

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

**SECURITIES EXCHANGE ACT OF 1934**

**Release No. 63760 / January 25, 2011**

**ADMINISTRATIVE PROCEEDING**

**File No. 3-14204**

**In the Matter of**

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

**Respondent.**

**ORDER INSTITUTING  
ADMINISTRATIVE AND CEASE-AND-  
DESIST PROCEEDINGS, MAKING  
FINDINGS, AND IMPOSING REMEDIAL  
SANCTIONS AND A CEASE-AND-  
DESIST ORDER PURSUANT TO  
SECTIONS 15(b)(4) AND 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**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 15(b)(4) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Respondent” or “Merrill”).

**II.**

In anticipation of the institution of these proceedings, Merrill 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, Merrill consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

### III.

On the basis of this Order and the Offer submitted by Merrill, the Commission finds<sup>1</sup> that:

#### A. RESPONDENT

Merrill, a Delaware corporation with its principal offices in New York, New York, is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. Merrill engages in a nationwide securities business. On January 1, 2009, Merrill and its parent company, Merrill Lynch & Co., were acquired by Bank of America Corporation, a Delaware corporation with its principal offices in Charlotte, North Carolina. Bank of America's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the New York Stock Exchange.

#### B. SUMMARY

This matter involves two kinds of misconduct at Merrill. First, Merrill's proprietary traders misused institutional customer order information which was improperly disclosed by the firm's market makers. Second, Merrill traders improperly charged mark-ups and mark-downs on certain riskless principal trades<sup>2</sup> of institutional and high net worth customers for which the firm had agreed to charge only a commission equivalent.<sup>3</sup>

Between February 2003 and February 2005, Merrill operated a proprietary trading desk, known as the Equity Strategy Desk ("the ESD"), which traded securities solely for the firm's own benefit and had no role in executing customer orders. The ESD was located on Merrill's equity trading floor in New York City, where traders on Merrill's market making desk received and executed orders for Merrill's institutional customers. While Merrill represented to customers that their order information would be maintained on a strict need-to-know basis, Merrill's ESD traders obtained information about institutional customer orders from traders on the market making desk and used it to place trades on Merrill's behalf. In doing so, Merrill misused this information and acted contrary to its representations to customers.

Between 2002 and 2007, Merrill had agreements with certain institutional and high net worth customers that Merrill would charge only a commission equivalent for executing riskless principal trades. In certain instances in which Merrill had these arrangements, Merrill also charged customers, in addition to a commission equivalent, undisclosed mark-ups and mark-downs by filling customer orders at prices less favorable to the customer than the prices at which Merrill purchased or sold the securities in the market. This charging of undisclosed mark-ups and mark-downs was improper and contrary to the agreements the firm had with its customers.

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<sup>1</sup> The findings herein are made pursuant to the Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

<sup>2</sup> A "riskless principal" trade occurs when a broker-dealer, after receiving a customer order to buy (or sell) a security, buys (or sells) the security for its own account from (or to) another person in a contemporaneous offsetting transaction and then allocates the shares to the customer order.

<sup>3</sup> As a general matter, when executing transactions on a principal or riskless principal basis, broker-dealers use the term "commission equivalent" to describe their remuneration for the trade.

As a result of the conduct described herein, Merrill violated Section 15(c)(1)(A) of the Exchange Act by effecting transactions in securities by means of manipulative, deceptive or other fraudulent devices or contrivances. Merrill also violated Section 15(g) of the Exchange Act<sup>4</sup> by failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information.<sup>5</sup> Under Section 15(b)(4)(E) of the Exchange Act, Merrill failed reasonably to supervise its traders with a view towards preventing them from violating the federal securities laws. In addition, Merrill violated Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder by failing to record certain terms and conditions of customer orders.

## C. FACTS

### **Misuse of Institutional Customer Order Information**

In February 2003, Merrill opened a proprietary trading desk, known within Merrill as the Equity Strategy Desk, which traded securities solely for the firm's own benefit and had no role in executing customer orders. The ESD, which had authority to trade over \$1 billion in capital, was physically located on Merrill's equity trading floor in New York City, where traders on the firm's market making desk received and executed orders for institutional customers. The ESD operated from February 2003 through February 2005 and had between one and three proprietary traders at any given time.

Merrill failed to establish policies and procedures reasonably designed to prevent the ESD traders from obtaining institutional customer order information. Although the ESD traders did not have direct access to the computer system the market makers used to execute customer orders, by virtue of being located on Merrill's equity trading floor, ESD traders could see customer order information on the market makers' computer screens and hear market makers discuss customer orders. Moreover, Merrill encouraged its market makers to generate and share "trading ideas" with the ESD traders, promising higher bonuses to market makers whose ideas were profitable.

Merrill represented to customers that information concerning their orders and other business affairs would be kept confidential. Merrill's *Guidelines for Business Conduct: Merrill Lynch's Code of Ethics for Directors, Officers and Employees* (dated January 2003), which it published on its website, expressly stated that Merrill's employees "may not discuss the business affairs of any client with any other person, except on a strict need-to-know basis." In certain instances, customer order information -- particularly information concerning potentially market moving orders submitted by institutional customers -- was material, nonpublic information.

