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UNITED STATES OF AMERICA

Before the

SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING

File No. 3-15141

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In the Matter of

MOHAMMED RIAD
AND KEVIN TIMOTHY
SWANSON

Respondents.

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

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I. INTRODUCTION

The Respondents, Mohammed Riad and Timothy Swanson, demonstrated in their Opening Brief that the Initial Decision in this proceeding was based on erroneous conclusions of law and fact, and that the record did not support a finding that the Respondents engaged in any violations of the securities laws. Rather than address these issues, the Division of Enforcement's (the "Division") Response to the Opening Brief (the "Opposition Brief") only compounds these errors.

Like the Initial Decision, the Opposition Brief is premised on a legal standard that has been rejected by the courts and contravenes longstanding Commission policy. The Division ignores key facts and legal authority that undermine its position and misstates other evidence to suit its arguments.

At bottom, proper analysis of the Respondents' culpability requires that the trier of fact ignore all but what was known at the time the disclosures were made. The trier must go through the difficult but necessary exercise of winding the clock back to 2006 through 2008, sit in Riad's and Swanson's chairs, and ask whether based on *facts then known* their decisions about disclosure were reasonable. We respectfully suggest that when properly viewed in this context, the answer to this question is "Yes."

II. THE DIVISION CONTINUES THE INITIAL DECISION'S FATAL DEFECT OF IGNORING THE LAW GOVERNING THE DISCLOSURES AT ISSUE AND THEREFORE APPLIES THE WRONG LEGAL STANDARD

The Respondents noted in their Opening Brief that the Initial Decision nowhere cites a single legal authority relating to the disclosure obligations at issue in this case.[1] The Division's Brief perpetuates this defect by similarly ignoring relevant disclosure requirements. In fact, the

[1] *In the Matter of Mohammed Riad and Kevin Timothy Swanson*, File No. 3-15141, Respondents' Opening Brief (July 31, 2014) [hereinafter "Opening Brief"] at 21.

legal requirements governing the disclosures at issue *must* be addressed because they control the fundamental question in this proceeding as to whether the Respondents properly disclosed the derivatives trades.

A. *The Division Erroneously Applies an Improper Results-Based Disclosure Standard*

The Initial Decision – without any citation of authority whatsoever – adopts a disclosure standard that directly conflicts with well-established law by making the result of an action the determinant of its materiality at the outset. The Decision erroneously stated that "[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."[2] Rather than address the numerous issues with this approach raised in the Respondents' Opening Brief,[3] the Division essentially repeats the same flawed standard: "*[g]iven 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*."[4] According to the Division's proposed approach, the mere fact that investments ultimately had a large impact on a portfolio – no matter how unexpected the result – implies that the outcome must have been known in advance.

It is critical for the Commission to consider the applicable legal standards and to compare them with the standard applied in the Initial Decision and urged in the Division's Brief, for three important reasons. First, the Respondents cannot be found liable for following the established legal requirements at the time of their conduct, rather than another standard

[2] Initial Decision at 31 (emphasis added).
[3] *See* Opening Brief at 22-24.
[4] *In the Matter of Mohammed Riad and Kevin Timothy Swanson*, File No. 3-15141, Division of Enforcement's Brief in Opposition to Respondents' Appeal [hereinafter "Opposition Brief"] at 2 (emphasis added).

advocated after-the-fact.[5] Second, the Commission has crafted the disclosure requirements applicable to investment companies after decades of notice and rule-making.[6] The Commission should not alter those complex and detailed disclosure standards through an ad hoc judicial redefinition of the rules without the benefit of comments from the industry and its own disclosure staff. Third, the disclosure standard applied in the Initial Decision and advocated in the Division's Brief is exceedingly unwise from a policy perspective and directly contradicts the SEC's own disclosure regime.[7] If the obligation to disclose is determined solely by whether future events ultimately occur – rather than whether it is reasonably believed at the time the statement is made that the events might occur – then every remote contingency will have to be disclosed and SEC disclosure documents will become useless catalogues of science fiction horrors.

B. *Under the Appropriate Legal Standard, Limited Disclosure of the Trading Was Required*

Closed-end funds such as HCE are required to disclose "the types of securities in which the Registrant invests or will invest principally"[8] and the "principal" risks to the fund.[9] The Commission's Forms state that three primary factors should be considered in determining what represents a principal investment strategy: (i) the amount of assets expected to be committed to

[5] As the Supreme Court cautioned in *SEC v. Chenery*, 332 U.S. 194, 202 (1947), for an agency such as the SEC with rule-making power the "function of filling in the interstices" of a law or regulation "should be performed, as much as possible, through this quasi-legislative promulgation of rules to be applied in the future." *See also SEC v. R.A. Holman & Co., Inc.*, 366 F.2d 456 (2d Cir. 1966).

