NO. 15-1080

**UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT**

JOHN P. FLANNERY

PETITIONER

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

RESPONDENT

ON PETITION FOR REVIEW OF AN ORDER OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

REPLY BRIEF OF PETITIONER JOHN PATRICK FLANNERY

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INTRODUCTION

The Securities and Exchange Commission's brief highlights why the Commission's opinion and order as to John Patrick ("Sean") Flannery should be vacated. The Commission makes little effort to prop up its factual conclusions, other than parroting its opinion while ignoring the same record evidence it ignored in reaching it. The Commission's legal arguments are contradictory. Its opinion claimed that Section 17(a)(3) of the Securities Act of 1933 is ambiguous and confusing, and that determining its meaning required the Commission's expertise in administering the securities laws. ADD70. The Commission now claims Section 17(a)(3) is unambiguously clear, and Flannery should have known the two August letters were within the "heartland" of its prohibitions. Commission Brief ("Com.Br.") 61. The Commission's roving legal positions do have one thing in common: they are inconsistent with the statute itself.

The Commission's brief attempts to belatedly refine its theory of liability, asserting that "Flannery acted negligently because he unreasonably *failed to correct*" the letters. Com.Br.15 (emphasis added). Whether the current theory is "failing to correct" or "helping to draft, edit and approve" (*id*. at 3), the record evidence refutes both theories:

- Flannery did not draft the allegedly misleading language in either letter.
- Flannery suggested one set of minimal edits to an early draft of the August 2 letter; none of those suggested edits were a basis for charges. The Head of

Fixed Income—more deeply knowledgeable about the Limited Duration Bond Fund ("LDBF") than Flannery—reviewed the letter and did not change the risk reduction language. The letter was then reviewed, discussed and edited sixteen additional times by others, without Flannery's involvement. SSgA's General Counsel, Mitchell Shames, approved the final letter.

- It is undisputed that LDBF's leverage and subprime exposure was significantly reduced after the AAA bond sale, reducing risk. Moreover, LBDF had four times more cash after the sale, and its credit quality remained the same. Flannery accurately believed that the three transactions referenced in the August 2 letter—two of which the Commission does not dispute—were successful efforts to reduce LDBF's risk. At a minimum, his belief was reasonable.

- Mark Duggan, SSgA's Deputy General Counsel, modified Flannery's opinion in the original draft of the August 14 letter with language he deemed legally appropriate. Along with other knowledgeable executives and outside counsel, Duggan then reviewed and edited the letter multiple times, and finally approved it. Flannery's boss used the "many judicious investors" language in his own communication two months later.

- The "many judicious investors" opinion was well-founded: Flannery and expert witness Eric Sirri testified, without rebuttal, that many investors will hold, rather than redeem, their investments in a chaotic market to await potential recovery. The Related Funds' in-kind redemptions reflected their decisions to remain exposed to LDBF's assets. There is no contrary evidence about why the Related Funds redeemed in-kind.

- The information the Commission claims LDBF's sophisticated investors "would have wanted to know" had already been disclosed to them in multiple ways. Because it called no investors to testify about either letter, the Commission offered no evidence that the allegedly misleading information would have been material to investors, much less that anyone was misled.

Based on the evidence, the Chief Administrative Law Judge ("CALJ") exonerated Flannery. The Commission's brief largely ignores the proceedings before the CALJ, other than arguing that her credibility determinations should be

afforded great weight when discussing a Commission witness against James Hopkins (Com.Br.28-29),[1] while ignoring those determinations when they are inconsistent with the divided Commission's opinion.

Finally, the Commission misstates the law. The Commission hopes blind deference will sustain its new and counter-textual interpretation of Section 17(a)(3), but the statute's plain meaning contradicts the Commission.

ARGUMENT

I. THE COMMISSION'S UNSUPPORTED FACTUAL CONCLUSIONS SHOULD BE REJECTED

A. Flannery Did Not Negligently "Fail To Correct" Or "Approve" The August 2 Letter

Flannery's role in the August 2 letter was minimal, a fact the Commission seeks to obscure. There is no dispute that Flannery suggested just one set of minor edits to an early draft, only some of which were incorporated into the letter. Flannery Opening Brief ("Flan.Br.") 25. His suggested edits made the draft more accurate, and were not a basis for charges. *Id*. Conceding these points as it must, the Commission's brief decries Flannery's alleged "failure to correct" or "approval of" the letter's risk reduction language, but this flounders, where numerous knowledgeable in-house and outside lawyers, Fixed Income, Risk, Compliance and Relationship Management executives reviewed, discussed and edited the letter

[1] There is no overlap between the allegations applicable to Flannery and Hopkins.

more than sixteen times after Flannery suggested minor edits to a letter he did not request, prepare, or send. Flan.Br.25-27.[2]

The Commission does not dispute the substantial role of knowledgeable counsel and other investment professionals in the August 2 letter, and claims its opinion below took this evidence into account. Com.Br.46. This is false: the Commission never weighed this evidence, and instead rests on the conclusory assertion that the involvement of others does not excuse *Flannery's* purported negligence in "approving" misleading language. *Id*. at 46-48.

