

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2008014569701**

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: First Southwest Company, Respondent
Member Firm
BD No. 316

Pursuant to NASD Rule 9216 of FINRA's Code of Procedure, Respondent submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against the Firm alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

First Southwest ("FSW" or the "Firm") has been a registered broker-dealer and a member of FINRA (f/k/a National Association of Securities Dealers or NASD) since March 1946. FSW is a full service brokerage firm headquartered in Dallas, Texas, and has 22 branch offices and over 200 registered personnel.¹

RELEVANT PRIOR DISCIPLINARY HISTORY

In May 2008, the Securities and Exchange Commission censured and fined FSW \$150,000 for violating Section 17(a)(2) of the Securities Act of 1933 for intervening in auctions for auction rate securities by bidding its

¹ On November 7, 2008, First Southwest Holdings, Inc., the parent of FSW, signed an agreement and plan of merger with Plains Capital Corporation and PlainsCapital Bank.

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proprietary account to prevent failed auctions and to prevent all-hold auctions without adequate disclosure.²

OVERVIEW

During the period from May 31, 2006 through February 28, 2008 ("the relevant period"), FSW violated NASD rules relating to communications with the public in its marketing and sale of auction rate securities ("ARS") and failed to maintain adequate supervisory procedures concerning its sales and marketing activities regarding ARS, as required by NASD rules.

During the relevant period, FSW used advertising and marketing materials for ARS that were not fair and balanced and did not provide a sound basis for evaluating the facts in regard to purchases of ARS. Among other things, the materials did not contain adequate disclosure of the risks of ARS, including the risks that ARS auctions could fail, that investments in ARS could become illiquid, and that customers might be unable to obtain access to funds invested in ARS for substantial periods of time. The materials thus violated NASD Rule 2210.

FSW also failed to establish and maintain a supervisory system, including written supervisory procedures, that was reasonably designed to achieve compliance with NASD rules in the marketing and sale of ARS. For instance, FSW failed to maintain policies and procedures that were reasonably designed to ensure that registered representatives (a) accurately described ARS to customers and (b) provided customers with full disclosure of the risks of ARS investments. FSW also failed to provide adequate training to registered representatives regarding the features and characteristics of ARS, especially those affecting liquidity.

As a result of the foregoing, FSW violated NASD Rules 2110, 2210 and 3010.

FACTS AND VIOLATIVE CONDUCT

Background: Auction Rate Securities

ARS are long-term securities with interest rates or dividend yields that are reset periodically through an auction process.³ Historically, ARS were held mainly by institutional investors, but in recent years a retail market developed for these securities, with a typical minimum investment of \$25,000. Although the maturity periods of ARS range from five years to 30 years or more for debt obligations and no stated maturity for closed-end fund preferred shares, auctions provide the

² See *First Southwest Company* (Securities Exchange Act of 1934, Release No. 57869, May 27, 2008).

³ The primary types of ARS are municipal bonds, student loan-backed auction rate certificates issued by trusts that hold student loans, and preferred shares issued by closed-end funds and collateralized by the assets in the funds.

primary source of liquidity for ARS investors and typically occur every 7, 14, 28 or 35 days.

ARS can become illiquid when an auction fails. ARS auctions fail when the supply of ARS being auctioned exceeds the demand for the securities in that auction. When an ARS auction fails, investors receive a maximum interest rate, typically a fixed percentage or a multiple of a reference rate such as LIBOR, or dividend until the next auction but are unable to sell their securities at that time. As a result, ARS may not be appropriate for investors who have a short-term need for the funds they are investing.