[6] *See, e.g.,* Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities and Exchange Commission (Effective Date: May 10, 2004), available at http://www.sec.gov/rules/final/33-8393.htm#IB.

[7] Tr. 3048:18- 3050:12; Baris Report at 10-11.

[8] Form N-2, Item 8.2(b)1 at 15. For a detailed discussion of the disclosure requirements relating to the derivatives at issue, *see* Respondents' Opening Brief at 21-24.

[9] Form N-2, Item 8.3(a) at 16.

the strategy, (ii) the amount of assets expected to be placed at risk by the strategy, and (iii) the likelihood of losing some or all of those assets from implementing the strategy.[10]

As explained in detail in the Opening Brief, the derivatives trades were neither a "principal investment strategy" of the Fund nor a "principal risk"[11] under any of these standards. The amount of assets committed to the strategy was exceedingly small; indeed, throughout the relevant period less than one percent of HCE assets were generally invested in the derivatives trades at issue.[12] Similarly, the Respondents' Value at Risk analysis – the same methodology mandated by Form N-2[13] – demonstrated that the amount of assets expected to be placed at risk was minimal.[14]

Based on the determination that these investments were not a "principal risk" or a "principal investment strategy," the Commission's rules mandate that the fund "*limit the . . . disclosure about such practice to that necessary to identify the practice*." It is undisputed that the Respondents identified short index puts and short variance swaps in multiple Fund filings.[15]

The Division makes no attempt to grapple with the proscriptions set forth in the Commission's disclosure rules. Instead, the Division merely cites the relevant disclosure language and then makes the conclusory statement that the written puts and short variance swaps "constituted a material change to HCE's investment policies, and altered the principal risk factors associated with a covered-call fund."[16] Such an unsupported assertion is insufficient to correct the Initial Decision's error in ignoring the disclosure requirements.

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[10] Form N1-A, Item 9(b), Instruction 2.
[11] Opening Brief at 21-24.
[12] *Exs.* 346 and 347; *see also* Tr. 1286:6-15.
[13] *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) at 18.
[14] Tr. 2171:10-2171:25; *id.* at 773:22-774:1.
[15] *See, e.g.,* Ex. 300 at 8 and 10; Ex. 301 at 11; Ex. 302 at 11.
[16] Opposition Brief at 36.

Perhaps the most significant problem with the Division's disclosure analysis is that it fails to take into account the understanding of the Respondents based on the facts known at the time. The fact that the disclosure guidelines focus on the amount "expected to" be committed to the strategy and placed at risk makes clear that the touchstone of these obligations is the view of the portfolio managers *when the disclosures were made*. Rather than follow this clear proscription, the Division instead engages in impermissible hindsight bias[17] by instead concentrating solely on the ultimate losses from the positions.

This problematic approach is embodied in the Division's statement regarding Riad's personal investments in the derivatives strategies. As noted in the Opening Brief, it is well understood by courts that investment of one's own money "belies any known or obvious danger"[18] and creates an inference against recklessness or negligence.[19] In response to this evidence of the Respondents' good faith and absence of scienter, the Division's Brief makes the surprising statement that "[t]his 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."[20] But the question as to whether the Respondents reasonably thought the strategy would succeed is *precisely* the issue that Form N-2 requires portfolio managers to answer: if the Respondents believed in good faith that the strategy would not place a large amount of the Fund's assets at risk, then they had no obligation to provide a fulsome disclosure of the derivatives at issue.

In fact, the evidence demonstrated that the Respondents had just such a belief in the strategies. The Initial Decision acknowledged that "thousands of hours of research" underlay the

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[17] For a detailed discussion of the problems with hindsight bias, *see* the Respondents' Opening Brief at 28-30.
[18] Opening Brief at 28, quoting *Hoffman v. Estabrook Co., Inc.*, 587 F.2d 509, 517 (1st Cir. 1987).
[19] *See* Opening Brief at 28.
[20] Opposition Brief at 32, n. 21 (emphasis added).

derivatives trades.[21] Based on this research, Riad and Swanson reasonably concluded that the derivatives strategy would be profitable, and that they would be able to limit any associated risks.[22] Indeed, "[a]n October 2008 FAMCO memo . . . stated that FAMCO had researched the probabilities of loss associated with written puts and variance swaps and determined that the possibility of significant losses was remote."[23] The Initial Decision further noted that "Riad's research provided the basis for his counterintuitive conclusion that the new strategy had minimal risk and would be profitable."[24] Similarly, Swanson "was led to believe that the written puts were relatively low risk investments" based on the risk-limiting features implemented by Riad.[25] These findings amply support the conclusion that the Respondents reasonably believed that the derivatives trades did not represent a principal strategy or a principal risk.

