

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 05-87

July 21, 2005

MERRILL LYNCH, PIERCE, FENNER & SMITH, INCORPORATED  
MEMBER ORGANIZATION

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**Violated Exchange Rules 401 and 476(a)(6) in that it failed to adhere to the principles of good business practice and engaged in conduct inconsistent with just and equitable principles of trade by failing to deliver prospectuses in connection with certain sales of registered securities; violated Exchange Rule 1100(b) in that it failed to deliver product descriptions in connection with certain sales of exchange traded funds; violated Exchange Rule 345 in that the Firm: permitted employees who were not properly registered with the Exchange to perform regularly duties which required such registration, failed to file and/or file promptly certain Forms U-4, and failed to update certain changes of address on Forms U-4; engaged in conduct inconsistent with just and equitable principles of trade in that the Firm failed to fully comply with an undertaking in connection with an earlier Exchange Hearing Panel Decision; violated Exchange Rule 440, Section 17(a) of the SEA and Rule 17a-4 thereunder in that the Firm failed to preserve certain electronic mail; violated Exchange Rule 401 in that it failed to timely register as a user of the EFP/PI and to respond to numerous EFP/PI requests; violated Exchange Rule 351(a) in that the Firm failed to report and/or promptly report certain reportable matters to the Exchange; violated Exchange Rule 351(d) in that the Firm failed to report, failed to timely report and/or failed to accurately report to the Exchange, statistical information regarding customer complaints; violated Exchange Rule 345A by allowing certain individuals to perform duties as registered persons after failing to comply with continuing education requirements; violated Exchange Rule 401 in that it failed to adhere to the principles of good business practice by failing to provide certain clients with the opportunity to decline the use of margin; 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 including maintaining a separate system of follow-up and review with respect to each of the items enumerated above. – Consent to censure, \$10,000,000 fine and an undertaking.**

**Appearances:**

For the Division of Enforcement  
Susan L. Merrill, Esq.  
Linda S. Riefberg, Esq.  
Joy A. Weber, Esq.  
Gino Ercolino, Esq.  
Kevin T. McDonald, Esq.

For the Respondent  
Ben A. Indek, Esq.  
Jonathan N. Eisenberg, Esq.  
Joel H. Goldberg, Esq.  
Adam S. Hakki, Esq.  
Richard F. Schwed, Esq.  
Marla Moskowitz, Esq.  
Jennifer M. Newcomb, 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 ("Respondent" or the "Firm"), a member organization of the Exchange. Without admitting or denying guilt, the Firm consents to a finding by the Hearing Panel that the Firm:

- I. Violated Exchange Rules 401 and 476(a)(6) in that it failed to adhere to the principles of good business practice and engaged in conduct inconsistent with just and equitable principles of trade by failing to deliver prospectuses in connection with certain sales of registered securities in violation of Section 5(b)(2) of the Securities Act.
- II. Violated Exchange Rule 1100(b) in that it failed to deliver product descriptions in connection with certain sales of exchange traded funds.
- III. Violated Exchange Rule 345 in that the Firm:
  - a. permitted certain employees who were not properly registered with the Exchange to perform regularly duties which required such registration;
  - b. failed to file and/or file promptly certain Forms U-4 with the Exchange; and
  - c. failed to update certain changes of address on Forms U-4.
- IV. Engaged in conduct inconsistent with just and equitable principles of trade in that the Firm failed to fully comply with an undertaking in connection with an earlier Exchange Hearing Panel Decision.
- V. Violated Exchange Rule 440, Section 17(a) of the SEA and Rule 17a-4 thereunder in that the Firm failed to preserve certain electronic mail.
- VI. Violated Exchange Rule 401 in that it failed to timely register as a user of the EFP/PI as set forth in Information Memorandum 03-55 and to respond to numerous EFP/PI requests.
- VII. Violated Exchange Rule 351(a) in that the Firm failed to report and/or promptly report certain reportable matters to the Exchange.
- VIII. Violated Exchange Rule 351(d) in that the Firm failed to report, failed to timely report and/or failed to accurately report to the Exchange, statistical information regarding customer complaints.
- IX. Violated Exchange Rule 345A by allowing certain individuals to perform duties as registered persons after failing to comply with continuing education requirements.
- X. Violated Exchange Rule 401 in that it failed to adhere to the principles of good business practice by failing to provide certain clients with the opportunity to decline the use of margin.

