UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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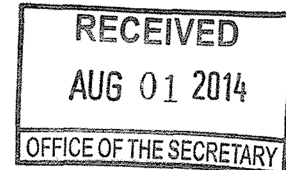


ADMINISTRATIVE PROCEEDING
File No. 3-15141

In the Matter of

MOHAMMED RIAD
AND KEVIN TIMOTHY
SWANSON

Respondents.

**OPENING BRIEF IN SUPPORT OF RESPONDENTS MOHAMMED RIAD AND KEVIN TIMOTHY SWANSON'S APPEAL OF INITIAL DECISION BY A HEARING OFFICER**

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## I. INTRODUCTION

This matter involves two portfolio managers who tried in good faith to manage their fund in a reasonable and prudent manner but were overwhelmed by an unprecedented financial collapse – the 2008 Financial Crisis – that had an unforeseen and negative impact on a strategy that they had carefully developed and implemented.

The Respondents, Mohammed Riad and Tim Swanson, were employed by Fiduciary Asset Management, Inc. ("FAMCO") as co-portfolio managers of the Fiduciary/Claymore Dynamic Equity Fund ("HCE" or the "Fund"), a closed-end investment company sub-advised by FAMCO and advised by Claymore Advisors, LLC ("Claymore"). After thousands of hours of careful research that demonstrated the minimal risk of investing in short index put options and short variance swaps and following consultation with relevant legal and compliance personnel, the Respondents began investing in these two derivatives in 2007. Riad believed in these new strategies so strongly that he invested nearly a quarter of his life savings – more than $1 million – in these same investments.[1] These derivatives had a modest, positive contribution to the Fund in the latter half of 2007 and the first part of 2008, but ultimately lost nearly $45 million during the Financial Crisis in 2008 when the market moved in unprecedented ways.

The foundation of the Initial Decision appears to be the fact that the Fund suffered a significant loss and the opinion works backwards from that fact to conclude that the Respondents must have acted improperly. As one example, the opinion explains that "[t]he fact that the new strategy eventually resulted in enormous losses highlights the materiality of the change in

[1] *In the Matter of Mohammed Riad and Kevin Timothy Swanson*, File No. 3-15141, Initial Decision, Release No. 590 (April 21, 2014) [hereinafter "Decision"] at 27 ("Riad invested in FOF [a private fund offered only to senior FAMCO personnel and co-managed by Riad that invested in the same trading strategies employed by the Fund] and lost approximately $1.6 million, which was a quarter of his life savings at the time.").

strategy."[2] Utilizing this "fraud by hindsight" approach – a legal standard that has been rejected by numerous courts – the Initial Decision found that the Respondents *must* have known that the investments were extremely risky prior to the Financial Crisis. The Initial Decision similarly deemed insufficient the numerous disclosures of these investments by the Respondents to various relevant parties because they failed to adequately highlight the eventual risk and the impact of these investments.

In reaching these conclusions, the Initial Decision almost completely ignores the majority of the evidence presented at trial, much of which related to the reasonableness of the Respondents' analysis of the derivatives strategies and the disclosure standard for closed-end funds. For example, the Initial Decision fails to even address[3] the fact that the former Chief Economist of the Commission, Respondents' expert Chester Spatt, found that the Respondents engaged in a careful analysis of these investments and were reasonable to conclude that the derivatives did not pose a significant risk to the Fund.[4] The opinion does not even mention the Respondents' other expert, Jay Baris, who provided important guidance regarding industry disclosure practices and the Commission's disclosure regime.[5] The failure to discuss these two key experts – much less make any findings as to whether they provided credible testimony – represents a fatal defect of the Initial Decision given how central their opinions were to the primary issues in the proceeding.

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[2] Decision at 31.
[3] The Initial Decision briefly mentions Prof. Spatt in a footnote, stating that he "concluded that Respondents' assessment that the puts and swaps would improve HCE's risk-adjusted trade-off was reasonable." Decision at 12, n.12.
[4] Expert Report of Chester S. Spatt, *In the Matter of Mohammad Riad and Kevin Timothy Swanson*, File No. 3-15141 (Mar. 19, 2013) [hereinafter "Spatt Report"] at 26.
[5] Tr. 3046:17-3073:16; *see also* Expert Report of Jay G. Baris, *In the Matter of Mohammad Riad and Kevin Timothy Swanson*, File No. 3-15141 (Mar. 19, 2013). Citations in this Brief to the transcript will be noted as "Tr." and denote testimony before the Court in this proceeding.

The Initial Decision's treatment of evidence that was actually considered is equally problematic. Indeed, the Initial Decision repeatedly relied only on documentary evidence but refused to give any weight to related testimony that expanded upon such documents, even when that testimony came from the author of the document and was corroborated by numerous witnesses. For example, in summarizing a January 16, 2008 call during which Respondents were told that outside counsel to the Fund had approved the derivatives trading, the Initial Decision minimizes this critical conversation by limiting its content to only what was memorialized in brief notes taken after the call by one participant.[6] In fact, the author of those notes, Susan Steiner, as well as several other witnesses testified that the call conveyed to the Respondents that the derivatives strategies were permissible going forward.[7] Indeed, the very purpose of the call was to discuss the strategies' risks and whether the strategies were adequately disclosed in the Fund's SEC filings.[8]

In addition to the application of an improper hindsight bias and flawed consideration of key evidence, the Initial Decision is also based upon four factual premises that are unsupported by the law or the evidence.

*First*, the Initial Decision relies on the fact that HCE was supposedly a generic, conservative covered call fund. According to the opinion, this is what the prospectus said and how the Fund was marketed, and it is also how the shareholders perceived HCE. The Initial Decision states that a covered call fund is inherently low risk and completely inconsistent with the kind of derivatives trading that occurred here.

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[6] Decision at 24 ("There is no evidence to support a finding that the result of the call was to approve naked puts and variance swaps as a strategy going forward, whether or not the prospectus permitted such transactions as 'strategic transactions.' Nor was there any discussion as to whether HCE was obligated to disclose any such strategy. Nor was there any discussion of risk.") (citations omitted).
[7] Tr. 1271-1273.
[8] *See, e.g.,* Tr. 1272:7-23; *id.* at 1049:6-11; *id.* at 2624:20-2625:23.

In fact, the plain language of the Fund's prospectus gave it broad latitude to invest in many strategies -- including the derivatives at issue. This fact was confirmed by Thomas Hale, the author of the HCE prospectus and counsel to the Fund. Moreover, the Fund was marketed to specifically emphasize the fact that HCE went beyond a "plain vanilla" covered call fund. Perceptions of two Fund investors and an industry observer[9] who performed only a cursory review of the relevant filings[10] do not overcome this evidence[11] and merely reflect the fact that the Fund correctly applied SEC guidance in identifying its principal strategy as a covered call strategy.[12]

*Second,* the Initial Decision asserts that the Respondents concealed the trading at issue from Claymore, the Fund board, and HCE shareholders by failing to explain the overall strategy in detail. They strengthened the cover up by failing to discuss the success of the strategy and by misleadingly suggesting that the investments were low risk.

In fact, there was no cover up: the Respondents openly disclosed the derivatives strategies to all relevant parties. The large and highly sophisticated Fund adviser, Claymore, knew the relevant facts and never claimed ignorance. Claymore lawyers even considered and accepted the characterization of the derivatives trading in the periodic filings as "hedges" and Claymore drafted the allegedly insufficient disclosures relating to the Fund's investments in

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[9] Decision at 10.

[10] *In the Matter of Mohammed Riad and Kevin Timothy Swanson*, File No. 3-15141, Reply to the Division of Enforcement's Post-Hearing Brief (July 26, 2013) at 22-23.

[11] *Dodds v. Cigna Securities, Inc.*, 12 F.3d 346 (2d Cir. 1993) ("[A] failure to read the prospectuses is not excused because of the documents' length.") (citing *Armstrong v. McAlpin*, 699 F.2d 79, 88 (2d Cir.1983); *DeBruyne v. Equitable Life Assur. Soc. of the U.S.,* 920 F.2d 457, 466 n.18 (7th Cir.1990) (plaintiff "cannot avoid the statute of limitations by possessing, but failing to read, the documents that would put [her] on inquiry notice")."

[12] As the Commission confirmed just a few weeks ago, "[i]n assessing what is a principal investment strategy, a fund should 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 losing some or all of those assets from implementing the strategy." IM Guidance, US Securities and Exchange Commission Division of Investment Management, No. 2014-08 (June 2014).

variance swaps. The Fund board[13] and Fund shareholders received precisely the amount of information specified by Commission requirements. It is perhaps unsurprising then that the Fund board determined – based on guidance from Fund counsel, Hale – in late 2008, after all the trading and losses were fully known and analyzed, that no illegal conduct had occurred.[14] Fund shareholders never sued or even complained about fraud. Moreover, as explained below, the Respondents had no motive to engage in a cover up. As the court said in *S.E.C. v. Steadman*, "[i]f we were to conclude that the [respondents] meant to defraud investors, we would have to believe that they did so for the sheer joy of it rather than for profit."[15]

*Third*, the Initial Decision claims that the Respondents knew the strategies were very risky. According to the Initial Decision, this is demonstrated by selected research they reviewed and the fact that the strategies lost large sums in the 2008 Financial Crisis.

