

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

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 52478 / September 21, 2005**

**INVESTMENT COMPANY ACT OF 1940**  
**Release No. 27071 / September 21, 2005**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-12048**

**In the Matter of**

**LEGG MASON WOOD WALKER,  
INCORPORATED,**

**Respondent.**

**ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS AND A CEASE-  
AND-DESIST ORDER PURSUANT TO  
SECTIONS 15(b) AND 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934  
AND SECTIONS 9(b) AND 9(f) OF THE  
INVESTMENT COMPANY ACT OF 1940**

**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 Sections 15(b) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Investment Company Act”) against Legg Mason Wood Walker, Incorporated (“Respondent” or “LMWW”).

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “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 Respondent 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 Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 (“Order”), as set forth below.

### III.

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

#### Nature of Proceedings

1. This matter involves LMWW’s processing of mutual fund orders in violation of Rule 22c-1(a) under the Investment Company Act, and failure to make and keep certain books and records in violation of Section 17(a)(1) of the Exchange Act. From at least September 1, 2002, through October 19, 2003, LMWW’s flawed mutual fund order processing system enabled LMWW registered representatives to process more than 18,000 mutual fund orders after 4:00 p.m. and receive the current day’s net asset value (“NAV”) without regard for the time the orders were placed. Hundreds of these orders were either received by LMWW after 4:00 p.m. or were the result of discretionary investment decisions made by LMWW registered representatives after 4:00 p.m.

2. Legg Mason had minimal written procedures governing the timing and pricing of mutual fund orders and, instead, relied almost exclusively on its mutual fund order entry system to block any orders from being processed after 4:00 p.m. ET, regardless of their time of receipt. In September 2003, LMWW discovered, however, that its system had been failing to block certain trades processed by LMWW registered representatives after 4:00 p.m. ET and that the problem existed since 1997. Although the violative trading was not the result of any improper agreements between LMWW personnel and their customers, this practice had the potential to affect shareholders in the mutual funds sold by LMWW. Shareholders in the mutual funds could have been harmed through dilution of their share values if personnel attempted to capitalize on post-market information by processing mutual fund orders after hours based on stale prices.

#### Respondent

3. **Legg Mason Wood Walker, Incorporated**, a Maryland corporation with its principal place of business in Baltimore, Maryland, has been registered with the Commission as a broker-dealer since 1970. LMWW conducts general securities business and, in addition, clears and finances securities transactions for 8 introducing broker-dealers. In total, LMWW carries the accounts of approximately 900,000 customers. In 2002 and 2003, LMWW processed approximately 150,000 mutual fund trades per month. LMWW is the principal underwriter for the Legg Mason Funds.

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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.

## **Facts**

### **4:00 p.m. ET Mutual Fund Trading Cut-off**

4. Rule 22c-1(a) prohibits, among other things, any dealer in mutual fund securities from selling or redeeming those securities except at a price based on the current NAV of the securities as next computed after receipt of the order. In essence, Rule 22c-1(a) prohibits those identified in the Rule from executing a mutual fund trade at that day's NAV if the trade was received after the time as of which the mutual fund has calculated that day's NAV (usually 4:00 p.m. ET). Orders to purchase, redeem or exchange mutual fund shares received by dealers after the time as of which the mutual fund calculates that day's NAV are to be priced at the following day's NAV. Rule 22c-1(a) seeks to prevent exploitation of post-market close information by some investors at the expense of other investors, and to promote fairness for all mutual fund investors.

5. From at least September 1, 2002 to October 19, 2003, LMWW entered into principal underwriter agreements with Legg Mason Funds ("Proprietary Funds") and dealer agreements with numerous other mutual fund families ("Non-Proprietary Funds") (collectively the "Funds"). These agreements generally required LMWW to sell and redeem mutual fund shares only in accordance with the terms and conditions of the Funds' current prospectuses. Most Funds required trades to be placed by customers before 4:00 p.m. ET to receive that day's NAV. LMWW's internal policy governing the timing and pricing of mutual fund orders mirrored the requirements of the Funds' prospectuses.

