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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.

RESPONDENTS' PETITION FOR
REVIEW OF INITIAL DECISION

Pursuant to Rules 410 and 411(b)(2)(ii) of the Commission's Rules of Practice, Respondents Mohammed Riad and Kevin Timothy Swanson ("Respondents") hereby petition the Securities and Exchange Commission (the "Commission") to review the Initial Decision rendered in the above-captioned action on April 21, 2014.[1] The Respondents seek review of the Initial Decision by the Commission because it is premised on clearly erroneous conclusions of law and clearly erroneous findings of material fact, and also establishes an important determination of law and policy that is improper. The Commission's Rules of Practice provide for direct review of an Initial Decision where a petitioner "makes a reasonable showing that the decision embodies an erroneous conclusion of law or an important determination of law or policy that [it] should review."[2] For the reasons set forth below and addressed in detail in the Respondents' post-hearing briefs, this petition satisfies such a showing and also identifies clear factual errors that should be reviewed.

The Respondents filed a Motion to Correct Manifest Errors of Fact on May 1, 2014 and the Division of Enforcement filed a Response in Opposition to Respondents' Motion to Correct on May 8, 2014. A decision on the Motion to Correct was rendered on May 15, 2014. According to the Initial Decision[3] and pursuant to Rule 410(b) of the Commission's Rules of Practice, a party has 21 days from the date of the order resolving the Motion to Correct. Rule 160(a) of the Commission's Rules of Practice provides that "[i]n computing any period of time prescribed . . . the day of the act, event, or default from which the designated period of time begins to run shall not be included." As a result, this petition remains timely under Rule 410(b) and the Notice

[1] The Respondents filed a Motion to Correct Manifest Errors of Fact on May 1, 2014 and the Division of Enforcement filed a Response in Opposition to Respondents' Motion to Correct on May 8, 2014. A decision on the Motion to Correct was rendered on May 15, 2014, such that this petition is timely under Rule 410(b).
[2] In re Rita C. Villa, SEC Rel. No. 40877, 1999 WL 940, at *1 (Jan. 4, 1999).
[3] Decision at 38.

given by the Commission on June 4, 2014 – the 20th day after the decision on the Motion to Correct – was therefore improper and should be vacated.

I. Introduction

This matter involves investments by a closed-end investment company, the Fiduciary/Claymore Dynamic Equity Fund ("HCE Fund" or the "Fund"), in short index puts and short variance swaps in the months leading to the financial crisis in the fall of 2008. The Respondents were the co-portfolio managers of the Fund, employed by Fiduciary Asset Management, Inc. ("FAMCO"), the subadviser to the Fund, which was advised by Claymore Advisors, LLC ("Claymore"). The core of the Respondents' defense rested on their lack of scienter and the good faith of their actions. As the Commission has noted, "[a]lthough we grant 'considerable weight and deference' to credibility determinations of law judges and other initial factfinders, we judge those determinations against the weight of the evidence."[4] Here, the weight of the evidence does not support even a finding of negligence and no reasonable fact finder could conclude otherwise.[5]

The Respondents presented evidence that they exercised reasonable care in analyzing the risks and benefits associated with the investments at issue, applying the "value at risk" methodology set forth in the Commission rules that govern the relevant disclosure forms.[6] The

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[4] *In re David F. Bandimere*, Admin Pro. No. 3-15324 (Jan. 16, 2014) (internal citations omitted).

[5] As the Second Circuit recently held in reversing a jury verdict against the defendant on a theory of negligence, "[t]he SEC's trial strategy focused entirely on O'Meally acting intentionally. When the jury rejected all claims of intentional misconduct, the district court sustained the jury's verdict on the theory that O'Meally negligently failed to read and heed instructions from his supervisors; yet other theories are argued on appeal. Because the evidence was insufficient to support a verdict against O'Meally under a theory of negligence, we reverse." *SEC v. Ginder, et al*, No. 13-1116, 2014 WL 2014046, at *1 (2d Cir. May 19, 2014).

[6] See Form N-2, Item 8.3, Instruction 4(c): "If a policy limits a particular practice so that no more than five percent of the Registrant's net assets are at risk, or if the Registrant has not followed that practice within the last year (or since its initial public offering, if such period is shorter) in such a manner that more than five percent of net assets were at risk and does not intend to follow such practice so as to put more than five percent of net assets at risk, limit the prospectus disclosure about such practice to that necessary to identify the practice." See also Item 9(b) of Form N-1A: "Whether a particular strategy, including a strategy to invest in a particular type of security, is a principal investment strategy depends on the strategy's anticipated importance in achieving the Fund's investment objectives,

Initial Decision makes no mention of this "value at risk" method of analyzing the risks associated with the investments in question. Indeed, the Initial Decision offers no explanation of how to measure the risk from an investment, even though such a determination is central to the SEC's disclosure regime for funds such as HCE and the majority of the trial was devoted to this specific topic.

The Initial Decision also makes no mention of the fact that the profits and losses associated with investments in short index puts and short variance swaps were incurred during a "hundred year storm" – a once-in-a-century period of market turmoil culminating in the 2008 financial crisis. Put simply, these extraordinary market moves caused the investments to incur much larger losses than had been predicted. Instead of placing the trading in this critical context, the Initial Decision completely ignores how exceptional and unpredictable the 2008 market disruptions were.[7]

The Initial Decision also mentions – but places no apparent weight on the fact – that the portfolio manager who made the investments, Mohammed Riad, invested his own money in the strategies, losing a quarter of his life savings because of these personal investments.[8] These facts are directly relevant to Riad's scienter since a person is normally assumed to act with care with his or her own money. Similarly, the Initial Decision references the fact that Swanson received a fixed salary and bonus and did not share in FAMCO's profits[9] but places no emphasis

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and how the strategy affects the Fund's potential risks and returns. In determining what is a principal investment strategy, consider, among other things, the amount of the Fund's assets expected to be committed to the strategy, the amount of the Fund's assets expected to be placed at risk by the strategy, and the likelihood of the Fund's losing some or all of those assets from implementing the strategy."

[7] In spite of the silence of the Initial Decision on this subject, the Commission can take judicial notice of the fact that the 2008 financial crisis was "the greatest financial crisis since the Great Depression." The Financial Crisis Inquiry Report, p. xv (Jan. 2011).

[8] The Initial Decision also makes no mention of the undisputed fact that the analyst who assisted Mr. Riad in evaluating these investments, Sean Hughes, also invested his own money in the HCE Fund and suffered personal losses because of these investments.

[9] Decision at 27.

on this evidence. Again, these facts are directly relevant to Swanson's scienter since they demonstrate that he had no financial motivation to mislead anybody regarding the investments at issue. The decision also places no apparent weight on the fact that Swanson reasonably believed that the investments at issue had little risk,[10] relegating this point to a footnote when it again relates directly to his scienter.

The theory of the Respondents' scienter presented in the Initial Decision could not be accepted by any reasonable fact finder. The Initial Decision concludes that the Respondents were too reluctant to boast of their successes when the investments were profitable, apparently, according to the Initial Decision, because they knew that the investments had great risks and would be likely to lose money in the future. The Initial Decision also portrays the Respondents as having deceived everyone with whom they interacted about the investments at issue – the Fund's adviser, Claymore; the Fund's outside counsel, Skadden Arps Slate Meagher & Flom ("Skadden"); the Fund's board; and the Fund's shareholders. In each case, the conclusion is based on flawed premises which no reasonable fact finder could accept.

Consider an example. The Initial Decision concludes that Mr. Riad was not credible in claiming that he considered the investments to be low-risk investments that would contribute moderately to performance. Evidence of this is that the positions supposedly contributed nearly half of the Fund's returns for the two-year period prior to HCE's collapse[11], and also that Mr. Riad had reviewed a small handful of academic articles that contained oblique references to the remote risk of these investments.[12] This analysis reflects three fundamental errors. First, the findings overstate the true contribution of these investments by including the performance of unrelated positions. Second, the findings ignore the numerous articles reviewed by FAMCO as

[10] Decision at 11, n. 10.
[11] Decision at 12.
[12] Decision at 15.

part of its research – as well as the testimony of former SEC Chief Economist Chester Spatt – confirming that these investments represented an exceedingly remote risk. The Initial Decision also fails to acknowledge that these losses were incurred because of a hundred year storm – the 2008 financial crisis. Failure to acknowledge this fact distorts any inferences that can fairly be drawn from the events.

Finally, the findings reflect impermissible "fraud by hindsight." Essentially, the Initial Decision assumes that because events did not work out as predicted, the Respondents must have intended this result all along. The mere fact that investments lost money– and therefore it must have been anticipated that they would lose money – cannot form the basis for a finding of scienter.

The findings in the Initial Decision about the Respondents' alleged deceptions of Claymore, Fund counsel, the Fund board, and Fund shareholders are equally without basis in fact. Openness was an important part of the Respondents' defense because openness evidences a lack of scienter. The Initial Decision mischaracterizes the facts on this defense, turning evidence of the lack of scienter – openness – into evidence of scienter – deception of all concerned parties.

