

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES ACT OF 1933**  
**Release No. 8919 / May 27, 2008**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 57869 / May 27, 2008**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13046**

**In the Matter of**  
  
**First Southwest Company,**  
  
**Respondent.**

**ORDER INSTITUTING  
ADMINISTRATIVE AND  
CEASE-AND-DESIST  
PROCEEDINGS, MAKING  
FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS AND  
A CEASE-AND-DESIST ORDER  
PURSUANT TO SECTION 8A  
OF THE SECURITIES ACT OF  
1933 AND SECTION 15(b) OF  
THE SECURITIES EXCHANGE  
ACT OF 1934**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”) and Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”) against First Southwest Company (“Respondent”).

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (“Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934 (“Order”), as set forth below.

### III.

On the basis of this Order and Respondent's Offer, the Commission finds that:<sup>1</sup>

#### A. RESPONDENT

Respondent **First Southwest Company**, headquartered in Dallas, Texas, is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act.

#### B. SUMMARY

As part of its broker-dealer business, Respondent underwrote and managed a limited number of auctions for auction rate securities. From at least January 1, 2003 through June 30, 2004, in connection with certain auctions, Respondent engaged in the practices described in Section III.C.2 below, and thereby violated Section 17(a)(2) of the Securities Act.

#### C. FACTS

##### 1. The Auction Rate Securities Market

Auction rate securities are municipal bonds, corporate bonds, and preferred stocks with interest rates or dividend yields that are periodically re-set through auctions, typically every 7, 14, 28, or 35 days. Auction rate bonds are usually issued with maturities of 30 years, but the maturities can range from 5 years to perpetuity. Auction rate securities are often marketed to issuers as an alternative variable rate financing vehicle, and to investors as an alternative to money market funds. Auction rate securities were first developed in 1984, and the auction rate securities market has grown to well over \$200 billion. Mostly institutional investors participate in the auction rate securities markets, although recently smaller investors also have begun participating in the market. Typically, the minimum investment is \$25,000.

a. Auction Mechanics. Auction rate securities are auctioned at par so the return on the investment to the investor and the cost of financing to the issuer between auction dates is determined by the interest rate or dividend yield set through the auctions.<sup>2</sup> According to the disclosure documents (the prospectus or official statement) for each security, the interest rate or dividend yield is set through an auction (commonly referred to as a "Dutch" auction) in which bids with successively higher rates are accepted until all of the securities in the auction are sold. Investors can only submit the following types of orders: 1) a "hold" order, which is the default order for current investors (i.e., the order that is entered for a current holder if the holder takes no

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<sup>1</sup> The findings 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.

<sup>2</sup> Between auctions, investors might be able to buy or sell auction rate securities in the secondary market at prices greater than, equal to, or less than par.

action), where a current investor will keep the securities at the rate at which the auction clears; 2) a “hold-at-rate” bid, where a current investor will only keep the securities if the clearing rate is at or above the specified rate; 3) a “sell” order, where a current investor will sell the securities regardless of the clearing rate; or 4) a “buy” bid, where a prospective investor, or a current investor who wants more securities, will buy securities if the clearing rate is at or above the specified rate. Disclosure documents often state that an investor’s order is an irrevocable offer.

The final rate at which all of the securities are sold is the “clearing rate” that applies to all of the securities in the auction until the next auction. Bids with the lowest rate and then successively higher rates are accepted until all of the sell orders are filled. The clearing rate is the lowest rate bid sufficient to cover all of the securities for sale in the auction.<sup>3</sup> If there are not enough bids to cover the securities for sale, then the auction fails, the issuer pays an above-market rate set by a pre-determined formula described in the disclosure documents, and all of the current holders continue to hold the securities, with minor exceptions. If all of the current holders of the security elect to hold their positions without bidding a particular rate, then the clearing rate is the all-hold rate, a below-market rate set by a formula described in the disclosure documents.

b. Broker-Dealers’ Role in Auctions. The issuer of each security selects one or more broker-dealers to underwrite the offering and/or manage the auction process. Investors can only submit orders through the selected broker-dealers. The issuer pays an annualized fee to each broker-dealer engaged to manage an auction (typically 25 basis points for the par value of the securities that it manages). The issuer also selects an auction agent to collect the orders and determine the clearing rate for the auction.

