**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-15141**

**In the Matter of**

**MOHAMMED RIAD**
**AND KEVIN TIMOTHY**
**SWANSON**

**Respondents.**

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# THE DIVISION OF ENFORCEMENT'S POST-HEARING BRIEF

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## I. PRELIMINARY STATEMENT

The hearing in this matter lasted eleven days, with testimony from twenty witnesses and the record contains nearly four hundred exhibits. There is too much information for any submission to describe all of the testimony or all of the exhibits. Accordingly, in this brief the Division will simply provide the Court with a summary of the evidence which would justify a decision holding Respondents liable.

Riad and Swanson felt significant pressure to meet or exceed their benchmarks and generate sufficient income to meet HCE's annual dividend targets. This very real pressure prompted them to seek out derivative investments that would generate additional income, but carried additional risk of loss. The investments selected by Respondents, written put options and short variance swaps, are not commonly-used in covered-call funds, and they were not described in HCE's registration statement. Accordingly, HCE's investors had no reason to know or expect that the Fund would begin investing in puts and swaps.

Riad and Swanson both knew these investments were risky and that losses could be very large in declining or volatile markets. However, they thought the likelihood of any such losses was remote. The additional income generated by the written put and variance swap investments allowed HCE to outperform its benchmarks and lead its competitors. Under Riad's and Swanson's management, these derivative investments became a principal fund strategy and they transformed the HCE fund into something different than its investors, Board members, and its Fund counsel thought that it was. HCE became an insurer of investments made by other market participants.

By September, Riad and Swanson knew that HCE could lose substantial sums of money on written put and variance swap investments. However, they were unwilling to close out HCE's derivative positions and tried to recover HCE's previous losses by doubling down in the same types of investments. This led to a disaster for HCE, and Riad and Swanson were loath to admit the truth about what had happened to HCE's Board.

Given the manner in which the written puts and variance swaps affected the HCE fund, for both good and bad, it is obvious that the disclosures to investors regarding performance, investment strategy and risks were risks and investment strategy were inadequate. In fact, they were so misleading as to be nearly useless. Riad and Swanson could have disclosed additional information about the performance, risk and strategies associated with HCE's investments in written puts and variance swaps to HCE's investors and the Fund's Board. They chose not to share this information for their own reasons, and their decision to ignore their disclosure obligations has caused HCE's investors to suffer severe financial losses.

The Commission should not permit portfolio managers who hide principal investment strategies, risks and performance results from Fund investors, who then suffer losses as a result of undisclosed investment decisions, to escape liability and an appropriate sanction. Allowing such a result would impose a terrible injustice on investors and send the wrong message to the entire securities industry.

The Division of Enforcement has proven that Riad and Swanson willfully violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and Section 34(b) of the Investment Company Act of 1940 ("Investment Company Act"), willfully aided and abetted and caused FAMCO's violations of Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act"), and Advisers Act Rule 206(4)-8, and willfully aided and abetted and caused HCE's violations of Section 34(b) of the Investment Company Act. The Division also demonstrated that Riad caused HCE's violations of Investment Company Act Rule 8b-16. So Riad and Swanson should each be found liable for the foregoing violations, be ordered to pay a substantial portion of their compensation in 2007 and 2008 as disgorgement, be ordered to pay a significant civil penalty, and be subject to a permanent Dodd-Frank associational bar.

## II. STATEMENT OF FACTS

### A. Background

#### 1. Riad and Swanson Were Responsible for Managing HCE

HCE was a diversified, closed-end investment company with shares offered to the public through a registration statement filed with the Commission on April 26, 2005. (Ex. 11) HCE was managed by Claymore Advisors, LLC ("Claymore"), which acted as the Fund's investment adviser, and Fiduciary Asset Management, LLC ("FAMCO"), which acted as the Fund's sub-adviser.[1] (Ex. 11 at 12386) Claymore's duties were described in an advisory agreement pursuant to which Claymore delegated certain of its duties, including the responsibility for managing HCE's investment portfolio, to FAMCO through

[1] On December 19, 2012, the Commission instituted settled administrative proceedings against FAMCO and Claymore. The Commission found that FAMCO willfully violated Section 34(b) of the Investment Company Act, Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder by managing HCE in a manner inconsistent with HCE's registration statement and making materially misleading statements and omissions of material fact in HCE's 2007 annual report and 2008 semi-annual report. (*See* Ex. 137, In re Fiduciary Asset Management, LLC, Advisers Act Rel. No. 3520, Investment Company Act Rel. No. 30309 (Dec. 19, 2012)). The Commission found that Claymore caused HCE's violations of Investment Company Act Rule 8b-16 and failed reasonably to supervise FAMCO with a view to preventing FAMCO's violations of the federal securities laws. (*See* Ex. 138, In re Claymore Advisors, LLC, Advisers Act Rel. No. 3519, Investment Company Act Rel. No. 30308 (Dec. 19. 2012)). FAMCO and Claymore settled the matters without admitting or denying the Commission's findings.

a sub-advisory agreement. (Ex. 237; Ex. 106) Riad and Swanson were HCE's co-portfolio managers. (Ex. 14 at 15491)

As FAMCO portfolio managers, Riad was compensated through base pay, a bonus, profit-sharing, and equity compensation, and Swanson through base pay and a bonus. In 2007, FAMCO paid Riad $255,769.11 base pay and $1,178,104.96 in profit-sharing, and paid Swanson $202,358.17 base pay and a $128,199.26 bonus. (Exs. 112, 113) In 2008, FAMCO paid Riad $249,999.84 base pay, a $112,105 bonus, and $85,774.29 equity compensation, and paid Swanson $206,299.92 base pay and a $87,514.50 bonus. (Ex. 111)

FAMCO's sub-advisory agreement with Claymore required FAMCO and the portfolio managers to manage HCE in accordance with the Fund's investment policies. (Ex. 106 at 134329-30) Riad and Swanson were responsible for ensuring that HCE's investments complied with HCE's prospectus. (Ex. 124 at 4261-62; Tr. 1290:5-13)

**2. HCE's Investment Objective and Strategy**

HCE's investment objective was to provide a high level of current income and current gains and, to a lesser extent, capital appreciation. (Ex. 11 at 12386) HCE's registration statement set out the investment parameters for the Fund, and described its primary investment strategy as investing in equities and writing call options on a substantial portion of those equities. (Ex. 11 at 12386) By writing a call option on an equity, HCE, in exchange for a premium payment, provides the purchaser the right to purchase or "call away" the stock from HCE at an agreed price. Since HCE owns the underlying stock, the call option is considered "covered." (Ex. 14 at 15493) This is commonly called a "covered call" strategy, and trades upside potential in the equities held in the portfolio for income from the option premiums received through the written calls. (Ex. 11 at 12386; Ex. 139 at ¶¶ 41, 48-49)

Covered call strategies are considered to be conservative equity strategies and are popular among retirees due to the high income generation. (Ex. 139 at ¶¶ 16, 54) Covered call strategies tend to have more stable performance and less market risk than pure equity strategies, and outperform pure equity strategies in down markets. (Tr. 1345:13-1346:6; Ex. 139 at ¶¶ 19, 51-52, Figure 1; Ex. 366 at 49:23-50:9) Riad and Swanson told investors in HCE's periodic reports that HCE's covered call strategy had the potential to protect the Fund from losses in a downward trending market. (Ex. 14 at 15493; Ex. 15 at 15522) Swanson even has emphasized that covered call strategies do quite well during tough market periods, and "that's why you own a covered call product." (Ex. 133 at 4:37-5:17)

There should be no serious dispute that HCE was a covered-call fund. Riad and Swanson often described HCE as a "covered-call fund" or "covered call product" and routinely compared HCE with other covered-call funds in communications with HCE's Board and Claymore. (Ex. 135 at 2:23-3:2; Ex. 136 at 4:18-5:3; Ex. 71 at 24572; Ex. 6 at 10330; Ex. 22 at 16786; Ex. 66 at 21762; Ex. 75 at 34141; Ex. 76 at 38045) HCE's chief compliance officer, HCE's outside counsel, and HCE Board members also understood HCE to be a covered-call fund. (Tr. 2647:17-19, 2830:17-22, 2834:8-17, 2914:10-2915:6, 2990:21-2991:3)

Further, HCE measured its performance against the CBOE Buy Write Index ("BXM"), which was a covered call index. (Ex. 14 at 15492-93) HCE investors and analysts also understood HCE to be a covered-call fund. (Tr. 1349:6-13; 1407:17-1408:19, 1458:7-1459:23) Claymore and FAMCO personnel knew that the market had not differentiated HCE from other covered-call funds.[2] (Ex. 180 at 7915) Michael Boyle, a manager of unit investment trusts whose firm was the largest investor in HCE, testified that his unit investment trusts, which invested $8.3 million in HCE, could not have invested in the Fund at all if it were not considered to be a covered-call fund. (Ex. 140 at 23; Ex. 152; Tr. 1475:6 – 1477:13)

### 3. Riad's and Swanson's Role in Reporting to Investors

Riad and Swanson regularly participated in HCE's periodic reporting to investors. For each annual or semi-annual report, Riad provided a signed certification to Claymore stating, to the best of his knowledge, that: (1) he had reviewed the portfolio of investments listed in the report and the list was complete and accurate; and (2) the securities in the portfolio were purchased in compliance with the investment parameters set forth in HCE's prospectus. (Ex. 9; Ex. 36) Each annual and semi-annual report also contained a Questions and Answers discussion with Riad and Swanson (the "Portfolio Manager Commentary") about the Fund's performance for the period, which included an introduction specifically attributing the statements in the section to both Riad and Swanson. (Ex. 14 at 15491; Ex. 15 at 15520)

The Questions and Answers discussion was drafted by Patty Delony, a consultant hired by Claymore, based on answers provided by Swanson during recorded interviews. (Tr. 1539:9-1543:4, 1548:10-17) After Delony prepared an initial draft of the commentary, Riad and Swanson reviewed and edited the Questions and Answers before they were included in a particular annual or semi-annual report. (Tr. 1928:16-1929:12, 1930:11-25)

[2] Claymore's sales staff tried to differentiate HCE from other covered-call funds based on certain tax advantages, not a broader investment mandate than other funds. (Ex. 180 at 7915)

Swanson then provided Claymore with a signed certification for each annual and semi-annual report stating that he had reviewed the portfolio manager commentary and, to the best of his knowledge, it did not contain any material misstatements or omissions that would make it inaccurate or misleading. (Ex. 35; Ex. 37)

#### 4. HCE's Dividend Target and the Pressure to Generate Return

In its periodic reports to investors, HCE stated that its goal was to pay investors an annual dividend of 8.5% of the Fund's initial offering price. (Ex. 14 at 15493) In order to meet this high payout objective, FAMCO needed to maintain an annualized return of 10% before fees. (Ex. 5 at 9410) Riad and Swanson recognized that the need to consistently beat the S&P 500 by 100 basis points with a covered call strategy posed "meaningful risk" of NAV erosion, and Riad believed HCE's dividend rate was unsustainable. (Ex. 8 at 11798; Ex. 66 at 21761-62) From the Fund's beginning, Riad expressed concern to the Fund's Board multiple times about meeting the Fund's dividend objective. (Tr. 1131:6-1132:7) In 2008, Riad sought authorization to utilize leverage in HCE to help maintain the Fund's NAV in light of the dividend, and he simultaneously sought permission to reduce HCE's dividend. (Ex. 5 at 9410; Ex. 22 at 16786; Ex. 66; Ex. 306 at 30774, 76)

Riad and Swanson also faced pressure and the risk of being replaced as portfolio managers if they did not meet their performance benchmarks. (2307:18-2313:1)

### B. <u>HCE's Put Option and Variance Swap Strategies</u>

#### 1. Riad and Swanson Turned HCE Into an Insurance Company

Beginning in mid-2007, Riad and Swanson adopted a strategy of writing out-of-the-money put options on the S&P 500 in HCE's portfolio and initiated a strategy of selling volatility using variance swaps as a means of generating additional income to sustain

HCE's high dividend objective.[3] (Ex. 75[4] at 34141; Ex. 63 at 18730-31) Riad primarily managed these strategies, but Swanson consulted with Riad and monitored the strategies' performance. (Ex. 70; Ex. 99 at 119708-10, 23; Tr. 1882:11-1883:24, 1911:15-20)

The variance swap strategy was designed to sell variance swaps to take advantage of perceived mispricing in the market and investors' tendency to overpay for protection. (Ex. 77 at 39550) The put-writing strategy also sought to profit from investors' tendency to overpay for protection by being a provider of that protection. (Tr. 679:13-680:18) At the outset of the strategy, FAMCO frequently purchased put options in combination with writing put options (which had the effect of partially offsetting the risk) but, by the end of 2007, FAMCO switched almost exclusively to writing put options without any long put positions to offset the risk.[5] (Ex. 63)

Riad and Swanson specifically targeted periods of fear and uncertainty as times to sell volatility. (Ex. 1 at 2) FAMCO's research revealed that selling variance swaps during periods of elevated volatility was on average more profitable than during periods of lower volatility. (Ex. 219 at 837-38) However, it is also riskier; variance swaps suffer losses

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[3] Variance swaps are essentially a bet on whether actual or realized market volatility will be higher or lower than an agreed-upon level ("variance strike") over the contract period. Therefore, a party who is "long variance" or the "purchaser" of variance makes a profit 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 makes a profit when realized volatility is less than the variance strike. (Ex. 139 at ¶¶ 94-96)

[4] Swanson drafted Exhibit 75, which was part of a response FAMCO provided during HCE's Board of Trustees' review of FAMCO's contract for renewal. (Tr. 1969:14-1970:18; *see* also Ex. 98 showing Swanson as drafter) In addition, Riad would have reviewed this submission before it was provided to HCE's Board of Trustees. (Tr. 2564:12-2567:1)

[5] For more detail on the nature of written put options and short variance swaps, *see* Ex. 139 at ¶¶ 63-120

more frequently during periods where implied volatility is greater than 20 (and thus when the market is pricing in more volatility), and the average size of those losses is larger. (Ex. 219 at 837-38)

From April to November 2007, Respondents frequently caused HCE to purchase and write S&P 500 put options in HCE's portfolio nearly simultaneously, but typically removed the long put positions before the short positions, leaving HCE with naked put exposure for periods. (Ex. 139 at ¶ 125; Ex. 63 at 18729-30) Beginning in November 2007, Respondents stopped holding long and written put options together and instead began regularly holding written put options without a corresponding long position in HCE's portfolio. (Ex. 139 at ¶ 126) The written put options typically had an expiration of one or two months and strike prices between 6% and 10% below the S&P 500. (Ex. 139 at ¶ 124) The "notional exposure"[6] of these options ranged anywhere from 60% to 140% of HCE's NAV, while the premiums generated by the options ranged from approximately $500,000 to $2.5 million each month HCE wrote put options. (Ex. 139 at ¶¶ 127, 129)

At nearly all times between July 2007 and October 2008, except for the two-month period between April and June 2008, Respondents maintained both written put options and short variance swaps in HCE's portfolio.

