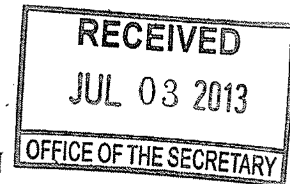
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



ADMINISTRATIVE PROCEEDING
File No. 3-15141

In the Matter of

MOHAMMED RIAD
AND KEVIN TIMOTHY
SWANSON

Respondents.

POST-HEARING BRIEF OF MOHAMMED RIAD AND KEVIN TIMOTHY SWANSON

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I. INTRODUCTION

After an 11-day trial, this action is before the Court for adjudication of the Division of Enforcement's (the "Division") allegations that Respondents Mohammed Riad and Timothy Swanson (collectively, the "Respondents") violated the federal securities laws with respect to the Fiduciary/Claymore Dynamic Equity Fund's ("HCE" or the "Fund") investment in certain derivatives in 2007 and 2008.

At the outset of the proceeding, the Division painted a vivid picture of the Respondents' nefarious deeds. Mr. Riad and Mr. Swanson allegedly lied to investors.[1] According to the Division, they hid[2] their fraudulent activities and concealed[3] important information. The Respondents "failed to come clean about the risky bets they were taking with investor money."[4] Not only did they commit such egregious deception,[5] but they actively "devised their risky strategy to cause the Fund to collapse."[6] In short, the Respondents were "rogue traders"[7] who gambled[8] and lost when they took a roll of the dice[9] with investor money.

But the evidence told a different story.

The record at trial demonstrated that the derivatives at issue were not a sudden "roll of the dice" that represented an extreme risk. In fact, the trading strategies emerged as the result of seven years of careful research and analysis overseen by Mr. Riad and performed by a brilliant research analyst at FAMCO. The conclusion of this investigation was that the investments

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[1] Opening Statement by the Division at 24:13.
[2] *Id.* at 19:20-21; 30:4.
[3] *Id.* at 26:3; 31:20.
[4] *Id.* at 24:11-12.
[5] *Id.* at 20:6.
[6] *Id.* at 31:18-19.
[7] Testimony of Lawrence Harris [hereinafter "Harris Testimony"] at 407-409. References to Testimony in this Brief denote testimony before the Court in this proceeding.
[8] *Id.* at 24:2. Harris Testimony at 353:23
[9] *Id.* at 27:7.

would modestly contribute to Fund performance and would pose only a minimal risk to the portfolio. Far from being a reckless gamble, these strategies were widely endorsed by numerous academic articles and financial industry papers. Significantly, the Respondents' conclusion regarding these investments was also validated by a former Chief Economist of the SEC.

The evidence also showed that there was no attempt on the part of the Respondents to lie, conceal, or hide any information regarding these investments. Prior to entering these transactions, the Respondents sought guidance from the Fund's investment adviser, Claymore Advisors, LLC ("Claymore"). The Respondents spoke about these investments at numerous Board meetings and also provided the Board with written information about the short index put options and written variance swaps at quarterly meetings. When a question arose regarding these investments in late 2007, the Respondents participated in a conference call with various individuals who had more experience with the relevant legal and compliance issues so that the problem could be addressed. Detailed information about these derivatives investments was disclosed in multiple shareholder reports.

The assertion that the Respondents were "rogue traders" is also belied by the fact that Mr. Riad and Mr. Swanson simply had no motive to mislead anybody. The Respondents worked at a Midwest investment firm that placed more emphasis on reputation and community than on performance. Mr. Swanson did not even share in the profits of the Fund and thus received no benefit from taking a risky bet with shareholder money. Mr. Riad's interests were aligned with investors because he invested his own money in the same derivatives strategies – a decision that cost him nearly half a million dollars.

To be sure, it is difficult to ignore the fact that these investments ultimately lost nearly $45 million of investor money. The potential disconnect between the reasonableness of the

Respondents' actions and the final outcome was perhaps best explained by Sean Hughes, the exceptional analyst whose research underlay the Fund's derivatives investments: "Nobody did anything wrong. We were acting prudently." In the end, however, "[w]e just got caught up in the crisis that nobody expected."[10]

The Respondents have proved by a preponderance of the evidence that their actions with respect to the investments at issue were performed at all times in good faith. Not only did the Division fail to demonstrate that the Respondents intended to deceive investors and the Board, but they were not even able to prove that they acted negligently. As a result, the Court should enter judgment for the Respondents on all charges.

II. VIOLATIONS ALLEGED BY THE DIVISION AND STANDARDS OF PROOF

1. The Provisions Of Law At Issue

The Order Instituting Proceedings ("OIP") charges that the Respondents willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 34(b) of the Investment Company Act of 1940 through their actions with regard to the HCE Fund's investments in short index put options and short variance swaps.[11] The OIP also charges that the Respondents "aided and abetted" and "caused" violations of Section 34(b) of the Company Act, Advisers Act Section 206(4) and Rule 206(4)-8, and also that Mr. Riad caused violations of Company Act Rule 8b-16.[12] As discussed below, the evidence at trial demonstrated that the Respondents did not violate any of these provisions.[13]

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[10] Testimony of Sean Hughes [hereinafter "Hughes Testimony"] at 799:3-5.
[11] OIP at ¶ 69, 71.
[12] *Id.* at ¶ 70, 72, 73.
[13] During the proceeding, the Division frequently conflated the Respondents' roles and responsibilities in managing HCE. When evaluating the conduct of the Respondents, however, it is important to recognize that Mr. Riad and Mr. Swanson played different roles with respect to the investments and disclosures at issue.

2. Antifraud Provisions

Respondents are charged with willfully violating the antifraud provisions of the Exchange, Advisers, and Company Acts,[14] which all prohibit essentially the same type of conduct. Rule 10b-5 of the Exchange Act makes it unlawful "in connection with the purchase or sale of any security (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit 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) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[15] Section 34(b) of the Company Act contains a similar proscription,[16] as does the Advisers Act in Section 206(4)[17] and Rule 206(4)-8,[18] which applies specifically to "any investment adviser to a pooled investment vehicle."

In order to establish its claims against the Respondents for violations of Sections 10(b) of the Exchange Act and Rule 10b-5 thereunder, the SEC must demonstrate that the Respondents acted with the requisite scienter when committing the alleged fraud.[19] When assessing scienter,

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[14] Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, and Section 34(b) of the Company Act.

[15] 17 C.F.R. 240.10b-5.

[16] Section 34(b) provides that "[i]t shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this title...It shall be unlawful for any person so filing, transmitting, or keeping any such document to omit to state therein any fact necessary in order to prevent the statements made therein, in light of the circumstances under which they were made, from being materially misleading."

[17] Section 206(4) provides that "[i]t shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly -- . . . (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative . . ."

[18] Rule 206(4)-8 provides that "[it] shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act for any investment adviser to a pooled investment vehicle to: (1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

[19] *Aaron v. SEC*, 446 U.S. 680, 690-91, 695-97 (1980); *SEC v. Steadman*, 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992). Scienter is not required to establish a violation of Company Act Section 34(b) and Advisers Act Section 206(4) and

it is critical to keep in mind the Supreme Court's mandate that the anti-fraud provisions are *not intended to punish good faith conduct*.[20] To the contrary, the Supreme Court cautioned that a claim for securities fraud must be supported, *inter alia*, by sufficient evidence to demonstrate that the defendant acted with a mental state embracing "intent to deceive, manipulate or defraud."[21] Other courts have indicated that evidence of "extreme recklessness" may be sufficient to satisfy this scienter requirement.[22]

Courts have interpreted extreme recklessness to encompass a standard that is tantamount to intentional conduct. The Seventh Circuit has concluded that recklessness encompasses only the circumstance where the defendant's action constitutes "a *highly unreasonable omission*, involving not merely simple, or even inexcusable negligence, but *an extreme departure from the standards of ordinary care*."[23] The Seventh Circuit provided further guidance by defining the standard to apply only to circumstances where the omission is "either *known* to the defendant or is *so obvious that the actor must have been aware of it*."[24] The court wrote that this "definition of recklessness should be viewed as the functional equivalent of intent."[25] The D.C. Circuit has also narrowly construed the scienter requirement, adopting the Seventh Circuit's standard.[26] In

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Rule 206(4)-8; instead, it is sufficient to demonstrate negligence on the part of the Respondents. *See In the matter of Fundamental Portfolio Advisers, Inc. et al.*, Investment Company Act Release No. 26099, 2003 SEC LEXIS 1654, *29 (July 15, 2003); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); *SEC v. Steadman*, 967 F.2d at 643 & n.5; *Steadman v. SEC*, 603 F.2d 1126, 1132-34 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981).

[20] *See generally Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *see also Aaron v. S.E.C.*, 446 U.S. 680, 691 (1980).

[21] *Ernst & Ernst*, 425 U.S. at 193 n. 12.

[22] *See, e.g., Graham v. Securities & Exchange Comm'n*, 222 F.3d 994, 1004 (D.C. Cir. 2000).

[23] *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (quotation omitted) (emphasis added).

[24] *Id.* (emphasis added).

[25] *Id.*

[26] *See S.E.C. v. Steadman*, 967 F. 2d 636, 641-42 (D.C. Cir. 1992) (The kind of recklessness required is an "extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.") (quoting *Sundstrand*, 553 F.2d at 1045).

assessing the Respondents' scienter, it is also critical to remember that "[t]here is no 'fraud by hindsight,' in Judge Friendly's felicitous phrase."[27]

Material misrepresentations and omissions violate Exchange Act Section 10(b) and Rule 10b-5, Company Act Section 34(b), and Advisers Act Section 206(4) and Rule 206(4)-8. In evaluating whether a misrepresentation or omission is material, the standard of materiality is whether or not a reasonable investor or prospective investor would have considered the information important in deciding whether or not to invest.[28]

3. Other Provisions

Rule 8b-16 requires investment companies to inform shareholders of "[a]ny material changes in the company's investment objectives or policies" as well as "[a]ny material changes in the principal risk factors associated with investment in the company."[29] This rule allows such information to be transmitted to shareholders in the company's annual report.[30]

4. Aiding and Abetting and Causing Violations

In order to find the Respondents liable for "aiding and abetting" a violation, the Division must establish three elements: (1) a primary or independent securities law violation committed by another party; (2) awareness or knowledge by the aider and abettor that his or her role was

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[27] *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990), cert. denied, 498 U.S. 941 (1990) (quoting *Denny v. Barber*, 576 F.2d 465 (2d Cir.1978) (Friendly, J.)). *See also Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1278 (D.C. Cir. 1994) ("The fact that a company's performance did not conform to that predicted supports no inference that [its] statements lacked a reasonable basis when made."); *In re Acceptance Companies Securities Litigation*, 423 F.3d 899, 901-02 (8th Cir. 2005) ("[I]t is not a reasonable inference to assume prior knowledge based upon actual knowledge at a later date.").

[28] *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32, 240 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992).

[29] 17 C.F.R. § 270.8b-16(b)(2) and (b)(4).

[30] 17 C.F.R. § 270.8b-16(b); *Goldstein v. Lincoln Nat'l Convertible Sec. Fund, Inc.*, 140 F. Supp. 2d 424, 444, n.19 (E.D. Pa. 2001) *judgment vacated in part, appeal dismissed sub nom. Goldstein v. Lincoln Nat. Convertible Sec. Fund, Inc.*, 01-2259, 2003 WL 1846095 (3d Cir. Apr. 2, 2003).

part of an overall activity that was improper;[31] and (3) that the aider and abettor knowingly and substantially assisted the conduct that constitutes the violation.[32] In other words, the Division must establish that the Respondents either acted with knowledge or that they "encountered 'red flags,' or 'suspicious events creating reasons for doubt' that should have alerted [them] to the improper conduct of the primary violator," or the danger was so obvious that they must have been aware of it.[33]

In order to find the Respondents liable for "causing" a violation, the Division must establish three elements: (1) a primary violation; (2) an act or omission by the Respondents that was a cause of the violation; and (3) the Respondents knew, or should have known, that their conduct would contribute to the violation.[34] Courts have made clear that negligence is not a sufficient basis for "causing" liability if scienter is an element of the primary violation.[35]

III. DISCUSSION

The heart of this case is the Respondents' scienter: if Mr. Riad and Mr. Swanson did not have the requisite mental state to commit the alleged violations, then the Division's argument must fail. In fact, the evidence at trial clearly demonstrated that neither Mr. Riad nor Mr. Swanson had any intent to deceive shareholders or the Board. Furthermore, the Division was not even able to show that their actions were negligent. Instead, there are four key points that

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[31] The knowledge or awareness requirement can be satisfied by recklessness when the alleged aider and abettor is a fiduciary or active participant. *See Leaddog Capital Markets, LLC, f/k/a Leaddog Capital Partners, Inc., Chris Messalas, and Joseph LaRocco, Esq.*, Securities Exchange Act Rel. No. 468 (Sept. 14, 2012) at 15 (internal citations omitted).

[32] *See Graham v. SEC*, 222 F.3d 994, 1000 (D.C. Cir. 2000); *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir. 1980); *SEC v. Coffey*, 493 F.2d 1304, 1316-17 (6th Cir. 1974).

[33] *Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004).

[34] *Erik W. Chan*, Securities Exchange Act Rel. No. 45693, 77 SEC Docket 851 (Apr. 4, 2002).

[35] *Howard v. SEC*, 376 F.3d 1136. Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. *See also KPMG Peat Marwick LLP*, Securities Exchange Act Rel. No. 43862 (Jan. 19, 2001), 54 S.E.C. 1135, 1175, recon. denied, Exchange Act Release No. 44050 (Mar. 8, 2001), 74 SEC Docket 1351, petition for review denied, 289 F.3d 109 (D.C. Cir. 2002), reh'g en banc denied, 2002 U.S. App. Lexis 14543 (D.C. Cir. 2002).

demonstrated the good faith of the Respondents. First, the analysis that underlay HCE's derivatives investments was rigorous and professional. Second, the Respondents were completely open about these investments with all relevant parties. Third, the Respondents reasonably relied on others with more experience in the relevant legal and compliance issues for assistance. Finally, the Respondents simply had no incentive to mislead anybody.

1. FAMCO Carefully Analyzed the Investments at Issue

The Respondents' analysis of the investments is central to the question of their scienter. If that research – and the conclusions generated by the analysis – was reasonable, then there can be no argument that the Respondents committed fraud.

In evaluating the reasonableness of the Respondents' actions, it is important to first understand the process by which HCE came to invest in the derivatives at issue. In the Division's portrayal, two struggling portfolio managers simply threw together the idea to enter exotic investments that they knew to be extremely risky in a last-ditch effort to achieve spectacular performance. As the evidence demonstrated, nothing could be further from the truth.

a. *FAMCO Performed Extensive Research Prior to Making The Investments*

HCE's investment in short index puts and short variance swaps was not conceived on a whim but instead reflected many years and countless hours of careful thought and research. The Division has misleadingly focused on the Respondents' actions starting in 2007 when HCE first began trading in short index puts and short variance swaps. However, the story of Mr. Riad's investment in these derivatives began nearly seven years earlier.

The genesis for the decision to invest in short index put options and variance swaps occurred around 2000 when Mr. Riad was overseeing accounts for General Dynamics. At that

time, General Dynamics asked Mr. Riad to develop new strategies with equities and options.[36] In response, Mr. Riad performed internal research on different approaches involving options and created various options strategies for this client.[37] At one point, Mr. Riad was surprised to discover that it was extremely attractive to sell deep in-the-money call options.[38] After reaching this conclusion, he testified that he wanted to understand "why does this persistence in the market occur, why is there something . . . that seems very rich and really inexplicable, and it seems to be an anomaly. You're getting a lot of return [from these call options], why is that?"[39]

The answer to this question served as the underpinning for all of FAMCO's subsequent research and trading involving short index put options and short variance swaps. Mr. Riad's key insight was that investors systematically overpay for financial protection: the reason that the deep-in-the-money call strategy was so successful "turned out [to be] the same reason . . . with this effect where people buy puts so much and they bid up the price."[40] Again, this conclusion was not based on a superficial analysis; instead, the development of this understanding reflected a "natural evolution of [Mr. Riad's] thinking over a period of three or four years."[41]

Despite this important discovery regarding the systematic overpayment for put options, Mr. Riad did not immediately implement a strategy at FAMCO based on this finding. Instead, he adopted a more cautious approach to ensure that he had a better understanding of any potential derivatives strategy before investing shareholder money: it was important to "put [on]

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[36] Testimony of Mohammed Riad [hereinafter "Riad Testimony"] at 2090:12-17.
[37] *Id.* at 2090:21-2091:1.
[38] *Id.* at 2091-2092. So-called "put-call parity" implies that if put options at a particular strike price are attractive, the counterpart call options will also represent an attractive proposition. As a result, Mr. Riad's research on call options could be extrapolated to put options.
[39] *Id.* at 2092:10-16.
[40] *Id.* at 2092:17-21. As Mr. Riad explained, the "in-the-money calls . . . were the same things as on-the-money puts." *Id.* at 2093:1-2.
[41] *Id.* at 2093:3-5.

some more research and really fully understand why this is happening."[42] As a result, Mr. Riad had FAMCO perform several years of additional analysis into these strategies prior to making its investments in short index put options and short variance swaps in 2007 and 2008.

In 2005, FAMCO hired Sean Hughes[43] as an analyst to assist with this research into various options strategies.[44] Mr. Riad made sure that they evaluated as many potential strategies as possible.[45] Even within each option strategy, FAMCO looked at a "wide variety of different strike prices and durations"[46] and Mr. Hughes also analyzed different combinations of options to see how they would perform.[47] Indeed, FAMCO "did so many iterations" of each analysis that "for the two or three strategies that ended up being implemented, we looked at 30 or 40 odd strategies that just were never implemented because they weren't [as] attractive . . ."[48] Each analysis was also updated over time: for example, an analysis of variance swap performance from December 1996 through 2007 was consistently revised throughout 2008 as new data

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[42] *Id.* at 2093:7-10.

