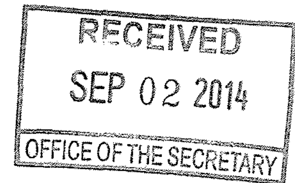
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



ADMINISTRATIVE PROCEEDING
File No. 3-15141

In the Matter of

MOHAMMED RIAD
AND KEVIN TIMOTHY
SWANSON

Respondents.

THE DIVISION OF ENFORCEMENT'S BRIEF IN OPPOSITION TO RESPONDENTS' APPEAL OF THE INITIAL DECISION

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I. PRELIMINARY STATEMENT

Respondents Mohammed Riad and Kevin Timothy Swanson implemented a new investment strategy in order to meet the annual dividend targets of the Fiduciary/Claymore Dynamic Equity Fund ("HCE" or "the Fund"), a closed-end mutual fund. Respondents' new investment strategy consisted of writing "naked" or uncovered put options and entering into short variance swaps, which are not typical investments for covered-call funds like HCE. Initially, both types of investments generated additional income for HCE; during 2007 and the first half of 2008, the written put option and variance swap positions were among the Fund's best performing investments. But these investments also carried an additional risk of loss, and Respondents knew that those losses could be significant in declining or volatile markets.

Respondents also knew that HCE's registration documents did not describe the use of written put options and short variance swaps, and that they were not described in HCE's periodic reports. Accordingly, HCE's investors had no reason to know or expect that the Fund would begin investing regularly in written puts and variance swaps. But throughout 2007 and 2008, Respondents hid their new investment strategy, its results and its corresponding risks from the Fund's shareholders and board of trustees.

Under Riad's and Swanson's management, these new derivative investments became a principal fund strategy and they transformed HCE into an insurer for other investors against turmoil in the financial markets. By September 2008, HCE had suffered millions of dollars in losses on its written put and variance swap investments. Respondents attempted to recover HCE's previous losses by doubling down in the same types of investments, and disaster ensued. By October of 2008, HCE lost nearly 75% of its net asset value ("NAV"), with $45 million of those losses directly attributable to Respondents' investments in put options and variance swaps.

Given the degree to which the written puts and variance swaps affected HCE, for both good and bad, it is obvious that the disclosures to investors regarding performance, investment strategy and risks were inadequate. In fact, they were so misleading as to be nearly useless. Riad and Swanson easily could have disclosed additional information about the strategies, performance, risk of investments in written puts and variance swaps to HCE's investors and the Fund's Board. Instead, they chose to hide their excessive risk-taking and used the puts and swaps to boost the Fund's return and beat its benchmarks, while claiming that they were superior stock pickers and were protecting the Fund from downside risk. Respondents' decision to ignore their disclosure obligations caused HCE's investors to suffer severe financial losses.

In this appeal, Respondents contend that: (a) HCE's prospectus gave them "broad latitude" to make the derivative investments at issue; (b) they disclosed their derivative strategies as "hedging" transactions and were not responsible for preparing the Fund's periodic reports; (c) they reasonably believed that the derivative investments were low risk transactions; (d) they consulted with HCE's counsel and were advised that their proposed derivative trading strategies were legal; and (e) Respondents had differing responsibilities and knowledge of HCE's investments. (Resp. Br. at 3-6, 8-35) And in their Petition for Review, Respondents also argued that the sanctions imposed on them are unwarranted. (Pet. for Rev. at 38-43)

Accordingly, the Division of Enforcement's brief will address the standards for review (Section II); show that Respondents' arguments about the weight of the evidence in this matter are unpersuasive (Section III); argue that Respondents should be found liable under all of the applicable legal standards (Section IV); and, finally, demonstrate that the sanctions imposed on the Respondents are justified under the facts of this case and consistent with prior Commission precedent (Section V).

The Commission should not permit portfolio managers who hide from investors their principal investment strategies, risks and performance results, and significant losses as a result of their risky and undisclosed investment decisions, to escape liability and an appropriate sanction.[1] Allowing such a result would impose a terrible injustice on investors and send the wrong message to the entire securities industry.

II. STANDARD OF REVIEW

It is well established that the Commission's review of a law judge's findings of fact and conclusions of law is *de novo*. *See In re Theodore Urban*, Rel. No. 34-63456, 99 SEC Docket 3731, 2010 WL 5092728 at *2 n.10 (Dec. 7, 2010). However, that does not mean that the Commission is free to disregard all of the factual findings of an initial decision. "A law judge's credibility findings are entitled to considerable weight because they are based upon hearing the witnesses' testimony and observing their demeanor." *In re Steven Altman*, Rel. No. 34-63306, 99 S.E.C Docket 2744, 2010 WL 5092725 at *4 n.10 (Nov. 10, 2010). Such findings may be disregarded only where the record contains "substantial evidence" for doing so. *See In re Anthony Tricarico*, Rel. No. 34-32356, 54 SEC Docket No. 342, 1993 WL 183678 at *3 (May 24, 1993).

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[1] The Division previously has taken action against two other entities arising out of this same matter by bringing settled administrative proceedings against Respondents' employer, Fiduciary Asset Management, LLC ("FAMCO") and against HCE's sponsoring institution, Claymore Advisors, LLC ("Claymore"). Without admitting or denying the Commission's charges, FAMCO settled claims that it willfully violated Section 34(b) of the Investment Company Act, Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder by managing HCE in a manner inconsistent with HCE's registration statement and making materially misleading statements and omissions of material fact in HCE's 2007 annual report and 2008 semi-annual report. (*See* Ex. 137, *In re Fiduciary Asset Management, LLC,* Rel. No. IA-3520 (Dec. 19, 2012)). Similarly, without admitting or denying the Commission's charges, Claymore settled claims that it caused HCE's violations of Investment Company Act Rule 8b-16 and failed to supervise FAMCO with a view to preventing FAMCO's violations of the federal securities laws. (*See* Ex. 138, *In re Claymore Advisors, LLC*, Rel. No. IA-3519 (Dec. 19. 2012)).

Here, Respondents argue that the Law Judge employed a "fraud by hindsight" approach, and ignored "the majority of the evidence presented at trial," by relying on documentary evidence over the testimony of fact and expert witnesses. (Resp. Br. at 2-3) However, the Law Judge correctly determined that the Division had proven its claims against Respondents by a preponderance of the evidence, and did not reason by hindsight, or ignore the majority of the evidence presented by the parties. To the contrary, the Initial Decision demonstrates that the Law Judge carefully considered all of the testimony and documentary evidence offered by the parties, including expert opinion testimony, and made factual findings based upon the weight of evidence presented, which included making credibility determinations.

In so doing, the Law Judge found the documentary evidence in this case, primarily Respondents' own contemporaneous writings, research and calculations, more persuasive than the *post-hoc*, self-serving testimony of Respondents, their expert witnesses, or their former colleagues. The Law Judge correctly found that Respondents knowingly, recklessly, and negligently misrepresented the Fund's investment strategy and performance while failing to disclose their use of derivatives and the corresponding risks.

III. ALL OF THE LAW JUDGE'S FINDINGS OF FACT ARE PROPERLY SUPPORTED BY THE FACTUAL RECORD.

A. HCE Was Established and Marketed As A Covered Call Fund.

Respondents contend that HCE was always planned and marketed as more than a conservative covered-call fund. (Resp. Br. at 8-13) However, this contention simply cannot be reconciled with the weight of the evidence in this matter. Respondents themselves often described HCE as a "covered-call fund" or "covered call product" and routinely compared HCE with other covered-call funds in communications with HCE's Board and Claymore. (*See e.g.*, Ex. 135 at 2:23-3:2; Ex. 136 at 4:18-5:3; Ex. 71 at 24572; Ex. 6 at 10330; Ex. 22 at 16786; Ex.

66 at 21762; Ex. 75 at 34141; Ex. 76 at 38045) HCE's chief compliance officer, HCE's outside counsel, and HCE Board members all testified that they viewed HCE as a covered-call fund. (Tr. 2647:17-19, 2830:17-22, 2834:8-17, 2914:10-2915:6, 2990:21-2991:3) Three investor representatives testified that they regarded HCE as a covered call fund. (Tr. 1349:6-13; 1407:17-1408:19, 1458:7-1459:23) One of these witnesses, a manager of unit investment trusts whose firm was the largest investor in HCE, testified that he could not have invested in HCE if it were not a covered call fund. (Ex. 140 at 23; Ex. 152; Tr. 1475:6 – 1477:13)

In addition, HCE's registration statement, which established the investment parameters for the Fund, described its primary investment strategy as investing in equity securities and writing call options on a substantial portion of those equities. (Ex. 11 at 12386) By writing a call option on a stock, HCE received a premium payment, and provided the purchaser with the right to purchase or "call away" the stock from HCE at an agreed price. Since HCE owned the underlying stock, the call option was considered "covered." (Ex. 14 at 15493) This is commonly referred to as a "covered call" strategy, which foregoes potential gains in the value of equities held in the Fund's portfolio for income in the form of option premiums for the written calls. (Ex. 11 at 12386; Ex. 139 at ¶¶ 41, 48-49)

