

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59555 / March 11, 2009

INVESTMENT ADVISERS ACT OF 1940
Release No. 2851 / March 11, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13407

In the Matter Of

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

Respondent.

: ORDER INSTITUTING
: PROCEEDINGS PURSUANT TO
: SECTIONS 15(b)(4) AND 21C
: OF THE SECURITIES EXCHANGE
: ACT OF 1934 AND
: SECTIONS 203(e) AND
: 203(k) OF THE INVESTMENT
: ADVISERS ACT OF 1940, MAKING
: FINDINGS, AND IMPOSING CEASE-
: AND-DESIST ORDER, PENALTIES,
: AND OTHER RELIEF
:
:
:

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”), be and hereby are instituted against Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill Lynch” or “Respondent”).

II.

In anticipation of the institution of these proceedings, the Respondent has submitted an Offer of Settlement (“Offer”) to the Commission, 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, the Respondent, without

admitting or denying the findings herein, except as to the Commission's jurisdiction over it and over the subject matter of these proceedings, consents to the entry of this Order Instituting Proceedings Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Cease-and-Desist Orders, Penalties, and Other Relief ("Order").

III.

On the basis of this Order and the Respondent's Offer, the Commission finds¹ that:

A. **RESPONDENT**

Merrill Lynch, Pierce, Fenner & Smith Incorporated is a Delaware corporation with its principal place of business in New York, New York. Merrill Lynch is a broker-dealer and investment adviser registered with the Commission pursuant to Section 15(b) of the Exchange Act and Section 203 of the Advisers Act. Merrill Lynch engages in a nationwide securities business.

B. **SUMMARY**

From 2002 to 2004, several Merrill Lynch retail brokers permitted day traders to hear confidential information regarding Merrill Lynch institutional customers' unexecuted orders as they were transmitted over Merrill Lynch's squawk box system. The equity squawk box is an industry-standard audio communication tool that Merrill Lynch's institutional equities business uses to allow position traders to transmit internally customer order information, among other information. The day traders used the customer order information to "trade ahead" of the institutional customer orders and, in many instances, profited from price movements that were caused by the market impact of the institutional customer order. The day traders compensated the brokers for access to this material, nonpublic order information through commissions and cash payments. The brokers' misuse of material, nonpublic information was in violation of the antifraud provisions of the federal securities laws and was the subject of civil enforcement actions by the Commission. *See SEC v. Amore, et al.*, CV-053885 (Glasser) (E.D.N.Y. August 15, 2005); *SEC v. A.B. Watley Group, Inc., et al.*, CV-061274 (Glasser) (E.D.N.Y. March 21, 2006).

Merrill Lynch maintained policies prohibiting insider trading, the front running of customer orders, and the improper disclosure of information about customer orders. Merrill Lynch informed its brokers, including those brokers who improperly disclosed customer order information to day traders, of these policies. However, Merrill Lynch lacked written policies or procedures to limit access to the equity squawk box, to track which employees had access to the equity squawk box or to monitor employees' use of the equity squawk box. Consequently, an undetermined number of retail brokers received access to equity squawk boxes despite the

¹ 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.

absence of any bona fide need for the information, such as demonstrating any ability to fill block orders; Merrill Lynch was unable to identify which employees had equity squawk boxes; and several retail brokers were able to provide equity squawk box information to day traders simply by placing their telephone receiver next to the equity squawk box for the entire trading day.

As a result, Merrill Lynch violated Section 15(f) of the Exchange Act and Section 204A of the Advisers Act, which require registered broker dealers and registered investment advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information.

C. **FACTS**

Merrill Lynch Retail Brokers Made Available Confidential Information Concerning Institutional Customer Orders to Day Trading Firms

From 2002 to 2004, several Merrill Lynch retail brokers permitted day traders to hear confidential information on the large unexecuted block orders of Merrill Lynch institutional customers. The retail brokers were located in three separate Merrill Lynch offices, Branch 1, Branch 2, and Branch 3. The order information was transmitted over Merrill Lynch's equity squawk box.

One common use of the squawk box system is to allow Merrill Lynch position traders to communicate information, including customer order information, to the sales force who might be able to assist in finding customers to complete potential trades. Although customer order information is broadcast over the squawk box, the information communicated over the equity squawk box does not include the customer name.