The Initial Decision acknowledges that Claymore knew about the short index put and variance swap trades, but did not know enough to understand them without a complete explanation of the strategy from the Respondents.[13] Even a brief description of Claymore undermines this position. Claymore was a much larger professional asset manager than FAMCO

[13] "The record does not show that Claymore was aware of the use of naked puts and variance swaps as a strategy. Rather, the evidence establishes that Respondents provided information concerning these transactions but that the disclosures were incomplete or concerned only single, isolated trade positions." Decision at 32. "Claymore had access to all trades in the sense that Claymore personnel could query the custodian's accounting system. Claymore was a party to the ISDA master agreements with HCE's counterparties. There was no evidence presented, however, the Respondents informed Claymore about each swap entered into under the master agreements." Decision at 25, n. 37 (citations omitted). "Respondents provided information to Claymore in addition to their direct input into the annual and semiannual reports. The evidence establishes that they provided information regarding the use of short puts and variance swaps, but that the disclosures were incomplete or concerned only single, isolated trade positions." Decision at 22. "Hill had no recollection of either Riad or Swanson discussing the magnitude, frequency, or risks of the short put or variance swap trades, or providing any details of the trades to him or the board; did not understand what the fund's 'macro hedging strategy' was; and was unaware of the extent of the use of the uncovered short puts and variance swaps underlying the 'macro hedges.'" Decision at 23 (citations and footnotes omitted).

with extensive experience managing derivatives trading strategies. It also was the adviser, not merely the sub-adviser like FAMCO, to the Fund and therefore had primary responsibility for the Fund's investments. Claymore needed no assistance to understand FAMCO's trades. Nor was there any allegation that Claymore was incapable of understanding the trades.

The Fund board is similarly described as having been informed about short index put and short variance swap trades, but having lacked the capacity to understand them because the overall strategy was not explained to them.[14] As with Claymore, it is implausible that skilled investment professionals like the Fund board[15] could not understand the information they received. Indeed, the Initial Decision entirely ignores the undisputed fact that one of the Fund directors, Mr. Barnes, was familiar with index put trades because he engaged in such trading in his own account.[16]

As for Fund counsel, numerous witnesses credibly testified that Mr. Hale from Skadden was consulted about the permissibility of the index put and variance swap trades in January 2008, before these trades had incurred any material losses,[17] although Mr. Hale implausibly did not recall such a consultation.[18] More important, the Initial Decision nowhere notes that undisputed evidence established that in November and December 2008, after all of the trades and losses were

[14] "[W]hile Toupin recalls Riad's mentioning short index puts and short variance swaps from time to time, Toupin understood them to be occasional transactions, not a strategy, and the majority of Riad's approximately fifteen minute presentations covered the equity selection and covered call strategy. Tr. 2992-93, 3008-14. Saxon's, Hill's, and Barnes's recollections were similar." Decision at 26 (citations omitted).

[15] "Ronald Toupin, who had retired after a career at John Nuveen Company, was chairman." Decision at 5 (citations omitted).

[16] Tr. at 2967:14-17 ("And is it – it's fair to say, is it not, that you have invested in naked put positions in your own personal trading? Yes.").

[17] "After consulting Hale, Saxon told Steiner they were permissible investments for HCE. Steiner recalled many conversations with Saxon about short puts; some emails document these exchanges. Steiner recalled that the issues were discussed among multiple Claymore and FAMCO representatives, including Riad and Swanson, and Hale during the January 16, 2008, conference call, and that Hale's approval of the trades was conveyed on that call." Decision at 23 (citations omitted). "Hill claimed that he asked Hale or Hale's associate whether variance swaps were permissible; Hale denied having been consulted." Decision at 23, n.31 (citations omitted). "Swanson testified that the call included 'relaying information from the fund's outside counsel to us.'" Decision at 24, n. 35 (citation omitted).

[18] "Hale testified that he first learned crucial information regarding HCE's trades from Riad and Swanson at the fall 2008 board meetings. Specifically, he learned that the frequency of the trades was beyond occasional; he had not gleaned this from reading the fund's reports. While Hill and Saxon recall consulting Hale, neither contacted him regarding disclosure requirements related to index puts or variance swaps." Decision at 24 (citations omitted).

known, Mr. Hale opined to the Fund board that no illegality had occurred. Any claim that a sophisticated lawyer like Mr. Hale could not understand index put and variance swap trades is ludicrous.

As for the Fund shareholders, the Initial Decision suffers from a complete lack of reference to relevant disclosure standards. First, as noted above, the Initial Decision claims that the index put and variance swap trades were a "principal risk" of the Fund and therefore needed to be discussed in detail.[19] Nowhere is the definition of "principal risk" as set forth in the Commission's Forms mentioned. Under that standard, the positions did *not* create a "principal risk" because the Respondents concluded that there was no more than a 0.5 percent chance of a loss of five percent or more of the Fund's assets – a classic value at risk measurement which is the methodology mandated by the Commission.[20] The Initial Decision also completely ignores the Commission's Plain English rules, which mandate shortened risk disclosures in order to ensure that investors are not overwhelmed with extraneous information.[21]

The Initial Decision also emphasized that the Fund's periodic filings failed to mention the profits earned on the investments in short index puts and short variance swaps before the financial crisis.[22] Again, there is no consideration given to the fact that the Respondents viewed these

[19] "Naked short puts and short variance swaps exposed HCE to potentially catastrophic losses in an extreme, albeit low-probability, market event." Decision at 14.
"An added strategy that compounds downside risk potential, no matter how remote, is information that a reasonable investor would consider important. The fact that the new strategy eventually resulted in enormous losses highlights the materiality of the change in strategy." Decision at 31.
[20] See Form N-2, Item 8.3, Instruction 4(c) ("If a policy limits a particular practice so that no more than five percent of the Registrant's net assets are at risk, or if the Registrant has not followed that practice within the last year (or since its initial public offering, if such period is shorter) in such a manner that more than five percent of net assets were at risk and does not intend to follow such practice so as to put more than five percent of net assets at risk, limit the prospectus disclosure about such practice to that necessary to identify the practice.").
[21] Reg S-K, Item 503(b) ("Where appropriate, provide under the caption "Risk Factors" a discussion of the most significant factors that make the offering speculative or risky. This discussion must be concise and organized logically. Do not present risks that could apply to any issuer or any offering.").
[22] "That 20% gain, which was achieved in only about seven months of the 2007 fiscal year, matched the gains from selling covered calls, which HCE's prospectus represented as the principal strategy of generating income for the fund. Thus, the written index put and variance strategy was also a principal strategy of the fund. However, the

profits as unusual and unexpected because the market moved in unprecedented ways in late 2007 and early 2008. The Initial Decision's emphasis on the absence of discussion of the success of the strategies also suffers from an inherent illogic. Why would portfolio managers conceal their successes? Has the Commission ever sanctioned a portfolio manager for concealing his successes? The emphasis on the lack of disclosure of the periods of successes seems premised on the assumption that this concealment was motivated by a sinister plan to conceal the eventual loses. The theory seems to be that the only reason to fail to brag about good results is that everyone knows that the good results will not last and will eventually generate huge losses. Again, the Initial Decision fatally applies "fraud by hindsight" and fails to even acknowledge the obvious fact that market movements in late 2007 and 2008 were unprecedented and unpredictable – the classic hundred year storm. The Initial Decision also presents a remarkably inept attempt at a cover up of the trades at issue; indeed, a cover up that was so inept it defies logic to characterize it as an attempted cover up.. Short index put trading was specifically described in the Fund's prospectus and SAI;[23] variance swap trading was described in the Fund's periodic filings;[24] and numerous Fund filings identified specific investments in short index puts and short variance swaps.[25]

Q&A sections of the November 30, 2007, annual and May 31, 2008, semiannual reports omitted to mention this." Decision at 30.

[23] "The Fund may write put and call options on securities index futures
Contracts"

[24] "Fund receives payment if the actual realized volatility of the S&P 500 Index, based on daily closing prices, over the life of the contract, is lower than the original strike price. The Fund will make payment if the actual realized volatility of the S&P 500 Index, over the life of the contract, is higher than the original strike price."

[25] Actual investments in short index puts and variance swaps were disclosed in SEC filings for some time prior to September and October 2008. For example, the quarterly list of securities holdings (on Form N-Q) for the period ended February 29, 2008, disclosed both short puts and variance swaps. Fiduciary/Claymore Dynamic Equity Fund Form N-Q ("Put Options Written" and "S&P Volatility Swap") (Feb. 29, 2008). Other periodic filings made before the financial crisis contained similar information. Indeed, index option investments were first disclosed in HCE's Form N-CSR, filed on February 8, 2007, and were disclosed in relevant filings thereafter. Fiduciary/Claymore Dynamic Equity Fund Form N-CSR at 11 (Nov. 30, 2006). Volatility swap investments were first disclosed in HCE's Form N-Q, filed on October 29, 2007, and were disclosed in relevant filings thereafter. Fiduciary/Claymore Dynamic Equity Fund Form N-Q (Aug. 31, 2007).

In sum, the Initial Decision's treatment of the disclosure issues is confusing and contradictory. It reflects a strained and unpersuasive effort to turn evidence of good faith and lack of scienter into a liability. No trades were concealed from Claymore, which never asserted it did not understand the information. A sophisticated board was aware of the investments in short index puts and short variance swaps and never asked for more information. Skadden blessed the investments both when they were made and after all of the losses were known; and, no one claimed that Skadden lacked the sophistication to understand the investments. The Fund's filings explicitly identified short index puts and short variance swaps as Fund investments and listed particular investments in these instruments. The absence of detailed discussion of the profits and risks associated with these instruments reflected the application of Commission standards based on a good faith interpretation of the market data available at the time.

Finally, and perhaps most important, the Initial Decision has important and harmful consequences for the Commission's entire disclosure regime. The lesson of this case seems to be that registrants must either disclose everything or correctly divine the future. The Initial Decision is replete with hindsight second-guessing of good faith determinations made during a time that no one anticipated would be an historic market collapse. This type of liability will encourage "telephone book" disclosures of every conceivable risk and trend – precisely the result that the Commission has sought to avoid for decades because such an approach to disclosure, although providing insurance against liability, renders SEC filings virtually unreadable and useless to ordinary investors.

