COMMONWEALTH OF MASSACHUSETTS
OFFICE OF THE SECRETARY OF THE COMMONWEALTH
SECURITIES DIVISION
ONE ASHBURTON PLACE, ROOM 1701
BOSTON, MASSACHUSETTS 02108

IN THE MATTER OF:

UBS SECURITIES, LLC AND
UBS FINANCIAL SERVICES, INC.,

RESPONDENTS.

DOCKET NO. 2008-0045

ADMINISTRATIVE COMPLAINT

I. PRELIMINARY STATEMENT

The Enforcement Section ("Enforcement Section") of the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth ("Division") files this complaint ("Complaint") in order to commence an adjudicatory proceeding against UBS Financial Securities, LLC ("UBS Securities") and UBS Financial Services, Inc. ("UBS Financial Services" and, collectively with, UBS Securities, "UBS") for violating M.G.L. c. 110A, the Massachusetts Uniform Securities Act (the "Act") and 950 CMR 10.00 *et seq.* ("Regulations").

This Complaint is focused on UBS' sales of financial instruments known as auction rate securities ("ARS") to retail and other customers. These sales were typically made with the express representation that they were liquid, safe, money-market instruments, that their interest rates would reset at periodic auctions based on the bids submitted by market participants, and that they could be sold at the next auction. The actual reality, well known to UBS but undisclosed to its customers, was that in fact, no true auctions existed for many of these securities. In addition to not disclosing the true nature of the so-called auctions of these securities and UBS' role in those auctions, UBS also did not disclose to customers the conflicts of interest that UBS experienced in its dual role in underwriting these securities and selling them to clients.

The Enforcement Section seeks an order (a) requiring UBS to permanently cease and desist from committing any further violations of the Act and Regulations, (b) requiring UBS to offer rescission of sales of ARS at par (or restitution to investors who have already sold these instruments below par) on the terms and conditions that a Hearing Officer deems appropriate, (c) censuring UBS, (d) requiring UBS to pay an administrative fine in an amount and upon such terms and conditions as a Hearing Officer may determine, and (e) requiring UBS to take any other action that a Hearing Officer may deem appropriate in the public interest and necessary for the protection of Massachusetts investors.

II. SUMMARY

This case highlights a conflict of interest that arose between UBS and its customers and the devastating effect that such conflict had on those customers, who were not apprised of the conflict and how it was affecting UBS' actions. It also revolves around UBS' profoundly deceptive sales practices with respect to ARS.

Beginning in mid-February 2008, the Division began receiving scores of telephone calls from shocked and outraged customers of UBS Financial Services who were sold instruments that they were told were safe and liquid. These instruments were often pitched to clients as money-market instruments or cash alternatives. These instruments were auction rate securities, some of which were listed on UBS Financial

Services' client statements under the titles "cash alternatives/municipal securities" and others as "cash alternatives/money market instruments." Some clients were told that the interest rates on these securities were set in periodic auctions and that the instruments were readily tradable in auctions and could be sold at the next auction, which would typically occur within the next 7 or 28 days. Others were told that the instruments matured in 7 or 28 days.

The common theme of all of the customers that contacted the Division was that the money UBS placed into ARS was intended to be their safe money and that it would be 100 percent principal-protected and completely (subject to the 7-day or 28-day auction delay) liquid. Investors that purchased those securities ranged from retirees, who sought to invest their money in ultra-safe, liquid investments that they could access if they needed the funds, to small business owners who needed to park operational cash in highly-liquid instruments to be accessed upon short notice for continuing operations and upcoming projects.

Those investors were not told that the auctions were not, in fact, true auctions. They were not told that UBS submitted a support bid for every auction for which it was the lead or sole broker-dealer to ensure that the auction did not fail. They were not told that UBS itself set the interest rate in most of the auctions with the bids it submitted. They were not told that UBS actively managed the interest rates so that they would be just high enough to move the ARS it had underwritten but not so high as to make the issuers that were its underwriting clients unhappy. They were not told that the only products offered to them were products that UBS had underwritten and was trying to distribute. They were not told that in August 2007 UBS intentionally let certain auctions fail because there were not sufficient buyers and UBS did not want to own more of the paper that it was trying to auction off.

UBS retail clients were also in the dark concerning the dangerous increase in auction rate security inventory that UBS was carrying on its books beginning during the Fall of 2007 and continuing through to February 2008. They were not informed that UBS' short-term desk had exceeded, multiple times in 2007 and in early 2008, the amount of capital it was authorized to use to support the auctions and that the auction rate desk was forced to repeatedly request an increase in that cap. They were not told of the extreme efforts that UBS made to decrease its inventory of ARS at the insistence of its risk management department—and they certainly were not told that sales to them were the cornerstone of UBS' inventory-reduction program.

UBS failed to inform its clients that beginning in the Fall of 2007, certain ARS, which UBS had structured and brought to market, were approaching their interest rate caps and were in danger of becoming unmarketable. Moreover, clients were not informed that beginning as early as September 2007, UBS was actively considering scenarios which included pulling out of its auction program altogether.

In the months following August 2007, UBS began to become increasingly concerned about the viability of its auction program and structural flaws in certain ARS, and began to debate pulling out of its auction market program. For example, in a September 6, 2007 email, David Shulman (Global Head Municipal Securities Group and Head of Fixed Income Americas at UBS Securities) ("Shulman") stated:

> please note we will be under severe inventory pressure from client base in the auction rate markets as we move into quarter end...(these are seasonal trends in municipals). I have legal looking into options to EXIT some business lines (to resign from

> supporting the programs that we have been senior manager on for 5+ years) to accommodate our firms request and what our liability in the marketplace/WM and reputational issues with issuers as well as investors would be

In another email that day, he stated, with respect to the auction rate product: "I don't want to service this product either –quite frankly and am happy to responsibly dispose of it---we are trying for sure."

By the end of October, UBS' auction program continued to struggle to the point where Shulman, in an October 31 email, referred to the auction rate program as "a huge albatross." Similarly, in a December 11 email, Ross Jackman ("Jackman") (who serves directly below Shulman on UBS Securities' Short-Term Desk) sent an email to Shulman acknowledging that "the auction process is flawed" and saying "I think eventually most of the book needs to be converted as the auctions aren't going to come back." Likewise, UBS' Risk Management Division also understood the dire straits that the auction program was mired in. In a December 11 email from Charles Paviolitis (who was responsible for monitoring the firm's day-to-day risk) to Jackman, Paviolitis stated that: "we need to be totally comfortable from a credit perspective on all of the assets that we auction if we are going to support auctions." Even the investment banking group realized the fundamental foundations of continuing the auction rate program were in jeopardy. On December 12, Jeffrey Scruggs ("Scruggs"), the person responsible for overseeing underwriting public finance for UBS Securities, emailed Shulman and a number of others, warning of "the continued deterioration of the auction rate market."

Perhaps realizing that the end was near for UBS' auction program, in a December 12, 2007 email to Shulman, Jackman stated: "the entire book needs to be restructured out of auctions . . . . timeframe (sic) prior to hitting max rates." (The maximum rate issue will be discussed below.) On December 12, 2007, Jackman sent another email to Shulman in which he stated: "The auction product does not work and we need to use our leverage to force the issuers to confront this problem our options are to resign as remarketing agent or fail or?" On December 15, 2007 Shulman emailed Joseph Scoby (UBS Securities' Chief Risk Officer) and indicated that he "will need some guidance from you as well as marcel in terms of our overall position and philosophy as it relates to continuing to support these auctions. . . . . What is clear is that the fundamental mechanism of the ARCs structure is not working in a liquidity squeezed environment..."

Similarly, in an email dated January 8, 2008, Jackman objected to two ARC deals that were on the business calendar, citing a management decision to not do any further deals during this troubled time in the auction rate market, to which Scruggs responded: "We need to talk about this. If I actually tell bankers we are not permitted to do an ARC deal (even after we have been appointed to it for that long), it will be another indication (perhaps preliminarily) that we are killing this thing." In a February 7, 2008 email Shulman acknowledged, with respect to UBS' auction rate program, that "this is unsustainable."

The same vulnerabilities in its auction rate program that were troubling UBS were causing some corporate cash clients to shun those specific instruments and were putting substantial pressure on all of UBS' auction rate instruments. As its awareness of these problems increased, UBS also had to step in with more and more of its own capital to make sure that auctions cleared, thus allowing it to continue its lucrative business of underwriting ARS through the end of 2007. In order to offset this inventory buildup, UBS began an all-out effort to market ARS generally and, in particular, troubled student loan-backed auction rate certificates. This marketing effort was considered necessary in order to offset sales by investors (generally corporate cash managers) who began to become uncomfortable with these instruments (despite UBS' client "re-education campaign" discussed herein), and thus to keep the auctions functioning without UBS extending more of its capital to support them than its risk management department was comfortable with. Shulman stated, as the justification for these marketing campaigns, that he was "under a lot of pressure to move paper." He was being told by risk management that "we need to beat the bushes harder than ever to unload this paper." However, in order to keep offloading its inventory of ARS, UBS kept purchasers in the dark about the very vulnerabilities of its auction rate program that UBS had discovered. For example, in a November 29, 2007 email from Edward Hynes, Institutional Sales Manager for the Municipal Securities Group, for UBS Securities, to a number of UBS personnel discussing a meeting with the sales force that had occurred, Hynes stated: "Problem is `auction'. We're not selling auction rate, we're selling student loans that because they price via the auction mode, are very cheap and represent value."

Ultimately, the issue with UBS' ARS program was the maximum rate structures which UBS' Investment Bank incorporated into its student loan ARS and other products, to protect issuers and achieve AAA ratings. As UBS explained to UBS Financial Service's financial advisors ("FAs") in April 2008, after UBS decided to stop supporting its auction program, "The simple fact is that the primary problem with these securities is that they have maximum rate caps and that in the current rate environment some of them either have or will reset at unattractive rates and many people do not want to own them at those rates" As investors shied away from these instruments, UBS' inventory of them began to grow dramatically and it needed to keep raising interest rates in order to move the paper. However, as those interest rates began to approach the maximum rates, UBS began an effort to seek waivers from the issuers and the rating agencies in order to allow the interest rates on those instruments to rise to a level where those instruments could clear to the market. Those waivers were short-term in nature and many were set to expire in early 2008. None of this information was disclosed to investors who purchased these instruments.

In and after August 2007, David Shulman spearheaded increased marketing efforts with respect to ARS after August 2007. He orchestrated a number of conference calls with UBS Financial Services' Wealth Management franchise's FAs to get them to focus on the value of ARS to retail clients. The extent of this marketing effort is detailed in Section VI(B)(5) below. However, on August 22, 2007—just as he orchestrated the enhanced marketing program for ARS--Shulman sold a large portion of his personal holdings of ARS. When asked in an on-the-record interview why he made those sales, he stated:

> I'm not sure of the particular timing, but there was a fail of auction—these are auction preferred securities, these are APS securities, there was a fail of APS securities in August in the marketplace, and not – those securities were unrelated to the mutual fund APS, which is the larger broader market in municipals, these – there was a concern obviously, since the non security act 1940 soft monoline APS had failed, so I decided to sell my other – any associated APS along with that – with the news in the marketplace.

At the same time, Shulman sold a large amount of municipal weekly ARS and purchased variable rate debt obligations. When asked why he did this, he stated: "Because I wanted to be in VRDO instruments because they had a liquidity backstop on those securities and I thought there was more protection."

In early December 2007, UBS' auction rate program experienced an enormous amount of stress. In order to offset the increased inventory that UBS was taking on Shulman, again, orchestrated an all-out sales effort in order to get retail customers to see the "value" in ARS at the prices at which UBS was willing to offer them. Yet, at the same time, on December 12, Shulman quietly sold the remainder of his personal holdings of ARS. He subsequently explained that he made these sales because "my risk tolerance from a credit perspective was – was something that drove me to want to sell" ARS. UBS' customers (and certain UBS Financial Services FAs), who were not apprised of the information that Shulman and the other UBS higher-ups knew about the escalating problems with UBS' auction rate program, were not so lucky. UBS Financial Services' FAs were encouraged to, and did, make sales of ARS to Massachusetts clients up until the last auction cleared on February 12.

On February 13, 2008, without advance notice to its customers, UBS ceased supporting its auction rate program, leaving hundreds of customers stuck with instruments that were now illiquid. This Division's investigation uncovered a profound disconnect between UBS' understanding to the ARS it was selling and its FAs' explanations of these securities to their customers. In addition, by setting up a situation where it was actively controlling whether auctions would clear and what rate they would clear at, UBS had (unbeknownst to its customers) set up a situation which put it in a fundamentally conflicted role between its desire to keep its underwriting clients happy with the promise of low financing costs and its "moral obligation" to retail customers to keep the auctions it had set up afloat. When corporate cash buyers started leaving the market and UBS' inventory started ballooning, UBS was confronted with a conflict between its customers who thought they had purchased safe, liquid, money-market instruments which without UBS' continued support would no longer be liquid, and its risk management arm which did not want to be stuck holding the very paper UBS underwrote and pushed to its clients.

None of these conflicts were visible to UBS' retail clients. As Marten Hoekstra (Deputy CEO Global Wealth Management and Head of Wealth Management US) subsequently admitted in April 2008, "if at any moment UBS announced that we weren't as committed in auctions, it would have been the same as giving up on auctions." Those customers trusted the advice of their UBS financial advisers who sold them these instruments that were liquid, safe and risk free. These customers have now discovered —now that UBS has decided to no longer support its auctions—that they have been blindsided by the very people who were supposed to have their best interests at heart. These customers unknowingly bore the risk that UBS would ultimately determine that its auction program was unsustainable.

In March 2008, the Division initiated its investigation. During the investigation, UBS was unable to make some of its basic business records pertaining to its auction rate business available to the Division in a timely manner and still has not produced certain basic records.

The Division herein charges UBS with fraud and multiple counts of dishonest and unethical conduct and with books and records violations.

The Enforcement Section seeks an order (a) requiring UBS to permanently cease and desist from committing any further violations of the Act and Regulations, (b) requiring UBS to offer rescission of sales of ARS at par (or restitution to investors who have already sold these instruments below par) on the terms and conditions that a Hearing Officer deems appropriate, (c) censuring UBS, (d) requiring UBS to pay an administrative fine in an amount and upon such terms and conditions as a Hearing Officer may determine, and (e) requiring UBS to take any other action that a Hearing Officer may deem appropriate in the public interest and necessary for the protection of Massachusetts investors.

III. JURISDICTION AND AUTHORITY

1. The Massachusetts Securities Division is a division of the Office of the Secretary of the Commonwealth with jurisdiction over matters relating to securities, as provided for by the Act. The Act authorizes the Division to regulate: 1) the offers, sales, and purchases of securities; 2) those individuals offering and/or selling securities; and 3) those individuals and entities transacting business as investment advisers within the Commonwealth.

2. The Division brings this action pursuant to the enforcement authority conferred upon it by section 407A of the Act and M.G.L. c. 30A, wherein the Division has the authority to conduct an adjudicatory proceeding to enforce the provisions of the Act and all Regulations and rules promulgated thereunder.

3. This proceeding is brought in accordance with sections 101, 203, 204 and 407A of the Act and its Regulations. Specifically, the acts and practices constituting violations occurred within the Commonwealth of Massachusetts.

4. The Division specifically reserves the right, especially in light of certain difficulties it has had obtaining information from UBS (as outlined in Section VI(d) below), to amend this Complaint and/or bring additional administrative complaints to reflect information developed during the current and ongoing investigation.

IV. RESPONDENTS

6. UBS Securities, LLC ("UBS Securities") is a registered broker-dealer and investment adviser, registered and notice filed with Massachusetts, with a Central Registration Depository ("CRD") number of 7654.

7. UBS Financial Services, Inc. ("UBS Financial Services") ") is a registered broker dealer and investment adviser, registered in Massachusetts, with a CRD number of 8174.

V. OTHER RELATED PERSONS OR ENTITIES

8. David Shulman ("Shulman") is a natural person, registered in Massachusetts as an agent of UBS Securities, with a CRD number of 1297077. Shulman, according to the CRD, is a direct owner of UBS Securities and serves as the Managing Director, Global Head Municipal Securities Group/Head of Fixed Income Americas.

9. Ross Jackman ("Jackman") is a natural person, registered as an agent of UBS Securities, with a CRD number of 2250891.

10. James Hausmann ("Hausmann") is a natural person, registered as an agent of UBS Financial Services, with a CRD number of 2155259. Hausmann, according to the CRD, serves as the Director of Product Management.

11. Christopher Long ("Long") is a natural person, registered as an agent of UBS Securities, with a CRD number of 3197822.

12. Thomas Lips ("Lips") is a natural person, registered as an agent of UBS Financial Services in Massachusetts, with a CRD number of 730324.

