UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

RECEIVED
JUL 29 2013
OFFICE OF THE SECRETARY

ADMINISTRATIVE PROCEEDING
File No. 3-15141

In the Matter of

MOHAMMED RIAD
AND KEVIN TIMOTHY
SWANSON

Respondents.

REPLY TO THE DIVISION OF ENFORCEMENT'S POST-HEARING BRIEF

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

I. PRELIMINARY STATEMENT

In 2008, the HCE Fund lost $45 million from certain derivatives investments. For nearly four years, the SEC Staff ("Division") investigated the conduct that led to this loss. The Division reviewed thousands of documents and interviewed dozens of witnesses. After settling proceedings with the Fund adviser and sub-adviser, the Division commenced an action against the Respondents to determine whether Mr. Riad or Mr. Swanson deceived any relevant parties. After all of this effort, the Division remains unable to overcome the most significant flaw in its case:

This is a fraud lawsuit without any victims in which the Respondents lacked scienter.

The HCE Board of Trustees that was allegedly duped by the Respondents declined to bring a claim against Mr. Riad and Mr. Swanson after carefully considering the issue and discussing with Fund counsel. The HCE shareholders who were purportedly defrauded did not complain in the immediate aftermath of the losses; even after the SEC created a fund as part of the Claymore settlement to compensate investors, only a small percentage of shareholders ultimately signed up to participate.[1] The Fund adviser that was supposedly kept in the dark regarding Respondents' activities agreed to a $45 million settlement with the Commission but has not sought to place any blame on the Respondents; to the contrary, Claymore consistently argued throughout the investigation that Mr. Riad and Mr. Swanson had acted appropriately.

The reason that none of these parties feel victimized by the Respondents is obvious: the Fund Board, Claymore, and HCE shareholders all recognize that the Respondents made a good faith investment decision that was simply overwhelmed by the unprecedented financial events that occurred in the fall of 2008, and these parties also know that they were not misled by the

[1] This evidence has recently come to the attention of Respondents' counsel based on a conversation between Susan Steiner and Bruce Saxon. Mr. Saxon conveyed this information regarding the distribution plan during that discussion.

Respondents because the strategies at issue were fully disclosed. The evidence presented at trial overwhelmingly supported these conclusions.

Moreover, the evidence makes clear that the Respondents lacked the requisite scienter to have committed any of the alleged violations. Not only is the Division unable to demonstrate any recklessness or bad intent on the part of the Respondents, it cannot even show negligence by Mr. Riad or Mr. Swanson. The Respondents acted with due care when implementing the strategies at issue; they were open with Claymore, the Fund Board and HCE shareholders; they had no conflicts of interest; and they reasonably relied upon expert counsel to ensure compliance with all applicable legal requirements.

II. ARGUMENT

a. The Respondents Acted with Due Care

The central issue in this proceeding is the reasonableness of the Respondents' analysis of the investments at issue. Indeed, four days of testimony were devoted almost entirely to this topic.[2] When the Respondents' analysis is examined in light of the entire evidence, however, the reasonableness of their approach becomes apparent.

The evidence at trial was uncontested that the Respondents carefully researched and analyzed the strategies at issue for years before utilizing short index put options and short variance swaps in the portfolio.[3] It was undisputed that the Respondents performed a Value-at-Risk ("VAR") analysis to evaluate these investments[4] – the leading industry approach for measuring risk.[5] In addition, the Respondents took additional steps to limit the risk of these

---

[2] The testimony of Professor Larry Harris, Sean Hughes, Mo Riad, and Professor Chester Spatt all focused in detail on the analytics that underlay the Fund's investment in HCE.

[3] *See* Respondents' Post-Hearing Brief at 8-12.

[4] The Division's own expert acknowledged that "FAMCO's method is a variant of the well-known value-at-risk method." Ex. 139, Expert Report of Lawrence Harris at 78.

[5] *See* Respondents' Post-Hearing Brief at 18, note 93.

investments.[6] The conclusion from this analysis was that short index put options and variance swaps would generate modest profits over time.[7] Although the Respondents recognized that the strategies were subject to occasional losses – as are all investments – their research further demonstrated that such risks were extremely remote.[8] These findings were confirmed by numerous academic and industry research reports that confirmed their findings.[9] Most significantly, FAMCO's analysis was validated by a former Chief Economist of the Commission, Professor Chester Spatt.[10]

Rather than confront this overwhelming evidence in support of the good faith with which the Respondents performed their analysis, the Division simply pretends that it does not exist. Prof. Spatt's testimony and Expert Report are *not even mentioned* in the Division's discussion of the investments at issue.[11] By contrast, the Division offers Prof. Harris' testimony and Expert Report as if they represent the unchallenged truth despite the fact that most of his assertions fell apart upon close scrutiny.[12] The Division offered only a passing mention of the analyses performed by Sean Hughes and his testimony on the investments at issue.[13] The Division had virtually no discussion of the Respondents' testimony regarding short index puts and short variance swaps. Incredibly, the Division does not even reference the VAR analysis performed by the Respondents – the primary basis for their belief that these were low-risk investments – nor

---

[6] *See* discussion in Respondent's Post-Hearing Brief at III(1)(c)(2). This analysis determined that the likelihood of a five percent loss from these investments was roughly half a percent – an extremely unlikely occurrence. Riad Testimony at 2171:10-2172:25; Hughes Testimony at 773:22-774:1.
[7] Swanson Testimony at 1755:15-20.
[8] *Id.*
[9] *See* Respondent's Post-Hearing Brief at III(1)(b)(2).
[10] *See* Spatt Report at 26 ("[i]n my judgment, the managers attempted to engage in a reasonably sophisticated and intricate analysis."); *see also* Spatt Testimony at 3244:19-22; Spatt Report at 6.
[11] *See* Division of Enforcement's Post-Hearing Brief [hereinafter "Division's Brief"] at 7-19.
[12] It is striking that Prof. Spatt is mentioned only three times in the Division's entire Brief, and all three references are in the context of the market for put options and variance swaps in the fall of 2008. In contrast, the Respondents provided a detailed critique of Prof. Harris, as evidenced by the fact that he was cited 65 times in their Brief.
[13] Division's Brief at 11 and note 10.

does it address their risk-limiting strategies.[14] Instead, the Division selects a handful of emails and other documents[15] that – when stripped of all context and viewed in the least favorable light possible – could conceivably support their case.

As one example, the Division boldly proclaims that Messrs. Riad and Swanson were aware that index put options and variance swaps exposed HCE to significant risk.[16] According to their Brief, "[a]ll of the research materials reviewed by Riad and Hughes . . . warned of the exposure to significant losses in turbulent markets."[17] Given the extreme claim that *all* of their research warned of these extreme risks, it is telling that the Division does not actually examine the vast majority of research materials discussed at trial but instead focuses on brief excerpts from *two* reports.[18] The weakness of the Division's argument is clear from the fact that even this cherry-picked sample does not support their claims.

---

[14] Instead of focusing on the VAR analysis – the primary risk evaluation performed by the Respondents – the Division concentrates its attention on Prof. Harris' analysis of "delta exposure" and emphasizes that this approach demonstrated the significant risk from the investments at issue. *See* Division's Brief at 21. The Division fails to mention that multiple witnesses discredited the delta analysis as an inadequate measure of the true risk of an investment. *See, e.g.*, Spatt Report at 18-20 (arguing that the delta analysis "does not reflect an appropriate quantification of the amount that is reasonably at risk"); Spatt Testimony at 3288-3300 (noting that Division was "misleading" to "suggest[] that the delta was the amount of risk"); Hughes Testimony at 764-775 (noting that delta is "a rough estimate. It's not as accurate as [FAMCO's analysis]."); Riad Testimony at 2218-2222; Swanson Testimony at 1775-1787. Significantly, these witnesses all pointed to VAR as the leading method for evaluating risk, *see, e.g.*, Spatt Report at 17-18; Riad Testimony at 2221, an assertion that was supported by leading academics and practitioners. *See* Spatt Report at 16-18; Spatt Testimony at 3504-3505; Harris Testimony at 464-466.

[15] As one example of their misleading approach, the Division cites several instant messages between Mr. Riad and Mr. Swanson in an attempt to demonstrate that the Respondents were aware of the risks from these investments but chose not to disclose the dangers. *See* Division's Brief at 19. Notwithstanding the fact that the Division selected only a handful of lines from a document that spanned almost two years and represented thousands of lines of text, *see* Ex. 99, the messages actually demonstrate a diligent risk management process that the Respondents followed with respect to *every* investment in the HCE portfolio on a frequent basis. In short, the Division attempts to transform a run-of-the-mill conversation regarding investments in the portfolio into a critical – and allegedly nefarious – discussion between the Respondents.

[16] Division's Brief at 11.

[17] *Id.*

[18] *Id.* at 11-12. The Division adopted a similarly misleading approach during its cross-examination of Bruce Saxon. The Division highlighted the same excerpt from one of the two reports cited in its Brief in an attempt to suggest that FAMCO's own research had identified the risk of these investments. Saxon Testimony at 2671:18-2673:19. Indeed, this single document appears to have been so significant that Mr. Saxon recanted the entire Wells Submission that he had submitted a year earlier. *Id.* at 2643-2645; 2677-2678. In its attempt to convince Mr. Saxon that he had been misled, however, the Division made a conscious decision *not* to show Mr. Saxon the vast majority of FAMCO's research. *Id.* at 2679:7-12 ("Q: So, have you looked at other research reports regarding variance

The first article relied upon by the Division serves as an example of their misleading treatment.[19] The Division quotes this paper for the proposition that "[t]here is no arguing that selling naked puts could be very risky" and that "put sellers may occasionally incur huge losses."[20] However, these statements relate to writing *at-the-money* put options, rather than the *deep-out-of-the-money* positions employed by HCE – a far less risky approach.[21] More importantly, the article concluded that the potential risk from these strategies was limited due to the systematic overpricing of puts.[22] In other words, the article cited by the Division as evidence that selling index puts is extremely risky instead demonstrated precisely the opposite.

