

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

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 85395 / March 22, 2019**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-19114**

**In the Matter of**

**MERRILL LYNCH, PIERCE,  
FENNER & SMITH  
INCORPORATED,**

**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 Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill” 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:

#### Summary

1. These proceedings arise out of Merrill's improper practices with respect to securities lending transactions involving pre-released American Depositary Receipts ("ADRs").<sup>2</sup>

2. ADR facilities, which provide for the issuance of ADRs, are established by a depositary bank ("Depositary") pursuant to a deposit agreement ("Deposit Agreement").

3. Typically, a Depositary issues ADRs to a market participant that contemporaneously delivers the corresponding number of foreign securities to the Depositary's foreign custodian ("Custodian").<sup>3</sup> However, in certain situations, Deposit Agreements may provide for "pre-release" transactions in which a market participant can obtain newly issued ADRs from the Depositary before delivering ordinary shares to the Custodian. Only brokers (or other market participants) that have entered into pre-release agreements with a Depositary ("Pre-Release Agreements") can obtain pre-released ADRs from the Depositary. The Pre-Release Agreements, consistent with the Deposit Agreements, require the broker receiving the pre-released ADRs ("Pre-Release Broker"), or its customer on whose behalf the Pre-Release Broker is acting, to beneficially own the ordinary shares represented by the ADRs, and to assign all beneficial rights, title, and interest in those ordinary shares to the Depositary while the pre-release transaction is outstanding. In effect, the Pre-Release Broker or its customer becomes the temporary custodian of the ordinary shares that would otherwise have been delivered to the Custodian.

4. From at least June 2012 until approximately November 2014, Merrill received pre-released ADRs from Pre-Release Brokers that had been issued by Depositaries where neither the Pre-Release Brokers nor Merrill had taken reasonable steps to satisfy the Pre-Release Brokers' obligations under the Pre-Release Agreements. Merrill, which was not a Pre-Release Broker, understood that the ADRs that Merrill borrowed from Pre-Release Brokers may have

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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.

<sup>2</sup> ADRs allow U.S. investors to invest in foreign companies without having to purchase the shares in the foreign markets, and allow foreign companies to get increased exposure to U.S. markets.

<sup>3</sup> The securities deposited typically are equity securities, but debt securities may also underlie ADRs.

been sourced from Depositaries pursuant to Pre-Release Agreements. Merrill also understood the beneficial ownership and other representations that Pre-Release Brokers were required to make to Depositaries in order to obtain pre-released ADRs. Merrill also understood the conduit nature of Pre-Release Brokers' securities lending businesses, which under the circumstances should have indicated that the Pre-Release Brokers did not own underlying ordinary shares.

5. Merrill's associated persons on its securities lending desk, by obtaining ADRs from Pre-Release Brokers in circumstances where they should have known that such ADRs likely had been pre-released without compliance with the Pre-Release Brokers' obligations under the Pre-Release Agreements, violated Section 17(a)(3) of the Securities Act of 1933 ("Securities Act").<sup>4</sup> Merrill's supervisory policies and procedures were not reasonably designed and implemented to provide sufficient oversight of associated persons to prevent and detect their violations of Section 17(a)(3) of the Securities Act. As a result, Merrill failed reasonably to supervise its associated persons within the meaning of Section 15(b)(4)(E) of the Exchange Act.

### **Respondent**

6. Merrill, a wholly owned indirect subsidiary of Bank of America Corporation ("BoA"), is a Delaware company headquartered in New York, NY. Merrill has been registered with the Commission as an investment adviser since 1978 and as a broker-dealer since 1959.

### **Background**

#### **ADRs and the Pre-Release of ADRs**

7. ADRs are negotiable instruments that represent an ownership interest in a specified number of foreign securities that have been deposited with a Depositary.<sup>5</sup> ADRs may be traded on U.S. stock exchanges or over-the-counter.

8. An ADR is either "sponsored" or "unsponsored." If the ADR is sponsored, the Deposit Agreement is among the foreign issuer whose securities are represented by the ADRs (*i.e.*, the sponsor), the Depositary, and ADR holders. If the ADR is unsponsored, the agreement

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<sup>4</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).

