

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 03-99

June 4, 2003

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED
MEMBER ORGANIZATION

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Violated Exchange Rule 342(a) and (b) in that the Firm failed to reasonably discharge its duties and obligations in connection with supervision and control of and providing separate systems of follow-up and review with respect to certain of its business activities by failing to establish and maintain appropriate procedures and systems necessary to adequately supervise a number of specified matters; violated Exchange Rule 405 in that the Firm failed to learn the essential facts relative to certain of its customers; and violated Exchange Rule 440 and SEC Rules 17a-3 and 17a-4 because certain information on its books and records concerning customer accounts was inaccurate – Consent to censure and \$900,000 fine.

Appearances:

For the Division of Enforcement
Susan F. Axelrod, Esq.
Kenneth R. Bozza, Esq.

For the Respondent
Ben A. Indek, Esq.
Anne C. Flannery, Esq.
Adrienne Ward, Esq.
Sandra De Poalo, Esq.

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An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement and Merrill Lynch, Pierce, Fenner & Smith Incorporated (the "Firm"). Without admitting or denying guilt, the Firm consented to a finding by the Hearing Panel that it:

- I. Violated Exchange Rule 342(a) and (b) in that it failed to reasonably discharge its duties and obligations in connection with supervision and control of and providing separate systems of follow-up and review with respect to certain of its business activities by failing to establish and maintain appropriate procedures and systems necessary to adequately supervise the following:
 - A. Obtaining and reviewing customer new account forms.
 - B. Monitoring activity in certain of the Firm's customer accounts.

- C. Reviewing actively traded customer accounts.
 - D. Properly reviewing accounts for unapproved discretionary trading.
 - E. Suitability of investments in certain of the Firm's customer accounts.
 - F. Adequately following up on compliance visit findings in the Firm's Winter Park, Florida office so that corrective actions were taken.
 - G. Timely allocating block orders in certain customer accounts.
- II. Violated Exchange Rule 405 in that the Firm failed to learn the essential facts relative to certain of its customers.
- III. Violated Exchange Rule 440 and SEC Rules 17a-3 and 17a-4 because certain information on its books and records concerning customer accounts was inaccurate.

For the sole purpose of settling this disciplinary proceeding, the Division of Enforcement and the Firm stipulate to certain facts, the substance of which follows:

Background and Jurisdiction

1. The Firm or its predecessor has been a member organization of the Exchange since 1885. The Firm is a full-service global broker-dealer engaging in, among other things, retail brokerage, investment banking, underwriting debt and equity securities and advising corporations, governments, institutions and individuals. As of December 27, 2002, the Firm employed approximately 35,700 people worldwide, including about 16,700 registered employees in its domestic private client advisory division, and operated approximately 640 branch offices. The Firm is a wholly owned subsidiary of its parent, Merrill Lynch & Co., Inc.
2. In or about August 2001, Enforcement received a Uniform Termination Notice for Securities Industry Registration ("Form U-5") reporting that registered representative ("RR") Tania M. Torruella ("Torruella"), who joined the Firm in August 1999 and was employed at the Firm's Winter Park, Florida office (the "Winter Park office"), was terminated by the Firm on July 5, 2001. The Form U-5 reported that the Firm received numerous customer complaints concerning Torruella's activities as an RR and that an internal review revealed that Torruella violated industry standards of conduct and Firm policies, including those regarding the exercise of discretion and suitability.¹

¹ On June 13, 2003, an Exchange Hearing Panel found Torruella guilty of violating Exchange Rule 477 in that she failed to comply with written requests by the Exchange that she appear and give on-the-record testimony concerning matters that occurred prior to the termination of her status as an employee of a member firm. (See Hearing Panel Decision 02-121). The Hearing Panel imposed the penalty of a censure and bar until she complied, which was to become permanent if she did not comply within three months. Since she did not comply within the three-month period, Torruella is permanently barred from the securities industry. Marcella M. Maresca ("Maresca"), one of Torruella's assistants, also failed to comply with the Exchange's requests to appear and give testimony in this matter. Maresca was censured and barred until she complies with such requests. (See Hearing Panel Decision 02-221).