The Division's discussion of FAMCO's internal analysis is equally deceptive. For example, the Division asserts that "FAMCO's backtesting and investment research also revealed that the market was subject to major volatility spikes and sudden declines"[23] and also that "[p]ut-writing historically enjoyed steady gains, but suffered sudden, significant losses in tumultuous markets, as much as 25% over one- and two-month periods."[24] The Division leaves out perhaps the most important feature of FAMCO's backtesting and investment research: namely, the *frequency* with which such volatility spikes and stock market declines occur. Indeed, the potential for a 25% decline is rendered virtually meaningless when one considers the fact that such steep losses had occurred only *twice over the previous 80 years* – a frequency of 0.21%.[25]

---

swaps, for example, or look[ed] at maybe some of the reports that the Respondents relied on in coming up with their analysis? A: No, I have not."). The reason that the Division was hesitant to provide Mr. Saxon with a complete set of their research materials was likely due to the fact that he would have reached the same conclusion as the Respondents regarding the minimal risk of these positions.

[19] Ex. 214 at FAM00149060.

[20] Division's Brief at 12.

[21] Ex. 214 at FAM00149060. *See also* Ex. 139 at 121.

[22] Indeed, the paragraph just before the Division's quote stated that "[f]or ATM [at-the-money] puts" – again, much riskier investments than what HCE actually employed -- "to break even . . . crashes of the magnitude experienced in October 1987 would have to occur 1.3 times per year." Ex. 214 at FAM00149060.

[23] Division's Brief at 12.

[24] *Id.*

[25] Ex. 204 at FAM00001120.

In essence, the Division is holding the Respondents to a standard whereby the mere possibility of any significant loss – no matter how extremely remote – is treated as a virtual certainty.

The Division also disputes the fact that the Respondents reasonably believed the strategic transactions would represent moderate positive contributors to performance over time.[26] But in order to demonstrate the importance of these positions, the Division was forced to misrepresent the Respondents' research and distort the contribution to performance of the derivatives at issue.

The Division claims that "FAMCO's backtesting allowed Riad to conclude that consistently selling variance swaps from January 1997 to March 2008 would have increased annual returns by hundreds of basis points."[27] However, the Division fails to mention that this backtesting analyzed a strategy of writing variance swaps *every day of the year* – a far cry from the actual strategy implemented in HCE.[28] Although a daily strategy might have been able to boost returns by "hundreds of basis point," the Respondents did not expect to earn nearly as much with the approach that was employed in the Fund. For short index put options, the Division notes that "Riad and Swanson expected their written put options to expire in-the-money only 4.7% of the time, so they expected to keep nearly all of the premiums they collected as substantial gains to HCE."[29] In truth, they expected nothing of the sort. Instead, the Respondents recognized that frequent small gains would occasionally be offset by moderate losses[30] but that, on average, the strategies would generate modest gains.[31]

---

[26] Specifically, the Division asserts that "FAMCO expected HCE's written put options and short variance swaps to be significant contributors to performance." Division's Brief at 10.
[27] *Id.* The Division cites three internal FAMCO analyses in support of this point; in reality, all three of these documents show the same analysis. *See* Ex. 119, Ex. 83 at 65183, and Ex. 231 at 61687.
[28] As the trading history demonstrated, HCE engaged in opportunistic sales of variance swaps on a *monthly* basis. *See* Ex. 139 at 123. In roughly 14 months, HCE only wrote eight variance swaps, further demonstrating the absurdity of using a daily analysis to evaluate HCE's trading.
[29] Division's Brief at 10.
[30] *See* Riad Testimony at 2164:21-2165:3
[31] *See* Swanson Testimony at 1755:15-20 ("these were low risk instruments that were not really expected to be large contributors to performance . . .").

The Division is particularly misleading in its attempt to establish the importance of the short index put options and short variance swaps to HCE's returns in 2007 and 2008. The Division claims that the "put option and variance swap strategies were a significant contributor to HCE's performance, and helped the Fund achieve its investment objective."[32] In support of this point, the Division asserts that "HCE's S&P 500 put and call options added 5.6% to HCE's return and accounted for 46.2% of HCE's NAV growth" for 2007.[33] The Division makes a similar claim in the 2008 semi-annual report[34] and the Order Instituting Proceedings.[35]

With all of the various figures and strategies listed, it is important not to be deceived by the Division's tactics. Put simply, the Division attempts to conceal the insignificance of the derivatives at issue by packaging their performance numbers with figures from completely unrelated investments in order to make the contribution of short index puts and short variance swaps seem larger.[36] The 5.6% figure cited for the 2007 fiscal year, for example, does not represent the contribution to performance of just the written index put options or short variance swaps. Instead, it includes *three other derivatives that are entirely unrelated to the strategies at issue*: long put options as well as short and long call options. Even worse, this figure also

---

[32] Division's Brief at 10.

[33] *Id.* at 30.

[34] *Id.* at 34-35. ("[i]n total, HCE's S&P 500 options and variance swaps contributed 2.2% to HCE's return, which accounted for 45% of HCE's outperformance over the S&P 500 . . .").

[35] OIP at ¶ 29. ("HCE's written put options, long put options, and written S&P 500 call options contributed approximately 2.0%, 1.7%, and 1.7% respectively to HCE's NAV growth [for 2007]; these strategies accounted for more than 40% of the Fund's NAV growth for the period, and nearly all of HCE's excess return above the S&P. . .").

[36] The Division employs the same misleading approach in its criticism of Mr. Swanson's statement that the derivatives investments allowed HCE to "do more with less." *See* Division's Brief at 10; Ex. 66. Mr. Swanson's assertion was merely an innocuous description of derivatives in general: since options do not require the same large outlay of capital as equities, they made it possible for the Fund to achieve profits without committing a significant amount of Fund assets. Indeed, the same ability to achieve "more with less" was one of the attractive features of the Fund's call-on-call strategy employed by the Fund. However, the evidence made clear that Mr. Swanson's statement was in reference to *all* of the HCE's derivatives investments – including long index put options and long variance swaps, as well as index call options. *See* Swanson Testimony at 1955:2-10. As a result, it is disingenuous for the Division to construe Mr. Swanson's entirely generic description of the Fund's *entire* derivatives strategy as a seemingly improper statement about *solely* the short index puts and short variance swaps.

includes the call-on-call strategy employed by the Fund[37] – a strategy that was fully disclosed in HCE's Prospectus, discussed in the periodic filings, and also not at issue in the proceeding. In reality, the combined performance for the short index puts and short swaps was only 1.6%[38] as compared to the total portfolio return of nearly 13%.[39] The figures cited for the 2008 semi-annual report are even more deceptive: they include not only the long put options, short call options, and long call options, but they also include *long* variance swaps in determining the total return figure.[40] It is exceedingly disingenuous to suggest that the Respondents hid the strong performance of risky investments by highlighting the profits generated by positions that the Division acknowledges were entirely safe.[41]

In the end, an evaluation of the Respondents' scienter must be based primarily on the analysis that served as the basis for their decision-making. In order to accept the Division's argument and conclude that the Respondents were reckless or negligent, the Court must therefore find that the analysis performed by Sean Hughes was unreliable and his testimony was implausible. The Court must determine that Prof. Harris was more credible than Prof. Spatt. The Court must ignore the numerous academic articles relied on by the Respondents and concentrate instead on the two brief excerpts cited by the Division. Most importantly, the Court must conclude that the Respondents essentially fabricated their testimony regarding these investments.

---

[37] *See* Ex. 139 at note 33 ("HCE had some SPY call on covered call positions that I counted in these calculations but which the SEC excluded from its calculations in paragraph 29 of the OIP.").

[38] According to the Division's own figures, the short index put options contributed 2.0% and the variance swaps generated a loss of -0.4% for the period. *See* Division's Brief at 29-31.

[39] Ex. 14 at 15492 ("On an NAV basis, the return was 12.87%.").

[40] Division's Brief at 34-35.

[41] According to the Division's own expert, the long put options, long variance swaps, and written call options all protect the portfolio in a down market. *See, e.g.*, Ex. 139 at ¶ 87 (describing a long put position as a hedge); *id.* at ¶ 106 (describing a long variance swap position as a hedge); *id.* at ¶ 126 (describing long put options as "protection"); *id.* at ¶ 141 ("Short call positions and long put positions have negative delta equivalent index risks. When added to a long equity portfolio, they decrease its risk exposure.").

b. Respondents Were Open with All Relevant Parties and Reasonably Believed that the Investments Were Approved by Legal and Compliance

The Division repeatedly argues that the Respondents misled people and concealed the investments at issue from various parties. In order to reach this conclusion, the Division ignores key evidence and creates a distorted impression of the Respondents' communications with the Board, Claymore and HCE shareholders.

i. It Was Reasonable for Respondents to Believe that the Board Understood the Fund's Derivatives Strategy and Approved of Its Use

The Division asserts that the Respondents misled the HCE Board regarding the Fund's investments in short index put options and short variance swaps. In evaluating this claim, it is important to first recognize what facts are not in dispute regarding the Respondents' alleged concealment from the Board.

1. HCE Board Consisted of Experienced Investment Professionals who Were Given Detailed Information Regarding the Investments

First, it is undisputed that the Board consisted of extremely sophisticated investment professionals, many of whom had extensive experience with derivatives investments -- including the specific instruments at issue in this proceeding.[42] Second, there is no question that Respondents discussed short index put options and short variance swaps at Board meetings.[43] Third, it is undisputed that the experienced investment professionals on the Board were provided with a list of portfolio holdings every quarter that identified both short index put options and

[42] *See, e.g.*, Gallagher Testimony at 988:21-989:7; Riad Testimony at 2079-2082; Swanson Testimony at 1816:3-9. Indeed, Mr. Riad even discussed the put-writing strategy at quarterly meetings with one of the Board members, *see* Riad Testimony at 2080:14-2082:4; Steiner Testimony at 1278:8-19; Gallagher Testimony at 1013:19-1014:2, who acknowledged that he engaged in such trading in his own portfolio. Barnes Testimony at 2967:14-22 ("Q: And is it – it's fair to say, is it not, that you have invested in naked put positions in your own personal trading? A: Yes."); *id.* at 2969:14-22 ("Q: And is it fair to say that on occasion at those board meetings you would talk with Mr. Riad about your own personal investments? . . . A: Yes. . . .Q: Okay. Is it possible that those discussions included a discussion of short puts? A: Yes.").

