UNITED STATES SECURITIES and EXCHANGE COMMISSION, Plaintiff,

v.

Brian STOKER, Defendant.

No. 11 Civ. 7388(JSR).

United States District Court,
S.D. New York.

June 6, 2012.

Background: Securities and Exchange Commission (SEC) brought action against broker-dealer's director who had structured and marketed an allegedly fraudulent fund consisting of collateralized debt obligations (CDOs), alleging violations of the antifraud section of the Securities Act. Defendant moved to dismiss.

Holdings: The District Court, Jed S. Rakoff, J., held that:

(1) complaint sufficiently alleged that director, acting as broker-dealer's agent, facilitated a fraud in violation of antifraud section of the Securities Act;

(2) complaint sufficiently alleged that director caused fraudulent statement to be made; and

(3) complaint sufficiently alleged that director went beyond misrepresentations to engage in a course of business which operated as a fraud.

Motion denied.

1. Securities Regulation ⚷27.21

Securities and Exchange Commission (SEC) plausibly alleged that broker-dealer's director, acting as its agent, facilitated a fraud in violation of antifraud section of the Securities Act; Act clearly provided that violation could occur if defendant obtained funds either "directly or indirectly" and SEC alleged that director had obtained millions of dollars for his employer while acting as its agent, or, alternatively, that director had personally obtained money indirectly from structuring and marketing fraudulent fund of collateralized debt obligations (CDOs). Securities Act of 1933, § 17(a)(2), 15 U.S.C.A. § 77q(a)(2).

2. Securities Regulation ⚷27.19

Antifraud section of Securities Act prohibits a defendant from obtaining money "by means of" an untrue statement; liability attaches so long as the statement is used to obtain money or property, regardless of its source. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a).

3. Securities Regulation ⚷27.21

Securities and Exchange Commission (SEC) plausibly alleged that broker-dealer's director, acting as its agent, was responsible for allegedly fraudulent statements used to market a fund of collateralized debt obligations (CDOs), and in effect, caused the statement to be made, as required to state claim against director for violation of antifraud section of the Securities Act; director knew that the statements would be disseminated to investors because the statements were made in the marketing materials specifically prepared to send to investors to encourage them to invest in the fund, and although director chose language previously used by firm in other documents, he made substantial edits to the offering circular to reflect fraudulent terms of the fund. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a).

4. Securities Regulation ⚷27.34

A defendant cannot evade liability for violation of antifraud section of Securities Act by copying and pasting inapplicable or inaccurate information from other documents into sections of a document that he is responsible for, editing some parts of the old language, and leaving other inaccurate language in place. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a).

5. Securities Regulation ⚩27.19

A defendant may be liable under both Section 17(a)(2) and Section 17(a)(3) of Securities Act based on allegations stemming from the same set of facts, as long as Securities and Exchange Commission (SEC) alleges that defendant undertook a deceptive scheme or course of conduct that went beyond the misrepresentations. Securities Act of 1933, § 17(a)(2, 3), 15 U.S.C.A. § 77q(a)(2, 3).

6. Securities Regulation ⚩27.21

Securities and Exchange Commission (SEC) plausibly alleged that broker-dealer's director had gone beyond mere misrepresentation to engage in a transaction, practice, or course of business which operated as a fraud or deceit upon purchaser of security, so as to be liable under both Section 17(a)(2) and Section 17(a)(3) of Securities Act; although misrepresentations and omissions were part of original scheme to market fund of collateralized debt obligations (CDOs), they were not the entirety of it, since director knew that certain hedge funds were going to perform poorly, knew that broker-dealer sought to include as many of those CDOs as possible in the fund, had personally selected many of the CDOs offered, and knew that a significant part of the rationale for broker-dealer's creation of the fund was to short certain CDOs for its own account. Securities Act of 1933, § 17(a)(2, 3), 15 U.S.C.A. § 77q(a)(2, 3).

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Brook Dooley, Caitlin Bales Noel, Daniel W. Gordon, Jan Nielsen Little, John W. Keker, Steven K. Taylor, San Francisco, CA, for Defendant.

OPINION

JED S. RAKOFF, District Judge.

The Complaint in this securities fraud action alleges that defendant Brian Stoker negligently violated Section 17(a)(2) & (3) of the Securities Act of 1933, 15 U.S.C. 77q(a)(2) & (3), in connection with his role in structuring and marketing a largely synthetic collateralized debt obligation ("CDO") called Class V Funding III ("Class V III").[1] On December 16, 2011, Stoker moved to dismiss all counts of the Complaint on three grounds: first, that the claim under Section 17(a)(2) fails to allege that Stoker personally obtained money or property by means of the alleged misleading statements or omissions; second, that that same claim fails to plausibly allege that Stoker had ultimate authority over, or was personally and primarily responsible for, the alleged misleading statements or omissions; and third, that the claim under Section 17(a)(3) fails to plausibly allege a fraudulent or deceptive scheme distinct from the misstatements and omissions alleged in the Section 17(a)(2) claim. On February 14, 2012, this Court issued a "bottom-line" order denying Stoker's motion. This Opinion explains the reasons for that ruling.

