

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2014041645601**

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

RE: UBS Financial Services, Inc. (CRD No. 8174), Respondent
Member Firm

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 Respondent 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

UBS Financial Services, Inc. ("UBS" or the "Firm"), with its predecessor, Paine Webber & Company, has been a FINRA member since 1936. UBS is a full service brokerage firm headquartered in Weehawken, New Jersey. The Firm has approximately 550 branch offices and employs approximately 12,400 registered individuals.

RELEVANT DISCIPLINARY HISTORY

In AWC No. 2009018081101 (October 2013), FINRA censured and fined UBS for violating, among other rules, MSRB Rules G-17 and G-30(a). \$20,000 of the \$260,000 fine was apportioned to the violations of MSRB Rules G-17 and G-30(a). FINRA found that UBS violated MSRB Rules G-17 and G-30(a) by transacting municipal securities between its own account and customers where, in five instances, the aggregate price (including any mark-down or mark-up) was not fair and reasonable.

In AWC No. 2007009401302 (September 2011), FINRA censured and fined UBS \$300,000 for failing to reasonably supervise certain cross-trades of municipal bonds by

retail customers, in violation of MSRB Rule G-27.

OVERVIEW

From July 2009 through December 2013 (the “relevant period”), UBS failed to reasonably supervise and to have an adequate supervisory system, including adequate written supervisory procedures, to address short positions in tax-exempt municipal bonds that resulted primarily from trading errors at the Firm’s retail branches. As a result of these supervisory failures, UBS inaccurately represented to approximately 4,371 customers that at least \$1,165,000 in interest that the Firm paid to those customers was exempt from taxation. In fact, the Firm did not hold the bonds on behalf of the customers and the interest that the customers received was paid by UBS and thus taxable as ordinary income.¹ The Firm failed to consider – and its automated system that calculated the interest owed to customers did not take into account – whether the interest it paid to customers should be coded as non-taxable when the interest was paid by the Firm rather than the municipal issuer. UBS’s failure to have adequate systems and procedures to address instances in which it became short municipal bonds violated MSRB Rule G-27. The Firm’s misstatements to customers regarding the tax-exempt status of interest payments violated MSRB Rules G-17 and G-8. And, its failure to maintain a record of the customers to whom its municipal short positions were allocated violated MSRB Rule G-8.

FACTS AND VIOLATIVE CONDUCT

Facts

Characteristics of Municipal Securities

Following an initial distribution period, municipal bonds generally trade infrequently in an over-the-counter dealer market with more than one million different individual municipal bonds outstanding.² Given the high number of individual municipal bonds, that many investors traditionally buy and hold municipal securities until maturity, and the lack of centralized trading in the municipal securities market, the average municipal bond is less liquid than the average corporate bond and may not always be available for purchase in the secondary market.³

Municipal bonds typically pay tax-exempt interest on a semi-annual basis. Only interest that is received from a municipal issuer is exempt from federal income tax,⁴ and any substitute interest paid by a firm on a short position is taxable. If a firm is short a tax-free municipal bond that corresponds to a customer long position, the firm will pay the customer any applicable interest.

¹ This resulted in the underpayment of not less than \$282,261 in federal income taxes.

² See Report on the Municipal Securities Market, U.S. Securities and Exchange Commission (July 31, 2012).

³ *Id.*

⁴ See IRS Rev. Rul 80-135 (1980-1 C.B. 18).

UBS Maintained Short Positions in Municipal Securities

During the relevant period, UBS held approximately 4,371 short positions in tax-exempt municipal securities that corresponded to long positions in customer accounts. The short positions resulted primarily from trading and operational errors. In these instances, UBS paid the interest to customers and the interest was taxable.

Most of the short positions resulted from trading errors that occurred at the firm's retail branches. When branch-level errors occurred in connection with a customer's municipal bond order, the resulting short position was moved to a branch error account. Branch managers and their delegates were responsible for identifying and covering short positions in branch error accounts. However, the Firm did not provide adequate guidance or oversight on how and when municipal short positions should be covered. This deficiency may have been prolonged due to the difficulty of covering these positions in light of the characteristics of municipal securities described above as well as the limited amount outstanding of a particular municipal bond. Beginning in 2012, the Firm recognized that short positions were not being covered in a timely fashion and undertook efforts that reduced the number of short positions. Nevertheless, during the relevant period, UBS often did not cover municipal short positions for a month or more, and some of the short positions were not covered for more than a year.

