

N.A.S.D. AWARD

NATIONAL ASSOCIATION OF SECURITIES DEALERS

In the Matter of the Arbitration Between

Name of Claimant

Mississippi Gulf Coast Regional Wastewater Authority

93-03411

Name of Respondent

Shearson Lehman Brothers, Inc., now known as
Smith Barney Shearson Inc.

REPRESENTATION

For Claimant: Mississippi Gulf Coast Regional Wastewater Authority ("Mississippi Gulf") was represented by William F. Ray, Esq. and George R. Fair, Esq. of Watkins & Eager, Jackson, Mississippi.

For Respondent: Shearson Lehman Brothers, Inc., now known as Smith Barney Shearson Inc., ("Shearson") was represented by George O. Richardson, Esq. of Smith Barney Shearson, Inc., New York, New York.

CASE INFORMATION

Statement of Claim filed: August 31, 1993.

Claimant's Submission Agreement signed on: August 23, 1993 by C.E. Miller, General Manager, Mississippi Gulf Coast Regional Wastewater Authority.

Statement of Answer filed by Respondent Shearson on: December 29, 1993.
Respondent Shearson did not file an executed submission agreement.

HEARING INFORMATION

Pre-Hearing Conference: September 20, 1994 for One (1) session with One (1) arbitrator.

Hearing Dates/Sessions: September 27, 1994 for Two (2) sessions;

September 28, 1994 for Three (3) sessions; and
September 29, 1994 for One (1) Session.

Hearing Location: New Orleans, Louisiana.

CASE SUMMARY

Claimant Mississippi Gulf alleged that Respondent Shearson misrepresented to Claimant that "Fannie Mae" investments were consistent with Mississippi Gulf's investment objectives and requirements. Claimants specifically alleged that:

1. Mississippi Gulf is a public body whose equipment and facilities for the treating of wastewater for communities is obtained in part with the proceeds of bond issues. When fees charged for its services exceed operating expenses, portions of the remaining funds are invested in interest-bearing securities and accounts in order to retire Mississippi Gulf's bonds. In connection with the bond issues, Mississippi Gulf has entered various covenants limiting the nature of the investments it can make;
2. In 1991, Mississippi Gulf sought competitive bids from financial institutions for investment of approximately \$2,500,000. In correspondence to Shearson, Mississippi Gulf stated that the investment must meet the following criteria: the investment must pay principal and interest for approximately twenty years, and the investment must be in a U.S. Government Security or have a U.S. Government Security pledged in support of the investment. In addition, Mississippi Gulf delivered a copy of its pertinent bond covenants to Shearson in order to inform Shearson of the Claimant's investment objectives and requirements;
3. Having acknowledged Mississippi Gulf's investment requirements and objective, Shearson recommended and sold to Claimant "Fannie Mae" investments, expressly representing that these investments were consistent with Mississippi Gulf's investment objectives and requirements, and would pay a return exceeding 9 per cent per annum. Based upon these representations, Mississippi Gulf agreed to purchase the investments and opened an account in September, 1991, acknowledging on the account agreement that the Claimant's investment objective was "income with safety";
4. In fact, Shearson sold to Mississippi Gulf interest-only, stripped mortgage-backed securities in two purchases totaling \$1,740,326.53 on September 16, 1991 and September 20, 1991. While Shearson had represented that this investment was consistent with Mississippi Gulf investment objectives, such investments are

extremely volatile, speculative, and risky;

5. Shearson did not disclose the volatility, risk or speculative nature of the investments. Shearson did not explain that the investments were "interest only", did not explain that there were specific pre-payment risks associated with the investments, and did not provide to Claimant a prospectus or statement disclosing the risk;

6. Shearson held these securities in its own account prior to sale to Claimants. Apparently recognizing that the securities were at risk of devaluation, Shearson deliberately dumped the securities upon Mississippi Gulf in order to protect itself from financial losses, acting in its own interests. Shearson violated a fiduciary duty to Mississippi Gulf by acting in its own best interest and against Mississippi Gulf's interest;

7. After the investments were sold to Mississippi Gulf, Shearson continued to deliver false and misleading statements to the Claimant designed to disguise the nature of the investments;

8. The value of the securities quickly eroded and were ultimately sold for \$260,944.89, with total interest payments in the sum of \$488,411.56. In addition, Mississippi Gulf lost the opportunity to invest the funds at favorable market conditions existing in September 1991, which would have created interest in the sum of approximately \$287,000.00;

9. Shearson's management failed to exercise proper supervision and control over its employees.

Based upon the above allegations, Mississippi Gulf asserted claims for violation of §10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78a et seq.) and SEC Rule 10b-5 (17 C.F.R. §240.10b-5); common law fraud and intentional misrepresentation; breach of fiduciary duty; and gross and reckless negligence and utter disregard for its customer's rights. In addition, claims were asserted against Shearson pursuant to "control person" liability under the federal securities laws, the doctrine of respondeat superior under common law, and for its own gross and reckless negligence and utter disregard for the interest and rights of the Claimant to which Shearson owed a fiduciary duty. Furthermore, Claimant asserted that the purchase of the securities was ultra vires.

