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Mark B. Sutton
President
U.S. Private Client Group

March 22, 2002

BY HAND DELIVERY

The Honorable Henry A. Waxman
Ranking Minority Member
Committee on Government Reform
2157 Rayburn House Office Building
Washington, DC 20515-6143

Dear Congressman Waxman:

This is in response to your letter of March 8, 2002 to Patrick Mendenhall, Branch Office Manager of the Houston office of UBS PaineWebber ("PaineWebber" or the "Firm"), and your letter of March 14, 2002 to Joseph Grano, Chairman and Chief Executive Officer of the Firm. In the pages that follow, we respond to each of the questions posed in the letters. For your convenience, we have reproduced your questions and our corresponding answers. We have also attached, as Bates numbers 000001 to 000877, the documents responsive to your requests. We appreciate the opportunity to answer the questions you have raised.

Response to Questions in Letter of March 8, 2002:

- (1) *Were financial advisors in the Emery Financial Group instructed, either explicitly or implicitly, that they should not encourage Enron employees to exercise Enron stock options or otherwise diversify their holdings? If so, who at the Emery Financial Group or UBS PaineWebber made such an instruction, and were senior executives at Enron aware of this instruction?*

PaineWebber provided stock option exercise administration services to Enron Corporation ("Enron"), as it does for other large public companies. In its contract with Enron, PaineWebber agreed that it would treat information regarding Enron's stock option plans confidentially and that PaineWebber personnel would not use such confidential information to solicit further business from any Enron employee. This agreement is a standard provision in stock option administration agreements used in the securities industry and is intended to prevent general solicitation of employee option holders. Under the contract, PaineWebber was permitted to discuss

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investments only with those employees who had opened brokerage accounts with the Firm. Therefore, financial advisors in the Emery Financial Group¹ (and other financial advisors in the Houston office where that Group was located) were instructed not to solicit business from Enron employees whose names and confidential information were set forth in records we held in administering the stock option exercise services, unless the individual employee had opened an account with PaineWebber. More generally, financial advisors in the Houston office also were told that they should not express a view to clients about whether to exercise options unless asked by the client to do so.

With the exception of the foregoing, we are not aware of any instruction from anyone at PaineWebber to financial advisors of the Emery Financial Group regarding the exercise of Enron stock options, nor are we aware of any instruction from anyone at PaineWebber to such advisers that they should not encourage Enron employees to diversify their Enron holdings.

- (2) *Were financial advisors in the Emery Financial Group permitted to advise Enron employees as to whether they should exercise Enron stock options or buy or sell Enron stock? If so, were there any restrictions on the type of advice they could give?*

As set forth above, pursuant to PaineWebber's contract with Enron, financial advisors in the Emery Financial Group were not permitted to solicit Enron employees about their Enron holdings unless they had opened brokerage accounts with the Firm. For those Enron employees who had opened such accounts, the financial advisors of the Emery Financial Group were free to provide investment advice, including advice relating to the importance of diversification and advice relating to the purchase or sale of Enron securities. However, financial advisors providing such advice were also required to adhere to the Firm's Solicitation Policy. That policy provides, in part, that "[a]ny solicitation or recommendation to a client must disclose any inconsistent PaineWebber research² opinions (including research purchased by PaineWebber from another source), if any, relating to the security being recommended." Accordingly,

¹ The Emery Financial Group was a group of financial advisors in PaineWebber's Houston office, led by Rocky Emery, who did business under that name. Rocky Emery and 20 employees of the Emery Financial Group voluntarily left the employment of PaineWebber in July 2001.

² Following the acquisition of PaineWebber Group Inc. by UBS AG in November 2000, all research provided to PaineWebber was provided by UBS Warburg ("Warburg"), an affiliated broker-dealer. Therefore, following the merger, the reference in the solicitation policy to PaineWebber research refers to Warburg research.

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because Warburg's research during the relevant period had a "strong buy" recommendation for Enron stock, financial advisors in the Emery Financial Group were required to disclose that research recommendation if they provided advice inconsistent with it.

Investment advice provided by financial advisors, including those in the Emery Financial Group, was also governed by other Firm policies and procedures, and regulatory rules and regulations, such as "know your customer," and other suitability concepts.

- (3) *Were financial advisors in the Emery Financial Group fired for advising Enron employees to exercise Enron stock options or buy or sell Enron stock? If so, please describe the circumstances surrounding any firing and whether anyone at Enron was notified of the firing.*

Mr. Chung Wu, who was a member of the Emery Financial Group, was terminated for sending to more than ten clients of the Firm an e-mail in which he recommended the sale of a security that was a "strong buy" recommendation by the Warburg Research Department without: (1) seeking and obtaining the required supervisory approval; and (2) informing the clients of the analyst's rating. We address the circumstances of the termination below.

