UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 78049A / July 7, 2016

INVESTMENT ADVISERS ACT OF 1940
Release No. 4420A / July 7, 2016

INVESTMENT COMPANY ACT OF 1940
Release No. 32146A / July 7, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-15141

In the Matter of

MOHAMMED RIAD and
KEVIN TIMOTHY SWANSON

AMENDED OPINION OF THE COMMISSION

CEASE-AND-DESIST PROCEEDING

INVESTMENT ADVISER PROCEEDING

INVESTMENT COMPANY PROCEEDING

Grounds for Remedial Action

Antifraud Violations

Respondents, who were associated with registered investment adviser, made fraudulent misstatements and omitted material facts in a closed-end fund's shareholder reports regarding the fund's use of new derivative investments and their effect on the fund's performance and risk exposure. *Held*, it is in the public interest to bar respondents from associating with a broker, dealer, investment adviser, municipal securities dealer, or transfer agent; order respondents to cease and desist from committing or causing any violations or further violations of the provisions violated; order disgorgement; and assess civil penalties of $130,000 against each respondent.

APPEARANCES:

Richard D. Marshall of Katten Muchin Rosenman LLP, for respondents.

Robert M. Moye, *Benjamin J. Hanauer*, and *Jeffrey A. Shank*, for the Division of Enforcement.

Petition for review filed:	June 4, 2014
Last brief received:	February 15, 2016
Oral argument:	March 16, 2016

I. **Introduction**

Respondents Mohammed Riad and Kevin Timothy Swanson appeal from an administrative law judge's initial decision finding that they violated the antifraud provisions of the securities laws while associated with an investment adviser responsible for managing the portfolio of a closed-end investment company, the Fiduciary/Claymore Dynamic Equity Fund (the "Fund").[1] Based on our independent, *de novo* review of the record, we find that both respondents committed fraud by misrepresenting and omitting material information about new derivatives in the Fund's 2007 annual and May 2008 semiannual reports.

The Fund's registration statement, which became effective in 2005, portrayed the Fund as principally using a covered-call investment strategy. Such a strategy, which involves taking a long position in the underlying security while writing call options representing the same number of shares, is relatively conservative in that investors give up return in rising equity markets for somewhat better performance in other conditions. Beginning in July 2007, Riad caused the Fund to regularly employ two new types of derivative instruments that respondents expected would contribute substantially to the Fund's performance and knew would expose the Fund to a substantial risk of losses in the event of market turmoil or a sharp decline in stock prices. Use of these derivatives eventually led to total investor losses of $45 million.

Despite this change, respondents, who shared ultimate responsibility for the Question and Answer sections in the 2007 and May 2008 reports, mischaracterized the Fund as being "hedged," when in fact the use of these new kinds of derivatives added to risk. Respondents' description of how the Fund would pursue its investment objective was misleading in that it failed to discuss the Fund's systematic, ongoing use of these instruments which, as respondents would later admit, had been adopted "as a means of sustaining [the Fund's] high dividend payout" target. And respondents again misled by omission in that they did not mention the derivatives even though they had a greater impact on the Fund's returns than the equity- and sector-selection decisions highlighted in the Fund's reports.

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[1] *Mohammed Riad and Kevin Timothy Swanson*, Initial Decision Release No. 590, 2014 WL 1571348 (Apr. 21, 2014).

We also find that Riad caused the Fund's violation of Investment Company Act Rule 8b-16. As we discuss in this opinion, Rule 8b-16(a) requires the filing of an amended Form N-2 registration statement on an annual basis. Rule 8b-16(b) exempts a closed-end fund from this requirement as long as the fund includes certain information in its annual shareholder reports, including "material changes in . . . investment objectives or policies" and "material changes in the principal risk factors associated with investment" in the fund.[2] The Fund's registration statement was never updated and the 2007 annual report did not disclose how the Fund was using the derivatives to achieve its investment objective or that their use significantly increased the risks to which the fund was exposed.

For these violations, respondents are ordered to cease and desist from violations of the securities laws, to disgorge ill-gotten gains, and to each pay a civil penalty of $130,000. Riad had more involvement in designing, executing, and monitoring the Fund's use of the new types of derivatives. Given his intimate understanding of their characteristics, we believe that he bears comparatively more culpability with respect to the disclosure violations and we therefore permanently bar him. We bar Swanson as well, but with the right to reapply after two years.

Finally, we reject respondents' challenges to the constitutionality of the Commission's administrative forum. We conclude that Commission ALJs are not "inferior officers" who must be appointed in the manner specified by the Appointments Clause of the U.S. Constitution. We also conclude that our decision to pursue this enforcement matter in the administrative forum as opposed to federal court did not violate respondents' right to equal protection.

II. **Background**

On December 19, 2012, we instituted administrative proceedings pursuant to Section 21C of the Securities Exchange Act of 1934, Sections 203(f), and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940.[3] The Order Instituting Proceedings alleged that the Fund used investment strategies that were not adequately disclosed and charged respondents with violating the antifraud provisions of the Exchange Act and the Investment Company Act (and rules thereunder), as well as aiding and abetting and causing the Fund and its advisers to violate the antifraud and disclosure provisions of the Investment Company Act and the Advisers Act (and rules thereunder). We find that the testimony and evidence introduced during the course of the 11-day hearing before the ALJ establishes the following facts by a preponderance of the evidence.

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[2] 17 C.F.R. § 270.8b-16(b). Form N-2 and Rule 8b-16(b) refer to a closed-end fund's "investment policies" or principal portfolio emphasis; in contrast, Form N-1A, the analogous registration statement for open-end funds, refers to a fund's "investment strategies." Respondents and the Division of Enforcement (as well as their respective experts) use these terms essentially interchangeably, as do many of the emails and other documents in the record. We discuss the relationship between these disclosure concepts *infra* Section III.D.

[3] *Mohammed Riad and Kevin Timothy Swanson*, Securities Exchange Act Release No. 68467, 2012 WL 6608204 (Dec. 19, 2012).

A. Background concepts and terminology

The Fund was originally conceived as a covered-call fund. The central issue in this proceeding is whether in the Fund's 2007 annual and May 2008 semiannual reports respondents adequately disclosed the Fund's use of two new kinds of derivatives—writing naked put options on the S&P 500 index and entering into short variance swaps. To provide context for what follows, we provide an overview of relevant concepts and terminology.

1. Options generally

An American-style call option is a contract that gives the purchaser the right, but not the obligation, to buy shares of a particular asset from the seller (also called the writer) of the call at a specified strike price on or before the option's expiration date. A put option, on the other hand, gives its purchaser the right to sell an asset to the writer of the put at the strike price on or before the expiration date. The buyer of an option must pay the seller a specified amount of money upfront, called the premium, which the seller is entitled to keep regardless of whether the buyer decides to exercise the option.

Options may be described as "in the money," "out of the money," or "at the money." A call is in the money when the strike price is lower than the market price of the underlying stock, whereas a put is in the money when the strike price is higher than the market price of the underlying stock. An option is out of the money when the opposite is true and an option is at the money when the strike price is equal to the stock's current market price.

The sensitivity of an option to changes in price of the underlying security can be characterized by certain variables. Two are relevant here, delta and gamma. The *delta* of an option is the rate of change in its price with respect to the price of the underlying security. When an option is deep *in* the money, a small change in the price of the underlying security will cause a nearly equal change in the price of the option; the delta, in other words, will be very close to 1 or -1. On the other hand, the delta of a deep *out* of the money option is close to 0 because the option's price is not significantly affected by small changes in the price of the underlying security.

The use of the qualifier small is important, for the delta of an option *itself* changes as the price of the underlying security gets closer to being in the money; this rate of change is called *gamma*. As an option moves from out of the money to in the money—or from deep out of the money to less out of the money—the delta of a call rises toward 1 and the delta of a put falls toward -1, and gamma measures how quickly this happens. Thus, the writer of a option is exposed to not only the risk of losses associated with changes in the price of the underlying security, but also to the risk that those losses will be magnified when further changes in that underlying price result in a rise in delta and therefore translate into a still greater impact on the option's value. This is called gamma risk, and option writers are more exposed to this risk when the positions are deeper out of the money.

2. Covered versus uncovered option positions

The difference between a covered and an uncovered (or "naked") option position is central to this proceeding. A covered-call position involves taking a long position in the underlying security while simultaneously writing call options representing the same (or fewer) number of shares against it; a covered-put position analogously couples taking a short position in the underlying security and writing puts representing the same (or fewer) number of shares. Such positions are "covered" because, in the event the option is exercised, the investor already has a corresponding position in the underlying security that must be bought (in the case of a covered call) or sold (in the case of a covered put). On the other hand, an option position is uncovered when the investor does not at the same time own the underlying security, and as a result, when the option is exercised must either buy or sell that security at the strike price.

A covered-call investment strategy is relatively conservative—*i.e.*, less risky than investing in the underlying security alone—in that investors give up return in strongly rising equity markets in exchange for somewhat better performance in other conditions. To be specific, the investor receives a premium for writing the calls. If the market price of the underlying security goes down, the loss on the long equity position is cushioned to some extent by the premiums earned for writing the call. Also, when the stock price falls, the call option drops in value. Because the writer of a covered call has a short position in the call, a decrease in the value of the option is effectively an increase in the value of the short option position. If the market price of the underlying security goes up, the investor participates in the increase, but only up to the strike price, at which point the option is exercised at the discretion of the option holder and assigned to the writer of the call; the writer then has to sell the underlying security at the strike price. Thus, a covered-call strategy tends to have more stable performance than a pure equity strategy. This feature, along with consistent income generation, makes covered-call funds popular among conservative investors like retirees.

A covered call-on-call strategy involves purchasing a deep-in-the-money call option (which has similar risk and return characteristics to buying the equity outright) and writing a call option against it. It is a variation of the covered-call strategy in which a deep in the money call option takes the place of the underlying equity asset. This strategy is not significantly more risky or aggressive than a traditional covered-call strategy. As Swanson acknowledged, it has the "same profile as a covered call" strategy. In fact, in some respects, it has *more* downside protection than a covered-call strategy, because if the stock price falls below the strike price of the long, deep-in-the-money call option position, the call can simply not be exercised.

Writing naked, or uncovered, options can be considerably riskier than pursuing either a covered-call or covered call-on-call strategy. The writer of a naked put option is effectively insuring the holder of the option against any decline in the price of the underlying security below the strike price.[4] A naked put has the same basic payoff profile as a covered call in the sense

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[4] The potential loss for a naked call position is unlimited because the price of the underlying security may climb any amount above the strike price of the option, whereas the potential loss for a naked put position is bounded because the price of the underlying security cannot go below zero. For additional background, see, for example, *William J. Murphy*, Exchange Act Release No. 69923, 2013 WL 3327752, at *11 (July 2, 2013); *Clyde J. Bruff*,

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that each position loses money in lockstep with the underlying asset once that asset has declined substantially in value. That is, once the price of the underlying security is below the strike price of the put, any further decline in that security's price will cause a one-for-one decline in the value of the naked put position.

The size of a short put position is directly linked to its riskiness. Thus, when a fund holds a very large put position, it will be extremely sensitive to sharp declines in the value of the underlying security. If a fund segregates assets equal only to the mark-to-market liability of its put positions, rather than the puts' notional value, it will be able to establish a larger put position.

3. Volatility, the effect of volatility on option prices, and variance swaps

Volatility refers to how a security's price changes over time. It is measured by a related figure called variance, which is calculated as the annualized average of the squared daily returns of the underlying security; variance is volatility squared. Volatility is conceptually distinct from performance. In other words, two different stocks might perform the same over a given period of time—*i.e.*, both may start and end the period at the identical price—yet have very different volatility. The highly volatile stock might reach the ending price by spiking upwards and downwards, while the less volatile stock might steadily and gradually climb (or fall) towards the ending price by the same amount each day. As a general rule, though, market downturns tend to coincide with periods of high volatility.

For purposes of this proceeding, we are concerned with two aspects of volatility: the relationship between volatility and option values and the characteristics of variance swap contracts. Typically, option values are higher when the underlying security is more volatile. When the price of a security is expected to fluctuate significantly, the likelihood that it will rise substantially above (in the case of a call option) or fall substantially below (in the case of a put option) the strike price of the option is greater than when the price is stable. Thus, when the expected future level of price volatility for a security rises, the options written on that security also will tend to increase in value, all else being equal. The holders of those options will profit, while the options writers—*i.e.*, those who hold short options positions—will lose. As a consequence, covered-call strategies are vulnerable to increases in volatility.

A variance swap is a cash-settled contract where the direction and magnitude of payment is based on the volatility experienced by the underlying security over a specified period. For the variance swaps employed by the Fund, no premium was exchanged at the outset of the transaction.[5] If the realized, or actual, variance is higher than the agreed upon variance strike

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Exchange Act Release No. 31141, 1992 WL 224091, at *4 & n.19 (Sept. 3, 1992); *Ronald L. Brownlow*, Exchange Act Release No. 18257, 1981 WL 28137, at *2 n.2 (Nov. 16, 1981).

5 The variance strike price was based on the current level of the VIX index, which is a measure of the market's expectation for future volatility. With the strike price fixed in this fashion, there was no initial cash outlay for the swap.

price, the writer—who is "short" volatility—pays the purchaser an amount that is proportional to the difference between the two quantities; otherwise, the purchaser pays the writer. The size of a swap contract is specified by a quantity called *vega*, which is essentially a multiplier applied to that difference.[6]

Gains from long variance positions and losses from short positions increase non-linearly as volatility rises. If volatility rises substantially (*e.g.*, from 20% to 30%), the swap is very profitable for the purchaser holding the long position; on the other hand, if volatility falls by the same amount (say, from 20% to 10%), the writer with the short position has a smaller gain.[7] Because of this asymmetry in payoffs, variance swaps are priced by the market such that the holder of the short position can be expected to profit a smaller amount most of the time and lose a much larger amount more rarely.

B. **The Fund, its adviser and subadviser, and respondents**

The Fiduciary/Claymore Dynamic Equity Fund was a closed-end investment company whose shares were offered to investors pursuant to a registration statement filed with the Commission in April 2005.[8] Claymore Advisors, LLC acted as the Fund's investment adviser from the Fund's inception in 2005 through its liquidation in 2009 and also served as the Fund's administrator from 2006 through 2009. In these capacities, Claymore was responsible for providing legal, compliance, and marketing support to the Fund and preparing its periodic filings. Pursuant to a subadvisory agreement, Claymore delegated some of its duties, including responsibility for managing the Fund's portfolio, to Fiduciary Asset Management, LLC ("FAMCO"), which was also a registered investment adviser. FAMCO thus acted as the Fund's subadviser from 2005 through 2009. The subadvisory agreement required FAMCO to manage the Fund in accordance with the Fund's "investment policies, objectives, and restrictions . . . as stated in the [Fund's] Prospectus." It also required FAMCO to keep the Fund and Claymore informed of "developments materially affecting" the Fund.

During the period at issue, from April 2007 to October 2008, respondents Riad and Swanson worked for FAMCO as portfolio managers of the Fund. As set forth in FAMCO's policies and procedures, they were responsible for, among other things, making sure that the

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6 The payoff at the end of the period is the product of the "variance notional" and the difference between the realized volatility squared and the swap strike squared. By convention, vega is defined as twice the product of the variance notional and the variance swap strike.

7 For example, suppose that a 400,000 vega variance swap had a variance strike of 20. If realized market volatility was 10, the short variance holder would profit by $3 million (*i.e.*, the variance notional of 10,000 multiplied by the difference between 20 squared and 10 squared). But if realized market volatility deviated from the swap price by the same amount in the other direction, the short variance holder would lose $5 million (*i.e.*, 10,000 multiplied by the difference 30 squared and 20 squared).

8 The Fund was also referred to as "HCE," but we will call it the Fund throughout.

Fund's investments were "consistent with the disclosures set forth in the [Fund's] prospectus[] and statement[] of additional information."

Riad joined FAMCO in 1997. By 2007, he was a principal and managing director of the firm. During the period at issue, Riad was FAMCO's chief derivatives strategist. He was a portfolio manager of the Fund from its inception in 2005. As such, he was responsible for, among other things, later developing, directing, and managing the Fund's use of naked index puts and short variance swaps. For each of the Fund's required periodic reports, Riad provided a signed certification to Claymore stating, *inter alia*, that the securities in the portfolio were purchased in compliance with the investment parameters set forth in the Fund's prospectus.

Swanson joined FAMCO in 2003. He was added as a co-portfolio manager to the Fund in late 2005 and had responsibility for the equity, covered call, and call-on-call portions of the portfolio. Although Swanson was not involved in the Fund's naked index put and short variance swap transactions from the "standpoint of making the actual trades," he was aware that the Fund was making use of them. He monitored both individual transactions and the derivatives' overall contribution to the Fund's performance. As he testified, he knew "exactly what those gains were" from "each of those different" types of investments employed by the Fund, including the underlying covered-call portfolio, the "short puts," and the "short variance swaps." On occasion, he expressed concern about the Fund's exposure and suggested to Riad that the Fund "dump" or scale back the positions to "help reduce risks."

Riad and Swanson were paid a fixed salary and a bonus that was not directly tied to the Fund's performance. Riad also received profit-sharing payments and equity distributions from FAMCO. In 2007 and 2008, FAMCO paid Riad compensation totaling about $1.88 million and it paid Swanson a total of about $624,000.

In October 2008, the Fund's board removed respondents as portfolio managers. Afterwards, Riad left FAMCO and started his own investment advisory firm in Missouri. Swanson remained at FAMCO until December 2010 and then served as the Chief Investment Officer for a St. Louis-based bank until 2012.[9] Both respondents testified that they intend to remain in the investment management field if opportunities are presented to them. Aside from this proceeding, respondents have a clean disciplinary record.

C. The Fund was originally conceived and marketed as a covered-call fund

It is "uncontroverted," as respondents acknowledge, that the Fund was marketed as covered-call fund. Although the parties agree on this point, respondents assert that the Fund was "on the less conservative end of the spectrum" within the "universe of covered-call funds" and thus had "greater investment flexibility." As we will explain, even assuming the Fund did have more "investment flexibility"—*i.e.*, in the sense that any individual naked index put or short variance swap position was not *forbidden* by the Fund's 2005 registration statement—we

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[9] The record does not contain any information about respondents' current activities.

conclude the Fund's subsequent disclosures in its 2007 and May 2008 reports were inaccurate and misleading.[10] The Fund began employing these derivatives on an ongoing basis in 2007, which had a significant effect on the Fund's returns and materially increased the Fund's risk. This rendered a number of statements in the Fund's annual and semiannual report misleading, including the description of how the Fund was pursuing its investment objectives.

For context, we begin by describing the Fund's Form N-2 registration statement (which consists of the Fund's prospectus and Statement of Additional Information ("SAI")) and the Fund's marketing communications. In these materials, the covered-call features of the Fund were highlighted throughout. None of these documents discloses the possibility that the Fund might use naked puts and variance swaps to boost returns or the risk of such derivatives.[11]

The full name of the Fund was the "Fiduciary/Claymore Dynamic Equity Fund."[12] Its prospectus stated the "Fund's objective" was to "provide a high level of current income and current gains and, to a lesser extent, capital appreciation." It sought to achieve this objective by investing in a "diversified portfolio of equity securities and writing . . . call options on a substantial portion of its portfolio securities"—a textbook definition of a covered-call strategy. The prospectus then discussed the basic "tradeoff" involved: The Fund received options premiums upfront, but in exchange the Fund enjoyed "reduced participation in potential future stock price appreciation."

The phrase "covered call" appeared over 70 times in the registration statement, and the covered-call strategy (along with the closely related covered-call-on-call strategy) was the only one discussed under the heading "OPTION STRATEGY." The prospectus provided that at least 80% of the Fund's assets were required to be invested in covered calls; up to 25% could be invested in the covered call-on-call strategy. Besides covered calls, the "Portfolio Contents" section of the prospectus stated that the Fund also could write covered put options on up to 20% of its assets and pursue certain "other income-producing strategies" with another 20% of its assets. But it did not identify writing uncovered puts or short variance swaps as among these

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[10] *See infra* Section III.B.1.b.

[11] The Fund's registration statement does not appear to contain statements that were misleading when made in 2005, since the Fund began using naked puts and variance swaps only two years later. During the period at issue, the registration statement was never amended.

[12] Respondents assert that the inclusion of the word "dynamic' in the "name of the Fund served as the first indication that HCE was meant to be . . . different . . . than simply a covered call fund." Based on the prospectus and other materials, the word "dynamic" is most plausibly understood to modify how the Fund would use covered calls: It meant that the Fund could "write covered call options on varying percentages of the Fund's common stock holdings and with varying option strike prices." Moreover, regardless of what the word "dynamic" in the name of the Fund might suggest, the relevant disclosure documents plainly did not disclose the ongoing use of naked puts and variance swaps or their corresponding risks.

other strategies.[13] Although there was a general reference to “Strategic Transactions,” including derivative contracts and swaps, the phrase “variance swap” did not appear anywhere in the Fund’s registration statement.[14]

Marketing for the Fund also emphasized its covered-call focus.[15] Pamphlets written by Claymore described the Fund as “[u]tiliz[ing] a dynamic call option strategy using varying strike prices and expiration dates.” Like the Fund’s prospectus, these materials indicated that the Fund would invest in equities and make use of covered calls, covered calls on calls, and covered puts. Nowhere in the Fund’s marketing materials was the use of the derivatives at issue mentioned. Claymore’s investor roadshows, which Riad participated in, similarly portrayed the Fund as a covered-call fund. Joseph Gallagher, FAMCO’s Chief Compliance Officer, testified that the covered call-on-call strategy—*not* the use of naked puts or short variance swaps—was the example used to illustrate how the Fund might “creatively use options.” Claymore’s marketing differentiated the Fund from other covered-call funds on the basis of its “dynamic” approach to entering into covered-call transactions and perceived “tax advantage[s].”

Both internally and externally, the Fund benchmarked its performance against the CBOE Buy-Write Index (BXM), which tracked a conventional covered-call strategy based on the S&P 500 index and index options, as well as other covered-call funds.[16] Its “peer group,” according to Claymore marketing materials, included the Madison/Claymore Covered-call fund, a “plain vanilla” covered-call fund offered by Claymore; the First Trust/Fiduciary Covered-call fund, another “plain vanilla” covered-call fund; and the Madison Strategic Sector Premium Fund, which used “[c]overed calls written on individual securities.”

Three witnesses—a financial adviser who invested in the Fund for his clients (Robert Shulman), a closed-end fund analyst at Janney Montgomery Scott LLC (Joseph Witthohn), and a manager of several unit investment trusts that invested in the Fund (Michael Boyle)—testified

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13 The possibility that the Fund might buy or write index options was mentioned under the heading “Additional Investment Policies” in the SAI as part of a three-page list of investments, ranging from warrants to asset-backed securities to options on interest-rate futures contracts.

14 A single sentence of the Fund’s prospectus mentioned the Fund’s authority to enter into swaps of an unspecified type. The Fund, it said, might use “derivative contracts,” including put and call options and “swaps, caps, floors or collars.” This sentence appeared in a paragraph entitled “Strategic Transactions” that was similar to that found in the prospectuses of many other covered-call funds. Elsewhere, the prospectus stated that “[s]uch strategic transactions are generally accepted under modern portfolio management and are regularly used by many mutual funds and other institutional investors.” No further elaboration was provided.