The Commission's argument is this: because Flannery was "an experienced securities professional," he should have known the letter was misleading—nothing else matters. Com.Br.47. This reasoning would, in effect, saddle "experienced

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[2]There is no evidence Flannery made "repeated" decisions to approve the letter or reviewed a "near-final version of the letter on or around August 2, 2007." Com.Br.12, 49. The Commission cites an August 3 e-mail from Larry Carlson (Co-Head, Relationship Management) to Jodi Luster (in-house counsel), in which Carlson writes he "had shown the letter to Sean, Mitch et al" at some unidentified point in time. JA2429-32. However, there were numerous drafts of the letter (*e.g*., JA2346-48, 2365-67, 2371-80, 4041-44, 4047-49, 4056-65, 4094-95, 4103-22), and this e-mail does not indicate which of them Carlson may have shown Flannery. Moreover, nobody remembered Carlson showing the letter to Flannery; Carlson testified that if he had, it would have been via e-mail (JA1062, 1473), but there is no such e-mail. The Commission also cites an e-mail sent to numerous Relationship Management personnel, copying Flannery and others, which *did not attach* the letter—it informed the recipients a letter was coming after legal approval. JA2368-70. Finally, the Commission cites an e-mail circulating the final letter to Relationship Management for dissemination to clients, *after* it had been approved by Legal, on which Flannery and many others were copied. JA2375-80. Nobody asked (or expected) Flannery to again review the approved, final letter, nor did he. JA1128-33.

securities professionals" with strict liability under Section 17(a)(3), even though proof of negligence is required. *See SEC v. Ficken*, 546 F.3d 45, 52 (1st Cir. 2008).

The facts demonstrate the absurdity of this argument. Flannery was Chief Investment Officer responsible for nine different groups and approximately $2 trillion in assets, of which LDBF constituted under 1%. ADD6. As Head of Fixed Income, Michael Wands monitored LDBF (JA1511-13); he reviewed the August 2 letter but did not change the risk reduction language. JA4047-50. So did many other investment professionals and others, without Flannery's involvement. JA1128-32, 1136, 1488, 2368-74, 2429-32, 4044, 4051-52, 4056-65, 4094-98, 4107-22. Multiple lawyers repeatedly reviewed and edited the letter. JA2371, 2429, 4056, 4059, 4063, 4094, 4103. SSgA's General Counsel made clear that he had to approve the final letter. JA4051, 4119. Yet the Commission deems all of this irrelevant because Flannery was "an experienced securities professional."

The Commission misrepresents *SEC v. Shanahan*, 646 F.3d 536 (8th Cir. 2011), claiming it held that "'[d]epending on others to ensure the accuracy of disclosures to purchasers and sellers of securities' *is* 'inexcusably negligent.'"

Com.Br.48 (citing *Shanahan*, 646 F.3d at 544) (emphasis added). But this is the actual passage from *Shanahan*:

> Depending on others to ensure the accuracy of disclosures to purchasers and sellers of securities—*even if* inexcusably negligent—is not severely reckless conduct….

Id. (emphasis added). The *Shanahan* court then *rejected* the Commission's negligence claims under Section 17(a)(2) and 17(a)(3), in part based on "the proper allocation of responsibilities between ESSI's finance and accounting professionals, outside auditors, inside and outside counsel, [and others]." *Id*. at 546. Rather than holding that reliance on the involvement of others "is" negligent, *Shanahan* held the opposite. Here, the "proper allocation of responsibilities" demonstrates that Flannery acted reasonably.

Regarding counsel specifically, the Commission perpetuates its false distinction between "business" and "legal" judgments, arguing that without this distinction, "a businessman could never act unreasonably so long as he sought the advice of counsel." Com.Br.47. First, there are many instances in which someone might be deemed unreasonable notwithstanding counsel's involvement including where, unlike here, the person ignored counsel's advice. Second, the Commission misses the point: professionals routinely seek advice from securities counsel regarding whether, in light of the language used and the other information available, a disclosure complies with the securities laws. *Howard*, 376 F.3d 1136,

1148 n.20 (D.C. Cir. 2004) (guidance of counsel for securities professionals is essential). Under the Commission's reasoning, "experienced securities professionals" would bear absolute responsibility for assessing the legal sufficiency of disclosures, and would always face liability regardless of whether informed securities counsel reviewed and approved the disclosures. This is not the law.

B. The Commission's Reliance On A Later Sentence In The August 2 Letter Exposes Its Baseless Theory

The August 2 letter stated that the transactions described were "steps to *seek to* reduce risk across the affected portfolios." ADD118 (emphasis added). Thus, even if, contrary to the facts, the transactions did not reduce risk, the letter was not misleading. Flan.Br.36-38. The Commission effectively concedes that the words "seek to" rendered the risk-reduction language accurate, but now focuses on a later sentence in the same paragraph, which said: "The actions we have taken to date in the Limited Duration Bond Strategy simultaneously reduced risk in other SSgA active fixed income and active derivative-based strategies." ADD126. The Commission argues that although the words "seek to" appeared a few sentences earlier in the paragraph, the absence of those words in the subsequent, quoted sentence was misleading. Com.Br.35.

The Commission has finally been forced to fully articulate its theory concerning the August 2 letter, exposing its folly. Counsel added the "seek"

language to both sentences of the paragraph. JA4063-65. "Seek" was subsequently deleted from the second sentence—though not from the first—on the afternoon of August 2, as reflected in e-mail correspondence from Larry Carlson to multiple lawyers, not involving Flannery. JA4115-18. There is no evidence Flannery reviewed this change; even if (as nobody remembers) Carlson "had shown" some version of the letter to Flannery, there is no evidence that it was the version with "seek" deleted. *See* n.2, *supra*. It is undisputed that General Counsel Shames approved the final letter. JA4119.

Thus, the Commission seeks to hold Flannery liable even though (1) somebody else deleted one of counsel's two insertions of "seek;" (2) Flannery did not review or approve that deletion; and (3) the deletion was ultimately approved by counsel.

C. The August 2 Letter Was Not Misleading

1. The "Ultimate Impact" Of The AAA Sale Was A Less Risky Fund

Unrebutted expert and fact witness testimony demonstrated that the impact of the three transactions described in the August 2 letter was to reduce risk. Flan.Br. 16-17. The Commission's expert did not conduct a risk analysis—he simply analyzed the amount of cash raised by the AAA sale and then used for redemptions. JA975, 3837-46. The Commission does not dispute that two of the three transactions reduced risk. All that is at issue is the AAA sale, which the

Commission contends, based on its own say-so, increased LDBF's risk because some of the resulting cash was used to pay redemptions.