By arguing that the Respondents' reasonable belief that the derivatives trades would produce modest returns with limited risks "misses the point," the Division's Brief essentially argues for the adoption of a strict liability standard. In essence, the ultimate result – no matter how remote or unpredictable – would prove scienter. Such a standard is nowhere applied in any of the Commission's disclosure obligations[26] – and for good reason.

The failure to consider the mindset of the Respondents at the time of the relevant investments and disclosures also enables the Division to perpetuate the Initial Decision's error of entirely ignoring the important context in which these actions were taken. Put simply, the

[21] Both the Initial Decision and the Division's Brief highlight five research reports that supposedly alerted to the Respondents to the risks associated with the Derivatives Trades. The Respondents' Opening Brief argued that these five articles are misread because they discussed trading strategies that were not used and contained warnings that were addressed by the trading that actually occurred. *See* Opening Brief at 28-30.
[22] *See* Tr. 1713:22-1714:4; *id.* at 2170:17-21; *id.* at 2168:19-2170:6.
[23] Initial Decision at 12, n. 13.
[24] *Id.* at 31.
[25] *Id.* at 11, n. 10.
[26] *See, e.g.,* Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities and Exchange Commission (Effective Date: April 7, 2003), available at http://www.sec.gov/rules/final/33-8182.htm (disclosure is unnecessary "if the likelihood of either the occurrence of an event implicating an off-balance sheet arrangement, or the materiality of its effect, is remote.").

2008 financial crisis is the central event in the story of the Fund and served as the reason that HCE suffered such extensive losses.[27] Yet neither the Initial Decision nor the Division's Brief anywhere mentions that in 2008 the world experienced "the greatest financial crisis since the Great Depression."[28] These unprecedented market dislocations overwhelmed the Respondents' carefully-crafted risk limiting mechanisms and reasonable measures of risk. Ignoring the 2008 financial crisis is an extreme example of hindsight bias and is completely unwarranted.

C. The Division Continues the Initial Decision's Error of Ignoring the Opinions of the Respondents' Disclosure Expert

The Initial Decision compounds its error of ignoring the legal standard governing the disclosures at issue by disregarding the opinions of Jay Baris, an expert on the disclosure obligations and practices of investment companies.[29] Prior to the proceeding, the Law Judge denied the Division's motion in limine to exclude Baris' opinion because it represented testimony on the law.[30] In its Opposition Brief, the Division now apparently seeks to re-argue the motion that it lost, and applauds the Initial Decision's omission of any reference to Baris. This is improper for three reasons.

First, it is inappropriate for the Division to fill in gaps in the reasoning of the Initial Decision. As courts have made clear, an administrative action is required to detail the justification for its decision: put simply, the "grounds upon which an administrative order must be judged are those upon which the record discloses that its action was based."[31] Here, the Initial

[27] *See* Initial Decision at 16-17.
[28] *The Financial Crisis Inquiry Report*: *Final Report of the Financial Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011) at xv.
[29] Opening Brief at 21-24.
[30] The motion was decided during an April 18, 2013 pre-trail conference. *See* Tr. 3043:9-12.
[31] *SEC v. Chenery Corp*, 332 U.S. 194, 196-7 (1947) ("If the administrative action is to be tested by the basis upon which it purports to rest, that basis must be set forth with such clarity as to be understandable. It will not do for a court to be compelled to guess at the theory underlying the agency's action; nor can a court be expected to chisel that which must be precise from what the agency has left vague and indecisive. In other words, 'We must know what a decision means before the duty becomes ours to say whether it is right or wrong.'") (internal citation omitted).

Decision gave no explanation for its refusal even to consider the opinions of Baris on central issues in the proceeding. The fact that the Division now applies a post hoc justification for this failure is insufficient to correct the original defect.

The rationale provided by the Division for the exclusion of Baris' opinions is also unfounded. As an initial matter, Baris did more than merely opine on the law. Indeed, the primary focus of his Expert Report and testimony was industry practice in applying the complex legal standards relating to disclosure.[32] This testimony should have informed the Initial Decision so that it could better address the disclosure requirements at issue.

To the extent that Baris' testimony could be considered legal opinions, his views nonetheless should have been considered by the Law Judge. Although "[i]t is true that 'matters of law' are generally inappropriate subjects for expert testimony,"[33] there may be "instances in rare, highly complex and technical matters where a trial judge, utilizing limited and controlled mechanisms, and as a matter of trial management, permits some testimony seemingly at variance with the general rule."[34] This is precisely such a case. It would have been beneficial to consider expert testimony on disclosure rules that the Commission's own Director of Investment Management has acknowledged are exceedingly complex.[35]

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[32] Expert Report of Jay G. Baris, *In the Matter of Mohammed Riad and Kevin Timothy Swanson*, File No. 3-15141 (Mar. 19, 2013) at 10-13. *See also* Tr. 3048:18-3053:12.