- XI. 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 including maintaining a separate system of follow-up and review with respect to each of the items enumerated above.

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. Respondent is a registered broker-dealer headquartered in New York, New York. Respondent or its predecessor has been a member organization of the Exchange since 1885. In 2003, the Firm, a full-service retail brokerage firm, operated more than 640 locations worldwide. The Firm is engaged in, among other things, securities brokerage business for retail and institutional customers, trading, underwriting, investment banking, research and providing investment advisory services, and employs approximately 50,000 people worldwide including more than 20,000 registered employees.
2. The Exchange's Division of Member Firm Regulation Sales Practice Review Unit ("SPRU") conducted sales practice examinations of the Firm in 2001 and 2002, and set forth various findings in reports to the Firm dated June 4, 2001 (the "2001 SPRU Report") and September 24, 2002 (the "2002 SPRU Report"), certain of which findings are included herein.
3. Additional matters identified by the Exchange or self-reported by the Respondent are also included in this Stipulation.

### **Prior Discipline**

4. Respondent previously has been the subject of Exchange disciplinary actions that are relevant to this matter.
5. In HPD 00-109, the Respondent consented to findings that it violated certain provisions of the Securities Exchange Act of 1934 ("SEA") and Exchange Rules, including: (1) SEA Rule 15c3-1(a) by failing to maintain net capital at the required level; (2) SEA Rule 15c3-1(e)(1) by withdrawing equity capital when it did not have minimum net capital at the required level; (3) Exchange Rule 345.17 by failing to file or file promptly certain Forms U-5; (4) Exchange Rule 351(a) by failing to report certain matters to the Exchange as required; (5) Exchange Rule 345.12 by failing to file or file promptly certain Forms U-4; (6) Exchange Rule 346(f) by having certain persons associated with it who were subject to statutory disqualification; (7) Exchange Rule 351(a)(9) by failing to promptly report its association with persons subject to a statutory disqualification; (8) Exchange Rule 351(d) by failing to report as required certain statistical information regarding customer complaints; and (9) Exchange Rule 342 by failing to provide for, establish and maintain adequate procedures and controls. Respondent consented to a censure, \$250,000 fine and an undertaking to perform a review of its systems and procedures in the area of reporting

of events to the Exchange, and to prepare a report that reflects the enhancements made to those systems and procedures.

6. In HPD 02-228, Respondent consented to findings that it violated: (1) Exchange Rule 346(f) by having persons associated with it who were subject to statutory disqualification; (2) Exchange Rule 351(a)(9) by failing to promptly report its association with persons subject to a statutory disqualification; and (3) Exchange Rule 342 by failing to provide for, establish and maintain adequate procedures to comply with Exchange Rules and federal securities laws relating to the employment of statutorily disqualified individuals. Respondent consented to a censure, \$300,000 fine and an undertaking.
7. In HPD 03-99, Respondent consented to a censure and a fine of \$900,000 based on a finding that it violated Exchange Rule 342 by failing to reasonably discharge its duties and obligations in connection with the supervision and control of a former registered representative who had numerous customer complaints. The Respondent was found, inter alia, to have failed to establish and maintain procedures and systems to adequately supervise the review of accounts for excessive activity and suitability of recommendations. Additionally, Respondent was found to have violated Exchange Rule 440 and SEA Rules 17a-3 and 17a-4 because certain information on its books and records was inaccurate.

