

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

**SECURITIES ACT OF 1933**  
**Release No. 10103 / June 23, 2016**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-17314**

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<b>In the Matter of</b>	:	
	:	<b>ORDER INSTITUTING CEASE AND</b>
<b>MERRILL LYNCH, PIERCE,</b>	:	<b>DESIST PROCEEDINGS PURSUANT TO</b>
<b>FENNER &amp; SMITH INCORPORATED,</b>	:	<b>SECTION 8A OF THE SECURITIES</b>
	:	<b>ACT OF 1933, MAKING FINDINGS AND</b>
<b>Respondent.</b>	:	<b>IMPOSING A CEASE AND DESIST</b>
	:	<b>ORDER</b>
	:	

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**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”) against Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill Lynch” or “Respondent”).

**II.**

In anticipation of the institution of these proceedings, Merrill Lynch has submitted an Offer of Settlement (“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 Lynch consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings and Imposing a Cease-and-Desist Order (“Order”), as set forth below.

**III.**

On the basis of this Order and Merrill Lynch’s Offer, the Commission finds<sup>1</sup> that:

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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.

## **Summary**

1. These proceedings involve Merrill Lynch's failure to adequately disclose certain fixed costs in a proprietary volatility index linked to structured notes known as Strategic Return Notes ("SRNs") of Bank of America Corporation ("BAC"). Merrill Lynch offered and sold approximately \$150 million of these volatility notes to approximately 4,000 retail investor accounts in 2010 and 2011. The disclosures made it appear as if the volatility product had relatively low fixed costs. The offering materials emphasized that investors would be subject to a 2% sales commission and a 0.75% annual fee. The offering materials failed to adequately disclose a third fixed, regularly occurring cost included in its proprietary volatility index known as the "Execution Factor" (distinct from "holding" or "decay" costs associated with daily calculation of the underlying index which are variable and depend upon market conditions). As a result, the disclosures in the offering materials of the fixed costs associated with the SRNs were materially misleading.

## **Respondent**

2. Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") is a registered broker-dealer headquartered in New York, New York. Merrill Lynch is an indirect, wholly-owned subsidiary of BAC.

## **Facts**

### **Strategic Return Notes**

3. Volatility products are complex financial instruments marketed and sold to both retail and institutional clients; this case arises from Merrill Lynch's retail sales of SRNs, which were the first structured volatility product offered and sold to retail investors by BAC through Merrill Lynch. A number of other large financial institutions marketed similar volatility products during the same time period.

4. Between October 2010 and July 2011, BAC offered and sold approximately \$150 million in SRNs linked to the Investable Volatility Index ("VOL" or "Index"). The public offering price was \$10 per unit and the underwriting discount was \$0.20. Underwriting fees to Merrill Lynch were approximately \$3 million.

5. Merrill Lynch was principally responsible for preparation of BAC's offering documents. These included the following prospectuses in registration statements filed with the Commission by BAC: a Prospectus dated April 20, 2009; a Medium Term Notes, Series L, Prospectus Supplement dated April 21, 2009; nine Final Pricing Supplements for offerings issued on October 4, 2010, November 8, 2010, December 3, 2010, December 31, 2010, February 7, 2011, March 7, 2011, April 4, 2011, May 9, 2011 and July 5, 2011 (collectively the "Pricing Supps"); and a fact sheet entitled "Investible Volatility Index" that was filed with the Commission as a free writing prospectus (together with Pricing Supps, Offering Documents).

6. The SRNs had a five-year term and permitted earlier redemption as specified in the Pricing Supps. The SRNs paid no interest. Investors were entitled to a cash payment at maturity or during specified redemption periods dependent upon the level of the VOL.

7. According to the Pricing Supps, the VOL “provides a measure of market volatility in the equity markets” and “is designed to measure the return of an investment in the forward implied volatility of the S&P 500 index for a three-month period with a mid-point approximately five months in the future.” The VOL does so by reference to publicly available levels of implied volatility on the S&P 500 index and uses those levels to calculate levels of forward implied volatility over different intervals of time. The VOL then treated those levels of forward implied volatility like assets that were bought and sold as part of a hypothetical portfolio. The hypothetical portfolio is rebalanced every business day to maintain a constant exposure to the specified forward implied volatility. In the daily rebalancing process, a fixed cost known as the “Execution Factor” is applied to each synthetic purchase of forward implied volatility as part of the Index calculation.

