

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 20080139905-02**

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: Merrill Lynch, Pierce, Fenner & Smith Inc., Respondent
CRD No. 7691

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Merrill Lynch, Pierce, Fenner & Smith Inc. ("Merrill Lynch" or the "Firm") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Merrill Lynch alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. Merrill Lynch hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

Merrill Lynch is a full service brokerage firm and has been a member of FINRA since January 26, 1937. The Firm is headquartered in New York City and has approximately 1,300 active branches and approximately 24,000 registered representatives. In February 2011, Merrill Lynch reported excess net capital of approximately \$8.9 billion and net capital of approximately \$9.7 billion.

RELEVANT DISCIPLINARY HISTORY

The Firm's relevant disciplinary history includes:

In March 2011, Merrill Lynch consented to findings that it violated NASD Rules 3010 and 2010 by misreporting certain historical delinquency data and by failing to establish a system to reasonably supervise the maintenance and updating of information it used for subprime residential mortgage-backed securitizations. The Firm was censured and fined a total of \$3 million. See Merrill Lynch, Case No. 200812808201, AWC (March 22, 2011).

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In December 2007, the Firm entered into a settlement, whereby it consented to findings that it violated NASD Rules 3010 and 2110, by failing to establish, maintain and enforce supervisory systems and procedures designed to ensure that eligible investors received the opportunity to purchase mutual funds at Net Asset Value ("NAV") through available NAV Transfer Programs. Merrill Lynch consented to a censure, \$250,000 fine and an undertaking. See Merrill Lynch, Case No. EAF0401090003, AWC (Dec. 2007).

In February 2006, the Firm consented to findings that it violated NASD Rules governing mutual fund sales contests and registration of securities principals. The Firm also consented to findings that it violated NASD Rules 3010 and 2110 by having deficient supervisory systems and procedures regarding mutual fund recommendations, required disclosures to customers, sales contests and registration of securities principals. The Firm received a censure, \$5 million fine and an undertaking. See Merrill Lynch, Case No. E9B2003042014, AWC (Feb. 2006).

OVERVIEW

The Firm failed to have in place a supervisory system to ensure that all employee and employee-interested accounts¹ were monitored and reviewed for potential misconduct. The Employee Activity Review System ("EARS") was the Firm's primary means of monitoring employee account activities. EARS automatically captured accounts opened by employees who were using their social security numbers as the primary tax identification number. However, if the employee's social security number or tax identification number was not the primary number associated with the account, EARS failed to automatically capture the account in its database. In these instances the Firm relied solely on its employees to input their accounts into EARS. A significant number of employees either did not report such accounts or did not do so in a timely manner and as a result, a significant number of employee/employee-interested accounts failed to be monitored in EARS. At FINRA's request, the Firm conducted a review of its EARS system and found that approximately 40,000 employee/employee-interested accounts were not reported or not reported for certain time periods on EARS from January 2006 to June 2010. Thus, these accounts were not reviewed in EARS for all required periods, in violation of NASD Rules 3010 and 2110 and FINRA Rule 2010.² The Firm's failure to capture and monitor all employee/employee-interested accounts had serious consequences.

The Firm also failed to establish, maintain and enforce written procedures to adequately supervise its registered representative, Bruce E. Hammonds ("Hammonds").³ From April 2007

¹ Employee-interested accounts are those accounts in which an employee has a financial interest or can exercise control, although the account is not in his/her name.

² FINRA Rule 2010 took effect after December 15, 2008 and superseded NASD Rule 2110.

³ On December 11, 2009, Hammonds was permanently barred after he executed an Offer of Settlement in which he consented to findings that, through the use of a Ponzi scheme, he violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, NASD Rules 2120, 2330 and 2110.

On October 2, 2009, in the Federal District Court for the Western District of Texas, Hammonds was sentenced to a 57-month term of imprisonment and was ordered to pay \$1,111,323 in restitution to investors for his guilty plea to two counts of securities fraud.

to June 2008, Hammonds used a business account he opened at the Firm to implement a Ponzi scheme. Hammonds fraudulently induced 11 individuals to invest in excess of \$1 million in a fraudulent scheme he ran as B&J Partnership ("B&J"). Hammonds misrepresented to the investors that B&J invested in S&P Index futures, oil contracts, BRIC (Brazil/Russia/India/China) investments and hedge funds, promising returns ranging from 30 to 100 percent. Although the Firm never approved of Hammonds' outside business activities in the B&J partnership, Merrill Lynch supervisors approved Hammonds' request to open a business account in name of B&J. Because the primary tax number associated with the account was B&J's tax identification number, not Hammonds' social security number, EARS did not automatically capture the B&J account on the system. Hammonds' fraudulent activities in the account went undetected by the Firm for over 10 months. The Firm's failure to establish, maintain and enforce procedures to adequately supervise Hammonds' activities enabled him to engage in the fraudulent scheme and thus the Firm violated NASD Rules 3010 and 2110.