In fact, the Respondents reasonably believed that the strategies were low risk and they only lost money because of the unpredictable and unprecedented dislocation in the financial markets that occurred in 2008. This claim was supported by the Respondents' expert and former Chief Economist of the Commission, Prof. Chester Spatt. The conclusion that the Respondents must have known about the eventual risks that emerged rests primarily on hindsight bias – an approach that courts have repeatedly deemed improper.[16] In reaching this conclusion, the Initial Decision never defines risk even though a substantial portion of the trial was devoted to this key

[13] The Initial Decision nowhere acknowledges, although Fund directors testified at trial, *see* Tr. 3026:6-17, that fund directors perform an oversight role and do not expect advisers and subadvisers to present detailed information about trades and trading strategies. *See Practical Guidance for Mutual Fund Directors: Board Governance and Review of Investment Advisory Agreements*, Report of the Mutual Fund Directors Forum (Oct. 2013), available at http://www.mfdf.org/images/uploads/newsroom/MFDF_Practical_Guidance_Oct2013_(web).pdf . *See also* David Katz, *Boards Play a Leading Role in Risk Management Oversight*, The Harvard Law School Forum on Corporate and Financial Regulation, available at http://blogs.law.harvard.edu/corpgov/2009/10/08/boards-play-a-leading-role-in-risk-management-oversight/ (Oct. 8, 2009).
[14] Ex. 197 at 2. References to Exhibits or "Ex." in this Brief denote references to the Parties' Joint Exhibits.
[15] *S.E.C. v. Steadman*, 967 F.2d 636, 642 (D.C. Cir. 1992).
[16] *See infra* at 29.

issue. Indeed, the evidence showed that the Respondents used the Commission mandated "Value at Risk" methodology[17] to reasonably conclude that there was no more that a 0.5 percent chance of losing five percent or more of the Fund's assets.

*Fourth*, the Initial Decision is premised on the fact that the Respondents never sought or received advice of counsel.

In fact, the Respondents requested guidance from counsel on two occasions prior to the Fund losses in the fall of 2008. In response, they were told by Claymore that Hale had been consulted and had concluded that the derivatives strategies were legal – a determination that he confirmed at the end of 2008, after all the trades and losses were known and fully analyzed.[18] The Respondents reasonably relied on this guidance in pursuing the strategies at issue.

## II. PROCEDURAL HISTORY

On December 19, 2012, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against the Respondents (the "OIP").[19] The Division alleged that the Respondents invested in risky derivatives that they concealed from the Fund adviser, Fund Board, and Fund shareholders.

An eleven-day hearing was held between April 22 and May 8, 2013, in St. Louis, Missouri, Chicago, Illinois, and Washington D.C. On April 21, 2014, the Administrative Law

[17] In one brief footnote, the Initial Decision mentions two experts who submitted reports and testified at trial, but does not mention any of the content of their analysis. Decision at 12. The Initial Decision does not even mention that the Division's own expert agreed that the Respondents used the value at risk method of measuring risk. Tr. 184:21-22 (". . . FAMCO used a variant of a risk management process called Value at Risk.").

[18] *See* Ex. 197 at 2.

[19] *In the Matter of Mohammad Riad and Kevin Timothy Swanson*, Admin. Proc. File No. 3-15141, Order Instituting Administrative And Cease-And-Desist Proceedings, Securities Act Rel. No. 68467 (Dec. 19, 2012).

Judge found that the Respondents had committed the alleged violations and imposed sanctions.[20] On June 4, 2014, the Respondents timely filed a Petition for Review with the Commission,[21] which was granted on June 10, 2014.[22]

## III. STANDARD OF REVIEW

The Commission reviews both findings of fact and conclusions of law from initial decisions *de novo*.[23] Rule 411(a) of the Commission's Rules of Practice specifies that "[t]he Commission may affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part, an initial decision by a hearing officer and may make any findings or conclusions that in its judgment are proper and on the basis of the record."[24] Courts have made clear that each individual Commissioner may make his or her own factual determinations *de novo* when reviewing an initial decision.[25]

The Commission's broad power to review initial decisions includes the authority to evaluate the law judge's credibility determinations. Indeed, "there are circumstances where, in the exercise of our review function, we must disregard explicit determinations of credibility."[26] As the Commission has noted, "[a]lthough we grant 'considerable weight and deference' to

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[20] *In the Matter of Mohammad Riad and Kevin Timothy Swanson*, Admin. Proc. File No. 3-15141, Initial Decision (April 21, 2014).
[21] *In the Matter of Mohammad Riad and Kevin Timothy Swanson*, Admin. Proc. File No. 3-15141, Petition for Review (June 4, 2014).
[22] *In the Matter of Mohammad Riad and Kevin Timothy Swanson*, Admin. Proc. File No. 3-15141, Corrected Order Granting Petition for Review and Scheduling Briefs (June 10, 2014).
[23] *See In re Gary M. Kornman*, Exchange Act. Rel. No. 59403, 2009 WL 367635, at *9 n.44 (Feb. 13, 2009), petition denied, 592 F.3d 173 (D.C. Cir. 2010); *In re Herbert Moskowitz*, Exchange Act Rel. No. 45609, 2002 WL 434524, at *1 (Mar. 21, 2002) (reversing initial decision after stating that "[w]e base our findings on an independent review of the record, except with respect to those findings not challenged on appeal." ).
[24] 17 C.F.R. § 201.411(a).
[25] *Graham v. S.E.C.*, 222 F.3d 994, 1006 n.22 (D.C. Cir. 2000).
[26] *In re Kenneth R. Ward*, Exchange Act Rel. No. 47535, 2003 WL 1447865, at *10 (Mar. 19, 2003), aff'd, 75 Fed. Appx. 320 (5th Cir. 2003) (citation omitted).

credibility determinations of law judges and other initial factfinders, we judge those determinations against the weight of the evidence."[27]

On *de novo* review, the Commission can also determine that "the law judge did not have a sufficient basis on which to conclude" that violations of law occurred.[28] Even under a more restrictive standard of appellate review than the one applied on this appeal, findings of negligence can be reversed if not supported by the evidence.[29]

## IV. THE HCE FUND WAS ESTABLISHED AND MARKETED AS MORE THAN A CONSERVATIVE COVERED CALL FUND

The Initial Decision asserts that HCE was conceived and marketed as a conservative covered call fund with limited investment flexibility.[30] This claim serves as the basis for the Initial Decision's narrative that the investments at issue constituted an "[e]volution of HCE's [r]isk [f]ootprint."[31] In fact, the assertion that HCE was a "plain vanilla" covered call fund with a restricted investment mandate represents an erroneous conclusion of fact based on a misreading of the plain language of the HCE prospectus and a disregard for testimony relating to Fund marketing.

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[27] *In re David F. Bandimere*, Admin Pro. File No. 3-15124, Order Denying Motion for Summary Affirmance, Granting Petition for Review, and Scheduling Briefs (Jan. 16, 2014) (internal citations omitted); *In re Robert M. Fuller*, Exchange Act Rel. No. 48406, 2003 WL 22016309, at *7 (Aug. 25, 2003) (internal quotation and citation omitted), petition denied, 95 F. App'x 361 (D.C. Cir. 2004).

[28] *In re Michael R. Pelosi*, Admin. Pro. File No. 3-34194, Opinion of the Commission (March 27, 2014); *cf. In re Kevin Hall, CPA*, Exchange Act Rel. No. 61162, 2009 WL 4809215, at *9 (Dec. 14, 2009). *See also In re Michael Flanagan*, Admin. Pro. File No. 3-9784, Opinion of the Commission (July 30, 2003).

[29] *S.E.C. v. Ginder, et al.,* 152 F.3d 569, 571 (2d Cir. 2014). 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."

[30] *See* Decision at 6-10; *id.* at 30.

[31] *Id.* at 14.

*a. The Fund's Prospectus Does Not Limit Its Investments to Covered Calls*

The Initial Decision claims 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."[32] In order to reach the conclusion that the investment parameters for the Fund were limited, however, the Initial Decision was forced to minimize the significance of key language in the prospectus describing the fund's use of "Strategic Transactions" that provided authority for HCE's investments in the puts and swaps at issue.

