

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

**INVESTMENT ADVISERS ACT OF 1940**  
**Release No. 2834 / January 30, 2009**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13357**

**In the Matter of**

**Merrill Lynch, Pierce,  
Fenner & Smith Inc.,**

**Respondent.**

**ORDER INSTITUTING  
ADMINISTRATIVE AND CEASE-AND-  
DESIST PROCEEDINGS, PURSUANT TO  
SECTIONS 203(e) AND 203(k) OF THE  
INVESTMENT ADVISERS ACT OF 1940,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS AND A CEASE-  
AND-DESIST ORDER AS TO MERRILL  
LYNCH, PIERCE, FENNER & SMITH INC.**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) against Merrill Lynch, Pierce, Fenner & Smith Inc. (“Merrill Lynch” 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 and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

### III.

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

#### A. SUMMARY

From at least 2002 through 2005, Merrill Lynch, through its pension consulting services advisory program, breached its fiduciary duty to certain of the firm's pension fund clients and prospective clients by misrepresenting and omitting to disclose material information. Merrill Lynch's pension fund clients came to it seeking advice in developing appropriate investment strategies and in selecting money managers to manage the assets entrusted to their care. In providing such advice, Merrill Lynch failed to disclose the facts creating the material conflict of interest in recommending clients use directed brokerage to pay hard dollar fees, and in recommending the use of Merrill Lynch's transition management desk. In addition, Merrill Lynch made misleading statements to the clients served by its Ponte Vedra South, Florida office ("Ponte Vedra South office") regarding its manager identification process. As a result of the above conduct, Merrill Lynch violated Section 206(2) of the Investment Advisers Act of 1940 (the "Advisers Act"). In addition, Merrill Lynch failed reasonably to supervise its investment adviser representatives in the Ponte Vedra South office with respect to the provision of advisory services to its Consulting Services clients. Finally, Merrill Lynch violated Section 204 of the Advisers Act and Rule 204-2(a)(14) thereunder by failing to maintain records of the offer or delivery of disclosure statements.

#### B. RESPONDENT AND OTHER RELEVANT ENTITIES

**Merrill Lynch, Pierce, Fenner & Smith Inc. ("Merrill Lynch")** – is the wholly-owned principal operating subsidiary of the holding company, Merrill Lynch & Co. As of January 1, 2009, Merrill Lynch & Co. is a direct subsidiary of Bank of America Corporation. Merrill Lynch has been registered with the Commission as a broker-dealer since March 12, 1959 and as an investment adviser since December 8, 1978.

**Merrill Lynch Consulting Services** – is an advisory program offered under the auspices of Merrill Lynch's Global Wealth Management Group, and provides advisory services to high net worth and institutional clients, including public pension funds.

**Merrill Lynch's Ponte Vedra South office ("Ponte Vedra South office")** – Merrill Lynch's Ponte Vedra South, Florida office had close to 100 public pension clients in Florida and a team of approximately ten Merrill Lynch employees, including four investment adviser representatives, who provided services to those clients. Prior to 2005, this group operated out of Merrill Lynch's Jacksonville, Florida office.

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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.

## C. **FACTS**

From at least 2002 through 2005 (the “relevant time period”), Merrill Lynch, through its Consulting Services program, provided advisory services to high net worth and institutional clients, including public pension funds. As an integral part of these services, Merrill Lynch assisted clients in developing appropriate investment policies and in determining asset allocations to meet their individual needs. Merrill Lynch also monitored Consulting Services clients’ existing money managers to provide information to clients on whether the managers’ performances remained consistent with the clients’ investment objectives. It also helped clients to identify and evaluate new money managers so that the clients could select one or more such managers for the discretionary management of their accounts.

During the relevant time period, Merrill Lynch’s Ponte Vedra South office had close to 100 public pension fund clients in Florida, including many municipal employee, police and firefighters’ pension funds. A team of ten Merrill Lynch employees, including several investment adviser representatives, provided services to these clients. The headquarters for Merrill Lynch Consulting Services was located in Jersey City, New Jersey, and provided support to this office and other investment adviser representatives who provided advisory services.

During the relevant time period, Merrill Lynch generated a Consulting Services Disclosure Statement furnished to clients in lieu of Form ADV Part II, as permitted by the Advisers Act Rule 204-3(a). Pursuant to Rule 203-1(b)(2), this document is considered filed with the Commission.