II. The Initial Decision is Based on Clearly Erroneous Findings of Material Fact

The Commission should review the Initial Decision because it contains clearly erroneous findings of material fact.[26]

a. The Decision Erroneously Characterizes the Nature of the HCE Fund

i. Erroneous Characterization of the HCE Prospectus

The Initial Decision asserts that "HCE's registration statement, comprised of a prospectus and Statement of Additional Information (SAI), described HCE as a covered call fund, and set forth the limited parameters for the fund's investments."[27] This assertion reflects a fundamental misreading of the HCE prospectus and represents an erroneous conclusion of fact. The Commission itself can read the HCE Fund's public filings. That evidence – the plain language of these filings – demonstrated that the registration statement clearly distinguished HCE from a pure covered call fund and made clear that the investments at issue were contemplated by the parameters set forth for the fund's investments.

As an initial matter, the Initial Decision states that "[n]either HCE's prospectus nor its SAI, however, made specific mention of naked puts or variance swaps."[28] Such an assertion – while partially correct – is entirely irrelevant to the issues in the case. There was no need to provide a specific mention of these transactions because the registration statement granted the Respondents broad authority to engage in such transactions.

The proper method of analyzing the investments at issue in light of the prospectus disclosures was provided in a memorandum[29] drafted by Thomas Hale, the lawyer who prepared

[26] These clearly erroneous factual findings contributed in large part to the erroneous legal conclusions contained in the Initial Decision. The Respondents thus reserve the right to argue that these factual errors constitute legal errors, and vice versa. Moreover, citations to factual inaccuracies in the record in this Petition are not intended to be exhaustive, and the Respondents reserve the right to rely on additional evidence from the record if and when it submits briefs on the merits of the issues addressed in this Petition.
[27] Decision at 7.
[28] Decision at 9.
[29] Ex. 265 at CLAY028598.

HCE's registration statement.[30] Hale made clear that the registration statement did, in fact, have a section "specifically discussing transactions involving index options" such as the short puts at issue[31] and concluded that "writing index put options is clearly within the authority granted to the Fund as disclosed in the Prospectus . . ."[32] Hale noted that the registration statement went even further in clarifying the use of these positions, explaining that, "[p]ursuant to the Prospectus, the Fund may write (sell) covered put options on up to 20% of its total assets to seek to earn current income and current gains."[33] According to the Prospectus, a put option is considered to be "covered" if "the Fund segregates assets determined to be liquid by the Sub-Adviser equal to the exercise price"[34] Following the fund losses in the fall of 2008, Hale "stated he had reviewed with representatives of Claymore information provided by HCE's custodian relating to HCE's segregation of assets in connection with the described transactions, and stated that, based on such information provided, the assets representing the market value of the positions generally were segregated in accordance with industry practice."[35] Significantly, Hale also emphasized that this conclusion regarding segregation extended to variance swaps as well.[36] In other words, Hale confirmed that the investments at issue in the proceeding constituted covered transactions that were allowed to constitute up to 20% of the Fund's total assets in an attempt to earn current income and current gains. Moreover, Hale made clear that the "Strategic Transactions Disclosure" in the prospectus was specifically "[i]ntended to be broad authority."[37] In short, the author of the HCE registration statement confirmed after the losses were known that (i) the transactions at issue

[30] Tr. 2827-29; Exs. 11, 12. Citations to the transcript will be noted as "Tr. __."
[31] Ex. 265 at CLAY028598.
[32] Ex. 264 at SASMF 0033.
[33] Ex. 265 at CLAY028597.
[34] Id. Hale further explained that "within the options industry [exercise price] is generally defined to mean the 'strike price.' This definition is consistent with the usage of 'exercise price' throughout the Prospectus." Ex. 264.
[35] Ex. 197 at 2. See also Ex. 265 at 4.
[36] Ex. 264 at SASMF0034.
[37] Ex. 265 at CLAY028598.

were appropriately covered and therefore not "naked"; (ii) the method of utilizing short index put options was disclosed in the Prospectus; and (iii) the "Strategic Transactions" provision of the prospectus made clear that the Fund had "broad authority" to undertake derivatives transaction such as the investments at issue. Significantly, Hale ultimately concluded in the fall of 2008 – after all of the losses were known and he had full knowledge of the investments – that the Respondents had not committed any violations – of the Prospectus or otherwise.

In contrast to the interpretation by the author of the actual document, the Initial Decision asserts that the description of "Strategic Transactions" in the Prospectus was mere "boilerplate."[38] As support for this point, the Decision highlights the fact that another covered call fund prospectus drafted by Hale "contained almost identical language" regarding such transactions.[39] In reality, however, the relevant language in these two prospectuses contained an important distinction regarding the fund's use of strategic transactions. For the pure covered call fund, the "Strategic Transactions" section emphasized that the "fund may, *but is not required or expected to any significant extent to*, use various strategic transactions . . ."[40] The analogous HCE provision, on the other hand, contained no such cautionary language regarding the use of strategic transactions – serving as further support for the assertion that HCE was intended to have the "broad authority" that Hale suggested. Moreover, the pure covered call fund made clear in its prospectus that the rationale for investing in the fund was that the covered call strategy serves as a conservative investment approach: a "program of options writing will provide ongoing current returns through varying market conditions, which may provide a partial hedge to investors in downward-trending equity markets . . . The Investment Manager believes the Fund's strategy leads to an overall reduction in risk compared to a strategy of simply owning stocks in a

[38] Decision at 8.
[39] Decision at 9, n. 8.
[40] *Id.* (emphasis added) *See also* Ex. 367

portfolio."[41] Significantly, the HCE prospectus makes no such assertion regarding the conservative nature of the Fund's investment strategy.[42]

The Initial Decision further notes that the "SAI discussed the purchase and sale of securities index options . . . The Madison/Claymore fund had nearly identical disclosure regarding potential use of securities index options."[43] To be sure, both HCE and the pure covered call fund prospectus allowed for the sale of put options. However, the pure covered call fund (Madison/Claymore) contained the more conservative requirement that such put options be written on common stocks that were already held in the Fund's portfolio.[44] Again, the HCE prospectus did not contain such a limitation.[45] In short, the plain language of the HCE prospectus – especially when contrasted with the Madison/Claymore fund – makes clear that HCE was not intended to be a conservative fund limited to pursuing a pure covered call strategy.

* * *

In any case, even if the HCE Fund prospectus and initial marketing did not adequately disclose investments such as short index puts and short variance swaps, subsequent disclosures can cure this defect.[46]

ii. Erroneous Characterization of HCE Marketing

[41] Ex. 367 at 5.
[42] *See* Ex. 11.
[43] Decision at 9.
[44] Ex. 367.
[45] *See* Ex. 11.

[46] See Investment Company Act Rule 8b-16(b): "Paragraph (a) of this section shall not apply to a registered closed-end management investment company whose registration statement was filed on Form N-2; provided that the following information is transmitted to shareholders in its annual report to shareholders: . . . (2) Any material changes in the company's investment objectives or policies (described in Item 8.2 of Form N-2) that have not been approved by shareholders; . . . (4) Any material changes in the principal risk factors associated with investment in the company (described in Item 8.3 of Form N-2)."

The Initial Decision also asserts that HCE was marketed as a covered call fund.[47] To reach this conclusion, the Initial Decision ignores key evidence and misinterprets other important facts.

The Initial Decision first focuses on the marketing pamphlets for the HCE Fund and emphasizes that these documents "highlighted the covered call attributes of the fund."[48] Noticeably absent from the discussion of these pamphlets is the fact that each of these marketing materials specifically emphasized the fact that the fund could write put options and discussed the risk of such a strategy.[49]

The Initial Decision also suggests that HCE marketing during the road show did not convey the fact that HCE would engage in naked index puts or variance swaps as fund strategies.[50] Although the Initial Decision acknowledged that Riad discussed put writing strategies during these presentations,[51] it then claims that "there is no evidence corroborating Riad's purported discussions beyond the equity, covered call, call on call, and covered put strategies of the fund."[52] In fact, Joseph Gallagher – Chief Compliance Officer of FAMCO – was asked specifically whether the call on call feature was identified as the only distinction between HCE and a covered call fund. He responded: "No, no. It was – I believe it was well characterized as, you know, the portfolio manager has got flexibility to do a lot of things with options."[53] Although HCE might not have specifically identified its index put option and variance swap strategies during the initial marketing, the testimony of Riad and Gallagher nonetheless make clear that investors were well aware that the Fund was planning to engage in a

[47] Decision at 9-10.
[48] *Id.* at 9.
[49] *See* Ex. 31 at Clay030380; Ex. 33 at CLAY03054; Ex. 116 at SASMF_0355; Ex. 117 at SASMF_0360.
[50] Decision at 10.
[51] *Id.*
[52] *Id.*
[53] Tr. at 999:7-13.

much wider range of strategic investments beyond a pure covered call strategy. Further, the evidence at trial showed that the strategy was thoroughly scrutinized and researched before its implementation. While Mr. Riad expressed an interest in utilizing short index puts at the fund's inception, this strategy was developed over the life of the fund. The Initial Decision notes the strategies were not discussed in detail when the fund was first marketed; however, the strategies had not been fully researched or vetted at this time.[54]

b. Erroneous Characterization of Investments at Issue

i. Erroneous Assessment of Their Impact

The Initial Decision repeatedly emphasizes the impact of the two trading strategies at issue. For example, the ALJ summarizes their contribution to performance by noting that "for the two-year period ended August 31, 2008, the written put and variance swap strategies captured a 2.9% annualized return for the fund out of the fund's 6.5% annualized return – representing approximately 45% of the fund's returns."[55] In order to reach this conclusion, however, the Initial Decision misconstrued the evidence presented regarding these return figures. In the document cited as support for the 45% contribution, the reference to a 2.9% return was for the "put and swap transactions" entered by the Fund: in other words, this figure included both *long* index put options and *long* variance swaps that were not at issue in the proceeding. However, the Initial Decision erroneously re-characterized this language as referring only to the "*written* [i.e., short] put and variance swap strategies," thereby attributing more importance to the strategies at issue than they actually merited.[56] In fact, the short index put options and short variance swaps contributed far less to the success of HCE than suggested by the Initial Decision. For the 2007 fiscal year, for example, the combined performance for the short index puts and short swaps was

