

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER, AND CONSENT
NO. 2018057201801**

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

RE: Merrill Lynch, Pierce, Fenner & Smith Incorporated (Respondent)
Member Firm
CRD No. 7691

Pursuant to FINRA Rule 9216, Respondent Merrill Lynch, Pierce, Fenner & Smith Incorporated 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 in this AWC.

I.

ACCEPTANCE AND CONSENT

A. Respondent accepts and consents to the following findings by FINRA without admitting or denying them:

BACKGROUND

Merrill became a FINRA member on January 26, 1937. The firm provides financial services to customers, including retail brokerage and wealth management to individuals. Merrill has a principal place of business in New York, New York and approximately 29,000 registered individuals in more than 3,900 branch offices.

On August 6, 2012, in AWC No. 2010022652202, FINRA censured and fined Merrill \$450,000 for its failure to establish, maintain, and enforce a supervisory system reasonably designed to adequately review and monitor the transmittal of funds from the accounts of customers to third-party accounts, in violation of NASD Rules 3010, 3012(a)(2)(B) and 2110, and FINRA Rule 2010. In that matter, one of the firm's registered representative was able to convert—through wires and checks—\$887,931 from 13 customer accounts.¹

OVERVIEW

From May 2013 through November 2018, Merrill failed to reasonably supervise the transmittal of customer funds via externally-initiated ACH (Automated Clearing House) transfers. As a result, the firm failed to detect that two of its registered representatives were able, in separate schemes that ran for multiple years, to steal in excess of \$6 million

¹ For more information about the firm, including prior regulatory events, visit BrokerCheck® at www.finra.org/brokercheck.

from 13 customers of the firm. Therefore, Merrill violated NASD Rules 3010 and 3012² and FINRA Rules 3110 and 2010.

FACTS AND VIOLATIVE CONDUCT

This matter originated after Merrill notified FINRA on January 25, 2018 that the firm terminated a registered representative for theft and other misconduct. On January 26, 2018, Merrill filed a Form U5 reporting the registered representative was terminated on January 8, 2018 for “[c]onduct including unauthorized transactions and theft.”

A. Member Firms Are Required to Monitor Transmittals of Customer Funds

FINRA Rule 3110(a), and its predecessor rule NASD Rule 3010(a), require each member firm to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD or FINRA rules.

NASD Rule 3012(a)(2)(B) required that member firms establish, maintain, and enforce written supervisory control policies and procedures reasonably designed to review and monitor all transmittals of funds from customers to third party accounts, to outside entities, and to locations other than a customer’s primary residence.

A violation of FINRA Rule 3110 or NASD Rules 3010 and 3012 is also a violation of FINRA Rule 2010, which requires a firm to observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business.

In Regulatory Notice 09-64 (November 2009), FINRA reminded member firms that “[a]s part of their duty to safeguard customer assets and to meet their supervisory obligations, FINRA firms must have and enforce policies and procedures governing the withdrawal or transmittal of funds or other assets from customer accounts.” These policies and procedures “should be reasonably designed to review and monitor all instructions to transmit or withdraw assets from customer accounts.” FINRA also explained that firms should periodically review and assess the adequacy of their supervisory systems and procedures, “which can become outdated or ineffective for a variety of reasons, including . . . new technologies, as well as changes in the size, volume and/or frequency of transmittals.”³

A firm’s duty of supervision also includes the responsibility to identify and respond to “red flags” or suspicious activity that suggest misconduct may be occurring.

² FINRA Rules 3110 and 3120 superseded NASD Rules 3010 and 3012 effective December 1, 2014. *See* Regulatory Notice 14-10 (March 2014).

³ Regulatory Notice 09-64, at 1–3. When FINRA issued Regulatory Notice 09-64 and related Regulatory Notice 12-05 (January 2012), NASD Rule 3012 and Incorporated NYSE Rule 401 were the relevant operative rules. Effective December 1, 2014, as part of FINRA’s new consolidated rules governing supervision, NASD Rule 3012’s requirements regarding the review and monitoring of transmittals of funds and securities, among other things, were relocated to FINRA Rule 3110(c)(2). *See* Regulatory Notice 14-10 (March 2014).