### 2. Riad and Swanson Implemented the Strategies Without Guidance From Compliance

Riad and Swanson never sought advice from Bruce Saxon, HCE's chief compliance officer, about the use of these strategies (or about any other compliance matter) and never discussed the risks of those strategies with Saxon. (Tr. 2648:22-2649:18) Riad and Swanson never went to FAMCO's internal compliance officers with questions about put

[6] An option's notional exposure is the amount of maximum loss which would be realized on an option if the underlying security or index were to decline to 0. (Tr. 552:23-553:7)

options and variance swaps or even notified them that they intended to or were trading the products in 2007. (Tr. 1159:15-1160:24, 1291:24-1293:3) In fact, FAMCO's own compliance officers did not become aware of HCE's use of put options and variance swaps until late 2007 or early 2008, and only after Jeffrey Grossman, a FAMCO accountant, brought the situation to their attention. (Tr. 1167:25-1168:6; 1260:17-1261:5)

### 3. FAMCO Expected HCE's Written Put Options and Short Variance Swaps to be Significant Contributors to Performance

The put option and variance swap strategies were a significant contributor to HCE's performance, and helped the Fund achieve its investment objectives. Swanson testified that the strategies helped HCE maintain its net asset value and believed that the strategies made it possible for HCE to maintain its dividend rate because they allowed HCE to "'do more with less.'" (Ex. 66 at 21761; Tr. 1954:21-1955:18) Respondents expected that these derivative investment strategies would significantly boost HCE's return, so long as there were no major market disruptions. Both the put options and variance swaps were *each* expected to add multiple percentage points to HCE's annual return.

Under Respondent's management, HCE wrote put options in sufficient quantities to generate $9.6 million in option premium income between April 2007 and August 2008. (Ex. 139 at ¶ 127; Ex. 86 at 89834) Riad and Swanson expected their written put options to expire in-the-money only 4.7% of the time, so they expected to keep nearly all of the premiums they collected as substantial gains to HCE. (Ex. 77 at 39551) Similarly, FAMCO's backtesting allowed Riad to conclude that consistently selling variance swaps from January 1997 to March 2008 would have increased annual returns by hundreds of basis points. (Ex. 119; Ex. 83 at 65183; Ex. 231 at 61687) HCE's written put options actually generated $4.4 million of profit between April 2007 and July 2008, adding 3.9% to

HCE's return in just over a year, while variance swaps added 1% to HCE's return from July 2007 to July 2008. (Ex. 139 at ¶¶ 128, 137) For the two-year period ending August 31, 2008, HCE's put option and variance swap strategies added 2.9% annually to the Fund's return, accounting for 45% of the Fund's 6.5% annual return over that two-year period.[7] (Ex. 75 at 34141)

The potential for large gains from these strategies and the opportunity to gain exposure to variance swaps was an important part of Sean Hughes' decision to invest in the Fund; Hughes was a FAMCO research analyst that assisted Riad in testing and formulating the investment strategies for HCE. (Tr. 875:5-877:7) These strategies were not ancillary strategies for the Fund; they were significant to how Hughes viewed HCE as an investment.

#### 4. Riad and Swanson Were Aware That Put Options and Variance Swaps Exposed HCE to Significant Risk

Selling put options and variance swaps is profitable because they are equivalent to selling insurance, and there is strong demand from investors to purchase protection and guard against risk. (Tr. 747:4-12, 748:8-17, 776:21-777:4, 830:5-16, 836:12-20; Ex. 82 at 52147-48) So as the insurer, HCE is compensated for taking additional risk for the insured. (Tr. 3345:2-3346:9)

FAMCO's research showed that writing put options and shorting variance swaps added risk to the portfolio. All of the research materials reviewed by Riad and Hughes, the analyst assisting Riad, touted the profitability of the strategies, but warned of the exposure to significant losses in turbulent markets. For example, one academic paper relied upon by Riad and Hughes noted that "[t]here is no arguing that selling naked puts could be very

[7] This contribution to return is even more significant when factoring in that HCE only began writing put options in April 2007 and variance swaps in July 2007, and did not trade those products for most of the first year of the two-year period.

risky" and that "put sellers may occasionally incur huge losses." (Ex. 214 at 149060, 68, 69 n.8; Tr. 677:5-11, 2141:3-10)

Another research report highlighted that variance swaps suffered greatest losses during market crises and were exposed to unlimited losses when faced with severe spikes in volatility.[8] (Ex. 41 at 801-02, 04) This report showed that short variance swaps were regularly subject to substantial losses. Historical backtesting showed that shorting variance swaps with 300,000 vega (an amount commonly used by HCE) could have lost up to $8.1 million during downturns in recent history, and that short variance swaps faced maximum losses of greater than $5 million several times going back to 1997. (Ex. 41 at 801; Tr. 922:4-923:5, 3370:20-3375:18; Ex. 208)

FAMCO's backtesting and investment research also revealed that the market was subject to major volatility spikes and sudden declines. (Ex. 88) Put-writing historically enjoyed steady gains, but suffered sudden, significant losses in tumultuous markets, as much as 25% over one- and two-month periods. (Ex. 204 at 1124-25; Ex. 74 at 33573-74) Written put options and variance swaps perform their worst at the same time: during market crises. (Tr. 922:6-13, 3488:24-3489:10)

FAMCO's research further showed that written put options and short variance swaps actually increase the volatility of an equity portfolio. Written put options have a clear, measurable, increasing effect on a portfolio's volatility by adding delta exposure to a portfolio, which made HCE's portfolio more sensitive to market movements. (Tr. 877:12-879:14; Ex. 139 at ¶ 307) Covered-call funds traditionally are less volatile than pure equity strategies, and HCE's covered call strategy's sensitivity to market movements was

[8] This report offered the idea of using options to hedge or cap exposure on short variance swaps, but Riad never utilized any such hedges. (Ex. 41 at 802, 25)

approximately 70% to 80% that of the equity market. (Tr. 877:12-878:15) HCE's written put options increased HCE's market exposure and sensitivity to market movements and the options' delta exposure was the functional equivalent of borrowing money and investing it in more covered call transactions. (Tr. 204:6-15, 878:16-879:14) FAMCO's backtested simulation of shorting one-month variance swaps in combination with an S&P 500 portfolio also increased the portfolio's volatility. (Ex. 119[9])[10]

Swanson recognized the risk associated with maintaining the written put option and short variance swap exposure. On at least two occasions, Swanson recommended reducing that exposure. In September 2007, Swanson asked Riad "is it prudent to take off at least a third of the short-put position in the FUNDS? . . . if [the Fed] surprise[s], we could be in trouble on those." (Ex. 99 at 119709-10) Riad acknowledged "it will be a volatile ride for the next two weeks" as a result of the put positions. (Ex. 99 at 119710) In November 2007, Swanson again suggested to Riad that "maybe it makes sense to at least dump the variance swap or the short-puts to help reduce risks." (Ex. 99 at 119723) However, Riad informed Swanson that they would have to ride out the positions because they were too expensive to sell, writing "we are boxed in." (Ex. 99 at 119723)

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[9] Ex. 119 shows writing variance swaps on top of an S&P 500 portfolio boosted return from 6.1% to 11.8% annually, but also increased the portfolio's standard deviation from 18.7% to 22.2%.

[10] Hughes presented one strategy to Riad known as forward start variance that involved using long and short variance swaps in combination, which Hughes' research showed both reduced volatility and increased return. (Ex. 202 at 1038, 41; Tr. 918:22-919:10) Hughes described the strategy as "an ideal tool to reduce volatility in our portfolios without reducing returns." (Ex. 202 at 1041) This strategy historically had modestly increased return *and* decreased portfolio volatility through its protective long variance position, but Riad instead opted for the potential for larger returns with unhedged short variance swaps. (Ex. 202 at 1038; Tr. 919:11-921:1)

Jeffrey Grossman, HCE's portfolio accountant who had significant options trading experience, warned Riad repeatedly of the risks associated with writing naked put options. (Tr. 494:15-497:16, 522:16-20) However, Riad dismissed these warnings; Grossman then brought his concerns that HCE could suffer large losses to FAMCO's compliance department. (Tr. 1293:17-1294:1) Grossman's concerns were never communicated to Claymore. (Tr. 1302:3-1305:5)

### 5. Professor Harris Quantified the Risk of These Strategies

The Division's expert, Professor Lawrence Harris, thoroughly analyzed FAMCO's trading in S&P 500 options and variance swaps, and he quantified those investments' effect on the Fund's performance and risk profile. (Ex. 139) The following is a summary of certain of his findings and conclusions relating to the risks inherent in these investments.

Professor Harris found that HCE's practice of writing put options and selling short variance swaps exposed HCE to significant losses in the event of substantial market declines or volatility. (Ex. 139 at ¶¶ 20, 25) Both the puts and the swaps increased HCE's exposure to declining markets, since volatility generally rises when markets fall. (Ex. 139 at ¶¶ 60, 107, 131) This downside exposure altered the Fund's risk profile by abandoning one of the fundamental characteristics of a covered call strategy: outperformance against equities in down markets. (Ex. 139 at ¶¶ 56-57)

Professor Harris further explained that since covered call strategies have a similar payout structure and risk exposure as writing put options, writing put options on top of a covered call portfolio is the same as adding pure leverage: borrowing money and investing the proceeds in the covered call strategy. (Ex. 139 at ¶¶ 73-75, 82-83, Figure 2 Panels C and D) The effect of the combination is a modest boost to return in most markets, at the expense of leveraged exposure to significant market declines. (Ex. 139 at Figure 2 Panels E and F) This additional exposure can be easily quantified by calculating the delta equivalent exposure of the option, which is a proxy for equating the size of the position to an investment in the S&P 500.

Professor Harris calculated and graphed the delta exposure for HCE's S&P 500 options on a daily basis, which showed that HCE's equivalent market exposure swung dramatically over time. (Ex. 139 at ¶¶ 149, 155, Figure 6, Exhibit 4) As Figure 6 demonstrates, beginning in July 2007 HCE had additional market exposure as a result of its S&P 500 options most of the time, with the additional exposure frequently exceeding $20 million and at times exceeding $60 million.[11] (Ex. 139 at Figure 6) In July 2008, put options added $87 million of additional market exposure to HCE, effectively leveraging the Fund 92% and nearly doubling the Fund's exposure to market movements. (Ex. 139 at ¶ 153) Figure 6 also shows how leveraged HCE became in the fall of 2008.

As another metric of risk, Professor Harris measured how HCE's written put option positions would have performed given market downturns between 10% and 25%, and compared those to the probabilities of such downturns as calculated by FAMCO's backtesting. (Ex. 139 at ¶¶ 160-162, Table 3) Table 3 shows that HCE regularly had significant exposure to loss in the event of market declines of 10% or greater. FAMCO's frequency analysis showed that such declines, while not common, occurred regularly. (Ex. 139 at Table 3; Ex. 74 at 33573-74) And the risk of such a loss occurring was increased by the fact that HCE regularly wrote put options (much like the odds of eventually rolling

[11] Interestingly, the two times that Swanson recommended reducing put option exposure – September 2007 and November 2007 – were periods where HCE's delta exposure had spiked and significantly leveraged the Fund. (Ex. 99 at 119709-10, 23; Ex. 139 at ¶ 152, Figure 6)

snake eyes is much higher for the player that rolls eleven times than for the player that rolls only once). (Ex. 139 at ¶¶ 163, 262-272, Table 7) HCE exposed itself to these risks on eleven separate occasions between July 2007 and October 2008. (Ex. 139 at Table 3)

Professor Harris also calculated an equivalent exposure for variance swaps based on a model of the relationship between volatility and market movements, which also showed substantial downside risk. (Ex. 139 at ¶¶ 108, 156) Professor Harris also backtested a variance swap strategy and found that variance swaps were capable of causing losses to HCE of 5% or greater (a huge amount in a profession where fractions of a percent can matter (*see* Ex. 139 at ¶ 174-175)), with a frequency between 1.02% and 1.79%. (Ex. 139 at ¶¶ 164-165, Table 4) Like with the put options, FAMCO regularly sold short variance swaps on eight separate occasions between July 2007 and September 2008, increasing the likelihood of an adverse event. (Ex. 139 at ¶¶ 163, 262-272, Table 7)

Professor Harris's analyses described above demonstrated that the written put options and variance swaps *each* exposed HCE to significant risk of loss in tumultuous markets. Because written put options and variance swaps perform poorly in the same types of markets, the risk of a substantial loss in down markets was magnified by the fact that HCE often had put option and variance swap exposure simultaneously, as HCE faced the risk of significant losses on both positions (which happened in the fall of 2008).