[54] Decision at 9-10.
[55] Decision at 12.
[56] Ex. 14 at 15492.

only 1.6% as compared to the total portfolio return of nearly 13%.[57] The Initial Decision later makes a similar mistake in claiming that the "gains from writing naked index puts generated about 20% of the fund's gains for the fiscal year ended November 30, 2007."[58] In reality, these positions generated only 15% of the Fund's gains for that period.[59]

The inaccurate 45% attribution figure is so significant that the Initial Decision cites it three times in support of the conclusion that these investments represented a "principal strategy"[60] and the Decision relies on this figure as the basis for the erroneous legal conclusion regarding the Respondents' conduct. In the Conclusions of Law section, for example, the Initial Decision again emphasizes the fact that the short puts and short swaps "generat[ed] nearly 45% of HCE's gains."[61] When assessing the materiality of these investments, the ALJ similarly claims that "nearly half of the firm's gains . . . were being generated by writing naked index puts, and to some extent, short variance swaps."[62] The fact that such a key assertion is premised on a mistake serves as an additional basis for review of the Initial Decision.

More important, as noted above, the strategies were not expected to be used as frequently as they were and were not expected to be as successful as they were. The Respondents were surprised by the dramatic market dislocations that occurred prior to the financial crisis just as they were surprised by the magnitude of the losses incurred in the crisis.[63] Without any recognition of the analysis performed by the Respondents and the unpredictability of the financial crisis, the Initial Decision imputes an after-the-fact knowledge of events, fraud by hindsight, to the Respondents.

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[57] *Id.*
[58] Decision at 30.
[59] Ex. 14 at 15492 ("On an NAV basis, the return was 12.87%.").
[60] Decision at 12, 16, and 30.
[61] Decision at 30.
[62] *Id.* at 31.
[63] Tr. at 1793:6-20; 2186:15-7.

Further, the Initial Decision selectively analyzes the impact of the strategies in 2007 and 2008,[64] rather than taking into consideration the long term goal of the strategic transactions and the Respondents' expectations about the impact of the strategic transactions on the fund's performance. The Respondents testified that these trades were part of a larger strategy that would include gains and losses. The Initial Decision analyzes the profitability of the strategies in late 2007 and early 2008 and their losses in the fall of 2008. Focusing on the performance of certain transactions that were part of a larger strategy in a narrow one-year period completely mischaracterizes the Respondents' overall strategy.

ii. Erroneous Characterization of Research and Trading Strategy

The Initial Decision erroneously claims that Riad was aware of the significant risks associated with selling index put options and selling variance swaps. In support of this assertion, the Initial Decision misconstrues the evidence and ignores important documents and testimony presented. When the full record is properly taken into account, the evidence demonstrates that the Respondents did not expect the strategies to have large losses.

To support the conclusion that the Respondents understood the risk from these investments, the Initial Decision selectively includes certain articles that discuss the potential risk of the short index put options and short variance swaps in isolation, while failing to consider the aggregate of Hughes' and Riad's research.[65] When the full scope of this research is taken into account, it becomes clear that the Respondents appropriately believed that the risk from these investments was minimal.[66] As one example, the Initial Decision highlights several research

[64] Decision at 2.
[65] *See, e.g.*, Decision at 16.
[66] *See, e.g.*, Ex. 213, Research paper by Oleg Bondarenko entitled "Market Price of Variance Risk and Performance of Hedge Funds" (Mar. 2004) (finding "selling variance swaps is an attractive strategy, produces significant returns over time with less risk that the stock market.") (Mr. Hughes reviewed this paper at the time that he performed his research into these strategies. See Hughes Testimony at 683:25-684:5); See also Ex. 214, Oleg Bondarenko, Why are Put Options so Expensive? (Nov. 2003) (finding "Investors strongly dislike negative returns, so they're willing

papers that analyze the sale of index put options.[67] The Initial Decision highlights an academic article, for example, that states that "[t]here is no arguing that selling naked puts could be very risky."[68] However, this claim is in reference to at-the-money put options – a completely different investment strategy than the deep out-of-the-money put options written by HCE.[69]

Moreover, when citing certain reports relied on by Respondents that purport to demonstrate the risk of these investments, the Initial Decision ignored the much larger volume of materials reviewed by the Respondents that showed precisely the opposite.[70] Furthermore, the Initial Decision ignored the testimony of Chester Spatt, former Chief Economist of the SEC, who validated the reasonableness of the Respondents' views regarding the minimal risk from these investments.[71]

Significantly, the Initial Decision also ignores critical evidence concerning the multiple steps taken by Riad to mitigate the potential risk from the investments at issue. For example, the index put options were written deep out-of-the-money – frequently, between eight and ten percent below the current index level – in order to provide a protective cushion in the event of a market decline.[72] Riad also attempted to limit the risk from these transactions by setting the size of each

to pay a hefty premium to buy some insurance to buy these put options. So it's a good strategy over time to sell these expensive put options.") (Both Mr. Riad and Mr. Hughes reviewed this article during the course of their research into these strategies. See Riad Testimony at 2141:3-10 (confirming that he reviewed this article prior to 2007); Hughes Testimony at 677:10-11 ("I read this paper during our analysis of all these different strategies."). Mr. Hughes was already familiar with Mr. Bondarenko's work since he had studied under him at Washington University. Hughes Testimony at 677:14-15 (noting that Bondarenko "was actually one of my professors when I was getting my MBA at Washington University.")).

[67] Decision at 16.

[68] *Id.*

[69] *See* Ex. 214 at FAM149060.

[70] *See* supra Note 70.

[71] The Decision only refers to Chester Spatt's testimony, which spanned two days, in passing, noting "Chester Spatt, also a former Chief Economist at the Commission, concluded that Respondents' assessment that the puts and swaps would improve HCE's risk-adjusted trade-offs was reasonable." Decision at 12, n. 12.

[72] *See, e.g.*, Harris Report at 121.

trade to a level that would be extremely unlikely to generate a loss of a certain size.[73] In addition, Riad placed the trades only at times when it losses were significantly less likely to occur.[74] Finally, FAMCO limited the risk of these investments by segregating a certain amount of assets for these transactions.

Rather than discuss these "four firewalls of risk" implemented by the Respondents, the Initial Decision simply treated the HCE Fund's investments in short index put options and short variance swaps as if they were undertaken without any additional risk-limiting strategies. In a section detailing the "Evolution of HCE's Risk Footprint," for example, the Initial Decision makes the blanket statement that "Riad was aware of the potential for large losses associated with naked puts and short variance swaps."[75] Indeed, such awareness was precisely the reason that Riad took so many additional steps to limit the potential risk from these investments. Similarly, the Initial Decision cites the Respondents' review of academic research detailing the risk of selling short index put options.[76] However, these papers focused primarily on at-the-money or near at-the-money short index put options; as a result, the Initial Decision fails to account for the fact that the Respondents wrote the positions far out of the money to prevent the downside losses highlighted in these academic papers.

c. Erroneous Characterization of HCE Disclosures

i. Erroneous Analysis of Periodic Filings

[73] During trial, Mr. Riad explained, "we've already decided that we're going to sell something that's far away from the market [in other words, deep-out-of-the-money], but that may not be good enough because we did see that sometimes the market does fall." Riad Testimony at 2170:13-16. His sizing analysis began by working backwards from the question: "[h]ow much exposure are you willing to lose?" Riad Testimony at 2171:17-18. See also id. at 2170:13-16 ("And to get an idea of where you want to be, you've got to see how much are you willing to lose, because then – and you back into how many put contracts you sell.").
[74] *Id.* at 20-21.
[75] Decision at 15.
[76] *Id.* at 16.

The Initial Decision suggests that the HCE Fund's disclosures in periodic filings regarding the investments at issue were insufficient. According to the ALJ, investors were unaware of the extent to which these strategies were being employed and the potential exposure from these investments.[77] This key assertion is clearly erroneous and ignores the fact that the HCE Fund's periodic filings disclosed extensive information about short puts and variance swaps.

After implementing the strategies at issue in 2007, the HCE Fund repeatedly disclosed their investment in these positions in public filings.[78] These disclosures alerted investors to the fact that the Fund was writing short index put options and short variance swaps without any corresponding long positions. Indeed, the fund's August 2007 N-Q,[79] November 2007 Annual Report,[80] and February 2008 N-Q,[81] all listed short index put options and short variance swaps but made no mention to a long position in either derivative. The Division's own witness, Robert Shulman, acknowledged this fact during his testimony.[82]

Furthermore, these disclosures made clear that the trades were not one-off transactions but rather served as part of a longer-term strategy. The repeated disclosure of these positions in multiple consecutive filings is significant because it put investors on notice that these investments were part of an ongoing strategy. After seeing short positions without corresponding long trades in three consecutive filings over a period of six months, it strains credulity to suggest that investors would not have understood HCE's investment in these derivatives or that they would have assumed it represented a one-time transaction.

[77] Decision at 31.
[78] Respondents' Pre-Hearing Brief at 28-31.
[79] Ex. 300 at 10.
[80] Ex. 304 at 16.
[81] Ex. 302 at 11.
[82] Tr. at 1378:7-10, 1381:21-1382:1.