A motion to dismiss tests, not the truth of the Complaint's allegations, but simply

1. This case is related to *SEC v. Citigroup Global Mkts. Inc.,* 11 Civ. 7387(JSR). Although the Second Circuit has granted a stay of the *Citigroup* case pending the appeal of this Court's denial of the parties' proposed consent judgment, *see SEC v. Citigroup Global Mkts. Inc.,* 673 F.3d 158 (2d Cir.2012) (per curiam), the stay affects only the *Citigroup* case and does not affect this related case.

whether the allegations state a legal cause of action. The allegations here pertinent are the following.

Citigroup Global Markets Inc. (hereinafter "Citigroup") is the principal U.S. broker-dealer of Citigroup Inc. Compl. ¶ 10. Credit Suisse Alternative Capital, LLC ("CSAC") is a registered investment adviser.[2] *Id.* ¶ 11. From March 2005 to August 2008, defendant Stoker was a director in a division of Citigroup that structured and marketed collateralized debt obligations ("CDOs"). *Id.* ¶ 9.

CDOs are debt securities collateralized by fixed income obligations, such as residential mortgage-backed securities. *Id.* ¶ 12. A CDO collateralized by other CDOs is called a "CDO squared." *Id.* One such CDO squared portfolio was a fund called "Class V III" (the "Fund").[3] *Id.* ¶ 9. Under the terms of the Fund and similar instruments, a "protection buyer" makes periodic premium payments to a "protection seller." In return, the protection seller agrees to pay the protection buyer if the CDO experiences a default. Piercing through the jargon, the protection seller is effectively taking a long position on the CDO, while the protection buyer is effectively taking a short position. *Id.* ¶ 13.

During late 2006 and early 2007, certain hedge funds "came to believe that mezzanine CDOs (CDOs whose assets consisted primarily of BBB-rated subprime residential mortgage-backed securities) would experience significant losses, leading even the A-rated tranches of mezzanine CDOs to potentially become worthless." *Id.* ¶ 20. By late October 2006, Citigroup's CDO trading desk had a large number of hedge fund customers seeking to buy protection on CDO tranches, particularly on mezzanine CDOs originated in 2006. Citigroup knew that there was significant demand from these hedge funds to short certain CDOs that were part of a series of transactions that were named after constellations (the "Constellation CDOs"). *Id.* ¶ 21. Moreover, "as Citigroup knew, a significant portion of the market interest in shorting the Constellation CDOs came from the very hedge fund that helped create those CDOs." *Id.* There was also significant market interest in shorting a similar group of CDOs, known as "President" deals. *Id.*

In late 2006, "internal discussions began at Citigroup" about the possibility of creating a CDO squared collateralized by some of the riskier CDOs. A "significant part" of Citigroup's rationale for creating such a fund was that it would enable Citigroup's trading desk to take a "naked short" position on those CDOs—in other words to buy protection on those CDOs for its own account—without an offsetting long trade with a customer. *Id.* ¶ 23. However, Citigroup "knew it would be difficult to place the liabilities of a CDO squared if it disclosed to investors its intention to use the vehicle to short a hand-picked set of CDOs and to buy Citigroup's hard-to-sell cash CDOs." *Id.* ¶ 25.[4] On the other hand, "Ci-

2. In December 2010, CSAC became Credit Suisse Asset Management, LLC. For the sake of consistency, this Opinion will refer to this entity as CSAC throughout.

3. The SEC alternates between labeling the Fund as a "CDO squared," Compl. ¶ 1, and a "hybrid CDO." *Id.* ¶ 14. A hybrid CDO is a CDO collateralized by both cash assets and synthetic assets. *Id.* The Fund was both a hybrid CDO and a CDO squared.

4. For reasons unknown, this key allegation of fraudulent knowledge on the part of Citigroup is omitted from the parallel Complaint against Citigroup itself. *See* Complaint, *SEC v. Citigroup,* 11 Civ. 7387, Dkt. 1 ("Citigroup Compl."). Additionally, the Citigroup Complaint does not include such related allegations of the instant Complaint as that Citigroup knew that the hedge fund that created

tigroup knew that representing to investors that an experienced, third-party investment adviser [like CSAC] had selected the investment portfolio would facilitate the placement of the notes that the CDO squared would issue." *Id.*