UBS Did Not Ensure Appropriate Tax Reporting to Customers When It Was Short Municipal Bonds

The Firm's branch managers and their delegates were responsible for covering short positions in municipal bonds in their respective branch error accounts. Separately, the tax reporting system used by UBS relied on coding from the Firm's automated income processing system to determine whether interest would be reported as taxable or tax-exempt. The Firm's system coded interest payments for short municipal bond positions as tax-exempt, thus causing tax reporting to customers to incorrectly categorize taxable income as tax-exempt. Consequently, UBS failed to disclose to customers that they were not receiving tax-exempt interest when the Firm was short municipal securities. In addition, as a result of the foregoing, UBS sent inaccurate Forms 1099 to customers who received firm-paid interest for calendar years 2009 through 2012 and also sent inaccurate account statements to certain customers during the review period that incorrectly classified firm-paid interest as tax-exempt when it should have been classified as taxable.

In 2013, FINRA examination staff found that UBS had inaccurately reported firm-paid interest from short municipal bond positions to customers on Forms 1099 and account statements. Thereafter, for calendar year 2013, UBS properly reported interest from short municipal bonds as taxable on customer Forms 1099 and made makeup payments to customers to account for the associated increase in tax liability. UBS has agreed in principal with the IRS to make a payment to relieve its customers of the burden of filing amended tax returns and paying additional federal income tax. UBS has also implemented revised procedures to minimize its short municipal bond positions and to

properly report firm-paid interest as taxable.

UBS Did Not Maintain Records of Customer Accounts Offsetting Its Short Municipal Bond Positions

During the relevant period, UBS did not maintain records identifying particular customer accounts that offset its short municipal bond positions. The Firm's short positions were held in aggregate and not allocated to specified customers. Because the Firm's short municipal bond positions were not offset against specific customer holdings, UBS was unable to accurately report taxable income to its customers who were receiving firm-paid interest as taxable income.

Violations

MSRB Rule G-27(a) requires each broker, dealer, and municipal securities dealer ("municipal dealers") to supervise the conduct of their municipal securities activities and to ensure compliance with MSRB Rules and the Securities Exchange Act of 1934. MSRB Rule G-27(b) requires municipal dealers to establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations and MSRB Rules. Rule G-27(c) further requires each municipal dealer to adopt, maintain, and enforce written supervisory procedures that are reasonably designed to ensure that the conduct of municipal securities activities is in compliance with MSRB Rules and the Exchange Act. As described above, UBS failed to reasonably supervise, implement adequate written procedures, or maintain a supervisory system that was reasonably designed to ensure compliance with MSRB Rules when the Firm maintained short positions in municipal securities and paid taxable substitute interest to its customers. As a result, UBS mischaracterized approximately \$1,174,000 in interest paid by the firm to customers as exempt from taxation. Accordingly, UBS violated MSRB Rule G-27.

MSRB Rule G-17 provides that "[i]n the conduct of its municipal securities activities, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice." ScienTer is not required to demonstrate a violation of MSRB Rule G-17. As described above, UBS inaccurately represented to approximately 4,317 customers that the interest the customers were receiving was tax exempt, and also failed to disclose that the interest they were receiving was not entitled to tax exempt status. Accordingly, UBS violated MSRB Rule G-17.

MSRB Rule G-8 requires municipal dealers to make and keep current certain books and records, including account statements that they choose to send to their customers. It also requires firms to maintain a record of the customers to whom its municipal short positions allocate. As described above, UBS sent account statements to approximately 4,317 customers that inaccurately stated that the customers were receiving tax-exempt income. It also failed to maintain a record of the customers to whom its municipal short positions allocated. Accordingly, UBS violated MSRB Rule G-8.

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

1. A censure; and,
2. A fine in the amount of \$750,000.

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

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

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

II.

WAIVER OF PROCEDURAL RIGHTS

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

- A. To have a Complaint issued specifying the allegations against it;
- 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, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, 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 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

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 it; 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 it;
 - 2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
 - 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: (i) testimonial obligations; or (ii) 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 undersigned, on behalf of the Respondent, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and have been given a full opportunity to ask questions about it; that Respondent 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.

7/30/15
Date (mm/dd/yyyy)

Michael L. Lane
UBS Financial Services, Inc.
Respondent

By: Michael L. Crane
(Name & Title)
Grand Managing Director and General Counsel
[Signature]
UBS Financial Services, Inc.
Respondent

7/30/15
Date (mm/dd/yyyy)

By: Elena Marguash
(Name & Title)
Managing Director

Reviewed by:

[Signature]

Susan L. Merrill
Counsel for Respondent
Sidley Austin LLP
787 Seventh Avenue
New York, NY 10019
Phone: (212) 839-8558

Accepted by FINRA:

8/12/15
Date

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



Perry C. Hubbard
Director

FINRA Department of Enforcement
15200 Omega Drive, 3rd Floor
Rockville, MD 20850
Phone: 301-258-8543
Fax: 202-721-8391