards" deemed actionable (emphasis added)).

Thus, the pitch book's representations about the investment analysis process for Octans I were misleading. On this point, I credit Wagner's opinion. Div. Ex. 8001 at 17-20, 39-40. The pitch book's representations were also material, because a reasonable investor would have considered the difference between the representations and reality significant. *See Genesee Cnty.*, 825 F. Supp. 2d at 1167-70; *Emps.' Ret. Sys. of the Gov't of the V.I.*, 804 F. Supp. 2d at 152, 154-55.

However, the pitch book's investment analysis process misrepresentations were not made with scienter. There is insufficient evidence that Chau, Lieu, or anyone else intended to mislead investors by, in essence, exaggerating the rigor and thoroughness of Harding's investment analysis process. Indeed, in order to find an intent to defraud, I would have to disbelieve every single lay witness who testified on the subject.

Nor was the disparity between the pitch book's representations and the reality of the process so clear and distinct that the representations rose to the level of an extreme departure from the standard of care. Lieu followed the represented review standards to some extent, albeit untidily and incompletely. The pitch book stated that Harding would "[e]valuat[e] credit enhancement and structural protection based on expected loss scenarios relevant for the particular asset class and collateral profile." Tr. 3283; Div. Ex. 1 at 45; Div. Ex. 8001 at 31, 41, 53. Harding, and Lieu, generally complied with that expectation. Of the forty ABX Index bonds at the Baa2 and Baa3 levels, Harding analysts analyzed cash flow for at least thirty-nine within the ten days leading to Lieu's decisions on May 31, 2006, including the twenty-four that Lieu had Kaplan run on May 31, 2006. *See* Tr. 4741; Div. Exs. 52-54, 267-70; Resp. Exs. 773-74. Lieu was not copied on every email for these runs, but all took place days and hours before her ABX Index review, and thus she would have had access to the runs as part of her review. *See, e.g.*, Resp. Exs. 324-35. The fortieth bond, for which no cash flow run records have been located, was approved by both Moy and Lieu on May 22, 2006, and had been approved several times before that, indicating that some testing would have been performed by either Lieu or Moy contemporaneously. *See* Div. Exs. 65-66; Resp. Exs. 298-99, 371-72.

The ABX Index reflected twenty of the most liquid deals in the market at the time, and as such, Lieu was familiar with the bonds, having come across almost all of them, at least some of them several times, and performing full reviews on them prior to receiving the inquiry on May 30, 2006. Just nine days earlier, on May 22, 2006, the credit department circulated a document memorializing review of thirteen of the twenty ABX Index deals as part of an OWIC, and the bidlist specifically listed collateral attributes as a reason for rejecting some of the bonds. *See* Div. Ex. 16. Another deal in the ABX Index was reviewed as part of a review for a proposed Merrill portfolio trade on May 30, 2006, and Lieu specifically stated that she had "run[] CF's and look[ed] at credit" for bonds not already in the master bidlist. *See* Div. Ex. 29.

For many of the same reasons listed above, Lieu did have adequate time to review the ABX Index bonds. First, many of the cash flow runs had been performed recently, and for the ones that Lieu requested from Kaplan, the results came back in approximately twenty minutes, as they were run all in one block. *See* Div. Exs. 52-53. Although reviewing the analyses takes more time than running them, since Lieu was already familiar with many of the bonds, and could compare many of the bonds' prior cash runs, she needed less time than if she were reviewing the bonds anew. Tr. 3286-87. Second, Lieu had ample time to review the collateral. The ABX Index consisted of twenty bonds, each with its own collateral, that were sold in different tranches. Because collateral and structural attributes were common to all tranches, they only needed to be reviewed once, and much of Harding's work had been performed prior to May 31, 2006, so it only needed refreshed review.

The Division's proposed benchmarks for the time it took to review bonds, which it argues makes Lieu's representations improbable, are inapplicable to the situation Lieu faced on May 31, 2006. *See* Div. Br. at 58. The Division cites to Doiron's testimony that it would take as long as eight man hours to review a single bond. Div. Br. at 110; *see* Tr. 1901-02. Doiron's testimony, however, discussed bonds that were brand new to the analyst, not ones that had previously been reviewed, especially ones that had been reviewed multiple times. Tr. 1901-02. The Division's argument is especially undercut by the fact that Moy, whose review the Division implicitly concedes was done correctly, reviewed the same bonds in an even shorter time than Lieu. Div. Exs. 65-66. Wagner conceded that he could have reviewed forty bonds in a day. Tr. 4757. Another collateral manager, ACA, which worked with Magnetar around the same time, indicated that review of the same ABX Index bonds would take "a day." Resp. Ex. 514.

Notably, Wagner did not explicitly opine that the ABX Index trade analysis constituted an extreme departure from the standard of care. To be sure, Wagner apparently opined that Chau's description of Harding's normal investment analysis process was "completely at odds" with the standard described in the pitch book. Div. Ex. 8001 at 39. But this aspect of Wagner's opinion was based on Chau's investigative testimony, not his hearing testimony, and Chau's hearing testimony described a more rigorous and thorough process. Tr. 4094-96, 4114-15; Div. Ex. 8001 at 38-39. Wagner also opined that the analysis for the ABX Index trade was "totally inconsistent" with the standard described in the pitch book. Div. Ex. 8001 at 39. Inasmuch as Wagner's choice of words may be construed as an opinion that the ABX Index trade analysis was an extreme departure from the standard of care, I do not credit Wagner's opinion. Lieu's efforts definitely departed from the pitch book's standard of care representations, but not to an extreme degree.

Thus, Section 17(a)(1) was not violated by these misrepresentations. Nor did the misrepresentations violate Section 17(a)(3). To be sure, Respondents apparently distributed the pitch book to multiple investors, but the record is insufficiently clear as to how many investors received it. *See* Resp. Ex. 187 (Merrill distributed pitch book to a prospective investor); *Flannery*, at 36. Without more, a misrepresentation about a single subject in a single document is not the kind of transaction, practice, or course of business actionable under Section 17(a)(3). *Flannery*, at 26. However, Harding's management fees, which would not have been paid but for the successful closing of Octans I, which itself was conditioned on the successful sale of Octans I tranches, were the result of use of the pitch book to sell those tranches. Div. Ex. 24 at 1-4. This meets the criterion announced in *Flannery* for a causal link under Section 17(a)(2). *Flannery*, at 35. Thus, the pitch book's misrepresentations regarding Harding's investment analysis process caused Harding to receive money by means of misrepresentations, in violation of Section 17(a)(2).

c. Investment Analysis Personnel

The Division contends that Respondents violated Section 17(a), subsections (1), (2), and (3), with respect to Octans I investors by misrepresenting, in the pitch book, Harding's investment analysis personnel. Div. Br. at 112-13, 115-16. Although this contention may be relevant for other purposes, it cannot form the basis of a separate Section 17(a) violation because it is not alleged in the OIP.[60] OIP at 11.

d. Magnetar's Participation in the Warehouse Agreement

The Division contends that Respondents violated Section 17(a), subsections (1), (2), and (3), with respect to Octans I investors by failing to identify, in the pitch book and offering circular, Magnetar's participation in the warehouse agreement. Div. Br. at 116, 123. The pitch book stated, in pertinent part:

> It is anticipated that many of the securities that will be purchased by the Issuer . . . 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. There is no mention in the pitchbook of Magnetar's ability to object to collateral going into the warehouse, or to veto collateral coming out of the warehouse, or any other aspect of "Magnetar's involvement in the warehouse phase." OIP at 11; Tr. 1844; *see generally* Div. Ex. 1.

The offering circular stated, in pertinent part, that the CDO's securities would be acquired "from a portfolio of Collateral Debt Securities selected by the Collateral Manager and held by [Merrill] pursuant to warehousing agreements between [Merrill] and the Collateral Manager." Div. Ex. 3 at 66. The offering circular went on to say that some of the CDO's securities "subject to such warehousing agreement may have been originally acquired by [Merrill] from the Collateral Manager or one of its affiliates or clients." *Id.* As with the pitch book, there is no mention in the offering circular of Magnetar's ability to object to collateral going into the warehouse, or to veto collateral coming out of the warehouse, or any other aspect of Magnetar's involvement in the warehouse phase. OIP at 11; Tr. 415; *see generally* Div. Ex. 3.

The omission of Magnetar's involvement in the warehouse was inaccurate, and therefore misleading, because the particular language at issue suggested that Merrill and Harding were the only parties to the warehouse agreement. Tr. 415, 1844. Also, that a third party had the ability to interfere with Harding's selection of collateral for Octans I is surely something that would

[60] I have carefully reviewed the OIP, and I have only sustained those allegations that were properly alleged. *Cf.* Resp. Br. at 153 n.166.

have been material to a reasonable investor. *See, e.g.*, Tr. 2063. As with Harding's misrepresentations regarding its investment analysis process, its "use" of the pitch book resulted in Harding obtaining money, within the meaning of Section 17(a)(2).

However, Respondents did not act with scienter, or even negligently. There is no evidence that Respondents' conduct was intentional. The sections of the pitch book and offering circular at issue were drafted by Merrill, not Harding. Tr. 369-71, 1829-30; Div. Ex. 4 at 19. That is, Merrill and its counsel were in charge of drafting the pitch book and offering circular, and Harding was responsible for providing a draft of the sections specifically pertaining to Harding. Tr. 571, 1823. Although Chau certified that he had "carefully examined the Offering Circular," and opined that "the information *concerning Harding Advisory* . . . included in the sections 'The Collateral Manager,' 'Risk Factors-Conflicts of Interest Involving the Collateral Manager,' [and] 'Risk Factors-Dependence on the Collateral Manager and Key Personnel' . . . did not include any untrue statement of material fact," those were not the sections containing the language at issue. Div. Ex. 501 at 1 (emphasis added). Suh reviewed the offering circular, and recommended disclosing Magnetar's position in an unrelated section. *See* Tr. 3073, 3119; Div. Ex. 138. Chau testified that he was unaware that the offering circular omitted mention of Magnetar's participation in the warehouse agreement, however, and there is no evidence that Suh knew of the omission, at least as it pertained to the language at issue. Tr. 4334-36.

The Division's strongest evidence regarding Respondents' state of mind pertains to the pitch book. In July 2006, after Eliran sent Chau and Wang a draft of the pitch book, Wang commented on a paragraph entitled "Conflicts of Interests of Collateral Manager," a paragraph for which Harding was responsible. Tr. 377-78; Div. Ex. 124 at 1. The part of the paragraph on which Wang commented was immediately before, and appeared on the same page as, the paragraph containing the language at issue. Resp. Ex. 179 at 29. However, there is no evidence that Chau or Wang actually reviewed that paragraph, nor would they have had reason to. Wang's review and comments, understandably, were limited to basics about Harding, specifically updating the language to reflect the fact that Maxim had become Harding. Div. Ex. 124 at 2-3. Suh did not review the pitch book. Tr. 3072-73, 3115. On balance, there is insufficient evidence that Respondents' use of the pitch book violated any subsection of Section 17(a) with respect to Magnetar's participation in the warehouse agreement.

e. <u>Harding's Selection of Octans I Collateral</u>

The Division contends that Respondents violated Section 17(a) with respect to Octans I investors by misrepresenting, in the pitch book and CMA, that Harding would select all collateral for the issuer, when Harding did not, in fact, select the collateral. Div. Br. at 122-23 ("Harding had simply taken the Index (a block selected by Magnetar) and excluded the worst performers"). The Division makes a similar contention regarding Section 206 with respect to the issuer. Div. Br. at 116 (same). But the OIP repeatedly alleges that Harding "select[ed]" the collateral, or words to that effect, and even contains a section entitled "Harding's Selections." OIP at 5, 6, 8. Either Harding selected the collateral or it did not; the principal pertinent allegation of the OIP is that Harding selected the collateral while under the undue and undisclosed influence of Magnetar, not that it did not actually select the collateral. *E.g.*, OIP at 7 ("Harding agreed to the concepts of acquiring exposure to the ABX Index and of excluding from that exposure selected bonds.”). Thus, this contention cannot form the basis of a violation of either Section 17(a) or Section 206 because it is not alleged in the OIP. OIP at 11.

f. Harding’s Adherence to the Standard of Care

The Division contends that Respondents violated Section 17(a) with respect to Octans I investors by misrepresenting, in the offering circular, the standard of care it intended to follow. Div. Br. at 123. The standard of care announced in the offering circular, which was repeated in the CMA, was that Harding would perform its obligations

> with reasonable care (i) using a degree of skill and attention no less than that which [it] would exercise with respect to comparable assets that it manages for itself and (ii) . . . 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.