FACTS AND VIOLATIVE CONDUCT

The Firm's Supervisory System and Review

EARS was the Firm's primary means of monitoring employees' account activities. Virtually all employee account activity flowed into and was monitored through this system. EARS provided information similar to that contained on monthly account statements, including deposits, withdrawals, checking activity, payee information on checks written against the account and wire activity. The Firm relied on its supervisors to utilize EARS to conduct its supervisory and compliance reviews of employee/employee-interested accounts. When an employee opened an account under the employee's social security number, the account was automatically reported on EARS. However, if the employee/employee-interested account was opened under a different social security number or tax identification number, such as with a business account, the Firm did not automatically include the account in EARS and instead relied upon its employee to disclose the account in the system.

At FINRA Enforcement's request, the Firm conducted a review of EARS and found that from January 2006 to June 2010 approximately 40,000 employee/employee-interested accounts were either not reported or not reported for certain time periods on EARS. Since the accounts were not available on EARS, they were not subject to the required review or monitoring by the Firm.

In July 2010, in connection with the purchase of the Firm by Bank of America, the Firm began transitioning from EARS to the Associate Investment Monitoring ("AIM") system to monitor and review all employee/employee-interested accounts. The Firm also developed a new account reconciliation tool that performs regular checks of the AIM system using the employees' social security numbers and tax identification numbers to ensure that all appropriate accounts are in fact reported in the system.

Hammonds' Misconduct

From April 2007 to June 2008, Hammonds fraudulently induced nine Firm customers and two other individuals to invest in excess of \$1 million in B&J, a fraudulent scheme Hammonds orchestrated. Several Firm customers funded their investments in B&J by liquidating positions or withdrawing funds from their Merrill Lynch accounts. Hammonds told his investors that B&J was affiliated with the Firm. He misrepresented the type of products the partnership would invest in and promised returns of 30% to 100%. Rather than investing all the funds in the promised securities, indexed funds, or futures contracts, Hammonds invested less than 10% of the funds and misappropriated the rest. Hammonds perpetuated his fraudulent scheme by both providing customers with fictitious account statements and paying certain investors "profits".

In order to facilitate the fraud, Hammonds opened a business account at the Firm. Hammonds misrepresented to at least one of his supervisors that he was funding the account from proceeds of his house-flipping business. Hammonds completed the new account documentation and submitted the B&J Partnership agreement to the Firm, as required by Firm policy. However, the Firm's procedures failed to require a supervisory review of the B&J Partnership agreement prior to approval of the account. Contrary to Hammonds' misrepresentations, the B&J Partnership Agreement stated that the partnership was formed to (a) conduct a securities business, (b) identified Hammonds as its President, (c) indicated that Hammonds was responsible for investing B&J assets, and (d) Hammonds would receive 55% of the partnership's profits. Despite the inconsistencies between the representations made to the Firm and the contents of the partnership agreement, the Firm approved the opening of the business account. The Firm assigned a "99" account number to Hammonds' business account and designated the account as an employee account but failed to include the account in EARS.⁴ The Firm also never approved Hammonds' engagement in the B&J outside business activities.

From April 2007 to June 2008, Hammonds deposited over \$1,000,000 from 11 investors into the B&J account. Deposits from nine Firm customers were made via checks payable to B&J drawn against their Firm accounts or bank accounts in the customers' names. These checks were deposited via deposit slips completed and initialed by Hammonds. For example, one of Hammonds' customers wrote ten checks drawn against her Firm account totaling \$480,500.

Although the customer deposited checks were clearly identified on the Firm B&J account statements, Hammonds deposit activity went unnoticed by the Firm. Additionally, the monthly statements for the B&J Firm account issued between September 2007 and May 2008, disclosed that Hammonds wrote 20 checks against the B&J business account, totaling over \$70,000, made payable to five Merrill Lynch customers. This check writing activity was also undetected by the Firm.

If the Firm were reviewing the B&J Firm account statements, it would have further detected that on eight occasions Hammonds wired a total of over \$93,000 from the B&J account to ABC bank for deposit in an account entitled "PFG Inc. Customer Segregated Funds account." A Firm

⁴ Not all accounts coded with the 99 designation were required to be reported on EARS. For example, the accounts of former employees of the Firm were not required to be reported on EARS but were coded as 99 in order for the employees to receive certain benefits related to their former employment such as lower trade commissions.

supervisor approved a Letter of Authorization dated February 20, 2008, in which Hammonds requested that \$5,000 be wired from the B&J account to the "PFG Inc. Customer Segregated Funds account" at another bank. All of this activity was undetected by the Firm.

The Firm's Policies and Procedures

Merrill Lynch's written policies required that all employee and employee-interested accounts opened at the Firm be approved by a supervisor. If the account were a business account and the business involved a partnership, the Firm's policies called for production and maintenance of documents that establish proof of the partnership, such as the partnership agreement.