[43] Mr. Hughes was widely-considered to be an exceptional employee with a brilliant analytical mind. *See, e.g.*, Testimony of Joseph Gallagher [hereinafter "Gallagher Testimony"] at 1224:19-1225:5, ("He's outstanding. He's as good as I've ever seen . . . Everything he does it's methodical and meticulous"); *id.* at 1225:12-15 (Mr. Hughes was considered a member of the "all-star team" in terms of his analytical work); Testimony of Timothy Swanson [hereinafter "Swanson Testimony"] at 1715:4-8 ("He [Mr. Hughes] was an exceptional employee. I think he was very smart, very intelligent. His background -- he had a biotechnology background that he came with. So absolutely very intelligent, very diligent, very thorough"); Riad Testimony at 2095:2-3 ("He [Mr. Hughes] was highly capable, intelligent, diligent, hard working."). Mr. Hughes was accepted to the MBA program at Washington University in St. Louis straight out of college despite the fact that the school typically required five years of prior work experience, making him one of the youngest students in his class. Hughes Testimony at 576:11-16. Mr. Hughes studied finance and accounting while at business school and also achieved his CFA charter degree while getting his MBA. *Id.* at 576:17-22. Subsequent to the events at issue in this proceeding, Mr. Hughes was recognized for his exceptional work at FAMCO and promoted to portfolio manager or several funds. *Id.* at 866:22-4.

[44] Hughes Testimony at 577:3-8. Mr. Riad had him "start with basics and then build [his] way up." *Id.* at 581:21-22.

[45] Riad Testimony at 2095:19-2096:4 ("I think we wanted to be exhaustive . . . We didn't want to narrow it on one thing . . . We wanted to make sure that we understood as many different strategies that were available to us and understood what drove those strategies and why they persisted.") Mr. Hughes similarly explained that "[w]e were looking at a wide variety of different option strategies and looking at them during different time periods." Hughes Testimony at 581:7-10.

[46] Hughes Testimony at 589:20-22.

[47] *Id.* at 601:3-6; 602:5-8.

[48] *Id.* at 607:17-22. When evaluating variance swap strategies, for example, Mr. Hughes examined trades that had varying durations: "we wanted to look at 1-month, 2-month, 3-month, 6-month, [and] 12-month." *Id.* at 633:19-20.

became available.[49] FAMCO also made sure to evaluate these strategies in varying market environments.[50] After Mr. Hughes performed a particular analysis, Mr. Riad would ask him to write up a summary of the results.[51] Mr. Riad then continued to probe each analysis to ensure that the results were robust: as Mr. Hughes explained, Mr. Riad would frequently ask him to perform a follow-up to his analysis in order to answer additional questions.[52] The conclusion from all this research was two-fold. First, the short index puts and short variance swaps were expected to represent modest contributors to Fund performance over time.[53] Second, the Respondents determined that the risk from these investments was minimal.[54]

In sum, the decision to invest in short index put options and short variance swaps was not a careless one. Instead, the strategy was developed over *seven years* and then carefully refined and examined by a brilliant analyst before it was ultimately implemented in the Fund. Mr. Hughes provided a particularly apt description of FAMCO's research: "I'd like to make the analogy to the Beatles, where before the Beatles ever played their very first concert, they did thousands and thousands of hours of practicing and rehearsing, and the same was true at

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[49] *Id.* at 609:12-13.
[50] *Id.* at 609:25-610:4 ("We wanted to see how these different strategies performed in a bear market, we wanted to see how these strategies performed in a bull market, and just compare them across different market conditions."). *See also id.* at 651:11-12.
[51] *Id.* at 658:2-5. Examples of these reports can be seen at Exhibits 202, 209 and 219 (Undated internal FAMCO research reports). References to Exhibits or ("Ex.") in this Brief denote references to the Parties' Joint Exhibits.
[52] Hughes Testimony at 665:14-20.
[53] Testimony of Timothy Swanson [hereinafter "Swanson Testimony"] at 1755:3-18 (The conclusion from FAMCO's research was that "these were low risk instruments that were not really expected to be large contributors to performance").
[54] Hughes Testimony at 798:23-799:2 ("We looked at many different sources, and they all pointed to the same conclusion; that these were profitable, low-risk strategies."); *id.* at 749:12-15 ("We did our own research and analysis, and all three of those sources pointed to the same conclusions that these were attractive strategies with low risk . . ."); Swanson Testimony at 1713:22-1714:4 ("Based on Mr. Hughes' research and the manner in which Mr. Riad was implementing the short put strategies . . . .I was led to believe that these were relatively low risk – these were low risk investments."); *see also* Swanson Testimony at 1721:1-1722:4; 1754:22-1755:20.

FAMCO. Before the portfolio manager ever did a single transaction, we spent thousands and thousands of hours over several years analyzing these various strategies."[55]

b. *FAMCO's Research and Analysis Was Reasonable*

It was not merely the quantity of the Respondents' analysis that demonstrated the reasonableness of their actions. Instead, the exceptional quality of their research was equally important in establishing the good faith that underlay these investments. In particular, there were three key aspects of their analysis that demonstrated the merits of their approach. First, Mr. Riad made sure that the research was unbiased: he did not specify a particular result, and he remained flexible when considering various strategies. Second, Mr. Riad and Mr. Hughes reviewed academic research and industry papers to validate their own conclusions and glean additional insight into these strategies. Third, Mr. Riad made sure carefully to analyze the potential risk from these investments using a well-known industry methodology. Taken together, these three features served to further confirm that it was neither negligent nor reckless for the Respondents to enter into these investments.

1. *FAMCO's Research Approach Was Comprehensive and Unbiased*

As noted above, Mr. Riad's experience with the accounts for General Dynamics and his early inquiry into call options strategies had strongly suggested the value of selling index put options. Rather than steer Mr. Hughes towards this same result, Mr. Riad instead asked Mr. Hughes to evaluate a variety of options strategies and come to his own conclusions. This explains why many of the early research reports by Mr. Hughes were focused on long variance swap positions[56] – the exact opposite of the investments at issue in this proceeding. However, Mr. Hughes and Mr. Riad eventually determined that it was extremely expensive to maintain

[55] Hughes Testimony at 624:19-625:3.
[56] *See, e.g.*, Exs. 202, 209, and 219 (Undated internal FAMCO research reports).

these long positions over time and it would be more attractive to purchase long variance swaps opportunistically while having the short positions on more frequently.[57] In evaluating the reasonableness of the Respondents' analysis, the key point here is that FAMCO's research was never performed with a particular result in mind but instead represented an impartial approach.

2. *FAMCO Reviewed Academic and Industry Research*

The second point to note when evaluating the quality of FAMCO's research is that Mr. Riad did not limit his investigation to internal analysis performed by individuals at FAMCO. Instead, he made sure to consult a wide variety of sources to validate his own conclusions. In particular, Mr. Riad and Mr. Hughes reviewed academic articles and financial industry papers on index put options and variance swaps to supplement their own research. All three of these sources – FAMCO's internal analysis, academic literature, and industry papers – pointed to the same conclusion and reinforced Mr. Riad's initial theory regarding these strategies.

Prior to investing in index puts and variance swaps, Mr. Hughes and Mr. Riad reviewed numerous academic papers on these derivatives.[58] Indeed, Mr. Riad began reading such research "probably back to the early 2000s"[59] and he even developed a "very defined practice" of setting aside one day each week to "catch up on [his] reading" of academic research.[60] Mr. Hughes similarly explained that in addition to FAMCO's internal analyses, "[t]he main thing we used was the white paper, some academic reports."[61] The purpose of all this research was to corroborate FAMCO's own findings and ensure that their approach was reasonable.

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[57] Riad Testimony at 2095:4-15.
[58] *Id.* at 2139: 18-2140:21.
[59] *Id.* at 2139:18-2140:2.
[60] *Id.* at 2140:6-12.
[61] Hughes Testimony at 625:7-8. *See also id.* at 686:16-17.

That is precisely what these academic articles did. In fact, the central insight that Mr. Riad had discovered – that investors systematically overpay for protection – was the focus of an important 2003 paper by Oleg Bondarenko.[62] This article supported FAMCO's finding that "[i]t's expensive to buy put options. Investors strongly dislike negative returns, so they're willing to pay a hefty premium to buy some insurance to buy these put options. So it's a good strategy over time to sell these expensive put options."[63] Another important takeaway from this article was that "the returns from this [put-selling] strategy are positive and stable and significant whereas the losses are rare. If it – and when the losses do occur, they don't offset all of the previous gains."[64] A March 2004 paper by Prof. Bondarenko[65] reached a similar conclusion regarding variance swaps and concluded that "selling variance swaps is an attractive strategy, produces significant returns over time with less risk than the stock market."[66] Mr. Hughes also reviewed a March 2007 paper[67] that demonstrated that put-selling represents an attractive strategy even for risk averse investors.[68] This paper recognized the same anomaly that Mr. Riad had discovered and concluded that "buying portfolio insurance" – for example, by purchasing

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[62] Ex. 214, Oleg Bondarenko, *Why are Put Options so Expensive?* (Nov. 2003). Both Mr. Riad and Mr. Hughes reviewed this article during the course of their research into these strategies. *See* Riad Testimony at 2141:3-10 (confirming that he reviewed this article prior to 2007); Hughes Testimony at 677:10-11 ("I read this paper during our analysis of all these different strategies."). Mr. Hughes was already familiar with Mr. Bondarenko's work since he had studied under him at Washington University. Hughes Testimony at 677:14-15 (noting that Bondarenko "was actually one of my professors when I was getting my MBA at Washington University.").

[63] Hughes Testimony at 679:5-10. As Mr. Riad put it, "Professor Bondarenko's hypothesis was similar to mine . . . [W]e were getting at the same question as to why does this [put overpricing] happen consistently." Riad Testimony at 2142:6-11.

[64] Hughes Testimony at 682:4-8.

[65] Ex. 213, Research paper by Oleg Bondarenko entitled "Market Price of Variance Risk and Performance of Hedge Funds" (Mar. 2004). Mr. Hughes reviewed this paper at the time that he performed his research into these strategies. *See* Hughes Testimony at 683:25-684:5.

[66] Hughes Testimony at 684:23-685:4.

[67] *Id.* at 719:21-25.

[68] *See* Ex. 206, Joost Driessen and Pascal Maenhout, "An Empirical Portfolio Perspective on Option Pricing Anomalies," (Mar. 2007).

index put options – "is never optimal. It's a losing proposition . . ."[69] Other academic articles relied on by Mr. Riad and Mr. Hughes similarly supported their own analysis.[70]

In addition to academic articles, Mr. Riad and Mr. Hughes also reviewed financial industry research to further validate their ideas. Mr. Riad stated that his weekly reading "would consist of any noteworthy research, whether it be from the Wall Street community" or from other sources.[71] Mr. Hughes confirmed that "we also looked at research from within the investment community itself."[72] The industry reports served to provide further insight into these strategies. For example, a 2003 research report from Goldman Sachs[73] that Mr. Hughes reviewed as part of his research,[74] demonstrated that selling volatility consistently produces attractive returns because investors overestimate future volatility.[75] A 2005 research report from Goldman Sachs[76] that Mr. Hughes reviewed prior to the financial crisis[77] provided similar support.[78] A 2006 report from J.P. Morgan[79] emphasized that "[h]istorically one of the most successful volatility strategies has been the systematic selling of short-dated index variance"[80] – precisely the strategy

[69] *Id.* at 721:11-14.
[70] For example, a January 2007 paper on variance swaps demonstrated that "selling volatility, selling variance, is an attractive strategy." Ex. 216, Viktor Todorov, "Variance Risk Premium Dynamics," (Jan. 3, 2007); Hughes Testimony at 724:22-725:1. Mr. Hughes also reviewed this paper during the course of his research. Hughes Testimony at 724:18-21.
[71] Riad Testimony at 2140:15-17.
[72] Hughes Testimony at 686:18-19.
[73] Ex. 207, Goldman Sachs Research Report entitled "Options and Volatility" (Jan. 27, 2003). Mr. Hughes emphasized that ". . . Goldman Sachs had very good research, very good analytics, and their analysis was some of the best we had seen. And they weren't trying to buy us up in any way. They were very objective in their analysis. They actually gave us the data so they allowed us to do the analysis ourself [sic] and either prove or disprove their analysis." Hughes Testimony at 686:19-687:1.
[74] Hughes Testimony at 686:6-10.
[75] *Id.* at 688:2-3; 689:18-690:2.
[76] Ex. 41, Goldman Sachs Research Report on variance swaps (Sept. 2005).
[77] Hughes Testimony at 693:24-694:2.
[78] *Id.* at 694:12-16.
[79] Ex. 82, J.P. Morgan Research Report on variance swaps (Nov. 17, 2006). The report noted that "short variance swaps can be used to capture the observed equity index volatility risk premium" – the consistent overpayment for protection that Mr. Riad had identified.
[80] *Id.* at FAM00052160.

utilized by HCE. Other industry research reviewed by Mr. Hughes and Mr. Riad confirmed many of the key points that underlay FAMCO's analysis.[81]

c. *Mr. Riad and Others Carefully Evaluated the Risks of These Strategies*

The thoughtfulness of Mr. Riad's approach is perhaps most evident from the approach that he took with respect to the risk from these investments. When performing research into various options, Mr. Riad could simply have pursued the strategy that provided the highest return regardless of the risk. The evidence clearly demonstrated, however, that the risk of each investment was foremost on Mr. Riad's mind. As explained by Mr. Hughes, Mr. Riad was not simply looking for the investment strategy that generated the highest profits but also wanted to make sure that the expected risk from any investment strategy was minimal.[82] More importantly, the methodology that Mr. Riad employed to analyze and mitigate the risk from these investments demonstrated the utmost good faith.

1. *FAMCO's Risk Analysis Was Reasonable*

Mr. Riad employed two primary tools to evaluate the risk of each investment. First, he examined how a particular investment had performed in certain bad market environments in the past – in essence, a form of "stress-testing" to determine the worst-case scenario for each strategy.[83] When looking at short index put strategies, for example, "Mr. Riad wanted to look at

[81] For example, these reports emphasized the mean-reverting nature of volatility. *See, e.g.*, Ex. 218, Goldman Sachs Research Report, "Index Options Research: VIX Futures Over the Last Decade," (Sept. 14, 2006). These reports also emphasized that the best time to sell volatility was following a crisis. Riad Testimony at 2150:8-23.

[82] *See* Hughes Testimony at 638:3-639:15. Indeed, Mr. Hughes spent a considerable amount of time during his testimony discussing the importance to FAMCO's analysis of the Sharpe ratio, a method of calculating the risk-adjusted return for each strategy and thereby determining the optimum strategy in terms of its risk/return profile. *See, e.g.*,*id.* at 583:7-584:13; 587:2-22; 588:18-589:10; 589:23-590:8; 590:23-591:15; 603:1-7; 611:6-15; 631:3-6; 636:23-637:2. The Sharpe ratio was calculated for many of the internal analyses that Mr. Hughes performed. *See, e.g.*, Ex. 74 at FAM00033534.

[83] The Division's Expert, Prof. Harris, asserts that FAMCO did not perform any stress testing. In contrast, Prof. Spatt – an authority on stress-testing based on his experience serving on the Federal Reserve's risk committee that analyzes precisely that issue – believed that the Respondents had, in fact, engaged in stress testing. As he noted, "[t]hey looked at – they certainly looked at different scenarios and within the context of their sample they had a

the [stock market] returns to determine what are some worst cases, what are some large losses in the stock market, historically speaking, and when did those occur."[84] As one example, Mr. Hughes performed analyses that evaluated how the strategy performed in the decline from 2000-2003[85] – then the worst bear market since the Great Depression.[86] Mr. Hughes also analyzed the performance of a short variance swap strategy from 1997-2008 to determine how it performed in bear markets.[87] Significantly, this period included *four* major downturns that were highlighted by the Division and its expert, Lawrence Harris.[88] Despite these significant declines in the stock market, FAMCO's internal analysis demonstrated that the gains from the short variance swap strategy more than offset the occasional losses.[89]

As a second tool to evaluate risk, Mr. Riad analyzed historical movements in the stock market (for index put options) and volatility (for variance swaps) over specified periods to determine the likelihood that each trade would lose a significant amount of money.[90] For the short index put options, FAMCO analyzed monthly movements in the S&P 500 index from 1927

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number of quite – you know, they had a number of quite negative, they had a number of quite adverse events." Testimony of Chester Spatt [hereinafter "Spatt Testimony"] at 3318:6-13.

[84] Hughes Testimony at 619:9-12.

[85] *Id.* at 651:11-16.

[86] *Id.* at 642:14-16.

[87] *Id.* at 667:24-669:3.

[88] Ex. 139, Expert Report of Lawrence Harris [hereinafter "Harris Report"] at ¶ 168 ("Although the impact of these events on the markets in September and October [2008] were large, they were not unprecedented . . . [F]our subsequent events in September 1998 (Hong Kong and Russian Financial Crises), March 2001 (Dot-com Slowdown), September 2001 (9/11 Terrorism), and July 2002 (Accounting Scandals) also had very significant impacts upon the markets.").

[89] Ex. 231, Internal FAMCO research regarding trading strategies (undated). Sean Hughes spent a great deal of time discussing the chart from this Exhibit that showed the performance of various variance swap strategies from 1997-2008. In describing the 1-month strategy that HCE actually employed, Mr. Hughes explained that it was "kind of like climbing a mountain. You gradually make process [sic]. It might rain for a couple days, you might slip down a little bit, but then you continue to make progress up the mountain . . . Once in a while you have a little bit of setbacks, but nothing major. . . . [The] peso problem means that you have these small gains that eventually get completely wiped out by a loss . . . But in here you can see that this is not a peso problem. *The losses do not wipe out the gains. It's anything but that.*" Hughes Testimony at 645:18-646:8. (emphasis added).