6. The LMWW written procedure that addressed this policy was a one page chart posted on the firm's intranet website that listed a 4:00 p.m. ET sale and buy cut-off for Proprietary and Non-Proprietary Funds. In the absence of additional procedural safeguards, LMWW relied heavily on its mutual fund order entry system to protect against violations of its policy governing the timing and pricing of mutual fund orders.

### **LMWW's Mutual Fund Order Entry Processes**

7. To process mutual fund orders, LMWW used a third-party vendor's order processing system called the Mutual Fund Routing System ("MFRS"). In general, the MFRS automates the process of submitting, tracking, and processing mutual fund orders through National Securities Clearing Corporation's ("NSCC") Fund/SERV trading platform, the central processing system for mutual fund transactions. The system allows brokers to place orders and send registration information, and allows mutual fund companies to transmit purchases, redemptions, exchanges, and account data between dealers and fund processors.

8. In 1997, LMWW replaced its existing mutual fund order entry system with two versions of the MFRS: a customized version specifically designed to process Proprietary Fund orders ("Proprietary MFRS"); and a standard off-the-shelf version used to process Non-Proprietary Fund orders ("Non-Proprietary MFRS").

9. When LMWW converted to the MFRS, the third-party vendor agreed to customize the Proprietary MFRS to allow LMWW to continue routing trades through its current transfer agent instead of the NSCC. In accordance with LMWW specifications, the vendor incorporated into the Proprietary MFRS a cut-off mechanism that was supposed to prevent registered representatives from processing any Proprietary mutual fund orders after 4:00 p.m. ET.

10. LMWW purchased the standard off-the-shelf MFRS for processing Non-Proprietary Fund orders. Although the MFRS came equipped with a range of options that enabled firms to tailor the system to meet their internal processing requirements, the option to define a specific cut-off time did not become available until 1998. LMWW never upgraded the Non-Proprietary MFRS to include the cut-off. Thus, beginning in 1997 and continuing through October 2003, LMWW Non-Proprietary MFRS allowed Non-Proprietary mutual fund orders to be processed until 5:30 p.m. even if the orders were received after 4:00 p.m. The trades entered into the MFRS between 4:00 and 5:30 p.m. ET automatically received the current day's NAV.

#### **Procedural Gaps and System Flaws Lead to Post-4:00 p.m. Processing of Trades at the Current Day's NAV**

11. During the period September 1, 2002 through October 19, 2003, LMWW processed more than 1.7 million mutual fund transactions. Of those transactions, registered representatives and operations personnel processed, between 4:00 and 5:30 p.m., more than 18,000 mutual fund orders which received the current day's NAV. LMWW did not keep records of when customer mutual fund orders were actually received, and therefore LMWW could not establish when it received a substantial majority of the 18,000 orders processed after 4:00 p.m. ET. Hundreds of these orders were either received by LMWW after 4:00 p.m. or were the result of discretionary investment decisions made by LMWW registered representatives after 4:00 p.m.

12. LMWW registered representatives processed Fund orders from their desktop computers in several ways: the MFRS single order entry screen; the MFRS FAST order entry screen ("Fast Screen"); e-mailing trades to the mutual fund operations desk; and submitting trades through the Fund Investor Services, a department that directly marketed and processed Proprietary Funds.

13. The orders entered through the single order entry screen were routed through either the Proprietary or Non-Proprietary MFRS depending on the Fund. Since the Proprietary MFRS had a 4:00 p.m. ET cut-off, the system effectively blocked any post-4:00 p.m. orders. The Non-Proprietary MFRS, however, lacked a 4:00 p.m. ET cut-off and accepted orders until 5:30 p.m. ET without regard for when the orders were placed.

14. LMWW registered representatives used the Fast Screen to process multiple Proprietary Fund orders simultaneously. A systems error caused certain post-4:00 p.m. ET Fast Screen orders to bypass the Proprietary MFRS cut-off. If a broker opened the Fast Screen after 4:00 p.m. ET, the cut-off blocked any trades from being processed. However, if brokers opened

the Fast Screen before 4:00 p.m. ET, they could hold the screen open and process orders until 5:30 p.m. ET, notwithstanding when the orders were placed.