[43] Toupin Testimony at 2992:12-17; Barnes Testimony at 2918:18-21 and 2922:6-9; Gallagher Testimony at 1013:19-1014:2. *See also* Ex. 190 at CLAY028200. Additionally, the Board was given a "Portfolio Manager Commentary" prior to every quarterly meeting that discussed the transactions at issue; the Respondents then elaborated on these written materials during their oral presentations. *See* Respondents' Post-Hearing Brief at 36-37.

short variance swaps.[44] As if that were not enough to bring these strategies to the Board's attention, the Respondents sent a formal proposal to the Board in 2008 requesting leverage *for the specific purpose of writing index put options and variance swaps*.[45] In short, there were multiple opportunities over the course of several years for Board members to raise any issues or request clarification regarding these investments.[46] Taken in the context of these communications, it was entirely reasonable for the Respondents to believe that the Board knew about the Fund's investment in these derivatives and approved of their use.[47]

2. Disclosures to the Board Were Not Misleading

It is not just that the Division ignores entirely this important background regarding the Respondents' communications with the Board. More than that, the Division affirmatively misrepresents the record regarding these discussions. For example, the Division claims that the Respondents misled the Board by describing their use of short index puts and short variance swaps as "opportunistic" and that they "never indicated that they were using these products on a consistent basis as part of a consistent strategy."[48] In fact, the Board members stated *precisely*

---

[44] *See* Barnes Testimony at 2960:15-23. In fact, the variance swap investment was specifically highlighted for the Board in a cover sheet that accompanied the annual and semi-annual reports. *See, e.g.*, Ex. 284 at CLAY010006 ("Note 2(d) Variance Swaps provides details of the new investment types.").

[45] The notes from the January 2008 Board meeting indicate that Mr. Riad proposed "using short term leverage to write puts." Ex. 188 at CLAY030752. The July 2008 Board meeting noted that "Mr. Riad proposed using leverage opportunistically to buy equities and then sell volatility protection on those equities . . ." Ex. 191 at CLAY030774.

[46] The evidence made clear that Board members were extremely active participants during the Respondents' presentations. *See, e.g.*, Gallagher Testimony at 1016 (stating that the Board asked a "lot of questions. A lot of, you know, follow-up. Very specific. Every board meeting we had a big portion of that board meeting was answering questions. . ."). It was in part the lack of any questions or comments about the derivatives from attending Board members that led the Respondents to believe that the Board understood and accepted the transactions at issue.

[47] Although this point was already noted in the Respondents' Post-Hearing Brief, it is important to emphasize again that certain Board members simply chose not to review the relevant section of the Fund's periodic filings where the short index put options and short variance swaps were listed. *See* Barnes Testimony at 2960:15-2963:20. The Fund's outside counsel at Skadden emphasized in a memorandum to the Board in late 2008 that the "SEC has taken several opportunities to highlight the role that a fund's board of directors and management must take in supervising a fund's use of derivatives." Ex. 264 at 7. In particular, the Commission "urged fund boards to exercise meaning[ful] oversight of fund derivative investments by becoming more involved in portfolio strategies [and] risk management disclosure . . ." *Id.* The Respondents should not be held liable for the fact that the Board failed to exercise the "meaningful oversight" required by the Commission.

[48] Division's Brief at 20.

the opposite of what the Division claimed: namely, that they were aware that the investments were being employed as a part of a more regular strategy rather than merely a one-time transaction.[49] The Division also claimed that the Respondents "did not disclose [the derivatives'] significance to HCE's performance. To the contrary, they conveyed to the Board that the put options and variance swaps were only a small component of HCE's overall strategy."[50] Again, the evidence directly contradicted this assertion.[51]

As a related point, the Division is highly misleading in its suggestion that Mr. Riad and Mr. Swanson somehow created the impression that the strong Fund performance was due entirely to the fact that they were "superior stock pickers and managed the covered call strategy with skill."[52] In fact, the evidence showed that the Respondents specifically broke out the contribution to performance from their equities and long call purchases – in essence, their "stock-picking ability" – in multiple written and oral communications with the Board.[53] These discussions made crystal clear that the Fund's outperformance was not due entirely to their

[49] Barnes Testimony at 2920:7-10 ("Q: Did he [Mr. Riad] ever describe these variance swaps as a regular strategy he was using in the funds? A: Yes."); *id.* at 2921:10-16 ("Q: Did he [Mr. Riad] ever go into detail as to a plan of how he was going to use them [variance swaps] as far as whether he would use them opportunistically at certain times or that he would use them, you know, consistently or regularly? A: My understanding was that they would use them regularly."). Bruce Saxon, Chief Compliance Officer of the Fund, attended Board meetings and also recognized that the puts and swaps were part of a "broader strategy." Saxon Testimony at 2628:10-12. When asked specifically whether they were part of a one-time transaction or were being used on an ongoing basis, Mr. Saxon said that "[i]t appeared that they were being used on an ongoing basis." *Id.* at 2629:14-19.

[50] Division's Brief at 19.

[51] Toupin Testimony at 2924:5-14; Gallagher Testimony at 1013:10-16.

[52] Division's Brief at 22. This deception was allegedly caused by the fact that the Respondents "never disclosed to the Board just how profitable [the index put and variance swap] strategies were." *Id.*

[53] In fact, **every** quarterly communication to the Board broke out the equity and long-call performance of the portfolio. In the written materials provided to the Board for the October 2007 Board meeting, for example, the Respondents specifically emphasized the fact that "[u]nderlying performance for the Fund's *equities and long-calls* was 3.3% gross of fees for the quarter ending September 30, 2007 and 11.2% for the trailing 12-month period ending September. In comparison, the S&P 500 Index increased 2.0% for the quarter and 16.4% for the 12-months ending September 30, 2007." Ex. 79. The same document then noted that the "Fund's option-overlay and hedging strategies" – in other words, the derivatives investments – "helped to add increment [sic] returns to overall portfolio performance. . ." *Id.* The same breakdown of performance for equities and long calls, as well as an emphasis on the beneficial impact of the derivatives investments, was repeated in every subsequent portfolio manager's discussion as well as FAMCO's memorandum to accompany its 15(c) contract review. *See* Ex. 6 at CLAY10329; Ex. 76 at FAM00038044-45; Ex. 89 at FAM00102411; Ex. 186 at CLAY008091.

"superior stock-picking," as the Division claims.[54] In sum, the Respondents did precisely what the Division alleges they failed to do in terms of their communications with the Board.

The Division also asserts that the Respondents misled the Board by claiming that the short index put options and short variance swaps represented "conservative high yielding strategies" and also that they served as a "hedge" that "mitigated downside risks."[55] Such a claim is mistaken for two reasons: first, the Respondents reasonably believed based on careful analysis that the investments did, in fact, serve to provide downward protection. More importantly, this description of the investments as a hedge was based in large part on the fact that these investments had been performing exactly as the Respondents claimed.

As Mr. Riad explained at trial, there were two reasons that FAMCO saw these positions as protective instruments. First, FAMCO's research showed that the variance swaps generated profits during steep market declines.[56] The takeaway for Mr. Riad from this research was straightforward: "if something is going down and another strategy adds, I take that to mean that that's working. It's – it's hedging.[57] Similarly, FAMCO's internal analyses demonstrated that by writing short index puts far out-of-the-money, the strategy would generate profits even in

---

[54] It is significant to note that the Division did not offer a single document as evidence that the Respondents touted themselves as "superior stock-pickers."

[55] *See generally* Division's Brief at 19-20. In the portion of the Brief in which it criticizes the Respondents' description of these investments, the Division disparages the fact that "Swanson has even described writing covered calls as selling volatility." *Id.* at 24. Such an assertion is entirely misleading and appears to be premised on the Division's misunderstanding of options. When volatility is elevated, call options generate more premium when they are written; as a result, in industry parlance the act of selling call options is often categorized as "selling volatility" – precisely the way that Mr. Swanson described it. The Division's misunderstanding of options is also evident from the fact that they attempt to conflate Mr. Swanson's reference to the "hedge-ratio" – which is used to describe the percentage of the equities that were covered with call options – with the short index put and short variance swap strategies. *See* Division's Brief at 21.

[56] Riad Testimony at 2200:18-22 ("so, we see that in dramatic times they actually went the other way, so the short variance strategy gave you something while you were losing money with stocks."). *See also id.* at 2199:19-22. The result was that "if you owned the stock market back in 2000, 2001, 2002, your portfolio would have been going down. If you had a short variance strategy embedded in it, it would actually offset some of that decline . . ." *Id.* at 2199:23-2200:3.

[57] *Id.* at 2200:4-12.

declining markets.[58] To be sure, the short puts and short variance swaps were occasionally subject to moderate losses, but the repeated gains from these strategies more than outweighed these declines and helped stabilize Fund performance even in difficult markets.[59] In other words, these strategies served as "a means of protection or defense (as against financial loss)."[60]

In attempting to discredit the idea that short index put options could serve as a hedge, the Division simply asserts that such positions tend to lose money when the stock market declines.[61] Such a claim ignores the key risk-limiting feature that FAMCO implemented for these positions by writing index puts so far out-of-the-money.[62] Indeed, this proposition that short index puts could provide downside protection was borne out repeatedly before the financial crisis. Prior to July 2008 – the date when the 2008 semi-annual report was released – the HCE Fund entered into ten short index put transactions that were held during a period when the market declined.[63] *Every single one of these short index put options made money for the Fund.*[64] In addition, a variance swap closed in July 2008 was held during a period in which the stock market declined nearly 7.5% but the trade generated more than $400,000 in profit for the Fund.[65] In short, these

---

[58] *See id.* at 2170:17-21.
[59] Ex. 231. As Mr. Riad explained, "[t]he other aspect of hedging that may not be as intuitive, especially with these difficult instruments, but it was illustrated really well with that chart [of variance swap performance], is that the short sale strategy kind of followed this kind of line where the stock market is going up and down, up and down, up and down . . . the short variance strategy kind of just meandered, took a couple of bumps and then just kind of meandered up." Riad Testimony at 2200:23-2201:7. Mr. Hughes colorfully described the same chart as "kind of like climbing a mountain," with the key point being that the "losses do not wipe out the gains. It's anything but that." Hughes Testimony at 645:18-646:8.
[60] Division's Brief at note 12.
[61] *Id.* at 12.
[62] As Mr. Riad explained, "it's, again, counterintuitive for most people when they say you're selling a put -- and this was brought up, I guess, I think, incorrectly with expert testimony that if you sell a short put . . . and the market goes down, and you're going to have a negative return, and what [FAMCO's research] demonstrates if -- *if you take the risk control and you . . . sell it far away from the market, that's not necessarily the case . . .*" Riad Testimony at 2202:24-2203:11 (emphasis added).
[63] *See* Ex. 139 at 121 (listing of short index puts trades) and Exs. 144 and 145 (showing stock returns in the S&P 500 and SPY).
[64] *Id.* In one case, the market decreased by more than five percent during the month when the short index put option was outstanding, while in another instance the market declined nearly 4.5%. Riad Testimony at 2205:3-15.
[65] Ex. 86 at FAM00089833; Ex. 144.

investments provided precisely the type of downside protection in adverse market conditions that Mr. Riad had claimed in his discussions with the HCE Board.

