

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2008015271401**

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

RE: City Securities Corporation, Respondent
Member Firm
BD No. 1459

Pursuant to FINRA 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

City Securities Corporation ("City Securities" 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 February 26, 1940. City Securities conducts business involving, among other things, underwriting and municipal debt/bond broker-dealer. City Securities is headquartered in Indianapolis, Indiana and has seven branch offices and 102 registered representatives.

RELEVANT PRIOR DISCIPLINARY HISTORY

City Securities has no relevant disciplinary history.

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OVERVIEW

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

During the relevant period, City Securities used material for ARS that, among other things, 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 material thus violated MSRB Rule G-21.

City Securities 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, City Securities 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. City Securities 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, City Securities violated NASD Rules 3010 and 2110 and MSRB Rules G-21, G-27 and G-17.

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.¹ 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 primary source of liquidity for ARS investors and typically occur every 7, 14, 28 or 35 days.

¹ 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.

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 penalty interest rate 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.² During the summer of 2007, ARS began to fail, and by February 2008, ARS auctions failed on a widespread basis. Many of those failures have continued until the present time, notwithstanding that certain ARS 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.

² 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).

ARS ACTIVITIES BY CITY SECURITIES

During the relevant period, City Securities acted as a remarketing agent for ARS issues. As of February 29, 2008, approximately \$158,225,000 of ARS were held in retail accounts at City Securities. Persons associated with City Securities held approximately \$3,550,000 of ARS as of February 29, 2008. As of the date a settlement in principle was reached in this matter, May 13, 2009, customers held approximately \$15,450,000 of ARS in City Securities retail accounts. Persons associated with City Securities held approximately \$800,000 of ARS as of May 13, 2009.

VIOLATIONS

Communications with the Public: MSRB Rule G-21

MSRB Rule G-21 governs advertisements relating to municipal securities. City Securities violated MSRB Rule G-21 by using material with customers and prospective customers that, among other things, failed to adequately disclose: the risks of investing in ARS; 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, City Securities used a 2004 third-party publication entitled "Auction Rate Securities," made available to its financial advisors and their clients on the Firm's website. The publication included several statements regarding the liquidity associated with ARS, but failed to adequately address the significant liquidity risk associated with auction failures, including further disclosure regarding the impact of continued failures on the investor. The manner in which risk was presented in the publication served to mitigate or minimize its significance, thereby further contributing to the unbalanced discussion of risk versus rewards. In addition, the publication failed to disclose that high credit ratings and insurance do not protect against illiquidity due to failed auctions and that insurance guarantees are based on the claims paying ability of the insurer. The publication contained statistics that were no longer accurate or useful to the investor after 2005. Finally, the publication remained available on the Firm's website through the start of FINRA's investigation in December 2008, ten months after the widespread auction failures occurred in February 2008.

As a result of the foregoing, City Securities violated MSRB Rule G-21 and, as a result, also violated MSRB Rule G-17.

Supervisory Procedures: NASD Rule 3010 and MSRB Rule G-27

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.

MSRB Rule G-27 requires each broker, dealer and municipal securities dealer to supervise the conduct of its municipal securities activities to ensure compliance with MSRB rules and the federal securities laws, and requires each firm to establish and maintain a system, including written procedures, to supervise municipal securities activities that is reasonably designed to achieve compliance with the federal securities laws and MSRB rules.

City Securities violated NASD Rule 3010 and MSRB Rule G-27 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 and/or MSRB rules. In particular, City Securities 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. City Securities 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.

City Securities also failed to establish and maintain procedures that were reasonably designed to ensure that the written materials it distributed to its registered representatives to educate them regarding the marketing and sale of ARS complied with the appropriate disclosure standards in MSRB Rule G-21.

As a result of the foregoing, City Securities violated NASD Rule 3010 and MSRB Rule G-27 and, as a result, violated NASD Rule 2110 and MSRB Rule G-17.

OTHER FACTORS

In determining the appropriate sanctions in this matter, FINRA notes that, as described below, City Securities will undertake to address harm sustained by customers as a result of the illiquidity in the ARS market that began in February 2008.

SANCTIONS

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

1. A censure;
2. A fine in the amount of \$250,000.

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

3. City Securities will offer to purchase at par ARS that are subject to auctions that have not been successful as of May 13, 2009 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 ARS from City Securities at any time between May 31, 2006 and February 28, 2008 into accounts maintained at City Securities. 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 City Securities 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 60 days following the date this AWC is accepted by FINRA, City Securities 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 ninety (90) days after the date of the Written Offer letter.

5. Commencing no later than six (6) months from the date the AWC in this matter is accepted by FINRA, City Securities shall make its best efforts to provide liquidity to all *other* investors not in the Relevant Class but who purchased Eligible ARS from City Securities. 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 customer credit standards, shall be completed no later than ninety (90) 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 City Securities can reasonably identify who sold Eligible ARS below par between February 28, 2008 and May 13, 2009 will be paid the difference between par and the price at which the investor sold the ARS.

Consequential Damages Claims

7. City Securities 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 City Securities and investors through FINRA's web site. No later than the date of the Written Offer letter, City Securities 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 City Securities. City Securities shall be able to defend itself against such claims provided, however, solely for the purposes of the SAP, City Securities shall not contest liability related to the sale of ARS; and provided further that City Securities 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 City Securities if such loan facility was made available to ARS holders.

Report Concerning Compliance with Settlement

9. City Securities shall provide FINRA with a report repurchase program 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 City Securities, and (c) the names, account numbers, and an accounting of those customers paid pursuant to paragraph 6 above. City Securities 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 City Securities.

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 City Securities, 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 FINRA Rule 9143 or the separation of functions prohibitions of FINRA 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 FINRA 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 FINRA 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.

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Respondent certifies that it has read and understands 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.

June 15, 2009

Date

City Securities Corporation

By: Jennifer M. Haas

Jennifer M. Haas
Senior Vice President
Corporate Compliance Officer
City Securities Corporation
30 South Meridian Street
Suite 600
Indianapolis, IN 46204

Reviewed by:

Accepted by FINRA:

September 1, 2009

Date

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

Mark A. Koerner (by Marcello Kerr, Senior Regional Counsel)
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