

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 1980 / September 28, 2001

ADMINISTRATIVE PROCEEDING
File No. 3-10600

**In the Matter of WESTERN ASSET MANAGEMENT CO. AND LEGG MASON FUND ADVISER, INC.,
Respondents.**

**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDING, MAKING FINDINGS AND
IMPOSING SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to institute a public administrative proceeding pursuant to Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") against Respondents Western Asset Management Co. ("WAM") and Legg Mason Fund Adviser, Inc. ("LM Fund Adviser").

II.

In anticipation of the institution of this administrative proceeding, WAM and LM Fund Adviser have each submitted an Offer of Settlement ("Offer"), 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 to which the Commission is a party, and without admitting or denying the findings contained herein, except that WAM and LM Fund Adviser admit the jurisdiction of the Commission over them and over the subject matter of this proceeding, WAM and LM Fund Adviser consent to the entry of this Order Instituting Public Administrative Proceeding, Making Findings and Imposing Sanctions ("Order").

Accordingly, IT IS HEREBY ORDERED that a proceeding pursuant to Section 203(e) of the Advisers Act be, and hereby is, instituted.

III.

On the basis of this Order and WAM's and LM Fund Adviser's Offers, the Commission finds that:

A. SUMMARY

This matter arises from a portfolio manager who defrauded a mutual fund and an offshore fund from 1996 to 1998. The portfolio manager concealed from the funds and their investment advisers that issuers of securities held by the funds were suffering severe financial problems and inflated the value of the troubled securities, which caused one of the funds materially to overstate its net asset value. The funds' manager, LM Fund Adviser, and the sub-adviser, WAM, failed to reasonably supervise the portfolio manager. LM Fund Adviser failed to have adequate policies and procedures to respond adequately to indications that the portfolio manager was overstating the value of one of the fund's securities. WAM failed to have adequate policies and procedures designed to prevent securities violations by the portfolio manager.

B. RESPONDENTS

WAM, located in Pasadena, California, has been registered with the Commission as an investment adviser (File No. 801-8162) since 1971. WAM is a wholly owned subsidiary of Legg Mason, Inc. WAM

was the sub-adviser for the Legg Mason High Yield Portfolio and the U.S. High Yield Investments, N.V. (collectively, the "Funds").

LM Fund Adviser, located in Baltimore, Maryland, has been registered with the Commission as an investment adviser (File No. 801-16958) since 1982. LM Fund Adviser is a wholly owned subsidiary of Legg Mason, Inc. LM Fund Adviser was the manager of the Funds.

C. RELATED PARTIES

Legg Mason High Yield Portfolio (the "High Yield Fund") is a series offered through Legg Mason Income Trust, Inc., an open-end investment company registered with the Commission since 1987 (File No. 811-0529). The High Yield Fund began operations in 1994. The High Yield Fund has an investment objective of providing a high level of current income and capital appreciation, had assets of \$485 million as of May 31, 1998, and \$219 million as of December 31, 2000, and invests its assets in high yield, fixed income securities.

U.S. High Yield Investments, N.V. (the "Offshore Fund") is part of a family of Legg Mason offshore funds. Established in 1996 as a limited liability company under Netherlands Antilles law, the Offshore Fund is available only to foreign investors. Its investment objective is to provide a high level of current income by investing primarily in high-yielding debt obligations of U.S. issuers. It had assets of \$259 million as of February 28, 1998, and \$159 million as of February 29, 2000.

The portfolio manager (hereinafter referred to as "Portfolio Manager") was employed by WAM as a portfolio manager from September 1993 until she resigned in November 1998. The Portfolio Manager was the portfolio manager for the High Yield Fund from its inception in February 1994 and the Offshore Fund from its inception in March 1996.

The broker-dealer (hereinafter referred to as the "Broker-Dealer") was registered with the Commission as a broker-dealer from July 1994 to March 2001. The Broker-Dealer was an investment banking firm specializing in mergers/acquisitions and private placements for institutional clients.

D. THE PORTFOLIO MANAGER'S FRAUDULENT SCHEME

1. The Portfolio Manager's Purchase of Notes From the Broker-Dealer

From July 1994 through April 1998, the Portfolio Manager caused the High Yield Fund to purchase from the Broker-Dealer \$30.2 million par value in notes for a total purchase price of \$27.9 million. In addition, from July 1997 through March 1998, the Portfolio Manager caused the Offshore Fund to purchase from the Broker-Dealer \$4.1 million in notes at par.