Covered call funds are considered to be conservative investments and are popular among retirees due to the income generation. (Ex. 139 at ¶¶ 16, 54) And covered call funds tend to have more stable performance and less market risk than pure equity investments, and outperform pure equity strategies during declining markets. (Tr. 1345:13-1346:6; Ex. 139 at ¶¶ 19, 51-52, Figure 1; Ex. 366 at 49:23-50:9) So it is not surprising that Riad and Swanson told HCE's investors, in the Funds' periodic reports, that HCE's covered call investment strategy was

designed to protect the Fund from losses in a downward trending market. (Ex. 14 at 15493; Ex. 15 at 15522; Ex. 133 at 4:37-5:17)

The fact that HCE used the term "dynamic" in its title does not constitute evidence that HCE was something other than a covered call fund. As noted in the Initial Decision, the word dynamic signified that HCE had greater flexibility in using call option strategies than certain other covered call funds. (Initial Dec. at 6-7) The Fund still measured its performance against the CBOE Buy Write Index ("BXM"), which was a covered call index. (Ex. 14 at 15492-93) Claymore's marketing materials and investor roadshows, in which Riad participated, presented HCE as a covered call fund. (*See* Initial Dec. at 9-10) Not surprisingly, HCE investors and analysts viewed HCE as a covered call fund. (Tr. 1349:6-13; 1407:17-1408:19, 1458:7-1459:23)

HCE's goal was to pay investors an annual dividend of 8.5% of the Fund's initial offering price. (Ex. 14 at 15493) In order to meet this objective, HCE needed to generate an annualized return of 10% before fees. (Ex. 5 at 9410) Respondents recognized the difficulty of consistently beating the S&P 500 by 100 basis points with a conservative covered call strategy, and Riad personally believed that HCE's dividend rate was unsustainable. (Ex. 8 at 11798; Ex. 66 at 21761-62) Accordingly, Respondents decided to adopt a new investment strategy in order to generate additional income. (Ex. 75 at 34141)

B. Respondents Repeatedly Failed To Make Appropriate Disclosures Of Their Derivative Investment Strategy.

Beginning in mid-2007, Respondents implemented a new strategy (in addition to the covered call strategy disclosed to investors) of writing out-of-the-money put options on the S&P 500 and selling volatility using variance swaps as a means of generating additional income.[2]

[2] Variance swaps are essentially a bet on whether actual or realized market volatility will be higher or lower than an agreed-upon level ("variance strike") over the contract period.

(*See Id.*; Ex. 63 at 18730-31) Riad primarily managed these strategies, but Swanson consulted with Riad and monitored the strategies' performance. (Ex. 70; Ex. 99 at 119708-10, 23; Tr. 1882:11-1883:24, 1911:15-20)

Respondents believed that selling variance swaps would allow them to profit from perceived mispricing in the market and investors' tendency to overpay for protection. (Ex. 77 at 39550) Similarly, Respondents believed that writing put options would enable them to profit from investors' tendency to overpay for protection by being a provider of that protection. (Tr. 679:13-680:18) Initially, Riad purchased put options in combination with writing put options (which partially offset the risk) but, by the end of 2007, Riad switched almost exclusively to writing put options without any long put positions to offset the risk.[3] (Ex. 63)

With regard to variance swaps, Riad concluded that that selling variance swaps during periods of elevated volatility was, on average, more profitable than during periods of lower volatility. (Ex. 219 at 837-38) However, this approach is riskier, and variance swaps suffer losses more frequently during periods where implied volatility is greater than 20, and the average size of those losses is larger. (Ex. 219 at 837-38)

1. HCE's Registration Statement Does Not Disclose A Strategy Of Investing In Uncovered Put Options Or Variance Swaps.

No investor reading HCE's publicly filed documents would have understood that HCE employed a derivative investment strategy consisting of uncovered written put options and variance swaps. Indeed, HCE's registration statement begins by describing the Fund's primary

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Therefore, a party who is "long variance" or the "purchaser" of variance makes a profit when realized volatility for the contract period is greater than the variance strike, and a party who is "short variance" or the "seller" of variance makes a profit when realized volatility is less than the variance strike. (*See* Ex. 139 at ¶¶ 94-96)

[3] For more detail on the nature of written put options and short variance swaps, please refer to the report of the Division's expert witness, Prof. Larry Harris. (Ex. 139 at ¶¶ 63-120)

strategy to be covered-call investments. (Ex. 11 at 12386). HCE's registration documents, which included its prospectus and Statement of Additional Information ("SAI"), emphasized the Fund's covered call strategy; they contain never mention writing uncovered put options and shorting variance swaps, and do not describe any of the risks associated with such investments. (*See* Ex. 11 and 12)

For example, the prospectus listed the types of securities the Fund would invest in under normal market conditions, but never mentioned writing uncovered put options or trading variance swaps.[4] (Ex. 11 at 12394-96; 12410-14) And in the 12-page section of the prospectus where HCE describes its investment objective and policies, only a single sentence discusses the possibility that the Fund may purchase or sell put options on securities, indices or other instruments, or invest in "swaps." (Ex. 11 at 12406-17) But that one sentence does not state whether the options the Fund may trade would be purchased or written, call options or put options, covered or uncovered, or whether the swaps would be interest rate swaps, currency swaps, commodity swaps, credit default swaps, variance swaps, total return swaps, or another kind of swap. (*See* Ex. 11 at 12415)

This sentence is part of a boilerplate paragraph called "Strategic Transactions" that conferred broad but nonspecific authority for HCE to utilize derivatives. (*Id.*; Tr. 2834:7-2835:21; Ex. 139 at ¶¶ 194-196) Such generic disclosures were common in many funds, including "plain vanilla" covered-call funds such as the First Trust and Madison/Claymore covered-call funds. (Tr. 2836:1-2838:6, 1706:14-1707:18, 2048:8-21, 2054:3-10, 2501:21-2505:10; Ex. 367 at 9, 21) Although Respondents place great emphasis on the "Strategic Transactions" paragraph, HCE's contemporaneous marketing materials made no mention of Strategic Transactions when describing the Fund and its strategies. (*See* Exs. 31, 32, 33, 149, 150, 151)

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[4] In fact, the term "variance swap" does not appear anywhere in HCE's registration statement. (*See* Ex. 11; Ex. 12)

HCE's disclosures regarding Strategic Transactions were so opaque that there was confusion within FAMCO, which was Claymore's sub-advisor and Respondents' employer, about whether HCE was permitted to invest in uncovered put options. (Tr. 1181:4-1184:3) Jeffrey Grossman, the Fund's accountant, was concerned that these disclosures were buried in the back of the prospectus and not conspicuous for investors. (Tr. 503:3-18)

Respondents argue repeatedly that FAMCO's compliance personnel contacted Claymore with the basic question of whether put options and variance swaps were allowable Fund investments, and argue further such a determination required input from fund counsel. (Resp. Br. at 31-37) But if Respondents' colleagues at FAMCO and Claymore needed an attorney to tell them whether these derivative investments were *legally permitted* under the Fund's registration documents, how could any Fund investor know that HCE actually employed a regular strategy of making such investments?

In addition, the seven-page "Risks" disclosure in HCE's prospectus did not discuss any risks associated with investing in uncovered put options and variance swaps, such as leveraging the Fund's exposure to market declines or exposure to spikes in market volatility.[5] (Ex. 11 at 12417-24; Ex. 139 at ¶¶ 204-208) HCE's risk disclosures merely contained a generic warning that the use of derivatives could leave the Fund worse off, without describing the types of market movements that could harm the Fund. (Ex. 11 at 12417-24) The risks identified in the SAI disclosure regarding index put options primarily related to the fact that options are an imperfect hedge on portfolio securities, thereby suggesting that any use of index options by HCE would be as a hedge

[5] The prospectus contained some risk disclosure regarding the Fund's use of *covered* put options, but this option strategy was expressly disclosed and limited to 20% of fund assets, and the coverage requirement limited the amount of options that could be written. (Ex. 139 at ¶ 186) But HCE's written index put options were not "covered" as defined by the prospectus and therefore did not qualify as covered put options.

against portfolio risk.[6] (Ex. 12 at 12447) Omitting disclosure of these new risks is particularly troubling for a covered call fund, whose investors reasonably expect to have some protection in declining markets, rather than the leveraged exposure they faced in HCE.

2. *Respondents Did Not Disclose Their Strategy Of Investing In Written Puts And Variance Swaps To HCE's Board.*

The Division acknowledges that, from time to time, Respondents mentioned to HCE's Board of Trustees that they had made investments in written puts and variance swaps. But these discussions were brief, lacked detail, and Respondents assured the Board that the put options and variance swaps were only a small component of HCE's overall strategy. (*See* Tr. 3007:25-3008:13, 3011:13-23, 3013:8-3014:1) Respondents consistently concealed the risk associated with writing put options and shorting variance swaps from both Claymore and HCE's Board, and misleadingly described the strategies as hedges, as downside protection, or as a means of mitigating portfolio volatility. (Tr. 2653:16-19; Ex. 361 at 138:12-139:14)

Respondents never discussed with HCE's Board the risk of potential loss associated with written puts and short swaps, or their reliance on those investments to meet HCE's investment objectives. (Tr. 1320:25-1321:18, 2653:24-2655:17, 2920:18-2921:9, 2925:3-10, 3014:18-3015:16; Ex. 365 at 119:12-21) Instead, Respondents repeatedly assured both Claymore and HCE's Board that they were using derivatives to mitigate risk.[7] (Tr. 2655:18-2656:18)

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[6] The SAI also noted that the principal risks of the Fund's principal strategies are discussed in the prospectus. (Ex. 12 at 12446) Yet there was no discussion of the risks of writing uncovered put options or trading variance swaps anywhere in the prospectus. (Ex. 11 at 12417-24)