The idea that these strategies could serve as financial protection was also confirmed by the research that FAMCO reviewed. A 2007 Goldman Sachs research report, for example, emphasized that the high risk premium generated by the systematic overpricing of risk "leads to outperformance [of put- and volatility-selling strategies] in hostile markets."[66] Significantly, Prof. Spatt also validated the idea that these investments could be viewed as a hedge.[67]

The evidence presented during the proceeding made clear that the Respondents were not simply labeling these investments to the Board as conservative strategies and a "hedge" while secretly believing the opposite.[68] Instead, the Respondents legitimately believed that these descriptions were accurate. For example, *internal* attribution reports – where there was no incentive to deceive anybody – included short index put options and short variance swaps under a section entitled "hedging strategy."[69] Similarly, Mr. Riad explained to an employee at Merrill Lynch that the Fund had been "utilizing SPX [S&P 500 Index] Put selling *as a hedging tool* in

[66] Ex. 203 at FAM00000760. The report noted that "during the worst bear market in recent history (9/00-9/02), variance selling strategies calibrated to be risk-equivalent to the SPX were up 45% vs. a decline in the SPX and achieved that performance with a volatility 4 points lower than the market." *Id.*

[67] When asked whether it was reasonable for the Respondents to describe the strategic transactions as a hedging strategy, Prof. Spatt responded: "Yes. I think -- you know, I think within – within limits, I think it was a hedging strategy." Spatt Testimony at 3279:5-9. His rationale for considering the investments as a hedge mirrored the two explanations set forth by Mr. Riad. First, he noted that the variance swaps performed well during dramatic market declines such as the bear market from 2000 to 2003. Spatt Testimony at 3280:21-3281:5; 3394:10-3395:15 ("You know, I look at this [chart of variance swap performance during the bear market] and my main interpretation is, wow, this is a home run . . . [I]t seems to me it's sort of remarkable here..."). Second, he emphasized that the short put options generated profits when the S&P 500 was down because the put positions were written so far out-of-the money. Spatt Testimony at 3279:18-3280:2.

[68] Indeed, it is striking that the Respondents consistently employed the same "hedge" terminology with *all* relevant parties. In addition to Mr. Riad describing the strategies as a hedge at Board meetings, Mr. Swanson also referred to the investments as a hedge during discussions with Ms. Delony. *See, e.g.*, Ex. 138 at 6 ("our global macro-hedges worked out."). Mr. Riad also described the variance swap as a "hedging transaction" in an email to Steve Hill at Claymore. Ex. 4. Given that Mr. Hill had access to all of the relevant information regarding these investments due to his position as head of the Fund Administration Group at Claymore, there would have been no reason for Mr. Riad to offer him a misleading description of this position.

[69] Ex. 48 at FAM00001118.

our closed end fund HCE."[70] Again, there would have been no motivation to mischaracterize these strategies with sophisticated third-party investment professionals.

In sum, FAMCO's internal research demonstrated that the investments at issue would provide protection in a variety of adverse market conditions. This conclusion was supported by industry research reports and validated by Prof. Spatt. Most importantly, HCE's experience with the derivatives prior to the financial crisis confirmed that these investments could protect the portfolio. Indeed, the Respondents were so convinced that these investments served as a hedge that they referred to the strategies by that description in internal discussions and in communications with external parties. In this context, it was entirely appropriate for the Respondents to describe the positions in precisely the same way to Claymore and the Board.

3. Board's Decision Not to Sue Demonstrates the Weakness of the Division's Fraud Claims

Perhaps the most compelling evidence that the Respondents did not mislead the Board is that the Board members specifically considered this issue in late 2008 – after all the losses were known – and concluded that the Respondents had not acted improperly. At the November 2008 quarterly meeting, the Board was deciding whether to bring a lawsuit in connection with the Fund's investments in short index puts and short variance swaps.[71] The Board convened an executive session at which they asked Mr. Hale whether there were any legal issues with respect to these investments.[72] Mr. Hale confirmed that there had been no illegality with respect to the derivatives[73] and the Board ultimately decided not to pursue any claims against FAMCO,

---

[70] Ex. 58. *See also* Riad Testimony at 2205:21-2207:3 ("I always consistently describe it as a hedging tool.").
[71] Barnes Testimony at 2972:8-12.
[72] Ex. 197 at CLAY 028513 ("Mr. Hale responded to questions from the Board regarding whether the types of variance swap and short put positions described by Mr. Riad, HCE's portfolio manager, . . . were in compliance with the Trust's investment policies and applicable legal and regulatory requirements.").
[73] *See* Ex. 266 (draft Board minutes with handwritten notes from Joseph Gallagher indicating that "Mr. Hale said more than that. He said we're all good."). *See also* Gallagher Testimony at 1074:11-17 (following the discussion with Mr. Hale, "there was no – no doubt in my mind that there was no illegalities."). Skadden was also asked by the

Claymore, or the Respondents.[74] At the Board meeting the following month, Mr. Hale was again asked to opine on whether there had been any legal violations in connection with the Fund's investments.[75] Mr. Hale again confirmed that there had been no wrongdoing.[76]

ii. It Was Reasonable for Respondents to Believe that Investors Were Appropriately Informed

The Division asserts that Fund disclosures were insufficient and did not adequately notify investors of the strategies at issue.[77] In contrast to the Division's claims, the evidence clearly demonstrated that the Respondents complied with all applicable disclosure requirements and that HCE filings *did* inform shareholders of these strategies, but the investor witnesses either failed to review these materials or simply ignored the information that was presented to them.

1. HCE Filings Appropriately Disclosed the Strategies at Issue

(a) Respondents Were Discouraged from Providing Too Much Information

One of the most striking features of the Division's Brief is that it ignores virtually any discussion of the actual disclosure obligations for closed-end funds such as HCE. Instead, the Division makes bold assertions that have no basis in any legal requirement. For example, the Division proclaims that "[g]iven the manner in which the written puts and variance swaps affected the HCE fund, for both good and bad, it is obvious that the disclosures to investors . . . were inadequate."[78] But the mere fact that an investment performed poorly in hindsight does not

Board to "analyze whether the certain short put transactions by the Fund were consistent with relevant disclosure in the Fund's Prospectus and Statement of Additional Information . . ." Ex. 264 at SASMF 0031. The memorandum that Skadden prepared in response to this question did not identify any disclosure issues relating to these positions.

[74] Gallagher Testimony at 1241:8-11.

[75] *See* Ex. 198 at SASMF_0012 ("Mr. Toupin asked Mr. Hale to comment on whether such described transactions were within the investment policies and practices of HCE, as described in HCE's initial public offering prospectus . . . *as well as applicable legal and regulatory requirements*.") (emphasis added). *See also* Hale Testimony at 2885:22-2886:9.

[76] Ex. 198 at SASMF_0012.

[77] The Division claims that "HCE's Registration Statement and periodic reports did not inform investors of the strategies." Division's Brief at 37.

[78] Division's Brief at 2.

demonstrate that statements made at the time of the transaction were improper.[79] The Division also claims that "Riad and Swanson *could have* disclosed additional information about the performance, risk and strategies associated with HCE's investments . . ."[80] But such an assertion is a truism that applies with respect to any investment: it is *always* possible to disclose more information regarding fund strategies. More importantly, the Division's claim ignores the fact that the Commission's own rules specifically mandate against such an approach.

The evidence made clear that a closed-end fund is not required to provide a fulsome description of every aspect of its portfolio. Instead, Form N-2 creates an important distinction between investments that are considered the most important to a fund – labeled in the Form as "principal" investments and risks – and those that are merely secondary to the portfolio.[81] In contrast to the detailed disclosure required for such principal investments, registrants are required to provide only the most basic information regarding the remainder of the portfolio.[82] The key determinant for identifying a non-principal strategy is whether the investment threatens more than five percent of the fund.[83]

---

[79] As Jay Baris explained, the "adequacy of disclosures made by a registered investment company should be judged in the context of reasonable, good-faith determinations *at the time of investments rather than after the fact with 20-20 hindsight.*" Baris Report at 4. Indeed, courts have emphasized this exact point: "*any* investment that turns out badly can appear to be – in hindsight – a low return, high risk investment. Not every bad investment is the product of misrepresentation." *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 8 (2d Cir. 1996).
[80] *Id.* (emphasis added).
[81] Ex. 142 at 18-19. The Registrant is required to "disclose how *principally* it will achieve its objectives, including the types of securities in which a registrant investor will invest *principally*...So there's an emphasis on *principle* [sic] and *principal* strategy, *principal* emphasis." Baris Testimony at 3052:17-24 (emphasis added).
[82] As Mr. Baris explained, "[t]he SEC makes clear, however, that such non-principal investments should not receive as much disclosure as the principal investments." Baris Report at 7. Specifically, Form N-2 requires registrants to "*[b]riefly discuss*" such investments, *see* Ex. 142 at 19 (emphasis added), and the Commission emphasizes that this disclosure "*should receive less emphasis* . . . and, if appropriate . . . *may be omitted or limited to the information necessary to identify the type of investment, policy, or practice* . . . ." *See id.* at 20 (emphasis added).
[83] 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."). *See also* Instruction c to Item 8.4 of Form N-2 ("[i]f 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."). The instructions to Form N-1A similarly suggest that the focus should be on the perceived risk from the strategy. Form N-1A, Item 9(b)(1)(2) (emphasis added).

