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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15141

In the Matter of

MOHAMMED RIAD AND KEVIN TIMOTHY SWANSON

Respondents.

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

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I. PRELIMINARY STATEMENT

In their Post-Hearing Brief, Respondents Mohammed Riad and Kevin Timothy Swanson do not dispute that:

- they were responsible for managing the Fiduciary Claymore/Dynamic Equity Fund ("HCE") in accordance with the Fund's registration statement and Statement of Additional Information ("SAI");
- HCE's registration documents and 2007 Annual and 2008 Semi-Annual Reports did not advise investors that the Fund employed a strategy of investing in written put options and variance swaps, that those strategies were the Fund's most successful investments, and that those investments carried significant risk of loss in declining or volatile markets;
- HCE's extensive use of written puts and variance swaps significantly increased the Fund's losses during the market decline of 2008; and
- The information that HCE was following a strategy of investing in written puts and variance swaps would have been material to HCE's investors.

Instead, Respondents argue that: (1) FAMCO carefully analyzed the written put and variance swap investment strategies before implementing those strategies; (2) they sought Claymore's permission before making any written put and variance swap investments and kept Claymore and HCE's investors informed about those investments; (3) they relied upon the guidance of Claymore and Fund counsel regarding these investments and during the disclosure process; and (4) they were under no pressure to mislead anyone by withholding information about HCE's written put and variance swap investments.

None of these arguments is supported by the weight of the evidence. And none of these arguments are legally sufficient to preclude the Respondents from being sanctioned for violating the securities laws. To the contrary, the weight of the evidence requires the Court to reject Respondents' proposed defenses and find them both liable for the violations alleged in the Order Instituting Proceedings.

In In re Fundamental Portfolio Advisors, Inc., et. al., Rel. No. 33-8251, 80 SEC Docket 1851, 2003 WL 21658248 (July 15, 2003), the Commission found that statements by a fund in its prospectus and marketing materials about the its safety, duration and hedging techniques were false and misleading in light of a new investment strategy implemented by the fund's portfolio manager. *Id.* at *10. This new strategy involved investing in floating-rate mortgage obligations instead of government securities, and was intended to secure a higher return. *Id.* at *5. The new strategy initially boosted the fund's return, but when interest rates rose, the fund's NAV declined dramatically. *Id.* at *6. The fund did not disclose its new investment strategy right away. *Id.* at *4. And the portfolio manager was warned that seeking both a high investment return and a low risk of loss was inherently inconsistent. *Id.* at *8. The Commission affirmed the Law Judge's initial decision and held the investment fund and its portfolio manager liable under Section 34(b) of the Investment Company Act of 1940 and Sections 10(b) and 15(c) of the Securities Exchange Act of 1934.[1] *Id.* at **11-14. The Commission also affirmed the Law Judge's

[1] Although there are some factual differences, the conduct which the Commission considered to be egregious in Fundamental Portfolio Advisors is similar to Respondents' conduct in this matter. Further, Respondents pose a continuing danger to the investing public because they engaged in repeated violations of the law, acting with *scienter*, and have shown no remorse or recognition of the wrongful nature of their conduct, let alone provided any assurance against future violations. They each will have more opportunities to violate the law through their continuing desire to be part of the investment industry.

imposition of an associational bar and substantial civil penalties for these and other violations. *Id.* at ** 16-18.

II. ARGUMENT

A. FAMCO's Research Revealed Significant Risk and Significant Expected Effect on HCE's Return

Respondents assert that so long as their research, analysis and conclusions regarding written put option and variance swap investments were reasonable, then they cannot be held liable for fraud. (Resp. Brief at 8) But there is no exemption in the federal securities laws which would excuse misstatements and omissions regarding a fund's investment strategies and risks if those strategies and risks were carefully and sincerely developed. Respondents' brief is an attempt to reframe the question before the Court from "Did the Respondents knowingly or recklessly make material misrepresentations about HCE to the Fund's investors?" to "Were Respondents negligent in analyzing written put options and variance swaps as investment strategies?"

Sean Hughes likened the FAMCO team to the Beatles: dedicating "thousands and thousands of hours" analyzing these strategies and mastering their craft before ever making a single trade. (Tr. 624:19-625:3) Accordingly, Respondents must have fully understood the capabilities and limitations of the instruments they were using to manage HCE. Respondents' analysis must have armed them with knowledge of the following material facts: (1) written put options and short variance swaps were expected to be significant contributors to HCE's performance, as well as the achievement of its investment objective of generating a high level of income; (2) HCE's written put options and variance swaps had a significant effect on HCE's performance during 2007 and early 2008; and (3) the written put options and variance swaps exposed HCE to the potential for massive losses in the event of a significant market downturn or a spike in market volatility. But instead of sharing these key facts about HCE with investors, Respondents elected to tout their stock-picking and management of their covered call strategy to investors – while claiming that they were taking steps to protect the Fund from market downturns.

Respondents cannot argue that they fully researched and understood the investments and their risks, yet they did not know the investments would be significant contributors to performance and that they could not have foreseen the possibility of catastrophic losses in adverse markets. Accordingly, Respondents' analysis and understanding of HCE's written put option and variance swap investments does not insulate them from liability.

1. The Risks of These Investments Were Apparent to Respondents

There is no dispute that written put options and variance swaps can offer attractive returns and be very profitable strategies. However, a profitable strategy very frequently adds risk to a portfolio. Risk goes to the very essence of put options and variance swaps. Professor Spatt stated in his report that the index put option market arose because investors wanted a straightforward way to share risks related to performance of the equity market and put options facilitate the allocation of risk among market participants. (*See* Spatt Report at 13) The writer of a put option takes on risk, and the purchaser of a put option offloads risk and gains protection. (Tr. 3345:9-3346:9; 2161:1-2162:23)

Likewise, variance swaps serve as a way to re-allocate and manage risk relative to market volatility. (Spatt Report at 14) Riad viewed long variance swaps to be "the ultimate protection" for HCE's portfolio. (Tr. 2120:9-2121:7; 2123:6-11) In fact, the core idea supporting Respondents' decision to invest in written put options and short variance swaps was their belief that investors systematically overpay for financial protection, and that HCE could profit by selling that protection to other investors. (Resp. Brief at 9, 14) There can be no doubt that Respondents knew writing put options and shorting variance swaps added risk to HCE's portfolio. Respondents even sized their put and swap positions based on the concept of how much risk they were adding and were well aware of the worst case scenarios for these investments. (Resp. Brief at 17-18, 20)

Respondents reviewed extensive academic research and industry publications, most of which noted the profitability of writing put options and shorting variance swaps.[2] (Resp. Brief at 13-16) However, these research publications also consistently warned that these same strategies were subject to significant risk.[3] Even Hughes's own research noted that selling puts will exacerbate losses when the market falls. (Ex. 83 at 65183) Respondents also acknowledged the risk of investing in put options and variance swaps in conversations among the FAMCO team. (Ex. 81; Tr. 860:8-862:11; Ex. 99 at 119709-10, 23)

Accordingly, there can be no dispute that Respondents knew exactly what a severe market decline and volatility spike would do to the HCE investments in written puts and variance swaps. They simply viewed the likelihood of a significant market disruption as

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[2] Several of these research papers were produced two years after the Division issued a subpoena to FAMCO for records relating to its trading in put options and variance swaps. Apparently, when Sean Hughes was asked to review his files for additional research, he was able to find more academic papers. (Tr. 940:1-945:18)

