INITIAL DECISION RELEASE NO. 590
ADMINISTRATIVE PROCEEDING
FILE NO. 3-15141

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of	:	
	:	
MOHAMMED RIAD and	:	INITIAL DECISION
KEVIN TIMOTHY SWANSON	:	April 21, 2014

APPEARANCES: Robert M. Moye, Jeffrey A. Shank, and Benjamin J. Hanauer for the Division of Enforcement, Securities and Exchange Commission

Richard D. Marshall, Eva C. Carman, and Jon A. Daniels of Ropes & Gray LLP for Respondents Mohammed Riad and Kevin Timothy Swanson

BEFORE: Carol Fox Foelak, Administrative Law Judge

SUMMARY

This Initial Decision (ID) concludes that Mohammed Riad (Riad) and Kevin Timothy Swanson (Swanson) (collectively, Respondents) violated the antifraud provisions of the federal securities laws while employed at an investment adviser that managed the portfolio of a closed-end investment company. The ID orders them to cease and desist from further violations and bars them from the securities industry. Additionally, the ID orders Riad to disgorge ill-gotten gains of $188,948.52 plus prejudgment interest and orders each to pay a third-tier civil penalty of $130,000.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission (Commission) instituted this proceeding with an Order Instituting Proceedings (OIP) on December 19, 2012, pursuant to Section 21C of the Securities Exchange Act of 1934 (Exchange Act), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 (Advisers Act), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (Investment Company Act). The undersigned held an eleven-day hearing between April 22 and May 8, 2013, in St. Louis, Missouri, Chicago, Illinois, and Washington, D.C. Twenty witnesses testified, including Riad and Swanson and three expert witnesses, and numerous exhibits were admitted into evidence.[1]

The findings and conclusions in this ID are based on the record. Preponderance of the evidence was applied as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 97-104 (1981). Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), the parties' Proposed Findings of Fact and Conclusions of Law and Reply pleadings were considered. All arguments and proposed findings and conclusions that are inconsistent with this ID were considered and rejected.

B. Allegations and Arguments of the Parties

This proceeding concerns Respondents' conduct during 2007 and 2008 concerning the Fiduciary/Claymore Dynamic Equity Fund (HCE), a closed-end investment company, while they were associated with Fiduciary Asset Management, LLC (FAMCO), an investment adviser that was sub-adviser to HCE. The OIP alleges that Respondents engaged in a trading strategy, which included writing naked index put contracts and entering variance swaps, that varied with the disclosures in HCE's registration statement and that they provided misleading information concerning the trading strategy that was included in HCE's November 30, 2007, annual and May 31, 2008, semi-annual reports. Thus, the OIP alleges, they violated the antifraud provisions of the Exchange, Advisers, and Investment Company Acts and aided and abetted violations by HCE and FAMCO of antifraud and disclosure provisions of the Investment Company Act.

The Division of Enforcement (Division) is seeking cease-and-desist orders, disgorgement, third-tier civil money penalties, and industry bars. Respondents argue that the charges are unproven and the proceeding should be dismissed.

II. FINDINGS OF FACT

A. Definitions and Background Facts[2]

A closed-end investment fund, like HCE, is an investment company with a fixed number of shares; unlike an open-ended fund, for example, most mutual funds, it does not issue or redeem shares on a continuous basis, but does trade on the secondary market.

At issue in this proceeding is the extent to which HCE represented that it would follow a covered call strategy. A call option is a contract that provides the purchaser with the right to purchase a security from the writer (seller), of the call at a specified strike price; a put option is a contract that provides the purchaser with the right to sell a security to the writer (seller), at a

[1] Citations to the transcript will be noted as "Tr. __." The exhibits were offered by the parties jointly and will be noted as "Ex. __."

[2] Multiple citations, passim, are found throughout the record of evidence for the definitions and background facts in this section. These are not controverted among the parties.

specified strike price. A covered call is selling a call on an equity in which the seller has a long position, while a covered put is selling a put while taking a short position in the underlying equity. An uncovered or "naked" put is a written put without a short position in the underlying security or a corresponding long call option. In a covered call strategy, the investor receives income from writing (selling) calls while holding a long position in the underlying equities; the income provides some downside protection – if the market price of the equities declines, the amount of the decline is set off against the income from premiums; if the market price of the equities increases, the investor receives the benefit of that up to the point of the strike price. A covered call-on-call strategy consists of purchasing deep-in-the-money calls as substitutes for investment in the underlying equities and selling covered calls on a substantial portion of the purchased calls; this strategy approximates the risk profile of a covered call strategy, but requires less up-front capital. The option value is the difference between the market price of an option and its "intrinsic value" (also referred to as "moneyness"), which is the difference between its strike price and the value of the underlying security. Where an option's strike price is equal to the underlying stock price, it is an "at-the-money" option. An "in-the-money" option is, for a call, when the strike price is lower than the stock price, and, for a put, when the strike price is higher than the stock price. An "out-of-the-money" option is, for a call, when the strike price is higher than the stock price, and, for a put, when the strike price is lower than the stock price. *Delta* is the amount that an option value changes when the price of the underlying security changes one unit. In-the-money options have a *delta* approaching 1 or (-1); the farther out of the money an option is, the closer to zero the *delta* is. *Gamma* is the rate at which *delta* changes as underlying prices change.

Beta is the measure of an asset's or portfolio's market sensitivity. A *beta* of 1 indicates that the asset will move with the market, a *beta* of less than 1 indicates that the asset will be less volatile than the market, and a *beta* of greater than 1 indicates that the asset will be more volatile than the market.

Volatility is the tendency of prices to change over time, typically measured by variance over the course of a year, the square root of which is called the standard deviation. Implied volatility is a market forecast of volatility; realized volatility is actual measured volatility. A variance swap is a contract that transfers a payment between writer and purchaser depending on the volatility levels of an index. The payout is set according to the difference between implied and realized volatility. *Vega* is an instrument's sensitivity in dollars to each volatility point, the amount of which is specified in a swap agreement. Variance swaps are essentially a bet on whether realized volatility will be higher or lower than an agreed-on level ("variance strike") over the contract period. Thus, a party who is "long variance" or the purchaser of variance profits when realized volatility for the contract period is greater than the variance strike, and a party who is "short variance" or the seller of variance profits when realized volatility is less than the variance strike.

B. Respondents and Other Relevant Entities

HCE was a closed-end investment fund established in 2005. Tr. 981-84; Ex. 11 at CLAY12386. Claymore Advisors, LLC (Claymore), was HCE's investment adviser, and FAMCO was its sub-adviser. Tr. 2069; Ex. 11 at CLAY12386, Exs. 106, 237. FAMCO's responsibility was to manage the assets in HCE's portfolio. Tr. 1708; Ex. 106. Claymore was responsible for legal, compliance, marketing, and secondary support, and it prepared HCE's periodic filings. Tr. 993, 1708, 2068-69; Exs. 106, 237. FAMCO employees Riad and Swanson were portfolio managers of HCE. Tr. 563, 1690; Ex. 14 at CLAY15491.

1. Riad

Riad has worked in the securities industry ever since he graduated from college. Tr. 2031-36. Except for the events at issue, Riad has had no disciplinary events or customer complaints. Tr. 2033-34. He joined FAMCO part-time in 1997, while pursuing an MBA at Washington University in St. Louis (Washington University). Tr. 2032, 2036-37, 2251. After receiving his degree in 1999, he accepted a position as portfolio manager at FAMCO. Tr. 2032-33. By 2007, Riad managed multiple products with which FAMCO was involved, and he was FAMCO's chief derivatives strategist. Tr. 2041. During Riad's employment at FAMCO, FAMCO's owner, Charlie Walbrandt (Walbrandt) was his father-in-law. Tr. 523, 2038-39, 2251. Toward the end of the events at issue, in October, 2008, Walbrandt replaced Riad as portfolio manager of HCE. Tr. 1157; Ex. 19 at CLAY16626-27. Between 2003 and 2009, Riad sat on an advisory board to the Chicago Board Options Exchange (CBOE). Tr. 2034-35. Riad intends to remain in the investment management field. Tr. 2035-36, 2583-85.

2. Swanson

Swanson joined the St. Louis financial services firm A.G. Edwards (now part of Wells Fargo Advisors) as a research analyst in 1994, after receiving an MBA at Washington University. Tr. 1680-81. He left A.G. Edwards in 2001 for a small St. Louis investment management firm, and then joined FAMCO in 2003 as a research analyst. Tr. 1682-86. After a year and a half at FAMCO, he became a portfolio manager.[3] Tr. 1688-89. Riad was working at FAMCO at the time Swanson joined the firm and was one of the five leaders of the firm. Tr. 1687-88. Riad was managing a small cap group and an equity product that sold options as well. Tr. 1688. Swanson was initially involved with marketing HCE and then became its co-portfolio manager in late 2005 or 2006. Tr. 1690. During 2007 and 2008, he was responsible for the equity and call-on-call portions of the portfolio. Tr. 1692. HCE's board removed Swanson, along with Riad, from the fund in October 2008; however, Swanson remained at FAMCO until December 2010.[4] Tr. 2002-03; Ex. 19. Except for the events at issue, Swanson has had no disciplinary issues or customer complaints. Tr. 1695-96.

3. FAMCO

FAMCO started in 1994 as an investment adviser in St. Louis when General Dynamics outsourced the management of its pension plan to FAMCO's founders, former employees, who

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[3] A research analyst analyzes companies and may recommend that the portfolio managers buy or sell a position; a portfolio manager actually makes the portfolio decisions. Tr. 1687.

[4] FAMCO promoted Swanson to head the equity portfolio in March 2009; he volunteered to leave when a large client withdrew $1 billion from his portfolio, necessitating cost-cutting measures. Tr. 1853-54.

included Walbrandt and Joseph Gallagher (Gallagher). Tr. 973-77. Eventually FAMCO began servicing high net worth individuals and institutional clients. Tr. 979-80. In the early 2000s FAMCO was introduced to financial firms in Chicago, including Claymore. Tr. 981. At the time it launched HCE, FAMCO had approximately $15 billion under management. Ex. 11 at CLAY12425. During the relevant period, Gallagher was FAMCO's chief compliance officer. Tr. 1092, 1247. Susan Steiner was a compliance manager under Gallagher, eventually replacing Gallagher as chief compliance officer. Tr. 1247, 2075. Sean Hughes (Hughes) was a research analyst who provided research to Riad, including on the derivatives trading at issue.[5] Tr. 575-726, 739-94, 812-971; Ex. 74. Jeffrey Grossman (Grossman) was a portfolio accountant who brought concerns about the risks of the derivative trading at issue to others at FAMCO. Tr. 472, 494-99. 505-99.

4. Claymore

Claymore (now part of Guggenheim Partners, LLC) was a registered investment adviser headquartered in Lisle, Illinois. Tr. 991, 1526. During the events in question, Nick Dalmaso (Dalmaso) was Claymore's chief executive officer until 2007, when he was replaced by Tom Futrell (Futrell); Steven Hill (Hill) was Claymore's chief financial officer and chief financial officer for HCE and other Claymore funds; Kevin Robinson (Robinson) was Claymore's chief legal officer; and Bruce Saxon (Saxon) was chief compliance officer for HCE and other Claymore funds. Tr. 526, 986-87, 1028, 2071-74, 2606-07, 2689-90, 2694-95, 2697, 2769. Claymore had in-house counsel that provided advice to FAMCO, Riad, Swanson, and HCE. Tr. 1695, 2070-71, 2073.

5. HCE's Counsel and Board

HCE's counsel was Thomas Hale (Hale), then of Skadden, Arps, Slate, Meagher & Flom LLP, who specialized in representing investment companies. Tr. 2824-30. HCE's board of directors was comprised of six independent directors (or trustees) and two affiliated directors. Tr. 1022-23, 1025; Exs. 19, 179, 180, 188, 197, 236, 306, 307, 308, 352. Dalmaso and Gallagher were affiliated directors. Id. Dalmaso was chairman of the board at least through April 23, 2008; thereafter, Ronald Toupin, who had retired after a career at John Nuveen Company, was chairman. Tr. 2988-89; Ex. 307. HCE's board was responsible for hiring and reauthorizing Claymore as adviser and FAMCO as sub-adviser. Tr. 2912-14. The board's counsel was the law firm Vedder Price. Tr. 986, 1255.

6. Fiduciary Opportunity Fund

The Fiduciary Opportunity Fund, L.P. (FOF), was offered to principals of FAMCO who were conflicted out of investing in HCE. Tr. 1195-96; Ex. 123. FOF's private placement memorandum stated that it would seek to "generate high risk-adjusted returns, primarily by investing in a portfolio of U.S. exchange listed large and mid-cap equity securities and writing (selling) covered call options on certain of the large and mid-cap equity securities held in the Fund's

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[5] Hughes earned an MBA from Washington University and has worked at FAMCO since graduating in 2005. Tr. 576-77.

portfolio." Ex. 123 at FAM667. Riad was the primary portfolio manager for FOF; a strategy committee comprised of FAMCO principals oversaw Riad's management of it. Ex. 123 at FAM665. FOF followed several of the same strategies that HCE did, including the use of uncovered puts and variance swaps, which caused FOF to lose large sums of money, just as HCE did. Tr. 1074-75, 2242, 2524-25; Ex. 109.

