

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

Securities Exchange Act of 1934
Release No. 39118 / September 23, 1997

ADMINISTRATIVE PROCEEDING
File No. 3-9426

In the Matter of	:	ORDER INSTITUTING ADMINISTRATIVE
	:	PROCEEDINGS PURSUANT TO
	:	SECTIONS 15(b) and 19(h) OF
SMITH BARNEY, INC.,	:	THE SECURITIES EXCHANGE
	:	ACT OF 1934, MAKING FINDINGS,
Respondent.	:	AND IMPOSING REMEDIAL SANCTIONS
	:	

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to institute public administrative proceedings pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Smith Barney, Inc. ("Smith Barney" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent Smith Barney has submitted an Offer of Settlement ("Offer") to the Commission, which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the findings contained herein, except as to the jurisdiction of the Commission over the Respondent and over the subject matter of this proceeding, which is admitted, Respondent Smith Barney by its Offer consents to the entry of findings and remedial sanctions set forth below.

Accordingly, **IT IS ORDERED** that proceedings pursuant to Sections 15(b) and 19(h) of the Exchange Act be, and, they hereby are, instituted.

III.

On the basis of this Order and the Offer submitted by Respondent Smith Barney, the Commission finds¹ that:

Background

Smith Barney is a member of the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD"). At all times relevant, Smith Barney maintained a public finance department that was engaged in the business of structuring and implementing transactions with municipal issuers. Through its public finance department, Smith Barney, among other things, underwrote offerings by municipalities for a variety of bonds. In the course of conducting this business, it was the general practice of Smith Barney to assemble a team of bankers, each of whom had specific responsibilities relating to a purported offering. This team would typically respond to an issuer's request for proposals ("RFP") and, if selected, generally would continue to deal with the issuer throughout the offering process.

At all times relevant, the public finance department of Smith Barney maintained a municipal derivatives product group that specialized in offering municipalities certain derivative products and in structuring interest rate swaps. In those instances in which Smith Barney intended to propose an interest rate swap to a municipality or where a municipality inquired about the potential use of an interest rate swap, a member of the municipal derivatives product group generally was assigned responsibility for addressing those issues and was assigned to the banking team.

In June 1993, Dade County, Florida (the "County") issued an RFP in connection with a proposed bond offering to finance the refunding of existing water and sewer bonds and, in addition, to finance certain construction projects for its water and sewer system. The County initially planned to raise approximately \$800 million through such an offering. After issuance of the RFP, the County determined to proceed with separate offerings: a new money offering of approximately \$431 million (the "WASA transaction") and a refunding offering.

¹ The findings contained herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Smith Barney, along with a Miami-based underwriter (hereinafter, the "Local Firm"), submitted a joint proposal in response to the RFP, whereby each would serve as co-senior managing underwriter. The response to the RFP discussed Smith Barney's background, experience and capabilities, including its experience in structuring interest rate swaps. The RFP also included a discussion of alternative plans of finance that the County could consider should market conditions change prior to marketing the bonds. In September 1993, the County selected Smith Barney and the Local Firm to serve as co-senior managing underwriters for the WASA transaction.

The County originally had planned for the WASA transaction to consist of traditional, fixed-rate bonds, whereby the County would be obliged to pay a fixed interest rate to bondholders over the life of the bonds. However, over the next several months, Smith Barney raised with the County a different financing structure as an alternative to fixed-rate bonds (the "Alternative Financing Structure"). The Alternative Financing Structure provided for the County to issue variable-rate bonds, and thereafter enter into a contract with a third-party (the "Swap Provider"), whereby the County would exchange its obligation to make variable-rate payments for an obligation to make fixed-rate payments².

Smith Barney assigned substantial responsibility for structuring the Alternative Financing Structure and calculating its benefits to a senior professional within Smith Barney's municipal derivative products group, who left Smith Barney in early 1995 but

² Mechanically, the proposed Alternative Financing Structure involved three steps. First, the County was to issue \$431,700,000 in variable rate bonds, whereby the County would be obliged to make interest payments at a rate that would fluctuate over the life of the offering. Second, the proceeds from such an offering allocated for the Construction Fund and for the Debt Service Reserve Fund ("DSR") were to be placed in guaranteed investment contracts ("GIC"). The GIC provider for the construction fund guaranteed interest payments to the County at a rate higher than the amount the County was obliged to pay variable-rate bondholders. Third, the County was to enter into a forward, variable-to-fixed interest rate swap with the Swap Provider, pursuant to which the County would "swap" its variable-rate interest payments for the certainty of a fixed rate payment with the Swap Provider. The Swap Provider paid a fee to Smith Barney in connection with this transaction.

who, at the time of the WASA transaction, was a managing director of the firm (hereinafter, the "SB Municipal Derivatives Banker").