[90] Specifically, he evaluated the probability that a transaction would generate a loss of roughly five percent of the Fund's net assets. For a detailed discussion regarding the importance of this five percent threshold, *see* Baris Report at 7-9; Respondents' Prehearing Brief at 23.

to 2007 and found that the likelihood of each short index put option transaction losing a large amount was minimal.[91] Similarly, FAMCO looked at the historical difference between realized and implied volatility from 1997-2007 and discovered that the probability of each variance swap trade losing a significant amount was also extremely low.[92]

Although FAMCO did not label it as such, this risk evaluation method was actually a widely-recognized industry approach called a Value at Risk ("VaR") analysis.[93] Indeed, it is undisputed that the Respondents employed a VaR approach: Prof. Spatt noted that "the analysis performed by FAMCO is actually a well-known and widely-accepted methodology for evaluating risk known as Value at Risk measurement,"[94] and the Division's own expert acknowledged that "FAMCO's method is a variant of the well-known value-at-risk method."[95]

2. *FAMCO Implemented Additional Risk-Limiting Strategies*

The good faith of the Respondents is further evident from the way in which they actually implemented the derivatives strategies at issue. As noted above, the stress-testing and VaR

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[91] *See* Ex. 74, Email from Sean Hughes to Susan Steiner regarding FAMCO research on put strategies (May 19, 2009) at FAM00033556-FAM00033578. *See also* Hughes Testimony at 618:7-11; 619:9-12.
[92] *See generally* Hughes Testimony at 667-670; Ex. 228, Undated internal FAMCO research regarding variance swap strategies, at FAM00060228.
[93] A detailed description of Value at Risk analysis can be found in the Spatt Report at 16-18. To be sure, the Division attempted to discredit this entire methodological approach for evaluating risk. It was particularly surprising that the Division would level such criticism at the VaR model in light of the fact that one of the most important SEC disclosures rules explicitly recommends the use of a VaR approach. *See* 17 CFR 229.305(a)(iii)(A) (requiring that registrants provide "[v]alue at risk disclosures that express the potential loss in future earnings . . .") *See also* Spatt Testimony at 3257:19-23. Moreover, several of the Division's key criticisms of the VaR methodology fell apart upon close examination. For example, Prof. Harris cited a prominent critic of the VaR method named Richard Bookstaber. Testimony of Lawrence Harris [hereinafter "Harris Testimony"] at 187:7-20; 269:17-24. On cross-examination, however, Mr. Harris was unable to explain why Mr. Bookstaber was quoted in a *New York Times* article as saying that "[i]f you put a gun to my head and ask me what my firm's risk was, I would use Value at Risk." *Id.* at 464:24-466:17. During its cross-examination of Prof. Spatt, the Division similarly attempted to discredit Value at Risk by citing carefully-selected sections from a textbook that criticized the VaR methodology. *See* Spatt Testimony at 3504-3505. However, the Division failed to note a paragraph *in the very same textbook* that made clear that VaR remains the method of choice among industry participants: as the textbook explained, "[v]alue at risk has become the most popular measure of risk among both regulators and risk managers in spite of its weaknesses." *Id.* at 3541:19-3542:8.
[94] Expert Report of Chester Spatt [hereinafter "Spatt Report"] at 17.
[95] Harris Report at 78.

analyses had already demonstrated that the risk from these investments was extremely low.[96] Nonetheless, out of an abundance of caution Mr. Riad adopted several additional measures that were intended to further limit any potential losses from these investments.

The first risk-protective measure was the fact that the short index put options were written deep out-of-the-money.[97] Academic articles had shown that it was an attractive strategy to write at-the-money or near at-the-money index put options.[98] However, such trades could be exposed to significant losses in the event that the stock market dropped more than a moderate amount – say, ten percent. By setting the strike price for these options far below the current level of the S&P 500 index – frequently, between eight and ten percent out-of-the-money[99] – Mr. Riad ensured that the position had a protective cushion in the event of such a market decline.[100] As a result, these put options would not only make money in all but the most extreme circumstances, but the positions also would be significantly less likely to suffer large losses. Indeed, prior to the financial collapse in the summer and fall of 2008, this was precisely what happened with FAMCO's investments: every time the stock market declined, the Fund actually *made* money on its short index put options.[101]

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[96] *See supra* at §III(1)(c)(1).
[97] Mr. Riad explained his rationale: "well, we've gone through do the strategies make sense, and then add another layer of risk control, let's pick a strike price where it's not likely to lose a significant amount of money. So, we did that." Riad Testimony at 2170:17-21.
[98] *See, e.g.*, Ex. 214 at Introduction ("Simple trading strategies that involve selling at-the-money and out-of-the-money puts would have earned extraordinary profits").
[99] *See, e.g.*, Harris Report at p. 121.
[100] Riad Testimony at 2168:19-2170:6 ("Q: And so, what's the probability that you're going to actually lose money on a deep out-of-the-money index put? A: Very low – very low. Q: So, was this another way in which you tried to control the risk of these investments? A: It was.").
[101] *See* Harris Report at 121; Riad Testimony at 2166-2167; Swanson Testimony at 1757:6-7 ("In each of those cases, particularly in a down market, the short puts made money.").

Second, the portfolio managers attempted to limit the risk of loss by setting the size of each trade to an acceptable level.[102] As Mr. Riad made clear, "before you enter [a trade] in a portfolio . . . you've got to say how many contracts are you willing to sell. You can't bring it out of the air."[103] The sizing analysis began by working backwards from the ultimate question: "[h]ow much exposure are you willing to lose?"[104] Mr. Riad made clear that he was "not willing to lose more than 5 percent of the portfolio" which "equals $5 million."[105] After selecting the maximum amount that he was willing to lose, Mr. Riad then had to target a particular probability for such an event occurring – for example, was he willing to lose five million dollars once every ten trades, or once every hundred? The probability figure that Mr. Riad targeted was a $5 million loss roughly 0.5 percent of the time.[106] Having selected the maximum exposure and the desired frequency of such a loss, it was then possible to "back into how many contracts do you have to sell"[107] – in other words, the size of the contract. As Mr. Riad, explained, this analysis "will give you an idea, okay, I want to sell 1,000 contracts or I want to sell 10,000 contracts."[108]

Third, FAMCO aimed to limit the expected losses from these transactions by placing the trades at what they perceived to be particularly advantageous times. Again, both internal FAMCO analyses as well as industry and academic articles had shown that it was extremely

[102] As Mr. Riad explained, "we've already decided that we're going to sell something that's far away from the market [in other words, deep-out-of-the-money], but that may not be good enough because we did see that sometimes the market does fall." Riad Testimony at 2170:13-16.
[103] *Id.* at 2170:22-2171:4. Even the Division's own witness, SEC Examiner Emmanouil Tsimouris, acknowledged that Mr. Riad did not simply put on the positions at the maximum possible size that a counterparty would permit. Testimony of Emmanouil Tsimouris [hereinafter "Tsimouris Testimony"] at 144:8-14.
[104] Riad Testimony at 2171:17-18. *See also id.* at 2170:13-16 ("And to get an idea of where you want to be, you've got to see how much are you willing to lose, because then – and you back into how many put contracts you sell.").
[105] *Id.* at 2171:20-23.
[106] *Id.* at 2171:10-2172:25.
[107] *Id.* at 2173:1-7.
[108] *Id.* at 2172:8-10.

attractive to engage in a consistent strategy of writing put options and writing variance swaps.[109] The problem with such an approach, however, is that such a strategy also makes it more likely that the positions will eventually suffer a large loss. As a result, Mr. Riad attempted to place the trades only at times where such losses would be significantly less likely to happen.[110]

In order to determine the ideal timing for each trade, the portfolio managers relied on two important factors that the FAMCO research team had identified regarding these financial instruments. First, they recognized that the volatility level of the stock market historically returns to its long-run average following extreme increases or decreases.[111] To take advantage of this so-called "mean-reversion" of volatility, the HCE Fund entered its short variance swap positions during periods when volatility was significantly elevated above its historical average and was therefore more likely to decline.[112] Second, FAMCO employed a high-level macroeconomic analysis to determine the best time to enter these transactions. Indeed, the Fund had a Strategy Committee that was devoted in part to forecast future market movements.[113] Based on the determinations made by this Committee, the portfolio managers made sure to write index put options and sell variance swaps only when they believed that a large market decline or

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[109] Hughes Testimony at 715:4-8 (noting that "[c]onsistently you have positive returns" with a short strategy; Ex. 214 (demonstrating the success of a consistent monthly short strategy); Ex. 82 at FAM00052160 ("Historically one of the most successful volatility strategies has been the systematic selling of short-dated index variance"); Ex. 41 at FAM00000796 ("Historical back-test confirms the profitability of variance selling strategies. We have back-tested the payoffs at expiration from taking a short position in a variance swap every trading day since 1997.").

[110] The Division has repeatedly tried to suggest that Mr. Riad did, in fact, engage in a *consistent* strategy of selling variance swaps and selling index put options. In order to make such an assertion, however, the Division was forced to ignore evidence that clearly contradicted this assertion, and it was also forced to cherry-pick the time period for its evaluation of the strategy. First, the simple fact is that Mr. Riad was *net long* for several periods in 2007 and 2008; in fact, for two months between April and June 2008 the Fund had *only* long positions in variance swaps and index puts. *See* Ex. 86 at 1-3; Ex. 139 at 121- 123. Second, the Division focuses its attention on the period from November 2007 through October 2008, but completely ignores the prior period when the Fund was net long for lengthy periods. *See* Ex. 86 at 1-3; Ex. 139 at 117. By selectively choosing this time frame and ignoring the earlier period, it creates an unfair and entirely misleading impression of Mr. Riad's activities.

[111] *See* Hughes Testimony at 97-98.

[112] *Id.*

[113] Riad Testimony at 2043:15-25.

spike in volatility was extremely unlikely. In contrast, the Fund *purchased* index put options and variance swaps during periods when the portfolio managers and the Strategy Committee were concerned about a significant downturn, such as in April 2008.[114]

Fourth, the Respondents understood that the risk from these investments was limited by the fact that the index put and variance swap trades had been "covered" in accordance with applicable requirements under the Investment Company Act.[115] These coverage requirements mandated that the HCE Fund set aside a certain amount of specified assets for derivative transactions entered by the Fund such as the index put options and variance swaps at issue.[116]

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[114] *See* Ex. 86, Fiduciary/Claymore Dynamic Equity Fund Purchase and Sale of Index Puts and Variance Swaps (Sept. 1, 2006 - Aug. 31, 2008).

[115] For a more detailed discussion of segregation, *see* Respondents' Prehearing Brief at 17-19. Despite the general assertions by several Division witnesses that these positions were not covered, the Division actually produced no evidence that the Fund failed to comply with applicable segregation requirements. Instead, the record demonstrated precisely the opposite: namely, that FAMCO had consistently satisfied all relevant segregation obligations. Both Claymore and Skadden evaluated the Fund's compliance with these requirements in late 2008 and determined that – with two minor exceptions – the Fund had complied with every relevant segregation obligation. *See* Ex. 197, Minutes of a Special Joint Meeting of the Boards of Trustees for the Fiduciary/Claymore MLP Opportunity Fund (FMO) and Dynamic Equity Fund (HCE) (Nov. 11, 2008) at 2 ("Mr. Hale stated he had reviewed with representatives of Claymore information provided by HCE's custodian relating to HCE's segregation of assets in connection with the described transactions, and stated that, based on such information provided, the assets representing the market value of the positions generally were segregated in accordance with industry practice."). As the Division's own witness, Thomas Hale, explained in a memorandum to Claymore in November 2008, "[w]e agree that [the Fund's segregation of the market value of each index put option] is consistent with our understanding of industry practice . . . [W]e also believe that this complies with the preponderance of applicable regulatory guidance." *See* Ex. 264, Memorandum from Thomas Hale to Kevin Robinson regarding certain put transactions in the HCE Fund (Nov. 6, 2008) at 4. Significantly, Skadden also emphasized that this conclusion extended to the variance swap transactions: "Finally, we note that such method of asset segregation" – in other words, segregating the market value of each instrument – "is consistent with segregation requirements applicable to other cash settled derivatives contracts, such as swaps." *Id.*

[116] *See, e.g.*, Testimony of Jay Baris [hereinafter "Baris Testimony"] at 3059-3060; Testimony of Susan Steiner [hereinafter "Steiner Testimony"] at 1256:1-14. Segregation thereby limits the amount of leverage that a fund can take on and "will assure the availability of adequate funds to meet the obligations arising from such activities." *Id.*

Mr. Riad explained that he "understood generally that segregation controls risk."[117] Numerous other witnesses agreed that segregation served as a risk-limiting mechanism.[118]

Taken together, these four "firewalls of risk"[119] added an additional layer of protection to the Fund's investments and helped ensure the safety of these investments.

d. *Prof. Spatt Confirmed That FAMCO's Analysis Was Reasonable*

Perhaps the most significant evidence regarding the reasonableness of FAMCO's analysis and its decision to invest in these derivatives is that every aspect of their approach was validated by a former Chief Economist of the SEC, Professor Chester Spatt.[120]

The evidence made clear that Prof. Spatt was struck by the care employed by the Respondents in evaluating these investments: put simply, FAMCO asked the right questions and went about answering them in a careful way. As he stated, "[i]n my judgment, the managers attempted to engage in a reasonably sophisticated and intricate analysis."[121] Furthermore, the "analyses that were done were sensible"[122] and represented "certainly a reasonable and strong effort . . . by them to make thoughtful decisions."[123] The decision by Respondents to use a VaR-type approach to analyze the risk was a "reasonable method . . . for this purpose."[124] Prof. Spatt also noted that the Respondents' "thinking about this was fully informed by the Wall Street and

[117] Riad Testimony at 2192:2-3. The risk-limiting function of the segregation requirement was specifically emphasized to Mr. Riad by the Assistant General Counsel at Claymore when he noted that HCE "*will be required under the '40 Act to segregate assets to cover any liability on the derivatives subject to the [agreement], which will ensure that it maintains adequate coverage for such liabilities.*" Ex. 316, Email from Matt Patterson to Mo Riad regarding ISDA Agreement with Goldman Sachs (Dec. 20, 2007) (emphasis added).
[118] *See, e.g.*, Steiner Testimony at 1256:15-16; Baris Testimony at 3060.
[119] Respondents' Opening Statement at 41:20.
[120] Prof. Spatt served as Chief Economist of the SEC from 2004-2007 and currently serves as a chaired professor of finance at the Tepper School of Business at Carnegie Mellon University. His full vita can be found in his Expert Report at 27.
[121] Spatt Report at 26.
[122] Spatt Testimony at 3244:23.
[123] *Id.* at 3248:7-9.
[124] *Id.* at 3257:12-14.

academic studies that they had reviewed,"[125] and they also appropriately considered industry and academic research into these derivatives and "tried to assess this in a thoughtful way."[126]

Not only did Prof. Spatt endorse the methodology employed by the Respondents, but he also believed that they reached reasonable conclusions based on their analyses. In particular, he agreed with the conclusion that the strategies were unlikely to expose more than five percent of the portfolio to risk,[127] and also that these positions could enhance expected return.[128]

e. *The Division's Criticisms of FAMCO's Analysis Are Erroneous*

The Division's argument against the reasonableness of these investments rests almost entirely on the testimony of two witnesses: Jeffrey Grossman and Prof. Harris. In addition to the fact that both of these witnesses are extremely unreliable, their assertions are simply belied by the facts.

1. *Jeffrey Grossman*

Mr. Grossman served as portfolio accountant at FAMCO.[129] According to his testimony, Mr. Grossman was able to immediately discern the allegedly extreme risk posed by the Fund's investments in short index put options and short variance swaps.[130] The reason the risk was so clear to him was that the notional value[131] of these positions was so high: in his words, the "best measure of risk, in my mind, was the notional value of what the transaction was . . . It was what

[125] *Id.* at 3246:4-6.
[126] *Id.* at 3259:1-6.
[127] *Id.* at 3244:19-22; Spatt Report at 6.
[128] Spatt Report at 14-15.
[129] Grossman Testimony at 472:15-16.
[130] *Id.* at 492:15-19.
[131] As the Division explained in the OIP, "[a]n option's notional exposure is the amount of maximum loss exposure on the option that would be realized in the event that the underlying referenced security or index, in this case the S&P 500, were to decline to 0." OIP at note 2. The absurdity of such a risk approach was demonstrated by the potential circumstances that witnesses suggested could lead to such a decline: an "asteroid would have to hit," Riad Testimony at 2217:5-9, or the earth would have to experience "[p]robably something like thermonuclear winter." Spatt Testimony at 3287:17-20.

could happen if – if the index went to zero. That was the number of – of the notional value. *That's what the risk was.*"[132]

Despite the Division's attempt to turn him into an expert on options,[133] Mr. Grossman in fact admitted that he had no professional experience investing in derivatives[134] and had no experience as an investment manager of any sort.[135] In fact, at the time that he was hired by FAMCO as a portfolio accountant, Mr. Grossman was not even working in the securities industry, but instead was involved with operations at an architectural engineering consulting firm.[136] In addition, Mr. Grossman did not recall preparing any written analysis regarding his risk concerns.[137] In fact, numerous witnesses testified that notional value is an extremely inappropriate way to view the risk from such investments;[138] Prof. Spatt even went so far as to assert that it was misleading for the Division – and, by extension, Mr. Grossman – to employ

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[132] *Id.* at 553:2-7 (emphasis added).
[133] *See, e.g.*, OIP at ¶ 22 ("When FAMCO began writing put options in HCE without any corresponding long positions, a FAMCO accountant *with options trading experience* warned Riad . . .") (emphasis added); Grossman Testimony at 482:15-21 (Q: "Are you familiar with the strategy or process of writing covered calls on an equity portfolio? A: Yes, I am. Q: Would you describe yourself as somewhat familiar or very familiar? A: *I'd call myself an expert.*") (emphasis added).
[134] Mr. Grossman worked as a market maker for the Chicago Board Options Exchange. Grossman Testimony at 474:22- 475:14. However, this job merely required him to be "buying when the public was selling" and "selling when the public was buying" – a far cry from the detailed analysis of such options that is required by investment managers. *Id.* at 476:4-14. In fact, Mr. Grossman admitted that he had never managed a portfolio of options investments other than his own personal account. *Id.* at 477:13-16.
[135] *Id.* at 474-478.
[136] *Id.* at 561:10-18. Mr. Gallagher testified that Mr. Grossman's alternative to working at FAMCO was to "work for his wife's father's hardware store." Gallagher Testimony at 1054:6-9.
[137] *Id.* at 568:6-16.
[138] *See, e.g.*, Hughes Testimony at 763:4-8 ("So the notional is kind of a distorted – it's not a good measure of actual risk in the position . . . It's not a good measure of risk."); Swanson Testimony at 1776:21-1777:23 (". . . the notional exposure of risk would imply that the market would have to go down to zero to generate that level of losses. So it's really not a good measure of risk. It's not an appropriate measure of risk."); Riad Testimony at 2216:10-2218:3 ("Q: So, would you consider the notional exposure that Mr. Grossman focused on to be a good risk measure? A: It's a risk measure, but not – not an accurate one."); Spatt Testimony at 3285:21-3288:11.

notional exposure in the way that it was used.[139] Finally, several of Mr. Grossman's assertions were flatly denied by other employees that worked with him at FAMCO.[140]

2. *Professor Lawrence Harris*

Prof. Harris' criticisms are equally suspect. Prof. Harris began his testimony by making several corrections to his Expert Report.[141] To be sure, he claimed that these multiple mistakes were only a "couple very small" errors and they did not "in any way affect [his] opinion."[142] Nonetheless, these mistakes represented the latest in a long line of cases in which there were issues with Mr. Harris' reports or testimony.[143] Indeed, in three of the prior seven cases in which he had given testimony, the Court either rejected his report outright or he was forced to make corrections.[144] Mr. Harris assured the Court that "there's stories behind" all of these issues,[145] and that these cases were "taken out of context;"[146] indeed, he assured the Court that the Division "will put them in proper context" during his re-direct examination.[147] It is telling that the Division never even attempted to do so.