[3] *See, e.g.*, Ex. 41 at 801-02 (selling variance is profitable but exposed to unlimited risk of severe volatility spikes); Ex. 82 at 2147 (selling volatility is akin to selling insurance and is very risky, but in the long run it can be lucrative provided enough capital is available to absorb the inevitable losses); Ex. 207 at 9052 ("**Although selling puts appears to offer the best potential alpha per unit of tracking error, it does introduce the most adverse results in extreme down markets (the distribution has the 'fattest' downside tail)**") (bold in original); Ex. 214 at 9060, 69 n.8 ("There is no arguing that selling naked puts could be very risky;" "After all, selling puts *is* risky and must be rewarded with risk-premium") (emphasis in original).

remote. Respondent's calculation, or wager, should not be confused with a lack of understanding that the risks they faced were present and possible.

a. First Firewall: Out-of-the-Money Options are Not Less Risky

Respondents claim that they engaged in four risk-limiting measures, the "four firewalls of risk," to ensure that the put options and variance swaps had minimal risk. (Resp. Brief at 18-22) The first supposed protective measure was to write index put options deep out-of-the-money, making the options less risky than at-the-money options. (Resp. Brief at 19) However, Professor Spatt acknowledged that in order to collect a certain option premium using out-of-the-money options, HCE would need to write more contracts than it would for at-the-money options; this is because out-of-the-money options are worth less to the purchaser and come with a much lower premium. (Tr. 3423:22-3424:5). The need to write additional out-of-the-money contracts in order to collect a targeted premium amount means that the out-of-the-money options actually would result in more exposure to loss in steep market declines. (Tr. 3430:14-3431:11, 3433:4-23)

b. Second Firewall: The Myth of the $5 Million Loss Limit

Respondents argue that they limited the size of the written put and variance swap positions so that there was only a 0.5% chance of a $5 million loss (or about 5% of HCE's NAV) on any transaction. (Resp. Brief at 20) However, there is no contemporaneous documentary evidence that Respondents made a decision to implement a hard cap on losses at $5 million, let alone evidence of any calculations showing how Respondents sized a particular trade. That evidence simply does not exist. It is understandable why Respondents have focused so much of their attention on the $5 million threshold in 2013. They intend to use Form N-2's instruction that if an investment practice is limited so that no more than five percent of net assets have been put at risk in the last year, or are intended to be put at risk, the prospectus need only identify the practice.[4] (Ex. 142 at 17) However, the facts show that HCE's put options and variance swaps put far more than $5 million of the Fund's assets at risk.

HCE obviously had more than $5 million at risk because it actually lost $45 million in the fall of 2008. In addition, Respondents' own records demonstrate that HCE had no $5 million loss limitation policy in place. Respondents called Sean Hughes as a witness, and through the use of a demonstrative, Hughes testified about FAMCO's risk analysis for an August 2008 put option position placed by HCE; Hughes testified that there was a 0.73% chance of a $5 million/5% loss to HCE from that position. (Tr. 752:8-758:24) However, he later admitted that the probability would be between 0.73% and 2.19% since the options written had a duration of nearly two months. (Tr. 828:11-829:7) But even that percentage range accounted for just one of HCE's two option positions on at the time, and the transaction selected in creating Hughes' demonstrative was the smaller of the two HCE positions. (Tr. 829:12-831:2) When factoring in the other position, the risk of loss would be closer to $10 million with the same probabilities, and the probability of a $5 million loss would be even higher. (Tr. 829:8-834:15)

[4] Even if Respondents met the 5% threshold, it would not absolve them of the need to disclose their strategies to investors. HCE's prospectus does not even identify naked put-writing or shorting variance swaps as an investment strategy of the Fund, and the word "variance swap" does not appear anywhere in the prospectus or the SAI. (*See* Exs. 11, 12) In addition, Form N-2 defines the amount at risk as the "potential liability or loss that may be incurred" from the particular practice. (Ex. 142 at 17) It does not exempt registrants from disclosing potential liability that a portfolio manager thinks is unlikely, or that falls below a probability threshold.

Professor Harris analyzed HCE's trades and confirmed that the risk of a 5% loss on any given put option position was greater than 0.5%, and in many cases HCE was exposed to losses of 20% or more. (Tr. 221:24-223:8; *see* Ex. 139, Table 3, at p.124[5])

In fact, Respondents wrote a memorandum to HCE's Board in the fall of 2008 contending that the probability of a market decline of the magnitude suffered in September and October 2008 was 0.42%. (Ex. 75 at 34141) And FAMCO's own research notes show that the two August 2008 put option positions that lost $6 million and $9.5 million respectively suffered through one-month market declines of 15% and 22%, and that such declines were expected to occur 0.94% and 0.42% of the time. (Ex. 204 at 1120) So it appears that in 2008 FAMCO was of the opinion that there was approximately a 0.5% to 1% chance that HCE would suffer a catastrophic decline in value, of the magnitude which occurred in October 2008. This demonstrates that the chance of HCE experiencing a 5% loss in value would be much greater.

The same holds true for the variance swaps. Respondents' own research reports warned them of significant risk and presented evidence of substantial potential losses, associated with selling variance swaps. One such report showed that short variance swap trades with a $300,000 vega notional value could have caused losses of $7.8 million in

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[5] Since HCE held multiple positions simultaneously which were written on different dates, the Division wishes to clarify the methodology employed in Table 3 to the Harris Report for the Court's benefit. This table reflects the weighted average percentage decline of one or more investment positions with the same expiration date. As an example, the options expiring on February 16, 2008 involve contracts written on January 11 and January 15, 2008, when the S&P 500 was at 1401.02 and 1380.95 respectively. For these options, the S&P 500 would have to decline to 1251.89 at expiration to generate the $1,869,175 loss shown in the 10% Decline column. A decline to 1251.89 would represent a 10.6% decline for the January 11 options and a 9.3% decline for the January 15 options, for a weighted average decline of 10%.

1997, $6.4 million in 1998, $5.4 million in 2001, and $8.1 million in 2002.[6] (Ex. 41 at 801; Tr. 3370:20-3371:11, 3372:19-3375:18)

FAMCO's own backtesting reveals that every single investment which HCE made in short one-month variance swaps equal to 30 basis points of the portfolio value, which equates to approximately $300,000 vega on a $100 million fund, subjected HCE to a 0.60% chance of a 5% loss to HCE's portfolio.[7] (Ex. 208) However, Respondents sold short variance swaps with vega notional exposures ranging anywhere from $250,000 to $450,000, and at times maintained vega exposure of $450,000. (*See* Exs. 4, 122) By definition, the $450,000 vega variance swaps had 1.5 times as much exposure as the $300,000 vega swaps, and as such had a 0.60% chance of a 7.5% loss. (Tr. 3450:15-3451:5) Accordingly, the Court may conclude that, during 2007 and 2008, Respondents were not attempting to cap HCE's potential losses on any given variance swap transaction at a 0.5% chance of a 5% loss. Obviously, if they had been interested in such a loss limitation, they would have limited their variance swap exposure to less than $300,000 at all times.

