

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 10507 / June 19, 2018

SECURITIES EXCHANGE ACT OF 1934
Release No. 83462 / June 19, 2018

INVESTMENT ADVISERS ACT OF 1940
Release No. 4944 / June 19, 2018

ADMINISTRATIVE PROCEEDING
File No. 3-18549

In the Matter of

**Merrill Lynch, Pierce, Fenner
& Smith Incorporated**

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTION 8A OF THE SECURITIES ACT
OF 1933, SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934,
AND SECTION 203(e) OF THE
INVESTMENT ADVISERS ACT OF 1940,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER**

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 Section 8A of the Securities Act of 1933 (“Securities Act”), Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”), and Section 203(e) of the Investment Advisers Act of 1940 (“Advisers Act”) against Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill Lynch” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) that the Commission has determined to accept. Respondent admits the facts set forth in Section IV below, acknowledges that its conduct violated the federal

securities laws, admits the Commission's jurisdiction over it and the subject matter of these proceedings, and consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933, Section 15(b) of the Securities Exchange Act of 1934, and Section 203(e) 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 that:

Summary

1. This proceeding concerns Merrill Lynch's sustained efforts to hide its practice of routing certain customer orders to other broker-dealers ("External Liquidity Providers," "Electronic Liquidity Partners," or "ELPs"), including proprietary trading firms and wholesale market makers, for execution. Merrill Lynch configured a number of internal and external trade reporting systems so that customer orders that were executed at ELPs instead appeared to customers to have been executed at Merrill Lynch. For example, Merrill Lynch programmed a system that provided automated messages to customers regarding each trade to report, falsely, that the execution venue was Merrill Lynch and not an ELP. Merrill Lynch similarly misreported ELP executions in reports provided to customers and in billing invoices. Further, when responding to customer questionnaires and in other communications, Merrill Lynch specifically omitted ELPs from lists of venues to which customer orders were routed.

2. Merrill Lynch referred to this practice internally as "masking." Merrill Lynch masked the ELP executions of the firm's "direct strategy access" or "DSA" customers. These customers typically were financial institutions such as asset managers, mutual fund investment advisers, and public pension funds. Merrill Lynch received DSA customer orders and typically sliced them into smaller "child" orders that it routed to various trading centers, including exchanges, Alternative Trading Systems ("ATs"), and ELPs.

3. During the five years that masking was in place (2008-2013), Merrill Lynch's DSA customers received more than 15.8 million child order executions at ELPs. These transactions involved more than 5.4 billion shares and had a notional value of over \$141 billion. Merrill Lynch falsely reported to customers that all of these transactions occurred at Merrill Lynch.

4. As a result of Merrill Lynch's masking practice, Merrill Lynch's customers did not know that (1) some of their orders were executed at ELPs; and (2) other orders were exposed to ELPs before being executed at other venues. This information was material. These customers wanted to know, and expected Merrill Lynch to inform them, if Merrill Lynch sent their orders to

ELPs. Certain customers used the execution venue information provided by Merrill Lynch to assess its performance and make strategic choices about their broker-dealer relationships and tactical routing decisions. Certain customers were concerned that orders routed to ELPs could be subject to information leakage. Moreover, certain customers specifically requested that their orders *not* be sent to ELPs, but Merrill Lynch nevertheless sent some of their orders to ELPs and masked any resulting ELP executions. As a result, these customers' orders received unwanted executions against entities with which they believed their orders would not interact. Because of masking, these customers did not know that Merrill Lynch violated their instructions.

5. Merrill Lynch stopped masking in May 2013 on a prospective basis, but did not inform customers that it previously had masked their ELP executions. To the contrary, Merrill Lynch configured systems so that future reports to customers, typically provided on a monthly or quarterly basis, continued to mask ELP executions that occurred prior to May 2013. More than 30% of the total number of subsequently identified masked executions occurred from May 2012 through May 2013.

6. Merrill Lynch's statements and omissions in communications to customers through responses to questionnaires, messages regarding trade executions, reports, and billing statements were materially misleading concerning orders that Merrill Lynch sent to ELPs and orders that the ELPs executed. Moreover, Merrill Lynch's efforts to mask the correct trading venues, including by altering trade reporting programs, operated as a fraud or deceit upon its customers. As a result, Merrill Lynch willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.¹

IV.