Professor Harris also performed simple stress tests to assess Respondents' claims that HCE was harmed only because of unprecedented market declines during the Fall of 2008. Professor Harris calculated how HCE's August and September put option and variance swap trades would have performed had the market behaved identically to recent past crises. (Ex. 139 at ¶¶ 168-169, Table 5) Professor Harris identified four events in the previous eleven years (an average of every 2.75 years!) whose market conditions, if repeated in the fall of 2008, would have caused greater than a 5% loss for HCE, including three such events during the previous bear market. (Ex. 139 at ¶¶ 169-170, Table 5)

Market movements similar to those experienced in September 2001 would have caused a -16.0% loss to HCE's Fall 2008 put option and variance swap positions, and movements similar to those experienced during the 2002 accounting scandals would have caused a -17.2% loss. (Ex. 139 at Table 5) Going back further, market movements similar to those experienced during the 1987 stock market crash would have caused a 49.1% loss – even greater than what HCE actually experienced in the fall of 2008. (Ex. 139 at Table 5)

### 6. Written Put Options and Short Variance Swaps Are Not Hedges

There was much discussion at the hearing about writing put options and shorting variance swaps as "hedges" for a portfolio. The term "hedge" refers to a transaction or strategy that reduces risk.[12] (Tr. 534:19-535:13; Ex. 139 at ¶¶ 87, 91) However, written put options should not be considered hedges, at least on a covered call portfolio, because they have a similar risk profile to that investment portfolio; they are the functional equivalent of leveraging a covered call portfolio by borrowing money and investing in more covered call exposure, thus magnifying both positive and negative performance. (Tr. 204:6-205:10, 536:6-13; Ex. 139 at ¶¶ 92, 195, Figure 2 Panels E and F) FAMCO's own research showed that writing put options is highly correlated to equities. (Ex. 74 at 33534)

Riad and Hughes recognized that writing put options increases a portfolio's beta (a measure of volatility of movements relative to the market (Tr. 594:7-14)) and exacerbates

[12] Merriam-Webster dictionary defines "hedge" in the context of finance as "a means of protection or defense (as against financial loss)." (http://www.merriam-webster.com/dictionary/hedge)

losses when the market falls. (Ex. 83 at 65183; Ex. 85 at 78043-44[13]; Tr. 878:16-879:14) Written put options perform their worst at the precise time an equity portfolio does: during market declines. (*See* Ex. 204 at 1124-25, showing puts losing during 2000-2002 bear market; Tr. 1896:4-9) During his investigative testimony, Hughes confirmed that written put options are not a hedge on a covered call strategy because they move in the same direction as the portfolio.[14] (Ex. 360 at 57:4-11)

Short variance swaps are also not hedges on a covered call portfolio because covered call portfolios already have short exposure to volatility from the written call options and already tend to decline when volatility rises. (Ex. 139 at ¶¶ 118-120, 195) In fact, Swanson has even described writing covered calls as selling volatility. (Ex. 136 at 7:16-19) Riad understood that HCE's covered call portfolio was already exposed to losses when market volatility increased, to an even greater degree than a pure equity portfolio. (Ex. 60 at 15165-68)

Riad testified during the Division's investigation that higher volatility was generally worse for HCE than lower volatility, and that calmer markets were better for the Fund. (Ex. 366 at 50:24-51:8) Hughes testified during the Division's investigation that short variance swaps are not hedges on an equity portfolio because you tend to lose money when

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[13] Riad testified during the Division's investigation that he suspects he was involved in the creation of Ex. 85. (Ex. 366 at 81:1-14)

[14] During the hearing, Hughes departed from his investigative testimony and insisted that written put options sometimes could be a hedge on an equity portfolio, although they tend to move in the same direction as equities. (Tr. 880:23-882:23) Hughes admitted, however, that writing put options had the effect of increasing HCE's sensitivity to market movements (which is entirely inconsistent with the concept of a hedge) and that "[a]cademically speaking, it – technically it's not a hedge." (Tr. 878:16-24)

volatility goes up.[15] (Ex. 360 at 48:4-10) Research reports relied upon by FAMCO state that long variance swaps – but not short variance swaps – act as hedges for an equity portfolio. (Ex. 82 at 52117, 22, 59) In fact, one such report analogized long variance swaps to buying insurance and short variance swaps to selling insurance; this report warned that short variance swaps are usually profitable but can be exposed to very large, unpredictable losses. (Ex. 82 at 52147-48, 60)

Finally, Riad and Swanson did not discuss written puts and short variance swaps in conversations with each other as if the puts and swaps were reducing risk or volatility for HCE. To the contrary, they discussed these products as risks that needed to be watched over and managed. (Ex. 99 at 119709-10, 23)

### C. Riad and Swanson Concealed the Risks They Were Taking

Riad and Swanson did not spend much time during their quarterly meetings with HCE's Board of Trustees talking about their put option and variance swap strategies. (Tr. 3007:25-3008:13) When they did talk about them, Respondents did not disclose their significance to HCE's performance; to the contrary, they conveyed to the Board that the put options and variance swaps were only a small component of HCE's overall strategy. (Tr. 3011:13-23, 3013:8-3014:1) Riad and Swanson consistently concealed the risk associated with writing put options and shorting variance swaps from both Claymore and HCE's Board, and described the strategies as mere hedges, or downside protection, or as a means of mitigating portfolio volatility. (Tr. 2653:16-19; Ex. 361 at 138:12-139:14)

[15] Hughes also deviated from his investigative testimony during the hearing when he claimed that short variance swaps could be a hedge on an equity portfolio in certain instances, although he acknowledged that short variance swaps tend not to be a hedge. (Tr. 882:24-885:15)

Riad and Swanson never discussed with HCE's Board the risk of potential loss created by the use of written puts and short swaps, or the extent to which Respondents were relying on those investments to meet HCE's investment objectives.[16] (Tr. 1320:25-1321:18; 2653:24-2655:17; 2920:18-2921:9, 2925:3-10, 3014:18-3015:16; Ex. 365 at 119:12-21) Instead, Riad and Swanson assured Claymore and HCE's Board that they were using derivatives to mitigate risk.[17] (Tr. 2655:18-2656:18) Riad and Swanson also described their use of put options and variance swaps as "opportunistic," and never indicated that they were using these products on a consistent basis as part of a consistent strategy or that they were doing so to sustain the Fund's dividend. (Tr. 3028:5-3030:25) After learning more about the risks and effects of put options and variance swaps in the Fall of 2008 and after, Brue Saxon, the Fund's Chief Compliance Officer, now believes that Riad and Swanson omitted important information about the risks of those products in their communications with HCE's Board. (Tr. 2675:9-2676:9)

The following is a summary of some of Riad's and Swanson's failures to communicate timely and truthfully with Claymore and HCE's Board:

- On June 20, 2007, Riad closed out a long put option position in HCE, leaving HCE with completely naked short put positions. (Ex. 63 at 18729-30; Ex. 139 at 178) Around that same time, Riad informed Swanson that he was selling the long puts in

[16] In his investigative testimony, Swanson testified that he and Riad did not discuss those risks, and that he did not know what, if anything, Riad was doing to assess the risks or exposure of the put options and variance swaps before placing those trades. (Ex. 365 at 103:24-104:3, 164:12-17, 165:15-20)

[17] Clearly, Respondents should have done this during their quarterly meetings with the Board. Respondents' expert Jay Baris testified that fund managers should present to their board information concerning their risk exposure resulting from the use of derivatives. (Tr. 3078:14-20)

the funds he managed. (Ex. 99 at 119708) Swanson asked whether they could have short puts sitting out there without collateral, which might raise a flag for a naked option, particularly in CCF (another fund managed by Riad). (Ex. 99 at 119708) Riad responded, "i was hoping by the time we had that discussion it will expire. i am stalling." (Ex. 99 at 119708)

- At the July 18, 2007 HCE Board meeting, Riad told the Board that he wanted to use more conservative option overlays for downside protection and told the Board that he had added beta-dampening collars to the portfolio, which lowered volatility and increased return.[18] (Ex. 180 at 7915) Just eight days later, Riad closed out long put option positions in HCE's portfolio, leaving HCE with naked put option exposure for nearly two months. (Ex. 63 at 18729-30; Ex. 139 at 182-86)

- In Riad and Swanson's October 2007 Portfolio Manager's Discussion, they told the Board that the Fund had benefited from having substantially the entire portfolio covered during the volatile summer months, and told the Board that the Fund's use of S&P 500 put options helped to further augment downside protection during the negative market environment. (Ex. 71 at 24571) They further stated that the Fund maintained a high hedge-ratio during the months of July and August, while volatility-dampening collars and hedges helped to augment protection during adverse markets. (Ex. 71 at 24572) In fact, HCE had naked put option and short variance swap exposure from late July through mid-September. (Ex. 63; Ex. 86)

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[18] A "collar" is an option strategy that limits the range of a portfolio's performance, much like a collar can limit an animal's movement. A collar involves the purchase of a put option, which limits the downside, and the sale of a call option, which limits the upside. (Tr. 1998:9-15)

- At the October 2007 Board meeting, Riad and Swanson explained to HCE's Board how the Fund had outperformed the market by so much relative to its peers. (Tr. 2927:15-2931:22) Riad and Swanson told the Board the same thing they told investors in the annual report (*see* Section D.2): that Riad and Swanson were superior stock pickers and managed the covered call strategy with skill. (Tr. 2931:23-2933:7) Riad and Swanson concealed from the Board the fact that HCE's sector-leading performance was being fueled by its S&P 500 option strategies and never disclosed to the Board just how profitable these strategies were.[19] (Tr. 2927:15-2934:1, 3013:8-3014:22; *see* Section D.2)

- In December 2007, Riad proposed to Claymore the idea of using leverage in HCE, and in doing so touted put-writing as a "conservative high yielding strategy" and that he would consider using leverage to invest in puts. (Ex. 22 at 16786) However, writing put options on a covered call portfolio should not be considered "conservative" as such a strategy effectively leverages the portfolio. (Ex. 139 at ¶ 308)

- In the January 2008 Portfolio Manager's Discussion submitted to HCE's Board and Claymore, Riad and Swanson stated that over the past year their volatility trading strategies and the effective use of S&P 500 puts had "augmented downside protection during adverse market periods." (Ex. 6 at 10329) Riad and Swanson told the Board that as an ongoing discipline, they manage the Fund's risk profile with supplemental hedging strategies "to help lessen performance volatility during unforeseen periods of uncertainty." (Ex. 6 at 10331)

[19] Jay Baris also testified that fund managers should present their board with information concerning the extent to which derivatives have affected fund performance. (Tr. 3080:9-13)

- In February 2008, FAMCO submitted a proposal to Steven Hill, Claymore's Vice President of Fund Administration and HCE's Chief Financial Officer, that would authorize the use of leverage in HCE to help support the Fund's NAV growth and to maintain HCE's 8.5% dividend yield. (Ex. 8) FAMCO told Claymore that previously it had "successfully purchased put-spreads, volatility swaps, and other Over-the-Counter (OTC) hedging transactions in order to mitigate portfolio downside risks." (Ex. 8 at 11798)

- In March 2008, Riad explained to Hill that he used written put options and short variance swaps as a way to "hedge (lock) in volatility levels for HCE." (Ex. 4) Riad described the short variance swaps to Hill as "a hedging transaction that was supposed to pay off regardless of the level of the US equity markets."[20] (Ex. 4) Riad admitted in his investigative testimony that he actually was not using variance swaps to lock in volatility levels. (Tr. 2430:8-2433:16) Two weeks later, Swanson forwarded an email communication between him and Hill to Riad, congratulating himself on a clever justification he provided to Hill for using structured notes or swaps. (Ex. 94 at 113953-54) Swanson confessed to Riad that his justification was "no 'selling puts to hedge against lower volatility', but not bad, if I do say so myself."[21] (Ex. 94 at 113953)

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[20] This email is misleading because short variance swaps should not be characterized as a hedge since they increased HCE's risk exposure, and variance swaps do not pay off in all equity markets, given that volatility rises when prices fall. (Ex. 139 at ¶ 306)

[21] Swanson's message to Riad highlights the insincerity of Riad's previous explanation to Hill. Swanson's message to Riad should be viewed as a somewhat sarcastic response, making fun of the bogus explanation which Riad provided to Hill for writing put options just two weeks earlier. Other contemporaneous documents authored by Riad and Swanson, as well as Riad's and Hughes' testimony, explain the put-writing as a means to profit from investors overpaying for protection and to help meet HCE's dividend goal. (*See, e.g.,* Ex. 59; Ex. 75 at 34141) Riad never cited hedging against lower volatility or

- At the April 2008 HCE Board meeting, Riad discussed with the Board the concept of "macrohedging" the portfolio in order to further protect the Fund during times of extreme volatility. (Ex. 178 at 21939) In the Portfolio Managers' Discussion for that meeting, Riad and Swanson told the Board that they had used opportunistic hedging to supplement performance during periods of high market volatility and used volatility trading strategies and put options to augment downside protection during adverse markets. (Ex. 736 at 38044-45)

- In Riad's and Swanson's July 2008 Portfolio Manager's Discussion submitted to HCE's Board for the July 22, 2008 Board meeting, Riad and Swanson informed the Board that over the past year, they had used "opportunistic hedging transactions" such as "volatility trading strategies, and "the effective use of S&P 500 Index puts which augmented downside protection during adverse market periods." (Ex. 5 at 9400) Riad and Swanson informed the Board that they were employing "macro-hedging strategies in order to help decrease participation in downside markets and lower overall portfolio volatility." (Ex. 5 at 9402) They made these statements despite being aware that HCE had taken "big losses" – in the amount of $2.8 million -- on written put option investments just a week before the meeting. (Ex. 66 at 21761; Ex. 39 at 30820C; Tr. 1954:4-20) Respondents never disclosed those losses to the Board. (Tr. 3011:24-3012:10)

All of these statements by Riad and Swanson to HCE's Board either were inconsistent with, or contradicted, their knowledge, research, and communications about the use of written put options and variance swaps. Both Riad and Swanson know that

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locking in volatility levels as justification for writing put options. In fact, Riad had previously stated that *increases* in volatility hurt covered-call funds. (Ex. 60 at 15165-68) As such, there would be no need to hedge HCE against *decreases* in volatility.

using written put investments and short variance swaps increases the risk and potential for investment losses. Significantly, Respondents never explained to the Board exactly how writing put options and shorting variance swaps could reduce downside market risk, portfolio volatility or act as a hedge on HCE's portfolio.