Securities firms play different roles in the ARS market. An Underwriter brings the ARS to market as an intermediary for the issuer of the security. An Auction Agent, which can be a bank, conducts the ARS auction by collecting orders from broker-dealers, determines the "clearing rate," the highest rate accepted in the auction that becomes the interest or dividend rate that applies until the next auction, and calculates the allocation of the securities among Auction Dealers. An Auction Dealer or Remarketing Agent is a broker-dealer that solicits bids for the securities from their customers, submits them to the Auction Agent and usually receives a fee paid by the issuer. Firms acting in these capacities are sometimes known as "upstream" firms. In the past, certain upstream firms placed bids for ARS for their proprietary accounts in order to, among other things, support the auctions and prevent them from failing.

In contrast to upstream firms, firms sometimes known as "downstream" firms do not act as agents for issuers in any capacity. Instead, downstream firms act in the traditional broker role as agents for their customers and place bids with Auction Dealers and Remarketing Agents on the customers' behalf to purchase and sell ARS. Downstream firms are paid fees by Auction Dealers and Remarketing Agents (which may vary by dealer and type of security) for effecting trades in ARS held in dealers' inventories.

Beginning in May 2006, the Securities and Exchange Commission brought a series of enforcement actions against underwriters, auction dealers and auction agents in the ARS market. During the summer of 2007, ARS began to fail, and by February 2008, ARS auctions failed on a widespread basis.⁴ Many of those failures have continued until the present time, notwithstanding that certain ARS

⁴ See Bear Stearns & Co., Inc.; Citigroup Global Markets, Inc.; Goldman Sachs & Co.; J.P. Morgan Securities, Inc.; Lehman Brothers Inc.; Merrill, Lynch Pierce, Fenner & Smith Inc.; Morgan Stanley & Co. Inc. and Morgan Stanley DW Inc.; RBC Dain Rauscher Inc.; Banc of America Securities LLC; A.G. Edwards & Sons, Inc.; Morgan Keegan & Co., Inc.; Piper Jaffray & Co.; Suntrust Capital Markets Inc.; and Wachovia Capital Markets, LLC (Securities Act of 1933, Release No. 53888, May 31, 2006); Deutsche Bank Trust Company Americas, the Bank of New York, and Wilmington Trust Co. (Securities Act of 1933, Release No. 8767, January 9, 2007); Citigroup Global Markets, Inc., successor by merger to Legg Mason Wood Walker Inc. (Securities Exchange Act of 1934, Release No. 55712, May 7, 2007); and First Southwest Company (Securities Exchange Act of 1934, Release No. 57869, May 27, 2008).

issuers redeemed particular ARS in the period since the widespread failures. Nevertheless, many investors, including those who need access to their funds, continue to be unable to sell their ARS holdings.

ARS ACTIVITIES BY FSW

During the relevant period, FSW underwrote and marketed nine ARS. FSW participated in auctions by collecting orders from customers and sending them to the auction agent. Until April 24, 2008 when the last auction for ARS marketed by FSW failed, FSW routinely submitted supporting bids to the auction agent.

FSW sold approximately \$465,045,000 of ARS to customers, primarily student loan ARS, during that period. As of February 28, 2008, approximately \$71,825,000 of ARS was held in 91 retail accounts at FSW. As of the date a settlement in principle was reached in this matter, September 15, 2008, customers held approximately \$41,600,000 of ARS in FSW retail accounts.

VIOLATIONS

: Communications with the Public: NASD Rule 2210 :

NASD Rule 2210(d)(1)(A) requires that:

All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service.

FSW violated NASD Rule 2210 by providing disclosure documents to customers and prospective customers that were not fair and balanced and did not provide a sound basis for evaluating the facts in regard to purchases of ARS.

Among other things, the disclosure documents used by FSW failed to adequately disclose the risks of investing in ARS, including the risk that ARS auctions could fail, that investments in ARS could become illiquid, and that customers might be unable to obtain access to funds invested in ARS for substantial periods of time.