Respondent

7. Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), a Delaware corporation with its principal offices in New York, New York, is registered with the Commission as a broker-dealer pursuant to Section 15 of the Exchange Act and as an investment adviser pursuant to Section 203 of the Advisers Act. Merrill Lynch is a member of various self-regulatory organizations, including the Financial Industry Regulatory Authority ("FINRA") and various exchanges. Merrill Lynch engages in securities brokerage for retail and institutional customers. Merrill Lynch operates a dark pool pursuant to Regulation ATS. In 2012, Merrill Lynch renamed its dark pool Instinct X. Merrill Lynch is a wholly-owned subsidiary of Bank of America Corporation. Bank of America Corporation is a Delaware corporation, whose common

¹ 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 (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)).

stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the New York Stock Exchange.

Facts

A. Background

8. One of the primary functions of broker-dealers is the routing of customer orders to trading centers for execution. The U.S. equities markets comprise multiple types of trading centers, including registered exchanges and ATSS, many of which operate as dark pools. In addition, certain broker-dealers themselves act as trading centers, including by functioning as wholesale market makers or internalizers.

9. Once orders have been executed, broker-dealers provide their customers with information regarding the executions. This information may identify where the executions took place—at exchanges, dark pools, or other broker-dealers. The information may be provided in varying formats and through different channels, including messages transmitted through the Financial Information eXchange (“FIX”) protocol system. FIX protocol is an electronic messaging protocol commonly used in the financial industry that allows parties to an electronic trade—the customer, broker-dealer, and trading venue—to transmit information about orders. This is done through a system of digital fields called “tags” that are populated during the trading process. Entities and individuals that receive FIX messages select which tags their broker-dealers should populate.

10. Two FIX message tags identify the venue where the execution occurred. “Tag 76,” or the “executing broker” field, identifies the broker with whom an order was held at the point of execution. Prior to masking, Merrill Lynch used Tag 76 to identify the specific exchange, ATS, or other broker-dealer where the order received execution. “Tag 30,” or the “last market” field, similarly identifies the trading venue at which the order was executed, again listing the specific exchange, ATS, or other broker-dealer. Many traders use these FIX tags to adjust intra-day trading and to assess historical performance. As discussed below, to implement masking, Merrill Lynch rewrote its code so that Tags 76 and 30 listed Merrill Lynch when customer executions occurred at ELPs.

B. Merrill Lynch’s “ELP” Program

11. In approximately late 2007, Merrill Lynch began developing a program to route certain customer orders, on an “Immediate or Cancel” basis,² to one or more ELPs, after first attempting to obtain executions in Merrill Lynch’s dark pool or at other ATSS. Merrill Lynch

² An immediate or cancel instruction requires that any part of the order which cannot be filled immediately is cancelled by the trading center.

then routed any remaining unexecuted shares to other ELPs, exchanges, and ATSS, or executed the shares itself as counter-party.

12. ELPs were broker-dealers that had proprietary trading and wholesale market-making components. Merrill Lynch also referred to the ELPs internally as “Trading Partners.” The ELPs gained access to customer orders, which they could choose to execute against. The ELPs provided liquidity by filling some customer orders, and the rest were then sent by Merrill Lynch to the broader market.

13. When implementing masking, a Merrill Lynch employee stated that the “[g]oal is to increase the volume sent to these trading partners.” Masking offered a way for Merrill Lynch to increase its order flow to ELPs without informing customers, including those who had specifically expressed concerns about ELPs. When orders were executed by ELPs, Merrill Lynch avoided the access fees typically charged by exchanges while receiving commissions from customers. In addition, listing ELP executions as having occurred at Merrill Lynch gave the misleading impression that Merrill Lynch was a more active trading center than it actually was.

C. Merrill Lynch “Masked” ELP Executions

14. Merrill Lynch began systematically routing customer orders to ELPs on May 20, 2008. Throughout the next five years, Merrill Lynch made changes to the program, adding and disabling broker-dealers as ELP destinations. Throughout the five-year period, Merrill Lynch took steps to ensure that customers did not learn that their orders had been sent to or executed at ELPs and instead believed that Merrill Lynch had executed the orders internally.