13. Thomas Eldredge ("Eldredge") is a natural person, registered as an agent of UBS Financial Services in Massachusetts, with a CRD number of 2056008.

14. Leonard Burd ("Burd") is a natural person, registered in Massachusetts as an agent of UBS Financial Services, with a CRD number 2937326.

VI. FACTS AND ALLEGATIONS

OUTLINE OF FACTS AND ALLEGATIONS

An outline of the facts and allegations is attached hereto as Appendix A.

A. How UBS Marketed and Sold its ARS to its Clients

1. *UBS Wealth Management's FAs Represented ARS to clients as Safe, Liquid, Cash Alternatives to Money-Market Instruments*

a. Overview of Client Understanding of the ARS They Were Sold

1. Beginning in mid-February 2008, the Division began receiving scores of telephone calls from shocked and outraged customers of UBS Financial Services.

2. These customers went to UBS looking for an ultra-conservative place to invest cash, with the primary goal being the preservation of principal.

3. UBS customers were sold ARS and, in most instances, were told they were safe, liquid money-market instruments.

4. Most UBS customers were told that the interest rates on these instruments were set periodically through the functioning of deep, liquid, fully functioning auctions that had never failed for 20 years. Some were not told about the auction process at all, but simply thought they were buying short-duration instruments.

5. UBS customers were not told that the auction rate product available to them was limited to ARS that UBS underwrote and distributed.

6. UBS customers were not apprised of the risks of ARS, including the risk of failed auctions or a market freeze.

7. UBS customers were never told that UBS had a policy of placing support bids in every auction for which it was the sole or lead broker-dealer, that UBS routinely intervened in the auction markets to set the interest rates just high enough to move the product but just low enough to keep its issuer clients happy, that certain potential conflicts of interest existed between UBS and its customers, that in August 2007 UBS changed its policy of placing support bids in every auction for which it was lead broker-dealer and allowed some of the ARS it had underwritten to fail, or that after August 2007 UBS was actively considering scenarios which included ceasing its practice of supporting its auctions.

8. After UBS decided to stop supporting its auctions, these clients were informed that the market for these instruments had frozen and that they no longer held liquid short-term instruments but instead held instruments with long or perpetual

maturities for which no market existed. Many of those instruments are no longer valued at par, even on UBS Financial Services' account statements.

9. Specific examples of UBS customer stories that the Division has received are as follows.

1. *Client A*

10. In January 2008, Client A, a small real estate development firm based in Massachusetts, opened a nondiscretionary account with UBS Financial Services.

11. Client A sought a safe place to park money it had made from the sale of a piece of property.

12. Leonard Burd, Client A's UBS Financial Advisor was instructed by Client A that liquidity and safety were of paramount concern to Client A, because they may need to put money into another project on relatively short notice.

13. After meeting with Client A and discussing the client's goals, Burd recommended that Client A purchase ARS. He based that recommendation on his understanding that they were safe and liquid money market instruments. Burd stated, with respect to his recommendations of sales of ARS, in an on-the-record interview with the Division: "I explained to him [Client A] that we had instruments that were money market instruments."

14. In January of 2008, Burd's assistant purchased the instruments for Client A based on their discussions. Client A was not informed of the specific instruments that had been purchased until it received the sales confirmation after the sale had taken place.

15. Client A was issued a checkbook against the assets of the account. The one limitation was that Client A should give Burd one week advance notice in order for the ARS to be sold at the next auction.

16. The securities purchased for Client A were: "Eaton Vance Ma Municipal Income Trust," "Mass Health & Education Tax Exempt Tr Auct Pro," "Nuveen Ma Divid Advantage Muni," and "Van Kampen Ma Value Muni Income Trust."

17. The securities were listed on UBS' account statements under the heading "Cash Alternatives." See Composite Exhibit 1.

18. In his on-the-record testimony, Burd testified that he did not inform Client A of any liquidity risks or risks that an auction might fail because to his knowledge there weren't any risks.

19. After UBS pulled out of its auction program, Client A demanded that UBS liquidate his ARS.

20. UBS informed Client A that they were unable to liquidate the ARS, but offered to lend Client A money backed by those (now illiquid) securities.

2. *Client B*

21. Client B, a seventy-eight year old retired Massachusetts investor, maintains a UBS brokerage account that is serviced by UBS Financial Advisor Thomas Eldredge.

22. Client B and his wife were looking for safe, liquid investments in which to invest the cash portion of his portfolio.

23. Client B was sold the following ARS: "Calamos Conv Opportunities & Income," "John Hancock Income Sec," "John Hancock PFD Income Fund," "Nicholas Applegate Conv & Income Fund," and "Scudder RReef Real Estate Fund." All of these ARS were listed under the heading "Money Market Instruments." See Composite Exhibit 1.

24. Client B was told that these APS were as liquid as cash, and that all he had to do was to let Eldredge know and he would receive his money in seven days.

25. Tellingly, Eldredge conceded (after UBS' pulled out of its auction program) that had he known more about the ARS he had sold to Client B, it would likely have affected his suitability analysis.

> Q: If you had known at the time that these weren't sort of free-flowing auctions, but that UBS was supporting the auctions by buying and selling from some account, do you think that would have affected your suitability analysis?
>
> A: It's a hard question to answer, but I'm sure that I would have made him more aware of that. But it would have – the answer is yes.

26. Despite, Eldredge's original assurances that the ARS purchased had seven day liquidity, a number of them remain illiquid.

3. *Client C*

27. In April of 2001, Client C an upstart internet company opened a non-discretionary account with UBS to manage its operating cash.

28. When dealing with UBS, Client C was always clear that the account needed to be liquid, and there should be no risk to principal. From 2001 through May of 2007, 100% of the company's funds were invested in various money market funds.

29. In May of 2007, Client C's new UBS Financial Advisor, Linda Koszalka, ("Koszalka") suggested that Client C invest in what she described as an insured money market, cash equivalent that had high liquidity, zero risk of principal loss, AAA credit ratings, with a slightly higher interest rate then the money market funds Client C was currently invested in. Koszalka told Client C that the investment rolled every seven days, but indicated UBS would liquidate Client C's holdings, if the business needed the cash.

30. In reliance upon Koszalka's recommendation and representations about the product, in May of 2007, Client C authorized Koszalka to purchase the instruments she had described to their account. Koszalka then purchased the following ARS for Client C's account: "DNP Select Income Fund Inc" and "Scudder Reef Real Estate Fund II Inc."

31. Client C spoke with Koszalka in late February of 2008 and requested that UBS liquidate its holdings through auction or otherwise, as she had promised she could do at the time of purchase.

32. UBS has been unable to liquidate any of Client C's ARS.

33. Since Client C has been unable to access its operating cash, Client C has been forced to reduce its advertising and has had to resort to other options, including funding operations off of credit cards.

4. *Client D*

34. Client D, a retired Massachusetts resident, opened a brokerage account in 2001 with UBS for the purpose of maintaining retirement income.

35. In 2001, when he opened his UBS account, Client D told his UBS Financial Advisor, James Healey ("Healey"), that he wanted as conservative of a risk profile as possible for the account.

36. Client D has no pension and relies on the returns from his investments with UBS for retirement income.

37. Healey suggested that Client D consider purchasing ARS for the account and Healey described the ARS as a higher yield alternative to a money market fund.

38. Client D asked Healey multiple times about the liquidity of the ARS. Healey replied that liquidity was available every 28 days. Client D asked Healey multiple times about whether his principal was protected. Healey replied that he would not lose principal.

39. In reliance upon Healey's recommendation and representations about ARS, on November 30, 2007 Client D purchased "Iowa Student Ln Liquidity Corp Student Ln Rev" student loan backed ARS, on January 3, 2008 Client D purchased "Massachusetts Edl Fing Auth Ed Ln Rev" student loan backed ARS and on February 6, 2008 Client D purchased additional "Massachusetts EDL Fing Auth Ed Ln Rev" student loan backed ARS.

40. Client D's UBS account statements indicate that the ARS in his account have dropped in value.

41. Client D contacted Healey in late February to request that his ARS be sold.

42. UBS has been unable to liquidate the ARS in Client D's account since late February.

5. *Client E*

43. Client E, a Massachusetts resident, opened a UBS brokerage account in 2002 for the purpose of maintaining a secure place for personal funds.

44. Client E opened his account with UBS for the sole purpose of keeping assets that he wanted to be liquid and secure in a separate account from his more risky equity investments.

45. Client E's UBS Financial Advisor, James Healey, suggested that Client E consider purchasing instruments with seven day liquidity.

46. Client E asked Healey multiple times if the instruments were safe. Healey assured him that they were and that they had liquidity every seven or twenty-eight days. Client E asked Healey multiple times if his principal would be safe in the investments. Healey assured him that the principal was and that the instruments had liquidity every seven or twenty-eight days depending on the instrument.

47. In reliance upon Healey's recommendation and representations about ARS, on August 29th, 2008 Client E purchased "Eaton Vance Ltd Duration Income Fund" ARS and on January 9 and 24 of 2008 Client E purchased "Massachusetts Edl Fing Auth Ed Ln Rev" ARS.

48. Because of the auction failure default rates associated with the "Massachusetts Edl Fing Auth Ed Ln Rev" ARS that Client E purchased, Client E is currently receiving no return on the ARS he purchased. Client E was never told that there was a possibility he would receive no return on the ARS he purchased.

49. Client E's UBS account statements indicate that the "Massachusetts Edl Fing Auth Ed Ln Rev" and the "Eaton Vance Ltd Duration Income Fund" ARS have

dropped in value. The ARS have lost value despite Healey's assurances that the principal would be safe.

50. Client E spoke with Healey in early March and requested that his ARS be sold.

51. UBS has been unable to liquidate any of the "Massachusetts Edl Fing Auth Ed Ln Rev" ARS or a portion of the "Eaton Vance Ltd Duration Income Fund" ARS in Client E's account since early March of 2008.

6. *Client F*

52. Client F, a retired UBS Financial Advisor, maintains a UBS brokerage account for the purpose of maintaining retirement income.

53. Client F is a conservative investor whose account is primarily comprised of tax free bonds.

54. Client F's UBS Financial Advisor, James Healey, suggested that Client F consider purchasing an instrument with 28 day liquidity for the account.

55. Client F asked Healey if the instruments were safe. Healey assured him that they were and that they had liquidity every 28 days.

56. In reliance upon Healey's recommendation and representations about the instrument, Client F purchased "Mass Edl Fing Auth Ed Ln Rv" student loan backed ARS on January 3, 2008 and January 11, 2008.

57. Because of the auction failure default rates associated with the "Massachusetts Edl Fing Auth Ed Ln Rev"ARS that Client F purchased, Client F is currently receiving no return on the ARS he purchased. Client F was never told that there was a possibility he would receive no return on the ARS he purchased.

58. Client F's UBS account statements indicate that the ARS in his account have dropped in value.

59. Client F spoke with Healey in early March and requested that his ARS be sold.

60. UBS has been unable to liquidate any of the ARS in Client F's account since early March.

7. *Client G*

61. Client G, a Massachusetts resident, maintains a brokerage account with UBS. In September, 2007, Client G informed his UBS broker, Marcus Fagersten ("Fagersten") that he needed to liquidate some equity holdings for the purpose of purchasing some property upon which he was planning on building a home.

62. Due to some issues surrounding the closing on the purchase of the property, Client G informed Fagersten that he was unsure of when the closing would occur but that he needed the money to be readily available.

63. Fagerston suggested that Client G place the money that he was planning on using for the purchase of the property in what he described as cash equivalent securities with seven day liquidity. He also described them as being like a money market fund.

64. In reliance upon Fagerston's recommendation and representations regarding the suitability of the product for Client G's goal of having money available to close on property, in October, 2007 Client G purchased "Massachusetts Edl Fing Auth Ed Ln Rev" student loan backed ARS.

65. Fagersten informed Client G in late February that the ARS that he had purchased were no longer liquid. At this time Client G asked that Fagersten place a sell order on his ARS.

66. UBS has been unable to liquidate any of the ARS since late February.

8. *Client H*

67. Client H is a Massachusetts small business owner.

68. Client H invested some money with UBS through an account serviced by UBS Financial Advisor Stephen Savrann ("Savrann"). When ARS were sold to him, he was told that they were totally liquid and just to give them seven days if he needed the liquidity. No liquidity or other risks of these instruments were disclosed to Client H. Client H thought it was just 7-day paper.

69. The ARS sold to Client H included "Eaton Vance Floating Rate Income Trust Series B Auction Preferred," the "Eaton Vance Senior FTG RT 7-Day Auction Preferred" and the" Nicholas Applegate Conv & Income Fund II (Wed) 7 day Series C Auction Preferred."

70. These securities were listed under the title "Money Market Instruments" in Client H's account statements.

71. A big selling point was that these were triple-A rated securities.

72. Client H was surprised to receive a call from Savrann towards the end of February telling him that now they are not liquid.

73. Client H asked that these securities be sold. UBS told him that they were unable to do so, but instead offered him a line of credit so he could borrow against those securities.

74. UBS has been unable to liquidate some of the ARS since late February.

9. *Client I*

75. Client I, a Massachusetts physician, and his wife went to Thomas Lips, a UBS Financial Advisor, in order to invest money with UBS. A portion of their funds was intended to be invested in safe, cash-like investments.

76. Lips and his colleagues put them the following ARS: "Cohen & Steers Reit & Util Income Fund Inc."

77. Those ARS were listed on Client I's account statements under the heading "Cash Alternatives/Money Market Instruments."

78. Lips never disclosed to Client I the risk that the auctions that provided 28 day liquidity could fail. On this point, Lips testified that "we would talk about a de minimis risk, and instruments that had a plus twenty year history, and we – but we did not talk about any specific risk."

79. After the auctions failed, Client I ultimately sold one of the ARS he had purchased for $550,000 in the secondary market for $462,000, for a loss of $88,000.

10. *Facts Common to Clients A thorugh I*

80. None of the UBS FAs for Clients A through I disclosed to those clients the risks associated with ARS, disclosed the risks associated with the specific ARS purchased for their accounts, or provided any risk disclosure documents in connection with the sale of the ARS to those clients. None of the UBS FAs for Clients A through I disclosed to those clients the risk that the auctions could fail or that the auctions had historically been prevented from failing because UBS chose to purchase ARS on to its own inventory for the purpose of preventing failure and preserving liquidity. None of

the UBS FAs for Clients A through I disclosed to those clients that UBS could in the future choose not to purchase the ARS necessary to prevent auction failure and thereby allow the auction to fail. None of Clients A through I was told by their UBS FAs how the risks associated with ARS differed from the risks associated with money market funds. None of the UBS FAs for Clients A through I disclosed to those clients that if an auction failure occurred, the instrument would pay a default rate nor did they describe how this rate would be calculated. None of Clients A through I that were sold ARS that are presently paying a default rate of zero percent were told by their UBS Financial Adivisor about the possibility that the ARS would pay a default rate of zero. None of Clients A through I that were sold ARS that presently have had their value written down were informed by their UBS Financial Advisor of the potential for loss to the underlying principal of their investment, and none of these clients were told that they could be holding a long term or perpetual instrument that may pay a low or a zero rate of return which would severely hinder its value and liquidity.

2. *UBS Brokers who sold ARS to Clients Understood them to be Safe, Liquid Cash Alternatives or Money Market Instruments*

81. The UBS Financial Services FAs that the Division interviewed had not received any instruction or compliance training from UBS with respect to ARS.

82. The FAs that the Division interviewed did not have even the most basic understanding of how ARS worked until after UBS pulled out of its auctions in February 2008.

a. Leonard Burd

83. Leonard Burd sold a number of ARS to Client A as described above, and a number of other clients in Massachusetts.

84. In his on-the-record interview with the Division, Burd testified that prior to educating himself about ARS after UBS had pulled out of the market in February 2008, his understanding was that ARS were "short-term money market instruments" that were "secure", "liquid" and "safe."

85. Burd testified that he received no training on ARS other than marketing materials posted on the UBS intranet and that he did not read those materials prior to UBS pulling out of the market in February 2008.

86. Burd testified that he gained his understanding of ARS from his two partners.

87. Prior to the market freezing in February 2008, Burd was not aware of any of the risks of ARS. When asked whether he spoke to anyone at UBS prior to the markets freezing in 2008 about the risks of ARS, he stated that "prior to February 2008, I wasn't aware of any risks."

88. Prior to the market freezing in February 2008, Burd did not know that UBS routinely supported its auctions. He testified that prior to the date the auctions froze, "all I knew is that they worked seamlessly, that it was something that worked in my career for ten years seamlessly, and I had no understanding as to the backdrops of it at all."