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[6] Respondents and their witnesses cited multiple times to a research report that indicated short variance swaps profited by 45% during the bear market of 2000 to 2002. (*See, e.g.*, Tr. 746:1-24) However, Respondents' own backtesting showed a very different result; in fact, the variance swap returns remained relatively flat overall during that entire period. (Ex. 228 (native) "Chart1" tab)

[7] Professor Harris's backtesting of variance swaps written when implied volatility exceeded 20 (which was the level when Respondents sold variance) revealed probabilities of a 5% loss for a $300,000 vega variance swap to be 1.79% or 1.02%, depending on whether you use data back to 1990 or 1987. (Ex. 139, Table 4, at p. 125; Tr. 230:9-231:10) Respondents have criticized Professor Harris repeatedly for "cherry-picking" his time period to take advantage of the 1987 market crash. (*See* Resp. Brief at 31) This is a highly unusual and unfair accusation, given that Professor Harris provided those results alongside results going back to 1990, and did so in the context of pointing out the significance of the data set one chooses to use. (Ex. 139, ¶¶ 164-66)

c. Third Firewall: Market Timing

Respondents' purported third firewall of risk relates to their confidence that they could time their transactions in the market to further reduce risk. Respondents testified that they took advantage of the mean-reverting nature of volatility, and noted that the best time to sell variance swaps was during periods of elevated volatility, including immediately following a crisis. (Resp. Brief at 16 n.81, 21) So Respondents typically sold variance swaps only when market volatility, as measured by the Chicago Board Option Exchange ("CBOE") Volatility Index ("VIX") was above 20. (Tr. 653:2-7) Respondents claim that by bucking the market's collective wisdom, and effectively selling insurance during periods when most market participants were concerned about protecting their portfolio, HCE was significantly less likely to suffer a large loss because volatility will mean-revert, or return to the mean. (Resp. Brief at 21)

This theory is contradicted by Respondents' own research, and Respondents appear to have confused an increased potential for profit with reduced risk of loss. These concepts are not the same. Respondents' own research showed that variance swap strike prices are very good predictors of market volatility over the short-term, and that variance swap strike prices take into consideration the concept of mean reversion. (Ex. 82 at 52149) This means that when the VIX is high, market volatility also is more likely to be high, at least in the short-term.

In addition, Respondents' research showed that while variance swaps are on average more profitable during periods when implied volatility exceeds 20, the results of such investments are more volatile; the average bad months are worse during such periods, and bad months occur with slightly more frequency. (Ex. 42 at 837-38)[8] This is corroborated by Professor Harris' report, showing that he found higher probabilities of a $5 million loss, by testing only periods when implied volatility exceeded 20, than Respondents did in creating a frequency distribution of variance swap trading in all markets. (Ex. 139, Table 4, at p. 125; Ex. 208) Respondents' research also showed that while the largest gains from variance swaps came immediately following market crises, the worst losses came during crises. (*See*, *e.g.*, Ex. 41 at 801)

Respondents are portfolio managers, not fortune tellers, and they did not have a crystal ball to tell them precisely when a financial crisis comes to an end. In fact, their research showed that "[t]here is *not* a strong pattern of reduction in volatility in the first month following a spike[9]," and that while many spikes follow with a return to more normal volatility rather quickly, some volatility spikes do not subside quickly and instead see "significant further increase in volatility" and take longer to subside. (Ex. 82 at 52173-74; *see also* Tr. 233:10-16) As such, selling volatility during periods of market distress is more risky, and will result in both the largest gains *and* the largest losses. Even Professor Spatt acknowledged this postulate as true. (Tr. 3371:12-3372:18) Moreover, the most significant market downturns and crises in the twenty years before 2008 occurred at times when the VIX was above 20.[10]

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[8] This research is consistent with Professor Harris's testimony that markets in periods of elevated volatility are unpredictable. (Tr. 231:11-232:15)

[9] Respondents fell victim to this phenomenon in October 2008, when volatility did not subside following the spike in September 2008, but instead became worse.

[10] For example, market volatility was above 20 in the several weeks leading up to the October/ November 1987 stock market crash. (Ex. 74 at 33568; Ex. 147) Market volatility surpassed 20 in the second half of July ahead of the significant

Respondents also claim that they reduced risk by following the guidance and market forecasts issued by FAMCO's Strategy Committee, and that they wrote index put options and sold variance swaps only when they believed that a large market decline or spike in volatility was extremely unlikely. (Resp. Brief at 21-22) However, they abandoned that practice in September 2008. FAMCO's Investment Strategy Report issued on September 17, 2008 noted that there was a current liquidity crisis, the near-term future remained murky, and that the current market uncertainty and financial turmoil was leading FAMCO investment advisers to maintain greater than normal cash positions. (Ex. 54 at 13088-89) Yet HCE maintained its written put option positions throughout September and early October 2008, and even sold new short variance swaps on September 19, 2008, while ignoring the warnings in the FAMCO Strategy Report. (Ex. 63 at 18731; Ex. 50)

d. Fourth Firewall: Asset Segregation Did Not Prevent Collapse

Respondents claim, as part of a fourth firewall of risk, that they set aside assets for segregation purposes in order to "cover" any derivative losses and ensure that there were adequate funds in place to meet their obligations to counterparties. (Resp. Brief at 22, n.116) However, Susan Steiner testified that there were two methodologies for segregating assets that they discussed with Claymore in January 2008; one method involved

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August/September 1990 market downturn. (Ex. 74 at 33568; Ex. 148) Market volatility surpassed 20 in the second half of July 1998 and was followed by continued steep declines during the August 1998 market crisis. (Ex. 74 at 33570; Ex. 148) Market volatility was above 20 in the months leading up to the significant dot-com slowdown in February/March 2001. (Ex. 74 at 33570; Ex. 148) Market volatility was elevated in the months leading up to the significant market downturn beginning in August 2001 and continuing through September 2001. (Ex. 74 at 33570; Ex. 148) Market volatility was above 20 throughout much of May 2002 ahead of the June/July 2002 market downturn from the accounting scandals. (Ex. 74 at 33571; Ex. 148) Market volatility was extremely elevated in August 2002 following the accounting scandals, yet the market plummeted even further in September 2002. (Ex. 74 at 33571; Ex. 148) segregating $30 million based on notional value of the options, and the other based on market value of a little over $200,000. (Tr. 1266:25-1268:3) Steiner originally thought they would need to segregate $30 million based on the strike price of HCE's put options, but FAMCO ultimately segregated based on market value. (Tr. 1266:25-1268:3; 1273:11-1274:9) The more flexible market value approach did not limit Respondents in any way and did not prevent HCE from losing $45 million.