Beginning in October 2006, personnel from Citigroup's CDO trading desk discussed with Stoker and others on Citigroup's CDO structuring desk the possibility that Citigroup would take short positions on a specific group of assets, including several Constellation and President deals. *Id.* ¶ 24. Stoker and other Citigroup employees also discussed the possibility of having the Fund purchase unsold tranches from CDOs that remained on Citigroup's books. *Id.* Stoker engaged in internal discussions about potential structures for the CDO squared, including the possibility that Citigroup would short assets into the CDO squared. *Id.* ¶ 28. Stoker prepared and distributed models showing the potential profits for Citigroup from shorting assets into the Fund. *Id.* On October 23, 2006, Citigroup's trading desk sent Stoker a list of 21 CDOs that it wished to short into the CDO squared; eighteen of those CDOs were Constellation or President deals. *Id.* ¶ 27. Stoker sent that list to a salesperson who sent it to CSAC; on November 2, 2006, the Managing Director on the CDO trading desk informed Stoker that CSAC appeared "amenable to the portfolio" and "receptive to the concept," and asked Stoker to draft an engagement letter for CSAC. *Id.* ¶ 31.

Stoker did so, and on November 3, 2006, Stoker was asked by his supervisor if the deal was going through. He replied, "I hope so. This is [Trading Desk Head]'s prop trade (don't tell CSAC). CSAC agreed to terms even though they don't get to pick the assets." *Id.* ¶ 32. "Prop trade" stands for "proprietary trade," which means "a trade undertaken for a firm's own account, rather than on behalf of the firm's customer(s)." *Id.*

On November 14, 2006, Stoker's supervisor told Stoker that Stoker should ensure that the structuring desk received "credit for profits" on the Fund. *Id.* ¶ 33. A week later, Stoker circulated the "latest structure" of the Fund, which included his recommendations about which assets to include in the final deal. *Id.* ¶ 34. In December 2006, CSAC and Citigroup agreed to go forward with the Fund. CSAC sent the Citigroup salesperson a list of 127 potential assets to include in the Fund; the salesperson forwarded the list to Stoker. The list included 19 of the original 25 names Citigroup had provided to CSAC. *Id.* ¶ 36. Citigroup selected 25 of the assets on CSAC's list and simultaneously told CSAC that it wanted to short those assets; 16 of the assets were Constellation or President deals, and all but one were 2006 mezzanine CDOs of the type that Citigroup's hedge fund clients had been eager to short. *Id.* ¶ 37. "Within an hour, CSAC agreed to include those 25 CDOs in the investment portfolio by selling protection to Citigroup" on those CDOs. *Id.*

On January 8, 2007, Citigroup and CSAC entered into an engagement letter, drafted by Stoker, pursuant to which Citigroup agreed to serve as "Placement Agent" and CSAC agreed to serve as "Manager" for the Fund. *Id.* ¶ 39. Two days later, with little or no involvement from Citigroup, CSAC selected 18 additional assets to include in the Fund. Citigroup did not take a short position on any of these assets. In fact, Citigroup only

the Constellation CDO also wanted to bet against it. *See id.*

took a short position on the assets it itself chose for inclusion in the Fund. *Id.* ¶ 59.

On January 12, 2007, Citigroup and CSAC agreed that Citigroup would double its investment in the Fund by doubling the amount that it had shorted each CDO in the Fund. *Id.* ¶ 42. This increased Citigroup's short position to approximately $500 million, including $490 million in "naked" (i.e. unprotected) shorts; this $500 million bet represented half of the Fund's investment portfolio. *Id.*

The two primary marketing documents for the Fund were "the offering circular (similar to a prospectus) and the pitch book (a PowerPoint presentation used in discussions with potential investors)." *Id.* ¶ 47. According to the Complaint, "[a]s lead structurer for Class V III, Stoker was responsible for ensuring the accuracy and completeness of the offering circular and the pitch book." *Id.* Both documents were adapted from documents used by Citigroup for earlier transactions. *Id.*

The Transaction Overview of the pitch book stated that CSAC was the "Manager" and that CSAC had selected the collateral for the Fund. *Id.* ¶ 49. The Manager Section, a 20–page section originally provided by CSAC, included a detailed, nine-page section titled "Portfolio Construction and Management," which described CSAC's purportedly rigorous approach to selecting each asset it included in the investment portfolio of its CDOs. *Id.* ¶ 49. This section stated that a key element of CSAC's "process" was "bottom-up fundamental security selection." *Id.* The offering circular identified as a risk factor the fact that the performance of the Fund's investment portfolio "depends on the investment strategy and investment process of the Manager in analyzing, selecting and managing the [portfolio]." *Id.* ¶ 54.

Page 88 of the 192–page offering circular included a generic disclosure that Citigroup "may provide CDS Assets as an intermediary with matching off-setting positions requested by [Credit Suisse] or may provide CDS Assets alone without any off-setting positions." *Id.* ¶ 56. The materials did not mention, however, that Citigroup, already had a $500 million short position on the collateral, or that the Fund was structured as a "prop trade," whose purpose was to allow Citigroup to short the assets for its own account. *Id.* ¶ 58–59. The marketing materials also did not disclose Citigroup's "substantial role" in selecting the assets for the Fund, or that Citigroup's proprietary short position was comprised of the CDOs it had been allowed to select, while Citigroup did not short those CDOs which it had no role in selecting. *Id.* ¶ 59.

