

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2008015717401**

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

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

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Respondent" or "the Firm" or "Merrill Lynch") 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 Respondent alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. Respondent 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 (or its predecessor entities) has been a registered broker-dealer since 1937. The Firm is a full-service broker-dealer. On January 1, 2009, the Firm was acquired by the Bank of America, but the Firm continues to do brokerage business under its own individual broker-dealer registration.

RELEVANT DISCIPLINARY HISTORY

Merrill Lynch has previously been disciplined on a number of occasions for violations of Rules pertaining to supervisory procedures, including the following:

- On March 31, 2011, the Firm entered into an AWC in which it was censured and fined \$3.5 million. The sanctions were based on findings that the Firm had violated NASD

Rule 2110 by negligently misrepresenting historical delinquency rates for numerous subprime residential mortgage-backed securitizations on the Firm website that the SEC requires broker-dealers to maintain for such securitizations, under SEC Regulation AB. These errors were referenced as static pool information in securitizations that the Firm subsequently underwrote and sold. Merrill Lynch also failed to establish a reasonable system to supervise the maintenance and updating of its website and did not act reasonably to prevent, identify and correct inaccuracies in the static pool information posted there, in violation of NASD Rules 3010 and 2110.

- On July 30, 2010, the Firm entered into an AWC in which it was censured and fined \$500,000 related to its failure to establish, maintain and enforce a supervisory system and written supervisory procedures reasonably designed to ensure that customers received appropriate “breakpoints” and “rollover and exchange” discounts on eligible purchases of Unit Investment Trusts.
- On July 28, 2009, the Firm entered into an AWC in which it was censured and fined \$150,000, based on its failure to establish, maintain and enforce a supervisory system and procedures reasonably designed to detect and prevent unsuitable short-term sales of closed end funds purchased at the initial public offering.

OVERVIEW

During the period 2006-2009 (the “Relevant Time Period”), Merrill Lynch violated FINRA rules by failing to establish adequate written supervisory procedures and failing to reasonably supervise total return swap transactions that involved U.S. equities and American Depository Receipts (collectively “underlying securities”). These “Total Return Swaps” were designed to generate for certain off-shore clients a perceived tax advantage related to dividend income on the underlying securities. The advantage was known by various terms throughout the industry, including “dividend uplift,” “dividend enhancement,” or “yield enhancement.” These terms represented the amount that would have been withheld in taxes on a dividend, but that the client obtained through a transaction with Merrill Lynch. In these transactions, the client did not hold the stock on the dividend record date; instead, the Firm structured the transactions as a Total Return Swap and provided yield enhancement as part of a securities derivative payment.

As a result of its supervisory failures, the Firm was unable to substantiate the validity of the yield enhancement payments.

Based on the above supervisory failures, Merrill Lynch violated NASD Rules 3010 and 2110 and FINRA Rule 2010.¹

¹ With regard to the Firm’s failure to observe high standards of commercial honor and just and equitable principles of trade, NASD Rule 2110 applies to all conduct on or before December 14, 2008 and FINRA Rule 2010 applies to all conduct on or subsequent to December 15, 2008.

FACTS AND VIOLATIVE CONDUCT

Failure to Supervise

NASD Rule 3010 requires member firms to establish and maintain a system, including written procedures, to supervise the activities of its employees. Further, this system must be reasonably designed to achieve compliance with applicable securities laws and regulations.

NASD Rule 2110 and FINRA Rule 2010 require that FINRA members "shall observe high standards of commercial honor and just and equitable principles of trade."

As shown below, with respect to the Total Return Swaps that were designed to generate yield enhancement on the underlying securities, Merrill Lynch failed to establish and enforce effective written supervisory procedures and to supervise its total return swaps business. Accordingly, Merrill Lynch violated NASD Rule 3010 and NASD Rule 2110 and FINRA Rule 2010.

Total Return Swaps

An equity-based swap is a contractual arrangement between two parties who agree to exchange cash flows that replicate the economics of owning an underlying equity (or index or basket of stocks). The buyer of a swap has the risks and benefits of owning the underlying equity, while the seller of the swap has countervailing risks and benefits. Thus, the buyer pays the seller if the underlying equity goes down in value, and the seller pays the buyer if the underlying equity goes up in value. In the swaps at issue here, the "total return" that the buyer received also included an amount equivalent to any dividends declared on the equity while the swap was in effect, or open.

Under regulations in effect during the Relevant Period and earlier, payments of dividends on the underlying securities held by an off-shore investor were taxed, but dividend equivalent payments made to the same recipient under a swap agreement were not. This distinction gave off-shore investors incentive to enter into swaps involving the underlying securities before the dividend record date. Broker-dealers competed for the swaps business of those investors. Merrill Lynch wrote swap transactions that allowed clients to seek yield enhancement through the payment of dividend equivalent amounts.

Structure of the Total Return Swap Transactions

In each of the Total Return Swaps that are the subject of this AWC, an off-shore client sold to the Firm an American Depositary Receipt ("ADR"), or shares of a dividend-paying security (or index or basket) of a U.S. issuer (or issuers). These sales took place shortly before the dividend record date on the underlying security. At the same time as this sale, the client entered into a swap with the Firm. The swap referenced the underlying security that had been sold to the Firm. The Firm hedged its investment in the swap. In cases where Merrill Lynch hedged by purchasing shares from the counterparty, the Firm usually followed up by selling these shares and converting its hedge into a swap of its own. In accordance with the swap with its client, the Firm made periodic payments to the off-shore client, who was the counterparty and buyer on the swap with the Firm. These periodic payments were based on the income the underlying security generated, and included payment of the yield enhancement amount.

The swap was terminated later, generally at the request of the off-shore client, after the dividend record date. At the swap's termination, the Firm unwound its own hedge.