The retail brokers first obtained from Merrill Lynch access to an equity squawk box. Then, each day, the retail brokers called the day trading firm and placed their telephone receiver next to the equity squawk box for the entire trading day. As a result, the day traders received real-time access to the equity squawk box and the confidential order information transmitted over it. The day traders compensated the brokers for access to the confidential order information through kickbacks in the form of commissions and cash. The day traders used the information to trade ahead of the customer orders and many times profited when the price of the security moved in their favor because of the market impact of the institutional customer orders.

For example, on September 5, 2003, at 11:09 a.m., a Merrill Lynch trader announced over the squawk box a block order to buy stock in "Company A". A Merrill Lynch retail broker gave access to the order information to day traders by leaving his open phone line next to the squawk box. From 11:09 a.m. through 11:11 a.m., at least fifteen day traders who received the information bought 52,400 shares of Company A stock at an average price of \$25.28 (plus an additional 8,400 shares over the next 20 minutes). From 11:09 a.m. through 11:48 a.m., Merrill Lynch purchased 405,800 shares of Company A stock for its customer at an average price above \$25.28 per share. From 11:12 a.m. through 11:48 a.m., at least seventeen day traders sold over 60,800 shares of Company A stock at an average price of \$25.43. As a result, the day traders made a profit of \$7,798.

Merrill Lynch Lacked Policies and Procedures Reasonably Designed to Prevent the Misuse of Material, Nonpublic Order Information

Merrill Lynch's Policies

Merrill Lynch maintained policies prohibiting insider trading, the front running of customer orders, and the improper disclosure of information about customer orders. Merrill Lynch notified its brokers of these policies.

For example, the compliance outline for retail brokers contained a prohibition on insider trading: “Persons who trade while in possession of inside information on the security or its issuer, or pass the information along to others who may trade on the basis of it, may be subject to severe criminal and civil penalties....” In addition, the compliance outline for retail brokers also contained a provision on the confidentiality of customer orders and a prohibition on front running: “You may not take advantage of a contemplated or pending client transaction by first entering orders for your employee accounts or any accounts you service or control (“front running”). Information on client orders may not be disclosed to any other person for other than bona fide business purposes, or used as the basis of any solicitation.”

However, Merrill Lynch did not have written policies and procedures reasonably designed to prevent the misuse of material, nonpublic institutional customer order flow information.

Access to the Squawk Box

Merrill Lynch lacked written policies or procedures to limit access to the information broadcast on the equity squawk box. Consequently, an undetermined number of Merrill Lynch brokers, including the retail brokers in this case, were able to obtain access to the equity squawk box despite the absence of any bona fide need for the information, such as having demonstrated any ability to fill block orders.

The purpose for broadcasting customer order information over the equity squawk box is to facilitate execution of the orders by generating contra-side liquidity from other Merrill Lynch customers. However, Merrill Lynch did not restrict access by brokers to the equity squawk box based on the brokers' bona fide need to know such information. An undetermined number of retail brokers obtained access to the equity squawk box by making an administrative request to Merrill Lynch's telecommunications group. No approval by Merrill Lynch's equities management was required. Accordingly, Merrill Lynch did not limit access to the equity squawk box based on any need for access to the information.

Tracking Access to the Squawk Box

Merrill Lynch also lacked written policies and procedures to keep track of who had access to the equity squawk box. Consequently, Merrill Lynch was unable to determine or

identify all of the employees who had access to institutional customer order information transmitted over the equity squawk box. This hampered efforts by Merrill Lynch to investigate instances of suspected leakage of customer order information.

In connection with an internal effort to limit retail broker access to the equity squawk box, a Merrill Lynch telecommunications consultant also pointed out deficiencies in Merrill Lynch's ability to track access to the equity squawk box. In a March 2004 email to a technology employee, the consultant wrote, "I have no way of knowing who is in the office and possibly listening to the circuit. I really can't control how many boxes are hooked up to the circuit either Also, many offices can splice the wire and hook up additional speakers without us knowing. So, to answer your question, we can not [sic] police the circuit."

Lack of Supervision of Use of the Squawk Box

Merrill Lynch also lacked written supervisory policies or surveillance procedures, particularly for branch managers in retail offices or compliance officers, to monitor the use of the equity squawk box. Merrill Lynch's branch management did not have an understanding of which retail brokers had access to the equity squawk box and were not required by policy to evaluate the manner in which the equity squawk box was being used by retail brokers. Consequently, the retail brokers in this case were able to provide day traders with continuous, real-time access to the equity squawk box simply by placing an open telephone line next to the squawk box on their desks.