The Commission continues to simply ignore the fact that the AAA sale drastically reduced (1) LDBF's leverage by over $1 billion; and (2) LDBF's exposure to the increasingly risky subprime mortgage market. The testimony that this reduced risk was unrebutted. Flan.Br.16-17. Because leverage magnifies both gains and losses, reducing leverage significantly reduced LDBF's exposure to further declines in the subprime market. JA1050-51, 4337, 4339, 4343.

The Commission persists in focusing on cash. It does not dispute that nearly half the net proceeds of the AAA sale after repayment of repurchase commitments remained in LDBF on August 2. Flan.Br.18. But it now suggests that the only way for SSgA to have reduced risk would have been to retain *all* of the resulting cash. Com.Br. 37 ("LDBF sold its highest-rated assets and did not retain the proceeds of the sale").

As an initial matter, retaining all cash would have been inconsistent with LDBF's promise of daily liquidity. ADD5. Moreover, over $1 billion of the cash was not LDBF's to retain, since it needed to be used to repay repurchase commitments—the source of the leverage. ADD16. With respect to the remaining cash, although approximately half was used to fund redemptions (hardly

"exhaustion"), the Commission overlooks that *LDBF held more cash on August 2 than it did before the AAA sale*:

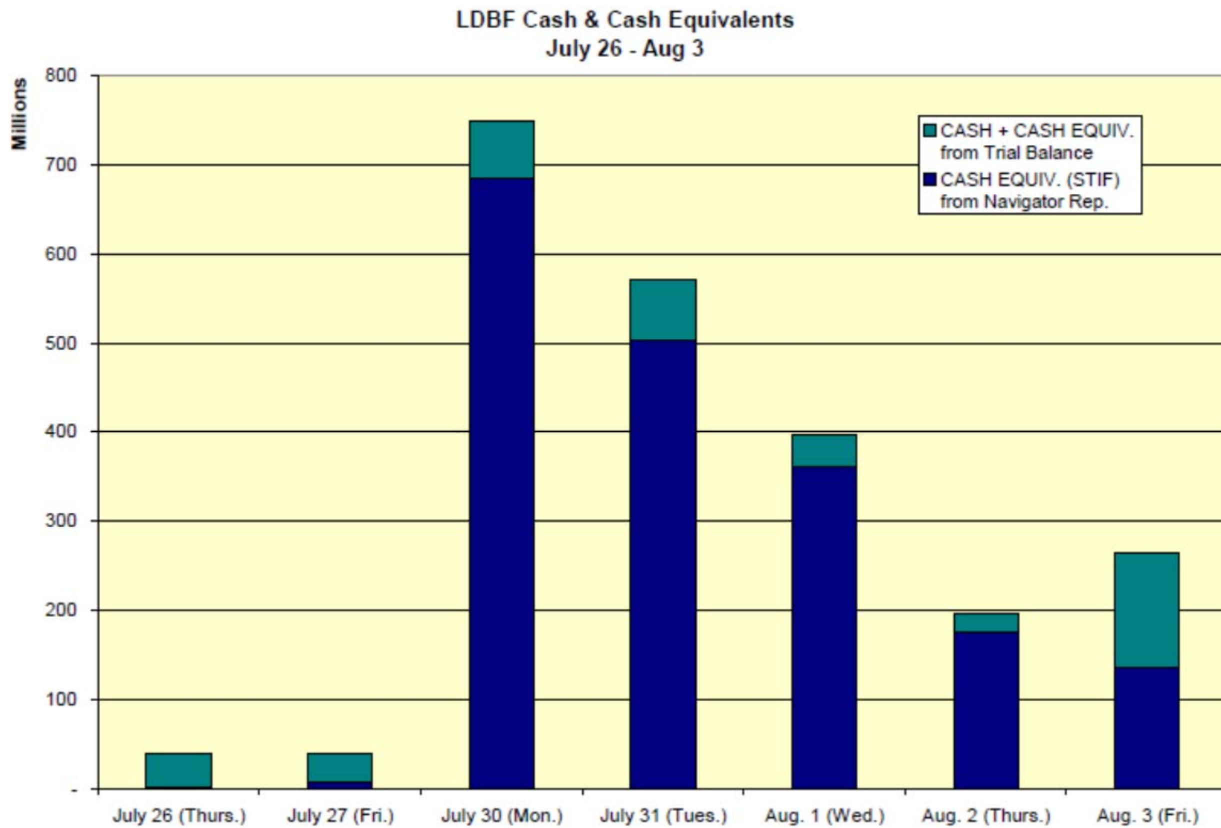

Fig. 1[3]

Even if cash alone were the barometer of risk the Commission contends, LDBF held approximately *4 times more cash* on August 2 than on July 26, prior to

[3] LDBF received the sale proceeds on July 30-31, as depicted in Figure 1 (based on JA2529-30, 2720, 4321 (disc exhibits)) from Flannery's post-hearing reply brief. JA50 (#577). The blue portions reflect cash the Division's expert considered, and the green portions reflect cash he overlooked. JA974.

the AAA sale, and cash increased on August 3. LDBF thus held more cash than it would have without the sale.[4]

In any event, the undisputed evidence demonstrates that measuring risk involves a variety of factors other than cash, including leverage. JA1388, 4333-45. As the only expert who performed a risk analysis opined, taking into account such factors, the AAA sale reduced risk. *Id.* Fact witnesses, including SSgA's Head of Investment Risk Management, similarly testified that the sale reduced risk. JA1350; Flan.Br.17.

