FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2014042578001

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

I.

ACCEPTANCE AND CONSENT

A. Merrill 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 has been a FINRA member since 1937 and is headquartered in New York, New York. It is a full-service brokerage firm with more than 34,000 registered individuals. Among other things, it provides sales and trading services, research, and underwriting services. The firm was acquired by Bank of America Corporation in January 2009.

OVERVIEW

From January 2010 through November 2014, Merrill did not establish and maintain adequate supervisory systems, and did not establish, maintain, and enforce adequate written procedures, reasonably designed to achieve compliance with applicable securities laws and regulations governing the use of proceeds from loans originated under a securities-based lending program called Loan Management Accounts ("LMAs").

In addition, from January 2010 through July 2013, Merrill did not establish and maintain adequate supervisory systems, and did not establish, maintain, and enforce adequate written procedures, reasonably designed to ensure the suitability of transactions in certain Puerto Rico securities, including municipal bonds and closed-end funds, where customers' holdings were highly concentrated in PR Securities and highly leveraged through either LMAs or margin.

By virtue of these failures, Merrill violated NASD Rule 3010[1] and FINRA Rule 2010.

FACTS AND VIOLATIVE CONDUCT

A. Supervision of LMAs

1. Restrictions on the use of LMA proceeds

Merrill LMAs are lines of credit that allow firm customers to borrow money from Bank of America, N.A. ("BANA") using the securities held in their Merrill brokerage accounts as collateral. From January 2010 through November 2014 (the "LMA review period"), Merrill opened more than 121,000 LMAs with more than $85 billion in aggregate credit extended by BANA as of August 31, 2014. As of early November 2014, there were nearly 65,000 open Merrill non-purpose LMAs with loan balances aggregating approximately $27.4 billion.

During the LMA review period, Merrill registered representatives presented customers with information concerning the availability of LMAs. When customers expressed interest, Merrill registered representatives typically explained the product, facilitated the customer's completion of the required paperwork, and then had the completed paperwork forwarded for review and approval. Merrill representatives were not compensated for opening LMAs, but could earn compensation if the customer used the LMA. Although the loan proceeds came from BANA, LMA accounts were established in the customers' names with Merrill and Merrill custodied the collateral and monitored collateral valuation for risk purposes.

LMAs are designated as either "purpose" or "non-purpose," and the LMA agreements prohibited proceeds from non-purpose LMAs from being used to purchase "margin stock." This contractual restriction correlates to Federal Reserve Board Regulation U, which governs securities-based loans issued by non-broker-dealers.[2] Under Regulation U, "purpose" credit is defined as "any

[1] NASD Rule 3010 was superseded by FINRA Rule 3110 effective December 1, 2014, after the time period relevant to this AWC.

[2] Regulation U was promulgated under Section 7 of the Securities Exchange Act of 1934.

credit for the purpose, whether immediate, incidental, or ultimate, of buying or carrying margin stock." Regulation U prohibits purpose loans from exceeding the "maximum loan value"—which, during the relevant time period, was 50% of the current market value for margin stock and "good faith loan value" for all other collateral—of the securities serving as collateral (the "collateral requirement"). Regulation U was adopted to, among other things, prevent the excessive use of credit for the purchase or carrying of margin stock.

The paperwork for opening an LMA included Form U-1, commonly referred to as a "purpose statement," which required that the applicant indicate whether the proceeds of the loan would be used to purchase or carry margin stock. If the answer was "yes," Form U-1 required the listing of the securities that would serve as collateral for the loan.

2. Merrill's inadequate supervision of LMAs

Merrill's supervision of the LMA program was not reasonably designed to achieve compliance with certain applicable federal securities laws and regulations and FINRA rules.

For example, Merrill did not adequately educate its representatives about LMAs or train them on the differences between purpose and non-purpose LMAs, the contractual and firm prohibition against using proceeds from non-purpose LMAs to buy margin stock, or the regulatory requirements applicable to LMAs used to buy margin stock. Merrill also did not reasonably supervise the LMA account-opening process. For example, representatives were not required to explain to the customer the difference between purpose and non-purpose LMAs, the restrictions that came with non-purpose LMAs, or the collateral requirement for LMAs used to purchase margin stock. In many instances, the completed Form U-1s were gathered from the customer and submitted for approval by sales assistants. Consequently, the Form U-1 could be accepted in situations where the customer had not discussed the purpose of the loan proceeds with a Merrill financial advisor.