89. Prior to the markets freezing, Burd had no knowledge of the default rate that would apply to the ARS he was selling if the auctions failed. He testified that: "prior to the auctions failing I had no knowledge at all of default rates, I had no knowledge as to anything other than the fact that these had worked seamlessly since I started with the company."

90. Burd did not engage in any due diligence with respect to the specific auction products he was selling.

91. Burd did not know that the universe of ARS available to him to sell to his clients was limited to the ARS UBS had underwritten. He testified as follows: "I had no idea whether it was Lehman, Goldman, UBS. I had no idea who the underlying issuer of it was, all I knew it was an auction rate preferred that met my criteria."

92. Burd purchased ARS for clients without receiving specific advance authorization to purchase the security, even in accounts that were non-discretionary accounts. The client would find out which security had been purchased for him upon receiving the confirmation.

93. Prior to the auction market freezing, Burd did not know that UBS placed support bids to make sure its auctions did not fail. He testified that, prior to the auctions freezing in February 2008, he had "no idea" that UBS had an inventory of ARS. He only learned after mid-February "that UBS and the other institutions were actually supporting the auctions that would have all typically not been successful, and they were maintaining the auction's integrity on the buy-sell equilibrium by using their own inventory."

b. Thomas Eldredge

94. Thomas Eldredge is another UBS Financial Services financial advisor who sold ARS to a number of Massachusetts clients, including Client B, as described above.

95. Prior to the UBS' auction failures, Eldredge also lacked even a rudimentary understanding of these instruments and how they worked. For example, Eldredge testified that he "had no understanding at all" how the penalty rates worked for the products he had sold to Client B.

c. Thomas Lips

96. Thomas Lips is a UBS broker who sold the ARS described below to Client I (described above).[1]

97. When asked what his understanding (prior to the market freezing in February 2008) was of how ARS worked, Lips stated that his understanding "was that they were treated as an alternative to money markets, with less liquidity than money markets, with high credit ratings, and in most cases more attractive yields than money markets." When asked what he meant by "less liquidity", he stated "[t]hat a money market typically has daily liquidity, these instruments do not."

98. When asked how he obtained his understanding of ARS, he stated that he "relied heavily on the knowledge of my partner, Mark Rousseau, and just broad based reading of the financial services marketplace."

[1] In his on-the-record testimony with the Division, Lips denied being directly involved in the sale of ARS to clients, stating that it was the other members of his group, Mark Rousseu and Andrew Worthington, who were responsible. These statements are inconsistent with the information that the Division has obtained from the clients the Division has spoken with, who insist that Lips himself was directly involved in the recommendation and sale of ARS that were sold to them.

99. Lips testified that he did not attend any compliance training sessions regarding ARS and when asked about how the reset rates worked in cases of auction failures, stated: "I was unknowledgeable – I personally was unknowledgeable until the auctions actually failed about the specifics."

100. Lips purchased ARS for clients without receiving specific advance authorization to purchase the security, even in accounts that were non-discretionary accounts. The client would find out what security had been purchased for him upon receiving the confirmation.

101. Lips testified that "we never, ever characterized [ARS] to our clients as the equivalent of a money market instrument." When confronted with the client statements sent by UBS Financial Services to his clients listing ARS under the heading "money market instruments", he stated that he never noticed that the client statements for his customers listed them under the category "money-market instruments."

102. Lips testified that his group did not make any specific disclosures pertaining to ARS to clients.

3. *UBS Did Not Provide its Financial Advisors With Any Mandatory Training With Respect to ARS That Would Allow Them to Understand the Nature of the Product They Were Selling*

103. UBS provided its FAs with no mandatory training with respect to ARS. James Hausmann ("Hausmann"), Director of Product Management, UBS Financial Services[2], when asked if there were any materials that it was obligatory for registered representatives to read with respect to ARS, testified "not to my knowledge."

[2] Hausmann was designated and testified as the person most knowledgeable about certain topics for UBS Financial Services.

104. This lack of training was confirmed by Eldredge, the Financial Advisor who sold ARS to Client B. When asked if ARS were ever discussed in any compliance trainings he had at UBS, he stated, "[n]ot to my knowledge." He also testified that the only information he received from UBS regarding ARS (prior to the markets freezing in mid-February 2008) was "that it was a cash alternative investment for clients to get a little better yield than a money market." When asked if UBS provided him with any training that would cause him to have any more information than that with respect to ARS, he said, "no." He learned that UBS routinely stepped in to support the auctions when there weren't enough buyers "after February 14." When asked what his understanding was of how auctions worked prior to February 14, he stated: "that it was a liquid market and they were just, they were bought and sold."

105. Ironically, in his testimony, Hausmann indicated a wide range of information that FAsshould know prior to selling ARS to customers, including who the issuer is, what type of security it is, what the credit quality is, how the auction process works, that a customer that submits a bid may or may not get filled for that auction. When asked, "[w]hat about potential conflicts of interest between UBS and the customer, should they know about that?", he responded "Yeah, I think they probably should know about that." When asked whether clients should know about the rate that kicks in when auctions failed, he replied "yes." He also testified that representatives should understand the long-term maturity of the instrument and the composition of the assets in the fund issuing the security.

106. However, UBS did not train or instruct its FAs to apprise themselves of any of this information or to inform the customer prior to selling the customer ARS.

4. *UBS Marketed ARS to Clients as Safe, Liquid Instruments*

107. The scores of UBS clients the Division spoke to uniformly stated that ARS had been marketed to them as completely liquid, safe money-market type instruments.

108. UBS Financial Services posted on its public website a marketing piece "Cash & Cash Alternatives Addressing our short-term needs," which stated, in relevant part:

> As you develop a portfolio strategy to work toward your long-term goals, the need to fund short-term financial goals may arise. For this reason, you should consider maintaining a portion of your portfolio in liquid assets. Liquidity refers to the ability to quickly convert investment s into cash when you need it. Investing in cash alternatives can add this flexibility to your overall portfolio strategy. Cash alternatives are highly liquid, short-term investments. They include:
>
> - Agency Discount Notes (GSEs)
> - Auction Preferred Stock (APS)
> - Certificates of Deposit (CDs)
> - Commercial Paper
> - U.S Treasury Bills (T-Bills)
> - Variable-Rate Demand Obligations (VRDOs)

See Composite Exhibit 2.

109. This page was taken down from UBS' website sometime in February 2008 after UBS stopped placing support bids for its auction rate program, which rendered its clients' holdings illiquid.

110. Similarly, in August 2007 UBS circulated its "Investment Intelligence" magazine, which is "a quarterly `statement stuffer' that is sent to all [UBS Financial Services'] retail clients and available to employees on the

intranet." The featured topic was "Planning Your Retirement Cash Flow Strategy." It states, in relevant part:

> - **Reposition short-term investments to earn more**
>
> Where are you keeping your liquid funds now? Liquidity refers to the ability to quickly convert investments into cash when you need it. You can choose from a wide selection of cash alternatives including:
>
> -- Agency Discount Notes (GSEs)
> -- Auction Preferred Stock (APS)
> -- Auction Rate Certificates (ARCs)
> -- Certificates of Deposit (CDs)
> -- Commercial Paper
> -- U.S. Treasury Bills
> -- Variable Rate Demand Obligations (VRDOs)
>
> Your Financial Advisor can provide more information about the features, credit quality and risks associated with these investments, as well as provide guidance on how they may fit into your cash management strategy. You can also request a copy of the *Putting Liquidity to Work: a Guide to Cash Alternatives* brochure as a resource for additional information.

(See Composite Exhibit 2).

111. In an email from Shulman to Joseph Scoby ("Scoby"), UBS Securities' Chief Risk Officer, dated December 15, 2007, Shulman acknowledged:

> These ARCS instruments—obviously not ideal as a structure . . but I believe have been sold for years as a cash alternative instrument—and retail clients have—I am confident been told that these are "demand" notes. . and will be redeemed at par on demand—thereby relying on the remarketing agent to provide this liquidity 100 cents on the dollar on auction date . . .

(A copy of the email is included in Composite Exhibit 3 which is attached hereto).

5. *ARS Were Listed Under the Heading "Money Market Instruments" on UBS Financial Services' Client Statements Through January 2008*

112. The client statements issued to retail customers through and including the January 2008, listed APS under the heading: "Cash Alternatives/Money Market Instruments." (See Composite Exhibit 4 which is attached hereto).

113. Even APS were listed as money market instruments, even though UBS was well aware, in the words of David Shulman (in an August 20, 2007 email), "this is ultimately preferred stock." (A copy of the email is included in Composite Exhibit 5 which is attached hereto).

114. In the February 2008 client statements, UBS had quietly removed the heading "cash alternatives/money market instruments" in its client statements. APS were then referred to as "cash alternatives/other."

115. This change was not highlighted by UBS to its FAs or customers.

116. For the May 2008 and subsequent statements, the heading on UBS Financial Services' account statements under which ARS appeared was changed again to "fixed income/ARS."

117. Student-loan auction rate certificates ("Student Loan ARCS") were typically listed under the heading "Cash Alternatives/Municipal Securities." This heading has now been changed to "Fixed Income/ARS."

118. VRDOs, which differ markedly from auction rate certificates because of the put they provide investors, were also listed as "Cash Alternatives/Municipal Securities." They have now been classified as Fixed Income/Municipal Securities."

6. *UBS Did not Disclose the True Nature of its ARS Program to its Clients*

119. UBS did not have any mandatory disclosures that its FAs were required to make.

120. On this topic, Hausmann testified that FAs were not required to inform clients of the possibility that auctions may fail. He said that he did not believe that FAs were required to inform clients that UBS Securities routinely intervened in the auction markets to prevent failure and to place a ceiling on clearing rates. Hausmann also testified that UBS Financial Services' FAs were not informed that UBS Securities' inventory of ARS had exceeded the $2.5 billion cap.

121. Burd testified that he obtained no training regarding ARS from UBS and made no disclosures to clients regarding the risks of ARS.

122. Eldredge testified that he obtained no training regarding ARS from UBS and made no disclosures to clients regarding the risks of ARS.

123. Lips testified that he obtained no training regarding ARS from UBS and made no disclosures to clients regarding the risks of ARS. When asked "were there any specific disclosures pertaining to ARS that your group made [in 2007]?" Lips responded: "No" and then clarified: "I don't have any – I don't have any knowledge, I mean, I don't know, I don't have any knowledge, I don't recall. I personally don't have knowledge."

B. The True Nature of UBS' ARS Program Stands in Dramatic Contrast to How It Was Being Promoted to Its Clients and Financial Advisors

1. *Background on Mechanics of ARS*

a. Dutch Auction Process

124. A Dutch auction is a competitive bidding process used to determine rates of interest on an instrument on each auction date. Bids are submitted to the auction agent by the investors interested in buying or selling their securities. The auction agent matches purchase and sale bids and the winning bid is the highest price (equivalent to the lowest rate) at which the auction clears. At the auction a holder may submit one of the following orders:

-- **Hold Order** – the holder wishes to continue to hold a position regardless of rate.

-- **Hold Rate Order or Bid Order** – the holder only wishes to continue to hold a position if the new rate is equal to or higher than a specified rate.

-- **Sell Order** – directs the broker-dealer to redeem the position at part regardless of the new rate.

b. Theory Behind Trading Long-Term Debt In a Dutch Auction Process

125. The theory underlying ARS stems from the upward sloping yield curve. Issuers of long-term debt typically have to pay higher interest rates on such debt than comparable issuers of short-term debt. However, if, through an auction mechanism, that long-term date could be readily tradable as if it were short-term debt, then issuers of such debt could have the benefit of having issued long-term debt but having to pay only a lower interest rate that is more in alignment with short term debt obligations.

126. References to ARS herein shall include three separate categories of instruments: APS of closed-end funds, municipal auction rate certificates and Student Loan ARCS.

c. Types of Auction Rate Securities

1. Auction Preferred Shares ("APS")

127. APS are equity instruments without a stated maturity issued by closed-end funds. They are collateralized by the assets in that fund and typically receive ratings from the major rating agencies. Interest rates are intended to be set in a Dutch auction process with auction cycles typically of 7 or 28 days. Typically, they have a maximum rate above which the interest rate cannot be set in an auction.

2. Municipal Auction Rate Certificates

128. Municipal auction rate certificates ("Municipal ARCS") are debt instruments (typically municipal bonds) issued by governmental entities with a long-term nominal maturity and a floating interest rate that is intended to be reset through a Dutch auction process. They receive long-term ratings from the major rating agencies and are often backed by monoline insurance.

3. Student Loan-Backed Auction Rate Certificates

129. Student Loan-Backed auction rate certificates ("Student Loan ARCS") are long-term debt instruments issued by trusts which hold student loans. Interest rates are supposed to be set in a Dutch auction process and yet typically they have a maximum rate above which the interest rate cannot be set in an auction. They receive long-term ratings from the major rating agencies.

d. Difference Between ARS and Variable Rate Demand Obligations

130. Variable rate demand obligations ("VRDOs") are floating rate obligations with a long-term maturity but have a coupon that is reset periodically (e.g. daily or weekly). Unlike ARS, the investor in VRDOs has the option to put the bonds back to the trustee or tender agent at any time with specified notice (typically seven days). The put price is par plus accrued interest.

e. ARS Not Eligible to be Purchased by Money -Market Funds

131. Because ARS do not have the put that VRDOs have, they are considered to be long-term debt and are not eligible to be purchased by money-market funds.

2. *UBS' ARS Program*

a. Underwriting

132. UBS Securities is one of the largest underwriters of Municipal ARCS and Student Loan ARCS.

133. UBS Securities was a large underwriter of APS until it ceased underwriting those shares in 2005 or 2006.

134. Of an approximately $80 billion market in Student Loan ARCS, UBS (and its clients) hold over $25 billion. Of an approximately $145 billion market in municipal ARS, UBS and its clients hold over $15 billion. Of an approximately $75 billion market in APS, UBS and its clients own over $11 billion.

135. UBS' compensation for underwriting ARS is typically one percent of the outstanding amount underwritten.

136. UBS competes with other investment banks to provide low-cost financing to issuers. Its ability to do so is a key factor in its ability to generate additional underwriting business.

137. The initial auction rate certificate interest rate or APS dividend rate is determined by UBS as part of its initial underwriting of the securities. It is set by a determination with respect to factors such as the credit quality of the issuer, supply and demand for a particular issue, the reset mode and any relevant tax benefits.

b. Broker-Dealer Agreements

138. For the ARS that it underwrites, UBS Securities typically serves as the manager of those auctions.

139. UBS Securities often serves as lead manager, but sometimes serves as co-manager of auctions with other large-broker dealers.

140. UBS Securities' management responsibilities are typically set forth in an agreement called a broker-dealer agreement that it enters into with the issuer.

141. UBS Securities' compensation under those broker-dealer agreements is typically 25 basis points annualized of the amount managed.

142. UBS Securities incentivizes UBS Financial Services' financial advisors ("FAs") to sell ARS by providing the FAs who make the sale a portion of its management fee. For example, for all of the ARS that Burd sold, he would get 40 percent of the 25 basis point fee annualized for the amount that each auction rate security he sold was outstanding and UBS would keep the remaining 60 percent.

c. Distribution of ARS by UBS Financial Services' Wealth Management Franchise

143. UBS Financial Service's Wealth Management franchise serves as the primary distribution model for the ARS it underwrites.

144. In an email dated January 13, 2008 from Shulman to a number of people including Scruggs and Hausmann, he states that "UBS IB relies solely on WM for distribution of all ARCS and APS products." (A copy of the email is included in Exhibit 6, which is attached hereto).

145. All the ARS which were sold to clients of UBS Financial Services came from UBS Securities' ARS program.

146. UBS Financial Services' Wealth Management franchise does not do its own due diligence to discern whether particular ARS are quality instruments to be offered to its retail clients. Instead, according to Hausmann, they would "rely on the diligence performed by our Investment Bank in bringing the deal to the market."

147. Hausmann testified that since he joined UBS Financial Services in 2005, he could not recall any instance in which UBS Financial Services had rejected or declined to distribute to its wealth management customers a product underwritten by UBS Securities.

148. UBS Financial Services' FAs are incentivized to put clients into ARS.

149. FAs receive a portion of 25 basis points annualized calculated based on the total amount of ARS they have clients in.

150. Those FAs would have received no commission if they had put those same investors in UBS' standard money market fund.

151. Both UBS Securities and UBS Financial Services' FAs are still receiving their respective portions of the commission, even though UBS pulled out of the market and the customers no longer wish to own their ARS.

152. That ongoing commission has been referred to by Shulman as "battle pay." (A copy of Shulman's email is included in Exhibit 7, which is attached hereto).

d. <u>UBS Routinely Placed Support Bids in Order to Prevent Failed Auctions</u>

153. On all of the auctions for which it was the sole or lead broker dealer, UBS Securities placed support bids to ensure that the auctions would not fail.