C. HCE as a Covered Call Fund

1. HCE's Establishment as a Covered Call Fund

HCE was conceived as a covered call fund, designed to generate high levels of income for investors. Tr. 2647, 2830. Claymore had success with its Madison/Claymore Covered Call Fund (Madison/Claymore), a "plain vanilla" covered call fund Claymore offered in collaboration with another fund manager, and saw an opportunity to add more covered call funds. Tr. 2831-32, 2914. Claymore engaged FAMCO, which had experience managing covered call funds, having managed, as sub-adviser, the First Trust Covered Call Fund (First Trust). Tr. 1323, 1706, 2299, 2503, 2832, 2914. Together, Claymore and FAMCO devised HCE, which was launched on April 26, 2005. Tr. 981-84; Ex. 11 at CLAY12386. The fund was distinguishable from other covered call funds in that it provided greater flexibility for the fund to use calls on calls (a synthetic stock position), vary the moneyness of calls,[6] and vary the percentage of stocks covered by calls as part of its strategy. Tr. 484, 1701, 2831-32, 2838-39. During the time at issue, HCE had approximately $100 million in assets under management. Tr. 531, 3014; Exs. 5-6, Ex. 14 at CLAY15499, Ex. 15 at CLAY15525.

HCE measured itself against covered calls funds and the equity market in general. The board established as its benchmarks the CBOE Buy-Write Index (BXM) and the S&P 500 Index. Tr. 2916. BXM is a covered call strategy basket that tracks the performance of a purchase of the S&P 500 at the beginning of the month and sale of a slightly out-of-the-money call at the end of the month. Tr. 1467, 2313-16. The S&P 500 is a generic equity index. Tr. 1467. Respondents themselves consistently referred to HCE as a covered call fund and compared it to other covered call funds. Prior to the October 2007 and January 2008 HCE board meetings, Riad and Swanson circulated memos titled "Portfolio Manager's Discussion" that compared the fund's performance to BXM and stated, "[HCE] was the top performing covered-call fund for the 12-month period ended December 31, 2007." Tr. 1924, 1943; Ex. 6 at CLAY10329, Ex. 71 at FAM24571. Swanson prepared a presentation for a covered call, closed-end fund conference in October 2007 that discussed HCE's performance in the context of a covered call fund strategy. Tr. 1802-03, 1887; Ex. 51 at FAM3548

Riad and Swanson do not dispute that the fund's primary investment strategy was to invest in equity and use covered calls. Tr. 1700, 2256. They do dispute that the fund was conceived solely as a covered call fund, claiming that the fund was unique and flexible, allowing for a broad spectrum of investment strategies, in addition to the covered call strategy, as distinguished from plain vanilla covered call funds, such as Madison/Claymore and First Trust. Tr. 1700, 1754, 1886,

[6] Covered call funds frequently write out-of-the-money calls to ensure that exercise of the calls is unlikely. Tr. 2832. HCE would include in-the-money calls that would command high premiums but that FAMCO research had shown to have little chance of exercise. Tr. 2832.

2049-53, 2503. HCE differed from Madison/Claymore in that it had a covered call strategy with the flexible ability to adjust the percentage of the portfolio against which covered calls were written, more flexibility about where the strike prices could be, and the ability to use a call-on-call strategy to take synthetic long positions in equities and write covered calls against that and add 20% written covered puts. Tr. 1097-99, 1106, 2838-39; Exs. 11, 367.

HCE was named "Fiduciary/Claymore Dynamic Equity Fund" to distinguish it from the crowded field of covered call funds, and to highlight the flexibility of the fund to engage in a broader range of options on its covered call strategy. See Tr. 2833-34. Contrary to Respondents' argument that the term "Dynamic" in the fund's name shows that HCE was not a covered call fund, the evidence demonstrates that the term referred to the variability of HCE's covered call function. See, e.g., Tr. 999, 1323, 1700-01. Specifically, the fund's registration statement and marketing materials make clear that the name of the fund, including the term "dynamic," referred to the fund's ability to engage in covered call option strategies that differed from the rest of the market. See Tr. 108-09, 2833, 2838; Exs. 11-12, 31. The fund's prospectus shows that the term "dynamic" modifies the nature of the covered call strategy, stating, for example, that the fund "will employ a dynamic covered call option strategy in which it will write (sell) covered call options." Ex. 11 at CLAY12391. Similarly, the prospectus stated that "[b]ased on [FAMCO's] dynamic option strategy and its evaluation of market conditions, the Fund may write covered call options on varying percentages of the Fund's common stock holdings and with varying option strike prices in relation to the market value of the underlying common stock. Ex. 11 at CLAY12390. The term "dynamic" does not appear in any other context in the prospectus. See Ex. 11.

2. HCE's Registration Statement

HCE's registration statement, comprised of a prospectus and Statement of Additional Information (SAI), described HCE as a covered call fund, and set forth the limited parameters for the fund's investments. Hale prepared HCE's registration statement. Tr. 2827-29; Exs. 11, 12. Riad and Swanson read the prospectus and SAI. Tr. 1702, 1874, 1890, 2277-82. As to its Investment Objective, HCE's prospectus and SAI both represented:

> The Fund's objective is to provide a high level of current income and current gains and, to a lesser extent, capital appreciation. The Fund seeks to achieve its investment objective by investing in a diversified portfolio of equity securities and writing (selling) call options on a substantial portion of its portfolio securities.

Ex. 11 at CLAY123989, Ex. 12 at CLAY12445. HCE's dividend target was 8.5%, necessitating an annual return before fees of 10%.[7] Tr. 1843-45, 1878-81; Ex. 8 at CLAY11798. The prospectus also capped leverage at 33% of the total assets of the fund. Ex. 11 at CLAY12450.

[7] The fund had been able to meet its dividend target consistently prior to engaging in the derivative strategies at issue in the case. Tr. 1842, 1844-45. Riad and Swanson worried, however, that the dividend rate was too high and that the fund would have to dip into unrealized gains in equity if the fund had trouble meeting its income goals. Tr. 1845; Ex. 65. Riad, in particular, lobbied for a lower dividend rate, eventually proposing it to the board, which approved the dividend rate cut in July 2008. Tr. 1845, 2235-36.

As to its Investment Parameters, HCE's prospectus represented:

> Under normal market conditions, the Fund will pursue an integrated investment strategy in which the Fund will invest at least 80% of its total assets in a diversified portfolio of [equities] and on an ongoing and consistent basis, write (sell) covered call options on a substantial portion of the equity securities . . . The Fund seeks to produce a high level of current income and current gains primarily from the option premiums it receives from writing (selling) call options and from dividends received on the equity securities . . . and, to a lesser extent capital appreciation in the value of equity securities underlying such covered call options. . . . Based on the Sub-Adviser's dynamic option strategy and its evaluation of market conditions, the Fund may write covered call options on varying percentages of the Fund's common stock holdings and with varying option strike prices in relation to the market value of the underlying common stock. For as long as the word "Equity" is in the name of the Fund, the Fund will invest at least 80% of its net assets, plus the amount of any borrowings for investment purposes, in equity securities.

Ex. 11 at CLAY12389-90. The same language as to objective and basic strategy (equities plus covered calls) appeared in HCE's November 30, 2007 and 2008, annual reports and May 31, 2008, semi-annual report. Exs. 14-15, 17.

As to its investments, HCE's prospectus represented that, under normal market conditions, it would invest in the following types of securities, listed in the following order: Common stock/equity securities; covered call options sold on a substantial portion of the equity securities; covered call-on-call option strategy with respect to up to 25% of total assets; writing covered put options on up to 20% of its total assets; purchasing put options; and foreign securities, up to 20% of its total assets. Ex. 11 at CLAY12394-95. Additionally, the prospectus represented that the fund might invest up to 20% of its total assets in other income-producing strategies, including investment grade debt securities, preferred stock, and convertible securities. Ex. 11 at CLAY12396.

The prospectus represented that HCE's "investment objective is considered fundamental and may not be changed without [shareholder] approval. . . . [I]ts investment strategy [is] non-fundamental and may be changed by the Board of Trustees of the Fund [, which] will provide investors with at least 60 days' prior notice of any change in the Fund's investment strategy." Ex. 11 at CLAY12396-97.

Finally, the prospectus contained boilerplate, common to many fund prospectuses, describing "Strategic Transactions." Tr. 2834-37.

> *Strategic Transactions*. The Fund may, but is not required to, use various strategic transactions in futures, options and other derivatives contracts (other than as described in connection with its option writing strategy) for purposes such as seeking to earn income, facilitating portfolio management and mitigating risks. Such strategic transactions are generally accepted under modern portfolio

> management and are regularly used by many mutual funds and other institutional investors.

Ex. 11 at CLAY12397.[8]

The SAI discussed the purchase and sale of securities index options. Tr. 131; Ex. 12 at CLAY12447. The Madison/Claymore fund had nearly identical disclosure regarding potential use of securities index options. Ex. 367 at 45. Neither HCE's prospectus nor its SAI, however, made specific mention of naked puts or variance swaps. Tr. 2288-89; see generally Exs. 11, 12.

HCE's registration statement was dated April 26, 2005. Ex. 11 at CLAY12386, Ex. 12 at CLAY12445. It was filed with the Commission on Form N-2 on April 25, 2005, and the Form N-2 was not amended after that date, according to the public official records of the Commission, of which official notice is taken pursuant to 17 C.F.R. § 201.323.

3. Marketing HCE as a Covered Call Fund

Marketing for HCE highlighted the covered call attributes of the fund. Marketing pamphlets written by Claymore for the fund described HCE in headlines as "An Integrated Equity and Call Option Strategy" and stated that the fund would invest substantially all of its assets in equity securities and pursue a strategy of writing options on the equity. Tr. 1696-1700, 2054-60; Ex. 31 at CLAY30378, Ex. 33 at CLAY30503-04, Ex. 116 at SASMF_0354, Ex. 117 at SASMF_0359. The pamphlets provided a conceptual example of the equity option strategy, described a covered call scenario, and included a graphic presentation titled "Covered Calls Overview." Ex. 31 at CLAY30379, Ex. 33 at CLAY30507, Ex. 116 at SASMF_0354, Ex. 117 at SASMF_0361. The pamphlets stated that HCE would use a "dynamic call option strategy using varying strike prices and expiration dates to seek attractive risk/reward characteristics." Ex. 31 at CLAY30378, Ex. 33 at CLAY30505, Ex. 116 at SASMF_0354, Ex. 117 at SASMF_0359.

Secondary marketing support compared HCE against peer funds, including Madison/Claymore and First Trust. Ex. 175 at CLAY19580, Ex. 176 at CLAY19201. Other peer funds to which HCE was compared included Eaton Vance Enhanced Equity Income Funds I and II, which were explained as being primarily equity based with varying covering percentages. Ex. 175

[8] The Madison/Claymore prospectus contained almost identical language:

> STRATEGIC TRANSACTIONS. The fund may, but is not required or expected to any significant extent to, use various strategic transactions in futures, options and other derivatives contracts (other than as described in connection with its option writing strategy) to seek to earn income, facilitate portfolio management and mitigate risks. Such strategic transactions are generally accepted under modern portfolio management and are regularly used by many mutual funds and other institutional investors.

Ex. 367 at page 9 of 73.

at 19581, Ex. 176 at CLAY19202. Another comparator peer fund was the Madison Strategic Sector Premium Fund, described as using covered calls written on individual securities. Ex. 175 at 19581, Ex. 176 at CLAY19202. These materials noted that the Eaton Vance Funds could invest up to 20% in “other derivative instruments,” while HCE was to have a “core equity portfolio, substantially covered.” Ex. 175 at 19581, Ex. 176 at CLAY19202.

Claymore drafted the road show presentation, with some input from FAMCO, to market HCE before launching the fund; Claymore drafted most marketing materials for HCE and was in charge of secondary marketing for the fund. Tr. 997, 1001, 1697, 2262. Riad was involved in early marketing of HCE, as a spokesman for FAMCO. Tr. 2054-55. Riad traveled with Claymore for the road show, and Swanson joined for some of the road show presentations. Tr. 1700, 2260. Swanson had no input into documents used in marketing HCE. Tr. 1697-1700.

Gallagher testified that HCE was marketed as a unique fund, with the road show conveying that HCE could engage in different types of strategies than most covered call funds. Tr. 998. Riad testified that, during the road show, he explained to advisors how the fund differed from other closed-end funds, saying that he discussed calls, calls on calls, and put writing. Tr. 2260-61. However, there is no evidence corroborating Riad’s purported discussions beyond the equity, covered call, call on call, and covered put strategies of the fund. Presentation materials from the road show reflect marketing investments in equities, and use of covered calls, calls on calls, and covered puts; there is nothing in the materials reflecting potential use of naked index puts or variance swaps as fund strategies. <u>See, e.g.</u>, Exs. 31, 33, 116, 117.

4. Market Understanding of HCE as a Covered Call Fund

As a closed-end fund, HCE was marketed to brokers and financial advisers who advised their clients on purchasing mutual funds and closed-end funds, including HCE. Three brokers and financial advisers whose clients invested in HCE testified; they understood HCE to be primarily a covered call fund, with the downside protection that would be expected in a covered call fund, based upon the language in the prospectus and SAI, from periodic disclosures, and from the fund’s marketing. Tr. 1335-50, 1400-28, 1435-99.

D. <u>Evolution of HCE’s Strategy and Risk Footprint</u>

1. HCE’s Derivative Trading Strategy Evolution

As discussed in this section, beginning in 2007, HCE added uncovered written index puts and variance swaps to its portfolio. HCE entered into an increasing number of these transactions, which led to a significant portion of HCE’s income and returns for portions of 2007 and 2008, prior to causing significant fund losses in the latter portion of 2008.