3. The Firm has since reported to the Exchange information concerning approximately 200 customer complaints against Torruella involving in excess of 550 separate accounts and alleging, among other things, failing to follow instructions, unsuitable trading, exercising discretion without written authorization and creating and issuing unapproved correspondence to customers. To date, the Firm has settled virtually all of these claims and has paid approximately \$28 million to Torruella's former customers.

Overview

4. During Torruella's tenure at the Firm, she was directly supervised by Ernest James Hinderliter ("Hinderliter") (See Exchange Hearing Panel Decision 03-111), the Senior Resident Vice President and later Managing Director of the Winter Park office, and John Salvatore Spinelli ("Spinelli") (See Exchange Hearing Panel Decision 03-110), the Administrative Manager.²
5. Although Hinderliter and Spinelli were responsible for the day to day running of the Winter Park office and were charged with reasonably supervising the employees and business activities subject to their control necessary for compliance with Exchange rules and federal securities laws, the Firm had the ultimate responsibility to exercise reasonable supervision and control over the Winter Park office and its employees for compliance with Exchange Rules and federal securities laws.
6. The Firm violated Exchange Rule 342(a) and (b) in that the Firm failed to reasonably discharge its duties and obligations in connection with supervision and control of and providing separate systems of follow-up and review with respect to certain of its business activities in the Winter Park office by failing to establish and maintain appropriate procedures and systems necessary to adequately supervise the following: obtaining and reviewing customer new account forms; monitoring trading activity in certain of the Firm's customer accounts; reviewing actively traded customer accounts; properly reviewing accounts for unapproved discretionary trading; suitability of investments in certain of the Firm's customer accounts; adequately following up on compliance visit findings in the Firm's Winter Park office so that corrective actions were taken; and timely allocating block orders in certain customer accounts. The Firm also violated Exchange Rule 405 in that it failed to learn the essential facts relative to certain of its customers, and Exchange Rule 440 and SEC Rules 17a-3 and 17a-4 in that certain information on its books and records concerning customer accounts was inaccurate.³
7. Based upon a breakdown in the implementation of the policies and procedures in place for the supervision and control of the Winter Park office, Torruella's violative conduct – *i.e.*, exercising discretion and making unsuitable investments in certain of

² Hinderliter worked in the Winter Park office during Torruella's entire tenure at the Firm. Spinelli worked in the Winter Park office from September 7, 1999, until March 19, 2001.

³ In addition to action against the Firm, this investigation has resulted in separate disciplinary actions against Hinderliter and Spinelli.

her customers' accounts, in that investments made by Torruella for such customers were not suitable in light of their age, financial resources, investment objectives and prior investment experience – went undetected for approximately a year and a half.

Tania Torruella's Hiring and Standing at the Firm

8. When Torruella came to the Firm after leaving her position with Firm A, she brought to the Firm between \$70 to \$80 million in assets from Firm A along with approximately 200 customers. As such, Torruella was given a significant compensation package, which included a substantial up-front bonus, various options and stock, and arranged to bring over to the Firm her two assistants.
9. During her tenure at the Firm, Torruella was a substantial producer for the Firm. In 2000, her ranking by production was 1 out of 28 in the Winter Park office and 830 out of 16,121 retail brokers nationwide (*i.e.*, ranked in the top 5% of Firm).
10. At or about the time Torruella joined the Firm, she was interested in enrolling her clients in the Firm's fee-based Personal Investment Advisory ("PIA") Program where she would function as a discretionary money manager. She expressed this interest during interviews with one of the Firm's senior supervisors, a District Director at the Firm, and Hinderliter was aware of her interest in this program as well. Although certain accommodations were made to allow Torruella to be in the PIA program, when she instead placed all of her clients in non-discretionary Firm Unlimited Advantage ("MLUA") accounts,⁴ the Firm failed to take adequate steps to determine whether Torruella was exercising discretion in such accounts.