Div. Ex. 4 at 8; *accord* Div. Ex. 3 at 197. The analysis of this contention, including the evidence considered, is almost identical to the analysis of the contention that the pitch book misrepresented Harding’s investment analysis process, *supra*, because both contentions pertain only to the selection of ABX Index bonds. OIP at 7-10; *see* Div. Br. at 123. The only difference is whether Harding’s investment analysis process comported with the standard of care articulated in the offering circular, as opposed to the description of that process in the pitch book. On this point, I credit Wagner’s opinion, which was that Harding departed from the standard of care (although, again, I find that the departure was not extreme). Div. Ex. 8001 at 38-41. As with the pitch book, it stands to reason that the offering circular was distributed to multiple prospective investors, although the record does not reveal how many, and Harding obtained money as a result of its use. Accordingly, I find that the standard of care misrepresentation in the offering circular violated Section 17(a)(2), but no other subsection of Section 17(a), and that Harding’s violation was only negligent.

B. Alleged Violations Against the Octans I Issuer

1. Violations of Advisers Act Section 206

Advisers Act Section 206 makes it unlawful

> for any investment adviser, by use of the mails or any means of instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client; [or]
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client[.]

15 U.S.C. § 80b-6.

The standard of care for a registered investment adviser is based on its fiduciary duty. *See Transamerica Mortg. Adviser, Inc. v. Lewis*, 444 U.S. 11, 17 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963). Investment advisers have an "affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts.'" *Capital Gains Research Bureau*, 375 U.S. at 194 (citations omitted); *SEC v. Blavin*, 760 F.2d 706, 711-12 (6th Cir. 1985). Respondents were required to "employ reasonable care to avoid misleading" clients. *See Capital Gains Research Bureau*, 375 U.S. at 194; *SEC v. Moran*, 922 F. Supp. 867, 895-96 (S.D.N.Y. 1996). The standard is one of "reasonable prudence, whether it usually is complied with or not." *Vernazza v. SEC*, 327 F.3d 851, 861 (9th Cir. 2003) (internal quotations omitted). As applicable here, an investment adviser has a "professional duty" to inform its clients of risks and conflicts. *Blavin*, 760 F.2d at 712; *see SEC v. Fife*, 311 F.3d 1, 10 (1st Cir. 2002). Scienter is required for a Section 206(1) violation, but is not required for a Section 206(2) violation. *SEC v. Slocum, Gordon & Co.*, 334 F. Supp. 2d 144, 182 (D.R.I. 2004); *see also SEC v. Steadman*, 967 F.2d 636, 641 n.3, 643 n.5 (D.C. Cir. 1992); *Steadman v. SEC*, 603 F. 2d 1126, 1134 (5th Cir. 1979).

It is undisputed that Harding was an investment adviser. Answer at 3. As with the Section 17(a) violations pertaining to Octans I investors, Respondents' activities occurred in interstate commerce.

The Division contends that Respondents violated Section 206 in four ways: (1) by misrepresenting, in the CMA, the standard of care it used to select the Octans I collateral; (2) by failing to follow the proper standard of care in selecting collateral, independent of its representations; (3) by failing to disclose that it had a conflict of interest between its duty to the issuer and its desire to please Magnetar; and (4) by failing to disclose Magnetar's participation in the warehouse agreement. Div. Br. at 117-20.

a. Threshold Issues Regarding Section 206

A. Waiver of Fiduciary Duty

Respondents argue that there can be no actionable violation under Section 206 because "Harding was not the Issuer's fiduciary." Resp. Br. at 143. Respondents contend that the CMA purported to disclaim all fiduciary duties and obligations. *Id.* at 143-44; *see also* Div. Ex. 4 at 8-9. Not so. *See, e.g.*, Div. Ex. 4 at 3, 6 ("The Issuer hereby appoints the Collateral Manager as *its investment advisor* and manager"; "The Collateral manager shall take all action required, as Collateral Manager for the Issuer, to be taken by it under the Investment Advisers Act of 1940, as amended.") (emphasis added). One paragraph of the CMA did limit Harding's general duties and obligations, but it did not limit those duties and obligations "expressly set forth" in the CMA, which undoubtedly included the provision appointing Harding as the issuer's investment adviser. Div. Ex. 4 at 8. Another paragraph of the CMA authorized Harding to "require the Trustee" to take certain actions "in the best interests of the Preferred Securityholders and Noteholders (and, to the extent that the interests of the Noteholders and the Preferred Securityholders conflict, in the best interests of the Noteholders)." Div. Ex. 4 at 5. However, this provision was "[s]ubject to . . . the provisions of the Indenture," and applied to Harding "as agent of the Issuer," that is, it in no sense trumped or waived Harding's fiduciary duties. Div. Ex. 4 at 4. Respondents cite no case law in support of their argument that fiduciary duties arising under the Advisers Act can be waived, nor am I aware of any.

Respondents argue, furthermore, that the issuer was created solely to execute the transaction documents for Octans I, and performed no independent due diligence or business judgment. *See* Resp. Br. at 146-54. The fiduciary duty, however, focuses on the adviser, not the client. *See SEC v. Gruss*, 859 F. Supp. 2d 653, 662-63 (S.D.N.Y. 2012) ("The fact that there is no private right of action is indicative that the focus of the act is the adviser and that clients of the investment adviser are not the class for whose special benefit the statute was enacted.") (internal quotations and citations omitted). The issuer's purpose and capabilities, or lack thereof, do not lessen or nullify Respondents' duties under the Advisers Act.

B. <u>Whether the Standard of Care in The CMA Was Forward Looking</u>

Respondents argue that any claim regarding the standard of care section of the CMA, as described in the offering circular, must fail because the language is forward looking. Resp. Br. at 304-07. According to Respondents, no duty arose until the CMA became effective on September 26, 2006, the date of the CMA and the date that the CDO closed, and after the selection of all of the bonds for Octans I. *Id.* However, the CMA memorialized Harding's involvement in the transfer of collateral from the warehouse to the issuer, and obliged Harding to provide the stated standard of care when "perform[ing] its obligations hereunder." Div. Ex. 4 at 8. The CMA's anticipated "[s]ervices" for Harding included "supervis[ing] and direct[ing] the Disposition and Acquisition of the Collateral Debt Securities (which includes Acquiring the Credit Default Swaps and Synthetic Securities . . . (as described in Section 17.1 of the Indenture))." *Id.* at 3. Section 17.1 of the indenture specifically discusses the purchase of the warehouse assets by the issuer through transfers of credit default swaps from the warehouse. Resp. Ex. 4 at 240. Accordingly, one of Respondents' first acts was advising the issuer on the transfer of the warehouse assets, and thus the standard of care section of the CMA applied to the issuer's purchase of warehouse assets, as well as assets purchased or disposed after the date of the CMA.[61]

b. <u>Harding's Standard of Care</u>

The Division's first two contentions are that Harding misrepresented, in the CMA, the standard of care that it followed, and that it failed in any event to comply with the standard of care applicable under the Advisers Act. Div. Br. at 117-18. The analysis of the first contention, including the evidence considered, is identical to the analysis of the contention that the offering

[61] The certification signed on September 26, 2006, stated that Harding reviewed the securities being acquired by the issuer to pledge as collateral for the Octans I notes, and that Harding certifies the securities meet the "Eligibility Criteria" as described in the related indenture agreement with the Octans I trustee. Div. Ex. 501. The Eligibility Criteria were a defined set of standards ensuring that any securities purchased by the Octans I issuer conformed to basic requirements of credit default swaps; they did not anticipate credit review quality. *See* Resp. Ex. 4 at 209-18.

circular misrepresented, within the meaning of Section 17(a), the standard of care Harding followed, *supra*, and I accordingly reach the same conclusion under Section 206. The second contention is almost identical, except that it pertains to the general standard of care, and on this point, I again credit Wagner's opinion that Harding departed from the standard of care, but do not find that its departure was extreme. Div. Ex. 8001 at 38-42. Accordingly, I find that the standard of care misrepresentation in the CMA violated Section 206(2), but not Section 206(1), and that Harding breached the applicable standard of care in any event, in violation of Section 206(2) but not Section 206(1).

Respondents nonetheless argue that the issuer knew everything that Merrill knew, because, among other factors, Merrill and the issuer retained the same counsel. Resp. Br. at 153-54. It is, indeed, black letter law that "notice to or knowledge possessed by an agent is imputable to the principal [including] in the relation of attorney and client." *Alioto v. Hoiles*, 531 F. App'x 842, 853 (10th Cir. 2013) (quoting *Chapman Coll. v. Wagener*, 45 Cal.2d 796, 291 P.2d 445, 448 (1955)), *cert. denied*, 134 S. Ct. 1561 (2014). However, there is no evidence that Merrill or its attorneys knew that Lieu's credit analysis was haphazard. Harding's misrepresentation regarding the standard of care therefore would not have been known to the issuer by virtue of its control by Merrill.

c. Conflict of Interest

The Division contends that Respondents failed to disclose that Harding had a conflict of interest between its duty to the issuer and its desire to please Magnetar. Div. Br. at 118-19. Failure to disclose a conflict of interest is both material and deceitful. *See Capital Gains Research Bureau*, 375 U.S. at 198-99.

The evidence is insufficient to conclude that Harding possessed a conflict of interest with respect to Octans I. The Division's theory is that Harding, motivated to facilitate its blossoming relationship with Magnetar, accepted bonds that were "disfavored" by its own analysts, because the acceptance of ABX Index bonds would benefit Magnetar, even though it would not benefit Octans I. *See* Div. Br. at 9-15. But there is insufficient evidence of pressure by Magnetar to corrupt Harding's credit process in the ABX Index trade. Harding was not a party to the long-range business arrangement that Merrill and Magnetar created. Magnetar initially came to Merrill to partner with it in structuring at least four CDO series, and those two parties agreed to select mutually agreeable collateral managers. Div. Ex. 12. Magnetar and Merrill chose Harding, but there is no evidence that Harding campaigned for the business. Tr. 133-34, 139; Div. Ex. 12. Likewise, there is insufficient evidence of a quid pro quo, i.e., that Harding was promised more business in exchange for allowing Merrill or Magnetar to dictate the assets in the CDO. Merrill and Magnetar had already decided on a reverse-inquiry basis to structure CDO deals together, with Magnetar investing in the equity portion of the CDOs, prior to ever involving Harding.

The Division argues that Harding relied on Merrill for business, especially early in their relationship. Div. Br. at 13. Accordingly, the argument goes, even if Respondents did not try to accommodate Magnetar to maintain its business, Chau kept Magnetar happy to maintain Merrill's business. *See id* at 13-14. There is evidence that Merrill tried to keep Magnetar happy.

The Division cites numerous emails between Merrill and Magnetar in which the two parties discuss plans to create a number of CDOs together, and testimony from Lasch that demonstrated that Merrill considered Magnetar one of its most important clients. *Id.* at 9-10; *see* Div. Exs. 11-12, 121; Tr. 112.