Riad and Swanson also attempted to downplay their risk-taking to HCE's investors. When Riad proposed using leverage in HCE in December 2007, Claymore concluded that doing so would require shareholder notice and proposed adding a statement about leverage statement to the 2007 annual report Questions and Answers section. (Ex. 22 at 16784, 86; Ex. 108 at 146387-88) Swanson responded by recommending that the annual report "downplay the term 'leverage' to use 'line of credit instead.' We do not want to give the impression that we are looking to use debt to add financial-leverage or volatility to the Fund . . . ." (Ex. 108 at 146386) Swanson proposed language that avoided the term "leverage" and emphasized the purpose as "hedging, volatility structures and supplemental hedged equity strategies." (Ex. 108 at 146386) In fact, Riad had clearly asked Claymore for permission to use leverage, or debt, to write additional put options; this is exactly the same as adding financial leverage to a covered call portfolio and increases the portfolio's sensitivity to market movements. (Ex. 22 at 16786; Tr. 204:6-205:10)

## D. HCE's Registration Statement and Periodic Reports Inadequately Disclosed HCE's Use of Put Options/Variance Swaps and Their Risks

### 1. HCE's Registration Statement Does Not Disclose the Strategies

HCE's registration statement, which includes its prospectus and statement of additional information ("SAI"), failed to inform investors of FAMCO's regular strategies of writing uncovered S&P 500 put options and shorting variance swaps, or of the risks associated with the use of those investments. In a section of the prospectus entitled "The

Fund's Investments," HCE listed the types of securities the Fund would invest in under normal market conditions, yet never mentioned writing uncovered put options or trading variance swaps.[22] (Ex. 11 at 12394-96) Likewise, the "Portfolio Contents" section never mentioned writing uncovered put options or trading variance swaps. (Ex. 11 at 12410-14)

In fact, in the 12-page section of the prospectus where HCE describes its investment objective and policies, only a single sentence discusses the possibility that the Fund may purchase or sell put options on securities, indices or other instruments or invest in "swaps." (Ex. 11 at 12406-17) That one sentence provides no information about whether the options the Fund "may" trade would be purchased or written, call options or put options, or covered or uncovered, or whether the swaps it would trade would be interest rate swaps, currency swaps, commodity swaps, credit default swaps, variance swaps, total return swaps, or another kind of swap. (Ex. 11 at 12415) This sentence appeared in a boilerplate paragraph called "Strategic Transactions" that gave broad -- but nonspecific -- authority, for HCE to utilize derivatives. (Ex. 11 at 12415; Tr. 2834:7-2835:21; Ex. 139 at ¶¶ 194-196) Such generic disclosure was commonplace in many funds, including "plain vanilla" covered-call funds such as the First Trust and Madison/Claymore covered-call funds. (Tr. 2836:1-2838:6, 1706:14-1707:18, 2048:8-21, 2054:3-10, 2501:21-2505:10; Ex. 367 at 9, 21) HCE's marketing materials and published fact sheets made no mention of Strategic Transactions when describing the Fund and its strategies. (Exs. 31, 32, 33, 149, 150, 151)

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[22] This section stated that the Fund may write "covered put options" on up to 20% of its total assets, but HCE wrote put options in quantities that exceeded the amount that could be considered "covered." (Ex. 139 at ¶ 186)

The Strategic Transactions disclosures did not convey that HCE would be using derivatives in any manner that was different than a plain vanilla covered-call fund. To the contrary, the prospectus stated that "[s]uch strategic transactions . . . are regularly used by many mutual funds and other institutional investors." Riad knew, however, that his volatility selling strategies were not regularly used by his competitors; they were primarily used in the hedge fund industry. (Ex. 58)

The term "variance swap" does not appear anywhere in HCE's registration statement. (Ex. 11; Ex. 12) HCE's registration statement also never disclosed that HCE will write uncovered put options. (Ex. 11; Ex. 12) In its SAI, HCE does disclose that it may purchase and sell securities index options in a three-page list of additional investments the Fund may make, but it describes the use of such options in the context of a hedge on the Fund's securities holdings -- including a hedge against a general decline in the securities market -- and describes the associated risks in the context of such options not being perfect hedges for the portfolio securities. (Ex. 12 at 12447)

HCE's registration statement disclosures relating to the use of Strategic Transactions were so opaque that there was confusion within FAMCO about whether HCE's registration statement even permitted writing uncovered put options, let alone clearly disclosed them as a fund strategy. (Tr. 1181:4-1184:3) FAMCO's compliance personnel reached out to Claymore for help to answer the basic question of whether put options and variance swaps were allowable investments. (Ex. 27; Tr. 2658:2-9) Such a determination required input from fund counsel. (Tr. 2658:2-2659:9) Grossman was also concerned that the disclosure was buried in the back of the prospectus and not conspicuous for investors. (Tr. 503:3-18)

The seven-page Risks disclosure in HCE's prospectus did not discuss the risks associated with the use of uncovered put options and variance swaps.[23] (Ex. 11 at 12417-24) There was no mention of the downside risks the Fund could face by trading index put options and variance swaps, including the Fund's leveraged exposure to market declines or its exposure to spikes in market volatility. (Ex. 11 at 12417-24; Ex. 139 at ¶¶ 204-208; *see also* Ex. 213 at 148969 (variance return should be considered a new risk factor for various assets)) HCE's risk disclosures relating to its use of derivatives contained a generic warning that the use of derivatives could leave the Fund worse off depending on the adviser's ability to correctly predict movements in the securities and interest rate markets, but did not include anything specific regarding the types of market movements that could harm the Fund. (Ex. 11 at 12417-24) The risks identified in the SAI disclosure regarding index put options primarily related to the risk of the options being an imperfect hedge on portfolio securities, further suggesting that index options would hedge against, rather than augment, portfolio risk.[24] (Ex. 12 at 12447)

HCE never cured these deficiencies through disclosure of its new put-writing and variance swap strategies in any of its annual reports prior to its losses in the fall of 2008. (Ex. 14; Ex. 16; Ex. 143; Ex. 139 at ¶¶ 200-201)

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[23] The prospectus contained some risk disclosure regarding the Fund's use of *covered* put options, but the covered put option strategy was limited to 20% of fund assets and the coverage requirement acted as a limit on the amount of options that could be written. HCE's written index put options regularly exceeded such limits and therefore did not qualify as covered put options. (Ex. 139 at ¶ 186)

[24] The SAI also noted that the principal risks of the Fund's principal strategies are discussed in the prospectus. (Ex. 12 at 12446) Yet there was no discussion of the risks of writing uncovered put options or trading variance swaps anywhere in the prospectus. (Ex. 11 at 12417-24)

### 2. The 2007 Annual Report Was Misleading

HCE's annual report for the period ended November 30, 2007 reported a 12.87% return on a NAV basis for fiscal 2007, compared to returns of 7.72% for the S&P 500 and 5.54% for the BXM covered call index. (Ex. 14 at 15492-93) The annual report's Questions and Answers section -- which purported to be an interview with Riad and Swanson -- explained what contributed to HCE's ability to exceed its benchmarks. (Ex. 14 at 15491-94) HCE's written S&P 500 put options, long S&P 500 put options, and written S&P 500 call options were all significant positive contributors to return, and HCE's short variance swaps were among the worst performers in HCE's portfolio; but, Riad and Swanson omitted any discussion of how those strategies helped and affected the Fund's performance from the commentary.

The Questions & Answers section contained several misleading statements. In response to the question "Which investment decisions most helped the Fund's performance," Riad and Swanson stated that "performance benefited from good sector and industry selection, positive stock selection, and also good strategic and tactical decisions on the options overlay." (Ex. 14 at 15492) The section highlighted particular sector and single stock investments that contributed to return. (Ex. 14 at 15492-93) Those single stocks mentioned each contributed between 0.09% and 1.01% to HCE's return. (Ex. 61 at 16326-30; Ex. 14 at 15492-93) The report did not disclose that the Fund received a significant boost from written S&P 500 put options and call options, which contributed approximately a return of 2.0% and 2.3% respectively, as well as long S&P 500 put options, which contributed a return of approximately 1.7%. (Ex. 14 at 15492-93; Ex. 139

at ¶ 222[25]) In the aggregate, HCE's S&P 500 put and call options added 5.6% to HCE's return and accounted for 46.2% of HCE's NAV growth; yet, these investments were not even mentioned as contributors to performance. (Ex. 139 at ¶ 223)

HCE's option investments played a far more significant role in the Fund's performance than stock selection. The equity portfolio outperformed the S&P 500 by only 1.25% (barely more than the Fund's 1.00% advisory fee). (Ex. 61 at 16329-31[26]; Ex. 139 at ¶ 223) The annual report misleadingly suggested that HCE's success was primarily the result of strong stock picking and the covered call strategy, when in fact, but for the S&P 500 options, HCE would have trailed the S&P 500 instead of beaten it by 5.15%. (*see* Ex. 139 at ¶ 223 (S&P 500 options added 5.6% to return)) Riad and Swanson each acknowledged in private communications that these supplemental strategies "contributed greatly to the strong performance of HCE this year" and "allowed us to have a good year thus far."[27] (Ex. 316; Ex. 14 at 15492-93; Ex. 56; Ex. 57; Ex. 58; Ex. 59)

Similarly, the Questions and Answers section did not mention the variance swap strategy when discussing which holdings hurt performance. (Ex. 14 at 15493) HCE lost $400,509 on its variance swap positions in 2007, or approximately 0.36% of the Fund's

[25] Exs. 63 and 86 provide the source data for purchase and sale proceeds for HCE's S&P 500 options, from which profits can be calculated.

[26] This portfolio attribution schedule shows that stock selection accounts for 1.24% outperformance over the benchmark, with HCE's equities returning 8.97% and the S&P 500 returning 7.73%. (*See* Ex. 61 at FAM00016331.)

[27] Swanson informed people at FAMCO that they had been successful in writing puts on the same day as his interview with Delony, yet he never mentioned writing puts to Delony. (Ex. 59; Ex. 135; Tr. 1897:14-1898:4)

NAV. (Ex. 139 at ¶ 225; Ex. 14 at 15501[28]; Ex. 63) Instead, Respondents' report highlighted four individual stock investments, all but one of which had smaller losses than the variance swaps, ranging from 0.00% to 0.13%. (Ex. 61 at 16326, 29; Ex. 139 at ¶ 225) In the recorded interview that served as the basis for the commentary, Swanson stated that HCE appropriately hedged the portfolio to take advantage of spikes in market volatility, when the Fund actually had lost money on its short variance swaps. (Ex. 135 at 8:4-8)

The Questions and Answers section also did not discuss HCE's put-writing and variance swap strategies when explaining the Fund's hedging strategies and how they affected performance. (Ex. 14 at 15493) Riad and Swanson stated that, at times during 2007, when the portfolio managers were concerned about the market, they bought index put options and wrote index call options for protection; but, they never mentioned the use or written put options, which theu considered to be part of the same strategy, or the variance swaps, which were also part of their "macro-hedging strategy."[29] (Ex. 14 at 15493; Tr. 1860:5-11, 1997:14-21) Riad acknowledged in his investigative testimony that it would have been more accurate and complete to include written put options in the disclosure, but could not explain that information had not been provided. (Ex. 366 at 189:20-190:1)

HCE's annual report also failed to address any of the risks associated with writing put options and trading variance swaps. The report contained a section highlighting the Fund's risks, which was attributed to both the FAMCO portfolio managers and Claymore,

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[28] HCE's beginning NAV for 2007 was $110,035,643. (Ex. 14 at 15501) $400,509 is equal to 0.36% of beginning NAV.