2. The Market Declines and Volatility Were Not Unprecedented

Respondents frequently claim that the 2008 financial crisis was unprecedented. However, HCE suffered its dramatic losses relatively early in the crises (by October 8 and October 17, 2008 for the variance swaps) and therefore these derivative investments did not suffer the full force of the crisis.[11] This means that the market declines that occurred in September and October 2008 were comparable to those suffered in the 1998 Long-Term Capital Management crisis, September 2001, and during the 2002 accounting scandals, and were not as severe as the earlier, more dramatic declines occurring in October 1987. (Ex. 47 at 1076; Tr. 838:6-840:10) Hughes even admitted that their research showed that the kind of market declines suffered by HCE in October 2008 had happened before, and in fact had occurred on average of once every four years over the previous twenty years. (Tr. 838:19-840:14) Riad was not only aware of these previous market crises, he actually had focused on them in his research. (Tr. 618:5-619:12)

The market volatility levels in September and October 2008, while extreme, were not unprecedented. The realized volatility observed on the dates HCE entered its

[11] The S&P 500 closed at 1056.89 on October 6, 2008 and 984.94 on October 8, 2008, the two days HCE closed out the written put options positions. (Ex. 144) The market continued to decline through the end of 2008 and into 2009. (*Id.*)

September and October 2008 variance swaps was 38.9 and 79.6 respectively, and HCE lost $7 million and $22.8 million on those positions. (Ex. 50) Respondents' research identified three periods in the previous twenty-one years – on average every seven years -- when realized volatility exceeded the level reached in connection with HCE's September variance swaps -- and other instances where volatility nearly reached 40 -- including October 1987, when realized volatility exceeded 100. (Ex. 47 at 1069, 72)

Finally, the value of Hughes's opinions is called into question by his testimony that, according to FAMCO's risk analysis, there was zero chance of a $7 million loss on the September 2008 variance swaps. (Tr. 782:2-15) He was spectacularly wrong. The fact that it happened to HCE shows the fallacy of a portfolio manager relying on an eleven-year history to draw strong conclusions about investment risk. One of the papers referenced in Professor Spatt's Report by an esteemed economist noted that – even with four to five years more data than Respondents had – there was insufficient data to analyze the possibility of a large move in variance swaps. (Tr. 3401:13-3405:25)

3. Respondents' Attacks on Grossman and Harris Miss the Mark

Respondents have launched attacks on each of the witnesses who suggested that HCE's written put option and variance swap investments involved a substantial risk of loss. They ask this Court to conclude that Jeffrey Grossman, a former options trader and faithful FAMCO employee, and Professor Larry Harris, a prominent finance professor and economist, had no basis to testify that in their view written put options and short variance swaps posed significant investment risk.

Respondents' counsel (who previously represented Mr. Grossman) now attack Mr. Grossman's qualifications, his opinions, and even his veracity. (Resp. Brief at 24-26) Respondents argue that Grossman was irrational to be concerned about the notional exposure of HCE's written put options.[12] (Resp. Brief at 24 n.131) However, FAMCO acknowledged in a formal memorandum written to HCE's Board that notional value is one accepted metric of describing a fund's exposure to risk. (Ex. 21 at 16771) And Randall Barnes, an HCE Board member and an experienced options trader, also viewed an investment's exposure to risk of loss based on its notional value. (Tr. 2940:11-2942:5)

Respondents launch similar attacks on Professor Harris's reliability, criticizing him for correcting a few minor errors in a 216-page report.[13] (Resp. Brief at 26) Respondents also claim that Professor Harris' opinions have been rejected by prior courts, but offered nothing as evidence of impeachment on this point at the hearing. Although Respondents criticize the Division for not asking Professor Harris for testimony on this point during redirect, the only evidence Respondents' cite in support of their rhetorical point is the citation to a question posed by Respondents' counsel (to which Professor Harris did not agree). (Resp. Brief at 26 n.144; Tr. 278:15-21) This does not prove their point.

Respondents further criticize Professor Harris for never reading any investigative testimony or speaking with FAMCO employees. (Resp. Brief at 26) This argument is a red herring. Professor Harris reviewed and considered Respondents' Wells submissions, which contained everything Respondents wanted the Division to know before deciding

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[12] This view of risk is completely rational. An investor who invests $10,000 in an S&P 500 index fund may reasonably view their total risk exposure as $10,000, even if the likelihood of losing the entire investment is remote. HCE's prospectus advised potential investors that an investment in the Fund could result in the loss of the entire amount invested, even though HCE was supposed to be primarily invested in a diversified portfolio of equity securities. (Ex. 11 at 12417)

[13] Professor Spatt's report, by contrast, contained no errors in analysis because Professor Spatt did not conduct any quantitative analysis or review of HCE's derivatives trading. Instead, Professor Spatt simply relied on Respondents' investigative testimony and Wells submissions in forming opinions about their research, understanding and trading decisions. (Tr. 3339:8-3340:5)

whether or not to bring this proceeding. (Ex. 139 at 162) Professor Harris reviewed Respondents' supplemental Wells submission and analyzed the quantitative analysis contained in that submission. (Ex. 139, Table 8, at 129) Respondents also acknowledge that Professor Harris correctly identified their value-at-risk methodology. (Resp. Brief at 18) They appear to be unhappy that Professor Harris actually conducted an objective analysis of HCE's trading and drew his own conclusions from that analysis, rather than accept their story without question and rely upon their views regarding risk. (Tr. 3439:9-14, 3443:5-3445:16)

The disagreements between Professor Harris and Respondents regarding the now-infamous "peso problem" appear to be semantic, rather than substantive. (*See* Resp. Brief at 27-28) Hughes claimed that written put option investments do not suffer from a peso problem because the occasional, large losses do not wipe out all previous gains. (Tr. 681:23-682:11) However, Professor Harris never suggested that inevitable large losses would necessarily wipe out *all* of the previous gains; in fact he agreed over the long run the losses would not eclipse all gains. (Tr. 259:5-21) However, Professor Harris focused on the significant risk those inevitable large losses pose to the investor and the difficulty of attempting to properly assess investment risk without large amounts of data. (*Id.*) In fact, the very same academic paper Hughes cited for the proposition that written put options do not suffer from a peso problem *also* warns that put-writing can be "very risky" and can result in "huge losses." (Tr. 677:5-682:11; Ex. 214[14] at 149060, 68, 69 n.8)

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[14] Notwithstanding Hughes's testimony, it is not clear if anywhere in the paper the author concludes that put-writing is immune to peso problems. The author merely states that the risk premium for writing put options cannot be explained away by the peso problem. (Ex. 214 at 149077)

Respondents further claim that Professor Harris had no idea what data Respondents considered because he did not review their testimony or speak to them. (Resp. Brief at 28) However, Professor Harris did review Respondents' analysis, and their variance swap testing went back to only 1997. (Ex. 208) Respondents criticize Professor Harris for relying on supposedly unreliable data from the CBOE. (Resp. Brief at 28-29) Riad testified that during his time on the CBOE Advisory Board, he was involved in discussions with CBOE where they determined that all of the firm's options data before 1993 was unreliable and decided to rebrand VIX with an accurate methodology. (Tr. 2034:25-2035:3, 2113:18-2114:25) CBOE changed its methodology in September 2003, and recalculated its data using the new methodology back to 1990. (Ex. 148; http://www.cboe.com/micro/vix/historical.aspx) CBOE continues to maintain the older data on its website without any restrictions or qualification about its reliability; in fact, CBOE continues to make calculations using the older methodology all the way to present day, ten years after changing course. (http://www.cboe.com/micro/vix/historical.aspx) CBOE actually released a paper in 2007, utilizing option data back to 1988, which FAMCO considered as part of its research. (Ex. 212; Tr. 899:3-900:17) Some of the research papers Respondents relied upon were also based upon that same unreliable option market data from the 1980s. (*See*, *e.g.*, Ex. 206 at 8995; Ex. 213 at 8946). So it seems pointless to criticize Professor Harris for using pre-1990 options data.

