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DATE: July 10, 1995

TO: MTA Board of Directors, Alternates

FROM: ~~Franklin E. White~~ Ronny J. Goldsmith

SUBJECT: Los Angeles Times Inquiry

Introduction

We provided the Board on June 14, 1995 our initial reactions to issues raised in a Los Angeles Times' article. The article focused on allegations made by a former Smith Barney investment banker who claims there was collusion among firms contracted with by the MTA, the LACTC, and many other public entities nationwide, to conduct securities sales. At that time we told you that, when completed, we would report to you the results of a study of the transactions under question conducted by our current financial advisor, Public Financial Management.

A former investment manager claimed that a number of government agencies were taken in a conspiracy amongst major bond firms. The conspiracy goes as follows: the firms handle large bond sales for an agency, charging a reasonable rate for their services. But, during the actual bond sale, securities are purchased for escrow accounts, and the conspirators have used these transactions to charge usurious rates , unnoticed by clients.

The MTA has done four transactions that are under review. LACTC conducted three such refundings and MTA one to take advantage of lower interest rates which occurred in security markets between 1991 and 1993. Through these refundings, debt service costs were reduced in the aggregate by $43.2M, representing interest that would have been paid with taxpayer funds had securities not been refunded.

Prior to the publication of the Times article, and independent of any questions from the newspaper we had asked our financial advisor, Public Financial Management (PFM), to provide an independent analysis of the transactions in an effort to determine if we paid fair market rates for the securities purchased for escrow accounts in four transactions between 1991 and 1993.

Public Financial Management Study

With respect to:

1993 Proposition A (Escrow sold by Lazard Freres)

PFM's analysis concluded that based on the average prices of three leading dealers, adjusted for cost of carry, further adjusted for the size of the transaction, and considering the risk profile of the transaction, the escrow securities purchased by Lazard Freres were $546,460,991 or $3,610,377 in excess of the estimated fair market value of $542,850,613 as calculated by PFM. In other words, as a result of negative arbitrage earnings, if the securities were priced $3,610,377 lower, it would have been of direct benefit to the Authority .

With respect to:

1991 Proposition A (Escrow sold by Goldman Sachs)
1992 Proposition A (Escrow sold by Lazard Freres)
1993 Proposition C (Escrow sold by Lazard Freres)

The costs of each escrow account exceeded the fair market value as of the transaction date, and totalled $4.3M more than should have been paid. In each case, the final escrow yield was approximately the same as the related refunding bond yield, and thus any result of lower securities prices would not benefit the Authority, since it would have to be offset by reducing the escrow yield in another fashion. As a result of arbitrage earning limitations, any overpayment for escrow securities would have been borne indirectly by the U.S.Treasury and not by the Authority.

<u>Due Diligence On Part of Authority</u>

To assure we received fair market rates and that transactions were properly handled at the time of the transaction, we obtained outside written verification by an independent broker/dealer. In three out of the four refundings we obtained written verification that we were not unduly charged for services, and that we obtained fair market rates. In the fourth instance, in June 1992, we obtained written verification that we were charged a fair market rate for services, however, this transaction involved a different type of security which did not require verification of fair market rate. These procedures were consistent with those followed by numerous government agencies and required by bond counsel. In every case an independent securities firm reviewed the transactions, <u>and bond counsel certified</u>, that the entire process was appropriate.

Subsequent Events

On June 23, 1995, the Authority was contacted by the Securities and Exchange Commission as part of an inquiry into securities transactions involving Lazard Freres. The SEC has requested and been provided documents concerning the above noted refundings.

The Authority will pursue legal remedies available to (1) seek reimbursement of funds overcharged as a result of 1993 Proposition A Refunding; and (2) seek reimbursement from Lazard Freres and Goldman Sachs for any funds due the U.S. Treasury as a result of windfall profits accruing to Lazard Freres and Goldman Sachs from the 1991 Proposition A, 1992 Proposition A, and 1993 Proposition C Refundings.

Current Financing Procedures

Over the past few years State and Federal guidelines have changed for these types of refinancings. As a result of these changes, and our internal review, we have revised our guidelines for future securities transactions. These changes include:

1. A debt management policy is being developed which will include what percentage of the Authority's debt portfolio will be subject to interest rate risk; procedures with regard to competitive bidding etc.

2. The Authority's Financial Advisors may no longer purchase securities for MTA which are to be held in escrow, construction, or reserve accounts.

3. All future escrow, construction and reserve account securities will be competitively bid.

4. Underwriters will be selected from the pre-established pool by competitive bid.

5. Swap fees paid to remarketing agents will be competitively bid.

6. An agreement will be received in writing from firms purchasing securities on the Authority's behalf as to the length of time securities will be held before being deposited to the Authority's account and which party will receive profits made during the period after purchase but preceding deposit.

7. Security dealers "carrying profit" (payment for risk of deal not closing) will be negotiated up front.

8. The Authority's Financial Advisor will prepare a list of comparable transactions that are performed on the same day as the Authority's to insure comparable purchase and sales costs.

PFM has been asked to analyze all outstanding bond issues entered into by the MTA to determine the basis upon which investments were purchased and bonds were sold to insure that the prices we paid were competitive. See Attachment A.