The proper method of analyzing these investments in light of the prospectus disclosures was provided in a memorandum[33] drafted by Thomas Hale, counsel to the Fund and the lawyer who prepared HCE's registration statement.[34] Hale made clear in this memorandum that the investment parameters of the Fund were never intended to be limited, as the Initial Decision suggests. Instead, Hale's memorandum explained that the "Strategic Transactions Disclosure" in the prospectus was specifically "[i]ntended to be broad authority."[35] Moreover, Hale's memorandum emphasized that investments such as the index puts at issue were explicitly contemplated by the prospectus: as he explained, the registration statement contained a section "specifically discussing transactions involving index options" such as the short puts at issue[36] and concluded that "writing index put options is clearly within the authority granted to the Fund as disclosed in the Prospectus . . ."[37] Hale also noted that the registration statement went even further in clarifying the use of these positions, explaining that, "[p]ursuant to the Prospectus, the

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[32] *Id.* at 7.
[33] Ex. 265 at 2.
[34] Tr. 2827-29; Exs. 11, 12.
[35] Ex. 265 at 2.
[36] *Id.*
[37] Ex. 264 at 3.

Fund may write (sell) covered put options on up to 20% of its total assets to seek to earn current income and current gains."[38]

Refusing to accept the clear interpretation by the author of the actual document, the Initial Decision instead asserts that the description of "Strategic Transactions" in the Prospectus was mere "boilerplate."[39] As support for this point, the Initial Decision highlights the fact that another covered call fund prospectus drafted by Hale "contained almost identical language" regarding such transactions.[40] In reality, however, the relevant language in these two prospectuses contained an important distinction. For the conservative covered call fund – described in the opinion as a "'plain vanilla' covered call fund"[41] – the "Strategic Transactions" section emphasized that the "fund may, *but is not required or expected to any significant extent to*, use various strategic transactions. . . ."[42] The analogous HCE provision, on the other hand, contained no such cautionary language regarding the use of strategic transactions – serving as further support for Hale's assertion that HCE was intended to have "broad authority." Moreover, the pure covered call fund emphasized in its prospectus that the rationale for investing in the fund was that the covered call strategy represents a conservative investment approach that would "[l]ead to an overall reduction in risk compared to a strategy of simply owning stocks."[43] Unmentioned in the Initial Decision is the fact that the HCE registration statement omitted this reference to risk reduction.

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[38] Ex. 265 at 1.
[39] Decision at 8.
[40] *Id.* at 9, n.8. 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." *Id.* at 9. 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. *See* Ex. 367. Again, the HCE prospectus did not contain such a limitation. *See* Ex. 11.
[41] Decision at 6.
[42] *See* Ex. 367 (emphasis added).
[43] *See id.*.

Hale's memorandum also highlights the error in the Initial Decision's conclusion regarding the coverage of the puts and swaps. The Initial Decision acknowledges that the "SAI discussed the purchase and sale of securities index options"[44] but asserts that "[n]either HCE's prospectus nor its SAI . . . made specific mention of naked puts or variance swaps."[45] Such an assertion serves as the foundation for the Initial Decision's finding that the Respondents' trading strategy violated the prospectus because Riad and Swanson allegedly "engaged in a trading strategy, which included writing naked index put contracts and entering variance swaps."[46] Significantly, the registration statement explains specifically how the index puts are meant to be covered. 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."[47] 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."[48] Based on this interpretation, Hale later confirmed that the puts and swaps at issue had been covered appropriately according to the Prospectus[49] – and therefore did not represent risky, "naked" positions as asserted by the opinion. 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,[50] serving as further evidence that the derivatives strategy was consistent with the Fund's investment mandate.

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[44] Decision at 9.
[45] *Id.*
[46] *Id.* at 2. *See also id.* at 11; *id.* at 13; *id.* at 14; *id.* at 15.
[47] Ex. 11 at 10 and 27.
[48] Ex. 264.
[49] Following the Fund losses in the fall of 2008, Hale acknowledged that "the assets representing the market value of the positions generally were segregated in accordance with industry practice." Ex. 197 at 2. *See also* Ex. 265 at 4.
[50] *See* Ex. 264 at 4.

*b. The Fund Was Not Marketed as a Covered Call Fund*

The Initial Decision also asserts that HCE was marketed as a covered call fund.[51] To reach this conclusion, the Initial Decision ignores key evidence and misinterprets 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."[52] 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.[53] The marketing documents and the road show also highlighted the Fund's use of a call-on-call strategy, a highly leveraged and volatile trading approach involving long and short options[54] – and therefore significantly more risky than a pure covered call approach. This uncontested fact further belies the assertion that the Fund was marketed as a conservative covered call strategy.

By focusing exclusively on the marketing pamphlets, the Initial Decision also ignores testimony from two of the individuals most closely involved with the actual marketing of the Fund regarding the depiction of the Fund that was conveyed to investors. For example, the Initial Decision 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.[55] The Initial Decision was forced to acknowledge Riad's testimony that he discussed put writing strategies during these presentations,[56] but 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."[57]

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[51] Decision at 9-10.
[52] *Id.* at 9.
[53] *See* Ex. 31 at CLAY030380; Ex. 33 at CLAY03054; Ex. 116 at SASMF_0355; Ex. 117 at SASMF_0360.
[54] *See id.; see also* Tr. 997:10-999:6.
[55] Decision at 10.
[56] *Id.*
[57] *Id.*

In fact, this testimony *was* corroborated by Joseph Gallagher, Chief Compliance Officer of FAMCO and an individual unaffiliated with any of the parties to this proceeding.[58]

## V. RESPONDENTS DID NOT CONCEAL THEIR DERIVATIVES INVESTMENTS FROM ANYONE

The Initial Decision does not deny that the Respondents "provided information regarding the use of short puts and variance swaps"[59] to the relevant parties. The Initial Decision nonetheless claims that the Respondents failed to explain completely the nature of these investments.[60] In particular, the Initial Decision suggests that there were three deficiencies with the disclosures: *first*, the Respondents failed to make clear that these trades were being employed as an ongoing strategy;[61] *second*, the Respondents did not discuss the contribution to performance from these investments;[62] and *third*, the Respondents hid the risk from these investments. All of these claims are directly contradicted by the evidence presented at the trial and are premised on an erroneous interpretation of the law.

### *a. The Respondents Made Clear that the Investments Represented a Strategy*

The assertion that the disclosures only concerned "single, isolated trade positions" is belied by the Fund's periodic filings.

The Fund repeatedly disclosed its investments in short index puts and variance swaps in *five* public filings in 2007 and 2008.[63] These disclosures were reviewed and approved by

[58] Gallagher 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." Tr. 999:7-13.
[59] Decision at 22.
[60] *See, e.g., id.* at 26.
[61] *See, e.g., id.* at 31.
[62] *See, e.g., id.* at 23-24.
[63] *See* Ex. 300 at 8 and 10; Ex. 301 at 11; Ex. 302 at 11; Ex. 303 at 11; Ex. 304 at 11 and 16.

Claymore and Fund counsel[64] and were also provided to the Fund Board[65] and HCE shareholders.[66]

These disclosures alerted investors to the fact that the Fund was repeatedly writing short index put options and short variance swaps without any corresponding long positions. Indeed, in *three consecutive quarterly filings* – the August 2007 Form N-Q,[67] November 2007 Annual Report,[68] and February 2008 Form N-Q,[69] – the Fund listed short index put options and short variance swaps but made no mention of a long position in either derivative.[70] Significantly, the Fund identified these variance swap positions despite the fact that there was no requirement to disclose this investment in the quarterly filings.[71] The recurring disclosure of these short positions without corresponding longs in multiple successive filings – and five filings in total – is significant because it put investors, counsel, Claymore, and the Board on notice that these investments were part of an ongoing strategy.[72]

Other evidence similarly shows that the Respondents disclosed the ongoing nature of these investments. For example, the Initial Decision failed to even mention a key email from Riad to Steven Hill, a Claymore executive and the Fund's Chief Financial Officer, from March 2008.[73] In his message, Riad writes that "*[a]s you are aware*, we a[re] short variance swap

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[64] *See, e.g.*, Tr. 994:11-25; *id.* at 1708:1-4, 18-25; *id.* at 2069:3-14; *id.* at 2840:13-18; *id.* at 2735:12-13; *id.* at 1551:14-23.
[65] *See, e.g.*, Ex. 284.
[66] *See, e.g.*, Tr. 1460:5-10; *id.* at 1247:17-24; *id.* at 1457:7-10; *id.* at 1457:16-21.
[67] Ex. 300 at 10.
[68] Ex. 304 at 16.
[69] Ex. 302 at 11.
[70] The Division's witness, Robert Shulman, acknowledged this fact during his testimony. Tr. 1378:7-10, 1381:21-1382:1.
[71] Tr. 2745:3-10 ("Because a swap doesn't – doesn't show up as part of a portfolio, just the way in which it's reported, it's a balance sheet obligation. And the NQ [sic] doesn't report the balance sheet, it only reports the scheduled investment. We added disclosure to show that in addition to the portfolio holdings, this swap was outstanding.").
[72] The Division's own expert, Lawrence Harris, acknowledged the importance of these position disclosures in his testimony. Tr. 317:17-22.
[73] Ex. 4.

position in the HCE Fund . . . *As we have discussed before, FAMCO uses both variance swaps and puts*" in the HCE Fund.[74] The fact that these positions had been "discussed before" and that Hill was already "aware [of the] short variance swap position" contradicts the Initial Decision's claim that they were presented as one-off transactions.