### **Relevant Statements**

8. The Cover Page and Key Features sections of the retail Pricing Supps disclosed certain fixed costs associated with the SRNs. The Cover Page represented that “Return [will be] reduced by a 2% sales charge and an Index Adjustment Factor that will accrue daily at the rate of 0.75% per annum.” The Key Features section of the Pricing Supps represented that the “SRNs provide a positive return for investors if the level of the [Index], adjusted as described below, increases by at least the sum of (i) approximately 2% and (ii) the accrued Index Adjustment Factor . . . the level of the Index will be reduced by the Index Adjustment Factor of 0.75% per annum . . .” The Key Features section further represented that the Index Adjustment Factor would lower the level of the VOL by 3.67% over the five year term of the note.

9. In addition, the Key Features section of the retail Pricing Supps represented that, as a result of the cumulative and combined effects of the sales charge and Index Adjustment Factor, “in order for you to receive at least the \$10 Original Offering Price per unit on the maturity date, the level of the Index must increase by more than 5.93% from the Starting Value.” The fixed costs represented by the 2% sales charge and the 0.75% Index Adjustment Factor were described multiple times in the Pricing Supps, in narrative language which explained the amount of each fixed cost, what it was multiplied against and how often it applied.

### **Execution Factor**

10. Merrill Lynch did not adequately include in the Offering Documents an additional regularly occurring fixed cost, known as the “Execution Factor,” that was included in the Index. The Execution Factor increased by 1.5% the cost, or level, of each unit of forward implied volatility being purchased as part of that day’s rebalancing. Because the hypothetical portfolio completely turned over each quarter, the Execution Factor imposed a cost of 1.5% on the Index each quarter. The Index also included a feature called the Index Multiplier which increased the daily Index calculation by 120% including the effect of the Execution Factor.

11. The Pricing Supps included a 4-page narrative or description of the VOL. The Execution Factor was not mentioned in that narrative description of the Index.

12. Under the heading “[t]he method by which the Index is calculated includes features which may reduce the amount payable on the SRNs,” the Risk Factors section of the Pricing Supps provided in relevant part: “The methodology of the Index includes an ‘Execution Factor’ that is designed to reflect the transaction costs that would be incurred in attempting to implement an investment strategy that replicates the Index. The Execution Factor has the effect of reducing the actual level of the Index on any given Index Business Day.” Because the forward implied volatility levels from which the Index is calculated do not themselves account for transaction costs, the Pricing Supps stated that the Execution Factor was intended to represent the transaction costs that would be incurred by an investor pursuing a strategy that replicates the Index.

13. Annex A to the Pricing Supps included a complex six-step mathematical formula used to calculate the level of the VOL. The following description of the Execution Factor was provided at step four of the Index calculation: “The Execution Factor is equal to 1.015 and is designed to reflect the transaction costs that would be incurred in implementing a strategy that replicates the Index. The Execution Factor is only applied to the equation where  $n1$  or  $n2$  is to be increased from the level  $n1\ t-1$  or  $n2\ t-1$ , respectively.” A sample Annex A is attached hereto.

14. A reasonable retail investor would have considered it important to the total mix of information available when purchasing the SRNs that the Execution Factor imposed a transaction cost of 1.5% of the Index value each quarter, accruing on a daily basis. Merrill Lynch’s failure to adequately include the Execution Factor rendered the cost disclosures relating to the fixed 2% sales charge and 0.75% Index Adjustment Factor materially misleading.

### **Merrill Lynch’s Negligence**

15. As an issuer of securities, BAC had a duty to disclose all material information necessary to make statements contained in the retail Pricing Supps, in light of the circumstances under which they were made, not misleading. BAC delegated to Merrill Lynch principal responsibility for drafting and reviewing the retail Pricing Supps. Within Merrill Lynch, primary responsibility for drafting and reviewing the retail Pricing Supps was spread among different groups (as supplemented by outside counsel). Merrill Lynch failed to have in place an effective policy, procedure or internal communication process to provide reasonable assurances that the individuals with primary responsibility for drafting, reviewing and approving the retail Pricing Supps prepared disclosures for BAC regarding the Execution Factor that were not materially misleading in light of the disclosure of other fixed, regularly occurring costs.