Remedial Efforts

Merrill Lynch has implemented certain remedial measures concerning access to the equity squawk box and use of the equity squawk box to communicate internally institutional equity customer order information.

D. LEGAL DISCUSSION

Section 15(f) of the Exchange Act requires brokers and dealers registered with the Commission to establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of the Exchange Act, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. Similarly, Section 204A of the Advisers Act requires investment advisers registered with the Commission to establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of the Advisers Act or Exchange Act, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser.

Given Merrill Lynch's extensive financial businesses, certain categories of employees are regularly in possession of material, nonpublic information or in contact with employees who are in possession of such information pertaining to Merrill Lynch's customers and clients. For

example, Merrill Lynch's institutional customers, such as pension funds, mutual funds, and large hedge funds, routinely place orders to buy and sell blocks of securities. Depending on the size of the order and the volume of trading in the security, these institutional customers' order information can constitute material, nonpublic information. Institutional customers understand that Merrill Lynch, with appropriate discretion, may share their order information with other Merrill Lynch customers who are reasonably considered potential counterparties, but they expect that Merrill Lynch will otherwise keep their orders and order information confidential for a variety of reasons, including the fact that: 1) the customers consider their order information confidential; 2) knowledge of a pending order can negatively affect the price at which Merrill Lynch could execute the customer's order; and 3) other market participants could discern the identity of the customer, to the detriment of the customer's market strategies.

As described above, Merrill Lynch failed to maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of Merrill Lynch's business, to prevent misuse, in violation of the federal securities laws, of material, nonpublic information by Merrill Lynch or any person associated with it. In fact, Merrill Lynch brokers in several offices did violate the antifraud provisions of the securities laws. Merrill Lynch failed to maintain written policies or procedures that reasonably: (a) limited access to the equity squawk box to those employees with a bona fide business need for the customer order information; (b) tracked who had access to the equity squawk box; (c) instructed supervisors on how to control access to, or monitor the use of, the equity squawk box. As a result of Merrill Lynch's failure to maintain and enforce policies and procedures reasonably designed to prevent misuse of the information carried on the equity squawk boxes, retail brokers were able to provide day traders with access to material, nonpublic information concerning customer orders broadcast over the squawk box, in violation of Merrill Lynch's more general policies and in violation of the securities laws. These day traders then traded ahead of customer orders to the detriment of Merrill Lynch's institutional customers.

The Commission has consistently made clear that broker-dealers and investment advisers must take seriously their responsibilities to design and enforce sufficiently robust policies and procedures to prevent the misuse of material, nonpublic information. *See, e.g., In re Goldman, Sachs & Co.*, Exch. Act. Rel. No. 48436; Admin. Proceeding No. 3-11240 (September 4, 2003) (finding violations of Section 15(f)); *In re Gintel Asset Management, Inc., et al.*, Exch. Act Rel. No. 46798; Admin. Proceeding No. 3-10930 (November 8, 2002) (finding violations of Sections 15(f) and 204A); *In re DePrince, Race & Zollo, Inc., et al.*, Adv. Act Rel. No. 2035; Admin. Proceeding No. 3-10798 (June 12, 2002) (finding violations of Section 204A); *In re Guy P. Wyser-Pratte et al.*, Exch. Act Rel. No. 44283; Adv. Act Rel. No. 1943 (May 9, 2001) (finding violations of Section 15(f) and Section 204A); *In re Gabelli & Co., Inc. and Gamco Investors, Inc.*, Exch. Act Rel. No. 35057 (December 8, 1994) (finding violations of Section 15(f) and Section 204A). Taking into consideration the extensive trading and retail brokerage activities of Merrill Lynch, its written policies and procedures were not reasonably

designed to prevent the misuse of material, nonpublic information. Merrill Lynch therefore willfully violated Section 15(f) of the Exchange Act and Section 204A of the Advisers Act.²

IV.

Merrill Lynch has undertaken to implement (or to continue, as the case may be) and maintain the policies and procedures set forth below. Nothing in this Order or in these undertakings shall relieve Merrill Lynch of its obligations under Sections 15(f) of the Exchange Act and Section 204A of the Advisers Act.

