CLIENT MEMORANDUM

SEC Loses Controversial Enforcement Case Against Two Investment Adviser Executives

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On December 8, 2015, the Court of Appeals for the First Circuit delivered a high-profile loss to the Securities and Exchange Commission (the "SEC" or the "Commission") when it vacated an order issued by the Commission against John P. Flannery and James D. Hopkins, two former senior investment adviser executives who had allegedly violated the federal securities laws by making false and misleading statements about certain State Street-managed fixed income funds during the 2007 subprime mortgage crisis.[1] The First Circuit's decision is particularly notable because it overturned a controversial Commission decision that itself had, by a 3-2 vote, overturned the decision by the SEC's own Chief Administrative Law Judge ("ALJ") that no violations had occurred.

After a careful review of the record, the First Circuit concluded that the materiality of the statements attributed to Hopkins was "thin" and, even coupled with other evidence, did not establish scienter and that, because the statements attributed to Flannery were not "materially misleading," the SEC's finding that Flannery had engaged in a fraudulent "practice" or "course of business" was not justified. In particular, the First Circuit noted that relevant portfolio information was available to clients before the challenged statements were made. The Commission's decision was thus not "supported by

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1 *Flannery v. SEC*, No. 15-1080 (1st Cir. Dec. 8, 2015).

substantial evidence," and the Commission "abused its discretion" in its determination to overrule the decision of its own ALJ.[2]

The First Circuit's decision represents a significant loss for the SEC, which has recently highlighted the prosecution of individuals as an integral component of the Commission's enforcement program[3] and come under criticism for increasingly using its in-house administrative tribunal to resolve contested enforcement matters.[4] The case also potentially serves as a warning to the SEC, which in recent years has often tried to bring cases based on imputing intent from limited information.

Background

In 2002, State Street Global Advisers ("SSgA") created the Limited Duration Bond Fund (the "LDBF"), a combination of two unregistered fixed-income funds that were invested in various fixed-income products. The LDBF, which was offered and sold only to institutional investors, was heavily invested in asset-backed securities ("ABS"), including residential mortgage-backed securities ("RMBS"). Since its inception, the LDBF had outperformed its benchmark index. Beginning in June 2007, however, as the subprime mortgage crisis unfolded, the LDBF experienced substantial underperformance.

Hopkins was a former vice president and head of North American Product Engineering and worked at SSgA from 1998 until 2010, when he was offered retirement as a result of the SEC proceeding. From 2006 to 2007, he was the senior product engineer responsible for fixed-income funds, including the LDBF. The First Circuit noted that Hopkins had worked in the securities industry for "thirty-five years with an unblemished record" apart from the SEC charges.

Flannery was a former chief investment officer ("CIO"), who worked at SSgA from 1996 as a product engineer until his position was eliminated in 2007 after a long career in fixed income. In 2005, he became SSgA's Fixed Income CIO for the Americas, with general supervisory oversight for SSgA's operations, although he was not involved in the LDBF's investment decisions or its daily management. As noted by the First Circuit, Flannery had an "unblemished record in the industry and a reputation for being very honest and having a great deal of integrity."

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[2] *Flannery*, slip op. at 24.

[3] Mary Jo White, Chair, SEC, *Understanding Disqualifications, Exemptions and Waivers Under the Federal Securities Laws* (Mar. 12, 2015), *available* here ("In my experience, in the enforcement arena, the most effective deterrent is strong enforcement against responsible individuals, especially senior executives. In the end, it is people, not institutions, who engage in unlawful conduct….As our record at the SEC shows, a critical priority of our enforcement program is to hold responsible individuals accountable….In fiscal year 2015 to date, we have charged individuals in more than 110 actions, or approximately 66 percent of our total actions.").