The County understood that there were certain additional costs and risks associated with the Alternative Financing Structure that were not present in a fixed-rate financing. Accordingly, to offset these additional costs and risks, the County required a certain economic benefit in the form of present value savings before it would select the Alternative Financing Structure. The County informed Smith Barney that it required a certain minimum threshold in present value savings in order to proceed with the Alternative Financing Structure. The SB Municipal Derivatives Banker knew about the County's minimum savings requirement.

ROLE OF THE SB MUNICIPAL DERIVATIVES BANKER

At all times relevant, the SB Municipal Derivatives Banker assigned to the WASA transaction for purposes of structuring and assessing the economic benefits of the Alternative Financing Structure occupied a unique role within Smith Barney's public finance department. The SB Municipal Derivatives Banker was involved in many deals and was permitted latitude in creating and structuring concepts for the various clients of Smith Barney. The SB Municipal Derivatives Banker was also responsible for assessing the relative costs associated with the two possible financing scenarios in the WASA transaction, fixed-rate versus the Alternative Financing Structure. Smith Barney's financing team made numerous presentations to the County concerning the proposed financing. The SB Municipal Derivatives Banker was responsible for that portion of the presentations relating to the benefits of the Alternative Financing Structure as opposed to a fixed rate structure. The savings evaluations performed by the SB Municipal Derivatives Banker were the centerpiece of such presentations.

From late October 1993 through January 25, 1994, the presentations to the County showed present value savings that the County would realize if it selected the Alternative Financing Structure over a fixed-rate structure. Those presentations were based substantially on assumptions made and calculations performed by the SB Municipal Derivatives Banker.

Certain savings presentations to the County in 1993 showed that the County would indeed realize savings in excess of its minimum savings threshold if it implemented the Alternative Financing Structure. However, in late December 1993 or early January 1994, because of a change in interest rates, calculations of the potential savings associated with the Alternative Financing Structure revealed such savings fell below the County's minimum savings threshold, as compared to a traditional fixed-rate model.

Thereafter, the SB Municipal Derivatives Banker, without informing his supervisors, manipulated certain of the variables used in the traditional fixed rate and Alternative Financing Structure models in order to create the false impression that the selection of the Alternative Financing Structure would still result in savings to the County in excess of its stated threshold. Those presentations ultimately persuaded the County to implement the Alternative Financing Structure.

TREATMENT OF THE DEBT SERVICE RESERVE FUND

The County Bond Ordinance, which authorized the issuance of the bonds, required that a certain amount of the bond proceeds be placed in a Debt Service Reserve Fund ("DSR"). In comparisons run prior to late December 1993, the Smith Barney calculation of the costs associated with the Alternative Financing Structure and the fixed-rate Structure accrued no interest on the DSR. In late December 1993 or early January 1994, the SB Municipal Derivatives Banker changed the savings calculations to include accrued interest on the bond proceeds earmarked for the DSR in the Alternative Financing Structure. The SB Municipal Derivatives Banker did not include accrued interest on the DSR for the fixed-rate financing model.

This treatment of the DSR resulted in an overstatement of the purported present value savings of the Alternative Financing Structure by at least \$4 million. This analysis was incorporated into the savings presentations made to the County.

TREATMENT OF THE CONSTRUCTION FUND

The SB Municipal Derivatives Banker also skewed the anticipated interest earnings on monies in the Construction Fund in favor of the Alternative Financing Structure. The SB Municipal Derivatives Banker used an unreasonably low interest rate for calculating interest earnings on the Construction Fund in the traditional fixed-rate analysis. This resulted in an overstatement of the Alternative Financing Structure by approximately \$1 million. This disparity was also included in the presentations to the County which further inflated the purported savings associated with the Alternative Financing Structure.

Accordingly, the presentations to the County showing present value savings were based on intentional manipulations by the SB Municipal Derivatives Banker of the underlying calculations and assumptions as to the fixed-rate model and the Alternative Financing Structure, undertaken to fraudulently present the Alternative Financing Structure in an artificially favorable light. The use of these faulty and inaccurate assumptions resulted, under conservative estimates, in an overstatement of the hypothetical

savings associated with the Alternative Financing Structure by at least \$5 million.