154. Shulman testified that "our practice was to support all auctions of which we were the lead broker dealer on."

155. According to information provided by UBS to the Division, in auctions for APS from January 1, 2006 through February 28, 2008, UBS Securities submitted support bids in 27,069 auctions. The support bids were drawn upon in order to prevent a failed auction 13,782 times, which represents 50.9 percent of those auctions.

156. According to information provided by UBS to the Division, in auctions for Municipal ARCS and student-loan backed ARCS from January 1, 2006 through February 28, 2008, UBS Securities submitted support bids in 30,367 auctions. The support bids were drawn upon in order to prevent a failed auction 26,023 times, which represents 85.7 percent of those auctions.

157. If UBS had not placed support bids in auctions, UBS' auction rate program would have failed.

e. UBS' Setting of Interest Rates

1. *Price Talk*

158. Prior to every auction for which it was the sole or the lead broker-dealer, UBS engaged in price talk. Price talk consisted of a range of bids that UBS Securities transmitted to UBS Financial Services' FAs indicating where UBS Securities expected the auctions to clear.

2. *Setting Interest Rates by Placing Bids*

159. In addition to attempting to influence the interest rates that would be set at the auction through price talk, UBS influenced them directly through submitting buy and sell bids from its own inventory.

160. UBS' Short Term Desk set the rate at which the auction would clear.

161. In the Fall of 2007, UBS raised interest rates in response to a buildup of its inventory of ARS (discussed below). (See Composite Exhibit 8).

162. In stark contrast to the understanding that retail investors were given that the interests rates on these securities were actually set through the auction process, Long, the Short Term Desk Manager, put it as follows: "We are making pricing decisions based on our ability to attract investors while managing issuer client relationships and will continue to do so in efforts to move securities." (See August 29, 2007 email from Chris Long to Anneleise Schwyter and Ross Jackman, included in Composite Exhibit 8).

163. As one FA succinctly put it to Jackman in an October 12, 2007, "[w]e have seen [inventory] levels start to come back down with the exception of student loan

issues. We are still feeling pressure on the student loan paper and continue to price to sell." (See October 12, 2007 email included in Composite Exhibit 8).

3. *In August 2007 UBS Intentionally Allowed Certain of its Auctions to Fail*

164. In August 2007, a number of broker-dealers, including UBS, failed the vast majority or all of their auctions.

165. A list of auction fails compiled by Jennifer D'Ambrosio, Director, Institutional Short Term Sales for UBS Securities LLC is attached hereto as Exhibit 9.

166. The auctions that UBS failed were intentionally allowed to fail by UBS.

167. The auctions that UBS failed consisted of a market of approximately $1.2 billion that UBS participated in of ARS that the monoline insurance companies had issued. Long explained UBS' decision to fail these auctions in August 2007 as follows[3]:

> Q: So, was the pattern that buying demand started to diminish and UBS started to buy more for its inventory for a while before UBS pulled out, is that the pattern that occurred?
>
> A: Initially there was selling pressure, drop off in demand, the investors—again, these were private placement deals, so they were either accredited investors or qualified institutional buyers who participated in this program, your more sophisticated investors, so to say, yes, buying—buying faded and selling pressure increased, and a higher level of inventory was taken on, and then ultimately we did not place a support bid soon after that.
>
> **Q: So, at a certain point a decision was made to just on a certain day stop supporting the market?**
>
> **A: In this particular segment, correct.** [Emphasis added]

[3] Long was designated and testified as the person most knowledgeable about certain topics for UBS Securities.

168. In an email from Jackman to Shulman dated August 21, 2007, he simply stated: "[w]e did not support the Contingent Financing Auction Deals today." (See Composite Exhibit 8).

169. UBS allowed those auctions to fail because it did not want, itself, to own too much of the paper it had underwritten and subsequently tried to foist off on clients.

170. When asked why UBS decided not to put a support bid in for those auction that it allowed to fail, Jackman testified: "I believe that we were concerned on the credits, the transactions."

171. Auctions continued to fail in the Fall of 2007.

172. After August 2007, Long sent weekly or daily reports of failed auctions to others at UBS, including Shulman.

4. *UBS' Inventory of ARS Increased Dramatically from August 2007 through mid-February 2008*

a. Inventory Increased Beyond Cap Imposed by Risk Management

173. UBS' inventory of ARS, which it added to each time it supported an auction that otherwise would have failed, began to increase after the auction failures in August 2007.

174. UBS' risk-control division imposed limits on the amount of auction rate inventory UBS could hold.

175. On this topic, Long testified that the Short-Term Desk was operating under an internally-imposed market risk-control inventory limit. The limit was \$2.1 billion on non-peak times and \$2.5 billion at peak times. Long explained:

> There are points in time in the year, which we typically refer to as seasonal times, where there may be increased selling pressure, or therefore a lack of demand, year end, tax time, quarter end, where broker dealers' participation in auctions would naturally increase because of the lack of demand from the buyer base, so that would be a period of time where we would have a peak limit, or an extension above our regular daily limit.

176. Long also explained that if there was a relative dearth of buyers UBS would have to step in more with its inventory to support the auctions.

177. When the inventory obtained by supporting auctions was reached, the Short-Term Desk had to request from risk-management an increase in that cap. (See Composite Exhibit 10).

178. On this point, Long testified that: "In the event that the desk found itself either approaching either the regular limit or the peak limit we would have to raise it through the appropriate channels within UBS to notify them of the situation, and basically request an extension upon the limit."

179. Long testified that UBS' inventory of ARS substantially exceeded the cap a number of times in the latter half of 2007 and the beginning of 2008. Specifically, he testified that they hit the 2.5 billion cap in September 2007 and requested that that limit be raised. He also testified that: "[w]e closed the year 2007 at five billion in ARS, December 31st." "When asked what was the most ARS UBS ever held, he said that "we might have had more securities . . back in 2004 . . . the SEC investigation of 2004."

180. UBS' support of the auctions caused its inventory of ARS to balloon even more in 2008. Long testified that "from January 1st of '08 through mid February, the inventory nearly doubled" and that "the actual peak inventory [in February 2008]

was somewhere in the area of 11 billion." He testified that these inventory increases occurred because "there was more support on behalf of UBS in the auctions, which increased the inventory."

b. Pushback from Risk Management

181. In the late summer and fall of 2007 and the beginning of 2008, UBS' risk management group was beginning to express concerns about the increase in the buildup of ARS. Risk management expressed these concerns in the context of the short-term desk's repeated requests to take on inventory of ARS above the caps imposed by risk management.

182. For example, in an email dated August 15, 2007, from Nerissa Alexis (who worked with Joel Aresco, Chief Risk Officer, Americas UBS Investment Bank), included in Composite Exhibit 11, stated: "Limited extension [of permission to operate over peak auction rate security inventory limit] granted for one night. There is little tolerance for increased inventory firm wide; please continue to price aggressively to keep inventory down."

183. On an email dated August 17, 2007 from Long to Joel Aresco ("Aresco"), and Nerissa Alexis ("Alexis"), included in Composite Exhibit 11, Long went over the short-term (including auction rate) inventory increase and requested "to operate under these increased limits until COB 8/20/07." Alexis replied: "Limit extension granted for one night. Please continue to price aggressively to work off inventory."

184. In an email dated August 21, 2007 from Ilissa Herskowitz to Jackman, she indicated that Panagoitis Koutsogiannis, who also was in risk management, "is

looking to find out how much [ARS inventory] you are increasing by (in CHF) and if you expect this number to reduce by end of Sept." (A copy of the email is included in Composite Exhibit 11, attached hereto).

185. On August 23, 2007, Jackman sent an email to Shulman and Long indicating that he had "another long conversation with Joel [Aresco] about being over our limit and how we were working to reduce our inventory." (A copy of the email is contained in Composite Exhibit 11).

186. The back-and-forth between the Short-Term Desk and risk management continued throughout the fall. (See, for example, September 6, 2007 email from Aresco to Long and Alexis, included in Composite Exhibit 11, in which he states "we need to discuss the ARC position again.")

187. In a November 15, 2008 email from Aresco to Alexis, Aresco asked "Chris – why the continual increase in ARC inventory? What measures are being taken to reduce this exposure?" (A copy of the email is included in Composite Exhibit 11).

188. On November 20, 2007, Aresco sent an email to Long and Alexis responding to Long's short-term inventory update of that day, and stating: "This is an overall ARC limit excess. With the current trend and double auction tomorrow I would like to see a gameplan for inventory reduction." (A copy of the email is contained in Composite Exhibit 11).

189. In an email dated November 27, 2007 from Aresco, he stated (in response to a another request for an increase in the inventory of ARS), "Ok – you need to make progress on reducing overall exposure. This issue has been o/s for a while.

Can we get a gameplan? And timing?" Shulman replied: "we continue to cheapen our levels to clear this paper." (A copy of the email is contained in Composite Exhibit 11).

190. Jackman testified that "there was a lot of concern that the inventory was increasing" in December 2007.

191. In an email dated December 10, 2007 from Charles Paviolitis ("Paviolitis"), another risk management employee, to Aresco and Alexis titled "Limit Extension," he stated: "We are currently over our 28/35 day Arcs inventory limit, as well as our overall Arcs limit. We would like to request a limit extension until the close of business 12/11." Aresco replied as follows: "As I said to [Jackman] CRO is not approving the excess in overall ARC exposure. Please revert back with gameplan for reduction." (A copy of the email is contained in Composite Exhibit 11).

192. On December 11, 2007, in response to an email from Scoby, the Chief Risk Officer, stating that he was "very nervous about getting long a bunch of paper," Shulman responded: "I understand completely the need to move this paper down . . . Despite being very hostage to the WM franchise for distribution of these products (we are pressing as hard as we can), we are reaching deep into the institutional client base to take these." (A copy of the email is contained in Composite Exhibit 11).

193. The same day, Shulman emailed Paul Wozniak (Wozniak"), a co-head of student loan group at UBS Investment Bank, and Edward Hynes ("Hynes") titled "need to put together a sales force call on muni arcs—student loan" and indicated "we need to move this paper and have to explore all angles possible. . . we need to do this as quickly as possible." (A copy of the email is contained in Composite Exhibit 11).

194. On December 17, 2008, Scoby sent an email to Shulman and others stating:

> I need to know your inventory each day of munis and student loans and how much it has changed . . . please do so just after any auctions for that day. Starting today. . . .
>
> **If you find yourself experiencing a horrible auction: ie you need to support more than 25% or more money that you have used in other auctions, call risk control BEFORE you support it.**
>
> **If you see signs that other dealers are walking away from auctions, let us know.** [Emphasis added]

(A copy of the email is contained in Composite Exhibit 11).

195. In an email dated January 2, 2008 titled "ARC Inventory Update & Calendar," Aresco stated: "As detailed below the Arc situation continues to worsen . . . I have notified Ross Jackman and asked that he take immediate action to curtail any increases to Ambac exposure and look to lighten Ambac inventory across the whole of MSG." (A copy of the email is contained in Composite Exhibit 11).

5. *UBS Attempted to Limit the Buildup of Auction Rate Securities Inventory by (a) Increasing its Marketing Efforts to its FAs (b) Putting a Short-Term Band-Aid On Certain Student Loan ARCS*

a. <u>Enhanced Marketing Efforts for ARS</u>

196. As UBS' inventory of ARS began to mushroom, Shulman orchestrated an aggressive campaign to offload that inventory.

197. This campaign began in August 2007 and continued until UBS pulled out of the market in February 2008.

198. In an email dated August 20, 2007 from Shulman to Andre Esteves, Global Head of Fixed Income, Currencies & Commodities, titled: "APS," Shulman stated:

> . . . am trying to determine best exit strategy for moving more risk off muni books . . . all of the APS product below (legacy from before integration) . . . is heavily reliant on our wealth management group for distribution . . . as this ultimately is preferred stock . . most firms on the street trade this off their preferred desk. We make zero revenue on this product . . . it all gets paid out 100 % to wealth management brokers. Our inventory is higher than our limits right now . . . and I will not recommend for us to participate to take on any more of this risk. . . .

(A copy of the email is contained in Composite Exhibit 12).

199. UBS' primary distribution channel for ARS was the FAs in UBS Financial Services' Wealth Management franchise.

200. A concerted marketing effort was made to get the FAs to move the product.

201. In an email dated August 22, 2007 titled: "FA call on the auction markets," sent from Shulman to Jackman and others, Shulman stated:

> we have encouraged our WM partners to mobilize the troops internally to focus on value so that we can move more product through the system . . . this is our best and most effective way of hedging our exposure . . . and to demonstrate the relative value in the muni product area . . . thank you for your focus.

(A copy of the email is contained in Composite Exhibit 12).

202. Later on August 22, Long sent an email to Todd Reit, an investment banker, and John Key, cc'd to Shulman and Jackman titled: "APS Performance 8/22/07," which stated:

> Attached is a copy of today's APS clearing rates [sic] both UBS deals and those of other Broker Dealers. On another note a

> conference call was held this afternoon with the retail FA system. The call had great participation from the field, the Wealth Management group did an excellent job in re-educating the field as to the structure and credit quality of the 40` act deals. Our hope is that this gains some traction with the sales force and alleviates capital usage concerns over the coming days.

(A copy of the email is contained in Composite Exhibit 12).

203. John Key responded: "Thanks for the update Chris. Encouraged by WM response, hope it translates into demand."

204. On August 23, 2007, Long received an email titled "YESTERDAY'S MEETING" from James Madden, a FA registered with UBS Financial Services. It states, in relevant part:

> We have had to counsel many of these folks over the years through the auction problems, accounting issues, and now credit fears. It has been a bumpy ride at times with these ARCS, but they are still a valuable and viable product. We are glad that UBS has decided to persevere in that regard.

(A copy of the email is contained in Composite Exhibit 12).

205. On August 23, 2007, Long sent an email to Hausmann and others titled "APS Update," which stated, in relevant part:

> I thought it would be beneficial to update all of you on the progress of the APS market in particular. Below tracks the last 7 trading days worth of secondary market activity in APS (UBS client purchases). While, in my opinion, yesterday's conference call was a success in many respects the greatest proof will be in the trend below continuing. Today marks the highest level, in regards to par value of **Retail** distribution in the APS market in over a week. While we still have considerable progress to make, I find some solace in today's result.

(A copy of the email is contained in Composite Exhibit 12).

206. Apparently, Shulman was not himself focused on the value of the ARS that he was preaching to UBS' FAs because on August 22, 2008, Shulman

(unbeknownst to FAs and retail customers), quietly sold his own personal holdings of APS. (See Exhibit 13).

207. When asked in an on-the-record interview why he made those sales, Shulman stated:

> I'm not sure of the particular timing, but there was a fail of auction—these are auction preferred securities, these are APS securities, there was a fail of APS securities in August in the marketplace, and not – those securities were unrelated to the mutual fund APS, which is the larger broader market in municipals, these – there was a concern obviously, since the non security act 1940 soft monoline APS had failed, so I decided to sell my other – any associated APS along with that – with the news in the marketplace.

208. For example, in an email dated August 28, 2007 from Long to Jackman and Schwyter, he indicated that:

> We are making every effort to sell down inventory. Friday is a double day due to the Labor Day Holiday Monday. It is traditionally a very quite week, the last week of August, trading on Friday will be particularly quite. But all efforts are being made, investor calls etc.

(A copy of the email is contained in Composite Exhibit 12).

209. In an August 30, 2007 email from Shulman to Michael Weisberg ("Weisberg"), Global Head of Products & Services & Head of Products & Services North America, Shulman stated:

> We are working closely with Hausmann and the marketing forces to demonstrate municipal bond relative value to the FA national sales force. As your division is critically important to us from a distribution perspective for specifically APS and ARCs product, it is important that the lines of communication stay wide open . . . As you can imagine during these stressful times, the pressure is on to move our inventory.

(A copy of the email is contained in Composite Exhibit 14).

210. Also in August 2007, UBS Financial services published the Investor Intelligence piece described in Section VI(A)(4) above.

211. On September 10, Shulman sent an email titled "Student loan product-taxable short term opportunities" to a number of people, including Wozniak and Amy Monblatt ("Monblatt"), a co-head of the student loan group at the Investment Bank. The email states, in relevant part:

> Amy/Paul....I would please request that you contact John Baldo-who has offered to have you participate on both Tuesday and/or Wednesday morning calls to discuss the inherent value and opportunities in this market...the extreme pricing in this market clearly creates opportunities for us to distinguish ourselves with our clients...and show them value...Please work with the desk and prepare a quick summary sheet as well as an EASY access to our inventory so that our salesforce can access this product easily...It is critical that we reach out on a wholesale basis away from our traditional buying base to recognize this value and similarly understand the credit dynamics...I want to broaden our distribution base and need us to better market this product and educate our groups...I will also like to ask Mike Curran to participate on these calls from a financing perspective and discuss options...John Baldo has offered to help coordinate these discussions and that is appreciated...-please send me a copy of what you will be presenting –as well as dial ins- so that we can scale this out...thank you ...David

(A copy of the email is contained in Composite Exhibit 12).