The evidence also confirms that the Respondents disclosed repeatedly the Fund's investments in short index puts and short variance swaps to HCE's Board of Trustees throughout the life of the Fund. Both Respondents testified that the short puts and variance swaps were discussed at multiple Board meetings.[75] This fact was confirmed by multiple board members. Ronald Toupin, Chairman of the Board, acknowledged that the Respondents discussed short index puts and short variance swaps at these meetings "from time to time as they were using them"[76] – suggesting that they were not presented as isolated transactions. Randall Barnes recalled that Riad discussed these derivatives at every Board meeting.[77] Joseph Gallagher also remembered Riad talking about these investments at multiple Board meetings.[78] Faced with testimony from *five* witnesses that these investments were discussed at multiple Board meetings, the Initial Decision notes that these assertions were not corroborated by the meeting minutes.[79] The Initial Decision acknowledges that Riad spoke for 15-20 minutes at each Board meeting;[80] the minutes at issue generally included only 2-3 short paragraphs summarizing these discussions,[81] yet the Initial Decision appears to assume that they reflect a complete transcription of everything that was said during these meetings. The Initial Decision also ignores references in

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[74] *Id.* (emphasis added)
[75] Tr. 1812-13; *id.* at 2156; *id.* at 2227; *id.* at 2552.
[76] *Id.* at 2992:12-17
[77] *Id.* at 2918:18-21; *see also id.* at 2922:6-9.
[78] *Id.* at 1013:10-1014:2.
[79] Decision at 26.
[80] *Id.* at 26.
[81] *See, e.g.,* Exs. 337, 338, 339, 340.

the minutes that corroborate the testimony of the five witnesses.[82] The Initial Decision similarly disregards the fact that the variance swap was specifically highlighted as a "new investment type" in the "Summary of Noteworthy Changes" cover sheet that accompanied the 2007 Annual Report delivered to the Board.[83]

Perhaps the best evidence that the Respondents explained their use of the investments at Board meetings as a strategy rather than as isolated transactions comes from the testimony of Board members themselves who claimed that they *understood the positions as a strategy*.[84] For example, Barnes was asked directly whether Riad "ever describe[d] these variance swaps as a regular strategy he was using in the funds?" His response was an unequivocal "[y]es."[85] Barnes was later asked whether Riad "ever [went] into detail as to a plan of how he was going to use them [variance swaps] as far as whether he would use them opportunistically at certain times or that he would use them, you know, consistently or regularly?" Barnes responded that his "understanding was that they would use them regularly."[86] Claymore Chief Compliance Officer Bruce Saxon had a similar recollection: "I understood that [the Respondents] were doing a broader strategy" and "[i]t appeared that [variance swaps] were being used on an ongoing basis."[87] Faced with this testimony directly on point, the Initial Decision nonetheless concludes that both Barnes and Saxon understood the positions to be "occasional transactions, not a strategy"[88] – the opposite of their testimony.

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[82] *See, e.g.*, Exhibit 188 at 4 ("Mr. Riad stated that management proposes using short-term leverage to write puts."); Ex. 306 at 3 ("Mr. Riad proposed using leverage opportunistically to buy equities *and then sell volatility protection on those equities as conditions warranted.*") (emphasis added).
[83] *See* Ex. 284. *See also* Tr. 2998:10-17 (acknowledging that fund administration would bring this type of information to the Board's attention).
[84] Tr. 2920:7-10; *id.* at 2921:10-16.
[85] *Id.* at 2920:7-10.
[86] *Id.* at 2921:10-16.
[87] *Id.* at 2628:10-11; *id.* at 2629:18-19.
[88] Decision at 26.

*b. The Respondents Appropriately Disclosed the Impact of the Investments*

The evidence also showed that the Respondents discussed the impact of these investments on Fund performance. Gallagher testified that he "certainly remember[ed] Mo talking about [volatility swaps] in the context of the performance attribution analysis of the portfolio" at Fund Board meetings.[89] In fact, the Respondents specifically broke out the contribution to performance from their equities and long call purchases – in essence, their stock-picking ability – in multiple written and oral communications with the Board.[90] These same communications also detailed the impact from the Fund's derivatives investments, including the short puts and swaps.[91] In another email unmentioned in the Initial Decision, Riad emailed Matt Patterson, Claymore Assistant General Counsel, in December 2007 and emphasized that the "OTC strategies" – which included the short index put options and short variance swaps – "have contributed greatly to the strong performance of HCE this year."[92]

Faced with these disclosures, the Initial Decision faults the Respondents for failing to disclose something that simply isn't true: namely, the overwhelming importance of these strategies to the Fund's performance. Indeed, the Initial Decision repeatedly emphasizes the impact of the two trading strategies at issue by claiming that they generated nearly 45% of the

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[89] Tr. 1013:10-16.

[90] In fact, *every* quarterly communication to the Board broke out the equity and long-call performance of the portfolio. In the written materials provided to the Board for the October 2007 Board meeting, for example, the Respondents specifically emphasized the fact that "[u]nderlying performance for the Fund's equities and long-calls was 3.3% gross of fees for the quarter ending September 30, 2007 and 11.2% for the trailing 12-month period ending September. In comparison, the S&P 500 Index increased 2.0% for the quarter and 16.4% for the 12-months ending September 30, 2007." Ex. 79 (emphasis added). *See also* Exs. 71, 6, 76, and 89.

[91] Ex. 79. This document noted that the "Fund's option-overlay and hedging strategies" – in other words, the derivatives investments – "helped to add increment [sic] returns to overall portfolio performance . . .." *Id.* The same breakdown of performance for equities and long calls, as well as an emphasis on the beneficial impact of the derivatives investments, was repeated in every subsequent portfolio manager's discussion as well as FAMCO's memorandum to accompany its 15(c) contract review. *See* Ex. 6; Ex. 76; Ex. 89; Ex. 186.

[92] Ex. 316.

Fund's return over a two-year period.[93] 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"[94] and the opinion relies on this figure as the basis for the erroneous legal conclusion regarding the Respondents' conduct. When assessing the materiality of these investments, the Initial Decision 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."[95]

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% figure, the calculation was based on the return 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 far more importance to the strategies at issue than they actually merited.[96] In fact, the combined performance for the short index puts and short variance swaps was much less: for fiscal year 2007, for example, the positions contributed only 1.6% as compared to the total portfolio return of nearly 13%.[97]

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.[98] Again, there is no consideration given to the fact that the Respondents viewed

[93] Decision at 12 (summarizing 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.").
[94] Decision at 12, 16, and 30.
[95] *Id.* at 31.
[96] Ex. 14 at 15492.
[97] *Id.*
[98] *Id.* at 30.

these profits as unusual and unexpected because the market moved in unprecedented ways in late 2007 and early 2008.

*c. The Respondents Disclosed the Expected Risks from these Investments*

The Respondents also discussed the potential risks of these investments. Disclosures in the periodic filings for variance swaps specifically highlighted the fact that the position would lose money if volatility rose.[99] Disclosures in the filings for both short index puts and short variance swaps also identified the unrealized loss for the position at the time of the report, thereby putting investors on notice as to the potential impact of the investment on the portfolio.[100] The March 2008 email from Riad to Hill discussed the "net exposure" of the contract.[101] The Board also recalled discussion by Riad about the research and analysis that had been performed on the risk from these investments.[102] It is implausible to suggest that the highly sophisticated[103] Board members were unable to understand from these discussions the risk from these investments, especially in light of the fact that Barnes engaged in similar index put trading in his own account.[104] The same point holds true for Claymore, a sophisticated entity with access to all of the relevant information regarding the potential exposure from these transactions.[105]

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[99] *See* Ex. 301 at 11

[100] For the October 2007 Form N-Q, for example, the Fund identified the unrealized loss from its variance swap of $850,000 – nearly one percent of the Fund's assets at the time. Ex. 301 at 11; *See also* Ex. 300 at 8.

[101] Ex. 4.

[102] Tr. 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.").

[103] *Id. at* 988:21-989:7.

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

[105] *See, e.g.,* Tr. 2615:10-13; *id.* at 2653:4-9; *id.* at 2192:7-2193:17; *id.* at 2700:11-15; Ex. 4.

When evaluating the disclosures in HCE periodic filings, the Initial Decision also failed to mention the fact that Claymore had such a strong understanding of the investments at issue that it *drafted the variance swap disclosure in the Fund's periodic filings.*[106] Significantly, Frank Gallery, a member of Claymore's Fund Administration Group who participated in creating this disclosure, had also received the confirmations for the variance swap trades and thus had all of the relevant information regarding the trades at hand, including the variance amount and the variance strike price[107] – the very same features of the transactions that the Initial Decision faulted the Respondents for not including in the periodic filings. For the Initial Decision to claim that Claymore – a sophisticated adviser with extensive derivatives experience – crafted this disclosure language without having any comprehension of the actual investment is unsupported by the record.

