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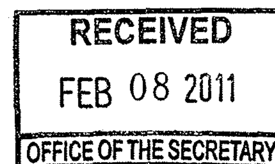
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of:	)	
	)	ADMINISTRATIVE PROCEEDING
JOHN P. FLANNERY and	)	FILE NO. 3-14081
JAMES D. HOPKINS	)	
	)	



JOHN PATRICK ("SEAN") FLANNERY'S PRE-HEARING MEMORANDUM

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TABLE OF CONTENTS

I. INTRODUCTION 1

II. SUMMARY OF FACTS 3

A. Sean Flannery 3

1. Personal Background 3

2. Professional Background and Role as CIO 5

a. Career before SSgA 5

b. Career at SSgA 6

c. Limited Role in Client Communications 7

B. The Limited Duration Bond Fund ("LDBF") 7

C. The Evolution of the 2007 Subprime Crisis and SSgA's Response 9

D. SSgA's Approach to Investor Communications Before and During 2007 16

1. Mr. Flannery Encouraged the Substantial Involvement of Legal in the Summer 2007 Letters 18

2. The Relationship Management Team Played a Substantial Role in the Summer 2007 Communications 20

E. Mr. Flannery Sought the Investment Committee's Direction Regarding the Market Turmoil and the Issues Facing LDBF 21

F. The August 2 and August 14 Letters 22

1. The August 2, 2007 Letter 22

a. Mr. Flannery's Role in the August 2 Letter Was Minimal 23

b. The August 2 Letter Contained Accurate Information 28

(i) The "Actions Taken" Reduced Risk 28

(ii) The Alleged "Omissions" from the August 2 Letter Had Been Disclosed to Clients 29

2. The August 14, 2007 Letter 30

a. The Language the Division Claims Was Misleading Was Authored by SSgA's Deputy General Counsel 31

b. SSgA's Deputy General Counsel Had Knowledge of the Relevant Facts When He Authored the Challenged Language 34

c. Relationship Management Also Reviewed the August 14 Letter 38

d. The August 14 Letter Contained Accurate Information. 39

III. ANALYSIS 40

A. The Division Cannot Prove the Elements Of Its Claims Arising Out of the August 2 Letter. 40

1. The Division's Section 10(b)/Rule 10b-5 Claims Fail. 40

a. Mr. Flannery Did Not "Make A Statement" Within the Meaning of the Law. 41

b. The August 2 Letter Was Not False Or Misleading 43

c. Mr. Flannery Did Not Act with *Scienter*. 44

2. The Securities Act § 17(a)(1) Charges Fail. 47
a. The August 2 Letter Was Not an Offer or Sale of Securities 47
3. The Securities Act §§ 17(a)(2) & (3) Charges Also Fail. 49
a. Mr. Flannery Was Not Negligent 49
b. Mr. Flannery Did Not Obtain Money or Property From the Letters 49
c. The Division Has Charged No Fraudulent or Deceptive Practice 50
B. The Division Cannot Prove the Elements of its Claims Arising Out Of the August 14 Letter. 50
1. Mr. Flannery Was Not Negligent in Connection with the August 14 Letter. 50
2. The August 14 Letter Did Not Contain Material Misstatements or Omissions. 53
3. The Division's Claims Based on the August 14 Letter Fail For Other Reasons 54
IV. EVEN IF, CONTRARY TO LAW AND FACT, MR. FLANNERY COULD BE HELD LIABLE FOR EITHER LETTER, SANCTIONS ARE UNWARRANTED AND NOT IN THE PUBLIC INTEREST 55
V. CONCLUSION 56

TABLE OF AUTHORITIES

Statutes & Rules
15 U.S.C. § 77q(a) *passim*
15 U.S.C. § 78j(b) *passim*
17 C.F.R. § 240.10b-5 *passim*

Cases
Aaron v. SEC, 446 U.S. 680 (1980) 41, 44
ACA Fin. Guar. Corp. v. Advest, Inc., 512 F.3d 46 (1st Cir. 2008) 53
Basic, Inc. v. Levinson, 485 U.S. 224 (1988) 44
Brown v. Credit Suisse First Boston LLC, 431 F.3d 36 (1st Cir. 2005) 53
Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) 43
Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir.1984) 47, 48
Dolphin & Bradbury, Inc. v. SEC, 512 F.3d 634 (D.C. Cir. 2008) 44
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 41, 44
Ezra Charitable Trust v. Tyco Int'l, Ltd., 466 F.3d 1 (1st Cir. 2006) 45
Fund of Funds, Ltd. v. Arthur Andersen & Co., 545 F. Supp. 1314 (S.D.N.Y. 1982) 48
Hoffman v. Estabrook & Co., 587 F.2d 509 (1st Cir. 1978) 45
Howard v. Everex Sys., Inc., 228 F.3d 1057 (9th Cir. 2000) 42
Howard v. SEC, 376 F.3d 1136 (D.C. Cir. 2004) 46
In re K-tel Int'l Sec. Litig., 300 F.3d 881 (8th Cir. 2002) 44
In re Software Toolworks, Inc., 50 F.3d 615 (9th Cir. 1994) 42
In the Matter of Albert Glenn Yesner, CPA, Release No. 184, 75 SEC Docket 156 (ALJ May 22, 2001) 49
Podany v. Robertson Stephens, Inc., 318 F. Supp. 2d 146 (S.D.N.Y. 2004) 53
Rubin v. United States, 449 U.S. 424 (1981) 48

SEC v. Brown, No. 09-1423, 2010 U.S. Dist. LEXIS 101403 (D.D.C. Sept. 27, 2010) 47, 48
SEC v. Caserta, 75 F. Supp. 2d 79 (E.D.N.Y. 1999) 46
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SEC v. Ficken, 546 F.3d 45 (1st Cir. 2008) 44, 45
SEC v. Fife, 311 F.3d 1 (1st Cir. 2002) 45
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SEC v. Glantz, No. 94 Civ. 5737, 1995 U.S. Dist. LEXIS 13701 (S.D.N.Y. Sept. 19, 1995) 49
SEC v. Lucent Techs., Inc., 610 F. Supp. 2d 342 (D.N.J. 2009) 50
SEC v. Patel, See SEC v. Patel, No. 07-cv-39, 2008 U.S. Dist. LEXIS 23553, (D.N.H. Mar. 24, 2008) 49
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SEC v. Selden, 632 F. Supp. 2d 91 (D. Mass. 2009) 46
SEC v. Snyder, 292 F. App'x 391 (5th Cir. 2008) 46
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SEC v. Tambone, 417 F. Supp. 2d 127 (D. Mass. 2006) 41, 44
SEC v. Tambone, 597 F.3d 436 (1st Cir. 2010) 41, 43
SEC v. Wolfson, 539 F.3d 1249 (10th Cir. 2008) 41
Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997) 43
Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979) 55
United States v. Peterson, 101 F.3d 375 (5th Cir. 1996) 46
United States v. Schiff, 602 F.3d 152 (3d Cir. 2010) 43
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Wells v. Monarch Capital Corp., No. 97-1221, 1997 U.S. App. LEXIS 30031 (1st Cir. 1997) 45
Wright v. Ernst & Young, LLP, 152 F.3d 169 (2d Cir. 1998) 41, 43

I. INTRODUCTION

The SEC's Division of Enforcement ("Division") has charged the former Chief Investment Officer-Americas of State Street Global Advisors ("SSgA"),[1] John Patrick ("Sean") Flannery, in connection with two letters that SSgA sent to its clients during the mid-2007 market crisis concerning a fixed income fund in which some of their holdings were invested. Specifically, the Division has charged Mr. Flannery with violating §§ 17(a)(1)-(3) of the Securities Act and § 10(b) of the Exchange Act (along with Rule 10b-5) in connection with an August 2, 2007 letter sent to clients, and with violating §§ 17(a)(2) and (3) of the Securities Act in connection with an August 14, 2007 letter sent to clients. The charges were brought even though the evidence establishes that Mr. Flannery reasonably believed that both letters were accurate and legally proper, and that each letter was carefully reviewed and approved by senior SSgA attorneys, outside securities counsel,[2] and Relationship Management personnel.

The Division will not be able to prove that Mr. Flannery engaged in any wrongdoing in connection with either letter. He genuinely believed that both letters were accurate. Mr. Flannery is neither an attorney nor does he possess any expertise with respect to investor disclosures. While Mr. Flannery was a senior SSgA executive, his was not a "client facing" position, and others were responsible for communicating with investors and ensuring that SSgA's communications with clients complied with SSgA's obligations under the law. With respect to the August 2 letter, the evidence will show that:

- Mr. Flannery's role was limited to offering one small set of "suggested edits" to a letter authored by someone else. His suggested edits did not materially affect the content of the letter. Indeed, Mr. Flannery's proposed changes were significantly revised further by

[1] SSgA is a leading institutional investment manager and a division of State Street Bank & Trust Company.

[2] Mr. Flannery is attempting to resolve a dispute with SSgA regarding highly exculpatory evidence being withheld on privilege grounds. If the dispute is not resolved, Mr. Flannery expects to file a motion with Your Honor.

others —the Relationship Management department, other people on the Fixed Income team, and SSgA's in-house and outside securities counsel — after Mr. Flannery provided them. Thus, Mr. Flannery did not make a "statement" within the meaning of the securities laws;

- The letter was not false, because its affirmative statements regarding reduction of risk were true, and the facts the Division claims were omitted had already been disclosed to clients publicly and through other communications, which Mr. Flannery reasonably believed the August 2 letter was intended to supplement;
- Mr. Flannery did not act intentionally, recklessly or negligently. Rather, he actively sought to involve SSgA's legal department and Relationship Management department — the department which, unlike Mr. Flannery, had actual responsibility for client communications and knew the mix of information that had been previously provided to clients — in all communications with clients during the relevant time period. He knew that the letter was heavily reviewed by these groups, both of which he understood to be fully informed about the underlying issues, and both of which were, in fact, fully informed;
- The letter did not offer securities for sale or solicit an offer or sale of securities within the meaning of § 17(a);
- Mr. Flannery received no money or property as a result of the letter as required by § 17(a)(2); and
- The Division has failed to allege that Mr. Flannery engaged in a fraudulent or deceptive practice within the meaning of § 17(a)(3).

With respect to the August 14 letter, the Division's claims will fail because:

- Mr. Flannery acted reasonably, and was not negligent. Rather, the evidence will show that, as with the August 2 letter, SSgA's experienced in-house and outside securities lawyers played active roles in preparing, reviewing and approving this letter, with knowledge of the relevant facts the Division now claims were improperly misstated or omitted. In fact, as the Division concedes in its Order Instituting this Proceeding, *the language challenged by the Division in the August 14 letter was inserted by a senior SSgA attorney, not Mr. Flannery*;
- The challenged language in the August 14 letter was nothing more than a sincerely-held statement of opinion not only of Mr. Flannery, but other members of the Fixed Income team. And, even if it were viewed as a statement of fact, it was true, as demonstrated by the anticipated testimony of Mr. Flannery and others;
- The letter did not offer securities for sale or solicit an offer or sale of securities within the meaning of § 17(a);

- Mr. Flannery received no money or property as a result of the letter as required by § 17(a)(2); and
- The Division has failed to allege that Mr. Flannery engaged in a fraudulent or deceptive practice within the meaning of § 17(a)(3).

The Division concedes in its Order Instituting this Proceeding (the "OIP") that the information it claims should have been disclosed in the two letters was, in fact, available to the Relationship Management team and was, in fact, provided to certain clients. Notwithstanding that, and despite the fact that Mr. Flannery reasonably believed the letters were accurate and legally proper, and were intended merely to supplement the detailed information that was available and provided to clients, the Division has charged a person who was not responsible for client communications and was not a lawyer, with a *scienter*-based charge in connection with a letter in which he contributed five innocuous words, and a negligence-based charge in connection with a sentence drafted by a lawyer. These claims will fail.

II. SUMMARY OF FACTS

A. Sean Flannery

1. Personal Background

Mr. Flannery is 52 years old. He and his wife, Lynn, have been married for over 26 years. Together they have four children, one of whom died in an automobile accident in 2003. Mr. Flannery is the child of immigrants and was the first in his family to attend college, earning his B.A. in economics from The George Washington University.

Mr. Flannery spends much of his free time serving his community, his church, and several charitable organizations. Since 1985, Mr. Flannery and his family have attended Saint Mary of the Nativity Church in Scituate, Massachusetts. In connection with St. Mary's, Mr. Flannery has served on a Confirmation Retreat Team, the Pre-Cana Marriage Team, the Parish Finance Council, and since 1989, he has been a Eucharistic Minister. From 1989 to 2006,

Mr. Flannery served as a member of the Advisory Board of Trustees to the Catholic Charities of Greater Boston, focusing on serving the needs of impoverished children.