212. John Baldo ("Baldo") at the time was the Structured Product Sales Manager.

213. On September 12, 2007 email to Baldo, Shulman acknowledged that he is "under a lot of pressure to move paper." Shulman testified the paper he was under pressure to move included ARS. In his testimony, he indicated that that pressure was

coming from "market risk control" and that they wanted him to bring down positions. (A copy of the email is contained in Composite Exhibit 12).

214. On September 13, 2007, Hynes circulated a one page PDF sales point memo on Student Loan ARCS. (See Composite Exhibit 15).

215. On October 17, 2007, UBS Financial Services posted the "Cash and Cash Alternatives" piece discussed in Section VI(A)(4) above.

216. On November 20, 2007, Monblatt sent Shulman an email titled: "Outline for Conference Calls" designed to engage the sales force. In the email, she stated: "David, as per your request, please see the attached power point presentation It's something that we've used before and provides a good overview of the topics that we'd cover on the call." It attaches a PowerPoint presentation titled: "Introduction to Taxable Student Loans." The presentation contains a detailed discussion of the merits of Student Loan ARCS but does not include a discussion of the risks of these products, the problem with their maximum rates or of the vulnerability of the auction rate markets. (The email, with its attachment is included in Composite Exhibit 15).

217. By email dated November 27, 2007 from Shulman to Monblatt and certain other people, Shulman states:

> I would please request Amy that you coordinate with Jon Bass, John Baldo, Ted Hynes . . . to scale out this as FIRST an internal call only . . . then we will roll out to our clients broadly for an interactive call . . . clearly there is great value and opportunity here and it is important for our salesforce to understand the credit dynamics and the clear market misperception of the instrument . . . we have the capabities [sic] and industry expertise to empower our sales team with good information to help move this product . ... . hopefully we can set up a call for either Wednesday this week or Friday . . .

(The email is included in Composite Exhibit 15).

218. In its messages to the sales force, UBS was very careful to tailor its message. In an email dated November 29, 2007 from Hynes to Monblatt, Long and another discussing a meeting with the sales force, Hynes stated:

> Less focus on muni, and more focus on txbl student loan paper. Their clients are buyers of stud loan FRN's. They know the strength of the credit. **Problem is `auction'. We're not selling auction rate, we're selling student loans that because they price via the auction mode, are very cheap and represent value.** [Emphasis added]

(The email is included in Composite Exhibit 15).

219. In a December 11, 2007 email from Baldo titled "Auction Inventory going over Year End. . . We are axed to move; pleas (sic) show bids," Baldo stated: "Our positions in munis need focus ASAP. I'm sure your teams have all worked on the ARC's positions. Can we all give the product renewed focus tomorrow morning?" (The email is included in Composite Exhibit 15).

220. In a December 11, 2007 email from Shulman to Wozniak and Hynes, titled: "Paul and ted . . . need you to put together a salesforce call on muni arcs – student loan." In it, Shulman states: "Please work with bass, baldo, ricci . . to get that group on the line. . . we need to move this paper and have to explore all angles possible . . we need to do this as quickly as possible . . please work on this priority." (See Composite Exhibit 15.)

221. Beginning in 2008, in response to the substantial decrease in corporate cash demand for ARS, UBS Financial Services FAs began a "re-education" campaign, which was described by Hausmann in testimony as follows:

> So there was a lot of focus on this isn't mortgage related and this is a different type of credit quality and they—lets make sure they understand the quality of the assets in the underlying trusts. In the case of student loans or in the case of student loans or in the case of auction rate preferreds, why were the rating agencies giving credit quality ratings that they were of triple-A, and so there was a lot of that and I might say re-education and tuning-up on the nature of the credit quality of the securities that they owned.

222. Conference calls between management and FAs discussing ARS were made on the following dates: August 22, 2007, September 6, 2007, September 24, 2007, November 29, 2007, December 19, 2007, December 21, 2007, January 10, 2007, January 24, 2007, January 30, 2007, January 31, 2008, February 7, 2008, February 8, 2008, February 13, 2008 (2), February 14, 2008 and February 15, 2008.

223. A number of these conference calls were recorded and were available for playback to the FAs.

224. In responding to requests from the Division, UBS claims to have no recording of these conference calls (even the ones that were available for recording and playback) other than the February 8, 14 and 15 calls, and one of the February 13th calls.

225. UBS additionally has failed to provide all the notes from participants in these calls.

226. Upon information and belief, most if not all of these conference calls were calls intended to increase financial advisor interest in selling ARS and UBS did not discuss the concerns it had with respect to or the risks associated with ARS.

227. On January 10, 2008, a UBS FA indicated in an email to Weisberg that she had a client with a lot of money that was unhappy with the returns on the UBS money-market fund. Consistent with UBS' ongoing and intensified push to lower its

inventory of ARS, Weisberg replied: "Have you thought about other cash management options ie: auction rate notes, etc." The FA's response is as follows:

> Michael,
> Thank you for following up. It is interesting that you raise auction rates as an alternative. We just listened to the conference call by the folks from that department and we continue to be frustrated by the lack of information that they are providing to us. It is very difficult to advise clients, since we do not have access to the specific terms of each issue (unless we read each prospectus). Of particular concern at the moment are client funds invested in 7 day ARPs that will be needed for taxes in April. If there is a failed auction, the client may not be able to access the funds. The bottom line is that rather than moving more cash into ARPs we will probably be liquidating them for many clients.
>
> Given the strange and difficult environment, it is imperative to us that we are fully aware of the risk we are taking. We do not want to imperil any relationships over something as "simple" as their cash investments. The lack of clarity regarding ARPS is contrary to our focus on "improving the client experience."

(The email is included in Composite Exhibit 15).

b. Waivers of Maximum Rates on Student-Loan Backed Auction Rate Certificates

228. UBS discovered a flaw in the Student Loan ARCS.

229. The flaw with the Student Loan ARCS was that the maximum rate at which their interest rate could reset was too low to compensate investors for the perceived risk of those instruments.

230. These maximum rates were well known to UBS as UBS Securities had built them into the instruments in order to make them more palatable to their underwriting clients.

231. The maximum rates often allowed the issuers to obtain a higher rating on the product in part because capping the interest rate on the product allowed them to satisfy the cash flow stress-tests of the rating agencies.

232. Many APS suffered from a similar flaw.

233. As investors shied away from ARS after the August 2007 auction failures, UBS' inventory began to grow dramatically and it needed to keep raising interest rates in order to move the paper.

234. However, as those interest rates began to approach the maximum rates on the securities with restrictive maximum rates, UBS began an effort to seek waivers from the issuers and the rating agencies in order to allow the interest rates on those instruments to rise to a level where those instruments could clear to the market.

235. Those waivers were short-term in nature and many that had been obtained in 2007 were set to expire in early 2008.

236. UBS became very concerned that when these waivers expired, these instruments would hit the maximum rate and the rate would reset to a level that would not be appealing to investors, thus requiring UBS to take on even more Student Loan ARCS.

237. For example, in a November 21, 2007 email from Long to Monblatt, Wozniak and others, Long stated: "More than a few weeks back Charlie and I spoke to you both about monitoring the impact of the current market environment on pushing Student Loan issuers closer to CAP rates. At the current time, volatile market conditions persist and in many facets have worsened, we request that we perform this exercise again to re-examine the model and timeframe for potential CAP rate

limitations being imposed. We understand and appreciate the major efforts that are being put forth with all issuer clients to address these concerns…." (The email is included in Composite Exhibit 16).

238. In a December 11, 2007 email to Shulman and Monblatt, Jackman stated: "we are very concerned about the max rate issue and to continue to support this product (as we own all the tail risk) we need to find a long term solution. Please push these providers into discussions now. **The auction product is flawed and we do not want to be in a position with resets at T-Bills + spreads come February and the turn of the calendar will not correct the problems in the marketplace.**" (Emphasis added) (The email is included in Composite Exhibit 15).

239. Similar concerns were raised in a December 11 email from Paviolitis to Jackman, in which he recapped a meeting in which a number of UBS personnel discussed "several areas of concern about the student loan portfolio," including the "'Maximum Auction Rate' probabilities, and when they would start to take place, based upon the current spreads where auctions were clearing." He also stated that: "we need to be totally comfortable from a credit perspective on all of the assets that we auction if we are going to support auctions." (The email is included in Composite Exhibit 16).

240. In a December 13, 2007 email from Long to Shulman, Long stated: "In my opinion, the achievement of the day was providing a clearer picture as to the risk posted by the STUDENT LOAN portion of our auction book. . ." (The email is included in Composite Exhibit 16).

241. In January 2008, UBS continued to seek waivers of the maximum rates from issuers. In a January 27, 2008 email from Long to David Gillinand, Executive

Director of UBS Investment Bank, Long stated: "We are currently reviewing all of the max rate language on the muni deals. . . Older ARC deals, unfortunately and to managements (sic) disliking, are tied to the lesser of a formula (ie LIBOR spread or % of BMA) or a maximum allowable rate. We are planning on approaching all of these issuers and having them waive any formula driven max rate . . ." (The email is included in Composite Exhibit 16).

242. In a February 6, 2008 email from Jackman to Shulman, Seema Mohanty ("Mohanty", Head of Municipal Securities Derivative Marketing Solutions Group, and Gallichio, Jackman states: "**D Day will come soon on the max rate issue on the ARCs and we need solutions or we are going to be left buried with below market securities and no options.** [Emphasis added] (The email is included in Composite Exhibit 16).

243. Three days before UBS pulled the plug on its auction rate program, Shulman sent an email, dated February 10, 2008, to Jackman, Paviolits, Hausmann and Wozniak containing a detailed explanation of his understanding of the problems with the max rates on the student loan issues, including the possibility that the resets "may need to go to TBILLS flat or even zero . . all in order to bring the cash flows to the avge of TBILLS + 120." (The email is included in Composite Exhibit 16).

244. Similarly, in an email dated February 11, 2008, from Shulman to Marten Hoeakstra ("Hoekstra"), Deputy CEO Global Wealth Management and Head of Wealth Management US, Wesiberg, Hausmann and Robert Wolf ("Wolf"), Chairman, Americas & COO, UBS Investment Bank, Shulman stated: "also below is the near term schedule for when we see max rate waivers expiring . . . remember . . this most

likely will cause resets to go fairly low . . . but that may only last a month or two depending on the trusts." (The email is included in Composite Exhibit 16).

245. UBS did not disclose its concerns with respect to maximum rates of Student Loan ARCS to investors.

246. Moreover, UBS' FAs were not aware of these features and did not explain them to customers.

6. *After August 2007, UBS' Concerns Regarding ARS Intensified Causing UBS To Debate Its Ongoing Role In The Auction Markets*

247. After August 2007, there was an ongoing dialogue within UBS as to the condition of the auction markets, with particular emphasis on Student Loan ARCS.

248. On September 5, 2007, Jackman confided in an email to Shulman, "[c]learly student loans are pushing us over inventory limits. I'm concerned that this will continue as retail buyers continue to prefer traditional muni credits We need to find a short term and a long term solution for this problem." (The email is included in Composite Exhibit 17).

249. In the Summer and Fall of 2007, UBS began a balance sheet reduction program, which required all divisions, including the short-term desk, to contribute to liquidity creation and balance sheet reduction.

250. By email dated September 6, 2007, Koutsogiannis asked Shulman "how do MUNIS plan to contribute to the liquidity creation and balance sheet reduction exercises?"

Shulman's answer, is as follows:

> Pete...we understand clearly the mandate and have been exploring all options without disrupting the marketplace and our banking franchise to continue to reduce inventory-**ALL OUR FOCUS IS ON THE SHORT TERM PRODUCT LINE...to get down 25% from where we are...**I potentially have to close out certain business lines...also...**please note we will be under severe inventory pressure from client base in the auction rate markets as we move into quarter end**...(these are seasonal trends in municipals). **I have legal looking into options to EXIT some business lines (to resign from supporting the programs that we have been senior manager on for 5+ years) to accommodate our firms request and what our liability in the marketplace/WM and reputational issues with issuers as well as investors would be...**long term - this will cost us - my view
>
> SHORT TERM INVENTORY –**currently at 3 billion.... 2.3 bill ARCS (1.3 bill is taxable student loans)-this is the area of focus for us in reducing (we are looking into discounting the paper to distribute as well as potentially resigning from supporting as senior manager). Many legal and reputational issues on this decision...**I cant commit to being down by 1 billion without exiting a business right now-this is a product that was created by WM and as an auction rate mechanism...just doesn't go away-without our resigning from programs or terming out to longer term financing. [Emphasis added]

(See Composite Exhibit 17).

251. Shulman forwarded the email to Wolf's assistant and commented:

> so you can see whats going on...I can't believe that given our ROE and ROA on capital (I believe one of highest in fixed income) and the RWA associated with this product as well as our smallest inventory by a huge factor...that munis are a major focus to withdraw from some business lines...this is WM legacy product (we get paid ZERO for it in the IB) yet are held hostage to it in every sense...**I don't want to service this product either –quite frankly and am happy to responsibly dispose of it---we are trying for sure.** [Emphasis added]

(The email is included in Composite Exhibit 17).

252. In stark contrast to the email referenced in the preceding paragraph, Shulman testified as follows:

Q. Could you please describe the liquidity creation exercise . . ?

A. Balance sheet was – very heavy all around the firm, and they wanted everyone to try to lower their overall balance sheet so that we didn't have to provide unsecured funding.

Q. And how did this liquidity creation exercise affect the ARS program?

A. It didn't really have any impact on it.

. . .

Q. How did the balance sheet reduction program affect the ARS program?

A. It didn't.[4]

253. On October 31, 2007, Shulman forwarded an email to Wolf titled "holding the bag." In that email, Shulman responds to an earlier email from Kenneth LaBarge, in which LaBarge wrote:

> David, adding to the list, I have to do a conference call with another client CFO who wants to sell all his AAA ARCS because his auditor, PWC, is telling him there are problems with auction securities and to get out now. I expect other clients to call knowing that PWC started the whole reclassification mess and how many corporate clients they have.

(The email is included in Composite Exhibit 17).

254. Shulman responded as follows:

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[4] Also in contrast to his September 6, 2007 email and many of the other emails described herein, Shulman was asked in his on-the-record interview: "After August, 2007 when did you become aware that UBS Securities was discussing as a possibility withdrawing its support for ARS in the auction markets for which it was a broker dealer? Shulman testified: "Not until the second week of February." He was asked the follow-up question: "So, you weren't even aware that there was any discussion of withdrawing support for auction markets until the second week of February?" His response was: "Not until the second week of February." This statement is also contradicted, for example, by a February 8, 2008 email titled "Muni – did you had any discussion with business re auction support" in which he was asked "Would you pls be so kind and let me know if our plan is still not to let any Student Loan ARC auction fail . . ." and in which he responded "of course. . . this decision will be taken way north of me . . I have been in conversations with Scoby, Wolf, Hoekstra, etc. all day and all night for the past week. . . . no question – the pressure is building."

> This is what we dealing with – fyi – retail wm that now is demanding liquidity – putting more pressure on balance sheet etc. . . this is the gift that keeps on giving . . am speaking to Weisberg tonight from zurich on this and all failed auction stuff. . . . **this is a huge albatross** . . . really something . . . wm enjoyed all the fees and rev when times are a good . . now the ib steps in to provide balance sheet and risk with a limited exit strategy - very hostage to wm for distribution – that was and is the model . . totally lopsided . . . unreal [Emphasis added]

(See Composite Exhibit 17.)

255. On November 5, 2007, Philip Olesen, Investment Grade Credit Trading for UBS Investment Bank, sent an email titled: "Auction Rate" to Shulman and Gallichio, which stated: ." . . a significant number of companies are adding disclosure regarding their auction rate exposure. Most companies are reclassifying exposure as assets available for sale instead of the prior classification of cash and cash equivalents." (The email is included in Composite Exhibit 17).

256. By early December 2007, it became clear that many institutional buyers were no longer interested in ARS. (See December 4, 2007 email from Jackman to Shulman titled "AIG" included in Composite Exhibit 17).

257. On December 7, 2007 Michael Curran, a recipient of Long's daily inventory report, raised the following concern with respect to the maximum rates on auction rate certificates (in an email included in Composite Exhibit 17) with Hynes: "My point is, I would hate to see an auction fail AND issuers not being incentivized to do anything, because "max rate" they pay is lower than prevailing yields/rates for the paper." (The email is included in Composite Exhibit 17).