RELIANCE BY THE COUNTY

On January 25, 1994, the County decided to implement the Alternative Financing Structure based upon the representation, as calculated by the SB Municipal Derivatives Banker, that the County would realize present value savings of more than \$8 million if it selected the Alternative Financing Structure. On January 25, 1994, the County entered into a thirty-year variable-to-fixed rate forward swap. On February 2, 1994, the County issued \$431,700,000 in variable-rate bonds.

BENEFITS TO SMITH BARNEY

Smith Barney's up-front fees from the WASA transaction were derived primarily from its share, after splitting with the Local Firm, of the swap fee, management and underwriting fees, and a fee paid in connection with the GIC. Smith Barney's up-front compensation amounted to approximately \$2.2 million before expenses.

Smith Barney has also earned and stands to earn additional fees pursuant to a remarketing agreement with the County dated February 4, 1994 (the "Remarketing Agreement"), whereby Smith Barney is obliged to perform certain duties in connection with bonds presented for sale over the 30-year life of the deal. Pursuant to the Remarketing Agreement, Smith Barney is entitled to earn a potential total of approximately \$5 million over the life of the variable-rate debt. As of the date of this Order, Smith Barney has received approximately \$709,668 pursuant to the Remarketing Agreement. Smith Barney's potential outstanding share of future fees due from the County for remarketing services is approximately \$3,125,634, after expenses.

Had the County undertaken a traditional, fixed-rate financing, Smith Barney would have earned only approximately \$700,000 before expenses and would not have entered into or received fees from a remarketing agreement. Smith Barney earned significantly more money on the WASA transaction as a result of the County's decision to implement the Alternative Financing Structure. After a credit for certain otherwise unreimbursed expenses, the economic benefit to Smith Barney for implementing the Alternative Financing Structure as opposed to a fixed rate financing, exclusive of remarketing fees, was over \$1.5 million.

PRIMARY VIOLATIONS OF THE FEDERAL SECURITIES LAWS

In preparing the false presentations to the County, the SB Municipal Derivatives Banker violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The amount of present value savings associated with the Alternative Financing Structure was material to the County's decision as to which structure to utilize in issuing securities. See Basic, Inc. v. Levinson, 485 U.S. 224 (1988). The SB Municipal Derivatives Banker's intentional manipulation of the assumptions included within the savings presentations as described more fully above, demonstrates that he undertook such conduct with an intent to deceive. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). Municipal securities brokers, dealers and municipal finance professionals, such as the SB Municipal Derivatives Banker, also must comply with the Municipal Securities Rulemaking Board ("MSRB") rules. Section 15B(c)(1) of the Exchange Act makes it unlawful to use the mails or other means or instrumentalities of interstate commerce to effect transactions in or induce the purchase or sale of any municipal security in contravention of the MSRB Rules. MSRB Rule G-17 requires that each broker, dealer, and municipal securities dealer deal fairly with all persons and refrain from engaging in any deceptive, dishonest, or unfair practice. Based on his previously described conduct, the SB Municipal Derivatives Banker also violated MSRB Rule G-17.

SMITH BARNEY'S FAILURE TO SUPERVISE

"The responsibility of broker dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities market." In the Matter of Lehman Brothers, Inc., Exchange Act Release No. 37673 (Sept. 12, 1996) (citing In re Smith Barney, Harris Upham & Co., Exchange Act Release No. 21813 (Mar. 5, 1985)).

At all relevant times, Smith Barney had no express written supervisory procedures providing for any meaningful review of the calculations performed by the SB Municipal Derivatives Banker, or the assumptions and methodology underlying such calculations, or disclosures made to the County. As a result of the absence of any such written procedures or other institutionally-recognized practice, the SB Municipal Derivatives Banker's disparate treatment in the two models went undetected, and the savings associated with a financing transaction proposed by Smith Barney to Dade County were overstated by at least \$5 million.

Accordingly, in light of the conduct described above, Smith Barney failed reasonably to supervise an individual subject to its supervision within the meaning of Section 15(b)(4)(E) of the Exchange Act with a view to preventing violations of Sections 10(b)

and 15B(c) (1) of the Exchange Act, Rule 10b-5 thereunder, and MSRB Rule G-17.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer submitted by Smith Barney and impose the sanctions specified therein.

Accordingly, **IT IS ORDERED** that:

A. Smith Barney shall be, and hereby is, censured;

B. Smith Barney shall comply with the undertakings described below:

1. Smith Barney represents that, since the conduct described above, it has modified its compliance and supervisory policies in the following respects: (i) it has implemented a Quality Control Checklist procedure for all negotiated transactions senior managed by Smith Barney, and (ii) it has established a Transaction Review Committee that reviews, among other things, interest rate swaps over \$25 million executed in conjunction with senior managed new issues. Smith Barney undertakes that, within twenty (20) days of the entry of the Order, it will further supplement, if it deems appropriate, its compliance and supervisory policies and procedures to address those deficiencies raised in this order. Smith Barney undertakes to maintain any modified supervisory and compliance policies and procedures, as well as existing supervisory and compliance policies and procedures, except as they may be inconsistent with, or superseded by, any new policies or procedures adopted in accordance with Paragraphs B.2. through B.7. below.

