

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2009017133201**

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

RE: UBS Financial Services Inc., Respondent
Broker-Dealer No. 8174
✓ UBS Securities LLC, Respondent
✓ Broker-Dealer No. 7654

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, UBS Financial Services Inc. ("UBS Financial") and UBS Securities LLC ("UBS Securities") (collectively, "UBS" or "the firm") 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 UBS alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. The firm 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

UBS Financial has been a registered FINRA member since October 13, 1936. UBS Securities has been a registered FINRA member since August 17, 1978. UBS is a global firm providing financial services to private, corporate and institutional clients. UBS has offices in more than 50 countries and employs more than 65,000 people worldwide.

OVERVIEW

Between January 1, 2006 and June 30, 2009 (the "review period"), UBS enabled its customers to lend their fully paid securities to the firm ("Fully Paid Lending") on a solicited and unsolicited basis to facilitate, among other things, short selling by other customers of the firm. Customers who lent securities to the firm received monthly interest payments, calculated as a percentage of the market value of the securities, and secured by a third-party Letter of Credit.

In connection with the loan transactions, UBS did not adequately disclose certain material facts to customers concerning the loan transaction that were necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading in violation of NASD Conduct Rule 2110 and FINRA Rule 2010.¹ The firm failed to disclose or inadequately disclosed that (1) the security was hard-to-borrow due to short selling and was frequently being borrowed to facilitate short selling; (2) the interest rates could be reduced by the firm; (3) registered representatives received commissions for the duration of the loan; (4) while securities were on loan, dividends were paid as a "cash-in-lieu" payment and therefore subject to higher tax rates; and (5) shares on loan could be sold at any time.

UBS failed to establish and maintain a system, including written procedures, to supervise the activities of each registered representative, registered principal, and other associated person related to Fully Paid Lending that was reasonably designed to achieve compliance with applicable securities laws and regulations, and with FINRA and NASD Rules. Fully Paid Lending from customers operated without a system or procedures specifically designed to supervise the activities of the firm's Securities Lending Department and the firm's registered representatives who solicited customers to participate in Fully Paid Lending. Branch managers and supervisors were not notified that customers of registered representatives they supervised were lending fully paid securities to the firm. In addition, the traditional tools that were already available to branch managers and other supervisors to monitor customer accounts were compromised when shares were lent through Fully Paid Lending. Most notably, because a customer's account no longer reflected the customer's position in the security when the shares were lent through Fully Paid Lending, exception reports such as concentration reports and account market value loss reports no longer captured the customer's account even if it became overly concentrated in the security or lost a significant amount of market value due to the lent security's loss in value. Therefore, the firm's ability to supervise values of positions, concentration levels, and on-going appropriateness of the loan transaction for the customers was compromised. As a result, the firm violated NASD Conduct Rules 3010(a) and (b).

FACTS AND VIOLATIVE CONDUCT

I. Fully Paid Lending

A. Background

Since 1997, UBS has solicited and facilitated loans of fully paid securities from its customers. During the review period, UBS arranged for 2,658 loans, involving 374 different securities borrowed from 492 customers.² The average annual market value of outstanding loans from customers from 2006 through 2008 was approximately \$51 million. Approximately 136 of the firm's registered representatives during the review period had retail customers who lent fully paid securities to the firm. These registered representatives generated in excess of \$1 million in

¹ The firm's conduct that occurred prior to December 15, 2008 violated NASD Conduct Rule 2110 and the conduct that occurred on or after December 15, 2008 violated FINRA Rule 2010.

² As of July 30, 2010, the firm has no outstanding fully paid loans from Fully Paid Lending.

commissions for soliciting the loans during the review period.

B. Fully Paid Lending Operations and Process

The firm's process for borrowing fully paid securities from customers, including retail customers, has been "ad-hoc" since inception. The firm made no efforts to organize or operate Fully Paid Lending as a formal program until 2007. Those efforts did not materialize and the firm ceased its efforts shortly thereafter. The firm therefore did not have a system or adequate procedures to operate or supervise the process of borrowing fully paid securities from its customers.