\* \* \*

16. As a result of the negligent conduct described above, Merrill Lynch violated Section 17(a)(2) of the Securities Act which prohibits obtaining money or property by means of material misstatements and omissions in the offer or sale of securities.

#### IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, it is hereby ORDERED that:

A. Merrill Lynch cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) of the Securities Act.

B. Merrill Lynch shall, within ten (10) days of the entry of this Order, pay a civil monetary penalty in the amount of \$10 million to the Securities and Exchange Commission for transfer to the general fund of United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment to the Commission must be made in one of the following ways:

- i. Merrill Lynch may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- ii. Merrill Lynch 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
- iii. Merrill Lynch 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 must be accompanied by a cover letter identifying BAC as a Respondent in these proceedings and the file number of these proceedings. Proof of payment must be sent to Reid A. Muoio, Deputy Chief, Complex Financial Instruments Unit, Division of Enforcement, Securities and Exchange Commission, 100 F St. NE, Washington, DC 20549.

By the Commission.

Brent J. Fields  
Secretary

## Annex A

### Index Calculation

#### Calculating the Index

For each scheduled Index Business Day, the Index is calculated as follows:

#### Step 1: Calculate the Forward Implied Volatility levels from the Index Components

On each Index Business Day, three Forward Implied Volatility levels can be computed from the Index Components. The Index Components on any given day can be identified in chronological order as "IC1," "IC2," "IC3," and "IC4," with IC1 representing the Index Component closest to the Index Business Day. For example, on June 5, 2010, which is prior to the expiration date in June 2010, IC1 represented VXJUN (with an expiration date in June 2010), IC2 represented VXSEP, IC3 represented VXDEC, and IC4 represented VXMAR. In contrast, on June 24, 2010, which is after the expiration date in June 2010, IC1 represented VXSEP, IC2 represented VXDEC, IC3 represented VXMAR, and IC4 represented VXJUN (with an expiration date in June 2011).

The three Forward Implied Volatility levels, identified as "FIVA," "FIVB," and "FIVC," are computed according to the following formulas:

$$FIVA = \sqrt{\frac{t_2 \times IC2^2 - t_1 \times IC1^2}{(t_2 - t_1)}}$$

$$FIVB = \sqrt{\frac{t_3 \times IC3^2 - t_2 \times IC2^2}{(t_3 - t_2)}}$$

$$FIVC = \sqrt{\frac{t_4 \times IC4^2 - t_3 \times IC3^2}{(t_4 - t_3)}}$$

with  $t_1$ ,  $t_2$ ,  $t_3$ , and  $t_4$  representing the portion of a calendar year, calculated using minutes, from the current time on the applicable Index Business Day to 9:30 a.m. (New York City Time) on the Listed Expiration Date (as described on page PS-15) for IC1, IC2, IC3, and IC4, respectively.

#### Step 2: Determine the appropriate Forward Implied Volatilities to use for the Index calculation

The Index uses two of the three Forward Implied Volatilities. The two Forward Implied Volatilities used for the Index Calculation are defined as *FIV1* and *FIV2*.

On each Index Business Day, *FIV1* and *FIV2* are identified using the process below:

- The Index Calculation Agent calculates the average time to maturity ("ATT") for each Forward Implied Volatility. The ATT represents the average of the time to maturity for the two Index Components used in calculating a Forward Implied Volatility.

$$ATT_A = \frac{t_1^d + t_2^d}{2}$$

$$ATT_B = \frac{t_2^d + t_3^d}{2}$$

$$ATT_C = \frac{t_3^d + t_4^d}{2}$$

where:  $t_1^d$ ,  $t_2^d$ ,  $t_3^d$ , and  $t_4^d$  represent the portions of a calendar year, calculated using actual days/365, from the applicable Index Business Day until the Listed Expiration Date for IC1, IC2, IC3, and IC4, respectively.