15 Claymore prepared the marketing materials, with some participation from FAMCO. Riad had limited involvement in this process.

16 In internal communications, respondents themselves described the Fund as a “covered-call fund” or a “covered call product” and benchmarked the Fund with other “peer group” funds in the “covered call industry.”

that they viewed the Fund to be a covered-call fund providing a degree of downside protection. They testified that they were unaware that the Fund would pursue returns by using naked puts or variance swaps and that they would not have invested in the Fund had that been the case.

For example, Shulman testified that he did not view the Fund as “aggressive.” He stated that the use of naked puts and variance swaps was not how the Fund “was ever presented to [him]” and that he “would never have invested . . . in that fund had [he] known it was going to take a different direction” than what the prospectus described as the “primary focus” of the Fund. He would not have felt comfortable putting his clients into the Fund if he had been aware of the use of those types of derivatives and the corresponding risks. Witthohn recalled being surprised in the fall of 2008 when the Fund’s NAV dropped so sharply because he did not understand how a fund that was, he thought, 80% invested in equities and covered calls could decline more than the overall market. Boyle, too, agreed that if had known that the Fund was doing things that were “nonstandard for a covered call portfolio,” he would have avoided it. Boyle thought that the Fund departed from being a “plain vanilla” covered-call fund only insofar as the portfolio managers might “vary[] the strike price of the options writing over the covered call portfolio” or “vary a little bit the term of the options.” He testified that that he would not have recommended investing in the Fund had he known it was using derivatives that substantially increased its risk in declining markets or that contributed to a significant portion of its returns. Indeed, Boyle averred that, if he had learned those things before the Fund’s collapse, even while the Fund was doing well relative to its peers, he still would have taken steps to exit the Fund.

D. Riad and other FAMCO employees researched the use of naked puts and variance swaps to enhance the Fund’s performance and to meet the Fund’s dividend target.

The Fund’s goal of paying an annual dividend of 8.5% could be met only if FAMCO could maintain an annualized return of 10% before fees. Historically, this would have required beating the S&P 500’s average annual return by approximately one percent on an ongoing basis. Riad and Swanson understood that this was a challenging task for any “covered call portfolio[]” that had to “sell upside participation in return for short-term income.” Riad believed that the dividend target was unsustainable and, on multiple occasions, he expressed concern to the Board about meeting it. Further, both respondents knew that they could be replaced as portfolio managers if the Fund underperformed. Riad, for example, readily acknowledged that the risk of trailing a benchmark “generates pressure” for a portfolio manager and agreed that being fired would have a negative effect on his career.

Before 2007, the Fund was able to meet its dividend target using the covered-call and call-on-call strategies discussed in the Fund’s registration statement.[17] Yet respondents knew all along that there was a “meaningful” risk that the Fund would have to return capital—thus

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[17] In 2005 and 2006, the Fund also engaged in a handful of index options transactions. It purchased index puts (which hedged its equity positions) and wrote out-of-the-money index calls (which primarily generated options premiums along with somewhat hedging its equity positions).

eroding the Fund's NAV—in difficult market conditions. Thus, as early as 2005, Riad explored the idea of using naked puts and variance swaps to boost the Fund's performance. He believed that they had the potential to provide the portfolio with a "very good risk adjusted return." As Swanson would later put it, these "more sophisticated investment instruments" allowed the Fund to "do more with less" and sustain the Fund's high dividend payout rate.

Riad tasked Sean Hughes, a FAMCO research analyst, to assist in testing and formulating the use of these derivatives. Hughes and other FAMCO employees eventually performed thousands of hours of research and reported to Riad, giving him a detailed understanding of the characteristics of the derivatives. The research showed that using the derivatives on an ongoing basis could be expected to enhance the Fund's risk-adjusted return. In other words, Riad and Hughes were convinced that the Fund would be well compensated for taking on this risk because loss-averse investors tended to overpay for protection, especially during periods of market uncertainty.[18] Thus, writing put options and shorting variance would allow the Fund to profit from this perceived mispricing in the market.

E. The Fund began using naked puts and variance swaps in mid-2007 and continually employed them thereafter

Beginning in the middle of 2007, Riad caused the Fund to make use of the derivatives at issue. Riad managed the trades. He did not seek advice from Bruce Saxon, then the Fund's Chief Compliance Officer, before implementing them. Nor did he consult with any compliance officers at FAMCO, who did not become aware of the Fund's use of naked puts or short variance swaps until late 2007—more than six months after the Fund entered into its first short variance swap. And that discussion came only after Jeffrey Grossman, a FAMCO accountant, went over Riad's head and brought his concerns that the Fund could suffer large losses to FAMCO's compliance department.[19]

Swanson did not make the decision to introduce the derivatives and was not responsible for any specific trades.[20] He was, however, aware of and monitored all of the Fund's positions.

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[18] In the case of variance swaps, respondents believed that investors overestimate future volatility and that volatility tends to be mean-reverting over time. Thus, when expectations of volatility were elevated, volatility was likely to subsequently decline.

[19] Grossman testified that he initially approached Riad about the risks of the naked puts. After Riad dismissed his concerns, Grossman next approached Susan Steiner, a FAMCO compliance manager. Grossman, Steiner, and Steiner's supervisor, Joseph Gallagher, scheduled a call with Claymore to discuss the puts. That call occurred in January 2008; it did not touch upon disclosure issues and addressed only the permissibility of puts under the Fund's registration statement. *See infra* Sections III.B.3 and III.C.2.

[20] There is no evidence that Riad and Hughes shared their detailed research with Swanson, who stated in his investigative testimony that he did not know what risk analysis had been undertaken.

He knew "exactly what those gains were," including "the equity performance and the call performance" and the gains from the "short puts, long puts, short calls . . . or the short variance swaps." Swanson also spoke with Riad about the derivatives and understood how they contributed to the Fund's performance and exposed the Fund to risk. For example, in September 2007, Swanson asked Riad whether it might be "*prudent*" to "take off at least a third of the short-put" position because an unexpected Fed announcement could lead to "trouble." (Emphasis added.) Riad responded that it would be a "volatile ride for the next two weeks." In November 2007, Swanson again suggested to Riad that it might "make[] sense to at least dump the variance swap or the short-puts to *help reduce risks*." (Emphasis added.) Riad demurred, telling Swanson that the positions were too expensive to close out and that they were "boxed in." In April 2008, Swanson asked Hughes to "take a look" at how a variance swap had been "performing over the past couple of days."

For nearly the entire period between July 2007 and October 2008 (except for two months in the spring of 2008), the Fund had naked written put and short variance swap positions open.

1. The Fund's use of naked puts

In April 2007, the Fund began regularly writing deep-out-of-the-money S&P 500 put option contracts. From April 2007 through November 2007, the Fund wrote and purchased put options at the same time, which somewhat offset the risk of the written options. Yet even during this period, there were several occasions when the long put position expired (or was sold) before the Fund exited the short put position, leaving the Fund with naked, written put exposure. Beginning in November 2007, the Fund continued to write put options but (with one exception) ceased offsetting them with purchased options. In the November 2007 to October 2008 period, the Fund had written put exposure 76% of the time with partial offsetting long put option protection only 22% of the time.

The Fund typically wrote short-duration put options that were 6% to 10% out-of-the-money, which reduced the likelihood that the index would drop below the strike price (and thus result in a loss for the Fund) in any given month. But because of the size of the option positions, a sharp drop in the index could result in very large losses. For example, the notional value—*i.e.*, the strike price multiplied by the number of units of the underlying security represented by the option—of the options written during 2008 ranged from 60% to 140% of the Fund's NAV. Thus, the Fund could hypothetically suffer a loss in excess of its NAV if the S&P 500 were to decline to 0.

Another measure of the size of the Fund's option positions was their delta-equivalent risk—in other words, the size of an equivalent long position in the underlying index that represents the same amount of risk as the option position.[21] Riad and Swanson were

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[21] As respondents' expert explained, the delta-equivalent risk answers this question: "If, instead of holding an option on the S&P 500 Index, I actually held stock in the index itself, what is the corresponding amount of equity that I would be holding in my portfolio?"

continually tracking these figures while they were managing the fund. There were positions for which the delta-equivalent index risk was as high as $13.5 million—13% of the Fund's entire portfolio—on the days that the put was written. The overall delta-equivalent exposure was often even greater, because several puts had overlapping holding periods. Furthermore, the positions were subject to gamma risk: Delta-equivalent risk rises non-linearly for put options as the underlying security declines.

The puts played a significant role in the Fund's performance. The Fund received approximately $500,000 to $2.5 million in premiums each month it wrote put options. For example, in the 2007 fiscal year, the Fund's NAV increased 12.9%, compared to the S&P 500's 7.7% return. The written puts contributed approximately 2.0% to the Fund's NAV growth, which was more than a third of the Fund's 5.2% outperformance relative to the index. Between April 2007 and July 2008, the Fund collected a total of $8.6 million in premiums from written put options, corresponding to about $4.4 million in net profit over that period. To put these figures in context, the Fund's total NAV was roughly $112 million before the Fund's collapse;[22] thus, written put options' overall contribution to the Fund's returns was approximately 3.9%.

2. <u>The Fund's use of short variance swaps</u>

In July 2007, the Fund began regularly selling variance swaps. It had short variance exposure in its portfolio 84% of the time from July 26, 2007 through October 17, 2007. Although the Fund also took long variance positions on two occasions, they were open for only 14% of that period. The short variance swaps exposed the Fund to large losses in the event of historically somewhat infrequent spikes in market volatility. Also, because volatilities typically rise when markets tumble, the swaps contributed to the overall Fund's downside risk. For example, on four different occasions, the Fund entered into 300,000 vega or larger short variance swaps with a maturity of one or more months; each such position had at least a 0.6% chance of causing a 5% or greater loss to the Fund's NAV.[23]

Between July 2007 and July 2008, the losses or gains for individual short variance swaps ranged from a loss of $186,000 to a gain of $437,000. In the aggregate, the short variance swaps written during that period increased the Fund's NAV by $1.0 million, or about 1%.

F. The Fund's November 2007 annual report and May 2008 semiannual report

A central issue in this proceeding is whether the Fund's November 2007 annual report and May 2008 semiannual report accurately and adequately disclosed that the Fund was investing regularly in naked puts and short variance swaps and that the ongoing use of these derivatives had a significant effect on the Fund's performance and risk profile. The reports

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22 This figure is the average of the year-end NAVs for 2006 and 2007.

23 The riskiness of these positions is disputed by respondents, and their value-at-risk analysis is discussed in detail *infra* Section III.C.1.b.

contained a Question and Answer section that was styled as an interview with "Portfolio Co-Managers Mohammed Riad and K. Timothy Swanson."

Patty Delony, a Claymore employee, prepared an initial draft of the Q&As based on telephone conversations with Swanson. These conversations were recorded, and their content generally tracks the written Q&As that eventually appeared in the Fund's reports. Riad and Swanson shared ultimate responsibility over the content of the Q&As. Delony always accepted their changes because she wanted that section to accurately convey the portfolio managers' message. Although Swanson had a more significant role in preparing the Q&As, Riad also reviewed and edited it before publication.[24] Swanson certified to Claymore that the commentary did not contain any misleading misstatements or omissions.

1. <u>The November 2007 annual report</u>

The Fund's 2007 annual report covered the one-year period ending November 30, 2007. The Q&A section began by asking respondents to discuss the Fund's objective and how they were pursuing it. Similar to the material contained in the Fund's prospectus, it stated that the Fund would invest "at least 80% of total assets in a diversified portfolio of common stock . . . and write (sell) covered call options on a substantial portion of the equity securities held in the Fund's portfolio." The report also stated that the portfolio managers would seek to "produce a high level of current income . . . primarily from the option premiums received from writing call options and from dividends on the equity securities in the portfolio and, to a lesser extent, capital appreciation in the value of equity securities underlying the covered call options."

Under the heading "HCE Risks and Other Considerations," the Q&A section stated that that the Fund was subject to investment, equity, fund distribution, market discount, and foreign securities risk. It identified various risks associated with a covered-call strategy, but did not address the increased sensitivity to market declines and heightened volatility caused by the use of the two new kinds of derivatives. Elsewhere, the Q&A section suggested that the Fund was, if anything, long on variance, insofar as it asserted that respondents wanted to be "100% hedged for . . . protection" in "more volatile" markets.[25] It described the Fund as pursuing a "macro-hedging strategy" that aimed to "protect on the downside in a downward trending market."[26] Respondents also purported to explain what investment decisions most helped or

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[24] For example, in 2008, Swanson edited Delony's draft to add language that the Fund was "strategically hedged for additional downside protection." Riad signed off on the version edited by Swanson and said that it "look[ed] good to [him]."

[25] This accords with what Swanson said during the interview—namely, that the past year had many spikes in volatility, which respondents "took advantage of" by "appropriately hedg[ing] the portfolio."

[26] In his interview with Delony, Swanson similarly said that the Fund implemented "opportunistic hedging strategies" that took the form of buying puts or collaring the portfolio to "increase the amount of protection during periods of a declining market."

hurt the Fund's performance. They stated that the Fund's "performance benefited from good sector and industry selection, positive stock selection, and also good strategic and tactical decisions on the options overlay" and identified several specific equity investments, but omitted mention of the naked put and variance swap trades.[27]

2. The May 2008 semiannual report

The Q&A section in the May 2008 semiannual report did not discuss the Fund's ongoing use of the derivatives either. The response regarding investment strategy repeated the similar discussion contained in the 2007 annual report. The risk-disclosure section again described the risks of writing options only in the context of covered calls. One Q&A response stated that the Fund was "strategically hedged for additional downside protection," which purportedly helped the Fund's performance "as equity markets trended downwards." Although the Fund did purchase some put options and also entered into some long variance swaps, these positions, which genuinely did hedge the underlying covered-call portfolio against market declines, were in place only sporadically. In fact, the Fund had written put and short variance swap exposure—positions that would tend do worse in adverse market conditions—during the majority of the period.[28] As in the 2007 annual report, respondents specifically identified other investments that drove the Fund's returns without mentioning the derivatives.

G. **The Fund's collapse in the fall of 2008**

Throughout the summer of 2008, the Fund continued to write naked puts and entered into short variance swaps. On August 25 and August 28, the Fund wrote S&P 500 puts with an expiration date of October 17, 2008. Their combined notional value was $139 million, which exceeded the Fund's NAV at the time, and their combined delta-equivalent exposure was approximately $13.5 million, about 13% of the Fund's entire portfolio. Riad also entered into a one-month, 250,000 vega, short variance swap in August 2008.

1. The Fund's exposure grows in September 2008 amidst market turmoil

By the end of August, the puts' delta- equivalent exposure had grown to more than $17 million, about 16% of the Fund's NAV. In September 2008, the financial markets became

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27 Before the interview, Swanson provided Delony with performance data, including an "Individual Equity Attribution" report. These materials did not mention the index options or variance swaps. During the interview, Swanson identified stock selection, bringing in "greater downside protection," and hedging at the right times as the "key ingredient[s]" for performance.

28 In his interview with Delony, Swanson stated that the Fund had "global hedges" that "helped to augment the downside" protection. He never mentioned writing put options or shorting variance during the interview.

increasingly volatile.[29] On September 10, Riad drafted an internal email lamenting that Hughes, the FAMCO research analyst with whom Riad worked to devise the use of the derivatives at issue, "told [him] this would happen" and remarking "[n]ever sell variance in front of a broker/dealer disaster." On September 17, FAMCO provided Claymore and the Fund's Board with a report describing the market environment as a "liquidity crisis" in which "market uncertainty . . . causes us to maintain greater than normal cash positions."

Riad left the Fund's put and swap positions open. The S&P 500 fell about 6.4% in September 2008. On September 19, Riad settled the expiring variance swap, realizing a loss of about $7 million. By that time, the unrealized losses on the August puts were about $1.2 million and their delta-adjusted exposure had ballooned to $39.7 million—45% of the Fund's NAV. In other words, the puts were adding the equivalent of $39.7 million in S&P 500 exposure to the Fund—on top of the existing downside risk that it already had from its equity and covered-call portfolio—leaving it even more vulnerable to further declines in the market.

On September 19, the same day that the Fund's previous variance swap position expired, Riad decided to enter into two new one-month short variance swaps with a total vega of 250,000. According to Riad, he pressed on despite market uncertainty because he expected to be able to "recoup those [prior] losses" given that volatility is mean-reverting and thus could be expected to decrease back to the historical average over time.

2. <u>The Fund experiences massive losses in October 2008</u>

In late September and early October 2008, the market continued to decline and volatility continued to increase. The delta-adjusted exposure of the written puts continued to grow and, at times, even exceeded the Fund's total NAV, making the Fund extraordinarily vulnerable to downside risk. On October 6 and October 8, the Fund covered its written put positions, realizing a loss of $15.5 million and costing the Fund 15.2% of its August 28, 2008 NAV.[30] The Fund also lost an additional $22.8 million on the short variance swap positions that Riad entered into in September. In all, the Fund lost 73.2% of its NAV between September 1 and October 17, the day that it closed its last variance swap position. Approximately $45 million of the Fund's losses (or about 43% of the Fund's NAV) in September and October 2008 were attributable to the put and swap positions.

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[29] Among other things, the Federal Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship on September 6 and Lehman Brothers filed for Chapter 11 bankruptcy protection on September 15.

[30] If the positions had been held until the October 17, 2008 expiration, the Fund would have lost another $10.6 million.

3. Riad and Swanson decide to be "upfront and explain the strategies instead of hiding"

Even as the Fund was sustaining losses in September and October 2008, respondents did not immediately disclose the Fund's use of the derivatives to the Board. For example, in response to a September 16 inquiry by the Fund's chairman regarding the status of the Fund, respondents referred generally to the Fund's "macro-hedging strategy" as adversely affecting its performance, without identifying the specific index put or short variance swaps that had caused a significant portion of the Fund's losses. Further, their response included as an attachment a FAMCO Investment Strategy Report, which stated that the Fund was taking a more diversified, cash-heavy position because of the "murky" near-term future. Two days later, on September 19, the Fund entered into a new variance swap position.

In early October 2008, Riad and Swanson worked with Claymore to draft a press release explaining the Fund's losses. In an October 3 email to Swanson, Riad wrote: "*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." (Emphasis added.) On October 6, the Fund published a Portfolio Manager Commentary stating that the Fund's performance was negatively impacted by what respondents called "macro strategies," including the "covered call index strategy," the "Fund's strategy of selling out-of-the-money index puts," and the "Fund's strategy of selling volatility."

Riad and Swanson briefed the Board again in mid-October 2008. Before an October 10, 2008 special meeting of the Board, respondents circulated an update acknowledging that the majority of the Fund's "extraordinary losses[] occurred in two asset classes," short puts and variance swaps. Respondents stated that the Fund had employed "Alternative Investment Strategies" to "both enhance returns and supplement protection."

At a subsequent October 20-21 Board meeting, Riad again reviewed the transactions. Respondents stated that "$29.8 million of losses were attributable to variance swap positions and $15.6 million of losses were attributable to the put strategy." Even at this late date, however, Riad was not fully forthcoming to the Board. Asked to "explain the losses on variance swap and short put positions held by the Fund," Riad characterized them as an "attempt to *reduce* the volatility and *hedge*" the Fund's portfolio.[31] Riad also claimed that "certain long put positions expired or were offset" in the summer of 2008, and that he had intended to replace them around the time of the presidential election. He asserted that the Fund was effectively locked into short put exposure because the Fund was "limited in its ability to react" during the "unprecedented market movement." Riad and respondents' expert, Professor Chester Spatt, acknowledged that in September 2008, offsetting puts could readily have been purchased on the open market (albeit at considerable expense).

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[31] In fact, taking a short variance position or writing put options increased the Fund's risk from market declines and increases in volatility. *See infra* Section III.B.1.a.i.

The Board removed Riad and Swanson as portfolio managers in October 2008. In the course of the Board's review of FAMCO's advisory contract in November 2008, respondents admitted that they had "adopted a practice of selling short out-of-the money puts" and a "strategy of selling volatility through over-the-counter variance swaps" as a "means of sustaining [the Fund's] high dividend payout objective."

Claymore, the Fund's investment adviser, later distributed $45 million to former Fund investors in compensation for the loss attributable to the undisclosed derivative transactions.[32]

III. **Discussion**

We find that respondents willfully violated the securities laws as alleged in the OIP. Specifically, we find that respondents violated the antifraud provisions of the Exchange Act and the Investment Company Act (*i.e.*, Exchange Act Section 10(b) and Rule 10b-5 thereunder and Section 34(b) of the Investment Company Act) by making false and misleading statements and by omitting material facts in the Q&A sections of the Fund's periodic reports. We also find that respondents willfully aided and abetted and caused FAMCO's violations of Advisers Act Section 206(4) and Rule 206(4)-8 thereunder and the Fund's violations of Investment Company Act Section 34(b); these violations, too, are premised on the fraudulent statements and omissions in the Fund's reports. Finally, we find that Riad caused the Fund's violations of Rule 8b-16 of the Investment Company Act by causing the Fund to materially change its investment policies and risk factors without making the disclosures required by that rule.

Because the antifraud violations involve the same misconduct on respondents' part—*i.e.*, making misrepresentations and omissions in the Fund's 2007 and May 2008 reports—we treat them together. We then consider Riad's Rule 8b-16 "causing" violation.

A. The applicable legal standard for antifraud violations

Exchange Act Section 10(b) and Rule 10b-5 make it unlawful for any person to engage in certain proscribed conduct in connection with the purchase or sale of a security through any instrumentality of interstate commerce. Specifically, Exchange Act Rule 10b-5 prohibits

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[32] The Commission instituted separate, settled administrative proceedings against FAMCO and Claymore. As part of its settlement, Claymore undertook to distribute $45 million to former investors. *Claymore Advisors, LLC*, Advisers Act Release No. 3519, 2012 WL 6608205, at *8 (Dec. 19, 2012). The settled orders contain findings as to FAMCO and Claymore pursuant to their respective offers of settlement. *Fiduciary Asset Mgmt., LLC*, Advisers Act Release No. 3520, 2012 WL 6608206, at *9 (Dec. 19, 2012); *Claymore Advisors, LLC*, 2012 WL 6608205, at *8. These findings as to FAMCO and Claymore "are not binding on any other person or entity." *See* 2012 WL 6608206, at *1 n.1; 2012 WL 6608205, at *1 n.1. Thus, our findings here are based solely on the record adduced before the ALJ in this proceeding. *See generally Edward Sinclair*, Exchange Act Release No. 9115, 1971 WL 120487, at *4 (Mar. 24, 1971), *pet. for review denied*, *Sinclair v. SEC*, 444 F.2d 399, 401-02 (2d Cir. 1971).

"employ[ing] any device, scheme, or artifice to defraud"; "mak[ing] any untrue statement of a material fact or to omit 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 "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[33] Advisers Act Section 206(4) imposes similar prohibitions on "any investment adviser" and makes it unlawful to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."[34] Advisers Act Rule 206(4)-8 makes it unlawful for "any investment adviser to a pooled investment vehicle" to "[m]ake any untrue statement of a material fact or to 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" or "[o]therwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative."[35] Finally, Investment Company Act Section 34(b) makes it unlawful to "make any untrue statement of a material fact" or to "omit to state . . . any fact necessary in order to prevent the statements made therein . . . from being materially misleading" in any "registration statement, application, record, or other document filed or transmitted pursuant to this title."[36]

There is significant overlap among the conduct proscribed by these antifraud provisions. All the provisions prohibit at least the making of fraudulent misstatements of material fact.[37] They also reach omissions of material fact, including when additional disclosure is necessary to make other "disclosed statements, whether mandatory or volunteered, not misleading."[38]

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[33] 15 U.S.C. § 78j(b); 17 C.F.R. 240.10b-5.