It is not just that Form N-2 attempts to limit disclosure of less important information. As the evidence made clear, the Commission itself has *actively discouraged* funds from including too much information in public filings[84] because "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."[85] Indeed, this was precisely the problem that the Commission confronted with earlier registration statements.[86] In response to these overloaded documents, the Commission has taken steps to achieve an appropriate balance that focuses investor attention on the most relevant fund information but does not burden them with unnecessary details. The SEC formalized this approach with the adoption of so-called "Plain English rules" in the 1990s[87] In addition, SEC staff members have also emphasized for nearly two decades that disclosure about derivative investments should not be excessively detailed.[88]

Rather than deal with these complex disclosure obligations, the Division simply sidesteps the issue. The Division asserts repeatedly that the investments at issue increased the risk of HCE and therefore constituted a "principal" risk, but they make no mention of the five percent loss threshold set forth in Form N-2. The Division emphasizes the fact that the investments made a

[84] For a discussion of the Division's repeated attempts to limit "information overload," *see* Baris Report at 23.
[85] Baris Testimony at 3048:18-22. The adopting release for Form N-1A made a similar point: "Prospectus disclosure requirements should not lead to lengthy disclosure that discourages investors from reading the prospectus or obscures essential information about an investment in a fund." *See* Baris Report at 8.
[86] Historically, prospectuses would often become "telephone books" in which registrants "would dump anything . . . 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." Baris Testimony at 3049:15-21. *See also* Baris Report at 10 (citing a letter from the SEC noting that "in many cases, fund disclosures regarding derivative instruments to be lengthy and highly technical in nature. We strongly encourage registrants to review their existing disclosure concerning derivative instruments to identify areas of such disclosure that can be deleted, reduced or modified to enhance investor understanding about pertinent risks."); *id.* at n. 80 (citing remarks by Commissioner Troy Paredes during which he criticized "information overload" in securities filings and complained that "disclosures have continued to pile up, with some of them being of questionable value.") and n. 81 (citing remarks from Chairman William H. Donaldson from 2005 during which he noted that "[f]ew would disagree that many mutual fund disclosure documents are too long and complicated. Investors need disclosure that is clear, understandable, and in a usable format in order to make informed investment decisions.").
[87] *See* Baris Testimony at 3048:23-3049:3. These rules were intended 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.
[88] *See* Baris Report at 10-11.

positive contribution to performance, but they fail to consider whether and to what extent the Respondents intended to use the derivatives to meet their investment objectives as required under the Commission's rules. In short, the Division attempts to fashion a new disclosure standard that ignores the actual requirements set forth in the governing rules. When evaluated in the context of the disclosure obligations set forth by the Commission, the disclosures by the Respondents were entirely appropriate. In essence, the Division seeks to punish the Respondents for not conforming to a disclosure requirement that simply does not exist.[89]

(b) Fund Disclosures Complied with Legal Requirements

Faced with these strict disclosure parameters for non-principal investments, the Respondents did exactly what was required under the Commission's rules: they identified the investments at issue, but they did not overload investors with unnecessary information. The result of Respondents' compliance with relevant disclosure obligations was that investors were appropriately informed about the strategies at issue.

It is undisputed that the Fund's periodic filings in 2007 and 2008 disclosed HCE's investments in short index put options and short variance swaps. Indeed, short index put options were specifically identified in *four* consecutive periodic filings over a one year period: the May 31, 2007 semi-annual report;[90] the August 31, 2007 Form N-Q;[91] the November 30, 2007 annual report;[92] and the February 29, 2008 Form N-Q.[93] The Fund similarly disclosed its short variance

[89] In *SEC v. Chenery Corp.*, 332 U.S. 194, 202-3 (1947), the Supreme Court found that the SEC should use its rulemaking authority rather than its adjudicatory authority to establish new standards of conduct. The Court explained that "[s]ince the Commission, unlike a court, does have the ability to make new law prospectively through the exercise of its rule-making powers, it has less reason to rely upon ad hoc adjudication to formulate new standards of conduct." The Court further stated that creating new standards of conduct "should be performed, as much as possible, through this quasi-legislative promulgation of rules to be applied in the future."
[90] Ex. 303 at 12.
[91] Ex. 300 at 8.
[92] Ex. 304 at 11.
[93] Ex. 302 at 11.

swap positions in numerous consecutive filings.[94] These disclosures included important details regarding each position, including information regarding risks[95] as well as the potential impact of these investments on the portfolio.[96]

The Division claims that the Fund's periodic filings were misleading despite these repeated disclosures because certain statements made in the "Questions & Answers" section of the annual and semi-annual reports were allegedly deceptive.[97] In reality, these statements were entirely accurate and complied fully with the Commission's own disclosure requirements.

The disclosures in the Q&A section appropriately focused on the equities and covered call portion of the portfolio. There were two reasons that Mr. Swanson concentrated on this aspect of the portfolio. First, the derivative investments at issue represented an exceedingly small portion of the total assets of the portfolio.[98] More importantly, equities and covered calls had a greater impact on the portfolio than short index puts and short variance swaps.[99] In 2007, for example, equities and covered calls made up more than 60% of the Fund's increase in NAV.[100] Since the derivatives were less important to the Fund's investment objectives and contributed relatively less to HCE performance, Mr. Swanson followed the Commission's own

---

[94] Ex. 300 at 10; Ex. 304 at 16; Ex. 302 at 11. These descriptions identified that HCE had entered a swap agreement based on S&P 500 volatility and explained that the Fund would lose money if the actual realized volatility of the stock market increased during the period of the investment.

[95] Significantly, the Division itself has highlighted the notional value of these positions, Division's Brief at 9, as well as the premium collected as clear indicators of the risk presented by short index put options. For the August 2008 short index put options, for example, the Division notes that "HCE collected $992,600 in option premiums, which was quite significant . . . and reflective of the large amount of exposure . . ." Division's Brief at 38.

[96] *See* Respondents' Post-Hearing Brief at 41-42.

[97] Division's Brief at 29. In one particularly misleading statement, the Division criticizes Mr. Swanson for editing this section of the 2007 Annual Report to "omit[] the risky parts of the 'macro-hedging strategy.'" *Id.* at 31. In reality, Mr. Swanson was simply correcting the terminology that Ms. Delony was using to ensure that it was accurate: he changed the phrase "covered calls" to "index calls" because the statement was in reference to call options written on the S&P 500 index rather than the call options written to cover the equity portion of the portfolio. The fact that the Division attempts to transform this entirely innocuous edit into a "significant" event serves as further evidence of the weakness of their claims.

[98] From April 25, 2007 through September 19, 2008, short index puts and short variance swaps constituted roughly one percent of the Fund's assets. Exs. 346 and 347. *See also* Steiner Testimony at 1286:6-15.

[99] *Id.*

[100] *See* Respondents' Prehearing Brief at 84 and n. 280.

guidance on non-principal investments and merely identified the beneficial contribution to performance from these investments rather than provide extraneous detail.

The Division criticizes the Respondents for failing to emphasize the derivatives investments' contribution to performance and for focusing on certain individual stocks that had a relatively smaller impact on HCE's returns than the derivatives strategy.[101] Such a claim is mistaken for several reasons. As noted above, the Division grossly overstates the importance of these derivatives to Fund performance.[102] Additionally, such a claim fails to appreciate the nature of the drafting process for these filings. Based on prior conversations, Mr. Swanson understood that his role in the interview with Ms. Delony was to prove a macro-level understanding of the portfolio.[103] The result of this approach was that Mr. Swanson discussed at a high level the three groups of investments that had the largest impact on the Fund's performance: equities, covered calls, and – significantly – the strategic transactions.[104] The decision to highlight specific individual investments *within* the two groups that contributed the most to performance – the equities and covered calls – was made by Claymore and did not reflect an attempt by Mr. Swanson to downplay the importance of the investments at issue.[105]

In the end, an evaluation of the disclosures in the annual and semi-annual reports must be based in large part on the credibility of Mr. Swanson. The Division argues that Mr. Swanson was deliberately misleading in his discussions with Ms. Delony. In fact, the evidence supports the conclusion that Mr. Swanson was open and forthcoming with all relevant parties and had no

---

[101] Division's Brief at 29 ("The Questions & Answers section contained several misleading statements. . . . The section highlighted particular sector and single stock investments that contributed to return. . . . The report did not disclose that the Fund received a significant boost from written S&P 500 put options and call options . . .").
[102] *See supra* at Section II(a).
[103] Ex. 364 ("I have the facts but want a bit of your view."). *See also* Swanson Testimony at 1731:5-10 ("[Claymore] wanted color commentary on the period . . . [I]t was never intended to be this forensic analysis of – or attribution reports. It was [to] highlight 30,000 foot comments about the overall period that they were interested in.").
[104] Ex. 135 at 3-4.
[105] *Id.* Although Mr. Swanson talked generally about individual stocks during the interview, the decision to focus on specific investments in the section detailing the largest contributors to performance was made by Claymore.

motive to deceive anybody.[106] The Court heard from multiple witnesses who testified to his honesty and integrity.[107] Most importantly, the Court had a chance to observe Mr. Swanson during the proceeding and assess his character first-hand. For all these reasons, the Court should find that Mr. Swanson acted in good faith with respect to the disclosures at issue.

2. Investors Were Aware of Fund Strategies

In light of these repeated, clear disclosures, it may be difficult to understand how the Division could plausibly claim that investors were unaware of these investments. Upon close examination of the testimony at trial, however, the answer becomes clear.

The reason that Joseph Witthohn was not aware of the Fund's investments in index puts and variance swaps is straightforward: he did not review any of the multiple periodic filings that described these investments in detail.[108] When he was asked to determine why the Fund had performed poorly in the fall of 2008, Mr. Witthohn "looked at the registration statement that [HCE] came out with at the time"[109] – a document from three years earlier.[110] However, the Division presented no evidence that Mr. Witthohn read the most important documents for

[106] Mr. Swanson did not even share in the profits of the Fund and thus would not have received any benefit from deceiving investors or shareholders. *See* Swanson Testimony at 1850:4.

[107] *See, e.g.*, Gallagher Testimony at 1077:2-21 (stating that Mr. Swanson was "[b]eyond reproach" and asserting that "[t]here's no way they would lie to Claymore."); Hughes Testimony at 795:2-17 (describing Mr. Swanson as "very honest" and "[c]areful and prudent"); Steiner Testimony at 1286:22-11 (stating that Mr. Swanson was "conscientious, honest, [and] very intelligent" and "just a good guy" who would not deliberately lie to investors); Bierbusse Testimony at 2804:19-2806:16 (stating that he has no questions about Mr. Swanson's personal integrity, describing Mr. Swanson as a "very solid citizen," and noting that he did not believe that Mr. Swanson would have misled shareholders).