258. In response, Hynes stated:

> Apart from using the current environment to pursue current issuers to convert to VRDO and new issuers to consider other modes than

> ARCS, Issuers are applying for a 6-9 month waivers to exceed their calculated max rates. This is already in progress and in some cases has been achieved. We will try to distribute info on max rates to sales once we get a consensus of which issuers get waivers.
>
> To your question though, we do not have a rip cord to collapse these issues. If the auction fails and the max rate is instituted, there is no more movement on the auction date unless better than max rate occurs. We won't be hit with more paper, and there will be no liquidity. I imagine clients will look for liquidity in the secondary and can imagine a secondary market trading at a discount.

(See Composite Exhibit 17).

259. On December 11, 2007, Ross Jackman sent an email to Monblatt and Shulman, in which he states:

> We were very concerned about the max rate issue and to continue to support this product (as we own all the tail risk) we need to find a long term solution. Please push these providers into discussions now. **The auction product is flawed** and we do want to be in a position with resets at T Bills + spreads come February and the turn of the calendar will not correct the problems in this market place. [Emphasis added]

(The email is included in Composite Exhibit 16).

260. In response, Scruggs asked: "How much do you need to move by February?"

261. In reply, Jackman stated:

> We need to scrub the book for any deals that will have a max rate in feb. and work on the deals first to be converted to vrdo's. **I think eventually most of the book needs to be converted as the auctions aren't going to come back.** . . .[Emphasis added]

(See Composite Exhibit 16.)

262. In a December 11 email from Paviolitis to Jackman, Paviolitis stated: **"we need to be totally comfortable from a credit perspective on all of the assets**

that we auction if we are going to support auctions." [Emphasis added] (The email is included in Composite Exhibit 16).

263. On December 12, Scruggs sent an email to Shulman and a number of others included in composite Exhibit 17), stating: "In light of the announcement about XL and the continued deterioration of the auction rate market there will be a mandatory meeting of the BOC to discuss the state of the market and the steps to be taken."

264. On December 12, 2007, Jackman sent an email to Shulman in which he stated: "The auction product does not work and we need to use our leverage to force the issuers to confront this problem our options are to resign as remarketing agent or fail or?" (The email is included in Composite Exhibit 17).

265. Of note, that same day (December 12), David Shulman sold his remaining personal shares of ARS, while at the same time continuing to orchestrate enhanced marketing efforts to clients. He subsequently explained that he made these sales because "my risk tolerance from a credit perspective was – was something that drove me to want to sell" ARS.[5]

266. In a December 12, 2007 email from Jackman to Shulman and others, Jackman states: "the entire book needs to be restructured out of auctions . . . . timeframe (sic) prior to hitting max rates." (The email is included in Composite Exhibit 17).

267. In an email dated December 14, 2008 from Shulman to Andre Esteves titled: "Discussion with Scoby," Shulman stated:

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[5] Ironically, just nine days earlier Shulman stated (in an email dated December 3, 2007, attached hereto as Exhibit 18) to Kevin Cox, a UBS colleague who had asked about whether Shulman "[felt] good about [auction rate certificates] from a security standpoint," Shulman responded, " I myself have decent exposure to these instruments."

> We went through all basic dynamics and issues concerning ARCS and exposure . . now developing formal gameplan that I will send you and scoby as it relates to our options currently . . most importantly – I will need to get some guidance from marcel as to our overall approach to WM should matters get much worse. . general conclusion at this juncture – as we discussed-concern about mechanism and liquidity (failed auction scenario), and seems less on credit basis currently—right now we hammering every channel institutionally as well as wm to move paper . . . . will send you action plan shortly.

(The email is included in Composite Exhibit 17).

268. In an email dated December 15, 2007 (attached as Exhibit 3), Shulman emailed Scoby, and indicated:

> As we discussed yesterday, our concern is clearly on the upcoming auctions through the 28th of December. In addition to establishing a task force mentioned below which will draw on all areas of the organization to develop potential strategies to restructure these ARCS instruments, **I will need some guidance from you as well as marcel in terms of our overall position and philosophy as it relates to continuing to support these auctions**. Given the size held within WM and all the reputational dynamics that go along with this decision, establishing somewhat of a framework is critically important in advance. I will be speaking to Michael Weisberg this weekend to discuss at length with him all the issues. **What is clear is that the fundamental mechanism of the ARCs structure is not working in a liquidity squeezed environment—** where the only real outlet for distribution is WM and corp cash management. . . .
>
> . . .
>
> **These ARCS instruments—obviously not ideal as a structure . . but I believe have been sold for years as a cash alternative instrument—and retail clients have—I am confident been told that these are "demand" notes. . and will be redeemed at par on demand—thereby relying on the remarketing agent to provide this liquidity 100 cents on the dollar on auction date . . . although there is no formal liquidity provision in place and always relies on the dutch auction mechanism to clear. . . the moral obligation runs very deep.**
>
> [Emphasis added]

(See Exhibit 3).

269. On December 19, 2007, Scoby sent an email to Shulman and others titled: " Munis/student loans etc. URGENT," in which he stated:

> Guys,
>
> Today we discussed the current situation at the [Governing Executive Board]. There were many questions and a sense of urgency. I need a written overview by Friday noon NY time. . . . The paper should address whatever you think the GEB should know, including:
>
> > 1. The size of the programs for which we are the lead, broken down by product (student loans, munis), and by type (ARCS, VRDOs, FRNs); what percentage of each is sold to wm usa. Within wm usa, what percentage are corporate cash desks versus individuals? Where else is the rest sold in each case? Who are key competitors for each segment and how big are they.
> >
> > . . . .
> >
> > 6 Describe our current inventory in pretty good detail…
> >
> > 8. Describe exactly what happens when an auction fails. What is the maturity usually? Will the coupon always be at the cap? Etc.
> >
> > **9. Where would failed auction paper be able to be sold? Where would we mark it?**
> >
> > **10. What is UBS' and the market history of failing to support an auction or similar event? I heard this happened a few years back. What type of paper? When? What happened?** [Emphasis added]

(The email is included in Composite Exhibit 19).

270. In an email dated December 19, 2007 from Long to Shulman, Jackman and Paviolitis, Long provided proposed responses to two questions that had been asked,

upon information and belief, by risk management. The questions and answers are as follows:

> **Question # 9: Where would failed auction paper be able to be sold? Where would we mark it?**
>
> In the event of a failed auction, the securities in question would be rendered illiquid. The liquidity for these securities is contingent solely on the basis of successful auctions taking place. Investors (who have predominantly been "retail" and "cash management accounts") would be forced to hold the securities, at the fail rate pursuant to the documents, until the next scheduled auction. At the next scheduled auction (i.e. 7, 28, or 35 days) we would attempt again to conduct a successful auction, this cycle would be repeated until either a successful auction occurs or the issuer takes action to either restructure the outstanding auction securities or worse case until final legal maturity. **While in failed mode we would have difficulty establishing fair market prices, due to the lack of outside pricing services as well as the lack of inter broker marketplace.** Our risk in essence, resulting from failed auctions, would be a required reclassification of the assets on the book from the current mode (i.e. 7, 28, or 35 day) to an asset (FRN) with a 30-40 year final maturity. This reclassification would be accompanied by significant increases in VAR, Stress and Capital charges.
>
> **Question # 14: Describe an ugly scenario, considering technical imbalances (supply/demand) and deterioration in credit worthiness. How much money we would lose?**
>
> On the macroeconomic level, the financial markets continue to falter, in particular further US economic downturn extends past Housing markets into Credit Cards, Auto Loans and Student Loans. This could result in a deterioration of the credit worthiness of all securities backed by these assets. Secondly, monoline insurance providers are downgraded multiple notches and the demand for ARS (both Municipal & Student Loan) retracts exponentially. The two largest monoline insurance providers, in the Student Loan space, are AMBAC and MBIA.
>
> **Focusing on Student Loans, prevailing market conditions have continued to cut into excess spread of these structured products. Continued stress will trigger max rates ("available funds caps") potentially resulting in auctions resetting at below market yields**. These max rates are integral in the securities

> meeting rating agency stress scenarios and ultimately maintaining current ratings. The unwillingness of rating agencies to grant waivers on current max rates, under current market conditions, will accelerate the onset of below market yields due to max rate caps. **This forces the hand of every broker dealer in the auction market to decide between supporting deals, taking inventories at levels far below market rates or failing auctions (not supporting) which triggers a chain reaction of selling across all auction products, regardless of them being Student Loans, Municipals or Auction Preferred Stock.**
>
> **Mark to market losses would be significant, to all parties involved.** [Emphasis added]

(The email is included in Composite Exhibit 19).

271. A student loan task force was set up in mid-December 2007. Shulman testified as to the reasons for this task force as follows:

> Q. And why was the student loan task force convened?
>
> A. Because I think we were looking for – for different opportunities to restructure student loans into – into VRDO mode, and that – so that was – what we were trying to examine.
>
> Q. Was this in response to the increasing inventory of student loan ARS.
>
> A. Yes.

272. In addition to the student loan task force, in December 2007, a broader working group was convened to discuss the broader condition of UBS' ARS Program. According to UBS' response to interrogatories propounded by the Division, "In late 2007, UBS formed a working group that addressed the general market conditions for ARS, as well as UBS' continued role in ARS auctions."

273. The broader working group held meetings on December 21, 2007, January 4, 2008, January 18, 2009, February 1, 2008 and February 29, 2008.

274. The broader working group discussed, among other things, the buildup in UBS' inventory of ARS and strategies for exiting the auction markets.

275. On January 3rd, Mohanty sent Gallichio and Jackman an email titled: "Tactical Review." The email discusses four "potential solutions" to the auction rate issues. The fourth is "Fail Auction." The benefit of that option was "limit inventory and balance sheet usage." Under "Considerations" for that option was: "Severe reputational issue which may also cause greater MTM exposure." (The email is included in Composite Exhibit 20).

276. In an email dated January 8, 2008, from Jackman to Mohanty and Scruggs (included in Composite Exhibit 20), Jackman states: "I see 2 ARCs deals on the calendar for later this month. We are not permitted to do any further deals." Scruggs responded: "They have been on the calendar for 5+ mths. We need to talk about this. **"If I actually tell bankers we are not permitted to do an ARC deal (even after we have been appointed to it for that long), it will be another indication (perhaps preliminarily) that we are killing this thing."** [Emphasis added]

(The email is included in Composite Exhibit 20).

277. In an email dated January 9, 2008 from Scoby to Wolf, Scoby wrote that he needed a write-up of the auction rate situation for UBS' Governing Executive Board. The write-up he needed was as follows:

> We need a write up on the situation for the geb today. This should include:
> 1. Description of ARCs and simple explanation of what happens to them in failed mode.
> 2. Description of inventory, including which is ffelp, partially ffelp, private with guarantee, and private. Define what ffelp

guarantee means. Estimate for where each type would trade if the auction market were systematically failed, ie investors find themselves confronted with potentially very long duration paper.
3. Status on issuer restructuring.
4. Status on discussions with citi.
5. feasibility, time required and other mechanics of providing a liquidity backstop for current inventory and thus being able to sell our inventory to 2a7 and similar money market funds.
6. How much we can repo.
7. Feedback from marten and Michael (I suggest you let them ghost write it) on reputation damage if we fail. Also get input from rick leaman. As an extension of this, what if we failed and then bid clients a price below par.
8. finally, the merits of a strategy in which we discriminate which auctions we fail based on credit quality and separately based on which clients own that particular issue.
9. An assessment from ramesh of whether such auction failures would materially affect commercial paper market.

Rich Metcalf's team is nearly done with item 2.
Given poor auction behavior this year, this is urgent...

(The email is included in Composite Exhibit 20).

278. In an email dated January 13, 2008 from Shulman to a number of members of the working group, he circulated a draft of discussion points. In it he stated that the situation was "clearly not a credit crisis but a liquidity issue based on concern for the auction structure and mechanism." He also said that "[t]he ARCS instruments must be converted to appeal to money market funds to be healthy." (The email is included in Composite Exhibit 6).

279. In the email, Shulman worried about "contagion and reputational risk of UBS becoming first to fail and breaking the moral obligation to support these markets in an orderly fashion." (See Composite Exhibit 6).

280. Contained in the talking points was the proposal: "If we do fail – be the 2^{nd} to fail."

281. Similarly, in a separate January 11, 2008 email to other members of the working group, Jackman proposed: "be the 2nd or 3rd to fail." (See Composite Exhibit 6.)

282. On February 8, Wolf sent an email to Shulman and others stating: "I do not think that the goldman-slma arc issue is in any way a statement about slma. It is a statement about the student loan short term product, **the arc mechanism that is a flawed product** and a supply and demand chain that is completely out of whack at the moment." [Emphasis added] (See Composite Exhibit 6).

7. *UBS' Conflicted Role in Catering to Underwriting Clients Versus Acting in the Best Interests of Retail Wealth Management Clients*

283. UBS' auction rate program, in which it actively managed the set the interest rates on ARS (which interest rates, in theory, should have been set by auctions), put it in a fundamentally conflicted role.

284. On one hand, as set forth in detail above, it often needed to raise interest rates in order for auction paper to clear.

285. On the other hand, if it raised interest rates too high, it ran afoul of its underwriter clients, to whom it had promised low-cost financing.

286. UBS Financial Services' investors, who thought their FAs were purchasing the best product available for them, were unaware of this conflict, as it was never disclosed to them.

287. On August 21, 2007, Schwyter sent an email to Shulman, Jackman and a couple of others titled "MUNI – liquidity/update following our discussion." Schwyter runs the group treasury function in the America. When asked why she sent this email, Shulman testified: "Anything to do with balance sheet or liquidity issues has to be in

conjunction, at least at our firm with group treasury, so that there are of what our finding needs could be or obligations are, so that group treasury is aware – are of our activities." (The email is included in Composite Exhibit 21).

288. In the email, Schwyter discussed inventory developments for ARS and stated: "As indicated earlier two 'non 1940 Act' auctions of $50mm each were not supported by UBS and failed, the paper converted to a preferred stock of the insurance company and the rate paid to investors is the predetermined maximum rate. . . . For all other auctions the interest rates were increased and the papers could in general be placed. UBS was clearly a trend setter for higher rates, peers followed to a certain extend [sic]." (See Composite Exhibit 21).

289. Shulman forwarded that email to Suneel Kamlani (assistant to Huw Jenkins) and Huw Jenkins , the then CEO of UBS Securities' Investment Bank. In the email, there is a reference to Todd Reit, who is a banker in the corporate finance area of the Investment Bank. In his email, he stated:

> So you know – we have been in constant dialogue with group treasury—to ensure they all informed of dynamics. . just spoke with marc silverman to answer some more questions..market felt better at close overall..**we walk a fine line as you know with aps issuers..pimco, eaton vance, brock etc . . in terms of our pricing (we are pricing to clear now—substantially cheaper than where our competitors are)..as you know, the cheaper we price the more it squeezes the asset manager on the margins. . .** merrill and the rest of the street do not think we are helping the situation in this market by pricing this cheaply . . **you should know that I am getting some pushback from fig group [Financial Institutions Group] (todd reit) that he is trying to defend our moves to these asset managers. Lastly – between aps and arcs products . . we in munis have roughly 45 billion of senior managed paper ALL in wealth management RETAIL that we are solely servicing where this "moral" responsibility to provide orderly auctions and pricing exists . . almost 98**

> **percent of these 2 products are strictly through WM . . . . .**
> [Emphasis added]

(The email is included in Composite Exhibit 21).

290. When asked about the pushback Reit was getting, Shulman explained as follows:

> Todd is a banker that covers Eaton Vance, BlackRock PIMCO for these auction preferred securities that are outstanding, he was the baker that helped to originate some of these transactions. So, his daily dialogue with these clients probably entails looking at how UBS is pricing their obligations on a rolling basis, and I'm sure this refers to the fact that he was either under pressure from those issuers that were pressing him in terms of why we are pricing where we were pricing.
>
> . . .
>
> Q. Right, but I guess what I'm trying to understand is you were pricing, I mean, I thought the interest rates were set in the auctions, by "we were pricing" do you mean prices set forth in price talk, or prices set forth in bids submitted by UBS?
>
> A. . . . [t]he inference here, I would glean would –was that we – our pricing guidance and clearing levels were higher than some of our competitors.

291. On September 7, 2007, Scruggs emailed Shulman and Gallichio. The email, titled: "Auction Securities." In it, Scruggs stated: "We have to solve this distribution issue- problem is not just student loans – as you know we get hammered by t-e auction clients about our performance." In response, Gallichio, stated:

> Yep, we cannot rely on a retail distribution model – it is not what we are anymore or want to be. Hopefully the bankers are offering other products or strategies/(It funding) to the clients when they get hammered. Identify the clients we want to partner with and going deeper with them is the best way to protect the bank and the franchise.