[7] Respondents complain that the Law Judge ignored the testimony of their expert witness, Jay Baris, a lawyer, who opined that HCE's disclosures met the applicable legal requirements. But the Law Judge's decision to place little weight on Baris' testimony is consistent with the Commission's longstanding position that testimony consisting of legal opinions is inadmissible. *See, e.g. In re IMS/CPAs & Assocs.*, Rel. No. 34-45019 55 S.E.C. 436, 459-61 (Nov. 5, 2001) (affirming exclusion of expert testimony of whether respondent's Form ADV disclosures

Respondents further described their use of puts and variance swaps as "opportunistic," and never indicated that they were using these products as part of a consistent strategy, or that they were doing so in order to meet the Fund's dividend objective. (Tr. 3028:5-3030:25) Accordingly, HCE's Chief Compliance Officer testified that Respondents had omitted important information about the risks of those products in their communications with HCE's Board. (Tr. 2675:9-2676:9)

In fact, Respondents' communications with HCE's Board about their use of derivatives were often inaccurate, and were deliberately, recklessly and negligently misleading. For example:

- At the July 18, 2007 Board meeting, Riad said that he wanted to use more conservative option overlays for "downside protection" and that he had added beta-dampening collars to the portfolio, which lowered volatility and increased return.[8] (Ex. 180 at 7915) Just eight days later, Riad closed out HCE's existing long put option positions, leaving HCE "un-collared" with naked put option exposure for nearly two months. (Ex. 63 at 18729-30; Ex. 139 at 182-86)
- In Respondents' October 2007 Portfolio Manager's Discussion, they wrote that HCE had benefited from having substantially the entire portfolio covered during the volatile summer months, and that HCE's use of S&P 500 put options helped to further augment "downside protection" during the negative market environment. (Ex. 71 at 24571) They further stated

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complied with securities laws); *In re Robert D. Potts*, Rel. No. 34-39126, 53 S.E.C. 187, 208 (Sept. 24, 1997). And Baris' testimony was not always helpful to Respondents. For example, he testified that portfolio managers should discuss with a fund's board the risks of derivative investments. (Tr. 3078:14-20) Baris also testified that portfolio managers should inform a fund's board of the extent to which derivatives have affected fund performance. (Tr. 3080:9-13) Respondents failed to do either of these things.

[8] A "collar" is an option strategy that limits the range of a portfolio's performance. A collar involves the purchase of a put option, which limits the downside, and the sale of a call option, which limits the upside. (Tr. 1998:9-15)

that the Fund maintained a high hedge-ratio during the months of July and August, while volatility-dampening collars and hedges helped to augment protection during adverse markets. (Ex. 71 at 24572) This was false. HCE had naked put option and short variance swap exposure from late July through mid-September, which increased the Fund's exposure to adverse markets. (Ex. 63; Ex. 86)

- At the October 2007 Board meeting, Respondents noted that the Fund had significantly outperformed the market relative to its peers. (Tr. 2927:15-2931:22) Respondents told the Board that they were superior stock pickers and managed the Fund's covered call strategy with skill. (Tr. 2931:23-2933:7) Respondents concealed from the Board that HCE's performance was being fueled by its written put options, and never disclosed to the Board just how profitable these strategies were. (Tr. 2927:15-2934:1, 3013:8-3014:22)
- In the January 2008 Portfolio Manager's Discussion submitted to HCE's Board, Respondents stated that over the past year their volatility trading strategies and the effective use of S&P 500 puts had "augmented downside protection during adverse market periods." (Ex. 6 at 10329) Respondents told the Board that as an ongoing discipline, they managed HCE's risk profile with supplemental hedging strategies "to help lessen performance volatility during unforeseen periods of uncertainty." (Ex. 6 at 10331)
- At the April 2008 HCE Board meeting, Riad discussed the concept of "macrohedging" the portfolio in order to further protect HCE during times of extreme volatility. (Ex. 178 at 21939) In the Portfolio Managers' Discussion for that meeting, Respondents wrote that they had used "opportunistic hedging" to supplement performance during periods of high market volatility and used volatility trading strategies and put options to augment "downside protection" during adverse markets. (Ex. 136 at 38044-45)

- In the July 2008 Portfolio Manager's Discussion, Respondents informed the Board that over the past year, they had used "opportunistic hedging transactions" such as "volatility trading strategies, and "the effective use of S&P 500 Index puts which augmented downside protection during adverse market periods." (Ex. 5 at 9400) Respondents touted their use of "macro-hedging strategies in order to help decrease participation in downside markets and lower overall portfolio volatility." (Ex. 5 at 9402) Respondents made these statements despite being aware that HCE had taken "big losses" in the amount of $2.8 million on written put options just a week before the meeting. (Ex. 66 at 21761; Ex. 39 at 30820; Tr. 1954:4-20) Respondents never disclosed those losses to the Board. (Tr. 3011:24-3012:10)

All of these statements by Respondents to HCE's Board either were inconsistent with, or contradicted, their knowledge, research, and private communications about the use of written put options and variance swaps. Respondents knew that using written puts and short variance swaps increased the risk and potential for investment losses in declining or volatile markets (*see* Section III.C), yet never disclosed this fact to the Board. Significantly, Respondents never explained to the Board exactly how writing put options and shorting variance swaps could reduce downside market risk, portfolio volatility or act as a hedge on HCE's portfolio.

3. Respondents Failed To Disclose Their Investment Strategy and Results, and Made Misleading Statements In The 2007 Annual Report.

HCE's 2007 annual report reported a 12.87% return on NAV, compared to returns of 7.72% for the S&P 500 and 5.54% for the BXM covered call index. (Ex. 14 at 15492-93) In the report's "Questions and Answers" section ("Q&A Section"), Respondents purported to explain

what contributed to HCE's ability to exceed its benchmarks.[9] (Ex. 14 at 15491-94) HCE's written S&P 500 put options were significant positive contributors to return, and HCE's short variance swaps were among the worst performers in HCE's portfolio. However, in the Q&A Section, Respondents omitted any discussion of those strategies or their effect on Fund performance. (*Id.*).

To prepare the Q&A Section, Ms. Delony interviewed Swanson for approximately thirty minutes. (Ex. 128; Ex. 135) Swanson provided Delony with portfolio performance data before the interview, but he only provided information for HCE's equity portfolio and withheld information about the S&P 500 options' or variance swaps' impact on performance. (Ex. 61; Ex. 62; Tr. 1557:16-1558:25) In explaining the Fund's strong performance, Swanson primarily talked about stock selection, which he identified as the "key ingredient" to strong performance for a "covered call product," and making the right calls on the covered call strategy, including "bring[ing] in greater downside protection."[10] (Ex. 128 at 0:57-9:09; Ex. 135 at 2:23-7:9)

Swanson briefly mentioned that HCE "implemented opportunistic hedging strategies throughout the year." (Ex. 128 at 9:10-10:25; Ex. 135 at 7:15-8:8) However, he explained that "[w]hat I mean by hedging strategies *is obvious*, is that when we were concerned with the market we bought puts for protection we collared the portfolio to try and increase the amount of protection during periods of a declining market." (Ex. 135 at 7:18-22, emphasis added) Swanson told Delony that it was a very volatile year with spikes in market volatility, and "we took advantage of those and appropriately hedged the portfolio where we needed to." (Ex. 135 at 7:24-8:8) Swanson

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[9] The Q&A Section purported to document a conversation with the Respondents. (Ex. 14 at 15492-93) However, the section was prepared by Patty Delony, a financial writer Claymore, based on a recorded interview of Swanson. (Ex. 128; Ex. 135)

[10] Swanson emphasized downside protection to Delony, and mentioned hedging or protecting the portfolio on the downside four separate times during the interview. (Ex. 135 at 4:23-5:1, 5:7-10, 6:5-16, 7:15-8:8)

never once mentioned that HCE had written put options or engaged in variance swaps, or that at times HCE had significant exposure to downside market risk and volatility. (Ex. 128; Ex. 135; Tr. 1558:1-11, 1933:5-25; Ex. 139 at ¶ 226)

Riad and Swanson both reviewed the Q&A Section several times before it was published in HCE's annual report, and they either made edits to the content or had the opportunity to do so. (Ex. 10; Ex. 95; Ex. 96; Ex. 107; Tr. 1583:18-24, 1590:19-22) Swanson even asked Claymore for the opportunity to review the section an additional time before it was finalized, and was given that opportunity. (Ex. 96 at 114362; Tr. 1931:12-19) When Claymore made a substantive edit to the Q&A Section after Riad's and Swanson's review, Delony checked the edit with Swanson because she did not feel comfortable making changes without consulting him. (Ex. 108 at 146386; Tr. 1592:19-1593:20) Swanson signed a certification that, to the best of his knowledge, the annual report's Q&A Section did not contain any material misstatement or omission that would make the report inaccurate or misleading. (Ex. 35; Tr. 1591:25-1592:13)

Respondents caused the annual report's Q&A Section to contain several misleading statements. In response to the question "Which investment decisions most helped the Fund's performance," Respondents stated that "performance benefited from good sector and industry selection, positive stock selection, and also good strategic and tactical decisions on the options overlay." (Ex. 14 at 15492) They highlighted particular sector and single stock investments that contributed to return. (Ex. 14 at 15492-93) Those single stocks mentioned each contributed between 0.09% and 1.01% to HCE's return. (Ex. 61 at 16326-30; Ex. 14 at 15492-93) However, Respondents did not disclose that the Fund also received a significant boost from written S&P 500 put options and call options, which contributed approximately a return of 2.0% and 2.3% respectively, as well as long S&P 500 put options, which contributed a return of approximately