Claymore's involvement with the 2008 Semi-Annual Report Q&A similarly demonstrates their knowledge and understanding of the investments. In a July 2008 email thread mischaracterized by the Initial Decision, Hill questioned whether the report should further explain how hedges work. The Initial Decision claims that Hill did not understand that "strategic hedging consisted of selling uncovered puts and variance swaps."[108] 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 Hill's question where Mark Mathiason, Claymore in-house counsel, concluded that the disclosure was adequate without further explanation of the

[106] Ex. 280.
[107] Ex. 158.
[108] Decision at 23-24, n.34.

strategy.[109] The suggestion that counsel would sign off on the adequacy of disclosure without understanding the strategy is unsupported by any evidence in the record.

*d. The Respondents' Disclosures Complied with Relevant Legal Standards*

The Initial Decision concludes that the Respondents' disclosures were legally deficient without any reference to the relevant standards by which to evaluate such disclosures.

In the section of the Initial Decision detailing the alleged violations by the Respondents, the Initial Decision claims that the short index puts and short variance swaps represented a "principal strategy of the fund."[110] Despite the fact that several witnesses testified about this issue – including extensive testimony by Respondents' expert Jay Baris[111] – the Initial Decision never actually explains how to determine whether an investment constitutes a "principal strategy." Instead, the Initial Decision appears to offer two reasons as to why these positions were a principal strategy: first, these positions contributed a large amount to Fund gains in 2007; and second, the investments increased the risk of the Fund. Both of these assertions are untethered to Commission guidance and are factually incorrect.

According to the Initial Decision, the gains from these positions were 20% of the Fund's total increase in 2007 – an amount roughly comparable to the gains from selling covered calls, which HCE stated in its prospectus was the principal strategy of the fund.[112] In fact, there was no evidence presented at the proceeding to suggest that the short index puts or short variance swaps contributed this much to HCE in 2007.[113] Moreover, the Initial Decision makes no effort to explain *why* a contribution of 20% in one specific period makes an investment a "principal strategy."

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[109] Ex. 362.
[110] Decision at 30.
[111] *See, e.g.,* Tr. 3050:2-3055:1.
[112] Decision at 30.
[113] In reality, these positions generated only 15% of the Fund's gains for that period. Ex. 14 at 15492.

Although Form N-2 does not contain precise guidance on point, the analogous Form N-1A – used for open-end funds – emphasizes that in determining whether an investment constitutes a principal strategy, it is important to consider the adviser's *expectation* as to the significance of the transactions. As the instructions explain, "[w]hether a particular strategy . . . is a principal investment strategy depends on the strategy's *anticipated* importance in achieving the Fund's investment objectives, and how the strategy affects the Fund's *potential* risks and returns."[114] In other words, the Commission has made clear that it is necessary to view investments *prospectively*. As discussed by the Respondents, the investments at issue were never intended to be primary contributors to Fund performance[115] and the fact that they had aberrational performance during one particular period did not suddenly make them a "principal strategy." In spite of the clear Commission guidance, the Initial Decision nonetheless adopts a *retrospective* approach and focuses on an inaccurate performance contribution figure to conclude that the investments served as a "principal strategy."

The Initial Decision also concludes that the investments were "clearly material" because they changed the "fundamental risk footprint of the fund."[116] Again, this assertion suffers from a complete lack of reference to *any* relevant disclosure standards or risk analyses. In fact, Commission Form N-2 sets forth precise parameters that must be applied in determining whether the risk of an investment demands additional disclosure. Specifically, "[i]f a policy limits a particular practice so that no more than five percent of the Registrant's net assets are 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*."[117]

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[114] U.S. Securities and Exchange Commission Form N-1A, Item 9(b)(l)(2).
[115] Tr. 1888:22-1829:1; *id.* at 2255:15-21.
[116] Decision at 31.
[117] *See* U.S. Securities and Exchange Commission Form N-2, Item 8.3, Instruction 4(c).

Based on their extensive research and risk-limiting approach, 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[118] – a classic "value at risk" measurement as mandated by the Commission.[119] This determination was endorsed by Prof. Spatt.[120] The Initial Decision did not evaluate these claims, nor did it cite to any evidence to the contrary.[121]

Rather than apply the rule set forth by the Commission, the Initial Decision invents an entirely new standard. According to the Initial Decision, "[a]n 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."[122] Such an approach directly contradicts Commission guidance and is also contrary to legal precedent. To the contrary, the Commission has frequently tried to adopt the opposite approach.[123] In addition, an evaluation of materiality based on the outcome of an investment is contrary to numerous legal opinions on the subject[124] and demonstrates an extreme example of hindsight bias. This materiality approach also is likely to generate useless disclosure. In the recent *Matrixx* decision, the Supreme Court noted that its earlier decision in *Basic* was "'careful not to set too low a standard of materiality' for fear that

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[118] Tr. 2171:10-2172:25; *id.* at 773:22-774:1.
[119] *See infra* at 25.
[120] *See* Spatt Report at 11.
[121] The Initial Decision also ignores the Commission's Plain English rules, which mandate shortened risk disclosures in order to ensure that investors are not overwhelmed with extraneous information. Final Rules: Plain English Disclosure, Securities and Exchange Commission Release Nos. 33-7497; 34-39593; IC-23011(effective date Oct. 1, 1998). *See also* Tr. 3048:23-3049:3; *id.* at 3050:7-12 (noting that Plain English rules were intended to "emphasize the importance of having prospectuses that are understandable and easy to read and are not cluttered with unimportant information.").
[122] Decision at 31.
[123] *See, e.g.*, Final Rule: Amendment to Rule 102(e) of the Commission's Rules of Practice, Securities and Exchange Commission Release Nos. 33-7593; 34-40567; 35-26929; 39-2369; IA-1771; IC-23489; File No. S7-16-98 (Effective Date Nov. 25, 1998) ("The final rule amendment addresses this issue by focusing on the behavior of an accountant under the facts and circumstances presented at the time. The standard does not permit judgment by hindsight, but rather compares the actions taken by an accountant at the time of the violation with the actions a reasonable accountant should have taken if faced with the same situation.").
[124] *See, e.g., Ganino v. Citizens Utility Co.*, 228 F.3d 154, 165 (2d. Cir. 2000).

management would 'bury the shareholders in an avalanche of trivial information.'"[125] The approach set forth in the Initial Decision creates a very low standard of materiality – namely *any* investment that increases risk or eventually might result in large losses – and would therefore require funds to provide the unwanted "avalanche of trivial information" that disclosure rules are designed to prevent.

The problematic nature of this newly-created materiality standard is also apparent from the evidence presented at the proceeding. Indeed, testimony from both of the Fund investors presented by the Division made clear that discovery of the short index put options and short variance swaps in the HCE portfolio had no impact on their trading decisions. Michael Boyle acknowledged that he was aware of the short index put options – and even discussed these positions with his analyst – prior to the Fund's collapse[126] but made no effort to sell his position. Similarly, Robert Shulman learned in late September 2008 that HCE had invested in short index put options and short variance swaps.[127] Upon discovering that the Fund held such allegedly risky positions, Shulman did *not* urge his clients to immediately liquidate their positions but instead waited several months before finally suggesting that they sell.[128] In other words, when faced with a true test of materiality, both investors clearly demonstrated that their investment decisions were not affected by the presence of these positions in the portfolio.

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[125] *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318 (2011) (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988). *See also TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976) ("[I]f the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury shareholders in an avalanche of trivial information, a result that is hardly conducive to informed decisionmaking.").

[126] Tr. 1505:24-1506:8.

[127] *Id.* at 1355:11-1356:2.

[128] *Id.* at 1358:20-1359:10.

## VI. RESPONDENTS DID NOT VIEW THE STRATEGIES AS EXTREMELY RISKY

The Initial Decision acknowledges that the Respondents believed that the risk from short index put options and short variance swaps was minimal.[129] The Decision further recognizes that the investments were made with caution: "Riad had wanted to implement the strategies as early as HCE's founding *but had not performed adequate research at that point*."[130] Moreover, the Decision admits that Riad and his assistant "performed thousands of hours of research"[131] into various trading strategies and that, based on this analysis, determined that the "they would be able to contain any associated risks" relating to the short index puts and short variance swaps.[132]

When evaluating the Respondents' understanding of the risk from these investments, it is also important to highlight the key pieces of evidence that were *not* discussed in the Initial Decision.