(The email is included in Composite Exhibit 21).

292. When asked about the reference to getting "hammered by T-E clients," Shulman testified as follows:

> Q. And what does he mean, we get hammered by T-E auction clients about our performance?
>
> A. There's a constant balance when you are an issuer of securities that are relying on a remarketing agent to set rates that are viewed by the issuers on a constant basis depending upon the issuer in terms of how competitive you are relative to the other programs they may have outstanding with other dealers to see where are rates were as compared to other dealers' rates were on a –weekly or monthly basis depending upon what those instruments were. So, there's a balancing act between trying to satisfy the issuer that they're getting the best reset rates and providing the clients with the most attractive rate for them as we looked to distribute securities. So, what Jeff is referring here – to here is the fact that it is the constant tension between a banker and the trading desk in terms of being able to price securities that satisfy both – both sides of – both motivations, motivation for the issuer to have lowest net interest cost and the motivation for a buyer to have the – best rate.

293. Retail purchasers of UBS auction rate paper thought that the interest rates were set by the auction markets, not by UBS' intentional setting of the interest rates resulting from its balancing of the needs of its underwriting clients (which are the greatest source of revenue for these products) and its need to move the product so that its inventory does not grow too large.

294. In an August 29, 2007 email from Long to Schwyter and Jackman, Long stated, in relation to attempts to sell ARS: "We are basing pricing decisions based on our ability to attract investors while managing issuer client relationships and will do so in effort to move securities." (See Composite Exhibit 21.)

295. The conflict stemmed in large part from UBS' use of its Wealth Management FAs to support the profitability investment bank--as opposed to, as

investors might expect, providing them with the best products for their particular investment situation.

296. In an email dated August 30, 2007 from Shulman to Weisberg, Shulman circulated to Weisberg an excerpt from the minutes of UBS' Governing Executive Board for a meeting held on August 8, 2007. Included in those excerpts is the following:

> Municipal Securities Overview
>
> The discussion results in the following summary and resolution:
>
> 1. Wealth Management will amend its incentive structure with a view to support the growth of the business within the Investment Bank.

(The email is included in Composite Exhibit 14).

297. This conflict became more acute when the auction markets began to crumble. If UBS did not raise rates enough, there would not be sufficient buying interest and UBS would have to take more auction rate paper onto its books. If it raised rates too high, it would either hit the maximum rates (that had been structured into the instruments to cater to the issuer clients but which were not disclosed to or known by retail investor clients) the issuer clients would become unhappy.

298. As Haumann testified, as UBS intensified what he referred to as "war-game exercises", UBS has "a balance essentially that we have to put on the table between what's responsible for our clients and what's responsible for our shareholders."

299. This conflict of interest pervaded all aspects of UBS' decision making process as to what products to distribute to its wealth management clients. With respect

to a Connecticut auction rate certificate transaction, Shulman sent an email on December 5, 2007 to Monblatt, Jackman and Wozniak. In it he states,

> Given relationship and commitment to issuer – I will approve moving forward on this transaction. However, - unless there are material changes going forward in the max rate adjustments as well as overall arcs mechanism . . I will not approve these structures in their current form going forward . . .

He then, in the same email chain, stated: "Amy, there should be no larger priority at this time – I need you to work with your team to go on a campaign for moving this product . . no kidding. . this is a critical time for us as a business - - and we need 100 percent focus." (See Composite Exhibit 21)

300. Similarly, there is another email chain where the group is considering, at the end of November 2007, issuing more Student Loan ARCS. Despite the growing concerns about the ability to successfully market this product to wealth management clients, the pitch for issuing these was based on how good a client the issuer was for the investment banks. (See Composite Exhibit 21).

301. This conflict caused them to bring deals to market that they know had a possibility of not being able to clear immediately after issuance. (See December 5, 2007 email from Shulman to Gallichio, Jackman and Monlatt included in Composite Exhibit 21).

302. As UBS' awareness of the lack of viability of its auction products became more poignant, Shulman's personal conflict intensified. Shortly before UBS pulled out of its ARS program, Shulman, in an email dated February 8, 2008, to Wolf, confesses his concerns with respect to the conflicts that found himself in:

> Robert,

> As you are aware, I will be presenting to the ERC on Tuesday to discuss the status of the Short Term Municipal issues and hopefully look to receive some closure or decision on the firm's overall posture and position with respect to the short term municipal market pressure we currently face. **I need to write this note to you to express that I am extremely conflicted in the role that I currently am in as Head of the MSG within the IB. While as a shareholder and dedicated employee, I am trying to walk the fine line and balance between managing market risk with overall franchise risk for UBS. In my functional role as Head of the MSG, I must communicate that I am not comfortable at all with the current risks that we in the IB are taking on with respect to ARCS (most specifically Student Loan) exposure. To me, for the IB – the risks of accumulating more positions are real and very significant, and while I do most certainly understand and deeply appreciate all the dynamics at hand from a franchise perspective, we must fully understand what position we put the IB and the MSG group in by continuing to support the auctions.** I do not like this risk nor would I look to accumulate this risk. I am most concerned (less about credit quality) but about the possibility of "max rate" reset features on these instruments. At some point – and every program is different, when these resets occur (and they will happen – all designed to protect the integrity of the cash flows of the trust estate), the coupon or reset rate adjusts downwards to float above t-bill rates…which will create an instrument that will yield and pay substantially below market rates (ie : t bills +120 bps) instead of LIBOR +75-+100. When this occurs, no doubt – this will result in large selling on behalf of WM clients and the IB owning substantial inventory being carried at well below funding costs (negative carry) and potentially 100bps below current "market" rates for that size position. This could mean owning up to theoretically 15-15bn of paper costing UBS 100bps+ just to carry and fund on an unsecured basis-could mean substantial real costs for the firm. Many of our competitors' decisions recently are now forcing our hand to make some very difficult decisions that obviously have many implications. I just thought appropriate to communicate to you, my deep concerns about the substantial risks we in the MSG are assuming, and how much this can compromise our overall Municipal franchise and quite frankly – all solely in an effort to support of our WM client franchise. [Emphasis added]

(See Composite Exhibit 21).

303. These conflicts were not disclosed to UBS Financial Services' clients until after UBS' auction program failed.

304. Not surprisingly, five days later (on February 13), UBS resolved this conflict between itself and it customers in its own favor.

305. As the auction rate market began to implode in August 2007 and the meltdown gained intensity through the end of 2007 and January 2008, customers were not informed of any of the problems. In fact, as is discussed in detail above, they were actively encouraged to buy ARS.

306. Tellingly, an email dated April 1, 2008 from Robert Michlovich to the various sales distribution lists, contains a synopsis of a call Hoekstra had with the Wealth Management network on April 1, 2008. That synopsis contained a heading "ARS Update," in which Hoekstra stated that UBS didn't announce in January as it accumulated ARS that it may let some auctions fail for the following reasons:

> 1.) we didn't know the auction market would eventually fail, we planned on continuing to prop up auctions (similar situation happened in 2004 and the market fixed itself) 2) we didn't know how long/cost it would take to keep supporting the auction market.
>
> **If at any moment UBS announced that we weren't as committed in auctions, it would have been the same as giving up on auctions.** [Emphasis added]

(The email is included in Composite Exhibit 21).

307. On February 21 and 22, 2008, Gallichio and Shulman had a telling exchange about this conflict. In that exchange, Galichio described the conflict as "risk management vs client franchise . . . IB balance sheet vs WM clients." (The email is included in Composite Exhibit 21).

8. *UBS Financial Advisors Were Not Apprised of this Back Story; Rather They Were Encouraged, Right Until UBS Pulled the Plug, to Keep Selling ARS*

308. Up through at least February 8, 2008, FAs were informed as follows:

> The public auction market continues to clear hundreds of auctions daily, with lead-broker-dealers frequently bidding to clear auctions where needed. While broker-dealers are not obligated to bid in auctions, we do not have reason to change our current practice when UBS is lead underwriter.

(See Composite Exhibit 22).

309. This message came one day after Shulman, in a February 7, 2008 email to Jackman, Gallicho and Mohanty, on the topic of whether UBS was contemplating failing auctions (included in Composite Exhibit 23), stated, with respect to UBS' auction rate program: "clock ticking-not sustainable." (See Composite Exhibit 23).

310. On February 8, 2007 UBS conducted a call with its Wealth Management FAs.

311. Prior to the call, in an email sent in the morning of February 8, 2008 to Shulman, Jackman asked: "How can Chris [Long] do this call? All the FA's will have one question on supporting?" (The email is included in Composite Exhibit 23).

312. On the call, Long, Hausmann and another speaker acknowledged the stress in the auction rate market and explained to FAs that UBS had, in fact, been propping up the auctions with its support bids but that its ongoing support was not guaranteed. However, (in contrast with the internal discussions outlined in Section VI(B)(6) above), the tone of the call was markedly upbeat with respect to UBS' auction markets. For example, they stated that "once again, a full week of auctions . . . have gone off successfully here at UBS" and that "some of our clients are beginning to look

at the auction market securities space, not just for their cash, you know, equivalent allocation, but within the fixed income allocation."

313. In addition, Long stated: "Everything that we are supporting is up in inventory and is available for sale; that would give you the measure of degree that the firm commitment behind continuing our role as lead broker/dealer on those auction securities." After apprising the FAs that UBS was stepping in to support auctions, Luby stated "there's a lot of demand, you know, from both the sale and the buy side going on as well as UBS stepping in to help facilitate the auctions."

314. At one point, one of the speakers stated: "as we all know in equities, volatility creates opportunity. So if you're having a conversation with a prospect and somebody's concerned about what's going on, maybe send them the WMR report, follow up and say, `You know our lead analyst is talking here about what's going on here factually, but it may create opportunity. Lets talk a little bit about it.'"

315. When asked by a Financial Advisor "(A) do we have a threshold as a firm as to the amount of money we're willing to commit to prevent failed auctions and (b) if we do have some threshold, are we close to it?" Long opined:

> I think, obviously, that there's probably many on the call who have a similar question around the threshold or is there a magic number, or you know, seeing inventories on a day-to-day basis increase and knowing that you're on the front line and you have clients who are selling, is there going to come a point in time that the window is shut and I think our statement remains the same as it's been on the last few calls and the statement is that UBS will continue to honor the market developments and will also make decisions that they feel are best for their clients and their shareholders. I am of the firm belief, and again, this is my opinion, **I am of the firm belief that we will make decisions or this organization will make decisions based on what they feel is best, not what other broker/dealers, not what other financial institutions are doing**. So the currents of failed auctions out of Piper Jaffray, or Goldman

> Sachs or Lehman Brothers in no way, shape or form, you know, play into a decision that UBS doing all their – having performed all their due diligence will make a decision based on the best outcome for their clients and their shareholders. [Emphasis added]

316. At that point Hausmann jumped in and added: "I would just add – this is Jim Hausmann. I think we need to look at our actions and I think our actions speak loudly in terms of where we've been on our auctions . . ."

317. On the call, none of the speakers discussed the problems they were having with the maximum rates on Student Loan ARCS. Rather, Hausmann generically stated: " I think that in most cases, the max rate is not designed to be helpful to the issuer of the security. It's actually designed to be punitive to the issuer and it's designed to be more helpful to the investor for essentially giving up that liquidity at a failed auction, so you're going to see that issuer become motivated at that point in time to consider all their alternatives."

318. The third speaker closed the call with the following reassuring statement:

> just to clarify again, you know, generally speaking, the public auction continues to be very effective for the ARS. It's clearing hundreds of auctions daily. In a lot of cases, lead broker/dealers are bidding to clear auctions when needed. That has been the practice of UBS in the past. If you look at the developments and the credit markets since August of 2007, UBS has not failed any public ARC or APS auction where it was lead manager. The firm will continue to monitor developments so that we can responsibly serve our clients and our shareholders.

319. On that call, FAs were also directed to Kathleen McNamara's Municipal Report titled "Short-term market disruption," attached as Exhibit 24 in

which she innocuously stated: "Keep in mind, the risk of failed auctions (though rare) has risen."

320. Those FAs were encouraged to, and did, make sales of ARS to Massachusetts clients up until the last auction cleared on February 12. For example, according to information produced by UBS to the Division, in the thirty days prior to the auction failures on February 13, 2008, two hundred and thirty-seven Massachusetts investors purchased over one hundred and ninety million dollars of ARS. In the five days during which auctions were held prior to the auction failures, seventy-eight Massachusetts investors purchased over fifty million dollars of ARS.

321. In an email dated February 12, 2008 titled "Inventory" from Scoby to Shulman and others, he stated: "we need to beat the bushes harder than ever to unload this paper." (See Exhibit 25).

322. In stark contrast to Shulman's sales of his personal holdings of ARS in August and December 2007 as the pressure on UBS' auction program increased and concerns were raised about the viability of the program, customers and FAs who were kept in the dark about UBS' concern about the viability of the program and UBS' wavering commitment to the program, found themselves stuck.

323. FA Lips confirmed in testimony before the Division that he first became aware that UBS was considering ceasing its support for its ARS program after the auctions failed on February 13, 2008.

324. Further, Lips testified that had he known UBS was considering withdrawing its support of its ARS program, he would have instructed his group to alter its approach to selling ARS.

325. In addition, Lips testified that he personally owned ARS and that had he known that UBS was considering withdrawing its support, he would have been interested in selling those positions. In fact, Lips opined, "I think I'd have significant company in that regard."

9. *UBS Pulls the Plug On February 13, 2008*

326. UBS Financial Services' FAs kept selling ARS through February 12, 2008.

327. On February 13, without any notice to its customers who had purchased ARS, UBS failed its auctions for ARS.

C. UBS' Post-Failure Actions

1. *Conflicting Reasons Provided by UBS for Failed Auctions*

328. In a February 13, 2008 conference call to FAs , Hoekstra emphasized the following points:

> UBS has made a choice in recent weeks to bid in auctions in spite of the fact that we are not obligated to do so. We have made a choice in recent days to bid in spite of the fact that our competitors don't. Given the overall situation with regard to credit and the UBS fund sheet, we're making the decision today to not be the only important dealer bidding in the market.
> . . .
> [T]he simple fact is that the primary problem with these securities is that they have maximum rate caps and that in the current rate environment some of them either have or will reset unattractive rates and many people don't want to own them at those rates. That's what's really going on.

329. Certain FAs sent letters to clients that explained the failures as follows (See Composite Exhibit 26):

> UBS worked to maintain liquidity during this unprecedented time of instability by purchasing securities in the auction markets.

> However, as part of our regular and ongoing evaluation of markets and or allocation of capital, we have determined that we should not continue to add to our positions at this time.

330. In a letter dated March 7, 2008 to retail clients, Hausmann explained the failure of UBS' auction markets as follows:

> As you may be aware, there has been a disruption in the auction rate securities (ARS) market due to a decline in investor demand. As a result, many of these auctions have failed.

(See Composite Exhibit 26).

331. By focusing on the decline in investor demand, Hausmann obviously neglects to mention that UBS intentionally allowed these auctions to fail because it did not want to take any more auction rate paper onto its books.

2. *Broad Disclosures Finally Provided*

332. On April 11, 2008, UBS, for the first time, posted on its website a comprehensive disclosure of its role in the auction markets. (See Exhibit 27).

333. Relevant portions of UBS' Auction Rate Practices and Procedures, which were first made available to investors in April 2008, include the following:

> **Bidding by UBS in Auctions:**
>
> UBS is permitted, but not obligated, to submit proprietary orders in auctions for ARCs or APS, either as a buyer or seller, and routinely does so. **When UBS submits a proprietary order, it has an advantage over investors who are bidders because it knows about the orders placed by its customers. Therefore, UBS can determine the rate and size of its own order. This increases the likelihood that its order will be accepted in the auction and that the auction will clear at a particular rate. For this reason, and because UBS is compensated by the issuer or conduit borrower for its services as broker-dealer, UBS may have a conflict of interest with its customers**. In a competitive auction (as defined above, one in which there is more than one broker-dealer accepting orders), UBS would not have knowledge of orders submitted to the auction agent by any other broker-dealer. **In a**

sole-managed auction, UBS would be the only broker-dealer submitting orders to the Auction Agent. As a result, UBS could calculate the clearing rate before the orders are submitted to the auction agent and set the clearing rate with its order.

> . . .
>
> Bids by UBS are likely to affect the auction rate, including preventing the auction rate from being set at the maximum rate or otherwise causing bidders to receive a lower rate than they might have received had UBS not bid. Bids by UBS are also likely to affect the allocation of the ARCs or APS being auctioned, including causing some bidders to have their bids rejected or receive fewer securities than they would have received had UBS not bid. [Emphasis added]
>
> **Other Investor Concerns/Risks:**
>
> ***Suitability:*** ARCs and APS may not be suitable for all investors. The minimum denomination is $25,000, and purchases in excess of $25,000 must be in $25,000 multiples. **Money market funds are generally precluded from investing in ARCs and APS because there is no guaranteed put feature on the bond**. These securities may not be suitable for income-oriented investors or investors with a long-term investment horizon. Please contact your tax advisor regarding the suitability of tax-exempt investments in your portfolio. [Emphasis added]

(See Exhibit 27).