<sup>5</sup> In a more technical sense, ADRs evidence American Depositary Shares, or ADSs, which represent the specific number of underlying securities of the same company on deposit with the Custodian in the foreign issuer's home market. In addition, an ADR for a particular company may actually represent one ordinary share, more than one ordinary share, or a fraction of an ordinary share. The ADR-to-ordinary share ratio varies by ADR facility, based on pricing in the foreign and U.S. markets.

is between the Depositary and the ADR holders.<sup>6</sup> In either case, the Deposit Agreement or ADR describes fees applicable to the ADRs and the party responsible for paying those fees. In addition, the Depositary files a Securities Act registration statement on Form F-6 with the Commission to register the offer and sale of the ADRs, which includes the Deposit Agreement and the form of ADR as exhibits.

9. Form F-6 is used to register the offer and sale of ADRs under the Securities Act if certain conditions are met, including that the ADR holder must be entitled to withdraw the deposited securities at any time, subject to certain limited exceptions inapplicable to the matters here. Typically, when ADRs are issued, a specified number of the ordinary shares represented by the ADR are contemporaneously delivered to the Custodian. In this way, those underlying ordinary shares are in effect removed from the market and the total number of securities in the markets — ADRs plus ordinary shares — is unaffected.

10. In some situations, a person may seek to obtain ADRs through a “pre-release” transaction pursuant to a Pre-Release Agreement with a Depositary, as provided for in the Deposit Agreements and in the ADR itself. In a pre-release transaction, a market participant obtains newly issued ADRs from the Depositary (as opposed to purchasing existing ADRs on the market) without simultaneously delivering the corresponding ordinary shares to the Custodian.

11. The traditional rationale for pre-release transactions was to address settlement timing disparities that could delay delivery to the Custodian of recently purchased ordinary shares. In theory, following the traditional rationale, the pre-release transaction would be closed within a few days after the purchased ordinary shares were received by the Pre-Release Broker. Once issued, pre-released ADRs are indistinguishable from other ADRs of the same issuer and can be freely traded, even while the pre-release transaction remains open.

12. Deposit Agreements, the ADR itself, and Pre-Release Agreements govern the terms of pre-release transactions. Pre-Release Brokers may obtain pre-released ADRs directly from Depositaries with which they have entered into Pre-Release Agreements.

13. Deposit Agreements, the ADR itself, and Pre-Release Agreements typically require a representation that at the time of each pre-release and for the duration such pre-release remains outstanding, the Pre-Release Broker or its customer (i) beneficially owns corresponding ordinary shares, (ii) assigns all beneficial right, title, and interest in the shares to the Depositary, and (iii) will not take any action with respect to such shares that is inconsistent with the transfer of beneficial ownership (collectively, the “Pre-Release Obligations”). In effect, the Pre-Release Broker or the customer on whose behalf the Pre-Release Broker is acting must maintain the ordinary shares for the benefit of ADR holders, similar to how the Depositary, through its Custodian, maintains the ordinary shares when it issues ADRs that are not pre-released.

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<sup>6</sup> An unsponsored ADR is created by the Depositary and does not involve the formal participation (or require the agreement) of the foreign company whose securities the ADRs represent.

14. Deposit Agreements, the ADR itself, and Pre-Release Agreements also include provisions addressing the situation where ADRs have been pre-released over a dividend record date. The provisions typically require the Pre-Release Broker or its counterparty to ensure that foreign withholding taxes, to the extent due in connection with the dividend on the corresponding ordinary shares, are paid to the foreign jurisdiction at the rate required for ADR holders, to forward to the Depository all dividends received on the ordinary shares, net of any foreign withholding tax paid, and to pass through any tax credits or refunds from the dividends to the Depository. In this way, the rights and obligations of all ADR holders (including those who hold pre-released ADRs) will be protected, and the flow of dividend and tax payments will not be altered by the fact that the ordinary shares were not simultaneously deposited with the Custodian when the pre-released ADRs were issued.