The Commission also suggests that the AAA sale resulted in LDBF being more heavily concentrated in lower-rated securities. But this ignores the fact that, as the Division conceded, LDBF's average credit quality (AA) remained unchanged following the AAA sale. ADD54. Moreover, credit rating alone is an inadequate measure of risk. *See* JA4336 (AAA bonds may be less desirable than lower-rated bonds); *see also* JA4859-60 (discussing Summer 2007 ratings downgrades). Indeed, while the bonds sold were AAA, they were highly leveraged, which meant their exposure to the subprime mortgage market ($1.54

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[4] The Commission repeatedly references the "ultimate impact" of the AAA sale (Com.Br.40), wording that is intentionally vague. The Commission's theory depends not on the sale itself, but on subsequent redemptions. However, the majority of redemptions *post-dated* the August 2 letter. JA2658-2719, 2721-55; Flan.Br.20. The "ultimate impact" of the sale on August 2 was that, regardless of redemptions by that date, LDBF had more cash and less subprime exposure and leverage.

billion) was over $1 billion greater than LDBF's cash investment in those bonds. JA4339-40.

2. The Commission's Reliance On Meeting Minutes Is Flawed

The Commission makes much of certain statements in draft minutes of the July 25, 2007 Investment Committee meeting, suggesting they somehow prove that the AAA sale increased LDBF's risk. This is meritless: the meeting reflected a discussion about how to respond to the market turmoil and the *potential* impact of various responses; it does not demonstrate that the subsequent sale increased risk because of redemptions, nor could it—nobody knew the actual size of future redemptions. JA1116, 1119, 1231-32, 4003. Moreover, the Commission relies on its own selective, self-serving interpretation of the minutes, despite the record.

The Commission suggests Flannery "acknowledged that, if SSgA sold LDBF's AAA-rated bonds" "and the cash raised was 'siphoned,'" then "LDBF would be 'stuck with a lower quality portfolio' that was 'less liquid' and 'valued less.'" Com.Br.34. The Commission combines and mischaracterizes two separate statements in the minutes. First, the minutes say: "If we don't sell a slice across the portfolio then we end up with a less liquid portfolio—valued less." JA2319. This statement was not about selling AAA bonds, but whether to sell a pro rata slice of assets. Flannery observed the need to sell *both* liquid and less liquid bonds (JA2319), which is exactly what occurred: the Committee instructed the

investment team to sell a pro rata slice, in response to which the investment team sold AA and A-rated bonds. JA1118, 1234-35, 2764. Indeed, the Committee gave three unanimous instructions to the investment team, all of which were carried out, and two of which the Commission ignores. JA2321; Flan.Br.15-16. Second, with respect to the statement about the possibility of liquidity being "siphoned" and a potentially "lower quality portfolio," as discussed above, LDBF had more cash on August 2 than it had before the sale—liquidity was not "siphoned." Nor was LDBF stuck with a "lower quality portfolio;" its credit quality remained the same. *See* p.11, *supra*.

The Commission asserts, "[o]thers acknowledged that the first approach—selling just the most highly rated securities—would, after redemptions, leave clients 'with riskier lower grade' investments." Com.Br.9 (quoting statement attributed to Paul Greff, Head of Global Fixed Income, JA2318). But again, the investment team did not sell "just the most highly rated securities." And as Greff reported at an August 8 Investment Committee meeting, SSgA raised liquidity and met redemptions *while maintaining the fund's risk profile*. JA1120, 2786-91.

The Commission mischaracterizes the following question, attributed to Patrick Armstrong, Head of Investment Risk Management: "are we exposing ourselves to fiduciary risk since we are changing the risk profile of the portfolio?" Com.Br.9, JA2319. But this was about *reducing* LDBF's risk profile: Armstrong's

concern was whether the contemplated transactions would reduce risk so greatly that LDBF would be unable to achieve its targeted returns. JA1117.

The minutes do not support the Commission.

3. No Investors Were Misled

The Commission perpetuates the falsehood that "[t]he August 2 letter misled investors" (Com.Br.14), but there is no evidence that a single investor was misled. Flan.Br.43. The Commission implies that advisory group clients and Related Funds received superior information causing them to redeem after the AAA sale, while other investors were misled by the August 2 letter. Com.Br.10. This theory was rejected by the CALJ (ADD53-54) and is baseless: (1) there is no evidence that anybody received superior information; (2) on August 2, the majority of redemptions (including the majority of Related Fund redemptions) had not yet occurred; and (3) immediately after August 2, cash redemptions by independent investors occurred daily, alongside cash and in-kind redemptions by the Related Funds. JA2658-2719, 2721-55; Flan.Br.20.

D. The "Many Judicious Investors" Opinion In The August 14 Letter Was Sincere And Well-Founded

The Commission continues to ignore why the "many judicious investors" opinion in the August 14 letter was sound: as expert and fact witnesses testified (and common sense corroborates), in a chaotic market, many investors will wait for the market to stabilize and prices to recover. Flan.Br.20; *see SEC v. Happ*, 392

F.3d 12, 21 (1st Cir. 2004) ("Certain information may be so basic that any investor can be expected to understand its implications."). The wisdom of this approach in August 2007 is clear: LDBF's bonds did not default and continued paying interest, and the market rebounded sharply in September 2007. Flan.Br.40; JA4873.

The Commission protests that the letter did not say that Related Funds and advisory group clients were "exiting" LDBF. Com.Br.37-38. Remarkably, the Commission's brief does little to confront the words used, which expressed an opinion about "many"—not "all"—judicious investors. ADD127.

Furthermore, the Related Funds and advisory group client redemptions had already been disclosed in other investor communications. Flan.Br.42. As such, the quote the Commission highlights from *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1328-29 (2015) concerning purported omission of information in a speaker's possession is inapposite. Even if such disclosures had not occurred:

> An opinion statement ... is not misleading simply because the issuer knows, but fails to disclose, some fact cutting the other way. A reasonable investor does not expect that every fact known to an issuer supports its opinion statement.

Id. at 1322.