B. Merrill Failed to Reasonably Supervise ACH Transfers

As described further below, from May 2013 through November 2018, Merrill's system to review and monitor the transmittal of customer funds via ACH transfers was not reasonably designed to identify improper transfers from customer accounts by the firm's registered representatives. In addition, the firm failed to follow up on red flags of potential misconduct.

By way of background, the ACH network is a batch processing system in which financial institutions accumulate transactions throughout the day for later processing. In an ACH transaction, an individual will initiate a deposit or a payment from an originating financial institution, which will be debited or credited by a receiving financial institution. Thus, a financial institution either initiates itself or receives from an external financial institution the ACH transfer request.⁴

1. In 2013, Merrill Became Aware of the Risk That Registered Representatives Could Steal Customer Funds via ACH Transfer

In May 2013, Merrill terminated a registered representative who had made payments in excess of \$100,000 from two of her customer's brokerage accounts to her own financial accounts, including credit card accounts, by externally-initiated ACH transfers.⁵ Thus, by 2013, the firm was aware of the risk that brokers could steal money from customers via ACH transfers initiated outside the firm. At the time the registered representative was terminated for this misconduct, two other Merrill representatives (Representatives 1 and 2) were engaged in similar misconduct, as described further below.

2. Two Merrill Representatives Converted Millions of Dollars of Customer Funds via ACH Transfers That Went Undetected for Years

While associated with Merrill from January 2011 to December 2017, Representative 1 made approximately 270 unauthorized ACH transfers from five customer accounts to his credit card accounts. These transfers totaled approximately \$3.2 million. Four of the customers were seniors.⁶ He concealed his fraud, in part, by creating and distributing unofficial account summaries to the customers, which contained inflated account values.

Separately, from December 2007 through November 2018, Representative 2 made over 300 unauthorized ACH transfers from eight customer accounts, primarily to pay his credit card accounts. These transfers also totaled approximately \$3.2 million.⁷

Representatives 1 and 2 initiated the ACH transfers from financial institutions other than Merrill, which acted as the receiving financial institution.

⁴ The ACH network is a significant and growing component of money transfers. In 2013, approximately \$38 trillion was transferred over the ACH network; in 2018, approximately \$51 trillion; and, in 2020, approximately \$62 trillion. See <https://www.nacha.org>.

⁵ In November 2013, FINRA barred that representative.

⁶ In May 2018, FINRA barred Representative 1.

⁷ In April 2019, FINRA barred Representative 2.

3. Merrill's Supervisory System Was Not Reasonably Designed and The Firm Failed to Investigate Red Flags

From at least 2009, ACH instructions from originating financial institutions to the firm typically included information concerning the beneficiary of the transfer, including in certain instances the name of the beneficiary of the originating financial account. Thus, it was possible to screen ACH transfers to detect instances in which one of its registered representatives was the beneficiary of a transfer of funds from a customer's account. Prior to November 2018, however, the firm did not systematically do so.

Rather, Merrill monitored customer ACH transactions through an internal fraud-detection system designed to detect fraud by third parties, *i.e.*, persons other than its own brokers. Based on parameters set by the firm, this system flagged ACH transactions for review by the firm's fraud unit. In certain circumstances, the fraud unit was required to compare the customer's name with the payee name; and, if the fraud unit could not clear a transaction for processing based on the guidance provided by the firm, it escalated the transaction through an email to the registered representative assigned to the customer account. The registered representative was then responsible for validating that the transaction had been initiated by the customer.

Thus, despite being aware in May 2013 that one of its registered representatives had converted customer funds via externally-initiated ACH transfers, the firm's supervisory system was not reasonably designed to identify such theft: (i) the firm did not have a system to screen all ACH transfers to detect instances in which identified beneficiaries were also representatives of the firm; (ii) the fraud unit was not instructed or trained to examine flagged ACH transfers for the possibility that firm representatives were responsible for the flagged transaction; and (iii) the firm relied on the registered representatives of the customers to clear certain of the alerts, including alerts relating to transactions where the representatives themselves were named as beneficiaries.⁸

Representative 1 exploited these weaknesses in the system when, between 2011 and 2014, he was able to conceal his theft by validating (or directing a client services associate to validate) four transactions that were escalated to him by the firm's fraud unit. Similarly, between 2010 and 2017, Representative 2 was able to conceal his theft by validating three transactions that were escalated to him by the firm's fraud unit. Although the fraud unit could have recognized from data in Merrill's systems that it was supposed to check as part of its review, that the beneficiary of the transfers was the registered representative of record on the accounts, it failed to do so.