Additionally, Merrill did not establish and maintain reasonable supervisory systems, or establish, maintain, and enforce adequate written procedures, designed to prevent, deter, and detect the use of proceeds from non-purpose LMAs to purchase margin stock. Except in limited situations where a customer had an open margin debit balance or a pending trade, there was no effective control in place to prevent customers from transferring proceeds from a non-purpose LMA to their Merrill brokerage account and immediately purchasing margin stock, nor any effective post-transaction review to detect such prohibited use of the LMA proceeds. This failure to supervise extended to the firm's policies and procedures, which prohibited the use of proceeds from non-purpose LMAs to purchase securities generally, and to the LMA

agreements, which prohibited the use of proceeds from non-purpose LMAs to purchase margin stock. Likewise, because Merrill did not have adequate systems to monitor whether proceeds from non-purpose LMAs were used to purchase margin stock, the firm failed to adequately monitor to ensure the collateral requirement was met in those instances when LMA proceeds were, in fact, used to purchase margin stock.

As a result of these failures, during the LMA review period, Merrill customers drew down on non-purpose LMAs, transferred the funds to their Merrill brokerage accounts, and within a short timeframe (often the same day) on thousands of occasions purchased margin stock. For example, during a nine-month sample period from January through September 2014, 545 Merrill brokerage accounts received proceeds transferred from non-purpose LMAs and collectively purchased $74.28 million in securities—a majority of which was margin stock—within 14 days of the transfer. One high-net-worth customer in particular, over a period of several years, used approximately $282 million in proceeds from multiple non-purpose LMAs to make unsolicited purchases of margin stock—generally mutual funds—often within the same day and in amounts identical to the LMA draw. Despite these transactions and an internal risk review of this customer's account, Merrill did not detect the connection between the transfers from the non-purpose LMAs to the brokerage accounts and the subsequent margin stock purchases.[3]

B. Supervision of Suitability of Transactions in Puerto Rico Securities

From January 2010 through July 2013, Merrill failed to establish and maintain a supervisory system, and failed to establish, maintain, and enforce written procedures, reasonably designed to ensure the suitability of transactions in Puerto Rico municipal bonds and Puerto Rico closed-end funds ("PR Securities") in certain circumstances. PR Securities provide Puerto Rico residents with various tax advantages, including exemption from U.S. estate and gift taxes. The Puerto Rican government further incentivized Puerto Rican residents to invest in PR Securities by establishing a Puerto Rico estate tax applicable to property held by a Puerto Rico resident outside of Puerto Rico. In addition, the PR Securities generally offer a triple tax benefit.

During this time, and as a result of these unique benefits, many Puerto Rico customers were concentrated in PR Securities, and many used leverage to buy additional PR Securities either through LMAs or through the use of margin in their securities accounts. Leveraged customers were required to maintain account equity in order to provide adequate collateral to support their leverage. Those who were both leveraged and highly concentrated in

[3] Merrill discovered the activity in the customer's account in early 2014 and promptly thereafter took remedial action, including developing more robust procedures and controls, to address the use of non-purpose LMAs to fund margin stock purchases. FINRA did not identify any customer harm resulting from these transactions.

PR Securities bore significant risk that a single market event affecting the value of those securities might significantly decrease their total account value and their equity. That risk increased during late 2012 and early 2013 as the Puerto Rico debt market became more precarious.

Despite this risk, during the relevant timeframe, the firm did not establish and maintain adequate supervisory systems and procedures to ensure that, where customers were both highly concentrated in PR Securities and using leverage, transactions were suitable in light of the customers' risk objectives and profiles.