On February 6, 2007 Stoker personally sent a copy of the pitch book to a prospective investor, along with a note declaring that the Fund was a "top of-the-line CDO squared." *Id.* ¶ 62. Later, when a potential investor raised questions about the Fund, the head of Citigroup's CDO syndicate desk sent an email to Citigroup employees, including Stoker, with the following instruction: "[CSAC] bought these static bonds and ... should have a rationale as to why [CSAC] found them attractive." *Id.* ¶ 63. Another Citigroup employee replied to everyone on the email and said that CSAC could "come up with stories for some" of the assets in the Fund, "but not all of them." *Id.*

The largest investor and long buyer in the Fund was Ambac Credit Products ("Ambac"). In January and February 2007, Stoker participated in "extensive discussions" with Ambac about the terms of Ambac's investment in the Fund, and in mid-February, Stoker personally provided a copy of the offering circular to Ambac. *Id.* ¶¶ 66, 68. Ambac's internal documents approving the investment in the Fund con-

tained extensive discussion of CSAC's purported expertise and asset selection process and noted the importance of CSAC's disciplined approach to the selection of securities. *Id.* ¶ 67.

The 25 CDOs selected by Citigroup for inclusion in the Fund performed significantly worse than other CDOs in the Fund and other comparable CDOs. *Id.* ¶ 76. Nine months after the transaction closed, the Fund experienced an event of default. *Id.* ¶ 77.

Citigroup was paid approximately $34 million in fees for structuring and marketing the Fund and, as a result of those fees and Citigroup's short position on the $500 million in assets in the Fund, Citigroup realized net profits of approximately $160 million. *Id.* ¶ 79.

In 2006, Citigroup paid Stoker a salary of $150,000 and a bonus of $1,050,000. In February 2007, Stoker negotiated a salary of $150,000 and a guaranteed bonus of $2.25 million for 2007. *Id.* ¶ 80.

Given the foregoing allegations, the Complaint appears to describe a rather straightforward fraud, facilitated and marketed in significant part by Stoker, by which Citigroup was able to dump some of its worse CDOs on investors by misrepresenting that the CDOs had been selected by CSAC when for all practical purposes many had been selected by Citigroup, which was betting on the failure of those CDOs that it had selected. On this basis, the Complaint charges Stoker with violations of the antifraud section of the 1933 Act, § 17(a), which makes it:

> unlawful for any person in the offer or sale of any securities ... by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a). More specifically, the Complaint alleges that Stoker violated subsections (2) and (3) of Section 17(a).[5]

Stoker makes two arguments why the Section 17(a)(2) claim against him fails. First, Stoker argues that the Complaint fails to allege that Stoker was able "to obtain money or property" by means of the fraud. He concedes that the Complaint alleges that Citigroup made money from the fraud, but argues that this cannot be imputed to Stoker personally. He also concedes that the Complaint alleges that his own compensation dramatically increased around the time of the fraud but argues that the Complaint does not link this to the fraud in a sufficiently direct way to qualify as "obtain[ing] money or property by means of" the fraud.

The case law addressing these points is surprisingly sparse, and inconclusive. The only case from any court in this Circuit is *SEC v. Glantz,* No. 94 Civ. 5737, 1995 WL 562180 (S.D.N.Y. Sept. 20, 1995). There, the defendant, Block, argued that the SEC failed to state a claim under Section 17(a)(2) because the Complaint did not allege that he profited from the alleged fraud. Judge Haight found that the defendant was not required to profit from the

5. For reasons unknown, the SEC chose not to allege violations of subsection (1).

misstatements because "[t]he plain language of the statute specifically imposes liability on all those who 'obtain money or property through fraud,' not only on those who 'profit' from such activity." *Id.* at *5. Thus, *Glantz* does not directly address the question here presented of what relationship between the defendant and the money or property fraudulently obtained is sufficient to satisfy Section 17(a)(2).[6]

Although a few cases from district courts outside this Circuit have addressed the issue, their holdings are split and their analysis meager. *Compare SEC v. Delphi Corp.,* No. 06–14891, 2008 WL 4539519, at *30 (E.D.Mich. Oct. 8, 2008) (Section 17(a)(2) "does not require that the person alleged to have made the false or misleading statement ... obtain money or property for [him]self;" it is sufficient that the defendant obtained the money for his employer) *with SEC v. Daifotis,* No. C 11–00137 WHA, 2011 WL 2183314, at *10 (N.D.Cal. June 6, 2011) ("[t]he parties cite opposed out-of-circuit district court decisions on this question; this order finds those requiring the defendant's [personal] receipt of money or property to be consistent with the statutory language and thus more persuasive"); *SEC v. Burns,* No. 84–0454, 1986 WL 36318, at *3–4 (S.D.Cal. Feb. 19, 1986) (the defendant must "personally acquire[ ] money or property").