In addition to identifying the short positions as part of an ongoing strategy, the Fund's disclosures also disclosed information about the potential risks from these investments. For example, the Fund's disclosures for written index put options included the number of options written and the exercise price, as well as the fact that each option represented 100 contracts.[83] As the Division's own witness, Robert Shulman, testified, this information allowed an investor to calculate the notional size of the position.[84] Another Division witness claimed that the notional value of these positions represented the "best measure of risk"[85] for these derivatives and stated that the size was so alarming that he could immediately recognize the excessive risk of the derivatives.[86] The SEC's own examiner also had immediate concerns when he saw the notional value of these trades.[87] If the risk of these positions was immediately clear from the notional position size – as several of the SEC's own witnesses argued – then the true risk of these positions must also have been adequately disclosed in the multiple HCE filings that disclosed the notional value of these positions.

In assessing the Respondents' disclosures, the Initial Decision also improperly focuses all of its attention on the Q&A discussions in the Fund's annual and semi-annual reports.[88] In reality, however, the Division's own witnesses emphasized that they focused instead on the Fund's quarterly reports – and in particular the detail of portfolio holdings – when trying to assess the risk of a fund. When asked "[w]here 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," Robert Boyle responded: "[t]he quarterly reports, I would

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[83] See, e.g., Ex. 303 at 11 and Ex. 304 at 11.
[84] Tr. at 1396:10-1397:5
[85] Tr. at 553:2-3.
[86] Id. at 553:2-7.
[87] Id. at 120:8-10.
[88] *See, e.g.*, Decision at 19 n. 21, 20-22, 30-32, and 36.

have wanted to have seen it there, if any place."[89] Similarly, Michael Boyle was asked "[w]hat would you look at if you wanted to consider the amount of risk that a particular fund had or that its investment strategies had?" His response pointed to the same source: "Well, the – the underlying ones, I mean – or the main fund just by reviewing the holdings."[90] The significance of this reliance on the quarterly reports is that these filings provided precisely the information that the ALJ erroneously claims was omitted.

ii. Erroneous Characterization of HCE Board Knowledge

The Initial Decision states that HCE "Board meetings presented an opportunity for Respondents to provide information to Claymore since Claymore officers attended all board meetings."[91] The ALJ mischaracterizes the evidence presented regarding these Board meetings and thereby fails to appropriately evaluate the disclosures made by the Respondents.

The Initial Decision focuses primarily on memos – entitled "Portfolio Manager's Discussion" – provided during the Board meetings and cites various deficiencies in these materials.[92] In particular, the Initial Decision faults the Respondents for the fact that these memos "did not explain the use of either naked short puts or variance swaps," nor did they "report figures on the short puts and variance swaps in these memos."[93] Instead, the Initial Decision asserts that these memos typically contained "vague statements" relating to the investments at issue.[94] By improperly focusing solely on these documents, the Initial Decision essentially ignored all of the testimony as to what information was actually conveyed during these meetings. As Riad explained, these memos were mainly to "inform [the Board] on the

[89] Tr at 1492:4-12.
[90] Tr. at 1492:4-12.
[91] Decision at 25.
[92] *Id.*
[93] *Id.*
[94] *Id.*

topics that we were going to discuss," whereas the actual discussion at the meeting "would have been very different" from the simplistic overview contained in these memos.[95] Even recognizing the fac thtat the notes did not reflect the full extent of what was discussed at the meetings, they nonentheless ...

In fact, the testimony from numerous witnesses confirms that the Respondents disclosed their investments in short index puts and short variance swaps to HCE's Board of Trustees throughout the life of the Fund. Mr. Toupin, Chairman of the HCE Board, confirmed that the Respondents discussed short index puts and short variance swaps at these meetings.[96] Randall Barnes similarly recalled that Mr. Riad discussed these derivatives at Board meetings.[97] The Respondents spoke with the Board about the research and analysis that they had performed on these investments.[98] In contrast to the ALJ's claim that there was only a brief reference to the potential use of these strategies at one Board meeting,[99] the Respondents specifically detailed the purpose of the transactions by explaining that the positions were designed to take advantage of FAMCO's market outlook[100] and – in the case of the variance swaps – that the trades were intended to capitalize on the systematic overestimation of volatility in the marketplace.[101] The Respondents made clear that these investments were being employed as a regular strategy.[102] The Respondents also emphasized the fact that these positions were contributing positively to

[95] Tr. at 2444:13-21; 2445:19-23.
[96] Tr. at 2992:12-17
[97] Tr. at 2918:18-21; 2922:6-9.
[98] Tr. at 2992:18-22. See also id. at 3016:5-11 (the Respondents "did quantify it [the potential loss] that it was not a large amount"); id. at 3018:4-7 ("The backtesting was characterized as testing to one or two or – two or three standard deviations that could produce a 1 to 2 percent loss.").
[99] Decision at 26 ("The only hint in the minutes of potential use of these transactions is in the minutes for April 23, 2008: 'Mr. Riad stated that management proposes using short-term leverage for opportunistic purposes.")
[100] Id. at 2993:23-25.
[101] Tr. at 2919:17-24.
[102] *Id.* at 2920:7-10; 2921:10-16.

Fund performance.[103] In light of this extensive testimony confirming that the Respondents provided numerous disclosures regarding the investments at issue, it is therefore an erroneous conclusion of fact to assert that the Respondents merely made only "vague statements" about the short index put options and short variance swaps.

d. Erroneous Characterization of Claymore's Knowledge and Responsibilities

i. Claymore was aware of the investments

The Initial Decision argues that "the record does not show that Claymore was aware of the use of naked puts and variance swaps as a strategy. Rather, the evidence establishes that Respondents provided information concerning these transactions but that the disclosures were incomplete or concerned only single, isolated trade positions."[104] The assertion that Claymore was unaware of these strategies represents an erroneous conclusion of fact.

Claymore was required to approve the ISDA agreements that allowed the HCE fund to enter into the trades at issue.[105] Claymore also received daily reports from the fund's custodian that detailed HCE's derivatives investments,[106] daily updates detailing the securities in the portfolio,[107] and received and reviewed confirmations for the derivatives transactions.[108] Indeed, Claymore had such a strong understanding of the investments at issue that it drafted the very disclosure regarding variance swaps that is at issue.[109] This disclosure provided a detailed overview of variance swaps and contained relevant information regarding the transaction.[110]

[103] Tr. at 1013:10-16 (Mr. Gallagher testified "[w]hen it comes to volatility swaps, I certainly remember Mo talking about those in the context of the performance attribution analysis of the portfolio, how the premiums collected on those things would help – were helping performance in the portfolio and, you know, specifically in that context, I absolutely remember it.")
[104] Decision at 32.
[105] *See* Tr. At 2192:7-2193:17; Exs. 310, 316, 318, and 321.
[106] Tr. At 2088:5-13; 2700:11-15; 2701:11-2702:5.
[107] Tr. at 2700:25-2702:14.
[108] Tr, at 2700:11-15; 2701:21-2702:2; and 2702:5; Ex. 158; Ex. 353.
[109] Ex. 280.
[110] *Id.*

Significantly, an individual at Claymore who participated in drafting this disclosure had also received the confirmations for the variance swap trades and thus had all of the relevant information at hand, including the variance amount and the variance strike price[111] – the very same features of the transaction that the Initial Decision faulted the Respondents for not including in the periodic filings. For the Initial Decision to claim that Claymore crafted this disclosure language without having any comprehension of the actual investment simply defies belief.

Following the January 2008 call to discuss the propriety of the investments in short index puts and short variance swaps, the Respondents continued to keep Claymore apprised regarding these investments. For example, the ALJ failed to consider[112] an email from Mr. Riad to Mr. Hill from March 2008 that does precisely what the Initial Decision claims never occurred: namely, provide detailed information to Claymore regarding these trades.[113] In his message, Mr. Riad writes that "[a]s you are aware, we a[re] short variance swap position in the HCE Fund . . . As we have discussed before, FAMCO uses both variance swaps and puts" in the HCE fund. Mr. Riad notifies Mr. Hill that "[t]oday we have 'rolled' this position to capture the current heightened level of volatility."[114] The email provides the amount of vega for the position and discusses the "net exposure" of the contract. Significantly, the email makes clear that Mr. Hill had already discussed previously both the short puts and swaps with Mr. Riad – implying that he knew these were more than mere one-off transactions. In addition, Mr. Riad explained the rationale behind these trades and provided an update regarding the specific position. An email thread between Mr. Swanson, Ms. Delony, and Ms. Hasbrouck of Claymore similarly

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[111] Ex. 158

[112] The Initial Decision claims that "Hill had no recollection of either Riad or Swanson . . . providing any details of the trades to him or the board." Decision at 23.

[113] Ex. 4.

[114] *Id.*

demonstrates Mr. Swanson's open communication about the strategies with Claymore.[115] When Ms. Delony asked Mr. Swanson to explain the performance of the equities and covered call portions of the portfolio in more depth, Mr. Swanson responded by first discussing these strategies, and then writing "[p]lease keep in mind that this is strictly the covered call portion of the portfolio. It does not include the call on call, *hedges, or volatility trades*."[116] Mr. Swanson specifically highlighted the fact that the figures about which Ms. Delony asked did not include the performance of the derivatives transactions at issue. Rather than conceal these transactions, as the Initial Decision suggests, Mr. Swanson brought these transactions to Claymore's attention when drafting the periodic filings.