In order for the firm to make delivery of shares for securities in demand, the supply desk within the firm's Securities Lending Department ("Securities Lending") most typically borrowed the securities from internal and external sources. However, if these sources were exhausted, then the Securities Lending staff searched the firm's database to identify customers that owned fully paid shares in order to borrow the securities. The Securities Lending staff did not utilize any eligibility requirements, parameters or suitability information when searching for customers who owned the securities, and the firm did not have any suitability requirements for customers willing to lend their stock. The Securities Lending staff then determined the interest rate that the firm was willing to pay the customer to borrow the security, although there was no oversight and no supervisory approval required for setting or changing interest rates.

After the Securities Lending staff identified a customer of the firm who was a fully paid holder of the security and determined the interest rate, the Securities Lending staff contacted the customer's registered representative to inquire as to whether the customer was interested in lending the security. The Securities Lending staff did not provide standardized information or materials to registered representatives about Fully Paid Lending. In most cases, the Securities Lending staff provided the registered representative with a limited amount of information about fully paid for lending. Typically, the Securities Lending staff only told the registered representative the name of the customer, the security that the firm wished to borrow, the interest rate the firm was willing to pay at that point in time, that the shares would come out of the customer's account, that the customer would be collateralized with a Letter of Credit, and that the customer could recall the shares at any time. The Securities Lending staff typically did not discuss things like risks or compensation to the registered representative. In addition, neither the firm nor the Securities Lending staff told the registered representative what specific information to provide to the customer about Fully Paid Lending. The Securities Lending staff also never contacted or provided any information to the registered representative's supervisor, Branch Manager, or anyone else at the branch regarding the requested loan of securities.

If, during the initial or subsequent call, the registered representative expressed interest on behalf of the customer, the Securities Lending staff sent the registered representative a proposed Customer Securities Loan Agreement ("CSLA"). It was left to the registered representative to contact the customer to provide information about Fully Paid Lending. The Securities Lending staff gave no instructions to registered representatives on what information to provide to customers, and the firm did not otherwise provide the registered representatives with any other

standard information to provide to customers. As a result, the amount and accuracy of the information customers received from their registered representatives varied widely.

If the customer was interested in lending securities, the registered representative sent the customer the proposed CSLA for execution. All customers who participated in Fully Paid Lending received and signed the CSLA. When UBS received the executed CSLA from the customer, the Securities Lending staff forwarded it to the firm's Operations Department for an account to be set up. Once this was accomplished, the firm removed the shares being lent from the customer's account. The lent securities were placed in a central pool of available stock held by the firm. UBS then requested the firm's third party lender to issue the Letter of Credit, and once issued, a copy of the Letter of Credit was sent to the customer by the issuer.

Until May 2007, the CSLA and the Letter of Credit were the only documents that the customer received related to the loan of their securities. In May 2007, Securities Lending began generating a one page confirmation (the "Confirm") of the initial lending transaction. The Confirm included the customer's name and account number, the registered representative's name, the date of the loan, the name of the security, the number of shares loaned, the interest rate to be paid to the customer, and a reference to the Letter of Credit as collateral. The Confirm was not sent to the customer by Securities Lending, but rather was sent to the customer's registered representative. The registered representatives were expected to then send the Confirm to the customer, but the Securities Lending staff did not direct the registered representatives to do so and there were no systems or procedures for ensuring that Confirms were sent to the customers. UBS did not send a separate Confirm if and when the interest rates changed. In early 2008, UBS added a reference to the commission earned by the registered representative to the Confirm. However, the Confirm did not identify this reference as commission being paid to a registered representative.

When the shares were loaned through Fully Paid Lending, the customer's monthly Account Statement reflected the delivery of the shares out of the account. For the duration of the loan, the customer's Account Statement misleadingly failed to reflect that the customer still owned the shares of the security that were lent, and therefore the market value of the customer's account was inaccurate. UBS provided no other statement to the customer reflecting the loaned securities.

II. Violations of FINRA and NASD Rules

A. UBS failed to disclose material facts to customers concerning Fully Paid Lending that were necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading

Customers who participated in Fully Paid Lending received and were required to sign a Customer Securities Loan Agreement that contained information, terms and conditions about Fully Paid Lending. Any other information received by customers came from their registered representatives, who did not receive training or consistent information about Fully Paid Lending from the Securities Lending staff.