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[139] Spatt Testimony at 3288:4-11 ("Q: Did you think it was misleading for the order [instituting proceedings] to reference notional exposure? A: Certainly in the way it was used. Yes . . . It seemed to me it was used in an inflammatory sort of way . . . ").

[140] For example, Mr. Grossman claimed that Mr. Gallagher told him after the January 16, 2008 meeting that "Mr. Riad had a noose around his neck and that we were supposed to hope that he didn't hang himself." Grossman Testimony at 522:1-5. Mr. Gallagher flatly denied that this conversation ever happened. Gallagher Testimony at 1053:3-6 ("Q: Did you say that to Mr. Grossman? A: No. I would never say anything like that to Mr. Grossman."). In addition, Mr. Grossman claimed that he had been promised a job at FAMCO as a portfolio manager by Mr. Riad but Mr. Riad testified that he never made such a promise. Riad Testimony at 2063:17-2064:15. Mr. Grossman insinuated that people at FAMCO were colluding to prevent him from obtaining another job. Grossman Testimony at 558-560. When asked about this statement, Mr. Gallagher stated that "[i]t's – I don't want to call it ludicrous because I don't know what goes through a person's head. But it's so far removed from anything that we were considering or doing or contemplating or the reasons for any of our actions; I don't know how to deal with that claim." Gallagher Testimony at 1058:17-1059:3. Mr. Gallagher even noted that he had offered to serve as a reference for Mr. Grossman when asked in early 2013. *Id.* at 1062:22-1064:7.

[141] Harris Testimony at 167:18-168:22.

[142] *Id.* at 168:18-20.

[143] *See* Harris Testimony at 274-279.

[144] *Id.* at 278:15-18.

[145] *Id.* at 278:21

[146] *Id.* at 278:23

[147] *Id.* at 279:1-2.

Many of Prof. Harris' misguided claims were addressed at length in the Respondents' Prehearing Brief in this matter.[148] Nonetheless, it is useful to address several of his key assertions. When evaluating Prof. Harris' critique, however, it is important to first emphasize what he *failed* to consider in generating his conclusions. Prof. Harris did not read any investigative testimony of the Respondents or other FAMCO employees[149] despite the fact that the Division evidently offered to provide him with such materials.[150] He never spoke with any of the relevant employees at FAMCO to gain an understanding of their actions.[151] Although his list of materials reviewed included research reports that FAMCO relied on as part of its research,[152] Prof. Harris admitted during testimony that he had not, in fact, read many of these documents.[153] In other words, Prof. Harris evaluated the reasonableness of the Respondents' actions without making any attempt to understand the rationale behind their decision-making.

This limited review may explain why Prof. Harris made several bold pronouncements regarding perceived failures of the Respondents that were directly contradicted by the evidence. As one example, Prof. Harris repeatedly argued that the investments at issue were plagued by the so-called "Peso problem"[154] and stated that "FAMCO was irresponsible when it did not consider the peso problem to be an additional risk factor."[155] In fact, however, the evidence demonstrated that FAMCO *had* considered the Peso problem through its own analyses and during its review of

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[148] *See* Prehearing Brief of Respondents at 61-70.
[149] Harris Testimony at 280:6-10.
[150] *Id.* at 406:21-24.
[151] *Id.* at 280:11-15.
[152] Ex. 139, Harris Report at p. 163.
[153] *See, e.g.*, Harris Testimony at 301:11-18 ("Q: This is a JP Morgan research report . . . What does it say, professor? A: *I've not read it before but I'll read it now.*") (emphasis added); *id.* at 302: 2-25 (when asked to discuss the Goldman Sachs research report in Exhibit 203, Prof. Harris responded that "The result refers to an average for a particular strategy in which, frankly, *I'm not familiar with because I haven't read the rest of this document.*") (emphasis added).
[154] *See* Harris Report at ¶ 283- 287. During testimony, Prof. Harris described the peso problem as a "problem that arises with certain types of investments that are characterized by a low probability of significant failure and a large probability of small profits." Harris Testimony at 173:2-5.
[155] Harris Report at ¶ 282.

academic articles.[156] Mr. Riad testified that FAMCO considered the Peso problem in the course of its analysis;[157] as he explained, "we did spend a lot of time as academics do worrying about a Peso problem."[158] Indeed, a 2003 paper reviewed by Mr. Hughes and Mr. Riad during their research analyzed whether short put option strategies were susceptible to a Peso problem and concluded that they were not.[159] Other articles relied on by the Respondents confirmed this point.[160] Most importantly, FAMCO's own research directly addressed this issue and showed that these investments were not susceptible to the Peso problem.[161]

Prof. Harris also asserted that FAMCO "didn't examine sufficient data" in performing its analyses.[162] In truth, however, Prof. Harris had no idea whether Mr. Riad or Mr. Hughes had considered certain data because he did not review their investigative testimony or speak to them in order to gain an understanding of why they had selected certain data sets. Indeed, the evidence demonstrated that the Respondents had examined *precisely the data that Prof. Harris claimed should have been used* – and ultimately decided that it was too unreliable to use.

For variance swaps, Prof. Harris argued that FAMCO should have used volatility figures from the S&P 100 VIX index – which has data going back to 1986 – as opposed to the S&P 500

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[156] *See, e.g.*, Hughes Testimony at 678:16-17 ("Many of the reports that we read address the peso problem."); *id.* at 789:18-24 ("[y]ou can see in all our academic research reports we read about the peso problem over and over again. It says that these strategies do not fall victim to the peso problem.").
[157] Riad Testimony at 2143:17-2144:22.
[158] *Id.* at 2413:25-2144:1.
[159] *See* Ex. 214; *See also* Hughes Testimony at 681:23-682:11 (noting that the paper concludes that a "strategy of selling put options like we did in the portfolio does not fall victim to the peso problem . . . [b]ecause the – the returns from this strategy are positive and stable and significant whereas the losses are rare. If it – and when the losses do occur, they don't' offset all of the previous gains."); Riad Testimony at 2143:4-5 ("if I recall, and he addresses whether this is a Peso problem in here.").
[160] *See* Ex. 206; *see also* Hughes Testimony at 720:20-722:16 ("This paper looks at shorting put options . . . And it's robust to the peso problem, again, they discuss the peso problem, that these strategies do not fall victim to the peso problem.").
[161] When discussing the results from one of his spreadsheets, for example, Mr. Hughes noted that "in here you can see that this is not a peso problem. The losses do not wipe out the gains. It's anything but that." Hughes Testimony at 646:6-8. *See also id.* at 668:23-25.
[162] Harris Testimony at 182:15-16. *See also* Harris Report at ¶ 159 ("FAMCO . . . did not use a sufficiently long data period to obtain reliable results."); Harris Report at ¶ 279 ("Eleven years of data are insufficient to adequately estimate risks associated with important, but uncommon events.").

VIX, which only has data starting in 1997.[163] Rather than negligently ignoring the longer data set available from the VIX 100, Mr. Riad and Mr. Hughes actually considered the earlier data but deemed it to be problematic. In fact, Mr. Riad was in a particularly good position to evaluate this earlier data set since he served on the Advisory Board of the Chicago Board of Options Exchange ("CBOE"), the entity that developed the VIX index.[164] During his tenure on the Board, the CBOE had discussions regarding the specific issue of historical volatility data[165] and concluded that the VIX 100 was so problematic that they had to scrap it for a different approach.[166] There was two main problems with the earlier data: first, "in the 80s there was not enough options trading in the marketplace for you to get an accurate gauge" of volatility.[167] As a result, practitioners were forced to "take pieces of the options prices and then you construct this volatility gauge. And if there are not a lot of options trading, you get – not a great sample set to create this."[168] Second, the later data set employed by FAMCO "takes a robust set of options on each security" whereas the "previous methodology didn't include that. And so, without including what we see is a very significant piece of the market, they realized that's a big mistake."[169] In other words, FAMCO did not ignore the earlier data out of negligence; in the

[163] Harris Report at ¶ 277-78.
[164] Riad Testimony at 2034:9-21.
[165] As Mr. Riad explained, "CBOE had the similar challenge of what type of data to use" for calculating historical volatility. *Id.* at 2115:23-24.
[166] People on the Board had raised the issue of "how confident are you in the data, and . . . some of us had said the structure [of the VIX 100] doesn't look like it's reasonable – I mean, you're – you're making estimations and guesses, and is that the way you should do it. And then the CBOE spent a lot of time researching it, and they – it changed the methodology for that, and then – and started their history in 1993 because they were not comfortable [with earlier data]." *Id.* at 2114:3-25. Prof. Harris admitted as much during testimony when he noted that "there were concerns that were raised about how VIX [100] was calculated early on." Harris Testimony at 312:23-313:1.
[167] Riad Testimony at 2116:18-2117:1. Mr. Hughes similarly pointed out that there was not a market for variance swaps prior to 1997. Hughes Testimony at 633:11-22; *id.* at 634:10-12. Mr. Hughes explained that "those [pre-1997] option prices are not liquid and they're not reliable, so your end result would not be that reliable. It's – it's a very, very rough estimate that it's not reliable enough. We weren't – we didn't trust that data enough because it's so illiquid in the '80s." *Id.* at 634:16-22.
[168] Riad Testimony at 2116:24-2117:4.
[169] *Id.* at 2117:18-2118:6.

words of Mr. Hughes, "[w]e would have liked to go back to the beginning of time if we could, but the data was just not reliable. You couldn't use that in your analysis."[170]

Prof. Harris also argued that FAMCO should have used daily data rather than monthly data when analyzing monthly movements in the S&P 500.[171] Again, however, the decision to use monthly data did not reflect carelessness on the part of the Respondents but instead was a conscious decision.[172] As Mr. Hughes explained, "I used monthly because when we were implementing the strategy, we would have only done one per month. We wouldn't have done one every single day. If you did one every single day, there would be quite a lot of overlap . . . And secondly, the results would be directionally about the same whether you use daily or monthly."[173] Prof. Spatt agreed that a daily analysis would generate problems with overlapping data and also concurred with Mr. Hughes that "I didn't really see a showing on [Prof. Harris'] part that the – that daily would lead to different conclusions."[174]

When evaluating Prof. Harris' critique regarding FAMCO's data, Prof. Spatt made the critical point that "it's certainly better to use more data *if your statistical analysis from more data is reliable*. And also it's better to use more data *that comes from the same underlying generating*

[170] Hughes Testimony at 711:5-8. Mr. Riad made a similar point when he noted that he wanted to "make sure that we get data that's meaningful. Garbage in, garbage out . . ." Riad Testimony at 2117:9-10. Prof. Spatt also seemed to echo Mr. Hughes when he stated that "if the data were all comparable, you'd surely like to have as much as you as you – as you could." Spatt Testimony at 3320:5-8. The problem is that "these environments were different. They were different for lots of reasons. I think the primary thing, the primary aspect that was on the minds of the Respondents and their – and their staff were the changes in market structure so they, the lack of variance swaps and even to some extent the lack of traded options . . . I think that was probably first and foremost on their – on their minds." *Id.* at 3320:9-18.

[171] Ex. 139 at footnote 24 ("Had they used monthly returns computed from every day in the month, they would have obtained more informative frequency distributions.").

[172] Hughes Testimony at 620:3-6.

[173] *Id.* at 619:17-620:2.

[174] Spatt Testimony at 3301:3-23. Indeed, Prof. Harris admitted as much during cross-examination when asked whether he actually performed a calculation comparing the monthly data against the daily figures: "Subject to what I just said, no. Such calculations are – they're very had to imagine. *I can imagine one way of doing it, and I didn't do it.*" Harris Testimony at 321:10-17 (emphasis added).

process."[175] The problem is that "the statistics from the greater amount of data may be misleading . . ."[176] When asked whether he would use data back to 1986 for his own analyses, Prof. Spatt stated that he "probably would not use that first decade from 1986 going forward . . . . I probably would have started around 1996 based upon what I know of today"[177] – in other words, the same time period that the Respondents utilized. Significantly, the Respondents' approach to data was also employed by academics and industry practitioners.[178]

In addition to his failure to fully appreciate FAMCO's analyses and their decision-making process, Prof. Harris also presented information in a biased way in order to make certain points. For example, Prof. Spatt was critical of the fact that Prof. Harris started many of his analyses with the market crash in 1987: "what was striking to me in Professor Harris's analysis when he – *when he kind of reached to include it*, by basically doing the alternative where he spotted [sic] the data in January of 1987."[179] In an attempt to demonstrate that HCE had consistent short put exposure, Prof. Harris similarly truncated his analysis to begin in November 2007,[180] thereby ignoring the fact that HCE had primarily *long* put exposure for lengthy periods prior to November 2007.[181]

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[175] *Id.* at 3302:14-18 (emphasis added).
[176] Spatt Report at 3303:3-5.
[177] Spatt Testimony at 3309:16-23.
[178] As Prof. Spatt noted, "[o]ne of the things that was striking to me is that a number of the academic studies have, for example, focused on a period of roughly 1996 and forward . . ." *Id.* at 3309:1-4.
[179] *Id.* at 3319:6-10 (emphasis added). As an example of one such analysis, Prof. Harris identified six large market declines in the last two decades and asserted that these "extreme events took place roughly once every five years on average so that the probability of a significant loss from these positions was approximately 20% per year." Harris Report at ¶ 170. However, Prof. Harris' own report cites an internet page that contains a "[l]ist[] of extreme volatility events and market crashes." *Id.* at Ex. 3, Item 26. This list showed that prior to 1987 – the start of Prof. Harris' analysis – the previous market crash occurred in 1937. *See* http://en.wikipedia.org/wiki/List_of_stock_market_crashes_and_bear_markets. Thus, Prof. Harris' assertion regarding six declines over two decades could just as easily have been viewed as seven declines over seventy years or once every ten years.
[180] Prof. Harris stated that "for most of the time, for ¾ of the time, HCE had written put exposure. And this is from November '07 to October '08." Harris Testimony at 193:12-14.
[181] *See* Ex. 86, Listing of variance swaps/put options trades in HCE (Sept. 1, 2006 – Aug. 31, 2008).

Somewhat inexplicably, Prof. Harris also disapproved of the fact that FAMCO's risk analysis attempted to limit the possibility of a loss equivalent to five percent of HCE's assets[182] – in other words, precisely the threshold number set forth in the SEC's own disclosure rules. He noted that there are "several problems with focusing on 5 percent."[183] First, it "doesn't discriminate between a loss of just 5 percent or a loss that could potentially be far greater than 5 percent."[184] In addition, FAMCO's analysis failed to take into account that both index puts and variance swaps "are going to lose at the same time."[185] Finally, Prof. Harris asserted that the Respondents improperly focused on individual transactions when analyzing the probability of loss rather than evaluating multiple sequential transactions.[186] In addition to the fact that these assertions are problematic from an analytical perspective, each of these criticisms also appears to be based on Prof. Harris' personal preferences rather than any sort of legal requirement.

Prof. Harris might deride the five percent figure as some sort of "magic" threshold,[187] but in fact it represents the standard that the SEC itself established and the Respondents used as the criterion for their risk analysis. Form N-2 states clearly "[i]f a policy limits a particular practice *so that no more than five percent of the Registrant's net assets are at risk*," then disclosure may be limited.[188] There is no guidance that registrants should evaluate what happens in the extremely unlikely scenario where the loss exceeds five percent. Prof. Spatt pointed out this important distinction when he noted that "I think the nature of the – of the standard implicit in

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[182] As he described the risk disclosure target: "5 million [dollars], that for some reason unknown to me seems to be magic, perhaps is, indeed, magic. . . ." Harris Testimony at 237:15-16.
[183] *Id.* at 251:22-23.
[184] *Id.* at 252:9-12.
[185] *Id.* at 252:23-24.
[186] Harris Report at ¶ 262. *See also* Harris Testimony at 253:12-23.
[187] Harris Testimony at 237:15-16.
[188] Instructions to Item 8.4 of Form N-2.

the N2 [sic] is really focused ultimately not so much on the exact size of the loss but *whether the loss . . . whether the amount exposed exceeds this 5 percent standard.*"[189]

Prof. Harris further argued that evaluating the risk on a transaction-by-transaction basis – as opposed to analyzing it at the strategy level – represented a "serious shortcoming" because "given enough time, for sure you're going to lose something."[190] But this truism is virtually meaningless and would suggest that *every* investment presents a significant risk that must be disclosed because in the long run it is going to suffer a decline. When asked to provide the "correct" time period to use when evaluating these multiple sequential transactions, however, Prof. Harris responded that "there's no simple answer to that."[191] Prof. Spatt critiqued Prof. Harris' proposed approach for precisely this reason, noting that "one of the issues, you know, one of the main questions I think would be what would be the [time] horizon . . ."[192] A related issue is the fact that HCE's strategy was not being implemented on a consistent basis.[193] Prof. Spatt emphasized that this would create an issue in evaluating the risk at a strategy level.[194] In short, "there is a lot of ambiguity as to what it would mean in the context of strategy whereas at the transaction level" – the approach adopted by the Respondents – "it's very well-defined what the nature of a risk would be and I think that's an appealing aspect of approaching it that way."[195]

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[189] Spatt Testimony at 3326:9-14.
[190] Harris Testimony at 253:24-254:3.
[191] *Id.* at 340:13-16.
[192] Spatt Testimony at 3277:1-4.
[193] As even Prof. Harris' acknowledged, "they didn't uniformly have short positions. They sometimes had long positions...[W]e understand that they were that on occasion that they changed their exposure and sometimes were long." Harris Testimony at 193:9-20.
[194] Spatt Testimony at 3277:6-8 ("Another [question] was related to the nature of the strategy where it wasn't – where it wasn't being implemented, implemented each month.").
[195] *Id.* at 3277:12-16.