Respondents also disagree with Professor Harris that any risks beyond a five percent loss matter, claiming that they are legally irrelevant under Form N-2. (Resp. Brief at 32) However, their citation to Form N-2 is inapposite, because the cited provision only applies where the "potential liability or loss that may be incurred" is no more than five percent. (Ex. 142 at 17) Form N-2 does not guide registrants to evaluate what happens in the event that a potential loss is greater than five percent, because the instruction is written for those with smaller potential losses who are relying on that particular section to limit their disclosure obligations. Form N-2 does not say "no more than five percent most of the time" or "no more than five percent with a reasonable degree of confidence." It talks about *potential* liability and the loss that may be incurred and provides no qualification for the likelihood of exceeding five percent.

Respondents and Professor Spatt also criticize Professor Harris's focus on the risk of a five percent loss on a strategy basis, rather than on a transaction-by-transaction basis. (Resp. Brief at 33) However, Professor Spatt acknowledged the limitations in Respondents' transaction-by-transaction analysis, and conceded that "[o]ne could imagine undertaking analogous analysis with respect to the risk at the strategy level . . ." (Tr. 3269:6-23) In fact, the language of Form N-2 supports Professor Harris's focus at the level of investment strategy, in posing the question whether more than five percent could be lost "in connection with a particular *practice*" rather than in a particular transaction. (Ex. 142 at 17) (emphasis added) Respondents admit that engaging in a strategy consistently "makes it more likely that the positions will eventually suffer a large loss."[15] (Resp. Brief at 20-21)

It makes sense that the frequency with which one engages in an investment strategy should be considered when evaluating the risk of loss. Under Respondents' unique method of risk assessment, it is irrelevant whether you roll the dice only one time, or a thousand times, in assessing the likelihood of obtaining a certain result. Further, by focusing only on

[15] Respondents argue that they were not consistently short variance swaps. However, from the first variance swap transaction in July 2007 until the last one was closed, HCE had short variance exposure in its portfolio 84% of the time. (Ex. 139 at ¶ 133)

the amount of risk within a relatively short time frame, such as a month, it becomes easier to determine that a particular investment does not pose a significant risk of loss. For example, using the same monthly value-at-risk methodology employed by Respondents, one would conclude that even a $25 million investment in the S&P 500, constituting 25% of HCE's entire portfolio, would not place more than 5% of the Fund's assets at risk and would require only limited rather than fulsome disclosure under Form N-2.[16]

Respondents also complain that Professor Harris focuses on the risks of loss associated with a particular strategy and ignores the investment gains. However, at least Professor Harris is consistent with the language of Form N-2, which says nothing about evaluating the gains or calculating net losses. The form focuses entirely on the risk of loss. (Ex. 142 at 17)

Finally, Respondents criticize Professor Harris for stating that Respondents should have considered the combined risk from the written put option and variance swap strategies. (Resp. Brief at 34-35) Instead, they argue that Form N-2 does not require that the potential losses from *different* strategies be analyzed together when evaluating risk. (Resp. Brief at 34) Be that as it may, Swanson testified that the put options and the variance swaps were part of the same "macro hedging strategy." (Tr. 1694:15-23, 1720:5-17, 1771:7-1772:2, 1789:20-1790:1, 1891:22-24, 1933:5-12) Further, FAMCO relied on the same "Strategic Transactions" prospectus disclosure to authorize the use of both written put options and variance swaps; so it is logical that the potential losses associated with

[16] A $25 million investment in the S&P 500 would have a 0.63% chance of losing $5 million in a given month, approximately the probability of a $5 million loss in the put options and variance swaps according to Respondents. (Ex. 74 at 33573 ($25 million x 20%))

HCE's use of Strategic Transactions should be evaluated together from a risk standpoint.[17] (Tr. 1271:20-1272:23) Respondents should not be heard to complain that they do not understand know how to evaluate the risks of the two strategies together. (Resp. Brief at 34) Both Respondents and Hughes talked at length about their research efforts and how they analyzed numerous combinations of derivative investments in order to identify the best strategies and risk-adjusted returns. (*See* Ex. 74; Tr. 600:16-603:7) It is only now, when dealing with two similar strategic transactions with a significant amount of combined risk, that it becomes too difficult for Respondents to evaluate them both together.

4. Professor Spatt's Opinions Are Not Based on Any Expert Analysis

Respondents claim that "every aspect of their approach was validated by" Professor Spatt and note that Professor Spatt believed that they reached reasonable conclusions about investing in written puts and variance swaps based on their research and analyses. (Resp. Brief at 23-24) However, Professor Spatt never actually analyzed any of HCE's trading or verified the accuracy of any of Respondents' work. (Tr. 3339:8-22) Instead, Professor Spatt simply relied on Respondents' representations of what they had done, which he read in their investigative testimony transcripts and Wells submissions; he did no independent or expert analysis aimed at testing FAMCO's work. (Tr. 3339:8-3341:17, 3439:9-14)

Professor Spatt's opinion was based on Respondents' claim that the risk of loss for the put options and variance swaps was limited to a 0.5% chance of a 5% loss to the Fund. However, the sole source of Professor Spatt's understanding that HCE's derivative

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[17] Under Respondents' approach, a portfolio could be comprised of ten different types of "Strategic Transactions" that individually have limited risk. The Fund could have substantial cumulative exposure to Strategic Transactions and not be required to provide detailed disclosure of any of those transactions or strategies. This is not logical, and would eviscerate the rule while undermining the Commission's disclosure goals as well as protections for investors.

investment risks were limited to a 0.5% chance of a 5% loss was the Respondents' Wells submission. (Tr. 3445:2-16) During the hearing, Professor Spatt agreed that Respondents' demonstrative exhibit, which showed a 0.73% chance of a $5 million loss, but accounted for only one of the two written put options in the Fund's portfolio, actually demonstrated that the combined risk of HCE's August 2008 put option positions exceeded a 0.5% chance of a $5 million loss. (Tr. 3445:17-3447:9)

Likewise, Professor Spatt conceded that because HCE was shorting variance swaps in amounts as great as $450,000 vega, at times the Fund had exposure equal to 1.5 times a $300,000 vega variance swap. (Tr. 3450:2-3453:10) Moreover, FAMCO's own risk analysis showed a $300,000 vega variance swap had a 0.6% chance of a 5%, which proves that HCE's investment risks when using these instruments were not limited to a 0.5% chance of a $5 million loss. (Tr. 3450:2-3453:10; Ex. 208) Consequently, one of the key underlying assumptions of Professor Spatt's expert opinion has been proven to be inaccurate.

Professor Spatt's opinions regarding the reasonableness of Respondents' research efforts lack a sufficient foundation because he simply lacked an understanding of the methodologies employed by Respondents in evaluating risk. Professor Spatt noted in his report that FAMCO routinely adjusted its frequency distributions to account for mean reversion of volatility and the likelihood of a significant market decline following another decline. (Tr. 3453:11-21) In other words, Respondents were modifying their probability tables to account for certain market conditions. Professor Spatt could not recall what, if anything, he looked at regarding these adjustments made by FAMCO to their distributions, what exactly FAMCO was doing on that front, or why such adjustments were reasonable.

(Tr. 3454:5-3457:2) If he could not explain what FAMCO was doing, it is unclear how he could conclude their actions were reasonable, or testify on that point in an evidentiary proceeding.

B. Respondents' Communications Demonstrate Their Intent to Conceal Risks, Not Openness and Good Faith

Respondents claim that their good faith is demonstrated by their openness about their investments and their reliance on the guidance of others. In fact, their actions are more consistent with subterfuge and misdirection .