There is evidence that Harding compromised its standards to accommodate Merrill. *E.g.*, Div. Ex. 224 (Chen complaining about "another last minute present" from Merrill). There is also evidence that Harding compromised its standards to accommodate investors, who were acting through Merrill. Div. Ex. 258 (Chen complaining about "another merrill jam job" involving Merrill's attempt to placate the "MS prop desk," presumably Edman's group). But there is insufficient evidence that Harding compromised its standards to accommodate Magnetar specifically. By September 18, 2006, prior to Octans I closing, Harding had closed a CDO with Citigroup, and thereafter partnered with other investment banks to structure several new CDOs, including Octans II. *See* Div. Ex. 239. Similarly, though Magnetar's relationship was important, Harding managed only four Magnetar CDOs –Octans I, Octans II, Octans III,[62] all the same series, and Tigris – out of twenty-one that it managed and that closed by October 2, 2007. *See id.* Of those, only Octans I was structured and underwritten by Merrill. *See id.* The Division cites Lasch, who testified that Magnetar had substantial influence over the underwriter because the underwriter needed equity investors to create deals, but Lasch made no mention of Magnetar's ability to influence collateral managers. Tr. 144-46, 187-89, Div. Ex. 121. The Division also emphasizes Chau's statement that underwriters "lined up at the door" for Magnetar's investment. Div. Br. at 11; *see* Tr. 1790-91. Even assuming that such eagerness extended to collateral managers, it did not mean that Harding compromised its standards just to please Magnetar. The Division also points to investigative testimony by Huang, discussing his discomfort with the level of involvement by Prusko in Octans I's assembly. Div. Br. at 15. But Huang appeared just as uncomfortable with the level of involvement by the underwriters of CDOs in the warehouse process as well, making his discomfort with Magnetar's involvement less meaningful. Tr. 725-28, 733-36.

The Division argues Magnetar had outsize influence over Harding's selection process, because "Harding could not get paid for its work assembling a CDO's portfolio unless the CDO closed . . . – which required an equity investor." Div. Br. at 12; *see* OIP at 6. That is true of all CDOs, however. Tr. 1473. Ordinary business incentives, absent other factors, are not indicative of a conflict of interest. *See, e.g., Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Grp., Inc.*, 537 F.3d 527, 544 (5th Cir. 2008) ("incentive compensation can hardly be the basis on which an allegation of fraud is predicated . . . only in an extraordinary case is it probative") (internal quotations and citations omitted); *In re Franklin Bank Corp. Sec. Litig.*, 782 F. Supp. 2d 364, 399 (S.D. Tex. 2011) ("[T]he desire to keep stock values high is a universal goal among corporations and their executives and consequently does not contribute significantly to an

[62] The Division refers to an email between Chau and Margolis in which Chau states his intention to work with Merrill to "maximize his deal flow." Div. Br. at 14; see Div. Ex. 125. Yet, the email refers to teaming up with Merrill again after Octans I and II to create Octans III with Merrill, which never occurred; Octans III was created with Citigroup as underwriter. *See* Div. Exs. 125, 239.

inference of scienter."), *aff'd sub nom., Harold Roucher Trust U/A DTD 9/21/72 v. Nocella*, 464 F. App'x 334 (5th Cir. 2012).

Furthermore, despite having no "skin in the game," it was not in Respondents' interest to collude with other parties to create a CDO that would fail. Harding only received fees as CDOs produced income. If a deal failed, Harding stopped receiving payment. Tr. 1475. The Division's argument that it was typical for managers to invest in the CDOs they managed, and that Harding's lack of investment was atypical, was also not proved. The Division points to Huang's testimony that some managers chose to invest their own capital in a CDO, yet that same testimony by Huang makes clear that Harding did not have its own capital to invest at the time. Tr. 730. Nor is HIMCO's capital investment a fair comparison, because HIMCO is an arm of a global insurance conglomerate with a mandate to invest a very large amount of capital. Indeed, Doiron's group at HIMCO was initially concerned only with investing HIMCO's assets, and only later did it create a CDO for other investors. *See* Tr. 1860. Harding was a small outfit in 2006 that was just spinning off from Maxim, it had no capital to invest, and it had no history of previously investing in its own deals.

The OIP alleges that Magnetar's interests in Octans I "were not aligned" with those of the debt investors of Octans I, but the OIP does not specify how those interests were misaligned. OIP at 2. The Division specifies in its post-hearing brief that "Respondents clearly understood . . . that Magnetar's strategy entailed simultaneously investing in, and *betting against* the performance of, the CDOs that Magnetar helped to create." Div. Br. at 19 (emphasis added). The evidence does not support this contention. The Division argues that Chau knew Magnetar sought to go short and long on the same deals to the extent that Magnetar could maintain market neutrality, and that Harding therefore knew or had reason to know that Magnetar's interests were adverse to Octans I note holders. Div. Br. at 16-17. Chau indeed believed that Magnetar was "market neutral," but that simply meant that it would make money whichever way the market went, not that it was betting against Octans I. Tr. 1743. Even if Magnetar did intend to bet against the CDO, rather than create a market neutral position, there is no evidence that Chau was aware of such an intention.[63] There is no evidence that Chau knew Magnetar intended to create

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[63] The Commission issued Proposed Rule 127B on September 28, 2011, regarding "Prohibition Against Conflicts of Interest in Certain Securitizations," and provided preliminary views on interpreting the proposed rule. 76 Fed. Reg. 60320-01. No action has been taken on the proposed rule, and thus the proposed rule does not have the force of law. Nevertheless, the preliminary commentary adopted by the Commission provides some guidance as to what it believes constitutes a material conflict of interest in situations like the one at hand. In the release, the commentary describes hypothetical situations and analyzes them for materiality. One of the hypotheticals involves a third party that helps select assets in a CDO, invests in tranches of that CDO, and then shorts some securities in the same CDO. The commentary states, "[b]y allowing the third party to select assets and then hedge a position in ABS purchased in the offering, the securitization participant would not be permitting the third party to do anything that the securitization participation itself could not do under the proposed rule." *Id.* at 60339. By contrast, the commentary offers another hypothetical that would constitute a material conflict of interest. In that hypothetical, the third party that selected assets would participate in the securitization, but would position itself to profit more from the short position than it would lose

a net short position. Tr. 4317-25. Although Chau was aware of Magnetar's general strategy, neither he nor anyone else from Harding were privy to Magnetar's specific positions, or even its intended positions. *See* Tr. 2776-78, 4323-24. Huang testified that he believed Magnetar's positions were general correlation or hedging strategies, but did not testify that he understood Magnetar was shorting Octans I or that it sought to influence the asset selection process. Tr. 740-50, 754-57, 765-67, 781. There is no evidence that Lieu, who actually reviewed the ABX Index bonds' creditworthiness, had any knowledge of Magnetar's strategies or positions. The Division presented no evidence that any other Harding employees were aware of Magnetar's strategies or positions.

Nor does the evidence show that Magnetar held a net short position in Octans I. To be sure, Magnetar hedged Octans I by shorting senior tranches, and Prusko testified that Magnetar aimed to position itself 2-to-1 short, which was Magnetar's understanding of "market neutral." Tr. 2337-39, 2390. But Prusko also testified that Magnetar intended to hold Octans I equity for several years and profit from its high returns. *See* Tr. 2333-36. Contemporaneous emails corroborate Prusko's testimony. Resp. Ex. 493. The Division argues that by re-securitizing $64 million of its equity position in Octans I into Tigris, Magnetar effectively ended its long position in that piece of Octans I, creating an $18 million net short position ($48 million short, $30 million long). Div. Br. at 20. The economic reality, though, was that Magnetar's Tigris interest was simply a repackaging of Magnetar's Octans I equity. By repackaging much of the Octans I equity into Tigris, Magnetar leveraged those positions to procure a loan from Mizuho. Although the loan was non-recourse, Magnetar was still obligated to repay it, and Magnetar retained a $500 million first-loss position in Tigris. Thus, Magnetar still held "virtually all the risk to the Octans I security that was in Tigris." Tr. 2484, 2757, 4155. The Division argues that Chau was aware, eight days prior to Octans I closing, of Magnetar's intention to use part of its Octans I equity position to securitize Tigris, and that this awareness influenced the selection of assets in Octans I. Div. Br. at 20-22. But Octans I was close to fully ramped by September 18, 2006, the date when Chau became aware of Magnetar's decision to procure a rating for a piece of its Octans I equity. *See* Div. Ex. 276. There is no evidence that in the succeeding eight days, Harding acted differently than it otherwise would have. Moreover, there is no evidence that Chau was aware prior to Octans I closing that Tigris would involve a non-recourse loan. *See id.* Thus, the peak of Magnetar's short position was approximately $48 million, slightly more than half of its long position, i.e., a ratio of approximately 1-to-2 long. Tr. 2225, 2483-84.[64] Overall,

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in the long position, which would "no longer qualify for the risk-mitigating hedging exception." *Id.* As far as the evidence shows, Harding had no reason to suspect that Magnetar's positions were the latter, instead of the former.

[64] Magnetar's position in Octans I contrasts sharply with positions in other CDOs in which it was the equity investor. *See, e.g.*, *Financial Guar. Ins. Co. v. Putnam Advisory Co.*, No. 12 Civ. 7372, 2014 WL 1678912, at *3 (S.D.N.Y. Apr. 28, 2014) ("Magnetar's short position to its equity position was often 6–to–1 or even higher, meaning that when a Magnetar CDO failed, the payoff on Magnetar's short positions was at least six times the amount of Magnetar's equity investment in the CDO.").

Magnetar did not have a net short position in Octans I.[65]

There is insufficient evidence that Respondents understood the ABX Index to be detrimental to the issuer. Magnetar represented that ramping Octans I with the ABX Index provided a potential arbitrage that would benefit the CDO, and communicated this idea to Chau and Huang. *See* Div. Exs. 23, 33. As Prusko told another CDO manager, when explaining the index arbitrage strategy, "[a]ll the benefit of the arb goes into the deal," and Prusko testified that he was explaining to the CDO manager that "[t]here's no involvement in [Magnetar] economically, other than as the ultimate purchaser of the equity." Tr. 2462-63; Resp. Ex. 384. Harding's consideration of the ABX Index, a well-known index with highly liquid bonds, was not out of the ordinary. Tr. 1265-67. Indeed, Harding received an OWIC the same day with the exact same assets. Div. Exs. 65-66. Following Magnetar's proposal, Harding vetted the ABX Index. Tr. 4753-54. Though Chau agreed that investors preferred not to have indexes in managed CDOs, because it provided the impression that the manager was not actually managing the fund, there is insufficient evidence that the assets in the ABX Index were unsuitable. Tr. 4291-92; *see also* Tr. 1265 ("[M]ost deals would have some ABX bonds. It is hard to avoid."). Even assuming Magnetar's representations were disingenuous, and it actually believed an ABX Index arbitrage would benefit Magnetar directly, to the detriment of senior Octans I tranches, there is no evidence that Chau or anyone from Harding was aware of such a fact. *See* Div. Br. at 34. In hindsight, as Ellson noted, the up-front premiums to Merrill reduced the net return on ABX Index bonds.[66] Tr. 1115. Nevertheless, the evidence demonstrates that all interested parties believed at the time that the ABX Index purchase would generate higher spread for Octans I.[67] *See, e.g.*, Div. Ex. 18 ("ABX BBB- pretty wide vs single name and cash"); *see also* Div. Ex. 169; Resp. Ex. 889.

There is also insufficient evidence that Magnetar placed any undue pressure on Harding to select a larger number of assets from the ABX Index than Harding otherwise would have. The Division argues that Magnetar's eagerness to push for names demonstrated to Harding the need to quickly and superficially review the ABX Index assets, and Harding obliged to please Magnetar. Admittedly, Prusko eagerly wanted Harding to review the ABX Index assets in late

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[65] Again, though Prusko conceded that it profited as a result of certain CDOs' default in the wake of the market collapse of 2007-2008, there was no evidence that Magnetar profited from the collapse of Octans I. Tr. 2682.

[66] As Respondents correctly argue, the probative value of Ellson's analysis was reduced by the fact that he compared only two categories, ABX Index assets and non-ABX index assets. Resp. Br. at 52-53; *see* Ellson Expert Rept. at 3-4. A more meaningful, "apples-to-apples" review would have involved separate comparisons for the Baa2 and Baa3-rated bonds, because their average spreads were different. Tr. 1113-15.

[67] The Division argues that Magnetar was intent on picking inferior assets to ensure that Octans I would fail and Magnetar would profit. *See, e.g.*, Div. Br. at 1 (Magnetar "heavily involved in the ramping of Octans I"). If true, it would make little sense for Magnetar to propose only one trade to Harding during the ramp, only thirteen bonds of which were allegedly of inferior credit quality. It is much more likely that Magnetar simply suggested a possible money-making opportunity that others may not have identified.