### Overview

8. Between October 2002 and March 2004, Respondent failed to deliver prospectuses with respect to approximately 64,000 transactions in connection with certain sales of registered open-end mutual fund securities. Further, between January 2004 and July 2004, Respondent failed to deliver prospectuses with respect to approximately 900 transactions in approximately 275 customer accounts in auction rate preferred stocks issued by closed end funds. In addition, due to the absence of codes in its system needed to trigger the delivery of product descriptions, Respondent failed to comply with Exchange Rules by failing to deliver product descriptions in connection with certain sales of exchange traded funds. This problem occurred because Respondent failed to implement systems and procedures for the delivery of product descriptions when such securities first began to be offered by it. Additional deficiencies where coding problems led to a failure to send prospectuses occurred in connection with: certain initial public offerings when Respondent was not a participant in the offering; certain after-market trades in which the Firm did participate in the offering; certain follow-on offerings in which stock was held in a special inventory account; and certain debt securities, asset-backed and mortgage-backed securities, and structured products.
9. Between December 2002 and February 2005, the Exchange and Respondent identified 69 employees whose registration had lapsed or had not been properly completed. After a review that concluded in February 2005, Respondent identified an additional 818 employees who did not maintain all applicable registrations.
10. Respondent did not preserve or retain certain electronic communications in accordance with Exchange Rule 440, Section 17(a) of the Securities Exchange Act of

1934 and SEA Rule 17a-4. In two instances, the failure to preserve or retain e-mail impacted Enforcement's ability to ascertain whether relevant information had been created with regard to its investigation of certain matters.

11. The SPRU Examiners conducted sales practice examinations of the Respondent's retail offices in 2001 and 2002 and set forth various findings in reports referred to in paragraph 2, above. The reports stated, among other things, that the Firm did not comply with the following Exchange and SEA Rules:
  - Exchange Rule 351 (failure to file Forms U-4, U-5 or RE-3; failure to properly report customer complaints);
  - Exchange Rule 342 (specifically with regard to the supervision of electronic mail or "e-mail" correspondence with retail clients; branch supervision of fax machines, and failure to have appropriately qualified supervisory personnel in branch offices);
  - Exchange Rule 440 and SEA Rule 17a-4 (books and records);
  - Exchange Rule 345A (continuing education); and
  - Exchange Rule 401 (good business practice).
12. Respondent did not timely register for the Exchange's Electronic Filing Platform for preliminary investigations, which became effective on June 30, 2004 and did not respond to numerous requests for information between July 1, 2004 and September 1, 2004.
13. Respondent did not timely report certain customer complaints, failed to report a significant number of litigation or arbitration judgments, awards or settlements between August 2003 through August 2004, and in five instances during the period January 2004 through March 2004, Respondent did not timely file Forms RE-3 necessary to report certain awards in Exchange arbitration proceedings. Respondent also did not update certain address changes on Forms U-4.
14. Between December 1999 and December 2000, Respondent's Client Relationship Agreement did not provide clients the opportunity to decline the use of margin.
15. With regard to the foregoing supervisory, operational and technological deficiencies, Respondent did not comply with certain Exchange Rules and federal securities laws, and it did not reasonably discharge its duties and obligations in connection with supervision and control, including maintaining a separate system of follow-up and review.