1. Riad Did Not Inform All Relevant Parties about the Trading

Respondents claim that Riad's decision to approach the relevant parties prior to entering into the Fund's first short index put position and variance swap position demonstrates his good faith. (Resp. Brief at 35) However, Riad did not have a choice. Riad testified that the put options and variance swaps were traded pursuant to ISDA agreements, which required Claymore's approval, so Riad *had* to have a conversation with Claymore about his intention to trade those investments. (Tr. 2192:23-2193:17) The real insight into Riad's mental state comes from *what* he told Claymore. Riad told Hill that he wanted to write put options and short variance swaps as a hedge against volatility. (Ex. 4; Tr. 2705:23-2706:1) In fact, Riad viewed long variance swaps and long put options were the real form of protection for HCE's portfolio. (Tr. 2121:1-7, 2123:6-11, 2162:19-23) The short variance swaps and written put options were designed to take advantage of the profitability of selling insurance, not to hedge against volatility. (Resp. Brief at 9)

It is also noteworthy that many relevant parties were unaware of Riad's trading until well after he began. Riad did not go to FAMCO's Chief Compliance Officer before he began trading. (Tr. 1160:19-1161:7) Steiner, also in FAMCO's compliance group, did not find out until the end of 2007, and only did because Grossman came to her to complain about the risk. (Tr. 1260:17-1261:5)

Finally, the first week that Riad removed a long put option position to leave HCE naked short, Swanson asked whether they can have naked short put options, to which Riad responded, "i was hoping by the time we had that discussion it will expire. i am stalling." (Ex. 99 at 119708[18]; Ex. 86 at 89834 and Ex. 139 at p. 178 (showing removal of all long put options on June 20, 2007)) "[I] am stalling" is not the response one would expect if Riad had been open and clear with everyone about what he was doing.

2. Respondents Misled Claymore and HCE's Board

Respondents claim that Respondents fully informed HCE's Board and Claymore about their use of written put options and variance swaps. (Resp. Brief at 36) Respondents further claim that they made presentations at every board meeting about these strategies. (Resp. Brief at 36) However, Respondents' presentation on these investments was extremely limited, often one to two minutes. (Tr. 2918:18-2919:10, 3008:9-13)

Every time the put options and variance swaps were discussed, Respondents discussed their use of put options and variance swaps using terms such as: downside protection; hedges; volatility-reducing; mitigating risk and volatility; and conservative.[19]

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[18] Respondents contend that this conversation had nothing to do with HCE because Swanson references "CCF," a different fund. However, Swanson says the naked options may raise a flag "*particularly* in CCF" (emphasis added), suggesting that he is referring to multiple funds. This conversation occurred the week of June 17, which happened to be the first week HCE dropped long put option exposure and maintained only written put options. Even if Respondents are to be believed that this conversation referred only to a different fund, the conversation is still damning to Riad's claim that he was open and never concealed anything about his put strategies.

[19] (Ex. 180 at 7915; Ex. 71 at 24571-72; Ex. 22 at 16786; Ex. 6 at 10329, 31; Ex. 8 at 11798; Ex. 4; Ex. 178 at 21939; Ex. 76 at 38044-45; Ex. 5 at 9400, 02)

(*See* Division's Post-Hearing Brief at 20-25; Tr. 2655:18-22) Respondents never discussed the risks of these investments at Board meetings. (Tr. 3014:18-3015:16) At the October 2007 Board meeting, Respondents concealed from an inquiring Board the significant effect their derivative strategies, particularly the put options, had on performance, instead focusing the conversation on their management of the covered call strategy. (Tr. 2927:15-2934:1, 3013:8-3014:22)

Respondents continued to hide the truth in the fall of 2008. After suffering millions in losses and getting a specific inquiry from HCE's Board about the portfolio, Respondents did not disclose put option and variance swap losses in the portfolio and sent to the Board a strategy report that suggested FAMCO was taking a defensive position. (Ex. 104; Ex. 54 at 13088-89; Ex. 20; Tr. 3019:21-3020:21) All the while, Respondents were placing a new bet on variance. (Ex. 50; Ex. 63 at 18731) When forced to explain the losses in October 2008, Riad told the Board that he had implemented a strategy of *purchasing* put options, and that he was using the written options merely to fund the long positions. (Ex. 19 at 16625-26) He claimed that he had a long put strategy, even though HCE had written put exposure 84% of the time from April 2007 to October 2008 and long positions only 38% of the time. (Ex. 139 at ¶ 126; *see also* Division's Post-Hearing Brief at 44-46) This claim is particularly amazing given that Riad's research showed that holding long put positions was never optimal and was a losing proposition. (Resp. Brief at 14-15) Accordingly, Respondents' actions demonstrate that they were obfuscating the truth about their trading.

3. HCE's Investors Were Not Informed

Respondents argue that investors were on notice that HCE was engaged in a long-term strategy of writing put options and shorting variance swaps because a couple of positions were disclosed in periodic reports. (Resp. Brief at 40) It should be noted that periodic reports are filed approximately two months after the report date, meaning that even the most savvy investor could not detect a pattern until months after the strategy was in full force.

Respondents suggest that it "strains credulity" to suggest that investors would not have understood HCE's use of these derivatives. (Resp. Brief at 41) Yet somehow two testifying professional investors could not determine from HCE's periodic reports that HCE was engaged in strategies of put-writing and trading short variance swaps. (Tr. 1352:3-6, 1353:19, 1366:13-19, 1370:12-1371:16, 1480:6-17, 1494:10-23)

Respondents claim they disclosed valuable risk information about the individual transactions. (Resp. Brief at 41) Respondents also assert that the notional exposure of the put options was disclosed, so HCE's investors must have been aware of the risk. (Resp. Brief at 42) To know HCE's put option notional exposure, an investor would have to first notice the written put option positions among a lengthy list of options, and then – assuming they know how -- calculate the notional exposure on their own. (*See* Ex. 14 at 15497-98) Investors are not required to engage in such detective work, and issuers cannot hide behind disclosing the pieces of information to claim they disclosed a risk or strategy that is not affirmatively disclosed. In re Oppenheimer Rochester Funds Group Sec. Litig., 838 F.Supp.2d 1148, 1164-69 (D. Col. 2012) (disclosure that requires investor to request SAI, locate specific investments contained therein, and then make calculations based on that information did not adequately disclose the information that could be derived from such steps).

Respondents attempt to extrapolate from Grossman's and Emmanouil Tsimouris's awareness of HCE's notional exposure to written put options that the risks must have been obvious to HCE's investors. (Resp. Brief at 42) Such a comparison is senseless, as Grossman noticed the put options because it was his job to monitor HCE's portfolio on a daily basis and he noticed them the very day they were placed into the portfolio. (Tr. 491:21-492:9) Tsimouris noticed the notional exposure in the context of a multiple-week after-the-fact examination of HCE's failure (when the losses caused by the put options were already known). (Tr.; 64:19-65:3) The variance swaps were even more difficult for investors to figure out, as the disclosures did not give any information about the extent of the exposure to volatility. (Ex. 139 at ¶ 201 n.31; Tr. 86:13-23)

Riad did not believe investors knew about the put option and variance swap strategies. In early October 2008, Riad and Swanson worked with Claymore to draft a press release that explained the Fund's aberrational performance. (Ex. 64) Riad – in an apparent acknowledgement that investors were previously unaware of his risky strategies -- wrote in an email to Swanson, "I decided to be upfront and explain the strategies instead of hiding. We will probably be getting whiplash either way but I think we have less risk if we are transparent." (Ex. 64 at 20380) If investors knew already what Respondents were doing, what would there be to explain and why would there be whiplash?