15. LMWW's mutual fund operations personnel and supervisors within the Fund Investor Services department likewise processed, at the current day's NAV, mutual fund orders after 4:00 p.m. without regard for the time the orders were placed.

16. The late processed trades were not the product of any formal or informal agreement between LMWW and its customers or the product of any scheme to exploit LMWW's order entry process. LMWW personnel did not receive any additional compensation, non-cash benefits, or payments from customers for late processing of trades.

17. Both the procedural gaps and systemic breakdowns caused confusion among LMWW personnel concerning the firm's internal policy and regulatory requirements governing the timing and pricing of mutual fund orders. LMWW registered representatives and operations personnel generally believed they were complying with, or otherwise misunderstood, the firm's internal policy.

#### **LMWW Failed to take Adequate Steps to Prevent Improper Pricing of Mutual Fund Trades**

18. Following the conversion to the MFRS in 1997, LMWW had been unaware that the Non-Proprietary MFRS cut-off had never been installed or that the Proprietary MFRS cut-off had been failing to block certain post-4:00 p.m. ET trades.

19. LMWW compounded the system deficiencies by failing to recognize for more than five years that its mutual fund order entry system had not been operating as anticipated. LMWW never tested the systems to ensure that the 4:00 p.m. ET cut-off had been installed and operating properly. Nor did LMWW, at any point until the Fall of 2003, undertake any surveillance or auditing efforts to ensure that its personnel had been processing orders through the MFRS in a manner consistent with the firm's internal policies and regulatory requirements.

20. In addition, the Commission staff requested in October 2003 that LMWW produce records relating to the original time of order entry for mutual fund transactions for the previous three years. However, LMWW only maintained complete records of original order entry for the period beginning September 2002. In addition, LMWW failed to maintain records reflecting the time it received mutual fund orders from customers for several months after May 2, 2003, the effective date of the amendment to Exchange Act Rule 17a-3 requiring broker-dealers to record the time of order receipt.

#### **LMWW's Correction of Procedural Weaknesses and System Failures**

21. In September 2003, the Commission's Office of Compliance Inspections and Examinations ("OCIE") requested that LMWW (among other large broker-dealers) provide information relating to its mutual fund trading practices. In connection with its response to OCIE,

LMWW initiated an investigation of its mutual fund trading operations. During the course of its investigation, LMWW discovered and notified the staff that its order entry system allowed mutual fund trades to be processed after 4:00 pm ET.

22. LMWW has implemented a number of enhancements to its systems, policies and procedures. These enhancements include an upgrade of its mutual fund order entry system so that orders for the purchase or sale of Non-Proprietary mutual funds are automatically rejected if not entered by LMWW brokers by 4:00 p.m. ET; a revamped Fast Screen that automatically rejects Proprietary Fund orders placed after 4:00 p.m. ET; and the establishment of additional written procedures that address Rule 22c-1(a) and the Exchange Act books and records requirements.

### **Violations**

23. As a result of the conduct described above, LMWW willfully<sup>2</sup> violated Rule 22c-1(a) under the Investment Company Act. Rule 22c-1(a) requires certain persons and entities, including principal underwriters and dealers in mutual fund shares, to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to buy or redeem. LMWW's late processing of mutual fund orders as described in this Order violated this regulation.

24. As a result of the conduct described above, LMWW willfully violated Section 17(a)(1) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder. Section 17(a)(1) of the Exchange Act requires every registered broker or dealer to make and keep, for prescribed periods, such records as the Commission, by rule, prescribes as necessary or appropriate in the public interest or for the protection of investors. Rule 17a-3(a)(6) thereunder requires a registered broker or dealer to make and keep current a memorandum of each brokerage order, showing the time the order was received. Rule 17a-4 under the Exchange Act requires every broker or dealer that is subject to Rule 17a-3 to preserve for three years certain records, including those required to be made pursuant to Rule 17a-3(a)(6).

### **LMWW's Remedial Efforts**

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

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<sup>2</sup> "Willfully," as used in this Order means intentionally committing the act that 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 or she is violating one of the Rules or Acts.