May 2006, telling Lasch on May 23 and 24, 2006, "[l]et's buy some index," and "ABX opening weaker, let's do call, BUY!!!" Tr. 168-69; Div. Ex. 21. Prusko had also discussed purchase of the ABX Index with Chau sometime prior to May 25, 2006, and Chau relayed Magnetar's proposed ABX Index trade to Lieu around that time as well. Nonetheless, several days passed before Merrill forwarded the ABX Index names to Harding for review. Moreover, five days passed between when Chau learned of the proposal for the ABX Index trade and when Merrill provided the list to Harding, giving Harding plenty of time to consider whether the trade made sense for Octans I. Though Chau and others at Harding were aware that they would receive the ABX Index names for review, there is no evidence that they were privy to Prusko's continual communications with Merrill, requesting quick review of the ABX Index bonds. There were no emails to Harding indicating that there were any deadlines to review the ABX Index bonds. Prusko sent several emails on May 30 and 31, 2006, to individuals at Merrill, in which he showed eagerness to receive approved bonds from Harding. *See, e.g.*, Div. Exs. 33, 45, 55. Also, Prusko sent an email to Chau and Huang on May 31, 2006, reminding them that Harding was supposed to provide names it wanted to exclude from the ABX Index. Div. Ex. 50. But there was no sense of alarm in the email. *See id.* The only response came from Huang late that morning, who told Prusko that he and Chau had been out of the office, and would provide the names "soon." *See id.* Huang's response did not indicate any sense of urgency. *See id.* Lieu was not copied on any of the emails. *See, e.g.*, 33, 45, 50, 55. Lieu did not request cash flow runs for what became the Kaplan spreadsheet for another hour that day, suggesting that she did not receive any pressure from Chau or Huang to expedite the process after Prusko emailed them. *See* Div. Ex. 52.

Nor is there sufficient evidence that Magnetar suggested Harding select a minimum number of ABX Index assets, despite having a general preference for more assets out of the ABX Index than less. All of the evidence suggests that Magnetar left the task of deciding which ABX Index bonds to include, including how many, to Harding. Tr. 2439; Resp. Ex. 889. Magnetar did not appear bothered by or resistant to Harding's rejection of names, especially at the Baa3 level. *See, e.g.*, Div. Ex. 33 ("Tony at Maxim will let us know if any names he wants to exclude."); Div. Ex. 89 ("thought we were going to start with baa2 though as they have more names approved at that level"). After May 2006, when the spread between ABX Index bonds and non-ABX Index bonds tightened, Magnetar became more interested in managers approving a greater ratio of ABX Index assets to take advantage of the ABX Index arbitrage. *See* Div. Ex. 131 ("[T]he recent massive spread tightening has made these deals marginal at best. I think we need to make some adjustments to make these deals viable . . . [n]eed to be aggressive in doing the index arb trades on ABX 1 and 2 right out of the gate. Have to push the managers to use as many bonds as possible out of the indices."). But there is no evidence that this type of push occurred on or about May 31, 2006.

The evidence does not show that Harding employees schemed to accept bonds over the objection of a senior analyst, nor did analysts cave in to pressure to relax standards to ensure that the bonds would pass review. Div. Br. at 110. For the Division's theory to hold up, the purported scheme with Magnetar would not only have to include Chau, but also Huang, as he stepped in to coordinate the ABX Index review while Chau was out of the office on May 30, 2006, the day of the phone call coordinating the proposed ABX Index trade that Huang handled. Huang, who was generally a credible witness, testified that he received no request to instruct

Lieu to review the ABX Index bonds any differently than normal. *See* Tr. 1209, 1266-76, 1286; *see* Div. Br. at 43-44 n.75. Additionally, any decision to provide only a cursory review of the ABX Index bonds, or defy credit results in favor of accepting a higher ratio of bonds, would also have had to extend to Lieu. Huang testified he never instructed Lieu to review the ABX Index bonds differently than normal.[68] Tr. 1347-48.

The Division charges that Harding accepted "disfavored" assets. Div. Br. at 52, 57. As noted, Moy and Lieu reviewed the same set of bonds on May 31, 2006, with different results. Div. Exs. 36, 52-53, 65-66, 70-71. The Division's interpretation is that Moy, the more senior reviewer, made a decision not to purchase those thirteen bonds. Div. Br. at 57, 113. This interpretation does not fit the evidence. Moy's title was senior to Lieu's, but the chain of command did not require Lieu to obtain Moy's approval or defer to Moy's decisions. Tr. 3270. Each reported to Chau, or another senior executive in Chau's absence. Tr. 258, 3246-47, 3263, 3691. Lieu and Moy made many credit decisions independently, including on May 31, 2006, an especially busy day. Div. Exs. 65-66, 70-71. There is no evidence of communications between Lieu and Moy regarding the ABX Index bonds on May 30 and 31, 2006, nor is there evidence that the two were even aware until later that they had reviewed the same bonds at the same time. Lieu's response on May 31, 2006, to Giasi's question of whether Harding had previously reviewed any of the bonds in the May 31 OWIC, was based upon her quick copying and pasting of CUSIPs for the bonds into a search function in records for previously reviewed bonds. Tr. 3697-3703; Div. Exs. 57, 65. I credit her testimony that she did not look them up by name, and thus was unaware that she was looking at many of the same bonds that she looked at as part of her ABX Index review. Tr. 3701-02. Although such a practice was quick, it was also careless, and although it supports the finding that Harding's credit review was negligent, it does not support a finding that Harding's credit review was reckless. Similarly, while Moy copied "MaximCDO" when she distributed her OWIC approval list, and Lieu therefore would have received it, it is unlikely Lieu would have been able to review Moy's decisions. Div. Ex. 65. Lieu's decisions on the ABX Index bonds were sent only an hour and twenty minutes after Moy sent her list of approvals, and during that time Lieu was apparently busy conducting her own review of the ABX Index bonds. *Id.*; Div. Ex. 70.

Similarly, there is no evidence that anyone more senior than Lieu or Moy, such as Chau or Huang, took notice of the disparity between Lieu's and Moy's decisions on the ABX Index bonds on May 31, 2006. Div. Br. at 112. Moy took on the task of reviewing bonds for that day's OWIC, and Lieu was assigned the task of reviewing the list of ABX Index bonds that Merrill forwarded to Harding. The two of them worked independently, Lieu forwarding her results directly to Huang, and Moy forwarding her results directly to Giasi. Huang then simply forwarded Lieu's decisions to Merrill.

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[68] The Division attempted to poke holes in Huang's testimony that there were no abnormal instructions regarding the ABX Index review by having Huang admit that Lieu and Chau could have had a side agreement to run the ABX Index bonds differently, without his knowledge. *See* Tr. 860-61. The fact that a separate conversation between Lieu and Chau could have taken place, however, does not mean that one likely occurred.

Nor is there evidence that Chau pushed the credit department to lower its loss curves in order to placate Magnetar or Merrill. The Division argues that the 6% cumulative loss rate used for the May 31, 2006, ABX Index review was lower than previous rates, and that Chau must have made the policy change to ensure that certain bonds could be added to Octans I. Div. Br. at 49-51. But the evidence shows that the credit department, along with Chau and Wang, determined that other market participants had been lowering cumulative loss rates for cash flow runs for some time, and that to remain competitive, Harding would have to lower its default rates as well. Tr. 3635; Resp. Ex. 767. There is no evidence that that change occurred in concert with Magnetar's participation in Octans I or the ABX Index trade. Lieu and Moy had been using a 6% loss curve for all cash flow runs no later than May 26, 2006, as evidenced by Lieu's email to Wang on that date, in which she stated "[J]amie and I already decided yesterday that *everything* will be run 6% loss curve." Resp. Ex. 767 (emphasis added). A few days later, on May 30, 2006, Moy forwarded Huang a list of cash flow results titled "Portfolio 2006-05-22 Results," which included a column for write-downs marked "writedown 6%." Resp. Exs. 772, 774.

The Division cites emails unconnected to the ABX Index review as evidence Harding lowered its standards to please Magnetar. Div. Br. at 35-37. For example, Huang stated that Harding was "less comfortable" with some of the bonds in the ABX Index. *See* Div. Ex. 81. In context, however, Huang was referring to the fact that Merrill had some control over the process of actually procuring the CDS trades in the market and, thus, he was indicating Harding's preference for Merrill to go long on the issuers in the index at the Baa2 level ahead of those at the Baa3 level. *See* Tr. 898-907. Huang was not suggesting that Harding was uncomfortable with any particular names at the Baa3 level or that the actual Baa3-level assets gave Harding pause. The Division also cites emails written by Moy as suggestive of a scheme to lower Harding's standards for the sake of accepting more ABX Index bonds than would normally be accepted, but those emails have a tenuous connection to the events of May 30 and 31, 2006. *See* Div. Br. at 33. Moy wrote to Lieu on August 28, 2006, during their review of bonds for Octans II, that "[w]e had it on the index for a 'Maybe' because we knew we had to pick the less worse," and Moy wrote to Lee on August 24, 2006, that "due to the fact we had to pick the lesser of evils when we were looking at the index we said 'Y' to FF." Div. Ex. 156 at 1-2. Moy's statements were made three months after the May 30-31, 2006, credit reviews for the ABX Index, and pertained to a different CDO, with a different underwriter.

In sum, the evidence as a whole does not show that Harding had a conflict of interest between its duty to the issuer and its desire to please Magnetar. Therefore, there was no violation of Section 206 arising from such a conflict.

d. Magnetar's Role in the Warehouse

The Division contends that Respondents failed to disclose to the issuer Magnetar's participation in the warehouse agreement. Div. Br. at 119-20. Chau testified that the Octans I issuer may have been provided the warehouse agreement as part of the closing package, but an August 31, 2006, draft of the closing agenda, listing all of the closing documents, did not include the warehouse agreement. Tr. 1516; Resp. Exs. 464-65. However, I agree with Respondents that the issuer knew of Magnetar's involvement independently of Harding (in contrast to Octans I investors, who may not have known it), because its attorneys (who were also attorneys for

Merrill) knew of it. Tr. 551-52, 1764, 2944, 2950-53; Resp. Exs. 184, 196, 197; *see* Resp. Br. at 153-54; *Alioto*, 531 F. App'x at 853. Although Harding had a general duty to disclose Magnetar's involvement in the warehouse, its omission was immaterial because it did not change the total mix of information available to the issuer, and, accordingly, there was no violation arising from the omission. *See Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 167 (2d Cir. 2000) ("a misrepresentation is immaterial if the information is already known to the market because the misrepresentation cannot then defraud the market"); *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351, 375 (S.D.N.Y. 2003) ("the market was apprised of the very conflicts and ratings issues raised by [plaintiffs]"), *aff'd*, 396 F.2d 161 (2d Cir. 2005).

2. Violations of Exchange Act Section 17(a)

The Division argues that Harding violated Section 17(a) as to its client, the Octans I issuer, through the same actions as its Advisers Act Section 206 violations, but with the added offer and sale components of the closing of the Octans I CDO, including the sale of securities from the warehouse to the Octans I portfolio. Div. Br. at 121. As discussed *supra*, Harding had no conflict of interest with Magnetar, and its failure to disclose Magnetar's role in the warehouse was immaterial. However, in selecting the ABX Index bonds, it negligently and materially misrepresented the standard of care it intended to follow, and negligently and materially failed to follow the standard of care it should have followed. Its misrepresentation caused it to obtain money, within the meaning of Section 17(a)(2), and its failure to follow the correct standard of care, a standard the issuer would have expected it to follow, operated as a fraud upon the issuer, within the meaning of Section 17(a)(3). Its misconduct was "in the offer or sale of securities" because Harding selected the securities which were sold to the issuer. Accordingly, Harding's two violations of Section 206(2) were also violations of Section 17(a)(2) and 17(a)(3).

