

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 78958 / September 28, 2016**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-17587**

**In the Matter of**  
  
**UBS Financial Services Inc.**  
  
**Respondent.**

**ORDER INSTITUTING**  
**ADMINISTRATIVE PROCEEDINGS**  
**PURSUANT TO SECTION 15(b)(4) OF THE**  
**SECURITIES EXCHANGE ACT OF 1934,**  
**MAKING FINDINGS, AND IMPOSING**  
**REMEDIAL SANCTIONS**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b)(4) of the Securities Exchange Act of 1934 (“Exchange Act”), against UBS Financial Services Inc. (“UBS” or “Respondent”).

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b)(4) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions (“Order”), as set forth below.

**III.**

On the basis of this Order and Respondent’s Offer, the Commission finds<sup>1</sup> that:

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<sup>1</sup> The findings herein are made pursuant to Respondent’s Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

## Summary

1. During the period from 2011 through 2014 (“Relevant Period”) UBS failed reasonably to supervise its personnel with a view toward preventing violations of the federal securities laws. UBS, through its Capital Markets Structured Solutions unit (the “Structured Solutions Desk”), failed to develop and implement policies and procedures reasonably designed to educate and train UBS registered representatives in connection with the Structured Solutions Desk’s single stock-linked reverse convertible notes (“RCNs”) business so that they could adequately understand the risks and rewards of the product such that the registered representatives could form a reasonable basis to make suitable recommendations to certain customers. Without adequate education and training, certain registered representatives made unsuitable recommendations in relation to the offer and sale of these RCNs to certain customers in light of their investment profiles.

2. During the Relevant Period, the Structured Solutions Desk structured approximately 2,500 different RCNs based upon 425 different underlying stocks. These products contained embedded derivatives. Among other criteria, the Structured Solutions Desk selected underlying single stocks with implied volatility sufficient to support attractive coupons and downside protection levels and incorporated into the products risk-neutral, model-derived risks of loss which ranged from a minimum of a 10% risk of a 20% loss to a maximum of a 40% risk of some loss.

3. UBS sold approximately \$10.7 billion of notional RCNs to approximately 44,000 customer accounts during the Relevant Period. These RCNs were offered for purchase by retail customers as a way to enhance yield while providing some downside protection. During the Relevant Period, UBS sold approximately \$548 million of notional RCNs (about 5.1% of total sales) to 8,743 UBS retail customer accounts, many of whom had little or no relevant investing experience and had identified to UBS modest reported income and net worth, primarily moderate or conservative investment objectives, and some of whom were retired. Nearly all of these transactions were recommended transactions by UBS registered representatives.

4. Because of the Firm’s inadequate education and training, certain UBS registered representatives did not adequately understand certain aspects of the RCNs, and thus they did not always form a reasonable basis to determine that the RCNs were suitable for certain customers. This conduct constituted a course of business that violated Section 17(a)(3) of the Securities Act of 1933 (“Securities Act”).<sup>2</sup>

5. UBS’s supervisory policies and procedures thus were not reasonably designed and implemented to provide effective oversight of the training, education and recommendations of the registered representatives to prevent and detect violations of the Securities Act. As a result, UBS

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<sup>2</sup> A violation of Section 17(a)(3) (prohibiting engaging in any course of business that operates or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities) may rest on a finding of simple negligence; scienter is not required. *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 453-54 (3d Cir. 1997).

failed reasonably to supervise its registered representatives within the meaning of Exchange Act Section 15(b)(4)(E).

### **Respondent**

6. UBS is a subsidiary of UBS AG that provides wealth management services in the United States and is registered with the Commission as a broker-dealer and investment adviser. UBS sold more than \$19.6 billion of structured notes in the Relevant Period, the majority of which were RCNs. UBS is incorporated in Delaware, and has its principal place of business in New York, New York.

### **Facts**

#### **Design and Sale of the Product**

7. The introduction of a new product for sale by UBS was subject to oversight and direction by its New Business and Complex Transactions policy and process, which was implemented by the New Business Control group (“NBC”). The NBC in relevant part approved the selling of RCNs by the Structured Solutions Desk after assessing both the need for appropriate registered representative training and educational materials when a new product was being offered, and the UBS-determined minimum customer eligibility levels.