Another significant shortcoming of Prof. Harris' strategy-level approach is that it focused entirely on the potential for a *single loss* while ignoring the many gains that accumulated across the multiple transactions. The problem with this approach was made clear by reviewing the graph that Mr. Hughes created as part of his research in order to analyze the long-term performance of the variance swap strategy.[196] As Mr. Hughes explained, "one of [Prof. Harris'] major flaws was that he only looked at these little dips here [in the chart] and said that these are large losses. Well, he didn't consider any of the gains. The gains are pretty significant during this period and the losses are actually quite small when they do occur."[197] Prof. Spatt similarly noted that when evaluating a strategy "it certainly also would be important to potentially account for gains . . ."[198] and he said that the fact that "there is no allowance for gains" contributed to the fact that Prof. Harris' approach was "just not capturing the right concept."[199] In short, Prof. Harris attempts to have it both ways: he argues that the investments at issue should be evaluated at the strategy level, but he then proceeds to analyze the risk at the individual transaction level.

Another criticism by Prof. Harris relates to the Respondents' alleged failure to evaluate the combined risk from these strategies. As an initial matter, there is no language in the relevant disclosure document – Form N-2 – that requires or even suggests that *different* strategies should be analyzed together when evaluating risk.[200] Moreover, it is unclear how registrants would even be expected to perform such an analysis for different investments. When Prof. Spatt was asked

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[196] *See* Ex. 228 at FAM00060232-33.
[197] Hughes Testimony at 642:19-25.
[198] Spatt Testimony at 3277:9-10.
[199] *Id.* at 3314:19-22.
[200] *See* Ex. 142, SEC Form N-2.

whether the risks of variance swaps and index puts should be evaluated in tandem, he responded that "I wouldn't agree with that because they certainly weren't perfectly correlated."[201]

2. Respondents' Openness Regarding These Investments Demonstrated Their Good Faith and The Absence of Negligence

The good faith of the Respondents is also evident from the openness that they demonstrated with respect to the investments at issue. When the Respondents first considered these transactions, they made sure to discuss the investments with the relevant parties and appropriately relied on their guidance as to how they should proceed. Once the Respondents actually made the trades in the Fund, they continued fully to apprise the Board and Claymore about these investments and also disclosed the positions to shareholders.

a. *Mr. Riad Requested Permission and Guidance Prior to Entering These Transactions*

Mr. Riad did not simply start writing derivatives with the hope that nobody would notice these investments in the portfolio. Instead, Mr. Riad demonstrated his good faith by approaching the relevant parties *prior* to entering into the Fund's first short index put and first short variance swap to disclose the fact that he planned on employing these trades in the Fund's portfolio and request guidance regarding their use.[202] In fact, both short index puts and short variance swaps were discussed as potential investments for HCE at the Fund's inception.[203] When he decided to start using variance swaps in 2007, Mr. Riad again approached Claymore personnel and inquired about the permissibility of these transactions and whether they qualified as strategic transactions

[201] Spatt Testimony at 3486:16-20. Later, Prof. Spatt noted again that "it wouldn't be appropriate to add them because they're not – certainly not anywhere near perfectly correlated." *Id.* at 3487:22-24.
[202] Riad Testimony at 2404-2406.
[203] Testimony of Steven Hill [hereinafter "Hill Testimony"] at 2729:11-16 ("My understanding is the first time they put it (a short index put position) on was very short after the funds launched in 2005.") During the relevant period, Mr. Hill served as Chief Financial Officer of the Fund and head of Claymore's Fund Administration Group. Ronald Toupin, Chairman of the HCE Board, also remembered that "[a]t the organizational meeting [in 2005], some of the strategies that could be employed by the fund included variance swaps." Testimony of Ronald Toupin [hereinafter "Toupin Testimony"] at 2990:9-13.

under the Fund's Prospectus.[204] Claymore subsequently discussed the issue with outside counsel at Skadden and confirmed that the Fund could enter these transactions.[205] Mr. Riad's repeated disclosure of his intention to invest in these permissible investments – as far back as 2005, and again in 2007 prior to entering the transactions – hardly represents the actions of an individual intent on hiding these trades or misleading anybody.[206]

b. *The Respondents Kept Relevant Parties Apprised Once These Investments Were Made*

Mr. Riad's openness extended beyond these initial conversations: he did not simply request approval and then leave the relevant parties in the dark once it had been granted. Instead, he made sure to appropriately disclose information regarding these investments with the Board, Claymore, and HCE shareholders throughout the relevant period.

1. *HCE Board Was Informed*

Throughout the life of the Fund, the Respondents disclosed their investments in short index puts and short variance swaps to HCE's Board of Trustees. At each quarterly Board meeting, the Respondents discussed HCE's portfolio holdings, performance of the holdings, and the underlying investment strategies.[207] As the evidence demonstrated during trial, these

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[204] *Id.* at 2704-5

[205] *Id.* at 2706:17-2707:2.

[206] The Division acknowledged that Mr. Riad had discussed these investments prior to entering the transactions. *See* Division Closing Argument at 3548:25-3849:4. The Division then claimed that Mr. Riad simply went to the wrong person when seeking advice: rather than contact the Chief Financial Officer of the Fund – an individual who also served as head of the Fund Administration group, and somebody who had frequent contact with various legal and compliance individuals – Mr. Riad should have gone directly to Fund outside counsel. *Id.* at 3548:23-25 ("Respondents in fact did not seek the advice of fund counsel before they began investing in written puts and variance swaps."). It was evidently not enough that Mr. Riad discussed these potential strategies with the entire Board – as well as outside counsel – at the Fund's organizational meeting. It was also insufficient that Mr. Hill provided guidance from outside counsel to Mr. Riad in 2007 when Mr. Riad had asked whether the investments were permissible. Instead, the Division's position appears to be that good faith can only be demonstrated by *directly* contacting precisely the right employee in the legal department. Such a requirement simply strains credulity.

[207] Board members also received an overview of what would be discussed during quarterly meetings through written "Portfolio Manager's Discussion" summaries. These summaries included a discussion of the strategic transactions at issue. For example, the October 2007 Portfolio Manager's Discussion emphasized "the portfolio's use of S&P

presentations were lengthy.[208] Significantly, these presentations included discussion of the short index put options and short variance swap positions.[209] The Respondents spoke with the Board about the research and risk analysis that they had performed on these investments.[210] They explained that the positions were designed to take advantage of FAMCO's market outlook,[211] and the Respondents also told the Board that the variance swaps were intended to capitalize on the systematic overestimation of volatility in the marketplace.[212] The Respondents made clear that these investments were being employed as a regular strategy.[213] The Respondents also emphasized the fact that these positions were contributing positively to Fund performance.[214]

The Respondents were also fully justified in believing that the Board members had a solid understanding of these investments when they discussed the derivatives at each meeting.

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500 Index puts helped to further augment downside protection during the negative market." Ex.71, Portfolio Manager's Discussion (Oct. 2007) at FAM00024571. In January 2008, the Portfolio Manager's Discussion noted that "[o]ver the past year, the Fund benefited from a number of strategic decisions, including . . . volatility trading strategies, and the effective use of S&P 500 Index puts which augmented downside protection during adverse market periods." Ex. 6, Portfolio Manager's Discussion (Jan. 2008) at CLAY010329. A similar disclosure was included in the April 2008 and July 2008 discussion. *See* Ex. 76, Portfolio Manager's Discussion (Apr. 2008); Ex. 89, Portfolio Manager's Discussion (July 2008). The Audit Committee also reviewed financial statements and as a practice would discuss new investments types. Hill Testimony at 2723:21-2724:3 (". . . . to the extent there is a new investment and it's disclosed, the practice would be – or new investment type, I should say, the practice would be within the audit committee meeting of the board where we would be reviewing financial statements to point those items out to the members of the audit committee.").

[208] *See, e.g.*, Gallagher Testimony at 1014:16-22 (". . . Mo would talk and talk and talk about the portfolio. It was usually he had a certain amount of time slated for it. He would go well beyond that."); *see also* Riad Testimony at 2223:22-2224:11.

[209] Mr. Toupin, Chairman of the HCE Board, confirmed that the Respondents discussed short index puts and short variance swaps at these meetings. Toupin Testimony at 2992:12-17. Randall Barnes similarly recalled that Mr. Riad discussed these derivatives at Board meetings. Testimony of Randall Barnes [hereinafter "Barnes Testimony" at 2918:18-21; 2922:6-9. Mr. Gallagher specifically remembered that Mr. Barnes was particularly interested in Mr. Riad's discussion of short index puts because Mr. Barnes was using similar strategies in his personal portfolio. Gallagher Testimony at 1013:19-1014:2.

[210] Toupin Testimony at 2992:18-22. *See also id.* at 3016:5-11 (the Respondents "did quantify it [the potential loss] that it was not a large amount"); *id.* at 3018:4-7 ("The backtesting was characterized as testing to one or two or two or three standard deviations that could produce a 1 to 2 percent loss.").

[211] *Id.* at 2993:23-25.

[212] Barnes Testimony at 2919:17-24.

[213] *Id.* at 2920:7-10; 2921:10-16.

[214] Gallagher Testimony at 1013:10-16 ("[w]hen it comes to volatility swaps, I certainly remember Mo talking about those in the context of the performance attribution analysis of the portfolio, how the premiums collected on those things would help – were helping performance in the portfolio and, you know, specifically in that context, I absolutely remember it.")

As an initial matter, it is important to recognize that the Board members were all sophisticated investment professionals.[215] Furthermore, these sophisticated individuals were provided with periodic filings for the Fund that listed these derivatives each quarter.[216] In fact, the first variance swap position in the Fund was specifically highlighted for Board members in the "Summary of Noteworthy Changes" cover sheet that accompanied the 2007 Annual Report and identified new investments in the portfolio.[217] As a result, the Respondents reasonably relied on the Board for supervision and assumed that any issues regarding these investments would have been brought to their attention.

2. *Claymore Was Informed*

The Respondents' openness with Claymore similarly extended beyond the initial conversations between Mr. Riad and Mr. Hill. Indeed, the evidence is clear that Respondents made sure to keep Claymore involved in every step of the process relating to these investments. As an initial matter, it is important to recognize that Claymore representatives attended the Board meetings where Mr. Riad discussed the strategic transactions at issue.[218] When a question arose regarding these investments in the fall of 2007, the Respondents participated in a conference call with Claymore where the derivatives were discussed in depth.[219] The Respondents continued to keep Claymore apprised of these positions throughout 2008.[220]

[215] Gallagher Testimony at 988:21-989:7

[216] *See* Barnes Testimony at 2960:15-23. The Respondents cannot be held responsible for the fact that certain Board members did not actually review the section of these reports where the positions were listed. *Id.* at 2961:16-18 ("I didn't focus on the balance sheets, the individual positions, and certain of the footnotes" in other words, the portions that identified the short index puts and the variance swaps).

[217] *See* Ex. 284, Undated document summarizing noteworthy changes since the last shareholder report for the Fiduciary/Claymore Dynamic Equity Fund and MLP Opportunity Fund.

[218] *See, e.g.*, Testimony of Bruce Saxon [hereinafter "Saxon Testimony"] at 2615:10-13; 2653:4-9; Hill Testimony at 2694:14-15.

[219] *See* Ex. 252, Meeting Request from Mark Mathiasen relating to a trade in the HCE Fund (Jan. 16, 2008).

[220] For example, in March 2008 Mr. Riad sent Mr. Hill an email regarding his most recent variance swap transaction that provided details regarding the size of the position, the Fund's rationale behind this investment, and the payout structure for the investment. *See* Ex. 4, Email from Mo Riad to Steven Hill (Mar. 6, 2008).

The Respondents felt particularly comfortable relying on Claymore for guidance because the adviser had access to comprehensive information regarding these investments. Claymore had to approve the ISDA agreements that permitted the Fund to enter into these trades.[221] Additionally, Claymore received reports from the Fund's custodian, Bank of New York, which detailed HCE's derivatives investments.[222] These reports included the size of the positions, the extent to which they contributed to fund performance, and the frequency in which they were used in the Fund's portfolio.[223] Claymore also reviewed the confirmations for each transaction[224] and received daily updates detailing the securities in the portfolio.[225]

In sum, the Respondents reasonably relied upon Claymore for guidance regarding investment products that the adviser had helped set up, monitored continuously, and frequently discussed with FAMCO. In light of Claymore's heavy involvement and oversight with these investments, it is perhaps telling that the adviser reached a settlement with the Commission for failure reasonably to supervise FAMCO's activities in which Claymore agreed to reimburse former HCE shareholders for the entire $45 million loss from the derivatives transactions.[226]

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[221] *See* Riad Testimony at 2192:7-2193:17 ("Q: Did you have an understanding as to whether or not Claymore had to approve those agreements before they were entered into, those ISDAs? A: They would. They were investment advisor -- our broker said that your investment advisor has to negotiate these ISDAs on your behalf if you were to engage in the securities, and that was specifically told to me."); *see also* Grossman Testimony at 498:1-4 ("These were legal documents, the ISDA's, and they involved multiple parties, and they involved Fiduciary. They would have involved First Trust and Claymore as the advisors.");

[222] Hill Testimony at 2700:11-15 ("the fund administration group [at Claymore] would receive information from the Bank of New York who is the fund's servicing agent."); *see also id.* at 2701:11-2702:5.

[223] *See, e.g.*, Ex. 353, Email from Wendy Ramirez to Anne Kochevar and Susan Steiner regarding Charles River compliance reports for HCE and FMO (Jan. 2, 2008); *see also* Steiner Testimony at 1256:22-1257:2 ("They [the Charles River reports] ran through the portfolio holdings and the transactions on a monthly basis, and they sent it to Fiduciary Asset Management to review. It was also a daily monitor for investments and transactions. They would provide alerts to Claymore."); Hill Testimony at 2701:21-2702:2; *Id.* at 2702:5 ("They [the Bank of New York reports] would list all the securities.").

[224] *See, e.g.*, Ex. 158, Email from Email from Jeffrey Grossman to Ben Dragstrem regarding a variance swap transaction in the HCE Fund (Sept. 25, 2007).

[225] *See* Hill Testimony at 2700:25-2702:14.

[226] *See* Ex. 138, Order Instituting Proceedings Against Claymore Advisers LLC (Dec. 19, 2012).

3. *HCE Investors Were Informed*

The Respondents' openness also extended to Fund investors. Indeed, there was extensive evidence that HCE shareholders were appropriately informed throughout the relevant period regarding the Fund's investments in short index put options and short variance swaps.

When the Respondents implemented the strategies at issue in 2007, they repeatedly disclosed their investment in these positions in HCE public filings.[227] It is important to focus on several important features of these reports. First, they alerted investors to the fact that the Fund was writing short index put options and short variance swaps without any corresponding long positions. Second, they made clear that these trades were part of a long-term strategy. Finally, they put investors on notice of the potential risk from these positions.

There can be no dispute that the Fund's periodic filings made clear that HCE was entering short index puts and short variance swaps that were not covered by a long position on the opposite side of the transaction. For example, the August 2007 N-Q,[228] November 2007[229] Annual Report, and the February 2008 N-Q[230] all listed short index put options and short variance swaps but did not include any reference to a long position in either of these derivatives. The Division's own witness, Robert Shulman, acknowledged this fact during his testimony.[231]

The repeated disclosure of these transactions in multiple filings was particularly significant because it alerted investors to the fact that these investments were part of an ongoing

[227] For a detailed discussion regarding these disclosures, *see* Respondents' Prehearing Brief at 28-31.
[228] Ex. 300, August 2007 Quarterly Schedule of Portfolio Holdings for the Fiduciary/Claymore Dynamic Equity Fund (Oct. 29, 2007), at 8 and 10.
[229] Ex. 304, Annual Report for the Fiduciary/Claymore Dynamic Equity Fund, at 11 and 16.
[230] Ex. 302, February 2008 Quarterly Schedule of Portfolio Holdings for the Fiduciary/Claymore Dynamic Equity Fund (Apr. 29, 2008), at 11.
[231] Shulman Testimony at 1378:7-10; 1381:21-1382:1.

strategy.[232] After seeing short positions without corresponding long trades in *three consecutive filings over a period of six months*, it strains credulity to suggest that investors would not have understood HCE's investment in these derivatives or that they would have assumed that they represented a one-time transaction. Indeed, the Division's own expert acknowledged that a central rationale behind the SEC's move to quarterly reporting for funds such as HCE was to allow investors to gain a better understanding of the portfolio and decrease the risk of "style drift"[233] – in other words, it would enable investors to recognize precisely the type of trading pattern that these reports demonstrated. When asked specifically where he would have "expected to get that information that would have helped you understand the risk to your clients in the precise trading strategy that the portfolio managers were employing," Mr. Shulman similarly pointed to "[t]he quarterly reports, I would have wanted to have seen it there, if any place."[234]

In addition to identifying the short positions as part of an ongoing strategy, the Fund's disclosures also provided valuable information regarding each individual transaction and the potential risks from these investments. For example, disclosures for variance swaps specifically highlighted the fact that the position would lose money if volatility rose.[235] Disclosures for both short index puts and short variance swaps also identified the unrealized loss for the position at the time of the report, thereby putting investors on notice as to the potential impact of the

[232] The Division repeatedly argued that these periodic filings represented only a "snapshot in time" and did not take into account any activity in between reporting periods. *See, e.g.,*Tsimouris Testimony at 85:12-16; Harris Testimony at 250:5-19; Division Closing Argument at 3561:1-3. To be sure, a single filing cannot provide a comprehensive overview of a Fund's trading strategy, especially in light of the static nature of the information contained in the report. However, investors can glean important information from repeated snapshots; indeed, this was precisely the impetus for the SEC's move to quarterly filing. *See* Respondents' Prehearing Brief (Apr. 8, 2013) at §3(a)(v)(b).
[233] Harris Testimony at 318:8-14.
[234] Shulman Testimony at 1373:4-10.
[235] *See* Ex. 301 at 11

investment on the portfolio.[236] Significantly, the Fund's disclosures for index put options included the number of options written and the exercise price, as well as the fact that each option represented 100 contracts.[237] As Robert Shulman – the Division's own witness – testified, this information permitted an investor to determine the notional size of the position.[238]

The inclusion of notional exposure for the index put positions highlights a glaring incongruity in the Division's case. On the one hand, the Division's argument rests in part on the assertion that the notional value of these positions was so alarming that even a Fund accountant at FAMCO was able to recognize the excessive risk of these derivatives.[239] The OIP similarly highlighted the extreme notional values from these positions, presumably in an attempt to show the significant risk that these investments posed to the portfolio.[240] Mr. Tsimouris also had immediate concerns when he saw the size of these trades.[241] The problematic fact for the Division is that *these same notional values were disclosed to Fund investors in multiple periodic filings*. If the risk was immediately obvious when Mr. Grossman and Mr. Tsimouris saw the notional value – a number that Mr. Grossman described as the "best measure of risk"[242] – then it certainly should have been recognized by "experienced investment professionals"[243] such as Division witnesses Michael Boyle and Mr. Shulman, as well as other investors.