In 2005 and 2006, HCE engaged in a handful of index options, including both purchased and sold call options and sold put options. Ex. 39 at CLAY30820A-B. Starting in early 2007, HCE began progressively increasing its use of put options, including uncovered puts.[9] Tr. 91-93, 507; Ex. 125. The first short index put position that was partially naked occurred by at least April 2007. Tr. 1891; Exs. 39, 63, 346. Between April and November 2007, HCE mostly either sold puts or purchased puts that were initially covered, meaning that for each put sold, i.e. short position, there was a corresponding purchased put, i.e. long position to cover the short position. Tr. 616; Exs. 39, 163. This strategy is known as a "put-spread." Tr. 616. For several of these purchased put-spread combinations, HCE closed out the long positions or let them expire without renewal prior to the short puts' expirations, leaving the short position naked. Tr. 2448-49; Exs. 39, 63. Eventually, around November 2007, HCE ceased regular purchase of corresponding long put positions, engaging in naked short positions nearly exclusively. Exs. 39, 63. Between April 25, 2007, and October 8, 2008, HCE had written put option exposure in the portfolio 84% of the time, and had offsetting long put protection only 38% of the time. Ex. 139 at 37. Between November 7, 2007, and October 8, 2008, HCE had written put exposure 76% of the time with offsetting long put protection only 22% of the time. Ex. 139 at 37, 120-21.

HCE collected between $500,000 and $2.5 million in premiums each month it wrote put options, totaling approximately $9.6 million between April 2007 and August 2008.[10] Tr. 199, 2500-01; Ex. 86 at FAM89834; Ex. 139 at 37, 121. During the same period, HCE netted approximately $4.4 million from the written puts, after taking into consideration losses on repurchases. Tr. 1968-69, 3147-48; Ex. 77 at FAM39552, Ex. 139 at 37.

HCE also began purchasing and selling short-term S&P 500 Index variance swaps in 2007 to take advantage of perceived mispricing between short-dated implied and realized volatility. Tr. 707, 2093, 2104; Ex. 13 at CLAY14854, Exs. 40, 158. In short positions, the seller believes that realized volatility of the underlying instrument – in HCE's case, the S&P 500 Index – would be lower than the variance strike; for long positions, the purchaser believes the inverse, that realized volatility will be higher than the variance strike. Tr. 626-27. Riad and Swanson considered short variance swaps to be akin to insurance against volatility. Tr. 1871, 2396-97.

HCE entered its first variance swap, a short position, on July 26, 2007. Tr. 508-09; Exs. 40, 158. Between the first variance swap in July 2007 and the last on September 19, 2008, HCE had an open swap position nearly all of the time, with only short gaps between swap expirations and new contracts. Tr. 2460-62; Ex. 40. HCE's variance swap positions were between two weeks and three months and between 150,000 and 1,000,000 *vega* units. Ex. 40. HCE acted as seller, i.e. held a short position, in nine of eleven variance swap contracts it entered into between July 26, 2007 and

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[9] Swanson learned in the spring of 2007, through discussions with Riad and seeing the positions in the portfolio listings, that HCE was investing in short index puts. Tr. 1712-13. Swanson did not make those trading decisions; Riad did. Tr. 1713. Riad told him that the trades were part of an effort to try to lower the volatility of the portfolio. Tr. 1713.

[10] Swanson was led to believe that the written puts were relatively low risk investments because they were sold far out of the money – around 8% to 10% – and for short durations, providing some confidence that the puts were unlikely to be exercised and, thus, that HCE would keep most of the premiums. Tr. 1713-14.

September 2008, when it entered its last swap. Ex. 40. The actual exposure time of short variance swaps between July 26, 2007, and October 17, 2007, was 84%, and 14% for long variance positions during the same period. Ex. 139 at 39. Realized gains and losses for individual variance swaps between July 2007 and July 2008 were between a loss of approximately $1.1 million and a gain of approximately $437,000. Ex. 40.

Together, for the two-year period ended August 31, 2008, the written put and variance swap strategies captured a 2.9% annualized return for the fund out of the fund's 6.5% annualized return – representing approximately 45% of the fund's returns. Ex. 75 at FAM34141. Those returns helped the fund rank in the top quintile for trailing 12-month and 24-month periods among domestic covered call funds investing in large cap U.S. equities. Id.

2. Respondents' Research on Short Puts and Variance Swaps

Riad had wanted to implement the short put and variance swap strategies as early as HCE's founding but had not performed adequate research at that point. Tr. 2283-84. He had been intrigued, based on FAMCO client investments using puts that brought in high premiums, as to why the market paid such high premiums to cover risk. Tr. 2090-92. Riad hypothesized that investors were "paying a million dollars to ensure their home of $500,000," because "the demand for risk . . . outstrip[ped] supply." Tr. 2104. After Hughes arrived at FAMCO, Riad commissioned him to conduct research into this issue. Tr. 577-78, 2090-92, 2334.

Hughes and others performed thousands of hours of research to determine which trades to recommend to Riad. Tr. 575-732, 739-93; Exs. 41, 74, 82-83, 202-04, 206-14, 216-19, 224, 226, 228-35. Based on the research, Riad and Swanson[11] believed that the trading strategy with short index puts and short variance swaps would be profitable, and that they would be able to contain any associated risks.[12, 13] Tr. 575-732, 739-93, 1713-22, 2334.

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[11] Swanson did not make the decision to trade index puts and variance swaps, but was told that they had a good risk-adjusted return and would diversify and reduce the volatility of the portfolio. Tr. 1722-27. Swanson's understanding of the research was limited at the time of the trades. At most, he knew that Riad and Hughes were researching the use of puts and variance swaps; they did not share the research with him. Tr. 1907-08.

[12] The Division's expert witness, Lawrence Harris, a former Chief Economist at the Commission, disagreed with this analysis of the risk profile of this trading strategy. Tr. 167-471; Ex. 139. The Respondents' expert witness, Chester Spatt, also a former Chief Economist at the Commission, concluded that Respondents' assessment that the puts and swaps would improve HCE's risk-adjusted trade-off was reasonable. Tr. 3239-3544.

[13] An October 2008 FAMCO memo, with which Riad was familiar, sent to the board following significant fund losses, stated that FAMCO had researched the probabilities of loss associated with written puts and variance swaps and determined that the possibility of significant losses was remote. Tr. 2188-89; Ex. 13.

3. Purpose of the Derivative Trades

Riad and Swanson referred to the use of naked short index puts and variance swaps to HCE's board, Claymore, and the public as part of a "global macro hedg[ing]" strategy. See, e.g., Tr. 1604; Ex. 15 at CLAY15522, Ex. 54 at FAM13088. There were varying representations regarding how the naked short index puts and variance swaps functioned as hedges.[14] There were also disputes that the naked index puts and variance swaps actually functioned as hedges.[15] Respondents' predominant explanation of how the trades served as hedges, however, was that the trades produced income for the fund to boost returns and assist in meeting its dividend, even during periods of market decline.[16] See, e.g., Tr. 1714, 1720, 1725, 1910, 1955, 2202-2205. In this respect, the naked index puts and variance swaps had a function similar to the covered calls,

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[14] Riad and Swanson both explained that the swaps acted as hedges against investments in the S&P 500 because the swaps were uncorrelated to the equity market, thus providing diversification. Tr. 1724-25, 2200-01. Riad testified that a purpose of written puts was to generate premium income to fund a "piggy bank" that would be available to purchase protection for the fund's assets, including long puts, when needed. Tr. 2160-61, 2204. This explanation is inconsistent with Riad's not using any of the "piggy bank" money to purchase long puts for protection. Tr. 2449-50. Riad told several parties, including Claymore and the HCE board, that the purpose of the trades was to "lock in volatility." Tr. 1945, 2431; Ex. 4.

[15] During the hearing, Hughes stated that, despite moving in the same direction, written puts could be considered a hedge on an equity portfolio; during his investigative testimony, he testified somewhat differently, that they did not act as hedges on a covered call portfolio. Tr. 880-82. Hughes testified that a hedge moves in the opposite direction of an investment. Tr. 883. He acknowledged that written put options tend to move in the same direction as equities; thus, for a covered call fund, written put options exacerbate losses in the equity market, increase *delta*-adjusted exposure, and increase volatility. Tr. 878-880; Ex. 83 at FAM65183. Hughes's research showed that *beta*, the sensitivity to movement compared to a dollar in the market, had a positive correlation for written puts, but negative correlation for short calls, undermining written puts' value as a hedge to a covered call, according to his own definition. Tr. 591-93.

Hughes's research titled "Hedging an SPX Portfolio with a Long Implied Volatility Position" described a forward variance swap as consisting of a long swap for a long period and a short swap for a short period. Tr. 658-59; Ex. 202 at FAM1014-15. Hughes concluded that such a forward variance swap would act as a beneficial hedge for a fund. Tr. 667; Ex. 202 at FAM1023. Hughes presented this to Riad, but Riad ultimately chose to invest only in short swaps, rather than the forward variance swap with both a long and short position. Tr. 920. It was unclear whether Hughes stood by his opinion of variance swaps as a hedge if the long swap was not included. He did testify, however, that: short variance swaps tended to move downward with the market; sellers of variance tended to lose against an equity portfolio when volatility went up; and long implied volatility would increase in value when market volatility increased. Tr. 883-84, 918; Ex. 202.

[16] Riad also testified that the written puts reduced *beta* because of premiums collected on the puts. Tr. 2337-39.

providing income and gains that offset downside risks of declines in the fund's underlying equity investments. See Tr. 2287-88; Ex. 11 at CLAY12391.

Swanson testified that there were two goals associated with the macro hedging strategy: reducing volatility and generating income. Tr. 1892. Swanson told Claymore, in the fall of 2008, that HCE adopted the short put and short variance swap strategies "as a means of sustaining its high dividend payout objective." Tr. 1971-72; Ex. 75 at FAM34141. According to Swanson, the puts acted as hedges because they were written out of the money and for short periods, effectively adding value to the portfolio, even in declining markets. Tr. 1714, 1720, 1724-25, 1955; Ex. 4. Swanson also told the board that selling one-month, out-of-the-money puts was an "attractive stand-alone investment strategy" that required no up-front cash outlays. Tr. 1955-56; Ex. 77 at FAM39551. Swanson expressed this sentiment in an email to Riad regarding the fund's ability to meet its dividend target, remarking that HCE's sophisticated investments enabled the fund to "do more with less." Ex. 66 at FAM21761.

Highlighting that the trades generated returns, even amid equity losses, Swanson discussed an equity attribution report for November 30, 2007, through May 31, 2008. Tr. 1743-44; Ex. 48 at FAM1118. The equity portfolio over that period had lost approximately 3% in value, covered calls had brought in approximately 2.3% of the equity value in income, and call on calls had lost approximately 0.6% in value as compared to the equity portfolio, for an ultimate loss of 1.33% in portfolio value for the period. Ex. 48 at FAM1118. During the same period, S&P 500 Index puts and calls and variance swaps contributed 2.31% to the fund's return, netting the fund a 1.08% return. Id. Though the report did not distinguish between long and short positions, Swanson testified that it was primarily the short put position that generated this gain. Tr. 1745; Ex. 48 at FAM1118.

4. Evolution of HCE's Risk Footprint

As discussed in this section, despite the research showing the seemingly profitable strategy associated with the use of the short index puts and variance swaps, the strategy altered HCE's risk footprint. Naked short puts and short variance swaps exposed HCE to potentially catastrophic losses in an extreme, albeit low-probability, market event. The potential for losses created by these trades exposed the fund to far greater potential losses than the covered call strategy.

A covered call fund holds primarily equities as assets and is thus sensitive to fluctuations in the equity market, but is less risky than investing only in equities. Selling calls on the underlying equity caps some of the upside potential of those equities, but adds some downside protection for investors in the form of premiums. Ex. 8 at CLAY11798. The downside risk of a covered call fund is the exposure of the underlying equities in the event of an equity market drop, less the premiums from the covered calls, which are a partial hedge against a decline in the equity values. Tr. 2287. The fund is also covered in the event that an option holder exercises the option because the fund already owns the shares, mitigating risks associated with selling calls. Accordingly, a covered call fund should outperform a declining equity market. See Tr. 264-65.

FAMCO monitored HCE's *delta*-adjusted exposure regularly. Tr. 1981, 2572; Exs. 21, 73. A spreadsheet compiled by Grossman around November 11, 2008, showed the daily positioning of

HCE's short index puts and swaps in September and October 2008.[17] Ex. 53. The spreadsheet showed that the *delta*-adjusted exposure from uncovered puts varied between a low of 17% of the fund's market value and a high of 134% of the fund's market level during that period. Id. Hughes agreed that writing put options increased *delta*-adjusted exposure for the fund. Tr. 878. He also agreed that puts have a roughly 70% correlation to the S&P 500, indicating that they run with the market, and with the fund, a majority of the time. Tr. 881-82, 934.

Parties entering into variance swaps agree on variance swap strike prices, typically based upon the CBOE VIX Index (VIX), a measure of implied volatility of S&P 500 index options, and so both short and long parties enter the contract with no initial cash outlay. Tr. 633-34; Ex. 139 at 29. At the end of the swap's contract period, the variance strike price, squared, is subtracted from the price variance, as determined by the square of the standard deviation, otherwise known as volatility, and then multiplied by the variance notional, which is set forth in the swap contract. Ex. 139 at 29. The payment at the end of the swap period is based upon the variance that occurred during the swap contract period. Ex. 139 at 30. By squaring volatility and variance strikes, profits and losses are non-linear and asymmetrical, rising substantially in periods of high volatility. Tr. 210. This is also known as convexity.