There is no conflict between the redemptions and the "many judicious investors" opinion—at most, the Commission argues that redemptions "cut the other way," but this does not render the opinion misleading under *Omnicare*. *Id.*

In fact, the redemptions did not cut the other way. First, the Related Funds and advisory group clients had different investment objectives and goals—the Commission refuses to acknowledge the undisputed evidence that there was no single "SSgA view." Flan.Br.9. Second, the Commission cannot avoid that most of the Related Funds' redemptions were in-kind, reflecting a continued belief in LDBF's strategy.[5] The Commission repeats the opinion's "LDBF strategy" versus "LDBF itself" distinction, claiming it is meaningful because those who remained in "LDBF itself" faced daily liquidity risk from future redemptions. Com.Br.38-39. But daily liquidity and its associated risk was a hallmark of LDBF—it was a daily liquidity fund. ADD5. This is why SSgA offered LDBF II (providing monthly liquidity) to all investors, giving them the option to shield themselves from others' daily redemptions. Flan.Br.21. Investors who chose to remain in LDBF retained their ability to make daily withdrawals and the known risk that this attribute could expose them to liquidity decisions of others. JA4139-42.

Finally, the first clause of the allegedly misleading sentence makes clear that redemptions were occurring, stating SSgA would "continue to liquidate assets for our clients when they demand it…." ADD134. The Commission discounts this

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[5] The Commission implies that the Related Funds redeemed in-kind because cash was exhausted. Com.Br.41. But the Commission offered no evidence concerning the reason for such redemptions; the only evidence is that the Related Funds redeemed in-kind because of their desire to remain exposed to LDBF's investment strategy and assets. JA1137; Flan.Br.19-20.

because it did not *specifically* reference redemptions by advisory group clients and Related Funds (Com.Br.38), even though such information had already been disclosed in the FAQs and the August 6 letter announcing LDBF II. JA4139-42, 4168. *See Dalberth v. Xerox Corp.*, 766 F.3d 172, 186 (2d Cir. 2014) (rejecting claims where "[t]he investing public had access to [the] information"). Indeed:

> Disclosure is not a rite of confession or exercise of common law pleading.… That Plaintiffs wish that *more* was said, perhaps in more evocative language, is simply insufficient…. The touchstone of the inquiry is not whether isolated statements … were true, but whether defendants' representations or omissions, considered together and in context, would affect the total mix of information….

Id. at 187 (citations omitted). Context is important here, given the grave tone of the August 14 letter, which described LDBF's "sharp[] underperform[ance]," unanticipated risks, and even that "traditional methods of estimating defaults may not yet fully capture the implications" of the situation. ADD132-34. No investor would have read the "many judicious investors" language in isolation, or have been misled.

E. Flannery Acted Reasonably In Connection With The August 14 Letter

The Commission fails to address the facts: Mark Duggan, an experienced and knowledgeable in-house securities lawyer, drafted the language at issue in the August 14 letter, which replaced Flannery's language; Duggan, who reviewed the letter numerous times, knew about LDBF's problems and redemptions in the fund;

Duggan vetted the draft with outside counsel several times; and many other knowledgeable executives reviewed the letter, including Flannery's boss who deemed it a "good communication"—he even used the same "many judicious investors" language in his own subsequent letter. Flan.Br.29-30.

The Commission makes the same point it made in connection with the August 2 letter—*i.e.*, Flannery was an "experienced securities professional" who knew about some redemptions, *ergo*, he was negligent. Com.Br.46. This ignores the reason that people seek guidance from counsel with respect to investor disclosures, as Flannery did here. Flannery knew Duggan and others in Legal had reviewed the FAQs and the August 6 letter disclosing advisory groups' and Related Funds' redemptions. JA1125, 1135-36, 4139-42. Duggan did not include such information in the letter, reflecting a legal decision about what facts needed to be disclosed. JA2440. Moreover, Duggan was a participant at the Investment Committee meeting and other meetings where LDBF's problems and potential redemptions were discussed. ADD15; JA185. Flannery was reasonable in relying on the legal sufficiency of Duggan's re-draft of the "many judicious investors" opinion.

F. The Commission's Materiality Arguments Fail

The thrust of the Commission's materiality argument is that Flannery did not prove that investors had actual knowledge of redemptions. Com.Br.40 ("[N]one of

the documents Flannery highlights establishes that investors *knew about* undisclosed redemption activity.") (emphasis added). However, the standard is not "actual knowledge," but whether the purportedly true facts would have "significantly altered" the "total mix of information *made available*." *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (emphasis added).

Moreover, the burden was not on Flannery to *disprove* materiality; the burden was on the Commission, which offered no evidence concerning the supposed materiality of the information allegedly misstated—no investors testified. *See SEC v. Phan*, 500 F.3d 895, 910-11 (9th Cir. 2007) ("The SEC, which [] bears the burden of proof … submitted no evidence to the district court demonstrating the materiality of the misstatement…. In light of that vacuum, we cannot conclude that an average investor would have viewed [the fact as material]."); *Shanahan*, 646 F.3d at 543 (where Commission elicited testimony from only one witness, evidence of materiality "deficient").

In any event, the Commission is wrong: the August 6 letter announcing LDBF II—launched specifically because of LDBF redemptions—was *sent to* all investors and highlighted the Related Funds' in-kind redemptions.[6] JA 4139-41.

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[6] The Commission contends that the August 6 letter was inadequate because it did not state that some Related Funds had *already* redeemed. Com.Br.39. This is a detour. The question is whether the August 14 letter was misleading. Whether Related Funds had already redeemed or intended to redeem on *August 6*, by

By August 1 and August 6, the FAQs contained detailed information on redemptions by advisory group clients and Related Funds. JA2363, 4166. The FAQs were actually used to communicate with LDBF's sophisticated investors and their consultants. *See, e.g.*, JA1139, 3979. The information in the FAQs was unquestionably available to investors.