[108] In fact, the Division's Brief highlights the absurdity of Mr. Witthohn's claim when it notes that he "read HCE's registration statement" – a document written in *2005* – "but could not decipher that HCE was using put options and variance swaps in the *fall of 2008*." Division's Brief at 38. If Mr. Witthohn had reviewed the Fund's periodic filings, he undoubtedly would have been aware of these positions.

[109] Witthohn Testimony at 1410:9-14. *See also id.* at 1411:20-25 ("Q: Describe for me what you did when you went deeper, so to speak. A: When I went deeper is, *I went to the registration statement to see exactly what the fund said it should be doing*, and then when I had a question about it, I sent a note to Claymore.") (emphasis added). The perfunctory nature of Mr. Witthohn's review is further demonstrated by the fact that – despite spending "between 30 minutes and 2 hours" on his research of HCE, *id.* at 1412:4-5, Mr. Witthohn failed to even notice the "Strategic Transactions" section of the Prospectus that authorized the Fund's investments in variance swaps.

[110] Mr. Withohn also looked at various online resources to "see what kind of leverage there was in the portfolio, to look at its net asset value . . ., to look at the share price . . ." *Id.* at 1411:1-15.

gaining an understanding of the Fund in *2008*: the periodic filings of HCE.[111] In other words, Mr. Witthohn testified that HCE created a misleading impression to investors without taking the time to determine precisely what kind of impression was actually being created.

Unlike Mr. Witthohn, Robert Shulman and Michael Boyle *did* review the Fund's periodic filings.[112] According to Mr. Boyle's testimony, if the Fund were engaging in investments that were inconsistent with its primary investment objectives then "under a thorough review, those things should jump out."[113] The problem for the Division is that this review informed Mr. Boyle and Mr. Shulman of precisely the investment strategies that were allegedly concealed by the Respondents. Mr. Boyle testified that he was aware of the Fund's investments in short index put options;[114] in fact, he specifically recalled focusing on these investments in a discussion with his research analyst.[115] Mr. Boyle's allegedly "thorough" review of the exceedingly brief[116] Fund filings somehow never came across the repeated description of variance swaps,[117] but Mr. Shulman specifically "recall[ed] that the term 'variance swaps'" was included in the Fund's

[111] When he was shown one of these documents he noted that he only recognized it "because I've seen it since. I don't know if I saw it at the time . . ." Witthohn Testimony at 1421:24-1422:1.

[112] *See* Boyle Testimony at 1460:5-10 ("Q: As part of this process, either of creating the initial universe or of making the selection, which included HCE, did you or your assistant ever review the periodic reports, the semi-annual, annual and quarterly findings [sic]? A: Yes."); Witthohn Testimony at 1247:17-24 ("Q: And with regard to HCE, do you believe you reviewed the majority of the periodic reports filed by HCE? A: Yes."). Mr. Boyle specifically emphasized that he reviewed the "most recent filing [of a fund] just to make sure it lines up with what we think, approximately, they should be holding." Boyle Testimony at 1457:7-10; *id.* at 1457:16-21.

[113] Boyle Testimony at 1491:4-11. Both Mr. Shulman and Mr. Boyle also agreed that the best way to evaluate the risk of a particular fund was to review its holdings. *See* Shulman Testimony at 1373:4-9 ("Q: Where would you 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? A: The quarterly reports, I would have wanted to have seen it there, if any place."); Boyle Testimony at 1492:4-12 ("Q: What would you look at if you wanted to consider the amount of risk that a particular fund had or that its investment strategies had? A: Well, the – the underlying ones, I mean – or the main fund just by reviewing the holdings.").

[114] Boyle Testimony at 1480:11-13.

[115] *Id.* at 1506:5-8.

[116] The HCE semi-annual and annual reports each contained roughly 20 pages of substantive information, while the quarterly reports had a mere ten pages. The description of variance swaps in these filings was lengthy. The fact that Mr. Boyle somehow missed the identification of this investment appears to suggest more about the diligence of his research efforts than it does about the actions of the Respondents with respect to Fund disclosures.

[117] Boyle Testimony at 1480:13-14 ("I don't recall in realtime my analysis ever running across swaps.").

periodic filings.[118] Put simply, the Division's assertion that Mr. Shulman and Mr. Boyle "both testified that they were unaware that HCE was engaged in put-writing or variance swap strategies"[119] is manifestly false.[120]

The testimony also made clear that the disclosures in the Fund filings were sufficient to alert investors to the risk of these trades. Mr. Shulman testified that he contacted Claymore in the fall of 2008 regarding the losses in HCE and discovered that the Fund had invested in variance swaps.[121] According to his testimony, Mr. Shulman was able to discern immediately that the position was risky because it involved taking a position on volatility[122] and also that such a trade was inconsistent with the strategy of the Fund.[123] The problem for the Division is that the same information conveyed by Claymore – namely, the fact that the Fund was taking a position on volatility – was specifically detailed in multiple Fund filings that Mr. Shulman allegedly reviewed.[124] Similarly, Mr. Boyle testified that his extensive options experience made him aware of the fact that put-writing could be a risky strategy[125] and that when he discovered that HCE had engaged in such derivatives trading in the fall of 2008 it was immediately clear that such a strategy could "magnify the loss."[126] Again, the challenge for the Division is that Mr.

[118] Shulman Testimony at 1378:17-21.
[119] Division's Brief at 38.
[120] The claim that these shareholders would not have invested in HCE had they known about these investments is also undermined by the investors' own testimony. Mr. Shulman became aware in late September 2008 that HCE was invested in short index put options and short variance swaps. Shulman Testimony at 1355:11-1356:2. According to his testimony, the mere presence of such risky investments would have prevented him from recommending the Fund. *Id.* at 1358:7-19. But when he actually discovered that HCE had taken a different direction and held these allegedly toxic positions, Mr. Shulman did *not* urge his clients to immediately liquidate their positions. Instead, he waited several months before finally suggesting that they exit their positions. *Id.* at 1358:20-1359:10. In other words, when faced with a true test of the materiality of these investments, Mr. Shulman clearly indicated that his investment decision was not impacted by their presence in the portfolio.
[121] *Id.* at 1355:11-1356:
[122] *Id.* at 1358:7-19.
[123] *Id.* at 1358:20-1359:10.
[124] *Id.* at 1347:17-24. In fact, Mr. Shulman specifically cited the *quarterly reports* – the listing of portfolio holdings – as the place where he "would . . . have expected to get that information that would have helped [him] understand the risk to [his] clients in the precise trading strategy that the portfolio managers were employing." *Id.* at 1373:4-10.
[125] *See generally* Boyle Testimony at 1497-1498
[126] *Id.* at 1497:1-10.

Boyle had reviewed and discussed similar short index put positions[127] with his analyst prior to the Fund's collapse.

3. Investors Were Interested in HCE Because of Its Broad Mandate

In a further attempt to paint the Respondents' actions in a bad light, the Division also claims that they presented HCE as a conservative covered call Fund to investors. As an initial matter, it is important to recognize that Claymore – *not* the Respondents or anybody at FAMCO – marketed the Fund to shareholders and therefore was responsible for any alleged misrepresentations regarding HCE's strategy.[128] More importantly, the Respondents had been specifically instructed by Claymore that HCE was intended to be more than a "plain vanilla" covered call fund.[129] This distinction was made clear to the Respondents in several ways. First, the Fund's prospectus provided greater latitude than pure covered call funds.[130] Second, the Respondents learned firsthand that HCE had a broader strategy than typical covered call funds when they attempted to trade variance swaps in the First Trust Covered Call Fund ("CCF"), another fund that they sub-advised. Unlike HCE, the Respondents were specifically told by the adviser to CCF that such trades were not allowed by the fund's more conservative investment

[127] The notional value of the two index put options written by the HCE Fund in August 2008 was $139 million. *See* Ex. 139 at 121. The notional value of the index put option listed in the August 31, 2007 Form N-Q was more than $102 million. *Id. See also* Ex. 300 at 8. The notional value of the index put option listed in the November 30, 2007 Annual Report, was nearly $104 million. Ex. 304 at 11.

[128] Hill Testimony at 2735:2-13.

[129] Swanson Testimony at 1701:15-18 (". . . it [HCE] was designed to offer flexibility . . . in order to differentiate it from a plain vanilla covered call fund."); Riad Testimony at 2050:11-16 ("Q: . . . in these conversations, did [Claymore] suggest that they wanted to create a fund that would be the same as First Trust covered call fund or different? A: No, it – they indicated they clearly wanted something different and unique.").

[130] In its Brief, the Division claimed that the "Strategic Transactions" section of the HCE Prospectus that gave broad authority for the Fund to utilize derivatives was merely "boilerplate" and a "generic disclosure [that] was commonplace in many funds, including 'plain vanilla' covered-call funds such as the First Trust and Madison/Claymore covered-call funds." Division's Brief at 32. However, the Division failed to note a key distinction between the "strategic transactions" language in the HCE Prospectus and the provision in the "plain vanilla" covered call funds. In the 'plain vanilla' funds, the language emphasized that the fund "may, but is not required *or expected to any significant extent to*, use various strategic transactions . . ." *See* Ex. 367 at 9. By contrast, HCE's prospectus did not contain any such limiting language. *See* Ex. 11 at CLAY012397. *See also* Hale Testimony at 2875:21-2876:3.

mandate.[131] In addition, the evidence showed that investors were specifically interested in the strategies of the Fund that differentiated it from more conservative covered call strategies.[132]

4. Absence of Investor Lawsuits Indicates Lack of Fraud

The weakness of the Division's claim that shareholders were misled is perhaps highlighted most by the fact that five years after the events at issue, *not a single investor has filed suit relating to the alleged fraud* – hardly the typical response of shareholders who have been duped. Indeed, after more than three years of investigation, interviews with multiple witnesses, and the collection and review of thousands of documents from FAMCO and Claymore, the Division was able to put forth only a *single document* in which an investor contemporaneously questioned the losses in HCE during the fall of 2008.[133]

The explanation as to why there have been no shareholder lawsuits is straightforward: investors were not misled regarding these investments because the positions were appropriately disclosed in Fund filings. The fact that the three witnesses offered by the Division did not focus on these disclosures says more about their own lack of diligence than it does about any failure on the part of the Respondents.