C. Alleged Violations Regarding Norma

The Division argues that Respondents violated both Advisers Act Section 206 and Securities Act Section 17(a) in their purchases and allocations of Norma bonds to CDOs it managed. Div. Br. at 124-25. The Division contends that Respondents selected the bonds in order to please Magnetar and Merrill, despite knowledge of Norma's poor quality or without performing adequate review. Div. Br. 124-25. That is, Respondents allegedly materially misrepresented the standard of care they intended to follow, and materially failed to follow the standard of care they should have followed. *Id.* As with Octans I, such allegations, if proven, would establish a material misrepresentation to an advisory client (in violation of Section 206) and in the offer or sale of securities (in violation of Section 17(a)), and a deviation from the standard of care owed an advisory client (in violation of Section 206) and fraud in the offer or sale of securities (in violation of Section 17(a)). *See Bayerische Landesbank, N.Y. Branch v. Barclays Capital*, 902 F. Supp. 2d at 473; *Stoker*, 865 F. Supp. 2d at 464; *Tourre*, 790 F. Supp. 2d at 163. Also as with Octans I, Harding was an investment adviser, and the interstate commerce requirement was satisfied.

The CMAs for the CDOs in which Harding placed Norma bonds required Harding to perform its obligations with

> reasonable care . . . using a degree and skill and attention no less than which the Manager would exercise with respect to comparable assets, if any, that it manages for itself or for others and . . . 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.

Div. Ex. 504 at 7; *accord* Div. Ex. 506 at 7; Div. Ex. 510 at 8; Div. Ex. 512 at 7. Each offering circular has a similar representation. Div. Ex. 503 at 97-98; 507 at 156; Div. Ex. 509 at 159; Div. Ex. 513 at 174. Wagner opined that the standards included an expectation that the manager's investment process would be standardized, consistent, rigorous, thorough, and independent. Div. Ex. 8001 at 3. Investment advisers also owe an affirmative fiduciary duty of care to their clients, in addition to any contractual obligations. *See Capital Gains*, 375 U.S. at 191-92, 194.

It is undisputed that Respondents purchased Baa2-rated Norma bonds with notional values of $10 million for Lexington and $5 million for NEO, two of four CDOs into which Harding allocated Norma bonds.[69] Div. Ex. 237 at 1; Resp. Ex. 879; Tr. 1644. The evidence demonstrates that in doing so, Respondents acted under a conflict of interest between their duty to their clients and their desire to please Merrill and Magnetar. Respondents' actions violated both the standards of care promised in the CMAs for Lexington and NEO, and industry standards, including the fiduciary standard of care owed to the CDOs as advisory clients. There is no evidence that Respondents disclosed their conflict of interest, and indeed, Respondents deny that one existed. Resp. Br. at 235-39.

Harding committed to purchasing A-rated Norma bonds prior to any emails or conversations with Magnetar, and without any palpable pressure from either Magnetar or Merrill. On January 9, 2007, shortly after receiving the price guidance, pitch book, and term sheet, Chau told Merrill that he considered Norma's turbo structure "very weak," that is, the turbo was relatively beneficial to the equity tranche. Div. Exs. 188-90; Tr. 1586-88. Norma's weak turbo feature meant that a relatively smaller amount of interest payments would be used to pay down the principal of mezzanine tranches. Div. Ex. 189; Tr. 1586. Chau knew that purchasing mezzanine-level Norma bonds would place Harding clients at higher risk, to the benefit of the equity purchaser, Magnetar. *See* Tr. 1586-87, 1650. Had the turbo not been "weak," it would have benefited the Baa2-rated tranche, but there is no evidence that any benefit would have accrued to the A-rated tranche. *See* Div. Ex. 217 at 1 (describing how the turbo would have redirected cash flow to the E tranche, with no mention of the D tranche); Div. Ex. 8001 at 54. In other words, Chau's complaint about Norma's turbo pertained to the mezzanine tranches, not to the more senior tranches.

Chau did not commit at that time to buy Norma, but on January 16, 2007, Chau messaged Phelps, asking "how is norma doing?" Div. Ex. 191. Phelps replied with the commitment percentages to that point, and asked, "ready to talk about your participation?" *Id.* Chau did not immediately reply to Phelps' question. *See id.* Later that day, Chen asked Merrill for Norma's

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[69] Lexington is sometimes referred to as "Lexington IV." *Compare* Div. Ex. 209 ("Lexington IV") *with* Div. Ex. 237 at 1 ("Lexington V").

"strats," and he received them the following day, January 17, 2007. Div. Exs. 192, 194. By January 19, 2007, Harding was discussing internally where it could place $40 million of A-rated Norma bonds, indicating that it was interested in purchasing them by that date. Div. Ex. 196. On February 1, 2007, Harding requested approval from the Merrill warehouse group to purchase A-rated bonds for Jupiter VI, although the trade actually occurred on January 26, 2007. Div. Exs. 209, 237. The record contains no written credit analysis predating the trade, although Chau testified that one had been run. Tr. 1642, 1647. There were no further communications of consequence between Harding and Merrill or Magnetar specifically regarding the A-rated tranche.

The chain of events leading to Harding's commitment to purchase Norma mezzanine bonds, however, illustrates Respondents' succumbing to pressure from Magnetar and Merrill, and statements made by Chau during the interactions evince scienter. On January 17, 2007, Chao asked Chau whether he was interested in purchasing Baa2-rated Norma bonds, and he told her he was "talkin' to Phelps about it." Div. Ex. 193. By January 23, 2007, Merrill and Magnetar were concerned about the weak distribution of Norma bonds to that point. Prusko explained to Snyderman how he and Merrill intended to place the mezzanine bonds, stating, "[P]helps . . . sounds like he will use his clout to stuff people with them, will stick baa3's in cdo2's in their pipeline. I will personally hammer wing, he's getting too big for his britches, we left a lot of loot on the table there."[70] Div. Ex. 199. Around the same time on January 23, 2007, Prusko emailed Chau, asking him to "Pls buy some norma bbb," adding, "Stop complaining about turbo. :) Remember who was there for u when u were a little guy." Div. Ex. 200. Chau responded "I hear you, not me holding up the deals, only a small cog in the machine." *Id*. Chau attempted to curb further pressure from Magnetar, telling Prusko he was a "team player" when he boasted to Prusko that he had already committed to purchasing A-rated bonds in Norma, after Prusko urged Chau to purchase mezzanine Norma bonds. *See id.* Prusko responded that he had not heard about Chau's commitment to purchase the A-rated bonds, he only heard Merrill "bustin' on [Chau] about the bbb's," indicating Chau's previous reluctance to purchasing the Baa2-rated bonds prior to that point. *See id.*

On January 24, 2007, Phelps emailed Chau, asking whether Chau had "sharpened [his] pencil on Norma BBBs" yet.[71] Div. Ex. 205 (internal quotations omitted). Chau replied, "I never forget my true friends." *Id.* This last colloquy occurred shortly before Harding committed to purchasing mezzanine Norma bonds on January 24, 2007. *See* Div. Ex. 204; Resp. Ex. 832. Chau nonetheless attempted to minimize his commitment. *See* Div. Ex. 204. Margolis told Phelps and other Merrill representatives on January 24, 2007, that "Wing [was] in for $20mm." *Id.* Margolis explained "I told him we would try and sell him down to $15mm if we could. . . He wants to talk about the spread but he will be in." *Id.* (ellipsis in original). After hearing that Harding's commitment had been reduced, Chau said, "Now that's what I'm talking about, the love is in the air." Div. Ex. 210.

[70] As noted *supra*, Prusko was uncharacteristically and conveniently forgetful about what he meant in this email.

[71] By this time, Merrill knew that Norma collateral contained a "weak pool." Div. Ex. 203.

Chau's explanation for many of these emails – essentially, that he was being flip and sarcastic – is laughably implausible. Tr. 1629. Admittedly, many emails of record do contain jocularity, including a parody of "Candle in the Wind" and, in response to an inquiry about Norma BBBs, "I thot her size was more in the single-A area/Really just busting your chops." Div. Exs. 193, 226. But in context, and taken at face value, Chau's statements plainly inculpate Respondents. For example, Chau testified that "I never forget my true friends" was meant to convey that "I have the time for you, I haven't forgotten you, you know, you are a friend, I'm going to look at your securities." Tr. 4197-98. But Chau did not simply "have the time" to examine the securities, he actually committed to purchasing them within hours. *See* Div. Ex. 205; Resp. Ex. 832. As another example, Chau's testimony that he was being sarcastic when he wrote, "the love is in the air," is fatally undermined by Margolis' acknowledgement that Merrill "would try and sell him down to $15mm." Div. Ex. 204.

Eventually Kaplan completed a written commentary on Norma, which gave the CDO a poor prognosis. *See* Div. Ex. 217. Kaplan projected a 10.17% write-down, which was higher than the Baa2-rated subordination, although less than the A-rated subordination. *See id.*; Tr. 1662-66. Kaplan calculated that 82.83% of the collateral failed Harding's "DQ" test, 46.02% failed the "60+ DQ" test, and 14.55% failed the "OC" test. Div. Ex. 217. Chau acknowledged that these percentages were high. Tr. 1664. Kaplan opined that "[t]here's quite a large percentage of deals failing surveillance tests, on the watch list, and on the do not buy list." Div. Ex. 217. Norma had substantial exposure to at least one originator Harding considered particularly bad.[72] Div. Exs. 215, 217. Lieu punctuated Harding's feelings on Norma originator concentration in a March 9, 2007, email, stating, "Who's the manager on NORMA? 31% NC and 14% Fremont?!" Div. Ex. 221. Indeed, Chau admitted that, "[a]ll else being equal," Norma's metrics overall were "pretty bad." Tr. 2188. After receiving Kaplan's commentary, Chau did nothing to stop or reverse the process of placing the Norma bonds into Harding-managed CDOs.

Chau testified that he likely paid no attention to Kaplan's commentary due to obvious mistakes in it. Tr. 4223. Even crediting this testimony, it hurts him, because if Chau believed the commentary to be so flawed as to render it meaningless, then Chau never reviewed *any* in-depth Norma analysis. Chau testified that analysis of Norma was performed prior to the commentary, which he would have reviewed, but there is no evidence of that analysis. *See* Resp. Br. at 269-70. Harding's CDO deal tracker showed that initial review of Norma was performed by January 17, 2007, including review of high-level stratifications, but deeper review was not performed at that time. Div. Ex. 238. The deal tracker spreadsheet was populated with most of the underlying data for four other bonds reviewed within a few days of January 17, 2007, in contrast to Norma, which did not yet have much of the information generated as part of the

[72] Respondents argue that the concentration of New Century and Fremont was disclosed in the Norma offering circular, and thus the investors and issuers were aware of the originators' participation. Resp. Br. at 271-72. This argument misses the point. The conflict of interest claim arose not from Respondents' failure to disclose New Century and Fremont as originators, but that Harding, as a purportedly independent manager, compromised its own standards, i.e., overlooked its negative opinion of these originators to purchase Norma bonds as a favor to Merrill and Magnetar.

commentary that Kaplan provided to Chau approximately a month later. Div. Ex. 238; *see also* Div. Ex. 217. Similarly, on January 16, 2007, Chen sought surveillance numbers on five bonds, including Norma, and Kaplan returned commentary on four of them on January 22, 2007, but not for Norma. Div. Ex. 197. No request to write up commentary on Norma was made until February 22, 2007. *See* Div. Ex. 216. Similarly, no evidence of Norma surveillance numbers was presented prior to Kaplan's commentary. *See* Div. Ex. 217.

Respondents' arguments justifying the purchase of Norma are unavailing. The first argument, that Chau's actions and statements were not evidence of Respondents' caving to pressure, but of a negotiating tactic to provide better spread for investors, is not convincing. Resp. Br. at 248-60. The driving force behind the purchase of the Norma mezzanine bonds was clearly Harding's willingness to do a favor for Magnetar and Merrill, and any forbearance for better spread was at most a side benefit. Before Chau ever learned of the "lead order" and enhanced spread from Phelps, Chau had told Prusko that it was "not [him] holding up the deals, only a small cog in the machine," and he had already told Phelps that he was "sharpen[ing] his pencil," even if he had not yet formally committed to purchase the bonds. Div. Exs. 198, 200. Similarly, when Phelps informed Chau of the most recent spread on the Baa3-rated Norma bonds, he also pressed Chau to consider buying Baa2-rated bonds, and Chau responded, "I never forget my true friends." Even at the enhanced spread, Chau was happy to receive a reduced allocation, from $20 million to $15 million, as Margolis suggested. *See* Div. Exs. 204, 210. Negotiating for better spread does not abrogate Respondents' failure to perform adequate diligence on the Norma bonds before committing to purchase them.