### **Merrill Lynch Made Material Misrepresentations**

During the relevant time period, Merrill Lynch misrepresented the process used to identify managers for clients of the Ponte Vedra South office in breach of its fiduciary duty to those clients. Merrill Lynch, in written communications, emphasized the extensive in-house resources and research that would be available through Merrill Lynch to match each individual client with appropriate money managers for that client’s needs. Their descriptions of these services, however, did not accurately describe the services that the Ponte Vedra South office was actually providing to its clients.

The Merrill Lynch disclosure statements provided to clients, as well as responses to client Requests for Proposals (“RFPs”), highlighted the extensive Merrill Lynch process that would be brought to bear on money manager selections for each client. These documents, taken together, described the typical procedure for identifying new money managers as follows: a client would send a questionnaire, through its investment adviser representative, to Merrill Lynch Consulting Services headquarters in New Jersey, providing information regarding, among other things, the client’s investment objectives and risk tolerance for the portfolio intended to be managed by the new manager. An investment manager research analyst in the Merrill Lynch Consulting Services offices in New Jersey would then compare the questionnaire against data about investment managers available to Merrill Lynch from a variety of sources, including, among others, both nonproprietary databases and subscription services, and generate a preliminary list of potential

investment managers whose investment processes and styles appeared to be compatible with the client's financial objectives and requirements. The analyst would then apply various criteria to reduce the preliminary list to a group of typically five to eight investment managers that appeared appropriate for the client. Merrill Lynch Consulting Services offices in New Jersey would then provide the requesting investment adviser representative with a booklet containing a list of managers and written background information on each manager, which would in turn be presented to the client. The documents provided to clients and potential clients regarding this service repeatedly refer to Merrill Lynch's large research staff and capabilities, giving the impression that those resources are deployed for every client's money manager search. In addition to these disclosures, members of the Ponte Vedra South office also sent letters to clients highlighting the benefits of Merrill Lynch's extensive research capabilities. These letters were reviewed by Merrill Lynch supervisors.

The Ponte Vedra South office's procedures for performing manager searches, however, deviated from the described process. The Merrill Lynch Consulting Services offices did not identify potential money managers for the Ponte Vedra South office's clients. Rather, from approximately 2002 through 2005, members of the Ponte Vedra South office conducted the manager search process themselves using a short list (the "Ponte Vedra South list") of managers, which had been developed by the Ponte Vedra South office. The Ponte Vedra South list consisted of approximately sixty money managers primarily from Merrill Lynch's vast approved lists. The Ponte Vedra South list was divided into ten or eleven categories of managers, each containing approximately six money managers, therefore potentially giving rise to a limited universe of recommendations. When one of the Ponte Vedra South office's clients requested a new manager search, an associate in the Ponte Vedra South office would refer to the pre-existing Ponte Vedra South list, seek input from the Ponte Vedra South office investment adviser representative who serviced the requesting client and sometimes from Merrill Lynch Consulting Services in New Jersey, obtain information on the managers on the list from publicly available and subscription databases, and compile this information into a booklet to be presented to the client. These search reports were not reviewed by Merrill Lynch Consulting Services headquarters in New Jersey. Rather, an investment adviser representative in the Ponte Vedra South office decided, sometimes with non-client specific input from Merrill Lynch Consulting Services, which managers from the Ponte Vedra South list to present to his clients. In addition to representing only a subset of the money managers vetted and approved by Merrill Lynch Consulting Services, the Ponte Vedra South list also included – and members of the Ponte Vedra South office recommended – certain money managers who had not been vetted and approved by Merrill Lynch Consulting Services. The New Jersey Consulting Services office was aware that the investment adviser representatives in the Ponte Vedra South office recommended money managers who had not been vetted, and that its manager identification process deviated from disclosures clients received about that process.

As a result of the conduct described above, Merrill Lynch willfully<sup>2</sup> violated Section 206(2) of the Advisers Act, which provides that "[i]t shall be unlawful for any investment adviser,

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<sup>2</sup> A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977

by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”<sup>3</sup>

### **Merrill Lynch Failed to Disclose Certain Conflicts of Interest to its Clients and Potential Clients**

During the relevant time period, Merrill Lynch charged for the advisory services provided through Merrill Lynch Consulting Services on a fixed-fee basis. Clients could pay in cash (referred to as “hard dollars”) or through “directed brokerage.” Directed brokerage was an arrangement whereby the clients directed their money managers to execute trades through Merrill Lynch’s institutional trading desk, consistent with the managers’ best execution obligations. In return, in addition to execution services, these clients received credit for a portion of the commissions generated by these trades against the hard dollar fee owed for the advisory services provided by Merrill Lynch Consulting Services. Even after the hard dollar fee had been satisfied, Merrill Lynch Consulting Services, and its investment adviser representatives, continued to receive a portion of the commissions generated through the directed brokerage relationship. In negotiating fees and payment arrangements with their clients, many of whom were not knowledgeable about their trading options, the investment adviser representatives in the Ponte Vedra South office recommended that the clients establish a directed brokerage relationship with Merrill Lynch. The majority of the Ponte Vedra South office Consulting Services clients elected to enter directed brokerage relationships. Clients who established directed brokerage relationships often were given a lower hard dollar fee than they would have received if they had not established such a relationship.