Respondent Shearson denied the material allegations of the Statement of Claim, asserting that the Claimant understood the nature and risks of the investments it made. Shearson specifically alleged that:

1. Before Mississippi Gulf could trade its account, Shearson required and received Claimant's properly executed resolutions adopted by the Claimant's

board. These resolutions gave broad powers to Claimant's representative and authorized him to invest in "all forms of securities";

2. Shearson's account representative explained the nature and risks of investing in a "Fannie Mae" interest-only strip, advising that the principal and interest on the bond is separated and the two pieces sold to different investors. The holder of the principal-only strip receives the principal payments and the holder of the interest-only strips receives the interest payments;

3. At approximately the same time, Mississippi Gulf purchased a \$1 million face Freddie Mac bond, known as an "inverse floater" because the interest on the bond would change and float inversely to interest rates generally. The two investments were meant to operate in conjunction as a hedge against interest rate swings;

4. The trust indenture by which Mississippi Gulf issued its bonds specifically authorized the investments made by Shearson; and

5. Mississippi Gulf had in its possession all the information relevant to its current analysis for a time well before it sold the investment, but continued to hold the strip in the belief that interest rates would rise. Claimant never advised Shearson that the investment was contrary to its investment objectives.

In addition, Shearson asserted several affirmative defenses, including the following:

1. The Statement of Claim fails to state a claim upon which relief can be granted;

2. The claims asserted are barred by the applicable statute of limitations and by ratification of the transactions in the account;

3. Respondent was not in a fiduciary relationship with the Claimant;

4. Claimant has failed to mitigate its damages; and

5. Claimant is equally at fault for any damages and is barred from recovery.

RELIEF REQUESTED

Claimant requested entry of an award against Respondent for economic losses in the sum of \$990,970.08 plus lost investment income of \$287,000.00, for a total of \$1,277,970.08; punitive

damages in an amount equal to its actual losses; costs, expenses and attorneys' fees.

Respondent requested that the Panel dismiss the Statement of Claim and award to Respondent its costs in this proceeding, including attorneys' fees.

OTHER ISSUES CONSIDERED & DECIDED

Respondent Shearson did not file an executed submission agreement, but as a member firm is required to submit to arbitration pursuant to Section 12 of the NASD Code of Arbitration Procedure.

The parties have agreed that the Award in this matter may be executed in counterpart copies or that a handwritten, signed Award may be entered. In either case, the parties have agreed to receive conformed copies of the Award while the originals remain on file with the NASD.

AWARD

After considering the pleadings, the testimony and the evidence presented at the hearing, the undersigned arbitrators have decided in full and final resolution of the issues submitted for determination as follows:

1. Respondent Shearson Lehman Brothers, Inc., now known as Smith Barney Shearson Inc., is liable for and shall pay to the Claimant, Mississippi Gulf Coast Regional Wastewater Authority, the sum of One Million Two Hundred Ninety-Three Thousand (\$1,293,000.00) Dollars as actual damages, with interest at the rate of five (5%) per cent per annum from September 29, 1994 until the sum is paid;
2. In addition, Respondent Shearson Lehman Brothers, Inc., now known as Smith Barney Shearson Inc. is liable for and shall pay to Claimant Mississippi Gulf Coast Regional Wastewater Authority the sum of Ninety-Four Thousand (\$94,000.00) Dollars in attorneys fees, expert witness fees and costs. In deciding to award attorneys' fees, the Panel reviewed the arguments of the parties and determined that authority existed for an award of attorneys' fees to the Claimant, Mississippi Gulf Coast Regional Wastewater Authority;
3. The request for punitive damages is hereby denied in its entirety;
4. Any relief not specifically granted is hereby denied.

OTHER COSTS

The NASD shall retain the \$1,000.00 postponement fee paid by Claimant Mississippi Gulf Regional Wastewater Authority. Respondent Shearson Lehman Brothers, Inc. is liable for and

shall pay to the Claimant, Mississippi Gulf Wastewater Authority the sum of \$1,000.00 as reimbursement of the postponement fee paid.

FORUM FEES

Pursuant to Section 43(c) of the Code of Arbitration Procedure, the following Forum Fees are assessed: One (1) Pre-hearing session before One (1) arbitrator x \$300.00 per session = \$300.00; Six (6) hearing sessions x \$1,000.00 per hearing session = \$6,000.00; Total fees = \$6,300.00.

The National Association of Securities Dealers, Inc. shall retain the \$250.00 non-refundable filing fee and the \$1,000.00 hearing session deposit previously deposited by the Claimant, Mississippi Gulf Regional Wastewater Authority. Respondent Shearson Lehman Brothers, Inc., now known as Smith Barney Shearson Inc., is liable for and shall pay to Claimant Mississippi Gulf Regional Wastewater Authority the sum of \$1,250.00 as reimbursement of the Claim filing fee and hearing session deposit. In addition, Respondent Shearson Lehman Brothers, Inc., now known as Smith Barney Shearson Inc., is liable for and shall pay to the NASD the sum of \$5,300.00 as additional forum fees.

Fees are payable to the National Association of Securities Dealers, Inc.

Concurring Arbitrators' Signatures
Name

Date

November 28, 1994

November 29, 1994

/s/ Ronald M. Roberts, PhD.
Ronald M. Roberts, PhD.
Industry Arbitrator

November 28, 1994

For NASD Use Only
Date of Service of Award: December 5, 1994