- (4) *In the case of Chung Wu, UBS PaineWebber has stated that he was fired for failing to follow "company policy and regulatory requirements before sending the message to a limited number of customers." What were the "company policy and regulatory requirements" that Mr. Wu violated? Have all other financial advisors who violated these policies and requirements regarding stocks other than Enron also been fired?*

On September 19, 2001, PaineWebber filed a Form U-5 with the National Association of Securities Dealers ("NASD") stating that on August 21, 2001, "Mr. Wu was terminated for violating Firm policy concerning electronic communications."

Chung Wu violated NASD Conduct Rule 2210. That Rule requires that "sales literature" be reviewed by a supervisory principal of the Firm prior to being sent to clients or the public. "Sales literature" is defined as "any written or electronic communication distributed or made generally available to customers or the public...." (NASD Rule 2210(a)(2)). A securities industry convention is that any communication to ten or more persons constitutes "sales literature." The NASD has made clear that "[g]roup e-mail is considered sales literature." (NASD Regulation Internet Guide for Registered Representatives). Similarly, New York Stock Exchange

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Rule 472 requires supervisory pre-approval of communications generally distributed to customers or the public.

Consistent with these regulatory requirements, PaineWebber policy required management approval before correspondence (including e-mail) could be sent to ten or more persons. Mr. Wu was aware of this policy from at least the following sources:

- Compliance Bulletin 99-30, issued October 8, 1999, which states:

While prior review and approval is generally not required for outgoing e-mail, the following types of outgoing messages *do* require review and approval by the Branch Office Manager or Series 8 designee *before being sent. It is incumbent upon the FA or other sender to seek out and receive such approval.*

- Correspondence being sent to 10 or more persons;
- Correspondence relating to securities not followed by the Firm, or advice or recommendations inconsistent with the Firm's research position;
- FA-prepared messages relating to account performance and/or individual security performance;
- Any discussion about specific options or futures contracts or strategies.

(Italics in original, footnote omitted.)

- Compliance Bulletin 00-24, issued October 23, 2000 (contains same language as Bulletin 99-30).
- PaineWebber Guide to Electronic Communications, issued June 1999, citing on page 6 Firm policies concerning communications with the public.

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➤ In a prominent location in Mr. Wu's office, the following was posted:

Outgoing Correspondence Procedures

...

5. **If mailing to 10+ clients/prospects, a copy of the Compliance Approval and BOM [Branch Office Manager] approval is required.** You must also attach a list of all mailees.... (Emphasis in original.)

Indeed, Mr. Wu twice certified to PaineWebber that he read, understood and agreed to abide by the Firm's electronic communications policies. He signed a certification to this effect on January 14, 2000, and he executed electronically another certification in January 2001.

Mr. Wu made no effort to seek or obtain the required supervisory approval for his August 21 e-mail to 73 clients, which was sent after midnight (12:21 a.m.), well after the office had closed and his supervisors had gone home. If his supervisors had had an opportunity to review his e-mail, they could have explored with him whether it was appropriate to send the e-mail and whether he had a reasonable basis for his recommendation in it.

Mr. Wu's August 21 e-mail also violated PaineWebber's Solicitation Policy, which is set forth in Compliance Bulletin 98-07. That policy requires a financial advisor to "disclose any inconsistent PaineWebber research opinions when making a recommendation concerning a security." Mr. Wu did not disclose in his e-mail the "strong buy" recommendation of the Warburg research analyst then in effect.

Further, because of the sell recommendation, Mr. Wu's August 21 e-mail and the attached material constitute a "research report," which a financial advisor is not permitted to prepare and issue. Compliance Bulletin 98-04 provides:

IEs³ may not draft and issue materials for any security which could be considered research reports under NYSE rules. In particular, IEs who conduct "due diligence" visits to corporations, interview corporate principals and senior management, gather and analyze financial and other statistical information and **produce a written report or summary stating a purchase or sale opinion** would likely be deemed

³ Financial advisors were formerly referred to as investment executives ("IEs").

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to have created a research report. The addition of disclosure language stating that the material is the opinion of the writer and not that of PaineWebber is not sufficient to allow the production and dissemination of such material. (Emphasis in original.)

The content of the e-mail sent by Mr. Wu, which was obviously hastily drafted, also raises other concerns. His e-mail does not disclose the basis for his recommendation. The subject line of his e-mail says “[m]ost recent 10-Q report indicates liquidity problems and decline in trading margin”, but the text never touches on these topics. He does not place this information in context or explain his reasoning. His suggestion to 73 clients that they pursue a call option strategy also raises basic suitability concerns.

We have not identified a prior situation that is directly comparable to the circumstances involving Mr. Wu. However, over the past several years the Firm has terminated several financial advisors for a variety of violations of Firm policies concerning electronic communications and communications with the public.

- (5) *Were financial advisors in the Emery Financial Group instructed, either explicitly or implicitly, to encourage clients to purchase stock in companies, such as Azurix and NewPower, for which PaineWebber had underwritten the initial public offering?*

We are not aware of any instruction given to financial advisors in the Emery Financial Group by anyone at PaineWebber to encourage clients to purchase stock in companies such as Azurix and NewPower in the aftermarket. PaineWebber was not the primary or lead underwriter in connection with the initial public offering of either Azurix or NewPower. PaineWebber was one of five brokerage firms that were co-managers of the Azurix offering, and also one of five brokerage firms that were co-managers of the NewPower offering. In July 1999, PaineWebber initiated research coverage of Azurix with a “buy” recommendation, which was reduced to “neutral” in October 2000. PaineWebber did not provide research coverage for NewPower.