Recognizing that the FAQs contradict its theory, the Commission, relying on *SEC v. Morgan Keegan & Co.*, 678 F.3d 1233 (11th Cir. 2012), argues that it would send an "extraordinarily dangerous message" to hold that misstatements are acceptable, provided the truth is "available upon request." Com.Br.42-43. Mischaracterizing *Morgan Keegan*, the Commission tries to draw a bright-line rule that information "available upon request" is irrelevant. However, *Morgan Keegan* rejected "bright-line" rules, and emphasized the fact-specific nature of the materiality inquiry. 678 F.3d at 1250-53. *Morgan Keegan* addressed whether written disclosures rendered a broker's private, oral representations to investors immaterial as a matter of law. *Id.* at 1247-48. The court held summary judgment was inappropriate because investors "aver[red] they never received" the disclosures. *Id.* at 1252. Here, the Commission called no investor to testify that they did not receive the available information. *Morgan Keegan* does not abrogate the Supreme Court's "total mix of information made available" test.

August 14 a reasonable investor would have been aware that Related Funds had redeemed, a fact also available to investors from other sources. JA2363, 4166.

Finally, the Commission asserts that LDBF investors' sophistication is irrelevant to the context-specific materiality inquiry. This is wrong. Flan.Br.53-54; Chamber of Commerce Brief ("Chamb.Br.") 9-12. As expert witness John Peavy testified, without contradiction, LDBF's institutional investors and their consultants would not have relied solely on the letters to guide their investment decisions. ADD33-34. Among other sources, LDBF's investors could—and did—obtain information directly from SSgA's Relationship Management and Consultant Relations teams. *Id.*; *see also* Chamb.Br.4-9; *cf. WC Capital Management, LLC v. Willow Creek Capital Partners, L.P.*, 711 F.3d 322, 330 (2d Cir. 2013) ("Willow Creek, admittedly a sophisticated investor, failed to follow up on UBS's clear invitation to obtain [additional] information").

II. THE COMMISSION'S INTERPRETATION OF SECTION 17(A)(3) MUST BE REJECTED

The Commission asserted in its opinion that "we recognize the ambiguity in … Section 17(a)," and claimed that the statute has "produced confusion in the courts and inconsistencies across jurisdictions." ADD70. It further observed that its own decisions have provided "relatively little interpretive guidance" and set out to "resolve" the purported ambiguity and confusion. *Id.* The Commission has since represented that its opinion in this case "resolve[d] the ambiguities" in Section 17(a) and should be afforded deference. *SEC v. Kaley*, 11th Cir. No. 13-

11976, Supp. Auth., at 1 (Dec. 16, 2014); *SEC v. AgFeed Indus., Inc.*, M.D. Tenn. No. 14-cv-663, Supp. to Resp. to Mot. Dismiss (Dkt. #85), at 1 (Mar. 23, 2015).

Now, the Commission suggests that Section 17(a) is unambiguous, and claims its opinion "is consistent with its past pronouncements and follows directly from the statutory text" and its "plain language." Com.Br.52-53, 55-56, 59-61. "Plain language" was hardly the basis for the Commission's opinion. *E.g.*, ADD70 (citing "history and policies"), 73 ("consideration of relevant policy objectives"), 84 ("appropriate flexibility in charging").

A. The Commission's "Plain Language" Argument Is Meritless

1. The Commission's About-Face Cuts Off Its Deference Bid

Flannery agrees that Section 17(a)(3) is not ambiguous, although the Commission's interpretation is contradicted by the statute. *See* p. 23-29, *infra*. In any event, the Commission's concession renders deference inappropriate, as there is no occasion for agency deference when there is no ambiguity to resolve. *See Chevron U.S.A., Inc. v. National Resource Defense Counsel, Inc.*, 467 U.S. 837, 842-43 (1984).

Cognizant of this problem, the Commission hints that it may be entitled to deference regardless of ambiguity, citing its "authority to administer" Section 17(a). Com.Br.52. This is wrong—where there are no gaps for the agency to fill, deference is improper, as the Commission ultimately concedes. *Id.*; *see City of*

Arlington v. FCC, 133 S. Ct. 1863, 1868 (2013) ("If the intent of Congress is clear, that is the end of the matter") (citing *Chevron*, 467 U.S. at 842-43).

Deference to an agency's statutory interpretation is often inappropriate irrespective of ambiguity. *See, e.g.*, *King v. Burwell*, 135 S. Ct. 2480, 2489 (2015) (agency deference inappropriate despite ambiguous statute); ANDREW N. VOLLMER, *SEC Revanchism and the Expansion of Primary Liability Under Section 17(a) and Rule 10b-5* (July 3, 2015), VIRGINIA PUBLIC LAW AND LEGAL THEORY RESEARCH PAPER NO. 37,[7] 47-57 (Commission's former Deputy General Counsel chronicling many reasons why deference in *Flannery* would be inappropriate). "A reviewing court certainly should not feel constrained by the agency's demand for deference." VOLLMER 47.

2. The Plain Language Of Section 17(a) Contradicts The Commission

"In the absence of either a built-in definition or some reliable indicium that the drafters intended a special nuance, accepted cannons of construction teach that [words] should be given [their] ordinary meaning." *SEC v. Tambone*, 597 F.3d 436, 442 (1st Cir. 2010) (rejecting contention that each subparagraph of Rule 10b-5 proscribes the same conduct). Section 17(a)(2) prohibits "untrue statement[s]" and "omission[s]" to state material facts. 15 U.S.C. § 77q(a)(2). Section 17(a)(3),

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[7] *Available at* https://securitiesdiary.files.wordpress.com/2015/07/sec-revanchism-and-the-expansion-of-primary-liability-under-section-17a-and-rule-10b5.pdf.

separated from Section 17(a)(2) by "or," prohibits "transactions[s]," "practice[s]" or "course[s] of business." 15 U.S.C. § 77q(a)(3). The plain language of these subsections prohibits distinct conduct; misleading statements are prohibited by Section 17(a)(2), provided money or property is obtained, while Section 17(a)(3) proscribes conduct that would result in a purchaser being deceived. Flan.Br.57-61.