Mr. Flannery has also devoted considerable time to supporting the Sunset Point Camp in Hull, Massachusetts. The children who attend Sunset Point come from all over the Greater Boston area, many from lower income households, and others from homes where extenuating circumstances are present such as the death of a parent or sibling. For his many years of service, Mr. Flannery was honored as the 1998 Summer Celebration Chairman and was the recipient of an Award for Dedicated Service.

For several years, Mr. Flannery and his family participated as a host family for the Children's Chernobyl Project, opening their home to children from Russia and Ukraine who traveled to Boston for medical care for radiation-related illnesses and respite.

Since 2002, Mr. Flannery has served on the Board of Directors of the New England Regional Office of the U.S. Fund for UNICEF, and was a member of the Executive Committee from 2004 to 2009. He has actively participated in field visits with UNICEF, including ones to the Dominican Republic in 2002 and Zambia in 2008. Mr. Flannery is also a Senior Economic Advisor to the Massachusetts General Hospital Division of Global Health and Human Rights. In this role, he was part of a small group invited by President Ellen Johnson Sirleaf of Liberia to assist in establishing an intervention strategy for bringing pediatric care to Liberia and to institute pediatric training at the country's medical and nursing schools.

Mr. Flannery and his family formed the [redacted] Flannery Memorial Fund in 2003 to honor the memory of Mr. Flannery's son. Mr. Flannery serves as a Trustee of the Fund, which provided funding to create a new athletic field in Scituate, Massachusetts, and which presents

annual scholarships to deserving graduates of his son's school, Boston College High School, and the local public school, Scituate High School.

Father Kevin T. O'Leary, who has known Mr. Flannery for more than ten years, will testify regarding Mr. Flannery's exceptional character, integrity, the importance to Mr. Flannery of personal responsibility, and Mr. Flannery's many years of service to his church and to the public. Father O'Leary nominated Mr. Flannery to the Knights of the Holy Supulchre, the highest papal order for both laity and clerics in the Catholic Church, and he was invested into the Order October 2010.

In short, the evidence will show that Sean Flannery, who has never been the subject of a criminal or civil enforcement action, is a good and honorable man. He has led an exemplary life, and there is no basis for concluding that someone with Mr. Flannery's well-deserved reputation for honesty and commitment to doing the right thing would intentionally, recklessly, or negligently mislead clients.

2. Mr. Flannery's Professional Background and Role as CIO

a. Career before SSgA

Sean Flannery has had an impeccable, over thirty-year career in the financial services industry. After college, Mr. Flannery was hired as a Vice President at Kenney & Branisel, selling bonds. Thereafter, he held a variety of sales jobs at different brokerage firms in Boston. After nine years on the sell-side, Mr. Flannery joined the Boston Company in November 1989 as a senior portfolio manager, where he managed U.S. fixed income strategies for endowment, foundations and pensions in separate accounts and ERISA pooled funds. In March 1993, Mr. Flannery left the Boston Company for Scudder, Stevens & Clarke, where he managed insurance company assets for Scudder's insurance asset management group.

b. Career at SSgA

In September 1996, Mr. Flannery joined SSgA as a Product Engineer for Global Tactical Asset Allocation and Global Fixed Income, and was a senior member of the Global Asset Allocation team. During the summer of 1997, Mr. Flannery was promoted to Director of Product Engineering. In this role, Mr. Flannery was responsible for the strategic focus of SSgA's investment products, including product development and analysis of the financial markets.[3] During the spring of 2003, Mr. Flannery was promoted to the Head of Global Fixed Income, responsible for both bond and cash funds, and in 2005 he added the titles of Executive Vice President and Chief Investment Officer ("CIO") Americas.

As CIO, Mr. Flannery had a number of product heads reporting to him directly, and there were two levels of senior management between Mr. Flannery and the portfolio managers (the head of Fixed Income and the head of Active Fixed Income). Mr. Flannery reported to William Hunt, President and CEO of SSgA. Mr. Hunt himself had six direct reports besides Mr. Flannery, including Mitch Shames, Otello Sturino, and Marc Brown, respectively the heads of Legal, Compliance, and Relationship Management.[4] Mr. Flannery did not supervise those departments. In addition to reporting to Mr. Hunt, Mr. Flannery also reported to SSgA's Investment Committee and its Chairman, Shawn Johnson. Mr. Flannery left SSgA in November 2007 as part of a restructuring of the Company.

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[3] As Director of Product Engineering, Mr. Flannery's interaction with clients and their consultants came mostly through presentations at industry conventions and meetings. He did not have day-to-day conversations with clients about their investments. To the extent he did meet with clients, it was to discuss SSgA generally and the products it offered. Mr. Flannery never had extensive client involvement while employed at SSgA.

[4] The Relationship Management department was also known as the Client Service department during the relevant time period.

c. Limited Role in Client Communications

As CIO, Mr. Flannery was responsible for overseeing strategy for all of SSgA's funds and assets under management, totaling approximately $1.85 trillion. He was not responsible for SSgA's client communications, compliance, or legal functions. While Mr. Flannery communicated with clients and their consultants when asked by Relationship Management to do so, he did not maintain the sort of regular communications that employees on the Relationship Management team had with their clients, and was not involved in decisions about the specific information made available to clients about the fund at issue, the Limited Duration Bond Fund ("LDBF"). He believed that clients were provided with substantial information, but it was SSgA's Relationship Management department that was responsible for determining precisely what information to provide to those clients, who to provide it to, and when — and it was SSgA's Legal and Compliance departments' responsibility to ensure that those communications satisfied SSgA's legal obligations.

B. The Limited Duration Bond Fund ("LDBF")

LDBF was established in 2002, a year before Mr. Flannery became Head of Global Fixed Income. As an unregistered fund, LDBF was exclusively available to sophisticated clients and trusts. LDBF was exempt from regulation under the Investment Company Act and from the registration and other requirements of the Securities Act. LDBF was designed to generate returns well in excess of money market funds (target annual return of LIBOR plus 50 to 75 basis points), although seeking to achieve those returns required LDBF to take on more risk than a money market fund. Since its inception, LDBF was heavily concentrated in bonds backed by first lien mortgages, including mortgages securing loans to what are now referred to as "subprime" borrowers. LDBF was a small part of SSgA's assets under management: it

represented less than 1% of the almost $2 trillion in assets under management for which Mr. Flannery, as CIO, was responsible for strategic oversight.

LDBF focused on mortgage-backed securities ("MBS") because (a) the yields had historically been attractive relative to other segments of the fixed income market (*i.e.*, credit card, auto and student loan asset-backed securities); (b) the risks were believed to be lower for MBS than other types of asset-backed securities; and (c) SSgA believed it had the analytical tools and the ability to properly measure the risks of MBS. While LDBF could invest in BBB-rated securities, its average credit quality during the entire period relevant to this case was between AA and AA+. As of the beginning of 2007, a small percentage of LDBF's market exposure was in BBB securities, while the majority was in AA and AAA securities.

The clients in LDBF were sophisticated, and consisted principally of institutional clients, many of whom engaged expert consultants to advise them on their investments. For such clients and their expert advisors, it was hardly a surprise that above-benchmark returns could only be achieved by assuming a level of risk greater than a money market fund. Indeed, expert witness Erik Sirri, a Professor of Finance at Babson College and the former Director of the Division of Trading and Markets at the SEC as well as the SEC's former Chief Economist, will testify that the risk and return characteristics of funds like LDBF would be of no surprise to sophisticated clients.

Among the many clients directly and indirectly invested[5] in LDBF were clients of three SSgA advisory groups: Global Asset Allocation ("GAA"), the Office of the Fiduciary Advisor ("OFA") and Charitable Asset Management ("CAM"). Whether viewed individually or in the aggregate, each of these group's clients' investments comprised a small portion of the overall

[5] Some clients invested directly in LDBF, while others invested in other SSgA funds that, in turn, invested in LDBF. Other SSgA funds that were invested in LDBF are sometimes referred to as commingled funds.

investments in the fund, and the clients of each group had their own unique investment guidelines based on their particular needs and objectives. While members of the advisory groups certainly interacted with others at SSgA and, in fact, the head of GAA reported to Mr. Flannery, the investment recommendations and decisions made by these groups were independent from, and did not represent the views of, SSgA. Indeed, there was no "single investment view" at SSgA, as the company offered a wide range of products (LDBF being one of them) representing competing philosophies and designed for different investment strategies and goals: the views about which product or mix of products was the best way to meet a particular investment objective naturally varied.

C. The Evolution of the 2007 Subprime Crisis and SSgA's Response

In early 2007, following a period of historic strength in the housing market, mortgage delinquencies began to rise markedly, and a number of subprime lenders began experiencing financial difficulties. These events, coupled with market participants holding large short positions in derivatives tied to the housing market, drove down values for LDBF's BBB ABX Index swaps. While SSgA reduced LDBF's BBB ABX Index exposure in February 2007, Mr. Flannery and the Fixed Income team believed that the decline was temporary, and that the sector remained fundamentally strong and would substantially recover.

Mr. Flannery's and the Fixed Income team's view of the market was consistent with that held by prominent government officials. For example, in a June 5, 2007 speech, Federal Reserve

Board Governor Kevin Warsh characterized the February-March 2007 time frame as follows:

> Well, it does not take a long memory to recall that this scenario played out for a few days in late February, a bit more than three months ago. As you all know, share prices quickly recovered, and implied volatility reverted to near-record low levels. What lessons can be drawn from such an episode? Perhaps because of more complete markets, ***shocks to liquidity are less likely to become self-fulfilling and less likely to impose more lasting damage. That hypothesis seems particularly credible when the shock is based neither on rapidly changing economic fundamentals nor a genuine breakdown in market infrastructure.***[6]

Notwithstanding Mr. Flannery's belief that investments in asset-backed securities were still sound, starting in February and March 2007, Mr. Flannery convened a series of meetings (in addition to meetings that members of the Fixed Income team were regularly holding concerning these issues) with portfolio managers, analysts, and traders because he "felt that the market activity was sufficiently volatile and unusual, that [he] wanted to make sure we were carefully re-assessing that segment of the market, and [he] wanted to make sure that we heard different perspectives." Flannery Tr. 65:8-13[7]. While the consensus of those at the meetings was that the Fixed Income team's core beliefs — *i.e.*, continued faith in the fundamentals of the strategy and long-term quality of the assets — were sound, Mr. Flannery emphasized the importance of continuing to question and analyze the team's position.

Stability subsequently returned to the subprime markets in April and May 2007. In fact, LDBF outperformed its monthly benchmark by 23 and 34 basis points in April and May 2007, respectively. When the Federal Open Market Committee ("FOMC") met on May 9, 2007, it left interest rates unchanged. Consistent with the Fixed Income team's and Mr. Flannery's views of the long term fundamentals, the FOMC's May 9, 2007 meeting minutes referred to the February events

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6 Kevin Warsh, Federal Reserve Board Governor, *Financial Intermediation and Complete Markets*, Address at the European Economics and Financial Centre (June 5, 2007) (emphasis added) (available at <http://www.federalreserve. gov/newsevents/ speech/Warsh20070605a.htm>).

7 All transcript citations refer to the transcripts of testimony given before the SEC.

as being a "correction" of the housing sector.[8] In a May 17, 2007 speech, Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, stated:

> [G]iven the fundamental factors in place that should support the demand for housing, we believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system. ***The vast majority of mortgages, including even subprime mortgages, continue to perform well.***[9]

In response to the positive market action and its continuing bullish view of the sector, SSgA's Fixed Income team caused LDBF to slightly increase its BBB ABX exposure back to approximately the same level it had been prior to February 2007. However, the market began deteriorating soon thereafter. In June 2007, Bear Stearns announced losses for two of its hedge funds that held a high percentage of subprime asset-backed securities and warned that the funds would likely have to liquidate. This raised new questions concerning the subprime market and again caused BBB ABX securities to decline in value. Higher-rated securities, however, which still represented the majority of the assets in the fund, remained largely unchanged.

In July 2007, market events began to unfold rapidly. On July 10, 2007, Standard & Poor's and Moody's downgraded and placed on downgrade watch an unprecedented number of bonds backed by subprime mortgages. Fitch followed suit soon thereafter. Most of the securities being reviewed or downgraded by the ratings agencies had ratings of BBB+, BBB, or BBB-, the lowest investment grade. Through several trades in mid and late July, SSgA reduced LDBF's exposure to BBB ABX, returning its BBB notional positions back to the February 2007

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8 *See* Press Release, Federal Open Market Committee (May 9, 2007) (available at <http://www.federalreserve.gov/ newsevents/press/monetary/ 20070509a.htm>); Minutes of the Federal Open Market Committee (May 9, 2007) (available at <http://www.federalreserve.gov/FOMC/minutes/20070509.htm>).