[1] The Court concludes that it is sufficient under Section 17(a)(2) for the SEC to allege that Stoker obtained money or property for his employer while acting as its agent, or, alternatively, for the SEC to allege that Stoker personally obtained money indirectly from the fraud.

To begin with, the statute, on its face, does not state that a defendant must obtain the funds personally or directly. On the contrary, all three prongs of liability under Section 17(a) are preceded by the common modifier "directly or indirectly." It would be contrary to this language, and to the very purpose of Section 17(a), to allow a corporate employee who facilitated a fraud that netted his company millions of dollars to escape liability for the fraud by reading into the statute a narrowing requirement not found in the statutory language itself. As the Supreme Court has repeatedly stated, "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purpose.' " *Affiliated Ute Citizens of Utah v. United States,* 406 U.S. 128, 151, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972) (quoting *SEC v. Capital Gains Research Bureau,* 375 U.S. 180, 195, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963)).[7]

The SEC has plausibly alleged that Stoker, acting as Citigroup's agent, facili-

6. While Stoker argues that *Glantz* impliedly assumes that the defendant must personally obtain money or property for himself, Judge Haight made no such finding and the thrust of *Glantz* is actually to the contrary. In *Glantz,* the Complaint alleged that Block's co-defendant had personally pocketed $400,000 of the funds obtained by the fraud, but that other funds were obtained by the *company* for which Block served as counsel. *Glantz,* 1995 WL 562180, at *5. Thus, Judge Haight's rejection of Block's motion to dismiss necessarily rested on the assumption that Block's obtaining money for the company for which he was counsel was within the scope of the statute.

7. It is also worth noting that Section 17(a) is modeled on the federal mail fraud statute, 18 U.S.C. § 1341 (enacted 1872). *See* Robert A. Prentice, *Scheme Liability: Does it Have a Future After Stoneridge?,* 2009 Wisc. L.Rev. 351, 365 n. 77. Applying language in that statute similar to Section 17(a), the Second Circuit has held that the statute does not require that "the defendant must receive the same money or property that the deceived party lost, but only that the party deceived must lose money or property." *United States v. Evans,* 844 F.2d 36 (2d Cir.1988).

tated a fraud by which Citigroup obtained millions of dollars by means of material misstatements and omissions. For example, the Complaint alleges in detail that investors would not have invested in the Fund if they had known that it was actually Citigroup that had effectively chosen many of the Fund's assets while maintaining a short position in those assets. Compl. ¶¶ 67, 69. Moreover, Stoker and Citigroup "knew it would be difficult to place the liabilities of a CDO squared if [Citigroup] disclosed to investors its intention to use the vehicle to short a hand-picked set of CDOs and to buy Citigroup's hard-to-sell cash CDOs." *Id.* ¶ 25. Stoker and Citigroup also knew that "representing to investors that an experienced, third-party investment adviser had selected the investment portfolio would facilitate the placement of the CDO squared's liabilities." *Id.* Without multiplying examples, it is clear that such allegations are, in the Court's reading of Section 17(a)(2), more than sufficient to impose liability on Stoker.

Alternatively, it is likewise sufficient that the Complaint alleges that Stoker, personally, though indirectly, profited from the fraud through increased compensation from Citigroup. Specifically, the Complaint alleges that in February 2007, Stoker successfully negotiated a doubling of his yearly bonus (from a little over $1 million to $2.25 million). Compl. ¶ 80. Although Stoker argues that his "salary and bonus could not have been tied to the alleged omissions from the pitch book and offering circular" because the Fund did not close until February 28, 2007, *see* Memorandum in Support of Brian H. Stoker's Motion to Dismiss ("Def. Mem.") at 12, CSAC and Citigroup agreed to the deal in December, 2006 and the negotiations about Stoker's bonus occurred after Stoker's supervisor told him to make sure that his desk got credit for the profits earned by the Fund. *Id.* at ¶¶ 33, 35. Reading these allegations most favorably to plaintiff, they permit the plausible inference that Stoker's compensation increase was at least partly the fruit of his fraud.

As a second reason for dismissing the Section 17(a)(2) claim, Stoker asserts that "the Complaint fails to allege facts sufficient to support the conclusion that Stoker should be the one individual at Citigroup held legally responsible for the alleged omissions from the pitch book and offering circular." Def. Mem. at 1. As defendant's papers make clear, the assertion here is not that Stoker has been wrongfully singled out among several persons who hypothetically could have been sued for facilitating the alleged fraud, but rather that the Complaint fails to adequately allege that Stoker was the person who "made" or was responsible for the alleged false statements in the pitch book and offering circular. But while there is much case law analyzing the requirements for "making" a statement under Rule 10b–5, and while Stoker argues that all of this case law likewise applies to a claim brought under Section 17(a), this argument is misplaced.

