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Judge rejects SEC action against State Street execs

Pair relied on in-house advice in sending letters

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A ruling involving the largest institutional fund management company in the world allows employees to rely more safely on advice they receive from in-house counsel, according to several lawyers familiar with the Securities and Exchange Commission case.

In *In the matter of Flannery, John P., et al.,* SEC Chief Administrative Law Judge Brenda P. Murray rejected an aggressive bid by the agency to hold two Boston-based employees from State Street Global Advisors liable for allegedly misleading investors in a series of client letters sent out during the 2007 subprime securities crisis.

Although the SEC has long pursued enforcement action against companies it believes to have violated securities laws, Boston lawyer Mark W. Pearlstein, who represented one of the respondent executives in *Flannery*, said the case is the rare instance in which the commission has tried to hold an *individual* responsible for allegedly misleading investors.

"This is a very significant decision in that if the judge had sided with the SEC, it would have almost literally required executives to retain their own personal disclosure attorney," said Pearlstein, who practices at McDermott, Will & Emery. "A contrary finding would have said that you cannot reasonably rely on the advice of well-informed, expert in-house counsel. Beyond being wildly impractical, it would have also led to some crazy policy."

Good-faith reliance

Before the letters that formed the basis of the SEC's charges were sent to investors, Pearlstein said, his client conferred in good faith with State Street's corporate legal department.
Those lawyers reviewed, edited and approved each letter, he said.

"But what the SEC told our clients, in effect, was that you don't qualify for the advice-of-counsel defense because they're the company's lawyers and not your own," Pearlstein said. "Unless you've unburdened yourself of all information that was relevant to the subject matter so that the lawyer was fully informed, the SEC was taking the position that you could not avail yourself of such a defense."

Pearlstein, who at one time served as acting U.S. attorney in Massachusetts, said the SEC's position fundamentally misconstrued the role of in-house counsel. It was also contrary to the way many large companies operate their legal departments, he added.

“There was no reason for my client to think anything other than the fact that the company’s lawyers were providing solid legal advice and that he was acting in good faith by following it,” he said. “What the judge found was that the in-house lawyer in question here had lots of sources of information about the State Street subprime exposure and that [my client] had every reason to rely on what he was being told.”

John F. Sylvia of Mintz, Levin, Cohn, Ferris, Glovsky & Popeo in Boston represented the other respondent. He said the SEC was simply looking for someone to blame in the aftermath of a well-publicized financial crisis.

After obtaining a settlement with State Street, the SEC set its sights on the respondents, Sylvia said.

“The message here is that it’s fine to blame individuals when you have evidence that they did something wrong, but it’s not fine to blame someone simply because you think you need to have a warm body,” he said.

The judge did not merely conclude that the SEC had failed to meet its burden of proof; she found that the respondents did nothing wrong, Sylvia said.

“This decision will only alleviate the concerns people have about the SEC’s charging decisions if you reach the conclusion that the SEC won’t do it again,” he said. “One would hope that a decision like this would cause the SEC to be more circumspect before being so aggressive, because the mere process of filing a complaint against someone and the damage it does to one’s reputation is really severe.”

Robert G. Flanders Jr., chairman of the litigation group at the Providence and Boston firm Hinckley, Allen & Snyder, said most securities laws require the government to prove an intent to deceive.

“What a decision like [*Flannery*] shows is that an employee’s reliance on the advice of counsel can go a long way toward vitiating any allegations of improper intent,” he said. “As long as the employee is acting in the course of his normal duties and in the business of his employer, then it would seem to be perfectly appropriate for that employee to seek out corporate counsel.”
David P. Bergers, the regional director of the SEC’s Boston office, could not be reached for comment prior to deadline.

Miscommunications?

In September 2010, the SEC filed a complaint against respondents John Flannery and James Hopkins. Flannery was State Street’s chief investment officer, and Hopkins was a vice president.

The SEC accused the respondents of misleading investors, via a series of letters and fact sheets sent out in 2007, about exposure to subprime investments in the marketing of a State Street bond fund. Even when investors started to raise concerns that the fund had only one subprime investment, the complaint alleged that Hopkins did nothing to correct the misunderstanding.

The SEC contended that the miscommunications continued through the summer of 2007. At a time when State Street’s internal advisory group advised clients to withdraw from the funds, the SEC said, Flannery and Hopkins encouraged others to continue to invest.

When the SEC charged State Street in February 2010 with misleading investors, the company paid more than $300 million as part of a settlement with Attorney General Martha Coakley and Secretary of State William F. Galvin.

The company spent an additional $350 million to resolve private complaints.
As part of the settlement, State Street agreed to provide information to the SEC about the potential liability of individuals working at the company.

In an administrative proceeding initiated against the respondents in September 2010, the SEC sought civil sanctions and a ban that would have prevented them from future employment with an investment company.

The court conducted a three-week trial in Washington, D.C., last winter, which produced more than 500 exhibits and 3,145 pages of transcripts.

Deeply involved
In an Oct. 28 decision, Murray wrote that the SEC failed to prove that Flannery or Hopkins had violated any securities law.

She found both men to be credible witnesses and noted “that neither [respondent] was responsible for, or had ultimate authority over, the allegedly false and materially misleading documents at issue in this proceeding.”

Murray said the letters in question were reviewed by numerous employees at the company, including portfolio managers and in-house lawyers.

In assessing a July 2007 letter that formed part of the SEC action, the judge wrote that the respondents did not sign or distribute the document and were not responsible for its final wording.

The unambiguous evidence, Murray said, was that members of State Street’s legal department were “involved deeply in the letter’s contents and approved its issuance.”

The judge also wrote that an attorney from the Boston office of Goodwin Procter
had been brought in by State Street to consult on the drafting of some of the letters.
Murray said the evidence in the case also failed to establish that the information in the letters contained material misrepresentations or omissions about the fund’s assets.

“Because I find there was no materially false or misleading statements or omissions, there can also be no fraudulent ‘course of conduct’ or ‘scheme liability,’” she said.