9 Chairman Ben S. Bernanke, Board of Governors of the Federal Reserve System, *The Subprime Mortgage Market*, Address at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007) (available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm>) (emphasis added).

level. The downgrades by the rating agencies had a ripple effect on AAA and AA subprime bonds, however. While the higher quality AAA and AA bonds were not downgraded, many market participants, finding bids on BBB bonds low and liquidity evaporating, began selling the higher quality bonds to reduce exposure to the sector, and AAA and AA spreads widened significantly (*i.e.*, their prices declined).[10]

Notwithstanding the downgrades, in July 2007, Chairman Bernanke again expressed optimism, stating that the anticipated "significant losses" due to subprime mortgages were "bumps" in "market innovations" (referring to hedge fund investments in subprime mortgages) and that, notwithstanding the problems in the housing market, the economy was poised for moderate growth.[11] Indeed, on July 19, 2007, the Dow Jones Industrial Average closed above 14,000 for the first time in its history.

On July 25, 2007, the July 30, 2007 edition of the Money Management Letter, a newsletter for fixed income investors, was released. It contained an article that featured LDBF as being among the "[l]osers in [the] subprime debacle," noting that the fund had lost between three and four percent during July. The article also discussed the fact that "[t]he fund is invested mostly in subprime mortgage-backed securities"; that "SSgA's Web site says the strategy also uses derivatives to eliminate interest rate risk"; and that "[s]ome of the firm's other active fixed-income and large-cap enhanced index strategies have some exposure to [LDBF]."[12] On the morning of July 26, 2007 Mr. Flannery read the article and forwarded it to his boss, Mr. Hunt.

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10 *See, e.g.*, Mark Pittman, *S&P May Cut $12 Billion of Subprime Mortgage Bonds*, Bloomberg.com, July 10, 2007 (available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=aN4sulHN19xc>).

11 *See* Subprime Mortgage Market Crisis Timeline, Joint Economic Committee, U.S. Congress (available at <http://jec.senate.gov/index.cfm?FuseAction=Files.View&FileStore_id=4cdd7384-dbf6-40e6-adbc-789f69131903>).

12 *SSgA Bond Fund Whacked By Subprime Losses*, Money Management Letter, July 30, 2007, at 1, 12 (available at <http://new. moneymanagementletter.com/pdf/MML073007.pdf >).

During this time period, advisory groups GAA, CAM and OFA recommended that their clients move from active to passive fixed income funds, determining that retaining investments in active funds was not consistent with the particular investment strategies of their clients, and a number of clients redeemed their investments in LDBF. The advisory groups' recommendations did not represent the views of SSgA or its Fixed Income team regarding the advisability of redeeming or of LDBF's fundamentals, which they continued to believe were strong.

On July 26, 2007, SSgA sent a letter to clients. The letter was heavily reviewed and edited by a number of people, including SSgA's lawyers. Mr. Flannery's role in connection with the letter was small, and the Division has not charged him based on this letter. Notable, however, is the fact that early in the letter-writing process, Mr. Flannery made clear that he wanted the client letter vetted by legal before it went out. The letter was intended to alert clients to substantial losses in LDBF due to subprime exposure; warn that market turmoil was expected to continue for some time; summarize the Fixed Income team's views on active bond investments given the present circumstances and explain its belief in the long-term fundamentals; and explain SSgA's plan of action, which involved reducing risk in the portfolios where liquidity in the market allowed. The letter also invited clients to contact SSgA concerning the impact of market events on their specific investments, and SSgA's Relationship Management team followed the letter with calls to the majority of the more than 250 clients in the fund.

During the latter half of July, SSgA's Fixed Income team did, in fact, take steps to reduce risk and raise liquidity in the portfolio. First, SSgA reduced LDBF's BBB ABX exposure as discussed above, by offsetting LDBF's BBB ABX Index swaps. On the same day the July 26th letter was sent to clients, SSgA sold some of its AAA bonds. At the end of July, SSgA also allowed certain total return swaps to expire. At trial, fact witnesses involved in managing the

fund, and-Ezra Zask, an investment management expert, will explain how these transactions reduced risk and increased liquidity in the LDBF portfolio.

On August 2, 2007, SSgA sent another letter to clients. The Division has charged Mr. Flannery in connection with this letter, and it is discussed in greater detail in Subsection F(1), below. The letter did not sugarcoat the situation. Rather, it discussed the sources of LDBF's underperformance, and noted that LDBF "experienced even more pronounced negative performance in the second quarter of 2007 which continued in July as spread widening moved up the capital structure to AAA and AA-rated securities secured by subprime mortgages." The letter also provided strategy-specific performance results to clients and advised how risk was actively being reduced in LDBF where possible. As discussed fully below, Mr. Flannery did not draft this letter, had no input regarding to whom it was sent, and made only one small set of "suggested edits", all of which were reviewed and subject to numerous further edits by others, including no less than five lawyers and key Relationship Management personnel, before the letter was sent.

On August 6, the August 13, 2007 edition of the Money Management Letter was released. It contained an article about the precipitous decline in LDBF during the month of July, noting that it "fell 11% last month, chalking up a $330 million loss." The article highlighted LDBF's subprime exposure and use of leverage: "this strategy was invested in asset-backed securities and the firm also lost money on a total return swap."[13]

Also on August 6, 2007, SSgA Relationship Managers sent another letter to those invested in LDBF.[14] The letter offered those clients the opportunity to participate in the Limited Duration Bond (II) strategy, which would allow clients to shelter themselves from the redemption activity of

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[13] Emma Blackwell, *State Street Bond Fund Takes $330M Hit*, Money Management Letter, Aug. 13, 2007, at 1 (available at <http://new.moneymanagementletter.com/ pdf/MML081307.pdf>).

[14] It appears this letter was sent out to clients over the course of several days, beginning on August 6.

other clients invested in LDBF while preserving their investment in the LDBF strategy.[15] The August 6 letter also disclosed that some SSgA commingled funds were redeeming in-kind their proportionate interests in the fund. As with the previous letters, SSgA in-house and outside lawyers played a substantial role in reviewing and approving the August 6 letter, and the Division has raised no challenge to that letter.

On August 7, 2007, the FOMC left the overnight federal fund rate at 5.25%, again referring to the tightening in the credit market and ongoing housing market tumult as a "correction" and forecasting that "the economy seems likely to continue to expand at a moderate pace over coming quarters, supported by solid growth in the employment and incomes and a robust global economy."[16] This view — that the housing issues were temporary and the economy's fundamentals remained strong — was consistent with the investment thesis of Mr. Flannery and members of the Fixed Income team that the subprime market dislocations were transient and the market would recover, as it had done after the February 2007 market turmoil.

On August 14, 2007, SSgA sent a letter to clients signed by Mr. Flannery. That letter, upon which the Division bases charges against Mr. Flannery and which is discussed in greater detail in Subsection F(2), below, described the events occurring in the market and the increasing risks posed in the subprime market. The letter also explained that liquidity was available on demand, but, consistent with Mr. Flannery's and the Fixed Income team's good faith belief at the time, offered the opinion that "many judicious investors" would wait for greater liquidity in the future. The letter also recognized that the fundamentals of the market segment might continue to weaken but cautioned about the risk of forced selling into a chaotic and illiquid market.

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[15] The investments in LDBF II were the same as LDBF except that, unlike LDBF, LDBF II clients could not redeem from the fund on a daily basis.

[16] Press Release, Federal Open Market Committee (Aug. 7, 2007) (available at <http://www.federalreserve.gov/newsevents/press/ monetary/20070807a.htm>).

As shown in detail below, SSgA's legal department extensively reviewed the letter, inserted the language the Division challenges, and, along with Relationship Management personnel and other senior executives within SSgA, approved the letter's content before it was sent to clients.

On August 27, 2007, SSgA sent another letter to clients notifying them that, in light of the continued volatility in the market, it might need to close and liquidate LDBF. Finally, on October 5, 2007, SSgA's CEO, William Hunt, sent a letter to clients concerning a lawsuit that had been filed against SSgA by Prudential. In that letter, Mr. Hunt stated that LDBF's losses resulted from "panicked selling" and redemptions by clients that forced SSgA to sell otherwise unimpaired assets into a largely illiquid market. The letter quoted language from the August 14 letter, including the "many judicious investors" language. The October 5 letter, like the prior letters, was heavily scrutinized by lawyers and others at SSgA, although Mr. Flannery played no substantive role. The Division has raised no challenges to the August 27 or October 5 letters.

D. SSgA's Approach to Investor Communications Before and During 2007

SSgA's system for communicating with clients, sometimes referred to as the "pull" system, predated Mr. Flannery's tenure at SSgA. Moreover, during his 11 years at SSgA, the system was never within his scope of responsibility; it was overseen by others at SSgA who did not report to him, and Mr. Flannery was never in a position to change the system. Nor did he have reason to try, as Mr. Flannery knew that SSgA's compliance team and legal counsel had reviewed and approved the system, and continued to monitor it.

Under SSgA's system, the Relationship Management team was LDBF clients' primary point of contact at SSgA. Relationship Managers provided information to clients, including

holdings and performance information and financial statements.[17] If clients had questions, the Relationship Managers would work with other departments within SSgA to answer those questions. Investment consultants, who often had several clients invested in SSgA's strategies, interfaced with SSgA's Consultant Liaisons in a similar way. Clients and their consultants were sophisticated, and their information needs varied, so Relationship Managers were responsible for ensuring that a particular client received the information that client wanted. SSgA's relationship with each client was governed by an investment management agreement that was negotiated with that client. Clients could include specific reporting requirements in those agreements. As expert witness John Peavy, an investment and portfolio manager with more than 35 years of investment management experience, will testify, it was customary and reasonable for managers of unregistered funds with institutional and investment consultant clients to make information available in this manner.

During 2007, and particularly during the fast-unfolding events of that summer and the unprecedented number of questions from clients and their consultants, SSgA augmented its standard means of communicating by developing a series of communications (including the August 2 and August 14 letters), which were designed to supplement the information available to clients. The evidence will show that Mr. Flannery made certain that the communications to clients were heavily vetted by multiple layers within SSgA, and believed in good faith that all relevant parties were informed of the underlying issues.

[17] Clients and consultants also had password-protected access to substantial information about their investments on SSgA's website.

1. Mr. Flannery Encouraged the Substantial Involvement of Legal in the Summer 2007 Letters

The evidence will show that Mr. Flannery — who is not a lawyer — believed it was critically important to involve the legal department in the letters to clients, and he ensured that SSgA's lawyers, over whom Mr. Flannery had no supervisory responsibility, were heavily involved in reviewing those communications. Prior to 2007, communications had not routinely been reviewed by counsel before being sent to clients. Notwithstanding that practice, Mr. Flannery sought legal review during the Summer of 2007 because he wanted to ensure SSgA complied with its legal obligations to clients, including "what additional information we should communicate [and] in what form." Flannery Tr. 858:24-859:24. A person seeking to mislead clients would hardly have been expected to invite lawyers to review the letters and to rely upon them with respect to the letters' content.

For example, when Mr. Flannery learned SSgA was preparing a letter to clients in July 2007 (which would become the July 26 letter, as to which the Division makes no allegations against Mr. Flannery), he requested that SSgA's legal department review the letter before it was sent to clients, and lawyers were, in fact, involved at every step in the process. Similarly, and as discussed in greater detail, below, SSgA's lawyers were also intimately involved in preparing, reviewing, and approving both the August 2 and August 14 letters, and SSgA's lawyers had full knowledge of the relevant facts when they reviewed and approved those letters.

In addition to the Summer 2007 letters to clients, Mr. Flannery was aware that SSgA's lawyers were heavily focused on the information being disclosed to clients by the Relationship Management department. For example, the legal department was actively involved in editing and approving each iteration of the Frequently Asked Questions document (the "FAQs"), a

document prepared for the Relationship Management team so that they could provide detailed, accurate, and consistent answers to client questions during this time period.

In explaining the role of SSgA's legal department in reviewing and approving the client letters, SSgA's General Counsel, Mitch Shames, testified:

> As my role as general counsel of SSgA, I viewed my primary obligation and responsibility to be, to assemble the right team with the right expertise to handle various matters . . . . [W]hen I received the first draft of [the July 26, 2007 letter], ***I assembled the right team, which in my mind was Mark Duggan, Chris Douglass, Glenn Ciotti, and Liz Fries.*** And while I reviewed the document for purposes of clarity, ***I had the confidence that my team of counsel was doing what they deemed necessary to review the communication.***
>
> . . . .
>
> When I reviewed the letter and identified that it was a client — a market commentary, I wanted to bring in lawyers who specifically had investment and securities experience. And so I assembled a team which would have — ***a team which I would have been confident in, would have reviewed the letter in a way that they thought was necessary in order for the legal group to sign-off on the letter.***

Shames Tr. at 80:4–13; 89:21–90:2.

Mr. Shames explained that his "understanding was that this was an accomplished and well-experienced team of legal advisers, and that they would raise the issues and make changes, so that the letters were consistent with whatever rules and regulations [SSgA was] subject to." Shames Tr. 156:1-5. Mr. Flannery's understanding of the role legal would play in reviewing the letters mirrored that of Mr. Shames. Mr. Flannery testified that "legal's job was to review the documents that we had drafted to — to render their legal opinions of the propriety of what we had included and . . . to let us know what was required and . . . offer legal guidance and instruction on what needed to be in" the letters. Flannery Tr. 861:3-10.