Overview of Customer Complaints

11. The allegations contained in most of the approximately 200 customer complaints the Firm received from former customers of Torruella include the following: that Torruella asked them for and they gave her discretion in the accounts without written authorization being obtained from them, and that neither Torruella nor her assistants contacted them before each solicited transaction was made in their accounts. This was despite the fact that all the accounts were non-discretionary (*i.e.*, MLUA) accounts. Furthermore, many of her customers allege they did not have extensive investment experience and relied upon Torruella to make diversified investments in their accounts which were safe and secure. Instead, for many of her customers, Torruella followed investment strategies that ultimately resulted in significant portions of their assets at the Firm being invested in technology, telecommunications or internet stocks.
12. The technology, telecommunications and internet stocks purchased by Torruella's customers as a result of her investment strategies were unsuitable for many customers in view of the concentrated nature of such positions and the customers' investment objectives, risk tolerance and financial resources. Moreover, unbeknownst to

⁴ MLUA, an asset-based non-discretionary brokerage service, was introduced by the Firm in July 1999.

Torruella's managers and the Firm, when customers made contact with Torruella, she gave them assurances that the declines suffered in their accounts as a result of these investments would improve over time if the customers continued to hold their positions.

13. In addition, in August 2000, customer EN told Spinelli, the Winter Park office's Service Manager, and later Hinderliter, among other things, that Torruella was not calling her as frequently as EN desired and was also not calling her before some transactions were effected in her account.

Supervisory, Books and Records and Know Your Customer Violations

New Account Documents – Retail Account Profiles (“RAP”)

14. While Torruella was employed at the Firm, written Firm policy required that a RAP be completed for every account opened at the Firm prior to any trading taking place in the account. The RAP, which listed a customer's investment objectives and risk tolerance and contained information about a customer's background, employment, income, and investment experience, was to be prepared by the RR in consultation with the customer. Hinderliter delegated to Spinelli the responsibility to supervise the process of obtaining a RAP for all accounts and then reviewing the RAP for suitability. Once this was done, Spinelli was to countersign the RAP and submit it for filing in the Winter Park office. Accounts that were missing the RAP were required to be restricted from trading if a RAP was not obtained either within 2 days of the assignment of an account number or prior to the first trade being made, whichever was earlier.
15. Each branch office, which included Winter Park, maintained a New Account Log Book ("Log Book") for monitoring the receipt of the RAP. Included in this book was the name of the customer and account number for every account opened at the Firm, the identity of the RR who was responsible for the particular account, and a column where the date of the receipt of the RAP for each account was to be entered.
16. Firm policy required that the Log Book be reviewed by branch management on a weekly basis to make sure that new account documentation was complete. This policy also required that management “diligently follow up on determining the disposition of and collection of new account forms for all account numbers that have been assigned.” Managers were also required to evidence their review by initialing each page of the Log Book “after he/she has verified that approved new account forms have been received for each account number assigned.”
17. While Spinelli was responsible for reviewing and initialing each page of the book, he did not begin doing so until at least three months after he began working at Winter Park. Hinderliter failed to take sufficient steps to make sure he was performing these duties. Once Spinelli began reviewing the Log Book, he observed that approximately 200 of Torruella's customer accounts, more than one-half of which were opened after