[34] 15 U.S.C. § 80b-6.

[35] 17 C.F.R. § 275.206(4)-8.

[36] 15 U.S.C. § 80a-33(b).

[37] *See, e.g., Raymond J. Lucia Cos., Inc.*, Exchange Act Release No. 75837, 2015 WL 5172953, at *12 (Sept. 3, 2015) ("It is sufficient to note that [Advisers Act Sections 206(1), (2), and (4)] encompass the making of fraudulent misstatements of material fact and omissions of material fact necessary to make statements made not misleading."), *pet. for review filed*, No. 15-1345 (D.C. Cir. Oct. 5, 2015); *Mitchell H. Fillet*, Exchange Act Release No. 75054, 2015 WL 3397780, at *11 (May 27, 2015) (finding that "Fillet's failure to disclose was a deceptive 'device, scheme, or artifice to defraud' under Rule 10b-5(a) and a deceptive act that operated as a fraud on the customer under Rule 10b-5(c)"); *David Henry Disraeli*, Advisers Act Release No. 2686, 2007 WL 4481515, at *8 (Dec. 21, 2007) ("Facts showing a violation of . . . [Exchange Act Section] 10(b) by an investment advisor will also support a showing of a Section 206 violation.") (alteration in original; quoting *SEC v. Haligiannis*, 470 F. Supp. 2d 373, 383 (S.D.N.Y. 2007)).

[38] *SEC v. Fehn*, 97 F.3d 1276, 1290 n.12 (9th Cir. 1996); *see also SEC v. Washington Inv. Network*, 475 F.3d 392, 404 (D.C. Cir. 2007) (rejecting argument that Section 206 was intended to cover "only actual misrepresentations of fact and other affirmative frauds" and holding that Section 206 "prohibits failures to disclose material information, not just affirmative frauds"); *John J. Kenny*, Exchange Act Release No. 47847, 2003 WL 21078085, at *7 (May 14, 2003)

(continued…)

Misleadingly incomplete disclosures or "half-truths" that are "literally true" but that "create a materially misleading impression[]" will "support claims for securities fraud."[39]

In their briefing, the parties do not distinguish between the statutory bases for antifraud liability. We do so here for clarity's sake. Respondents are primary violators under Exchange Act Section 10(b) and Rule 10b-5 with respect to the misrepresentations and omissions in the Q&A sections of the Fund's 2007 and May 2008 reports, which were specifically attributed to Riad and Swanson.[40] FAMCO, by managing the Fund in a manner that was inconsistent with the Fund's disclosures, violated Advisers Act Section 206(4) and Rule 206(4)-8. And the Fund, by making misleading statements and omissions in the Fund's reports, itself violated Investment Company Act Section 34(b). Respondents aided and abetted and caused FAMCO's and the Fund's violations by making investments that were inconsistent with the Fund's disclosures and by making misleading statements and omitting material information in the Fund's reports.[41]

(…continued)

(explaining that, upon voluntarily choosing to speak, a respondent is "obligated to do so truthfully and in a way that was not misleading"), *aff'd*, 87 F. App'x 608 (8th Cir. 2004).

[39] *Wilson v. Merrill Lynch & Co.*, 671 F.3d 120, 130 (2d Cir. 2011) (quotation marks omitted); *see also Piper Capital Mgmt.*, Exchange Act Release No. 48409, 2003 WL 22016298, at *9 n.40 (Aug. 26, 2003) ("[H]alf truths . . . trigger a duty to disclose any additional or contradictory facts that may be necessary to present . . . a complete picture.") (quotation marks omitted).

[40] There is no dispute that Riad and Swanson are "makers" of the statements in the Q&A sections and jointly shared ultimate authority over those statements for purposes of Rule 10b-5. *Cf. Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011).

[41] Aiding-and-abetting liability requires: (1) a primary violation of the securities laws; (2) awareness or knowledge of the primary violation by the aider and abettor; and (3) knowing and substantial assistance by the aider and abettor in the commission of the primary violation. *See, e.g.*, *SEC v. DiBella*, 587 F.3d 553, 566 (2d Cir. 2009); *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956 (7th Cir. 2004); *Graham v. SEC*, 222 F.3d 994, 1000 (D.C. Cir. 2000). The knowledge or awareness requirement can be satisfied by recklessness. *See, e.g.*, *Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004). One who aids and abets a primary violation is necessarily a cause of that violation. *E.g.*, *Joseph John Vancook*, Exchange Act Release No. 61039, 2009 WL 4005083, at *14 (Nov. 20, 2009); *Sharon M. Graham*, Exchange Act Release No. 40727, 1998 WL 823072, at *7 n.35 (Nov. 30, 1998), *petition denied*, 222 F.3d 994 (D.C. Cir. 2000).

B. Respondents willfully violated the antifraud provisions

Each respondent willfully violated the antifraud provisions and aided and abetted and caused FAMCO's and the Fund's antifraud violations.[42] At bottom, these violations took the form of false and materially misleading statements and omissions in the Q&A sections of the Fund's 2007 and May 2008 reports.[43] On appeal, respondents do not dispute that the threshold requirements for applicability of the antifraud provisions are met—for example, that their conduct implicated the jurisdictional element of the securities laws and that FAMCO was a registered investment adviser. Likewise, it is undisputed that the "in connection with" element is satisfied.[44] Consequently, whether or not respondents have violated the antifraud provisions requires resolution of three questions: *first*, whether the Fund's disclosures were misleading or incomplete; *second*, whether the inaccurate or omitted information was material; and, *third*, whether respondents acted with scienter. We answer each of these questions in the affirmative for the reasons that follow.

1. <u>The disclosures in the Fund's reports were misleading and incomplete</u>

The Fund's systematic and ongoing use of naked puts and variance swaps significantly increased the Fund's risk exposure and affected the Fund's returns. The Q&A sections in the Fund's 2007 and May 2008 reports misrepresented and omitted important information about how the Fund was using these derivatives.

a. *The derivatives were not adequately or accurately described in the Fund's 2007 and May 2008 reports*

We find that respondents' disclosures in the Fund's reports were inadequate and inaccurate in three basic ways: they misleadingly said that the Fund was "hedged" when in fact the use of the derivatives increased the Fund's risks in downward trending or volatile markets; they provided an incomplete and misleading description of how the Fund intended to pursue its investment objectives given the anticipated and actual effect of the derivatives on the Fund's

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[42] Willfulness means the intentional commission of an act that constitutes the violation of the securities laws; there is no requirement that the actor be aware that he or she is violating any statutes or regulations. *Wonsover v. SEC*, 205 F.3d 408, 413-14 (D.C. Cir. 2000).

[43] The Division of Enforcement has limited its "scienter-based claims . . . only to the disclosures in the annual and semi-annual reports."

[44] Material misstatements and omissions in fund disclosure documents satisfy the "in connection with" element because potential investors might refer to and rely on this information in deciding whether to buy or sell shares of the fund. *See, e.g.*, *Fundamental Portfolio Advisors, Inc.*, Exchange Act Release No. 48177, 2003 WL 21658248, at *8-9 (July 15, 2003), *pet. denied*, 167 F. App'x 836 (2d Cir. Feb. 16, 2006); *SEC v. Benson*, 657 F. Supp. 1122, 1131 (S.D.N.Y. 1997) ("The registration statements and annual and quarterly reports . . . satisfy the [in connection with] requirement.").

returns; and they failed to disclose the performance impact of the derivatives, which was misleading by omission in light of other statements made by respondents about what drove the Fund's returns—*e.g.*, identifying specific equity- and sector-selection decisions.

i. Mischaracterization as "hedges"

We find that respondents committed fraud by misstating they were "hedging" or protecting the Fund against the risk of market declines and increase in volatility—because that was precisely the opposite effect of the naked puts and variance swaps. For example, the Q&A section in the 2007 report stated that the Fund had taken steps to "protect on the downside in a downward trending market" and that respondents desired to be "hedged" for "protection" in "more volatile" markets. It asserted that respondents had "*bought* index puts" or set up collars by "*purchasing* protective index puts and writing index calls" on account of respondents' "concern[s] about the market." In fact, the Fund *wrote* index puts—a fact that Riad conceded in his investigative testimony was an "omission" whose inclusion would have "clarified" the Q&A response and made it "more descriptive."[45] Similarly, the Q&A's treatment of volatility suggested that the Fund was *long* on variance by claiming that respondents wanted to be "100% hedged for . . . protection" in "more volatile" markets. The Fund actually entered into two short variance swaps during the period covered by the 2007 report.[46] Again in the May 2008 semiannual report, respondents asserted that the Fund was "strategically hedged for additional downside protection." The Q&A section stated that the Fund was "able to buy some protection from downward trending share prices."

In fact, rather than "hedge" against poor performance in the Fund's underlying equity and covered-call portfolio, the derivatives increased the risk that the Fund would lose money in the event of either a sharp market decline or increased volatility. Respondents thus err in characterizing their use as components of the Fund's "global macro hedge."[47] Naked puts and short variance swaps *increase* the exposure of a covered-call portfolio to downside price risk and to upside volatility risk, so they cannot accurately be described as "hedges." Rather, the Fund's

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[45] The 2007 report did indicate that the Fund had an open written put, but did not say that the position was naked or that it was only one of several puts written in the prior months.

[46] Although the financial statements included in the 2007 report contained a reference to an open short variance swap, they did not include information on the size of the swap or inform investors that the Fund had entered into another variance swap earlier that year.

[47] Contrary to respondents' suggestion, counsel for Claymore did not approve this characterization. In July 2008, Steve Hill, Claymore's Vice President of Fund Administration and the Fund's Chief Financial Officer, noted that the Q&A section stated that the Fund was "strategically hedged for additional protection" and asked whether the section should also "explain[] how the hedge actually works." Claymore's in-house counsel replied that the previous sentence in the Q&A section discussing the Fund's "global macro hedges" made clear that the "strategic hedge" and the "macro hedge" were the same thing. But Claymore's counsel never evaluated whether the derivative strategies *in fact* functioned as hedges.

use of the derivatives dramatically increased the Fund's downside exposure in the event of market declines or increases in market volatility.

A hedge, as that term is conventionally understood, is a transaction designed to lower the overall risk of a portfolio by adding a position that is expected to offset potential losses from other positions already present in the portfolio.[48] For example, if the remainder of the portfolio would tend to drop in value if the market falls, the total risk of the portfolio could be reduced, or hedged, by purchasing an index put since such contracts rise in value when the market falls. A covered-call portfolio moves in the same general direction as the market.

A naked put, like a covered call, declines in value when the underlying asset declines in value; therefore, rather than hedge this risk, it adds to it. Writing put options therefore is the functional equivalent of leveraging a covered-call portfolio by borrowing money and taking out a larger covered-call position, so it also increases portfolio volatility. Instead of decreasing exposure to market declines, a naked put position results in large, even magnified losses once the market falls significantly.[49] Moreover, the delta-equivalent risk grows when the price of the underlying security approaches, and eventually dips below, the strike price. On three separate occasions between July 2008 and October 2008, the delta-equivalent index risk of the Fund's written puts was more than half of the Fund's total NAV which shows how leveraged the Fund had become and how dramatically the puts had increased the Fund's vulnerability to market declines. For example, the puts written in June 2008 contributed $87 million of delta-equivalent risk exposure to the Fund's portfolio as of July 14, or 92% of the Fund's total NAV at that time.

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[48] Respondents assert that the derivative strategies generated returns in flat or mildly declining markets, and thus could be viewed as a "hedge" against underperformance in such market conditions. We disagree. As the Division's expert, Professor Harris, explained, a "hedge" is generally understood to be something that reduces the risk of loss for other positions in the fund's portfolio. *See also, e.g.*, Concept Release, *Short Sales*, Exchange Act Release No. 42037, 1999 WL 958430, at *9 & n.52 (Oct. 20, 1999) ("[T]he Commission has described a bona fide hedge [for purposes of Exchange Act Rules 10a-1] as largely a matter of custom and practice, but it must involve," among other things, "positions in related securities" where one security "substantially offsets the risk of [another] security"); Adopting Release, *Securities Transactions by Members of National Securities Exchanges*, Exchange Act Release No. 15533, 1979 WL 173563, at *8 (Jan. 29, 1979) (discussing the term "bona fide hedge" in the context of Exchange Act Section 11(a)(1)(D): "While the application of that term is largely a matter of custom and practice, the Commission believes that it implies that an appreciable offset of risk, for all or part of the position being hedged, must be involved.").

[49] The Fund's use of deep-out-of-money puts meant that declines would have to be quite large before any particular put would be exercised and the Fund would suffer a loss. But because the Fund entered into very sizable positions—enabled by its decision to segregate assets on a mark-to-market basis—its exposure was correspondingly magnified in the event of a steep market decline. *See infra* Sections III.C.1.c.i and III.C.1.c.iv.

A short variance swap likewise is not a hedge for a covered-call portfolio.[50] Increases in volatility hurt covered-call funds, which already have short exposure to volatility because written calls tend to rise in value (and thus their liability to the fund's portfolio increases) as volatility rises. Since the liability to a portfolio of a short variance swap position also increases when volatilities rise, a short variance swap *adds* to the risk of a covered-call portfolio. In addition, far from increasing in value when the market declines, a short volatility swap is likely to lose money in such situations because volatility historically tends to spike when equity prices fall. A short variance swap position, like an underlying equity or covered-call portfolio, thus tends to lose money when markets decline. Riad's research confirmed that shorting variance on top of an equity portfolio increases the portfolio's overall volatility.

ii. Failure to accurately describe how the Fund was pursuing its investment objective

As discussed above, the Q&A section of the Fund's 2007 and May 2008 reports purported to discuss how the Fund was pursuing its investment objective. Respondents stated that the Fund would seek to "produce a high level of current income . . . primarily from the option premiums received from writing call options and from dividends on the equity securities in the portfolio and, to a lesser extent, capital appreciation in the value of equity securities underlying the covered call options." Respondents omitted material information—the Fund's regular use of naked puts and variance swaps and their substantial effect on the Fund's returns—necessary to make these statements not misleading.[51]

Riad and FAMCO analysts under his supervision did extensive research into the derivatives, which led respondents to believe that they would help improve the Fund's performance and enable the Fund to achieve its investment objective. The impact of the derivatives in practice was also substantial, as were the assets they placed at risk.[52]

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[50] We are unpersuaded by respondents' argument that they elsewhere described how the swaps would hurt the Fund's overall performance in difficult market conditions. They identify statements that the Fund would profit from short variance swaps if realized volatility was lower than the strike price and would lose money if realized volatility was higher than the strike price. But these statements simply define a variance swap, and did not correct or clarify the misimpressions created by the Q&A section that the Fund was "100% hedged" for "protection" in "more volatile" markets. Respondents also point to a note to the financial statements included in the 2007 report, which stated that, while the "swap agreement is open, the Fund may be subject to risk from the potential inability of the counterparty to meet the terms of the agreement." This statement regarding counterparty risk does not render true respondents' assertion that the Fund was hedged, or protected, against the risk of a spike in volatility.

[51] As explained above, the antifraud provisions prohibit the telling of misleading half-truths even in the absence of an affirmative duty to disclose. *See supra* notes 38-39.

[52] *See infra* Sections III.B.1.a.iii and III.C.1.b.

Respondents admit that the Fund's reports did not mention the profits earned on the naked puts or short variance swaps. But they argue that they viewed these profits as "unusual and unexpected before the market moved in unprecedented ways in late 2007 and early 2008." Riad's and Hughes's research in fact led respondents to expect that the derivatives would significantly contribute to the Fund's performance and help it meet its investment objective. And regardless of respondents' expectations beforehand, by the time they prepared the Q&A sections, the derivatives *already had* a substantial impact on the Fund's performance.

What is more, respondents themselves understood that the Fund was using naked puts and variance swaps as a consistent practice to boost returns and to meet the Fund's dividend objective—not just engaging in one-off, opportunistic transactions. In an October 2008 write-up about the Fund's performance, respondents described the Fund's use of derivatives as "Alternative Investment Strategies" that aimed to "enhance returns" by taking advantage of "pricing anomalies." Respondents sought to justify their "strategic and consistent selling" of deep-out-of-the-money puts by citing backtesting data that showed it was "attractive stand-alone investment strategy." Respondents likewise claimed that backtesting also supported their "strategic and consistent use of . . . variance swap trades." At an October 21, 2008 meeting of the Fund's Board, Riad again defended the "strategy of . . . selling out-of-the money puts" and the "strategy with respect to the variance swaps" as having "generally produced benefits to HCE," even though they had more recently resulted in large losses. Similarly, in response to the Board's review of FAMCO's advisory contract in November 2008, respondents admitted that the Fund had "adopted a practice of selling short out-of-the money puts" and a "strategy of selling volatility" as a "means of *sustaining [the Fund's] high dividend payout objective*." (Emphasis added.)[53] Respondents contended that the "strategies helped contribute" to the Fund's strong performance relative to other covered-call Funds in the two-year period ending August 2008.

iii. Misleading half-truths about sources of Fund's returns

Finally, in light of respondents' volunteered statements about specific trades that drove the Fund's returns—*e.g.*, the equity- and sector-selection decisions highlighted in the Q&A sections—their failure to disclose the use of derivatives was misleading by omission. We therefore find that respondents committed fraud by undertaking to discuss the sources of the Fund's returns and, having done that, failing to provide complete and accurate information with respect to that subject.[54] The Fund's returns from its use of naked puts and variance swaps

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[53] Respondents also noted that the "strategies helped contribute to . . . an annualized increase of 6.5% in net asset value for the two-year period ended August 31, 2008," of which "2.9% per annum was attributable to put and swap transactions." The 2.9% figure appears to include both written and purchased puts and both short and long variance swaps.

[54] *See supra* notes 38-39.

taken together exceeded its excess returns attributable to its core, disclosed covered-call strategy.[55]

Specifically, the Q&A section of the 2007 report purported to explain what investment decisions most helped or hurt the Fund's performance. Overall, the Fund reported a 12.87% return on a NAV basis, compared to returns of 7.72% for the S&P 500 index. Despite the fact that the Fund's written puts made a significant positive contribution to return (a gain of about 2.0%) and its short variance swap was among the worst individual performers (a loss of more than $400,000, or approximately 0.4% of the NAV), the section omitted any discussion of them. Instead, the Q&A section stated that "performance benefited from good sector and industry selection, positive stock selection, and also good strategic and tactical decisions on the options overlay."[56] It described specific sector and stock investments, such as a position in Caterpillar Inc. and the Fund's "significant position in information technology." Each of the individual stock investments contributed between 0.15% and 1.03% to the Fund's return and the sectors contributed between 1.1% and 1.6%. Yet the Q&A section did not disclose that the Fund received a significant boost from written puts on the S&P 500, which together contributed a return of about 2%, much more than any of the other investments highlighted in the report. Indeed, the return attributable to the Fund's equity portfolio as a whole was only 1.25% greater than the S&P 500's return. This omission is particularly stark given that respondents, in contemporaneous, internal communications, recognized that the Fund had "successfully used" naked puts and variance swaps, which "allowed [it] to have a good year thus far."[57] By contrast, the Q&A section blamed investments in the homebuilding and consumer discretionary sectors when identifying "[w]hich holdings hurt performance." Yet three of the four individual stock investments that the Q&A section drew attention to had *smaller* losses than the short variance swap, which was not mentioned.

For basically the same reasons, the Fund's May 2008 semiannual report was misleading by omission on the subject of what drove the Fund's performance. The Fund reported a 0.37% return on a NAV basis, compared to returns of -4.50% for the S&P 500 index. During that period, the Fund's written S&P 500 put options contributed approximately 2.1% to the Fund's NAV growth and its short variance swaps contributed approximately 0.8%. Yet the Q&A

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55 Respondents point out an error in the ALJ's initial decision: Namely, she incorrectly attributed 45% of the Fund's return to the written puts and short variance swaps, when in fact that 45% figure also includes *long* index puts and *long* variance swaps. The Commission's review is *de novo*, and our findings are based on our independent review of the record.

56 Elsewhere, the Q&A section explains that the "good strategic decisions on the option overlay" pertained to "individual *equities and industry sectors*." Thus, the "options overlay" could not have referred to the Fund's use of naked *index* puts.

57 Riad, for example, wrote that the Fund had a "lot of success in utilizing SPX Put selling" and started "using a lot of volatility selling tactics recently in this market and the results are paying off." He recognized that the use of these derivatives set the Fund apart: "I am not aware of many closed end funds employing such strategies."

section obscured the importance of the written puts and variance swaps in driving the Fund's 5.2% outperformance relative to the S&P 500 index. In response to a question asking which "investment decisions or strategies" most helped the Fund's performance, respondents stated that "performance benefited from success in . . . industry and stock selection, the covered-call strategy, and the hedge program."[58] Nowhere did respondents mention the Fund's naked puts or variance swaps. In fact, the return on the Fund's equity portfolio was -3.13%, or only 1.37% in excess of the S&P 500's return. Thus, although Fund's written index puts actually contributed significantly *more* to the relative outperformance of the Fund than did "stock selection" (2.1% versus 1.4%), only the latter was discussed.

Respondents dispute none of these figures. Rather, they suggest that the performance discussion in the Q&A sections properly highlighted the contribution of equity and sector selection decisions as opposed to that of the derivatives. They claim that the effect of the latter (which gained 2% in the case of the written puts and lost 0.4% in the case of the short variance swaps during the period covered by the 2007 annual report) were dwarfed by the equity portion of the portfolio (which gained 8.97%). Respondents' suggested comparison is inapposite in that the Q&A section in context was discussing the sources of the Fund's outperformance *relative to its benchmarks*, not the *total* return of the equity portion.[59] The Q&A section of the 2008 semiannual report similarly omits discussion of the naked puts and variance swaps in spite of their impact to the Fund's performance in relation to its benchmarks.

Respondents also claim that the contribution of *individual* equity positions cannot be compared with the total contribution from all derivative transactions of a certain type (*e.g.*, all naked index puts or all short variance swaps). But the Q&A sections did not mention the impact of the derivatives at all, whether in the aggregate or broken out by position. Additionally, there were a number of individual derivative positions with greater impact that the individual equity positions highlighted by respondents. At the end of the period covered by the 2007 annual report, for example, the short variance swap with an expiration date of December 21, 2007 had a mark-to-market loss of $723,327 (or 0.65% of the Fund's beginning NAV for 2007—greater than the losses from Lennar (0.13%); Best Buy (0.11%); Comcast (0.31%); and Nordstrom (0.45%). The written put position entered into on November 2, 2007 and closed on December had a net profit of $976,360, or a NAV gain of about 0.9%—more than the contribution of the highlighted investments in Honeywell (0.53%); Emerson Electric (0.40%);

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[58] The Fund actually *underperformed* a pure covered-call strategy, as measured by the BXM index.

