

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2016050874301**

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

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

Pursuant to FINRA Rule 9216 of FINRA’s Code of Procedure, UBS Financial Services Inc. (“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. 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, 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 640 FINRA branch offices and approximately 12,000 registered individuals.

RELEVANT DISCIPLINARY HISTORY

In AWC No. 2014041645601 (August 12, 2015) (the “2015 AWC”), without admitting or denying the findings, UBS consented to a censure and fine of \$750,000 for violating MSRB Rules G-27, G-17, and G-8. The Firm failed to reasonably supervise and maintain a reasonably designed supervisory system and procedures to address short positions in tax-exempt municipal bonds. Because of these failures, UBS inaccurately represented to approximately 4,371 customers that at least \$1,165,000 in interest that the Firm had paid to them was exempt from taxation. Because UBS did not have the municipal bonds in its possession, UBS was paying taxable interest to the customers. FINRA also found that UBS

had failed to maintain a record allocating the short positions to particular customer accounts, in violation of MSRB Rule G-8.

OVERVIEW

After UBS's 2015 AWC, between August 13, 2015 and at least December 31, 2017, UBS continued to fail to establish and maintain reasonably designed supervisory systems and written supervisory procedures to address short positions in tax-exempt municipal securities. As a result, the Firm failed to take action to address the tax consequences of certain short positions in municipal securities. In addition, the Firm's supervisory systems were not reasonably designed to identify whether taxable "substitute" interest had been paid to customers.

Because of these failures, UBS: (i) inaccurately represented that approximately 2,853 municipal bond positions on customer account statements and Forms 1099 had received approximately \$261,610 in interest that was tax-exempt, and (ii) inaccurately represented on approximately 950 additional customer account statements and Forms 1099 that they had received taxable interest, when in fact some or all of the interest was exempt from taxation. In many instances, the firm made these inaccurate statements to the same customer on multiple account statements. In addition, UBS failed to maintain records of the specific customer accounts that offset its municipal short positions, as required by MSRB Rule G-8. By virtue of this misconduct, UBS violated MSRB Rules G-8, G-17, and G-27 between August 13, 2015 and at least December 31, 2017.

From March 16, 2015 through January 31, 2017, UBS also violated Securities Exchange Act (SEA) Rule 15c3-3(d)(4), which requires that for "[s]ecurities included on the broker's or dealer's books or records that allocate to a short position of the broker or dealer or a short position for another person ... for more than 30 calendar days," a firm must "not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities." UBS also failed to establish and maintain reasonably designed supervisory systems and written supervisory procedures to address SEA Rule 15c3-3(d)(4). UBS thereby violated SEA Rule 15c3-3(d)(4), and FINRA Rules 3110 and 2010.

FACTS AND VIOLATIVE CONDUCT

1. Characteristics of Municipal Securities

Individuals often purchase municipal securities because the interest earned on these investments is exempt from federal and many state and local taxes. However, only interest that is actually received from a municipal issuer is exempt

from taxation.¹ When FINRA member firms are short municipal securities that are held in customer accounts, the firm, rather than the municipality, is the source of the interest payments to the customers. Consequently, the interest earned by those customers during the period the firm is short, known as “substitute interest,” is subject to applicable federal, state, and local taxation.

Following an initial distribution period, municipal securities generally trade infrequently in an over-the-counter dealer market, and there are more than one million different individual municipal bonds outstanding.² The average municipal security is less liquid than the average corporate bond and may not always be available for purchase in the secondary market. When a broker-dealer is short a municipal security held in customer accounts, the municipal security may also be available for purchase from customers of the firm.

2. Violations Related to Short Positions in Municipal Securities

In Regulatory Notice 15-27 (July 2015), FINRA reminded member firms that their written supervisory procedures must include processes for detecting and preventing the consequences of short positions in municipal securities before settlement and, when short positions in municipal securities are created, ensuring that their communications with customers, including the tax status of interest payments, are not false or misleading.