[2] It is true, of course, that much of the wording of Section 17(a) of the Securities Act of 1933 is similar to the wording of Rule 10b–5 promulgated under Section 10(b) of the Securities and Exchange Act of 1934, leading the Second Circuit in a case that did not present the instant issue to note that "*[e]ssentially* the same elements [as those required to show a violation of section 10(b) and Rule 10b–5] are required under Section 17(a)(1)-(3) in connection with the offer or sale of a security." *See SEC v. Monarch Funding Corp.,* 192 F.3d 295, 308 (2d Cir.1999) (emphasis added). But when it comes to the issue here presented, there are significant difference between the language of 17(a) and

the language of 10b–5 that dictate different results. *See Aaron v. SEC,* 446 U.S. 680, 695–97, 100 S.Ct. 1945, 64 L.Ed.2d 611 (1980). Specifically, Section 17(a)(2), unlike Rule 10b–5, prohibits a defendant from obtaining money "by means of" an untrue statement. Accordingly, Stoker may be held liable under 17(a)(2), though not under 10b–5, if, he obtains money or property *by use* of a false statement, whether prepared by himself or by another. *SEC v. Tambone,* 550 F.3d 106, 127 (1st Cir.2008) *reh'g en banc granted, opinion withdrawn,* 573 F.3d 54 (1st Cir.2009) and *opinion reinstated in relevant part on reh'g,* 597 F.3d 436 (1st Cir.2010) (en banc). As the First Circuit held in *Tambone,* the text of Section 17(a)(2) makes clear that "[l]iability attaches so long as the statement is *used* 'to obtain money or property,' regardless of its source." *Id.; see also SEC v. Radius Capital Corp.,* 2:11–CV–116–FTM–29, 2012 WL 695668 (M.D.Fla. Mar. 1, 2012) (adopting the *Tambone* rule).

This conclusion is implicitly strengthened by a close reading of the Supreme Court's recent decision in *Janus Capital Group, Inc. v. First Derivative Traders,* ––– U.S. ––––, 131 S.Ct. 2296, 2302, 180 L.Ed.2d 166 (2011), on which, ironically, Stoker purports to rely. *Janus* was a private action brought under Rule 10b–5, which extends liability to a defendant who "make[s] any untrue statement of a material fact." In *Janus,* Justice Thomas undertook a textual analysis of the word "make," explaining:

> "One 'makes' a statement by stating it. When 'make' is paired with a noun expressing the action of a verb, the resulting phrase is 'approximately equivalent in sense' to that verb. For instance, 'to make a proclamation' is the approximate equivalent of 'to proclaim,' and 'to make a promise' approximates 'to promise.' The phrase at issue in Rule 10b–5, '[t]o make any . . . statement,' is thus the approximate equivalent of 'to state.' "

Id. at 2303 (citing 6 Oxford English Dictionary 66; Webster's New International Dictionary 1485).

By contrast, Section 17(a), as noted, prohibits a defendant from obtaining money "by means of" an untrue statement. Although "to make a statement" is the equivalent of "to state," to obtain money "by means of" a statement plainly covers a broader range of activity. Thus, the emphasis of the *Janus* Court on the word "make" serves, if anything, to highlight the importance of the difference in language between the two provisions.

The Court in *Janus* was also concerned with the fact that, since a private right of action is implied under section 10(b) of the 1934 Act, Rule 10b–5 should be read narrowly, since "concerns with the judicial creation of a private cause of action caution against its expansion." *Id.* at 2302 (quoting *Stoneridge Investment Partners, LLC v. Scientific–Atlanta, Inc.,* 552 U.S. 148, 165, 128 S.Ct. 761, 169 L.Ed.2d 627 (2008)). By contrast, there is no need to read Section 17(a) narrowly in light of concerns about the implied private cause of action, because there is no private right of action—implied or explicit—under Section 17(a). *See Finkel v. Stratton Corp.,* 962 F.2d 169, 174 (2d Cir.1992).

Accordingly, the Court concludes that *Janus* implicitly suggests that Section 17(a)(2) should be read differently from, and more broadly than, Section 10(b).[8]

8. At oral argument, Stoker stated that a "very lengthy" decision by Judge Murray, an SEC Administrative Law Judge, had held that *Janus* applied to Section 17 cases and was "worthy of consideration." See *Transcript of Oral Argument,* Jan. 25, 2012 ("Tr.") at 14. While