HCE's short variance swaps did not have corresponding long positions to offset risks of increasing volatility, as Hughes had originally urged Riad to employ. Tr. 658-59; Ex. 74 at FAM33544-45.

Riad was aware of the potential for large losses associated with naked puts and short variance swaps. A September 2005 Goldman Sachs paper on which Hughes relied in his research and Riad likely read warned: selling variance was profitable but exposed the seller to significant risk, especially in cases of severe spikes in volatility, like those that had occurred a few times in the previous ten years; variance swaps perform the worst during market crises; and purchasing call positions could mitigate potential losses on short variance swap positions. Tr. 921-23, 2380; Ex. 41 at FAM801-02. Similarly, a September 2006 Goldman Sachs paper with which Hughes and Riad were familiar states that sellers of variance "risk unlimited losses if the [volatility] exceeds the strike prices of the short call strike at expiration." Ex. 218 at FAM52236. A November 2006 JPMorgan paper with which Hughes and Riad were familiar states that "selling volatility can be likened to selling insurance (or credit protection): potentially very risky, but in the long run likely to make lucrative returns, providing enough capital is available to absorb the occasional losses." Tr. 707, 2384-85; Ex. 82 at FAM52147-48. Hughes understood in 2007 that the amount that could be lost on a short variance position was unlimited. Tr. 909. Hughes informed Riad of that and warned that large spikes in volatility could lead to large losses. Tr. 860-62. Riad conceded that there was market data that there had been instances of extreme volatility prior to 1997, including the 1987 market crash when volatility rose to approximately 104%. Tr. 2371; Exs. 47, 81.

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[17] Recognizing that these were HCE's worst months and that these particular trades proved to be the largest harms to the fund, no evidence of *delta*-adjusted exposure from either puts or swaps was provided for other periods.

Riad was familiar with the convexity of returns in variance swaps. Tr. 707, 921, 2380, 2385; Ex. 41 at FAM801-02, Ex. 82 at FAM52126. He described it in an email following sharp losses in fall 2008: "we have learned the concept of convexity in this time – i.e. a triple rise in volatility is 3 times worse than a double." Ex. 64 at FAM20381. He also acknowledged, "[I] think we have to emphasize that what we experienced in the equity markets in terms of downdraft and volatility is indeed a 3 standard deviation on performance that HCE was not prepared for." Id.

Similarly, a January 2003 Goldman Sachs paper, titled "Options and Volatility," that Hughes and Riad read warned, regarding selling short index put options, in bold lettering, "Compared to the index returns, the returns for an index with put selling or combined put and call selling have a higher probability of more extreme downside moves (fatter tails)." Tr. 686, 2144-45; Ex. 207 at FAM149049. The paper conveys a similar sentiment a few pages later, again in bold lettering, stating, "Although selling puts appears to offer the best potential alpha per unit of tracking error, it does introduce the most adverse results in extreme down markets (the distribution has the 'fattest' tail)." Ex. 207 at FAM149052. An academic paper, on which Riad and Hughes relied, states, in the introduction, "There is no arguing that selling naked puts could be very risky." Tr. 953-54, 2141; Ex. 214 at FAM149060.

E. HCE Goes Downhill

Beginning in August and September 2008, as the markets began to crumble, HCE experienced extreme losses, significantly worse than the equity markets faced. The 30-day period ended October 8, 2008, included a 22.2% S&P 500 Index drop. Ex. 75 at FAM34141. The S&P 500 Index fell approximately 700 points from its height by October 27, 2008, an approximately 45% drop. Tr. 1969-70; Ex. 75 at FAM34141. As the equity markets fell, volatility spiked dramatically. Ex. 139 at 74.

HCE entered into two uncovered puts, on August 25, 2008, and August 28, 2008; each was written 8% out of the money. Ex. 121. On October 6, 2008, and October 8, 2008, the two trades were reversed for losses of $6 million and $9.5 million, respectively, totaling $15.5 million. Ex. 75 at FAM34141-42, Ex. 121. HCE's market value as of August 29, 2008, was approximately $100.9 million. Ex. 53 at FAM11048. The two uncovered puts lost approximately 15% of that value.

On August 15, 2008, HCE entered a short variance swap with a September 19, 2008, expiration date. Ex. 122. That swap closed with a loss of approximately $7 million. Id. Despite that loss, HCE entered into two more short variance swaps on September 19, 2008, each with an October 17, 2008, expiration date.[18] Id. The two swaps closed on October 17, 2008, with losses of approximately $9.1 million and $13.7 million, respectively. Id. The losses from the August and

[18] Riad executed a short position variance swap in FOF on September 4, 2008; the swap closed on September 19, 2008, with an approximately $2.3 million loss. Ex. 114. Riad did not enter a new variance swap in FOF after that loss, as he had with HCE. Tr. 2245-46; Ex. 114. He testified that he had confidence in the trade, but he did not believe FOF had sufficient capital at that point to be eligible to enter a new variance swap, and investors in the fund, which was already down approximately 50% in value, were considering closing the fund. Tr. 2246-47.

September variance swaps totaled approximately $29.7 million. Id. These losses were enormous because the August swap had a spread between implied and realized volatility of approximately 20%, and the September swaps had volatility spreads of nearly 50%. Tr. 925; Ex. 50.

Prior to entering the last two variance swap trades on September 19, 2008, the fund updated its risk models and reevaluated its research[19] to determine whether to enter new variance swaps. Tr. 783-84, 2489. Volatility had been historically low leading up to the fall of 2008, but spiked in September following the collapse of Lehman Brothers. Tr. 708. Riad, based on Hughes's research, believed the market would normalize ("mean revert"), so that the period of high volatility was an opportune time to sell. Tr. 708, 730, 783-84, 859-60, 2383. He conceded, however, that he did not know when the market would mean revert. Tr. 2384.

The day prior to the new variance swaps, Steiner, Grossman, and Gallagher met to discuss Grossman's concerns that HCE was taking on too much risk, especially because Grossman believed that the International Swaps and Derivatives Association (ISDA) agreements that HCE had signed obligated the fund to notify counterparties of the fund's drop in value. Tr. 547-48, 1311-12; Ex. 92. The ISDA agreements allowed HCE's counterparties to terminate agreements and unwind positions after receiving this notification. Tr. 547-48, 188; Ex. 92. Grossman believed that Riad was aware of his concerns. Tr. 547.

An internal review of the fund's losses attributed HCE's major losses to a $24.3 million loss on equities and long-call positions (the covered call portion of the fund), a $29.8 million loss on variance swap positions, and a $15.6 million loss on the put strategy. Ex. 19 at CLAY16625. Riad acknowledged that HCE performed particularly poorly due to the additional derivative transactions, not due to the covered call segment. Tr. 2513. Riad also acknowledged the contribution of volatility to HCE's fall 2008 losses. Tr. 2266-68.

HCE's November 30, 2008, annual report described the impact of the short index puts and variance swaps on the fund's losses. Ex. 17 at CLAY15651. It explained that these two categories of trades had an extremely negative effect on performance that overwhelmed the equity portfolio. Tr. 2784; Ex. 17 at CLAY15651.

On August 29, 2008, the fund's market value was approximately $100.9 million, and by October 17, 2008, it had fallen to approximately $27.7 million, a nearly 75% loss. Ex. 53 at FAM11048. Because of the failed trades and subsequent losses, HCE had to access its capital reserves in order to pay its variance swap counterparties. Tr. 2398.

The board conducted its annual review of FAMCO as sub-adviser in November 2008. Tr. 1154-56; Ex. 19 at CLAY16626, Ex. 197 at CLAY28514. In addition to the typical review, the board sent FAMCO supplemental questions concerning HCE's losses. Ex. 75. Riad and Swanson

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[19] In August 2008, research by Hughes showed that HCE would lose 5% of its net asset value if volatility reached 34%, representing a 15-point jump from the variance strike. Tr. 847. Reviewing historical volatility showed that the largest spread between implied and realized volatility between January 1997 and February 2008 was approximately 19%. Tr. 847-50; Ex. 43.

were removed as portfolio managers. Ex. 19 at CLAY16626-27. On December 28, 2008, the board voted to liquidate the fund. Official notice, pursuant to 17 C.F.R. § 201.323, taken of HCE's Form N-8F filed June 29, 2009.

F. Disclosure

Claymore was responsible for preparing HCE's registration statement, its annual and semiannual reports, and other communications with shareholders and filings with the Commission; FAMCO was responsible for providing Claymore with information needed for these disclosures.[20] Exs. 106, 237. Information that Respondents provided directly, or through FAMCO, to Claymore, or failed to provide, is addressed in this section.

1. Disclosures in HCE's November 30, 2007, Annual and May 31, 2008, Semiannual Reports

Each HCE annual and semiannual report included a question and answer section (Q&A) designed to provide investors with important information about the fund. Tr. 1546; Exs. 14, 15. Claymore hired Patty Delony (Delony) to draft the Q&As based on information she obtained from the portfolio managers. Tr. 1537. To do so, she consulted Claymore regarding information that it wanted to address and, shortly after the end of the reporting period, contacted the portfolio manager to set up a telephone interview, held a few days later and audio-recorded. Tr. 1539-40. As of May 2007, Swanson was HCE's portfolio manager whom she interviewed. Tr. 1548, 1729; Ex. 364. Then, using her own notes and the recording, she drafted the Q&A and sent the draft to Swanson. Tr. 1541-42. Swanson sent the draft to Riad to edit as necessary. Tr. 1930; Exs. 69, 96. After incorporating the managers' changes, she sent a new draft to designated Claymore personnel, including Claymore's legal and compliance and chief financial officer, and after all changes were incorporated, she asked the fund manager to sign a certification form. Tr. 1542-45, 1930. This process was used for the Q&As in the November 30, 2007, annual and May 31, 2008, semiannual reports. Exs. 14-15, 61. Delony understood HCE to be a covered call fund. Tr. 1561.

Neither Swanson nor Riad included any specific language regarding the use of uncovered puts or variance swaps in either report. Exs. 14-15. Riad did not think it was necessary, because it would "upset [the] process." Tr. 2477-78. He added that he and Swanson were not in charge of

[20] Specifically, the sub-advisory agreement among HCE, Claymore, and FAMCO required FAMCO to consult with Claymore before engaging in hedging, leverage, or risk management transactions. Tr. 1089-91, 1235; Ex. 106. It required FAMCO to follow the investment policies of the fund, to consult with Claymore regarding investment strategies, risk strategies, and hedging, and to operate within the parameters set by the board of the fund. Tr. 2274; Ex. 106. It also required FAMCO to "keep [HCE] and [Claymore] informed of the developments materially affecting [HCE] and shall, upon request, furnish to [HCE] all information relevant to such developments" and to provide services in accordance with HCE's "investment objective, policies and restrictions . . . as stated in [HCE's] Prospectus filed with the SEC as part of [HCE's] Registration Statement on Form N-2." Ex. 106 at FAM134330. FAMCO's investment advisor policies and procedures manual required portfolio managers to familiarize themselves with fund disclosure documents and restrictions, and to follow the restrictions. Tr. 1091-92, 2272; Ex. 124 at 1-31.

disclosure and what was included in the portfolio commentary "wasn't up to them." Tr. 2477-78. However, the Q&As were specifically attributed to Riad and Swanson. Tr. 2750-52; Ex. 14 at CLAY15491, Ex.15 at CLAY15520. Hill was unaware of Claymore ever restricting the content of the Q&A disclosures, and there is no evidence in the record suggesting that it did so.[21] Tr. 2750-51.

a. November 30, 2007, Annual Report

For the year ended November 30, 2007, HCE returned 12.87% overall on an NAV basis. Ex. 14 at CLAY15490, 15492. FAMCO told Delony that the equity and long call portion of the fund generated 9.61%, compared to the S&P 500 Index's 7.72% and BXM's 5.5% returns for the period. Ex. 61 at FAM16319, FAM16322. The variance swaps produced a gain of $322,818, which is 0.36% of the fund's NAV value for the same period. Ex. 40.

In a December 13, 2007, interview for the Q&A, Swanson began by explaining HCE as a covered call product. Tr. 1560-61; Ex. 135 at 2-3. He then explained that there were three buckets of the fund's strategy comprised of: 1) equities, 2) short calls on the equities, and 3) use of opportunistic hedging, which, as he said, included purchasing puts for protection. Tr. 1562-72; Ex. 135. Delony understood that, while HCE was "more exotic" than a plain vanilla fund, its equity portfolio was the main driver of performance. Tr. 1563-65; Ex. 135 at 21. Swanson never mentioned the term "variance swap" or HCE's use of uncovered short puts during his interview, and Delony was unaware that HCE used uncovered puts or variance swaps. Tr. 1558; Ex. 135.

To prepare for the interview, FAMCO gave Delony an equity attribution report, which showed the equity sector breakdowns and equity performance metrics but did not show information regarding option or swap positions and their effect. Tr. 1739-40, 1749-50; Ex. 61. Swanson mentioned buying puts for protection but never mentioned writing puts. Tr. 1957-58; Ex. 135 at 3.