1.7%. (Ex. 14 at 15492-93; Ex. 139 at ¶ 222) In the aggregate, HCE's S&P 500 put and call options added 5.6% to HCE's return and accounted for 46.2% of HCE's NAV growth; yet, Respondents never identified these investments as contributors to performance. (Ex. 139 at ¶ 223)

In fact, HCE's option investments played a far more significant role in the Fund's performance than stock selection. The equity portfolio outperformed the S&P 500 by only 1.25%, barely more than the Fund's 1% advisory fee. (Ex. 61 at 16329-31; Ex. 139 at ¶ 223) The annual report suggested that HCE's success was the result of strong stock picking and the covered call strategy, when, but for the S&P 500 options, HCE would have trailed the S&P 500 instead of beaten it by 5.15%. (Ex. 139 at ¶ 223) Respondents each acknowledged that these supplemental strategies "contributed greatly to the strong performance of HCE this year" and "allowed us to have a good year thus far."[11] (Ex. 316; Ex. 14 at 15492-93; Ex. 56; Ex. 57; Ex. 58; Ex. 59)

Similarly, the Q&A Section did not mention the variance swap strategy when discussing which holdings hurt HCE's performance. (Ex. 14 at 15493) HCE lost $400,509 on its variance swap positions in 2007, or .36% of the Fund's NAV. (Ex. 139 at ¶ 225; Ex. 14 at 15501; Ex. 63) Nevertheless, the Q&A Section highlighted four individual stock investments as poor performers, all but one of which had smaller losses than the variance swaps, ranging from 0% to 0.13%. (Ex. 61 at 16326, 29; Ex. 139 at ¶ 225) There was no reference to variance swaps in the Q&A Section because Swanson never disclosed them in his interview with Delony. (Ex. 135). Instead, Swanson misleadingly told her that HCE appropriately hedged the portfolio to take advantage of spikes in market volatility. (Ex. 135 at 8:4-8)

[11] Swanson informed his colleagues at FAMCO that he and Riad had been successful in using written puts on the same day as his interview with Delony. (Ex. 59; Ex. 135; Tr. 1897:14-1898:4)

The Q&A Section also did not discuss HCE's put-writing and variance swap investments when explaining the Fund's hedging strategies. (Ex. 14 at 15493) Respondents stated that when they were concerned about the market, they bought index put options and wrote index call options for protection. But Respondents never mentioned the use of written put options or variance swaps, which they considered to be part of the same "macro-hedging strategy."[12] (Ex. 14 at 15493; Tr. 1860:5-11, 1997:14-21) Riad even acknowledged that it would have been more accurate and complete to include written put options in the disclosure, but could not explain why he failed to do so. (Ex. 366 at 189:20-190:1)

HCE's annual report also failed to disclose any of the risks associated with writing put options and trading variance swaps. The report contained a section highlighting the Fund's risks, which was attributed to both the FAMCO portfolio managers and Claymore, but that section contains no discussion of the risks associated with writing put options or trading variance swaps. (Ex. 14 at 15494, 15503)

Although HCE's annual report disclosed a single, open written put option position in its portfolio holdings, it did not disclose the extent of HCE's prior use of written puts investments throughout the year. (Ex. 14 at 15498) And the portfolio holdings list excluded any mention of HCE's variance swap position which existed at the time.[13] (Ex. 14 at 15496-98) A footnote to the financial statements explained generally what a variance swap was, that the Fund had entered into a variance swap and either would profit if realized volatility was lower than the strike price or would lose money if realized volatility was higher than the strike price. (Ex. 14 at 15503) HCE

[12] Significantly, this sentence, which omits the risky parts of the "macro-hedging strategy," was one that Swanson edited during the comment process. (Ex. 130)

[13] Riad signed a certification that the annual report's portfolio of investments was a complete and accurate list of the securities held in the Fund as of the report date. (Ex. 9)

disclosed the current variance swap position in that same footnote, but provided no information regarding the size of the position or the degree to which it could profit or lose money based on movements in volatility. (Ex. 14 at 15503) The disclosures of the put option and variance swap positions did not explain how those products were being used in the portfolio, the extent of their prior use, that they were part of an ongoing strategy, that they had materially affected HCE's performance, or the risks posed by those investments.

4. Respondents Did Not Disclose Their Investment Strategy And Results, And Made Misleading Statements In The 2008 Semi-Annual Report.

HCE's 2008 semi-annual report contained many of the same deficiencies as the 2007 annual report. HCE reported a 0.37% return on NAV for the period, compared to returns of 4.5% for the S&P 500 and 2% for the BXM. (Ex. 15 at 15521) HCE's equity portfolio lost just over 3%, outperforming the S&P 500 by approximately 1.5% (which was barely more than the Fund's advisory fee). (Ex. 48 at 1118; SEC-Delony-0000234D; Ex. 139 at ¶ 229) HCE's covered call options added only 2.33% to HCE's return, which was far inferior to the BXM's 6.5% increase over the S&P 500 (2.00% BXM return compared to -4.50% for S&P 500). (*See* Ex. 48 at 1118) Written S&P 500 put and call options contributed approximately 2.1% and 0.8% to HCE's return, and short variance swaps contributed 0.8%. (Ex. 139 at ¶ 228) HCE's protective long put options and long variance swaps contributed -0.6% and -0.8%. (Ex. 139 at ¶ 228) In total, HCE's S&P 500 options and variance swaps contributed 2.2% to HCE's return, which accounted for 45% of HCE's outperformance over the S&P 500, and elevated HCE from a loss for the year to a positive return. (Ex. 139 at ¶ 228)

Delony again interviewed Swanson for thirty minutes prior to preparing a draft Q&A Section. (Ex. 133; Ex. 136) Before the interview, Swanson provided Delony with a report for the equity investments, but did not provide any information on the effect of put options and variance

swaps on HCE's performance. (Ex. 132; Ex. 131; Tr. 1594:17-1597:11) Swanson again emphasized the covered call strategy as the reason for HCE's success. (Ex. 136 at 4:23-6:1) Swanson also mentioned good equity performance, and told Delony that "we have global hedges that we put on, and that we have on periodically during periods of high volatility, that further helped to augment the downside and actually added to excess performance." (Ex. 136 at 6:1-16) However, Swanson never mentioned writing put options or trading variance swaps at any time during the interview, nor HCE's resulting exposure to declining markets and volatility. (Tr. 1607:1-7, 1934:1-8; Ex. 133; Ex. 136)

Respondents both reviewed the Q&A Section multiple times before it was published in HCE's semi-annual report, and they either made or had the chance to make edits to the content. (Ex. 93; Ex. 134; Ex. 67; Ex. 69) In fact, Swanson edited Delony's initial draft to add language that HCE was "strategically hedged for additional downside protection." (Tr. 1614:14-17; Ex. 134 at 699; *see* Ex. 93 at 113540 for the original language) Swanson again signed a certification attesting that the Q&A Section did not contain any material misstatement or omission that would make the report inaccurate or misleading. (Ex. 35; Ex. 25)

The Q&A Section again obscured the real drivers of performance and avoided discussing the put-write and variance swap strategies. In response to a question asking what investment decisions most helped HCE's performance, Respondents stated that performance benefited from "industry and stock selection, the covered call strategy, and the hedge program." (Ex. 15 at 15522) Respondents noted that the call options offset 2/3 of the 3% loss on HCE's equity portfolio. (Ex. 15 at 15521) Respondents also claimed that "[d]uring most of this period, the portfolio was strategically hedged for additional downside protection, and that proved to be a good decision as equity markets trended downward." (Ex. 15 at 15522) This statement suggested that HCE had

hedged the portfolio against market declines by purchasing put options, and had profited from such declines. In fact, HCE had written put option and short variance swap exposure in the portfolio during most of the period, while it held protective long put options and long variance swaps far less of the time and actually lost money on these long hedges.[14] (Ex. 86 at 89833-35; Ex. 139 at ¶ 228)

Respondents did not discuss HCE's written put options and variance swaps as contributors to performance in their explanation of the Fund's hedging programs. (Ex. 15 at 15520-23) They also failed to highlight the long put option or long variance positions in response to a question about which holdings most hurt performance, even though those positions were some of the worst performers in the entire portfolio, and implied that these "downside hedges" had helped HCE's performance. (Ex. 15 at 15522-23; Ex. 139 at ¶ 232; Ex. 131 at 234D)

Once again, the semi-annual report did not discuss any of the risks associated with written puts and variance swaps in its risks disclosure, which limited discussion of risks of writing options to a discussion of writing covered *calls*. (Ex. 15 at 15523, 32) HCE did not have any open written puts or short variance swaps in the portfolio at the end of May 2008, so there was no disclosure of either of those investments in the portfolio holdings section of the report. (Ex. 15 at 15525-26) There was no way to tell from the semi-annual report that HCE had written puts and short variance swaps during the six-month period, or that those positions contributed substantially to HCE's performance in relation to its benchmarks.