**Delivery Failures in Connection with the Sale of Certain  
Registered Securities and Exchange Traded Funds**

Prospectus Delivery

16. Section 5(b)(2) of the Securities Act of 1933 (the “Securities Act”) prohibits the delivery of certain securities unless such delivery is accompanied or preceded by a prospectus that meets the requirements of the Securities Act. Exchange Rule 401 requires that member firms adhere, at all times, to the principles of good business practice in the conduct of their business affairs. Exchange Rule 476(a)(6) requires member firms to comport with just and equitable principles of trade.
17. In March 2004, Respondent discovered that due to an operating system modification made in October 2002, it had not delivered prospectuses in connection with sales of certain open-end mutual fund securities. The open-end mutual funds that were impacted had experienced certain changes to the security identification information for a fund (e.g., where the name of the fund was changed or the fund was merged with another fund). This situation was corrected within two business days.
18. On October 11, 2004, Respondent notified the Exchange that it had discovered that certain of its customers did not receive prospectuses in connection with their purchases of certain securities. Respondent thereafter reported to the Exchange additional operational issues, including the product description issues described below.
19. Specifically, between October 2002 and March 2004, Respondent failed to deliver prospectuses with respect to approximately 64,000 transactions in connection with certain sales of registered open-end mutual fund securities. Respondent identified the issue and thereafter made appropriate rescission offers commencing on December 21, 2004 that complied in all respects with the federal securities laws.
20. During the period from January 2004 through July 2004, due to the replacement of its operating system for the offering of auction rate preferred securities (“AMPS”) with a system that did not include the proper coding instructions, Respondent failed to deliver prospectuses with regard to approximately 900 AMPS trades in approximately 275 customer accounts. The systems error was discovered during a subsequent review in July 2004, and a manual process was instituted immediately to ensure timely prospectus delivery. That function was automated as of September 2004.
21. Thereafter, on December 31, 2004, Respondent made appropriate rescission offers that complied in all respects with the federal securities laws.
22. The failure to deliver prospectuses resulted from supervisory and operational failures at Respondent prompted by the absence of reasonable syndicate, trading and operations departments’ procedures that would trigger the mailing of such materials as required.

### Product Description Delivery

23. Exchange Rule 1100(b) provides that with respect to certain securities known herein as Exchange Traded Funds (“ETFs”) as to which the sponsor or other appropriate party has obtained an exemption from Section 24(d) of the Investment Company Act of 1940 (“ICA”) and which are listed on the Exchange or have unlisted trading privileges, members and member organizations shall provide to all purchasers of such securities a written description of the terms and characteristics of such securities, in a form prepared or approved by the Exchange, not later than the time a confirmation of the first transaction in such security is delivered to such purchaser.
24. In November 2004, Respondent notified the Exchange that it had discovered that, due to the absence of codes in its securities master database triggering the delivery of product descriptions for certain ETFs, certain customers who purchased ETFs did not receive product descriptions in connection with their purchases. In fact, 150 of the 156 ETFs listed in Respondent’s database were not properly coded for such delivery. All but 15 of these ETFs were covered by exemptive orders.
25. Respondent’s deficient coding was caused by, among other things, the Firm’s failure to implement systems and procedures for the delivery of product descriptions when such securities first began to be offered by Respondent.
26. This problem lasted until November 23, 2004, when Respondent corrected its securities master database to provide that all ETFs were coded so as to trigger an instruction that a product description should be delivered.
27. The failure to deliver product descriptions resulted from supervisory and operational failures at Respondent prompted by the absence of reasonable syndicate, trading and operations departments’ procedures that would trigger the mailing of such materials as required.

### Other Deficiencies in Delivery of Prospectuses to Customers

28. In addition to the problems with prospectuses and product descriptions described above, Respondent also failed to send prospectuses as required in areas within Respondent where coding problems occurred, including the following:
  - a. Prior to December 2004, in certain situations in which the Firm was not a participant in an offering, it improperly failed to include enclosure codes in its securities master database that would have triggered delivery of prospectuses as required for certain after-market trades in equity offerings within 25 days of the initial public offering.
  - b. In certain instances in which Respondent was a participant in the offering, Respondent did not code its securities master database as requiring prospectus delivery in sufficient time to send prospectuses to customers if the after-market trade occurred on the same day as the initial offering. In 2004, this occurred in 324 after-market trades in 237 accounts.

- c. In some situations, due to a coding error, Respondent failed to deliver prospectuses for trades in shares issued in follow-on offerings as required. In 2004, this occurred with 852 trades in 16 equity follow-on offerings.
- d. For certain Firm structured products, Respondent had improperly failed to include enclosure codes that would have triggered delivery of the prospectuses as required. Thus in 2004, there were 12,243 trades involving 4,885 accounts in 57 securities that did not have a prospectus delivery due to the coding error.
- e. For certain debt securities, because of a failure to provide coding information, Respondent failed to deliver prospectuses for approximately 2,700 trades in 29 debt securities during the period October through December 2004.
- f. Approximately 1,000 trades in 120 asset-backed and mortgage-backed securities were incorrectly not flagged for prospectus delivery, during the first 90 days of trading, during the period October through December 2004.