Failure to Supervise Total Return Swaps

A yield enhancement payment would be improper if the client retained beneficial ownership of the underlying security throughout the life of the swap. The client would retain such ownership if the Total Return Swap was effectively a repurchase or stock loan agreement. Moreover, independent stock sales and purchases would be reported and recorded differently than repurchase or stock loan agreements.

To support the legitimacy of its yield enhancement payment, the Firm had to be able to substantiate that the client surrendered beneficial ownership of the underlying security during the life of the swap, and that the reacquisition of the underlying security was independent of the swap. Whether the client was subject to market risk in these transactions is a key factor in determining the propriety of the yield enhancement payment.

Because of the supervisory failures discussed below, the Firm was unable to demonstrate that the swaps were properly structured and supervised with particular regard to yield enhancement payments. The Firm failed to establish and maintain written supervisory procedures that were reasonably designed to ensure compliance with applicable laws and regulations. The Firm's procedures were inadequate in some respects, and in other respects were not appropriately enforced by Merrill Lynch.

Areas in which the Firm exhibited such supervisory deficiencies involved the following: (1) initial absence of written procedures; (2) failure to document and review early terminations, as the procedures required; (3) short-term transactions; and (4) market-on-close pricing.

The Firm initially lacked any written procedures regarding its Total Return Swap program, and failed to institute such procedures until October 2006.

Once written and distributed to Firm staff, the Firm's procedures generally provided that swaps on which the underlying security was a single stock were to be held open for a year. Moreover, the procedures provided that swaps must be open for 15 days, and further provided that if a swap was initiated with shares "crossed in" from the client to the Firm, then the swap must be held open for at least 25 days.¹ The Firm's procedures did allow for swaps to be unwound early, provided that such early terminations were recorded in an exceptions log for subsequent compliance review. However, in practice, no such exceptions logs were kept, there was no after-the-fact supervisory review of early swap terminations, and any requisite approval was not documented. The Firm began to enforce the 15-day holding period only in or about 2008. Records relating to early swap terminations began to be kept in February 2008, and only in May

¹ In a "cross" trade, the parties conduct the securities transaction directly with each other, and execute it in the over-the-counter market. In the Total Return Swaps, the "cross in" occurred when the client sold the stock to the Firm at the start of the transaction.

2009 did Merrill Lynch actually begin using an exception report to identify early swap terminations that warranted review.

In practice, despite the general limitations in the procedures, swaps were often terminated early. For example, in the period 2006-2007, when the Firm failed to document and carry out after-the-fact review of swaps that were terminated early, 598 swaps were open for less than 45 days and, of these, 215 were open for less than 25 days and 78 for less than 15 days. Allowing clients to engage in short-term swap transactions that bracketed the dividend record date enabled clients to re-establish their original securities position while limiting their market risk.

Moreover, a substantial portion of this trading was done by a few individual counterparties who repeatedly opened and closed swaps on a short-term basis. Such trading patterns warranted a level of supervision that the Firm failed to provide. For example, the counterparty on 27 of the 77 swaps that were open for less than 15 days in the 2006 and 2007 period was a single client, client "A." The security underlying one of these swaps was approximately 12,500,000 ADRs in Company "XYZ." This swap was one of approximately three between the Firm and client "A," where each such swap was opened on January 3, 2007, and closed on January 5, 2007. Similarly, client "B" opened and closed eight swaps in ten or fewer days each. The underlying security in one such Total Return Swap with client "B" was approximately 14,000,000 ADRs, also in "XYZ," that was opened on October 5, 2007 and closed on October 15, 2007.

Certain Merrill Lynch sales material advised that, after a swap ended, the counterparty could continue exposure to the security by purchasing it (or by entering into a second swap). However, the Firm did not monitor counterparties, after swaps were unwound, to determine whether the counterparties were buying stock to reconstitute their original positions.

The Firm's procedures for swaps also forbade crossing in and then exiting at a market-on-close price ("MOC"), or entering and exiting at an MOC price. However, the Firm allowed clients to open swaps on a volume weighted average price basis ("VWAP") basis and close on an MOC basis. In practice, using the "market on close" price of the underlying equity to calculate the termination payment due under the swap allowed clients to re-establish their securities positions at minimal market risk. Clients who engaged in such a practice knew they could unwind the swap and purchase the same amount of the underlying securities at the same, or virtually the same, price.

In practice, because the Firm did not initially have written supervisory procedures, and because the Firm failed to provide the supervisory review that its procedures subsequently required, swaps could be opened and closed in a few days' time, at prices that allowed market risk to be minimized.

Because of these supervisory deficiencies, Merrill Lynch lacked the ability to substantiate that its clients had parted with beneficial ownership of their original securities position and faced market risk in re-establishing a position at the close of the swap. As such, the Firm was unable to substantiate the propriety of its yield enhancement payments. These supervisory failures violated NASD Rule 3010 and NASD Rule 2110 and FINRA Rule 2010.

B. Respondent also consents to the imposition of the following sanctions:

1. a censure; and
2. a fine of \$500,000.

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

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

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

II.

WAIVER OF PROCEDURAL RIGHTS

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

- A. To have a Complaint issued specifying the allegations against Respondent;
- 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, Respondent 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.

Respondent 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

Respondent 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 Respondent; and
- C. If accepted:
 - 1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against Respondent;
 - 2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about Respondent'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. Respondent 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. Respondent 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 Respondent's right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.
- D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent 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.

November 8, 2011

Date:

Merrill Lynch, Pierce, Fenner & Smith Incorporated

Respondent

Merrill Lynch, Pierce, Fenner & Smith Incorporated

By:

J. David Montezano

Reviewed by:

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Accepted by FINRA:

12/7/11
Date

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

Susan Light

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