Response to Questions in Letter of March 14, 2002:

- (1) *Did UBS PaineWebber financial advisors discourage Enron employees from diversifying their assets? If so, why?*

We are not aware of any PaineWebber financial advisor discouraging any Enron employee from diversifying his or her assets.

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- (2) *Was Mr. Wu fired because he advised clients to sell Enron stock or because he did not have authorization to e-mail the advice to a number of clients? If Mr. Wu was fired for the latter reason, why did you notify his clients that you were "retract[ing]" his advice?*

As noted above, Mr. Wu was fired for sending to more than ten clients of the Firm an e-mail in which he recommended the sale of a security that was a "strong buy" recommendation by the Warburg Research Department without: (1) seeking and obtaining the required supervisory approval; and (2) informing the clients of the analyst's rating. PaineWebber sent the August 21 e-mail from Branch Office Manager Patrick Mendenhall as an appropriate way of "undoing" the unauthorized communication to clients who had received Mr. Wu's original e-mail.

- (3) *Did any Enron employee directly or indirectly instruct, advise, or suggest to UBS PaineWebber that Mr. Wu should be fired because of his August 21, 2001, e-mail? If so, please provide the name(s) of the Enron employee(s) and copies of any correspondence, e-mails, memoranda, or documents between the Enron employee(s) and UBS PaineWebber.*

Mary Joyce and Aaron Brown, the Enron personnel responsible for administering Enron's stock option plan, contacted PaineWebber on August 21, 2001, to bring Mr. Wu's e-mail to the Firm's attention. Ms. Joyce expressed her extreme displeasure that the e-mail had been sent to dozens of Enron employees⁴, requested that the Firm address the situation promptly, and in words or tone expressed her view that strong disciplinary action be taken. PaineWebber personnel undertook to investigate to determine what, in fact, had occurred. Shortly thereafter, it became apparent that Mr. Wu had violated Firm policies in sending his early-morning e-mail and that his employment was in jeopardy as a result. At that time, Mr. Wu acknowledged that he had violated Firm policy and recognized the seriousness of the situation.

Attached are copies of e-mails and correspondence on August 21, 2001, between Mr. Brown, Ms. Joyce and PaineWebber concerning Mr. Wu's e-mail of the same date.

- (4) *In 2000 and 2001, were UBS PaineWebber financial advisors permitted to give financial advice contrary to published PaineWebber analyst recommendations? If not, were all financial advisors who provided such contrary advice terminated from their positions?*

⁴ Ms. Joyce was also concerned that the e-mail may have been recirculated to other Enron employees who were not PaineWebber clients.

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In 2000 and 2001, PaineWebber's financial advisors were permitted to give financial advice contrary to published Warburg analyst research recommendations, but were required to disclose to a client the analyst's contrary research recommendation. This policy continues to be in effect today.

Following the events of August 21, 2001, in an effort to prevent a similar situation in the future, the Houston branch informed financial advisors in the branch that, with respect to stock option issuers, financial advisors should, rather than give their personal opinion, refer their clients to any relevant Warburg analyst's report.

- (5) *Did UBS PaineWebber modify or rescind its August 17, 2001, "strong buy" recommendation of Enron stock? If so, when was this recommendation modified or rescinded, and was this change communicated to Enron clients?*

The Warburg analyst downgraded Enron to a "hold" on November 28, 2001. This change was communicated to all PaineWebber financial advisors, sent by e-mail to all clients requesting e-mail alerts of research changes regarding Enron, and widely reported in the media.

In summary, PaineWebber firmly believes that our response to Mr. Wu's misconduct was appropriate. Any financial advisor who sends an e-mail in the middle of the night to dozens of Firm clients urging them to take an action contrary to Warburg's research recommendation, without informing the clients of that recommendation or obtaining the necessary review and approval, would be treated the same as Mr. Wu.

* * *

In addition to your questions, your letter of March 8 requested that we produce two categories of documents. Attached to this letter is a copy of the Firm's Sales Practice Policy Manual, which includes the Firm's "Code of Conduct," which are among the many documents that describe the considerations financial advisors should take into account in providing advice to their clients. These documents are confidential and proprietary and we request that you treat them as confidential and restrict their access to Members and Staff. I have also attached a printout reflecting all Enron employees who exercised stock options in 2000 or 2001. In order to protect the privacy of the option holders and pursuant to an agreement with your Staff, we have redacted their names and social security numbers. We further request that this document be kept confidential and that access be limited to Members and Staff.

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If you have any questions after reviewing our response, please do not hesitate to contact me.

Sincerely,



Mark B. Sutton
President
U.S. Private Client Group