Following the Regulatory Notice and UBS’s 2015 AWC, UBS continued to fail to establish and maintain reasonably designed supervisory systems and written supervisory procedures to address short positions in municipal securities.

UBS’s Supervisory Systems Failed to Address Short Positions in Municipal Securities

From August 13, 2015 to December 31, 2017, supervisors in UBS’s branches were primarily responsible for identifying and covering all short positions created as a result of a branch error or trading that occurred at the branch, including short positions in municipal securities. Each branch received a daily branch error report reflecting the shorts created at their branch. However, the Firm did not maintain procedures or provide training that instructed its employees responsible for identifying and covering short positions in what ways they should attempt to obtain municipal securities to cover short positions. The Firm also did not provide guidance to supervisors that any short position in municipal securities held past settlement would result in the payment of substitute interest to customers and inaccuracies in customer statements regarding the tax status of certain interest accruals or payments, if the short position was not addressed

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

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

before settlement date. As a result, branch supervisors did not always follow-up with the Firm's municipal trading desk prior to settlement for assistance to cover short positions and no consistent process was in place to escalate aged short positions. In addition, in certain instances employees sought and waited to receive internal approvals to purchase municipal securities at particular prices, even when securities had been identified that were available for purchase or the securities were available from the Firm's customers. In some instances, the Firm's inaction with respect to these positions caused the Firm to pay substitute interest and, as described further below, make misstatements and omissions to customers regarding the tax status of certain interest payments.

In addition, the Firm generated and distributed to the municipal trading desk a report identifying short positions in municipal bonds in Firm-wide error or other Firm accounts. However, the report identified short positions on a post-settlement-date basis, resulting in tax consequences for thousands of municipal short positions. This contributed to the Firm's delay in taking remedial actions as necessary between trade date and settlement date such as, for example, those actions described in Regulatory Notice 15-27, including cancelling the trade or purchasing the bond from the market or from another customer on a shortened settlement basis.

UBS Failed to Allocate Short Positions in Municipal Securities to the Appropriate Customer Accounts, as required by MSRB Rule G-8, and Made Misstatements to Customers Regarding the Tax Status of Their Interest Payments

Regulatory Notice 15-27 reminded member firms that they must maintain procedures to correct any inaccurate or misleading communications provided to customers that result from short positions in municipal securities. The Regulatory Notice also stated that any municipal short positions held after settlement that correspond to a customer long position will result in the payment of substitute interest for the period the bond is short.³

The necessary first step in correcting inaccurate statements to customers regarding the tax status of their interest payments is promptly allocating the municipal short position to particular customer account(s). UBS, however, only allocated its municipal short positions to particular customer accounts when and if the short position still existed as of the record date for the semi-annual bond coupon payment ("record date"), not if a short position existed for any period of time after settlement. As a result, UBS failed to maintain records timely identifying the particular customer accounts that offset its short positions in municipal securities. Instead, the vast majority of the Firm's short positions in municipal securities were held in aggregate and not allocated to specific

³ When short positions result from fails to receive securities from counterparties that are ultimately resolved "as of" the original trade date, substitute interest is not paid.

customers. MSRB Rule G-8(a)(iii) requires member firms to allocate short positions in municipal securities to the appropriate customer account(s).

UBS also failed to make any corrective disclosures to customers until after the record date, when UBS re-characterized the interest as taxable on the customers' account statements. Because UBS only re-characterized interest as taxable if the position was still outstanding on the record date, UBS failed to identify or correct the associated inaccurate statements to customers for the short positions in municipal securities that were covered prior to the record date. In addition, when UBS did re-characterize customers' interest as taxable, it mischaracterized the interest paid during the entire preceding coupon payment period as taxable, rather than the actual period the bond was short. Finally, UBS did not account for shorts that were resolved as of the original settlement date with the original counterparty. As a result, UBS mischaracterized the payment made to those customer accounts as receiving substitute interest when in fact they received tax-exempt interest.