The Broker-Dealer sold the notes through private placements, and the notes were held by either the High Yield Fund alone or with the Offshore Fund. In purchasing these notes, the Portfolio Manager signed, or directed an employee of the Broker-Dealer to sign on her behalf, note purchase contracts on behalf of the funds. In these transactions, the Portfolio Manager and the Funds were represented by bondholder's counsel, which was chosen by the Portfolio Manager but was paid by the issuers.

2. The Portfolio Manager's Inflated Pricing of Notes Held by the Funds

a. The Portfolio Manager's Pricing Procedures

To calculate NAV, the Funds' securities were priced daily. For publicly traded securities, the Funds used a service to price the securities. For securities that the service could not price, the Portfolio Manager was to obtain bid and ask quotes from two brokers. For the notes purchased from the Broker-Dealer, the Portfolio Manager could not obtain two broker quotes because they were not traded. Instead, the Portfolio Manager set the bid and ask quotes for the notes through discussions with a principal of the Broker-Dealer.

Initially, the Portfolio Manager provided the pricing information to the Funds' accountants by entering two bid and ask quotes for each security on a spreadsheet and faxing the spreadsheet to the accountants. Even for the notes purchased from the Broker-Dealer, the Portfolio Manager entered in the spreadsheet two bid and ask fictional price quotes, despite the fact that she had obtained the price quotes from a discussion with the Broker-Dealer and not from two brokers. Beginning in 1995, the Broker-Dealer took over from the Portfolio Manager the manual task of entering the price quotes provided by the Portfolio Manager into the spreadsheet and faxing the spreadsheet to the Funds' accountants. These spreadsheets continued to show the two fictional bid and ask price quotes for the notes purchased from the Broker-Dealer.

b. The Issuers' Financial Troubles, the Roll Up Transactions and the Portfolio Manager and the Broker-Dealer's Inflated Pricing

Five of the issuers, which sold a total of \$15.7 million par value notes to the High Yield Fund, had severe financial trouble from 1996 through 1998, which resulted in the issuers' defaulting on interest payments, being forced into involuntary bankruptcy, and/or having all their assets taken away in foreclosure proceedings. The Portfolio Manager and the Broker-Dealer knew of these financial problems.

In 1997 and 1998, the Portfolio Manager and the Broker-Dealer principal rolled up the five troubled notes into two shell companies controlled by the Broker-Dealer principal. In these roll up transactions, the Portfolio Manager had the Funds purchase from the Broker-Dealer \$8.5 million in notes (\$6 million for the High Yield Fund and \$2.5 million for the Offshore Fund) issued by one of the shell companies and buy \$5.6 million in notes (\$4 million for the High Yield Fund and \$1.6 million for the Offshore Fund) issued by the other shell company. The first shell company then used a portion of the proceeds to purchase three of the High Yield Fund's problem notes, and the second shell company used a portion of the proceeds to purchase two other of the High Yield Fund's problem notes. Following the roll up transactions, the Broker-Dealer principal managed the shell companies and their assets (i.e., the problem notes purchased from the High Yield Fund).

The Portfolio Manager and the Broker-Dealer principal's pricing of the five notes and the shell companies' notes failed to reflect the notes' performance and the original issuers' financial condition and overstated the value of the notes. As a result of this inflated pricing, the Portfolio Manager and the Broker-Dealer principal caused the High Yield Fund materially to overstate its NAV. In particular, by one reasonable measure, the High Yield Fund's NAV was overstated from at least August 30, 1996, through November 30, 1998, by amounts ranging from \$.09 to \$.20, or from .52% to 1.33% of NAV, respectively.

As a result of her conduct, the Portfolio Manager violated Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, Section 34(b) of the Investment Company Act of 1940 ("Investment Company Act") and aided and abetted violations of Sections 206(1) and (2) of the Advisers Act and Section 34(b) of the Investment Company Act and Rule 22c-1(a) under the Investment Company Act.

E. WAM'S AND LM FUND ADVISER'S SUPERVISION OF THE PORTFOLIO MANAGER

Section 203(e)(6) of the Advisers Act authorizes the Commission to sanction an investment adviser that has failed to reasonably supervise, with a view to preventing violations of the federal securities laws, another person who commits such a violation, if such other person is subject to its supervision. The Commission has repeatedly emphasized that the duty to supervise is a critical component of the federal regulatory scheme. In re Rhumblin Advisers, Advisers Act Rel. No. 1765 (Sep. 29, 1998).