[59] For example, the Q&A section addressed what "most *helped* the Fund's performance" and what decisions "*added* the most to *positive* performance." (Emphasis added.) This was consistent with Riad's prior interview with Swanson, where he purported to explain the "areas" that had "good relative performance versus benchmarks and piers [sic]." Likewise, the performance attribution analysis that respondents drew upon in developing the Q&A responses examined the effect of respondents' allocation and selection decisions relative to the S&P 500's "Bench[mark] Contribution To Return."

Deere & Company (0.34%); Caterpillar Inc. (0.15%); Nike Inc. (0.38%); or McDonald's Corp. (0.18%).

b. *The Fund's prospectus, SAI, and quarterly schedules of portfolio holdings did not adequately disclose the Fund's use of the derivatives, their risks, and their effect on the Fund's performance*

Respondents argue that the Fund's ongoing use of naked puts and short variance swaps, as well as their contribution to the Fund's performance and their risks, in fact was sufficiently disclosed in other materials. These arguments lack merit.

i. Permissibility of derivative transactions

Respondents argue that the Fund's registration statement gave it more latitude than a "plain vanilla" covered-call fund would have to invest in derivative transactions.[60] They assert that the "Strategic Transactions" disclosure in the prospectus—which said that the Fund might use "derivative contracts," including writing put and call options and entering into "various transactions such as swaps"—gave the Fund "broad authority" beyond investing in covered calls.

Whether or not written puts and variance swaps were *permitted* investments under the Fund's registration statement has little bearing on the issue whether the statements contained in the Fund's subsequent shareholder reports as to how respondents were achieving the Fund's investment objective were materially accurate.[61] Respondents failed to disclose that the Fund

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[60] Respondents also contend the Fund's other marketing materials, such as roadshow handouts, made clear that it was not confined to a conservative covered-call strategy. This argument is irrelevant for the basic reason that investors are entitled to rely on the Fund's formal disclosure documents—*e.g.*, the registration statement and required periodic reports—and could not have been expected to seek out these additional documents. As the Fund's prospectus advised investors in boldface, "you should rely only on the information contained or incorporated by reference in this prospectus" and "if anyone provides you with different or inconsistent information, you should not rely on it."

Further, as discussed above, these materials did not mention the use of naked index puts or short variance swaps, even though other aspects of the Fund's flexibility, such as the potential use of covered call-on-call options were discussed. *See supra* Section II.C. FAMCO's Chief Compliance Officer did not recall Riad saying that the Fund might "write naked written put options" or "engage in short variance swap transactions." This is unsurprising: The marketing materials were prepared in 2005, two years *before* Riad even tasked Hughes with researching those kinds of derivatives. It is exceedingly implausible that Riad would have discussed them during the roadshow presentations.

[61] Witthohn, the closed-end fund research analyst who testified at the hearing, recalled being concerned about the Fund's sharp decline in the fall of 2008. He reviewed the Fund's registration statement for between 30 minutes and 2 hours before sending an inquiry to

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would be continually employing those derivatives to enhance the Fund's returns. Further, although the prospectus stated that "strategic transactions" might be used "to hedge various market risks inherent in the Fund's portfolio[] or to manage the effective maturity or duration" of assets, naked index puts or short variance swaps do not function as hedges vis-à-vis a covered-call portfolio. Other references to hedging in the Fund's registration statement also did not convey the derivatives' risks.[62]

Respondents point out that Thomas Hale, counsel to the Fund and the lawyer who prepared the Fund's registration statement, opined in a November 2008 memorandum to the Board—*i.e.*, after the Fund's collapse—that "writing index put options is clearly within the authority granted to the Fund as disclosed in the Prospectus." Hale's memorandum principally relied on the prospectus's "Strategic Transactions" disclosure as well as similar statements in the SAI's "Additional Investment Policies" discussion.[63] Yet Hale repeatedly acknowledged that he was never "asked by the Board to analyze or offer an opinion on the *sufficiency of disclosures*" in the Fund's annual or semiannual report; his assignment was limited to determining whether the "transactions were *permissible*" under the prospectus.

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Claymore. He testified that he found nothing in that document that would have foreshadowed the Fund's use of the derivatives or made their risks clear to him.

[62] For example, one risk identified in the prospectus was "imperfect correlation between the price of options . . . and movements in the price of the securities being hedged." Similarly, the risks identified in the SAI regarding index options primarily related to how well they would correlate with the Fund's other securities; an imperfect correlation would, according to the SAI, mean that a "decreases in the value of the securities being hedged against may not be wholly offset by a gain on . . . a securities index put option." As noted above, the derivatives were designed to take advantage of the profitability of selling insurance, not to hedge against market declines or volatility.

[63] Hale also asserted that certain short put positions without a corresponding long put position might qualify as *covered* written puts, which the prospectus defined as including positions as to which the "Fund segregate[d] [liquid] assets . . . equal to the exercise price." The prospectus limited "covered put options" to "up to 20% of [the Fund's] total assets." This is not the standard definition of a covered put, which instead refers to a put that is combined with a short position in the underlying security. At any rate, many of the index puts written by the Fund would not be considered "covered put options" as defined by the prospectus because they often had notional values greater than 20% of the Fund's NAV—and often greater than the Fund's *entire* NAV. In August 2008, for example, the Fund wrote two-month, 9% to 10% out-of-the-money put options with a combined notional value of $139 million, almost 1.4 times the Fund's NAV. Professor Harris found that the notional value of the options "written during 2008 ranged from 60% to 140% of the Fund's net asset value."

Indeed, Hale conceded that he was initially "surprised" when he learned of the extensive use of puts and swaps; they "struck [him] as outside the core investment strategy" of the Fund.[64] He testified that he later "[o]n [his] own"—that is, outside the ambit of the Board's charge to him—formed the opinion that both the written puts and written swaps "should have been disclosed more" in the annual and semiannual reports. He realized that the "frequency [of the trades] was more than occasional" and their scope was "significant" and had concerns that the disclosures "had not been sufficient or adequate." In his hearing testimony, Hale opined that they "should have been disclosed more" in the Fund's reports. Hale disagreed that it was acceptable for the Fund to omit disclosures in the periodic reports merely because were already statements in the "initial prospectus [and] SAI" authorizing the Fund to "engage in these type of derivative trades." In short, Hale agreed that, based on "what he eventually learned about the frequency and risks associated with these trades," he came to "believe that using these two trading strategies constituted a change in some respect to the [Fund's] principal trading strategies."

Therefore, even on the assumption that any single naked put and short variance swap transaction standing alone was allowable under the Fund's registration statement, the Fund used these derivatives on an ongoing basis. Doing so materially altered how the Fund aimed to achieve its investment objective, the Fund's returns, and the risks to which the Fund was exposed. Our conclusion that respondents committed antifraud violations would remain unchanged because respondents' statements in the Fund's 2007 annual and May 2008 semiannual reports were inaccurate or misleading by omission.

ii. Listing of individual put and swap positions

Respondents next contend that the listing of certain naked put and short variance swap positions in the Fund's periodic filings adequately disclosed the Fund's use of the derivatives. We find that these scattered references did not remedy the disclosure violations in the Fund's shareholder reports.

Form N-Q is used by registered investment companies to file their portfolio holdings as of a certain date; it contains no discussion or disclosure of the positions held between reporting dates. The Fund's Form N-Q filings for August 2007, February 2008, and August 2008 listed short index puts and short variance swaps. They merely identified positions held and gave their unrealized profits or losses at the time of each report. The May 2007 annual report included a single written put position among the Fund's listing of portfolio holdings and disclosed a single variance swap position in a footnote to the Fund's financial statements. Because the Fund did not have open written puts or short variance swaps at the end of May 2008, there was no mention of such investments in the portfolio holdings section of the semiannual report. In fact, the Fund had written put option exposure for 108 days and short variance swap exposure for 117 days over

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64 Hale denied that Riad or anyone at FAMCO had described these "type of trades as something that had been intended to be engaged in as during the normal course of the fund's life back when the fund was launched."

the six-month period covered by that report. None of these documents provided any context for the Fund's use of naked puts and variance swaps or revealed that those derivatives had become an integral part of how the Fund sought to achieve its investment objective.

For example, the August 2007 Form N-Q reported an outstanding variance swap agreement with a mark-to-market loss of $857,901. It did not provide any detail regarding the position, such as the vega or variance strike price, from which an investor could determine the exposure that this position created. The next listing of portfolio holdings, with the 2007 annual report, reported a different outstanding variance swap with a mark-to-market loss of $723,327. No details about this position were provided either, and there was no mention of whether the swap reported in the August 2007 Form N-Q was held to maturity or what its ultimate profit or loss was. Because there were no details regarding the size or variance strike price of the variance swap positions, there was no way a reader could determine the degree to which they could profit or lose money based on movements in volatility.[65]

Respondents make much of the fact that that these positions appeared in a number of consecutive filings. In urging that we deem this disclosure sufficient, they would effectively charge the Fund's investors with cobbling together these scattered disclosures to infer how the Fund was using the derivatives and the ensuing consequences. As a factual matter, though, this would not have been possible: Professional investors testified at the hearing that they could not determine from the Fund's reports that it was employing naked puts and short variance swaps on a continuing basis.[66] More fundamentally, the material misstatements and omissions in the Fund's 2007 and May 2008 reports cannot be rectified by scattering disparate bits of information across other lengthy filings that investors must assemble.[67] A defendant cannot seek shelter for

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65 The notional exposure of certain written put positions could in principle have been calculated based on the Fund's filings. However, because the reports show only portfolio positions as of the effective date of the report, investors reading these static portfolio snapshots would have no way to ascertain the swings in risk exposure to which the Fund was subject between the reporting dates.

66 Shulman, for example, observed that the Fund's schedule of portfolio holdings showed only the positions as of a certain date; he testified that he could not have known from reading it how often the Fund had previously written naked puts or entered into short variance swaps. He agreed, moreover, that the filing did not "tell [him] anything about the risk of loss" on these instruments or that the puts and swaps "had been used as a monthly strategy." Witthohn gave essentially the same testimony on these points. He agreed that the "sections of the annual and quarterly reports" listing individual positions failed to disclose the "frequency with which HCE had been investing in either variance swaps or written puts," the "size of positions" on other dates, and their "total potential loss."

67 *See, e.g.*, *Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 641 (D.C. Cir. 2008) (rejecting argument that defendant did not have a duty to disclose information that was necessary to make statements not misleading, where information "was technically in the public domain" but "not reasonably available to investors"); *In re Oppenheimer Rochester Funds Grp. Sec. Litig.*, 838 F.

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misleading omissions and half-truths by pointing to the possibility that investors might be able to cobble together countervailing information.[68]

iii. Respondents' fund disclosure expert

Respondents also complain that the ALJ did not discuss the testimony of their expert witness, Jay Baris, a lawyer, who opined that the Fund's disclosures met applicable legal requirements. We have independently considered Baris's opinion and decline to accept it.

The Commission "has the duty to make its independent analyses and findings" and resolve the issues raised in an administrative proceeding giving "such weight to the expert testimony" as is warranted under the circumstances.[69] We do not defer to expert testimony as to the meaning of the law.[70] More fundamentally, Baris's opinions about the sufficiency of respondents' disclosures relied on factual premises that are not supported by the record and that are contrary to our findings. Baris characterized the Fund's investments in short index puts and short variance swaps as a "macro hedging strategy." He "assumed" for purposes of his "analysis of [the Fund's] disclosures" that this "strategy was never intended to serve as a significant contributor to Fund performance" or a "'significant emphasis' of the portfolio." Moreover, his opinions rested on his "understanding" that the "purpose of this strategy" was to function as a "'strategic hedge' that would provide protection" to the Fund. He further assumed that respondents "reasonably believed the Fund's exposure" was minimal and that FAMCO's "internal analyses" and "back-testing" showed that it was "extremely unlikely that these investments would cause a loss of more than five percent of the portfolio's net assets." And he asserted that respondents should not be second-guessed for failing to anticipate the "extraordinary" severity of the "2008 global financial crisis." As detailed elsewhere, these assumptions and statements are incorrect as well as inconsistent with how the Fund was actually using the derivatives.

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Supp. 2d 1148, 1164-65 & n.10 (D. Colo. 2012) (rejecting argument that disclosures "included all information necessary for investors to 'do [] the math' and determine inverse floater leverage ratios for themselves" when investors would have needed to request the SAI, locate specific investments among various lists and tables, and then perform a further calculation).

68 *See, e.g.*, *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1097-98 (1991) ("[N]ot every mixture with the true will neutralize the deceptive. . . . The point of a [disclosure document], after all, should be to inform, not to challenge the reader's critical wits.").

69 *Guy P. Riordan*, Exchange Act Release No. 61153, 2009 WL 4731397, at *13 n.63 (Dec. 11, 2009) (quotation marks and citations omitted).

70 *See, e.g.*, *IMS/CPAS & Assocs.*, Exchange Act Release No. 45019, 2001 WL 1359521, at *10 n.45 (Nov. 5, 2001); *Robert D. Potts, CPA*, Exchange Act Release No. 39126, 1997 WL 690519, at *10 n.56 (Sept. 24, 1997).

2. The inaccurate and omitted information was material

We find that respondents' misrepresentations and omissions about the Fund's ongoing use of the derivatives and their effect on the Fund's returns and risk exposure were material. The standard of materiality is whether there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information" available.[71] "The question of materiality . . . is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor."[72] Materiality is not "assessed after the fact" or with the benefit of hindsight;[73] rather, the question is whether a "'reasonable investor' would have considered the omitted information significant at the time," given the totality of information available.[74]

We are convinced that a reasonable investor would have considered it important that the Fund was employing the derivatives on a regular basis throughout 2007 and the first half of 2008; that they were being used to achieve the Fund's investment objective, that they had a significant effect on the Fund's performance; and that instead of functioning as "hedges," they exposed the Fund to a significant risk of losses under adverse, but not historically unprecedented, market conditions.[75] Disclosure of this information would have altered the total mix of information available to investors. We as well as courts have long recognized that a "reasonable investor would have considered it important" to know about changes to portfolio composition that increase the risk exposure of a fund.[76] Likewise, a "changed investment strategy" is material because a reasonable investor would view this information as bearing on

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71 *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

72 *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976).

73 *Rodney v. KPMB Peat Marwick*, 143 F.3d 1140, 1144 (8th Cir. 1998).

74 *Basic Inc.*, 485 U.S. at 232.

75 Respondents take issue with the initial decision's statement that any "downside risk potential, *no matter how remote*," is material. We need not, and do not, endorse the ALJ's articulation of the standard for materiality. The strategies had far more than a *de minimis*, remote risk of loss.

76 *Fundamental Portfolio Advisors, Inc.*, Exchange Act Release No. 48177, 2003 WL 21658248, at *11-12 (July 15, 2003) (holding that changes to a fund's portfolio resulting in increased interest rate risk and volatility were material), *pet. denied sub nom.*, *Brofman v. SEC*, 167 F. App'x 836, 838 (2d Cir. 2006)); *see also SEC v. Mudd*, 885 F. Supp. 2d 654, 666 (S.D.N.Y. 2012) (finding that exposure to subprime loans would be "important to investors because of the volatility in the housing and secured-transaction markets"); *cf. Flannery v. SEC*, 830 F.3d 1, 2015 WL 8121647, at *7-8 (1st Cir. 2015) (rejecting finding of materiality on wholly distinguishable facts).

whether the fund "would be able to achieve its stated investment objectives."[77] And a reasonable investor would also "consider the true source of returns as important when making the decision to invest."[78]

The materiality of this information is confirmed by investor testimony in this proceeding.[79] As detailed above, a financial adviser who directed client investments to the Fund and a manager of unit investment trusts that invested in the Fund testified that that they were unaware that the Fund was using the derivatives and, moreover, that they would not have invested in the Fund had they been aware of them. The fact that certain Fund investors did not immediately liquidate their holdings upon discovering the truth in the Fall of 2008 does not, contrary to respondents' contention, undermine a finding of materiality. This is because a misrepresentation is material as long as a reasonable shareholder would deem it *important* to his or her investment decisions; the Commission need not prove that disclosure of the omitted fact would have caused a reasonable investor to *change* his or her behavior.[80] It is clear that the misstatements and omissions at issue here pertained to matters of great importance to investors.

3. <u>Respondents acted with scienter</u>

We find that respondents acted with scienter. Liability under Exchange Act Section 10(b) and Rule 10b-5 requires scienter, which is defined as an intent to deceive, manipulate, or defraud that includes extreme recklessness.[81] Recklessness is highly unreasonable conduct that

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77 *Fundamental Portfolio Advisors, Inc.*, 2003 WL 21658248, at *12; *see also SEC v. Trabulse*, 526 F. Supp. 2d 1008, 1013 (N.D. Cal. 2007) (holding that "fail[ure] to keep investors informed as to the types of investments" was material).

78 *SEC v. Small Bus. Capital Corp.*, 2013 WL 4455850, at *9 (N.D. Cal. 2013).

79 *E.g.*, *Fundamental Portfolio Advisors, Inc.*, 2003 WL 21658248, at *12 (noting, in connection with finding of materiality, that a "public investor . . . testified" that he "would not have invested in the Fund" if he had known the truth about its risk and investment strategies). Hale, the Fund's counsel, agreed that accurate disclosure of this information was important to investors: "It can change . . . or at least inform their decision . . . as to whether they want to continue to own [the Fund] . . . [or] whether the fund investment is appropriate for them."

80 Nor, as a general matter, is the Commission required to establish investor reliance or investor harm in an enforcement proceeding. *See, e.g.*, *SEC v. Morgan Keegan & Co.*, 678 F.3d 1233, 1244 (11th Cir. 2012); *Graham*, 222 F.3d at 1001 n.15; *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir.1985).

81 *See, e.g.*, *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992). Scienter need not be found to establish a violation of Advisers Act Section 206(4) and Rule 206(4)-8 or of Investment Company Act Section 34(b); as to these provisions, a showing of negligence is sufficient. *See Capital Gains Research Bureau, Inc.*, 375 U.S. at 195; *Steadman v. SEC*, 603 F.2d 1126, 1134 (5th Cir. 1979); *Warwick Capital Mgmt., Inc.*, Advisers Act Release No. 2694, 2008 WL 149127, at *8-9 (Jan. 16, 2008); *Fundamental Portfolio Advisors, Inc.*, 2003 WL 21658248, at *8, 15. Negligence is also sufficient to establish causing liability with respect to a

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represents an "extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[82] Thus, scienter can be satisfied by a strong showing of reckless disregard for the truth, as well as actual knowledge of falsity.[83] "Scienter can be established by direct or circumstantial evidence," and the "objective unreasonableness of a defendant's conduct may give rise to an inference of scienter."[84]

The evidence shows that respondents acted knowingly and recklessly and thus with scienter. They made misstatements and omitted information about how the Fund was using the derivatives to achieve its investment objective, the Fund's source of returns, and the Fund's risk exposure. All along, respondents knew the facts rendering their misstatements and omissions misleading or incomplete when made. Before the Fund started employing naked puts and variance swaps, FAMCO employees did "thousands and thousands of hours over several years analyzing them." At Riad's direction, Sean Hughes, the FAMCO analysis, reviewed academic papers and other materials and conducted detailed, numerical analyses; he provided this research to Riad and discussed it with him.

Based on this research, the derivatives were expected to make a significant contribution to the Fund's performance and help the Fund meet its investment return objectives. Respondents themselves later would admit that those investments were employed "as a means of sustaining [the Fund's] high dividend payout objective." Riad's and Hughes's research showed that using the derivatives could, as Riad put it, provide a "very good risk adjusted return," and, in Swanson's words, enable the Fund "do more with less."[85] Based on historical data, they were expected to provide the Fund with substantial gains—*i.e.*, adding a percentage point or more to the Fund's annual returns. For example, Riad intended to select put options that were so out-of-the-money that they were expected to expire in-the-money only 4.7% of the time, meaning that the Fund would keep a majority of the collected premiums. As it turned out, the

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primary violation that does not itself require scienter. *KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 WL 47245, at *19, *petition denied*, 289 F.3d 109 (D.C. Cir. 2002).

[82] *Rockies Fund, Inc. v. SEC*, 428 F.3d 1088, 1093 (D.C. Cir. 2005).

[83] *See, e.g.*, *SEC. v. Lyttle*, 538 F.3d 601, 603 (7th Cir. 2008). Scienter in the context of the securities laws "means awareness of the underlying facts, not the labels that the law places on those facts." *SEC v. Falstaff Brewing*, 629 F.2d 62, 77 (D.C. Cir. 1980); *see also SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 852 n.15 (2d Cir. 1968).

[84] *Gebhart v. SEC*, 595 F.3d 1034, 1041 (9th Cir. 2010), *aff'g Alvin W. Gebhart, Jr.*, Exchange Act Release No. 58951, 2008 WL 4936788 (Nov. 14, 2008).

[85] Respondents' expert, Professor Spatt, agreed, explaining that "in the period before the financial crisis in 2008 it was widely viewed that the short index put and variance swap positions substantially enhanced expected return."

put options written by the Fund generated $8.6 million in premiums between April 2007 and July 2008, for a net profit of about $4.4 million.

FAMCO's backtesting showed that selling short-term, deep-out-of-the-money S&P 500 puts offered "superior risk-adjusted returns versus" investing in the index directly. Thus, even in October 2008, respondents stood by their characterization of writing index puts as an "attractive stand-alone investment strategy." Likewise, the backtesting showed that selling volatility (*i.e.*, taking the short side of a variance swap) every month from January 1997 through March 2008 would have beat the S&P 500 index's returns by over 7% on an annual basis. Hughes summarized his research: "Adding a short volatility overlay can significantly enhance risk adjusted portfolio returns." In short, the entire premise of the Fund's use of the written index puts and short variance swaps was that other investors overpaid for protection, and that the Fund "could take advantage of mispricing" by selling protection to other investors to "enhance return."

At the same time, FAMCO's research also revealed that the derivatives increased exposure to the risk of significant losses in falling or volatile markets—and therefore did not serve as "hedges" for the Fund's underlying covered-call investments. Written put options and short variance swaps perform at their worst during market crises; they are equivalent to selling protection to the purchaser. For example, one article that Riad and Hughes reviewed noted that there "is no arguing that selling naked puts could be very risky"—indeed, the fact that selling puts is risky is *precisely why* they "must be rewarded with risk-premium"—and that "put sellers may occasionally incur huge losses." In effect, writing put options is equivalent to selling insurance in exchange for the premium, which compensates the put-writer for the risk incurred.[86] Thus, although put-writing generally experienced steady gains over time, it was susceptible to sudden, very large losses—as much as 25% over some one- or two-month historical periods. As a January 2003 Goldman Sachs report phrased it, selling puts can produce the "most adverse results in extreme down markets" because it has the "'fattest downside tail."

Riad's and Hughes's research showed that short variance swaps, too, were analogous to selling insurance against increases in volatility and could lead to large losses. One presentation cautioned that being short variance exposed the investor to "severe spikes in realized volatility" and could result in "unlimited loss in the event a spike [was] realized."[87] And under the heading "Selling variance is often profitable, but is exposed to risks," a slide showed that a one-month short variance swap with 100,000 vega—about a third of the size of many of the

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[86] As Professor Spatt stated in his report, index options are a way to "share risks related to the overall performance of the broad equity market." The writer of a put takes on risk, while the purchaser of a put gains protection.