[236] For the October 2007 Form N-Q, for example, the Fund identified the unrealized loss from its variance swap of $850,000 – nearly one percent of the Fund's assets at the time. *See* Ex. 301 at 11. *See also* Ex. 300 at 8.
[237] *See, e.g.*, Ex. 303 at 11 and Ex. 304 at 11.
[238] *See* Shulman Testimony at 1396:10-1397:5. Mr. Shulman admitted that he was able to calculate the notional exposure based on this disclosure ("Q: So, as of that date, you could have known the exposure from the written put options in the portfolio; is that correct? A: That's correct.").
[239] Grossman Testimony at 553:2-7.
[240] OIP at ¶31 ("In late August 2008, FAMCO wrote two-month, 10% out-of-the-money S&P 500 put options in HCE *with a $139 million notional exposure, which equated to 136% of the Fund's NAV* . . .") (emphasis added).
[241] Tsimouris Testimony at 120:8-10 ("I questioned [Mr. Swanson] about the amount of the transactions. There was a 700 and 500 [number of options], *these are very large notional amounts*.").
[242] Grossman Testimony at 553:2-3.
[243] Division Closing Argument at 3562:6-7.

In evaluating the openness of the Respondents with shareholders, it is also important to consider one final point regarding the Fund's disclosures to investors: if the Respondents had truly wanted to deceive investors, nothing prevented them from hiding these positions entirely. The fact that these filings represented only a "snapshot in time" – as the Division repeatedly emphasized[244] – meant that the Respondents could have easily concealed these investments from the Board or shareholders by removing its derivatives positions just prior to each quarter end. As a result, the positions would never have been listed in HCE filings. Instead of engaging in such "windowdressing," however, the Respondents made no attempt to hide their investments from either the Board or shareholders. As further evidence of the Respondents' good faith, Mr. Hill noted that there was no requirement for the Fund to disclose its investment in variance swaps in the quarterly filings but the Fund nonetheless identified these positions in shareholder reports.[245]

3. Respondents' Reliance on Guidance From Relevant Parties Demonstrates Their Good Faith and Absence of Negligence

The openness of the Respondents was particularly important because it occurred within a framework that was specifically designed to assist them in dealing with precisely the types of issues at the heart of this proceeding. Put simply, the Division is unable to demonstrate that Respondents were negligent because Mr. Riad and Mr. Swanson reasonably relied upon both Fund counsel and Claymore to provide guidance regarding these investments and followed any instructions that they were given. This guidance related to two key issues. First, the Respondents looked to Claymore and counsel for direction as to whether and how these

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[244] *See, e.g.*, Tsimouris Testimony at 85:12-16 ("This is – since this is a balance sheet, it's a snapshot in time . . . It doesn't tell you what happened intraperiod."); Harris Testimony at 250:5-19; Division Closing Argument at 3561:1-3 ("We know that it disclosed . . . in the portfolio holdings at the time, a snapshot of what was in the portfolio.").

[245] Hill Testimony at 2745:3-10 ("Because a swap doesn't – doesn't show up as part of a portfolio, just the way in which it's reported, it's a balance sheet obligation. And the NQ [sic] doesn't report the balance sheet, it only reports the scheduled investment. We added disclosure to show that in addition to the portfolio holdings, this swap was outstanding.").

investments could be used in the portfolio. Second, the Respondents depended on Claymore and counsel for guidance with respect to the disclosures relating to these investments. As a result, any alleged violations of law relating to the Fund's use of these investments are the responsibility of those entities, rather than the Respondents.

a. *Oversight Regarding Derivatives Investments*

Neither Mr. Riad nor Mr. Swanson had any background or training in legal or compliance matters. As a result, they reasonably depended on advice from personnel at FAMCO and Claymore for assistance with any legal or compliance matters related to Fund investments and depended on these entities to inform them of any potential issues. Indeed, this is precisely what they were supposed to do: as Mr. Baris explained, "portfolio managers are not – they are not lawyers and they are not experts in the law . . . [T]hey get guidance from the advisor [sic], the compliance officer, and their counsel as to how to meet disclosure requirements, that it's reasonable for them to rely on those, that advice from the advisor and fund counsel."[246]

The reliance on fund advisers started as soon as the Respondents began considering the investments at issue. As noted above, Mr. Riad discussed the potential derivatives strategies with Claymore prior to investing. It is important to note, however, that Mr. Riad *also* discussed the potential investments with First Trust, the investment adviser to a covered call fund subadvised by the Respondents called the First Trust Covered Call Fund ("CCF").[247] In contrast to the guidance that he had received regarding HCE,[248] Mr. Riad was specifically told that he

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[246] Baris Testimony at 3072:2-11. Mr. Toupin held a similar view of the oversight provided by legal and compliance personnel: "[w]e had those individuals [from legal and compliance] at the board meetings with us to provide that kind of guidance" as to whether there were any potential legal violations with respect to Fund investments. Toupin Testimony at 2995:16-24.
[247] *See id.* at 2046:11-22. As he recalled, he "ask[ed] permission from First Trust. I think it was for a variance swap." *Id.* at 2591:4-5.
[248] As noted above, Mr. Riad received guidance from Skadden – via Mr. Hill – that the investments were permissible in HCE. *See* discussion *supra* at §III(2)(a).

could *not* engage in variance swaps in CCF because the transactions were inconsistent with CCF's investment mandate.[249] The good faith of the Respondents is evident from the fact that Mr. Riad did exactly as instructed and did not engage in such trades in CCF. Indeed, the lack of comparable derivatives trading in CCF – despite the fact that Mr. Riad had the same exact incentive to engage in such transactions – represents a major flaw in the Division's portrayal of the Respondents as reckless gamblers intent on deceiving people.

Once the Fund began investing in these derivatives, the Respondents had an additional level of comfort from the elaborate trade compliance system that had been set up for HCE by Claymore. As FAMCO's Chief Compliance Officer, Susan Steiner, explained, "when the fund was established, Claymore provided a list of investment restrictions according to the prospectus" that were coded into a pre-trade compliance system called Moxy.[250] This system identified any transaction that violated these restrictions[251] and also flagged any new asset – such as a variance swap – that was not already in the system, at which point "a discussion would have to be made to be able to label that asset and to account for it in our system."[252] In addition to Moxy, transactions in the Fund were also reviewed on a post-trade basis by the Charles River System[253] that was also set up by Claymore.[254] Charles River evaluated HCE's trading to make sure that it complied with certain investment restrictions and then generated a monthly report detailing any

[249] As Mr. Swanson explained, "CCF was the First Trust Fund that was – that we also managed and that was the covered call fund that had a much more restrictive prospectus in terms of using strategic investments." Swanson Testimony at 1798:19-23. Unlike Claymore, this investment adviser "didn't view [variance swaps] as an appropriate strategy for that fund." Riad Testimony at 2591:8-9.
[250] Steiner Testimony at 1249:22-1250:2; *see also* Swanson Testimony at 1710:17-1711:15; Riad Testimony at 2076:19-2077:22. Both Mr. Riad and Mr. Swanson testified that they were aware of this system and its pre-trade compliance oversight function. *See* Riad Testimony at 2076:19-2078:7; Swanson Testimony at 1710:12-1711:15.
[251] Swanson Testimony at 1711:4-7.
[252] Steiner Testimony at 1250:21-1251:16. At that point, the portfolio manager would be required to have a discussion with others at FAMCO regarding this new product. *Id.* at 1251:17-21.
[253] Swanson Testimony at 1711:16-1712:6. Both Mr. Riad and Mr. Swanson testified that they were aware of this system and its post-trade compliance oversight function. *See* Riad Testimony at 2086:24-2088:25; Swanson Testimony at 1711:16-1712:6.
[254] Steiner Testimony at 1257:4-6.

issues.[255] The Respondents understood that "there was a compliance overview from the Charles River System as far as what positions . . . were permissible in the account, and met all the requirements that needed to be met . . ."[256] In sum, the Respondents had a good faith belief that their trading activity was being evaluated by two comprehensive systems established by Claymore to detect any impermissible transactions.

Perhaps the most compelling evidence of the Respondents' good faith can be seen in their response to concerns that were raised regarding HCE's investment in the index puts and variance swaps. Mr. Grossman testified that in the fall of 2007 he warned Mr. Riad and others at FAMCO about the risk of these investments and questioned whether they were allowed by the Fund Prospectus.[257] In response, neither of the Respondents attempted to silence Mr. Grossman or bury his concerns. As Mr. Riad recalled, he "suggested it to [Grossman] to take the – take the appropriate measures"[258] and also "suggested that Mr. Grossman follow[] the normal protocol of informing compliance and having discussions."[259] As a result of Mr. Grossman's discussions with FAMCO's Chief Compliance Officer and Compliance Manager, FAMCO arranged a conference call with Claymore in January 2008 to discuss the issues that had been raised regarding these investments.[260] Significantly, Mr. Grossman participated in this call and was given every opportunity to voice his concerns directly to Claymore.[261]

The substance of this January 2008 call is central to understanding the reasonableness of Respondents' actions. According to Mr. Riad, advice was conveyed from outside counsel to the

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[255] *Id.* at 1257:15-1259:15; *see also* Ex. 353.
[256] Riad Testimony at 2088:5-13.
[257] *See, e.g.*, Grossman Testimony at 494-497.
[258] Riad Testimony at 2419:21-25.
[259] *Id.* at 2421:19-21.
[260] *See* Ex. 252, Meeting Request from Mark Mathiasen relating to a trade in the HCE Fund (Jan. 16, 2008).
[261] This was particularly important because Mr. Grossman – in his own words – was "not a person that was going to be silent about my feelings." Grossman Testimony at 499:3-4.

Fund at Skadden that short index puts and variance swaps were permissible investments in the HCE portfolio.[262] Indeed, every witness who remembered participating on the call reached the same conclusion that the investments were permissible and that they had been blessed by Skadden and Claymore.[263] The Division repeatedly tried to emphasize that Mr. Hale was only consulted about the *permissibility* of these investments and was never asked to opine about any other legal issues such as disclosure. Again, however, the Division's assertion is belied by the facts. Indeed, Mr. Hale's own affidavit made clear that that his normal practice was not to limit his advice as narrowly as the Division would suggest: "[w]hen asked to opine on the permissibility of a particular investment by a registered fund, my normal, established practice is to . . . (ii) discuss with the client whether additional disclosure to investors regarding such investment would be necessary or appropriate."[264] During testimony, Mr. Hale confirmed that when asked whether an investment was allowed, he would make sure to discuss any risks associated with the investment as well as any potential disclosure issues.[265] It is unsurprising given Mr. Hale's normal practice that individuals at FAMCO and Claymore expected him to advise them if there were *any* legal issues relating to these investments, such as a disclosure problem.[266]

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[262] Riad Testimony at 2213:15-2214:4; *see also* Swanson at 1835:24-1837:14.
[263] *See, e.g.*, Steiner Testimony at 1272:7-23 ("Q: And they [Mr. Hill and Mr. Hale] said that these short index put options are allowed? A: Yes, that's correct. Q: And they also said the short variance swaps are allowed? A: Yes. That was a strategic transaction."); Gallagher Testimony at 1049:6-11 ("Hale or Tom Hale's stand-in [said] that these things had been looked at and they're approved."); Saxon Testimony at 2624:20-2625:23 (confirming that Mr. Hale had confirmed that the investments were permissible and that this advice was conveyed on the call).
[264] Ex. 368, Hale Affidavit (June 7, 2012) at ¶ 7.
[265] Testimony of Thomas Hale [hereinafter "Hale Testimony"] at 2900:3-2901:4.
[266] Toupin Testimony at 3002:23-3003:9 ("Q: So, based on Mr. [Hale's] typical practice, if he was answering a question about permissibility, would you have expected him to also mention any other legal issues that he thought were relevant; so, for example, if there were disclosure violations, do you believe that he would have brought it to your attention at the time? A: Mr. Hale's practice was to discuss with us those issues applicable to the fund. So, if he felt there was an issue, he would have brought it to our attention."); *id.* at 3006:9-13 ("Q: . . . if Mr. Hale believed there was some other legal or regulatory issues with respect to these investments, do you believe that he would have raised them at that time? A: I do.").

b. *Claymore Oversaw and Controlled the Fund Disclosure Process*

In addition to relying on relevant compliance and legal personnel for ongoing guidance regarding these investments, the Respondents were also heavily dependent on Claymore for assistance with respect to Fund disclosures.

The evidence is undisputed that Claymore – *not* FAMCO or either of the Respondents – was specifically tasked with the preparation of periodic filings for the Fund according to the language of the HCE Investment Advisory Agreement.[267] As this document made clear, Claymore was required to "[p]repare or oversee preparation for review and approval by officers of the trust financial information for the trust's semiannual and annual reports, proxy statements, and other communications with shareholders required or otherwise to be sent to trust shareholders."[268] Indeed, all of the relevant individuals at FAMCO and Claymore understood that Claymore was primarily responsible for preparation of HCE's SEC filings.[269]

Given its contractual mandate to oversee the Fund's filings, it is unsurprising that Claymore controlled virtually every aspect of the creation and dissemination of these reports. In providing an overview of the procedure for drafting the shareholder reports, for example, Mr. Hill demonstrated that Claymore had a hand in every step of the process: the "fund administration group [at Claymore] coordinated the book as a whole…[T]he marketing department handled the front section; meaning, the shareholder letter, the Q&A with the portfolio managers . . . [Fund Administration] coordinated kind of the fund highlights and then

[267] Ex. 237, Investment Advisory Agreement between Fiduciary/Claymore Dynamic Equity Fund and Claymore Advisors LLC (Apr. 26, 2005).
[268] *Id.*
[269] *See, e.g.*, Gallagher Testimony at 994:11-25; Swanson Testimony at 1708:1-4, 18-25; Riad Testimony at 2069:3-14; Hale Testimony at 2840:13-18 ("Q: Who was responsible for the content of that document [the annual and semi-annual reports]? A: Claymore."); Saxon Testimony at 2610:20-25 ("Q: And who was responsible for the fund periodic filings? A: It would be a combination of Steve Hill and Mark Mathiasen. Q: Okay. So, both at Claymore? A: Yes.").

the annual statements, themselves, along with footnotes . . ."[270] Significantly, the risk disclosure section was drafted and edited entirely by Claymore with no input from the Respondents.[271]

Claymore's control of the process also extended to the section of the HCE shareholder reports that are at issue in this proceeding: namely, the portfolio manager commentary section of the HCE Fund's Annual Report for 2007 and Semi-Annual Report for 2008. The portfolio manager commentary section was drafted by a consultant hired by Claymore named Patty Delony.[272] For each report, Ms. Delony would set up an interview with Mr. Swanson and participate in a phone call during which she would ask Mr. Swanson questions about Fund performance over the relevant period.[273] Significantly, the content and format of this interview was specified by Claymore. As Ms. Delony testified, she was given a "general list of things to cover" by Claymore and "Claymore dictated what information had to be in the report."[274] In addition, "Claymore prescribed that we always discuss things that helped and things that hurt."[275]

Claymore also controlled the post-interview process during which the report was written and reviewed. Following the interview, Ms. Delony used her notes from the conversation and an audio recording of the discussion to "draft the Q and A part of the report as prescribed by Claymore."[276] This draft then went through a thorough review process that was again dictated by Claymore.[277] At first, the draft was sent to Mr. Swanson for review "[b]ecause that's the process

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[270] Hill Testimony at 2735:2-13.
[271] *Id.* at 2735:12-13 ("[W]e [Claymore] would coordinate with the legal and compliance team so that the risk disclosures were put in the report."). *See also* Delony Testimony at 1551:14-23.
[272] Delony Testimony at 1537:14-17.
[273] *Id.* at 1539:18-1540:13.
[274] *Id.* at 1540:13-18. *See also id.* at 1540:19-24 ("Q: So Claymore gave you an idea of what it wanted in the question and answer section of the reports and you based your interview questions based on what you understood Claymore wanted addressed? A: Yes.").
[275] *Id.* at 1609:5-6. Mr. Hill similarly testified that it was his "understanding is that [the] Q&A would start with Claymore's marketing department . . . to determine the questions to be asked and actually that write the Q&A section." Hill Testimony at 2736:4-12.
[276] Delony Testimony at 1541:10-16.
[277] *See, e.g.*, Delony Testimony at 1626:20-22.