The lawyers involved included Mr. Shames, as well as Mark Duggan, SSgA's Deputy General Counsel — the number two person in SSgA's legal department and ***the securities law expert within the organization***. Mr. Duggan had substantial experience with communication

and disclosure issues. SSgA lawyers Chris Douglass, Glenn Ciotti, Jodi Luster and Charles Cullinane also were involved in reviewing the communications. Outside counsel from Goodwin Proctor, Elizabeth Fries, with whom Mr. Shames had worked for many years and who is an experienced securities lawyer with specific expertise with communications and disclosure issues, was involved in reviewing the letters at issue.[18] Ms. Fries was also well-steeped in both the make-up of the funds and the market conditions in 2007.

2. The Relationship Management Team Played a Substantial Role in the Summer 2007 Communications

Along with Legal, the Relationship Management team played a heavy role in investor communications during 2007. Members of that team, who were well-versed in the particular needs of their clients and whose responsibility it was to communicate with them, were substantially involved in reviewing each of the letters that was sent to clients in July and August.

The evidence will show that Mr. Flannery and SSgA took steps to ensure that the Relationship Management team was informed about the issues facing LDBF. In fact, Mr. Flannery challenged the Fixed Income team to provide more information to clients and their Relationship Management counterparts. In addition, Mr. Flannery understood that Relationship Managers participated in daily meetings on the trading floor (Mr. Flannery did not attend these meetings). Mr. Flannery had every reason to believe the Fixed Income team was providing information requested by clients to Relationship Management, and was assured by the Fixed Income team that Relationship Management was receiving the information it needed. Indeed, the evidence will demonstrate that the Relationship Management team was armed with the necessary

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[18] Ms. Fries and Goodwin Proctor represented SSgA on its CDO deals and had true expertise in this sector. According to Ms. Fries' current professional biography, she chairs Goodwin Proctor's Hedge Funds Practice, and has particular expertise in, among other things, innovative investment products, hedge funds and other alternative investments, fiduciary issues, and compliance matters. *See* <http://www.goodwinprocter.com/People/F/Fries-Elizabeth-Shea.aspx >.

information, and that Mr. Flannery — who was not in a client-facing role — reasonably believed that such information was being provided to clients.[19] There was an entire structure in place (one which had existed long before Mr. Flannery joined SSgA) to ensure that clients received information about funds managed by SSgA, including LDBF. The Relationship Management team, a group that did not report to Mr. Flannery, was responsible for disseminating information to clients and was in the best position to assess the mix of information requested by and being provided to those clients. Mr. Flannery was not responsible for any shortcomings of SSgA's Relationship Management team.

E. Mr. Flannery Sought the Investment Committee's Direction Regarding the Market Turmoil and the Issues Facing LDBF

Mr. Flannery raised the issue of the LDBF strategy with SSgA's Investment Committee, the highest investment decision-making body within SSgA.[20] The Investment Committee was made up of senior members of various groups within SSgA, and had ultimate decision-making authority regarding investments. The entire Fixed Income team, including Mr. Flannery, reported to and was accountable to the Investment Committee. That is why the committee was chaired by someone outside of SSgA's investment group, Shawn Johnson. Among other things, investment teams were required to present their investment strategies to the committee on a quarterly basis and, in conjunction with Risk Management and Compliance, provide assurances that they were investing in a manner consistent with investment guidelines for that strategy. The Investment Committee was deeply engaged in the substantive issues, including the issues addressed in the letters to clients.

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[19] While it is true that the market tumult of the summer of 2007 led to an unprecedented number of client inquiries, overwhelming SSgA and causing some delays in the flow of information, Relationship Management, in conjunction with other teams, attempted to address the issue by putting in place a centralized approach for responding to clients.

[20] In addition to seeking direction from the Investment Committee, Mr. Flannery discussed LDBF and the subprime market throughout this period with other senior personnel within SSgA.

At Mr. Flannery's request, Mark Duggan, SSgA's Deputy General Counsel, was asked to participate in the July 25th and August 8th Investment Committee meetings. Mr. Flannery asked that Mr. Duggan attend so he could understand the relevant business issues, which were discussed openly at those meetings, and effectively advise SSgA. At the July 25, 2007 Investment Committee meeting, Mr. Flannery requested that the Committee discuss and provide the Fixed Income team with direction concerning the issues LDBF was facing. As was his nature, Mr. Flannery actively solicited input about those issues from the people at that meeting. Those discussions, in which Mr. Duggan was an active participant and advised SSgA as to its legal obligations, concerned subjects such as the state of the subprime market and its effect on portfolios, liquidity issues, possible redemptions (based on redemption estimates from Relationship Management), the possibility of freezing redemptions, and LDBF's risk profile.

F. The August 2 and August 14 Letters

Against this backdrop of disclosure and transparency, Mr. Flannery viewed the August 2 and August 14 letters — the only two letters in connection with which he has been charged — as supplements to the broader set of information he understood was being provided to clients.

1. The August 2, 2007 Letter

The Division has charged Mr. Flannery in connection with statements in the August 2, 2007 letter to clients, which he did not write, which he played no role in distributing, and with which he had only passing involvement. That letter stated, in relevant part:

> **Actions Taken**
> While we believe that events over the past several months have been largely the result of liquidity and leverage issues, versus long-term fundamentals, we are also aware that the downdraft in valuations have [sic] had a significant impact on the risk profile of our portfolios, and thus we have taken steps to reduce risk across the affected portfolios. Within the Limited Duration Bond Fund we have reduced exposure to a significant portion of triple B securities, we have sold a large amount of our triple A cash positions and will be reducing additional triple A exposure as total return swaps roll off at month end. These actions will

simultaneously serve to reduce risk in other SSgA strategies that hold units of the Limited Duration Bond Fund.

The Division claims that letter was misleading because (1) the actions SSgA had taken were not intended, according to the Division, to reduce risk; (2) the letter allegedly did not disclose information that SSgA "had provided to its internal advisory groups and certain other investors who requested the information" (presumably, LDBF's exposure to subprime and the fact that GAA had recommended redemption); and (3) the letter allegedly did not disclose that SSgA had sold the BBB ABX, AAA cash bonds, and allowed the total return swaps to expire because they were anticipating redemptions in the portfolio. OIP ¶¶ 37-38. However, the evidence will demonstrate that the actions taken by SSgA were intended, and did in fact, reduce risk and increase liquidity in the fund. With respect to the purported omissions, that information was already being provided to clients through other contemporaneous communications, of which the August 2 letter was simply a part. Moreover, Mr. Flannery's role with respect to the letter was small, and it was reviewed and edited by numerous other individuals with responsibility for communicating with clients, as well as by experienced securities lawyers, after Mr. Flannery provided his limited comments and before it was sent.

a. Mr. Flannery's Role in the August 2 Letter Was Minimal

With respect to the August 2 letter, Mr. Flannery's involvement was limited to a few "suggested edits" to the paragraph at issue, and only five words from those "suggested edits" were included in the final draft. Mr. Flannery did not draft the August 2 letter, nor did he ask that it be drafted. He also did not sign the letter. The August 2 letter initially was drafted by Adele Kohler, Senior Managing Director, Product Development & Product Engineering, on July 31, 2007. Later that day, Mr. Hopkins and others exchanged e-mails about her draft, and Mr. Hopkins added information to the draft. After some additional correspondence that same day

concerning the content of the letter, Ms. Kohler e-mailed the letter to a group of people, including Mitch Shames, the General Counsel. Messrs. Brown (Chief Marketing Officer) and Flannery were among eight people copied on that e-mail. The others copied were Staci Reardon (Co-Managing Director, U.S. Relationship Management), Larry Carlson (Co-Managing Director, U.S. Relationship Management), Nicholas Mavro (Vice President- Consultant Relations), James Hopkins (Product Engineer), and Michael Wands (Director- Fixed Income). Ms. Kohler did not solicit Mr. Flannery's input; rather, she requested only that Mr. Shames review the letter. Mr. Shames immediately e-mailed the letter to SSgA's outside legal counsel, Elizabeth Fries, at Goodwin Proctor LLP, an expert in securities laws.

On August 1, Mr. Carlson sent an e-mail explaining that the Relationship Management team was in the process of preparing a letter for investors. Messrs. Hopkins, Wands, and Flannery received that e-mail, in which Mr. Carlson identified, among others, three things that needed to happen before the letter was ready to send to client: (1) "***Legal will confirm that the letter is good to send***," (2) "We will be running holdings reports of all affected Funds", and (3) ***Relationship Managers "will need to decide what contacts to send [the letter] to and inform the consultant liaison for each client***." SSgA 708 (SS-SEC 119665) (emphasis added).[21]

On August 1, 2007, Mr. Flannery replied to Ms. Kohler and all who had received her e-mail, including the General Counsel and the most senior employees in Relationship Management, and with minimal "suggested edits," commented on the letter for the first and only

21 The documents cited herein appear on the Exhibit List submitted by Mr. Flannery.

time. Mr. Flannery's only proposed revisions to the "Actions Taken" paragraph (the only paragraph with which the Division takes issue) were:

> Actions Taken
>
> While we believe that events over the past several months have ~~been largely the result of liquidity and leverage issues, versus long term fundamentals, we are also aware that~~ <u>indicate some deterioration in longer-term fundaments, we believe price action has been dominated by the unwinding of leverage in a market segment with sharply reduced liquidity. Additionally,</u> the downdraft in valuations ~~have~~ has had a significant impact on the risk profile of our portfolios, ~~and thus we have taken~~ <u>prompting us to</u> take steps to reduce risk across the affected portfolios. Within the Limited Duration Bond Fund we have reduced exposure to a significant portion of triple B securities, we have sold a large amount of our triple A cash positions and ~~will be reducing~~ additional triple A exposure as <u>some</u> total return swaps rolled off at month end. These actions ~~will~~ simultaneously <u>serve to</u> reduce risk in other SSgA strategies that hold units of the Limited Duration Bond Fund.[22]

Mr. Flannery copied Mr. Shames on the e-mail containing his comments, and Mr. Shames forwarded Mr. Flannery's comments to Jodi Luster, an attorney within SSgA. After making further revisions to the letter, Ms. Luster forwarded her comments to Mr. Cullinane (another lawyer within SSgA), Mr. Shames, and Ms. Fries. On August 2, Ms. Fries circulated her comments on the letter to Ms. Luster and Mr. Shames. In her cover e-mail, Ms. Fries demonstrated an in-depth command of the facts pertaining to the fund:

> One thing we did not discuss yesterday is that we should be certain this is exclusively targeted at investors with products that have a NAV based on fair market value. Presumably Stable Value is not affected by price action, and products such as CDOs have probably not realized "losses" at this stage.

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[22] Mr. Flannery's only other "suggested edits" to the draft consisted of changing "delinquencies" to "defaults" in one paragraph; deleting "through an exchange traded vehicle" from the end of a sentence in that same paragraph; and asking that one fact be re-checked in another paragraph. The OIP does not make any allegations with respect to those other suggestions. Mr. Flannery's "suggested edits" to the entirety of the draft (most of which is not challenged by the Division) consisted of deleting 34 words, replacing them with 34 words, and asking that a single fact be re-checked.

See SS-SEC 103873. Ms. Fries' comments to the letter were circulated back through SSgA's internal legal team. Mr. Flannery was not included on any of these e-mail exchanges. Subsequently, Mr. Carlson hosted a meeting to discuss the letter with Attorney Cullinane, Attorney Luster, Vincent Thornton (Relationship Manager) and Nicholas Mavro (VP, Consultant Relations). Following that meeting, SSgA's lawyers again revised the letter. The draft was subsequently provided to yet another lawyer, the fifth lawyer involved in reviewing the draft, Glenn Ciotti. After being vetted by five lawyers, on August 2, Attorney Luster circulated the letter to Mr. Carlson, Mr. Mavro, and Mr. Thornton. Mr. Flannery was not included on these e-mails, and did not participate in the meeting that was held concerning the letter.

The lawyers involved in reviewing and editing the August 2 letter were not "in the dark" regarding the relevant facts, and Mr. Flannery reasonably believed they were fully informed. His belief was based upon, for example, Legal's review of various iterations of the FAQs and involvement in substantive discussions such as the one that took place at the July 25 Investment Committee meeting, where the state of the subprime market and liquidity issues were discussed extensively, and in various other meetings and conversations that took place throughout this period. With respect to the July 25 Investment Committee meeting, Mr. Duggan told Mr. Shames, who was one of the many attorneys actively involved in editing the August 2 letter, what had been discussed at that meeting.