[87] The same presentation observed that potential losses could be limited by also buying call options on realized volatility and thus hedging the short variance position. And Hughes specifically recommended coupling short and long variance swaps to reduce risk. Riad opted not to hedge the Fund's short variance swaps so as to increase the potential gain.

variance swaps that the Fund eventually would enter into—would have resulted in a $2.7 million loss during the then-recent 2002 market downturn. Another analysis that Hughes performed showed that shorting one-month variance swaps and holding an underlying S&P 500 index portfolio, while boosting return, *increased* volatility over both the January 1997-September 2008 and January 2006-September 2008 periods.

We recognize that Riad and Swanson had different roles with respect to the conduct at issue. Riad, for example, had a more in-depth understanding of the derivatives and their risks because of the extensive research that he and Hughes did.[88] Riad was also responsible for the Fund's trades and thus was aware of the quantitative loss estimates derived from the historical frequency data. But notwithstanding their different degrees of understanding, the evidence shows that each respondent knew that the Fund was entering into naked index put and short variance swap positions on an ongoing basis. And each respondent appreciated that these derivatives were intended to—and did in fact (at least until the Fall of 2008)—boost the Fund's returns and, at the same time, exposed the Fund to an increased risk of loss for the entire period they were used. Contemporaneous emails show that Swanson discussed the derivatives with Riad and monitored their effect on the Fund's performance. On at least two occasions, in September and November 2007, Swanson advised Riad to trim the Fund's short put and variance swap positions to be "prudent" and "reduce risk."

Further, each respondent was responsible for the misrepresentations and omissions in the Fund's 2007 and May 2007 reports. Swanson signed a certification that, to the best of his knowledge, the portfolio manager commentary in the reports did not contain any misleading misstatements or omissions. Although Delony interviewed only Swanson in preparing initial drafts of the Q&A sections, both Riad and Swanson reviewed drafts before publication, edited them, and shared responsibility for the version that was ultimately published. Riad, for example, read the draft of the Q&A section in the May 2008 semiannual report, saw "how it described the Fund's investment strategy objective and global hedging strategies," and then wrote back to Swanson that it "look[ed] good to him." He testified that he would not have allowed the Q&A section to be published if it contained any information that he "though was inaccurate at the time" and that he could have insisted on changes if he felt they were important.

We are not persuaded by respondents' assertion that their purported transparency with Claymore and the Fund's Board shows that they lacked scienter. In particular, in their discussions with Claymore and the Board, they omitted material information about the Fund's use of the derivatives, including their significance to how the Fund pursued its investment objective and their effect on the Fund's risk exposure. Only in October 2008 did respondents finally decide, as Riad put it in an email to Swanson, to be "upfront and explain the strategies instead of hiding"—a strong indication of their scienter prior to that date. As Saxon, the Fund's

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[88] Grossman, an accountant for the Fund, also repeatedly warned Riad about the risks associated with writing naked put options.

Chief Compliance Officer, testified at the hearing, respondents omitted important information in their communications with the Board.[89]

It is not disputed that respondents mentioned the Fund's use of naked puts and variance swaps to the Fund's Board and other Claymore employees. But these discussions lacked detail and failed to convey that the Fund was engaging in these transactions as a consistent strategy that contributed significantly to the Fund's performance.[90] Although respondents testified that Riad discussed all of the Fund's strategies, including the use of naked puts and variance swaps, in 15- to 20-minute discussions across six or seven Board meetings, the contemporaneously prepared documentary evidence fails to corroborate this assertion. The testimony of the attendees was also at odds with that of respondents. Some participants acknowledged that Riad mentioned short index puts and variance swaps, but they also recalled that Riad presented these kinds of transactions as trades "opportunistically" entered into by the Fund or, at most, "small component[s]" of the Fund, not ongoing strategies used on a "consistent basis." They testified that Riad spent the majority of the time talking about the Fund's equity selection and covered-call strategies, and never went into "specifics" regarding the derivatives or conveyed how "significant" they were.

Respondents also inaccurately described the naked puts and variance swaps as "hedges" or as providing a measure of "downside protection" during adverse market conditions when in fact they exposed the Fund to an increased risk of losses in the event of a substantial market decline—misrepresentations to the Board that paralleled the misrepresentations in the Fund's shareholder reports. In short, respondents' internal communications misleadingly downplayed both the importance to the Fund's performance and the risks to the Fund from its use of the derivatives. They therefore do not undermine, but rather confirm, our finding that respondents acted with scienter.

We also are not persuaded by respondents' contention that they did not have any reason to conceal the Fund's use of the derivatives and that this absence of motive cuts against a finding of scienter.[91] Respondents assert that they did not face pressure to boost the Fund's returns

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89 Respondents claim that the Board, in late 2008, determined that "no illegal conduct had occurred." This overstates what happened. Instead, the Board reviewed Hale's memorandum discussed *supra*—which evaluated only the permissibility of the transactions, not the sufficiency of the disclosures—and apparently decided to pursue no further action.

90 We have carefully reviewed all the discussions cited by respondents and provide more detail in Appendix A about our findings with respect to each.

91 The absence of a motive to deceive is less relevant to the scienter analysis when, as here, there is direct evidence of respondents' actual knowledge of falsity. *See Donald L. Koch*, Exchange Act Release No. 72179, 2014 WL 1998524, at *14 (May 16, 2014) ("[I]t is only where direct evidence of scienter is lacking that circumstantial evidence of intent, such as motive, becomes critical."), *pet. denied in part and granted in part on other grounds*, 793 F.3d 147 (D.C. Cir. 2015), *cert. pending*, No. 15-781 (filed Dec. 14, 2015).

because the Fund "easily met the dividend target before they invested in the derivatives." The evidence is to the contrary. Respondents acknowledged that they could be fired or replaced if the Fund's performance was unsatisfactory.[92] The Fund's stated goal was to pay an annual dividend of 8.5%, which corresponded to a before-fees return objective of 10%—*i.e.*, the Fund had to beat the market by about a percent a year. Both respondents realized this was a difficult goal for a covered-call strategy, which was designed to trade off "upside participation" for better performance in moderately downward-trending markets. In internal communications, they described the dividend target as "not sustainable" and so high as to pose a "meaningful" risk of "NAV erosion." FAMCO Chief Compliance Officer Joseph Gallagher recalled that, from the "very beginning," Riad expressed concern to the Board that "in a tough market it would be tough to keep up with the dividend target." Respondents thus had every reason to pursue "using more sophisticated investment[s]" beyond the covered-call strategy. Only in July 2008, more than a year after the Fund began using the derivatives, did the Board finally lower the target at Riad's request. After the Fund's collapse, respondents admitted to the Board that these "Alternative Investment Strategies"—*i.e.*, the "strategic and consistent use" of naked puts and variance swaps—were used to "enhance returns." They had been adopted as a way of "sustaining [the Fund's] high dividend payout objective."

Importantly, respondents had a motive to conceal the Fund's use of the derivatives even while they were improving the Fund's performance. The Fund was conceived, marketed, and widely understood as a covered-call fund, and was distinguished from other such funds principally by a "dynamic" approach to varying strike prices and expiration dates and by the potential use of covered call-on-call options. Its investors chose it *because* it was a covered-call fund. Because the Fund's reliance on naked puts and short variance swaps to boost performance fundamentally transformed the nature of the Fund, revealing the truth could have caused investors to reconsider their Fund positions. In fact, a number of investors testified at the hearing that they would not have invested in the Fund if they had been aware of these facts. Full disclosure might also have led the Board or Claymore to reconsider FAMCO's role as the Fund's sub-adviser.

Finally, we are not persuaded by Riad's claim that his personal investments shows that he did not view them as especially risky. We recognize that Riad invested in the Fund and as well as FAMCO's private hedge fund, the Fiduciary Opportunity Fund, L.P. ("FOF"), both of which wrote naked puts and entered into short variance swaps.[93] We also recognize that Riad lost

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[92] Swanson's contention that his *compensation* was not linked to the performance of the Fund thus misses the point; his continued *employment* surely was.

[93] FOF's investment objective and strategy were different from those of the Fund. FAMCO's chief compliance officer testified that FOF was an unconstrained, "traditional hedge fund." FOF sought an annual rate of return of "at least twice the S&P 500," which was understood to be an "extraordinarily aggressive" goal. Its private-placement memorandum stated that it would "not be limited to any pre-defined investment strategies" or "investment instruments" and would have "no restrictions" on holdings. Riad managed FOF and caused

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approximately $1.5 million from his personal investments when the Fund collapsed. But under the circumstances of this case, we do not find that these facts weigh against a finding of scienter.

It is entirely plausible that, as they now contend, respondents genuinely believed that writing naked puts and entering into short variance swaps had good risk-adjusted performance and would likely boost returns. But respondents are *not* alleged to have been insufficiently careful in analyzing the derivatives or to have believed that they were inherently faulty. Rather, the premise of this proceeding is that respondents knew that the Fund's regular use of the derivatives was important to the Fund's performance and entailed significant risk when they made the misrepresentations and omissions at issue.[94] Because of respondents' antifraud violations, the Fund's investors did not know what Riad did about written puts or variance swaps and could not—unlike Riad himself—have made an informed decision to invest (or to stay invested) in the Fund.

C. **Respondents' defenses lack merit**

Respondents contend that the ALJ ignored the evidence that they presented and applied incorrect legal standards. They assert that the Commission cannot "fill in gaps in the reasoning of the Initial Decision" or "cure, through a post hoc justification, a manifest error in the Initial Decision." Their reliance on *SEC v. Chenery Corp.*, which holds that an agency's decision cannot be defended in court on grounds that were not invoked by the agency in the course of its decisionmaking process, is misplaced.[95] *Chenery* does not preclude an agency from relying on reasoning different from that employed by its ALJ or, for that matter, reaching an entirely different result. Our review is *de novo* and plenary both as to factual findings and legal conclusions, and the ALJ's initial decision "ceased to have any force or effect once [the respondents] filed [their] petition for review."[96]

(…continued)

FOF to write uncovered puts and short variance swaps. And FOF, like the Fund, experienced large losses in the fall of 2008.

94 *See, e.g.*, *Dane S. Faber*, 2004 WL 239507, at *6 (holding that a "registered representative's willingness to speculate with his own funds . . . does not excuse his failure to disclose material information to his customer"); *Richard J. Buck & Co.*, Exchange Act Release No. 8482, 1968 WL 86080, at *7 (Dec. 31, 1968) ("[A] salesman's willingness to speculate with his own funds . . . cannot justify recommending the purchase or retention of such stock by customers without disclosure of that information so that the customers can make their own informed decision."), *aff'd sub nom.*, *Hanley v. SEC*, 415 F.2d 589 (2d Cir. 1969).

95 332 U.S. 114 (1947),

96 *Wendy McNeeley*, Exchange Act Release No. 68431, 2012 WL 6457291, at *13 n.32 (Dec. 13, 2012); *accord Michael Mendenhall*, Exchange Act Release No. 74532, 2015 WL 1247374, at *1 (Mar. 19, 2015); *Fundamental Portfolio Advisors, Inc.*, 2003 WL 21658248, at *13 n.44.

For ease of discussion, we group respondents' defenses into two basic categories: (1) that they reasonably investigated the written index puts and short variance swaps and that it is only with the benefit of hindsight that their risks became apparent; and (2) that they relied on the advice of counsel. We reject each of these arguments.

1. The risk of the derivatives were apparent to respondents at the time of they made the misrepresentations and omissions at issue

Respondents contend that they reasonably analyzed the derivatives before the Fund began using them on a regular basis in 2007.[97] However, the basis for our finding of antifraud liability is *not* that respondents were negligent portfolio managers or that they should conducted a more careful evaluation. Rather, respondents, based on the research that they actually did and the analysis that they actually conducted, knew that there were material risks associated with the Fund's use of the derivatives. There is overwhelming evidence that they had this knowledge, and therefore must have appreciated the falsity of, among other things, the 2007 and May 2008 reports' characterization of the Fund as "hedged."

a. *The risk was apparent from FAMCO's research*

Respondents do not dispute that certain of the articles and papers reviewed by Riad and Hughes described—and often explicitly quantified—the very significant potential downside risk of writing naked puts or taking a short variance position. But they contend that the Division cherry-picked these materials and that other articles "showed precisely the opposite."[98] In fact, *none* of the articles cited by respondents say that using these derivatives is free of significant risk. Instead, the articles tout their favorable *risk-adjusted performance*—*i.e.*, that it was potentially advantageous or "attractive" to employ them because the risk was more than compensated for by additional returns. That is beside the point, though: Even a carefully vetted strategy that the portfolio manager genuinely expects to perform well most of the time may still have a material contribution to risk, as was the case here.

Before the ALJ, the parties devoted considerable attention to whether writing out-of-the-money put options or writing variance swaps suffer from the "peso problem" in that their expected returns are strongly affected by low-probability, catastrophic events. The Division's expert, Professor Harris, opined that they did, asserting that while such trades typically produce small and regular profits—*e.g.*, the premiums received from writing options that very often expire out of the money—when done repeatedly, they occasionally result in

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97 Respondents also assert in passing that they viewed any resultant profits as "unusual and unexpected." There is no support for this claim; Riad tasked Hughes with researching the derivatives precisely because he believed that they could contribute to the Fund's performance and help the Fund meet its dividend target.

98 Respondents also assert that some of the articles addressed writing *at*-the-money puts, not the deep-out-of-the-money puts that the Fund wrote. As discussed *infra* Section III.C.1.c.i, the latter is not necessarily any less risky.

extremely large losses that swamp the gains. Respondents disagreed and argued that put writing was not technically susceptible to a peso problem in that "when the losses do occur, they don't offset all of the previous gains."

Regardless of this terminological dispute (and regardless of whether the long-run returns are negative or positive), there can be no dispute that writing naked puts regularly carries with it a significant risk of large interim losses. Indeed, the very article that respondents' witness cited for the proposition that naked put writing does not have a peso problem elsewhere warns that the strategy can be "very risky" and can result in "huge losses." In short, the risk associated with taking on a very large, deep-out-of-the money short put position is *not* that any single position is likely to lose money; many such trades may turn out to be profitable. Instead, the risk is that if one repeatedly executes such trades, sooner or later, there will be a sharp market downturn, and then the put position will lose a great deal of money—a risk that was borne out when the Fund collapsed in the fall of 2008.

b. *Respondents' "value-at-risk" analysis did not reduce risk to an insignificant or minimal level*

Respondents argue they used a value-at-risk (VaR) methodology to limit the size of the trades such that no single position would expose the Fund to more than a 0.5% chance of a $5 million loss (or about 5% of the Fund's NAV).[99] According to their expert, Professor Spatt, respondents believed that this was an "acceptable level of loss" given its expected likelihood. We find, based on FAMCO's own assumptions about the historical frequency of market declines and volatility spikes, that many of the Fund's positions exceeded this supposed limit. Therefore, respondents were not observing a self-imposed VaR limit in sizing the trades, and far from supporting respondents' contention that they viewed the Fund's use of the derivatives as posing only minimal risks, their VaR analysis must have made them aware of the seriousness of those risks.[100]

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[99] Respondents' arguments focus on this 5% threshold presumably because Instruction (c) to Item 8.4 of Form N-2 specifies that if a policy of a fund "limits a particular practice" so that it places "no more than five percent of the [Fund's] net assets at risk," the disclosure in the prospectus may be limited to "that necessary to identify the practice."

[100] We do not decide the significance of these numerical VaR thresholds as a general matter (or, for that matter, the appropriateness of a VaR, as opposed to some other analytic, methodology under all circumstances). Insofar as the discussion here is centered on a 0.5%/5% VaR threshold, it is to address respondents' argument that they were using it as a risk-management approach. This opinion should not be construed as expressing the view that a risk to less than 5% of a fund's assets is immaterial as a matter of law or that a risk that exceeds a 0.5%/5% VaR threshold necessarily triggers a disclosure obligation.

Based on FAMCO's own assumptions, the Fund took out such large derivative positions that there was an apparent risk that the Fund could sustain significant losses.[101] The evidence from specific trades refutes respondents' argument and shows that they did not rely on a VaR analysis to determine that there was no more than a 0.5% chance of a 5% or greater loss of fund assets from the derivative positions, as they now argue. For example, if the S&P 500 index had declined 10%, the Fund's written put positions expiring in September 2007 would have sustained $5.6 million in losses, corresponding to about a 5.1% drop in NAV; FAMCO's frequency analysis showed that the one-month probability of a 10% market decline was 2.92%. Relatedly, the frequency analysis also predicted a one-month probability of a 20% market decline of 0.63%—*i.e.*, above the 0.5% threshold. Yet a 20% market decline would have caused the Fund's written put positions expiring on *each* of 11 dates between August 18, 2007 and October 18, 2008 to incur losses of between 5.5% and 19.3% of the Fund's NAV.[102] The Fund's August 2008 put positions offer still another example of how low-probability (but still foreseeable) market declines could cause losses exceeding $5 million. Those positions lost $6 million and $9.5 million respectively on account of market declines of 19% and 22%. Riad's and Hughes's research showed that such declines could be expected to occur 0.73% and 0.42% of the time over a one-month period. Hughes conceded in his testimony that his analysis of the *smaller* of the Fund's two August 2008 put positions showed that there was at least a 0.73% chance of a $5 million loss to the Fund from that position alone.[103] Hughes further admitted that when the Fund's other August put position was factored in, the probability of an aggregate $5 million or greater loss was even higher.

Riad's and Hughes's risk analysis likewise showed that a one-month short variance swap entered into with a 30-basis-point initial notional value—*i.e.*, approximately 300,000 vega—had at least a 0.6% chance of causing a 5% or greater loss to the Fund's NAV. The Fund wrote short variance swaps with vegas of 300,000 or more on four separate occasions. Thus, for example, the 450,000 vega short variance swap position that was opened on January 2, 2008 had, applying FAMCO's own assumptions about potential increases in volatility, at least a 0.6% chance of causing a 7.5% or greater drop to the Fund's NAV and at least a 0.8% chance of

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[101] We take FAMCO's analysis and assumptions as a given because there is no claim in this proceeding that respondents were "negligent in analyzing written put options and variance swaps as investment strategies." We therefore have no occasion to decide the adequacy or reasonableness of respondents' VaR analysis, its underlying assumptions, or its focus on individual derivative positions in isolation.

[102] Specifically, the August 18, 2007; September 22, 2007; November 17, 2007; December 22, 2007; February 16, 2008; March 22, 2008; May 17, 2008; July 19, 2008; August 16, 2008; September 20, 2008; and October 18, 2008 positions.

[103] The actual loss probability was even higher, because the duration of the put in question was nearly two months.

causing a 5% or greater drop.[104] Riad and Hughes performed other backtesting as well, concluding, for example, that the probability of losing $3.9 million from selling one-month, 250,000 vega variance swaps was 1.83% under average market conditions and that the probability of losing $5.9 million from the same position was 0.63% in "bad" markets.

In sum, even crediting FAMCO's analysis—and contrary to what respondents now argue—many of the Fund's derivative positions were large enough to put more than 5% of the Fund's assets at risk of more than a 0.5% probability of loss. The VaR figures presented in FAMCO's Supplemental Wells submission show more than a 0.5% probability of a greater than 5% NAV loss for at least a dozen of the derivative transactions. Even Professor Spatt, respondents' expert, acknowledged in his testimony that the Fund's combined put option positions in August 2008 had a risk of a $5 million loss in excess of 0.5%.[105] Respondents must have appreciated these risks if, as they claim, they were performing VaR analyses all along, which further supports our finding of scienter.

c. *Respondents' four "firewalls" did not reduce risk to an insignificant level*

Respondents also argue that they implemented "four risk-limiting features" or "firewalls" with respect to the Fund's use of the derivatives: (i) the index put options were written deep out of the money; (ii) the size of each trade was limited to a level that would be unlikely to generate large losses; (iii) the variance swaps were sold only during periods of elevated volatility; and (iv) the Fund segregated assets to cover losses from the trades. None of these "firewalls" reduced risks to an immaterial level. And even if they had been fully effective in that task, they would not have rendered true the misstatements in the 2007 and May 2008 reports describing the Fund as "hedged" or cured the misleading omissions in those reports about how the Fund sought to achieve its investment objective and about the source of the Fund's returns.

i. Use of deep-out-of-money puts

The Fund wrote index put options deep out of the money, which means that the strike price was significantly less than—often between eight percent and ten percent below—the current index level. Although, as respondents point out, this decreased the *likelihood* that any particular put would be exercised (and thus that the Fund would owe money at expiration), the fact that the options were deep out of the money also meant that the premium that the Fund was paid up front was less per contract. Thus, as Professor Spatt acknowledged, in order to collect the same amount of premium, the Fund would need to write *more* contracts than it would if it

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[104] On the same day, the Fund entered into offsetting long variance swaps that were closed out within two weeks, leaving the Fund with a 450,000 vega short variance position between January 17, 2008 and March 20, 2008.

[105] Professor Spatt relied on FAMCO's Wells submissions and respondents' investigative hearing testimony without conducting any independent quantitative work; accordingly, we do not separately address his opinions about the appropriateness of FAMCO's VaR analysis.

were writing the options with strike prices closer to the current price of the index. Professor Spatt agreed that if a fund were writing "10 percent out of the money puts instead of at the money puts," it "would have had to have written more contracts" to generate a given level of income "because certainly [it] would have gotten a lot less premium" per contract. Thus, for a given level of income, writing *at* the money options has "more risk" in times of "lesser market declines," whereas in "steep market declines," *out* of money put options become "more sensitive" and resulted in larger losses.

In other words, by entering into deep-out-of-the-money put positions with very large notional values, Riad actually increased the Fund's leverage significantly and magnified the Fund's loss *exposure* in the event that the market declined steeply enough that the puts were exercised, which respondents knew would happen with some frequency. FAMCO's models assessed the one-month probability of an 8% or greater drop in the S&P 500 as 4.7%—*i.e.*, it could be expected to occur at least as often as every other year.

ii. Value-at-risk

Respondents also argue that they used a VaR methodology to limit the size of the written put or short variance swap positions so that there was no more than a 0.5% chance of losing 5% or more of the Fund's NAV. As explained above, the amount at risk exceeded this threshold for several individual trades. The Fund entered into such large naked put positions that, based on respondents' own frequency analysis, the probability of one-month S&P 500 declines sufficient to cause 5% or greater NAV loss was in many cases greater than 0.5%. Similarly, the Fund wrote short variance swaps with vegas exceeding 300,000 on more than 4 separate occasions, while respondents' frequency analysis showed that the probability of a 5% or greater NAV loss on any one-month short variance swap with a 300,000 vega initial notional value was 0.6%. There is no evidence that a 0.5%/5% VaR limitation was consistently observed by respondents.

iii. Selling variance only when volatility was elevated

Respondents contend that they sold variance only "at times when . . . losses were significantly less likely to occur." According to respondents, their research showed that the least risky time to sell variance swaps was when the VIX volatility index was above 20 because volatility is mean reverting—*i.e.*, when volatility is elevated, it is likely to subsequently decrease and return to the mean.

Riad's and Hughes's research in fact showed the opposite: Although selling variance when volatility is elevated is *on average* more profitable, that is also when losses are both more likely to happen and bigger when they do occur. Mean reversion does not mean that volatility will fall back to normal within a predictable, short period of time, such as the month or two that any given swap position is open. To the contrary, high VIX is historically correlated with increased volatility measured over the subsequent month. Riad's and Hughes's research showed that variance swap strike prices are good predictors of future volatility in the short term; thus, when VIX is high, realized volatility over the next month is likely to be high as well. There is "*not*," a JPMorgan research note explained, a "strong pattern of reduction in volatility in the first month following a spike." FAMCO's analysis also showed that selling variance swaps during periods of elevated volatility had more variability in returns and resulted in both larger gains and larger losses.