Claymore representatives also attended Board meetings where the investments at issue were discussed.[117] In contrast to the Court's claim, Claymore's Chief Compliance Officer, Bruce Saxon, did not believe that the strategic transactions employed by HCE were being used as "single, isolated trade positions" or "occasional transactions." Indeed, Mr. Saxon was asked specifically whether the puts and swaps were part of a one-time transaction or were used on an ongoing basis. He replied that "[i]t appeared that they were being used on an ongoing basis."[118] Later, when Mr. Saxon was asked about his recollection of the short index put options, he stated that "I'm not really sure what I understood other than it was part of a strategy." Tr. at 2656:1-2. As further support for this position, HCE Board member Randall Barnes was asked directly whether Mr. Riad "ever describe[d] these variance swaps as a regular strategy he was using in the funds?" His response was an unequivocal "[y]es."[119] Mr. Barnes was later asked whether Mr. Riad "ever [went] into detail as to a plan of how he was going to use them [variance swaps]

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[115] Ex. 289.
[116] *Id.* (emphasis added).
[117] Tr. At 2615:10-14 and 2653:4-9; 2694:14-15.
[118] Tr. at 2628:10-12.
[119] Tr. at 2920:7-10 (emphasis added).

as far as whether he would use them opportunistically at certain times or that he would use them, you know, consistently or regularly?" Mr. Barnes responded that his "understanding was that they would use them regularly."[120] Given that Claymore attended the same Board meetings, it seems clear that its representatives should also have understood the fund's trading in short index put options and variance swaps as a strategy.[121]

The Initial Decision is also incorrect to conclude "[t]he only record evidence of Claymore's commenting on the Q&As for the November 30, 2007, and May 31, 2008, reports regarded inclusion of language on consideration of a line of credit, wholly unrelated to the fund's trading strategies." Put simply, this statement is flatly contradicted by the record. Claymore exchanged numerous emails about the 2007 Annual Report that included comments on the Q&A section of the Annual Report discussing the fund's hedging strategies.[122] Claymore personnel also drafted language in the 2007 Annual report about variance swaps, one of the trades at issue. On January 3, 2008, two members of the Claymore Fund Administration Group exchanged an email containing language about variance swaps that would ultimately be included in the 2007 Annual Report.[123] This language was included because swaps were considered to be a "new investment type," a fact acknowledged in an update to HCE board members.[124] These exhibits directly contradict the claim that "inclusion of language on consideration of a line of credit" was the only evidence of Claymore commenting on the Q&As.

Additionally, Claymore personnel commented on the 2008 Semi-Annual Report Q&A in an email exchange that is completely mischaracterized by the Initial Decision. The Initial Decision claims a July 2008 email thread where Mr. Hill questions whether the 2008 Semi-

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[120] *Id.* at 2921:10-16.
[121] Tr. at 2708.
[122] See Ex. 277.
[123] See Ex. 14 and Ex. 280.
[124] Ex. 284.

Annual report should further explain how hedges work shows Mr. Hill did not understand that "strategic hedging consisted of selling uncovered puts and variance swaps."[125] There is no support for this inference. Instead, this email shows a discussion between Claymore personnel on what should be included in this periodic filing, not confusion over the strategy. The initial decision problematically omits the response to Mr. Hill's question, admitted in the record after initial privilege objections, where counsel concludes that the disclosure was adequate without further explanation of the strategy.[126] This email thread supports Respondents' argument that Claymore concluded the periodic filings were adequate, not the Division's claim that Claymore did not understand the strategy.

III. Erroneous Conclusions of Law

In addition to the erroneous findings of material fact identified above, the Initial Decision also contains multiple erroneous conclusions of law that merit correction.

a. *Erroneous Application of Relevant Standards For Closed End Fund Disclosures*

i. The Court failed to interpret and apply the guidelines set forth in Form N-2

The Initial Decision contains no discussion of the legal standard relevant to disclosures set forth on Form N-2, the form established by the SEC for closed end investment companies. The Initial Decision notes that "Investment Company Act Section 8(b) requires investment companies to disclose the investment objectives and policies that will constitute their principal portfolio emphasis, including how the fund proposes to achieve its objectives,"[127] but the Initial Decision never offers any analysis as to how to determine whether an investment represents a "principal

[125] Decision at 23-24, fn. 34.
[126] Ex. 362.
[127] Decision at 33.

strategy." Instead, the Initial Decision merely offers the conclusory statement that because the written index put options generated significant returns in one year, they therefore must have represented a "principal strategy."

In concluding that the investments at issue represented a principal strategy of the Fund, the Initial Decision erroneously ignored evidence presented at trial that set forth the standard by which disclosures on Form N-2 are to be evaluated. The Initial Decision failed to even mention the Expert Report or testimony of Jay Baris that elucidated industry practice and the standard of conduct for funds filing on Form N-2.

ii. Respondents' disclosures satisfied the requirements of Form N-2

As set forth in the Respondents' post-trial briefings, the disclosures regarding HCE's investment in short index put options and short variance swaps complied with the all applicable legal requirements.[128] 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.[129] The key determinant for identifying a non-principal strategy is whether the investment threatens more than five percent of the fund's assets.[130] As the guidelines to the Form explain, "[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."[131] The

[128] See Respondents' Post-Hearing Brief at 52-54 and Respondents' Post-Hearing Reply Brief at 19-22.
[129] Ex. 142 at 18-19. Mr. Baris testified that 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." Tr. at 3052:17-24 (emphasis added).
[130] Tr. at 3053:8-12 (Mr. Baris testified "if less than 5 percent of the assets of the fund are at risk, you should not include extensive disclosure of those strategies, bur you should limit the disclosure to identifying the strategy or security.").
[131] Instruction c to Item 8.4 of Form N-2.

instructions for Form N-1A – the analogous form for open end funds – similarly suggests that the focus should be on the perceived risk from the strategy.[132]

The evidence at trial made clear that the Respondents did exactly what was required under the Commission's rules: they evaluated the likelihood that these investments would place more than five percent of the fund's net assets at risk, and after determining that such a loss was extremely remote they appropriately decided not to overload investors with unnecessary information regarding the strategies at issue.[133]

The Initial Decision made no mention of the five percent risk threshold set forth in Form N-2 for disclosure of principal strategies.

iii. The Initial Decision improperly renders Form N-2 superfluous

Rather than apply the disclosure regime set forth in Form N-2, the Initial Decision instead creates a new disclosure approach whereby any risk – no matter how remote – that ultimately results in losses is classified as a principal risk. As a result, the five percent risk threshold established by the rule is rendered superfluous.

b. *Erroneous Conclusion Regarding Respondents' Scienter*

i. Claymore's Role In Managing HCE Is Omitted in the Discussion of Scienter

The Initial Decision discusses Claymore's role in managing the HCE fund in depth but only discusses Claymore's role in relation to Respondents' scienter in passing. The decision notes Claymore "drafted most marketing materials for HCE and was in charge of secondary marketing for the fund," acknowledges that "Claymore was responsible for legal, compliance,

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[132] Form N-1A, Item 9(b)(1)(2).

[133] *See* Tr. 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. In addition to the Plain English rules, SEC staff members have also emphasized for nearly two decades that disclosure about derivative investments should not be excessively detailed. See Baris Report at 10-11.

marketing, and secondary support, and it prepared HCE's periodic filings," and notes Claymore "had in-house counsel that provided advice to FAMCO, Riad, Swanson, and HCE." Claymore's responsibilities, particularly its responsibility for drafting and reviewing the periodic filings, should have been considered in the initial decision's analysis of scienter and should factor into what Respondents' considered to be reasonable.

In addition, the Initial Decision fails to acknowledge Claymore's higher responsibility to shareholders than both FAMCO as sub-advisor and Riad and Swanson as portfolio managers. Claymore acted as the liaison between the fund and shareholders, and Respondents were both aware of this responsibility and relied on Claymore's expertise in determining what was permissible under the Fund's prospectus and in drafting and revising the periodic filings. Respondents developed a pattern and practice of relying on Claymore's counsel and experienced personnel in drafting and finalizing periodic filings. Respondents followed the same practice for the 2007 Annual Report and 2008 Semi-Annual Report, understanding that Claymore, with a higher responsibility to shareholders, would review and finalize these periodic filings as they had reviewed previous filings.

ii. The Initial Decision Improperly Inputes Scienter to Mr. Swanson, in Contradiction to Its Own Findings

The Initial Decision finds that Mr. Swanson acted with a high degree of scienter, even though its own findings undermine this finding. For example, the Initial Decision found that:

- "Swanson had no input into documents used in marketing HCE.[134]
- "Swanson learned in the spring of 2007, through discussions with Riad and seeing the positions in the portfolio listings, that HCE was investing in short index puts. Tr. 1712-13. Swanson did not make those trading decisions; Riad did."[135]

[134] Decision at 10

[135] Decision at 11, n. 9

- "Swanson was led to believe that the written puts were relatively low risk investments because they were sold far out of the money – around 8% to 10% – and for short durations, providing some confidence that the puts were unlikely to be exercised and, thus, that HCE would keep most of the premiums."[136]

- "Swanson did not make the decision to trade index puts and variance swaps, but was told that they had a good risk-adjusted return and would diversify and reduce the volatility of the portfolio. Tr. 1722-27. Swanson's understanding of the research was limited at the time of the trades. At most, he knew that Riad and Hughes were researching the use of puts and variance swaps; they did not share the research with him."[137]

These findings are inconsistent with findings of scienter against Mr. Swanson, yet the Initial Decision finds that Mr. Swanson acted recklessly. This finding seems to be based solely upon two conversations between Mr. Swanson and a freelance editor, Patty Delony, that led to the drafting of the question and answer section of the last semi-annual and annual reports filed by the Fund. According to the Initial Decision, "Swanson initially provided the answers to Delony to include in the Q&As and signed certifications that they were accurate."[138] These actions are described as "clearly willful."[139] This conclusion ignores the fact that, as noted above, the Initial Decision accepts Mr. Swanson's very limited knowledge about the index put and variance swap trades and his lack of involvement in those trading decisions. The Initial Decision also ignores that, while Mr. Riad spent thousands of hours analyzing the trades in question and executing them, Mr. Swanson had two forty-five minute conversations with Ms. Delony about the question and answer section of the periodic filings and that Mr. Swanson reasonably relied upon the certification of the much more knowledgeable Mr. Riad about the accuracy of the text of the question and answer sections.

iii. Erroneous Application of the Advice of Counsel Defense

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[136] Decision at 11, n. 10.
[137] Decision at 12, n. 11.
[138] Decision at 32.
[139] *Id.*

The Initial Decision asserts in a footnote that "Respondents do not claim that they were relying on advice of counsel."[140] In addition to being factually incorrect, the ALJ erroneously failed to adequately take this argument into account when evaluating the scienter of the Respondents.

