

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 20070091803**

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

RE: Ferris, Baker Watts Inc., N/K/A RBC Capital Markets, Respondent
CRD No. 285

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Respondent submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Respondent alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND AND OVERVIEW

Ferris, Baker Watts, Inc. ("FBW") was a broker-dealer with its principal place of business in Baltimore, MD. RBC Capital Markets Corporation, acquired FBW in June 2008, and the integration with RBC Wealth Management was completed in March 2009. FBW no longer exists.

During the period January 2006 to July 2008 ("Relevant Period"), FBW failed to have adequate written supervisory procedures governing the sales of reverse convertible notes ("reverse convertibles" or "RCNs") and to reasonably supervise accounts that purchased RCNs. In addition, FBW did not conduct reviews of accounts that held reverse convertibles at either the branch office manager level or compliance office level for overconcentration in reverse convertibles or conduct reasonable reviews for suitability compatibility with certain customer profiles, such as age and net worth.

FBW also did not have reasonable grounds to believe that the recommended sales of reverse convertibles were suitable for 57 accounts held by customers 85 years

old and older and customers who had a stated net worth of under \$50,000 (among approximately 2,000 FBW accounts in which reverse convertibles were purchased during the Relevant Period).

RELEVANT DISCIPLINARY HISTORY

FBW had no relevant disciplinary history.

FACTS AND VIOLATIVE CONDUCT

Reverse Convertible Notes

Generally, reverse convertibles have a finite term, usually three months, six months, or one year. Here, the majority of the reverse convertibles sold had three month maturities. Reverse convertibles generally do not trade during their term, and typically the investor does not have access to the principal invested. The investor earns a coupon, which is a percentage of interest earned on principal invested during the life of the reverse convertible, ranging from 10% to over 30% per annum. Reverse convertibles are linked to the performance of an underlying stock. Many of the underlying stocks in this case were large cap household names such as GM, Ford, Continental Airlines, Whole Foods Markets, Inc., Google, Merrill Lynch, etc. A higher coupon usually reflects volatility in the price of the underlying stock.

On the initiation date of a reverse convertible, the closing price of the underlying stock (Initial Valuation Date or Initial Valuation Price) determines the number of shares of the underlying stock per \$1,000 invested in the reverse convertible that the investor will receive if the put-like feature is triggered. The investor receives stock when the underlying stock drops below a certain price level during the life of the convertible – called variously “Knock In Level” or “Comfort Level” or “Protection Price” -- usually 70% to 80% of the Initial Valuation Price. Some reverse convertibles also required that the closing price of the underlying stock be below the Initial Valuation Price on the Final Valuation Date, which is usually three days before the maturity date of the convertible (Final Valuation Price).

At maturity of a reverse convertible, the investor receives the final coupon payment and the principal investment amount is returned to the investor unless the underlying stock price drops below the Comfort Level and in some instances when the Final Valuation Price is below the Initial Valuation Price. Then, the underlying stock is delivered (although sometimes in a cash equivalent), plus cash for fractional shares as follows: Per \$1,000 investment, the number of shares resulting from dividing the Initial Valuation Price into \$1,000 times the Final Valuation Price.

An example of a reverse convertible where FBW’s customers partially lost principal as a result of stock delivery is:

- Underlying Stock: XYZ

- Term: Three months
- Coupon: 26% per annum (or 6.5% for three months)
- Initial Valuation Date and Price: June 30, 2008, \$23.69, equaling 42.2119 shares per \$1,000 invested.
- Knock-in Level: 80% or \$18.952 (XYZ closed under this price during the three month term).
- Final Valuation Date and price: October 3, 2008, \$18.

If the price of XYZ stock had stayed above the knock-in level of \$18.95, investors would have received the return of their principal invested, plus the \$65 Coupon per \$1,000. Here, however, the price of XYZ closed under the knock-in level during the life of the security and closed under the Initial Price at maturity and instead, investors received XYZ stock. At maturity, per \$1,000 of invested principal, investors received \$18 (XYZ closing price on the Final Valuation Date) times 42 XYZ shares (\$1,000 divided by \$23.69 closing price on the Initial Valuation Date), plus \$3.80 in cash for a fractional share, plus \$65, the amount of the Coupon. Thus, investors received \$824.80 per \$1,000 invested and lost \$175.20 per \$1,000 invested.