UBS's systems and procedures caused the Firm to make inaccurate representations on approximately 2,853 customer account statements and Forms 1099, to the effect that approximately \$261,610 in interest that the customers had received on municipal bond positions in their accounts was tax-exempt. UBS also inaccurately reported on approximately 950 other customer account statements and Forms 1099 that they had received taxable substitute interest paid by the Firm, when in fact some or all of the interest they had received was tax-exempt interest paid by the municipal bond issuer.

UBS Omitted Material Facts in Communications with Customers about Taxable Substitute Interest

When UBS allocated a municipal short position to a particular customer, UBS adjusted the customers' account statements and Forms 1099 that the interest they had received was taxable. At year-end, UBS also made a supplemental payment to the customers. UBS represented in letters to these customers that the supplemental payment would fully compensate them for the additional federal tax liabilities resulting from their receipt of substitute interest. However, UBS failed to disclose to affected customers that they may, depending on individual circumstances, be subject to additional state taxation.

Resulting MSRB Rule Violations

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 misstated the tax status of certain customers' municipal

securities interest. It also failed to disclose to customers that its supplemental payment might not fully compensate them for their potential state tax obligations. Accordingly, UBS violated MSRB Rule G-17.

MSRB Rule G-8 requires every broker, dealer and municipal securities dealer (“municipal dealers”) to make and keep current certain books and records, including account statements that they choose to send to their customers. MSRB Rule G-8(a)(iii) specifically requires municipal dealers to maintain a record of the location of all such securities long and the offsetting position to all such securities short, and the name or other designation of the account in which each position is carried. As described above, UBS failed to timely allocate its municipal short positions to particular customer accounts and sent account statements to customers that misstated whether the interest they had received was taxable. Accordingly, UBS violated MSRB Rule G-8.

MSRB Rule G-27(a) requires each municipal dealer 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 complies with MSRB Rules and the Exchange Act. In addition, Rule G-27(c) requires firms to amend their written supervisory procedures as appropriate within a reasonable time after changes to applicable rules and as changes occur in its supervisory system, and to communicate those changes throughout its organization. As described above, UBS’s supervisory system and written supervisory procedures were not reasonably designed to address short positions in municipal securities. Accordingly, UBS violated MSRB Rule G-27.

3. Between March 16, 2015 and January 31, 2017, UBS Failed to Take Prompt Steps to Bring Short Positions in Municipal Bonds and CDs Within Its Control Within 30 Days, as Required by SEA Rule 15c3-3(d)(4)

Effective March 3, 2014, SEA Rule 15c3-3(d)(4) required that no later than one business day after 30 calendar days broker dealers must take prompt steps to obtain physical possession or control of securities that are included on the broker-dealer’s books or records that allocate to a short position of the broker or dealer or a short position for another person. Subpart (n) of the rule allows the broker-dealer to apply to FINRA to extend the period of time for the broker-dealer to take action to obtain possession or control of the security, which FINRA may grant if satisfied that the broker or dealer is acting in good faith and that exceptional circumstances warrant such action.

On November 24, 2014, FINRA's Credit Regulation Department instructed UBS not to file requests for extensions for municipal securities and to take steps to bring them under possession or control. On February 11, 2015, FINRA's Credit Regulation Department notified UBS that it was revoking all previously granted requests for extensions of time for the Firm to bring municipal securities and CDs within its possession or control, and instructed the Firm to take prompt action to cover short positions in municipal securities or CDs and alleviate any possession or control deficits.

Yet during the period from February 2015 until at least August 2016, UBS accumulated a total of 342 short positions in CDs and municipal bonds that at some point during the period were aged more than 30 days and for which UBS did not take prompt steps to bring within possession or control. Although many of these positions remained aged less than two months, some were aged more than seven years. In August 2016, FINRA inquired about those positions. Subsequently, the Firm obtained control of almost all of these securities from other parties or its own customers, with 75 percent of the 32 municipal bond short positions open at the time covered within a month.