Based upon the information Swanson furnished, the Q&A stated that HCE sought to achieve its investment objectives by "investing in a diversified portfolio of equity securities and writing (selling) call options on a substantial portion of the securities in the portfolio." Ex. 14 at CLAY15491. The Q&A noted that the fund produced a 12.87% return on its net asset value as compared to 7.72% for the S&P 500 Index and 5.54% for the BXM; there was no breakdown on how HCE's return was achieved. Id. at CLAY15492. In response to the question "Which investment decisions most helped the Fund's performance," the report recited a list of equity sectors that provided the best returns, including industrials, consumer discretionary, and information technology." Id. The report noted that equities in the homebuilding sector hurt the fund. Id. at CLAY15493. In response to the question, "Please explain the Fund's covered call program and hedging strategies and how they affected performance," the report states that the fund benefited from some "good strategic and tactical decisions on the option overlay, with regard to both individual equities and industry sectors." Id. It also noted that the fund "bought index puts for protection or collared the portfolio by simultaneously purchasing protective index puts and writing

[21] The only record evidence of Claymore's commenting on the Q&As for the November 30, 2007, and May 31, 2008, reports regarded inclusion of language on consideration of a line of credit, wholly unrelated to the fund's trading strategies. Tr. 1768; Ex. 275.

index calls." Id. There was no mention of the fund's use of uncovered put positions[22] or variance swaps. Id. at CLAY15491-95. Indeed, in response to the question, "Which holdings hurt performance," the Q&A listed a few equities, which contributed less to the fund's overall losses than short variance swap positions had during the 2007 fiscal year. Ex. 14 at CLAY15493.

The annual report included a breakdown of the fund's investments. Ex. 14 at CLAY15496-48. One table included the individual equities that that the fund held, the number of shares, and the value of the position. Id. at CLAY1496. Another table provided all outstanding written call options, the equities the calls were written against, the expiration dates, the exercise prices, the number of contracts, and the values of the positions. Id. at CLAY15498. Additionally, the report included a table listing all outstanding call options purchased by the fund, their respective expiration dates, exercise prices, values, and percentage of the fund those values represented.[23] Id. at CLAY15497. The report disclosed a single written put option, but made no indication whether it was covered or not. Id. at CLAY15498.

A section titled "Variance Swaps" in the notes to the financial statements described variance swaps and noted an outstanding variance swap with unrealized depreciation of $723,327 as of November 30, 2007. Ex. 14 at CLAY15503. The only information disclosed on the variance swap was the counterparty, the type of swap, the termination date, and the unrealized depreciation. Id. There was no explanation of the *vega* of the contract, units purchased, or variance strike price. Id. Riad acknowledged that there was no way to glean from the disclosures in the annual report what sort of exposure the variance swap created.[24] Tr. 2546; Ex. 64.

Riad approved the final Q&A and Swanson signed a certification that, after reviewing it, "to the best of his knowledge" it was accurate.[25] Tr. 1742, 2462-64; Exs. 35, 96. Riad signed a certification stating that as portfolio manager of HCE, he had reviewed the portfolio of investments in the annual report and that, to the best of his knowledge, it was a complete and accurate list of the securities held in the fund and that they were purchased in compliance with the investment parameters set forth in the prospectus. Tr. 2471; Exs. 9, 34. The annual report was filed with the Commission on January 29, 2008. Official Notice.

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[22] In his investigative testimony Riad testified that it was an omission to have not included language about the written puts. Tr. 2456.

[23] Forms N-Q filed with the Commission for the periods ended August 31, 2007, February 29, 2008, and August 31, 2008, contained similar disclosures. Ex. 300 at 8, Ex. 301 at 10, Ex. 302 at 11.

[24] Forms N-Q filed with the Commission for the periods ended August 31, 2007, February 29, 2008, and August 31, 2008, contained similar disclosures. Ex. 300 at 10, Ex. 301 at 11, Ex. 302 at 12.

[25] Swanson knew that others, including personnel from Claymore reviewed the reports, including the Q&A, before they were finalized. Tr. 1763.

b. May 31, 2008, SemiAnnual Report

HCE's semiannual report for the six month period ended May 31, 2008, reported a net return of 0.37%. Ex. 15 at CLAY15518, CLAY15521. The Q&A compared this with returns of 2% for the BXM and -4.5% for the S&P 500 Index. Ex. 15 at CLAY15521.

Swanson conveyed to Delony that it was a "good environment, believe it or not, to own a covered call type strategy." Tr. 1601; Ex. 136 at 2. He made note that the covered calls offset two-thirds of the equity losses during that period. Tr. 1603; Ex. 136 at 2. He explained that the period saw high levels of volatility, which was a "wonderful environment to be selling volatility and to be hedging, which is exactly what the covered call strategy does." Tr. 1606. In response, Delony suggested that the section discussing the covered call aspect of the fund should be moved to the beginning, because it was the most important strategy in the fund; Swanson agreed. Tr. 1607. A follow-up email among Delony, Swanson, and others recited the statistics for HCE's covered call aspect, which had losses; Swanson reminded Delony that the statistics did not include call on calls, hedges, or volatility trades. Ex. 289. The same email reiterated the fact that the fund's losses were offset in large part due to the covered call program. Tr. 1768; Ex. 289 at SEC-Delony-604.

The Q&A, like the November 30, 2007, Q&A, stated that the fund aimed to achieve its investment objectives by "investing in a diversified portfolio of equity securities and writing (selling) call options on a substantial portion of the equities in the portfolio. Ex. 15 at CLAY15520. The Q&A reported that the fund's net asset value return for the prior six months was 0.37%, compared to the S&P 500 Index's -4.5% return and BXM's 2% return, and that the fund paid an annualized distribution rate of 9.74%. Id. at CLAY15521. The response to the question, "Which investment decisions or strategies most helped the Fund's performance," was that "[a] covered call strategy tends to contribute most in a market environment with high volatility and weak equity returns" and that the fund was able to buy protection from downward trending by "writing short dated covered calls that were at the money or slightly in the money on some of the securities with the greatest volatility." Id. The report added that "[i]n addition to the covered call strategy, our global macro hedges worked out well," and the fund was "strategically hedged for additional downside protection." Tr. 2474; Ex. 15 at CLAY15522. Concluding the response to the question on the greatest contributions to the fund, the report stated "performance benefited from success in the three aspects of our strategy: industry and stock selection, the covered call strategy, and the hedge program." Ex. 15 at CLAY15522. In response to the question, "Please explain more about the Fund's covered call and hedging programs," the report stated that the main investment objective was to "support the fund's distributions through premiums earned on call options sold." Id. It added, "[w]e also had the flexibility to vary our hedge ratio [and] [i]n more volatile and downward trending markets, we want to be fully hedged." Id. The report did not elaborate any further on the global macro hedging strategy, nor did it mention the use of uncovered short puts or variance swaps. Ex. 15, passim.

The semiannual report included a breakdown of the fund's investments. Ex. 15 at CLAY15525-26. One table included the individual equities that the fund held, the number of shares, and the value of each position. Ex. 15 at CLAY15525. Another table provided all outstanding written call options, the equities the calls were written against, the expiration dates, the exercise prices, the number of contracts, and the values. Ex. 15 at CLAY15527. Additionally, the report included a table listing all outstanding call and put options purchased, their respective expiration dates, exercise prices, values, and the percentage of the fund those values represented. Ex. 15 at CLAY15526.

HCE had no outstanding written puts or variance swaps as of May 31, 2008. Ex. 40. However, the semiannual report did not disclose in the Q&A, or elsewhere, the use of uncovered written puts and variance swaps, including during the preceding six-month period. Ex. 15.

Riad approved the final Q&A and Swanson signed a certification that, after reviewing it, to the best of his knowledge Q&A was accurate. Tr. 1741-42; Exs. 37, 69. Riad signed a certification stating that as portfolio manager of HCE, he had reviewed the portfolio of investments in the annual report and that, to the best of his knowledge, it was a complete and accurate list of the securities held in the fund and that they were purchased in compliance with the investment parameters set forth in the prospectus. Ex. 36. The semiannual report was filed with the Commission on August 4, 2008. Official Notice.

2. Additional Information Provided to Claymore

As discussed in this section, Respondents provided information to Claymore in addition to their direct input into the annual and semiannual reports. The evidence establishes that they provided information regarding the use of short puts and variance swaps, but that the disclosures were incomplete or concerned only single, isolated trade positions.

Grossman maintained a daily log of trades and followed the HCE's earnings and profits daily. Tr. 479-82. He was familiar with options due to his work history, including as a market maker at CBOE. Tr. 474-82. In November 2007, Grossman discussed with Steiner Riad's use of uncovered puts (either in HCE or another fund that Riad managed), which he felt exposed the fund to excessively large losses. Tr. 492, 495-97, 1260-63, 1292. He and Steiner went to Gallagher to discuss the transaction.[26, 27] Tr. 493, 1167-69, 1262. On January 11, 2008, Riad next sold an uncovered put.[28] Ex. 39 at CLAY30820C. Gallagher elevated the issue of Riad's uncovered puts to Claymore; it was discussed on a January 16, 2008, telephone conference call. Tr. 1176-81; Ex. 27.

[26] Grossman also recalled Riad's being at the meeting with Gallagher and that they decided the transaction was not allowed under the prospectus, so the trade was reversed. Tr. 493. These additional recollections were not corroborated by Steiner, Gallagher, or Riad. Riad was generally aware of Grossman's concerns, however. Tr. 496, 506, 2417-21.

[27] FAMCO dismissed Grossman after the fall 2008 market meltdown. Tr. 554. He believed that his dismissal was related, in part, to his having raised the risks in the fund, though he was told that FAMCO was cutting staff due to the decline in business. Tr. 555-57, 1058-62.

[28] Steiner sought the opinion of Melissa Nguyen (Nguyen), a Claymore attorney on whether the trade raised coverage and segregation requirements; Nguyen forwarded the question to Anne Kochevar, another Claymore attorney, who believed that if the put were uncovered, it would require segregated assets; there was further discussion regarding the amount required for asset segregation. Tr. 1267; Exs. 28, 241-42, 246.

Saxon, HCE's chief compliance officer, first learned of HCE's use of short puts in January 2008, after Steiner contacted him. Tr. 2615-17; Ex. 28. After consulting Hale, Saxon told Steiner they were permissible investments for HCE. Tr. 2659-60. Steiner recalled many conversations with Saxon about short puts; some emails document these exchanges. Tr. 1254, 1274; Exs. 256, 263. Steiner recalled that the issues were discussed among multiple Claymore and FAMCO representatives, including Riad and Swanson, and Hale during the January 16, 2008, conference call, and that Hale's approval of the trades was conveyed on that call. Tr. 1269-70, 1299-302; Ex. 252. Saxon was aware of the use of variance swaps in 2007, but had a limited understanding of them. Tr. 2628. Neither Riad nor Swanson ever came to Saxon to discuss any compliance issues, and they never discussed the use of short puts or variance swaps with him. Tr. 2648-49.

Hill had a general awareness that Riad was using short puts.[29] Tr. 2729. He was aware of, and had discussed with Riad,[30] the use of variance swaps; after asking others, he told Riad they were permissible investments for HCE.[31, 32] Tr. 2404-05, 2704-11; Ex. 4. Hill had no recollection of either Riad or Swanson discussing the magnitude, frequency, or risks of the short put or variance swap trades, or providing any details of the trades to him or the board; did not understand what the fund's "macro hedging strategy" was; and was unaware of the extent of the use of the uncovered short puts and variance swaps underlying the "macro hedges."[33, 34] Tr. 2754-57, 2770; Ex. 362 at SEC-Delony-653.

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[29] Hill denied that Riad had ever discussed the use or permissibility of short puts with him, contrary to Riad's claim that he had done so. Tr. 2155, 2758.

[30] Riad requested permission from First Trust's advisor to enter variance swaps, and his request was denied. Tr. 2591. The advisor did not explain the denial, other than to say that variance swaps were not appropriate for the fund. Tr. 2591. Riad testified that he believed the request was denied because First Trust Fund, unlike HCE, was a plain vanilla covered call fund. Tr. 2503-05.

[31] Hill claimed that he asked Hale or Hale's associate whether variance swaps were permissible; Hale denied having been consulted. Tr. 2704-10, 2880.

[32] Hill's understanding of the purpose of hedging function of the short puts and variance swaps is at odds with Respondents' explanation. Respondents consistently said the trades were aimed at reducing volatility in the fund and hedging against rising volatility. Tr. 1971, 2337. Hill's understanding was that the trades were a hedge against decreasing volatility. Tr. 2752-53.

[33] Hill was surprised by the levels of *delta*-adjusted exposure created by uncovered puts, which he learned about only after the fund's fall 2008 losses. Tr. 2760, 2778. He was also surprised to learn the extent of the positions and the potential losses that Riad and Swanson had considered in their own risk calculations and that they disclosed to HCE's board in October 2008. Tr. 2772; Ex. 8.

[34] A July 2008 email discussion between Claymore representatives and Delony concerning the May 31, 2008, Q&A included a question from Hill directed to Claymore counsel regarding whether the description "strategically hedged for additional downside protection" in the Q&A section was sufficiently clear; Hill asked whether they should describe how the hedge worked. Ex. 362 at SEC-

Gallagher believed, based on meetings with Claymore and attorneys, including the January 16, 2008 telephone call, that the prospectus permitted variance swaps and short puts in HCE's portfolio. Tr. 1044-57.

a. January 16, 2008, Telephone Conference

Based on concerns raised by Grossman, and issues discussed in the emails regarding asset segregation, FAMCO and Claymore representatives held a telephone conference on January 16, 2008. Tr. 1269, 1833; Exs. 250, 252. The call was convened "to discuss the segregation and asset coverage requirements of a put written by HCE." Ex. 252. The "Required Attendees" included Claymore attorneys Mark Mathiasen and Anne Kochevar.[35] Id. In addition to determining the segregation and asset coverage requirements, the attendees decided, "This trade was considered a strategic transaction as discussed in the Pro[spectus and] therefore there is no violation," as recorded in Steiner's contemporaneous note. Ex. 27.