[29] Significantly, this sentence, which omits the risky parts of the "macro-hedging strategy," was one that Swanson edited during the comment process. (Ex. 130)

but that section contains no discussion of the risks associated with writing put options or trading variance swaps. (Ex. 14 at 15494) The annual report discussed the risks of writing options, but limited that discussion to writing covered calls. (Ex. 14 at 15503)

The Commission acknowledges that HCE did disclose a written put option position in its portfolio holdings. (Ex. 14 at 15498) But the portfolio holdings list excluded any mention of HCE's variance swap position held at the time.[30] (Ex. 14 at 15496-98) The only mention of a variance swap in this report was in a footnote to the financial statements, which explained generally what a variance swap was and that the Fund had entered into variance swaps where the Fund would profit if realized volatility was lower than the strike price and would lose money if realized volatility was higher than the strike price. (Ex. 14 at 15503) HCE disclosed the current variance swap position as of the report date in that footnote, but provided no information regarding the size of the position or the degree to which it could profit or lose money based on movements in volatility that would give an investor any indication of the Fund's exposure to volatility.[31] (Ex. 14 at 15503) The disclosures of the put option and variance swap positions did not address how those products were being used, that they were part of an ongoing strategy, that they had materially affected HCE's performance, or the risks posed by those investments.

Delony interviewed Swanson for thirty minutes to get enough information for the Questions and Answers section. (Ex. 128; Ex. 135) Swanson provided Delony with

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[30] Riad signed a certification that the annual report's portfolio of investments was a complete and accurate list of the securities held in the Fund as of the report date. (Ex. 9)

[31] This disclosure must be viewed in the context of HCE's risks disclosure in the annual report, which omits any discussion of the Fund's sensitivity to market volatility. (Ex. 14 at 15494)

portfolio performance data before the interview, but he only provided attribution information for HCE's equity portfolio; he provided no information about the S&P 500 options or variance swaps' impact on performance. (Ex. 61; Ex. 62; Tr. 1557:16-1558:25) In explaining the Fund's strong performance, Swanson primarily talked about stock selection -- which he identified as the "key ingredient" to strong performance for a "covered call product" -- and making the right calls on the covered call strategy, including "bring[ing] in greater downside protection."[32] (Ex. 128 at 0:57-9:09; Ex. 135 at 2:23-7:9)

Swanson also briefly mentioned that HCE "implemented opportunistic hedging strategies throughout the year." (Ex. 128 at 9:10-10:25; Ex. 135 at 7:15-8:8) Swanson noted that "[w]hat I mean by hedging strategies is obvious, is that when we were concerned with the market *we bought puts for protection we collared the portfolio to try and increase the amount of protection during periods of a declining market.*" (Ex. 135 at 7:18-22; emphasis added) Swanson told Delony that it was a very volatile year with spikes in market volatility, and "we took advantage of those and appropriately hedged the portfolio where we needed to." (Ex. 135 at 7:24-8:8) Swanson never once mentioned to Delony that HCE had writing put options or variance swaps, or that HCE had significant naked exposure to downside risk at times during 2007. (Ex. 128; Ex. 135; Tr. 1558:1-11, 1933:5-25; Ex. 139 at ¶ 226)

Riad and Swanson both reviewed the Questions and Answers section several times before it was published in HCE's annual report, and they either made edits to the content or had the opportunity to do so. (Ex. 10; Ex. 95; Ex. 96; Ex. 107; Tr. 1583:18-24, 1590:19-

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[32] Swanson emphasized downside protection on this call. Swanson talked about hedging or protecting the portfolio on the downside four separate times during the interview. (Ex. 135 at 4:23-5:1, 5:7-10, 6:5-16, 7:15-8:8)

22) Swanson even asked Claymore for the opportunity to review the section an additional time before it was finalized, and was granted that opportunity. (Ex. 96 at 114362; Tr. 1931:12-19) When Claymore made a substantive edit to the Questions and Answers section after Riad's and Swanson's review, Delony checked the edit with Swanson because she and Claymore did not feel comfortable making changes and finalizing the section without first consulting him. (Ex. 108 at 146386; Tr. 1592:19-1593:20) Swanson signed a certification for Claymore that, to the best of his knowledge, the portfolio manager commentary in the annual report did not contain any material misstatement or omission that would make the report inaccurate or misleading. (Ex. 35; Tr. 1591:25-1592:13)

**3. The 2008 Semi-Annual Report Was Misleading**

HCE's semi-annual report for the six months ended May 31, 2008 contained many of the same deficiencies as the 2007 annual report. HCE reported a 0.37% return on a NAV basis for the period, compared to returns of -4.50% for the S&P 500 and 2.00% for the BXM. (Ex. 15 at 15521)

HCE's equity portfolio lost just over 3% for the period. (Ex. 48 at 1118; SEC-Delony-0000234D; Ex. 139 at ¶ 229) Stock selection thus accounted for less than 1.5% of the superior performance over the S&P 500 (again barely more than HCE's 1.00% advisory fee). HCE's covered call options added 2.33% to HCE's return, which was far inferior to the 6.5% increase the BXM's covered call strategy provided over the S&P 500. (2.00% BXM return compared to -4.50% for S&P 500) (Ex. 48 at 1118) Written S&P 500 put and call options contributed approximately 2.1% and 0.8% to HCE's return, and short variance swaps contributed 0.8%. (Ex. 139 at ¶ 228) HCE's protective long put options and long variance swaps contributed -0.6% and -0.8%. (Ex. 139 at ¶ 228) In total, HCE's S&P 500 options and variance swaps contributed 2.2% to HCE's return, which accounted for 45% of

HCE's outperformance over the S&P 500 (more so than stock selection) and elevated HCE from a loss for the year to a positive return.[33] (Ex. 139 at ¶ 228)

Riad and Swanson's Questions and Answers section once again obscured the real drivers of performance and avoided discussing the put-write and variance swap strategies. In response to a question asking what investment decisions most helped the Fund's performance, Riad and Swanson stated that performance benefited from "industry and stock selection, the covered call strategy, and the hedge program." (Ex. 15 at 15522) Riad and Swanson touted the Fund's covered call strategy by noting that the call options offset 2/3 of the 3% loss on HCE's equity portfolio. (Ex. 15 at 15521) Riad and Swanson also claimed that "[d]uring most of this period, the portfolio was strategically hedged for additional downside protection, and that proved to be a good decision as equity markets trended downward." (Ex. 15 at 15522) This statement misleadingly suggested that HCE had hedged the portfolio against market declines by purchasing put options and profited from such declines.[34] In fact, HCE had written put option and short variance swap exposure in the portfolio during most of the period, while it held protective long put options and long variance swaps far less of the time and actually lost money on its long hedges. (Ex. 86 at 89833-35[35]; Ex. 139 at ¶ 228)

[33] HCE outperformed the S&P 500 by 4.87% (0.37% versus -4.50%). 2.2% is equal to 45.2% of 4.87%.

[34] In his December 2007 interview with Delony, Swanson told her that it was "obvious" that when he talked about hedging strategies he was referring to buying put options for protection and collaring the portfolio to try to increase the amount of protection during declining markets. (Ex. 135 at 7:18-22).

[35] For the six-month period, HCE had written put option exposure from December 1 to December 21, 2007 and from January 11 to April 6, 2008 (a total of 108 days), short variance swap exposure from December 1 to December 20, 2007 and from January 2 to

Riad and Swanson did not discuss HCE's written put option and variance swap strategies as contributors to performance in their explanation of the Fund's hedging programs. (Ex. 15 at 15520-23) They also did not highlight the long put option or long variance positions in response to a question about which holdings most hurt performance, even though those positions were some of the worst performers in the entire portfolio. (Ex. 15 at 15522-23; Ex. 139 at ¶ 232; Ex. 131 at 234D)

Once again, the semi-annual report did not discuss any of the risks associated with written put options and variance swaps in its risks disclosure, which was attributed to the portfolio managers and Claymore. (Ex. 15 at 15523) The risks disclosure once again limited discussion of the risks of writing options to a discussion of writing covered call options. (Ex. 15 at 15523, 32) HCE did not have any written put options or short variance swap positions in the portfolio at the end of May 2008, so there was no disclosure of either of those strategies in the portfolio holdings section of the report. (Ex. 15 at 15525-26) In fact, HCE had a purchased put option disclosed in its portfolio holdings, which was consistent with and provided context to Riad and Swanson's statement about strategically hedging the portfolio for additional downside protection. (Ex. 15 at 15526) There was no way to tell from the semi-annual report that HCE had been holding written put options and short variance swaps for the majority of the six-month period, or that those positions contributed substantially to HCE's performance in relation to its benchmarks.

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April 7, 2008 (a total of 117 days), while it had long put option protection from April 7 to May 31, 2008 (a total of just 55 days) and long variance swap protection from January 2 to January 16, 2008 and from April 7 to May 22, 2008 (a total of just 61 days). (Ex. 86 at 89833-35) HCE's long put option hedges contributed -0.6% to HCE's return for the period, and the long variance swaps contributed -0.8%. (Ex. 139 at ¶ 228)

Delony again interviewed Swanson for thirty minutes prior to preparing a draft Questions and Answers section. (Ex. 133; Ex. 136) Before the interview, Swanson provided Delony with a portfolio attribution report for the equity investments, but did not provide Delony with any information on the effect put options and variance swaps had on HCE's performance. (Ex. 132; Ex. 131; Tr. 1594:17-1597:11) Swanson emphasized the covered call strategy as the reason for HCE's success. (Ex. 136 at 4:23-6:1) Swanson also mentioned good equity performance, and also told Delony that "we have global hedges that we put on, and that we have on periodically during periods of high volatility, that further helped to augment the downside and actually added to excess performance." (Ex. 136 at 6:1-16) Once again, Swanson never mentioned writing put options or trading variance swaps at any time during the interview. (Tr. 1607:1-7, 1934:1-8; Ex. 133; Ex. 136)

Riad and Swanson both reviewed the Questions and Answers section multiple times before it was published in HCE's semi-annual report, and they either made or had the chance to make edits to the content. (Ex. 93; Ex. 134; Ex. 67; Ex. 69) In fact, Swanson provided Delony with the language that HCE was "strategically hedged for additional downside protection" in a round of edits to Delony's original draft. (Tr. 1614:14-17; Ex. 134 at 699; *see* Ex. 93 at 113540 for original language) Swanson signed a certification for Claymore that, to the best of his knowledge, the portfolio manager commentary in the semi-annual report did not contain any material misstatement or omission that would make the report inaccurate or misleading. (Ex. 35; Ex. 25)

### 4. HCE's Registration Statement and Periodic Reports Did Not Inform Investors of the Strategies

We heard testimony from two professionals that invested in HCE, and one analyst that looked into HCE in the fall of 2008; none of them had figured out from HCE's filings that HCE was regularly writing put options or trading variance swaps or was exposed to significant additional risk of market declines or increases in volatility. Joseph Witthohn, an experienced closed-end fund analyst at Janney Montgomery Scott LLC, read HCE's registration statement but could not decipher that HCE was using put options and variance swaps in the fall of 2008. (Tr. 1400:8-16, 1401:17-1403:19, 1409:18-1414:10; Ex. 115) Robert Shulman, a financial adviser who invested in HCE for his clients, and Michael Boyle, who operated several unit investment trusts that invested in HCE, both testified that they were unaware that HCE was engaged in put-writing or variance swap strategies, and that if they had been aware of such strategies, they would not have invested in HCE. (Tr. at 1352:3-6, 1353:19, 1366:13-19, 1370:12-1371:16, 1480:6-17, 1494:10-23)

### E. HCE's Collapse in the Fall of 2008

#### 1. HCE's Trading in August and September 2008

Riad and Swanson continued to write put options and trade variance swaps in HCE's portfolio throughout the summer of 2008. (Ex. 39 at 30820C) In July 2008, HCE closed out one of its written put options at a \$2.8 million loss. (Ex. 39 at 30820C) In August of 2008, Riad wrote two-month, 9% to 10% out-of-the-money put options with a notional value of \$139 million (nearly 1.4 times HCE's NAV). (Ex. 139 at ¶ 238) HCE collected \$992,600 in option premiums, which was quite significant given the options were far out-of-the-money and reflective of the large amount of exposure should they expire in-the-money. (Ex. 139 at ¶ 129, Table 3)

At the time Riad and Swanson placed these trades, they used a delta-adjusted exposure method, to approximate the expected loss exposure for these options, since adjusting using delta takes into account the probability that an option will expire in-the-money and provides a measure of the amount at risk. (Ex. 73 at 32776-77; Ex. 365 at

182:2-12; Tr. 768:20-769:22) FAMCO calculated those options to have a loss exposure equal to $13,535,000, or approximately 13% of HCE's entire portfolio. (Ex. 73 at 32777; Tr. 1981:6-1982:14; Ex. 365 at 200:25-201:4) FAMCO's internal analysis estimated that these written put options' delta-adjusted exposure had grown to $17,630,000 (or approximately 17% of the Fund's NAV) as of the end of August. (Tr. 1984:17-1985:4; Ex. 53 at 11038, 41[36])

Riad also entered into one-month short variance swaps in August 2008. (Ex. 40) In August and early September 2008, Riad made similar written put option and variance swap trades in Fiduciary Opportunity Fund ("FOF"), a private hedge fund he managed for himself and several principals of FAMCO.[37] (Ex. 123 at 659; Tr. 2240:23-2242:15; Ex. 114)

In early September 2008, the financial markets became quite volatile and began declining rapidly. (Ex. 103 at 122857) Around this time, Fannie Mae and Freddie Mac were placed into conservatorship and Lehman Brothers filed for bankruptcy. (Ex. 103 at 122857) On September 10, 2008, Riad drafted an internal email stating that: "Sean [Hughes] told me this would happen. Never sell variance in front of a broker/dealer disaster." (Ex. 81) Around this same time, Jeffrey Grossman met again with FAMCO's

[36] Ex. 53 is a spreadsheet that flows across multiple pages. FAM00011041 is a continuation to the right of FAM00011038. The bottom of those pages shows that as of August 29, 2008, HCE's delta-adjusted exposure on its two put option positions grew to $17,630,000 (8,855,000 + 8,775,000).