Separately, from 2014 to 2017, the firm's email surveillance system flagged for review four emails containing the inaccurate account summaries, described above, that Representative 1 had created. Although supervision personnel escalated two of these emails for further supervisory review, the firm failed to reasonably follow up on the

⁸ The firm was separately warned by FINRA in September 2013 of the danger of allowing registered representatives to clear fraud alerts relating to their customers' accounts.

emails, which represented red flags of potential misconduct. Had it done so, the firm could have uncovered Representative 1's theft.

Merrill discovered Representative 1's misconduct after a customer complained in December 2017. Subsequently, Merrill conducted a review of its controls and developed a tool to monitor externally-initiated ACH transfers that are made for the benefit of certain firm personnel, including the registered representative assigned to the customer's account. When the firm ran the tool for the first time in November 2018, it discovered Representative 2's conversion of millions of dollars of customer funds via ACH transfer.

By failing to reasonably supervise the transmittal of customer funds, Respondent violated FINRA Rules 3110 and 2010 and NASD Rules 3010 and 3012.

SANCTIONS CONSIDERATIONS

In determining the appropriate sanctions in this matter, FINRA considered, among other factors, that after discovery of Representative 1's misconduct, the firm developed a tool to identify externally-initiated fraudulent ACH transfers and was able, thereafter, to discover Representative 2's misconduct; and, that Merrill previously paid, or made reasonable efforts to pay, restitution to each of the customers or their estates affected by the conduct described above. In addition, the firm revised the fraud unit's procedures to examine flagged ACH transfers for the possibility that firm representatives were beneficiaries; enhanced its customer account statements to include available ACH beneficiary information; and made similar enhancements to the firm's customer online portal and internal workstation used by firm personnel.

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

- a censure;
- a \$950,000 fine; and
- an undertaking that within no later than 90 days of the date of issuance of this AWC, a senior officer and principal of Merrill shall certify in writing that Merrill has completed a review of its policies, procedures, and systems regarding the monitoring of transmittals of customer funds, and they are reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA rules. This certification shall be submitted to Mark Geiger, Counsel, FINRA Enforcement Department, Brookfield Place, 200 Liberty Street, 11th floor, New York, NY, 10281 and to Mark.Geiger@finra.org. Upon written request showing good cause, FINRA staff may extend the procedural date set forth above.

Respondent agrees to pay the monetary sanction 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 it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim an inability to pay, now or at any time after the execution of this AWC, the monetary sanction imposed in this matter.

The sanctions imposed in this AWC shall be effective on a date set by FINRA.

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 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, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, 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 its acceptance or rejection.

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 action brought by FINRA or any other regulator against Respondent;
 - 2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
 - 3. FINRA may make a public announcement concerning this agreement and its subject matter 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. Nothing in this provision affects Respondent's testimonial obligations in any litigation or other legal proceedings.
- 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.

The undersigned, on behalf of Respondent, certifies that a person duly authorized to act on Respondent's 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 Respondent has agreed to the AWC's provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth in this AWC and the prospect of avoiding the issuance of a complaint, has been made to induce Respondent to submit this AWC.

December 15, 2021
Date

Mark L. Keene
Merrill Lynch, Pierce, Fenner & Smith,
Incorporated
Respondent

Print Name: MARK L. KEENE

Title: ASSOCIATE GENERAL COUNSEL

Reviewed by:

Michael J. Leotta

Michael J. Leotta

Brenda E. Lee

Counsel for Respondent

Wilmer Cutler Pickering Hale and Dorr LLP

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Accepted by FINRA:

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

12/20/2021
Date

Jessica Zetwick-Skryzhynskyy

Jessica Zetwick-Skryzhynskyy

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