Put simply, the Initial Decision is wrong to state that the Respondents did not make an advice of counsel claim. As stated in the Motion to Correct, the self-evident inaccuracy of the Court's statement is demonstrated by the fact that the Respondents devoted large portions of both their Pre-Hearing and Post-Hearing briefs to this very issue. Section 3.b.iii(d) of the Respondents' Prehearing Brief, for example, is entitled "The Respondents Reasonably Relied Upon Advice of Counsel."[141] For nearly five pages, the Respondents detailed their reliance on guidance from attorneys regarding the investments at issue in the proceeding. As the Respondents summarized at the outset of this section: they "reasonably relied on their understanding that Skadden and Claymore's in-house counsel understood how the index puts and variance swaps were used, understood how they were disclosed, and never suggested that any disclosure issues existed."[142] The Respondents then explained the corresponding legal argument by noting that "[r]eliance on the 'advice of counsel may show that a person lacked a culpable intent' for charges that require a showing of scienter."[143] Later, the Respondents argued that they had "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."[144] The Respondents further explained that "Claymore's in-house counsel also played a material role,

[140] Decision at 32, n. 39.
[141] Respondents' Pre-Hearing Brief at 78.
[142] *Id.*
[143] *Id.* (citing S.E.C. v. McNamee, 481 F.3d 451, 455 (7th Cir. 2007)).
[144] *Id.* at 32.

which caused the Respondents to believe that the disclosures regarding the index puts and variance swaps were sufficient."[145]

Similarly, Section II.d. of the Respondents' Post-Hearing Reply Brief is entitled "The Respondents Reasonably Relied on Counsel's Involvement."[146] For nearly four pages, the Respondents again outlined the same argument: "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."[147] The Respondents then reiterated the legal argument that "[r]eliance on the 'advice of counsel may show that a person lacked a culpable intent' for charges that require a showing of scienter."[148] In this section, the Respondents also argued that they had been "informed that [HCE counsel] Mr. Hale had validated his earlier guidance and confirmed that these investments could be utilized by HCE."[149] This section contained numerous citations to the evidence presented at trial in support of the claim that they had relied on the advice of counsel.[150]

Finally, it is important to recognize that both Respondents claimed during their testimony that they had relied on the advice of counsel. For example, Mr. Swanson testified that after the January 2008 call in which advice was conveyed from Mr. Hale, there was no question in his mind that the investments at issue were permissible because they had been "okayed as strategic transactions" by counsel from Skadden and Claymore.[151] Mr. Riad similarly testified that Mr.

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145 *Id.* at 80.
146 Respondents' Post-Hearing Reply Brief at 29.
147 *Id.* at 29-32.
148 *Id.*
149 *Id.* at 30.
150 *See, e.g.*, Initial Decision at 29, n. 150, 30 nn. 152, 153, 154, 155, & 156.
151 *See* Tr. at 1835:24-1837:19.

Hale's approval of the transactions had been conveyed during that call, and that he relied upon this advice in certifying the HCE Annual and Semi-annual reports at issue.[152]

Faced with this evidence, the Initial Decision simply side-stepped the issue and did not perform any analysis of the advice of counsel issue. As a result, any legal conclusions regarding the Respondents' scienter are clearly erroneous.

Bizarrely, the Initial Decision noted in the Order denying the Motion to Correct that the "Respondents do not address whether the four elements of [an advice of counsel] claim were present."[153] But the Respondents' Motion was merely highlighting the fact that the Initial Decision blatantly misstated the record regarding the advice of counsel defense; it was not intended to provide a legal argument in support of this defense. Instead, it is the Initial Decision that failed to address whether any of the elements of the claim were present in the Initial Decision. Indeed, the evidence presented demonstrates that the Respondents clearly relied on advice of counsel relating to the investments at issue throughout 2007 and 2008.

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.[154]

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

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[152] *See* Tr. at 2213:15-2214:10.
[153] Order at 2, n. 2.
[154] *S.E.C. v. McNamee*, 481 F. 3d 451, 455 (7th Cir. 2007). As courts have explained, reliance of 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.").

strategic transactions in 2007, Mr. Riad requested guidance from Steven Hill, Chief Financial Officer of the Fund and the head of Claymore's Fund Administration Group.[155] Mr. Hill discussed the issue with outside counsel at Skadden and confirmed to Mr. Riad that he could pursue these investments in the Fund.[156]

When a question arose regarding these transactions in the fall of 2007, the Respondents participated in a conference call during which the derivatives were discussed in depth.[157] During the call, outside counsel at Skadden conveyed the advice that short index puts and variance swaps were permissible investments in the HCE portfolio.[158] At trial, every witness who remembered participating on the call agreed that Skadden had deemed the investments were permissible.[159] The Initial Decision attempts to obscure the fact that counsel had blessed these investments by emphasizing that Skadden did not specifically approve the use of short index puts or short variance swaps as a continuous strategy.[160] Such a distinction is implausible for several reasons. First, as discussed *supra*, the investments were disclosed in multiple consecutive periodic filings that were all reviewed by Mr. Hale, thereby making it clear that the positions were being employed as part of an ongoing strategy. Second, the Initial Decision failed to mention Mr. Hale reaffirmed his advice in the fall of 2008 *after all the facts regarding the investments were known.*

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[155] Tr. at 2704-5.
[156] *Id.*
[157] *See* Ex. 27; Ex. 252; Tr. At 1269:7-1271:5.
[158] Tr. at 2213:15-2214:4; see also Tr. at 1835:24-1837:14.
[159] *See, e.g.*, testimony from Susan Steiner, Tr. at 1272:7-23 ("Q: And they [Mr. Hill and Mr. Hale] said that these short index put options are allowed? A: Yes, that's correct. Q: And they also said the short variance swaps are allowed? A: Yes. That was a strategic transaction."); testimony from Mr. Gallagher, Tr. at 1049:6-11 ("Hale or Tom Hale's stand-in [said] that these things had been looked at and they're approved."); testimony from Mr. Saxon, Tr. at 2624:20-2625:23 (confirming that Mr. Hale had confirmed that the investments were permissible and that this advice was conveyed on the call).
[160] Initial Decision at 32 ("However, while they were told that such transactions were permissible, there is no evidence that they were told that the prospectus permitted HCE to engage in the transactions continuously as a strategy.") (footnote omitted).

The Initial Decision also attempts claims that Mr. Hale was never consulted regarding the disclosure of these investments.[161] Such an assertion ignores two key points of evidence presented at trial. First, several witnesses testified that when Mr. Hale opined on the permissibility of an investment, he would regularly provide advice on disclosure issues as well.[162] More importantly, this fact was confirmed both by an affidavit and Mr. Hale's own testimony during trial, where he acknowledged that when asked whether an investment was allowed, he would make sure to discuss any risks associated with the investment as well as any potential disclosure issues.[163]

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.[164] Indeed, Skadden had a policy of discussing and opining on all legal issues – including disclosure concerns – when asked a question about Fund investments.[165] 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.[166] 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.

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161 Initial Decision at 24. ("While Hill and Saxon recall consulting Hale, neither contacted him regarding disclosure requirements related to index puts or variance swaps").
162 Ex. 368, Hale Affidavit (June 7, 2012) at ¶ 7.
163 Tr. at 2900:3-2901:4.
164 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. 293, email from S. Hill to J. Howley re. the HCE N-Q filing (Oct. 24, 2007). In early 2008, lawyers from Claymore insisted that the Fund's periodic filings disclose HCE's potential use of leverage as a new investment strategy. Ex. 22, Dec. 28, 2007 email from Hill to Saxon et al. re. the use of leverage in the HCE fund.
165 Ex. 368, Hale Affidavit (June 7, 2012) at ¶ 7.
166 *See, e.g.*, Ex. 349 (July 3, 2008 email from Grossman to Hill and Jim Nowley re. Structured Notes).

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.[167] Importantly, the Respondents were entitled to rely on that advice even if it was not passed directly from counsel to the Respondents.[168]

IV. The Sanctions Imposed Are Not Warranted

a. Erroneous Imposition of Industry Bar

The conclusion in the Initial Decision that that *Steadman* factors favor a lifetime associational bar for the Respondents[169] reflects a fundamental misapplication of those factors. This error was exacerbated by the ALJ's failure to consider any sanction less than a permanent bar. An erroneous legal conclusion regarding the application of the *Steadman* factors has significant implications for numerous other cases in which the Commission seeks sanctions and therefore warrants review.

Even if examined in the least favorable light, the conduct of Respondents does not approach the level of misconduct shown to warrant a collateral bar. A bar is only appropriate in the most egregious cases,[170] which is not the case here.

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[167] 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).

[168] As the D.C. Circuit reasoned in Howard, supra 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.

[169] Decision at 36-37.