As of July 2013, several hundred customer accounts in Merrill's Puerto Rico branch with modest net worth and conservative or moderate investment objectives had 75% or more of their account assets invested in PR Securities. Of those accounts, approximately 50 also were leveraged through LMAs or margin. Approximately half of those accounts eventually received margin or maintenance calls upon which they liquidated PR Securities at a loss. These customers—25 in total—suffered aggregate losses of nearly $1.2 million as a result of liquidating PR Securities to meet the calls.

C. Violations

By virtue of the foregoing supervisory failures, Merrill violated NASD Rules 3010(a) and 3010(b) and FINRA Rule 2010.

OTHER FACTORS

In determining the appropriate sanction, FINRA considered the following factors: (a) prior to detection by a regulator, the firm conducted a comprehensive internal review of the use of non-purpose LMA proceeds to purchase margin stock and took remedial measures to strengthen its related controls and procedures; (b) the firm reported to FINRA certain of the violations addressed in the AWC; and (c) the firm provided substantial assistance during FINRA's investigation by sharing the results of its internal investigation with FINRA staff.

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

- a censure;
- a $6,250,000 fine; and
- restitution (including prejudgment interest) in the aggregate amount of $779,999, to be paid to 22 affected Merrill PR customers ("eligible customers").[4]

  A registered principal on behalf of Respondent shall submit satisfactory proof of payment of restitution or of reasonable and documented efforts undertaken to effect restitution. Such proof shall be submitted by e-mail from a work-related account of the registered principal of Respondent to Kathleen Cuomo at kathleen.cuomo@finra.org. This proof shall be provided to the FINRA staff members listed above no later than 120 days after acceptance of the AWC.

  If for any reason Respondent cannot locate any customer after reasonable and documented efforts within 120 days from the date the AWC is accepted, or such additional period agreed to by a FINRA staff member in writing, Respondent shall forward any undistributed restitution and interest to the appropriate escheat, unclaimed property or abandoned property fund for the state in which the customer is last known to have resided. Respondent shall provide satisfactory proof of such action to the FINRA staff member identified above and in the manner described above, within 14 days of forwarding the undistributed restitution and interest to the appropriate state authority.

In the event an eligible customer accepts payment of restitution as provided for in this AWC, the firm may require from the eligible customer that the firm and persons currently or formerly associated with the firm be released from any additional liability relating to the facts of this AWC. In the event an eligible customer has a pending arbitration claim against the firm and persons currently or formerly associated with the firm, on or before the effective date of this AWC, the firm shall permit the eligible customer to choose to maintain his or her claim and direct the restitution payment to an escrow account, which will be distributed to the customer if no arbitration award is received through the claim. In the event an award is received for an amount less than the restitution amount, the firm shall reduce its restitution payment to the eligible customer by the amount of the award. In the event an award is received for an amount greater than the restitution amount, the firm shall permit the eligible customer to choose either (1) the restitution amount or (2) the arbitration award, and if the eligible customer chooses the award, the escrowed restitution amount will be returned to the firm. Restitution will not be owed to customers who have received an arbitration decision, award, entered into a settlement agreement, or

[4] The amount of restitution ordered takes into account that Merrill has already reimbursed certain affected customers pursuant to private settlement agreements.

otherwise agreed to the resolution of their claims with the firm, relating to the facts of this AWC, on or before the date of this AWC.

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 imposition of a restitution order or any other monetary sanction herein, and the timing of such ordered payments, does not preclude customers from pursuing their own actions to obtain restitution or other remedies.

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 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 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 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 accordance with FINRA Rule 8313;

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: (i) testimonial obligations; or (ii) 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. Merrill 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.

11/21/2016
Date (mm/dd/yyyy)

Merrill Lynch, Pierce, Fenner & Smith Incorporated

By: Mark L. Keene

Name: MARK L. KEENE

Title: ASSOCIATE GENERAL COUNSEL

Reviewed by:

Counsel for Respondent

Daniel T. Chaudoin
Wilmer Cutler Pickering Hale and Dorr LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006

Accepted by FINRA:

11/30/2016
Date

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

Russell G. Ryan
Senior Vice President & Counsel
FINRA Department of Enforcement
15200 Omega Drive, 3rd Floor
Rockville, MD 20850