[33] *Flores v. Arizona*, 516 F.3d 1140, 1166 (9th Cir. 2008) (citing *Aguilar v. Int'l Longshoremen's Union Local No. 10*, 966 F.2d 443, 447 (9th Cir. 1992)).

[34] *Id.* (quoting *Nieves-Villanueva v. Soto-Rivera,* 133 F.3d 92, 101 (1st Cir.1997).

[35] Donahue, Andrew J., Speech by SEC Staff, Investment Company Act of 1940: Regulatory Gap between Paradigm and Reality? (April 17, 2009) ("This dichotomy — or gap between technical compliance with the '40 Act versus actual performance — is precisely the issue I am concerned about today. As an example, consider the recent performance of fixed income funds in 2008 when a number of funds suffered one-year losses in excess of 30%. Unquestionably, some of this performance is due to adverse results from investment decisions . . . Some of the explanation, however — and for some funds a lot of the explanation — likely may rest with the use of derivatives to magnify the economic exposure of the portfolio. To be clear, I am not suggesting that the fund disclosures were legally deficient. Rather, I submit that many investors in these funds . . . neither appreciated the potential magnitude of nor anticipated the actual diminution in value of these funds.").

III. THE DIVISION MISCHARACTERIZES THE QUESTION AND ANSWER SECTIONS OF THE FUND PERIODIC FILINGS

The Division's Brief focuses on the Question and Answer sections in the Fund's annual and semi-annual reports and alleges that these disclosures were false and misleading. These claims misstate the evidence, fail to consider the context in which these disclosures were made, and ignore the openness with which the Respondents discussed these investments during the preparation of the reports.

A. The Performance Discussions Were Accurate

The Division alleges that the Question & Answer section for the 2007 Annual Report was misleading in its discussion of Fund performance for two reasons.[36] First, the Division argues that Respondents failed appropriately to emphasize the contribution of the derivatives investments. Second, the Division claims that the Respondents improperly highlighted the contribution of specific equity investments while ignoring the relatively larger contribution of certain derivatives. In reality, the statements at issue in the 2007 report were entirely accurate and appropriate.

In response to the question as to "[w]hich investment decisions most helped the Fund's performance" during the relevant period, Swanson emphasized the contribution of the Fund's equities.[37] This emphasis was appropriate: HCE had an annual return of 12.87% for 2007, and the equity portion of the portfolio increased by 8.97% – representing *seventy percent* of HCE's NAV growth.[38] The short index put options at issue contributed 2.0% to the Fund's return while the short variance swaps generated a loss of 0.4%. In total, these two derivative investments

[36] Opposition Brief at 13,14.
[37] Ex. 14 at CLAY015492-93.
[38] Ex. 14 at CLAY015502; Ex. 61 at FAM00016328.

generated less than fifteen percent of the Fund's returns – a mere fraction of the equity contribution.

Faced with the undeniable fact that the equities represented the "investment decision[] [which] most helped the Fund's performance," the Division distorts the performance figures to increase the relative importance of the Fund's derivatives investments. First, the Division aggregates *all* of the Fund's derivatives – including *long* index put options and call options that are not at issue in this proceeding – to demonstrate that these positions "added 5.6% to HCE's return and accounted for 46.2% of HCE's NAV growth."[39] But even this misleading aggregation is insufficient, because the seventy percent increase from the equities *still* represented the largest contributor to Fund performance. As a result, the Division is forced to compare apples to oranges: rather than measure the performance contribution of the derivatives against the equities, the Division instead contrasts the *total* performance of the derivatives strategies with the *relative outperformance* of the equities against their benchmark.[40] Only by making such artificial comparisons can the Division demonstrate that the derivatives were more important than the equities.

The Division's criticism of the 2008 Semi-Annual Report contains many of the same errors. Swanson was again asked "[w]hich investment decisions or strategies most helped the Fund's performance."[41] He answered this question by focusing on the covered call program, which generated the highest return of any part of the portfolio – and more than the derivatives investments, as the Division's own brief makes clear.[42] However, the Report also went on to highlight the second largest contributor to performance by noting that "[i]n addition to the

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[39] Opposition Brief at 16.
[40] *Id.*
[41] Ex. 15 at CLAY015521.
[42] Opposition Brief at 18. The "covered call options added . . . 2.33% to HCE's return" whereas the "S&P 500 options and variance swaps contributed 2.2% to HCE's return."

covered call strategy, our global macro hedges worked out well" – a reference to the derivatives at issue. In other words, Swanson accurately highlighted the two areas of the portfolio that had contributed the most to its strong performance: the covered calls and the derivative investments.