Under Merrill Lynch’s standard directed brokerage relationship, Merrill Lynch Consulting Services and, consequently, its investment adviser representatives potentially could receive and, in fact, often did receive significantly more revenues through directed brokerage commissions than they would have received if clients had paid brokerage commissions for trade executions elsewhere and paid Merrill Lynch only the hard-dollar annual Consulting Services fee. For example, in one instance in the Ponte Vedra South office a client who was obligated to pay a \$7500 annual hard dollar fee for the advisory services it received through Merrill Lynch Consulting Services generated almost \$175,000 in production credits<sup>4</sup> by executing trades at Merrill Lynch. Other examples in that office include a client generating \$65,000 in production credits for trade executions with a hard dollar fee of \$7500 and another client generating production credits of \$145,000 for trade executions with a hard dollar fee of \$32,000. Beginning in 2004, the Ponte Vedra South office disclosed the amount of each client’s hard dollar fee and the amount of directed

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(D.C. Cir. 1949)). There is no requirement that the actor “‘also be aware that he is violating one of the Rules or Acts.’” *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

<sup>3</sup> Proof of scienter is not required to establish a violation of Section 206(2) of the Advisers Act. *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 195 (1963).

<sup>4</sup> Production credits represent the portion of the commissions the clients paid to Merrill Lynch for brokerage services that were shared in by Merrill Lynch Consulting Services and its investment adviser representatives.

brokerage commissions generated by the client. Prior to November 2005, Merrill Lynch's disclosures for Consulting Services clients failed to disclose the fact that Merrill Lynch Consulting Services and, consequently, its investment adviser representatives might have a financial incentive to recommend that its clients enter into a directed brokerage relationship.

During the relevant time period, Merrill Lynch also failed to inform its Consulting Services clients that Merrill Lynch's Global Wealth Management Group and, consequently, its investment adviser representatives had a direct financial incentive to recommend that clients use Merrill Lynch for transition management services. Transition management was a service offered by Merrill Lynch's Transition Management group, a separate unit of Merrill Lynch, to clients in the process of terminating one money manager and hiring another. Without the services of a transition manager, the money manager being terminated would sell the shares held by the fund that the new money manager did not want in its portfolio and transfer the proceeds from those sales to the client's account. The new money manager would then use these proceeds to purchase securities for its portfolio on behalf of the client. Consequently the process of terminating and hiring a new manager resulted in the generation of commissions. Merrill Lynch's transition management group represented that it could manage a transition more efficiently and cost-effectively by offering cross trades and reduced commission costs. Moreover, beginning in 2003, Merrill Lynch Consulting Services actively promoted the use of Merrill Lynch's transition management services to its Consulting Services clients. Between July 2000 and the end of 2005, more than nine Ponte Vedra South office Consulting Services clients used Merrill Lynch for transition management services on at least 19 separate occasions.

Merrill Lynch's Global Wealth Management Group directly benefited from the Consulting Services clients' use of the Merrill Lynch transition management services and generally received 1¢ per share in production credits from the Transition Management group for every transitioned share. For example, one transition generated production credits of slightly over \$150,000 and another generated production credits of more than \$38,000. The Global Wealth Management Group's financial interest in Consulting Services clients' use of the Merrill Lynch transition management service created a potential conflict of interest when its investment adviser representatives recommended that service. Because during the relevant period the fact that the Global Wealth Management Group benefited from Consulting Services' recommendation to use transition services was not disclosed to the clients, the clients were unable to evaluate whether the recommendation of Merrill Lynch's Transition Management services was disinterested.