---

[131] As Mr. Swanson explained, "CCF . . . had a much more restrictive prospectus in terms of using strategic investments." Swanson Testimony at 1798: 19-23. Unlike Claymore, First Trust "didn't view [variance swaps] as an appropriate strategy for that fund." Riad Testimony at 2591:8-9.

[132] At each HCE quarterly meeting, Claymore prepared a report for the Board that included a discussion of the most "frequently asked questions" that the Claymore marketing group had fielded from investors in the secondary market. Gallagher Testimony at 1000:18-1002:14. Notably, throughout 2007 and 2008 every one of these reports included as one of the six questions an inquiry as to whether HCE wrote options on stock indexes, suggesting this was a specific feature that interested investors. *See* Exs. 175 176, and 177. If – as the Division and the investor witnesses suggest – it was so obvious that the Fund could not write index put options, then there would have been no reason for potential shareholders to continually inquire about such investments.

[133] *See* Ex. 3. Only after the SEC – the regulator that oversees his financial firm – contacted him in early 2013 did Mr. Boyle come forward with various complaints; there was no evidence presented that he contemporaneously questioned the Fund's investments. Boyle Testimony at 1502:10-13. Mr. Witthohn was not even an investor in the Fund but rather an industry observer. Witthohn Testimony at 1407:9-16.

c. *The Respondents Acted With Loyalty*

There is no evidence to suggest any conflict of interest or bad faith on the part of the Respondents. None of the investments was purchased through an affiliate of FAMCO.[134] Most importantly, there was no incentive for the Respondents to engage in allegedly risky behavior. In fact, HCE's performance was so strong prior to entering these transactions that two prominent investment research companies had recommended the Fund as an investment.[135] When the Fund submitted its 15(c) materials for contract review in September 2007 – prior to the period emphasized by the Division during which HCE primarily held short positions in index puts and variance swaps without corresponding long positions – the portfolio had "outperformed the CBOE Buy Write Index by 110 basis points per annum since inception."[136] Put simply, HCE had no incentive to engage in risky trading strategies to make up for failing performance.

The Division simply ignores the strong performance of the Fund prior to entering the investments at issue. Even worse, the Division completely disregards the fact that Mr. Riad had such confidence in the strategies that he invested a substantial amount of his own money for a year and a half in a separate fund that employed short index put options and short variance swaps to a significant extent[137] as well as in HCE.[138] Not surprisingly, the Division has downplayed the

[134] Riad Testimony at 2234:1-10 ("Q: . . .[D]id you have any conflict of interest such as trading through an affiliated broker, receiving benefits from a broker, payments from a broker, soft dollars, business referrals from the broker, any conflict of interest in connection with any of the brokers who entered into those variance swap or index put trades? A: No.").
[135] Ex. 174. This research report was published a week prior to the Fund's first investment in short index put options or short variance swaps and rated the HCE Fund as a "Buy" due to the Fund's "highly competitive income and appealing valuation." The report emphasized that the Fund's "market performance has been good recently" and noted that the Fund had "performed well on a market basis since its inception." *See also* Ex. 180 (Mr. Dunleavy noted that "Oppenheimer & Company initiated coverage on HCE with a 'buy' rating and Merrill Lynch has also made recommendations on the Fund."). *See also* Riad Testimony at 2234:11-16.
[136] Ex. 186 at CLAY008091.
[137] *See* Riad Testimony at 2243-2244. ("Q: So, a quarter of your life savings were lost on these investments in the Fiduciary Opportunity Fund? A: Right. Q: Why would you have invested in index puts and variance swaps putting your own money at risk in this fund? A: I felt it was a good risk adjusted strategy."). For a detailed discussion of Mr. Riad's personal investments, see Respondents' Post-Hearing Brief at 56-57.
[138] Riad Testimony at 2587:15-2588:3.

fact that Mr. Riad lost nearly half a million dollars of his own money from the investments at issue[139] -- a fact that was not even mentioned in its Brief.

In order to suggest that the Respondents had an improper motive, the Division sets forth two arguments that rely on an extremely misleading presentation of the evidence. First, the Division claims that the Respondents felt pressure due to HCE's high dividend target.[140] Left entirely unmentioned by the Division is the key fact that *HCE's dividend was reduced in the summer of 2008, prior to the losses at issue* – thereby alleviating any pressure that the Division claims was a motivating factor behind the Respondents' allegedly improper actions. Moreover, the Division failed to note that the Fund never had any difficulty meeting its dividend target throughout the relevant period.[141] To the contrary, the Fund often had sufficient gains to satisfy not only its upcoming distribution target but several subsequent dividend payments as well.[142]

The Division also suggests that trading in the Fiduciary Opportunity Fund ("FOF") in the fall of 2008 demonstrates an improper motive on the part of Mr. Riad.[143] According to the Division, Mr. Riad "got defensive in FOF"[144] and closed out index put positions in FOF while maintaining exposure in HCE.[145] Not only were these index puts so insignificant that they were not even mentioned in the OIP, but the evidence demonstrated that this transaction was a minor

---

[139] *Id.* at 2540-2543 ("So, the loss -- your loss in FOF attributable to the derivative transactions was only about $500,000 . . .").
[140] Division's Brief at 7. The Division emphasizes the fact that "Riad expressed concern to the Fund's Board multiple times about meeting the Fund's dividend objective" and that "[i]n 2008, Riad sought authorization to utilize leverage in HCE to help maintain the Fund's NAV in light of the dividend, and he simultaneously sought permission to reduce HCE's dividend." *Id.*
[141] *See, e.g.*, Ex. 65 ("It seems that in the HCE Fund, we have never had an issue with raising the needed E&P to pay a quarterly distribution."); Ex. 66 ("looks like we have the August dividend earned even without August option premium."); Riad Testimony at 2235:14-17 ("Q: And through August 2008 did the fund ever have trouble generating realized gains to pay for the dividend? A: No, we never did.").
[142] *See, e.g.*, Ex. 178 at CLAY021939 ("[Mr. Riad] also stated The Trust had realized enough gains to cover the next two dividend distributions.").
[143] This issue was dealt with in detail in the Respondents' Post-Hearing Brief at III(4)(c).
[144] Division's Brief at 41.
[145] *Id.*

rebalancing trade that was likely executed by Charles Walbrandt rather than Mr. Riad.[146] The Division also claims that "Riad did not enter into any new variance swap trade . . . at this time, despite maintaining that exposure in HCE" even though the evidence is irrefutable that he was legally prevented from entering into any additional variance swap trades in FOF at the time.[147]

d. The Respondents Reasonably Relied on Counsel's Involvement

i. Respondents Received Guidance from Counsel at Skadden and Claymore Regarding the Investments

The Respondents reasonably relied on the fact that Skadden and Claymore's in-house counsel understood how the index puts and variance swaps were used and how they were described in HCE filings and never suggested that any disclosure issues existed. Reliance on the "advice of counsel may show that a person lacked a culpable intent" for charges that require a showing of scienter.[148]

There is no dispute that both Skadden and in-house counsel at Claymore were consulted on two occasions *before* the Fund experienced any significant losses from these investments. Prior to entering the first strategic transactions in 2007, Mr. Riad requested guidance from Steven Hill at Claymore.[149] Mr. Hill discussed the issue with outside counsel at Skadden and confirmed to Mr. Riad that he could pursue these investments in the Fund.[150] When a question arose in late 2007 regarding the permissibility of these investments, a conference call was

---

[146] Riad Testimony at 2516:1-16 ("Most likely the derivative transactions weren't myself, but Mr. Walbrandt, he understands puts . . .").
[147] Division's Brief at 41. For a detailed discussion of the Division's unfair characterization of this issue, *see* Respondents' Post-Hearing Brief at 58-59. Mr. Riad also noted in an email to Claymore in October 2008 that "[w]e talked to GS [Goldman Sachs] and MS [Morgan Stanley] this morning . . . Essentially they said there is not much of a market to close [the variance swap position]." Ex. 358 at CLAY031131.
[148] *S.E.C. v. McNamee*, 481 F.3d 451, 455 (7th Cir. 2007). As courts have explained, reliance on counsel serves as "evidence of good faith, a relevant consideration in evaluating a defendant's scienter." *Howard v. S.E.C.*, 376 F.3d. 1136, 1147 (D.C. Cir. 2004); *see also United States v. Peterson*, 101 F.3d 375, 381 (5th Cir. 1996) ("[r]eliance on the advice of an attorney may constitute good faith.").
[149] Hill Testimony at 2704-5. At the time, Mr. Hill served as Chief Financial Officer of the Fund and the head of Claymore's Fund Administration Group.
[150] *Id.*

arranged for January 2008 to discuss the derivatives in HCE.[151] The call included multiple legal and compliance representatives from Claymore.[152] During this call, the Respondents were informed that Mr. Hale had validated his earlier guidance and confirmed that these investments could be utilized in HCE.[153] Skadden was also present at multiple Board meetings in 2007 and 2008 where the portfolio managers discussed these investment strategies and Audit Committee meetings when the Fund's periodic filings – which specifically identified the investments in short index puts and variance swaps – were reviewed and approved.[154]

It was entirely reasonable for the Respondents to believe that Skadden or Claymore would have informed them during one of these repeated interactions if any disclosure issues existed because they had provided such guidance in the past.[155] Indeed, Skadden had a policy of discussing and opining on all legal issues – including disclosure concerns – when asked a question about Fund investments.[156] Whenever Claymore or Skadden had a concern regarding new investments, they would ask the Respondents to quantify the risks and focus on such strategies in discussions with the Board.[157] Based on this understanding, the Respondents reasonably concluded that the derivatives trades – which Claymore and Skadden lawyers had reviewed and discussed on multiple occasions – were not a new investment strategy that needed to be highlighted in the Fund's periodic filings.