The Division adopts a similarly misleading approach in criticizing Swanson for highlighting specific stocks in the annual report rather than focusing on the derivative investments.[43] In order to show the relatively greater importance of the derivatives, the Division compares the total contribution of each *class* of derivative – for example, all short index put options – with the *individual* equity positions cited in the report. For example, when highlighting the 2.0% return from written S&P 500 put options in the 2007 annual report, the Division fails to mention that this return was generated from *six* positions during the period.[44] Rather than compare the impact of an individual S&P 500 put option against an individual equity position, the Division is forced to combine the six positions and then claim that the total aggregated return was greater than one equity position.

Moreover, the Division's criticism of the references to individual stocks in the periodic filings ignores the context of these disclosures. In both of the reports at issue, Swanson highlighted particular areas of the equity portfolio that had most impacted the Fund's performance and then mentioned individual stocks within these sectors to provide investors with an understanding of the Respondents' decision-making. For example, Swanson noted for the 2007 Annual Report that the "sectors that added the most to positive performance were industrials, consumer discretionary and information technology."[45] These three sectors generated 4.54% to performance during the period[46] – far more than the total contribution from

[43] Opposition Brief at 15.
[44] Ex. 139 at Table 1, Panel A.
[45] Ex. 14 at CLAY015492.
[46] Ex. 61 at FAM00016326-30.

the short index put options and short variance swaps. As an explanation of the Fund's large position in information technology, Swanson noted that the Respondents were "especially interested in the large data streams moving between consumers and content providers" and cited Apple Inc. as a demonstrative example.[47]

B. *The Description of the Derivatives as a Hedge that Provided Downward Protection Was Accurate*

The Division also asserts that the periodic filings were misleading by claiming that the portfolio had been hedged for downside protection throughout the relevant period.[48] In fact, this description of the investments at issue as a hedge was entirely accurate and was based on the fact that these derivatives had been providing precisely the type of downside protection suggested in the filings.

Riad's extensive research showed that the variance swaps generated profits during steep market declines.[49] Similarly, FAMCO's internal analyses demonstrated that the short index put strategy would generate profits even in declining markets.[50] Significantly, Prof. Spatt also validated the idea that these investments could be viewed as a hedge.[51]

Most importantly, the notion that these derivatives could provide downside protection was borne out repeatedly before the financial crisis. Prior to July 2008 – when the 2008 semi-annual report was released – the HCE Fund entered into ten short index put transactions that were held during a period when the market declined.[52] *Every single one of these short index put options made money for the Fund.*[53] In addition, a variance swap closed in July 2008 was held

[47] Ex. 14 at CLAY015493.
[48] Opposition Brief at 30-31.
[49] Tr. 2200:18-22. *See also id.* at 2199:19-22; *id.* at 2199:23-2200:3.
[50] *See id.* at 2170:17-21.
[51] Tr. 3279:5-9; *id.* at 3279:18-3280:2.
[52] *See* Ex. 139 at 121 and Exs. 144 and 145.
[53] *Id.* In one case, the market decreased by more than five percent during the month when the short index put option was outstanding, while in another instance the market declined nearly 4.5%. Tr. 2205:3-15.

during a period in which the stock market declined nearly 7.5% but the trade generated more than $400,000 in profit for the Fund.[54] In short, it was entirely appropriate for Swanson to state – based on his understanding of the derivatives, the research that had been performed on these investments, and the outcome from these trades – that the Respondents had engaged in a "macro-hedging strategy" that provided downside protection.

The evidence also established the Respondents legitimately believed that these descriptions were accurate. For example, *internal* attribution reports – where there was no incentive to deceive anybody – included short index put options and short variance swaps under a section entitled "hedging strategy."[55] Similarly, Riad explained to an employee at Merrill Lynch that the Fund had been "utilizing SPX [S&P 500 Index] Put selling *as a hedging tool* . . ."[56] Again, there was no motivation to mischaracterize these strategies with sophisticated third-party investment professionals.

Significantly, a Claymore lawyer specifically considered the language describing the derivatives as a hedge and determined that the wording was appropriate.[57] On June 27, 2008, Delony emailed a group of Claymore personnel regarding the HCE Semi-Annual report[58] and noted that "[i]n Q5, we say that the portfolio was 'strategically hedged for additional downside protection.' Steve [Hill] asks whether we need to describe how. We have referred to the hedging in the past without explaining how the hedge actually works. Your thoughts?"[59] Claymore in-house counsel responded that a definition of these strategic hedges was not necessary since he was "comfortable with the way it presently reads."[60] The fact that this team

[54] Ex. 86 at FAM00089833; Ex. 144.
[55] Ex. 48 at FAM00001118.
[56] Ex. 58. *See also* Riad Testimony at 2205:21-2207:3 ("I always consistently describe it as a hedging tool.").
[57] *See* Ex. 362.
[58] *Id.*
[59] *Id.*
[60] *Id.*

discussed and ultimately approved the description of the strategic transactions at issue serves as further evidence of the reasonableness of Respondents' description.