[4] Jacob Gershman, *Former Official Says SEC Beset by "Crisis of Confidence" Over In-House Judges*, THE WALL STREET JOURNAL LAW BLOG (Dec. 2, 2015, 5:37 PM) (explaining that former SEC commissioner Joseph Grundfest is among others "who worry that the SEC may be seen as seeking to exploit a home-court advantage by sending more of its serious cases to its own tribunal…" and that "[c]riticism of the internal tribunals picked up after The Wall Street Journal published an analysis…showing the agency won contested cases heard by its in-house judges at a far higher rate than ones it took to federal court"), *available* here.

The Commission alleged that Hopkins and Flannery "engaged in a course of business and made material misrepresentations and omissions that misled investors" about the LDBF, and it charged Hopkins and Flannery with violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5. [5]

The charges against Hopkins and Flannery involved three communications about the LDBF that Hopkins and Flannery either made or were involved with in 2007: a slide from a standard PowerPoint presentation that SSgA used when presenting information about the LDBF to investors that described typical portfolios in the strategy (the "Typical Portfolio Slide"); and two letters, dated August 2 and August 14, 2007, regarding conditions in the housing-related securities market that Flannery either wrote or had seen before they were sent to investors (the "August 2 Letter" and the "August 14 Letter," respectively).

- The Typical Portfolio Slide described the LDBF as "high quality" and contained a sector allocation graph showing that the LDBF was 55% invested in ABS, 25% in CMBS, and 10% MBS. In 2007, however, the LDBF's actual investment in ABS reached 80% to nearly 100%. Hopkins used the slide at an investor presentation in May 2007 (the "May Presentation") without updating the Typical Portfolio Slide's sector breakdown.

- The August 2 Letter was sent to clients in at least 22 fixed-income funds and described the actions SSgA had taken to respond to conditions in the subprime mortgage market, including the sale of significant portions of certain BBB- and AAA-rated securities held in its Limited Duration Bond Fund. The August 2 Letter, which Flannery had a hand in editing, described certain bond sales that SSgA had undertaken in response to the crisis, stating that these actions "simultaneously reduced risk in other SSgA active fixed income and active derivative-based strategies."

- The August 14 Letter was sent by Flannery to LDBF investors in an attempt to explain what was taking place in the market. The letter, which was vetted by SSgA's president and CEO and in-house and outside legal counsel (among others), ended by stating: "while we will continue to liquidate assets for our clients when they demand it, we believe that many judicious investors will hold positions in anticipation of better liquidity in the months to come."

After an 11-day hearing involving 19 witnesses and about 500 exhibits, the SEC's Chief ALJ dismissed the proceeding, finding that neither Hopkins nor Flannery was responsible for, or had ultimate authority over, the documents at issue and that these documents did not contain materially false or misleading statements or omissions.

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[5] The charges against Flannery and Hopkins were related to those brought against SSgA, which the firm settled in 2010. See *State Street Bank and Trust Company*, Securities Act of 1933 Release No. 9,107 (Feb. 4, 2010). The SEC charged SSgA with violating Section 17(a)(2) and Section 17(a)(3) of the Securities Act of 1933 for allegedly misleading investors about the extent of the LDBF's subprime investments. Under the terms of the settlement, SSgA agreed to replace key senior personnel and portfolio managers, pay more than $300 million to investors who had lost money, and provide the SEC with information to help evaluate individuals' potential liability related to investor communications about the LDBF.

On appeal by the Division of Enforcement, the Commission reversed the ALJ's ruling, finding Hopkins liable under Section 17(a)(1) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5, and Flannery liable under Section 17(a)(3) of the Securities Act of 1933. The Commission imposed cease-and-desist orders against Flannery and Hopkins, suspended them from association with any investment adviser or company for a period of one year, and ordered Flannery and Hopkins to pay civil monetary penalties of $6,500 and $65,000, respectively.