Section 203(e)(6) provides a statutory affirmative defense to a failure to supervise charge for investment advisers that demonstrate that they have established and complied with procedures reasonably designed to prevent and detect the violations at issue. The Commission has repeatedly sanctioned investment advisers that did not establish and implement such procedures. See In re Scudder Kemper Investments, Inc., Advisers Act Rel. No. 1848 (Dec. 22, 1999) (adviser failed to reasonably supervise employee by not having policies and procedures designed to detect and prevent

employees' unauthorized trading in client accounts); In re Rhumblin Advisers (same); In re Nicholas-Applegate Capital Management, Advisers Act Rel. No. 1741 (Aug. 12, 1998) (adviser failed to reasonably supervise employee by not having policies and procedures designed to detect and prevent employees from engaging in improper personal trading); In re Van Kampen American Capital Asset Management, Inc., Advisers Act Rel. No. 1525 (Sep. 29, 1995) (adviser failed to reasonably supervise employee by not having policies and procedures designed to detect and prevent employees from mispricing fund securities).

Supervisors must also respond vigorously to indications of possible wrongdoing. In re Rhumblin Advisers. Supervisors must inquire into red flags and indications of irregularities and conduct adequate follow-up and review to detect and prevent future violations of the federal securities laws. *Id.*

1. WAM's Failure to Supervise

WAM was a supervisor of the Portfolio Manager. WAM employed the Portfolio Manager and appointed her as the Funds' portfolio manager. The Funds' investment guidelines provided that the Funds could purchase private placement securities. The Portfolio Manager caused the Funds to purchase notes through private placements and then defrauded the Funds by inflating the prices for these securities despite the issuers' financial problems or even defaults and bankruptcies and then rolling up the distressed notes into shell companies and inflating the prices of the shell companies' notes.

WAM failed reasonably to supervise the Portfolio Manager with a view to preventing and detecting her violations of the federal securities laws. WAM, moreover, had not established or implemented adequate procedures regarding the purchase, monitoring and pricing of such private placement securities.¹ WAM's failure to supervise and lack of adequate procedures allowed the Portfolio Manager to perpetrate her scheme for so many years.

First, with respect to purchasing securities through private placements, WAM had a policy that contracts, including agreements to purchase securities in a private placement and hire outside counsel, had to be approved and signed by certain WAM officers and that portfolio managers, such as the Portfolio Manager, did not have authority to enter into such contracts. WAM, however, distributed this policy only once in writing (an e-mail that WAM could not find) and had no procedures designed to enforce this policy. As a result, the Portfolio Manager was able to perpetrate and continue her scheme by signing, or authorizing an employee of the Broker-Dealer to sign, on behalf of the Funds securities purchase contracts, including contracts for the roll up transactions. The Portfolio Manager was also able to hire bond counsel to facilitate the transactions without oversight by WAM.

Second, with respect to monitoring fund securities, WAM's policy was that the Portfolio Manager ensured that interest payments or issuer financial statements were received. WAM, however, had no policy or procedure to ensure that the Portfolio Manager was, in fact, monitoring the securities and properly reporting and acting on any defaults. As a result, in this case, the Portfolio Manager was able to hide the fact that issuers' defaults were a sign that the issuer was having severe financial problems and/or not providing periodic financial statements as required by the securities purchase agreements.

Finally, with respect to pricing, the Funds' offering documents described the Funds' policies that the Funds' securities would be valued using market quotations obtained from a pricing service. The High Yield Fund's offering documents further provided that, in the absence of readily available market quotations, prices would be obtained from recognized broker-dealers in the same or similar securities. The Offshore Fund's offering documents provided that securities with no readily available market quotations were valued at fair value under the supervision of the fund's managing director and supervisory board. WAM, however, did not have adequate policies and procedures to ensure that the Funds' securities were priced in compliance with the Funds' offering documents. WAM merely relied on parties who had an interest in seeing that the securities' prices were high—the Portfolio Manager and the Broker-Dealer—to ensure that the necessary broker-quotes were obtained. As a result, in this case, the Portfolio Manager, with the Broker-Dealer, was able to price the troubled notes at inflated prices.

2. LM Fund Adviser's Failure to Supervise

LM Fund Adviser also failed reasonably to supervise the Portfolio Manager with a view to preventing and detecting her violations of the federal securities laws. LM Fund Adviser was the manager of the High Yield Fund and, pursuant to a written agreement between LM Fund Adviser and WAM, delegated the investment advisory function to WAM. That written agreement specifically stated that WAM's provision of those investment advisory services was subject to the supervision of LM Fund Adviser. LM Fund Adviser was also involved in the Portfolio Manager's appointment as the High Yield Fund's portfolio manager. LM Fund Adviser further received complaints from the Portfolio Manager that WAM did not provide her with sufficient support and relayed those concerns to WAM, which then hired an analyst to assist the Portfolio Manager.