C. *The Respondents Were Open with All Relevant Parties During the Preparation of the Periodic Reports*

The Division asserts that the Respondents attempted to mislead investors by suggesting in the periodic reports that the Fund's success was the "result of strong stock picking and the covered call strategy"[61] and by hiding key facts regarding the derivatives investments. In reality, the evidence clearly demonstrated that the Respondents made no attempt to hide anything from investors, the adviser, or Fund counsel during the preparation of the periodic filings.[62]

A striking example of the Division's approach to the evidence can be seen in its treatment of the variance swap disclosure in the 2007 Annual Report. The Division criticizes the fact that the "portfolio holdings list excluded any mention of HCE's variance swap position which existed at the time," even though "Riad signed a certification that the . . . portfolio of investments was a complete and accurate list of the securities held in the Fund as of the report date."[63] However, the Fund's Chief Financial Officer explained that an instrument such as a variance swap is not considered as part of the portfolio of investments.[64] The Respondents nonetheless included a footnote in the Annual Report describing the variance swap.[65] In other words, *the Respondents disclosed this variance swap position even though there was no obligation to do so*. The Division attempts to transform this clear demonstration of the Respondents' good faith and compliance with well-established reporting guidelines into evidence of some sort of nefarious intent.

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[61] Opposition Brief at 16.
[62] *See* Opening Brief at 13-24.
[63] Opposition Brief at 17 and n. 13.
[64] 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.").
[65] Ex. 67 at CLAY015503.

Swanson's forthrightness regarding these investments is also demonstrated by a July 2008 email exchange.[66] As the 2008 semi-annual report was being finalized, Delony asked Swanson a question about the equity and covered call portion of HCE's portfolio. In his response, Swanson provided the requested performance information but asked that she "[p]lease keep in mind that this . . . does not include the call on call, hedges, or volatility trades."[67] In other words, Swanson specifically highlighted the fact that the figures he was providing did not include the derivatives transactions. If he were trying to hide these investments from Delony, then there would have been no reason to emphasize these strategies to her in the email.

Riad was similarly open about the contribution of these investments. In an exhibit cited by the Division in its Brief,[68] Riad sent an email to the Assistant General Counsel at Claymore in December 2007 emphasizing that the "OTC [derivatives] strategies have contributed greatly to the strong performance of HCE this year."[69] Again, it is clear that there was no effort on the part of the Respondents to hide these investments from any of the relevant parties.

IV. THE DIVISION CANNOT REMEDY THE INITIAL DECISION'S FAILURE TO PROPERLY CONSIDER THE RESPONDENTS' ADVICE OF COUNSEL DEFENSE

The Initial Decision states in a footnote that "Respondents do not claim that they were relying on the advice of counsel."[70] As discussed in detail in the Respondents' Opening Brief, that statement is incorrect.[71] As a result, no consideration whatsoever was given to the

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[66] Ex. 289.
[67] *Id.*
[68] Opposition Brief at 16.
[69] Ex. 316 at SEC_FAM Exam 0076787.
[70] Initial Decision at 32, n. 39.
[71] The Respondents filed a motion to correct this manifest error in the Initial Decision, but that motion was denied, not because the Initial Decision was accurate, but rather only because "[t]he quoted sentence . . . is in the Conclusions of Law section of the ID, not the Findings of Fact." *In the Matter of Mohammed Riad and Kevin Timothy Swanson,* File No. 3-15141, Order (May 15, 2014).

Respondents' advice of counsel defense even though it was repeatedly advocated throughout the proceeding.

The Division's Brief does not dispute that Respondents asserted an advice of counsel defense, but asks the Commission to reject this defense because the Respondents supposedly did not disclose sufficient information to the attorneys to obtain their informed advice and failed to ask for advice on certain key issues. Again, the Division cannot cure, through a post hoc justification, a manifest error in the Initial Decision.[72]

The Division's Brief also cites cases holding that advice of counsel is not a defense where legal standards are clear and well-known.[73] Elsewhere, the Division's Brief argues that "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?"[74] In fact, both of these points are related and inapplicable in this case. As noted above, the Commission's own Director of Investment Management has acknowledged the complexity of the relevant disclosure requirements.[75] The Commission has also issued a concept release requesting comments to help clarify a host of issues relating to the use of derivatives by investment companies, including the disclosure of such investments.[76] Thus, the Commission itself has acknowledged that the law governing investment companies' uses of derivatives, including the disclosure of those instruments, is highly complex and perhaps flawed. This is

[72] *SEC v. Chenery Corp.*, 332 U.S. 194, 196-7.
[73] Opposition Brief at 27.
[74] Opening Brief at 9.
[75] *See* n. 35 *supra.*
[76] Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Invest. Co. Act Rel. 29776 (Aug. 31, 2011).

hardly an area where two non-attorneys can fairly be held liable despite seeking and obtaining legal advice on these difficult disclosure issues.