For example, although the disclosure describing ARS on the Firm's website (that also was referred to in trade confirmations sent to customers) and in a brochure periodically sent to customers made some disclosure regarding auction failures, the disclosure was insufficient to provide a sound basis for evaluating the facts and failed to provide a balanced presentation of the risks and potential benefits as required by NASD Rule 2210. Additionally, claims that "most ARS are rated AAA by at least one of three rating agencies" because of insurance or subordination or over-collateralization, violated Rule 2210 because the materials

failed to disclose that such insurance or rating does not insure against illiquidity due to failed auctions or that guarantees of such insurance is based on the claims-paying ability of the issuer.

As a result of the foregoing, FSW violated NASD Rule 2210, and, as a result, also violated NASD 2110.

Supervisory Procedures: NASD Rule 3010

NASD Rule 3010 requires each member firm to establish and maintain a system, including written procedures, to supervise the activities of its employees that is reasonably designed to achieve compliance with the federal securities laws and NASD rules.

FSW violated NASD Rule 3010 by failing to establish and maintain procedures that were reasonably designed to ensure that it marketed and sold ARS in compliance with the federal securities laws and applicable NASD rules. For instance, FSW failed to maintain procedures reasonably designed to ensure that its registered representatives accurately described ARS to customers during sales presentations and that representatives provided customers with adequate disclosure of the risks of ARS, including the risk that ARS auctions could fail and that investments in ARS could therefore become illiquid. FSW also failed to provide adequate training to its registered representatives regarding the features and characteristics of ARS and the differences between ARS and other investments.

FSW also failed to establish and maintain procedures that were reasonably designed to ensure that the written materials it used in connection with the marketing and sale of ARS complied with the appropriate disclosure standards in NASD Rule 2210.

As a result of the foregoing, FSW violated NASD Rule 3010 and, as a result, violated NASD Rule 2110.

OTHER FACTORS

In determining the appropriate sanctions in this matter, FINRA notes that, as described below, FSW will undertake to address harm sustained by customers as a result of the illiquidity in the ARS market that began in February 2008. In addition, FINRA considered the fact that, prior to the initiation of FINRA's investigation, FSW bought back approximately \$238 million in ARS from its customers.

SANCTIONS

B. Respondent also consents to the imposition of the following sanctions:

1. A censure;
2. A fine in the amount of \$300,000.

Respondent agrees to pay the monetary sanction(s) upon notice that this AWC has been accepted and that such payment(s) are due and payable. Respondent has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanction(s) imposed in this matter.

Buyback Offer to Individual Investors

: 3. FSW will offer to purchase at par ARS that are subject to auctions that have not been successful as of September 15, 2008 and are not subject to current calls or redemptions ("Eligible ARS") from all investors in the Relevant Class, as described below. For purposes of this AWC, the Relevant Class shall be comprised of all Individual Investors who purchased Eligible ARS from FSW at any time between May 31, 2006 and February 28, 2008 into accounts maintained at FSW. In addition to natural persons, the following entities will also be treated as Individual Investors:

- a. Any account with the following beneficial owner:
 1. non-profit charitable organizations; and
 2. religious corporations or entities.
- b. Any account with the following beneficial owner the value of which at the time of any ARS purchase made through FSW did not exceed \$10 million:
 1. trusts;
 2. corporate trusts;
 3. corporations;
 4. Employee pension plans/ERISA and Taft Hartley Act plans;
 5. educational institutions;
 6. incorporated non-profit organizations;
 7. limited liability companies;

8. limited partnerships;
9. non-public companies;
10. partnerships;
11. personal holding companies; and
12. unincorporated associations.

4. No later than 30 days following the date this AWC is accepted by FINRA, FSW will:

- a. Provide notice to current customers in the Relevant Class and make its best efforts to provide notice to former customers in the Relevant Class of the settlement terms set forth in this AWC. Such notice shall not be unacceptable to the FINRA staff;
- b. Contemporaneously establish a dedicated telephone assistance line, with appropriate staff, to respond to questions from investors concerning the terms of the settlement; and
- c. Commence the buyback of all Eligible ARS by written offer to the Relevant Class (the "Written Offer"). Investors will be given at least thirty (30) days from the date of the Written Offer letter to respond to the Written Offer. The buyback will be completed no later than sixty (60) days after the date of the Written Offer letter.