LM Fund Adviser also had indications of irregularities regarding the problem notes. First, in March 1997, LM Fund Adviser learned of a red flag: the stale pricing (i.e., a price that was not changed daily) of two of the troubled notes at 99, despite the issuers' having defaulted on the last three interest payments. In a March 27, 1997 memorandum, a LM Fund Adviser officer wrote that the two issuers had defaulted on the last three interest payments and planned to make the payments by issuing additional notes. The memorandum added that the notes were "troubled" because the Broker-Dealer had priced the notes at 99 since October 1996 and that it seemed "very unusual that the notes have missed three consecutive interest payments without impact to the market value." The memorandum noted that the Broker-Dealer also had underwritten the notes and was working to resolve the missed payments. The memorandum further stated that the Portfolio Manager had explained that the issuers were able to make the interest payments but were using their cash to "grow the business" and that the price of 99 reflected the issuers' prospects "going forward."

Second, in mid April 1997, LM Fund Adviser received notice of another irregularity: a proposed roll up transaction. In April 1997, prior to the roll up transactions described above, the Portfolio Manager and the Broker-Dealer principal negotiated another roll up transaction in which the shell company would issue notes and other securities to the High Yield Fund in exchange for the five problem notes and the Broker-Dealer principal would manage the shell company and its assets (i.e., the problem notes contributed by the High Yield Fund). LM Fund Adviser learned of this proposed transaction and that the purpose of the transaction was to have the Broker-Dealer principal administer the underlying notes and manage any problems that might develop with the issuers' fulfilling their obligations under the notes. Although the proposed roll up transaction was stopped by LM Fund Adviser, LM Fund Adviser never investigated why the High Yield Fund needed the Broker-Dealer principal's services to administer and manage the notes.

Third, also in April 1997, LM Fund Adviser received notice of another irregularity: more of the High Yield Fund's stale prices. On April 21, 1997, a LM Fund Adviser officer received from an accounting manager for the High Yield Fund a copy of his memorandum of the same date to the Portfolio Manager regarding the High Yield Fund's stale prices despite the market turmoil of the previous week. The accounting manager wrote a note to the LM Fund Adviser officer asking whether "at some point does this need to go the Board as a `Board valued security'?", with an arrow pointing to the discussion that two of the problem notes had prices that were 121 days stale. The LM Fund Adviser officer's answer to the manager's question was "maybe" and asked how many of the stale priced securities were priced by brokers. The manager indicated on the stale price report the broker-priced securities, which included the five troubled notes. During the remainder of 1997 and 1998, the High Yield Fund continued to have a high percentage of securities with stale prices.

LM Fund Adviser did not adequately follow-up and review these irregularities and had not established or implemented procedures for such follow-up and review.² Despite the irregularities regarding the notes and their pricing, LM Fund Adviser did not do any investigation beyond confirming with the Portfolio Manager and the Broker-Dealer (who had underwritten the problem notes) that their pricing and pricing procedures included obtaining two broker quotes. Had LM Fund Adviser conducted any independent investigation, it should have discovered that the Portfolio Manager's and the Broker-Dealer's confirmations were false, that they did not obtain prices from two brokers, that the issuers were in severe financial condition, that their prices were overstated and that the current pricing did not comply

with the Funds' policies or disclosure. In these circumstances, LM Fund Adviser became a supervisor of the Portfolio Manager.

IV.

Based on the foregoing, the Commission deems it appropriate and in the public interest to accept the Offers submitted by WAM and LM Fund Adviser and impose the sanctions specified in the Offers. In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by WAM and LM Fund Adviser and cooperation afforded the Commission staff.

Accordingly, IT IS HEREBY ORDERED that WAM and LM Fund Adviser are censured.

IT IS FURTHER ORDERED that WAM and LM Fund Adviser shall each, within thirty (30) days of the entry of this Order, pay a civil money penalty in the amount of \$50,000 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 or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312-0003; and (D) submitted under cover letter that identifies WAM and LM Fund Adviser as the Respondents and the file number of this proceeding, a copy of which cover letter and money order or check shall be sent to Sandra J. Harris, Associate Regional Director, Pacific Regional Office, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, CA 90036.

IT IS FURTHER ORDERED that WAM and LM Fund Adviser shall comply with its undertaking to maintain the enhanced supervisory policies and procedures previously implemented.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

1 Prior to the date of the Order, WAM adopted enhanced supervisory policies and procedures relating to the types of violations that gave rise to these proceedings and that are described in the Order.

2 Prior to the date of the Order, LM Fund Adviser adopted enhanced supervisory policies and procedures relating to the types of violations that gave rise to these proceedings and that are described in the Order.