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[14] HCE had written put option exposure from December 1 to December 21, 2007 and from January 11 to April 6, 2008 (108 days), short variance swap exposure from December 1 to December 20, 2007 and from January 2 to April 7, 2008 (117 days), while it had long put option protection from April 7 to May 31, 2008 (55 days) and long variance swap protection from January 2 to January 16, 2008 and from April 7 to May 22, 2008 (61 days). (*See* Ex. 86 at 89833-35) HCE's long put option hedges contributed -0.6% to HCE's return for the period, and the long variance swaps contributed -0.8%. (Ex. 139 at ¶ 228)

5. Respondents Did Not Reveal Their Derivative Investments Strategy Until the Fall of 2008.

Respondents did not disclose to the Board HCE's put option and variance swap strategy until October 2008, when Respondents helped Claymore to draft a press release that explained the Fund's collapse. (Tr. 2937:8-15; Ex. 64) In an email to Swanson, Riad acknowledged that investors and the board members were previously unaware of HCE's investment strategies. "I decided to be upfront and explain the strategies instead of hiding. We will probably be getting whiplash either way but I think we have less risk if we are transparent." (Ex. 64 at 20380) However, Riad was not ready for fully transparency.

At an October 2008 meeting, Riad told the Board that over the past 18 months, Respondents had attempted to reduce the volatility and hedge HCE's portfolio by implementing a strategy of purchasing put options and offsetting the cost of those purchases by selling out-of-the-money put options. (Ex. 19 at 16625) Riad also said that he entered into variance swaps as part of this same strategy.[15] (*Id.* at 16625-26) Finally, Riad claimed that long put option positions expired or were offset over the summer with the intention of replacing them around the time of the presidential election, and he decided to retain the short put exposure. (Ex. 19 at 16626)

However, Riad's statements were untrue. The trading patterns show that HCE maintained written put option exposure far more frequently than it had purchased put option protection, it did not often use the long and short puts in combination, and it often went long

[15] Only later, during the Board's review of FAMCO's contract in November 2008, did Respondents admit that they had adopted a practice of selling put options and variance swaps in the Fund as a means of sustaining its high dividend payout objective. (Ex. 75 at 34141; *see* Ex. 98 showing drafting in November)

periods of only using written put options.[16] (Ex. 139 at ¶ 307) Moreover, HCE collected $9.6 million in written put option premiums from April 2007 through August 2008, which far exceeded the "cost" of its put option purchases (which was zero given that they were profitable). (Ex. 139 at ¶¶ 127, 307; Ex. 86 at 89833)

Riad's suggestion that he was attempting to reduce the effects of volatility on HCE and hedge the portfolio was also untrue. Riad's own research showed that shorting variance swaps on top of an equity portfolio actually increased volatility. (Ex. 47 at 1074) Writing put options also increases portfolio volatility, because doing so is the functional equivalent of leveraging a covered call portfolio by borrowing money and investing in more covered calls. (Ex. 139 at ¶¶ 74, 307; Tr. 204:6-205:10, 3522:1-3525:12)

C. Respondents Understood That HCE's Derivative Investments Were Risky.

1. *Riad and Swanson Were Aware That Written Puts and Variance Swaps Exposed HCE to Significant Risk.*

All of the research materials reviewed by Riad and Sean Hughes, the junior portfolio analyst, touted the profitability of the written put and variance swap investments, but warned of the exposure to significant losses in turbulent markets. For example, one academic paper noted that "[t]here is no arguing that selling naked puts could be very risky" and that "put sellers may occasionally incur huge losses." (Ex. 214 at 149060, 68, 69 n.8; Tr. 677:5-11, 2141:3-10) Another research report highlighted that variance swaps suffered greatest losses during market crises and were exposed to unlimited losses when faced with severe spikes in volatility and that

[16] In fact, HCE maintained naked short put positions 76% of the time from November 2007 to October 2008, yet maintained purchased put option protection only 22% of the time. (Ex. 139 at ¶ 126) Riad's and Swanson's contemporaneous communications during 2007 also show that they were actually focused on volatility selling, not purchasing protection. (Ex. 58; 59) In one email, Swanson explained that put option protection is bid up and that they have been successful in HCE by taking the other side of the bet by writing puts. (Ex. 59)

short variance swaps were regularly subject to substantial losses. (Ex. 41 at 801-02, 804) The report warned that shorting variance swaps with 300,000 vega (an amount commonly used by HCE) could have lost up to $8.1 million during downturns in recent history, and that short variance swaps faced maximum losses of greater than $5 million several times going back to 1997. (*See* Ex. 41 at 801; Tr. 922:4-923:5, 3370:20-3375:18; Ex. 208)

Riad's investment research also revealed that the market was subject to major volatility spikes and sudden declines. (Ex. 88) This "backtesting" showed that put-writing historically would have enjoyed steady gains, but also would have suffered sudden, significant losses in tumultuous markets, as much as 25% over one- and two-month periods. (Ex. 204 at 1124-25; Ex. 74 at 33573-74) Making matters worse, Riad acknowledged that written puts and variance swaps perform their worst at exactly the same time: during market crises. (Tr. 922:6-13, 3488:24-3489:10)

Riad's research further showed that written puts and short variance swaps actually increase the volatility of an equity portfolio. Written put options have a clear, measurable, increasing effect on a portfolio's volatility by adding delta exposure to a portfolio, which made HCE's portfolio more sensitive to market movements. (Tr. 877:12-879:14; Ex. 139 at ¶ 307) Covered-call funds traditionally are less volatile than pure equity strategies, and HCE's covered call strategy's sensitivity to market movements was approximately 70% to 80% that of the equity market. (Tr. 877:12-878:15) HCE's written puts increased HCE's market exposure and sensitivity to market movements. (Tr. 204:6-15, 878:16-879:14) FAMCO's backtested

simulation of shorting one-month variance swaps in combination with an S&P 500 portfolio also increased the portfolio's volatility. (Ex. 119[17])[18]

Swanson recognized the risk associated with maintaining the written put and short variance swap exposure. On at least two occasions, Swanson recommended reducing that exposure. In September 2007, Swanson asked Riad: "is it prudent to take off at least a third of the short-put position in the FUNDS? . . . if [the Fed] surprise[s], we could be in trouble on those." (Ex. 99 at 119709-10) Riad acknowledged "it will be a volatile ride for the next two weeks" as a result of the put positions. (*Id.* at 119710) In November 2007, Swanson again suggested to Riad that "maybe it makes sense to at least dump the variance swap or the short-puts to help reduce risks." (*Id.* at 119723) However, Riad said that they would have to ride out the positions because they were too expensive to sell, writing "we are boxed in." (*Id.*)

Finally, Jeffrey Grossman, HCE's portfolio accountant who had significant options trading experience, warned Riad repeatedly of the risks associated with writing naked puts. (Tr. 494:15-497:16, 522:16-20) However, when Riad dismissed these warnings; Grossman brought his concerns that HCE could suffer large losses to FAMCO's compliance department. (Tr. 1293:17-1294:1)

2. *Professor Spatt's Opinions Should Be Disregarded As Irrelevant Because They Are Not Based on Any Expert Analysis.*

Respondents claim that their Professor Spatt evaluated their risk analysis and concluded that they reached reasonable conclusions about investing in written puts and variance swaps based

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[17] Ex. 119 shows writing variance swaps on top of an S&P 500 portfolio boosted return, but also increased the portfolio's standard deviation.

[18] Hughes presented one strategy to Riad that involved using long and short variance swaps in combination, which showed both reduced volatility and increased return. (Ex. 202 at 1038, 41; Tr. 918:22-919:10) But Riad decided to seek larger returns with unhedged short variance swaps. (Ex. 202 at 1038; Tr. 919:11-921:1)

on their research and analyses. (Resp. App. Br. at 2, 5, 27) However, Spatt never actually analyzed any of HCE's trading or verified the accuracy of any of Respondents' work. (Tr. 3339:8-22) Instead, Spatt simply relied on Respondents' own representations of what they had done, from their investigative testimony transcripts and Wells submissions; and did no independent analysis or testing of FAMCO's work. (Tr. 3339:8-3341:17, 3439:9-14)

Spatt based his opinion on Respondents' claim that the risk of loss for the put options and variance swaps was limited to a 0.5% chance of a 5% loss to the Fund. However, during the hearing, Spatt agreed that one of Respondents' demonstrative exhibits, which showed a 0.73% chance of a $5 million loss based on only one of the two written put options in the Fund's portfolio, actually demonstrated that the combined risk of HCE's August 2008 put option positions exceeded a 0.5% chance of a $5 million loss. (Tr. 3445:17-3447:9)

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

Spatt also noted in his report that Riad routinely adjusted its frequency distributions to account for mean reversion of volatility and the likelihood of a significant market decline following another decline. (Tr. 3453:11-21) In other words, Respondents were modifying their probability tables to account for certain market conditions. Spatt could not recall what, if anything, he looked at regarding these adjustments made by Riad, what exactly Riad was doing on that front,

or why such adjustments were reasonable. (Tr. 3454:5-3457:2) If he could not explain what Riad was doing, then he had no basis to conclude that his actions were reasonable.

D. Respondents Did Not Seek The Advice of Legal Counsel Regarding Investment Strategies Or Disclosure Issues.

Respondents contend that they lack scienter because they reasonably relied upon Claymore and HCE's counsel to provide guidance regarding the written put and variance swap investments, and because the Commission has discouraged registrants from providing too much information about their less important investments. (Resp. Br. at 6, 17, 20-23, 30-36) None of these arguments are supported by the record.