Following Mr. Flannery's only set of proposed revisions, the "Actions Taken" paragraph was extensively revised as follows by others prior to being sent to clients:

> Actions Taken
>
> ~~While w~~We believe that ~~events over the past several months have indicate some deterioration in~~what has occurred in the subprime mortgage market to date this year has been more driven by liquidity and leverage issues than long~~er~~ term fundamentals~~, we believe price action has been dominated by the unwinding of leverage in a market segment with sharply reduced liquidity~~. Additionally, the downdraft in valuations has had a significant impact on the risk profile of our portfolios, prompting us to take steps to seek to reduce risk across the affected portfolios. ~~Within~~To date, in the Limited Duration Bond ~~Fund~~Strategy, we have reduced ~~exposure to~~ a significant portion of ~~triple B~~our BBB-rated securities~~,~~ and we have sold a ~~large~~significant amount of our ~~triple A~~AAA-rated cash positions ~~and a~~. Additionally, ~~triple A~~AAA-rated exposure has been reduced as some total return swaps rolled off at month end. Throughout this period, the Strategy has maintained and continues to be AA in average credit quality according to SSgA's internal portfolio analytics. The~~se~~ actions we have taken to date in the Limited Duration Bond Strategy simultaneously ~~served to~~ reduced risk in other SSgA active fixed income and active derivative-based strategies ~~that hold units of the Limited Duration Bond Fund~~.[23]

In total, just five words from Mr. Flannery's "suggested edits" to the "Actions Taken" paragraph were ultimately included in the letter sent to clients. Those words are in bold below:

> We believe that what has occurred in the subprime mortgage market to date this year has been more driven by liquidity and leverage issues than long term fundamentals. **Additionally**, the downdraft in valuations has had a significant impact on the risk profile of our portfolios, **prompting us to** take steps to seek to reduce risk across the affected portfolios. To date, in the Limited Duration Bond Strategy, we have reduced a significant portion of our BBB-rated securities and we have sold a significant amount of our AAA-rated cash positions. Additionally, AAA-rated exposure has been reduced as **some** total return swaps rolled off at month end. Throughout this period, the Strategy has maintained and continues to be AA in average credit quality according to SSgA's internal portfolio analytics. 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.

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[23] *Blue underlined text* signifies words added by others that did not appear in Mr. Flannery's "suggested edits" version. ~~*Red strike-through text*~~ signifies words that appeared in Mr. Flannery's "suggested edits" version but were subsequently removed by others. The remaining text was unchanged.

b. The August 2 Letter Contained Accurate Information.

i. The "Actions Taken" Reduced Risk

The "actions taken" by SSgA, referenced in the August 2 letter were intended to and did, in fact, reduce risk and increase liquidity, notwithstanding the Division's contentions to the contrary. In mid to late July 2007, SSgA made a number of trades that reduced the fund's exposure to the BBB tranche of the ABX Index. These trades were made following Standard & Poor's and Moody's decisions to downgrade a number of securities backed by subprime mortgages, most of which had ratings of BBB+, BBB, or BBB-. At a time when BBB ABX spreads continued to grow, reducing this exposure to the BBB ABX necessarily reduced risk in the portfolios, as the language in the letter indicates SSgA was seeking to do. The sale of AAA bonds to Citibank later in July was similarly undertaken to reduce risk and did, in fact, reduce risk. Indeed, contemporaneous evidence will demonstrate that the trades were intended to reduce risk, and expert witness Ezra Zask will testify that both the BBB and AAA transactions decreased risk in the LDBF portfolio, as did the expiration (or "rolling off") of total return swaps at the end of July.

Finally, to the extent the Division takes issue with the statement in the August 2 letter regarding the credit quality of the fund, that statement was accurate: LDBF security sales and redemption data maintained by SSgA supports the conclusion that the average credit quality of the funds remained at the AA level throughout the month of August, and, in any event, there is no basis for believing that Mr. Flannery had a contrary understanding. In fact, on August 8, 2007, the Fixed Income team reported to Mr. Flannery and the Investment Committee that SSgA had been able to meet redemptions while maintaining the average credit quality of the portfolio.

ii. The Alleged "Omissions" from the August 2 Letter Had Been Disclosed to Clients

With respect to alleged omissions, the Division states that the August 2 letter "did not disclose the information that State Street had provided to its internal advisory groups and certain other clients who requested the information." OIP ¶ 37. While the OIP is unclear regarding exactly what the Division contends was omitted from the letter, to the extent the Division claims that the omissions concerned LDBF's exposure to subprime and the fact that GAA had recommended redemption, see OIP ¶36 (discussing alleged omissions from July 26 letter, which is not charged against Mr. Flannery), those claims are meritless. The fund's exposure to subprime was already available to clients from a number of sources, including public sources such as the article from Money Management Letter released on July 25. The information was also available through the FAQs. And, as the Division concedes, the fact that GAA had redeemed was also available to clients through the FAQs. The Division's claims regarding purported omissions ignore the total mix of information available to clients, to whom Mr. Flannery reasonably believed the allegedly omitted information was being provided.

The evidence will demonstrate that the August 2 letter (as well as the August 14 letter) was never intended to be the only means for communicating with clients. The letter was not sent in a vacuum, and instead, was part of a larger communication initiative by SSgA during the mid-2007 crisis. The goal of that initiative was to keep clients informed of market developments and the performance of LDBF. The FAQ document was part of this effort, and was distributed to the Relationship Management department for use before the August 2 letter was sent to clients. As the Division states in the OIP, the FAQs were "far more comprehensive" than the letters and "enabled" SSgA's "client service personnel to disclose material information to certain investors,

including that the fund was concentrated in subprime investments and that State Street's largest internal advisory group had decided to redeem out of the Fund and the related funds." OIP ¶ 36. Hundreds of client calls took place during this period, and Mr. Flannery had every reason to believe this information was being provided to clients.[24]

As the OIP and the FAQs plainly reflect, the information the Division contends should have been disclosed was available to every person on the Relationship Management team and was provided to clients, and that was certainly Mr. Flannery's understanding at the time.[25] Tellingly, just two business days after the August 2 letter was sent, SSgA sent the August 6 letter to clients, which also contained information the Division claims should have been included in the August 2 letter. The August 6 letter is wholly inconsistent with an attempt by SSgA to hide this information from clients.

2. The August 14, 2007 Letter

The Division challenges a single sentence in the six-paragraph August 14, 2007 letter: "While we will continue to liquidate assets for our clients when they demand it, we believe that many judicious investors will hold the positions in anticipation of greater liquidity in the months to come." OIP ¶ 40. The Division contends this statement was misleading because three small SSgA advisory groups had recommended that their clients redeem. The Division also generally

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[24] The Division further states that "[i]n late July and early August, in response to requests from certain investors or their outside consultants, State Street also provided the Fund's holdings and disclosed the fact that State Street had decided to reprice some of the Fund's securities to reflect market prices that were lower than the vendor prices State Street had been using to arrive at the Fund's net asset value." OIP ¶ 36. Indeed, literally hundreds of calls with clients took place during this period.

[25] Pursuant to Company policy, the FAQs could only be used orally by Relationship Management professionals in response to a question from an investor. Mr. Flannery had nothing to do with that limitation on use of the FAQ. In any event, Mr. Duggan testified that he considered whether it would violate securities laws to provide material information contained in the FAQs to some clients and not others. Mr. Duggan believed Ms. Fries considered whether using the FAQs to disseminate information to clients might violate securities laws.

contends that the letter omitted the illiquid nature of the remaining investments in LDBF, and the use of leverage. *Id.*

a. The Language the Division Claims Was Misleading Was Authored by SSgA's Deputy General Counsel.

The genesis of the August 14 letter was an e-mail exchange that began on August 2, 2007, in which Mr. Flannery asked senior members of the Relationship Management team what clients were asking about following Standard & Poor's and Moody's unprecedented downgrading of a significant number of bonds backed by subprime mortgages:

> At this point I know we have had a number of interactions with clients and consultants. ***It is important to get frank and constructive feedback on what is working well and what we can do to improve things.*** I want to underscore that our role here is to do the best job possible.
>
> Please provide that feedback to me (and directly to individuals if appropriate) so I can help. In addition, anything you need from me (***I haven't had any client calls***) is on the table.

SSgA 308 (SS 162489) (emphases added). The next day, Larry Carlson responded, stating that there had been feedback:

> Thanks Sean. There have been a few comments that we [SSgA] may be a little cavalier about the situation. A couple of [Relationship Managers] have mentioned that we feel that we do not necessarily need to apologize per se . . . but should be saying up front that we realize that this is a serious situation, that we are disappointed in what has transpired and are doing everything we can to mitigate the damage and make sure that we rectify the situation.

SSgA 308 (SS 162489). Out of a desire to address some of the concerns articulated in Mr. Carlson's e-mail, Mr. Flannery ***volunteered*** to draft a letter to clients. He did so because he wanted to provide a real-time perspective regarding what was going on in the market and address the frustrations he was told some clients had expressed about SSgA. Mr. Flannery told his boss, SSgA's CEO, William Hunt, that he wanted to send a letter because he felt it was important to provide clients with information and that, in his view, sending such a letter "was the right thing

to do." Flannery Tr. at 604:15–23. Mr. Hunt advised Mr. Flannery not to send the letter under his own name, asking: **"Why would you raise your head up?"** *See* Flannery Tr. at 609:2–611:18. Mr. Flannery, however, felt strongly about the issue, and Mr. Hunt ultimately agreed that sending the letter to clients made sense.

Mr. Flannery created the original draft of the August 14 letter on August 4, 2007. As originally drafted by Mr. Flannery, the sentence in question read: "While we will continue to liquidate assets for our clients when they demand it, our advice is to hold the positions for now." This statement reflected the Fixed Income team's and Mr. Flannery's good faith view of the long term fundamentals of the market and their belief that clients should hold their positions. Through subsequent edits by others at SSgA, by August 7 that sentence became: "While we will continue to liquidate assets for our clients when they demand it, our advice is to hold the positions in anticipation of greater liquidity in the months to come."

Then, on August 7, SSgA's Deputy General Counsel, Mark Duggan, further revised the sentence, adding the language the Division challenges:

> We believe that many judicious investors will
>
> the year, we believe that liquidity will slowly re-enter the market and the segment will regain its footing. While we will continue to liquidate assets for our clients when they demand it, ~~our advice is to~~ hold the positions in anticipation of greater liquidity in the months to come.

SSgA 719 (SS-SEC 118350). Mr. Flannery believed the language inserted by Mr. Duggan was true, consistent with the views of members of the Fixed Income team. Tellingly, Ms. Fries of Goodwin Procter, upon whom Mr. Duggan and the SSgA legal department were heavily relying in this time period, did not make further changes to this language when she reviewed the draft. Indeed, Mr. Duggan testified that he and Ms. Fries had numerous conversations about the August

14 letter, including one regarding the changes he made to Mr. Flannery's draft, which included the "many judicious investors" change. Thus, it was SSgA's lawyer — the securities law expert within SSgA — who authored the very language at the center of the Division's claims, and Mr. Flannery had no reason to believe the language drafted by Mr. Duggan was improper. Indeed, the evidence will show that Mr. Duggan concluded that the August 14 letter complied with applicable laws and regulations.

Ultimately, Mr. Duggan reviewed the August 14th letter at least six more times before it was disseminated to clients. He reviewed it so many times that, in an e-mail to Mr. Flannery, he wrote: "**How many times do we have to sign off???**" SS-SEC 118389 (emphasis added). General Counsel Shames also reviewed the draft August 14th letter after Mr. Duggan revised the "many judicious investors" language.

That Mr. Flannery took care to follow the advice of counsel is undeniably demonstrated by what he did after he received Mr. Duggan's "many judicious investors" language. To ensure that Mr. Duggan's advice was followed throughout the letter, Mr. Flannery referenced that same "many judicious investors" language in an e-mail he sent to Mr. Duggan the next day, saying:

> I also want to draw your attention to the 3rd paragraph on the second page where I say we think it is unwise to sell under the current conditions. ***We softened the language on the last page as agreed, but I want to make sure that you are comfortable with this <u>as well</u>.*** As you know, my preference would be to leave that in.

SEC Exhibit 694 at SS-SEC 118355 (emphasis added). In other words, Mr. Flannery (i) referred Mr. Duggan to the language that read "[w]hile we believe that the subprime markets clearly convey far greater risk than they have historically, we feel that forced selling in this chaotic and illiquid market is unwise," (ii) compared it to the "many judicious investors" language, and (iii) sought Mr. Duggan's express approval of the language. In response to Mr. Flannery's e-mail,

Mr. Duggan ***did change*** the language in the third paragraph on the second page to language that was akin to the "softened" "many judicious investors" language:

> **<u>August 7, 2007 Draft Text (Mr. Flannery's initial language):</u>**
> While we believe that the subprime markets clearly convey far greater risk than they have historically, we feel that forced selling in this chaotic and illiquid market is unwise.
>
> **<u>August 8, 2007 Draft Text (Mr. Duggan's "final edits"):</u>**
> While we believe that the subprime markets clearly convey far greater risk than they have historically, we feel that investors must take into account the downside of forced selling in this chaotic and illiquid market.