The Commission relies on 1934 dictionary definitions, observing that "practice"[8] meant " repeated or customary action" and "course" meant "a succession of acts or practices." Com.Br.53 (citing WEBSTER, NEW INTERNATIONAL DICTIONARY 1937 (2d ed. 1934)). But these definitions denote, on their face, actions, not words. This is underscored by a broader excerpt of the definition of "course" when Section 17(a) was enacted:

> 8. *Customary or established sequence of events*.... 9. *Method of procedure; manner or way of conducting; conduct; behavior*....10. A series of *motions or acts* arranged in order; a succession of *acts or practices* connectedly followed....

WEBSTER, NEW INTERNATIONAL DICTIONARY 518 (1st ed. 1926) (emphasis added). None of Webster's definitions of "course" indicated that "course of business" included mere words. In contrast, Webster's defined "statement" as "an embodiment in words of facts or opinions; a narrative, recital; report; account; relation." *Id*. at 2461.

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[8] The Commission found that Flannery engaged in a "course of business," not a "practice." ADD59.

The 1933 edition of Black's Law Dictionary, unlike Webster's, actually defined the phrase "course of business" as "what is usually *done in the management* of trade or business." BLACK, LAW DICTIONARY 456 (3d ed. 1933) (emphasis added). Black's defined a "statement" as "a declaration of matters of fact." *Id.* at 1653. Dictionary definitions undermine the Commission's assertion that "course of business" denotes two purported misstatements.

The Commission contends that if Section 17(a)(3) does not cover misstatements alone, Flannery does not address what it covers. Com.Br.53. This is false. As the Commission itself points out, Section 17(a)(3) prohibits "negligent *misconduct* [that] results in investors receiving misleading information." Com.Br.51 (emphasis added). Indeed, it is well-settled that "[c]onduct itself can be deceptive[.]" *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008).[9] Thus, Section 17(a)(3) cases routinely involve fraudulent transactions and activities beyond mere misstatements. *See, e.g., SEC v. Ficken*, 546 F.3d 45, 47-49 (1st Cir. 2008) (repeated market timing involving use of disguised identities); *SEC v. Fife*, 311 F.3d 1, 10 (1st Cir. 2002) (misappropriation of investor funds *and* fraudulent securities offering); *Mawod &*

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[9] As the Commission argued in *Agfeed* (involving charges under Sections 17(a)(1) and (3) and Rule 10b-5(a) and (c)), "courts have consistently held that scheme liability can co-exist with misleading statements *so long as the deceptive conduct goes beyond the misstatements*." Resp. to Mot. Dismiss (Dkt. #59), at 18 (June 30, 2014) (emphasis added) (collecting cases).

Co. v. SEC, 591 F.2d 588, 595 (10th Cir. 1979) (market manipulation, wash sales and matched orders to inflate stock price).

The Commission's statement that Flannery "offers no reason why a series of misstatements" does not satisfy the statute (Com.Br.53) is also false. The reason is that this is not what the statute says. Moreover, reading Section 17(a)(3) to envelop the prohibitions of Section 17(a)(2), as the Commission advocates, violates the "general/specific cannon" which avoids "superfluity of a specific provision that is swallowed by the general one." *RadLAX v. Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2071 (2012).

The Commission contends that its construction does not swallow Section 17(a)(2) and render meaningless its money or property requirement because Section 17(a)(2) would still have a role in cases involving one misstatement. Com.Br.54-55. However, there is no support for the notion that Congress intended to require a defendant to obtain money or property when a case involves one misstatement, but not when it involves two. Moreover, Section 17(a)(2) cases involving one misstatement are rare: of the at least twenty-one reported Section 17(a)(2) cases that resulted in appellate opinions during the past twenty years, only one (arguably) concerned a single misstatement. *See Phan*, 500 F.3d at 912 (Commission alleged misstatements in single Form S-8). While the Commission cites nothing to suggest Congress intended Section 17(a)(2) to apply only to such a

tiny sliver of activity, there is no need for speculation, because the statute's terms are dispositive.

United States v. Naftalin, 441 U.S. 768 (1979) conclusively supports Flannery's reading of Section 17(a). Flan.Br.58-59. *Naftalin* held that "each subsection [of Section 17(a)] proscribes a distinct category of misconduct." 441 U.S. at 774. Failing to explain how this holding means anything other than what it says, the Commission instead argues that Section 17(a)(3) is, in effect, a catch-all provision because of *Naftalin*'s statement that "[e]ach succeeding prohibition is meant to cover additional kinds of illegalities—not to narrow the reach of the prior sections." *Id*. The Commission interprets this to mean that "the subsections are successively broader in scope." Com.Br.54. This latter statement is found nowhere in *Naftalin* and ignores what the case was about: declining to import the "upon the purchaser" limitation found in Section 17(a)(3) into Section 17(a)(2) because doing so would narrow Section 17(a)(2)'s reach *contrary to its terms*. 441 U.S. at 773-74.

Ironically, the Commission has never explained how reading Section 17(a)(3) to govern conduct beyond mere misstatements would "narrow" the reach of the prior section, *i.e.*, Section 17(a)(2), in the way it contends *Naftalin* prohibits. The Commission's argument here is the precise opposite: it contends that Section 17(a)(2) should not be read to narrow Section 17(a)(3), and that Sections 17(a)(2)

and (a)(3) are each broader than the subsections preceding them. As such, the Commission's argument makes no sense even under its erroneous interpretation of *Naftalin*.