Unmentioned in the Initial Decision is the fact that the methodology employed by the Respondents to analyze the risks of the investments at issue was the "value at risk" approach set forth in the Commission rules that govern the relevant disclosure forms.[133] The fact that the Respondents employed a Value at Risk approach was confirmed by both Prof. Spatt[134] and the Division's own expert, Prof. Lawrence Harris.[135] According to Prof. Spatt, this approach is "actually a well-known and widely-accepted methodology for evaluating risk."[136]

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[129] Decision at 11, n.10 ("Swanson was led to believe that the written puts were relatively low risk investments . . ."); *id.* at 31 ("Riad's research provided the basis for his counterintuitive conclusion that the new strategy had minimal risk . . .").
[130] Decision at 12 (emphasis added).
[131] *Id.*
[132] *Id.*
[133] *See* Form N-2, Item 8.3, Instruction 4(c). *See also* Form N-1A, Item 9(b). For a detailed discussion of the Value at Risk approach, see *In the Matter of Mohammed Riad and Kevin Timothy Swanson*, File No. 3-15141, Post-Hearing Brief of Mohammed Riad and Kevin Timothy Swanson (July 2, 2013) [hereinafter "Respondents' Post-Hearing Brief"] at 18.
[134] Spatt Report at 17.
[135] Harris Report at 78.
[136] Spatt Report at 17.

The Initial Decision also fails to reference the four risk-limiting features that the Respondents employed when making the investments at issue. *First*, 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.[137] *Second*, Riad also attempted to limit the risk from these transactions by setting the size of each trade to a level that would be extremely unlikely to generate a loss of a certain size.[138] *Third*, Riad only placed the trades at times when – based on their research – losses were significantly less likely to occur.[139] *Fourth*, FAMCO limited the risk of these investments by segregating a certain amount of assets for these transactions.[140]

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. 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."[141] Indeed, such awareness was precisely the reason that Riad took all of these 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.[142] However, these papers focused primarily on at-the-money or near at-the-money short index put options; as a result, the Initial

[137] *See, e.g.*, Harris Report at 121.
[138] During trial, 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." Tr. 2170:13-16. His sizing analysis began by working backwards from the question: "[h]ow much exposure are you willing to lose?" *Id.* 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.").
[139] *Id.* at 20-21.
[140] *See, e.g.*, Ex. 316.
[141] Decision at 15.
[142] *Id.* at 16.

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.

The Initial Decision also does not mention that every aspect of the Respondents' approach to these investments was validated by Prof. Spatt, former Chief Economist of the Commission. Spatt stated that the Respondents "attempted to engage in a reasonably sophisticated and intricate analysis"[143] and that the "analyses that were done were sensible."[144] The Value at Risk approach to analyze the risk was a "reasonable method . . . for this purpose."[145] The Respondents appropriately considered industry and academic research into these derivatives and "tried to assess this in a thoughtful way."[146] Most important, Spatt agreed with the Respondents' conclusion that the strategies were unlikely to expose more than five percent of the portfolio to risk.[147] The entirety of Spatt's expert report and extensive testimony is relegated to a single footnote that ignores his key conclusions.[148]

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." Put simply, these extraordinary market moves during the 2008 financial crisis were well beyond anything that was expected based on Riad's extensive research and 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 the exceptional and unpredictable nature of the 2008 market disruptions.[149]

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[143] Spatt Report at 26.
[144] Tr. 3244:23.
[145] *Id.* at 3257:12-14.
[146] *Id.* at 3259:1-6.
[147] *Id.* at 3244:19-22; Spatt Report at 6.
[148] Decision at 12, n.12.
[149] 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).

The Initial Decision also mentions – but places no apparent weight on the fact – that Riad invested his own money in the strategies, losing a quarter of his life savings – nearly $1.6 million – because of these personal investments.[150] This fact is directly relevant to Riad's evaluation of the risk of these investments since a person is assumed to act with care with his or her own money. As the First Circuit has explained, "[w]e cannot ignore the fact that [the defendant] invested money of his own . . .; that belies any known or obvious danger."[151] Other courts have similarly found that investment of one's own money creates an inference against recklessness or negligence.[152]

By ignoring this evidence, the Initial Decision was able to falsely claim that Riad recognized that there were significant risks associated with selling index put options and selling variance swaps. This assertion appears to be premised on erroneous considerations.

The Initial Decision cites brief excerpts from five articles and research papers reviewed by Riad and Hughes that contain language discussing the potential danger of these investments as evidence that Respondents were aware of the risks from these positions.[153] When citing these selected quotes, however, the Initial Decision ignored the much larger volume of materials reviewed by the Respondents that showed precisely the opposite.[154] The Initial Decision's

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[150] Decision at 26.

[151] *Hoffman v. Estabrook Co., Inc.*, 587 F.2d 509, 517 (1st Cir. 1987).

[152] *See, e.g., Cummings et al. v. Paramount Partners, LP, et al.*, 715 F. Supp. 2d 880, 902 (D. Minn. 2010). ("Thompson's argument that any inference of scienter is 'fatally weakened' by the fact that his own money was invested in Paramount presents a relevant counter-inference that is appropriate for this Court to consider"); *In re Intrabiotics Pharmaceuticals, Inc. Securities Litigation*, No. C 04-02675 JSW, 2006 WL 708594, at *13 (N.D. Cal. Jan. 23, 2006) ("Personally investing their own money near to the time when the company announced it was terminating the trial tends to undermine any inference of scienter with respect to these defendants"); *Branch-Hess Vending Services Employees' Pension Trust v. Guebert*, 751 F. Supp. 1333, 1341 (C.D. Ill. 1990) ("There was no evidence of an actual intent on Guebert's part to mislead the Plaintiffs. Considering that Guebert and his family lost $68,000.00 of their own money in CSI investments, at worst we can conclude that this was a case of "white heart/empty head.").

[153] Decision at 16.

[154] *See, e.g.*, Ex. 213 (finding "selling variance swaps is an attractive strategy, produces significant returns over time with less risk that the stock market."). Hughes reviewed this paper at the time that he performed his research into these strategies. Tr. 683:25-684:5. *See also* Ex. 214(finding "[i]nvestors strongly dislike negative returns, so they're

approach thus serves as a classic illustration of impermissible "hindsight bias:"[155] "With the benefit of hindsight, people not only rate the given outcome as more foreseeable, *but are also more likely to remember event information that is consistent with the reported outcome and rate that information as more influential.* They minimize, discount, or even forget event information that is inconsistent with the reported outcome."[156] In addition to ignoring the research that supported the Respondents' view, several of the excerpts highlighted by the Initial Decision discuss the risk from selling at-the-money put options – a completely different investment strategy than the deep out-of-the-money put options written by HCE.[157] Furthermore, the Initial Decision ignored the testimony of Prof. Spatt, who reviewed the same articles and research

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willing to pay a hefty premium to buy some insurance to buy these put options. So it's a good strategy over time to sell these expensive put options."). Both Riad and Hughes reviewed this article during the course of their research into these strategies. Tr. 2141:3-10; Tr. 677:10-11.

[155] Chancellor Chandler of the Delaware Chancery Court observed that courts are not well suited to second-guess corporate decision-makers "due in part to a concept known as hindsight bias." *In re Citigroup*, 964 A.2d 106, 124 (Del Ch. 2009). The Court cited Professor Bainbridge's observation that " '[t]here is a substantial risk that suing shareholders and reviewing judges will be unable to distinguish between competent and negligent management because bad outcomes often will be regarded, ex post, as having been foreseeable and, therefore, preventable ex ante.' "*Id.* at 126 n.58 (quoting Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, 57 VAND. L. REV. 83, 114–15 (2004)).

Courts have repeatedly rejected efforts to show "fraud by hindsight" and instead have held that "proximity between positive statements stressing a firm's strengths and announcements of poor economic performance do not create an inference that the earlier statements were fraudulent." *Arazie v. Mullane*, 2 F.3d 1456, 1467 (7th Cir. 1993) (citation omitted). The leading fraud by hindsight case is *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990). In affirming the dismissal of a complaint under Rule 9(b) of the Federal Rules of Civil Procedure, the court stated:

> The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition. . . . There is no "fraud by hindsight," in Judge Friendly's felicitous phrase, and hindsight is all the DiLeos offer. *Id.* at 627–28 (citations omitted).

Similarly, in *Kowal v. MCI Communications Corp.*,16 F.3d 1271, 1278 (D.C. Cir. 1994), the D.C. Circuit Court of Appeals, in affirming the dismissal of a securities fraud complaint, referred to plaintiffs' contention that the "gross deviation" between the results actually achieved and the results that MCI predicted would be achieved supported an inference of fraud. The court stated: "[w]e entirely reject this theory. The fact that the company's performance did not conform to that predicted supports no inference that MCI's statements lacked a reasonable basis when made." *Id.*

[156] Erin M. Harley, Hindsight Bias In Legal Decision Making, 25 SOC. COGNITION 48 (2007) (citations omitted). This entire issue of Social Cognition consists of articles documenting hindsight bias. *See also, e.g.,* Baruch Fischhoff, Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty, Journal of Experimental Psychology: Human Perception and Performance, Vol 1(3), Aug 1975, 288–299. (emphasis added)

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

papers[158] and reached the same conclusion as the Respondents regarding the minimal risk from these investments.[159]

## VII. THE RESPONDENTS REASONABLY RELIED UPON ADVICE OF COUNSEL.

The Initial Decision makes two serious errors in evaluating the Respondents' advice of counsel defense. First, the Initial Decision is simply incorrect in stating that the Respondents never asserted an advice of counsel defense.[160] More importantly, the Initial Decision completely ignores the Respondents' repeated consultation with counsel on a host of questions and the fact that they consistently followed counsel's advice. The numerous attempts by the Respondents to seek out advice from counsel and compliance officers– and their subsequent reliance on this guidance – demonstrates the reasonableness of their actions and mitigates allegations of negligence or recklessness.