Compare SEC Exhibit 694 at SS-SEC 118357, *with* SSgA 722 (SS-SEC 118405). Mr. Flannery's good faith effort to ensure that legal counsel's advice was consistent throughout the letter is compelling evidence of his careful and reasonable conduct and belies any claim that he acted improperly.

The following day (August 9), Mr. Duggan circulated the draft letter to Hannah Grove (Director Media Relations, State Street Corp.), CEO Hunt, and Marc Brown (Chief Marketing Officer), stating "we are OK with it, but wanted your thoughts." SSgA 723 (SS-SEC 118359-63). After receiving their feedback, Mr. Flannery made one change to Ms. Grove's proposed revisions — a change he made ***to ensure that clients were not being misled***. In explaining the change, Mr. Flannery wrote: "I have only one edit and that is to replace [the word] reduction (which replaced meltdown) with contraction as I believe reduction might convey a lowering of exposure instead of the negative market impact to which we refer." SSgA 723 (SS-SEC 118359).

b. SSgA's Deputy General Counsel Had Knowledge of the Relevant Facts When He Authored the Challenged Language

The Division contends the "many judicious investors" language inserted by Mr. Duggan was misleading because three advisory groups within SSgA had previously recommended that their clients withdraw their investments from LDBF. The Division claims that Mr. Flannery was

negligent in not raising that issue with Mr. Duggan. However, as discussed below, the actions of three small advisory groups were consistent with the letter, which did not state that every judicious investor would remain invested, and instead predicted that "many judicious investors" would stay invested. Moreover, Mr. Duggan was aware that at least one of the advisory groups had made a withdrawal recommendation well before inserting the "many judicious investors" language, and Mr. Flannery reasonably believed that Mr. Duggan had that knowledge when the lawyer made the critical insertion into the letter.

One of the advisory groups was GAA. On August 6, 2007, Mr. Duggan received a copy of the FAQs, which, as discussed above, were prepared by SSgA's legal and Relationship Management departments to help Relationship Management personnel respond to the flood of client inquiries. Mr. Flannery received this FAQ document as well, and knew by August 6 that Mr. Duggan had received it, because he was copied on the transmittal e-mail to Mr. Duggan. Mr. Duggan testified that he reviewed the FAQs when he received them during the first week of August, that he discussed them with outside securities counsel, Ms. Fries, prior to August 14, and that he participated in several meetings about them prior to that date. The FAQs included the following information:

> ***31. What affect has this*** **[*i.e.*, exposure to subprime]** ***had on your Asset Allocation Funds? What is your GAA Team doing to address this?***
>
> **Our GAA team has reviewed the situation**, *relative to whether they should continue to hold various strategies (Active Core Bonds/ Limited Duration Bond Fund)* **and are recommending a move to passive fixed income**. *Their concern is that turmoil in the ABX segment of the market may continue for several months and they would like to limit, to the extent possible, any further losses.*

SSgA 14 (SS 4379050) (emphasis added). FAQ number 31 was drafted and finalized by no later than August 1, well before the August 14 letter was sent to clients. In-house lawyers Messrs. Duggan, Shames, and Ciotti reviewed drafts of the FAQs after FAQ number 31 was

added to the document. In fact, Mr. Duggan took part in at least three meetings about the FAQs before the August 14 letter was transmitted to clients, at least one with Mr. Flannery. Furthermore, Mr. Flannery was present when Mr. Duggan spoke with Mr. Lowe on July 26 concerning the fact that GAA was considering whether to recommend redemptions. Thus, it is clear that Mr. Duggan was aware that at least one of the advisory groups within SSgA was recommending that clients withdraw from LDBF, and nonetheless chose to insert the "many judicious investors" language. Moreover, Mr. Flannery was aware that Mr. Duggan had this knowledge. That Legal believed that the "many judicious investors" language was consistent with one or more of the advisory groups recommending withdrawal is further evidenced by the inclusion of this portion of the August 14 letter — including the "many judicious investors" language — in an October 5 letter to clients from CEO Hunt, long after clients of GAA, CAM and OFA withdrew.

Mr. Flannery sincerely believed the opinions expressed in the August 14 letter. In the initial draft of the letter he prepared, Mr. Flannery wrote: "While we will continue to liquidate assets for our clients when they demand it, our advice is to hold the positions for now." That draft language was based on Mr. Flannery's and the SSgA's Fixed Income team's good faith view that "when markets are starved for liquidity and in times of crisis, it is generally a bad idea to demand liquidity." Flannery Tr. 948:7-14. As Mr. Duggan testified, Mr. Flannery "absolutely" believed:

> . . . Smart money stays. Selling now is trying to catch a falling knife. This will revert back in a month or two. People who are leaving, that's really a dumb decision. We've seen historical reversions . . . In March this happened, and it was back within two weeks, and people are locking in their losses now.

Duggan Tr. 456:23-457:8. Mr. Flannery's view was consistent with the members of SSgA's Fixed Income team, as well as senior government officials such as Ben Bernanke.

With respect to the alleged omissions in that letter (*i.e.*, the illiquid nature of the remaining investments in LDBF, and the fact that LDBF had subprime exposure and used leverage), there can be no serious contention that Mr. Flannery acted negligently. Mr. Flannery was included on the multiple drafts of the August 14 letter that were circulated to SSgA's senior Relationship Management personnel, who knew what information had already been provided to clients. The drafts were also provided to Mr. Duggan, who Mr. Flannery reasonably believed was fully informed, in part because Mr. Duggan attended both the July 25 and August 8 Investment Committee meetings. As discussed above, at the July 25th Investment Committee meeting, the following topics were discussed: there were serious liquidity concerns in the market, there was a need to increase liquidity in LDBF, the market conditions were making it difficult to raise liquidity and properly price securities in LDBF, and SSgA's Relationship Management team was anticipating redemptions in the range of 25 to 50% from LDBF. At the August 8 Investment Committee meeting, the Committee again discussed the illiquidity in the market, the issues caused by the illiquid market, how these issues were affecting LDBF, and how best to protect clients' interests. As noted above, Mr. Flannery was also aware that Mr. Duggan received and reviewed the FAQs and that the Relationship Management department received the FAQs and were using them with clients. That document discussed the illiquidity of the market and its impact, and LDBF's subprime exposure and use of leverage.

When asked whether the legal team he assembled had all the facts needed to effectively advise the Company with respect to the letters, SSgA's General Counsel, Mr. Shames, testified:

- Shames Tr. at 156:25–157:2: ". . . I had confidence that [Ms. Fries] either had the information that she needed, or that she would have requested the information that she needed."

- *Id.* at 157:5–8: ". . . Mark Duggan had the experience and the expertise, and I had the confidence in that, that he would have undertaken what he needed to undertake, along with Ms. Fries, to provide the approval."
- *Id.* at 158:25–159:2: "I was confident that the team would undertake whatever actions they needed to undertake, in order to sign-off on the letter."
- *Id.* at 160:18–22: "My expectation is that they could do or undertake whatever, ask any questions that they had and if they — if they felt, because of their knowledge of the law that they needed to question things, it would be my expectation that they would."

Like Mr. Shames, Mr. Flannery trusted in and relied upon Mr. Duggan and the SSgA legal department's advice and abilities, and reasonably believed that they were aware of the relevant facts. When Mr. Duggan inserted the "many judicious investors" language in the August 14th letter, Mr. Flannery believed that Mr. Duggan's change fully satisfied SSgA's legal obligations.

c. Relationship Management Also Reviewed the August 14 Letter

In addition to following the advice of SSgA's Deputy General Counsel concerning the "many judicious investors" language, Mr. Flannery actively solicited the input of Relationship Management. For example, after incorporating Mr. Duggan's "many judicious investors" revision to the letter, Mr. Flannery circulated the draft letter and wrote:

> I do think we need to hear from Relationship Management as to how valuable this letter is (or is not) and to whom and under what circumstances we would send it. I will rely on [Relationship Management co-heads Ms. Reardon] and [Mr. Carlson] to advise re anyone else in SSgA that needs to review this letter or send it.

SSgA 694 (SS-SEC 118355). In addition to the three lawyers that reviewed the August 14 letter, at least seven senior executives also reviewed it. CEO Hunt reviewed, commented on, and formally approved the letter. Mr. Brown (Chief Marketing Officer), who was ultimately responsible for determining who would (and would not) receive this letter, reviewed and commented as well. Mr. Carlson (Managing Director of U.S. Relationship Management), who

reported to Mr. Brown, not only reviewed the letter and determined who would receive it, he reported to Mr. Flannery that he was pleased with the content. In fact, in addition to the two most senior lawyers within SSgA (Messrs. Shames and Duggan) and SSgA's outside counsel (Ms. Fries), the following Relationship Management professionals reviewed a draft of the August 14 letter *after* they had received the FAQ that disclosed GAA's recommendation to its clients: Mr. Brown, Mr. Carlson, Ms. Reardon, and Mr. Mavro. Each of these individuals had full knowledge regarding GAA's recommended redemptions, as well as the of the total mix of information being made available to clients. None of them suggested that the letter include GAA's recommendation, or that the "many judicious investors" language was incompatible with the recommendations of GAA or otherwise false.

d. The August 14 Letter Contained Accurate Information.

Market conditions in Summer 2007 were unprecedented and the vast majority of government officials and investment professionals misjudged the scope, extent, and consequences of the problems in the market. At the time of the communications in questions, it was the opinion of Mr. Flannery, along with these government officials and investment professionals, that the market would recover. Expert witness Erik Sirri will testify regarding the tumultuous and rapidly changing nature of the market during Summer 2007, and that during the time period before and including the August 14 letter, it was reasonable to believe that many investors would continue to hold their positions in anticipation of greater liquidity in the months to come.

Moreover, the fact that internal advisory groups had recommended redemption to their clients did not render the "many judicious investors" language misleading. Each of these groups had their own investment guidelines, and a determination by one or all of them to redeem did not

change the fact that, at the time, it was reasonable to think that many other investors would not redeem into an illiquid market. Furthermore, many clients, *i.e.* owners of commingled funds (who represented a larger percentage of the portfolio than the GAA/OFA/CAM), ***did*** believe that holding their investments was the reasonable thing to do at the time — a view shared by the Fixed Income team. Many clients took in-kind redemptions from LDBF in order to remain exposed to its underlying strategy.

And, with respect to alleged omissions, as discussed above, the information that the Division says was not disclosed in the August 14 letter was disclosed elsewhere to clients (*i.e.* the FAQs and the August 6 letter, which addressed subprime and liquidity issues) or publicly available. On July 25th, for example, an article of the Money Management Letter featured LDBF's losses as a result of the subprime crisis, discussed the fund's use of derivatives, and contained other information. And, again, the evidence will demonstrate that the August 14 letter was never intended to be the only means for communicating with clients, to whom the allegedly omitted information was otherwise available, and with whom Mr. Flannery believed the information was being shared.

III. ANALYSIS

A. The Division Cannot Prove the Elements Of Its Claims Arising Out of the August 2 Letter.

1. The Division's Section 10(b)/Rule 10b-5 Claims Fail.

As set forth above, the Division charges a violation of § 10(b) and Rule 10b-5 only with respect to the August 2 letter. In order to prove a 10(b)/10b-5 violation, the Division must prove that, in connection with the purchase or sale of securities, the defendant made an untrue statement of material fact, omitted a fact that rendered a prior statement misleading, or

committed a deceptive act as part of a scheme to defraud,[26] and that the defendant acted with the requisite scienter. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195-96 (1976). The Division cannot prove the elements of its claims against Mr. Flannery arising out of the August 2 letter.

a. Mr. Flannery Did Not "Make A Statement" Within the Meaning of the Law.

The Division cannot prevail on its § 10(b)/Rule 10b-5 claim without proving Mr. Flannery personally either made an untrue statement of material fact or omitted a fact he was obligated to disclose—in other words, that he committed a primary violation.[27] *See SEC v. Tambone*, 417 F. Supp. 2d 127, 131-35 (D. Mass. 2006) (citing *inter alia Aaron v. SEC*, 446 U.S. 680, 695 (1980); *Wright v. Ernst & Young, LLP*, 152 F.3d 169, 174-75 (2d Cir. 1998)). This the Division cannot do, where Mr. Flannery did not draft the language about which the Division complains, where his single round of edits was minimal and inconsequential, and where the letter was extensively reviewed and edited by lawyers and others — including those with responsibility for client communications — before and after Mr. Flannery's limited set of "suggested edits."

The Division must prove that Mr. Flannery actually "created" the misstatements about which the Division complains or at least "caused the[ir] existence." *SEC v. Tambone*, 597 F.3d 436, 447 (1st Cir. 2010); *Wright*, 152 F.3d at 175 (employing "bright line" test for primary liability); *SEC v. Wolfson*, 539 F.3d 1249, 1259 n.16 (10th Cir. 2008) (employing "creation" test for primary liability). Such a standard is most consistent with the First Circuit's *en banc* decision in *SEC v. Tambone* which, though not directly on point, held that a statement "crafted entirely by others" does not constitute the making of a statement under Rule 10b-5. 597 F.3d at

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26 The Division does not allege a "scheme to defraud" against Mr. Flannery.