To assert a reliance defense, Respondents must show that they: "(1) made a 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." *Zacharias v. SEC*, 569 F.3d 458, 467 (D.C. Cir. 2009). Respondents simply cannot satisfy these elements because they never disclosed to any attorney (or anyone else) the extent of their use of written puts and variance swaps, the fact that they used derivatives as a consistent strategy, the risks the derivatives entailed, or that they were describing the practice as "hedging."[19] Similarly, Respondents never received advice from any attorney: (a) that their investments were described in the registration documents as a strategy, (b) the extent to which they could use written puts

[19] Rather than making complete disclosure, Respondents hid critical facts from Claymore and Fund counsel. Respondents have argued that the January 16, 2008 telephone conference between FAMCO and Claymore as an example of seeking legal advice. But Fund counsel is not shown participating, and topic of the call is the sale of an uncovered put – not the use of variance swaps. (*See* Ex. 27) Several of the participants on this call have testified that there was no discussion of disclosure issues; and there was no discussion of the potential size of FAMCO's investments in derivatives, the frequency, the duration or the risks of those investments. (*Id.*) Moreover, this telephone conference took place more than six months after Respondents began making derivative investments in HCE, belying any claim that Respondents preemptively sought legal advice.

and swaps, (c) that the practice could fairly be described as hedging, (d) that the strategy, and the corresponding risks, were sufficiently disclosed; or (e) that their annual and semiannual report disclosures were adequate.

Moreover, reliance on counsel is "only one factor for consideration" in assessing *scienter*, such that the defense may not be valid even if the above elements are satisfied. *Markowski v. SEC*, 34 F.3d 99, 104-105 (2d Cir. 1994). Courts have refused to allow a reliance defense when the defendant, like Respondents, have significant industry experience or is a senior official at his firm. *See, e.g. Graham v. SEC*, 222 F.3d 994, 1005-06 (D.C. Cir. 2000) (rejecting reliance defense where defendant was an "experienced professional who has an independent duty to use diligence 'where there are any unusual factors,'"; the fact that her supervisor/compliance officer approved the trades did not relieve the defendant of her illegal conduct). *Wonsover v. SEC*, 205 F.3d 408, 415 (D.C. Cir. 2000) (reliance defense was unavailable for a broker who claimed reliance on his firm's restricted stock department, transfer agents, lawyers, and auditor, who all approved the illegal transactions at issue); *SEC v. Advance Growth Cap. Corp.*, 470 F.2d 40, 52 (7th Cir. 1972) (a mutual fund officer's claimed reliance on fund accountants cannot excuse his liability for the fund's misleading SEC filings). Here, both Riad and Swanson had sufficient experience that they should have insisted that HCE's disclosures regarding investment strategies, performance and risk were accurate, instead of depending on Claymore or Fund counsel to identify, raise, address and correct issues without knowing all the facts known to Respondents.[20]

Additionally, reliance on counsel is not a defense to the charges at issue that do not contain a *scienter* element. *SEC v. McNamee*, 481 F.3d 451, 456 (7th Cir. 2007). Courts have

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[20] Respondents also knew that their disclosures regarding the drivers of Fund performance and downside protection were inaccurate, and they did not need legal counsel to remind them to speak truthfully.

consistently held that a reliance defense "is simply a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud." *U.S. v. Peterson*, 101 F.3d 375, 381 (5th Cir. 1996). Put another way, a reliance defense merely "addresses *scienter*." *SEC v. Huff*, 758 F. Supp. 2d 1288, 1348 (S.D. Fla. 2010) (collecting cases). For this reason, courts routinely refuse to allow a reliance defense to negate claims that do not have a *scienter* element. *Erenstein v. SEC*, 316 Fed. Appx. 865, 869 (11th Cir. 2008); *SEC v. Verdiramo*, 890 F.Supp.2d 257, 271 (S.D.N.Y. 2011); *SEC v. Mut. Benefits Corp.*, 2004 U.S. Dist. LEXIS 23008, *55 (S.D. Fla. Nov. 10, 2004). The *scienter*-based claims in this matter relate only to the disclosures in the annual and semi-annual reports. Respondents have offered no evidence that they sought or received any advice of counsel in connection with the preparation of these reports. Accordingly, even if Respondents are deemed to have consulted counsel on certain issues, such consultation is irrelevant to the *scienter*-based disclosure violations alleged in this case.

E. Riad And Swanson Each Acted Improperly, With *Scienter*, And May Each Be Held Liable For Violating The Securities Laws and Sanctioned.

Finally, Respondents are correct that their roles with respect to HCE, and their knowledge of the investments at issue, differed in some significant ways: *i.e.*, that Riad had a better understanding of the derivative investment strategies than Swanson, and Swanson was more involved in the preparation of the Q&A Section than Riad. (*See* Resp. Br. at 37-38)

However, Respondents also suggest that the difference in their roles and knowledge should immunize them both against liability, essentially arguing that neither of them had the required state of mind to be found liable. This contention must be rejected because it would reward them for ignoring what they did know, and would lead to an absurd result.

Both Riad and Swanson worked together to implement a new, derivative investment strategy which was not described in HCE's registration documents in order to meet the Fund's

dividend targets. They each knew that their strategy was a significant driver of Fund performance, and that the strategy carried additional risks of loss. However, both Respondents failed to disclose their investment strategy, results and risks to investors or Board members, when they had the opportunity. Swanson withheld information about the derivative strategy in his interviews with Delony, and was inaccurately referred to it as a risk-reducing hedging strategy, even though he knew that was not truthful, and he knew that the strategy had contributed significantly to HCE's performance. Riad reviewed the Q&A Sections and never attempted to improve the disclosure of the "global hedging strategy," and repeatedly withheld important information from the Board about the strategy during discussions at Board meetings. Accordingly, they are both responsible for the failures to disclose information to HCE's investors.

IV. ALL OF THE LAW JUDGE'S LEGAL CONCLUSIONS WERE BASED UPON THE EVIDENCE AND APPROPRIATE LEGAL STANDARDS.

A. Riad and Swanson Willfully Violated the Antifraud Provisions of the Exchange Act and the Investment Company Act.

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit any person, in connection with the purchase or sale of any security, from directly or indirectly: (a) employing any device, scheme, or artifice to defraud; (b) making any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. Section 34(b) of the Investment Company Act prohibits any person from making any untrue statement of a material fact in any registration statement or other document filed or transmitted under the Investment Company Act. It also prohibits any person filing, transmitting or keeping any such

document from omitting to state any fact necessary in order to prevent the statements made, in the light of the circumstances under which they were made, from being materially misleading.

A misstatement or omission is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. *Basic Inc. v. Levinson,* 485 U.S. 224, 231 (1988). *Scienter* is defined as a "mental state embracing the intent to deceive, manipulate or defraud," and is a required element of a Section 10(b) claim. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Reckless conduct also satisfies the scienter requirement. *See SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044 (7th Cir.); *cert denied*, 434 U.S. 875 (1977). Proof of *scienter* may be inferred from circumstantial evidence. *See Herman & Maclean v. Huddleston*, 459 U.S. 375, 390 n.30 (1983). However, Section 34(b) of the Investment Company Act does not require a showing of scienter. *In re Fundamental Portfolio Advisors, Inc.*, Rel. No. IC-26099, 56 S.E.C. 651, 670 (July 15, 2003).

Both Respondents made false and misleading statements and omitted material facts in the Q&A Sections in HCE's 2007 annual report and 2008 semi-annual report. Specifically, Respondents claimed that the most significant contributors to HCE's performance, both positive and negative, were individual stock selections and the Fund's covered call strategy. This was not the case. Respondents both failed to mention the more substantial effect that written puts and variance swaps strategies had on HCE's overall return.

Further, Respondents minimized the risk of their derivative investment strategies in these same reports by describing them generically as a "global hedging strategy." They failed to inform investors that the written put and variance swap investment strategies exposed HCE to significant downside risk and substantial investment losses during periods of market decline or volatility.

Respondents never described their written put option and variance swap investment as principal investment strategies, even though they clearly were principal strategies in terms of both risk and return.

The Q&A Sections also misled investors into believing that Respondents were actually protecting the Fund against downside risk. In the 2007 report, Respondents stated that they further protected the portfolio by buying index puts and collaring the portfolio by simultaneously purchasing index puts and writing index calls. This statement omitted the fact that they were exposing the Fund to downside risk by writing naked put options for a significant portion of the year.

In the 2008 report, Respondents again claimed that for most of the period they had strategically hedged the portfolio for additional "downside protection," which proved to be a good decision as equity markets trended downward. This statement was misleading, since HCE had naked written put and short variance swap exposure for the majority of the period, and when they actually did purchase protective long puts and long variance swaps, they lost on those trades.

This case is not, as Respondents' claim, an example of "fraud by hindsight." Each of the decisions cited by Respondents involved a motion to dismiss, where the sole allegations of fraud were an initial positive statement by an issuer which subsequently turned out to be incorrect, and there was no other evidence to suggest *scienter*. (*See* Resp. Br. at 29) Here, there is ample evidence that Respondents: (a) made statements about HCE's trading practices which were false or misleading *at the time they were made*, (b) and omitted information that, *at the time*, Respondents knew was material and important to investors and HCE's Board.