15. Merrill Lynch reconfigured its FIX messaging system to “mask” the execution venue of orders that received executions at ELPs. Merrill Lynch altered software code so that its systems removed the ELP’s identifier from the two FIX fields that identify the execution venue and replaced it with the Merrill Lynch identifier prior to sending the FIX messages to customers.

16. Similarly, Merrill Lynch reprogrammed the systems responsible for generating Transaction Cost Analysis (“TCA”) reports provided to customers. Customers could elect to receive these reports with various frequencies, such as monthly or quarterly. The TCA reports contained pie charts that aggregated the customer’s executions by venue, listing each exchange and ATS by the percentage of the customer’s executed trades that occurred at that venue over the relevant period. Merrill Lynch modified the TCA reports to remove ELPs as venues and to instead falsely show that the ELP executions had occurred at Merrill Lynch.

17. Merrill Lynch similarly removed ELP venues from billing invoices sent to its customers and instead identified ELP executions as having occurred at Merrill Lynch. At first,

Merrill Lynch employees manually deleted ELPs from customers' monthly bills. Merrill Lynch eventually automated the process.

18. Merrill Lynch extended "masking" to communications with customers regarding trading centers. When responding to questions from customers regarding routing destinations, Merrill Lynch specifically omitted ELPs. For example, in response to customer questionnaires that asked for a precise list of all trading destinations to which Merrill Lynch sent the relevant customer's orders, Merrill Lynch repeatedly listed specific exchanges and dark pools but not the multiple ELPs where Merrill Lynch also sent the customer's orders. Merrill Lynch also removed references to ELPs from ad hoc communications with customers regarding order routing and potential venues.

19. Merrill Lynch also engaged in "masking" when describing the execution venue data that Merrill Lynch provided in FIX messages and TCA reports. For example, in a June 2012 questionnaire response to one customer, Merrill Lynch wrote, "Since we feel it is important for clients to examine where brokers are routing their orders, we regularly provide clients with liquidity maps [TCA reports] upon demand. . . . Clients can also elect to receive real-time venue and liquidity flag information for each fill on their FIX execution messages." This response did not, however, advise the customer that in its TCA reports and FIX messages, executions that had occurred at ELPs would falsely be reflected as executions that occurred at Merrill Lynch. During the time period that masking was in effect at Merrill Lynch, more than 67,000 of this customer's orders for more than 28 million shares with a notional value of more than \$839 million received executions at ELPs. Merrill Lynch masked all of these executions.

20. In February 2013, a different customer asked Merrill Lynch whether it supported various FIX tags, including Tag 30, the "last market" field. Merrill Lynch responded that the firm did support Tag 30. However, the response failed to tell the customer that Tag 30 falsely listed Merrill Lynch whenever the customer's orders were executed at ELPs. During the time period that masking was in effect, more than 9,800 of this customer's orders for more than 3 million shares with a notional value of more than \$68 million received executions at ELPs. Merrill Lynch masked all of these executions.

21. In March 2013, another customer asked Merrill Lynch to provide information regarding the total shares routed to and total shares executed at each trading venue to which Merrill Lynch had sent the customer's orders. Merrill Lynch personnel initially created a table that provided this information for all of the venues to which the customer's orders had been routed and at which they had received executions, including ELPs. Prior to sending the response, however, Merrill Lynch modified the table and deleted ELPs from the list of execution venues, and the shares Merrill Lynch had routed to ELPs or that were executed at ELPs were included in the total for orders routed to and executed at Merrill Lynch. During the time period that masking was in effect at Merrill Lynch, more than 9,000 of this customer's orders,

consisting of more than 2.9 million shares with a notional value of more than \$91 million, were executed at ELPs. Merrill Lynch masked all of these executions.

22. Merrill Lynch's masking efforts were focused on customers and customer communications. Merrill Lynch's internal data systems responsible for records provided to regulators accurately reflected execution venues when trades occurred at ELPs.