Finally, Respondents assert that they acted in good faith because they did not engage in an even greater fraud by window-dressing the portfolio by removing the positions before the reporting period ended. (Resp. Brief at 43) Respondents claim they could have easily fooled everybody and concealed the trading from HCE's Board and shareholders by doing so. (Resp. Brief at 43) However, Respondents have asserted time and again that there was no way to conceal their trading activities from Claymore, who had access to all trading records and had to sign ISDA agreements for the derivative transactions. (Tr. 2192:23-2193:17) Since Respondents could not hide their trading from Claymore, they instead opted to mischaracterize their trading as protective hedges for the portfolio. It would have been quite risky to attempt to conceal the trading entirely from the Board given Claymore's awareness, as would it be risky to engage in a blatant pattern of manipulative trading such as window-dressing.

C. **Respondents Did Not Rely on Any Guidance Regarding Their <u>Disclosures to Investors or the Adequacy of Prospectus Disclosure</u>**

Respondents contend that they lack *scienter* because they reasonably relied upon Claymore and HCE's counsel to provide guidance regarding the written put and variance swap investments, and because the Commission has discouraged registrants from providing too much information about their less important investments. (Resp. Br. at 43-54) None of these arguments are persuasive.

Riad and Swanson never sought advice from Bruce Saxon, HCE's chief compliance officer, about the use of these strategies (or about any other compliance matter) and never discussed the risks of those strategies with Saxon. (Tr. 2648:22-2649:18) Riad and Swanson never went to FAMCO's internal compliance officers with questions about put options and variance swaps or even notified them that they intended to or were trading the products during 2007. (Tr. 1159:15-1160:24, 1291:24-1293:3) FAMCO's own compliance officers did not become aware of HCE's use of put options and variance swaps until late 2007 or early 2008, and only after Jeffrey Grossman brought the situation to their attention. (Tr. 1167:25-1168:6; 1260:17-1261:5) It is unclear exactly when Riad spoke to

Steven Hill about written puts or variance swaps, because there is no documentation of any such conversation.

Although Claymore and its legal counsel both confirmed that Respondents were allowed to trade in written put options or variance swaps, neither Claymore nor the Fund's counsel advised Respondents on how often they could write put options, or enter into short variance swaps and to what degree. Nor did Respondents seek any advice from Claymore or the Fund's counsel about whether to describe their written put and variance swap investments as a global hedging strategy.

Riad and Swanson were the ones who told Claymore, Fund counsel and the Board that these investments were risk- and volatility-reducing hedges. Neither Claymore nor Fund counsel directed Respondents to use certain words, phrases or descriptions in describing how the FAMCO Portfolio Managers were attempting to accomplish HCE's investment objectives, and how the Fund had performed since the last report. Accordingly, Respondents did not rely in good faith on the advice of anyone else in how to disclose the written put or variance swap investments.[20]

Courts have consistently held that a reliance defense, such as reliance on counsel, "is simply a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud." *U.S. v. Peterson*, 101 F.3d 375, 381 (5th Cir. 1996); *see*

[20] The fact that the Commission has, in the past, given guidance about "plain-English" disclosures and has attempted to eliminate the dumping of useless information is, in connection with this case, nothing more than another red herring. None of these rules or guidelines supersede FAMCO's obligations under Form N-2, and the Commission has not required or encouraged registrants to hide information about investments strategies a fund actually is using from investors, let alone to preclude registrants from including in annual or semi-annual reports information about investment results or risks from those same strategies. Respondents might have a better argument if they ever had gone to Fund counsel with a question about their Portfolio Manager Q & As, but they did not do so.

also SEC v. McNamee, 481 F.3d 451, 455-56 (7th Cir. 2007). Put another way, a reliance defense merely "addresses *scienter*." *SEC v. Huff,* 758 F. Supp. 2d 1288, 1348 (S.D. Fla. 2010) (collecting cases). For this reason, courts routinely refuse to allow a reliance defense to negate claims that do not have a *scienter* element. *Erenstein v. SEC*, 316 Fed. Appx. 865, 869 (11th Cir. 2008); *SEC v. Verdiramo*, 2011 U.S. Dist. LEXIS 101856, *31 (S.D.N.Y. Sept. 9, 2011); *SEC v. Mut. Benefits Corp.*, 2004 U.S. Dist. LEXIS 23008, *55 (S.D. Fla. Nov. 10, 2004).

Similarly, courts refuse to allow a reliance defense when the defendant, like Riad and Swanson, have significant industry experience or is a senior official at his firm. For instance, in *Graham v. SEC*, 222 F.3d 994, 1005-06 (D.C. Cir. 2000), the court rejected the defendant's reliance defense. Even though the defendant obtained her supervisor/compliance officer's approval for the illegal trades at issue, because she was an "experienced professional who has an independent duty to use diligence 'where there are any unusual factors,'" the fact that her supervisor/compliance officer approved the trades did not relieve the defendant of her illegal conduct. *Id.* (citations omitted). The defense was similarly unavailable for a broker who claimed reliance on his firm's restricted stock department ("RSD"), transfer agents, lawyers, and auditor, who all approved the illegal transactions at issue. *Wonsover v. SEC*, 205 F.3d 408, 415 (D.C. Cir. 2000) ("Precedent will not suffer Wonsover's argument that he justifiably relied on the clearance of sales by the RSD, the transfer agent and counsel."). Nor was the defense available for a firm's CEO who claimed reliance on his lawyer and a subordinate, yet knew that the firm was violating SEC and NASD rules. *Markowski v. SEC*, 34 F.3d 99, 104-05 (2d Cir. 1994). Likewise, a mutual fund officer's claimed reliance on fund accountants cannot excuse his liability for the fund's misleading SEC filings. *SEC v. Advance Growth Cap. Corp.*, 470 F.2d 40, 52 (7th Cir. 1972). Here, both Riad and Swanson had sufficient experience that they should have insisted that HCE's disclosures regarding investment strategies, performance and risk were accurate, instead of depending on Claymore or Fund counsel to raise, address and correct issues without knowing all the facts known to Respondents.

Finally, a defendant may only assert a reliance defense if he (a) "fully disclosed all material facts" to the person whose advice was sought and (b) "actually relied" on the advice he received. *U.S. v. Rice*, 449 F.3d 887, 897 (8th Cir. 2006). Riad and Swanson did neither of these things, as they hid critical facts from Claymore and Fund counsel. The only record of such a conversation involving Riad or Swanson is Susan Steiner's memo of a January 16, 2008 telephone conference between FAMCO and Claymore. (Ex. 27) Fund counsel is not shown participating, and topic of the call is the sale of an uncovered put – not the use of variance swaps.

Several of the participants on this call have testified that there was no discussion of disclosure issues; and there was no discussion of the potential size of FAMCO's investments in derivatives, the frequency, the duration or the risks of those investments. And this telephone conference took place more than six months after Riad began making derivative investments in HCE. So if Riad and Swanson already had permission to make investments in naked written puts and short variance swaps – this telephone conversation would not have been necessary. Riad and Swanson received permission to trade in written puts and variance swaps, but they did not seek any "advice" of Fund counsel; and, clearly they never disclosed any of the information that would have been necessary for Claymore or Fund counsel to consider whether additional disclosure was necessary.