Respondents' second argument, that Chau was attempting to add diversity to the CDO portfolios despite poor credit projections, is not very believable. *See* Resp. Br. at 268. Chau testified that "[i]f we were to just invest in only the assets that my analysts or Harding's analysts would approve, we would create a de facto 100 percent correlation." Tr. 4143. This may be one factor to consider in selecting assets, but the standard of care required independent, rigorous, and thorough diligence before approving bonds, rather than just looking at correlation. Nor does the reduction of correlation have any bearing on the conflict of interest documented in the various emails.

Respondents' third argument, that the write-downs included in Kaplan's commentary were for the whole loan portfolio, not for the CDO, is unconvincing. *See* Resp. Br. at 265. As Prusko explained, analyzing CDOs includes reviewing cash flows of the underlying assets – the RMBS – not the loans underlying the RMBS. Tr. 2342-43. Chau testified to something similar, stating "the way to truly gauge the relationship of your CDO investment is looking at the performance of the actual BBB securities that collateralized the CDO and not the thousands and thousands of loans that underlie the RMBS securities." Tr. 4156. Write-down projections showing potential loan-level losses, rather than RMBS losses, would be largely meaningless to a manager in a CDO review.

Nor do Chau's explanations regarding Norma's quality line up with his effort to unload the bonds shortly after they were placed in the CDOs. On May 22, 2007, Chau attempted to sell the A-rated Norma bonds to Edward Fitzgerald, a former colleague of Chau's, at a severe discount. *See* Div. Ex. 226; Tr. 1689-91. Chau offered the bonds for $87, distinctly lower than the $99 purchase price. *See* Div. Exs. 207, 226. Chau's explanation for the offer was puzzling and evasive. He testified that he was simply "trying to ascertain market price[]," yet he seemed anxious to unload the bonds, stating, "c'mon, value at these [prices]." Tr. 1693; Div. Ex. 226. Chau refused to admit the obvious implication in Fitzgerald's song parody response, answering the question of whether he thought Fitzgerald's views of Norma were negative, "Negative? As we said before, it is a song parody. I don't know what Ed was saying when he wrote that song, the meaning behind the words." Tr. 1701.

The bulk of the Norma-related evidence pertains to the purchase of its Baa2-rated tranche, and I find violations related to the Baa2-rated tranche of Norma bonds, but not the A-rated tranche. Admittedly, there is evidence that the purchase of its A-rated tranche was at least negligent. In particular, there is no documentation of any Norma analysis predating late February 2007, and Kaplan's commentary suggests that any such analysis would have revealed problems even with the A-rated tranche. Nonetheless, I agree with Respondents that any violations associated with the A-rated tranche were not sufficiently pled in the OIP. Resp. Br. at 241; *but see* Div. Reply at 27. It is a close question, and it was not addressed in resolving Respondents' Motion for More Definite Statement. *See Harding Advisory LLC*, Admin. Proc. Rulings Release No. 1239, 2014 SEC LEXIS 539 (Feb. 12, 2014). The OIP discusses the purchase of the A-rated tranche, and refers to the placement of Norma notes into "the portfolios of *several* CDOs," but the thrust of the OIP's allegations is that Chau "did not [want] to buy Norma's lower-rated tranches." OIP at 12-13 (emphasis added). It would have taken little effort to list in the OIP the exact transactions alleged to have violated the law. Moreover, when Respondents' counsel asserted during the hearing that only the mezzanine tranche was alleged in the OIP, the Division did not object. Tr. 4237. On balance, the OIP was not sufficiently clear that the purchase of Norma's A-rated bonds was at issue, and I therefore find no violations in connection with it.

Both the Section 206 and Section 17(a) violations were committed with scienter. Unlike the ABX Index purchases, which involved several people making independent judgments, Chau drove the entire process of Norma purchases singlehandedly. He made the decisions for Harding to purchase Norma bonds. Chau knew that Norma mezzanine bonds were poor choices for Lexington and NEO, yet he allowed himself to be cajoled into purchasing the bonds by Merrill and Magnetar. Chau, aware of and familiar with the standards of care in the CMAs, knew that his acceptance of the bonds only after pressure by Merrill and Magnetar constituted a conflict of interest. *See* Tr. 1504-05, 1532. Chau was the controlling shareholder and chief executive officer of Harding. In addition, Chau was integrally involved in every aspect of the Norma bond purchases and allocations. As the controlling owner and president of Harding, Chau's scienter is imputed to Harding for both Advisers Act Section 206 and Securities Act Section 17(a) violations. *See In re Marsh & Mclennan Companies, Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 481 (S.D.N.Y. 2006) ("A corporate defendant's scienter is necessarily derived from its employees . . . courts have readily attributed the scienter of management-level employees to corporate defendants.").

D. Chau's Liability

The OIP charges both Harding and Chau with primary violations. OIP at 13. An associated person may be liable as a primary violator, where, as here, the associated person controlled the investment adviser. *See John J. Kenny*, 56 S.E.C. 448, 485 n.54 (2003); *Alexander V. Stein*, 52 S.E.C. 296, 299 & n.10 (1995) ("Our authority . . . does not rest on whether or not an entity or individual has registered . . . [but] on whether or not an entity or individual in fact acted as an investment adviser."). Chau was not only the controlling and majority shareholder of Harding, he was virtually the only person at Harding involved with the Norma-related violations. The finding that Harding, through Chau's actions, violated Sections 206(1) of the Advisers Act and Section 17(a)(1) of the Securities Act, in connection with placing Norma bonds, necessarily implies that Chau violated those provisions, as well. Chau was not directly involved in the Octans I-related violations, because those violations are all based on the ABX Index trade, which Chau did not supervise or direct. Thus, Chau was not primarily liable for Harding's Octans I-related violations.

To establish a claim of aiding and abetting, the Division must show: (i) a primary violation occurred; (ii) knowledge of the violation on the part of the aider and abettor; and (iii) substantial assistance by the aider and abettor in the achievement of the violation. *SEC v. DiBella*, 587 F.3d 553, 566 (2d Cir. 2009). The knowledge or awareness requirement can be satisfied by recklessness when the alleged aider and abettor is a fiduciary or active participant. *See Ross v. Bolton*, 904 F.2d 819, 824 (2d Cir. 1990). A finding of aiding and abetting necessarily implies that the respondent caused the primary violations. *Sharon M. Graham*, 53 S.E.C. 1072, 1085 n.35 (1998), *aff'd*, 222 F.3d 994 (D.C. Cir. 2000). Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. *KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1175 (2001), 289 F.3d 109 (D.C. Cir. 2002), *recons. denied*, Exchange Act Release No. 44050, 2001 SEC LEXIS 422 (Mar. 5, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002).

There is no question that Chau aided and abetted and caused Harding's Norma-related violations, because Chau knew of Harding's misconduct and more than substantially assisted it. As to the Octans I-related violations, Chau had responsibility for all of Harding's marketing materials, certified that he personally reviewed the offering circular, and signed the CMA. However, there is insufficient evidence that Chau was aware that the ABX Index trade analysis was negligent, and the Division makes only a cursory argument for his secondary liability. Div. Br. at 125-26. Although Chau would have been aware of Harding's investment analysis process as it occurred in general, there is insufficient evidence that Chau was aware of Lieu's slapdash process for the Octans I ABX Index trade specifically. Admittedly, Wagner opined that Harding's process in general was inconsistent with the represented standard of care. Div. Ex. 8001 at 40-42. However, Chau's description of Harding's investment analysis process suggests that, had he been aware of it, he would have considered Lieu's work on the ABX Index trade to be substandard. *E.g.*, Tr. 4095 (Lieu was supposed to have analyzed "stress case expected losses"). The record does not support a finding by a preponderance of the evidence that Chau was aware of, or contributed to, Lieu's slapdash work. Accordingly, he neither caused nor aided and abetted Harding's Octans I-related violations.

E. **Affirmative Defenses**

1. Statute of Limitations

Respondents assert that charges associated with Octans I are at least in part barred by the statute of limitations set forth by 28 U.S.C. § 2462, which prohibits proceedings for enforcement of any civil fine, penalty, or forfeiture unless commenced within five years from the date the claim first accrued. Resp. Br. at 336. Under 28 U.S.C. § 2462, the limitations clock starts running at the time that the cause of action becomes enforceable. *Gabelli v. SEC*, 133 S. Ct. 1216, 1220-21 (2013). Respondents argue that a tolling agreement they entered into with the Commission tolled the statute of limitations after August 31, 2006, until the filing of the OIP; accordingly, any conduct prior to August 31, 2006, cannot be the basis of an action here. Resp. Br. at 336-37. The Division agrees that claims accruing before the tolled period cannot support penalties or associational bars, and, to its credit, concedes an additional eighteen days, or a limitations period beginning on September 18, 2006. Div. Reply at 48. The Division contends, however, that no claims accrued until September 26, 2006. *Id.* at 49.

Even if it applies, 28 U.S.C. § 2462 does not bar claims brought for disgorgement, prejudgment interest, or cease-and-desist orders. *Riordan v. SEC*, 627 F.3d 1230, 1234-35 (D.C. Cir. 2010); *Zacharias v. SEC*, 569 F.3d 458, 471-72 (D.C. Cir. 2009); *Johnson v. SEC*, 87 F.3d 484, 489-92 (D.C. Cir. 1996). The statute of limitations clearly does not apply to the Norma-related violations, nor do Respondents assert that it does. Resp. Br. at 336-37. As for Octans I, some of the Securities Act Section 17(a) violations may have occurred prior to September 18, 2006 – for example, in connection with use of the pitch book and offering circular for marketing the CDO – but at least some of the Section 17(a) violations occurred later – namely, those violations where the issuer was the victim, or which resulted in an actual sale (as opposed to an unconsummated offer). By contrast, the Advisers Act Section 206 violations did not occur until September 26, 2006, when the advisory relationship began, and are definitely not time-barred in any fashion.

2. Judicial Estoppel

Respondents argue that the Division is judicially estopped from asserting certain positions as to Octans I, because they are inconsistent with the Commission's theory of the case in *Tourre*, and with the Commission's views expressed in proposed Rule 127B. *See* Resp. Br. 293-94, 337. Under the doctrine of judicial estoppel, "where a party assumes a certain position in a legal proceeding, and succeeds in maintaining that position, he may not thereafter, simply because his interests have changed, assume a contrary position, especially if it be to prejudice the party who has acquiesced in the position formerly taken by him." *New Hampshire v. Maine*, 532 U.S. 742, 749-50 (2001) (quoting *Davis v. Wakalee*, 156 U.S. 680, 689 (1895)) (alteration omitted). It is meant to "prevent[] a party from prevailing in one phase of a case on an argument and then relying on a contradictory argument to prevail in another phase." *Id.* at 749 (quoting *Pegram v. Herdrich*, 530 U.S. 211, 227 n.8 (2000)).

Whether judicial estoppel applies is informed by several factors, three of which were enumerated in *New Hampshire v. Maine.* First, a party's later position must be "clearly inconsistent" with its earlier position. *New Hampshire*, 532 U.S. at 750. Second, courts inquire as to whether the party has succeeded in persuading a court to accept the party's earlier position, so that judicial acceptance of an inconsistent position in a later proceeding would create "the perception that either the first court or the second court was misled." *Id.* Third, courts inquire as to whether the party seeking to assert an inconsistent position would derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped. *Id.* at 751. The Court cautioned that these three considerations are not an exhaustive list, and may require examination of the particular facts and circumstances. *Id.* at 750-51; *see also In re Adelphia Recovery Trust*, 634 F.3d 678, 695 (2d Cir. 2011); *Comcast Corp. v. FCC*, 600 F.3d 642, 647 (D.C. Cir. 2010).

I rejected Respondents' judicial estoppel argument during the hearing. Tr. 65-66. Respondents now request that I reconsider my ruling. Resp. Br. at 337. After considering the entire record, my ruling stands. Respondents argue that in *Tourre*, the Division's position that an equity investor's "skin in the game" demonstrated alignment of interests, and that hedging by hedge funds is normal, common, and proper, was inconsistent with its position in this proceeding that despite its equity investment, Magnetar's interests were misaligned with those of other investors. Resp. Br. at 60, 289-93. But the Division's position is not proven by the evidence, that is, I have not accepted the contention that Magnetar's interests were misaligned with those of other investors in Octans I, and the second *New Hampshire* element is not satisfied.