- Spinelli began working in the Winter Park office, were missing a RAP. Unbeknownst to Hinderliter, however, Spinelli took no remedial action, and RAPs were not obtained for most of these accounts, nor was trading restricted as required by Firm policy. Moreover, Hinderliter did not adequately monitor the Log Book to determine if a RAP had been obtained for all of Torruella's customers or, as Firm policy required, to see whether Spinelli had properly reviewed and initialed each page of the book.
18. Further, while Firm policy required that each office conduct its own quarterly compliance review of accounts opened during the previous quarter, the Firm failed to reasonably supervise this process as no such quarterly reviews were conducted during Torruella's employment at the Firm.
 19. As a result of the above-described supervisory failures, in April 2001, it was discovered by Spinelli's successor as Administrative Manager that 215 of Torruella's accounts were missing a RAP.
 20. In June 2001, a newly-appointed District Administrative Manager of the Firm was alerted to the problems that had been uncovered in the Winter Park office regarding missing RAPs, among other things. Shortly thereafter, the District Administrative Manager visited the Winter Park office where she assisted in the preparation of RAPs for those of the 215 customer accounts that were still open at the Firm and missing such documentation. As a result, approximately 183 RAPs, 148 of which were for the accounts of 56 customers who ultimately initiated complaints against Torruella, were completed over a two-day period, but Torruella refused to verify the information and sign the RAPs when given to her.
 21. The Firm's failure to ascertain during Hinderliter's and Spinelli's tenure that a continuing problem existed with Torruella obtaining and completing a RAP for each of her customers' accounts, and the failure to properly supervise and monitor Torruella, as well as Hinderliter and Spinelli, to make sure that such documents were on file for all customer accounts, prevented the Firm from learning at an early stage of problems concerning Torruella's handling of her accounts and caused the Firm to violate the "know your customer" rule (*i.e.*, Exchange Rule 405) in that it failed to learn the essential facts relative to those customers missing RAPs. Further, because it was not detected that some of the information reflected on certain RAPs completed by Torruella was inaccurate, the Firm violated Exchange Rule 440 and SEC Rules 17a-3 and 17a-4.

Active Account Reviews/Exception Reports

22. During Torruella's tenure at the Firm, it had in place active account reviews/exception reports to monitor activity in MLUA accounts. These reports were referred to as Exceeding Threshold Reports ("ETRs") through November 2000 and Account Review Monitoring and Online Reporting ("ARMOR") MLUA Reports as of December 2000.

23. Prior to the switch to ARMOR MLUA, Senior Compliance Officer CO was responsible for reviewing and distributing the ETRs to the Winter Park office. During the relevant period, CO did not perform an adequate review before disseminating such reports to that office.
24. Hinderliter delegated to Spinelli the responsibility to conduct, according to Firm procedures, monthly reviews of accounts that appeared on the ETRs and ARMOR MLUA Reports as a result of the activity and losses sustained in the accounts and to consider contacting customers as part of such reviews based on criteria promulgated by the Firm.
25. Despite the fact that many of Torruella's customers had accounts that appeared at various times on these reports, because of Hinderliter's failure to adequately monitor Spinelli's work, he was unaware that Spinelli failed to ever contact any of Torruella's customers as part of an active account review.
26. Hinderliter never contacted any customers himself as part of an active account review nor did he direct that Spinelli do so. As a result of the considerable losses sustained in many of Torruella's customer accounts, Firm policy required that these customers be contacted – the only exception to this Firm policy would be if a bona fide reason, which was required to be documented, existed for not making such contact. In accordance with Firm policy, in addition to notifying customers of the volume of trades and of the significant depreciation that had taken place in their accounts year to date, the customers, in the course of such contact by branch management, should have also been asked to review their investment activity in light of their investment objectives and tolerance for risk and should have been told to contact Spinelli if they would like to discuss any aspect of their account.
27. Hinderliter also did not detect that Spinelli failed to continue to monitor accounts that appeared on successive ETRs and ARMOR MLUA Reports and that he made false notations on certain ETRs indicating that some customers were indeed contacted. Furthermore, neither Hinderliter nor anyone else at the Firm ever learned that on September 22, 2000, Spinelli drafted letters to eight of Torruella's customers whose accounts had appeared on the July 2000 ETR but then decided not to mail them. Spinelli made this decision after he showed the letters to Torruella who convinced him that since the information was outdated, he should continue to monitor the accounts and wait until they appeared on a later ETR before the customer was contacted. Spinelli then failed to continue to monitor these accounts. In light of the activity in the aforementioned eight accounts, Spinelli's decision not to mail these letters was not reasonable and in contravention of Firm policy.
28. The failure to contact customers whose accounts appeared on ETRs or ARMOR MLUA Reports was in violation of Firm procedures that were designed to detect whether unsuitable investments were being made and whether discretion was being exercised by Torruella, among other things. Furthermore, based upon customer EN