There is no evidence to support a finding that the result of the call was to approve naked puts and variance swaps as a strategy going forward,[36] whether or not the prospectus permitted such transactions as "strategic transactions." Nor was there any discussion as to whether HCE was obligated to disclose any such strategy. Tr. 1305-06, 1938. Nor was there any discussion of risk. Tr. 1304-05.

b. Hale

Hale testified that he first learned crucial information regarding HCE's trades from Riad and Swanson at the fall 2008 board meetings. Tr. 2856-58. Specifically, he learned that the frequency of the trades was beyond occasional; he had not gleaned this from reading the fund's reports. Tr. 2856-57. While Hill and Saxon recall consulting Hale, neither contacted him regarding disclosure requirements related to index puts or variance swaps. Tr. 2659, 2758-61.

c. Automated Compliance Systems

Compliance systems in place at FAMCO and Claymore were unable to flag changes in strategy like Respondents' increasing use of uncovered puts and variance swaps. The Charles River System (Charles River), a compliance system, tracked all trades by HCE and generated periodic reports for compliance review, showing whether the fund was in compliance. Tr. 2611. HCE's

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Delony-653. This suggests that Hill did not understand that the strategic hedging consisted of selling uncovered puts and variance swaps.

[35] Swanson testified that the call included "relaying information from the fund's outside counsel to us." Tr. 1937-38. Hale was not actually on the call – he was not listed as an attendee either on the agenda or on Steiner's contemporaneous note and denies being on the call. Tr. 2880; Exs. 27, 252.

[36] Variance swaps were discussed in passing at the end of the call. Tr. 1044-47, 1269-72.

custodian managed Charles River.[37] Tr. 1255-57. Charles River flagged trades that fell outside of pre-designated prospectus restrictions. Tr. 1257, 2650; Ex. 353. Charles River dealt mainly with numerical and technical limits, such as leverage ratios; it did not address strategy shifts or compliance with disclosure. Tr. 1291, 2631, 2650; Ex. 353. Charles River never flagged any compliance issues for trades by HCE, prior to the market crash. Tr. 1259, 1711.

3. HCE Board Meetings

Board meetings presented an opportunity for Respondents to provide information to Claymore since Claymore officers attended all board meetings. Exs. 19, 179, 180, 188, 197, 236, 306-08, 352. Hill and Claymore's then-CEO, Saxon, as well as other Claymore personnel, attended all board meetings from April 2007 through 2008. Id. Both Riad and Swanson attended board meetings; usually Swanson participated by telephone, and Riad led the discussions concerning the portfolio. Tr. 1812-13.

Respondents' memos entitled "Portfolio Manager's Discussion" containing a discussion of performance, commentary on the covered call industry and the markets generally, various charts, and proposals, were circulated before board meetings. Tr. 1949, 2438; Exs. 5-6, 71, 76, 340. Those for the quarterly board meetings between October 2007 and June 2008, did not explain the use of either naked short puts or variance swaps. Id. Each memo represented that 100% of the portfolio was comprised of equities, long calls, and covered calls, and cash. Id. Riad and Swanson did not report figures on the short puts and variance swaps in these memos. Id. and Tr. 2439. Swanson justified this by noting that outstanding uncovered puts and variance swaps required little or no upfront capital. Tr. 1955-56.

Typical disclosure in the memos regarding these types of trades was limited to vague statements like:

> the Fund's covered call strategy was able to more than offset the decline in equities and long calls, while opportunistic hedging transactions throughout the year further supplemented performance during periods of high market volatility. Over the past year, the Fund benefited from a number of strategic decisions, including the active management of the portfolio's coverage ratio, volatility trading strategies, and the effective use of S&P 500 Index puts which augmented downside protection during adverse market periods.

Ex. 6 at CLAY10329, Ex. 76 at FAM38044-45.

[37] Claymore had access to all trades in the sense that Claymore personnel could query the custodian's accounting system. Tr. 1253, 1733. Claymore was a party to the ISDA master agreements with HCE's counterparties. Tr. 1905. There was no evidence presented, however, the Respondents informed Claymore about each swap entered into under the master agreements. See, e.g., Ex. 369.

Riad and Swanson each testified that Riad discussed all of HCE's trading strategies, including the use of short puts and variance swaps; Riad referred to "15, 20-minute discussions at six or seven board meetings." Tr. 1812-13, 2156, 2227, 2552. The minutes of meetings prior to HCE's fatal losses do not corroborate this. Exs. 179-80, 188, 236, 306-08. The only hint in the minutes of potential use of these transactions is in the minutes for April 23, 2008: "Mr. Riad stated that management proposes using short-term leverage for opportunistic purposes."[38] Ex. 307 at CLAY30799. Further, while Toupin recalls Riad's mentioning short index puts and short variance swaps from time to time, Toupin understood them to be occasional transactions, not a strategy, and the majority of Riad's approximately fifteen minute presentations covered the equity selection and covered call strategy. Tr. 2992-93, 3008-14. Saxon's, Hill's, and Barnes's recollections were similar. Tr. 2653-56, 2675, 2729-30, 2925-35. For example, neither Riad nor Swanson ever informed the board that the fund had lost approximately $2.8 million on a June 6, 2008, swap. Tr. 3012.

As the markets declined in fall 2008, the board called several ad hoc meetings and sent queries to discuss the fund's situation, but Respondents did not fully disclose the put and variance swap strategy until the October 20-21, 2008, board meeting. Ex. 19 at CLAY16625-26. Riad and Swanson's September 17, 2008, update, provided for a board conference call, stated that HCE's "macro hedging strategy" had adversely affected relative performance for the first two weeks of the month as compared with the fund's benchmarks, the S&P 500 Index and the BXM. Tr. 1788-89; Ex. 54 at FAM13088. There was no mention of either short puts or variance swaps in the update. Ex. 54. This was two days before HCE entered the September 19, 2008, short variance swaps. Ex. 40. The decision to enter into those variance swaps was not disclosed to the board until weeks later. Tr. 2946-47, 3024-25.

The board first learned about the extent of the losses and exposures created by the short put positions and variance swaps at the time of the October 10, 2008, special board meeting. Tr. 2937, 3027; Ex. 13, Ex. 197 at CLAY28514. Just prior to that meeting, on October 8, 2008, Claymore sent the board members a financial update written by Riad and Swanson. Tr. 2016-17; Ex. 13. That update discussed "put-sale[s]" and variance swaps as "Alternative Investment Strategies" HCE had implemented. Ex. 13 at CLAY14854. It was not until the October 20-21, 2008, board meeting that Riad described the nature and specifics of the transactions that the fund had entered into, as well as the associated risks. Ex. 19 at CLAY16625-26.

[38] A draft of the April 23, 2008, minutes, annotated by counsel to the board, includes a sentence stating that Riad discussed "macrohedging" the portfolio to protect the trust during times of extreme volatility. Ex. 26 at CLAY21961. Counsel circled the word "macrohedging" and wrote, "What does this mean? I heard him say he thought worst was over end of Feb and March 17 – Bear Stearns and so he was more unhedged than he would have liked to be." Id. These notes show that any discussions of "macrohedging" were limited, and that Respondents did not inform attendees of the extent to which these trades were being implemented. The sentence does not appear in the final version of the minutes. Ex. 306 at CLAY30799.

H. Respondents' Compensation Related to HCE

In 2007, Riad was paid approximately $255,000 in salary. Tr. 2252; Ex. 112. As an equity holder in FAMCO, he was paid approximately $1.1 million in quarterly distributions and lump-sum payments by Piper Jaffray, which purchased FAMCO. Tr. 2253-54; Ex. 113. For 2008, Riad was paid approximately $362,000, which included a salary payment of approximately $250,000, and a bonus of approximately $115,000. Tr. 2255; Ex. 111. He was also paid approximately $75,000 in connection with his equity stake in FAMCO during 2008. Ex. 111. Riad invested in FOF and lost approximately $1.6 million, which was a quarter of his life savings at the time. Tr. 2587.

Swanson received a fixed salary and a bonus of 10% to 25% of his base salary; he did not share in FAMCO's profits. Tr. 1849-50, 1876. In 2007, Swanson received a salary of approximately $200,000, and a bonus of $128,000 – $100,000 of which was half of a retention bonus related to Piper Jaffray's purchase of FAMCO. Tr. 1874-76; Ex. 112. Swanson was paid approximately $293,000 in 2008, including a $200,000 salary, and a bonus of $87,500, including $50,000 of his retention bonus from Piper Jaffray. Tr. 1875-77; Ex. 111. Swanson had no investments in FOF or HCE; most of his investments are in his sons' 529 plans, in which HCE was not allowed as an investment. Tr. 1850-52.

III. CONCLUSIONS OF LAW

The OIP charges that Respondents willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 34(b) of the Investment Company Act. Additionally, it charges that Respondents willfully aided and abetted and caused FAMCO's violation of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder and HCE's violations of Section 34(b) of the Investment Company Act, and that Riad caused HCE's violation of Investment Company Act Rule 8b-16. As discussed below, it is concluded that Respondents willfully violated Exchange Act Section 10(b) and Rule 10b-5 and Investment Company Act Section 34(b) and aided and abetted and caused FAMCO's violation of Advisers Act Section 206(4) and Rule 206(4)-8 thereunder, and that Riad caused HCE's violation of Investment Company Act Rule 8b-16.

A. Antifraud Provisions

Respondents are charged with violations of the antifraud provisions of the, Exchange, Investment Company, and Advisers Acts – Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, and Sections 34(b) of the Investment Company Act – which prohibit essentially the same type of conduct. United States v. Naftalin, 441 U.S. 768, 773 n.4, 778 (1979); SEC v. Pimco Advisors Fund Mgmt. LLC, 341 F. Supp. 2d 454, 469 (S.D.N.Y. 2004).

Exchange Act Section 10(b) and Rule 10b-5 make it unlawful "in connection with the purchase or sale of" securities, by jurisdictional means, to:

1) employ any device, scheme, or artifice to defraud;

> 2) obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary to make the statement made not misleading; or
>
> 3) engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Similar proscriptions are contained in Advisers Act Section 206(4), as well as in Advisers Act Rule 206(4)-8, which applies specifically to "any investment adviser to a pooled investment vehicle." 15 U.S.C § 80b-6(4); 17 C.F.R. § 275.206(4)-8. Investment Company Act Section 34(b) makes it unlawful "to make any untrue statement of a material fact in any registration statement, application, record, or other document filed or transmitted pursuant to this title." 15 U.S.C. § 80a-33(b).

Scienter is required to establish violations of Exchange Act Section 10(b) and Rule 10b-5. Aaron v. SEC, 446 U.S. 680, 690-91, 695-97 (1980); SEC v. Steadman, 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992). It is "a mental state embracing intent to deceive, manipulate, or defraud." Aaron, 446 U.S. at 686 n.5; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12 (1976); SEC v. Steadman, 967 F.2d at 641. Recklessness can satisfy the scienter requirement. See David Disner, 52 S.E.C. 1217, 1222 & n.20 (1997); SEC v. Steadman, 967 F.2d at 641-42; Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990). Reckless conduct is "conduct which is 'highly unreasonable' and represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 47 (2d Cir. 1978) (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)).

Scienter is not required to establish a violation of Investment Company Act Section 34(b) or Advisers Act Section 206(4) and Rule 206(4)-8 thereunder; a showing of negligence is adequate. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); SEC v. Steadman, 967 F.2d at 643 & n.5; SEC v. Yorkville Advisors, LLC, No. 12-cv-7728, 2013 WL 3989054, at *3 (S.D.N.Y Aug. 2, 2013); SEC v. Quan, No. 11-cv-723, 2013 WL 5566252, at *16 (D. Minn. Oct. 8, 2013); Fundamental Portfolio Advisors, Inc., 56 S.E.C. 651, 670 (2003), recon. denied, 85 SEC Docket 1754 (May 23, 2005); Byron G. Borgardt, 56 S.E.C. 999, 1021 & n.34 (2003). Negligence is the failure to exercise reasonable care. IFG Network Sec., Inc., Exchange Act Release No. 54127 (July 11, 2006), 88 SEC Docket 1374, 1389.

Material misrepresentations and omissions violate Exchange Act Section 10(b) and Rule 10b-5, Investment Company Act Section 34(b), and Advisers Act Section 206(4). The standard of materiality is whether or not a reasonable investor or prospective investor would have considered the information important in deciding whether or not to invest. See Basic Inc. v. Levinson, 485 U.S. 224, 231-32, 240 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); SEC v. Steadman, 967 F.2d at 643.