- The Index Calculation Agent compares the ATT values for FIVA, FIVB, and FIVC, and identifies the ATT value that is both closest to and less than 5/12. The Forward Implied Volatility to which this ATT pertains is defined as *FIV1*. The ATT of *FIV1* is defined as  $ATT_1$ .
- The Index Calculation Agent compares the ATT values for FIVA, FIVB, and FIVC, and identifies the ATT value that is both closest to and greater than or equal to 5/12. The Forward Implied Volatility to which this ATT pertains is defined as *FIV2*. The ATT of *FIV2* is defined as  $ATT_2$ .

#### Step 3: Determine the weights for *FIV1* and *FIV2*

The Index Calculation Agent calculates the Forward Implied Volatility weights  $w_1$  and  $w_2$ , for the forward volatilities *FIV1* and *FIV2*.

respectively, such that (i)  $w_1 ATT_1 + w_2 ATT_2$  is approximately 5/12 and (ii)  $w_1 + w_2 = 1$ . The weights are designed to keep the weighted ATT values of the Forward Implied Volatilities used for the Index calculation at approximately 5/12. As time passes (over a period of approximately three months),  $w_1$  will decrease to approach 0, and  $w_2$  will increase to approach 1. On the day (defined as a "New Contract Day") when  $ATT_2$  declines from being greater than 5/12 to being less than 5/12, the Forward Implied Volatilities are rolled, such that the Forward Implied Volatility defined as FIV2 becomes FIV1 and the next Forward Implied Volatility becomes FIV2.

If the Index Business Day is a New Contract Date, then  $w_1 = 1$  and  $w_2 = 0$ .

Otherwise:

$$w_1 = \frac{ATT_2 - \frac{5}{12}}{ATT_2 - ATT_1} \text{ and } w_2 = 1 - w_1$$

**Step 4: Determine the number of contracts for FIV1 and FIV2**

The contracts  $n_1^t$  and  $n_2^t$  represent the amount of theoretical investment the Index has in FIV1 and FIV2, respectively. The contracts are adjusted daily to keep the exposure to FIV1 and FIV2 consistent with the weightings  $w_1$  and  $w_2$ , and to account for transaction costs which would be incurred in implementing a strategy that replicates the Index.

Calculate  $n_1^t$  and  $n_2^t$  for FIV1 and FIV2:

For  $n_1$ :

$$n_1^t = n_1^{t-1} + \frac{w_1^t S_t - n_1^{t-1} FIV1}{FIV1 * ExecutionFactor} \text{ when } w_1^t S_t - n_1^{t-1} FIV1 > 0.$$

Otherwise, including on the Base Date (December 31, 2004):

$$n_1^t = \frac{w_1 S_t}{FIV1}$$

For  $n_2$ :

$$n_2^t = n_2^{t-1} + \frac{w_2^t S_t - n_2^{t-1} FIV2}{FIV2 * ExecutionFactor} \text{ when } w_2^t S_t - n_2^{t-1} FIV2 > 0.$$

Otherwise, including on the Base Date (December 31, 2004):

$$n_2^t = \frac{w_2 S_t}{FIV2}$$

where:

$$S_t = n_1^{t-1} FIV1 + n_2^{t-1} FIV2$$

The Execution Factor is equal to 1.015 and is designed to reflect the transaction costs that would be incurred in implementing a strategy that replicates the Index. The Execution Factor is only applied to the equation where  $n_1$  or  $n_2$  is to be increased from the level of  $n_1^{t-1}$  or  $n_2^{t-1}$ , respectively.

**Step 5: Calculate the simple return of the Index on the Index Business Day**

The simple return of the Index,  $r_t$ , is equal to:

$$r_t = \frac{S_t - S_{t-1}}{S_{t-1}}$$

**Step 6: Calculate the Index closing level**

The Index closing level,  $I_t$ , is equal to:

$$I_t = I_{t-1} \times (1 + Index Multiplier \times r_t + IA_t)$$

where:

Index Multiplier = 120%

Interest accrual,  $I A_t$

$Rate_{t-1}$

$$\frac{1}{360} \times d$$

where  $Rate_{t-1}$  is the closing level of the one-month U.S. Treasury bill yield on Index Business Day  $t-1$ , and  $d$  is the number of calendar days from, but excluding, Index Business Day  $t-1$ , to and including, Index Business Day  $t$ .

$I_t$  is rounded to 2 decimal places.