- telling Spinelli, the Service Manager, and later Hinderliter in August of 2000 that Torruella was not calling her before some transactions were effected in her account, branch management knew or should have known that Torruella was taking discretion in at least one customer account. Despite this, branch management did not take sufficient action with respect to EN's complaint, nor did they conduct, or direct that anyone else conduct, any investigation to learn whether other customers were also not being contacted prior to trades being effected in their accounts.
29. Further, in violation of Firm policy, Hinderliter failed to notify the Firm's Compliance Department of the receipt of EN's complaint.
 30. In addition, because Spinelli purportedly became overwhelmed with his job and was getting behind in his work, he failed to review the November 2000 ETR and the December 2000 ARMOR MLUA Report, a fact that was not discovered until shortly after a new Administrative Manager took over for Spinelli in March 2001. As such, neither Spinelli nor Hinderliter discovered that 292 accounts belonging to Torruella's customers appeared on the December 2000 ARMOR MLUA Report, which included the accounts of four (4) of the customers to whom Spinelli was going to send his September 22nd letters.
 31. Based upon the level of trading activity and losses sustained in many of the accounts that appeared on the December 2000 report, and in the absence of any bona fide documented reason for not making such contact as required by Firm policy, Spinelli was required to contact these customers, which he failed to do.

Spinelli's Request for Assistance

32. In or about the Fall of 2000, Spinelli came to Hinderliter to ask him for help and advised him that he was busy and getting behind in his work. Subsequently, Hinderliter and Spinelli each individually spoke with the National Administrative Manager, whose Division encompassed the Winter Park office, about this issue. Although Spinelli never told this individual or anyone else at the Firm that he was unable to do his job or review the ETR for November 2000 and the ARMOR MLUA Report for December 2000, Hinderliter and the Firm took insufficient steps to investigate why Spinelli was requesting assistance or in what manner he was not performing his duties. Additionally, the Firm has no records establishing that any help was provided to Spinelli, and several months went by before Spinelli's dereliction of duties was discovered.

Compliance 1028 Reports

33. Another of the duties delegated to Spinelli by Hinderliter was the daily review of the Firm's Compliance 1028 reports that reflected all of the transactions executed in the

Winter Park office on the previous day by each RR, which included Torruella.⁵ During certain periods and on various dates the 1028 Reports for the Winter Park office reflected that a significant number of transactions for a large number of customers were made by Torruella (for example, on April 4, 2000, Torruella effected 1,306 transactions for at least 113 different customers, and on October 26, 2000, she effected 1,040 transactions for 122 customers). As indicated in those reports, virtually all of these transactions were solicited.

34. Given that virtually all of Torruella's customers had non-discretionary MLUA accounts, branch management not only should have suspected that it was not possible for Torruella to have contacted and spoken with every one of these customers, they also should have inquired further as to whether Torruella was doing so. Had they done so, Hinderliter, Spinelli and, through them, the Firm, could have detected that Torruella was exercising discretion in these accounts.
35. At no time during their tenure in the Winter Park office did Hinderliter's or Spinelli's review of a Compliance 1028 report ever prompt them to take action to ascertain whether discretion was being taken by Torruella.

June 2000 Compliance Examination of the Winter Park Office

36. Prior to a compliance visit CO made to the Winter Park office in June 2000, he suspected Torruella was exercising discretion based upon his review of three (3) weeks worth of Compliance 1028 reports and his observation of a significant number of transactions for a large number of customers that appeared on such reports. CO addressed his concerns with Spinelli prior to his compliance visit and both Spinelli and Hinderliter during such visit. Notwithstanding this, CO's only action was to conduct a meeting attended by both managers, Torruella and Torruella's two assistants. After CO was told during the meeting that both Torruella and one of her assistants were calling clients, and after CO reminded Torruella that customers must be contacted one or two days in advance of an order entry and that they be advised of the particulars of the transaction that would be taking place, nothing further was done to verify that Torruella was not exercising discretion.
37. Moreover, no further action was taken by any Firm employee, including reaching out to customers to confirm with them that they were aware of the transactions being effected in their accounts.
38. Following CO's compliance visit, a memorandum dated July 17, 2000, and addressed to the Firm's District Director, whose District encompassed the Winter Park office at that time, was prepared setting forth his findings. The memo was also copied to six other supervisors, including Hinderliter and Spinelli as well as supervisors to whom