Investors must submit orders for an auction to the broker-dealer by a specified time. Many broker-dealers have an internal deadline by which investors must submit their orders to the broker-dealer. This internal deadline allows the broker-dealer sufficient time to process and submit the orders to the auction agent. Other broker-dealers allow investors to submit orders up until the submission deadline, i.e., the deadline for broker-dealers to submit orders to the auction agent. The broker-dealers must submit the orders to the auction agent before the submission deadline, and usually must identify each separate order.

c. Auction Agents’ Role in Auctions. After receiving the orders from the broker-dealers, the auction agent calculates the clearing rate that will apply until the next auction. In practice, however, if there is only one broker-dealer, the broker-dealer can discern the clearing rate before submitting the orders to the auction agent.

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<sup>3</sup> For example, suppose \$100,000 of securities were for sale and the auction received four buy bids. Bid A was for \$50,000 at 1.10%, Bid B was for \$50,000 at 1.15%, Bid C was for \$50,000 at 1.15%, and Bid D was for \$25,000 at 1.20%. Under these circumstances, the “clearing rate” would be 1.15%, meaning all of the securities in the auction would pay interest at a rate of 1.15% until the next auction. Bid A would be allocated \$50,000, Bids B and C would receive pro-rata allocations (\$25,000 each), and Bid D would receive no allocation.

The auction agent allocates the securities to the broker-dealers based on the orders they submitted. The auction procedures generally state that orders are filled in the following order: hold orders, hold-at-rate and buy bids with a rate below the clearing rate, hold-at-rate orders with a rate at the clearing rate, and buy bids with a rate at the clearing rate. When there are more bids for securities at the clearing rate than securities remaining for sale, the securities are allocated on a pro rata basis first to the hold-at-rate bidders and then to the buy bidders. Generally, the auction procedures require broker-dealers to follow the same hierarchy in allocating the securities to their customers.

d. Disclosures Regarding Broker-Dealer Bidding. During the relevant period, the disclosure documents for different securities varied as to what, if anything, they disclosed about broker-dealers bidding in auctions that they were managing. Some disclosure documents did not disclose anything about bidding by broker-dealers. Other disclosure documents disclosed that broker-dealers may bid in auctions with language similar to the following: “[a] broker-dealer may submit orders in Auctions for its own accounts.” Still other disclosure documents disclosed that broker-dealers may bid in auctions and may have an information advantage with language similar to the following: “[a] Broker-Dealer may submit orders in Auctions for its own accounts. Any Broker-Dealer submitting an order for its own account in any Auction might have an advantage over other bidders in that it would have knowledge of other orders placed through it for that Auction (but it would not have knowledge of orders submitted by other Broker-Dealers, if any).”

## 2. Respondent’s Conduct

Without adequate disclosure, Respondent intervened in auctions by bidding for its proprietary account to prevent failed auctions and to prevent all-hold auctions. In certain instances, the interventions affected the clearing rate.<sup>4</sup>

a. Bids To Prevent Failed Auctions. Without adequate disclosure, Respondent bid to prevent auctions from failing. Failed auctions occur when there are more securities for sale than there are bids for securities and result in an above-market rate described in the disclosure documents. Respondent submitted bids to ensure that all of the securities would be purchased to avoid failed auctions and thereby, in certain instances, affected the clearing rate.

b. Bids To Prevent All-Hold Auctions. Without adequate disclosure, Respondent submitted bids to prevent the all-hold rate, which is the below-market rate set when

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<sup>4</sup> The clearing rate determines the interest rate or yield the issuer must pay to investors until the next auction. In those instances when these practices lowered the clearing rate, investors received a lower rate of return on their investments. Conversely, in those instances when the practices raised the clearing rate, issuers had to pay a higher interest rate or yield. To the extent that these practice affected the clearing rate, investors may not have been aware of the liquidity and credit risks associated with certain securities.

all current holders want to hold their positions so that there are no securities for sale in the auction. In certain instances, this practice affected the clearing rate.