See also SEC v. Pentagon Capital Mgmt. PLC, 844 F.Supp.2d 377 (S.D.N.Y.2012) ("Nor does *Janus* apply to SEC enforcement claims brought pursuant to Section 17(a) of the Securities Act."); *SEC v. Sentinel Management Group, Inc.,* No. 07 C 4684, 2012 WL 1079961, at *15 (N.D.Ill. Mar. 30, 2012) (*Janus* is inapplicable to Section 17(a) claims because the wording of Rule 10b–5 and Section 17(a) are different, and the policy concerns applicable in *Janus* do not apply to Section 17(a) claims); *SEC v. Mercury Interactive, LLC,* No. 5:07–cv–02822, 2011 WL 5871020, at *3 (N.D.Cal. Nov. 22, 2011) ("*Janus* may not be extended to statutes lacking the very language that *Janus* construed"); *SEC v. Daifotis,* 2011 WL 3295139, at *5 (N.D.Cal. Aug. 1, 2011) (declining to apply *Janus* to Section 17(a) claims because the word "make" does not appear in the language of Section 17(a)); *SEC v. Geswein,* No. 10–cv–1235, 2011 WL 4565861, at *2 (N.D.Ohio Sept. 29, 2011) (same); *but see SEC v. Kelly,* 817 F.Supp.2d 340, 345 (S.D.N.Y.2011) (holding that *Janus* does apply to a case brought under Section 17(a)(2)).

Although the Court adopts the *Tambone* standard and finds it fully consistent with *Janus,* it is worth noting that the Complaint also meets one of the higher standards sought by Stoker. Specifically, Stoker argues that if the 10b–5 standard set forth in *Janus* does not apply to the instant case, the Court should adopt the standard set forth by Judge Cote in a case that predates both *Janus* and *Tambone.* In that case, Judge Cote held that the SEC must allege that Stoker was "sufficiently responsible for the statement—in effect, caused the statement to be made—and knew or had reason to know that the statement would be disseminated to investors." *See SEC v. KPMG LLP,* 412 F.Supp.2d 349 (S.D.N.Y.2006).

[3, 4] Here, the Complaint meets the *KPMG* standard. To begin with, Stoker did know that the statements would be disseminated to investors, because the statements were made in the marketing materials specifically prepared to send to investors to encourage them to invest in the Fund. Compl. ¶ 4, 47, 62. As for the sections of the pitch book originally written by Citigroup, and specifically the Risk Factors section, the Complaint adequately alleges that Stoker and his team chose language from a previous Citigroup document, copied this language into a new document, and made edits to some of the language. Compl. ¶ 48.[9] The portions of the offering circular originally written by Citigroup were also drafted by Stoker and his team. *Id.* ¶ 50. Although Stoker used an offering circular from a previous transaction as a template, he made "substantial edits" to the offering circular to reflect the terms of the Fund. *Id.* at ¶¶ 50–51. A defendant cannot evade liability by copying and pasting inapplicable or inaccurate in-

the opinion as a whole was lengthy, Judge Murray's analysis of the issue here presented was quite limited. She cited two district court cases that came out on opposite sides of the question, and then she simply stated, "[t]his case involves allegations of materially false or misleading statements or omissions, and I find the *Janus* test to be the appropriate standard to apply in evaluating the extent of Respondents' conduct." *In the Matter of Flannery,* SEC Release No. 438, 2011 WL 5130058, at *34 (ALJ Oct. 28, 2011).

9. The Risk Factors section stated that CSAC had "selected" the collateral for the Fund. Compl. ¶ 49. Moreover, the statute covers both misstatements and material omissions, and the pitch book omitted any reference to Citigroup's role in the selection of the assets as well as the fact that it already had a naked short position in the assets that it helped to select.

formation from other documents into sections of a document that he is responsible for, editing some parts of the old language, and leaving other inaccurate language in place.[10]

The more difficult question, if the *KPMG* standard were to apply, is whether Stoker can also be held liable for statements made in the "Manager" sections of the pitch book and offering circular, which were the portions originally drafted by CSAC. *See* Compl. ¶ 49, 54.[11] Standing alone, the allegation in the Complaint that Stoker was "responsible for ensuring the accuracy and completeness of the offering circular and pitch book," Compl. ¶ 47, which the SEC calls a factual allegation, Plaintiff's Memorandum of Law in Opposition to Motion to Dismiss ("Pl. Mem.") at 22, might well be too conclusory to survive the motion to dismiss. But, in light of the other factual allegations in the Complaint related to Stoker's role in marketing the Fund, and specifically his role in drafting and editing significant portions of the pitch book and offering circular, *see, e.g.,* Compl. ¶ 47, 50, 51, the Court finds that the SEC has plausibly alleged that Stoker was responsible for all of the misstatements and omissions in the pitch book and offering circular.