Contrary to Merrill's representations to customers, traders on Merrill's market making desk at times shared institutional customer order information with the firm's ESD traders, both orally and through instant messages. An ESD trader on one occasion told a market maker in an instant message: "[I] always like to do what the smart guys are doing." In certain instances after

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<sup>4</sup> Section 15(g) of the Exchange Act was formerly Section 15(f). The provision was recently renumbered by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

<sup>5</sup> Section 15(g) of the Exchange Act seeks to protect investors and ensure the integrity of the markets by preventing broker-dealers and others from misusing material, nonpublic information.

receiving information about a customer order -- sometimes within minutes -- ESD traders placed orders similar to the customer orders. The following are examples of improper ESD trades made shortly after, and on the basis of information about, customer trades:

On September 3, 2003, an institutional customer placed an order with Merrill to sell approximately 40,000 shares of Teva Pharmaceutical Industries Ltd. Approximately three minutes after this order was placed, a Merrill market maker sent an instant message to an ESD trader informing him about the trade. Two minutes later, the ESD trader placed an order to sell 10,000 shares of Teva for the ESD account, which executed 31 minutes after the customer order.

On October 23, 2003, an institutional customer placed an order to buy 25,000 shares of Comverse Technology, Inc. An ESD trader sent an instant message to a firm market maker asking who was buying the stock. The market maker provided the requested information. Seconds after receiving this information, the ESD trader placed an order to buy 50,000 shares of Comverse, which executed seven minutes after Merrill completed the customer order.

On November 24, 2003, an ESD trader again asked a Merrill market maker who was selling shares of Comverse. The market maker responded that a particular institutional customer that had just bought 25,000 shares. One minute later, the ESD trader submitted an order to buy 25,000 shares of Comverse, which executed four minutes after the customer order. Minutes later, the market maker told the ESD trader that the same customer was "still interested on buy side." The ESD trader then placed an order to buy an additional 25,000 shares, which executed one minute after Merrill completed the customer order.

On February 12, 2004, an institutional customer placed two orders to purchase a total of 120,000 shares of Harmony Gold Mining Co. Ltd. A Merrill market maker sent an instant message to an ESD trader stating that the institutional customer was "buying hmy." Nineteen minutes after receiving this information, the ESD trader placed an order to buy 60,000 shares of Harmony, which executed seven minutes after Merrill completed the customer's second order.

In these and other instances, Merrill market makers executing institutional customer orders shared information concerning those trades with ESD traders. At times, Merrill's proprietary traders used that information to place trades for Merrill. This disclosure and use of institutional customer order information by Merrill's traders was improper and contrary to Merrill's confidentiality representations to its customers.

### **Improper Charging of Mark-Ups and Mark-Downs**

During the relevant time period, Merrill operated one of the largest NASDAQ market making operations in the world. Most of the institutional and high net worth customer orders for NASDAQ securities that Merrill received were executed on an agency basis through a computer system at the firm. At times, however, Merrill also executed orders for these customers on a principal basis through traders on Merrill's market making desk.

Between 2002 through 2007, Merrill had agreements with certain institutional and high net worth customers to charge them only an agreed upon commission equivalent for executing

riskless principal trades. These arrangements normally applied to trades in which the customer did not ask Merrill to risk its own capital in executing the trade, such as by guaranteeing the customer a particular price.

In certain instances between 2002 and 2007, Merrill improperly charged institutional and high net worth customers an undisclosed mark-up or mark-down, in addition to a commission equivalent, on certain riskless principal trades for which Merrill had agreed only to charge a commission equivalent. The following are examples:

In December 2002, Merrill agreed to sell shares of a public company for an executive pursuant to a “10b5-1 plan.”<sup>6</sup> The plan required Merrill to execute market orders for the customer every Monday between January 2003 and January 2005. The customer did not ask Merrill to place its own capital at risk in executing these market orders, and Merrill and the customer agreed that Merrill would charge only a commission equivalent. Contrary to this agreement, in addition to charging the customer a commission equivalent, Merrill also charged an undisclosed mark-down on the transaction by filling the customer order at a lower price than it actually obtained selling the securities in the market.

In July 2003, Merrill received from an institutional customer an order to buy 300,000 shares of NetApp, Inc. over the course of the day. The customer did not ask Merrill to place its own capital at risk, and Merrill had agreed that its only compensation for executing the trade would be a commission equivalent. Contrary to this agreement, Merrill also charged the customer, in addition to a commission equivalent, an undisclosed mark-up, by filling the customer’s order at a higher price than it paid to purchase the securities in the market.

In November 2003, Merrill received from an institutional customer a series of orders to sell more than 5 million shares of Novell, Inc. The customer did not ask Merrill to place its own capital at risk, and Merrill had agreed that its only compensation for executing the trade would be a commission equivalent. Contrary to this agreement, Merrill also charged this customer, in addition to a commission equivalent, an undisclosed mark-down, by filling the customer order at prices below the prices at which Merrill sold the securities in the market.