Fifteen months after the effective date of the revisions to 15c3-3(d)(4), in June 2015, the Firm published written operational procedures that described how, on a daily basis, the Firm would identify 30 calendar-day-old deficits and notify the group at the Firm responsible for the creation of the deficit. However, the Firm's procedures did not give reasonable guidance or authorization to the Firm's employees regarding the steps they should then take to obtain the securities. For example, the procedures did not state whether the Firm's employees should attempt to purchase the position from a customer of the Firm, if necessary.

FINRA Rule 3110(a) requires, among other things, that members establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws, regulations, and FINRA rules. FINRA Rule 3110(b) requires that members establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws, regulations, and FINRA rules. FINRA Rule 3110(b)(7) further requires members to promptly amend their written supervisory procedures to reflect changes in applicable securities laws or regulations, including FINRA rules, or as changes occur in its supervisory system, and to promptly communicate the written supervisory procedures and amendments to all relevant associated persons.

By virtue of the foregoing conduct, UBS violated SEA Rule 15c3-3(d)(4), and FINRA Rules 3110 and 2010.

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

1. A censure;
2. A fine of \$2,000,000 (\$1,750,000 of which is allocated to the MSRB Rule violations)⁴ and,
3. The restitution and undertakings described below.

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

UBS 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.

4. The Firm agrees to comply with the following undertakings:

a. Payment to the Internal Revenue Service (IRS): Within 90 days of the Notice of Acceptance of this AWC, UBS agrees to certify in writing to FINRA that it has taken good faith steps, including communicating with the IRS, to make a payment to the IRS to relieve UBS's customers of the burden of filing amended federal tax returns and paying additional federal income tax owed for tax years 2014-2017⁵ resulting from the municipal short positions maintained by the Firm during that period, including by making a payment to the IRS on behalf of the customers. UBS shall submit this certification, which should contain a description of all steps taken, to Frank Mazzaelli, Director, 15200 Omega Drive, 3rd Floor, Rockville, MD, 20850-3241 either by letter that identifies UBS and the case number of this AWC or by e-mail from a work-related account of a registered principal of Respondent firm to EnforcementNotice@FINRA.org.

b. Restitution to Customers:

1. UBS shall provide restitution sufficient to compensate its customers who may have incurred increased state tax liabilities

⁴ In determining the fine in this matter, FINRA considered, among other factors, the Firm's recidivism.

⁵ Between January 2014 and the August 2015 AWC, UBS made misstatements to customers holding an additional 1,836 municipal bond positions that approximately \$306,202 in interest they had received was tax-exempt.

resulting from UBS having mischaracterized interest accrued between 2014 and 2017 as taxable substitute interest (the “Eligible Customers”).

2. Within 45 days of the date this AWC is accepted, the Firm will provide to FINRA a detailed plan to pay restitution to the Eligible Customers based on specific criteria and a formula that is not unacceptable to FINRA. In the event FINRA does object to the plan, the Firm will have an opportunity to address FINRA’s objections and resubmit the plan within 20 days. The date that FINRA notifies the Firm that it does not object to the plan shall be called the Notice Date.
3. Within 30 days from the Notice Date, the Firm will submit to FINRA a schedule of Eligible Customers identified for restitution and include the details of the total dollar amounts of restitution that will be provided to each customer. Each Eligible Customer will receive restitution, plus interest, from the date the short was created to the date of acceptance of this AWC at the rate set forth in Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. 6621(a)(2).
4. Restitution payments to customers shall be preceded or accompanied by a letter, not unacceptable to FINRA staff, describing the reason for payment and the fact that the payment is being made pursuant to a settlement with FINRA and as a term of this AWC.
5. A registered principal on behalf of UBS shall submit satisfactory proof of payment of restitution or of reasonable and documented efforts undertaken to effect restitution. Such proof shall be submitted to Frank Mazzairelli, Director, 15200 Omega Drive, Third Floor, Rockville, MD, 20850-3241, either by letter that identifies UBS and the case number of this AWC or by e-mail from a work-related account of the registered principal of Respondent firm to EnforcementNotice@FINRA.org. This proof shall be provided to the FINRA staff member listed above no later than 120 days after acceptance of the AWC.
6. If for any reason UBS cannot locate any customer to whom restitution is owed after reasonable and documented efforts within 120 days from the Notice of Acceptance of this AWC, or such additional period agreed to by a FINRA staff member in writing, UBS shall forward any undistributed restitution and interest to the appropriate escheat, unclaimed property or abandoned property

fund for the state in which the customer is last known to have resided. UBS shall provide satisfactory proof of such action to the FINRA staff member identified above and in the manner described above within 14 days of forwarding the undistributed restitution and interest to the appropriate state authority.