8. Although there are several variations or structures, single stock-linked RCNs are a type of structured product issued by a financial institution as an unsecured debt obligation that is linked to the performance of an underlying single stock. UBS’s single stock-linked RCNs at issue involved certain complex structures, including: (1) Trigger Yield Optimization Notes; (2) Trigger Autocall Optimization Securities; (3) Trigger Phoenix Autocall Optimization Securities; (4) Airbag Yield Optimization Notes; and (5) Airbag Autocallable Yield Optimization Notes. Each of these structures is described in more detail in Exhibit A.

9. Single stock-linked RCNs are structured to pay a higher interest rate than conventional debt of the same issuer because of the inclusion of the embedded derivative that provides essentially a synthetic put on the underlying stock. Single stock-linked RCNs also typically provide some downside protection to investors, as long as the underlying stock does not close below a specified price or “trigger.”

10. In exchange for an attractive coupon rate and some downside market protection, the investor risks not receiving his full principal at maturity, depending on the performance of the underlying stock. Certain of the single stock-linked RCNs structured by the Structured Solutions Desk were “autocallable” – meaning the issuer will call the security if the stock is trading at or above a certain price on specified “observation dates,” which creates additional complexity and different risk of loss for investors.

11. A key aspect of the structure of the RCNs is the embedded derivative, which involves payoff profiles similar to those of complex options. Single stock-linked RCNs are the economic equivalent of the issuer selling a bond to the RCN purchaser and the RCN purchaser selling – or being “short” – a put option on the underlying stock to the issuer. These options have features that make them different from and potentially more complex than commonly traded

options. For example, the “kick in” or “knock in barrier” options used as an underlying component of an RCN require a certain price level – or “barrier” – to be reached as of the option’s expiry date to be exercisable, an event referred to as “kicking in” or “knocking in.” When the Structured Solutions Desk solicited competitive bids from issuers for the single stock-linked RCNs it designed, it described the embedded derivative from what it characterized as “the investor’s perspective” so that there would be no confusion as to the product that the Structured Solutions Desk intended to create. For example, for the structures listed below, the Structured Solutions Desk generally described to potential issuers the embedded options from the investor’s perspective in the competitive bid request, as follows:

<b>Structure</b>	<b>Option Legs (from investor’s perspective)</b>
Trigger Yield Optimization Notes	Long par bond Short 1 European [Kick In or Knock In (“KI”)] put
Trigger Autocall Optimization Securities	Long series of 100% strike digital calls Short 1 100% strike put with European KI barrier
Trigger Phoenix Autocall Optimization Securities	Long series of 100% strike digital calls Short 1 100% strike put with European KI barrier
Airbag Yield Optimization Securities	Long par bond Short (1/conversion price) conversion price European puts
Airbag Autocallable Yield Optimization Notes	Long par bond Short (1/conversion price) conversion price European puts Long series of four 100% strike digital calls

12. A second key aspect of the RCNs is the role of implied volatility in the selection of the underlying stocks. Implied volatility represents the market’s assessment of the risk and expected future volatility – or uncertainty regarding the magnitude of changes in the market value – of a stock and is determined largely by observing the prices of options on that stock in the listed options markets. Among other criteria, the Structured Solutions Desk selected stocks that had implied volatility sufficient to generate attractive coupons and downside market protection levels. For example, approximately 75% of the stocks the Structured Solutions Desk chose as RCN underlying securities during the Relevant Period were constituents of the S&P 500 or were large capitalization foreign issuers similar to the constituents of the S&P 500 based on market capitalization. When that 75% of underlying stocks is compared to the constituents of the S&P 500, about 83% of the stocks chosen by the Structured Solutions Desk were in the top half of the distribution of implied volatilities within the S&P 500 at the time that those RCNs were issued, and about 45% were in the top 20% of implied volatilities.

13. A third key aspect of RCNs structured by the Structured Solutions Desk is the potential for breach, meaning the risk that the underlying stock would close below the specified downside market protection level or barrier, causing investor losses. The Structured Solutions Desk required that each RCN have a risk-neutral, model-derived determination of at least a 10% risk of at least a 20% loss, and no more than a 40% risk of some loss.