⁵ In addition to the identity of the RR, the information on these reports included the name of the customer and the customer's account number, the date of the trade, the name and the quantity of the particular security that was bought or sold, and whether the transaction was solicited or unsolicited.

the District Director reported. Copies were also sent by interoffice mail to CO's managers in New York.

39. However, the issue of discretion that CO raised during his compliance visit was not included in the July 17, 2000 memorandum. A revised memorandum, dated July 18, 2000, was prepared which stated that, among other things, RRs should be reminded that time and price discretion for non-discretionary accounts was strictly prohibited. None of the persons to whom this revised memo was addressed ever received it. At the time, the Firm had no formal mechanism in place to confirm that this revised report was circulated and received.
40. CO did not discuss with his managers the concerns he had identified prior to his compliance visit, the results of his on-site visit or his original or revised memoranda. Moreover, CO did not adequately address any of the above-mentioned issues with supervisory personnel outside of the Winter Park office.
41. While CO discussed with the relevant District Administrative Manager that during his compliance visit he had held a meeting to confirm that a broker, whom he did not identify, was contacting her clients prior to entering orders and that following the meeting he was comfortable that she was doing so, the reason why this issue came up was not discussed. In addition, although at the time of his visit CO knew Torruella was still interested in enrolling clients in PIA, there were no further discussions between himself and the manager concerning this issue.

Allocation of Trades

42. During the relevant period, Firm policy, as well as Exchange rules and Information Memoranda, required that all order tickets or electronic trading records specifically identify the account for which the trade is being placed before the order is executed. To accomplish this, the RR was to complete the account allocation using the Firm's automated account allocation system.
43. Notwithstanding this policy, in late 1999 and on several occasions in 2000, the Firm became aware that certain of Torruella's block trades were not being timely allocated to customers' accounts. In particular, it came to the attention of various Firm employees that on one or more occasions after block trade orders were entered by Torruella or her assistants, rather than using the Firm's automated system, Torruella would instead send to the Firm's trading desk a list as much as two to three days later of accounts for which executed trades were to be allocated. On certain occasions the lists being sent by Torruella contained up to 200 different accounts.
44. Although the evidence has not disclosed that any preference was given to any of Torruella's customers, the Firm did not adequately follow-up on the above described issues regarding the timely allocation of block trades, which improperly allowed Torruella to have an inordinate latitude in allocating trades or portions of trades in various customer accounts.

Conclusion

45. As set forth above, the Firm violated Exchange Rules 342, 405 and 440 and SEC Rules 17a-3 and 17a-4. Not only did Hinderliter and Spinelli fail to properly perform their supervisory duties and adequately investigate Torruella's activities, but the Firm also failed to have reasonable procedures in place for supervision and control, including a separate system of follow-up and review, necessary for compliance with Exchange rules and federal securities laws. Torruella's misconduct (including her exercise of discretion without written authorization and making unsuitable investments in her customers' accounts) continued for approximately eighteen months without Hinderliter, Spinelli, a Senior Compliance Officer or the Firm taking adequate steps to detect the violative conduct described herein.

Other

46. The Division of Enforcement has considered the prompt action taken by the Firm in investigating the above matter and terminating Torruella shortly thereafter; the Firm's payment of \$28 million in compensation to virtually all of Torruella's customers who had claims against her; and developing and implementing enhanced supervisory policies particularly in areas dealing with new accounts, active account reviews, customer contact, compliance oversight of branch offices, and allocation of block trade orders.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found the Firm guilty as set forth above by unanimous vote.

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by the Firm of a censure and a fine of \$900,000.

For the Hearing Panel

Vincent F. Murphy
Hearing Officer