- (A) Merrill Lynch will continue, by means of its policies and procedures manuals, to inform its employees that information concerning customer orders is confidential. Merrill Lynch will maintain policies and procedures providing that its employees can obtain access to the equity squawk box only after his/her manager has approved such access in writing because the employee's responsibilities include the facilitation of customer securities transactions through providing contra-side liquidity for large orders.
- (B) Merrill Lynch will require all employees who are granted access to the equity squawk box to certify that he/she has read and agrees to abide by Merrill Lynch's policies and procedures related to the equity squawk box, as set forth in subsection C.2 below.
- (C) Merrill Lynch will design and implement a program to effectuate its policies and procedures concerning the confidentiality of customer order information communicated through the equity squawk box. As part of this program, Merrill Lynch has undertaken to:
 - 1. Grant an employee access to the equity squawk box, the webwall (an intranet webpage containing limit price and quantity information concerning institutional customer orders), or any successor technology or other technology utilized to disseminate internally institutional equity customer order information for the purpose of seeking contra-side liquidity ("squawk-related technology") only after obtaining a written authorization from the manager responsible for supervising that employee. The written authorization should state that the manager has verified that the employee's responsibilities include the facilitation of customer securities transactions through providing contra-side liquidity to large orders. The Head of U.S. Cash Equity Trading must then approve this authorization in writing. On an annual basis, the Head of U.S. Cash Equity Trading will review whether those who have access to customer order information should continue to have access. Merrill Lynch must maintain the manager's written authorizations and the Head of U.S. Cash Equity Trading's written approvals and written annual reviews.

² A willful violation of the securities laws means merely "that the [party] charged with the duty knows what [it] is doing." *See Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)).

2. Every employee requesting access to squawk-related technology is required to submit a certification form acknowledging that a) he/she must protect confidential information relating to customer trading activities that he/she receives or has access to over these applications; b) he/she may generally disclose customer trading information only to persons who have a legitimate and bona fide need to know such information and who there is a reasonable basis to believe can be trusted to handle such information in an appropriate manner; and c) he/she must immediately inform his/her manager if he/she believes a recipient is using the confidential information to trade against the interests of the customer that provided the information.
 3. Place signs on all equity trading floors reminding employees that customer order information is confidential.
 4. Continue compliance training for all employees who use squawk-related technology regarding access procedures to these applications and the employees' obligations to safeguard confidential customer order information.
 5. Discontinue access to squawk-related technology for all employees who have not been approved by the Head of U.S. Equity Cash Trading to retain access, and maintain a list of all employees who have access to squawk-related technology.
 6. Design and implement appropriate surveillance regimens to enforce its policies and procedures concerning the confidentiality of customer order information.
- (D) Merrill Lynch's internal audit department shall audit Merrill Lynch's policies and procedures at least every two years for at least six years following the date of this order. For each of these audits, the firm will provide the Staff with a copy of the audit report; the firm will implement any recommendations in the report within the time period specified by internal audit; and internal audit will confirm the completion of any required actions within 90 days following the date specified for completion.
- (E) Merrill Lynch may, as necessary and appropriate, modify its policies and procedures in the future in response to changes in technology and the evolution of its business. Any such modifications to policies and procedures will be reasonably designed to safeguard confidential customer order information and prevent the misuse of material, nonpublic information.

V.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 15(b)(4) of the Exchange Act and Section 203(e)(5) of the Advisers Act, Merrill Lynch be, and hereby is, censured;

B. Pursuant to Section 21C of the Exchange Act and Section 203(k) of the Advisers Act, Merrill Lynch shall cease and desist from committing or causing any violations and any future violations, of Section 15(f) of the Exchange Act and Section 204(A) of the Advisers Act;

C. Within ten days of the issuance of this Order, Merrill Lynch shall pay a civil money penalty in the aggregate amount of \$7,000,000 to the United States Treasury. Such payment shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the Securities and Exchange Commission; (3) 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 (4) submitted under cover letter that identifies Merrill Lynch, Pierce, Fenner & Smith Incorporated as the Respondent in these proceedings, and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Kay L. Lackey, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, New York, NY 10281; and

D. Merrill Lynch shall comply with the undertakings enumerated in Section IV A - D above.

By the Commission.

Elizabeth M. Murphy
Secretary