The Commission instead argues that Flannery's reading would mean that Section 17(a)(2) somehow narrows the scope of *Section 17(a)(1)*. Com.Br.54. First, the meaning of Section 17(a)(1) is not before the Court. Second, reading Section 17(a)(1), which prohibits "any device, scheme, or artifice to defraud" made with *scienter* as prohibiting more than misstatements would not "narrow" that subsection's reach—it would comport with its terms, which do not mention misstatements. Third, if the Commission were correct that each subsection of Section 17(a) is "successively broader in scope," then by definition, Section 17(a)(1) could not include misstatements, which are expressly covered in Section 17(a)(2).

The Commission claims *Aaron v. SEC*, 446 U.S. 680, 696 (1980) "seemed to envision … overlapping subsections that become sequentially broader in scope" (Com.Br.55), but *Aaron* does not support this claim. *Aaron* addressed the extent to which *scienter* is necessary to prove liability under Section 17(a). *Id*. at 682. In holding that only Section 17(a)(1) requires *scienter*, the court observed, "[t]his is not the first time that this Court has had occasion to emphasize the distinctions among the three subparagraphs of § 17(a)." *Id*. at 697 (citing *Naftalin*, 441 U.S. at

774). Nowhere did *Aaron* suggest that 17(a)(3) proscribes mere misstatements or is a catch-all.

Finally, the Commission has not "long held" this interpretation of Section 17(a)(3). Com.Br.55. Indeed, its opinion concedes that the Commission's pronouncements have provided "little interpretive guidance." ADD70. The one case it cites, *In the Matter of Cady, Roberts & Co.*, Exchange Act Release No. 6668, 1961 WL 60638 (Nov. 8, 1961), pre-dated *Naftalin* and is otherwise inapposite. *See Tambone*, 597 F.3d at 449 (rejecting claim of "longstanding administrative interpretation" where Commission "cobbled together a bricolage of agency decisions" pre-dating Supreme Court precedent). *Cady* involved a broker executing trades based on nonpublic information. 1961 WL 60638, at *2. It does not support the proposition that two misstatements alone are a "course of business."

The Commission's interpretation of Section 17(a)(3) is internally inconsistent, belied by the statute's words, and unsupported by precedent.

B. Fair Notice And Lenity Require Vacatur

The Commission's arguments about fair notice and lenity stem from the same assertion, *i.e.*, that Flannery should have known that Section 17(a)(3) could have been interpreted as the Commission did, and that, even if "the outer contours of liability remain unclear," Flannery somehow falls within the statute's

"heartland." Com.Br.57-61. These contentions are disingenuous where the Commission took the position below that the statute was a source of confusion, requiring Commission intervention to resolve. Moreover, the notion that Flannery falls in the "heartland" of Section 17(a)(3) is absurd, where the Commission concedes that a single alleged misstatement cannot be a "course of business," and this case involves just two. The Commission's interpretation of Section 17(a)(3) cannot fairly be applied to Flannery, because the two letters long pre-dated its opinion. Flan.Br.64-65; Chamb.Br.17-18.

The unexpected nature of the Commission's new standard is highlighted by the fact that it was never argued below. The Commission claims this does not matter, because it is the "formality of the adjudicative process itself—not the nature of the arguments made" that matters. Com.Br.56. This puzzling argument does not follow from the cases the Commission cites, and contradicts *Tambone*. *See* 597 F.3d at 449 (where Commission never before articulated theory of liability, deference inappropriate).

Finally, if this Court finds Section 17(a)(3) is ambiguous, lenity precludes deference. Flan.Br.62-63; Ch.Br.14-21. Misreading precedent, the Commission argues that lenity is inapplicable because Flannery did not demonstrate "grievous" ambiguity. Com.Br.60-61. But it is *the Commission* that claimed below that Section 17(a)(3) is ambiguous; trying to escape lenity, it now it suggests the statute

is, at most, only *a little* ambiguous. "Grievous" ambiguity is not, as the Commission suggests, a "heightened" ambiguity standard—lenity applies "when, after consulting traditional canons of statutory construction, we are left with an ambiguous statute." *United States v. Shabani*, 513 U.S. 10, 17 (1994).

C. Flannery Did Not "Misread" The Commission's Opinion

Because Flannery did not make or draft the alleged misstatement in the August 2 letter, he does not satisfy the Commission's legal test for Section 17(a)(3) liability, *i.e.*, that "one who *repeatedly* makes or drafts such misstatements over a period of time" may be liable. ADD84; *In the Matter of Anthony Fields, CPA*, 2015 WL 728005, at *10-11 (reiterating "make or draft" standard from *Flannery*); *see also* Flan.Br.60. The Commission does not dispute that Flannery did not make or draft the August 2 letter's alleged misstatement, but claims a "course of business" includes a potentially unlimited array of attenuated, misstatement-related activity, such as "declin[ing] to correct" a misstatement. Com.Br.45. But the Commission should be held to the purportedly clarifying legal standard it announced, particularly here, where its opinion *specifically concerned* the extent to which Section 17(a)(3) supposedly proscribes misstatements—it did not casually select the words "make or draft."[10] Because Flannery did not make or draft the

[10] Section 17(a)(3) contemplates conduct, not mere misstatements. Flan.Br.56-57; *supra* p. 23-29. However, if it is construed to apply to misstatements alone, the Commission should be held to its own "clarifying" legal standard.

August 2 letter, this alone means that the Commission's course of business theory fails.

CONCLUSION

The Commission's opinion and order should be vacated and judgment entered for Flannery.

Date: August 3, 2015

Respectfully submitted,

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I hereby certify that on August 3, 2015 I electronically filed the foregoing document with the United States Court of Appeals for the First Circuit by using the CM/ECF system. I certify that the following parties or their counsel of record are registered as ECF Filers and that they will be served by the CM/ECF system:

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