The Decision of the Court of Appeals

In reviewing the Commission's decision, the First Circuit noted that the "SEC's factual findings control if supported by substantial evidence," so long as its orders and conclusions are not "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *Flannery*, slip op. at 16 (quoting *Cody v. SEC*, 639 F.3d 251, 257 (1st Cir. 2012)). Where (as here) "the Commission and the ALJ reach different conclusions," the Court continued, a different standard applies. In that instance, because the evidence supporting a conclusion may be less substantial when an impartial, experienced examiner who has observed the witnesses and lived with the case has drawn conclusions different from those reached by the Commission, "our review is slightly less deferential than it would be otherwise." *Id.* at 17.

Applying that standard, the First Circuit concluded that there was not substantial evidence to support the Commission's decision, either as to materiality of the challenged statements or as to scienter, and vacated the SEC's ruling. *Id.* at 16.

Beginning with the Typical Portfolio Slide, the First Circuit held that, even assuming that the slide was misleading, the SEC's evidence of materiality was "marginal." Because materiality turns on "how a reasonable investor would react," the court noted, "context makes a difference." Although the SEC's decision identified a witness who attended the May Presentation who believed SSgA did not adequately inform him of the risks in the portfolio, myriad other facts – including (i) that the slide itself was labeled "typical," (ii) that it was only one slide of at least 20, (iii) that the purpose of Hopkins's presentation was to explain why the LDBF had underperformed in the first quarter of 2007 and to discuss the specific index investment that contributed to underperformance, and (iv) that expert evidence established that such PowerPoint presentations were merely meant to be "starting points" after which investor due diligence is performed – all suggested that the information in the Typical Portfolio Slide was not material at all. Indeed, not only were clients given specific information upon request, but information about the LDBF's actual percent of sector investment was available through fact sheets and annual audited financial statements before the May Presentation took place. Those facts weighed heavily against any conclusion that the Typical Portfolio Slide had "significantly altered the 'total mix' of information made available." *Flannery*, slip op. at 22 (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

That "thin materiality showing," the First Circuit continued, could not support a finding that Hopkins had acted with scienter. Hopkins himself testified that he did not believe that the sector breakdown was important to investors and was never asked to provide that breakdown information, either at the May Presentation or otherwise. Further, the fact that Hopkins had notes of the actual sector breakdowns with him at the time the presentation was made was not evidence of scienter, given the substantial evidence weighing against materiality.

The SEC's case against Flannery fared no better. In its opinion, the SEC asserted that the August 2 Letter was misleading because the bond sales had increased – not decreased – the fund's credit risk and liquidity risk. But the evidence, said the First Circuit, did not support those assertions. Among other reasons, counsel for the Commission conceded at oral argument that there was no particular sentence in the August 2 Letter that was inaccurate and that there was no evidence that SSgA did not "seek to reduce risk across the affected portfolios," just as it said it would. The SEC did not dispute the truth of the statements in the August 2 Letter that the LDBF maintained an average AA-credit rating, and lay and expert opinion at trial established that the bond sales did in fact reduce the fund's risk. To the extent the Commission claimed that the fund's liquidity risk increased after the bond sales, the First Circuit noted, it was incumbent upon the SEC to show that that risk would have been higher if no bond sales had occurred at all, which it failed to do.

As a consequence, the First Circuit found it unnecessary to review the August 14 Letter since Section 17(a)(3) of the Securities Act of 1933, under which the Commission found Flannery liable, does not "proscribe…a single act of making or drafting a material misstatement to investors." In other words, even if the August 14 Letter were misleading, that would not be enough evidence to find that Flannery had engaged in a fraudulent "practice" or "course of business" under Section 17(a)(3).

Conclusion

Flannery notably reaffirms the "total mix" standard for determining materiality and for establishing the burden of proof required to prove scienter. In addition, the First Circuit implicitly undermined the SEC's theory of scienter, which was based, in part, on institutional investors' relying only on written documents provided to them and not on information they choose to obtain through due diligence. The case also demonstrates the limitations of the idea that every SEC case will support individual liability. Here, the SEC appears to have stretched to find individual liability. As has occurred in past periods in which the SEC has engaged in an aggressive enforcement program in an attempt to shape the law, it is individuals seeking to clear their names that often challenge the program and ultimately define the legal standards.

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