[37] FOF had starkly different investment objective and policies than HCE. FOF's objective was to achieve annual return at least twice that of the S&P 500, and FOF had unlimited discretion as to what investment strategies it would pursue. (Ex. 123 at 658) FOF's offering memorandum warned that FOF was a "speculative investment" with substantial risks. (Ex. 123 at 664, 73)

compliance department and reiterated his concerns about the risks inherent in the put options and variance swaps. (Ex. 92) Yet Riad left the put and swap positions open.

On September 19, 2008, Riad settled HCE's expiring one-month variance swap position at a loss of approximately $7 million, or 7% of HCE's NAV as of the end of August. (Ex. 50; Ex. 141 at 3[38]) The S&P 500 had fallen 6.4% in September, causing sizable unrealized losses on HCE's written put options and FAMCO's internal estimate of its potential exposure on written put options had grown to $39.7 million (or approximately 45% of the HCE's NAV). (Ex. 144 at 2; Ex. 2 at 1323; Tr. 1985:5-1986:15; Ex. 53 at 11037, 40[39]) At this point, those put options had the equivalent effect of HCE adding an additional $39.7 million of leveraged S&P 500 exposure to the Fund, and meant that HCE had much greater exposure to downward market moves. (Tr. 3523:15-3524:13)

Just two days earlier, FAMCO provided to Claymore and HCE's Board an Investment Strategy Report containing the firm's economic outlook and strategy, which described the current market environment as "a liquidity crisis," observed that "[t]he near-term future remains murky," and stated that "the current market uncertainty and financial turmoil causes us to maintain greater than normal cash positions." (Ex. 54 at 13087-88; Ex. 20) Nevertheless, on September 19, Riad made "an excruciating decision" to enter into two new one-month short variance swaps for HCE's portfolio, despite already facing substantial downside exposure from the written put options and a "murky" near-term future. (Ex. 40; Tr. 2179:18-25; 2181:25-2182:8) At this point, just days following the

[38] The $7,025,454 loss equaled 7.0% of HCE's NAV as of August 31, 2008.

[39] FAM00011037 and FAM00011040 must be viewed side-by-side. This shows that as of September 19, 2008, the delta-adjusted exposure on HCE's written put options grew to $39,650,000 (20,930,000 + 18,720,000).

failure of three major financial institutions, market prices indicated an expectation that extreme volatility would continue. (Ex. 139 at ¶ 247) Historically, the market has been an excellent predictor of whether volatility will be high or low over the near-term. (Ex. 139 at ¶ 248)

### 2. Riad Got Defensive in FOF

However, Riad was much more careful in managing his and FAMCO's principals' money and took a more conservative and defensive posture in FOF. On September 16, 2008, the day after Lehman Brothers filed for bankruptcy, Riad closed out the written put options in FOF prior to their expiration -- while keeping similar positions in HCE open. (Ex. 114; Tr. 2516:1-2518:16; Ex. 63 at 18731) Riad did not enter into any new variance swap trade or write new put options in FOF at this time, despite maintaining that exposure in HCE. (Ex. 114)

Riad testified that he was unable to trade variance swaps in FOF because FOF's assets fell below the required threshold for investing in variance swaps. (Tr. 2245:17-2246:8) However, Riad also testified that he would have entered into a variance swap trade in FOF if he could because it was a very attractive time to do so and that there was no reason not to invest in FOF as he did in HCE. (Tr. 2247:7-2247:14) In fact, Riad's hands weren't tied if he wanted to sell protection. Riad testified that FOF could have written put options in September 2008. (Tr. 2534:5-9) Professor Spatt also testified that there was an extremely liquid exchange market for put options that was operating in September 2008, which would have been available to FOF. (Tr. 3466:7-3467:16, 3471:10-13) In fact, Professor Spatt acknowledged that in September 2008 those willing to take on the risk of writing put options were being compensated handsomely through elevated premiums for bearing that risk in light of the market turmoil. (Tr. 3466:23-3467:21; 3471:10-25) Riad was only willing to accept that type of risk in HCE, when the Fund's shareholders would pay the consequences, but not in FOF, when FAMCO's principals would suffer any losses. In fact, Riad wasn't even willing to maintain FOF's existing put position and abandoned the insurance selling business immediately following Lehman's bankruptcy.

### 3. HCE's October 2008 Losses

The financial market continued to decline with increased volatility in late September and early October 2008. (Ex. 103 at 122857-58) HCE's delta-adjusted exposure (effective leverage) from its written put options continued to grow during this time, and at times it approached and even exceeded the entire value of the Fund. (Ex. 53 at 11039-40; Tr. 1987:9-16, 3524:16-3525:12; Ex. 139 at ¶¶ 152-155, 241) HCE covered its written put positions in early October at a $15.5 million loss. (Ex. 39 at 30820C[40]) Had HCE held its written put options to expiration, HCE would have lost an additional $10.6 million, for a total loss of $26.1 million. (Ex. 139 at ¶ 242)

HCE also lost an additional $22.8 million on the new variance swap contracts entered into in September. (Ex. 50) As a result, HCE lost 73.2% of its NAV between September 1 and October 17, 2008, the day it closed its last variance swap position. (Ex. 139 at ¶ 231 n.32) These losses far exceeded the declines in the S&P 500 or the BXM (Ex. 139 at ¶ 231 n.32) Of HCE's total losses in September and October 2008, approximately $45.4 million were directly attributable to the Fund's written put option and variance swap strategies. (Ex. 139 at ¶ 22)

[40] This schedule shows all S&P 500 option trades in HCE. It shows that the put options written on August 25, 2008 were closed at a $9,522,804 loss and the put options written on August 28, 2008 were closed at a $6,004,502 loss, for a total loss of $15,527,306.

While HCE's losses were quite large, they did not happen overnight and grew gradually over a six-week period. (Ex. 2 at 1322-23; Ex. 139 at ¶ 240). Moreover, the market declines, while severe, were in line with declines suffered during other recent crises, and were hardly unprecedented. (Tr. 838:19-840:14; Ex. 88 at 97751)

#### 4. Riad and Swanson Concealed Their Activities in the Fall of 2008

Even after HCE began suffering losses, Riad continued to hide the details of his risky investments from HCE's Board. On September 16, 2008, after HCE had sustained millions in losses from written put options and short variance swaps, Ronald Toupin, HCE's Chairman, inquired about the then-current status of HCE. (Ex. 104; Tr. 3019:21-3020:21) Riad and Swanson provided Claymore a written response to the request the next day, which was forwarded to the Board. (Ex. 54; Ex. 20) Their response never mentioned the substantial losses suffered from the put options and variance swaps or the continued exposure to puts and swaps; instead, they referred generally to the Fund's "macro hedging strategy" adversely impacting HCE's performance. (Ex. 54 at 13088-89)

Riad's and Swanson's written response included a FAMCO Investment Strategy Report, which suggested that FAMCO was taking a conservative approach. (Ex. 54; Ex. 20) The Investment Strategy Report stated that FAMCO did not own Lehman Brothers or AIG and instead had financial holdings that outpaced the market, even though HCE had in fact held Lehman and AIG and Swanson was discussing HCE's $3 million loss in Lehman just hours before sending out the update. (Ex. 54 at 13088-89; Ex. 55; Ex. 141 at 2; Tr. 1863:3-13) Riad had discussed the Lehman losses with Grossman just two days earlier. (Ex. 99 at 119746-47) The Investment Strategy Report also stated that FAMCO was more broadly diversified than normal due to the "murky" near-term future and that the current market uncertainty and financial turmoil caused them to maintain greater than normal cash positions. (Ex. 54 at 13088-89) Despite this cautious approach presented to the Board, Riad and Swanson placed a new variance swap trade on September 19 and maintained their written put option exposure. (Ex. 50; Ex. 63 at 18731)

The Board did not find out about the put option and variance swap losses until October. (Tr. 2937:8-15) As the losses continued to mount, Riad decided they could not hide the truth any longer. In early October 2008, Riad and Swanson worked with Claymore to draft a press release that explained the Fund's aberrational performance. (Ex. 64) Riad – in an apparent acknowledgement that investors were previously unaware of his risky strategies -- wrote in an email to Swanson, "I decided to be upfront and explain the strategies instead of hiding. We will probably be getting whiplash either way but I think we have less risk if we are transparent." (Ex. 64 at 20380)

When the Board finally learned about the puts and swaps in October 2008, and the millions in losses they caused, the Board specifically asked Riad about his use of the investments at an October 2008 Board meeting. (Ex. 19 at 16625) Riad responded that "steps had been taken in the past 18 months to seek to *reduce* the effect of volatility on the Trust's portfolio." (Ex. 19 at 16625) (emphasis added) Riad told that Board that in an attempt to reduce the volatility and hedge the Trust's portfolio, he had implemented a strategy of *purchasing* put options and offsetting the cost of those purchases by selling out-of-the-money put options. (Ex. 19 at 16625) He said that he also entered into variance swaps as part of this same strategy.[41] (Ex. 19 at 16625-26) Finally, Riad claimed that long

[41] This explanation differs substantially from the one given subsequently during the Board's review of FAMCO's contract in November 2008. At that time, Riad and Swanson acknowledged that HCE had adopted a practice of *selling* put options and

put option positions expired or were offset over the summer with the intention of replacing them around the time of the presidential election, and he decided to retain the short put exposure. (Ex. 19 at 16626)

Riad's statements misled the Board about the true nature of his trading. As evidenced by the trading patterns, HCE maintained written put option exposure far more frequently than it had purchased put option protection, it did not often use the long and short puts in combination, and it often went long periods where it used written put options only. (Ex. 139 at ¶ 307) Moreover, HCE collected $9.6 million in written put option premiums from April 2007 through August 2008, which far exceeded the "cost" of its put option purchases (which was zero given that they were profitable). (Ex. 139 at ¶¶ 127, 307; Ex. 86 at 89833)

In fact, HCE maintained naked short put positions 76% of the time from November 2007 to October 2008, yet maintained purchased put option protection only 22% of the time. (Ex. 139 at ¶ 126) Riad's and Swanson's contemporaneous communications during 2007 also show that they were actually focused on volatility selling, not purchasing protection. (Ex. 58; 59) In one internal FAMCO email, Swanson explained that put option protection is bid up and that they have been successful in HCE by taking the other side of the bet by writing puts. (Ex. 59) In a later memo to the Board, FAMCO discussed its strategy of writing put options, but made no mention of using them to fund purchased put options. (Ex. 75 at 34141)

Riad's suggestion that he was attempting to reduce the effects of volatility on HCE and hedge the portfolio was also misleading. FAMCO's internal research showed that

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variance swaps as a means of sustaining its high dividend payout objective. (Ex. 75 at 34141; *see* Ex. 98 showing drafting in November) shorting variance swaps on top of an equity portfolio actually increased portfolio volatility. (Ex. 47 at 1074) Writing put options is the functional equivalent of leveraging a covered call portfolio by borrowing money and investing in more covered calls, so it also increases portfolio volatility. (Ex. 139 at ¶¶ 74, 307; Tr. 204:6-205:10, 3522:1-3525:12)

Riad also explained to the Board that HCE's put options "were timed securities with firm expiration dates and that during this period of unprecedented market movement, the Trust was limited in its ability to react." (Ex. 154 at 30872) However, it was untrue that HCE was locked in to its put option exposure. Both Riad and Professor Spatt acknowledged that in September 2008 HCE could have accessed an extremely liquid and operating exchange market for put options to offset its positions. (Tr. 2534:5-9; 3466:7-3467:16, 3471:10-13)

In October 2008, after learning more about the extent and size of the put and swap trading, the Board replaced Riad and Swanson as portfolio managers. (Ex. 19 at 16626-27) The Board and Fund counsel had no idea that the portfolio managers had been using put options and variance swaps in the magnitude that they did, as they had been told the puts and swaps were a small part of the portfolio. (Tr. 2856:1-2858:8; 2937:16-2940:21, 3013:8-12)

## III. ARGUMENT

The Division should prevail in this matter because it has proven, by the preponderance of the evidence, that Riad and Swanson acted knowingly, recklessly and negligently in making misleading statements and omitting to state material facts in HCE's 2007 annual and 2008 semi-annual reports. *See* Steadman v. SEC, 450 U.S 91, 102-03

(1980); In the Matter of Sandra K. Simpson and Daphne Ann Pattee, Exchange Act Rel. No. 45923, 77 SEC Docket 1784, 2002 WL 987555 at *16 (May 14, 2002).