This information about HCE's derivative investments was material to the Fund's investors. By distorting the actual drivers of HCE's performance, and the Fund's exposure to (and lack of

protection from) declining or volatile markets, Respondents concealed from investors the fact that HCE was achieving its favorable returns by making aggressive investments with significant risk of loss. The put and swap investments were material because:

- HCE received a significant boost to performance from these strategies;
- HCE investors would not have invested in a covered call fund which made such extensive use of derivatives;
- Professor Harris showed that using puts and swaps exposed HCE to significant potential losses, and changed the Fund's risk profile; and
- HCE suffered far greater losses than its covered call peer group during the Fall of 2008, which required the Fund's liquidation.

In addition, Respondents' contemporaneous communications from 2007 and 2008 show that they considered the put and variance swap strategies, which were misleadingly described as "hedging," to be important to HCE's success during that time period.[21]

These misrepresentations were in connection with the purchase or sale of securities. Material misstatements or omissions in a company's periodic reports meet the "in connection with" requirement because potential investors might rely on such statements in deciding whether to purchase or sell the company's securities. *SEC v. Benson*, 657 F. Supp. 1122, 1131 (S.D.N.Y. 1997); *Steiner v. Ames Dep't Stores, Inc.*, 991 F.2d 953, 962 (2d Cir. 1993). As a decision cited by Respondents recognizes, "the prospective purchaser [is] entitled to a full disclosure of all the facts that were known to the Corporation at the time" of its statements to investors. *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 165 (2d Cir. 2000).

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[21] Riad claims that the fact that he invested money in a private fund he managed that employed the puts and swaps strategy negates his scienter. This argument misses the point. The issue is not whether Riad believed his strategy would succeed, the issue is whether the strategy, its results and the attendant risks were disclosed to investors.

Respondents are each "makers" of the false and misleading statements and omissions within the meaning of *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct 2296, 2302 (2011) (a "maker" is a person or entity "with ultimate authority over the statement, including its content and whether and how to communicate it . . . attribution within a statement or implicit from surrounding circumstances is strong evidence that a statements was made by – and only by – the party to whom it is attributed."). The introductions to the Q&A Sections and the "risks" sections of the 2007 annual report and the 2008 semi-annual report directly attribute the statements in those sections to Respondents. Respondents reviewed the sections multiple times, and Swanson signed a certification as to their accuracy. Delony did not feel comfortable making any substantive changes to the section without checking with Respondents. Accordingly, each Respondent can be held liable for making false statements under Section 10(b) and Rule 10b-5 thereunder.

B. Respondents also Aided and Abetted and Caused HCE's Violations of Section 34(b) of the Investment Company Act.

In addition to their direct violations of Sections 10(b) and 34(b), Respondents aided and abetted and caused HCE's violations of the law. To establish aiding and abetting liability under the federal securities laws, the Division must show: (1) a primary violation; (2) awareness or knowledge by the aider and abettor that his or her role was part of an overall activity that was improper; and (3) that the aider and abettor knowingly and substantially assisted the conduct constituting the violation. *See Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956 (7th Cir. 2004). A showing of recklessness is sufficient to establish the knowledge or awareness requirement. *See In re vFinance Invs., Inc.*, Rel. No. 34-62448 98 SEC Docket 2879 (July 2, 2010).

To establish causing liability, the Division must show: (1) a primary violation; (2) an act or omission by the respondent that was a cause of the violation; and (3) that the respondent knew, or should have known, that his conduct would contribute to the violation. *In re Robert M. Fuller*, 56

S.E.C. 976, 984 (2003), *pet. denied*, No. 03-1334 (D.C. Cir. 2004). A respondent who aids and abets a violation also is a cause of the violation. *See In re Sharon M. Graham*, 53 S.E.C. 1072, 1085 n.35 (1998), *aff'd,* 222 F.3d 994 (D.C. Cir. 2000). Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. *See KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1175 (2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002).

By making misleading statements and omissions in its 2007 annual and 2008 semi-annual reports, HCE violated Section 34(b) of the Investment Company Act. Respondents aided and abetted and caused HCE's violations by making misleading statements and omitting material information in the Q&A and risks sections of HCE's 2007 annual report and 2008 semi-annual report. As discussed above, Respondents acted recklessly and negligently in making these misstatements and omitting material information from HCE's reports.

C. Riad Aided and Abetted and Caused FAMCO's Violations of Section 206(4) of the Advisers Act and Rule 206(4)-8 Thereunder.

Section 206(4) of the Advisers Act prohibits an investment adviser from engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. Rule 206(4)-8 states that it shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business for an investment adviser of an investment company to: (1) make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor in the investment company; or (2) otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any of the investment company's investors or prospective investors. Section 206(4) does not require a showing of scienter. *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992).

By utilizing undisclosed investment strategies to such a degree that those strategies became an integral part of HCE's ability to achieve favorable investment returns, and by exposing the Fund to additional undisclosed risks, Riad managed HCE in a manner that operated as a fraud on its investors and conflicted with the Q&A Sections in HCE's 2007 annual and 2008 semi-annual reports. As a result, Riad aided caused FAMCO's violations of Section 206(4) and Rule 206(4)-8(a)(2). Similarly, by making false and misleading statements to investors in HCE's 2007 Annual and 2008 Semi-Annual Reports, both Riad and Swanson aided and abetted and caused FAMCO's violations of Section 206(4) and Rule 206(4)-8(a)(1).

D. Riad Caused HCE's Violations of Rule 8b-16 Under the Investment Company Act.

The Commission's Form N-2 requires that closed-end investment companies disclose in their registration statements the investment objectives and policies that will constitute the principal portfolio emphasis, including the types of securities in which the fund will invest principally, all significant investment practices or techniques the fund employs or intends to employ, and all other types of investments that will be made by the fund. (Ex. 142 at 15, Form N-2 Item 8.2). Form N-2 further requires that funds discuss the principal risk factors associated with investment in the fund specifically and those associated with the fund's investment objectives and policies. (Ex. 142 at 16, Form N-2 Item 8.3)

A fund's disclosure of a type of risk, without discussion of the extent of the risk, does not necessarily make its risk disclosures complete and not misleading. *In re TCW/DW N. Am. Gov't Income Trust Sec. Litig.*, 941 F. Supp. 326, 330-31 (S.D.N.Y. 1996) (risk disclosure excluded discussion of extent of risk and consequences); *In re Oppenheimer Rochester Funds Group Sec. Litig.,* 838 F. Supp. 2d 1148, 1164-67 (D. Col. 2012) (risk disclosures regarding inverse floater bonds failed to disclose even a general range of degree to which inverse floaters were leveraged;

failure to disclose floaters' ability to obtain negative values that could trigger a fund crisis was material omission given generic and sanguine risk disclosures in place).

Form N-2 requires disclosure identifying any investment practices used by a fund that place no more than 5% of the fund's net assets at risk. The amount of net assets at risk is determined by reference to the potential liability or loss that may be incurred. (Form N-2 Item 8.4 instruction c) Form N-2 further requires full discussion in the SAI of any significant investment policies not discussed in the prospectus, including the extent to which the fund may engage in the policies and the risks inherent in such policies. (Ex. 142 at 24-25 Form N-2 Item 17.3 instruction 3).

Investment Company Act Rule 8b-16 requires investment companies to amend their registration statements annually, but exempts closed-end funds from the annual amendments if they include, among other things, in annual reports to shareholders: (1) any material changes in the company's investment objectives or policies that have not been approved by shareholders; and (2) any material changes in the principal risk factors associated with investment in the company.

As explained previously, Respondents' written put and short variance swap strategies constituted a material change to HCE's investment policies, and altered the principal risk factors associated with a covered-call fund. (Tr. 2859:3-2864:23) Accordingly, HCE violated Rule 8b-16 by failing to amend its registration statement or disclose in its 2007 annual report the material changes to HCE's investment policies and principal risk factors resulting from Respondents' written put option and variance swap strategies.

Riad was primarily responsible for managing the written put option and variance strategies for HCE. Riad was also responsible for familiarizing himself with HCE's registration statement and managing the portfolio consistent with the disclosures therein. He was aware that HCE's registration statement did not disclose or explain the written put option and variance swap

strategies he was implementing to the point they became primary drivers of HCE's performance. In fact, he participated in a conference call involving FAMCO and Claymore, one of the focuses of which was the Strategic Transactions disclosure in HCE's registration statement, so he was well aware of the Fund's limited disclosure regarding the use of derivatives. He also was aware that HCE's registration statement failed to disclose the risks associated with writing puts or trading variance swaps. However, Riad continued to use these derivative investment strategies to such a degree that they became an integral part of the manner in which HCE sought to achieve its investment objectives in 2007 and 2008.

Riad also failed to raise the disclosure issue with Claymore and never sought advice about whether his strategies were adequately disclosed. Instead, Riad contributed to HCE's disclosure failures by describing, to Claymore and the Board, the strategies as augmenting downside protection and as small components of HCE's portfolio. By doing so, Riad acted at least negligently in causing HCE's violations of Rule 8b-16.

V. ALL OF THE SANCTIONS IMPOSED ON THE RESPONDENTS ARE APPROPRIATE AND CONSISTENT WITH COMMISSION PRECEDENT.

In determining whether the public interest requires the imposition of sanctions, the Commission should consider: (1) the egregiousness of Respondents' actions; (2) the isolated or recurrent nature of their violations; (3) the degree of *scienter* involved; (4) the sincerity of Respondents' assurances, if any, against future violations; (5) Respondents' recognition, if any, of the wrongful nature of their conduct; and (6) the likelihood that Respondents' occupations will present opportunities for future violations. *See Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981)). Other factors include the age of the violations and the degree of harm to investors and the marketplace as a result of the violations. *See In the Matter of Marshall E. Melton, et al.*, Rel. No. IA-2151, 2003 WL 21729839, at *2 (July 25, 2003).