7. The imposition of a restitution order or any other monetary sanction herein, and the timing of such ordered payments, does not preclude customers from pursuing their own actions to obtain restitution or other remedies.
- c. Certification Regarding Implementation of Procedures Relating to Short Positions in Municipal Securities and Compliance with SEA Rule 15c3-3(d)(4). Within 90 days of the Notice of Acceptance of this AWC, one or more principal(s) and officer(s) of UBS with supervisory authority over the areas described in Section I.A of this AWC shall certify in writing to Frank Mazzaelli, Director, at the address listed above, that: (i) with respect to the areas described in Section I.A of this AWC, the Firm has implemented systems, policies and written supervisory procedures that are reasonably designed to achieve compliance with the federal securities laws, FINRA rules, and MSRB rules cited herein; (ii) the Firm has published written supervisory procedures, including department-level procedures, that address and detail the responsibilities of each supervisor of the Firm with respect to short positions in municipal securities and compliance with SEA Rule 15c3-3(d)(4); (iii) the Firm has published and implemented written supervisory procedures, systems, and policies that are reasonably designed to ensure that it makes prompt amendments to, and distributes to appropriate personnel, written supervisory procedures that reflect changes in applicable securities laws or regulations, including FINRA rules and guidance, and as changes occur in its supervisory system; and (iv) the Firm has distributed the written supervisory procedures described above to all associated persons of the Firm with responsibilities for the areas described therein, including associated persons in its operations, compliance, trading, and branch sales functions.
 - d. Upon written request showing good cause, FINRA staff may extend any of the procedural dates set forth above.

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

II.

WAIVER OF PROCEDURAL RIGHTS

UBS 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, UBS specifically and voluntarily waives any right to claim bias or prejudice 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.

UBS 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

UBS 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:

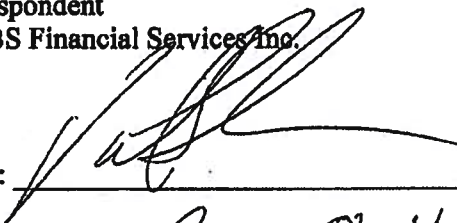
1. this AWC will become part of the Firm's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;
2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
3. FINRA may make a 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. UBS 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 Firm, certifies that a person duly authorized to act on its behalf 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.

09/17/2019
Date (mm/dd/yyyy)

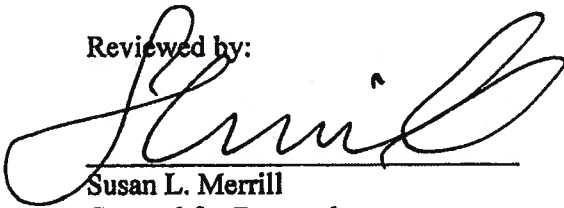
Respondent
UBS Financial Services Inc.

By: 

Print Name: Patrick Sheilings

Title: Managing Director

Reviewed by:

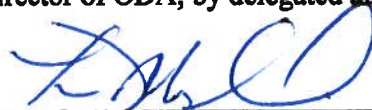


Susan L. Merrill
Counsel for Respondent
Sidley Austin LLP
787 Seventh Avenue
New York, NY 10019
(212) 839-5300

Accepted by FINRA:

10/02/2019
Date

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



Frank Mazzealli
Director
FINRA Department of Enforcement
15200 Omega Drive
Rockville, MD 20850
(301) 258-8557