## Undertakings

Respondent has undertaken to:

1. Employ an independent consultant (“Independent Consultant”) knowledgeable in the pricing of mutual funds and compliance with Rule 22c-1 under the Investment Company Act and keeping and preserving required books and records under 17(a)(1) of the Exchange Act, and not unacceptable to the staff of the Philadelphia District Office (PDO): (a) to conduct a review to determine whether the changes to the policies and procedures (the “Policies and Procedures”) that LMWW has adopted and implemented to correct the activities described in this Order are reasonably designed to detect and prevent any future “late processing of orders” from LMWW registered representatives in violation of Rule 22c-1 under the Investment Company Act and to ensure compliance with Section 17(a)(1) under the Exchange Act; (b) to determine whether and to what extent there is a need for additional or amended Policies and Procedures to detect and prevent, insofar as practical, “late processing of orders” from LMWW registered representatives; and (c) to recommend that LMWW adopt such additional Policies and Procedures which the Independent Consultant believes are necessary to provide reasonable assurance that LMWW can detect and prevent “late processing of orders” from LMWW registered representatives.
2. Cooperate fully with the Independent Consultant and provide the Independent Consultant with access to its files, books, records, and personnel as reasonably requested for the review;
3. Require, at the conclusion of the Independent Consultant’s review of the Policies and Procedures, which in no event will be more than 180 days after the date of entry of the Order, the Independent Consultant to submit to LMWW and to the Commission staff a written report regarding LMWW’s compliance with its Policies and Procedures and the adequacy of those Policies and Procedures. The report shall include a description of the review performed, the conclusions reached and, if necessary, recommendations for changes in or improvements to the Policies and Procedures and a procedure for implementing the recommended changes or improvements;
4. Within 30 days after the date of issuance of the report of the Independent Consultant (“Report Date”), adopt all recommendations contained in the report and remedy any deficiencies in its Policies and Procedures; provided, however, that as to any recommendation that LMWW believes is unnecessary or inappropriate, LMWW may, within 45 days of the Report Date, advise the Independent Consultant and Commission staff in writing of any recommendations that it considers to be unnecessary or inappropriate. With respect to any recommendation that LMWW considers unnecessary or inappropriate, LMWW need not adopt that recommendation at that time but shall propose in writing an alternative policy, procedure, or system designed to achieve the same objective or purpose. As to any recommendation on which LMWW and the Independent Consultant do not agree, such parties shall attempt in good faith to reach an agreement

acceptable to the Commission staff within 90 days of the Report Date. In the event LMWW and the Independent Consultant are unable to agree on an alternative proposal acceptable to the Commission staff, LMWW will abide by the original recommendation of the Independent Consultant;

5. Within 120 days of the Report Date, submit an affidavit to the Commission staff stating that it has implemented any and all actions recommended by the Independent Consultant, or explaining the circumstances under which it has not implemented such actions;

6. LMWW: (a) shall not have the authority to terminate the Independent Consultant without the prior written approval of the Commission staff; (b) shall compensate the Independent Consultant, and persons engaged to assist the Independent Consultant, for services rendered pursuant to the Order at their reasonable and customary rates; and (c) shall not be in and shall not have an attorney-client relationship with the Independent Consultant and shall not seek to invoke the attorney-client or any other doctrine or privilege to prevent the Independent Consultant from transmitting any information, reports, or documents to the Commission; and

7. Require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with LMWW, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Commission's Philadelphia District Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with LMWW, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

#### **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 Sections 15(b) and 21C of the Exchange Act and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. LMWW is hereby censured;

B. LMWW shall cease and desist from committing or causing any violations and any future violations of Section 17(a)(1) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder, and Rule 22c-1(a) under the Investment Company Act;



C. LMWW shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of \$1,000,000 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 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 LMWW as a Respondent in these proceedings, and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Arthur S. Gabinet, District Administrator, Philadelphia District Office, Securities and Exchange Commission, 701 Market Street, Suite 2000, Philadelphia, PA 19106; and

D. LMWW shall comply with its undertakings as enumerated in Section III., Undertakings, above.

By the Commission.

Jonathan G. Katz  
Secretary