### A. Riad and Swanson Willfully Violated the Antifraud Provisions of the Exchange Act and the Investment Company Act

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit any person, in connection with the purchase or sale of any security, from directly or indirectly: (a) employing any device, scheme, or artifice to defraud; (b) making any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. Section 34(b) of the Investment Company Act prohibits any person from making any untrue statement of a material fact in any registration statement or other document filed or transmitted under the Investment Company Act. It also prohibits any person filing, transmitting or keeping any such document from omitting to state any fact necessary in order to prevent the statements made, in the light of the circumstances under which they were made, from being materially misleading.

A misstatement or omission is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988). *Scienter*, defined as a "mental state embracing the intent to deceive, manipulate or defraud," is a required element of a Section 10(b) claim. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). Reckless conduct also satisfies the *scienter* requirement. *See* SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1044 (7th Cir. 1977); *cert denied*, 434 U.S. 875 (1977). Proof of *scienter* need not be direct, but may be a matter of inference from circumstantial evidence. *See* Herman & Maclean v. Huddleston, 459 U.S. 375, 390 n.30 (1983). Section 34(b) of the Investment Company Act does not require a showing of *scienter*. In re Fundamental Portfolio Advisors, Inc., Investment Company Act Rel. No. 26099, 56 S.E.C. 651, 670 (July 15, 2003).

The Division has shown that both Riad and Swanson made false and misleading statements and omitted material facts in the Questions and Answers discussion in HCE's 2007 annual report and 2008 semi-annual report. Specifically, Riad and Swanson each claimed that the most significant contributors to HCE's performance, both positive and negative, were individual stock selections and the Fund's covered call strategy. This was not the case. Riad and Swanson both failed to mention the more substantial effect that written put and variance swap investment strategies had on HCE's overall return.

Further, Riad and Swanson minimized the risk of their derivative investment strategies in the 2007 Annual Report and 2008 Semi-Annual Report by describing them generically as a "global hedging strategy." They failed to inform investors that the written put option and variance swap investment strategies exposed the Fund to significant downside risk and substantial investment losses during periods of market decline or volatility. In fact, the risks disclosures in the annual and semi-annual reports, which were attributed in part to Riad and Swanson, did not mention anything about writing put options or variance swaps. Although Riad and Swanson never described their written put option and variance swap investment as principal investment strategies, they clearly were principal strategies in terms of both risk and return.

Not only did Riad and Swanson fail to disclose the risks, the Questions and Answers sections in both the 2007 Annual and 2008 Semi-annual Report misled investors into believing that Riad and Swanson were actually *protecting* the Fund against downside risk. Both reports included a statement that HCE's covered call strategy had the potential to protect on the downside.

In the 2007 report, Riad and Swanson stated that they further protected the portfolio by buying index puts and collaring the portfolio by simultaneously purchasing index puts and writing index calls. This statement was misleading, as it omitted that they were also exposing the Fund to downside risk by writing index put options for a significant portion of the year. In fact, when they collared the portfolio with a purchased put and a written call, it usually involved a written put option as part of that same trade. Riad admitted it was an omission to exclude written put options from that disclosure.

In the 2008 report, Riad and Swanson once again claimed that for most of the period they had strategically hedged the portfolio for additional downside protection, which proved to be a good decision as equity markets trended downward. This statement was also misleading, since HCE had naked written put option and short variance swap exposure for the majority of the period, and when they actually did purchase protective long puts and long variance swaps, they lost on those trades.

This information about HCE's derivative investments was material to the Fund's investors. By distorting the actual drivers of HCE's performance, and the Fund's exposure to (and lack of protection from) downside risk, Riad and Swanson concealed from investors the fact that HCE was achieving its favorable returns in large part by making aggressive investments with significant additional downside risk. The materiality of the puts and swaps is demonstrated by several factors: (1) HCE received a significant boost to performance from these strategies that allowed it to outperform benchmarks and its peers;

(2) representatives of HCE investors testified that they would have been essential for them to know that HCE invested in derivatives that exposed them to greater risks of losses in declining or volatile markets than a typical covered-call fund; (3) Hughes found the strategies to be significant enough to factor into his personal investment decisions with respect to HCE; (4) Professor Harris's report shows the significant potential losses the puts and swaps exposed the Fund to, and Professor Harris demonstrated how the strategies changed the Fund's risk profile; and (5) HCE suffered far greater losses than the market as a whole in the fall of 2008, enough to result in HCE's liquidation. Respondents have offered no evidence to suggest that this type of information was not considered material by reasonable investors.

The Division has demonstrated that Riad and Swanson acted knowingly, recklessly and negligently as alleged in the OIP. Riad's and Swanson's contemporaneous communications from 2007 and 2008 show that they considered the put and variance swap strategies to be important to HCE's success during that time period. Riad and Swanson also misleadingly stated that HCE was hedged for downside protection when they knew, or were reckless in not knowing, that their written put options and short variance swaps had exposed HCE to additional downside risks and potential losses. (*see* Ex. 99 at 119708-10, 23) Respondents also misled Claymore and HCE's Board about the strategies by downplaying their significance to performance and insisting that they reduced risk in the portfolio. Their pitch that these strategies reduced risk and were only a small component of the portfolio deflected attention from the Fund's disclosure deficiencies with respect to the significance and risk of those strategies to the Fund.

The misrepresentations were in connection with the purchase or sale of securities. Material misstatements or omissions in a company's periodic reports meet the "in connection with" requirement because potential investors might rely on such statements in deciding whether to purchase or sell the company's securities. SEC v. Benson, 657 F. Supp. 1122, 1131 (S.D.N.Y. 1997); SEC v. Softpoint, Inc., 958 F. Supp. 846, 862-63 (S.D.N.Y. 1997), *aff'd*, 159 F.3d 1348 (2d Cir. 1998); Steiner v. Ames Dep't Stores, Inc., 991 F.2d 953, 962 (2d Cir. 1993).

Riad and Swanson are each "makers" of the false and misleading statements and omissions 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 statements was made by – and only by – the party to whom it is attributed."). The introductions to the Questions and Answers discussions and the risks sections of the 2007 annual report and the 2008 semi-annual report directly attribute the statements in those sections to HCE's portfolio managers. Riad and Swanson reviewed the sections multiple times, and Swanson signed a certification as to its accuracy. Delony and Claymore did not feel comfortable making any substantive changes to the section without running those changes by Riad and Swanson first. Accordingly, each Respondent can be held liable for making false statements under Section 10(b) and Rule 10b-5 thereunder.

**B. Riad and Swanson also Aided and Abetted and Caused HCE's Violations of Section 34(b) of the Investment Company Act**

In addition to their direct violations of Sections 10(b) and 34(b), Riad and Swanson aided and abetted and caused HCE's violations of the law. To establish aiding and abetting liability under the federal securities laws, the Division must show: (1) a primary violation; (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 constituting the violation. *See* Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000). A showing of recklessness is sufficient to establish the knowledge or awareness requirement. *See* In re vFinance Invs., Inc., Exchange Act Rel. No. 62448 (July 2, 2010), 98 SEC Docket 2879; Monetta Fin. Servs., Inc. v. SEC, 390 F.3d 952, 956 (7th Cir. 2004); *see also* Howard v. SEC, 376 F.3d 1136, 1143 (D.C. Cir. 2004) ("A secondary violator may act recklessly, and thus aid and abet an offense, even if he is unaware that he is assisting illegal conduct.").

To establish causing liability, the Division must show: (1) a primary violation; (2) an act or omission by the respondent that was a cause of the violation; and (3) that the respondent knew, or should have known, that his conduct would contribute to the violation. In re Robert M. Fuller, 56 S.E.C. 976, 984 (2003), *pet. denied*, No. 03-1334 (D.C. Cir. 2004). A respondent who aids and abets a violation also is a cause of the violation. *See* In re Sharon M. Graham, 53 S.E.C. 1072, 1085 n.35 (1998), *aff'd* 222 F.3d 994 (D.C. Cir. 2000). 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), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002).

By making misleading statements and omissions in its 2007 annual and 2008 semi-annual reports, HCE violated Section 34(b) of the Investment Company Act. Riad and Swanson aided and abetted and caused HCE's violations by making misleading statements and omitting material information in the Question and Answers discussions and risks sections of HCE's 2007 annual report and 2008 semi-annual report. As discussed above, the Division has demonstrated that Riad and Swanson acted recklessly and negligently in making these misstatements and omitting material information from HCE's reports.

### C. Riad and Swanson Aided and Abetted and Caused FAMCO's Violations of Section 206(4) of the Advisers Act and Rule 206(4)-8 Thereunder

Section 206(4) of the Advisers Act prohibits an investment adviser from engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. Rule 206(4)-8 states that it shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business for an investment adviser of an investment company to: (1) make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor in the investment company; or (2) otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any of the investment company's investors or prospective investors. Section 206(4) does not require a showing of *scienter*. SEC v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992).

By utilizing undisclosed investment strategies to such a degree that those strategies became an integral part of HCE efforts to achieve favorable investment returns, and by exposing the Fund to additional undisclosed risks, Riad managed HCE in a manner that operated as a fraud on its investors and conflicted with the Questions and Answers discussion in HCE's 2007 annual and 2008 semi-annual reports. As a result, Riad aided caused FAMCO's violations of Section 206(4) and Rule 206(4)-8(a)(2).

Similarly, by making false and misleading statements to investors in HCE's 2007 Annual and 2008 Semi-Annual Reports, Riad and Swanson aided and abetted and caused FAMCO's violations of Section 206(4) and Rule 206(4)-8(a)(1).

### D. Riad Caused HCE's Violations of Rule 8b-16 Under the Investment Company Act

Form N-2 requires that closed-end investment companies disclose in their registration statements the investment objectives and policies that will constitute the principal portfolio emphasis, including the types of securities in which the fund will invest principally, all significant investment practices or techniques the fund employs or intends to employ, and all other types of investments that will be made by the fund. (Ex. 142 at 15, Form N-2 Item 8.2). Form N-2 further requires that funds discuss the principal risk factors associated with investment in the fund specifically and those associated with the fund's investment objectives and policies. (Ex. 142 at 16, Form N-2 Item 8.3).

A fund's disclosure of a type of risk, without discussion of the extent of the risk, does not necessarily make its risk disclosures complete and not misleading. In re TCW/DW N. Am. Gov't Income Trust Sec. Litig., 941 F. Supp. 326, 330-31 (S.D.N.Y. 1996) (denying motion to dismiss because disclosure of type of risk excluded discussion of extent of risk and consequences); In re Oppenheimer Rochester Funds Group Sec. Litig., 838 F. Supp. 2d 1148, 1164-67 (D. Col. 2012) (risk disclosures re: inverse floater bonds failed to disclose even a general range of degree to which inverse floaters were leveraged plausibly omitted material information; failure to disclose floaters' ability to obtain negative values that could trigger a fund crisis was material omission given generic and sanguine risk disclosures in place).

Form N-2 even requires disclosure identifying any investment practices used by a fund that place no more than 5% of the fund's net assets at risk.[42] the amount of net assets at risk is determined by reference to the potential liability or loss that may be incurred. (Ex. 142 at 17, Form N-2 Item 8.4 instruction c) Form N-2 further requires full discussion in the SAI of any significant investment policies not discussed in the prospectus, including the extent to which the fund may engage in the policies and the risks inherent in such policies. (Ex. 142 at 24-25 Form N-2 Item 17.3 instruction 3).

Rule 8b-16 under the Investment Company Act requires investment companies to amend their registration statements annually. Rule 8b-16-(b) exempts closed-end funds from the annual amendments if they include, among other things, in annual reports to shareholders: (1) any material changes in the company's investment objectives or policies that have not been approved by shareholders; and (2) any material changes in the principal risk factors associated with investment in the company.

As explained previously, Respondents' written put and short variance swap strategies constituted a material change to HCE's investment policies, and altered the principal risk factors associated with a covered-call fund. (Tr. 2859:3-2864:23) Accordingly, HCE violated Rule 8b-16 by failing to amend its registration statement or disclose in its 2007 annual report the material changes to the Fund's investment policies and principal risk factors resulting from Respondents' written put option and variance swap strategies.

Riad was primarily responsible for managing the written put option and variance strategies for HCE. Riad was also responsible for familiarizing himself with HCE's

[42] The amount of net assets at risk is determined by reference to the potential liability or loss that may be incurred. (Ex. 142 at 17, Form N-2 Item 8.4 instruction to instruction c)

registration statement and managing the portfolio consistent with the disclosures therein. He was aware that HCE's registration statement did not disclose or explain the written put option and variance swap strategies he was implementing as principal fund strategies or primary drivers of performance. In fact, he participated in a conference call involving FAMCO and Claymore, one of the focuses of which was the Strategic Transactions disclosure in HCE's registration statement, so he was well aware of the Fund's limited disclosure regarding the use of derivatives. He also was aware that HCE's registration statement failed to disclose the risks associated with writing puts or trading variance swaps. However, Riad continued to use these derivative investment strategies to such a degree that they became an integral part of the manner in which HCE sought to achieve its investment objectives in 2007 and 2008.

Riad also failed to raise the disclosure issue with Claymore and never sought advice about whether his strategies were adequately disclosed. Instead, Riad and contributed to HCE's disclosure failures by describing the strategies as augmenting downside protection and as small components of the portfolio in discussions with Claymore and HCE's Board, making it far more difficult for others to notice the disclosure deficiencies. By doing so, Riad acted at least negligently in causing HCE's violations of Rule 8b-16.

### E. <u>Riad and Swanson Have Offered No Viable Defenses</u>

Thus far, Riad and Swanson have not offered any evidence or explanation that would constitute a legally sufficient defense to any of the charges at issue in this matter.