Investment advisers, such as Merrill Lynch, owe fiduciary duties to their clients and, therefore, must, among other things, disclose all actual or potential conflicts of interest.<sup>5</sup> In

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<sup>5</sup> Capital Gains, 375 U.S. at 191, 196-97 (1963) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship . . . . An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether the adviser is serving two masters or only one, especially if one happens to be economic self-interest."); In re O'Brien Partners, Inc., Advisers Act Release No. 1772 (Oct. 27, 1998) (" . . . since even potential conflicts of interest are material and must be disclosed, [the investment adviser] was required to disclose its receipt of third-party payments, even if it had concluded that the payments did not influence the manner in which it advised its clients."); In the Matter of Feeley & Willcox Asset Management Corp., Advisers Act Release No. 2143 (July 10, 2003) ("It is the client, not the

addition, investment professionals who advise pension funds must be aware of the important role that pension plans play in the financial security of the beneficiaries.

As a result of the conduct described above, Merrill Lynch willfully violated Section 206(2) of the Advisers Act, which provides that “[i]t shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”

### **Merrill Lynch Failed to Supervise its Ponte Vedra South Investment Adviser Representatives Offering Consulting Services**

During the relevant time period, Merrill Lynch did not reasonably supervise certain of the investment adviser representatives in the Ponte Vedra South office with a view to preventing violations of the federal securities laws. The supervisory structure of the investment adviser representatives was not well-delineated. Branch level supervisors believed that the Merrill Lynch Consulting Services offices in New Jersey were responsible for supervising most aspects of the investment adviser representatives’ provision of advisory services, while Merrill Lynch Consulting Services personnel in New Jersey believed that this responsibility rested with the local managers. This left a vacuum in supervision of the Ponte Vedra South office, where the procedures that existed for supervising that office were not being adequately enforced. An example of the lax controls is the fact that the Ponte Vedra South office maintained its own computer server, the contents of which the local managers never reviewed. Merrill Lynch Consulting Services was not aware of its existence. Moreover, to the extent Merrill Lynch Consulting Services personnel were aware of the activities of the Ponte Vedra South office, they allowed its practices to deviate from standard Merrill Lynch Consulting Services procedure, which led to violations of the Advisers Act. Specifically, the Ponte Vedra South office conducted its own manager identification searches, recommended money managers who had not been vetted and used a short list for recommendations. These practices were inconsistent with disclosures about the manager identification process provided to clients and prospective clients.

In addition, Merrill Lynch did little to train its investment adviser representatives about their duties to advisory clients. This lack of oversight and inadequate training allowed for an environment in which the investment adviser representatives in the Ponte Vedra South office were permitted to act in a manner that was inconsistent with the duty owed to their clients and resulted, in part, in the failure to disclose conflicts of interest.

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adviser, who is entitled to make the determination whether to waive the adviser’s conflict. Of course, if the adviser does not disclose the conflict, the client has no opportunity to evaluate, much less waive, the conflict.”).

Based on the foregoing conduct, Merrill Lynch failed reasonably to supervise certain investment adviser representatives in the Ponte Vedra South office who aided and abetted Merrill Lynch's violations of Section 206(2) of the Advisers Act, with a view to preventing violations of the Advisers Act.

### **Merrill Lynch Did Not Maintain Adequate Records**

During the relevant time period, as mentioned above, Merrill Lynch generated a Consulting Services Disclosure Statement furnished to clients in lieu of Form ADV Part II, as permitted by the Advisers Act Rule 204-3(a). Until December 2005, however, Merrill Lynch Consulting Services did not maintain a record of the delivery of the Disclosure Statements to its clients. As a result of this conduct, Merrill Lynch willfully violated Section 204 of the Advisers Act, and Rule 204-2 (a)(14) promulgated thereunder, which requires that investment advisers registered with the Commission maintain and preserve certain books and records. Rule 204-2 (a)(14) requires that registered investment advisers keep "a copy of each written statement and each amendment or revision thereof, given or sent to any client or prospective client . . . and a record of the dates that each written statement . . . was given, or offered to be given . . . ."

### **Merrill Lynch's Remedial Efforts**

In determining to accept the Offer, the Commission considered voluntary and significant remedial acts promptly undertaken by Respondent.

#### **IV.**

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

Accordingly, pursuant to Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

- A. Merrill Lynch is censured;
- B. Merrill Lynch cease and desist from committing or causing any violations and any future violations of Sections 204 and 206(2) of the Advisers Act, and Rule 204-2(a)(14) thereunder; and
- C. Merrill Lynch shall, within 90 days of the entry of this Order, pay a civil money penalty in the amount of \$1 million to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the



Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Merrill Lynch as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Laura B. Josephs, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549.

By the Commission.

Elizabeth M. Murphy  
Secretary