Respondents were counting on their ability to foresee when exactly a financial crisis would come to an end. As the September 2005 Goldman Sachs presentation that Riad and Hughes reviewed explained, the "[w]orst losses" come from selling variance "*during* crises," and the "[l]argest gains" come from selling variance "*right after* market crises." (Emphasis added.) The duration of a crisis is unpredictable, though—and when a volatility spike does not immediately subside, historical data showed that "significant further increase[s]" in volatility are common. Indeed, some of the most significant market downturns and crises in the 20 years before 2008 occurred at times when VIX was already above 20. For example, VIX exceeded 20 as early as August 1987, and when Black Monday hit on October 19, 1987, VIX spiked still further to close at 150.19.[106] It did not close below 20 until July of the following year. Selling variance when VIX was high was not a risk-limiting "firewall," but rather part and parcel of the reason that the Fund's regular use of the swaps was expected to boost its performance.

iv. Asset segregation

Respondents' final "firewall" is their claim that they limited risk by "segregating a certain amount of assets" for the transactions. The Fund set aside a certain amount of liquid assets to "cover" potential losses from the derivative trades and ensure that the Fund's obligations to counterparties could be satisfied. After considering alternatives, FAMCO decided to segregate assets based on the market value of the options written, instead of their much larger notional value. Thus, the deep out-of-the-money puts required only minimal Fund assets to be set aside at the time the Fund entered into the transactions.

As a result, the Fund's asset-segregation policy did not meaningfully limit the size of the written put positions that the Fund entered into, the leverage incurred by the Fund, or the potential losses that the Fund could incur.[107] Indeed, at times, the Fund had highly leveraged

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[106] In 2003, CBOE adopted a new methodology for measuring volatility. CBOE recalculated VIX from 1990-2003 using the updated methodology, while continuing to make available pre-1990 volatility index data using the old methodology, which was based on S&P 100 index options instead of S&P 500 index options. Respondents assert that the old methodology is unreliable in various respects, and that they were justified in using only the later data. But they do not dispute the qualitative features of trends in volatility and, moreover, some of the publications that Riad and Hughes relied upon in their research likewise employed the pre-1990 volatility data.

[107] The Division of Enforcement does not argue that the Fund's asset-segregation policy was improper and we, too, assume that to be the case. In December 2015, we proposed a rule that would further implement the risk-limiting provisions of Section 18 of the Investment Company Act by, among other things, establishing new asset-segregation requirements, limiting leverage, and requiring certain funds to establish derivatives risk management programs. *See* Proposed Rule, *Use of Derivatives by Registered Investment Companies and Business Development*

(continued…)

delta-equivalent exposures that were a substantial proportion—often exceeding 50% and at one point reaching 92%—of the Fund's total NAV. These exposures were in addition to the other exposures in the Fund's portfolio, including those associated with its variance swaps and covered-call positions.

d. *The market conditions in October 2008 were not unprecedented and unforeseeable*

Respondents also insist that the risks of the naked index puts and short variance swaps were clear only with the benefit of hindsight, and that their derivative positions lost money only because of the "extraordinary," "unprecedented" and "unpredictable" events of the 2008 financial crisis. They characterize the events of September and October 2008 as a "hundred year storm" that caused the trades to "incur much larger losses" than could have been anticipated. We disagree.

Even under "normal" market conditions, the risks associated with regularly and continually employing the derivatives at issue were significant and material. For example, a 10% drop in the S&P 500 over one month—which, according to FAMCO's frequency analysis, might happen 3% of the time—would have caused more than $1 million in losses for each of the Fund's written put positions expiring in August 2007, September 2007, November 2007, February 2008, July 2008, and August 2008. Further, as discussed above, even crediting respondents' analysis, there were a number of individual derivative trades that placed more than 5% of the Fund's assets at more than a 0.5% risk of loss. Therefore, although the size of the

(…continued)

Companies, Investment Company Act Release No. 31933, 2015 WL 8622264 (Dec. 11, 2015). The basis for antifraud liability in this proceeding is that respondents failed to adequately *disclose* the derivative strategies at issue here, not that respondents' decision to use them itself violated any then-existing rules or itself was improper. For the reasons set forth in the Division's February 11, 2016 opposition papers, we deny respondents' motion to dismiss this proceeding on the ground of the Commission's alleged impartiality; the Proposed Rule creates neither actual bias nor an impermissible appearance of bias in the resolution of respondents' appeal. Further, respondents' motion to disqualify the entire Commission fails as a matter of law. The "Commission is the only governmental agency with the statutory authority" to institute and dispose of administrative proceedings, which means that "disqualification cannot be permitted to prevent the Commission, the only tribunal with the power to act in this matter, from performing its duties." *Jean-Paul Bolduc*, Exchange Act Release No. 43884, 2001 WL 59123, at *2 (Jan. 25, 2001) (citing *FTC v. Cement Institute*, 333 U.S. 683 (1948), and applying the "rule of necessity"); *Augion-Unipolar Corp.*, Securities Act Release No. 5113, 1970 WL 103717, at *2 (Nov. 18, 1970). For this reason as well, we deny respondents' motion. Each Commissioner has also made a determination that his or her disqualification is not appropriate. *See* 17 C.F.R. § 200.60 (providing that each member shall individually rule on the question of his or her disqualification).

Fund's losses in October 2008 was undoubtedly magnified by the severity of the financial crisis, a significant risk existed (which was known and kept hidden by respondents).

Respondents' premise that it was only the "unprecedented" 2008 financial crisis that caused the Fund to realize substantial losses is flawed. The historic record is replete with examples of sudden, sharp declines in the market and episodes of continuing, elevated volatility that, given the size of the Fund's positions, would have resulted in very large losses. These include the 1987 stock market crash, the 1998 Asian and Russian financial crises (which triggered the collapse of Long-Term Capital Management), the 2001 Dot-Com slowdown; the September 11 attacks, and the 2002 accounting scandals. Had the Fund held the same positions that it held in August and September 2008 during these five other periods, it would have lost 49.1%, 5.1%, 7.1%, 16.0%, and 17.2% of its NAV, respectively. Counting the 2008 financial crisis itself, market events of this severity took place roughly once every five years on average, corresponding roughly to a probability of a significant loss from these positions of approximately 20% per year.

Indeed, Hughes admitted that his research showed that market declines as deep as had occurred in October 2008 happened on average once every four years. The elevated levels of volatility in September and October 2008 were not unprecedented either; Riad and Hughes identified three previous events in which realized volatility over a month exceeded the level reached in connection with the Fund's September 2008 variance swaps—*i.e.*, Black Monday (the month ended November 12, 1987); LTCM's collapse (the month ended September 24, 1998); and the initial revelation of the Enron accounting fraud (the month ended August 14, 2002). One presentation on swaps identified the "Asian crisis (1997), Russian debt default (1998), aftermath of the 9/11 attacks (2001), and 2002 corporate accounting scandals" as examples of the "[w]orst losses" from selling variance before or during a crisis. In short, the Fund would have suffered significant losses even in market conditions less adverse than those encountered in the 2008 financial crisis.

2. Respondents have not established an advice-of-counsel defense

To assert an advice-of-counsel defense to a scienter-based violation, 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."[108] We find that respondents have not satisfied the elements of this defense.

We have thoroughly reviewed the record, and find that respondents did not disclose to any attorney, whether directly or indirectly, how the Fund's was making use of naked written

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[108] *Zacharias v. SEC*, 569 F.3d 458, 467 (D.C. Cir. 2009).

puts and short variance swaps, their contribution to the Fund's performance, the risks entailed, and the fact that the strategies did not function as a hedge.[109]

Respondents identify a number of occasions on which they claim that they provided information to Fund counsel and others and received approval to proceed. FAMCO and Claymore did confirm to respondents that the Fund was *allowed* to trade in written put options or short variance swaps—*i.e.*, in the sense that these investments were not forbidden by the terms of the Fund's registration statement. But respondents neither sought nor received advice regarding the accuracy and sufficiency of the Fund's disclosures in the 2007 or May 2008 reports or whether the derivatives could properly be characterized as hedges.

For example, respondents rely heavily on a January 16, 2008 conference call involving Riad, Swanson, and a number of FAMCO compliance officers and Claymore attorneys. But the topic of that call was the permissibility of naked puts as strategic transactions, not disclosure issues or risk. Susan Steiner, a compliance manager at FAMCO, testified that she did not recall any discussion on the January call about "whether the fund was using written puts or variance swaps as a strategy," "whether the fund was obligated to disclose any strategy relating to the puts or variance swaps," or "about the risk of loss associated" with the derivatives.[110] Bruce Saxon, the Fund's CCO, was equally emphatic in his testimony. He explained that he simply relayed Fund counsel Thomas Hale's opinion that naked puts were permissible investments to Steiner and others; he agreed that he "didn't talk about variance swaps," "didn't talk about risk," and "didn't talk about disclosure issues" with Hale.[111] At any rate, the timing of the January 16 call negates any claim of reliance: That call took place *after* the Fund wrote its first naked index put and short variance swap and *after* Swanson and Delony met to prepare the Q&A section that would appear in the Fund's 2007 annual report.

Independently of respondents' failure to make the requisite factual showings, we also determine that respondents could not show that they relied in *good faith* on any advice that they

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109 We summarize the principal discussions in Appendix B.

110 Steiner prepared a contemporaneous memorandum summarizing the call. The memo states that the conclusion reached on the call was that the "trade [the sale of an uncovered put] was considered a strategic transactions as discussed in the [prospectus] therefore there is no violation." It contains no discussion relating to disclosure issues.

111 It was not until after the Fund's collapse that Hale learned more about the Fund's ongoing use of naked puts and variance swaps, so Hale would not have been in a position to offer meaningful guidance on such issues. He did not recall either respondent ever describing the "derivative trading strategies in the same detail in . . . meetings prior to September 2008." Likewise, Hale admitted in his hearing testimony that he not discuss with anyone at FAMCO or Claymore any "risk analysis they might have done in connection with index put or variance swap investments."

claim to have received.[112] As experienced portfolio managers, respondents must have understood their obligation to ensure that the Fund's disclosures regarding investment strategies, performance, and risk were accurate and complete, without needing to be prompted by counsel.[113] Although a securities professional cannot necessarily be "expected to display finished scholarship in all of the fine points" of the securities laws,[114] the duty not to mislead investors and to provide them with material information is fundamental.

Respondents were personally responsible for the inaccurate and incomplete disclosures in the Q&A section of the Fund's annual and semiannual reports and—as set forth in detail above—knew the facts that made those disclosures materially misleading and incomplete when made.[115] The initial version of the Q&A section closely tracked Delony's interviews with Swanson. Respondents reviewed and approved Delony's draft before it was sent to Claymore and Fund counsel. And they retained the final say over its content, to the point that Delony always accepted their changes because she wanted the Q&A section to accurately convey respondents' message. Respondents made the decision to focus on the Fund's equity selection and covered-call strategy while concealing the performance impact and risks of writing naked puts and entering into short variance swaps. They decided to characterize the Fund's use of these derivatives as a "global macro hedge." These were not technical, compliance-related or

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[112] *See, e.g.*, *Raymond J. Lucia Cos., Inc.*, 2015 WL 5172953, at *20 & n.89, *26 (holding that "any reliance [that the respondents] placed on third party review would not have been reasonable" because they "were well aware of the facts that rendered the [communications] misleading") (quotation marks omitted).

[113] *See, e.g.*, *Graham*, 222 F.3d at 1005-06 (fact that respondent's immediate supervisor approved unlawful trades did not negate scienter given her actual awareness of warning signs and red flags); *Wonsover v. SEC*, 205 F.3d 408, 415 (D.C. Cir. 2000) ("Precedent will not suffer [the respondent's] argument that he justifiably relied on the clearance of sales by . . . the transfer agent and counsel.").

[114] *Howard v. SEC*, 376 F.3d 1136, 1148 (D.C. Cir. 2004).

[115] *Cf. Donner Corp. Int'l*, Exchange Act Release No. 55313, 2007 WL 516282, at *12 (Feb. 20, 2007) ("We reject [the respondent's] argument that he did not act with scienter because he relied on . . . Compliance and Legal Department directives. [The respondent] . . . *himself* read the reports that contained positive statements about the issuers, reviewed the public filings pertaining to the issuers that included negative financial information, and knew that this negative information was not included in the reports. [The respondent] did not believe that the individuals on whom he purportedly relied were investigating financial information beyond the companies' public filings. . . . . [The respondent] did not reasonably rely on . . . the compliance or legal department to correct the material misstatements and omissions that he recklessly disregarded."); *Dane S. Faber*, Exchange Act Release No. 49216, 2004 WL 239507, at *6 (Feb. 10, 2004) (rejecting respondent's argument that he lacked "scienter because he properly relied on [his firm's] research" on a company when he "*in fact* read [the firm's] business plan, which contained much of the material information he failed to disclose").

legal judgments that respondents could reasonably have believed others were independently evaluating. In short, Riad and Swanson could not in good faith have relied on any advice that purported to excuse them from the duty to speak the truth to investors about the Fund's investment strategies, performance, and risks.[116]

D. Riad caused the Fund's violations of Investment Company Act Rule 8b-16

The Fund violated Rule 8b-16 by failing to amend its registration statement or disclose in its 2007 annual report the material changes to the Fund's investment policies and principal risk factors resulting from the use of the derivatives at all. We find that Riad caused the Fund's violations of Rule 8b-16.

1. The Fund's underlying violations of Rule 8b-16

Section 8(b) of the Investment Company Act requires registered investment companies to file a registration statement with the Commission.[117] Closed-end funds must file a registration statement on Form N-2. Item 8.2 of that Form requires disclosure in the prospectus of a fund's "investment objectives and policies . . . that will constitute [the fund] principal portfolio emphasis," including, among other things, "how the [fund] proposes to achieve its objectives"; "the types of securities in which the Registrant invests or will invest principally"; and a description of the "significant investment practices or techniques that the [fund] employs or intends to employ." Item 8.3 further requires disclosure of the "principal risk factors" associated with investment in the fund specifically, as well as those risk factors associated with investment in a fund with investment objectives and policies similar to those of the fund. Item 8.4 requires the fund to "briefly discuss" the types of investments that will be made by the fund, "other than those that will constitute its principal portfolio emphasis."

As discussed above, the covered-call strategy was the only principal investment strategy discussed in the Fund's registration statement. That document did not identify either written index puts or short variance swaps as a manner in which the Fund would achieve its investment objective, as a principal type of security in which the Fund would invest, or as even a significant

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[116] *See United States v. King*, 560 F.2d 122, 132 (2d Cir. 1977) ("[S]ignificant representations were made as to specific facts . . . [and] we cannot understand how a businessman who knows that such factual representations are untrue can screen himself by trying to rely on advice of counsel."); *Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 641-44 (D.C. Cir. 2008) (rejecting reliance-on-counsel defense when the petitioner "could not have had a genuine belief in" his statements' "completeness and accuracy"); *SEC v. Goldfield Deep Mines Co. of Nevada*, 758 F.2d 459, 467 (9th Cir. 1985) (rejecting reliance-on-counsel defense when defendants "knew" that statements made in public filings "were false or misleading").

[117] 15 U.S.C. § 80a-8(b).

investment practice or technique that the Fund would employ.[118] Nor did it disclose the risks associated with these derivatives; for example, a reasonable investor reading that document would not have appreciated that they exposed the Fund to a substantial risk of losses in the event of a sharp decline in the market or increased volatility.

Although Rule 8b-16(a) requires that an investment company filed an amended registration statement annually, Rule 8b-16(b) exempts a closed-end investment company from this requirement, as long as the fund includes certain information in its annual report, including "material changes in the company's investment objectives or policies" and "material changes in the principal risk factors associated with investment in the company," as described in Items 8.2 and 8.3 of Form N-2, respectively.[119] Rule 8b-16(b) thus required the Fund to disclose in its 2007 annual report the material changes to its investment policies and principal risk factors that resulted from the use of the derivatives if it intended to avoid filing a post-effective amendment to its registration statement.

The 2007 annual report did not disclose either the material changes in the Fund's investment policies (*i.e.*, the systematic use of the derivatives to help achieve the Fund's objective of maintaining a high dividend rate) or the material risks to the Fund that resulted. Thus, because the annual shareholder report did not contain the required disclosure and the Fund did not file a post-effective amendment, it violated Rule 8b-16.

Riad argues that the Fund was not required to update its registration statement or make additional disclosures in the annual report on account of the derivatives. He asserts that the written put options and short variance swaps were never principal strategies of the Fund. He also claims that their risks were so insignificant that they were exempt from disclosure under the value-at-risk framework set forth in Item 8.4. Neither of these arguments is persuasive.

a. *The Fund's regular and ongoing use of the derivatives materially changed its investment policies*

Both respondents and the Division have framed their arguments on the understanding that the definition of "principal investment strategy" given in Form N-1A, the registration statement used by open-end funds, is applicable here, although neither Form N-2 nor Rule 8b-16 uses that precise language. Form N-2, under Item 8.2's heading "Investment Objectives and Policies," directs registrants to "[c]oncisely describe the investment objectives and policies of the [fund] that will constitute its principal portfolio emphasis," including a description of:

> How the [fund] proposes to achieve its objectives, including [] the types of securities in which the [fund] invests or will invest principally . . . and the

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118 Item 17 of Form N-2 requires a full discussion in the SAI of any "significant investment policies" not already described in the prospectus, including the "extent to which [the fund] may engage" in them and the "risks inherent" to them.

119 17 C.F.R. § 270.8b-16.

> significant investment practices or techniques that the [fund] employs or intends to employ

By comparison, Form N-1A states:

> Whether a particular strategy . . . is a principal investment strategy depends on the strategy's anticipated importance in achieving the fund's investment objectives[] and how the strategy affects the fund's potential risks and returns . . . . [C]onsider, among other things, the amount of the Fund's assets expected to be committed to the strategy, the amount of the Fund's assets expected to be placed at risk by the strategy, and the likelihood of the Fund's losing some or all of those assets from implementing the strategy.

No party has identified any reason why open-end and closed-end funds should be governed by different disclosure concepts in this context; they use the various phrases interchangeably both in their briefing to us and in contemporaneously prepared documents. For example, the Fund's prospectus referred the reader to its discussion of "Investment Objectives and Policies" for a "complete description of the Fund's investment strategy." The parties' common understanding about the nature of the disclosure concepts shared between Forms N-1A and Form N-2 is a reasonable interpretation of our rules and regulations.[120] Specifically, we conclude that the Fund's use of derivatives resulted in material changes to the matters required to be disclosed under Item 8.2 for purposes of Rule 8b-16 because they played a significant role in how the Fund sought to achieve its investment objective and had a significant effect on the Fund's risks and returns.

As explained above, respondents all along expected the Fund's use of the derivatives to boost the Fund's performance and help them meet the Fund's dividend target. Respondents themselves understood at the time that they were using the derivatives that they were executing "Alternative Investment Strategies" that were intended to "enhance returns." For instance, they defended their "strategic and consistent selling" of deep-out-of-the-money puts over the last year as supported by backtesting data demonstrating that it was an "attractive stand-alone investment strategy." They admitted in a November 2008 memorandum to the Fund's Board that they "adopt[ed] the [derivative] strategies as a means of sustaining [the Fund's] high dividend payout objective." The actual contribution of the derivatives to the Fund's performance and risk exposure was also significant, as we have detailed above.

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[120] Respondents' disclosure expert, Jay Baris, agreed that Forms N-1A and Form N-2 are "pretty similar" in this respect and recognized that those involved in preparing closed-end fund disclosures draw upon the "guidance provided by Form N-1A."

b. *The Fund's regular and ongoing use of the derivatives materially changed its risks*

We find that the Fund's use of the derivatives changed the "principal risk factors" of the Fund within the meaning of Item 8.3 and Rule 8b-16. On a qualitative level, it exposed the Fund to risks that were materially different from those faced by ordinary covered-call funds. As stated by Thomas Hale, counsel to the Fund, the latter include the "risks of owning common stock, the risks of securities selection, the risks of covered call writing, of liquidity risks." The derivatives introduced fundamentally different risks. For example, unlike covered calls, naked puts and short variance swaps can result in losses that are greater than the initial size of the investment. When, as here, a mark-to-market asset-segregation approach is employed by a fund, a naked-put strategy may increase the fund's leverage and significantly increase the risk of the fund's portfolio. This creates the possibility for very large losses in the event of a market decline. Likewise, short variance swaps can result in large losses, theoretically unlimited, in the event of spikes in market volatility. These risks are materially different in kind from those inherent to covered-call funds.

Additionally, on a quantitative level, the derivatives increased the Fund's leverage and placed a significant percentage of the Fund's assets at risk. The Commission has not established a *per se* numerical threshold at which a risk becomes "principal" for purposes of Rule 8b-16(b), and we do not do so here either. However, the risk taken on by the Fund was substantial by any measure. For example, there were a number of put positions whose delta-equivalent risk exposure at times exceeded 50% of the Fund's NAV, showing how leveraged the Fund had become. Also, there were over a dozen derivative positions that *each* placed more than 5% of the Fund's assets at more than a 0.5% risk of loss; the risk in the aggregate was greater still.

Riad argues that the Fund's disclosure obligations with respect to the derivatives were limited by Instruction (c) to Item 8.4 of Form N-2.[121] That instruction specifies that if a policy of the fund "limits a particular practice" so that it places "no more than five percent of the [Fund's] net assets at risk," the disclosure in the prospectus may be limited to "that necessary to identify the practice." Riad's reliance on Instruction (c) is misplaced. As explained above, FAMCO's own VaR analysis showed that many of the Fund's naked index put and short variance swap positions put more than 5% of the Fund's assets at risk of more than a 0.5% probability of loss. Further, Instruction (c) explains that the potential loss must be measured at the level of the "particular practice," rather than any particular *transaction*. Considered together, the derivative positions, which were entered into by the Fund on a regular and ongoing basis, placed far more than 5% of the Fund's assets at risk.

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[121] Respondents also point to our "Plain English" guidelines, which encourage the use of concise and understandable risk disclosures in order to ensure that investors are not overwhelmed with extraneous information or boilerplate. That is not license for registrants to omit material information about a principal strategy.

2. Riad caused the Fund's violations

Causing liability requires finding (1) a primary violation; (2) that the respondent knew, or should have known, that his or her conduct would contribute to the violation; and (3) that the respondent engaged in an act or omission that contributed to the violation.[122] We find that Riad caused the Fund's Rule 8b-16 violations by causing the Fund to employ the derivatives at issue while being aware that they were not disclosed in the Fund's registration statement or identified as new strategies in the Fund's 2007 annual report; failing to manage the Fund in a manner consistent with the Fund's prospectus disclosures; and contributing to the Fund's disclosure violations by describing the derivatives in his communications with Claymore and the Board as "hedges" or as providing downside protection.