#### **D. LEGAL SECTION**

Section 17(a)(2) of the Securities Act prohibits material misstatements and omissions in any offer or sale of securities. Negligent conduct can violate Section 17(a)(2). See, e.g., SEC v. Hughes Capital Corp., 124 F.3d 449, 453 (3d Cir. 1997). As a result of Respondent's conduct, Respondent willfully<sup>5</sup> violated Section 17(a)(2) of the Securities Act.

#### **E. THE PENALTY AMOUNT**

The Commission aims to promote voluntary disclosures in industry-wide investigations and to encourage firms to provide comprehensive information to the staff in such investigations. See In the Matter of Bear, Stearns & Co. Inc. et al., Securities Act Release No. 8684 (May, 31, 2006); In the Matter of Citigroup Global Markets, Inc., successor by merger to Legg Mason Wood Walker Inc., Securities Exchange Act Release No. 55712 (May 7, 2007) (collectively "Previous Settlements"). In determining the size of the penalty in this matter, the Commission considered Respondent's cooperation afforded the Commission staff and Respondent's relatively small share of the auction rate securities markets compared to each of the broker-dealers in the Previous Settlements. The Commission, however, also considered that Respondent did not report to the Commission the practices described in Section III.C.2.

### **IV.**

In view of the foregoing, the Commission deems it appropriate, and in the public interest, to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Section 8A of the Securities Act and Section 15(b) of the Exchange Act, it is hereby ORDERED that:

- A. Respondent be, and hereby is, censured.
- B. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) of the Securities Act.
- C. Respondent shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$150,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such

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<sup>5</sup> "Willfully" as used in this Order means intentionally committing the act which constitutes the violation, see Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that he is violating one of the Rules or Acts.

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 Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Kenneth R. Lench, Division of Enforcement, Securities and Exchange Commission, 100 F Street N.E., Washington, D.C. 20549-6041.

- D. Not later than 6 months after the entry of this Order, Respondent shall provide all of its customers who hold auction rate securities (“Holders”) and the issuers of such securities (“Issuers”) with a written description of the Respondent’s material auction practices and procedures. In addition, commencing not later than 6 months after the entry of this Order, Respondent shall, at or before the completion of the applicable transaction, provide all customers who are first-time purchasers, and all broker-dealers who are purchasers, of auction rate securities from Respondent (“Purchasers”) with a written description of its material auction practices and procedures. Respondent may fulfill the foregoing requirements to provide such written description to Holders and Purchasers by sending a written notification (e.g., via e-mail, subject to applicable legal requirements) or, with respect to Purchasers, by including a written notification with the trade confirmation, that a written description of Respondent’s material auction practices and procedures is available on a specified web page of its website accessible to such Holders and Purchasers. Such written notification must be set forth prominently in such a manner as to call it to the attention of the reader and also state that a written description of Respondent’s material auction practices and procedures will be sent to the Holder or Purchaser upon request. In addition, not later than 6 months after the entry of this Order, Respondent shall send a written description of its material auction practices and procedures accompanied by a list of all auction rate securities for which it serves as broker-dealer (including related CUSIP numbers) to each Nationally Recognized Municipal Securities Information Repository (“NRMSIR”) and appropriate State Information Depository (“SID”), if any. Respondent may use the facilities of DisclosureUSA for such purpose with respect to auction rate securities that are municipal securities.

Furthermore, commencing not later than 3 months after the entry of this Order, Respondent shall at all times make a description of its then-current material auction practices and procedures available to (1) all customers and broker-dealers who are participating through Respondent in an auction of auction rate securities on the portion of its website that is accessible to such customers and broker-dealers and is related to such auction and (2) the general public on another portion of its website accessible to the general public.

As used in this Section, “auction rate securities” means, with respect to Respondent, auction rate securities sold in auctions managed by it.

- E. Not later than 6 months after the date of this Order, unless otherwise extended by the staff of the Commission for good cause shown, Respondent’s chief executive officer or general counsel shall certify in writing to the staff of the Commission that Respondent has implemented procedures that are reasonably designed to prevent and detect failures by it to conduct the auction process in accordance with the auction procedures disclosed in the disclosure documents and any supplemental disclosures and that Respondent is in compliance with Section IV.D of this Order.

By the Commission.

Florence E. Harmon  
Acting Secretary