As the Commission itself has recognized, although a securities professional should be familiar with the "rudiments" of securities law, he should not be "expected to display finished scholarship in all of the fine points."[161] As a result, "[a]n essential means by which securities professionals comply with the law is through the guidance of counsel."[162] Courts have made clear that reliance on the advice of counsel serves as "evidence of good faith."[163] Reliance on the

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[158] *See* Spatt Report at Appendix B.

[159] *See id.* at 26.

[160] The Initial Decision asserts in a footnote that "Respondents do not claim that they were relying on advice of counsel." Decision at 32, n.39. This statement is clearly false. 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. Both Respondents also claimed during their testimony that they had relied on the advice of counsel. *See* Tr. 1835:24-1837:19 ; *id.* at 2213:15-2214:10.

[161] *Howard v. S.E.C.,* 376 F.3d 1136, 1148 (quoting *In re Charles C. Carlson,* 46 S.E.C. 1125, 1132-33 (1977)).

[162] *Howard,* 376 F.3d at 1148 n.20 (D.C. Cir. 2004).

[163] *Howard,* 376 F.3d at 1147 (D.C. Cir. 2004). *See also In re Reserve Fund Secs. & Derivative Litig. v. Reserve Mgmt. Co.,* No. 08 Civ. 4346 (PGG), 2012 U.S. Dist. LEXIS 147723 (S.D.N.Y. Sept. 12, 2012); *S.E.C. v. Mut. Benefits Corp.*, No. 04-60573-CIV, 2004 U.S. Dist. LEXIS 23008 (S.D. Fl. Nov. 10, 2004).

"advice of counsel may show that a person lacked a culpable intent" for charges that require a showing of scienter[164] as well as allegations that require mere negligence.[165]

There are four elements that must be established for an advice of counsel defense: the Respondents must have "(1) made complete disclosure to counsel; (2) requested counsel's advice as to the legality of the contemplated action; (3) received advice that it was legal; and (4) relied in good faith on that advice."[166] An evaluation of Respondents' conduct with respect to counsel makes clear that their actions were all performed in good faith and with reasonable care and satisfied all four of these requirements..

*a. Respondents Requested Advice as to the Legality of the Investments*

The Respondents requested counsel's advice as to the legality of the investments at issue on multiple occasions *before* the Fund experienced any significant losses from these investments.[167] Prior to entering the first strategic transactions in 2007, Riad requested guidance from Steven Hill, Chief Financial Officer of the Fund and the head of Claymore's Fund Administration Group.[168] Hill discussed the issue with outside counsel at Skadden and confirmed to Riad that he could pursue these investments in the Fund.[169] When a question arose regarding these transactions in the fall of 2007, the Respondents again sought guidance as to whether the Fund could invest in these derivatives and participated in a conference call during which the

[164] *S.E.C. v. McNamee*, 481 F.3d 451, 455 (7th Cir. 2007). *See also U.S. v. Peterson*, 101 F. 3d 375, 381 n.4 (5th Cir. 1996) ("[r]eliance on the advice of an attorney may constitute good faith.").
[165] *Draney v. Wilson*, 592 F.Supp. 9, 11 (D. Ariz. 1984).
[166] *Zacharias v. S.E.C.*, 569 F.3d 458, 467 (D.C. Cir. 2009) (citation omitted).
[167] The Respondents never requested advice directly from outside counsel. Nonetheless, the Respondents were aware that their contacts at Claymore – in particular, Bruce Saxon and Steven Hill – were in regular communication with outside counsel. As a result, when the Respondents sought guidance from Claymore regarding the investments at issue, it was presumed that any response would include information based on conversations with Skadden. As the D.C. Circuit reasoned in *Howard*, such indirect advice of counsel is sufficient. *See also S.E.C. v. Prince*, 942 F. Supp. 2d 108, 139 n.16 (D.D.C. 2013) ("[t]o the extent that the SEC argues that [the Respondent] himself did not request the advice of counsel, that argument has been rejected by our Court of Appeals.") (citations omitted).
[168] Tr. 2704-5.
[169] *Id.*

derivatives were discussed in depth – including with Claymore counsel.[170] During the call, Claymore stated that outside counsel at Skadden had been consulted regarding the short index puts and variance swaps at issue.[171]

The Initial Decision attempts to minimize these good faith efforts to comply with the law by drawing an implausible distinction between the broad, open-ended question posed by the Respondents – namely, whether it was legal for HCE to invest in the derivatives at issue – and the allegedly limited guidance provided by Skadden. Specifically, the Initial Decision acknowledges that the Respondents were "told that such transactions were permissible," but "there is no evidence that they were told that the prospectus permitted HCE to engage in the transactions continuously as a strategy."[172] In addition, the Initial Decision claims that Hale was never contacted "regarding disclosure requirements related to index puts or variance swaps."[173]

Such assertions ignore key evidence presented at trial. First, several witnesses testified that whenever Hale opined on the permissibility of an investment, he would regularly provide advice on disclosure issues as well.[174] This fact was confirmed both by Hale's affidavit and by Hale's own testimony, 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.[175] Indeed, Hale had a policy of always discussing and opining on *all* legal issues – including disclosure concerns – when asked a question about Fund investments.[176] Whenever Claymore or Hale had a concern regarding new investments, they would also ask the

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[170] *See* Ex. 27; Ex. 252; Tr. 1269:7-1271:5.
[171] Tr. 2213:15-2214:4; *see also id.* at 1835:24-1837:14.
[172] Decision at 32 (footnotes omitted).
[173] *Id.* at 24.
[174] Ex. 368 at ¶ 7.
[175] Tr. 2900:3-2901:4.
[176] Ex. 368 at ¶ 7.

Respondents to quantify the risks and focus on such strategies in discussions with the Board.[177] It was therefore entirely reasonable for the Respondents to believe that by asking Skadden and Claymore whether they could invest in these derivatives, it was assumed based on past practice that the question included issues related to disclosure as well as any other potential legal concerns.[178]

As a result, it is clear that the Respondents "actively sought" advice on the central question at issue in this case: whether HCE could engage in a strategy of short index puts and short variance swaps and whether additional disclosure would be necessary. Put simply, "this case is not one in which the defendant did not actively seek the opinion of counsel or did not present the entire question to counsel for consideration."[179]

*b. Respondents Received Advice from Counsel that the Investments were Legal*

The second relevant factor to be considered in evaluating an advice of counsel defense is whether, after requesting guidance from counsel as to the legality of a particular action, the Respondents received advice from counsel that such action was legal. As the Initial Decision acknowledged, Respondents "were told that such transactions were permissible."[180] As discussed above, it was understood by all relevant parties – and acknowledged by Hale himself – that when opining on the permissibility of an investment, Hale would also evaluate and discuss all relevant legal issues, including disclosure concerns.[181] In other words, the Respondents received advice that the investments at issue were allowed by the Fund prospectus and the use of

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[177] *See, e.g.,* Ex. 349.

[178] 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. 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.

[179] *S.E.C. v. Prince*, 942 F. Supp. 2d at 139.

[180] Decision at 32.

[181] Tr. 2900:3-2901:4.

these derivatives did not create any disclosure issues. As a result, the Respondents "received advice that [the contemplated action] was legal."[182]

*c. Respondents Disclosed All Relevant Information Regarding the Proposed Investments*

The Respondents also disclosed to counsel all relevant information that would bear on the legality of the proposed investments. The Initial Decision asserts that the Respondents failed to disclose that HCE was engaging in the transactions continuously as a strategy and also failed to describe the risks of these investments.[183] However, several witnesses testified that the investments were identified as a strategy during Board meetings attended by Hale.[184] Moreover, the disclosure of these investments in multiple quarterly reports made clear that the puts and swaps were being entered as more than mere one-off transactions.[185] As for the risks, the Respondents reasonably believed that counsel at Claymore and Skadden understood the investments at issue and would alert them to any potential issues regarding the risks of these investments as they had with other investments.[186] In short, the Respondents "made complete disclosure to counsel" by informing counsel of all relevant facts.[187]

*d. Respondents Reasonably Relied on the Advice in Good Faith*

After receiving advice that the proposed investments were legal, the Respondents reasonably relied on that advice in good faith.[188] There was no evidence proffered at the proceeding to suggest that Riad or Swanson did not believe that Skadden or Claymore counsel's

[182] *See Zacharias*, 569 F.3d at 467.
[183] Decision at 23-24.
[184] *See* Tr. 2723:21-2724:3; *id.* at 1014:16-22; *id.* at 2992:12-17.
[185] *See* Ex. 300 at 8 and 10; Ex. 301 at 11; Ex. 302 at 11.
[186] *See* Ex. 349.
[187] *See Zacharias*, 569 F. 3d at 467.
[188] *See id.*; *See also Prince*, 942 F. Supp. 2d at 140.

advice was accurate or legal.[189] To the contrary, Swanson testified that after the January 2008 call in which advice was conveyed from Hale, there was no question in his mind that the investments at issue were legal because they had been "okayed as strategic transactions" by counsel from Skadden and Claymore.[190] The evidence also demonstrated that Riad relied on Hale's advice in certifying the HCE Annual and Semi-annual reports at issue.[191]

As a result, the Respondents successfully established during the proceeding that they requested and received advice from counsel at Skadden and Claymore after disclosing all relevant information and then relied on that advice in good faith when determining that the investments were legal and there was no need to disclose additional information regarding the derivatives.