2. Smith Barney undertakes to retain within twenty (20) days of the date of the Order, at Smith Barney's expense, an Independent Consultant ("Consultant"), not unacceptable to the Commission's staff, to conduct a review of, and to report and make recommendations as to Smith Barney's supervisory and compliance policies and procedures applicable to the public finance department, related to the types of conduct which gave rise to this proceeding and which are described in this Order.

3. The Consultant shall conduct a review of Smith Barney's supervisory and compliance policies and procedures applicable to the public finance department, related to the types of conduct which gave rise to this proceeding and which are described in this Order.

4. Smith Barney shall cooperate fully with the Consultant in this review, including making such non-privileged information and documents available, as the Consultant may reasonably request, and by permitting and requiring Smith Barney's employees and agents to supply such non-privileged information and documents as the Consultant may reasonably request.

5. The Consultant shall provide a written report to Smith Barney and the Staff of the Commission within three (3) months of the date of this Order setting forth the Consultant's recommendations. The Consultant shall have the option to seek an extension of time by making a written request to the Commission staff.

6. Smith Barney shall adopt all recommendations contained in the written report of the Consultant; provided, however, that as to any recommendation that Smith Barney believes is unduly burdensome or impractical, Smith Barney may suggest an alternative policy or procedure designed to achieve the same objective, submitted in writing to the Consultant and the Commissions staff. Smith Barney and the Consultant shall then attempt in good faith to reach agreement as to any policy or procedure as to which there is any dispute and the Consultant shall reasonably evaluate any alternative policy or procedure proposed by Smith Barney. Smith Barney will abide by the Consultant's determinations with regard thereto and adopt those recommendations deemed appropriate by the Consultant.

7. Within thirty (30) days of the receipt of the Consultant's written report, Smith Barney shall submit an affidavit to the Commission's staff stating that it has implemented the recommendations of the Consultant.

8. To ensure the independence of the Consultant, Smith Barney: (i) shall not have the authority to terminate the Consultant without the prior written approval of the staff of the Southeast Regional Office of the Commission ("SERO"); and (ii) shall compensate the Consultant, and persons engaged to assist the Consultant, for services rendered pursuant to this Order at their reasonable and customary rates.

9. For the period of the engagement and for a period of two years from the completion of the engagement, the Consultant shall not enter into any employment, consulting, attorney-client or auditing relationship with Smith Barney, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. Any firm with which the Consultant is affiliated or of which he/she is a member, and any person engaged to assist the Consultant in performance of his/her duties under this Order shall not, without prior written consent

of the SERO, enter into any employment, consulting or other professional relationship with Smith Barney, or any of its present or former directors, officers, employees, or agents in their capacity as such for the period of the engagement and for a period of two years after the engagement.

10. Smith Barney shall agree to forego, in connection with the Remarketing Agreement, 46.6% of its prospective quarterly billings to the County under the remarketing agreement, to a maximum of \$3,125,634 for the full term of the agreement, representing the outstanding amount of its share of such fee that exceeds certain anticipated expenses. Smith Barney's obligations under this Remarketing Agreement shall otherwise remain unchanged by this Order.

C. IT IS FURTHER ORDERED that Smith Barney shall, within thirty (30) business days after the entry of the Order, pay disgorgement in the amount of \$1,584,671 and prejudgment interest in the amount of \$452,365 to Dade County, Florida.

D. IT IS FURTHER ORDERED that Smith Barney shall also, within thirty (30) business days after the entry of the Order, pay a civil money penalty in the amount of \$250,000 to the United States Treasury. Such payment shall be: (a) made by United States postal money order, certified check, bank cashier's check or bank money order; (b) made payable to the Securities and Exchange Commission; (c) hand-delivered to the Comptroller, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, Mail Stop O-3; and (d) submitted under cover letter which identifies Smith Barney as a respondent in these proceedings, the file number of this proceeding, a copy of which cover letter and money order or check shall be sent to David Nelson, Southeast Regional Office, Securities and Exchange Commission, 1401 Brickell Avenue, Suite 200, Miami, FL 33131.

By the Commission.



Jonathan G. Katz
Secretary