15. Significantly, these agreements are intended to ensure that, at all times until the pre-release position is closed by delivery of ordinary shares to the Custodian (or delivery of an equivalent number of ADRs to the Depository), the Depository and the Pre-Release Broker or its counterparty are collectively maintaining, for the benefit of ADR holders, the number of ordinary shares that corresponds to the number of outstanding ADRs. This ensures that the total number of ordinary shares plus shares represented by ADRs available in the markets is unaffected by the fact that ADRs were pre-released, and that any economic or tax impact related to holding the ordinary shares flows to the Depository and the ADR holders for whose benefit the Depository custodies ordinary shares.

### **Merrill's Practices with Respect to Securities Lending Transactions Involving Pre-Released ADRs**

16. From June 2012 through November 2014, Merrill's securities lending desk borrowed securities from numerous sources, including ADRs from Pre-Release Brokers.

17. Merrill had entered into Pre-Release Agreements with Depositories as early as the mid-1990s. But at some point by at least the mid 2000s, Merrill discontinued the practice of obtaining pre-released ADRs under those agreements because Merrill's securities lending desk could not comply with the Pre-Release Obligations in connection with the types of transactions, described below, in which it wanted to engage.

18. Instead of obtaining ADRs directly from Depositories, Merrill's securities lending desk, in over 40,000 transactions from June 2012 until approximately November 2014, obtained ADRs from Pre-Release Brokers, which obtained those ADRs in pre-release transactions with Depositories. Merrill borrowed these ADRs pursuant to standard master securities loan agreements ("MSLAs") with Pre-Release Brokers, which did not address pre-released ADRs and did not contain any provisions requiring Merrill to satisfy the Pre-Release Obligations.

19. Under the circumstances of the transactions, Merrill securities lending personnel should have known not only that they were potentially receiving pre-released ADRs and that the Pre-Release Brokers would not be complying with the Pre-Release Obligations.

20. First, Merrill securities lending personnel were aware that the Pre-Release Brokers in these transactions were conduit lenders that routinely sourced securities through pre-release transactions with Depositaries. Indeed, on certain occasions, Pre-Release Brokers explicitly informed Merrill that the ADRs were coming from Depositaries. On other occasions, Merrill negotiated the terms of pre-release transactions, or discussed the availability of ADRs, directly with Depositaries and then arranged to obtain the pre-released ADRs via the Pre-Release Brokers. In addition, Merrill sometimes used Pre-Release Brokers to obtain hard-to-borrow stock in order to handle the settlement of counterparty trades after institutional sources of supply had been exhausted. In light of the exhaustion of those institutional sources, Merrill securities lending personnel, at minimum, should have recognized the likelihood the Pre-Release Brokers were obtaining the ADRs from Depositaries through pre-release transactions.

21. Second, Merrill securities lending personnel should have recognized that Pre-Release Brokers were not complying with the Pre-Release Obligations. For example, in early 2007, Merrill received a notice from a Pre-Release Broker (“Pre-Release Broker A”) stating that any loans of pre-released ADRs from Pre-Release Broker A to Merrill occurred in reliance on Merrill’s — not Pre-Release Broker A’s — ownership of corresponding ordinary shares. After receipt of the notice, Merrill did not take steps to change its written policies to address the notice. Merrill securities lending personnel should have recognized that it would make no economic sense for a Pre-Release Broker to obtain pre-released ADRs from a Depositary, lend them to Merrill, and maintain corresponding ordinary shares for the benefit of a Depositary for the duration of the transaction, rather than simply exchanging the shares for ADRs and lending the ADRs.

22. Similarly, Merrill at times borrowed ADRs from Pre-Release Brokers in structured transactions opened in advance of dividend record dates. For Merrill, the purpose of those transactions was to profit by lending the ADRs to a non-U.S. party with tax-favored status in a foreign jurisdiction, who would be entitled to receive more of the dividend than would be received by a standard U.S. taxpayer subject to foreign withholding tax. Such a person would have been willing to borrow the ADRs from Merrill at a total cost equal to some percentage of this foreign tax benefit — *i.e.*, some portion of the part of the dividend that would have been withheld for taxes in the foreign jurisdiction had the party not been tax advantaged. As was typical in the securities lending industry, such structured transactions were negotiated using “all in” rates — the comprehensive cost of borrowing shares expressed as a percentage of the gross dividend for those shares — which in turn were used as inputs to calculate the daily rebate rate that the borrower would pay to its lender.