[170] *See, e.g.*, In the Matter of Gregory Bartko, Esq., Admin. Proceeding File No. 3-14700, Opinion of the Commission, Rel. No. 71666 (Mar. 7, 2014) (Lifetime bar upheld for individual found criminally convicted of conspiracy, mail fraud, and illegal sales of unregistered securities); *see also* In the Matter of Joseph Contorinis,

In contrast, the Respondents lacked any intent to deceive. The Respondents consulted with the Fund's adviser and counsel regarding the investments at issue. The strategies were based on extensive research that showed the risk to be minimal. The investments were disclosed in multiple periodic filings. Significantly, Riad even invested his own money in the same strategies and ultimately lost nearly a quarter of his life savings.

Furthermore, the ALJ failed to provide any analysis articulating whether it is in the public interest to impose a lifetime collateral bar on two Respondents with an unblemished record and outstanding reputation in the industry. Since a lifetime associational bar constitutes the "most drastic remed[y]" available to the Commission, the Commission therefore "has a greater burden to show with particularity the facts and policies that support these sanctions and why less severe action would not serve to protect investors."[171] As the Commission recently reiterated, "[i]n order for the Commission to adopt and affirm a law judge's decision to impose an industry-wide bar, the law judge's analysis must explain, based on the facts and circumstances presented in that case, why such bars are in the public interest."[172] In making this evaluation, the administrative law judge should "consider the record evidence [presented in that case] to determine whether such a remedy is necessary or appropriate to protect investors and markets . . . ."[173] Furthermore, the decision should make findings regarding the respondent's fitness to participate in the industry in the barred capacities.[174] The analysis need not include a "'ritualistic incantation' regarding [the] remedial effect" of the bars, but it should be grounded in specific "findings regarding the

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Admin Proceeding File No. 3-15308, Release No. 72031 (April 25, 2014) (Summary Affirmance of lifetime bar for individual found guilty of conspiracy to commit securities fraud and seven counts of insider trading).

[171] *Steadman*, 603 F.2d at 1137.

[172] *In the Matter of Ross Mandell*, Exchange Act Release No. 71668, 2014 WL 907416, at *2 (Mar. 7, 2014).

[173] *Id.*, quoting *In the Matter of John W. Lawton*, Admin. Proceeding File No. 3-14162, 2012 WL 6208750 at *9.

[174] *Id.*

protective interests to be served" by barring the respondent and the "risk of future misconduct."[175] Moreover, the sanctions analysis must adequately address any mitigating factors, such as the level of participation in the conduct at issue.[176]

The Initial Decision did precisely what the Commission has proscribed. The ALJ imposed a collateral lifetime bar with a perfunctory analysis of the determination. Beyond general assertions regarding the Respondents' actions and opportunity for future misconduct, the Initial Decision does not articulate specifically why a lifetime associational bar is warranted or how it would protect the trading public from further harm. The ALJ also failed to consider any mitigating factors or discuss the varying levels of participation in the conduct at issue. For example, the discussion regarding sanctions makes no mention of the differing roles that Riad and Swanson played with respect to the conduct at issue in the proceeding. For example, Riad did not participate in either of the interviews that served as the basis for the Q&A sections of the annual and semi-annual reports. According to the Initial Decision's own factual determination, "Swanson did not make the decision to trade index puts and variance swaps" and his "understanding of the research was limited at the time of the trades. At most, he knew that Riad and Hughes were researching the use of puts and variance swaps; they did not share the research with him."[177] In addition, the Initial Decision acknowledges that Swanson did not make the relevant disclosures regarding the investments at issue at HCE Board meetings but rather "Riad led the discussions concerning the portfolio."[178] Moreover, Swanson's salary for "management

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[175] *Id*, quoting *McCarthy v. S.E.C.*, 406 F.3d 179, 189-90 (2d Cir. 2005). In denying the request for summary affirmance of an industry-wide bar in Ross Mandell, the Commission specifically emphasized that "although the initial decision discussed the public interest factors in general terms, it did not sufficiently articulate why the facts and circumstances of [the] case warrant the industry-wide bars imposed or how such bars 'protect the trading public from further harm' . . ." Id.
[176] *See McCarthy v. SEC*, 406 F.3d 179, 189 (2d. Cir. 2005); *Paz v. SEC*, 566 F.3d 1172, 1175 (D.C. Cir. 2009).
[177] Decision at 12, n. 11.
[178] Decision at 25.

of HCE related largely to the equity and covered call portion of the fund, the noncontroversial segment of HCE."[179]

b. Erroneous Calculation of Disgorgement

The Initial Decision orders Riad to disgorge $188,948.52 plus prejudgment interest.[180] This amount reflects the "portion of his salary devoted to HCE for 2007, prorated from April 25, 2007, when HCE wrote its first naked written index put, and for 2008 should be disgorged."[181] However, the Initial Decision earlier acknowledged that "[b]etween April and November 2007, HCE mostly either sold puts or purchased puts that were initially covered, meaning that for each put sold, i.e. short position, there was a corresponding purchased put, i.e. long position to cover the short position . . . Eventually, around November 2007, HCE ceased regular purchase of corresponding long put positions . . ."[182] Indeed, the short index put option written on April 25, 2007, was covered by a corresponding long position and therefore not "naked."[183] As a result, the ALJ applied an erroneous time frame – based on an incorrect date for the first naked written index put by HCE – when calculating the disgorgement figure for Riad.

V. The Initial Decision, if enforced, would create bad policy

Finally, the Initial Decision, if enforced, would enact bad policy for the Commission and for registered Investment Advisers as a whole. The Initial Decision concluded that the mere "fact that the new strategy eventually resulted in enormous losses highlights the materiality of the change in strategy."[184] Moreover, the Initial Decision suggests that any action that increases the

[179] Decision at 35.
[180] Decision at 35.
[181] Id.
[182] Decision at 11.
[183] Ex. 86 at FAM00089834.
[184] Decision at 31.

risk of a portfolio – "no matter how remote, is information that a reasonable investor would consider important."[185] Based on this language, the Initial Decision effectively creates an enforcement regime in which the materiality of an investment decision is determined in hindsight based on its result, and in which the probability of the outcome at the time of the decision is irrelevant.

The standard for materiality set forth by the Supreme Court in *Basic v. Levinson* requires the court to balance the "indicated probability that the event will occur and the anticipated magnitude of the event."[186] Here, the Initial Decision apparently ignores the proscription that the likelihood of the event must be taken into account and instead establishes that all risks – "no matter how remote" – are material to investors. Such an approach not only defies all relevant precedent but it also contravenes the policy approach that the SEC has adopted for disclosure of risk to investors.[187]

This is particularly true with respect to mutual fund prospectuses. As former SEC Chairman William Donaldson explained, "[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."[188] A requirement to disclose any action that increases fund risk would cause fund managers to disclose all potential risks, leading to voluminous documents that are useless for investors.

The determination of materiality based on the fact that an investment ultimately generated sizeable losses is equally problematic from a policy perspective. Indeed, courts have frequently

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185 *Id.*
186 485 U.S. 224, 238 (1988).
187 *See* Baris Report at 6 ("The general instructions on Form N-2 make clear that the intent of this form is to give investors a basic understanding of the registrant without overloading shareholders with unnecessary details.").
188 Remarks of Chairman William H. Donaldson Before the Mutual Fund and Investment Management Conference (Mar. 14, 2005), available at http://www.sec.gov/news/speech/spch031405whd.htm.

emphasized the importance of not judging fraud based on hindsight: it is well-settled that the "determination of materiality is to be made upon all the facts as of the time of the transaction and not upon a 20-20 hindsight view long after the event."[189] Similarly, in assessing the Respondents' scienter, it is critical to remember that "[t]here is no 'fraud by hindsight,' in Judge Friendly's felicitous phrase." That the Fund's investments in index puts and variance swaps turned out to be losing investments in retrospect is insufficient to prove materiality or scienter and is certainly insufficient to sustain an action for violation of the federal securities laws.[190] Nonetheless, this is precisely the policy approach that the Initial Decision has adopted.

VI. Conclusion

For the foregoing reasons, Respondents Mohammed Riad and Kevin Timothy Swanson respectfully request that the Commission grant review of the Initial Decision in this matter.

Dated: June 4, 2014

Respectfully submitted:

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[189] Spielman v. General Host Corp., 402 F.Supp. 190, 194 (S.D.N.Y. 1975), aff'd, 538 F.2d 39 (2d Cir.1976); see also Pommer v. Medtest Corp., 961 F.2d 620, 626 (7th Cir. 1992) ("The truth (or falsity) of defendants' statements, and their materiality, must be assessed at the time the statements are made, and not in the light of hindsight.").

[190] See Fulton County Employees Retirement System v. MGIC Inv. Corp., 2012 WL 1216314, *4 (7th Cir. 2012) ("Judge Friendly famously said that there is no securities fraud by hindsight. . . . [The Defendant] had no duty to foresee the future"); Olkey v. Hyperion 1999 Term Trust, Inc., 98 F.3d 2, 8 (2d Cir. 1996) ("Not every bad investment is the product of misrepresentation...It is in the very nature of securities markets that even the most exhaustively researched predictions are fallible...'Fraud by hindsight' alone will not sustain a complaint.") (quotations and citations omitted); Plumbers & Steamfitters Local 773 Pension Fund v. Canadian Imperial Bank of Commerce, 694 F.Supp. 2d 287, 301 (S.D.N.Y. 2010) ("That [defendant] chose an incremental measured response, while erroneous in hindsight, is as plausible an explanation for the losses as an inference of fraud. [Defendant], like so many other institutions, could not have been expected to anticipate the crisis with the accuracy Plaintiff enjoys in hindsight").

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