The Commission's proposed Rule 127B would prohibit certain conflicts of interest in connection with certain securitizations. *Prohibition Against Conflicts of Interest in Certain Securitizations*, 76 Fed. Reg. 60320-01 (Sept. 28, 2011). But action on the proposed rule is pending, and "proposed rules do not have the force of law." *Union Commerce Corp. v. Huntington Bancshares Inc.*, 556 F. Supp. 374, 380 (N.D. Ohio 1982). Moreover, the proposed rule was not asserted in a legal proceeding. Accordingly, judicial estoppel does not apply to proposed Rule 127B.

F. <u>Constitutional Claims</u>

Respondents raise two constitutional arguments, based on the Equal Protection and Due Process Clauses of the Constitution. It is unclear whether these claims are justiciable in this forum. *See David F. Bandimere*, Initial Decision Release No. 507, 2013 SEC LEXIS 3142, at *215-17 (Oct. 8, 2013), *pet. for review granted*, Exchange Act Release No. 71333, 2014 SEC LEXIS 158 (Jan. 16, 2014); *but see Chau v. SEC*, No. 14-cv-1903, 2014 WL 6984236, at *10, *13 (S.D.N.Y. Dec. 11, 2014) ("the SEC is competent to consider [Respondents'] constitutional claims, at least in the first instance"). Assuming they are justiciable, they fail on the merits.

Respondents' claims are identical to the ones they presented to the Commission in their petition for interlocutory review. *See Harding Advisory LLC*, Securities Act Release No. 9561, 2014 WL 988532, at *2, *6-8 (Mar. 14, 2014); Resp. Br. at 337-38. As to equal protection, Respondents allege that the Commission's decision to bring this claim as an administrative proceeding while suing similarly situated parties in federal court constitutes disparate treatment. Respondents do not claim that they are members of a protected class; they instead claim that the

Commission has treated them as a "class of one" with no rational basis. *See Harding Advisory LLC*, 2014 WL 988532, at *2, *8; *cf. Village of Willowbrook v. Olech*, 528 U.S. 562, 563 (2000) (per curiam) ("Our cases have recognized successful equal protection claims brought by a 'class of one,' where the plaintiff alleges that she has been intentionally treated differently from others similarly situated and that there is no rational basis for the difference in treatment."). As to due process, Respondents allege that bringing this case administratively, and refusing to adjourn the case while they prepared their defense, violated their rights. In particular, Respondents argue that the Division's production of 22 million documents from the investigative file placed an unfair burden on Respondents in preparing for the hearing, and made it impossible for them to prepare an adequate defense. *Harding Advisory LLC*, 2014 WL 988532, at *2, *8.

On interlocutory review, the Commission held that Respondents had "not made even a colorable showing of the violations they allege." *Harding Advisory LLC*, 2014 WL 988532, at *6. Respondents point to no evidence supporting these allegations that has been adduced since their petition for interlocutory review was denied. Resp. Br. at 337. Nor do I find any such evidence. Accordingly, Respondents still have not made a colorable showing of constitutional violations.

G. Motion to Amend Hearing Transcript

On August 5, 2014, I ordered amendments to the hearing transcript to correct stenographic errors. *Harding Advisory LLC*, Admin. Proc. Rulings Release No. 1670, 2014 SEC LEXIS 2814. The parties stipulated to the vast majority of the amendments. I reserved ruling on one proposed correction that the parties disputed. Specifically, the Respondents moved to insert the word "not" in Lieu's answer, "[i]t would have been part of the ramping for Octans I." *See* Tr. 3724. I find the context supports the original answer. Lieu was responding to my own question regarding whether the May 31, 2006, OWIC was part of the Octans I ramping. The OWICs at the time were reviewed as part of ramps for Harding-managed CDOs, and it stands to reason that the May 31, 2006, OWIC would have been as well. Lieu's testimony on this point will not be amended.

H. Summary

In summary, Harding committed the following violations:

a. negligently misrepresenting to Octans I investors, in the pitch book, Harding's investment analysis process, in violation of Section 17(a)(2);
b. negligently misrepresenting to the Octans I issuer, in the CMA, the standard of care Harding followed in selecting collateral, in violation of Section 206(2) and Section 17(a)(2);
c. negligently failing to follow the correct standard of care, with respect to the Octans I issuer, in violation of Section 206(2) and Section 17(a)(3);
d. negligently misrepresenting to Octans I investors, in the offering circular, the standard of care Harding followed in selecting collateral, in violation of Section 17(a)(2);

e. failing to follow the correct standard of care, with respect to two advisory clients which received Norma mezzanine bonds, in violation of Section 206(1) and Section 17(a)(1); and
f. misrepresenting to two advisory clients, in each client's CMA, the standard of care Harding followed in selecting Norma mezzanine bonds for each client's portfolio, in violation of Section 206(1) and Section 17(a)(1).

Additionally, Chau is primarily liable for, and aided and abetted and caused, Harding's Norma-related violations.

IV. SANCTIONS

The Division requests: as to both Respondents, a cease-and-desist order and disgorgement (jointly and severally); as to Harding, a maximum civil penalty imposed once per CDO, totaling $3,250,000, and permanent revocation of its investment adviser registration; and as to Chau, a maximum civil penalty imposed once per CDO, totaling $650,000, and a permanent, industry-wide direct and collateral associational bar, including a bar on association with investment companies. Div. Br. at 132-39 & n.211.

A. Willfulness and the Public Interest

Some of the requested sanctions are only appropriate if Respondents' violations were willful. *See* 15 U.S.C. § 80b-3(e)(5), (f). A finding of willfulness does not require intent to violate the law, but merely intent to do the act which constitutes a violation of the law. *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976). Respondents' actions were unquestionably willful: Chau controlled Harding, generally supervised the actions of Harding's credit analysts, approved Harding's marketing materials, and personally made the decision to place Norma bonds into Harding-managed CDOs.

When considering whether an administrative sanction serves the public interest, the Commission considers the factors identified in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981): the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations (*Steadman* factors). *See Altman v. SEC*, 666 F.3d 1322, 1329 (D.C. Cir. 2011); *Gary M. Kornman*, Advisers Act Release No. 2840, 2009 SEC LEXIS 367, at *22 (Feb. 13, 2009), *pet. denied*, 592 F.3d 173 (D.C. Cir. 2010). Other factors the Commission has considered include the age of the violation (*Marshall E. Melton*, 56 S.E.C. 695, 698 (2003)), the degree of harm to investors and the marketplace resulting from the violation (*id.*), the extent to which the sanction will have a deterrent effect (*see Schield Mgmt. Co.*, Exchange Act Release No. 53201, 2006 SEC LEXIS 195, at *35-36 & n.46 (Jan. 31, 2006)), whether there is a reasonable likelihood of violations in the future (*KPMG*, 54 S.E.C. at 1185), and the combination of sanctions against the respondent (*id.* at 1192). *See also WHX Corp. v. SEC*, 362 F.3d 854, 859-61 (D.C. Cir. 2004). The Commission weighs these factors in light of the entire record, and no one factor is dispositive. *KPMG*, 54 S.E.C. at 1192; *see Gary M. Kornman*, 2009 SEC LEXIS 367, at *22.

Respondents committed multiple violations in 2006 and 2007, involving multiple distinct violative acts, including misrepresentations, failure to follow the standard of care, and selling securities by fraud; the violations were plainly recurrent. *Cf.* Resp. Br. at 345 (incorrectly characterizing the Division's case as "the process by which Harding selected certain ABX index assets for Octans I on a single day in May 2006"). Respondents' degree of scienter was low – indeed, technically nonexistent – as to the Octans I-related violations, but high as to the Norma-related violations.

The egregiousness of the violations varied, as well, as between Octans I and Norma. Although all violative misrepresentations were material, there is no evidence that the victims actually relied on the misrepresentations. There is also no direct evidence that Respondents' failure to follow the appropriate standard of care contributed to any CDO's failure, particularly as to the Norma-related violations, where the fraction of Norma bonds in each CDO's collateral was very low. Resp. Ex. 879. However, Respondents obtained millions of dollars as a result of their violations, and as to Norma, Respondents were shockingly oblivious to their fiduciary duties. On balance, Respondents' Norma-related violations qualify as egregious.

As for the other public interest factors, Chau's occupation and Harding's continuing operations obviously present opportunities for future violations. It is to their credit that they cooperated with the Division's investigation, and even accepted a lengthy tolling agreement, but Respondents ultimately neither offered assurances against future violations nor recognized the wrongful nature of their conduct. Resp. Br. at 345. The violations occurred some time ago, and there is little evidence of harm to investors or the marketplace directly resulting from the violations. On the other hand, any sanction here will have a considerable deterrent effect, both on Chau and on the industry in general, and Chau provided repeated, unbelievable explanations for emails evidencing clearly inappropriate conduct, which suggests a likelihood of violations in the future because of his "failure to appreciate his responsibilities as a securities professional." *Flannery*, at 55. I consider the combination of sanctions on a sanction-by-sanction basis.

B. Cease-and-Desist

Securities Act Section 8A(a) and Advisers Act Section 203(k) authorize the Commission to impose cease-and-desist orders for violations of, respectively, the Securities Act and the Advisers Act. *See* 15 U.S.C. §§ 77h-1(a), 80b-3(k). The Commission requires some likelihood of future violation before imposing such an order. *KPMG*, 54 S.E.C. at 1185. However, "a finding of [a past] violation raises a sufficient risk of future violation," because "evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits our ordering him to cease-and-desist." *Id.* at 1185.

Although the relevant factors do not all weigh in favor of a cease-and-desist order, such an order is still appropriate. The Norma-related violations, in particular, support a cease-and-desist order, because of Respondents' scienter and the egregiousness of the violations. I have also placed particular weight on Respondents' utter lack of recognition of the wrongful nature of their conduct. The incremental prejudice to Respondents arising from a cease-and-desist order, compared to the other sanctions, is minimal. Cease-and-desist orders, as to both the Securities Act and Advisers Act violations, will be imposed.

C. Disgorgement

Disgorgement is authorized in this case by Securities Act Section 8A(e), Investment Company Act Section 9(e), and Advisers Act Section 203(j). *See* 15 U.S.C. §§ 77h-1(e), 80a-9(e), 80b-3(j). Disgorgement is an equitable remedy that requires a violator to give up wrongfully obtained profits causally related to the proven wrongdoing. *See SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1230-32 (D.C. Cir. 1989). It returns the violator to where he or she would have been absent the misconduct and deters others from violating the securities laws. *Id.*; *see Zacharias v. SEC*, 569 F.3d 458, 471 (D.C. Cir. 2009). The amount of the disgorgement need only be a reasonable approximation of profits causally connected to the violation. *See Laurie Jones Canady*, 54 S.E.C. 65, 84 n.35 (1999) (quoting *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1475 (2d Cir. 1996)), *pet. denied*, 230 F.3d 362 (D.C. Cir. 2000). Once the Division shows that its disgorgement figure reasonably approximates the amount of unjust enrichment, the burden shifts to Respondents to demonstrate that the Division's disgorgement figure is not a reasonable approximation. *Guy P. Riordan*, Securities Act Release No. 9085, 2009 WL 4731397, at *20 (Dec. 11, 2009), *pet. denied*, 627 F.3d 1230 (D.C. Cir. 2010). The consequence of uncertainty as to the disgorgement amount falls on the wrongdoer whose illegal conduct created the uncertainty. *See First City Fin. Corp.*, 890 F.2d at 1232. The standard for disgorgement is but-for causation and has nothing to do with the public interest; in essence, disgorgement is always in the public interest. *Jay T. Comeaux*, Exchange Act Release No. 72896, 2014 WL 4160054, at *3 & n.18, *5 (Aug. 21, 2014). The combination of sanctions also does not affect disgorgement. *Id.* at *4 n.32.