23. Given Merrill’s awareness that the structured transaction was priced by splitting up portions of the foreign tax that was not paid on the dividend in light of the borrower’s tax-favored status in the foreign jurisdiction, and given certain Merrill personnel’s understanding that Pre-Release Brokers at times would have lent pre-released ADRs to counterparties, such as Merrill, in the ordinary course of their business, Merrill should have recognized the risk that it could be receiving pre-released ADRs not backed by ordinary shares. It would not have made economic sense for the Pre-Release Broker to have earned a spread, equating to a portion of the withholding tax amount, by lending the shares while maintaining ordinary shares and paying full withholding taxes to the foreign jurisdiction, as would have been required by the Pre-Release

Obligations. Moreover, in some such transactions, Merrill's customer or counterparty sought ordinary shares, so many of the ADRs obtained by Merrill had to be converted. If the Pre-Release Brokers owned the ordinary shares, they should have been able to lend them directly.

24. When borrowing ADRs from Pre-Release Brokers, Merrill securities lending personnel should have recognized the risk that, in effect, Merrill may have been engaging in indirect pre-release transactions in which neither the Pre-Release Brokers nor Merrill could satisfy the Pre-Release Obligations. For example, upon receiving the notice from Pre-Release Broker A as described above, Merrill did not change its written policies to address the notice. As a result of its transactions, the pre-released ADRs that Merrill borrowed from Pre-Release Brokers were not actually backed by ordinary shares held for the benefit of a Depositary in accordance with the Pre-Release Obligations and the terms of the relevant Deposit Agreements.

25. Merrill did not have any supervisory policies and procedures in place governing the firm's potential indirect borrowing of pre-released ADRs from Pre-Release Brokers.

26. Merrill failed to establish and implement policies and procedures that would be reasonably expected to detect whether its associated persons on the securities lending desk were engaging in transactions in which pre-released ADRs were inappropriately obtained by Pre-Release Brokers and lent to Merrill, and used by Merrill for settling customer trades or lending to Merrill counterparties.

27. From June 2012 until approximately November 2014, Merrill's net revenues from the securities lending transactions with Pre-Release Brokers described above totaled approximately \$4.4 million.

28. Merrill cooperated with the staff's investigation, including by voluntarily providing factual summaries of relevant information and analyses, and by entering into tolling agreements with the Commission.

### **Failure Reasonably to Supervise**

29. 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. Merrill was responsible for supervising its securities lending desk personnel to address whether they were borrowing and lending pre-released ADRs that were not backed by underlying ordinary shares. Merrill failed reasonably to fulfill such supervisory responsibilities within the meaning of Section 15(b)(4)(E) of the Exchange Act because Merrill failed to establish reasonable policies and procedures, and a system for implementing such policies and procedures, that would reasonably be expected to prevent and detect the violations of Section 17(a)(3) of the Securities Act by the associated persons on the securities lending desk described above. If Merrill had developed reasonable policies and procedures and systems to implement those procedures, it is likely that the firm would have prevented and detected the violations of its associated persons on the securities lending desk.

### **Merrill's Cooperation**

30. In determining to accept the Offer, the Commission considered the cooperation afforded the Commission staff.

#### **IV.**

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

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

- A. Respondent is censured.
- B. Merrill shall, within 30 days of the entry of this Order, pay disgorgement of \$4,448,291.52 and prejudgment interest of \$724,795.40 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.
- C. Merrill shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of \$2,891,389.48 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 Merrill as 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 Sanjay Wadhwa, Senior Associate Director, Division of Enforcement, Securities and Exchange Commission, 200 Vesey Street, New York, NY 10281.

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.

E. Respondent acknowledges that the Commission is not imposing a civil penalty in excess of \$2,891,389.48 based upon its cooperation and agreement to cooperate in a Commission investigation and related enforcement action. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondent knowingly provided materially false or misleading information or materials to the Commission, or in a related proceeding, the Division may, at its sole discretion and with prior notice to the Respondent, petition the Commission to reopen this matter and seek an order directing that the Respondent pay an additional civil penalty. Respondent may contest by way of defense in any resulting administrative proceeding whether it knowingly provided materially false or misleading information, but may not: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Vanessa A. Countryman  
Acting Secretary