At all relevant times, Riad was primarily responsible for overseeing the Fund's use of written puts and short variance swaps. There is no dispute that he was familiar with the Fund's registration statement and the disclosures that it contained. Indeed, on an annual basis, Riad provided a signed certification to Claymore stating that the securities in the Fund's portfolio were purchased in compliance with the investment parameters set forth in the prospectus. And although Swanson had principal responsibility for preparing, revising, and certifying the accuracy of the Q&A sections in the Fund's periodic reports, both Riad and Swanson reviewed it and had shared responsibility for the content. Riad thus must have known that neither the Fund's registration statement nor the 2007 report adequately disclosed the derivatives he managed or explained their impact on the Fund's performance and their risks. Yet Riad continued to employ them and, in so doing, caused the Fund's violations of Rule 8b-16.

IV. **Sanctions**

Respondents' egregious, scienter-based antifraud violations warrant significant sanctions. We permanently bar Riad and bar Swanson with right to reapply after two years. We also order respondents to cease and desist from violations of the securities laws and to each pay a civil penalty of $130,000. And we order Riad to disgorge his ill-gotten gains of $128,091.81.

A. **Bars**

We may impose a suspension or bar from association with investment advisers or investment companies under Section 9(b) of the Investment Company Act if we find that (1) the individual willfully violated, or willfully aided and abetted or caused any violation of, the securities laws and (2) the sanction is in the public interest.[123] We may impose a suspension or

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122 *See, e.g.*, *Gateway Int'l Holdings, Inc.*, Exchange Act Release No. 53907, 2006 WL 1506286, at *8 (May 31, 2006); *Robert M. Fuller*, Exchange Act Release No. 48406, 2003 WL 22016309, at *4 (Aug. 25, 2003), *petition denied*, 95 F. App'x 361 (D.C. Cir. 2004).

123 15 U.S.C. § 80a-9(b)(2) to -(3). Specifically, the Commission may prohibit the person from "serving or acting as an employee, officer, director, member of an advisory board,

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bar under Section 203(f) of the Advisers Act if those two conditions are met and, additionally, the individual was associated with an investment adviser during the relevant period.[124] There is no question that respondents were associated with an investment adviser, and we have found that they willfully committed antifraud violations under the securities laws and, in Riad's case, willfully caused the Fund's violations of the Investment Company Act. Thus, the remaining issue is whether a bar is in the public interest. We conclude that it is.

In assessing what sanction would be in the public interest, we consider the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the respondent's recognition of the wrongful nature of his or her conduct, the sincerity of the respondent's assurances against future violations, and the likelihood that the respondent's occupation will present opportunities for future violations.[125] We do not look solely at "past misconduct."[126] Rather, because the remedy is intended to "protect[] the trading public from further harm," not to punish the respondent,[127] the "degree of risk [that the respondent] poses to the public" and the extent of the respondent's "unfitness to serve the investing public" are central considerations to our analysis.[128] Our inquiry is flexible, and no one factor is dispositive.[129]

"[B]ecause the appropriate remedial action depends on the facts and circumstances of each particular case, the proper sanction cannot be precisely determined by comparison with action taken in other cases."[130] Under the particular circumstances here, we bar Riad

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investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter." *Id.*

124 15 U.S.C. § 80b-3(f); *see also id.* § 80b-3(e)(5) to -(6). Specifically, the Commission may "suspend for a period not exceeding 12 months or bar any such person from being associated with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization." *Id.* § 80b-3(f). We do not bar respondents from association with municipal advisors and nationally recognized statistical rating organizations. *See Koch*, 793 F.3d at 157-58.

125 *See, e.g.*, *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd*, 450 U.S. 91 (1981).

126 *Johnson v. SEC*, 87 F.3d 484, 490 (D.C. Cir. 1996).

127 *McCarthy v. SEC*, 406 F.3d 179, 188 (2d Cir. 2005).

128 *Meadows v. SEC*, 119 F.3d 1219, 1228 & n.20 (5th Cir. 1997).

129 *See, e.g.*, *Gary M. Kornman*, Exchange Act Release No. 59403, 2009 WL 367635, at *6 (Feb. 13, 2009).

130 *Jason A. Craig*, Exchange Act Release No. 59137, 2008 WL 5328784, at *6 & n.41 (Dec. 22, 2008) (collecting cases); *see also Geiger v. SEC*, 363 F.3d 481, 488 (D.C. Cir. 2004) (stating

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permanently and bar Swanson with the right to apply after two years. Respondents' conduct was egregious and undertaken with scienter.[131] The Fund's 2007 and May 2008 reports contained misleading discussions regarding the Fund's exposure to market declines or increases in volatility, how the Fund was pursuing its investment objective, and the sources of the Fund's returns. Respondents failed to disclose the Fund's use of written index puts and short variance swaps, their impact on the Fund's performance, and the risk to which they exposed the Fund. By making the material misrepresentations and omissions discussed above while knowing of their falsity and incompleteness, respondents committed fraud. Further, Respondents' misconduct was recurrent. The inaccurate disclosures regarding the Fund's use of the derivatives were made in successive reports to shareholders.[132] Their misconduct thus cannot be viewed as an isolated lapse in judgment.[133] Respondents also have not recognized the wrongful nature of their misconduct; indeed, they have attempted to shift responsibility for the accuracy and sufficiency of the Fund's disclosures on to the Fund's Board or its counsel.[134] Nor have they supplied assurances against future violations. And given their stated intention to remain in the investment management field if given a chance to do so, opportunities for future

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that, because "[t]he Commission is not obligated to make its sanctions uniform," court would not compare sanction imposed in case to those imposed in previous cases).

[131] Scienter is "highly relevant to a determination of whether the defendant has the propensity to commit future violations," and thus to our evaluation of each respondent's ongoing risk to the investing public. *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 542 (2d Cir. 1973); *see also Aaron v. SEC*, 446 U.S. 680, 701 (1980) (observing that an "important factor" in determining the likelihood of future violations "is the degree of intentional wrongdoing evident in a defendant's past conduct").

[132] *See, e.g.*, *Fundamental Portfolio Advisors, Inc.*, 2003 WL 21658248, at *16 (noting that the "fraud upon Fund investors continued for almost two years").

[133] *See, e.g.*, *Francis V. Lorenzo*, Exchange Act Release No. 74836, 2015 WL 1927763, at *10 n.32, *13 (Apr. 29, 2015) (noting that respondent sent "two misleading emails separately, to different customers, thus presenting separate opportunities to mislead prospective investors").

[134] *See, e.g.*, *John W. Lawton*, Advisers Act Release No. 3513, 2012 WL 6208750, at *12 & n.64 ("[F]ailure[] to recognize the wrongfulness of his conduct presents a significant risk that, given th[e] opportunity, he would commit further misconduct in the future."); *vFinance Invs., Inc.*, Exchange Act Release No. 62448, 2010 WL 2674858, at *15 (July 2, 2010) ("As we have stated, 'attempts to shift blame are additional indicia of [a respondent's] failure to take responsibility for his actions."') (quoting *Clyde J. Bruff*, Exchange Act Release No. 40583, 53 SEC 880, 1998 WL 730586, at *5 (Oct. 21, 1998), *pet. denied*, 198 F.3d 253 (9th Cir. 1999))); *cf. Seghers v. SEC*, 548 F.3d 129, 136-37 (D.C. Cir. 2008) (rejecting argument that the Commission violated the respondent's due process rights by taking into account his failure to recognize the wrongfulness of his conduct).

violations will arise.[135] Collectively, these considerations demonstrate that respondents pose a continuing substantial danger to the investing public and that a significant sanction is warranted.

Respondents' principal argument against a bar is that they lacked the intent to deceive and were transparent about how they managed the Fund—assertions that are inconsistent with the record and our findings above. Respondents also argue that bars are appropriate only in the most egregious cases and cite two follow-on proceedings involving criminal convictions. But scienter-based antifraud violations by investment advisers often result in industry-wide, permanent bars,[136] and we have barred advisers even for committing fraud without scienter.[137] Respondents point to their previously unblemished disciplinary records. Yet their "lack of previous securities law violations does not outweigh the concern that, for the reasons discussed above, [they] will pose a continuing danger to investors."[138]

Given Riad's involvement in researching, evaluating, and ultimately implementing the derivative trades at issue, he plainly was aware they were not adequately disclosed. He hid these facts from the Fund's Board and its shareholders. Riad signed off on the Q&A section in the Fund's reports and shared responsibility with Swanson for their contents. Riad also took the lead on portfolio discussions at Board meetings and thus was responsible for keeping the Board in the dark. For these reasons, we have determined that it is the public interest to permanently bar him. But as to Swanson—who did not personally research the derivatives (although he was aware of their impact on the Fund's performance and their risky nature), decide to implement them, or receive any direct personal benefit[139]—we have determined that a bar with a right to reapply after two years will provide sufficient protection of the public interest and investors.

B. **Cease-and-desist order**

Section 21C of the Exchange Act, Section 203(k) of the Advisers Act, and Section 9(f) of the Investment Company Act authorize us to issue a cease-and-desist order upon a person who "is violating, has violated, or is about to violate" any provision of these statutes or any rule or

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135 *See, e.g.*, *Fundamental Portfolio Advisors, Inc.*, 2003 WL 21658248, at *17 (noting the "likelihood that [the respondent's] occupation will present opportunities for future violations" in light of his "expressed goal of resuming his career as a mutual fund portfolio manager").

136 *See, e.g.*, *Raymond J. Lucia Cos., Inc.*, 2015 WL 5172953, at *26; *Brendan E. Murray*, Advisers Act Release No. 2809, 2008 WL 4964110, at *10 (Nov. 21, 2008); *Justin F. Ficken*, 2008 WL 4610345, at *3; *Fundamental Portfolio Advisors, Inc.*, 2003 WL 21658248, at *17.

137 *See, e.g.*, *Mitchell M. Maynard*, Advisers Act Release No. 2875, 2009 WL 1362796, at *10 (May 15, 2009).

138 *See, e.g.*, *Raymond J. Lucia Cos., Inc.*, 2015 WL 5172953, at *25.

139 Swanson was paid a fixed salary and bonus that was not based on the Fund's performance or its assets under management.

regulation thereunder.[140] Such orders must be in the public interest, and in making that determination, we consider essentially the same factors that we considering when imposing a suspension or bar.[141] In addition, we "consider whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought."[142] The risk of future violation needed to support a cease-and-desist order "need not be very great"[143] and even a "single egregious violation can be sufficient to indicate some risk of future violation."[144] Indeed, "[i]n the ordinary case, and absent evidence to the contrary, a finding of past violation raises a risk of future violation sufficient to support our ordering a respondent to cease and desist."[145]

Respondents do not contest the appropriateness of a cease-and-desist order. For essentially the same reasons that we find that a bar is appropriate as to Riad and that a bar with a right to reapply is appropriate as to Swanson—*e.g.*, the nature of the violations, the egregiousness of their misconduct, and the other public interest factors discussed above—we conclude that there is a sufficient risk of future violations to justify the entry of a cease-and-desist order.

C. **Civil penalties**

Sections 21B of the Exchange Act, 203(i) of the Advisers Act, and 9(d) of the Investment Company Act authorize us to impose civil money penalties for willful violations of the securities laws when such penalties are in the public interest.[146] In determining whether penalties are in the public interest, we consider: (1) whether the act or omission involved fraud; (2) whether the act or omission resulted in harm to others; (3) the extent to which any person was unjustly enriched; (4) whether the individual has committed previous violations; (5) the need to deter such person and others from committing violations; and (6) such other matters as justice may require. If we determine that the imposition of a civil penalty is in the public interest, a three-tier system establishes the maximum such penalty that may be imposed for each violation

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140 15 U.S.C. §§ 78u-3, 80a-9(f), § 80b-3(k).

141 *E.g.*, *KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 WL 47245, at *26 (Jan. 19, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002); *Joseph J. Barbato*, Exchange Act Release No. 41034, 1999 WL 58922, at *14 n.31 (Feb. 10, 1999).

142 *KPMG Peat Marwick LLP*, 2001 WL 47245, at *26.

143 *Id.* at *24; *see also Robert L. Burns*, Advisers Act Release No. 3260, 2011 WL 3407859, at *8 & nn.34-35 (Aug. 5, 2011).

144 *Dolphin & Bradbury, Inc.*, Exchange Act Release No. 54143, 2006 WL 1976000, at *15 (July 13, 2006), *pet. denied*, 512 F.3d 634 (D.C. Cir. 2008).

145 *Fundamental Portfolio Advisors, Inc.*, 2003 WL 21658248, at *18.

146 15 U.S.C. §§ 78u-2, 80a-9(d), 80b-3(i).

found. For each act or omission involving fraud or deceit that additionally resulted in (or created a significant risk) of substantial losses to other persons or that resulted in substantial gains to the wrongdoer, a third-tier penalty may be warranted.[147] For the time period at issue here, the maximum third-tier penalty for a natural person was $130,000 for each violation.[148]

Respondents made fraudulent misstatements and omissions in willful violation of the securities laws. Their conduct was egregious and resulted in about $45 million in losses to the Fund's investors. The ALJ considered respondents' misconduct to be a single "course of action resulting in one unit of violation" and imposed the maximum, $130,000, third-tier civil penalty on each respondent.[149] Neither the Division nor respondents challenge this aspect of the initial decision. We impose a $130,000 civil penalty on each respondent as well.[150]

D. **Disgorgement**

Sections 21C(e) of the Exchange Act, 203(j) of the Advisers Act, and 9(e) of the Investment Company Act authorize us to order disgorgement of ill-gotten gains.[151] "[D]isgorgement's underlying purpose is to make lawbreaking unprofitable for the law-breaker[.]"[152] Accordingly, a disgorgement calculation requires only a "reasonable approximation profits causally connected to the violation" and may include "all gains flowing from the illegal activities."[153] Once the Division shows that its disgorgement figure is a prima facie reasonable approximation of the amount of unjustly earned gains, the burden shifts to the respondent to demonstrate that the Division's estimate is not a reasonable approximation.[154] Therefore, although salaries and other amounts earned through lawful and legitimate activities unconnected with the wrongdoing are not subject to disgorgement,[155] "any risk of uncertainty" in

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147 15 U.S.C. §§ 78u-2(c), 80b-3(i)(3); *see also Anthony Fields*, 2015 WL 728005, at *24.

148 17 C.F.R. § 201.1003 sets forth the inflation-adjusted maximum civil penalty amounts for violations occurring after February 14, 2005 but before March 3, 2009.

149 *Mohammed Riad*, 2014 WL 1571348, at *34.

150 Our decision should not be regarded as endorsing the view that misconduct like respondents' could be characterized *only* as a single violative course of action.

151 15 U.S.C. §§ 78u-3(e), 80a-9(e), 80b-3(j).

152 *SEC v. Contorinis*, 743 F.3d 296, 301 (2d Cir. 2014); *accord Sheldon v. Metro-Goldwyn Pictures Corp.*, 309 U.S. 390, 399 (1940) (explaining that the purpose of disgorgement is "not to inflict punishment but to prevent an unjust enrichment").

153 *SEC v. JT Wallenbrock & Assocs.*, 440 F.3d 1109, 1113-14 (9th Cir. 2006) (quotations and citation omitted).

154 *SEC v. Lorin*, 76 F.3d 458, 462 (2d Cir. 2006); *see also SEC v. Whittemore*, 659 F.3d 1, 8 (D.C. Cir. 2011).

155 *See, e.g.*, *SEC v. Teo*, 746 F.3d 90, 107 n.31 (3d Cir. 2014); *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971); *Gregory O. Trautman*, Exchange Act Release No.

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distinguishing between lawful and unlawful proceeds must "fall on the wrongdoer whose illegal conduct created that uncertainty."[156]

The ALJ ordered Riad to disgorge a total of $188,948.52.[157] She reasoned that Riad had three major roles at FAMCO—portfolio manager of the Fund, portfolio manager of another fund, and managing director at FAMCO—so that one-third of his salary and bonus for the period that the Fund used the derivatives was a reasonable approximation of ill-gotten gains, which she calculated as summing to $179,095.49. She also ordered Riad to disgorge the portion of his equity distributions attributable to management fees paid on the Fund's assets under management: $7,853.03.

Riad challenges this disgorgement calculation in one respect: He correctly argues that the ALJ erroneously assumed that the Fund wrote its first naked index put on April 25, 2007. In fact, it was only on November 2, 2007 that the Fund began to write puts without offsetting them with purchased puts; the Fund wrote its first short variance swap on July 26, 2007. Thus, we instead order disgorgement in the amount of $36,905.50 (*i.e.*, one third of Riad's 2007 salary and bonus prorated from July 26 onwards) plus $83,333.28 (*i.e.*, one third of Riad's 2008 salary and bonus) plus $7,853.03 from Riad's equity distributions, or a total of $128,091.81.

V. **<u>Constitutional claims</u>**

We reject respondents' constitutional challenges to the Commission's administrative forum, as we have done in a number of other recent matters.[158]

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61167A, 2009 WL 6761741, *23 & n.104 (Dec. 15, 2009) (ordering disgorgement of a proportion of the respondent's compensation so as to "reflect in an equitable way the fact" that the respondent "provided some legitimate services").

156 *See, e.g.*, *SEC v. Calvo*, 378 F.3d 1211, 1217 (11th Cir. 2004); *First City Fin. Corp.*, 890 F.2d 1215, 1232 (D.C. Cir. 1989).

157 The ALJ found that Swanson's salary was earned primarily from his management of the equity and covered-call portion of the Fund, which was not at issue in this proceeding. Likewise, she found that Swanson's bonuses did not relate to the derivative strategies. Therefore, she declined to order disgorgement as to Swanson, which is a determination that the Division does not challenge and that we do not now revisit.

158 *See David F. Bandimere*, Exchange Act Release No. 76308, 2015 WL 6575665 (Oct. 29, 2015), *pet. for review filed*, No. 15-9586 (10th Cir. Dec. 22, 2015); *Timbervest, LLC*, Advisers Act Release No. 4197, 2015 WL 5472520 (Sept. 17, 2015), *pet. for review filed*, No. 15-1416 (D.C. Cir. Nov. 13, 2015); *Raymond J. Lucia Co.*, 2015 WL 5172953, *supra* note 37.

A. **Appointments Clause**

Respondents argue that ALJ Carol Fox Foelak—who presided over this matter and issued the Initial Decision—was not appointed in a manner consistent with the Appointments Clause of the Constitution. We find that the appointment of Commission ALJs is not subject to the requirements of the Appointments Clause.

The Appointments Clause provides that that the President "by and with the advice and consent of the Senate, shall appoint . . . Officers of the United States . . . but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments."[159] It therefore requires that certain high-level government officials be appointed in particular ways: "Principal officers" must be appointed by the President (and confirmed by the Senate), while "inferior officers" must be appointed either by the President, the heads of departments, or the courts of law. The great majority of government personnel are neither principal nor inferior officers, but rather "mere employees" whose appointments are not restricted by the Appointments Clause.[160] The Division does not dispute that ALJ Foelak was not appointed by the President, the head of a department, or a court of law.[161] Respondents therefore contend that her appointment violates the Appointments Clause because, in their view, ALJ Foelak should be deemed an inferior officer. The Division counters that she is an employee and thus there was no violation of the Appointments Clause.

As we have previously explained,[162] the D.C. Circuit's decision in *Landry v. FDIC* guides our resolution of this question.[163] *Landry* held that, for purposes of the Appointments Clause, ALJs at the Federal Deposit Insurance Corporation ("FDIC"), who oversee administrative proceedings to remove bank executives, are employees rather than inferior officers. *Landry* explained that the touchstone for determining whether adjudicators are inferior officers is the extent to which they have the power to issue "final decisions."[164] Although ALJs at the FDIC take testimony, conduct trial-like hearings, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders, they "can never render the decision

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159 U.S. Const. art. II, § 2, cl. 2.

160 *Landry v. FDIC*, 204 F.3d 1125, 1134 (D.C. Cir. 2000) (quoting *Freytag v. Comm'r*, 501 U.S. 868, 882 (1991)); *see also Buckley v. Valeo*, 424 U.S. 1, 126 (1976).

161 The Commission constitutes the "head of a department" when its commissioners act collectively. *See Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 512-13 (2010).

162 *David F. Bandimere*, 2015 WL 6575665, at *19; *Timbervest, LLC*, 2015 WL 5472520, at *24 (Sept. 17, 2015); *Raymond J. Lucia Co.*, 2015 WL 5172953, at *21.

163 204 F.3d 1125 (D.C. Cir. 2000).

164 *Id.* at 1133-34.

of the FDIC."[165] Instead, they issue only "recommended decisions," which the FDIC Board of Directors reviews *de novo*, and "[f]inal decisions are issued only by the FDIC Board."[166] The FDIC ALJs thus function as aides who assist the Board in its duties, not officers who exercise significant authority independent of the Board's supervision. Because ALJs at the FDIC "have no such powers" of "final decision," the D.C. Circuit "conclude[d] that they are not inferior officers."[167]

The mix of duties and powers of the Commission's ALJs are very similar to those of the ALJs at the FDIC. Like the FDIC's ALJs, the Commission's ALJs conduct hearings, take testimony, rule on admissibility of evidence, and issue subpoenas. And like the FDIC's ALJs, the Commission's ALJs do not issue the final decisions that result from such proceedings. Just as the FDIC's ALJs issue only "recommended decisions" that are not final, the Commission's ALJs issue "initial decisions" that are likewise not final.[168] Respondents may petition the Commission for review of an ALJ's initial decision,[169] and it is our "longstanding practice [to] grant[] virtually all [such] petitions."[170] We are "unaware of any case in which the Commission has declined to grant" a respondent's timely petition for review from an ALJ's initial decision.[171] Indeed, when we amended our Rules of Practice in 2004, we eliminated the filing of oppositions to petitions for review, deeming such oppositions pointless, "given that the Commission has long had a policy of granting petitions for review, believing that there is a benefit to Commission review when a party takes exception to a decision."[172] Absent a petition, we may also choose to review a decision on our own initiative.[173] We have *sua sponte* ordered review on a number of occasions.[174] In either case, our rules expressly provide that "the initial decision [of an ALJ]

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165 *Landry*, 204 F.3d at 1133.

166 *Id*.

167 *Id*. at 1134.

168 *See* Rule of Practice 360(a)(1) & (d), 17 C.F.R. § 201.360(a)(1) & (d).

169 Rule of Practice 411(b), 17 C.F.R. § 201.411(b).

170 Exchange Act Release No. 35833, 1995 WL 368865, at *80-81 (June 9, 1995).

171 Exchange Act Release No. 33163, 1993 WL 468594, at *59 (Nov. 5, 1993).

172 Exchange Act Release No. 48832, 2003 WL 22827684, at *13 (Nov. 23, 2003).

173 Rule of Practice 411(c), 17 C.F.R. § 201.411(c); *see also* 15 U.S.C. § 78d-1(b) (providing that "the Commission shall retain a discretionary right to review the action of any . . . administrative law judge . . . upon its own initiative or upon petition").