Providing Liquidity to Other Purchasers of ARS

5. Commencing no later than six (6) months from the date the AWC in this matter is accepted by FINRA, FSW shall make its best efforts to provide liquidity to all *other* investors not in the Relevant Class but who purchased Eligible ARS from FSW. Such best efforts, which may include, but are not limited to, offers to purchase Eligible ARS and/or offers of low or no-interest loans, extended on the basis of reasonable and customary credit standards, shall be completed no later than sixty (60) days following commencement of the best efforts.

Relief for Investors Who Sold Below Par

6. No later than the completion of the buyback, any investor in the Relevant Class that FSW can reasonably identify who sold Eligible ARS below par between February 28, 2008 and September 15, 2008, will be paid the difference between par and the price at which the investor sold the ARS.

Consequential Damages Claims

7. FSW agrees to arbitrate claims for consequential damages filed by investors in the Relevant Class relating to Eligible ARS through a Special Arbitration Program (SAP) in accordance with rules set forth by FINRA Dispute Resolution under the authority of this AWC. Such rules will be issued and available to FSW and investors through FINRA's web site. No later than the date of the Written Offer letter, FSW shall notify investors in the Relevant Class that they are eligible to seek consequential damages related to Eligible ARS through the SAP. This process is voluntary on the part of qualifying investors and does not preclude those investors who elect not to participate in the SAP from pursuing other available remedies. Arbitration under the SAP shall be conducted by a single public arbitrator, unless the claim for consequential damages is \$1,000,000 or greater, in which case, a panel of three public arbitrators may be appointed if both parties agree.

8. Any investors who choose to pursue such claims shall bear the burden of proving that they suffered consequential damages and that such damages were caused by investors' inability to access funds consisting of investors' ARS purchases through FSW. FSW shall be able to defend itself against such claims provided, however, solely for the purposes of the SAP, FSW shall not contest liability related to the sale of ARS; and provided further that FSW shall not be able to use as part of its defense an investor's decision not to sell ARS holdings prior to the acceptance of this AWC nor the investor's decision not to borrow money from FSW if such loan facility was made available to ARS holders.

Reports Concerning Compliance with Settlement

9. FSW shall provide FINRA with a report no later than thirty (30) days following the completion of the buyback setting forth (a) the names and account numbers of each ARS customer to whom the buyback offer was made, (b) an accounting of each instance in which such ARS customers accepted the buyback offer and sold ARS holdings to FSW, and (c) the names, account numbers, and an accounting of those customers paid pursuant to paragraph 6 above. FSW shall also notify FINRA within thirty (30) days of the completion of the best efforts undertaking set forth above in paragraph 5 of the nature and results of such efforts. The accuracy of such reports shall be certified by the Chief Compliance Officer of FSW.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

For good cause shown, and upon receipt of a timely written request from FSW, FINRA staff may extend any of the dates set forth above.

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against the Firm;
- B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of NASD Rule 9143 or the separation of functions prohibitions of NASD Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Respondent understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to NASD Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against the Firm; and

C. If accepted:

1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against the Firm;
2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about the Firm's disciplinary record;
3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-3; and
4. The Firm may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. The Firm may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

- D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

Respondent certifies that it has read and understand all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that it has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce Respondent to submit it.

December 11, 2008

Date

FIRST Southwest Company

Respondent

First Southwest Company

By:

Hill A. Feinberg
Hill A. Feinberg
Chief Executive Officer

Reviewed by:

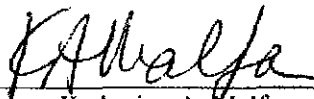
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Accepted by FINRA:

12/16/08
Date

Signed on behalf of the
Director of ODA, by delegated authority



Katherine A. Malfa
Vice President

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