In November 2006, Merrill received from an institutional customer an order to buy 800,000 shares of BEA Systems, Inc. The customer did not ask Merrill to place its own capital at risk, and Merrill and the customer had agreed that Merrill’s only compensation for executing the order would be a commission equivalent. Contrary to this agreement with the customer, Merrill charged the customer, in addition to a commission equivalent, an undisclosed mark-up, by filling the order at a higher price than it paid to purchase the securities in the market.

In these and other instances, Merrill charged institutional and high net worth customers undisclosed mark-ups and mark-downs on riskless principal trades for which Merrill had agreed to charge the customer only a commission equivalent. In doing so, Merrill acted improperly and contrary to its agreements with its customers.

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<sup>6</sup> So-called 10b5-1 plans are pre-arranged trading plans that derive their name from Rule 10b5-1(c) of the Exchange Act.

**Merrill Failed to Make Records  
of Certain Terms and Conditions of Customer Orders**

From 2002 through 2007, Merrill generally made written records of customer orders to buy or sell equity securities that included, among other terms and conditions of the order, the name of the security, whether it was a buy or sell order, the quantity of shares, and the price for any limit on the order. During that time period, in response to certain orders placed by institutional customers, Merrill at times agreed to guarantee the customer a specific per-share execution price or a price tied to an agreed upon benchmark, such as the volume weighted average price of the security on a particular date. Merrill's traders usually made these price guarantees orally during telephone conversations with the customer representatives and, in many instances, did not make written records of the guarantees.

Section 17(a)(1) of the Exchange Act provides that each broker-dealer "shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this chapter." Exchange Act Rule 17a-3(a)(6)(i) requires broker-dealers to make and keep current "[a] memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. The memorandum shall show the terms and conditions of the order or instructions..." An agreement by Merrill to guarantee an execution price for a customer is part of the terms and conditions of the customer's order.

During the period 2002 through 2007, Merrill failed in many instances to make records of price guarantees that were part of the terms and conditions of institutional customer orders.

**VIOLATIONS**

As a result of the conduct described above, Merrill willfully violated Section 15(c)(1)(A) of the Exchange Act, in that Merrill, while acting as a broker-dealer, effected transactions in securities by means of manipulative, deceptive or other fraudulent devices or contrivances.

As a result of the conduct described above, Merrill willfully violated Section 15(g) of the Exchange Act, in that Merrill, while acting as a broker-dealer, failed to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse, in violation of the Exchange Act or rules thereunder, of material, nonpublic information by Merrill or persons associated with it.

As a result of the conduct described above, Merrill willfully violated Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder, in that it, while acting as a registered broker-dealer, failed to make records of certain terms and conditions of customer orders.

## **FAILURE TO SUPERVISE**

Section 15(b)(4)(E) of the Exchange Act requires broker-dealers reasonably to supervise persons subject to their supervision, with a view toward preventing violations of the federal securities laws. *See, e.g., Dean Witter Reynolds, Inc.*, Exchange Act Rel. No. 46578 (October 1, 2002). The Commission has emphasized that the “responsibility of broker-dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets.” *Smith Barney, Harris Upham & Co. Incorporated and Robert G. Heck*, Exchange Act Rel. No. 21813 (March 5, 1985).

As a result of the conduct described above, Merrill failed reasonably to supervise traders associated with the ESD and its NASDAQ market making operations, with a view to detecting and preventing violations of the Exchange Act. Specifically, Merrill failed to detect and prevent the conduct of these traders in misusing confidential customer order information and improperly charging customers undisclosed mark-ups and mark-downs on trades for which Merrill had agreed to charge only to a commission equivalent.

## **REMEDIAL EFFORTS**

In determining whether to accept the Offer, the Commission considered significant remedial acts voluntarily taken by Merrill.

### **IV.**

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, pursuant to Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent Merrill shall cease and desist from committing or causing any violations and any future violations of Sections 15(c)(1)(A), 15(g) and 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder;
- B. Respondent Merrill be and hereby is censured pursuant to Section 15(b)(4) of the Exchange Act; and
- C. Pursuant to Section 15(b)(4) and Section 21B of the Exchange Act, Respondent shall, within ten (10) days of the entry of this Order, pay a civil money penalty to the United States Treasury in the amount of \$10 million. Such payment shall be: (1) made by wire transfer, 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, Alexandria, VA 22312-0003; and (4) submitted under a cover letter that identifies Merrill Lynch, Pierce, Fenner & Smith Incorporated as the Respondent in this proceeding and includes the file number of this proceeding,

a copy of which cover letter and money order or check shall be sent to Antony Richard Petrilla, Division of Enforcement, Securities and Exchange Commission, 100 F Street N.E., Washington, D.C. 20549-5010-B.

By the Commission.

Elizabeth M. Murphy  
Secretary



Service List

Rule 141 of the Commission's Rules of Practice provides that the Secretary, or another duly authorized officer of the Commission, shall serve a copy of the Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Order") on the Respondent and its legal agent.

The attached Order has been sent to the following parties and other persons entitled to notice:

Honorable Brenda P. Murray  
Chief Administrative Law Judge  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-2557

Antony Richard Petrilla, Esq.  
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