1. Respondents Are Fiduciaries

FAMCO was a registered investment adviser, and Respondents were associated persons of an investment adviser. See Advisers Act Sections 202(a)(17), 203(f). Investment advisers and their associated persons are fiduciaries. Fundamental Portfolio Advisors, Inc., 56 S.E.C. 651, 684 (2003); see Capital Gains Research Bureau, Inc., 375 U.S. at 191-92, 194, 201; see also Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979). As fiduciaries, they are required "to act for the benefit of their clients, . . . to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients." SEC v. DiBella, No. 3:04-cv-1342, 2007 WL 2904211, at *12 (D. Conn. Oct. 3, 2007) (quoting SEC v. Moran, 922 F. Supp. 867, 895-96 (S.D.N.Y. 1996)), aff'd, 587 F.3d 553 (2d Cir. 2009); see also Capital Gains Research Bureau, Inc., 375 U.S. at 194 ("Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients." (footnotes omitted)). "[W]hat is required is '. . . not simply truth in the statements volunteered but disclosure' [of material facts]." Capital Gains Research Bureau, Inc., 375 U.S. at 201. "The law is well settled . . . that so-called 'half-truths' – literally true statements that create a materially misleading impression – will support claims for securities fraud." SEC v. Gabelli, 653 F.3d 49, 57 (2d Cir. 2011), rev'd on other grounds, 133 S. Ct. 1216 (2013).

2. Aiding and Abetting; Causing

The OIP charges that Respondents "aided and abetted" and "caused" violations by FAMCO and HCE of various provisions. For "aiding and abetting" liability under the federal securities laws, three elements must be established: (1) a primary or independent securities law violation committed by another party; (2) awareness or knowledge by the aider and abettor that his or her role was part of an overall activity that was improper; and (3) that the aider and abettor knowingly and substantially assisted the conduct that constitutes the violation. See Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000); Woods v. Barnett Bank of Ft. Lauderdale, 765 F.2d 1004, 1009 (11th Cir. 1985); Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir. 1980); IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980); Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94-97 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304, 1316-17 (6th Cir. 1974); Russo Sec. Inc., 53 S.E.C. 271, 278 & n.16 (1997); Donald T. Sheldon, 51 S.E.C. 59, 66 (1992), aff'd, 45 F.3d 1515 (11th Cir. 1995); William R. Carter, 47 S.E.C. 471, 502-03 (1981). A person cannot escape aiding and abetting liability by claiming ignorance of the securities laws. See Sharon M. Graham, 53 S.E.C. 1072, 1084 n.33 (1998), aff'd, 222 F.3d 994 (D.C. Cir. 2000). The knowledge or awareness requirement can be satisfied by recklessness when the alleged aider and abettor is a fiduciary or active participant. See Ross v. Bolton, 904 F.2d 819, 824 (2d Cir. 1990); Cornfeld, 619 F.2d at 923, 925; Rolf, 570 F.2d at 47-48; Woodward, 522 F.2d at 97. That is, it must be established that a respondent either acted with knowledge or that he "encountered 'red flags,' or 'suspicious events creating reasons for doubt' that should have alerted him to the improper conduct of the primary violator," or there was a danger so obvious that he must have been aware of it. Howard v. SEC, 376 F.3d 1136, 1143 (D.C. Cir. 2004).

For "causing" liability, three elements must be established: (1) a primary violation; (2) an act or omission by the respondent that was a cause of the violation; and (3) the respondent knew, or should have known, that his conduct would contribute to the violation. Robert M. Fuller, 56 S.E.C.

976, 984 (2003), pet. for review denied, 95 F. App'x 361 (D.C. Cir. 2004). A respondent who aids and abets a violation also is a cause of the violation under the federal securities laws. See Graham, 53 S.E.C. at 1085 n.35. Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. See KPMG Peat Marwick LLP, 54 S.E.C. 1135, 1175 (2001), recon. denied, 55 S.E.C. 1 (2001), pet. for review denied, 289 F.3d 109 (D.C. Cir. 2002), reh'g en banc denied, 2002 U.S. App. Lexis 14543 (D.C. Cir. 2002).

3. Willfulness

In addition to requesting a cease-and-desist order, as authorized by Sections 21C(a) of the Exchange Act, 9(f) of the Investment Company Act, and 203(k) of the Advisers Act and disgorgement, as authorized by Sections 21C(e) of the Exchange Act, 9(e) of the Investment Company Act, and 203(j) of the Advisers Act, the Division requests sanctions pursuant to Sections 15(b) of the Exchange Act, 9(b) and 9(d) of the Investment Company Act, and 203(f) and 203(i) of the Advisers Act. Willful violations by Respondents must be found in order to impose sanctions on them pursuant to Sections 15(b) and 21B of the Exchange Act, 9(b) and 9(d) of the Investment Company Act, and 203(f) and 203(i) of the Advisers Act. A finding of willfulness does not require an intent to violate, but merely an intent to do the act which constitutes a violation. See Wonsover v. SEC, 205 F.3d 408, 413-15 (D.C. Cir. 2000); Steadman v. SEC, 603 F.2d at 1135; Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965).

B. Antifraud Violations

The record shows that each Respondent willfully violated Exchange Act Section 10(b) and Rule 10b-5 and Investment Company Act Section 34(b) and willfully aided and abetted and caused violations by HCE of Investment Company Act Section 34(b) and violations by FAMCO of Advisers Act Section 206(4) and Rule 206(4)-8. The violations consisted of material misrepresentations and omissions in the Q&A sections of HCE's annual and semiannual reports. Each Respondent's actions show a reckless degree of scienter – a highly unreasonable and an extreme departure from the standards of ordinary care – and a clear violation of the fiduciary duty owed by an investment adviser.

HCE was established and marketed as a covered call fund. During 2007 Riad added a new strategy – selling naked puts and variance swaps to generate income for the fund and add to its gains. The new strategy achieved its goals without succumbing to losses for more than a year, generating nearly 45% of HCE's gains, and provided a substantial amount of cash for the fund, enabling it to meet its dividend requirements. The gains from writing naked index puts generated about 20% of the fund's gains for the fiscal year ended November 30, 2007, and were in the form of cash (unlike the gains created by holding equities that rose in value, which accounted for 60% of the fund's gains). That 20% gain, which was achieved in only about seven months of the 2007 fiscal year, matched the gains from selling covered calls, which HCE's prospectus represented as the principal strategy of generating income for the fund. Thus, the written index put and variance strategy was also a principal strategy of the fund. However, the Q&A sections of the November 30, 2007, annual and May 31, 2008, semiannual reports omitted to mention this. Instead, the Q&As stated that HCE sought to achieve its investment objectives by "investing in a diversified portfolio of equity securities and writing (selling) call options on a substantial portion of the securities in the portfolio" and discussed the process for investing in equities and selling calls, commenting on various equity sectors. While this representation was consistent with the prospectus, it was not consistent with HCE's actual investment strategy.

The November 30, 2007, Q&A did not disclose the new strategy. Instead, the Q&A attributed nearly all of HCE's income generation and gains to equity investments in high-producing industry sectors, as well as "good strategic decisions on the option overlay, with regard to both individual equities and industry sectors," i.e. the covered calls. The Q&A also specifically mentioned purchased index puts as part of a collaring strategy, but made no mention of written index puts or variance swaps. The May 31, 2008, semiannual report's Q&A section, similarly, failed to disclose the strategy that Riad had devised. Like the November 30, 2007, Q&A, the May 31, 2008, Q&A touted the covered call strategy of the fund. Additionally, the May 31, 2008, Q&A attributed HCE's positive performance, compared to the S&P 500 Index, to the covered call strategy and to the fund's purchase of protection by way of "writing short dated covered calls that were at the money or slightly in the money on some of the securities with the greatest volatility." There was no mention of written index puts or variance swaps in the May 31, 2008, Q&A.

There were no disclosures of the new strategy elsewhere in the annual and semiannual reports or in HCE's Forms N-Q. The May 31, 2008, semiannual report referred vaguely to a "hedge program" and "global macro hedges work[ing] out," but did not explain what the hedge program and the global macro hedges were or how they worked. The November 30, 2007, annual report did not even refer to hedges. It did disclose an outstanding written index put, but not that it was naked or that it was one of several consecutive, and sometimes overlapping, index puts written during the prior seven months. The same report included a note in the financial statements that there was an outstanding variance swap, but did not include information on the size of the trade or information informing investors that the fund had entered into back-to-back variance swaps in July and October 2007. There were no such disclosures in the May 31, 2008, semiannual report. Forms N-Q for the periods ended August 31, 2007, February 29, 2008, and August 31, 2008, provided similar disclosures of single written index puts and variance swaps, but none provided any more context than had been disclosed in the November 30, 2007, annual report.

The misrepresentation and omission were clearly material. While Riad's research provided the basis for his counterintuitive conclusion that the new strategy had minimal risk and would be profitable, a reasonable investor or prospective investor would have considered the information important in deciding whether or not to invest. HCE's prospectus represented that it would generate income and gains through the investment managers' stock picking, covered call writing, and calls on calls. Instead, nearly half of the firm's gains and a substantial amount of the fund's income reserved for dividends were being generated by writing naked index puts, and to some extent, short variance swaps. This shift impacted not only the core investment strategies of the fund, but also the fundamental risk footprint of the fund. The principal risk in a covered call fund is loss in equity value; the covered calls have no downside risk if the equity markets fall. An added strategy that compounds downside risk potential, no matter how remote, is information that a reasonable investor would consider important. The fact that the new strategy eventually resulted in enormous losses highlights the materiality of the change in strategy.

Riad and Swanson were the "makers" of the statements in the Q&A sections of the November 30, 2007, annual and May 31, 2008, semiannual reports within the meaning of Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011) (a "maker" is a person or entity "with ultimate authority over the statement, including its content and whether and how to communicate it . . . attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by – and only by – the party to whom it is attributed."). The Q&As specifically attribute the answers to Riad and Swanson. Swanson initially provided the answers to Delony to include in the Q&As and signed certifications that they were accurate. Riad reviewed and approved them. Their actions were clearly willful.

Respondents described the naked puts and variance swaps as permitted by the "strategic transactions" paragraph of HCE's prospectus. However, while they were told that such transactions were permissible,[39] there is no evidence that they were told that the prospectus permitted HCE to engage in the transactions continuously as a strategy.

Respondents argue that Claymore was responsible for disclosure, not they, and that Claymore personnel parsed HCE's disclosure before issuing the annual and semiannual reports. Assuming, arguendo, that Claymore personnel were aware of the change in strategy, the fact that others contributed to the misrepresentation does not relieve Respondents from responsibility. See James J. Pasztor, 54 S.E.C. 398, 406-07, 411-13 (1999) (supervisor held liable for registered representative's execution of violative directed trades; supervisor had tried to stop the trading but was overruled by broker-dealer's owner who was friendly with the customer). Further, the record does not show that Claymore was aware of the use of naked puts and variance swaps as a strategy. Rather, the evidence establishes that Respondents provided information concerning these transactions but that the disclosures were incomplete or concerned only single, isolated trade positions.

In sum, it is concluded that Respondents willfully violated Exchange Act Section 10(b) and Rule 10b-5 and Investment Company Act Section 34(b) and willfully aided and abetted and caused violations by HCE of Investment Company Act Section 34(b) and violations by FAMCO of Advisers Act Section 206(4) and Rule 206(4)-8 by the same material misrepresentations and omissions.

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[39] Respondents do not claim that they were relying on the advice of counsel. In considering whether to credit an advice of counsel claim, the Commission considers four elements: "that the person made complete disclosure to counsel, sought advice on the legality of the intended conduct, received advice that the intended conduct was legal, and relied in good faith on counsel's advice" (footnote citing precedent omitted). Howard Brett Berger, Exchange Act Release No. 58950 (Nov. 14, 2008), 94 SEC Docket 11615, 11629-31, petition for review denied, 347 F. App'x 692 (2d Cir. 2009), cert. denied, 130 S. Ct. 2380 (2010). Counsel must also be independent. C.E. Carlson, Inc. v. SEC, 859 F.2d 1429, 1436 (10th Cir. 1988); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 181-82 (2d Cir. 1976).

C. Investment Company Act Rule 8b-16

Investment Company Act Section 8(b) requires investment companies to disclose the investment objectives and policies that will constitute their principal portfolio emphasis, including how the fund proposes to achieve its objectives. See Form N-2, Item 8.2, and 8.2(b). Investment Company Act Rule 8b-16(a) requires that an investment company update its registration statement annually. Investment Company Act Rule 8b-16(b) exempts a closed-end investment company from having to file a registration statement update, provided it discloses certain updates in its annual report to shareholders. Mandatory updates include material changes in the closed-end investment company's investment objectives or policies. The HCE prospectus did not identify the written index put and variance swap strategy as a principal strategy of the fund, and the registration statement was never amended to include this. For the same conduct described above, HCE violated, and Riad caused the violation of, Rule 8b-16.

IV. SANCTIONS

The Division requests cease-and-desist orders, bars, disgorgement (plus prejudgment interest), and third-tier civil money penalties. As discussed below, Respondents will be ordered to cease and desist from violations of Exchange Act Section 10(b) and Rule 10b-5 thereunder and Investment Company Act Section 34(b), and from aiding and abetting Advisers Act Section 206(4) and Rule 206(4)-8 thereunder, and Investment Company Act Section 34(b). Riad will be ordered to cease and desist from causing violations of Investment Company Act Rule 8b-16. Both will be barred from the securities industry. Riad is ordered to disgorge $188,948.52 plus prejudgment interest and to pay a third-tier civil penalty of $130,000. Swanson is ordered to pay a third-tier civil penalty of $130,000.