[5, 6] Turning to the claim under Section 17(a)(3), that section prohibits a defendant from engaging "in any transaction, practice, or course of business which operates . . . as a fraud or deceit upon the purchaser" of any security. 15 U.S.C. § 77q(a)(3). Although Stoker argues that the Section 17(a)(3) claim alleged in the Complaint is duplicative of the Section 17(a)(2) claim, a defendant may be liable under both Section 17(a)(2) and Section 17(a)(3) based on allegations stemming from the same set of facts as long as the SEC alleges that the defendants "undertook a deceptive scheme or course of conduct that went beyond the misrepresentations." *In re Alstom SA, Sec. Litig.,* 406 F.Supp.2d 433, 475 (S.D.N.Y.2005). Here, the Complaint plausibly alleges a course of conduct beyond the misrepresentations that are covered by Section 17(a)(2). The misrepresentations and omissions were part of that conduct, but they were not the entirety of it. In particular, the Complaint alleges that Citigroup knew that certain hedge funds, including the hedge fund that created one of the CDOs, thought that particular CDOs (President and Constellation CDOs) were going to perform poorly. *Id.* ¶ 20. The Complaint further alleges that Citigroup sought to include as many of those CDOs as possible in the Fund, *id.* ¶ 27, and that, indeed, a significant part of the rationale for Citigroup's creation of the Fund was to short certain mezzanine CDOs for its own account. *Id.* ¶ 23. Stoker himself recommended the inclusion of President and Constellation deals in the Fund, *id.* ¶ 32, and discussed the possibili-

10. Stoker asserts that "the fact that Stoker did not edit or change the sections of the offering circular that the SEC contends were misleading strongly suggests that he was *not* responsible for those sections." Def. Mem. at 18 (emphasis in original). Stoker's assertion is one plausible inference that one could draw from the Complaint, but it is far from the only plausible inference. At least as plausible is that Stoker took language that was arguably not misleading in other contexts and adapted it to a context in which it became materially misleading.

11. That section also continued a disclaimer that "[i]nformation related to CSAC . . . has been provided by CSAC. Citigroup is not responsible for the content of the following section and has not independently verified any such information." Little Decl. Ex. A at CITI 09570344. But in fact, according to the Complaint, Stoker was responsible for ensuring the accuracy of the entire pitch book. Compl. ¶ 47.

ty of including in the Fund CDO tranches that were unsold and still on Citigroup's books. *Id.* ¶ 24.

Furthermore, Citigroup engaged CSAC as a collateral manager because it knew that it would not be able to sell the assets in the Fund unless investors thought they were chosen by a reputable outside entity. *Id.* ¶¶ 25–26. Then Citigroup worked to get CSAC to include particular assets, so that Citigroup could short them. *Id.* ¶¶ 27–30. Stoker was involved in the discussions of which assets to include in the Fund and which assets to short; he prepared models showing the potential profits to Citigroup from shorting specific assets into the CDO squared. *Id.* ¶¶ 24, 28. Stoker was aware that the Fund was designed as a proprietary trade, and he ensured that CSAC did not know about this arrangement by telling his supervisor not to tell CSAC that Citigroup had designed the Fund as a proprietary trade. *Id.* ¶ 32. Stoker actively encouraged particular investors to invest in the Fund, and when he sent the pitch book to one prospective investor, he said that the Fund was a "top-of-the-line CDO squared," *id.* ¶ 62, even though he knew that Citigroup had chosen assets for the Fund that it believed were likely to perform poorly. In the end, Citigroup induced CSAC to include 25 assets in the Fund, on which it took a $500 million short position. *Id.* ¶¶ 36–38, 41–43. These assets performed significantly worse than the other assets in the Fund. *Id.* ¶ 76.

Although these allegations are more than sufficient to state a claim under Section 17(a)(3), the SEC also asserts that "the factual allegations in the Complaint depict [the Fund] as a transaction that was intended by Citigroup as a vehicle to position it to profit from the downturn in the United States housing market by buying protection through CDS on A-rated tranches of mezzanine CDOs." Pl. Mem. at 24 (citing Compl. ¶ 20).[12] It is true that paragraph 20 of the Complaint does not specifically mention Stoker or Citigroup; that paragraph alleges only that market participants sought to benefit from the downturn in the housing markets. The succeeding paragraphs, however, state that Citigroup knew that there was significant market demand to short certain assets because market participants believed they would perform poorly, that Citigroup discussed how it would profit from shorting those assets, and that Citigroup chose assets that it knew other market participants had already bet were going to fail. Compl. ¶¶ 21–27. Therefore, a more than plausible inference from the Complaint is that Citigroup also sought to benefit from a downturn in the housing market by selecting and shorting these particular assets.

Together, all of these allegations, especially when combined with the misstatements and/or omissions in the marketing materials, are more than sufficient to state a claim under Section 17(a)(3).

For the foregoing reasons, the Court reaffirms its Order dated February 14, 2012 denying Stoker's motion to dismiss.

12. Stoker argues that these assertions would describe an intentional fraud, but that the SEC has only pled negligence. Def. Reply Mem. at 9. It is true that the SEC's decision to only charge negligence seems inconsistent with many of its allegations in the Complaint that so plainly imply intentional fraud. Nonetheless, these allegations may also be read to allege that Stoker was at least negligent, and there is no further scienter required under Section 17(a).