The Division argues that the entirety of Harding's management fees, from Octans I and from the CDOs into which Norma bonds were placed, should be disgorged. Div. Br. at 134-35. I agree with Respondents that the Division's request fails to properly account for Harding's legitimate activities, including its post-closing management activities and its lawful selection of collateral. Resp. Br. at 340-43 (citing *First City Fin. Corp.*, 890 F.2d at 1231). The cases on which the Division relies do not stand for the general proposition that disgorgement may be ordered "without regard to whether or not the violator also claims to have performed 'legitimate' services." *See* Div. Br. at 135 & n.205.

Although the Division's theory leads to an excessive disgorgement amount, the proper disgorgement amount may be calculated from the record. Specifically, the most reasonable disgorgement amount is simply Harding's management fees prorated by the percentage of collateral which was unlawfully placed into each CDO. For Octans I, the ABX Index bonds had a notional value of $220 million, or 14.67% of Octans I's $1.5 billion in total collateral.[73] Div.

[73] To be sure, some of the ABX Index bonds might have been purchased for Octans I even if Harding had not violated the law. However, the OIP adequately alleged, and the evidence proves, that Harding's collateral selection process for all the ABX Index bonds was inconsistent with Harding's representations. OIP at 11.

Ex. 6A; Answer at 2. For NEO, the Norma bonds comprised 1.66% of the collateral, and for Lexington, 1.63% of the collateral. Resp. Ex. 879.

Thus, the proper disgorgement amount is the sum of the management fees Harding received for Octans I, NEO, and Lexington, plus prejudgment interest, multiplied by, respectively, 14.67%, 1.66%, and 1.63%:

Octans I fees:	4,563,733.94 x .1467 =	669,500
NEO fees:	4,490,522.84 x .0166 =	74,543
Lexington fees:	1,285,112.77 x .0163 =	20,947
Octans I prejudgment interest:	1,441,679.97 x .1467 =	211,494
NEO prejudgment interest:	1,283,498.00 x .0166 =	21,306
Lexington prejudgment interest:	332,906.72 x .0163 =	5,426
Total:		1,003,216

Div. Ex. 240A; Div. Br. at App'x 5. The Division's posthearing brief was filed June 13, 2014, and prejudgment interest was presumably calculated through the first quarter of 2014. Div. Br. at 135. Joint and several liability is clearly appropriate here, because Respondents collaborated and had a close relationship in engaging in the illegal conduct. *See SEC v. Whittemore*, 659 F.3d 1, 10-11 (D.C. Cir. 2011) (quoting *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 455 (3d Cir. 1997)).

D. <u>Civil Penalties</u>

Under Section 203(i) of the Advisers Act, the Commission may impose a civil money penalty if a respondent willfully violated any provision of the Advisers Act, and if such penalty is in the public interest. 15 U.S.C. § 80b-3(i) (2006). A three-tier system establishes the maximum civil money penalty that may be imposed for each violation found. *Id.* at § 80b-3(i)(2). Where a respondent's misconduct involved fraud, deceit, or deliberate or reckless disregard of a regulatory requirement, and resulted in substantial pecuniary gain to the respondent, the Commission may impose a "Third-Tier" penalty of up to $130,000 for each act or omission by an individual and $650,000 for each act or omission by an entity, for violations occurring between February 15, 2005, and March 3, 2009. *Id.*; 17 C.F.R. §§ 201.1003. Where misconduct did not involve fraud, deceit, or deliberate or reckless disregard of a regulatory requirement, the Commission may impose a "First-Tier" penalty of up to $6,500 against an individual and $65,000 against an entity. 15 U.S.C. § 80b-3(i)(2); 17 C.F.R. §§ 201.1003. Investment Company Act Section 9(d) has similar provisions. 15 U.S.C. § 80a-9(d) (2006); 17 C.F.R. §§ 201.1003; *see* OIP at 13.

In determining whether a penalty is in the public interest, six factors may be considered: (1) whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, (2) the resulting harm to other persons, (3) any unjust enrichment and prior restitution, (4) the respondent's prior regulatory record, (5) the need to deter the respondent and other persons, and (6) such other matters as justice may require. 15 U.S.C. §§ 80a-9(d)(3), 80b-3(i)(3). Other factors may also be considered:

> (1) the egregiousness of the violations at issue, (2) defendants' scienter, (3) the repeated nature of the violations, (4) defendants' failure to admit to their wrongdoing; (5) whether defendants' conduct created substantial losses or the risk of substantial losses to other persons; (6) defendants' lack of cooperation and honesty with authorities, if any; and (7) whether the penalty that would otherwise be appropriate should be reduced due to [respondents'] demonstrated current and future financial condition.

SEC v. Lybrand, 281 F. Supp. 2d 726, 730 (S.D.N.Y. 2003), *aff'd on other grounds*, 425 F.3d 143 (2d Cir. 2005) (*Lybrand* factors). Within any particular tier, the Commission has discretion to set the amount of the penalty. *See Brendan E. Murray*, Advisers Act Release No. 2809 2008 SEC LEXIS 2924, at *42 (Nov. 21, 2008); *The Rockies Fund, Inc.*, Exchange Act Release No. 54892 2006 SEC LEXIS 2846, at *25 (Dec. 7, 2006). "[E]ach case has its own particular facts and circumstances which determine the appropriate penalty to be imposed" within the tier. *SEC v. Murray*, No. OS-CV-4643 (MKB), 2013 WL 839840, at *3 (E.D.N.Y. Mar. 6, 2013) (quotation omitted); *see also SEC v. Kern*, 425 F.3d 143, 153 (2d Cir. 2005).

While a penalty may be imposed for "each act or omission," the statutes leave the precise unit of violation undefined. 15 U.S.C. §§ 80a-9(d)(2), 80b-3(i)(2). The Division seeks five third-tier penalties (one for each defrauded CDO) and no first-tier penalties. Div. Br. at 137. However, the record supports imposition of penalties exceeding first-tier only for the two violations of Section 206(1), and the two violations of Section 17(a)(1). These four violations meet third-tier requirements: all related to Norma bonds, and therefore occurred after September 18, 2006, all involved scienter, and all resulted in substantial fees for Respondents. Accordingly, only four third-tier penalties will be imposed. The record also supports imposition of first-tier penalties for those violations of Section 206(2) and Sections 17(a)(2) and 17(a)(3) which occurred after September 18, 2006. Because the Division does not seek first-tier penalties, however, I will not impose them.

Those statutory and *Lybrand* factors weighing in favor of a severe sanction include fraud and scienter, unjust enrichment with no prior restitution, the need to deter Respondents and others, egregiousness, recurrence, and failure to admit wrongdoing. Those statutory and *Lybrand* factors weighing against a severe sanction include lack of losses or other harm, and Respondents' clean regulatory record. Although it stands to reason that by, in essence, sabotaging NEO and Lexington to please Merrill and Magnetar, Respondents created a risk of substantial losses, the actual evidence of such a risk is virtually nonexistent, especially considering the small percentage of Norma bonds relative to the rest of the NEO and Lexington portfolios; this factor is equivocal. Although Respondents generally cooperated with authorities, Chau provided unbelievable testimony at the hearing regarding Norma, and the "cooperation and honesty" *Lybrand* factor is also equivocal. There is no evidence of inability to pay.[74] On

[74] I decline Respondents' request for an additional "opportunity to provide information regarding ability to pay." Resp. Br. at 346 n.323. Respondents had more than ample opportunity to

balance, including consideration of the combination of sanctions, a civil penalty of about two-thirds of the maximum is appropriate as to both Respondents. Accordingly, Harding will be ordered to pay four penalties of $425,000 each, or $1.7 million total, and Chau will be ordered to pay four penalties of $85,000 each, or $340,000 total.

E. <u>Bar and Revocation</u>

Section 203(e) of the Advisers Act authorizes the Commission to revoke an investment adviser's registration if: (1) it, or any person associated with it, has willfully violated, or willfully aided and abetted the violation of, any provision of the Securities Act or Advisers Act; and (2) revocation is in the public interest. 15 U.S.C. § 80b-3(e). As discussed above, the public interest factors are mixed. However, as they pertain to the Norma-related violations, they weigh in favor of revocation, and although the combination of sanctions is onerous, it is not so onerous as to weigh against revocation. Thus, I find that registration revocation is appropriate to vindicate the public interest.

Section 203(f) of the Advisers Act authorizes the Commission to bar or suspend a person from association with an investment adviser, or censure him, for willful violations of the Securities Act or Advisers Act, if it is in the public interest. 15 U.S.C. § 80b-3(f); *see John W. Lawton*, Advisers Act Release No. 3513, 2012 WL 6208750, at *7-10 (Dec. 13, 2012). As with registration revocation, the public interest factors weigh in favor of a permanent direct and collateral associational bar. I place particular weight on Chau's lack of recognition of wrongful conduct, notwithstanding the extensive documentation of misconduct with respect to Norma, and on the fact that Chau continues his employment as an investment adviser, with current assets under management of about $1 billion. Tr. 4335.

Section 9(b) of the Investment Company Act authorizes the Commission to bar a person from association with a registered investment company for willful violations of the Securities Act or Advisers Act, or aiding and abetting the same, if it is in the public interest. 15 U.S.C. § 80a-9(b)(2), (3). Here, also, the public interest factors weigh in favor of a permanent associational bar.

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the Record Index issued by the Secretary of the Commission on December 23, 2014, with the exceptions noted in footnote 2, *supra*.

VI. ORDER

IT IS ORDERED that Respondents' motion to amend page 3724, lines 17-18, of the transcript is DENIED.

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provide such information during and prior to the hearing, including as part of the hundreds of exhibits they offered and I admitted.

IT IS ORDERED that, pursuant to Section 203(e) of the Investment Advisers Act of 1940, the investment adviser registration of Harding Advisory LLC is REVOKED.

IT IS FURTHER ORDERED that, pursuant to Section 203(f) of the Investment Advisers Act of 1940, Wing F. Chau is permanently BARRED from association with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

IT IS FURTHER ORDERED that, pursuant to Section 9(b) of the Investment Company Act of 1940, Wing F. Chau is permanently BARRED from association with a registered investment company.

IT IS FURTHER ORDERED that, pursuant to Section 8A(a) of the Securities Act of 1933 and Section 203(k) of the Investment Advisers Act of 1940, Harding Advisory LLC shall CEASE AND DESIST from committing, and Wing F. Chau shall CEASE AND DESIST from committing, aiding and abetting, or causing the commission of, any violations or future violations of Investment Advisers Act of 1940 Section 206, and Securities Act of 1933 Section 17(a).

IT IS FURTHER ORDERED that, pursuant to Section 203(i) of the Investment Advisers Act of 1940 and Section 9(d) of the Investment Company Act of 1940, Harding Advisory LLC shall PAY A CIVIL MONEY PENALTY in the amount of $1,700,000.

IT IS FURTHER ORDERED that, pursuant to Section 203(i) of the Investment Advisers Act of 1940 and Section 9(d) of the Investment Company Act of 1940, Wing F. Chau shall PAY A CIVIL MONEY PENALTY in the amount of $340,000.

IT IS FURTHER ORDERED that, pursuant to Section 8A(e) of the Securities Act of 1933, Section 203(j) of the Investment Advisers Act of 1940, and Section 9(e) of the Investment Company Act of 1940, Harding Advisory LLC and Wing F. Chau shall, jointly and severally, PAY DISGORGEMENT in the amount of $764,990.

IT IS FURTHER ORDERED that, pursuant to Section 8A(e) of the Securities Act of 1933, Section 203(j) of the Investment Advisers Act of 1940, and Section 9(e) of the Investment Company Act of 1940, Harding Advisory LLC and Wing F. Chau shall, jointly and severally, PAY PREJUDGMENT INTEREST in the amount of $238,226.

Payment of disgorgement, prejudgment interest, and civil penalties shall be made no later than twenty-one days following the day this Initial Decision becomes final, unless the Commission directs otherwise. Payment shall be made in one of the following ways: (1) transmitted electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) direct payments from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or (3) by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission. Any payment by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order shall include a cover letter identifying the Respondent(s) and Administrative Proceeding No. 3-15574, and shall be delivered to: Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Bld., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Cameron Elliot
Administrative Law Judge