For the first time in this proceeding, the Division's Brief also makes the argument that even if the Respondents establish an advice of counsel defense, this defense would be irrelevant to negligence claims.[77] Since negligence is the failure to exercise reasonable care,[78] Respondents' good faith efforts to consult with legal counsel regarding these issues should be taken into account when evaluating the reasonableness of their actions – particularly in light of the complexity of the disclosure obligations at issue.

V. THE DIVISION CANNOT REMEDY THE INITIAL DECISION'S FAILURE TO ADDRESS THE PROBITY OF PROFESSOR SPATT'S EXPERT OPINIONS

The Respondents demonstrated in their Opening Brief that Professor Chester Spatt presented highly credible and competent expert opinions on issues that are central to this case.[79] The Initial Decision only offers one reference to Professor Spatt, in a single sentence within a footnote that makes no finding as to his opinions.[80] As with the failure to consider the opinions of Baris, it was erroneous for the Initial Decision to completely ignore the fact that a former Chief Economist of the Commission found the actions of the Respondents to be reasonable.

The Division's Brief does not address the failure of the Initial Decision to evaluate the opinions of Spatt. Instead, the Division attempts to offer a justification for the Initial Decision's oversight by asking the Commission to find that Professor Spatt's expert opinions "are not based on any expert analysis."[81] But just as with Baris, the Division's Opposition Brief cannot correct an error in the Initial Decision.[82]

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[77] Opposition Brief at 27-28.
[78] Initial Decision at 28.
[79] Opening Brief at 27.
[80] Initial Decision at 12, n. 12.
[81] Opposition Brief at 24-26.
[82] *See* discussion *supra* at §II.C.

Furthermore, the Division is mistaken in its claim regarding the quality of Prof. Spatt's analysis. The Division's Brief argues that Professor Spatt's expert opinions should be found by the Commission to lack validity because "he could not explain what Riad was doing"[83] and "never actually analyzed any of HCE's trading or verified the accuracy of any of Respondents' work."[84] Such claims are contradicted by the record. First, it is simply false to assert that Spatt never analyzed HCE's trading. In fact, the list of materials reviewed by Spatt included FAMCO's internal analyses that led to the trading strategies at issue as well as a list of all the index put and variance swap trades entered by the HCE Fund during the relevant period.[85] Although Spatt acknowledged during testimony that he had not performed any *supplementary* quantitative analysis of these transactions, he nonetheless evaluated their actual trades – and the analysis that demonstrated the reasonableness of their trading strategy – rather than "simply rel[ying] on Respondents' own representations of what they had done."[86]

The Division also criticizes Spatt for claiming that the risk of loss from the short index put options and short variance swaps was "limited to a 0.5% chance of a 5% loss" when in fact that potential risk from two particular options and swaps may have been trivially higher than 0.5%.[87] In fact, Spatt's opinion was perfectly consistent with these potential risk figures: as he explained multiple times in his Expert Report, the Respondents sized the trades so that the risk of a five percent loss was "*roughly* 0.5%."[88] It is unwarranted to suggest that a potential loss of 0.6% or

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[83] Opposition Brief at 26.
[84] Opposition Brief at 25.
[85] 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"], Appendix B.
[86] Opposition Brief at 25.
[87] *Id.*
[88] Spatt Report at 11, 16

0.7% – as opposed to the "roughly 0.5%" figure offered by Spatt – demonstrates that "one of the key underlying assumptions of [his] opinion has been proven to be inaccurate."[89]

The Division is similarly mistaken in asserting that Spatt had no knowledge or understanding of the adjustments made by Riad to account for various market factors.[90] Spatt reviewed the frequency tables in which the Respondents' had taken into account mean reversion of volatility and the likelihood of a significant market decline.[91] Spatt testified that "[t]here were documents that [he] saw that they had the adjusted frequencies" and "they seemed reasonable."[92] In other words, Spatt reviewed and considered precisely the issue that the Division alleges he overlooked.

VI. THE DIVISION IMPROPERLY CHARACTERIZES OTHER ARGUMENTS AND KEY EVIDENCE

A. HCE Was Not a Conservative Covered Call Fund

Three pages of the Division's Opposition Brief are spent attacking a straw man.[93] The Division notes that the "Respondents contend that HCE was always planned and marketed as more than a conservative covered call fund."[94] Indeed, the Respondent's brief made clear that – while still primarily a covered call fund – HCE was established to engage in investments beyond the conservative, "plain vanilla" investment parameters of a typical covered call fund.[95] In other words, *within the universe of covered call funds*, it was widely understood – and, in fact, intended – that HCE would fall on the less conservative end of the spectrum.