There were five material facts that UBS either failed to disclose or inadequately disclosed to customers concerning Fully Paid Lending in connection with the loan transactions that were necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Each of these facts was material because a reasonable investor would have taken into account such information in determining whether or not to participate in Fully Paid Lending. The five material facts that were not disclosed or inadequately disclosed were:

1. The security was hard-to-borrow due to short selling and was frequently being borrowed to facilitate short selling

In most cases, the securities that the firm sought to borrow from UBS's customers were hard-to-borrow because of significant short selling of the securities. As the Securities and Exchange Commission notes, a market participant may choose to engage in short selling for several reasons: "In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security."³ The CSLA failed to disclose, and UBS's registered representatives typically did not disclose to customers, that the securities were hard-to-borrow due to short selling and that the firm frequently sought to borrow their securities to facilitate short selling.

2. The interest rates could be reduced by the firm

When customers were contacted to lend fully paid securities, they were offered and agreed to a specific interest rate. While the CSLA gave the firm the right to terminate the loan at any time, it did not reference possible reductions in the interest rate, and customers generally were not informed that the rates could be reduced. Yet, interest rate changes were not uncommon and, at times, were significant. For example, in 2008, interest rate reductions ranged from 2% to 78%, with at least 30 percent of those reductions exceeding 25%.

3. Registered representatives received commissions for the duration of the loan

The registered representative who served as the customer's registered representative of record received a commission, based upon the number of shares lent. That commission was paid to the branch and then the registered representative received a negotiated share. The registered representatives continued to accrue commissions as long as the shares remained on loan. Compensation to registered representatives was not disclosed to customers in the CSLA, the customer's monthly Account Statement, or the Confirm.

³ Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, available at <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>.

4. While securities were on loan, dividends were paid as a "cash-in-lieu" and therefore subject to higher tax rates

Customers who lent shares through Fully Paid Lending continued to receive dividends, but the dividends were paid to the firm, and then the firm made a "cash-in-lieu" payment to the customer while the shares were on loan. Customers therefore could suffer a tax consequence because qualified corporate dividends are entitled to a preferential maximum tax rate of 15%,⁴ while substitute payments in lieu of dividends are taxed as normal income, with rates as high as 35%. The CSLA did not address the tax implications of receiving a cash-in-lieu payment rather than a dividend. The firm's registered representatives generally did not discuss this with customers.

5. Shares on loan could be sold at any time

Under the terms of the CSLA, customers were permitted to recall their loaned shares at any time by giving three business days' notice to the firm to return the shares. The CSLA, however, did not disclose that customers also could sell some or all of their shares on loan at any time prior to recalling the shares and/or waiting for the delivery of the shares back to their account. Being able to sell without waiting for delivery meant that even if the firm were unable to get the shares back for settlement, the customer was not at risk.

By failing to disclose this material information to customers in connection with the loan transactions, UBS violated NASD Conduct Rule 2110 and FINRA Rule 2010.

B. UBS failed to establish and maintain a system, including written procedures, to supervise Fully Paid Lending

1. Failure to establish and maintain a supervisory system

UBS failed to establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person related to Fully Paid Lending that was reasonably designed to achieve compliance with applicable securities laws and regulations, and with FINRA and NASD Rules. The Fully Paid Lending process operated without a system specifically designed to supervise the activities of the Securities Lending staff and registered representatives, and to adequately monitor the accounts of customers participating in Fully Paid Lending. In addition, the firm did not provide any training regarding Fully Paid Lending to its registered persons.

Individual Securities Lending staff generally determined whether the security was hard-to-borrow and how much the firm needed to borrow, set and changed interest rates, communicated with registered representatives, established Letter Of Credit levels, and handled

⁴ In 2003, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JFTTRA) to help promote the economy and encourage investors to invest in U.S. based companies. This Act capped the federal tax on qualified corporate dividends at a maximum rate of 15%.

recalls without supervision or principal approvals required. There was no systematic coordination of their efforts to ensure that interest rates were being set or changed fairly or appropriately for customers, or that shares were being returned in accordance with the terms of the CSLA. There was also no system to monitor the rates at which the customers' securities were being re-lent and, accordingly, the spread between the rates paid to the customers and the rates earned by the firm through re-lending the securities.