334. This document was not available to UBS customers or FAs prior to April 2008.

335. Prior to April 2008, UBS had created a document "Putting Liquidity to Work: A Guide to Cash Alternatives," (A copy of which is attached hereto as Exhibit 28).

336. According to counsel for UBS, this document was posted on UBS Financial Services' public website from October 17, 2007 through the end of February 2008. It contains a milder version of some of the disclosures contained in Exhibit 27.

The document also stated that "[y]our UBS Financial Advisor can help you understand the advantages and risks of" ARS and that "your financial advisor can help you understand if any of these cash alternatives may be an appropriate solution to help you preserve principal, maintain credit-worthiness or keep your assets liquid."

337. None of the customers the Division spoke to were aware of this document or any of the disclosures contained in it.

338. Materials produced by UBS from the files of the FAs servicing Massachusetts customers indicate that this document was occasionally but not consistently distributed to customers.

339. One customer stated to the Division in an April 14, 2008 in which he enclosed the newly-available "Auction Rate Practices and Procedures", "ATTACHED JUST APPEARED ON A BLOG WE HAVE BEEN FOLLOWING. HAD WE EVER BEEN SHOWN IT BEFOREHAND WE NEVER WOULD HAVE PURCHASED ANY." (See Composite Exhibit 27).

3. *UBS Sought to Profit from the Desperate Situation Issuers Found Themselves in*

340. Within a day after failing its auctions and leaving investors stuck with instruments that were no longer liquid, UBS seized upon the opportunity to profit from this calamity of its own making.

341. The municipal ARS that UBS had underwritten typically did not have a cap on the interest rate (other than applicable maximum rates set by state law). Accordingly, when UBS pulled out of its auction markets, these securities—after an initial period of disruption, began to clear the market at much high rates that they had cleared at prior to the February disruption.

342. These municipal ARC auctions began to clear at interest rates up to 15 percent per annum.

343. These rates put an extreme burden on the municipal issuer clients who had to pay these rates.

344. Seeing the pain that this situation was causing, Mohanty sent an email on February 14 to Shulman in which she states:

> After the fails—I am being bombarded!!!! Every muni issuer (even just our arcs) are asking for [letter of credit] to convert. **We have a money making opportunity!!! We are rarely in the leverage position**. I think we should [sic] as much of our capacity as possible for core munis – **they are desperate**. . . . [Emphasis added]

(See Composite Exhibit 29).

345. Shulman responded: "Am aware – sit tight – we are at the gates—great chance for us to step in." (See Composite Exhibit 29).

346. Later on February 14, Shulman sent an email to Mohanty, which stated, in relevant part:

> unprecedented opportunity to restructure a 300 bn overall failed auction market. . we have the relationships, access, expertise to be a true differentiator in the industry . . we need to have the tools to be able to take advantage of this situation so that we can continue to service wm as well as bring value added revenues to the ib . . .

(See Composite Exhibit 29).

347. In another February 14, 2008 email, Shulman referred to this as "the single greatest opportunity in decades for us to leverage our banking relationships more now than ever as we embark on a journey to restructure a 300 bn market in arcs . . . **This is a bankers dream market**." [Emphasis added] (See Composite Exhibit 29).

4. *UBS Putting Misleading Spin on U-4 Filings*

348. In a document dated March 12, 2008 titled Regulatory Reporting of ARS Client Complaints," UBS stated:

> Due to the complexity and sensitivity of the ARS issues, when making U4 filings the Firm, where appropriate, will add language that the complaint was due to the market dislocation.

(See Exhibit 30).

349. When disclosing a customer complaint using the form U-4 on the CRD, the registrant is given an opportunity to "provide a brief summary of the circumstances leading to the customer complaint, arbitration/CFTC reparation and/or civil litigation as well as the current status or final disposition(s)."

350. In response to this question for most, if not all, of UBS Financial Services' U-4 Amendments reporting customer complaints relating to ARS, UBS Financial Services stated: "THE COMPLAINT AROSE BECAUSE OF UNPRECEDENTED MARKET EVENTS THAT CAUSED THE BREAKDOWN OF LIQUIDITY IN THE MARKET FOR ARS."

351. In light of the facts set forth above this characterization of the complaint arising "because of unprecedented market events" is misleading.

352. In particular, the term "unprecedented" is misleading given the fact that UBS voluntarily walked away from certain of its ARS and intentionally let those fail in August 2007.

353. In addition, the characterization that the complaints "arose" because of unprecedented market events is misleading because they arose, at least in large part,

from how UBS marketed these products to customers and UBS' lack of meaningful disclosures about its auction program.

5. *Loans to Clients*

354. UBS consistently refused clients' demands to purchase back the ARS that had been sold to them.

355. UBS offered to loan clients money using the ARS as collateral.

356. Under the loan scenario, the loans would be the personal obligations of the client. The client would not be able to use the ARS to pay down the debt unless and until those securities became liquid again.

357. On the question of whether those clients who had partaken of this loan program would be able to leave UBS, Hausmann testified as follows:

> Q. If someone owns one of these securities, a UBS Financial Services client, and they have the loan out from UBS and they decide to leave UBS and go to another broker-dealer, they'd still owe the money to UBS?
>
> A. Yeah, no, if there's a loan and so specifically if there's a loan versus the collateral, I believe that they would require to be – keep that collateral at our firm.
>
> Q. So those people couldn't leave UBS as clients until they paid off the loan, is that –
>
> A. That's correct, they could pay off the loan and then once they were – the loan, the terms of the loan were satisfied they could move their securities.

5. *UBS Began Selectively Clearing Auctions*

358. After the auctions failed, Shulman requested and obtained authorization to selectively clear auctions.

359. In a February 15, 2008 email from Shulman to Jackman, he stated: "You can selectively . . . step in to clear auctions – where appropriate – also failed auction paper you can trade—do not want inventory to go any higher by 500 mm from where we are." (The email is included in Composite Exhibit 31).

360. In an email dated March 1, 2008 to Long and Schwyter, Shulman stated: "we have authorization from Scoby to selectively step in and clear auctions where we see appropriate to facilitate WM for their needs—the approved amount is up to 500 mm. The intent is solely to service our WM partners and we are choosing to do so only on core muni arcs where max rate resets are very high." (The email is included in Composite Exhibit 31).

361. When asked why they were focusing on core municipal auction rate certificates and not Student Loan ARCS, Shulman testified: "on the student loan side we did not have enough information where we felt comfortable enough participating in those auctions in failed mode." When pressed on what he meant by this, he stated: "We needed – we needed to get more – more –more documentation on – on understanding the – on understanding what happens in failed mode on the student loans." When asked: "wouldn't you have understood that already before any of these products were sold?" he responded: "We needed more information, okay, in terms of how these would behave as a failed instrument in failed mode in student loans."

362. On page two of the March 1 email chain, an email from Long states: "We roughly put up $36MM for deals with "A" or better underlying ratings, whose

max rates are fixed at 12%-15%. All core muni issuers for which we are seeing stronger demand. While at the same time, albeit small, injecting some liquidity for the individual retail investor type who are looking to sell ARS regardless of their max rate." When Shulman was asked how it was decided which retail investors to provide liquidity for, Shulman testified that, despite the fact that he had obtained authorization for this program, he did not know: "I don't know how we determined which investors and or which issues, aside from the high max rate paper, we were deciding to be able to step in and clear." (The email is included in Composite Exhibit 31)

363. In Shulman's on-the-record testimony before the Division, he stated "I can't tell you the parameters and how we selected which auctions we chose to allow to clear." When, asked "so, who would be aware of those parameters?" he answered "Chris Long would." Ironically, in an email to Long dated March 1, 2008, when asked whether UBS had decided to start supporting auctions again, "what our policy exactly is" and "what are the set/agreed limits around starting to support auctions again?", Long forwarded the email to Shulman, stating "I think you are better fit to answer the follow up questions." Shulman replied: "Yup doing now." (The email is included in Composite Exhibit 31)

D. Books and Records Violations

364. As of the date of this Administrative Complaint, UBS has not provided a complete response to the subpoenas served on March 28, 2008 (the "March 28 Subpoena").

365. UBS' response to Documents Request No. 6 is one example of the number gaps in production.

366. Document Request No. 6 stated: "Provide all marketing materials and disclosure documents provided by UBS Personnel [from January 1, 2007 to the present] to Massachusetts customers pertaining to ARS." The production date specified in the March 28 Subpoena was April 11, 2008. Upon request of UBS, the Division granted an extension of this deadline to April 18. On April 21, the Division received a letter dated April 18, 2008, which indicated that UBS had only provided firm-wide pre-approved ARS marketing materials available for use by FAs "that were likely provided to Massachusetts customers." UBS indicated, without having obtained an extension from the Division, that the remaining material would be produced before May 2. On May 2, the Division received "hard-copy marketing and disclosure documents collected from Financial Advisors' client files and branch management files at ten Massachusetts branch locations." By letter dated May 21, the Division stated:

> In Document Request No. 6, the Massachusetts Securities Division (the "Division") requested "all marketing materials and disclosure documents provided by UBS Personnel to Massachusetts customers pertaining to ARS."
>
> UBS responded with pre-approved marketing materials and "hard-copy marketing and disclosure documents collected from Financial Advisors' client files and branch management files at ten Massachusetts branch locations." The Division did not authorize any limitation on the scope of this request. If Massachusetts clients were serviced by Financial Advisors outside of those ten locations, then all responsive documents from the other locations must be produced. In addition, if Massachusetts clients were serviced by locations outside of Massachusetts, such as Thomas Lips' group's office in Connecticut, then responsive files from those locations must be provided as well.

367. The remaining portion of Document Request No. 6 has not been provided. In fact, by letter dated June 16, 2008 indicating that it "aims to complete this production by July 14, 2008," more than three months after the subpoena was sent.

368. UBS' inability to produce FA files, which are basic business records, to the Division in a timely manner violate the provisions of the Act and Regulations set forth in Section VIII below.

369. In addition, UBS' failure to retain copies of its conference calls to its FAs (especially those which were recorded for playback at a later date) constitutes books and records violations.

VII. VIOLATIONS OF SECURITIES LAWS

A. COUNT I – VIOLATIONS OF §101 BY UBS SECURITIES AND UBS FINANCIAL SERVICES

370. Section 101 of the Act provides in pertinent part:

> It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly:
>
> (1) to employ any device, scheme or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

371. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 370 above.

372. The conduct of UBS, as described above, constitutes violations of M.G.L. c. 110A, § 101.

B. COUNT II – VIOLATIONS OF § 204 (a)(2)(B) BY UBS SECURITIES AND UBS FINANCIAL SERVICES

373. Section 204 (a)(2)(B) of the Act provides in pertinent part:

> (a) The secretary may by order impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action if he finds (1) that the order is in the public interest and (2) that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser:–
>
> (B) has willfully violated or willfully failed to comply with any provision of this chapter . . . .

374. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 373 above.

375. The conduct of UBS as described above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(B).

C. COUNT III – VIOLATIONS OF § 204 (a)(2)(G) BY UBS SECURITIES AND UBS FINANCIAL SERVICES

376. Section 204 (a)(2)(G) of the Act provides in pertinent part:

> (a) The secretary may by order impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action if he finds (1) that the order is in the public interest and (2) that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser:–
>
> (G) has engaged in any unethical or dishonest conduct or practices in the securities, commodities or insurance business.

377. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 376 above.

378. The conduct of UBS as described above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(G).

379. Without limiting the generality of the foregoing, the conduct of UBS set forth above constitutes violations of the following provisions of the Regulations:

950 CMR Section 12.204 (1)(a):

> (4) Recommending to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that such transaction or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer.
>
> (6) Exercising any discretionary power in effecting a transaction for a customer's account without first obtaining written authority from the customer, unless the discretionary power relates solely to the time and/or price for the execution of the order.
>
> . . .
>
> . . . (14) Representing that a security is being offered to a customer "at the market" or a price relevant to the market price unless the broker-dealer knows or has reasonable grounds to believe that a market for such security exists other than that made, created or controlled by such broker-dealer, or by any person for whom he/she is acting or with whom he is associated in such distribution, or any person controlled by, controlling or under common control with such broker-dealer.
>
> (28) Failing to comply with any applicable provision of the NASD rules of Fair Practice.

380. Without limiting the generality of the foregoing, applicable NASD rules include the following:

> **2310. Recommendations to Customers (Suitability)**
>
> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such

customer as to his other security holdings and as to his financial situation and needs…

IM-2310-2. Fair Dealing with Customers

(a)(1) Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public…

2760. Offerings 'At the Market'

A member who is participating or who is otherwise financially interested in the primary or secondary distribution of any security which is not admitted to trading on a national securities exchange, shall make no representation that such security is being offered to a customer "at the market" or at a price related to the market price unless such member knows or has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by such member, or by any person for whom he is acting or with whom he is associated in such distribution, or by any person controlled by, controlling or under common control with such member.

2110. Standards of Commercial Honor and Principles of Trade

A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.

2120. Use of Manipulative, Deceptive or Other Fraudulent Devices

No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.

2210. Communications with the Public

(d) Content Standards

(1) Standards Applicable to All Communications with the Public

> (A) All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.
>
> (B) No member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. No member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading. . . .

D. COUNT IV – VIOLATIONS OF § 204 (a)(2)(J) BY UBS SECURITIES AND UBS FINANCIAL SERVICES

381. Section 204 (a)(2)(J) of the Act provides in pertinent part:

> The secretary may by order deny, suspend, or revoke any registration if he finds (1) that the order is in the public interest and (2) that the applicant or registrant (J) has failed reasonably to supervise agents, investment adviser representatives or other employees to assure compliance with this chapter.

382. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 381 above.

383. The conduct of UBS, as described above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(J).

E. COUNT V – VIOLATION OF SECTION 203 BY UBS SECURITIES AND UBS FINANCIAL SERVICES

384. Section 203(a) of the Act states:

> Every registered broker-dealer and investment advisor shall make and keep accounts, correspondence, memoranda, papers, books, and other records as the secretary prescribes by rule or order.

385. 950 CMR Section 12.203(2) states in relevant part:

Each broker-dealer shall maintain the following records: . . .

(b) All records required to be maintained by SEC Rules 17a-3 and 4 (17 CFR 240.17a-3 and 17CRF 240.17a-4).

(c) All records required to be maintained by any SRO or national exchange of which the broker-dealer is a member.

386. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 385 above.

387. The conduct of UBS, as described above, constitutes violations of M.G.L. c. 110A, § 203.

VIII. STATUTORY BASIS FOR RELIEF

Violations, Cease and Desist Orders and Costs

388. Section 407A(a) of the Act provides in pertinent part that:

> (a) If the secretary determines, after notice and opportunity for a hearing, that any person has engaged in or is about to engage in any act or practice constituting a violation of any provision of this chapter or any rule or order issued thereunder, he may order such person to cease and desist from such unlawful act or practice and may take affirmative action, including the imposition of an administrative fine, the issuance of an order for accounting, disgorgement or rescission or any other relief as in his judgment may be necessary to carry out the purposes of [the Act].

389. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 388 above.

390. UBS directly and indirectly engaged in the acts, practices, and courses of business as set forth in this Complaint above, and it is the Division's belief that UBS will continue to engage in acts and practices similar in subject and purpose, which constitute violations if not ordered to cease and desist.

IX. PUBLIC INTEREST

For any and all of the reasons set forth above, it is in the public interest and will protect Massachusetts investors to provide the relief requested in Section X below.

X. RELIEF REQUESTED

Wherefore, the Enforcement Section of the Division requests that Hearing Officer take the following action:

A. Find that all the sanctions and remedies detailed herein are in the public interest and necessary for the protection of Massachusetts investors;

B. Find as fact the allegations set forth in paragraphs 1 to 390 of the Complaint; and

C. Enter an order (a) requiring UBS to permanently cease and desist from committing any further violations of the Act and Regulations, (b) requiring UBS to offer rescission of sales of ARS at par (or restitution to investors who have already sold below par) on the terms and conditions that a Hearing Officer deems appropriate, (c) censuring UBS (d) requiring UBS to pay an administrative fine in an amount and upon such terms and conditions as a Hearing Officer may determine, and (e) requiring UBS to take any other action that a Hearing Officer may deem appropriate in the public interest and necessary for the protection of Massachusetts investors.

ENFORCEMENT SECTION
MASSACHUSETTS SECURITIES DIVISION

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