#### *1. HCE's Registration Statement Disclosures Were Insufficient*

The Division acknowledges that HCE's registration statement authorized the use of written put options and variance swaps in HCE's portfolio, but that is a separate question from the issue of adequacy of disclosure. Thomas Hale, HCE's outside counsel, testified that he opined that put options and variance swaps were permissible investments under the Strategic Transactions provision of the registration statement, but that the registration statement and annual and semi-annual reports failed to adequately disclose HCE's regular use of written put options and short variance swaps. (see Tr. 2851:17-2853:9, 2859:6-2864:23)

Written put options and variance swaps were not described in the registration statement's description of the types of investments HCE would make under normal market conditions. To the contrary, the registration statement stated that the Fund may engage from time to time in certain "Strategic Transactions." Neither the registration statement nor the SAI suggested that any "strategic transactions" would be used repeatedly as regular fund strategies.

Riad and Swanson held written put options or short variance swaps in HCE's portfolio more than 80% of the time from April 2007 through mid-October 2008. (Ex. 139 at ¶¶ 126, 133) These investments became an integral part of Respondents' efforts to achieve HCE's dividend payment and investment objectives. Moreover, the registration statement's disclosures of risk failed to address the principal risks from the Respondents' derivative investment strategies or disclose HCE's exposure to significant losses during declining markets or periods of increased volatility which accompanied the written put option and variance swap investments.

These deficiencies in HCE's registration statement were not cured by disclosures in any of HCE's periodic reports, including the 2007 annual report or the 2008 semi-annual report. These reports only provided snapshots of fund holdings on a specific date, and did not provide any narrative description of Riad and Swanson's derivative investment strategies for the Fund. Moreover, investors could not glean from the periodic reports whether the transactions were isolated transactions or part of a consistent investment strategy. In addition, as discussed below, the periodic reports' risk disclosure sections did not discuss any of the specific risks associated with the written put option and variance swap strategies.

2. *HCE's Periodic Reports Omitted Crucial Information*

As explained previously, the written put option and short variance swap strategies were major contributors to HCE's performance in 2007. Riad and Swanson's stock selection paled in comparison to the overall contribution of the written put options. HCE's equity portfolio returned only 7.97% net of fees, barely beating the S&P 500's return of 7.72% during the same time. However HCE's derivative strategies, including the sale of put options, were almost exclusively responsible for the fact that HCE outperformed the S&P 500 by 5%. And these gains came at the expense of increased downside risk to the Fund's portfolio. Short variance swaps, on the other hand, were one of the worst contributors to performance, yet were not discussed in the section on what most hurt performance.

Despite the fact that written put options were a positive contributor to HCE's performance in the first half of 2008, Riad and Swanson did not even mention written put options in the 2008 semi-annual report. Moreover, Riad and Swanson stated that the portfolio was hedged for downside protection even though the written put options and variance swaps actually exposed the portfolio to downside risk, and failed to protect the portfolio against market declines.

### 3. *Respondents Have Not Established That They Acted in Good Faith.*

Riad and Swanson did not introduce any evidence that they relied upon the advice of Claymore or the Fund's counsel, for the adequacy of the Questions and Answers sections of HCE's 2007 Annual and 2008 Semi-Annual Reports.[43] Delony wrote the initial draft commentary, after interviewing Swanson. Riad and Swanson reviewed the draft before it was sent out for review by Claymore and Fund counsel. Riad and Swanson decided to use the generic description of a "global hedging strategy" in describing the Fund's derivative investments. And Riad and Swanson made the decision to focus the Question and Answers on equity investments and the covered call strategy while minimizing the impact and risks of the derivative investments. Neither Claymore nor Fund counsel directed Respondents to use certain words, phrases or descriptions in describing how the FAMCO Portfolio Managers were attempting to accomplish HCE's investment objectives, and how the Fund had performed since the last report. Accordingly, Respondents did not rely in good faith on the advice of anyone else in how to disclose the written put or variance swap investments.

## IV. SANCTIONS

If Riad and Swanson are found liable for violating the federal securities laws, the Court must consider whether the public interest requires the imposition of sanctions, and

[43] The fact that Claymore and its legal counsel confirmed that Respondents were allowed to trade in written put options or variance swaps is insufficient to prove that either Riad or Swanson acted in good faith. Neither Claymore nor the Fund's counsel advised Respondents on how often they could write put options, or enter into short variance swaps and to what degree. Nor did Respondents seek any advice from Claymore or the Fund's counsel about whether to describe their written put and variance swap investments as a global hedging strategy. This advice must also be viewed in the context of Riad's and Swanson's statements to Claymore that these investments were risk- and volatility-reducing hedges.

should consider the following factors: the egregiousness of the actions; the isolated or recurrent nature of the infractions; the degree of scienter involved; the sincerity of a respondent's assurances against future violations; a respondent's recognition of the wrongful nature of his or her conduct; and the likelihood that a respondent's occupation will present opportunities for future violations. *See* Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981) (*quoting* SEC v. Blatt, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)). Other factors include the age of the violations and the degree of harm to investors and the marketplace as a result of the violations. *See* In the Matter of Marshall E. Melton, et al., Advisers Act Rel. No. 2151 (July 25, 2003), 2003 WL 21729839, at *2. The Commission also may consider the extent to which a sanction will have a deterrent effect. *See* In the Matter of Schield Management Co., et al., Exchange Act Rel. No. 53201 (Jan. 31, 2006), 2006 WL 23162, at *8.

Here, Riad's and Swanson's misconduct was egregious and was repeated throughout 2007 and 2008. Their conduct involved deliberate deception by hiding from investors material information which should have been included in HCE's annual and semi-annual reports. Riad and Swanson have shown no recognition of the wrongful nature of their actions, and have offered no assurances against future violations. Although neither Respondent has any prior disciplinary history, both are relatively young and, since leaving FAMCO have worked in the securities industry. In fact, Riad started his own investment advisory firm and expects to manage money for U.S. investors in the future. (Tr. 2035:10-2036:6) Accordingly, both Riad and Swanson will have ample opportunities to commit future violations of the securities laws.

In addition, the harm suffered by HCE's investors as a result of Respondents' violations has been severe. Investors lost approximately $45.4 million as a direct result of Respondents' conduct. Imposing a sanction upon Riad and Swanson is necessary to deter them from engaging in any future misconduct, as well as deter other industry participants from concealing risks from investors.

### A. Respondents Should Be Subject to Cease-and-Desist Orders

Section 21C of the Exchange Act, Section 203(k) of the Advisers Act and Section 9(f) of the Investment Company Act authorize the Court to issue cease-and-desist orders. Riad's and Swanson's violations of the securities laws raise a sufficient risk of future violations to justify the entry of such an order. *See* In the Matter of KPMG Peat Marwick LLP, Exchange Act Rel. No. 43862 (Jan. 19, 2001), 54 S.E.C. 1135, 1183-91 (such a showing is "significantly less than that required for an injunction," and "absent evidence to the contrary," a single past violation may raise "a sufficient risk of future violation").

### B. Respondents Should Pay Disgorgement and Prejudgment Interest

Under Section 21C(e) of the Exchange Act, Section 203(j) of the Advisers Act and Section 9(f)(5) of the Investment Company Act, Respondents may be required to pay disgorgement, plus prejudgment interest.[44] To determine the appropriate amount of disgorgement, the Division only needs to show that the amount of disgorgement is a reasonable approximation of the profits from the violative conduct. *See* SEC v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989). The burden then shifts to the respondent to show that the approximation is inaccurate. *Id.*

[44] The conduct in this case predates the enactment of the Dodd-Frank Act. Accordingly, the cited authority for disgorgement and prejudgment interest is based on the statutes as in effect at the time of the conduct.

During 2007, Swanson received an even greater amount in salary and bonus, and Riad received a salary plus more than $1 million in profit sharing payments from FAMCO. (Exs. 112, 113) During 2008, both Riad and Swanson profited from their continuing violations of the securities laws by receiving a base salary of more than $200,000 plus a substantial bonus. (Ex. 111) If the Respondents' disclosure violations in connection with HCE's 2007 Annual report had been known, neither man would have been permitted to remain as HCE's portfolio manager and could have lost their position with FAMCO. Accordingly, the Court should order Riad and Swanson to disgorge from their 2007 and 2008 earnings the profits they earned from their violations of the securities laws, plus prejudgment interest. .

### C. <u>Respondents Should Pay Substantial Civil Penalties</u>

In addition, the public interest requires that Riad and Swanson be ordered to pay significant civil penalties for their misconduct. *See* Section 203(i) of the Advisers Act, and Section 9(d) of the Investment Company Act. In considering whether civil penalties are appropriate in the public interest, the factors to consider include: (1) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to other persons resulting either directly or indirectly from such act or omission; (3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior; (4) whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization to have violated the federal securities laws, state securities laws or self-regulatory rules, has been enjoined from violating such laws or rules, or has been convicted of violations of such laws or of any felony or misdemeanor described in Section 15(b)(4)(B) of the Exchange Act or Section 203(e)(2) of the Advisers Act; (5) the need to deter such person and other persons from committing such acts or omissions; and (6) such other matters as justice may require. *Id.*

The Court should impose third-tier civil penalties of up to $130,000 for each violation against both Riad and Swanson. *See* 17 C.F.R. § 201.1003. Riad committed at least three violations worthy of third-tier penalties: (1) managing in a manner that rendered its registration statement misleading; (2) making false and misleading statements in HCE's 2007 annual report; and (3) making false and misleading statements in HCE's 2008 semi-annual report. So Riad should pay a civil penalty of up to $390,000. Swanson committed at least two violations by making false and misleading statements in both HCE's 2007 annual report and 2008 semi-annual report. So Swanson should pay a civil penalty of up to $260,000.[45]

Based on the multiple violations, the use of fraud, deceit, manipulation or a deliberate or reckless disregard of regulatory requirements, the substantial harm and risk of harm to investors and the need to deter Riad and Swanson from committing future violations, the Court should impose multiple third-tier penalties against each of the Respondents. *See, e.g.*, In re Fundamental Portfolio Advisors, Inc., Lance M. Brofman, and Fundamental Serv. Corp., Securities Act Rel. No. 8251 (July 15, 2003), 80 SEC Docket 2234 (cease-and-desist order, civil penalty of $250,000 and permanent associational bar ordered against portfolio manager who misled investors about a new risky investment strategy in the mutual fund he managed); SEC v. Kimon P. Daifotis and

[45] The misstatements in HCE's 2007 annual and 2008 semi-annual reports were distributed to numerous investors and could be viewed as separate violations for each investor.

Randall Merk, Lit. Rel. 22415 (July 16, 2012) (settlement imposing disgorgement of $250,000 and civil penalty of $75,000 against portfolio manager enjoined for misleading investors about the risks of investing in a bond fund). The amount of any civil penalty assessed against both Riad and Swanson should be sufficient to deter them and others from engaging in the type of conduct at issue in this proceeding.

**D. Respondents Each Should Be Subject to a Permanent Associational Bar**

Under Section 203(f) of the Advisers Act, and Section 9(b) of the Investment Company Act, as amended by Section 925 of the Dodd-Frank Act, the Commission may bar or suspend registered persons from being associated with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization. *See* In the Matter of John W. Lawton, Advisers Act Rel. No. 3513 (December 13, 2012), 2012 WL 6208750 (collateral bars imposed pursuant to Section 925 of Dodd-Frank may be imposed in proceedings based on pre-Dodd-Frank conduct).

Based on Riad's and Swanson's willful violations of the securities laws, and orders entered in similar Commission proceedings, the Court should impose an associational bar on both Riad and Swanson which would preclude their continued employment in the securities industry. *See, e.g.*, In re Top Fund Management, Inc. and Barry C. Ziskin, Securities Act Rel. No. 9377 (Dec. 21, 2012) (settlement imposing collateral bar against mutual fund manager from the securities industry for failing to follow the investment objectives of a stock mutual fund, leading to the fund's collapse); SEC v. Kimon P. Daifotis and Randall Merk, Lit. Rel. 22415 (July 16, 2012), Exchange Act Rel. No. 67454, 2012 WL 2921019 (July 18, 2012) (settlement imposing collateral bar with right to reapply after three years against portfolio manager enjoined for misleading investors about the risks of investing in a bond fund); In re Fundamental Portfolio Advisors, Inc., Lance M. Brofman, and Fundamental Serv. Corp., Securities Act Rel. No. 8251 (July 15, 2003), 80 SEC Docket 1851 (permanent associational bar ordered against portfolio manager who misled investors about a risky investment strategy).

The length of an associational bar should be sufficient to protect investors from the type of harm which is at issue in this proceeding. Respondents have shown themselves to be uniquely vulnerable to the pressures which accompany professional investment management. They have not recognized the wrongful nature of their conduct, or given any assurances that they can be trusted to obey the securities laws and make effective disclosures to investors in the future. Accordingly, they should be barred permanently from associating with registered investment advisers and the full range of other entities described in the Dodd-Frank Act. This is the only way to ensure that investors are protected fully against the dangers of misleading disclosures by firms which may employ the Respondents in the future.

## V. CONCLUSION

The Division of Enforcement respectfully requests that the Court accept all the documentary and testimonial evidence presented at the hearing, and issue an Initial Decision finding that Respondents Mohammed Riad and Kevin Timothy Swanson engaged in the violations described in the Order Instituting Proceedings, and imposing significant sanctions against each Respondent.

Dated: July 2, 2013.

Respectfully submitted,

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