Faced with these facts, the Division manufactures a duty for portfolio managers that simply does not exist. According to the Division, the Respondents "implemented the strategies

---

[151] *See* Ex. 252.
[152] *See id.* For a detailed description of this call, see Respondents' Post-Hearing Brief at III(3)(a).
[153] Riad Testimony at 2213:15-2214:4; *see also* Swanson at 1835:24-1837:14.
[154] *See* Exs. 178, 188, 191, 306, and 308. Mr. Hale was included in the list of attendees for each of these meetings.
[155] In late 2007, for example, Claymore suggested the inclusion of a disclosure regarding variance swaps in the Fund's quarterly report and an expanded disclosure in HCE's annual report. Ex. 29. In 2008, Claymore insisted that the Fund's periodic filings disclose HCE's potential use of leverage as a new investment strategy. Ex. 22.
[156] Ex. 368 at ¶ 7.
[157] *See, e.g.*, Ex. 349.

without guidance from compliance."[158] In order to support this assertion, the Division is forced to adopt an incredibly narrow definition of "compliance" personnel that somehow excludes outside Fund counsel at Skadden. Specifically, the Division complains that the Respondents did not directly seek advice from Bruce Saxon, the Chief Compliance Officer of HCE, or any of FAMCO's internal compliance officers.[159] The claim that the Respondents failed to seek such legal guidance from Mr. Saxon is particularly ironic in light of the fact that Mr. Saxon made clear that he "*was told not to practice law by my attorneys.* And if there were questions about permissibility or other questions I couldn't answer, I was to go to Skadden."[160] In other words, Mr. Saxon himself suggested that the best approach for handling such compliance issues was to obtain guidance from Skadden – precisely what Mr. Riad did prior to investing and again in January 2008. Furthermore, the Division's assertion that the Respondents failed to get guidance from "compliance" ignores entirely the January 2008 conference call – a conversation in which Mr. Saxon participated, as did FAMCO's internal compliance officers.[161] In short, even if the Respondents did not directly contact Mr. Saxon or FAMCO's internal compliance officers at the outset – which was unnecessary, given that they had already received approval from Mr. Hale – they nonetheless received validation from Mr. Saxon and FAMCO's compliance officers nearly eight months before the Fund suffered any significant losses.

The Division also claims that "Riad and Swanson did not introduce any evidence that they relied upon the advice of Claymore or the Fund's counsel, for the adequacy of the Questions and Answers sections of HCE's 2007 Annual and 2008 Semi-Annual Reports."[162] According to the Division, "[n]either Claymore nor Fund counsel directed Respondents to use certain words,

---

[158] Division's Brief at 9.
[159] *Id.*
[160] Saxon Testimony at 2629:23-2630:3.
[161] *See* Ex. 252.
[162] Division's Brief at 59.

phrases or descriptions"[163] in these filings. But this claim entirely misses the point: there was no need for the Respondents to request specific guidance on particular words and phrases because they had already discussed these investments with Claymore and Skadden, received their approval for utilizing these investments in the portfolio, and trusted these more experienced legal and compliance professionals to inform them if there were any improprieties with respect to these disclosures. As in *Howard v. S.E.C.*, the Respondents reasonably relied on their belief that Skadden and Claymore's in-house counsel had concluded that the disclosures surrounding the index puts and variance swaps were sufficient.[164]

ii. Claymore Oversaw Fund Disclosures

In addition to ignoring the Respondents' reliance on guidance from Fund counsel, the Division also overlooks the context in which Fund disclosures were prepared and disseminated to the public.[165] The Division makes it appear as though Mr. Riad and Mr. Swanson spoke directly to investors.[166] In reality, the evidence demonstrates there were multiple layers of review before information about the Fund was communicated to investors.[167] The Respondents were confident Claymore received all of the relevant information regarding the derivatives and relied on Claymore to intervene if there was an issue with any of these disclosures.

[163] *Id.*
[164] In *Howard*, the non-lawyer Respondents "believed that [higher management] and outside counsel had approved [the] actions" that give rise to the securities fraud charges at issue. *Howard v. SEC*, 376 F.3d 1136, 1146 (D.C. Cir. 2004). Importantly, the Respondents were entitled to rely on that advice even if it was not passed directly from counsel to the Respondents. *See id.* at 1148-49 ("Suppose a company president communicates directly with competent outside counsel; makes full disclosure; is advised -- incorrectly – that the proposed transaction is entirely lawful; tells junior officers in the company of the legal advice; and instructs them to consummate the transaction. Under the SEC's theory, the president could avoid charges of fraudulent conduct by using the attorney's advice to prove his lack of scienter while those working under him could not. That is illogical and makes no sense whatsoever. If the SEC were right, all corporate employees below the top echelon would have to consult outside counsel directly in order to receive the same legal advice given top management. That not only would run up the legal bills, but it would be impractical and highly inefficient.").
[165] *See* Respondents' Post-Hearing Brief at III(3)(b).
[166] Division's Closing at 3559:9-16.
[167] *See* discussion in Respondents' Post-Hearing Brief at III(3).

1. Claymore Had All of the Relevant Information Regarding the Investments at Issue

Mr. Riad and Mr. Swanson were aware that Claymore had all of the relevant information regarding the Fund's investments in short index put options and short variance swaps. Claymore had to approve the ISDA agreements that permitted the Fund to enter into trades.[168] Claymore received daily reports from the Fund's custodian that detailed HCE's derivatives investments,[169] and received and reviewed confirmations for each derivatives transaction.[170] Further, Claymore representatives attended Board meetings where the investments at issue were discussed.[171]

2. The Respondents Reasonably Believed that Claymore was Performing a Thorough Review of the Filing

In addition to their understanding that Claymore had access to all of the relevant information regarding these investments, Messrs. Riad and Swanson reasonably believed Claymore's legal and compliance department performed a thorough review of the periodic filings before they were finalized and would address any problems that arose.[172] As Mr. Swanson wrote to Mr. Riad regarding the HCE 2007 Annual Report, "Claymore compliance is usually responsible for running [these filings] through the checks. And they generally do a good job (read: conservative) job."[173] Indeed, Mr. Riad and Mr. Swanson had experienced just such intervention from Claymore in the past. During the drafting of the 2007 HCE annual report, for example, Claymore required a disclosure that the Fund was considering the use of leverage.[174]

---

[168] *See* Riad Testimony at 2192:7-2193:17. *See also* Exs. 310, 316, 318, and 321.
[169] *See* Riad Testimony at 2088:5-13; Hill Testimony at 2700:11-15 and 2701:11-2702:5.
[170] Hill Testimony at 2700:11-15; Ex. 353; Hill Testimony at 2701:21-2702:2 and 2702:5; Ex. 158.
[171] *See, e.g.,* Saxon Testimony at 2615:10-13 and 2653:4-9; Hill Testimony at 2694:14-15.
[172] In an email exchange during the drafting of the 2007 Annual Report, for example, Ms. Delony informed Mr. Swanson that she had "just sent this version to Claymore's legal and compliance people, and I believe it incorporates all their changes." Ex. 96.
[173] Ex. 274.
[174] Ex. 108. Claymore emailed Patty Delony, the consultant hired by Claymore to draft the report, and explained that "Steve [Hill] would like something put into the Q&A in regards to leverage he stated that the prospectus states that the fund is able to use leverage and is thinking of utilizing leverage. The Q&A needs some kind of notice in it to

The Respondents accepted the insertion because they trusted Claymore regarding such compliance issues.[175] Moreover, Claymore not only mandated the inclusion of a description of variance swaps in the Fund's filings, but Claymore also drafted this disclosure – the very description that is at issue in this proceeding.[176] In short, the Respondents relied on Claymore to determine what information needed to be included in Fund filings and how such information should be provided.

An additional piece of evidence further highlights the nature of the relationship between the Respondents and Claymore. During the drafting of the 2008 semi-annual report, Mr. Swanson was told that Claymore did not require a disclosure regarding the potential use of leverage because it had been mentioned in the prior report.[177] Despite the fact that Claymore had made clear the subject did not have to be disclosed again, the Respondents adopted an overly cautious approach and suggested to Claymore that such a disclosure be included.[178] This serves as evidence of the Respondents' openness and also demonstrates that they depended on Claymore to make the ultimate determination regarding disclosure decisions.

Mr. Swanson's understanding of the relationship is also demonstrated by a July 2008 email exchange. As the 2008 semi-annual report was being finalized, Ms. Delony asked Mr. Swanson a question about the equity and covered call portion of HCE's portfolio.[179] In his response, Mr. Swanson provided the requested information but also emphasized that she "[p]lease keep in mind that this is strictly the covered call portion of the portfolio. It does not

---

notify the shareholders that the fund is thinking of using leverage." *Id* at FAM00146388. Ms. Delony then informed Mr. Swanson that Claymore was mandating the inclusion of this disclosure. *Id.* at FAM00146386.

[175] *Id.* at FAM00146386.

[176] *See* Ex. 293.

[177] Ms. Delony informed Mr. Swanson that "[r]e mention of leverage, I looked back at the last report. We did mention it there but said we had decided not to use for now. So I don't think any mention is required." Ex. 275.

[178] As Mr. Swanson explained to Mr. Riad, "[i]t sounds like the Fund's potential leverage issue was discussed and dropped per Claymore. I will let Patty know that there is a good chance that we will be using leverage and see if Claymore would like to include in the commentary." *Id.*

[179] Ex. 289.

include the call on call, *hedges, or volatility trades*."[180] In other words, Mr. Swanson did not attempt to conceal the strategic transactions from Ms. Delony but he specifically highlighted the fact that the figures he was providing did not include the derivatives transactions at issue. It was his understanding that she was aware of those investments and their impact on the portfolio; otherwise, his email would have made no sense to her.

The evidence also demonstrated that the Respondents were entirely justified in believing that Claymore performed a thorough review of HCE filings. The Q&A section of Fund filings was reviewed in detail by multiple members of Claymore's legal and compliance departments as well as the Fund Administration Group.[181] Significantly, these individuals focused on and discussed the specific language describing the derivatives investments that is allegedly misleading.[182] Rather than confront the fact that Claymore analyzed and blessed the disclosures at issue in this proceeding, the Division does not even mention this email exchange in its Brief.

III. 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.

[180] *Id.* (emphasis added).
[181] *See* Respondents' Post-Hearing Brief at 49-53.
[182] Mr. Hill raised a question about how the strategic transactions were described in a draft of the 2008 Semi-Annual report. Ex. 362 at SEC-Delony-0000653. His question was relayed to Claymore's in-house counsel, who ultimately determined that he was "comfortable with the way [the filing] presently reads." *Id.* at SEC-Delony-0000652.

Dated: July 26, 2013

Respectfully submitted:

Richard D. Marshall

Richard D. Marshall
Eva C. Carman
Jon A. Daniels
Attorneys for Respondents
Mohammed Riad and Kevin Timothy Swanson
Ropes & Gray LLP
1211 Avenue of the Americas
New York, NY 10036-7804
Phone: (212)-596-9006
Fax: (646)-728-1770
Email: richard.marshall@ropesgray.com