A. Sanction Considerations

In determining sanctions, the Commission considers such factors as:

> the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Steadman, 603 F.2d at 1140 (quoting SEC v. Blatt, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)). The Commission also considers the age of the violation and the degree of harm to investors and the marketplace resulting from the violation. Marshall E. Melton, 56 S.E.C. 695, 698 (2003). Additionally, the Commission considers the extent to which the sanction will have a deterrent effect. Schield Mgmt. Co., Exchange Act Release No. 53201 (Jan. 31, 2006), 87 SEC Docket 848, 862 & n.46. As the Commission has often emphasized, the public interest determination extends to the public-at-large, the welfare of investors as a class, and standards of conduct in the securities business generally. See Christopher A. Lowry, 55 S.E.C. 1133, 1145 (2002), aff'd, 340 F.3d 501 (8th Cir. 2003); Arthur Lipper Corp., 46 S.E.C. 78, 100 (1975). The amount of a sanction depends on the facts of each case and the value of the sanction in preventing a recurrence. See Berko v. SEC, 316 F.2d 137, 141 (2d Cir. 1963); see also Leo Glassman, 46 S.E.C. 209, 211-12 (1975).

B. Sanctions

1. Cease and Desist

Sections 8A of the Securities Act, 21C(a) of the Exchange Act, 203(k) of the Advisers Act, and 9(f) of the Investment Company Act authorize the Commission to issue a cease-and-desist order against a person who "is violating, has violated, or is about to violate" any provision of those Acts or rules thereunder. Whether there is a reasonable likelihood of such violations in the future must be considered. KPMG Peat Marwick LLP, 54 S.E.C. at 1185. Such a showing is "significantly less than that required for an injunction." Id. at 1183-91. In determining whether a cease-and-desist order is appropriate, the Commission considers the Steadman factors quoted above, as well as the recency of the violation, the degree of harm to investors or the marketplace, and the combination of sanctions against the respondent. See id. at 1192; see also WHX Corp. v. SEC, 362 F.3d 854, 859-61 (D.C. Cir. 2004).

Each Respondent violated, or aided and abetted or caused violations of, provisions of the Exchange Act, Advisers Act and Investment Company Act. Each Respondent's education, experience, and chosen occupation in or related to the financial industry will present opportunities for future violations. The violations were neither recent nor remote in time, having ended about six years ago. In light of these considerations, a cease-and-desist order against each Respondent is appropriate.

2. Disgorgement

Sections 8A(e) of the Securities Act, 21B(e) and 21C(e) of the Exchange Act, 203(j) of the Advisers Act, and 9(e) of the Investment Company Act authorize disgorgement of ill-gotten gains from Respondents. Disgorgement is an equitable remedy that requires a violator to give up wrongfully-obtained profits causally related to the proven wrongdoing. See SEC v. First City Fin. Corp., Ltd., 890 F.2d 1215, 1230-32 (D.C. Cir. 1989); see also Hateley v. SEC, 8 F.3d 653, 655-56 (9th Cir. 1993). It returns the violator to where he would have been absent the violative activity.

The amount of the disgorgement ordered need only be a reasonable approximation of profits causally connected to the violation. See Laurie Jones Canady, 54 S.E.C. 65, 84-85 n.35 (1999) (quoting SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1475 (2d Cir. 1996)), petition for review denied, 230 F.3d 362 (D.C. Cir. 2000); see also SEC v. First Pac. Bancorp, 142 F.3d 1186, 1192 n.6 (9th Cir. 1998) (holding disgorgement amount only needs to be a reasonable approximation of ill-gotten gains); accord First City Fin. Corp., Ltd., 890 F.2d at 1231-32.

The Commission is authorized to order disgorgement of salary. Rita J. McConville, Exchange Act Release No. 51950 (June 30, 2005), 85 SEC Docket 3127, 3151 n.64. Likewise, commissions derived from management fees are appropriately disgorged where they constitute ill-gotten gains earned during the course of violative activities. SEC v. Kapur, No. 11-cv-8094, 2012 WL 5964389, at *3-*4 (S.D.N.Y. Nov. 29, 2012); SEC v. Radical Bunny, LLC, No. 09-cv-1560, 2011 WL 1458698, at *8 (D. Ariz. Apr. 12, 2011), aff'd, No. 11-16275, 2013 WL 3456657 (9th Cir. July 10, 2013); Joseph John VanCook, Exchange Act Release No. 61039A (Nov. 20, 2009), 97 SEC Docket 22664, 22691-93. However, the Commission distinguishes between amounts earned through legitimate activities and those connected to violative activities, and it falls on the Division to show what a reasonable approximation of the salary or fees was unjust enrichment. See Gregory O. Trautman, Securities Act Release No. 9088A (Dec.15, 2009), 97 SEC Docket 23492, 23529-32 (finding that all of respondent's salary was not a reasonable measure of his unjust enrichment, but that fifty percent was related to illegitimate revenues earned through violative conduct); accord Joseph John VanCook, 97 SEC Docket at 22691.

Riad will be ordered to disgorge a total of $188,948.52 plus prejudgment interest. His role with HCE dealt primarily with managing the non-covered call derivatives, the fund components not disclosed to shareholders. Thus, the portion of his salary devoted to HCE for 2007, prorated from April 25, 2007, when HCE wrote its first naked written index put, and for 2008 should be disgorged. Since Riad had three major roles at FAMCO – portfolio manager of HCE, portfolio manager of the First Trust, and managing director at FAMCO, one-third – $141,727.16 – of his salary for 2007 and 2008 ties to HCE, as well as one-third – $37,368.33 of the bonus he received in 2008. Accordingly, he will be ordered to disgorge those sums. Riad's equity distributions resulted from the entire business of FAMCO, which had about $15 billion in assets under management. HCE's assets of approximately $100 million were 1/150th of FAMCO's assets under management. Accordingly, Riad will be ordered to disgorge 1/150th of his FAMCO equity distributions for 2007 – $7,853.03. Prejudgment interest will be ordered from September 1, 2008, the first day of the month following Riad's violation.

Salary for Swanson's management of HCE related largely to the equity and covered call portion of the fund, the noncontroversial segment of HCE. Thus, his salary will not be ordered disgorged. Because Swanson's 2007 and 2008 bonuses did not relate to personal direction of HCE's written index puts and variance swaps, he will not be ordered to disgorge any portion of them.

3. Civil Money Penalty

Sections 21B of the Exchange Act, 203(i) of the Advisers Act, and 9(d) of the Investment Company Act authorize the Commission to impose civil money penalties for willful violations of the Securities, Exchange, Advisers, or Investment Company Acts or rules thereunder. In considering whether a penalty is in the public interest, the Commission may consider six factors: (1) fraud; (2) harm to others; (3) unjust enrichment; (4) previous violations; (5) deterrence; and (6) such other matters as justice may require. See Sections 21B(c) of the Exchange Act, 203(i)(3) of the Advisers Act, and 9(d)(3) of the Investment Company Act; New Allied Dev. Corp., 52 S.E.C. 1119, 1130 n.33 (1996); First Sec. Transfer Sys., Inc., 52 S.E.C. 392, 395-96 (1995); see also Jay Houston Meadows, 52 S.E.C. at 787-88 (1996), aff'd, 119 F.3d 1219 (5th Cir. 1997); Consol. Inv. Servs., Inc., 52 S.E.C. 582, 590-91 (1996).

Respondents violated the antifraud provisions, so their violative actions "involved fraud" within the meaning of Sections 21B(b)(3)(A), (c)(1) of the Exchange Act; 203(i)(2)(C)(i), (3)(A) of the Advisers Act; and 9(d)(2)(C)(i), (3)(A) of the Investment Company Act.

Penalties in addition to the other sanctions ordered are in the public interest in this case in consideration of fraud, harm to others, unjust enrichment, and the need for deterrence. See Sections 21B(c) of the Exchange Act, 203(i)(3) of the Advisers Act, and 9(d)(3) of the Investment Company Act; see also H.R. Rep. No. 101-616 (1990). The Division requests that Respondents be ordered to pay third-tier penalties. A third-tier penalty, as the Division requests, is appropriate because Respondents' violative acts involved fraud and resulted in substantial losses to other persons who may have decided not to invest or continue to invest in HCE had they received accurate information. See Sections 21B(b)(3) of the Exchange Act, 203(i)(2)(C) of the Advisers Act, and 9(d)(2)(C) of the Investment Company Act. Under those provisions, for each violative act or omission after February 14, 2005, and before March 4, 2009, the maximum third-tier penalty is $130,000 for a natural person. 17 C.F.R. §§ 201.1003, .1004. The provisions, like most civil penalty statutes, leave the precise unit of violation undefined. See Colin S. Diver, The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies, 79 Colum. L. Rev. 1435, 1440-41 (1979).

The naked written index puts and variance swaps caused substantial losses to investors, who were unaware of HCE's written naked index puts and variance swap trading because of respondents' misrepresentations and omissions. Accordingly, third-tier penalties are warranted. The events at issue related to Riad's and Swanson's failure to apprise investors of the naked written index put and variance swap strategy in the Q&A sections of the November 30, 2007, annual and May 31, 2008, semiannual reports will be considered as one course of action resulting in one unit of violation. Accordingly, each Respondent will be ordered to pay a third-tier penalty of $130,000.

4. Bar

The Division requests a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, nationally recognized statistical rating organization, and investment company bar against each Respondent. Such collateral bars are authorized pursuant to Sections 15(b) of the Exchange Act, 203(f) of the Advisers Act, and 9(b) of the Investment Company Act.[40] The Steadman factors weigh in favor of a collateral bar against Respondents.

[40] Collateral bars are authorized pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). While Respondents' misconduct antedates the July 22, 2010, effective date of the Dodd-Frank Act, the Commission has determined that sanctioning a respondent with a collateral bar for pre-Dodd-Frank wrongdoing is not impermissibly retroactive, but rather provides prospective relief from harm to investors and the markets. John W. Lawton, Advisers Act Release No. 3513 (Dec. 13, 2012), 105 SEC Docket 61722, 61737; see also Alfred Clay Ludlum, III, Advisers Act Release No. 3628 (July 11, 2013), 2013 WL 3479060, at *1, 6; Johnny Clifton, Securities Act Release No. 9417 (July 12, 2013), 2013 WL 3487076, at *1, 13; Tzemach David Netzer Korem, Exchange Act Release No. 70044 (July 26, 2013), 2013 WL 3864511, at *1, 7.

Respondents' conduct was egregious. The underlying trading strategy at issue was recurrent without any public disclosure for approximately eighteen months, and Respondents made misrepresentations and omissions in two successive reports to shareholders. Respondents acted with a reckless degree of scienter. Both Respondents continue to deny any personal responsibility for the violations, contending that the responsibility for disclosure was Claymore's. Each Respondent's occupation, in light of his education and experience, presents opportunity for future misconduct as well. It is in the public interest to bar respondents from the securities industry, and is an appropriate deterrent.

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on March 7, 2014, as corrected on March 27, 2014.

VI. ORDER

IT IS ORDERED that, pursuant to Sections 21C(a) of the Securities Exchange Act of 1934, 9(f) of the Investment Company Act of 1940, and 203(k) of the Investment Advisers Act of 1940,

> Mohammed Riad CEASE AND DESIST from committing any violations or future violations of Securities Exchange Act of 1934 Section 10(b) or Rule 10b-5 thereunder and Investment Company Act of 1940 Section 34(b), or aiding, abetting, or causing any violations or future violations of Investment Company Act of 1940 Section 34(b) and Rule 8b-16 thereunder, and Investment Advisers Act of 1940 Section 206(4) and Rule 206(4)-8 thereunder; and
>
> Kevin Timothy Swanson CEASE AND DESIST from committing any violations or future violations of Securities Exchange Act of 1934 Section 10(b) or Rule 10b-5 and Investment Company Act of 1940 Section 34(b), or aiding, abetting, or causing any violations or future violations of Investment Company Act of 1940 Section 34(b), and Investment Advisers Act of 1940 Section 206(4) and Rule 206(4)-8 thereunder.

IT IS FURTHER ORDERED that, pursuant to Sections 8A(e) of the Securities Act of 1933, 21B(e) and 21C(e) of the Securities Exchange Act of 1934, 203(j) of the Investment Advisers Act of 1940, and 9(e) of the Investment Company Act of 1940,

> Mohammed Riad DISGORGE $188,948.52 plus prejudgment interest at the rate established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), compounded quarterly, pursuant to 17 C.F.R. § 201.600(b). Pursuant to 17 C.F.R. § 201.600(a), prejudgment interest is due from September 1, 2008, through the last day of the month preceding which payment is made.

IT IS FURTHER ORDERED that, pursuant to Sections 21B of the Securities Exchange Act of 1934, 203(i) of the Investment Advisers Act of 1940, and 9(d) of the Investment Company Act of 1940,

Mohammed Riad PAY A CIVIL MONEY PENALTY of $130,000; and

Kevin Timothy Swanson PAY A CIVIL MONEY PENALTY of $130,000.

IT IS FURTHER ORDERED that, pursuant to Sections 15(b) of the Securities Exchange Act of 1934, 203(f) of the Investment Advisers Act of 1940, and 9(b) of the Investment Company Act of 1940,

> Mohammed Riad IS BARRED from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and IS PROHIBITED, permanently, from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.
>
> Kevin Timothy Swanson IS BARRED from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and IS PROHIBITED, permanently, from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

Payment of penalties and disgorgement plus prejudgment interest shall be made on the first day following the day this Initial Decision becomes final. Payment shall be made by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission. The payment, and a cover letter identifying the Respondent(s) and Administrative Proceeding No. 3-15141, shall be delivered to: Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Bld., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111(h) of the Commission's Rules of Practice, 17 C.F.R. § 201.111(h). If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial

Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Carol Fox Foelak
Administrative Law Judge