Claymore defined."[278] After that, the draft "was sent to many people for review"[279] including Fund Administration, marketing, legal, finance, and compliance members at Claymore.[280] These groups "would always provide input"[281] and "[i]t was not unusual for questions to be raised,"[282] at which point Ms. Delony would incorporate all of the requested changes from these groups.[283] The process also included a review of the filings by outside counsel at Skadden[284] as well as by members of the Fund Board[285] and the HCE Audit Committee. [286]

Throughout this entire review process, Claymore made sure to retain ultimate authority over the content of the filing. As Ms. Delony explained, it was "generally the practice that if Claymore wanted something to be included, it would have been included."[287] Furthermore, Ms. Delony made it a point to always accept all requested changes from Claymore.[288] Ms. Delony further supported the idea that Claymore maintained final authority over these filings when she testified that she "would take direction from Claymore" – *not* the Respondents – as to whether any substantive changes by Claymore after Mr. Swanson's certification would have to be run by the Respondents.[289]

Following these multiple layers of careful review and editing by Claymore, Skadden, and the Fund Board, the report would ultimately be filed with the SEC. Again, this process was

[278] *Id.* at 1577:20-23.
[279] *Id.* at 1541:20-21.
[280] *Id.* at 1626:23-1627:1; *see also id.* at 1543:13-1544:1.
[281] *Id.* at 1544:3-4
[282] *Id.* at 1544:19-20.
[283] Delony Testimony at 1586:19-20.
[284] Hale Testimony at 2840:7-12 ("Q: Did you review portions of any periodic reports? A: The annual and semi-annual reports, yes, I would review the – the shareholders – the MD&A – the question-and-answer with the portfolio manager.").
[285] Toupin Testimony at 2996:20-2997:2 ("Q: Did you review HCE's periodic filings to [sic] the semi-annual report, annual report, quarterly reports? A: Yes, both the semi-annual and annual reports, yes. Q: And when would you have reviewed them? A: They would be provided to us before they were sent to shareholders . . .").
[286] *Id.* at 1650:20-1651:3.
[287] Delony Testimony at 1625:3-6.
[288] *Id.* at 1587:2.
[289] *Id.* at 1666:10-15.

overseen by Mr. Hill and Fund Administration at Claymore; this group "would coordinate the reports from the perspective of ensuring that they were complete, on time and then released to print and mailed to the mailing facility."[290] The Division presented no evidence to suggest that the Respondents played any role in the actual filing of this document with the Commission.

The Respondents' reliance on Claymore for guidance regarding Fund disclosures was well-founded. Indeed, the evidence showed that Claymore focused specifically on the disclosures that lay at the heart of this proceeding.[291] On June 27, 2008, Patty Delony emailed a group of Claymore personnel regarding the HCE Semi-Annual report[292] and noted that "[i]n Q5, we say that the portfolio was 'strategically hedged for additional downside protection.' Steve [Hill] asks whether we need to describe how. We have referred to the hedging in the past without explaining how the hedge actually works. Your thoughts?"[293] In other words, Claymore legal and compliance personnel were trying to determine whether it was necessary to disclose additional information regarding the Fund's strategic hedge[294] – the very disclosure that the Division now alleges was insufficient. Mark Mathiasen, Claymore in-house counsel, responded that a definition of these strategic hedges was not necessary since he was "comfortable with the way it presently reads."[295] Jennifer Hasbrouck, Vice President of Compliance at Claymore, noted that she was "fine with Mark's proposals."[296] The Respondents were aware that Claymore's legal and compliance team reviewed the language in the periodic filings,[297] and the

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[290] Hill Testimony at 2734:3-6.
[291] *See* Ex. 362, Email from Jennifer Hasbrouck to Mark Mathiasen regarding HCE write-up (July 2, 2008).
[292] *Id.*
[293] *Id.*
[294] The "strategic hedge" was an internal FAMCO reference to the short index put and short variance swap strategy.
[295] *Id.*
[296] *Id.*
[297] *See, e.g.*, Swanson Testimony at 1763:8-25 ("Q: . . . [W]as it your understanding that after [Ms. Delony] finished interacting with you there were other people at Claymore who reviewed this information before it went into the periodic filing? A: Yes. Q: And why did you have that belief? A: Because she would have told me that after we did

fact that this team discussed and ultimately approved the description of the strategic transactions at issue serves as further evidence of the reasonableness of Respondents' actions.

c. *SEC Disclosure Requirements*

When assessing the Respondents' openness regarding these investments, it is also important to understand exactly what was required of them in terms of disclosure.[298] When such constraints are taken into account, it becomes clear that the Respondents were not negligent because they provided the appropriate information to the Board and shareholders regarding the investments at issue.

Throughout the proceeding, the Division attempted to suggest that the Respondents should have disclosed more information regarding short index put options and short variance swaps because the Board and shareholders would have found such information useful. For the Division, the disclosure issue was straightforward: "it would have been very easy for [Respondents] to describe those strategies in the periodic reports if they had cared enough to do so."[299] The Division also implied that the Respondents should have provided more fulsome disclosures because nobody "put a gun to [their] head" and mandated that they limit their description of the investments.[300]

As the evidence made clear, however, the issue is not so simple and more disclosure is *not* always required.[301] In fact, registrants have been actively discouraged by the SEC from

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our interview . . . after she created the draft, after I looked at that, after I certified it, it would go to Claymore's compliance and legal department and it would be a much longer process for them reviewing the question and answer portion than it would have been with the conversations between me and Ms. Delony . . .").

[298] For a more detailed discussion of disclosure requirements for closed end funds, *see* Respondents' Prehearing Brief at 21-25; Baris Report at 6-13.

[299] Division Closing Argument at 3562:16-18.

[300] Riad Testimony at 2470:16-18.

[301] This issue was highlighted when the Division asked Mr. Hill whether it would have been "inappropriate" for the Respondents to include additional detail regarding variance swaps. Mr. Hill struggled to provide a straightforward answer because "one of the issues that we run into is . . . the information that's being disclosed to the public . . .

providing excessive detail regarding less important investments in the portfolio[302] because the inclusion of too much detail in fund filings makes it difficult for investors to concentrate on the most important information.[303] As a result, the Respondents were only required to provide robust disclosures regarding these strategies if (1) they intended to employ them to a significant extent in order to meet the Fund's investment objectives, or (2) the investments placed more than five percent of HCE's assets at risk.[304] The record made clear that registrants are given significant discretion in assessing the relative importance of these strategies and the perceived risk because the SEC's guidance in this area is extremely vague.[305]

In essence, the SEC's own approach to disclosure has forced registrants to make extremely difficult choices when drafting fund filings. The Respondents made just such a determination with respect to their derivatives disclosures based on a careful analysis that had demonstrated the minimal risk and insignificant contribution to performance from these

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because of the easy-to-read [requirements] and providing some of the details that were in a few of these reports might have been difficult or at least in contradiction to some of the easy-to-read terms, if you will, or guidelines that we have for the prospectus[,] annual and semi-annual reports." Hill Testimony at 2788:9-19 (emphasis added).

[302] In fact, Form N-2 specifically *mandates* limited disclosure for non-principal investments. *See* Instruction c to Item 8.4. of Form N-2 ("If a policy limits a particular practice so that no more than five percent of the Registrant's net assets are at risk…limit the prospectus disclosure about such practice to that necessary to identify the practice."). *See also* Instructions to Item 8.3 of Form N-2 (disclosure relating to such non-principal investments "*should receive less emphasis* in the prospectus than that required by Item 8.2 and, if appropriate . . . *may be omitted or limited to the information necessary to identify the type of investment, policy, or practice* . . . ." (emphasis added).

[303] As Mr. Baris explained, "[t]he theory is that if you include excessive detail, complex language, legal terms, it . . . makes the document less readable and it affects the ability of the investor to understand the important disclosures." Baris Testimony at 3048:18-22. Indeed, this was precisely the problem that the Commission confronted with earlier registration statements: historically, prospectuses would often become "dumping grounds" in which registrants "would dump anything into a prospectus as an effort to protect yourself against liability. And over the years, the SEC recognized that all of that detail, that data dump was cumbersome and did not add to investor's understanding." *Id.* at 3049:15-21. Partially in response to this problem, the SEC adopted the so-called "Plain English rules" in the 1990s to "emphasize the importance of having prospectuses that are understandable and easy to read and are not cluttered with unimportant information." *Id.* at 3050:7-12. In addition to the Plain English rules, SEC staff members have also emphasized for nearly two decades that disclosure about derivative investments should not be excessively detailed. *See* Baris Report at 10-11.

[304] *See* Instruction c to Item 8.4. of Form N-2. *See also* Baris Testimony at 3053:8-12 ("if less than 5 percent of the assets of the fund are at risk, you should not include extensive disclosure of those strategies, but you should limit the disclosure to identifying the strategy or security.").

[305] Indeed, "the issue of fund risk disclosure obligations has generated considerable confusion among industry participants for many years." Baris Report at 10. *See also id.* at 13; Baris Testimony at 3056:12-14; 3058:3-4.

investments. The Division now seeks to punish the Respondents based on the fact that, in hindsight, their reasonable decision ultimately turned out to be unprofitable.

4. Respondents Had No Motive to Deceive the Board or Fund Shareholders

Unable to demonstrate that the Respondents' analysis was negligent or that the disclosures were improper, the Division concocted an elaborate narrative in an attempt to demonstrate some sort of nefarious motive that led the Respondents to deceive the Board and investors. According to the Division, the Respondents faced "intense pressure" to perform – in part due to a high dividend payout objective – and therefore took unnecessary risks with the Fund in an attempt to line their own pockets. In contrast to the Division's assertions, there was no evidence to suggest any misconduct or bad faith on the part of the Respondents.

a. *No "Pressure to Perform" at FAMCO*

Prof. Harris boldly proclaimed that Mr. Riad and Mr. Swanson faced "intense pressure to perform"[306] at FAMCO. When asked during cross-examination whether he had any basis for this claim, Mr. Harris initially attempted to back away from his assertion[307] before finally admitting that his statement was not based on any actual evidence.[308] To the contrary, *every* FAMCO employee who testified as a witness asserted that there was no such pressure on the Respondents.[309] In fact, when asked whether there was intense pressure to perform at FAMCO,

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[306] Harris Report at ¶ 176.
[307] Harris Testimony at 350:20-351:10 ("Q:...[Y]ou meant the pressure to perform at FAMCO was extremely intense; is that correct? A: ... Whether they -- whether they felt it directly or not, I couldn't speak to that.").
[308] *Id.* at 351:11-17 ("Q: Well, the way you say it now is very measured but the way you say it in the report is not measured. You say extremely intense. Do you have any evidence that the pressure to perform at FAMCO was extremely intense? A: I have no idea what the pressure to perform was at FAMCO.").
[309] When asked whether there was any pressure to put on risky investments in order to generate performance, for example, Joseph Gallagher stated that "as far as pressure to do something that flies in the face of reason and facts, there was zero...[I]t was just, you know, beyond my understanding that someone would say that there was pressure to go do something like that. I just don't buy it." Gallagher Testimony at 1239:3-22. Susan Steiner similarly noted that she "wasn't aware of any intense pressure" to perform at FAMCO. Steiner Testimony at 1248:12-18.

Mr. Hughes said that such a suggestion was "kind of laughable, actually."[310] The reason this assertion seemed so preposterous to Mr. Hughes was that the atmosphere at FAMCO was different from the prototypical financial institution: "[W]e're in the Midwest here, we're in St. Louis. It's not a very high finance society. We seem to value our families just as much as our jobs, and there wasn't any pressure at work at all."[311] Most importantly, the Respondents themselves denied that they felt any pressure to perform at FAMCO. Mr. Swanson disagreed with Prof. Harris' assertion[312] and explained that the atmosphere at FAMCO was "very collegial. It was a family environment. It was very open."[313] Mr. Riad similarly denied that Prof. Harris' statement had any validity.[314] Instead, he reiterated what all of the other witnesses had said: FAMCO had a "very open environment . . . [W]e were all friends outside of the firm. Our kids knew each other, and it was a different investment firm you have in St. Louis than you have in New York City. It was much more of a family oriented – no pressure."[315]

b. *HCE Never Faced Any Difficulty Meeting Its Dividend Objective*

Aside from a general – and unsubstantiated – assertion that there was pressure to perform at FAMCO, the Division also argued that the Respondents faced specific pressure due to HCE Fund's stated goal of meeting a certain dividend payout each quarter.[316] Again, however, the evidence demonstrated precisely the opposite: FAMCO never experienced any difficulty in meeting its dividend objective. Throughout the relevant period, the Fund always had sufficient

[310] Hughes Testimony at 729:9-10.
[311] *Id.* at 729:1-18.
[312] Swanson Testimony at 1851:24-1852:2.
[313] *Id.* at 1852:3-5.
[314] Riad Testimony at 2247:15-24.
[315] *Id.* at 2247:25-2238:9.
[316] *See* OIP at ¶13

realized gains to pay its dividend – even in the absence of these investments.[317] Furthermore, the dividend was actually reduced in July 2008 – several months *before* the losses at issue.[318] If the high dividend payout objective had, in fact, motivated the Respondents to take extreme risks, then such a reduction would surely have eliminated any such incentive. Indeed, both Mr. Riad and Mr. Swanson specifically confirmed that the dividend reduction reduced any potential pressures to generate realized gains.[319] FAMCO's Chief Compliance Officer similarly believed that the desire to make a dividend "had nothing to do" with the Fund's use of swaps or puts.[320]

c. *No Financial Incentive to Make Risky Trades*

Further evidence of the Respondents' good faith can be found in the fact that Mr. Riad invested his own money in the strategies at issue – both in HCE as well as a private investment partnership open to senior employees at FAMCO known as the Fiduciary Opportunity Fund ("FOF"). Indeed, it is undisputed that Mr. Riad lost nearly half a million dollars from his personal investments in short index puts and short variance swaps that were written in FOF.[321]

The evidence demonstrated that for nearly eighteen months, Mr. Riad oversaw trading in the FOF that paralleled HCE's investments in short index put options and short variance swaps.[322] In his Report, Prof. Spatt emphasized the importance of manager co-investment in a

[317] *See, e.g.*, Swanson Testimony at 1845:8-14 ("Q: Does this reflect the fact that even as late as August 2008 the fund was generating sufficient realized gains to pay its dividend? A: Yes. Q: And that's consistent with your recollection? A: It is.").
[318] Riad Testimony at 2238:17-22 ("Q: Did there come a time when the dividend was cut? A: Yes. Q: When was that? A: Sometime in the summer of 2008, July or August."); Swanson Testimony at 1848:4-6 ("Q: Was the dividend, in fact, cut in July 2008? A: It was. It was."); Gallagher Testimony at 1229:1-7.
[319] Riad Testimony at 2238:24-2239:4; Swanson Testimony at 1848:7-13.
[320] Gallagher Testimony at 1228:21-25. *See also id.* at 1131:1-5 ("Q: Was anyone at FAMCO particularly concerned with their ability to deliver on these dividend objectives? A: I mean, like I said, no more so than any other fund that I know of.").
[321] *See* Riad Testimony at 2587:3-14.
[322] *See* Ex. 114, Summary of variance swap and put option trades in FOF (Feb. 2007 – Sept. 2008), and Exhibits 39 and 40, Summaries of variance swap and put option trades in HCE.

similar strategy.[323] As he explained, there are two reasons why manager co-investment is so significant. First, the fact that Mr. Riad was willing to place his own money at risk demonstrates that he had a "good faith belief in the soundness of these derivatives" and "did not perceive these investments to represent an extreme risk."[324] Second, the manager co-investment served to align the interests between Mr. Riad and Fund shareholders by "encourag[ing] the asset manager to focus his research and thinking about these investments and positions;"[325] as Prof. Spatt noted, "asset managers in this type of situation would have a strong incentive to keep their 'eyes on the ball'."[326] Significantly, the Division's own expert acknowledged that a portfolio manager investing his own money in a strategy tends to align his interests with those of his shareholders[327] and Prof. Harris was forced to "concede . . . what I've spoken about before, that no question . . . that when managers are invested in – basically, when -- when the cook eats their own cooking, that's evidence of some confidence in the – the cooking."[328]

The Division nonetheless attempts to have it both ways with respect to Mr. Riad's trading in FOF. The Division refuses to give Mr. Riad any credit for the fact that he placed so much of his own money in the strategies at issue for an extended period of time and denies that this demonstrated his confidence in the derivatives trades. Instead, the Division focused on a *single* trading discrepancy between HCE and FOF[329] as evidence of the fact that Mr. Riad had an

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[323] Spatt Report at 25.
[324] *Id.*
[325] *Id.*
[326] *Id.*
[327] Harris Testimony at 352:15-21. Significantly, the fund on which Prof. Harris serves as a director considered manager co-investment to be so important that it cited such parallel investing as a "principal reason why investors should be comforted" and that they could be "sure we are committed to living up to your expectations." *Id.* at 352:22-353:6.
[328] *Id.* at 355:5-9.
[329] In addition to the variance swap trade in FOF, the Division also highlighted the fact that two short index put options were taken off in FOF in the days after Lehman failed whereas the put options were maintained in HCE through the end of October. *See* Riad Testimony at 2515:23-2516:3. The weakness of this argument is demonstrated by the fact that this trading was not even mentioned in the Order Instituting Proceedings. In addition,

improper motive. According to the Division, Mr. Riad took off the last variance swap trade in FOF before it expired, while simultaneously writing an additional variance swap trade in HCE. In reality, the evidence showed that Mr. Riad's actions during the fall of 2008 were entirely consistent with the good faith that he had exhibited throughout the life of the Fund.