D. Merrill Lynch Routed to ELPs Despite Customer Instructions

23. Some Merrill Lynch customers instructed Merrill Lynch not to route orders to firms that were ELPs when Merrill Lynch routed the customers' orders to external venues. However, Merrill Lynch routed orders to ELPs on behalf of multiple customers in contravention of these instructions. As a result, these customers' orders were exposed to entities with which they believed their orders would not interact.

24. For example, one customer had in place a directive since August 2008 to exclude interactions with all ELPs on all of its orders. Despite this instruction, Merrill Lynch subsequently sent this customer's orders to ELPs, resulting in more than 108,000 executions for more than 33 million shares with a notional value of more than \$1 billion. Merrill Lynch masked all of these executions.

25. Another customer provided Merrill Lynch with a list in December 2012 of the counterparties and venues with which it wanted to interact, and none of the venues listed were ELPs. In bolded lettering, the customer instructed Merrill Lynch, "If your platform connects to any venue other than those listed here, please arrange to disconnect that venue as of January 1, 2013." Nevertheless, Merrill Lynch decided to continue sending the customer's orders to ELPs because (as discussed in an internal e-mail) they were "currently masked as MLCO [Merrill Lynch]," meaning that the customer would not be able to see that Merrill Lynch had disregarded the instructions. This customer received more than 104,000 ELP executions for more than 33 million shares with a notional value of more than \$1.2 billion. Merrill Lynch masked all of these executions.

26. A number of other customers instructed Merrill Lynch that they did not want their orders to interact with certain categories of counterparties (such as high frequency traders or market makers), which would include ELPs, in Merrill Lynch's dark pool. However, Merrill Lynch did not discuss with these customers the possibility that their orders could interact with ELPs should Merrill Lynch send their orders for execution outside of the dark pool.

E. Merrill Lynch Stops Masking ELP Executions But Does Not Inform Customers

27. The impact of masking was significant. From July 2009 through May 2013, Merrill Lynch's routing of DSA customer orders to ELPs resulted in approximately 15.8 million

customer executions at ELPs, representing approximately 5.4 billion shares with a notional value of approximately \$142 billion. Merrill Lynch falsely reported all of these transactions to customers as having occurred at Merrill Lynch.

28. In October 2012, Merrill Lynch personnel discussed ending masking in order to “provide transparency to our clients.” Despite this recognition, Merrill Lynch continued to mask ELP executions over the next seven months and did not inform customers about the practice.

29. On May 6, 2013, Merrill Lynch began providing customers with accurate information regarding execution venues on a prospective basis. In subsequent FIX messages, TCA reports, billing invoices, and customer communications, Merrill Lynch included ELPs when listing execution venues, but only for trades occurring on or after May 6, 2013.

30. Merrill Lynch did not provide written notice to its customers nor did it systematically communicate to affected customers that their orders had been sent to ELPs, with their executions masked, for the preceding five years. To the contrary, Merrill Lynch specifically programmed its reporting systems so that customers whose TCA reports straddled May 6, 2013 would see only those trades that occurred on or after May 6, 2013 marked as ELP executions.

31. Information about masking was material. After Merrill Lynch ended masking and executions at ELPs became transparent, a number of customers modified their routing options to exclude the ELPs as potential destinations.

V.

VIOLATIONS

32. As a result of the conduct described above, Merrill Lynch willfully violated:

a. Section 17(a)(2) of the Securities Act, which makes it unlawful for “any person in the offer or sale of any securities . . . directly or indirectly . . . to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.”

b. Section 17(a)(3) of the Securities Act, which makes it unlawful for “any person in the offer or sale of any securities . . . to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”

In determining to accept the Offer, including the amount of the civil penalty, the Commission considered cooperation Respondent afforded the Commission staff beginning in May 2017.

VI.

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 Section 8A of the Securities Act, Section 15(b) of the Exchange Act, and Section 203(e) of the Advisers Act, it is hereby ORDERED that:

- A. Merrill Lynch cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act;
- B. Merrill Lynch is censured;
- C. Merrill Lynch shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of \$42 million (\$42,000,000) 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 Lynch as a 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 Joseph G. Sansone, Chief, Market Abuse Unit, Division of Enforcement, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, NY 10281.

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.

By the Commission.

Brent J. Fields
Secretary