27 The Division has not alleged aiding and abetting liability against Mr. Flannery.

442, 446. Even if this Court were to hold that the Division must only establish Mr. Flannery's "substantial participation," *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061-61, n.5 (9th Cir. 2000), the Division could not prove its claim, as merely contributing limited revisions to a communication cannot establish primary liability unless the defendant played a "significant role" in the overall drafting process, and participated in "extensive review and discussions." *See SEC v. Fraser*, No. CV-09-00443, 2009 U.S. Dist. LEXIS 70198, *19-20 (D. Ariz. Aug. 11, 2009) (quoting *In re Software Toolworks, Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994)).

Mr. Flannery did not commission, draft, or sign the August 2 letter. He was one of eight people asked to comment on the letter and his involvement was limited to a single set of "suggested edits" that consisted of deleting and replacing 34 words (in a ~1,000-word draft) and asking that a single fact be re-checked. With respect to the only portion of the letter that the Division cites in the OIP, Mr. Flannery proposed replacing exactly ten words in the original draft prepared by Ms. Kohler with eight slightly different ones. As noted above, ***only five of those words appeared in the final letter***. Mr. Flannery's "suggested edits" made no substantive changes to Ms. Kohler's draft. Other than to clarify that only "some" swaps had rolled off, they were purely stylistic.

It is undisputed that, after Mr. Flannery offered his "suggested edits," others at SSgA — including its General Counsel — reviewed and substantially rewrote the text. *See* Redlined version, Page 27, *supra*. To the extent the Division complains about the "continues to be AA in average credit quality" statement, that statement was inserted by someone else ***after*** Mr. Flannery made his comments. To the extent the Division complains about risk reduction statements more generally, those were in Ms. Kohler's draft before it reached Mr. Flannery—he simply passed along her statements, while changing some verb tenses to (accurately) reflect that

the transactions being described already had occurred. The *en banc* First Circuit in *Tambone* flatly rejected the Division's attempts to "imply that 'X' has made a false statement [because] he passed along what someone else wrote [because to do so] would flout a core principle that underpins the *Central Bank* decision—[dividing primary and secondary liability under the securities laws]." *Tambone*, 597 F.3d at 446 (citing *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 173 (1994)). Finally, to the extent the Division complains about alleged omissions from the letter, it is legally untenable to lay those at Mr. Flannery's feet given his minimal involvement in the letter's preparation, and in client communications more generally. *United States v. Schiff*, 602 F.3d 152, 167 (3d Cir. 2010) ("[T]he plain language of § 10(b) and corresponding Rule 10b-5 do not contemplate the general failure to rectify misstatements of others.") (*citing*, *inter alia*, *SEC v. Tambone*, 597 F.3d at 446; *Wright*, 152 F.3d at 175; *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997)).

b. The August 2 Letter Was Not False Or Misleading

As discussed above, the transactions cited in the OIP (the AAA sale, reducing the BBB ABX exposure, and allowing the total return swaps to roll off at the end of July) were intended to, and ***did*** in fact, increase liquidity while reducing risk in the portfolio, as expert witness Ezra Zask will testify. To the extent the Division complains about the credit quality statement in the August 2 letter, the evidence will show that LDBF's overall average credit quality did continue to be AA throughout this period. The Division also vaguely asserts that the August 2 was misleading because it omitted information, presumably, GAA's redemption recommendation and LDBF's exposure to subprime. This claim fails. SSgA clients already had received the allegedly omitted material information from a number of sources, including the publicly available July 25 article from Money Management Letter and the FAQs, which as of August 1 disclosed GAA's recommendation that its clients redeem their investments in LDBF.

Furthermore, to the extent it relies on omissions, the Division would have to demonstrate both that the omitted fact was material under the circumstances and that Mr. Flannery had a duty to speak on that subject. *See, e.g., Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("To be actionable, of course, a statement must also be misleading. Silence, absent a duty to disclose, is not misleading under Rule 10b-5."); *id.* at 231–32 (Even assuming a duty to disclose, the securities laws require dissemination only of those facts that would have been substantially likely to have struck a reasonable investor as "having significantly altered the total mix of information made available.") (internal quotation marks omitted). While a duty to disclose can arise if "disclosure is required to prevent a voluntary statement from being misleading," *In re K-tel Int'l Sec. Litig.*, 300 F.3d 881, 904 (8th Cir. 2002), such a duty applies ***only*** to those individuals to whom the voluntary statement is publicly attributable, *Tambone,* 417 F. Supp. 2d at 135 (citing *SEC v. Druffner*, 353 F. Supp. 2d 141, 148 (D. Mass. 2005), *aff'd sub nom., SEC v. Ficken*, 546 F.3d 45 (1st Cir. 2008); *SEC v. PIMCO Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 467 (S.D.N.Y. 2004)). The August 2 letter was not attributed to Mr. Flannery, he was not generally responsible for client communications, and he had a reasonable basis to believe the information was being provided to clients.

c. Mr. Flannery Did Not Act with *Scienter*.

The Division's § 10(b)/Rule 10b-5 charge fails for a third reason: the Division cannot demonstrate that Mr. Flannery acted with *scienter*—"an intention to deceive, manipulate, or defraud." *See Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 639 (D.C. Cir. 2008) (explaining that "Section 17(a)(1) of the Securities Act, section 10(b) of the Exchange Act, and Rule 10b-5 require proof of *scienter*") (citing *Aaron*, 446 U.S. at 697; *Hochfelder*, 425 U.S. at193); *see also Druffner*, 517 F. Supp. 2d at 508. There simply is no evidence even suggesting that Mr. Flannery either harbored a "conscious intent to defraud" or acted with a "high degree of recklessness" at any

time. *See Ficken*, 546 F.3d at 47; *see also SEC v. Fife*, 311 F.3d 1, 9 (1st Cir. 2002), *cert. denied*, 538 U.S. 1031 (2003). The degree of recklessness the Division would need to prove is "a highly unreasonable omission, involving not merely simple, *or even inexcusable* [] negligence, but an extreme departure from the standards of ordinary care . . . which present[ed] a danger of misleading buyers or sellers that [was] either known to [Mr. Flannery] or [was] so obvious [that he] must have been aware of it." *See Ficken*, 546 F.3d at 47-48 (quoting *Fife*, 311 F.3d at 9-10); *accord, e.g., Ezra Charitable Trust v. Tyco Int'l, Ltd.*, 466 F.3d 1, 12 n.10 (1st Cir. 2006) (Inexcusable negligence is "well short" of the required showing.); *Wells v. Monarch Capital Corp.*, No. 97-1221, 1997 U.S. App. LEXIS 30031, at *19 (1st Cir. Oct. 29, 1997) (*per curiam*) (Even "carelessness approaching indifference" may not be sufficient to establish *scienter*.) (quoting *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516 (1st Cir. 1978)).

The Division has ***not alleged*** that Mr. Flannery acted with a conscious intent to defraud or a high degree of recklessness with respect to the August 2 letter.[28] That is not surprising, as he had no motive to mislead anyone. His compensation was not tied to LDBF, and there is no evidence that he did anything other than try to make the letter grammatically correct and more accurate.

The extensive involvement of SSgA's counsel and Relationship Management professionals in the letter drafting process underscores Mr. Flannery's lack of bad faith or recklessness. As noted above, when Mr. Flannery learned SSgA was preparing a client letter, he requested that SSgA's legal department review the letter before it was distributed. It is undisputed that Mr. Flannery first received a draft of the August 2 letter by way of an e-mail directed to Mr. Shames (SSgA's General

[28] The Division's rote, boilerplate recitation that Mr. Flannery violated every section and rule at issue "willfully," *see* OIP ¶¶ 42–44, is no substitute for actual allegations concerning Mr. Flannery's supposed state of mind. Indeed, the Division has reflexively written "willfully" even where the charges at issue, such as those under §§ 17(a)(2) and 17(a)(3), require negligence. Nowhere in the OIP does the Division actually allege that Mr. Flannery ever harbored an intent to defraud any investor or acted recklessly—or even negligently—to say nothing of substantiating such allegations.

Counsel) and eight others, with copies to Mr. Flannery and one other person, in which Ms. Kohler specifically asked Mr. Shames for his opinion as to the legality of its contents. It is also undisputed Mr. Flannery circulated his minimal "suggested edits" back to that same group, including Mr. Shames. Between that time and the time that the letter went out to clients, no fewer than ***five*** different lawyers reviewed it: Mr. Shames, Ms. Fries (a "securities law expert," according to Mr. Shames, and a partner at Goodwin Procter LLP), Ms. Luster, Mr. Ciotti, and Mr. Cullinane.

Mr. Flannery believed that the attorneys who edited and approved the letter were in the possession of the important facts, and the evidence will show that they did have the relevant facts, in part due to the actions of Mr. Flannery. The involvement of these experienced and informed attorneys in reviewing and approving the August 2 letter precludes the Division from proving that Mr. Flannery acted with any bad intent. Numerous courts—and even the SEC itself—have recognized that good faith involvement of counsel or other outside professionals negates allegations of *scienter*. *See, e.g., SEC v. Selden*, 632 F. Supp. 2d 91, 98-99 (D. Mass. 2009) ("[R]eliance on advice of counsel is 'evidence of good faith, a relevant consideration in evaluating a defendant's scienter'") (quoting *Howard v. SEC*, 376 F.3d 1136, 1147 (D.C. Cir. 2004) ("[R]eliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter"; vacating charges where petitioner relied on competent and experienced inside and outside counsel)).[29]

Relationship Management professionals were also heavily involved in editing the letter. Mr. Flannery reasonably believed that substantial information had already been provided to clients, and

[29] *See also SEC v. Caserta*, 75 F. Supp. 2d 79, 94–95 (E.D.N.Y. 1999) ("Good faith reliance on the advice of an accountant or an attorney has been recognized as a viable defense to *scienter* in securities fraud cases.") (collecting cases); *SEC v. Snyder*, 292 F. App'x 391, 406 (5th Cir. 2008) ("reliance on counsel's advice is . . . 'a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud'") (quoting *United States v. Peterson*, 101 F.3d 375, 381 (5th Cir. 1996)).

Relationship Management in fact knew what information had been provided to clients. If more disclosure was necessary, Relationship Management would know. Mr. Flannery had a very limited role with respect to client communications, and he relied in good faith on others to do their jobs during this extremely demanding period.[30] Like the attorneys, he understood that Relationship Management had all of the relevant information, and he took steps to ensure that was the case. This further negates a finding of *scienter*.

2. The Securities Act § 17(a)(1) Charges Fail.

The Division's § 17(a)(1) charge fails for the same reasons the Division's Section 10(b) claim fails: (1) Mr. Flannery did not make a "statement" within the meaning of the law, (2) the August 2 letter was not false or misleading, and (3) Mr. Flannery did not act with *scienter*. In addition, the August 2 letter did not constitute an offer or sale of securities within the meaning of Section 17(a).

a. The August 2 Letter Was Not an Offer or Sale of Securities

The Division does not even plead, much less have a means of proving, that the August 2 letter was written in connection with "the offer or sale of any securities." *See* 15 U.S.C. § 77q(a). Indeed, the OIP suggests the opposite—that the purpose of the letter was to keep SSgA's clients from redeeming LDBF holdings they already owned. This failure alone dooms the SEC's § 17(a) claims. *See Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 945 (2d Cir. 1984) (dismissing § 17(a) claims after determining that the alleged misstatements were not "in the offer or sale of a security."), *cert denied*, 469 U.S. 884 (1984); *SEC v. Brown*, No. 09-1423, 2010 U.S. Dist. LEXIS 101403, *32 (D.D.C. Sept. 27, 2010) (dismissing § 17(a) charges

[30] As expert John Peavy will testify, SSgA's communication and disclosure model was reasonable and the industry standard for unregistered funds with sophisticated institutional clients, like LDBF. SSgA's clients understood SSgA's information sharing model, *i.e.*, that they could request any desired information from SSgA.

because the SEC fails to state a claim under § 17(a) "when it fails to allege that an offer or sale of securities ever occurred.")