In its response to this argument, the Division does not even try to demonstrate that HCE was at the conservative end of the covered call spectrum. Instead, the Division merely asserts as

[89] Opposition Brief at 25.
[90] *Id.*
[91] *See* Spatt Report at B-3.
[92] Tr. 3456:17-19.
[93] Opposition Brief at 4-6.
[94] *Id.* at 4.
[95] Opening Brief at 8-13.

its rebuttal a point that is uncontroverted: namely, that HCE was a covered call fund. But the Respondents never argued that "HCE was something other than a covered call fund,"[96] as the Division claims. Instead, the Respondents claimed that the Fund was *less conservative, and had greater investment flexibility,* than a typical covered call fund.

B. The Supposed Motive Created by the Fund's Dividend Target Is Baseless

The very first sentence of the Division's Brief claims that "Respondents . . . implemented a new investment strategy in order to meet the annual dividend targets of [HCE]."[97] The Division thus places the supposed pressure to maintain the Fund's dividend at the center of the Respondents' motive for the alleged fraud.

In fact, the Initial Decision flatly rejected this theory – and rightly so. The Respondents easily met the dividend target before they invested in the derivatives trades – and that target was lowered in July 2008, *before any of the derivatives trades that caused substantial losses occurred.*[98] Pressure to maintain the dividend did not exist and no evidence suggests otherwise.

C. The Respondents Reasonably Concluded that the Risks from the Derivatives Strategies Were Minimal

In its attempt to demonstrate that the Respondents were aware of the risks from the derivative strategies, the Division repeats many of the same mistakes as the Initial Decision. As noted in the Opening Brief, the Initial Decision entirely ignores the risk-limiting strategies implemented by the Respondents to minimize the potential of loss from the investments at issue.[99] Similarly, the Division fails to discuss any of these additional steps. As a related point, the Initial Decision highlights academic articles demonstrating the risk of at-the-money short index put options, whereas the Respondents specifically wrote the positions far out of the money

[96] Opposition Brief at 6.
[97] *Id.* at 1.
[98] Initial Decision at 7, n. 7.
[99] Opening Brief at 26-7.

to prevent the downside losses identified in these papers.[100] The Division repeats this error.[101] The Division goes beyond the Initial Decision and claims that "Swanson recognized the risk associated with maintaining the written put and short variance swap exposure."[102] Even the Initial Decision does not suggest that Swanson had such awareness because the evidence so clearly demonstrated precisely the opposite.[103]

D. HCE's Board Was Appropriately Informed

The Division argues that the Respondents misled the Board by failing to disclose their put and swap strategy to the HCE Board.[104] These assertions are factually incorrect.

As an initial matter, it is important to recognize that the Respondents discussed these investments with the Board from the Fund's inception[105] and Board members clearly recognized that these instruments were being employed as part of an ongoing strategy.[106] The Division then claims that "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."[107] In fact, the Chairman of the Board testified that Riad quantified the potential loss from the investments[108] and another Board member recalled that the Respondents had specifically emphasized that these investments were contributing positively to Fund

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[100] *See* Tr. 2170:17-21; *id.* at 2168:19-2170:6.

[101] Opposition Brief at 22. For example, the Division cited an academic paper that noted that "[t]here is no arguing that selling naked puts could be very risky" and that "put sellers may occasionally incur huge losses." In fact, this paper referred to at-the-money written put options – a strategy that the Respondents avoided in favor of the safer, out-of-the-money approach.

[102] *Id.* at 24.

[103] *See, e.g.*, Initial Decision at 11, n. 9 ("Riad told [Swanson] that the trades were part of an effort to try to lower the volatility of the portfolio."); *id.* at 11, n. 10 ("Swanson was led to believe that the written puts were relatively low risk investments."); *id.* at 12, n. 11 ("Swanson . . . was told that they . . . would diversify and reduce the volatility of the portfolio; *id.* at 14 (Swanson testified that a goal associated with the macro hedging strategy was to reduce volatility).

[104] Opposition Brief at 10.

[105] *See, e.g.*, Tr. 2990:9-13.

[106] Tr. 2920:7-10; *id.* at 2628:10-11 and 2629:18-19.

[107] Opposition Brief at 10.

[108] Tr. 3016:5-11; *id.* at 3018:4-7.

performance.[109] The Division asserts that the Respondents misleadingly describing these positions as protective investments.[110] As discussed above, FAMCO's research had demonstrated that these derivatives could serve as a hedge to the portfolio, and the investments had, in fact, provided downside protection for an extended period.[111] In short, there is no evidence that the Respondents misled the Board in any way.

VII. CONCLUSION

For the reasons set forth above, it is respectfully submitted that the Commission should reverse the Initial Decision and dismiss this enforcement proceeding against the Respondents.

Dated: September 12, 2014

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[109] Tr. 1013:10-16.
[110] Opposition Brief at 10.
[111] *See discussion supra* at §III(b).

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 6,997 words, excluding the parts of the brief exempted by the Rule.[1]

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[1] 17 C.F.R. §201.450 (c).