The Commission also may consider the extent to which a sanction will have a deterrent effect. *See In the Matter of Schield Management Co., et al.*, Rel. No. 34-53201, 2006 WL 23162, at *8 (Jan. 31, 2006).

Here, Respondents' misconduct was egregious and was repeated during 2007 and 2008. Their conduct involved deliberate deception by hiding from HCE's investors material information about the Fund's investment strategies, performance, and risk, which should have been included in HCE's annual and semi-annual reports. To date, Respondents have shown no recognition of the wrongful nature of their actions, and have offered no assurances against future violations. Instead, they continue to deny all liability. Although neither Respondent has any prior disciplinary history, both are relatively young and, since leaving FAMCO, have continued to work in the securities industry. In fact, Riad started his own investment advisory firm and plans to manage money for U.S. investors in the future. (Tr. 2035:10-2036:6) Accordingly, both Respondents, unless sanctioned, will have ample opportunities to commit future violations of the securities laws.

In addition, HCE's investors suffered severe harm as a result of Respondents' violations, and lost approximately $45.4 million as a direct result of Respondents' conduct. Imposing sanctions on Respondents is necessary to deter them from engaging in any future misconduct, as well as deter other portfolio managers from concealing investment strategies, performance and risks from investors. Accordingly, and as explained below, all of the Law Judge's determination on sanctions should be affirmed.

A. <u>Respondents Should Be Subject to Cease-and-Desist Orders</u>

Section 21C of the Exchange Act, Section 203(k) of the Advisers Act and Section 9(f) of the Investment Company Act all authorize the Court to issue cease-and-desist orders. Respondents' violations of the securities laws pose a sufficient risk of future violations to justify

the entry of such an order. *See In the Matter of KPMG Peat Marwick LLP*, Rel. No. 34-43862 (Jan. 19, 2001), 54 S.E.C. 1135, 1183-91 (such a showing is "significantly less than that required for an injunction," and "absent evidence to the contrary," a single past violation may raise "a sufficient risk of future violation").

B. Riad Should Pay Disgorgement and Prejudgment Interest

Under Section 21C(e) of the Exchange Act, Section 203(j) of the Advisers Act and Section 9(f)(5) of the Investment Company Act, Riad may be required to pay disgorgement, plus prejudgment interest.[22] The amount of disgorgement need only constitute a reasonable approximation of the profits obtained from the illegal conduct. *See SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989). Here, the Law Judge's calculation of an appropriate disgorgement for Riad, $188,948.52, is a modest fraction of his total compensation for 2007 and 2008, and reasonably approximates his ill-gotten gains. (*See* Initial Dec. at 35)

C. Respondents Should Each Be Required To Pay Third-Tier Civil Penalties.

In addition, the public interest requires that both Respondents be ordered to pay third-tier civil penalties for their misconduct. *See* Advisers Act Section 203(i) and Investment Company Act Section 9(d). In considering whether civil penalties are appropriate in the public interest, the factors to consider include: (1) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to other persons resulting either directly or indirectly from such act or omission; (3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior; (4) whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization

[22] Because the conduct in this case predates the enactment of the Dodd-Frank Act, the authority cited is based on the statutes in effect at the time of the conduct.

to have violated the federal securities laws, state securities laws or self-regulatory rules, has been enjoined from violating such laws or rules, or has been convicted of violations of such laws or of any felony or misdemeanor described in Section 15(b)(4)(B) of the Exchange Act or Section 203(e)(2) of the Advisers Act; (5) the need to deter such person and other persons from committing such acts or omissions; and (6) such other matters as justice may require. *Id.*

The Commission should affirm the third-tier civil penalties of $130,000 imposed against each Respondent. Riad committed at least three violations worthy of a third-tier penalty: (1) managing HCE in a manner that rendered its registration statement misleading; (2) making false and misleading statements in HCE's 2007 annual report; and (3) making false and misleading statements in HCE's 2008 semi-annual report. So Riad could have been ordered to pay at least $390,000. However, the Law Judge has ordered him to pay only for a third of that amount. Swanson committed at least two violations worthy of a third-tier penalty: by making false and misleading statements in both HCE's 2007 annual report and 2008 semi-annual report. So Swanson could have been ordered to pay at least $260,000. However, the Law Judge has ordered him to pay only one-half of that amount.

The imposition of civil penalties against Respondents is consistent with prior orders by the Commission. *See, e.g., In re Fundamental Portfolio Advisors, Inc.*, Rel. No. IC-26099 (July 15, 2003), 80 SEC Docket 2234 (imposing $250,000 civil penalty against portfolio manager who misled investors about a new risky investment strategy in the mutual fund he managed); *SEC v. Kimon P. Daifotis and Randall Merk*, Lit Rel. No. 22415 (July 16, 2012) (settlement imposing civil penalty of $75,000 against portfolio manager for misleading investors about the risks of investing in a bond fund). Affirming the penalties which the Law Judge ordered against

Respondents would deter them, and others, from engaging in the type of conduct at issue in this proceeding.

D. Respondents Each Should Be Subject to a Permanent Associational Bar

Under Section 203(f) of the Advisers Act, and Section 9(b) of the Investment Company Act, as amended by Section 925 of the Dodd-Frank Act, the Commission may bar or suspend registered persons from being associated with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization. *See In the Matter of John W. Lawton*, Rel. No. IA-3513, 2012 WL 6208750 (December 13, 2012) (collateral bars imposed pursuant to Section 925 of Dodd-Frank may be imposed in proceedings based on pre-Dodd-Frank conduct).

Based on Respondents' willful violations of the securities laws, and orders entered in similar Commission proceedings, it is appropriate for the Commission to impose an associational bar on both Riad and Swanson which would preclude their continued employment in the securities industry. *See, e.g., In re Top Fund Management, Inc.*, Rel. No. 33-9377 (Dec. 21, 2012) (settlement imposing collateral bar against mutual fund manager from the securities industry for failing to follow the investment objectives of a stock mutual fund, leading to the fund's collapse); *SEC v. Kimon P. Daifotis and Randall Merk*, Lit. Rel. 22415 (July 16, 2012), Rel. No. 34-67454, 2012 WL 2921019 (July 18, 2012) (settlement imposing bar with right to reapply after three years against portfolio manager enjoined for misleading investors about the risks of investing in a bond fund); *In re Fundamental Portfolio Advisors, Inc.*, Rel. No. IC-26099 (July 15, 2003), 80 SEC Docket 1851 (imposing permanent associational bar against portfolio manager who misled investors about a risky investment strategy).

Respondents claim that industry bars are only appropriate in the most egregious cases, and cite two follow-on proceedings involving criminal convictions. (Pet. For Review at 39) However, the Commission has barred individuals in less severe circumstances. *See, e.g., In re Mitchell M. Maynard*, Rel. No. IC-2875, 2009 SEC LEXIS 1621, at *34-35 (May 15, 2009) (imposing collateral bar for non-scienter based violations); *Schield Management Co.*, Rel. No. 34-53201, 58 S.E.C. 1197 (Jan. 31, 2006) (affirming industry bar based on books and records violations).

The length of the associational bar ordered by the Law Judge should be sustained as necessary to protect investors from the type of harm which is at issue in this proceeding. *In re Marshall E. Melton*, 56 S.E.C. 695, 713 (July 25, 2003) ("conduct that violates the antifraud provisions of the federal securities laws is especially serious and subject to the severest of sanctions under the securities laws"). Nor would a bar of shorter length provide sufficient protection. *In re Christopher Lowry*, Rel. No. IC-2052, 55 S.E.C. 1133, 1146 (Aug. 30, 2002) (We do not find that the lesser sanctions proposed by Lowry… provides sufficient protection for investors or prevents against a recurrence).

Respondents have shown themselves to be uniquely vulnerable to the pressures which accompany professional investment management. They still do not recognize the wrongful nature of their conduct, or offer any assurances that they will obey the securities laws and make the necessary disclosures to future investors. Accordingly, they should be barred permanently from associating with registered investment advisers and the full range of other entities described in the Dodd-Frank Act. This is the only way to ensure that investors are protected fully against the dangers of misconduct by firms which may employ the Respondents in the future.

VI. CONCLUSION

Respondents willfully violated Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and Section 34(b) of the Investment Company Act, willfully aided and abetted and caused FAMCO's violations of Section 206(4) of the Advisers Act, and Advisers Act Rule 206(4)-8, and willfully aided and abetted and caused HCE's violations of Section 34(b) of the Investment Company Act. In addition, Riad caused HCE's violations of Investment Company Act Rule 8b-16. So Riad should be required to pay disgorgement plus prejudgment interest, and both Riad and Swanson should each be ordered cease and desist from their illegal conduct, to pay a third-tier civil penalty, and be subject to a permanent Dodd-Frank associational bar.

For all of the foregoing reasons, the Division of Enforcement respectfully requests that the Commission affirm the Law Judge's Initial Decision finding that Respondents Mohammed Riad and Kevin Timothy Swanson engaged in violations of the federal securities laws and imposing sanctions against each Respondent.

Dated: August 29, 2014.

Respectfully submitted,

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