UBS had no system or procedures that notified branch managers that customers in their branches were participating in Fully Paid Lending. Many of the firm's branch managers and other supervisors were not even aware that Fully Paid Lending existed or that they supervised registered representatives who had customers participating in Fully Paid Lending. UBS failed to supervise its registered representatives with respect to the Fully Paid Lending process and their communications with customers about Fully Paid Lending.

The traditional tools that were already available to branch managers and other supervisors to monitor customer accounts were significantly compromised when shares were lent through Fully Paid Lending. Most notably, because a customer's account no longer reflected the customer's position in the security when the shares were lent through Fully Paid Lending, exception reports such as concentration reports and account market value loss reports no longer captured the customer's account even if it became overly concentrated in the security or lost a significant amount of market value due to the lent security's loss in value. Therefore, the firm's ability to supervise values of positions, concentration levels, and the suitability of any subsequent securities recommendations for the customers was compromised.

2. Failure to establish, maintain and enforce written procedures

UBS failed to establish, maintain, and enforce written procedures that were reasonably designed to supervise Fully Paid Lending. The firm's only written procedures regarding Fully Paid Lending related to operating policies and procedures for Securities Lending and the firm's operational staff, and contained very little information about the process or supervision of Fully Paid Lending. This lack of procedures resulted in untimely return of shares and incorrect interest payments to customers. In addition, these procedures were not accessible to the firm's registered representatives and branch managers, and there were no other procedures at the branch level regarding Fully Paid Lending.

The firm had no written procedures for any of the following: (a) how the Securities Lending staff should complete their job functions related to Fully Paid Lending, including but not limited to identifying hard-to-borrow securities, identifying customers, setting interest rates, communicating with registered representatives, maintaining records, establishing and re-establishing Letter Of Credit amounts, making interest rate changes, and recalling shares; (b) how the head of Securities Lending should supervise the Securities Lending staff related to the Fully Paid Lending process; (c) how registered representatives should perform their functions in the Fully Paid Lending process, including but not limited to what information, such as risks, should be provided to customers, what documents should be provided to customers, when and how they could sell shares for their customers and how to effectuate a recall; (d) how branch

managers or any other supervisors should supervise their registered representatives relating to Fully Paid Lending; and (e) how to supervise or monitor the accounts of customers participating in Fully Paid Lending.

By virtue of the above, UBS failed to establish and maintain a system, including written procedures, to supervise the activities of the Securities Lending staff and the firm's registered representatives relating to Fully Paid Lending that was reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA and NASD Rules, in violation of NASD Conduct Rule 3010(a) and (b).

B. The firm also consents to the imposition of the following sanctions:

1. a censure;
2. a fine in the amount of \$350,000; and
3. an undertaking that, prior to soliciting or facilitating any new fully paid loans from customers, the firm shall establish and maintain a system, including written procedures, to supervise the activities of each registered representative, registered principal, and other associated person relating to Fully Paid Lending or similar program that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with FINRA and NASD Rules. Furthermore, prior to soliciting or facilitating any new fully paid loans from customers, an Officer of UBS shall certify that the firm's system and written procedures relating to Fully Paid Lending are in compliance with NASD Rule 3010(a) and (b).

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

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

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

II.

WAIVER OF PROCEDURAL RIGHTS

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

- A.** To have a Complaint issued specifying the allegations against the firm;

- B. To be notified of the 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, the firm 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.

The firm further specifically and voluntarily waive 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

The firm 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 the firm'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 8313; 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 the firm's right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.
- D. The firm may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. The firm 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.

The firm 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 the firm to submit it.

8/31/10
Date

UBS Financial Services Inc.

By: [Signature]
Name: _____
Title: _____

8/31/10
Date

UBS Securities LLC

By: [Signature]
Name: Judith Romo
Title: Executive Director

Accepted by FINRA:

9/29/10
Date

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

[Signature]
Samuel L. Israel
Associate Vice President and Chief Counsel
FINRA Department of Enforcement
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