* * *

The good faith of the Respondents and the reasonable care with which they entered these investments is further highlighted by three additional incidents relating to requests for guidance from counsel.

Although this fact was unmentioned in the Initial Decision, the Respondents also considered trading variance swaps in a different fund that they sub-advised, the First Trust Covered Call Fund ("CCF").[192] Unlike their experience with HCE, the Respondents were specifically told by the adviser to CCF – presumably based on conversations with counsel – that such trades were not allowed by the fund's more conservative investment mandate.[193] The good

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[189] *See Steadman*, 967 F.2d at 638 (noting that evidence failed to support a finding that defendants knew advice of counsel was incorrect or recklessly relied on this advice).
[190] Tr. 1835:24-1837:19.
[191] *Id.* at 2213:15-2214:10.
[192] Tr. 2591:8-9.
[193] As Swanson explained, "CCF was the First Trust Fund that . . . we also managed and that was the covered call fund that had a much more restrictive prospectus in terms of using strategic investments." Tr. 1798: 19-23. Unlike with HCE, First Trust "didn't view [variance swaps] as an appropriate strategy for that fund." Tr. 2591:8-9.

faith of the Respondents is evident from the fact that Riad did exactly as instructed and did not engage in such trades in CCF.

In late 2007, the Respondents were considering the use of leverage as a new investment strategy in HCE. Riad immediately notified Claymore of these intentions because he believed that such a strategy might be considered inconsistent with the Fund's portrayal to investors: in a December 24, 2007 email to Claymore he explained that he "wanted to run by [you] the idea of using leverage in HCE . . . I know that we have [been] marketing HCE as a non-leverage fund so I wanted to get your take on it."[194] In response, Claymore discussed the matter internally and informed the Respondents that they would be required to get Board approval and notify shareholders about the use of leverage as a new investment strategy.[195] Following this guidance, the Respondents subsequently disclosed in periodic filings the fact that they were considering the use of leverage.[196] When this disclosure was excluded from an early draft of the 2008 semi-annual report, Swanson even went so far as to highlight this omission to Delony.[197] The fact that the Respondents went to such lengths to highlight the *potential* use of a new investment strategy – especially one that would be perceived as making the Fund much less conservative – belies the idea that they were bent on concealing risky activities from investors.

A similar scenario occurred in July 2008 when the Fund considered a new type of investment called a "structured note." Rather than simply enter this transaction, Riad again consulted with counsel as to the propriety of the investment. Riad was informed by Mark Mathiasen, Assistant General Counsel at Claymore, that Claymore had spoken with Skadden and "concluded that HCE can proceed with the purchase of the structured note given the fact that the

[194] Ex. 22.
[195] *Id.*
[196] *See, e.g.*, Ex. 14.
[197] *See* Ex. 275.

underlying securities are those in which the Fund would normally invest."[198] However, Mathiasen made sure to emphasize that if the Fund intended to make such investments on a regular basis then the investment guidelines for the Fund would have to be changed.[199] In a subsequent email, Hill requested that FAMCO quantify the downside exposure of the structured note.[200] In response, FAMCO provided a spreadsheet demonstrating the potential loss from this investment under certain scenarios.[201] In short, this discussion demonstrates that when counsel provided advice regarding the permissibility of new investments, they also gave guidance as to the frequency and the extent to which HCE could engage in such investments and the necessary disclosure that would be required. It was therefore reasonable for the Respondents to assume that Claymore or Skadden would have provided similar cautions regarding the short index put options or short variance swaps if they had any concerns regarding these investments.

## VIII. THE INITIAL DECISION IMPROPERLY TREATS RIAD AND SWANSON AS IF THEIR ACTIONS WERE IDENTICAL

The Initial Decision finds that Swanson acted with a high degree of scienter, even though the opinion's own findings undermine this conclusion. For example, the Initial Decision found that:

- Swanson had no input into the Fund's marketing documents.[202]
- Swanson did not make any of the trading decisions relating to the investments at issue and only learned of these transactions based on discussions with Riad and by reviewing the list of portfolio holdings.[203]
- At the time of the trades, Swanson had only a limited understanding of the research performed by Riad and Hughes.[204]

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[198] *See* Ex. 349.
[199] *Id.*
[200] *Id.*
[201] *Id.*
[202] Decision at 10.
[203] *Id.* at 11, n.9.
[204] *Id.* at 12, n.11.

- Swanson "was led to believe that the written puts were relatively low risk investments" based on the risk-limiting features implemented by Riad[205] and that they would "reduce the volatility of the portfolio."[206]
- Swanson's compensation was not tied in any way to the performance of the Fund or the investments at issue.[207]

These findings are entirely inconsistent with findings of even negligence – much less intentional conduct – against Swanson, yet the Initial Decision finds that Swanson acted recklessly. This finding seems to be based solely upon two conversations between 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.[208] According to the Initial Decision, "Swanson initially provided the answers to Delony to include in the Q&As and signed certifications[209] that they were accurate."[210] These actions are described as "clearly willful."[211] This conclusion ignores the fact that, as noted above, Swanson had very limited knowledge about the index put and variance swap trades and had virtually no involvement with the relevant trading decisions. The Initial Decision also ignores that Swanson reasonably relied upon the much more knowledgeable Riad for the accuracy of the portions of the periodic filings that related to the derivatives overseen by Riad, and that the process involved an extensive review by Claymore's legal and compliance departments ensuring that all appropriate disclosures were included prior to publishing.[212]

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[205] *Id.* at 11, n.10.
[206] *Id.* at 12, n.11.
[207] *Id.* at 27 (noting that Swanson received a fixed salary and bonus and did not share in FAMCO's profits).
[208] *Id.* at 19; *id.* at 21.
[209] Sarbanes-Oxley certification do not support allegations of scienter. *See, e.g., Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 1002–04 (9th Cir. 2009); *In re Ceridian Corp. Sec. Litig.*, 542 F.3d 240, 248 (8th Cir. 2008); *Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc.*, 537 F.3d 527, 545 (5th Cir. 2008); *Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546, 555 (5th Cir. 2007).
[210] Decision at 32.
[211] *Id.*
[212] *See* Respondents' Post-Hearing Brief at 49-53.

In contrast with Swanson, Riad oversaw the research on the derivatives strategies and executed the trades but had almost no involvement in the preparation of the Fund's periodic filings at issue. The Initial Decision asserts that "Riad approved the final Q&A" for both the 2007 Annual Report and the 2008 Semi-annual Report.[213] However, none of the evidence cited as support for this assertion demonstrates that Riad in any way approved these documents and no such evidence was presented at trial. Indeed, Riad's only involvement with those filings consisted of being sent a draft of the Q & A section prior to filing and signing a certification for each report that the list of portfolio investments was accurate.[214]

## IX. CONCLUSION

For the reasons set forth above, it is respectfully submitted that the Commission should find that the Initial Decision is based on erroneous conclusions of fact and law and that the Division has failed to meet its burden of proving by a preponderance of the evidence that the Respondents have violated any statutes, rules or regulations set forth in the OIP.

**ORAL ARGUMENT REQUESTED**

Respondents request oral argument before the Commission in this matter.

[213] Decision at 20 and 22.

[214] Exs. 9, 34 ("[A]s portfolio manager of HCE, he had reviewed the portfolio of investments in the . . . report and that, to the best of his knowledge, it was a complete and accurate list of the securities held in the fund and that they were purchased in compliance with the investment parameters set forth in the prospectus.").

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## CERTIFICATE OF COMPLIANCE WITH RULE 450(d)

I, Richard Marshall, certify that this brief complies with the word limitation set forth in Commission Rule of Practice 450(c), as it contains 13,617 words, excluding the parts of the brief exempted by the Rule.[1]

Richard D. Marshall /MHB

Richard D. Marshall

[1] 17 C.F.R. §201.450 (c).