The total amount of the XYZ reverse convertible offering was \$1,581,000. As with other reverse convertibles, the head of FBW's fixed income trading desk conducted due diligence on the reverse convertible, approved it and put it onto an internal approved list. Any registered representative who wanted to sell reverse convertibles was required to take an on-line training course. 62 customer accounts at FBW were invested in this XYZ reverse convertible, with a total principal investment of \$1,261,000. Investors lost a total of \$220,927 (\$1,261,000 divided by \$1,000 times \$175.20 lost per \$1,000). In this example, the sale of the XYZ reverse convertible was not necessarily unsuitable for all of the customers who invested, but was unsuitable for certain modest net worth customers, as described below. This example also shows the complexity of the structured product and that the amount of principal returned in stock cannot be discerned until the maturity of the reverse convertible. Although reverse convertibles are generally not liquid – in the sense that there is no established secondary market – and a customer therefore usually must hold the reverse convertible until maturity despite a price decrease in the underlying security, the customer does not receive the stock unless the price of the underlying security drops below the knock-in level, in this example 80% of the Initial Valuation Price.

Failure to Supervise

NASD Rule 3010 required FBW to establish, maintain, and enforce written procedures reasonably designed to supervise registered representatives who sold reverse convertibles. FBW was also required to establish and maintain a supervisory system reasonably designed to achieve compliance with securities laws, regulations and rules in connection with sales of reverse convertibles.

As demonstrated in the above example, reverse convertibles are complex, have the potential for substantial loss, and have a put option feature. In September 2005, as a result of concern that member firms were not fulfilling their obligations with respect to sales of structured products, including reverse convertibles, especially to retail customers, the NASD issued Notice to Members 05-59. With regard to accounts eligible to purchase reverse convertibles, the Notice stated:

Member firms also should consider whether purchases of some or all structured products should be limited to investors that have accounts that have been approved for options trading. Given the similar risk profile of many structured products and options, particularly those where principal invested is at risk from market movements in the reference security, it may be an appropriate investor safeguard to require that such structured products only be purchased in accounts approved for options trading. Firms that determine not to limit purchases of structured products in which investors' principal is at risk from market movements in the reference security to accounts approved for options trading should develop other comparable procedures designed to ensure that structured products are only sold to persons for whom the risk of such products is appropriate.¹

FBW's written supervisory procedures relating to structured products, including reverse convertibles, specifically stated that "the Firm has determined that recommendations and/or purchases of the product will not be limited to only persons who have approved options accounts." FBW's written procedures further stated "FBW will prepare a document that outlines what standards of customer-specific suitability must be used in recommending such products." FBW never promulgated such procedures.

FBW's written procedures were thus inadequate in that they did not set forth standards designed to ensure that reverse convertibles were only sold to customers for whom the risks of losing principal and illiquidity during the term of the reverse convertible were appropriate. During the Relevant Period, FBW sold approximately 961 issues of RCNs to over 2,000 accounts without having appropriate reasonable guidelines in place for registered representatives.

Furthermore, review of accounts that purchased reverse convertibles was the responsibility of branch office managers without the aid of compliance reports such as adequate overconcentration reports or reports that highlighted purchases by seniors or customers with modest net worth. Specifically, branch managers conducted a spot check of daily blotters, but FBW did not give branch managers any guidance or tools to determine suitability and whether a customer was over-concentrated in this particular product. For this reason, FBW's procedures were also inadequate.

¹ In February 2010, after the Relevant Period, FINRA issued Regulatory Notice 10-09, reminding firms of their sales practice obligations with respect to reverse convertible notes. Among other things, the recent notice discussed suitability in terms of risk of loss of principal, illiquidity, and understanding the complex terms of RCNs. The 2010 notice also reiterated the need to have written procedures either restricting RCN sales to accounts approved for options trading or a comparable procedure to restrict sales to accounts that can bear the risk of loss.

By virtue of the foregoing conduct, FBW violated NASD Rules 3010(a) and (b) and 2110 by failing to establish (1) written procedures for the sale of reverse convertibles to eligible accounts; and (2) a reasonably designed system or procedure to monitor accounts that held such securities.

Unsuitable Sales of Reverse Convertible Notes

NASD Rule 2310 requires that, before recommending the purchase or sale of a security, firms must have a reasonable basis for determining that the product is both suitable for at least some investors, and suitable for each specific customer to whom it is recommended.

Reverse convertibles have features that do not make them suitable for every customer type. Reverse convertibles are far more complex than a traditional bond and involve elements of options trading. Reverse convertibles expose investors not only to risks traditionally associated with bonds and other fixed income products—such as the risk of issuer default and inflation risk—but also to the additional risks of the unrelated assets, namely the underlying stocks, and the potential for loss of all or part of principal invested. Reverse convertibles also generally do not trade during the life of the RCN and therefore tend to be illiquid. Reverse convertibles also have complex pay-out structures involving multiple variables that can make it difficult for registered representatives and their customers to accurately assess their risks, costs and potential benefits.

As a result of these features, the 2005 Notice to Members 05-59, suggested that firms limit sales to sophisticated customers who qualified for options trading or have a substantially equivalent limitation on sales to customers who could understand the complexity of reverse convertibles and could withstand the risks.