14. The NBC and Structured Solutions Desk authorized the selling of RCNs in increments of \$1000 for all investors. During the Relevant Period, UBS sold approximately \$548 million of notional RCNs (about 5.1% of total sales) to 8,743 UBS retail customer accounts, many of whom had little or no relevant investing experience and had identified to UBS modest reported

income and net worth, primarily moderate or conservative investment objectives, and some were retired.

### **Inadequate Education and Training**

15. The NBC and Structured Solutions Desk developed the RCN platform as a major business initiative and had an interest in widely distributing the product. UBS's supervisory policies relating to RCNs delegated to the NBC and Structured Solutions Desk, with help from other departments as appropriate, responsibility for developing substantive training and educational materials with respect to the offering of RCNs, and determining the applicable eligibility criteria for the product. The NBC and Structured Solutions Desk, however, failed adequately to educate and train UBS registered representatives who sold RCNs.

16. UBS's internal education and training primarily focused on describing the payouts for the various products, and while it included discussion of other terms of the RCNs, it did not provide adequate training on certain important aspects of RCNs. For example, although the Structured Solutions Desk provided potential issuers with information regarding the RCN option features from the "investor's perspective," internal educational materials lacked similar information. In addition, UBS's internal educational materials did not describe sufficiently the role of implied volatility and the potential for breach in the selection of the equity securities underlying the RCNs. As a result, UBS registered representatives were not adequately educated and trained to understand adequately the risk and characteristics of the product, including relevant volatility concepts and the role that volatility played in the selection of the equity securities underlying the RCNs.

### **Unsuitable Recommendations to Certain Customers**

17. This inadequate training and education led to the unsuitable recommendations of RCNs to certain of the customers who had identified to UBS modest reported income and net worth, primarily moderate or conservative investment objectives, and some of whom were retired. A customer who purchased RCNs from UBS reasonably expected his or her registered representative to sufficiently understand RCNs before recommending them. Because the policies and procedures were not reasonably designed to provide effective oversight of NBC's and Structured Solutions Desk's education and training and the registered representatives' obligation to sufficiently understand RCNs before recommending them, certain registered representatives did not sufficiently understand particular aspects of the RCNs before recommending the product to certain of these customers.

### **UBS's Failure to Supervise**

18. UBS failed to ensure that its registered representatives were adequately educated and trained in connection with the RCNs such that the registered representatives could adequately understand the risks and rewards of the RCNs to be able to form a reasonable basis that recommended transactions in RCNs were suitable for certain customers. UBS's supervisory policies and procedures thus were not reasonably designed and implemented to provide effective oversight of the training, education and recommendations of the registered representatives to prevent and detect the violations of the Securities Act outlined above.

## Conclusions

19. Under Section 15(b)(4)(E) of the Exchange Act, broker-dealers are responsible for supervising, with a view to preventing and detecting violations of the federal securities laws, persons subject to their supervision. UBS was responsible for supervising its NBC and Structured Solutions Desk in the development of its training and education of UBS's registered representatives as well as its registered representatives in making suitable recommendations to customers.

20. UBS failed reasonably to fulfill such supervisory responsibilities within the meaning of Section 15(b)(4)(E) of the Exchange Act because UBS failed to establish reasonable policies and procedures, and a system for applying such procedures, that would reasonably be expected to prevent and detect the violations of Section 17(a)(3) of the Securities Act described above.

## UBS's Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by UBS and cooperation afforded the Commission staff.

## IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent UBS's Offer.

Accordingly, pursuant to Section 15(b)(4) of the Exchange Act, it is hereby ORDERED that:

A. Respondent is hereby censured.

B. UBS shall, within twenty (20) days of the entry of this Order, pay disgorgement of \$8,227,566 and prejudgment interest of \$798,316 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center

Accounts Receivable Branch  
HQ Bldg., Room 181, AMZ-341  
6500 South MacArthur Boulevard  
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying UBS as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Reid A. Muoio, Deputy Chief, Complex Financial Instruments Unit, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

C. UBS shall, within twenty (20) days of the entry of this Order, pay a civil money penalty in the amount of \$6,000,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center  
Accounts Receivable Branch  
HQ Bldg., Room 181, AMZ-341  
6500 South MacArthur Boulevard  
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying UBS as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Reid A. Muoio, Deputy Chief, Complex Financial Instruments Unit, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

D. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, it shall not argue that it is entitled to, nor shall it benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that it shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the

Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Brent J. Fields  
Secretary



## Exhibit A

Structure	Description of Structure
<b>Trigger Yield Optimization Notes</b>	<p>Trigger Yield Optimization Notes were described as “enhanced income strategies for investors who are comfortable accepting downside equity market risk.”</p> <ul style="list-style-type: none"> <li>• Each note was to be issued for a price equal to the closing price of the underlying asset on the trade date (the initial price).</li> <li>• A monthly coupon was to be paid regardless of the performance of the underlying asset.</li> <li>• At maturity, the issuer would either repay the principal amount in cash or, if the underlying asset closed below the specified trigger price on the final valuation date, the issuer would deliver one share of the underlying asset per note, which was expected to be worth substantially less than the principal amount and may have no value.</li> </ul>
<b>Trigger Autocallable Optimization Securities</b>	<p>Trigger Autocallable Optimization Securities were described as “tactical investments designed to take advantage of flat or rising markets.”</p> <ul style="list-style-type: none"> <li>• On a monthly basis, the closing price of the underlying asset was to be observed and if it was greater than or equal to the underlying asset’s closing price on the trade date, the issuer would automatically call the securities and pay a call price equal to the principal amount plus the applicable call return. The call return increased the longer the securities were outstanding.</li> <li>• If the securities were not called, the issuer would either repay the full principal amount at maturity or, if the closing price of the underlying asset on the final valuation date was below the trigger price, the issuer would repay less than the full principal amount at maturity, if anything, resulting in a loss to investors that was proportionate to the decline in the underlying asset price over the term of the securities.</li> </ul>
<b>Trigger Phoenix Autocall Optimization Securities</b>	<p>Trigger Phoenix Autocallable Optimization Securities were described as “enhanced income strategies for investors who believe the value of the underlying asset will not decline significantly.”</p> <ul style="list-style-type: none"> <li>• On a quarterly basis, the closing price of the underlying asset was to be observed and if it was greater than or equal to the coupon barrier, the issuer would pay the coupon for that quarter. Otherwise, no coupon was to be paid for that quarter. In addition, if the closing price of the underlying asset was greater than or equal to the underlying asset’s closing price on the trade date, the issuer would also automatically call the securities and repay the principal amount.</li> <li>• If the securities were not called, the issuer would either repay the full principal amount at maturity plus the applicable coupon for the period or, if the underlying asset closed below the trigger price on the final valuation date, the issuer would repay less than the full principal amount at maturity, if anything, resulting in a loss to investors that was proportionate to the decline in the underlying asset price over the term of the securities.</li> </ul>
<b>Airbag Yield Optimization Securities</b>	<p>Airbag Yield Optimization Notes were described as “enhanced income strategies for investors who are comfortable accepting downside equity market risk.”</p> <ul style="list-style-type: none"> <li>• The issuer would pay a monthly coupon regardless of the performance of the underlying asset.</li> <li>• At maturity, the issuer would either repay the principal amount in cash or, if the underlying asset closed below the specified conversion price on the final valuation date, the issuer would deliver a number of shares of the underlying asset per note equal to the principal amount per note divided by the conversion price, which was expected to be worth less than the principal amount and may have no value.</li> </ul>
<b>Airbag Autocallable Yield Optimization Notes</b>	<p>Airbag Autocallable Yield Optimization Notes were described as “enhanced income strategies for investors who are comfortable accepting downside equity market risk.”</p> <ul style="list-style-type: none"> <li>• The issuer would pay a monthly coupon regardless of the performance of the underlying asset.</li> <li>• On a quarterly basis, the closing price of the underlying asset would be observed and if it was greater than or equal to the underlying asset’s closing price on the trade date, the issuer would automatically call the securities and repay the principal amount plus the applicable monthly coupon. No further coupon payments would be made.</li> <li>• If the securities were not called, the issuer either would repay the principal amount at maturity in cash or, if the underlying asset closed below the specified conversion price on the final valuation date, the issuer would deliver a number of shares of the underlying asset per note equal to the principal amount per note divided by the conversion price, which was expected to be worth less than the principal amount and may not have any value.</li> </ul>