Section 17(a) claims are typically limited to misleading statements or omissions in a prospectus, registration statement or other offering document. *See, e.g., Brown*, 2010 U.S. Dist. LEXIS 101403 at *32 (Section 17(a) typically involves omissions and misstatements made in securities registration statements.); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 861-63 (S.D.N.Y. 1997) (limiting § 17(a) claims to offering documents and unregistered offerings). That is not by accident. While the definitions of "offer" and "sale" have been interpreted to cover a range of conduct, all of that conduct must be related to an actual or attempted securities transaction. *See Rubin v. United States*, 449 U.S. 424, 429 (1981) ("The term 'sale' or 'sell' shall include every contract of sale ***or disposition*** of a security ***or interest in a security,*** for value. The term ... 'offer' shall include every ***attempt or offer to dispose of,*** or solicitation of an offer to buy, a security ***or interest in a security,*** for value.") (quoting § 2(3) of the Securities Act; emphasis supplied by the Supreme Court); *Chemical Bank*, 726 F.2d at 939–40 (quoting same). It is hardly surprising that the "offer or sale" element has not been stretched to cover conduct outside of that realm such as the conduct alleged here. Were that not the case, § 17(a) would be the preferred enforcement tool over § 10(b) and Rule 10b-5, due to the less stringent *mens rea* requirement under §§ 17(a)(2) and 17(a)(3). Because no offer or sale has been alleged, and none can be shown, the Division's § 17(a) claims must fail. *See, e.g., Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314, 1353 (S.D.N.Y. 1982) (noting that "Federal courts at all levels have agreed with [defendant] that § 17(a) is limited in its application to offerors or sellers" and dismissing § 17(a)(3) claim because "there is no basis in this record for finding [the defendant] to be a seller."); *Brown*, 2010 U.S. Dist. LEXIS 101403 at *32 ("The SEC has failed to cite, and this Court has failed to

identify, any precedent holding that a complaint may properly state a claim under § 17(a) when it fails to allege that an offer or sale of securities ever occurred.").

3. The Securities Act §§ 17(a)(2) & (3) Charges Also Fail

For the reasons discussed above, Mr. Flannery made no statement in connection with the August 2 letter, the letter was not false or misleading, and there was no offer or sale of a security. Accordingly, the Division's claims under Section 17(a)(2) and (3) fail. *See SEC v. Patel*, No. 07-cv-39, 2008 U.S. Dist. LEXIS 23553, *40 (D.N.H. Mar. 24, 2008). The Division will not be able to prove these claims for the additional reasons discussed below.

a. Mr. Flannery Was Not Negligent

For purposes of its §§ 17(a)(2) and 17(a)(3) claims, the Division must establish Mr. Flannery acted negligently. However, Mr. Flannery acted reasonably in offering minor edits to the August 2 letter, and circulating them to SSgA's General Counsel, key members of the Relationship Management department, and a member of the Fixed Income team close to the day-to-day activities in LDBF and the market. *See, e.g., In the Matter of Albert Glenn Yesner, CPA*, Release No. 184, 75 SEC Docket 156 (ALJ May 22, 2001) (initial decision) ("With respect to the non-*scienter* primary violations [defendant] is alleged to have caused, a negligence standard will be applied, and [his] conduct will be measured by reasonableness . . . The reasonableness standard . . . enunciates a standard of care being that of a reasonable man under like circumstances.") (citations omitted).

b. Mr. Flannery Did Not Obtain Money or Property From the Letters

Section 17(a)(2) requires that the Division allege and prove that the defendant actually obtained money or property by means of the untrue statements. *SEC v. Glantz*, No. 94 Civ. 5737, 1995 U.S. Dist. LEXIS 13701, *15-16 (S.D.N.Y. Sept. 19, 1995). The Division has made no such allegation and it could not prove such an allegation even if it had done so. There is no

evidence in the two-year record assembled by the Division even suggesting that Mr. Flannery obtained money or property by means of any alleged misstatement, or that his compensation was tied to asset levels in LDBF.

c. The Division Has Charged No Fraudulent or Deceptive Practice

With respect to its Section 17(a)(3) claim, the Division also has failed to allege and cannot prove that Mr. Flannery, in the offer or sale of a security, "engage[d] in any transaction, practice, or course of business which operate[d] or would operate as a fraud or deceit upon the purchaser." *See* 15 U.S.C. § 77q(a)(3). As is the case with Rule 10b-5(c) (not alleged against Mr. Flannery), "the alleged conduct must be more than a reiteration of the misrepresentations underlying the [§ 17(a)(2)] misstatement claims." *Brown*, 2010 U.S. Dist. LEXIS 101403 at 56-57 ((quoting *SEC v. Lucent Techs., Inc.*, 610 F. Supp. 2d 342, *361 (D.N.J. 2009)); *accord United States v. Naftalin*, 441 U.S. 768, 774 (1979) ("each subsection [of § 17(a)] proscribes a distinct category of misconduct "). Here, the SEC has not alleged any fraudulent or deceptive conduct by Mr. Flannery other than the two letters themselves. Thus, its § 17(a)(3) claims must fail.

B. The Division Cannot Prove the Elements of its Claims Arising Out Of the August 14 Letter.

With respect to the August 14 letter, the Division charges violations of Sections 17(a)(2) and (3). The Division cannot prevail on these claims.

1. Mr. Flannery Was Not Negligent in Connection with the August 14 Letter.

The Division also cannot prove negligence with respect to this letter. It is undisputed that Mr. Duggan (Deputy General Counsel), whom Mr. Shames (General Counsel) called SSgA's internal securities law "expert," reviewed the letter multiple times before it went out to clients. As even the OIP acknowledges, Mr. Duggan inserted the very statement about which the Division

complains — the "many judicious investors" statement — into the final letter. As set forth above, Mr. Duggan was aware of GAA's recommendation to its clients that they withdraw their investments from LDBF, and he reviewed the letter at least six more times after he redrafted the language and before the letter was sent to clients. Mr. Flannery reasonably believed that Mr. Duggan had all of the relevant facts he needed to review and approve the letter. Indeed, the evidence will prove that Mr. Duggan believed he had all of the information necessary to advise SSgA, and that there was nothing about the letter that he would change even with the benefit of hindsight. Finally, Mr. Duggan discussed the letter with SSgA's outside securities law expert, Ms. Fries, who similarly was aware of the relevant facts.

The Division also alleges Mr. Flannery was negligent because the August 14 letter omitted "the illiquid nature of the remaining investments in the Fund and that the Fund's exposure to subprime was actually magnified through the use of credit default swaps, total return swaps, and repurchases tied to subprime investments." OIP ¶ 40. That allegation, however, is at odds with the evidence. In fact, Mr. Flannery reasonably believed that both the legal and Relationship Management departments were aware of this information, and determined that the information need not be included in that particular letter (*e.g.*, because it was already known to clients). Mr. Flannery in fact believed that LDBF clients had the information. For example, on July 26, Mr. Flannery reviewed the publicly availably Money Management Letter article that featured LDBF, which said that "[t]he fund is ***invested mostly in subprime*** mortgage-backed securities"; that "SSgA's Web site says ***the strategy also uses derivatives*** to eliminate interest rate risk"; and that "[s]ome of the firm's other active fixed-income and large-cap enhanced index strategies have some exposure to [LDBF]."

Moreover, Mr. Flannery instructed the Fixed Income team to provide more information to the Relationship Management team to assist in responding to questions from clients. The evidence will show that, from Mr. Flannery's perspective, disclosure obligations were being met, and his team was doing its part to make sure that the Relationship Management team had any information it needed. Indeed, *the Division concedes in its OIP that the Relationship Management department had the information it complains was not disclosed in the August 14 letter*. Specifically, the Division acknowledges that the FAQs, which were provided to every person in the Relationship Management department, contained the information the Division says should have been disclosed and that, in fact, the information was disclosed to certain clients. *See* OIP ¶¶ 36, 40.

The Division's complaint appears to be that the information was not disclosed to all clients in a uniform manner.[31] Stated simply, it was not within the scope of Mr. Flannery's job responsibilities to determine who received information and in what form. This was the role of Relationship Management, in conjunction with the legal department. Mr. Flannery reasonably believed that once the information was provided to Relationship Management — which the Division necessarily concedes happened with the FAQs — it was Relationship Management's responsibility, working in conjunction with Legal, to determine how to deliver that information to clients. To the extent there was a selective disclosure problem, it was Legal's job to identify that problem and work with Relationship Management to resolve it.

To prove that Mr. Flannery acted negligently, the Division must show that it was unreasonable for Mr. Flannery to rely on the company's expert securities lawyer, with whom he had

[31] Underlying the Division's allegation against Mr. Flannery is dissatisfaction with SSgA's disclosure and communication model — a model which, as expert John Peavy will testify, was standard in the industry. The Division would like the letters to be self-contained units with registration-like detail. These letters, however, ***supplemented*** information that SSgA already made available to investors and must be viewed in that light.

worked for years and whom he believed was in possession of the relevant facts, for guidance as to whether any additional facts should have been disclosed in the August 14th letter. In other words, the Division must prove that Mr. Flannery should have recognized that the letter might mislead clients when Mr. Duggan himself did not. Moreover, the Division must also show that he was unreasonable in relying upon SSgA's Relationship Management department—the very people within SSgA whose job it was to know what clients had and had not been told already. The Division will not be able to carry that burden.

2. The August 14 Letter Did Not Contain Material Misstatements or Omissions.

The "many judicious investors" language challenged by the Division was an opinion that Mr. Flannery and others both inside (*e.g.*, the Fixed Income team) and outside SSgA undisputedly held at the time. Such a forward-looking statement of opinion can only constitute a misrepresentation if the speaker did not sincerely hold that opinion when he made the statement. *See, e.g.*, *Brown v. Credit Suisse First Boston LLC*, 431 F.3d 36, 47, 49 (1st Cir. 2005) (to establish that a statement of opinion constituted securities fraud, a plaintiff must prove "that the speaker did not believe that particular opinion to be true when uttered"), *overruled in part on other grounds as stated in ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 F.3d 46, 52 (1st Cir. 2008); *Podany v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 146, 154 (S.D.N.Y. 2004) (allegations that "it would have been possible to reach a different opinion than that reached by defendant based on information available to defendant at the time, or even that the defendant's opinion was unreasonable" are insufficient to state a Section 10(b)/Rule 10b-5 claim) (cited with approval in *Credit Suisse First Boston*, 431 F.3d at 48-49). The "many judicious investors" language reflected Mr. Flannery's honest opinion as of August 14, 2007.

Even if the "many judicious investors" language is viewed as a statement of fact, it was not false. As discussed above, the recommendations of the advisory groups simply was not an indication that clients would choose to exit the fund *en masse*. Indeed, expert Erik Sirri will testify that it is generally inadvisable to redeem into an illiquid market. Furthermore, the evidence reflects that commingled funds within SSgA, which represented a far larger percentage of the portfolio than the internal advisory groups, *did hold their investments*, and took "in kind" distributions because they believed in the strategy.

In any event, the relevant facts — including the redemption recommendation by GAA — had already been disclosed to clients in prior communications, including the FAQs, which the August 14 letter was intended to supplement. The letter must be viewed in context of a larger effort to provide information to clients; it was never meant nor represented to contain all potentially-material information. Stated simply, the August 14 letter was just part of the total mix of information available to clients, and the letter did nothing to alter that mix.

3. The Division's Claims Based on the August 14 Letter Fail For Other Reasons

The Division's claims arising out of the August 14 letter claim also fail for the same reasons discussed in connection with the August 2 letter, above:

- Like the August 2 letter, nothing about the August 14 letter could be construed as an offer or sale of securities;
- With respect to § 17(a)(2), the Division does not allege and cannot show that Mr. Flannery obtained money or property in connection with the August 14 letter; and
- With respect to § 17(a)(3), in addition to the reasons just discussed, the Division does not allege any fraudulent or deceptive practice other than the letter itself.

IV. EVEN IF, CONTRARY TO LAW AND FACT, MR. FLANNERY COULD BE HELD LIABLE FOR EITHER LETTER, SANCTIONS ARE UNWARRANTED AND NOT IN THE PUBLIC INTEREST

Even if the Division could prove its claims in connection with either letter, there is no sound basis for sanctioning Mr. Flannery, as the imposition of sanctions would be contrary to the public interest. *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981) (public interest factors to be considered include 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 its conduct; and the likelihood of future violations; no one factor is controlling).

In his more than thirty years in the financial services business, Mr. Flannery has no record of prior misconduct of any sort. He has led an unblemished existence, both professionally and personally. His life has been marked by extensive service to charitable organizations, to his church, and to the community, and he has been significantly honored as a result of such service. He received no profit or other benefit as a result of either letter, and the Division has not alleged otherwise.

Mr. Flannery is an honest man, who sought to do the right thing. In connection with the August 2 letter, he merely offered a "single set" of suggested edits. He volunteered to author and send the August 14 letter, over the objections of his boss, who asked Mr. Flannery why he would "raise his head up." This conduct is far from egregious, and sanctioning Mr. Flannery would simply dissuade other executives from efforts at transparency, particularly where the Division has excused the conduct of those who had a far greater role in both letters and in investor communications generally.

It is easy to view the subprime crisis in hindsight, and it is tempting to seek to lay blame for the losses sustained. But it would be contrary to the public interest and fundamental fairness to place such blame at the feet of Mr. Flannery. Even a minimal sanction against Mr. Flannery would unfairly tarnish his otherwise highly distinguished career and personal reputation, and would not advance the public interest.

V. CONCLUSION

A finding against Mr. Flannery in connection with the August 2 and August 14, 2007 letters would be contrary to the evidence and the law. Accordingly, Mr. Flannery respectfully requests a ruling in his favor on all charges at the hearing of this matter.

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Respectfully Submitted,

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