As an initial matter, it is important to recognize that Mr. Riad did not remove the last variance swap trade early, as the Division initially suggested.[330] Instead, the position was held to its expiration in the middle of September.[331] Indeed, the Division was forced to note in its closing that "the variance swap closed, the Division concedes, automatically on September 19th"[332] – not as part of some nefarious scheme by Mr. Riad to protect his own investment at the expense of HCE shareholders. When this initial story was no longer plausible, the Division instead conjured a new version: in their telling, Mr. Riad *could have* placed another variance swap trade in FOF, but he chose not to because he knew that it was too risky.[333] In this telling,

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the evidence was unclear that Mr. Riad was even responsible for the removal of those trades. Indeed, Mr. Riad had no such recollection of having made the transactions at issue and speculated that the trades could have been made by Charles Walbrandt, one of the principals of FAMCO and co-portfolio manager of the Fiduciary Opportunity Fund. *See* Riad Testimony at 2516:1-16. Furthermore, it is important to emphasize that the losses from these positions were roughly $100,000 – a miniscule amount in comparison to other trades in FOF. The SEC offered no evidence as to why a minor adjustment in FOF's holdings reflected a major divergence in the fund's strategy from that of HCE.

[330] *See, e.g.*, Riad Testimony at 2514-2515 ("Q: So, when feeling this pressure not to do something, you did make a decision with regard to your own personal investments; *you decided to take off the position in FOF*, is that right? . . . "Q: If I'm reading this correctly, you put it on September 4th and you *took it off* on September 19th; is that right? A: I don't think I took it off. I think it expired. Q: I thought the expiration date was on the 20th of September.") (emphasis added); *id.* at 2546:1-4 ("someone *took the positions off* in FOF"). *See also* Harris Report at ¶297 ("[T]hey renewed their exposure when the August variance swap expired on September 19 while, at the same time, *I understand that they terminated exposure to variance swaps through a personal fund in which they and their colleagues also invested.*") (emphasis added). The Division also suggested that "by taking off its positions, FOF did better than HCE which had that additional put on." Riad Testimony at 2538:22-24. *See also* Riad Testimony at 2543:15-21 ("[t]he point, Mr. Riad, is that by taking off those derivative transactions, both you and the other partners in FOF benefited from a capping for the losses that the investors in the HCE fund ultimately endured...").

[331] *See, e.g.*, Riad Testimony at 2514-2515.

[332] Division Closing Argument at 3576:12-14.

[333] Riad Testimony at 2526:3-6 ("But that in late September the FOF fund would have had nearly $6 million had it wanted to make additional investments such as the variance swap that you put on in HCE on September 19th; isn't that right?"); *id.* at 2526:14-17 ("Isn't it likely that you had several million dollars to invest in the FOF fund, and you could have put a variance swap on had you chosen to do that?"); *id.* at 2528:5-9 ("Wouldn't you agree with me that had you wanted to go out and try to make a variance swap transaction as of September 19th, an [sic] FOF, you

the absence of a corresponding trade in FOF must therefore mean that Mr. Riad was gambling with investors' money while protecting his own account. Again, the facts ultimately failed to support the Division's newest theory. Instead, the evidence clearly demonstrated that Mr. Riad wanted to make a corresponding swap transaction in FOF[334] but was prevented from making any additional volatility trades due to legal restrictions.[335] The reason that he could not write another swap was that FOF – which "was already a small fund to begin with"[336] – "wouldn't have qualified at that small asset level to be a fund that anybody would sell you a variance swap."[337]

Mr. Riad's explanation was confirmed by the ISDA agreement that governed the FOF's ability to engage in variance swap transactions.[338] Pursuant to this agreement, the Fund was only permitted to engage in such transactions so long as the party qualified as an "'eligible contract participant' as defined in the U.S. Commodity Exchange Act (as amended)."[339] One of the key requirements to be an eligible contract participant is that the entity must have "total assets exceeding $10,000,000."[340] After the significant losses suffered by the fund in September,[341]

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had several million dollars with which you could have tried to do so?"); *id.* at 2529:2-4 ("You could have tried to do the same thing in FOF that you actually did in HCE; correct?").

[334] Riad Testimony at 2529:6-7 ("We had an intent [to make such a trade], but we couldn't do it."). Significantly, when asked directly whether he would have made another variance swap investment in FOF on September 19 if the fund had been legally able to do so – the heart of the Division's argument that he placed investors at risk while protecting himself – Mr. Riad unequivocally stated that "[y]es, we would have, and we discussed why it was a very attractive time to do, and…there would be no reason not to do it in that fund as well as HCE." *Id.* at 2247:7-14.

[335] As Mr. Riad explained during testimony, the fund had suffered significant losses – "maybe 50 percent" of its assets" (Riad Testimony at 2245:20-24) – and "at that point it could not enter another portfolio variance swap." *Id.* at 2245:25-2246:1. As an additional reason for not making the trade in FOF, Mr. Riad also noted that "at that point we were deciding whether to close the fund altogether." *Id.* at 2246:1-3.

[336] *Id.* at 2245:24-25.

[337] *Id.* at 2246:6-8.

[338] *See* Ex. 369, Confirmation Agreement between Fiduciary Opportunity Fund and Morgan Stanley & Co. International plc for a variance swap transaction (Sept. 8, 2008).

[339] *Id.* at 6.

[340] The definition of an eligible contract participant is contained in § 1a(18) of the Commodity Exchange Act, 7 U.S.C. 1, et seq. ("The term 'eligible contract participant' means acting for its own account – a corporation, partnership, proprietorship, organization, trust, or other entity that has total assets exceeding $10,000,000.).

[341] The variance swap trade alone lost $2,294,626.95. Ex. 114, Fiduciary Opportunity Fund variance swaps and put options trades (Feb. 2007 – Sept. 2008).

FOF was no longer able to meet the required $10 million threshold.[342] Even *after* the evidence had been presented that FOF was legally prevented from putting on another swap, the Division nonetheless continued to maintain its assertion that Mr. Riad could have made such a trade.[343]

The Division's criticism of the September 19 trade was not limited to the fact that there was no corresponding transaction in FOF. The government also argued that the September 19 trade in HCE was simply a reckless form of "gambling"[344] by an "out of control"[345] "rogue trader"[346] in a last-ditch attempt to recoup some of the losses that the Fund had already suffered. In contrast to these extreme assertions, the evidence demonstrated that the last variance swap trade in HCE was carefully considered and was entered based on reasonable analysis.

Prior to entering the last trade, Mr. Riad discussed the transaction with Mr. Swanson to gather his input[347] – hardly the action of an individual bent on taking wild risks. In his words, the decision to place the trade was "excruciating"[348] – again, not the description that would be normally associated with a "rogue trader." In the end, the reason that he put on the variance swap was straightforward: Mr. Riad had a carefully-considered strategy that he believed in, and it is imprudent for money managers to abandon their approach at the first sign of trouble. As he explained, FAMCO had "an investment process and an investment discipline. As investment managers, you wouldn't be in the business without that . . . That means it's not [just] we have a

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[342] By the end of the month the market value of the fund's assets had dwindled to $5,864,558.19. *See* Ex. 110, Fiduciary Opportunity Fund Portfolio Appraisal (Sept. 30, 2008), at 4. At the end of the prior month, FOF had assets of $10,388,000.26. Ex. 109, Fiduciary Opportunity Fund Portfolio Appraisal (Aug. 31, 2008), at 5.
[343] *See* Division Closing Argument at 3576:20-25 ("we think the trading and the other testimony listed in here shows that if they had really wanted to put on another investment, they thought this was a great time to trade variance swaps, they could have found a way to do it.").
[344] Harris Report at ¶ 249; Harris Testimony at 407:21; 409:17; 412:4-12.
[345] Harris Testimony at 412:6.
[346] *Id.* at 407:23.
[347] Swanson Testimony at 1791:21-24 ("Q: And did Mr. Riad discuss with you his decision to enter into that last variance swap trade on September 19th? A: Yes, he did.").
[348] Riad Testimony at 2179:20.

gut instinct to do something. It has to be rooted in some type of discipline or process."[349] As a result, Mr. Riad "fell back on what is our investment process and discipline, not only just for this product, but for everything to do with at FAMCO and everything we've learned, which is you stick to your investment discipline in good times and bad . . ."[350] Even the Division's own expert admitted that the "biggest mistake that people make is that they sell when the market drops and then they lose the opportunity to make money when it returns" and acknowledged that this statement was consistent with Mr. Riad's rationale for the last variance swap trade.[351]

The investment process alluded to by Mr. Riad had made clear on September 19 that it was a particularly opportune time to sell a variance swap because volatility was abnormally high. As noted above, a central insight behind FAMCO's analysis was that volatility is "mean-reverting."[352] Sean Hughes explained that this "means that if [volatility is] above average, it tends to move back down towards the average of 17 . . . The same thing is true if volatility was at 10, it's going to tend to move up towards its average of 17."[353] Mr. Swanson specifically recalled Mr. Riad discussing this point when explaining his rationale for entering the final trade.[354] Many academic papers and industry research reports came to the same conclusion.[355]

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[349] *Id.* at 2179:22-2180:4.
[350] *Id.* at 2180-2182.
[351] Harris Testimony at 356:2-23.
[352] All of the relevant witnesses – including the Division's own expert – agreed that volatility demonstrates this mean-reverting tendency. *See, e.g.*, Riad Testimony at 2151:23-2152:2 ("Sometimes it gets above that, sometimes it gets below that, but there is a median average of uncertainty that's placed in the market, and when it goes above, it tends to be – revert to that mean."); Hughes Testimony at 653:8; Spatt Testimony at 3250:24-3251:7 (". . .[W]hen volatility is high, while to some degree it will continue to be high, it's also likely to come down somewhat from those high levels . . .); Harris Testimony at 231:19-21 ("Volatility typically will drop eventually because it – as we've discussed before, volatility is mean reverting . . .").
[353] Hughes Testimony at 653:8-15.
[354] Swanson Testimony at 1791:25-1792:18. ("[Mr. Riad] referenced the research that had been done about being an opportunistic time to be selling variance swaps when volatility was elevated . . . His theory behind this, which I concurred with, is...the backtesting data show that when you have a large spike in volatility it's a good time to be selling variance swaps.").
[355] As Mr. Hughes testified, "numerous studies have found . . . that it's advantageous to sell volatility when it's above average. It's a very profitable strategy." Hughes Testimony at 656:10-14; 17-19. *See also id.* at 657:17-18.

The mean-reverting nature of volatility implies that the most advantageous time to sell volatility is when it is particularly elevated – as it was on September 19. A 2005 research report from Goldman Sachs, for example, stated that the "largest gains came from trades initiated right after market crises."[356] In fact, the Division's own expert admitted that "[f]rankly, I would have come to the same conclusion [as Mr. Riad], that this was a good time [in September 2008] to sell volatility" because "when you're selling volatility at a time when volatility is very high, the volatility has a tendency to drop."[357] In fact, the volatility level on September 19 was not just moderately elevated; instead, it had risen well above the historical mean.[358] The result was that "[i]t seemed like a very good time to sell it considering that it's mean reverting and it tends to go back down towards this average of 17 over time. It just seemed like a great time to do it."[359]

Two other events are also relevant in evaluating the conduct of the Respondents with respect to the last variance swap trade. In addition to their internal analysis, the rationale to enter this final position was also based on macroeconomic factors: in particular, the fact that "there was an indication that things were going to get better."[360] There was good reason for such an expectation: the U.S. government announced on the evening of September 18 that it planned to

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[356] Ex. 41, Goldman Sachs research report on variance swaps (Sept. 2005), at FAM00000801. Mr. Hughes emphasized that this insight regarding large gains following crises was a "very important page [of this report] that we focused on." Hughes Testimony at 700:5-6. Another Goldman report from the following year similarly noted that the "VIX [volatility index] is mean reverting, and the largest gains often occur in months directly following volatility spikes." Ex. 218, Goldman Sachs research report on VIX Futures (Sept. 14, 2006), at FAM52220. The same report also noted that "[m]any of the largest gains came immediately after months with the largest losses as the VIX mean reverted after a spike." *Id.* at FAM52224.
[357] Harris Testimony at 409:24-410:7.
[358] As Mr. Hughes explained, "variance had been trading around 10 for 4 or 5 years. It spiked up to 30." Hughes Testimony at 729:25-730:1. This value was "2 or 3 standard deviations above average. It's far above average." *Id.* at 783:19-20.
[359] *Id.* at 730:3-7. Even though he was not in the office when this trade was put on, *id.* at 854:15-21, Mr. Hughes nonetheless concluded later that "it was a well informed decision. There was a lot of research that went into this to support our conclusions of selling variance at 30." *Id.* at 730:13-15. In fact, Mr. Hughes even went so far as to state that he "would have made the same decision if I was in that position based on all the research at that point in time." *Id.* at 854:25-855:2.
[360] Swanson Testimony at 1792:18-20.

implement the Emergency Economic Stabilization Act of 2008 in an attempt to assist struggling financial institutions.[361] At the time, many market participants believed that this action would stabilize the market and that the worst of the financial crisis had passed – the precise mindset of Mr. Riad when he entered the trade.[362] Several days later, however, Congress unexpectedly voted down the bill, greatly increasing volatility in the marketplace.[363] A second factor that affected the final trade was the short sale ban implemented by the SEC on the afternoon of September 19 after the variance swap transaction had been entered.[364] The ban surprised Mr. Riad[365] and also created a "whole new regime of volatil[ity] – uncertainty started from that day."[366] In short, the final variance swap position was implemented at a time when the recent market chaos was expected to subside. The trade ultimately failed in large part due to two unexpected actions by the government that both served greatly to increase volatility in the marketplace. Mr. Swanson summed it up succinctly when he noted that "there was a lot of unforeseen events that happened after the variance swap."[367]

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[361] *Id.* at 1792:10-13 ("So there was all this bad news that drove up the volatility of the market and then you had an event where again the Bush Administration announcing that they were going to be proposing an Economic Stability Act.").

[362] Prof. Spatt testified that it was a "very reasonable perspective to—you know, especially in the context of the announcement of the TARP or the proposal, or I should say, the proposal of the TARP, that they thought the worst of the crisis was behind us." Spatt Testimony at 3324:6-11.

[363] As Mr. Riad recalled, "it was voted down that Congress said, no, we're not going to do it and…of course, that started another problem in the market place" and had a dramatic impact on volatility. Riad Testimony at 2185:18-2186:8.

[364] Swanson Testimony at 1793:6-10 ("There was I think late on that Friday afternoon after the variance swap was put on there was a ban on short sale that was implemented that which would increase the volatility of the market.").

[365] Riad Testimony at 2183:19-24.

[366] *Id.* at 2184:22-23. *See also* Swanson Testimony at 1793:3-12 (Q: "And after that last variance swap was entered, were there subsequent developments that caught you by surprise? A: …Later the following week there was – I believe Congress voted down the Economic Stability Act.").

[367] Swanson Testimony at 1793:16-18.

The Division also asserts that Mr. Riad refused to close out the final variance swap in HCE early because he was hoping to recover his losses before it expired.[368] In reality, the evidence demonstrated that FAMCO tried to remove the final trade but was unable to do so because the market dislocation at the time made it prohibitively expensive to take off the position. Indeed, both Mr. Riad and Mr. Swanson confirmed that FAMCO attempted to exit the position but could not remove the trade.[369] Although Prof. Harris speculated that the trade could have been removed,[370] Mr. Harris acknowledged that he was not actually trading index puts or variance swaps during September or October 2008[371] and therefore had no basis for such an assertion. He did, however, admit that there was "no question" that the market was disrupted during that period.[372] Significantly, when asked whether he had any evidence to contradict the Respondents' assertion that they had difficulty finding counterparties at that time, he was forced to concede that "I don't have that evidence."[373]

With all of the emphasis on Mr. Riad's investments in FOF, it is also important to remember that *Mr. Riad[374] and Mr. Hughes[375] had personal investments in the HCE Fund* – a

[368] Harris Report at ¶ 247 ("Riad and Swanson undoubtedly hoped that they would obtain extreme profits which would offset their previous losses."); *id.* at ¶ 249 ("They undoubtedly hoped that HCE would may [sic] substantial profits from these contracts that would have allowed them to cover the losses from the August 15, 2008 contract.").

[369] As Mr. Riad explained, "[w]e did contemplate [taking off the position], and we discussed it internally, and we called Wall Street, which was in complete disarray, and we asked for pricing on these types of securities, okay, where is it right now, what are the levels right now, and everything was all over the place, and I don't even think there were real prices at that point they were quoting, I think they were just making numbers up, and it was a very chaotic non-transparent market at that point in time." Riad Testimony at 2186:21-2187:6. *See also id.* at 2187:8-10. When asked whether Prof. Harris was incorrect that they did not try to exit the last variance swap, Mr. Swanson responded that "[h]e is incorrect. I mean, we called the counterparties directly and asked if we could get out of this and they said, 'It is going to be prohibitively expensive to do that. Implied volatility is showing at an infinite level.' That is the exact words that one of the brokers said." Swanson Testimony at 1794:21-1795:5.

[370] Harris Report at ¶297; ¶312. Prof. Harris asserted that the Respondents "had the ability to remove the positions and cut losses at any point, but they continued to ride their losses throughout October." *Id.*

[371] Harris Testimony at 2-5.

[372] *Id.* at 360:6-9.

[373] *Id.* at 360:10-16.

[374] Riad Testimony at 2587:17-19 ("Q:...[Y]ou were also a shareholder in the HCE fund, weren't you? A: I was.").

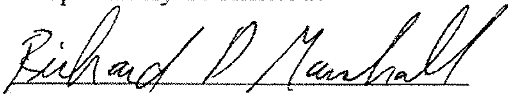
fact that was ignored entirely by the Division. As a result, the September 19 trade that Mr. Riad placed in HCE *did*, in fact, place his own money at risk.[376] This co-investment serves as further evidence of the good faith belief that Mr. Riad had in that final trade.

IV. CONCLUSION

For all the foregoing reasons, Respondents Mohammed Riad and Timothy Swanson respectfully request that this Court dismiss the Commission's Order Instituting Proceedings and deny the Commission the relief sought therein.

Dated: July 2, 2013

Respectfully submitted:



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[375] Hughes Testimony at 725:17-19 ("Q: Did you make an investment yourself in the HCE Fund? A: I did."). In fact, Mr. Hughes was so confident in HCE's strategy that he invested his money in the Fund despite the fact that he "had $80,000 of student loans, so I had a negative net worth, basically, at that point in time." *Id.* at 726:4-6.
[376] Riad Testimony at 2587:25-2588:3 ("Q: So, as a shareholder in the HCE fund, you also suffered personal losses from that investment directly of the fund; correct? A: Yes, I would have.").