D. Respondents Had Motive to Deceive HCE's Shareholders and Board

Finally, Respondents contend that they had no motive to deceive anyone about their written put option and variance swap investments because, unlike other portfolio managers, they felt no pressure to perform at FAMCO, they were under no financial pressure to make risky trades, and because Riad had invested his own and his partners' money using strategies similar to HCE's. (Resp. Brief at 54-64) These arguments are not persuasive.

In the first place, Respondents had reasons to mislead HCE's shareholders about their use of written puts and short variance swaps because they knew that the Fund's registration statement described its primary investment strategy as investing in equities and writing call options on a substantial portion of those equities. (Ex. 11 at 12386) HCE investors and analysts also understood HCE to be a covered-call fund. (Tr. 1349:6-13; 1407:17-1408:19, 1458:7-1459:23) Some of HCE's investors, like Michael Boyle, chose HCE because it was a covered call fund – and they would not have invested in the Fund if it were something different.[21] (*See* Ex. 140 at 23; Ex. 152; Tr. 1475:6 – 1477:13) So Respondents could not reveal that HCE was regularly investing in written put options and variance swaps, as one of the Fund's principal investment strategy, without also revealing that they had transformed HCE from a safe and conservative covered call fund into a more-risky derivative fund that essentially offered insurance to other investors against market losses.

[21]In November 2007, Riad believed that written put option strategies were primarily being used in hedge funds, and was disappointed that these techniques were becoming more widely-known. (*See* Ex. 58 ("Too bad the word is out b/c we have been having a lot of success in utilizing SPX Put Selling as a hedging tools in our closed end fund HCE. . . I am not aware of many closed end funds employing such strategies. They are used extensively in the hedge fund industry primarily."))

Second, Riad and Swanson were under constant pressure to deliver income to the Fund's investors. HCE advised investors that its goal was to pay an annual dividend of 8.5% of the Fund's initial offering price. (Ex. 14 at 15493) In order to meet this objective, FAMCO needed to maintain an annualized return of 10% before fees. (Ex. 5 at 9410) Riad and Swanson recognized that the need to consistently beat the S&P 500 by means of a covered call strategy posed "meaningful risk" of NAV erosion, and Riad believed HCE's dividend rate was unsustainable. (Ex. 8 at 11798; Ex. 66 at 21761-62) In fact, from the Fund's inception, Riad had expressed his concern to the Board about HCE's ability to meet the dividend objective. (Tr. 1131:6-1132:7)

In 2008, Riad sought authorization to utilize leverage in HCE to help maintain the Fund's NAV in light of the dividend, and he simultaneously sought permission to reduce HCE's dividend. (Ex. 5 at 9410; Ex. 22 at 16786; Ex. 66; Ex. 306 at 30774, 76) But until they had permission to use leverage, or HCE's dividend was reduced, Riad and Swanson needed a way to earn additional income for the Fund beyond what the primary covered call strategy generated. Although Respondents' referred to their use of written put options and short variance swaps as hedging transactions, designed to reduce risk or volatility in the portfolio, FAMCO subsequently informed HCE's Board that the Fund had adopted the written put option and variance swap strategies "as a means of sustaining its high dividend payout objectives." (Ex. 75 at FAM 34141)

Third, even though Respondents described FAMCO as a "family-oriented" "no-pressure" place to work (Resp. Br. at 55), Riad testified that he and Swanson faced constant pressure and the risk of being replaced as portfolio managers if they did not meet their performance benchmarks. (Tr. 2307:18-2313:1) Riad stated unambiguously that for a portfolio manager, the risk of trailing a relevant benchmark "generates pressure." (Tr. 2308:20-2309:2) He also recognized that being fired as a portfolio manager would have had a negative effect on his career. (Tr. 2312:19-2313:7) In fact, this is what happened to both Riad and Swanson when HCE suffered dramatic losses and missed its benchmarks in the Fall of 2008; they both were removed as HCE's portfolio managers.

And besides the risk of being replaced by other FAMCO employees as portfolio managers for HCE, every Fall Riad, Swanson and their partners a FAMCO faced the risk that the Board could decide not to retain FAMCO as the Fund's sub-advisor. In October of 2007, and again in October of 2008, FAMCO had to submit its Section 15(c) Contract Review to the Board. (*Compare* Ex. 186 (2007) and Ex. 75 (2008)) In its September 20, 2007 submission, FAMCO was required to attest that HCE was a covered call fund, that its "underlying portfolio of stocks and long calls has outperformed" the S&P 500 and the CBOE Buy Write Index every year since inception, and that HCE's NAV performance is comparable to other funds with similar investment strategies. (Ex. 186at 8090-91) Respondents could not reveal that their extensive use of written put options and variance swaps had transformed HCE into a different type of fund without jeopardizing FAMCO's retention as Claymore's sub-advisor.

Whether or not Riad and Swanson had a good reason to deceive HCE's investors and the Board about investment strategies, results and risk, the fact remains that they did so. In early October 2008, HCE's losses were beginning to mount, and the Board demanded an explanation. Riad and Swanson provided a "Financial Update to Trustees" which revealed the extent of HCE's losses on short puts and variance swaps, and revealed that Respondents had been using these instruments as "Alternative Investment Strategies" in order to enhance returns. (Ex. 77 at 39549) This update was much more detailed than anything provided to the Board before quarterly meetings, and specifically described HCE's investments, the Fund's recent losses, the written put and variance swap strategy, and FAMCO's backtesting and risk expectations. (*Id.*) If the Trustees already knew all of this information, then this memo was unnecessary. The memo then admits that FAMCO had been treating naked written puts as an attractive stand-alone investment. The memo describes short variance swaps as a stand-alone investment, not as a hedge – which would be expected to perform better than HCE's other investments in an adverse market. This memo makes clear, finally, that Riad and Swanson had been using both types of these investments to generate return for HCE under all market conditions, rather than using them as a hedge which would protect the portfolio from declines in the market or spikes in volatility.

The fact that Riad and Hughes invested in HCE, and that Riad had money invested in the FOF fund, is not by itself evidence of Respondents' *scienter*. Respondents did not announce to investors or Board members that they were investing in HCE because of its derivative strategies, or that they had other investments which followed similar strategies. And whether or not Respondents were careful investment managers, because they kept their eyes on funds containing some of Riad's money, says nothing about whether the disclosures to investors regarding strategy, results and risks were appropriate. The fact that Riad (and Hughes) invested in HCE and FOF because they believed in the written put and variance swap strategies makes then anomalies. They disclosures at issue in this matter do not explain to investors everything that Riad, Swanson and Hughes knew about the HCE fund. So no investor who was not a FAMCO insider could possibly have made a decision to invest in HCE because of the Fund's use of written puts or variance swaps.

III. CONCLUSION

For all of the foregoing reasons, as well as the reasons stated in its initial Post-Hearing Brief, the Division of Enforcement respectfully requests that the Court issue an Initial Decision finding that Respondents Mohammed Riad and Kevin Timothy Swanson engaged in the violations described in the Order Instituting Proceedings, and imposing significant sanctions against each Respondent.

Dated: July 26, 2013.

Respectfully submitted,

/s/Robert M. Moye

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