Merrill Lynch's policies and procedures also required that all its employees report on EARS any Merrill Lynch account in which the employee had an interest and any outside business activities in which the employee was involved. The Firm's policies stated that employees were responsible for ensuring that EARS contained accurate and current records of all their accounts. The Firm's policies and procedures also required branch level supervisors to review EARS on a monthly basis and investigate any suspicious transactions.

The Firm failed to establish, maintain and enforce written policies and procedures requiring its supervisors to review EARS after approving the opening of an employee/employee-interested account to ensure that the employee had reported the account on EARS. Moreover, the Firm's existing written policies and procedures were inadequate in that they failed to require its supervisors to: (a) review documents establishing proof of a business (such as the partnership agreement) prior to approving an employee's request to open a business account; and (b) verify that an employee was approved to engage in the outside business activity before authorizing the opening of an account in the name of that particular business. Hammonds used the Firm's excessive reliance on employee self-reporting on EARS and the Firm's inadequate procedures to his benefit and to the detriment of his customers.

Supervisory Deficiencies

NASD Rule 3010 requires members to, among other things, "establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules. Final responsibility for supervision shall rest with the member." The rule further provides that "[e]ach member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of the registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable rules of NASD."

NASD Rule 2110 and FINRA Rule 2010 provide that "[a] member in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." Violations of NASD/FINRA Rules are viewed as violations of Rules 2110/2010 because

members of the securities industry are expected and required to abide by the applicable rules and regulations.

Merrill Lynch failed to have in place an adequate supervisory system that was designed to ensure that all employee/employee-interested accounts were appropriately monitored and reviewed for potential misconduct in violation of NASD Rules 3010 (a) and 2110 and FINRA Rule 2010. Although EARS automatically captured accounts opened by employees using their social security numbers, it failed to automatically capture employee/employee interested accounts that were opened using a tax identification number or social security number that was different from the employee's social security number. Given that EARS was the Firm's primary system to monitor and review the activities in employee/employee-interested accounts, the Firm should not have relied solely on its employees to report such accounts on EARS. As a result, a large number of employee/employee-interested accounts were not reviewed by the Firm. The Firm failed to have a system in place to ensure that all required employee/employee-interested accounts were in fact reported in EARS. Merrill Lynch's faulty system resulted in its failure to monitor and review approximately 40,000 employee/employee-interested accounts for certain time periods from January 2006 to June 2010. This deficiency also contributed to the Firm's failure to detect the fraudulent activities by Hammonds and his use of the B&J account at the Firm to facilitate his fraudulent scheme.

The Firm also failed to establish, maintain and enforce written procedures to adequately supervise Hammonds. The Firm failed to require its supervisors to review EARS after approving the opening of an account to ensure that the employee in fact reported the account on the system. Additionally, while the Firm's procedures required the production of the partnership agreement, the Firm failed to establish and maintain written procedures that required its supervisors to review the partnership agreement as part of the account approval process. The Firm also failed to have written procedures that required a supervisor to verify the approval of an outside business activity before authorizing the opening of an account by an employee for that particular business. Had the Firm established such a procedure, it would have discovered that Hammonds never obtained Firm approval for his outside business activities involving B&J. Merrill Lynch's failure to establish, maintain and enforce written procedures to adequately supervise and prevent Hammonds' fraudulent activities violated NASD Rules 3010 (b) and 2110.

OTHER FACTORS

In determining the appropriate sanction in this matter, FINRA took into consideration the Firm's discovery of Hammonds' misconduct and the remedial steps Merrill Lynch took to address it, including its repayment in full to the investors who were harmed by the misconduct and the transition of accounts to the AIM system.

B. The Firm also consents to the imposition of the following sanctions:

- a. A censure; and
- b. A fine in the amount of \$1,000,000.

The Firm agrees to pay the monetary sanction upon notice that this AWC has been accepted and that such payment is due and payable. The Firm has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

The Firm specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanction imposed in this matter.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

II.

WAIVER OF PROCEDURAL RIGHTS

The Firm specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

- A. To have a Complaint issued specifying the allegations against it;
- B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, the Firm specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

The Firm further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the

terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

The Firm understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against the Firm; and
- C. If accepted:
 - 1. this AWC will become part of the Firm's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;
 - 2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about the Firm's disciplinary record;
 - 3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and
 - 4. The Firm may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. The Firm may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects the Firm's right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.
- D. The Firm may attach a *Corrective Action Statement* to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. The Firm understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that the Firm has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

08/10/2011
Date (mm/dd/yyyy)


Joaquim Sena
Associate General Counsel
Merrill Lynch, Pierce, Fenner & Smith, Inc.

Reviewed by:


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Accepted by FINRA:

October 3, 2011
Date

Signed on behalf of the
Director of ODA, by delegated authority


Susan Light
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