Here, FBW sold reverse convertibles to over 2,000 accounts over a two year period. RBC Capital Markets Corporation and FINRA conducted an analysis of accounts held by customers 85 years old or older or who had a stated net worth of under \$50,000. Out of the accounts in those two categories, FBW did not have reasonable grounds to believe that the recommended sales of reverse convertibles were suitable for 57 accounts. Sales of reverse convertibles exposed these customers to risk of loss that was inconsistent with their investment objectives, risk tolerance, age, net worth, and investment experience. Some of these accounts were also over-concentrated in reverse convertibles relative to the percentage of assets in the accounts. These customers suffered net losses as a result of investing in reverse convertibles.

A few examples of the 57 accounts are:

ME IRA

ME, an 86 year old retired social worker, had an investment objective of growth and income, very little experience trading common stocks, mutual funds, and bonds, and no prior options experience. ME's new account form indicated a net worth of \$2 million. ME's IRA account had approximately \$169,000 in assets, including a handful of common stocks, mutual funds, and cash. Between April and November 2007, FBW sold five reverse convertibles to ME in the

amount of \$10,000 each. The concentration level of these positions in the account ranged, at various times, between 15% and 25% of the total portfolio value. ME's account sustained \$466 in net losses due to two reverse convertible purchases.

RF Accounts

RF, a 20 year old single male employed as a clerk/sales person, funded a Roth IRA with \$4,000 and an individual securities account with \$10,000 in cash and \$8,000 of a stock. RF had an annual income under \$24,999, and liquid net worth under \$49,999. He had very limited prior investment experience and no options experience. Between December 2006 and August 2007, FBW sold three reverse convertibles to RF in the amounts of \$3,000, \$5,000 and \$5,000, respectively in the individual account and two reverse convertibles in the amount of \$2,000 each in the Roth IRA account. The concentration level of these investments in the Roth IRA were as high as 51%. In May 2007, 44% of the individual account was invested in two reverse convertible positions. The customer lost money in two out of the five reverse convertible purchases and made a profit in three purchases. RF's accounts sustained a combined net loss of \$1,299.

CD IRA

CD, a 65 year old retired veteran, funded an IRA account with approximately \$7,800 from his savings. CD had annual income between \$25,000 to \$49,999, and liquid net worth of \$50,000 to \$99,000. His investment objective was growth and income, he had very little prior investment experience in common stocks, mutual funds, and bonds, and no experience in options. Between August 2006 and March 2008, FBW sold three reverse convertibles to ME in the amounts of \$4,000 each. The concentration level of these positions in the account ranged, at various times, between 48% and 98% of the total portfolio value. CD's account sustained \$429 in net losses due to one of the RCN purchases.

By virtue of the foregoing conduct, FBW violated NASD Rules 2310 and 2110 by not having reasonable grounds to believe that the recommended sales of RCNs were suitable for certain customers.

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

1. A censure;
2. A fine of \$500,000; and
3. Restitution of \$189,723.22 to be paid to certain customers. A registered principal on behalf of Respondent firm shall submit satisfactory proof of payment of restitution or of reasonable and documented efforts undertaken to effect restitution. Such proof shall be submitted to Laura Cooper, Senior Counsel, FINRA Department of Enforcement, 14 Wall Street, 14th Floor, New York, NY

10005 by e-mail from a work-related account of the registered principal of Respondent firm to EnforcementNotice@FINRA.org. This proof shall be provided to the FINRA staff member listed above no later than 120 days after acceptance of the AWC.

If for any reason Respondent cannot locate any customer to whom restitution is to be paid after reasonable and documented efforts within 120 days from the date the AWC is accepted, or such additional period agreed to by a FINRA staff member in writing, Respondent shall forward any undistributed restitution and interest to the appropriate escheat, unclaimed property or abandoned property fund for the state in which the customer is last known to have resided. Respondent shall provide satisfactory proof of such action to the FINRA staff member identified above and in the manner described above, within 14 days of forwarding the undistributed restitution and interest to the appropriate state authority.

Respondent has specifically and voluntarily waived any right to claim an inability to pay at any time hereafter the monetary sanction(s) imposed in this matter.

The imposition of a restitution order or any other monetary sanction herein, and the timing of such ordered payments, does not preclude customers from pursuing their own actions to obtain restitution or other remedies.

Respondent agrees to pay the monetary sanctions upon notice that this AWC has been accepted and that such payment is due and payable.

II.

WAIVER OF PROCEDURAL RIGHTS

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

- A. To have a Complaint issued specifying the allegations against it;
- B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of

Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Respondent understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
- C. If accepted:
 - 1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against them;
 - 2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about Respondent's disciplinary record;
 - 3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and
 - 4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression

Accepted by FINRA:

10/19/20
Date

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

Susan Light
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