174 *See, e.g.*, *MGSI Sec., Inc.*, Exchange Act Release No. 42717, 2000 WL 462952, at *1 (Apr. 25, 2000) ("The Commission has determined to review the decision on its own initiative for the limited purpose described below."); *Robert I. Moses*, Exchange Act Release No. 37795, 1996 WL 580130, at *1 (Oct. 8, 1996) ("On our own motion, we ordered a limited review of the [initial] decision . . . ."); *accord Dian Min Ma*, Exchange Act Release No. 74887, 2015 WL 2088438, at *1 (May 6, 2015); *Michael Lee Mendenhall*, Exchange Act Release No. 74532, 2015

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shall not become final."[175] Even where an aggrieved person fails to file a timely petition for review of an initial decision and we do not order review on our own initiative, our rules provide that "*the Commission* will issue an order that the decision has become final," and it becomes final only "upon issuance of the order" by the Commission.[176]

Moreover, as does the FDIC, we review our ALJs' decisions *de novo*. Upon review, we "may affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part," any initial decision.[177] We do not defer to our ALJs' factual findings. Nor do we view the possibility that we might make a factual finding partially based on an ALJ's demeanor-based credibility determination to vest them with the type of authority that would qualify them as inferior officers.[178] Moreover, "any procedural errors" made by an ALJ in conducting the

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WL 1247374, at *1 (Mar. 19, 2015); *George C. Kern, Jr.*, Exchange Act Release No. 29356, 1991 WL 284804, at *1 (June 21, 1991)

175 Rule of Practice 360(d)(1), 17 C.F.R. § 201.360(d)(1).

176 Rule of Practice 360(d)(2), 17 C.F.R. § 201.360(d)(2) (emphasis added). An initial decision does *not* become final simply "on the lapse of time" for seeking review. Exchange Act Release No. 49412, 2004 WL 503739, at *12 (Mar. 12, 2004). And any sanctions become effective only after the date specified in the Commission's notice of finality. Rule of Practice 360(d)(2), 17 C.F.R. § 201.360(d)(2) ("The order of finality shall state the date on which sanctions, if any, take effect.").

177 Rule of Practice 411(a), 17 C.F.R. § 201.411(a); *see also* 5 U.S.C. § 557(b) ("On appeal from or review of the initial decision, the agency has all the powers which it would have in making the initial decision . . . .").

178 As we have repeatedly made clear, we do not accept such determinations "blindly," and we will "disregard explicit determinations of credibility" when our *de novo* review of the record as a whole convinces us that a witness's testimony is credible (or not) or that the weight of the evidence warrants a different finding as to the ultimate facts at issue. *Kenneth R. Ward*, Exchange Act Release No. 47535, 2003 WL 1447865, at *10 (Mar. 19, 2003), *aff'd*, 75 F. App'x 320 (5th Cir. 2003); *accord Francis V. Lorenzo*, Exchange Act Release No. 74836, 2015 WL 1927763, at *10 n.32 (Apr. 29, 2015), *petition for review filed*, No. 15-1202 (D.C. Cir. July 1, 2015); *Irfan Mohammed Amanat*, Exchange Act Release No. 54708, 2006 WL 3199181, at *8 n.46 (Nov. 3, 2006), *petition denied*, 269 F. App'x 217 (3d Cir. 2008); *see also Kay v. FCC*, 396 F.3d 1184, 1189 (D.C. Cir. 2005) ("The law is settled that an agency is not required to adopt the credibility determinations of an administrative law judge."). In any event, our practice in this regard is no different from the FDIC's and so does not warrant a departure from *Landry*. *Compare [Redacted] (Insured State Nonmember Bank)*, FDIC-82-73a, 1984 WL 273918, at *5 (June 18, 1984) (stating, "as a general rule," that "assessment of the credibility of witnesses" by the FDIC's ALJs is given "deference" by the FDIC) *with Ramon M. Candelaria*, FDIC-95-62e, 1997 WL 211341, at *3-4 (Mar. 11, 1997) (noting that the FDIC ALJ found respondent to be "entirely credible" but rejecting respondent's testimony "in light of the entire record").

hearing "are cured" by our "thorough, *de novo* review of the record."[179] Although our ALJs may oversee the taking and hearing of evidence, we have made clear that we have "plenary authority over the course of [our] administrative proceedings and the rulings of [our] law judges—both before and after the issuance of the initial decision and irrespective of whether any party has sought relief."[180] This includes authority over all evidentiary and discovery-related rulings. Lastly, we are not limited by the record that comes to us from the ALJ. We may expand the record by "hear[ing] additional evidence" ourselves or remanding for further proceedings before the ALJ, and may "make any findings or conclusions that in [our] judgment are proper and on the basis of the record."[181]

Respondents rely on several decisions in which district courts have found that the Commission's ALJs are inferior officers.[182] Those decisions decline to follow the D.C. Circuit's reasoning in *Landry* and rely instead on *Freytag v. Commissioner*,[183] in which the Supreme Court held that a "special trial judge" of the Tax Court was an inferior officer. But we agree with *Landry'*s analysis and the distinctions that the D.C. Circuit identified between ALJs and the special trial judges at issue in *Freytag*.[184] The greater role and powers of the special trial judges relative to Commission ALJs, in our view, makes *Freytag* inapposite here. First, unlike the ALJs whose decisions are reviewed *de novo*, the special trial judges made factual findings to which the Tax Court was required to defer, unless clearly erroneous.[185] Second, the special trial judges were authorized by statute to "render the [final] decisions of the Tax Court" in significant, fully-litigated proceedings involving declaratory judgments and amounts in controversy below $10,000.[186] As discussed above, our ALJs issue initial decisions that are not final unless the Commission takes some further action. Third, the Tax Court (and by extension the court's special tax judges) exercised "a portion of the judicial power of the United States,"

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179 *Heath v. SEC*, 586 F.3d 122, 142 (2d Cir. 2009); *see also, e.g.*, *Fields*, 2015 WL 728005, at *20 ("[O]ur *de novo* review cures any evidentiary error that the law judge may have made.").

180 *Mendenhall*, 2015 WL 1247374, at *1. Further, our "ALJs' rulings are not precedential and are not binding on the Commission or on other ALJs." *Bandimere*, 2015 WL 6575665, at *23 n.138 (collecting cases).

181 Rules of Practice 411(a), 452; 17 C.F.R. §§ 201.411(a), 452.

182 *See Ironridge Global IV, Ltd. v. SEC*, No. 1:15-cv-2512-LMM, ECF No. 23 (N.D. Ga. Nov. 17, 2015) (appeal pending); *Gray Financial Group Inc. v. SEC*, No. 1:15-cv-492-LMM, ECF No. 56 (N.D. Ga. Aug. 4, 2015) (appeal pending); *Duka v. SEC*, No. 15 Civ. 357(RMB)(SN), 2015 WL 4940057 (S.D.N.Y. Aug. 3, 2015) (appeal pending); *Hill v. SEC*, No. 1:15-cv-1801-LMM, 2015 WL 4307088 (N.D. Ga. June 8, 2015) (appeal pending).

183 501 U.S. 868 (1991).

184 *Landry*, 204 F.3d at 1133 (explaining that the special trial judges at issue in *Freytag* exercised "authority . . . not matched by the ALJs").

185 *See id.*

186 *Freytag*, 501 U.S. at 882.

including the "authority to punish contempts by fine or imprisonment."[187] Commission ALJs, by contrast, do not possess such authority.[188] And while Commission ALJs may issue subpoenas to compel noncompliance, they are powerless to enforce their subpoenas; the Commission must seek and then obtain an order from a federal district court to compel compliance.[189] In this respect, too, our ALJs are akin to the FDIC's ALJs that *Landry* found to be "mere employees."[190] The fact that our ALJs may rule initially on certain evidentiary matters and discovery issues (subject to our *de novo* review) does not distinguish them from the FDIC's ALJs in *Landry* who have the same authority.

Based on the foregoing, we conclude that the mix of duties and powers of our ALJs is similar in all material respects to the duties and role of the FDIC's ALJs in *Landry*. Accordingly, we follow *Landry*, and we conclude that our ALJs are not "inferior officers" under the Appointments Clause.[191]

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[187] *Id.* at 891.

[188] *See* Rule of Practice 180, 17 C.F.R. § 201.180. The Commission's rules provide ALJs with authority to punish contemptuous conduct in only the following, limited ways: If a person engages in contemptuous conduct before the ALJ during any proceeding, the ALJ may "exclude that person from such hearing or conference, or any portion thereof" or "summarily suspend that person from representing others in the proceeding in which such conduct occurred for the duration, or any portion, of the proceeding." *Id.* § 201.180(a). If there are deficiencies in a filing, a Commission ALJ "may reject, in whole or in part," the filing, such filing "shall not be part of the record," and the ALJ "may direct a party to cure any deficiencies." *Id.* § 201.180(b). Finally, if a party fails to make a required filing or to cure a deficiency with a filing, then a Commission ALJ "may enter a default . . . , dismiss the case, decide the particular matter at issue against that person, or prohibit the introduction of evidence or exclude testimony concerning that matter." *Id.* § 201.180(c). Any such ruling would, of course, be subject to *de novo* Commission review.

[189] *See* 15 U.S.C. § 78u(c).

[190] *See* 12 C.F.R. §§ 308.25(h), 308.26(c), 308.34(c) (providing that an aggrieved party must apply to a federal district court for enforcement of a subpoena issued by a FDIC ALJ).

[191] Beyond *Landry*, we believe that our ALJs are properly deemed employees (rather than inferior officers) because this is how Congress has chosen to classify them, and that decision is entitled to considerable deference. *See Burnap v. United States*, 252 U.S. 512, 516 (1920). For example, as we discussed above, Congress created and placed ALJ positions within the competitive service system, just like most other federal employees. Like such other employees, an ALJ who believes that his employing agency has engaged in a prohibited personnel practice can seek redress either through the Office of Special Counsel or the Merit Systems Protection Board. *See* 5 U.S.C. §§ 1204, 1212, 1214, 1215, 1221. And ALJs—like other employees—are subject to reductions-in-force. *See id.* § 7521(b).

B. Equal protection

Respondents argue that they were denied equal protection because the Commission proceeded against them administratively rather than in federal district court. They do not allege that they have been singled out because of their membership in a protected class or group. Instead, respondents contend that the Commission's discretionary choice of an administrative forum disadvantages them given the "nearly unique size and complexity of this case." We reject this claim for three reasons.

First, as we have previously explained, respondents' equal protection claim is not legally cognizable in this context.[192] The Supreme Court held in *Village of Willowbrook v. Olech* that an individual who is not a member of a protected class may in some contexts assert a "class-of-one" equal-protection claim by establishing that he or she was "intentionally treated differently from others similarly situated and that there is no rational basis for the difference in treatment."[193] But the Supreme Court has subsequently made clear that *Olech*, which involved a landowner's challenge to a zoning decision, does not apply to every kind of government action. There are, the Court explained in *Engquist v. Oregon Department of Agriculture*, "some forms of state action . . . which by their nature involve discretionary decisionmaking based on a vast array of subjective, individualized assessments."[194] In such contexts, a "'class-of-one' theory of equal protection has no place" because "allowing a challenge based on the arbitrary singling out of a particular person would undermine the very discretion that such state officials are entrusted to exercise."[195] That an inherently "subjective, individualized decision" in fact was made in a subjective, individualized manner is no failing. Here, the Commission's decision to bring charges in one forum rather than another is an inherently discretionary one.[196] In the analogous context of federal prosecutors' decisions about charging defendants, courts have rejected

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[192] *David F. Bandimere*, 2015 WL 6575665, at *17-19; *Timbervest, LLC*, 2015 WL 5472520, at *28-30.

[193] 528 U.S. 562, 564 (2000).

[194] 553 U.S. 591, 592, 603 (2008).

[195] *Id.* at 603.

[196] *See* 17 C.F.R. § 202.5(b) ("After investigation or otherwise the Commission may in its discretion take one or more of the following actions: Institution of administrative proceedings looking to the imposition of remedial sanction, initiation of injunctive proceedings in the courts, and, in the case of a willful violation, reference of the matter to the Department of Justice for criminal prosecution."); *Robert Radano*, Investment Advisors Act Release No. 2750, 2008 WL 2574440, at *8 n. 74 (June 30, 2008) (determination whether to proceed against some rather than others is committed to agency discretion); *Eagletech Commc'ns, Inc.*, Exchange Act Release No. 54095, 2006 WL 1835958, at *4 (July 5, 2006) (same).

class-of-one claims based on prosecutorial discretion.[197] Accordingly, respondents' class-of-one equal-protection challenge must fail as a matter of law.

Second, respondents cannot, as they must, demonstrate that they were treated differently from others similarly situated.[198] Individuals asserting such a claim "must show an extremely high degree of similarity between themselves and the persons to whom they compare themselves."[199] But respondents have merely pointed out that the Commission only sometimes mentions the size or complexity of a proceeding when extending an ALJ's deadline for issuing an initial decision.[200] They have not compared the facts and circumstances of their case with any others. Nor have they shown that the Commission otherwise has a practice of pursuing large and complex cases only in federal court. Quite the contrary, in fact: As we have repeatedly observed, "many Commission proceedings involving complicated issues resulting in voluminous files."[201] Moreover, as respondents acknowledge, the Commission has in a number of recent cases granted extensions in part because of their size and complexity. Therefore, even under respondents' own theory, they cannot show that they have been singled out from others similarly situated.

Finally, respondents have failed to establish that "there is no rational basis for the [alleged] difference in treatment."[202] A choice of venue made even "solely for reasons of

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[197] *See, e.g., United States v. Moore*, 543 F. 3d 891, 901 (7th Cir. 2008) (holding that "the discretion conferred on prosecutors in choosing whom and how to prosecute" precludes a class-of-one equal-protection claim in that context); *United States v. Green*, 654 F.3d 637, 650 (6th Cir. 2011) (rejecting a class-of-one claim premised on "government's decision to prosecute [the defendant] under MEJA in the civilian justice system while prosecuting his coconspirators under UCMJ in the military justice system").

[198] *Olech*, 528 U.S. at 564.

[199] *Clubside, Inc. v. Valentin*, 468 F.3d 144, 159 (2d Cir. 2006); *see also Cordi-Allen v. Conlon*, 494 F.3d 245, 250-51 (1st Cir. 2007) (explaining that the requirement of establishing a "extremely high degree of similarity" includes demonstrating the absence of any "distinguishing or mitigating circumstances as would render the comparison inutile").

[200] Our Rules of Practice provide that we may extend this deadline if we determine that "additional time is necessary or appropriate in the public interest." Rule of Practice 360(a)(3), 17 C.F.R. § 201.360(a)(3). Because of the variety of factors that may enter into the public interest determination—*e.g.*, the workload of ALJs and their staffs, deadlines in other proceedings, and external scheduling constraints—our decision to grant an extension in a case does not establish that it is larger or more complex than others.

[201] *Gregory M. Dearlove*, Exchange Act Release No. 57244, 2008 WL 281105, at *36 (Jan. 31, 2008).

[202] *Olech*, 528 U.S. at 564; *cf. Campbell v. Rainbow City*, 434 F.3d 1306, 1314 n.6 (11th Cir. 2006) (requiring plaintiff asserting rational-basis challenge to "negativ[e] every conceivable basis which might support the government action") (quotation marks omitted).

administrative convenience" is within the bounds of prosecutorial discretion.[203] Here, for example, it was particularly rational for us to pursue this enforcement matter in the administrative forum because the proceedings involved a request for an associational bar. Respondents suggest that the Commission could have obtained equivalent relief by pursuing this action in district court in the first instance and then instituting a follow-on administrative proceeding to consider the associational bar. But this argument misses the point: By bringing this proceeding in the administrative forum in the first instance, an additional step (and additional potential delay) in the final resolution of the claims was eliminated. Congress specifically authorized the Commission to proceed administratively when it determines that doing so would protect investors and is in the public interest.[204] The Commission is entitled to make its forum-selection decisions, in part, based on the advantages that inhere in resolving all related claims and issues in a single proceeding.

For all of the above reasons, we reject respondents' equal-protection defense.

An appropriate order will issue.[205]

By the Commission (Chair WHITE and Commissioners STEIN and PIWOWAR).

Brent J. Fields
Secretary

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203 *Moore*, 543 F.3d at 899.

204 15 U.S.C. § 78o-7(d)(1).

205 We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

Appendix A: Additional findings regarding respondents' communications with the Fund's Board

- *July 18, 2007 Board meeting*: Riad told the Board that he wanted to use "conservative option overlays" for "downside protection" and that he added "collars"—an option strategy that couples the purchase of a put option with the sale of a call option—to the portfolio to dampen the Fund's volatility. About a week later, Riad closed out the Fund's existing long put option position, leaving the Fund with naked put exposure.

- *October 2007 memorandum from respondents to the Board*: Respondents stated that the Fund had benefited from having "substantially the entire portfolio covered" during the summer months and that the Fund's use of index put options provided "downside protection" during that volatile period. Respondents claim that this discussion "detailed the impact from the Fund's derivative investments, including the short puts and swaps." Yet the document only vaguely referred to the "option-overlay and hedging" strategies; did not mention either the naked written puts or short variance swaps; and did not quantify their contribution to performance. By contrast, the document does quantify the performance of the "Fund's equities and long-calls."

- *October 2007 Board meeting*: Respondents told the Board that the Fund had significantly outperformed its peers and attributed that result to their stock-picking skill and their management of the covered-call strategy. Respondents told investors essentially the same thing in the Fund's 2007 Annual Report.

- *January 2008 memorandum from respondents to the Board*: Respondents stated that the Fund used derivatives to "augment[] downside protection during adverse market periods" and "help[] lessen performance volatility."

- *January 23, 2008 Board meeting*: Riad proposed "using short-term leverage to write puts" and offered to "present a formal proposal on leverage if FAMCO wished to proceed." The Board never approved the use of leverage.

- *February 7, 2008 proposal to Claymore*: FAMCO submitted a proposal to Steve Hill, Claymore's Vice President of Fund Administration and the Fund's Chief Financial Officer, stating that the Fund had "successfully purchased put-spread, volatility swaps, and other Over-the-Counter (OTC) hedging transactions in order to mitigate portfolio downside risks" and to "reduc[e] NAV volatility."

- *March 6, 2008 email from Riad to Claymore*: Riad wrote an email to Hill explaining that the Fund's short variance swap position initiated in January 2008 was "a hedging transaction" that "lock[ed] in" heightened volatility levels and that was "supposed to pay off regardless of the level of the US equity market."

- *April 2008 memorandum from respondents to the Board*: Respondents stated that they had used “opportunistic hedging” and other derivative strategies to supplement performance during periods of high volatility while providing “downside protection” during adverse markets. A draft of the minutes for this meeting stated that Riad discussed “macrohedging the portfolio to further *protect* the [Fund] during times of extreme volatility.” (Emphasis) Counsel for the Board circled the word “macrohedging” and wrote “What does this mean?”

- *July 2008 memorandum from respondents to the Board*: Respondents again informed the Board that, over the past year, that had used “opportunistic hedging transactions” such as “volatility trading strategies” and “index puts.” These “macro-hedging strategies,” respondents wrote, helped to “decrease participation in downside markets and lower overall portfolio volatility.” A week before this meeting, the Fund took a “big loss[]” of $2.8 million on a naked put position. Respondents did not mention this loss to the Board.

Appendix B: Additional findings regarding respondents' communications with counsel and compliance personnel

- *Riad obtained approval from Claymore before entering into the Fund's first short index put and variance swap positions, but did not provide complete information about them*: Because the derivatives were traded pursuant to an International Swaps and Derivatives Association (ISDA) master agreement, Claymore had to approve the Fund's use of these investments.[206] Steven Hill, Claymore's chief financial officer and chief financial officer for the Fund, was generally aware that Riad was using short puts and swaps. Hill, however, had no recollection of either respondent discussing those trades as ongoing strategies; did not understand what the Fund's "macro hedging strategy" was;[207] and incorrectly believed that the short puts and swaps were a hedge against volatility. Further, Hill testified that he was surprised to learn, after the Fund's October 2008 losses, of the extent of the positions held by the Fund and the risk exposure that resulted. All this is evidence that Riad was not forthcoming with Claymore.

- *Riad did not seek guidance from compliance personnel before implementing the strategies:* Riad did not approach Gallagher, FAMCO's Chief Compliance Officer, before he began using the strategies. In November 2007, Jeffrey Grossman, a portfolio accountant, expressed concerns about Riad's use of naked puts to Susan Steiner, a compliance manager under Gallagher. This was the first time that FAMCO's compliance officers became aware of the issue; respondents never approached Steiner directly. Bruce Saxon, the Fund's chief compliance officer, first learned of the trades in January 2008, after Steiner contacted him. Saxon consulted with Thomas Hale and told Steiner that short puts were permissible investments for the Fund. Neither respondent discussed compliance or disclosure issues with Saxon.

- *The January 16, 2008 conference call did not address disclosure issues*: Gallagher elevated the issue of Riad's uncovered puts to Claymore and a conference call was held on January 16, 2008. Steiner's memorandum summarizing the call stated that the topic was the sale of "uncovered put[s]" and

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[206] Riad testified that there was no way for the Fund to conceal the trades from Claymore, who had access to all trading records and was the party to the ISDA agreement. Claymore and FAMCO also had automated compliance systems that could identify trades that fell outside the limitations in a fund's prospectus. But, as a Claymore compliance manager testified, these systems could not flag disclosure violations or changes in a fund's investment strategies.

[207] Hill's July 2008 query regarding whether the Q&As' description of the Fund as "strategically hedged for additional downside protection" was sufficiently clear corroborates his testimony that he did not understand that the "hedge" was supposed to refer to selling uncovered puts and variance swaps.

that the “trade was considered a strategic transactions as discussed in the [prospectus] therefore there is no violation.” Contrary to respondents’ assertion, the call addressed only the permissibility of the trades and associated asset-segregation requirements. Fund counsel Thomas Hale’s conclusion that the trades were permitted was conveyed on the call. Several participants testified that there was no discussion of disclosure issues; the potential size of the Fund’s positions; or the risks of those investments. Steiner, for example, denied that there was “discussion about the risk of loss associated with the written puts or variance swaps,” “discussion about . . . whether the fund was using written puts or variance swaps as a strategy,” and “discussion about whether the fund was obligated to disclose any strategy relating to the puts or variance swaps.” Even Swanson agreed that the “message” was the “permissibility of these” trades, and that the sufficiency of the Fund’s disclosures was not discussed.

- *Transmittal page accompanying 2007 annual report*: The cover sheet identified the July 26, 2007 short variance swap listed in the financial statements as a “new investment type.” But it provided no detail about the characteristics of the swap or the impact and risks of the short variance swap strategy.

- *March 6, 2008 email from Riad to Hill*: Riad informed Hill that the Fund was rolling over a short variance swap position and that “as we have discussed before, FAMCO uses both variance swaps and puts.” He stated that “net exposure” of the variance swap was “$441,100.” This email misleadingly stated that the short variance swap was a “hedging transaction that was supposed to pay off regardless of the level of the US equity markets” and that the Fund used swaps and puts to “hedge (lock) in volatility levels.” In fact, as discussed elsewhere, a short variance swap meant that the Fund would incur losses in the event of increases in volatility. Also, Riad did not specify the variance strike price, so the “net exposure” figure was not a meaningful measure of the amount of at risk from the swap.

- *Other occasions on which respondents requested guidance about different investment strategies*: Respondents sought permission to introduce new kinds of investments on three other occasions. Riad was told by the adviser to the First Trust Covered Call Fund that variance swaps were not appropriate for that fund, and he did not engage in such trades. Riad requested permission to use leverage in the Fund several times in 2007 and 2008. And he engaged in an extended discussion with Claymore about the Fund’s use of structured notes. These events are of exceedingly marginal relevance. Compliance with the law in some instances does not excuse violations in others.