### **Registration Failures**

- 29. Exchange Rule 345(a) requires each member organization to register persons who regularly perform the duties performed by registered representatives and supervisors.

### Failure to Transfer or Properly Complete Employee Registrations

- 30. Breakdowns in Respondent's registration process were discovered after the Exchange received approximately 52 employee registration reinstatement requests from Respondent between 2001 and 2004 for individuals whose registrations had lapsed. Seventeen additional employees were later identified by Respondent as having lapsed registrations, bringing the total number of employees with lapsed or incomplete registrations to 69. Such employees' General Securities Registrations ("Series 7") had either: (a) lapsed from not being timely transferred to Respondent, (b) never been properly completed upon hire or re-hire with Respondent, or (c) lapsed after a Form U-5 was mistakenly filed terminating the registration.
- 31. These registration failures occurred at the registration department ("RD") level, the human resources ("HR") level and the branch office or business unit level. Failures occurred at multiple branches and business units.
- 32. The failures at the RD level occurred in one of three ways: (a) after receiving notice from a branch office, business unit or HR of the need to register an employee, the RD failed to start the process; (b) after receiving a signed Form U-4 from the employee, the RD failed to file it with the Central Registration Depository ("CRD"); or (c) after filing a Form U-4, the RD failed to monitor it for deficiencies and did not detect that the registrations had not transferred to Merrill Lynch.
- 33. Failures at the HR level occurred because it did not notify the RD to begin the transfer of the registration process for a new employee and, in at least one instance, because it failed to update accurately certain employee records which, in turn, generated a Form U-5 terminating certain registrations.

34. At the branch office or business unit level, breakdowns occurred in instances where: (a) branch offices or business units failed to contact the RD upon the hire of a new employee; (b) branch offices or business units failed to follow up with the RD after being reminded to complete Forms U-4; (c) branch offices or business units failed to complete and/or forward Forms U-4 to the RD for filing, preventing the registrations from becoming effective; and (d) registered employees were transferring to a different office within Respondent or changing positions, and certain branch offices or business units mistakenly filed Form U-5 termination notices for certain employees causing registrations to lapse.
35. Respondent lacked appropriate procedures of supervision and control, including a separate system of follow-up and review to: (a) detect whether employees had lapsed or ineffective registrations; and (b) determine whether such employees were acting in a registered capacity without the required registrations. As a result, almost all of the employees with lapsed or ineffective registrations regularly acted in a registered capacity without the required registrations.
36. The majority of these employees acted in such a capacity for periods between approximately one and four years. However, at least eight of the 69 employees acted in registered capacities without the proper registration for periods between approximately five and 17 years.
37. Upon identification, the employees whose registrations had lapsed were told to stop undertaking activities requiring registration until the appropriate registrations were obtained.

#### Failure to Maintain Proper Registrations for Certain Employees

38. After the discovery of Respondent's registration deficiencies, the Firm undertook an additional review in order to determine the total number of other employees at Respondent who might also have registration deficiencies. Specifically, between October 2004 and February 2005, Respondent performed a comprehensive review of the registration status of certain employees whose jobs may have required registration to determine whether such employees were maintaining positions or performing activities that required them to hold some form of securities registration. At the conclusion of the review, Respondent identified the additional 17 employees noted above whose registrations had lapsed. The review also disclosed that as of November 19, 2004, 818 individuals were deficient in their Series 7 and/or certain other registrations including the Series 3, 6, 9, 10, 14, 23, 24, 26, 27, 31, 53, 55, 63, 65 and 66 licenses.
39. Respondent lacked appropriate procedures of supervision and control, including a separate system of follow-up and review to: (a) detect whether employees were maintaining the proper registrations; and (b) determine whether such employees were acting in a registered capacity without the required registrations. Each of the employees who did not maintain these registrations performed certain job functions which required such registrations.

40. The majority of these employees acted in such a capacity for periods between approximately one and four years. However, 93 of the 818 employees acted in registered capacities without the proper registration(s) for periods between five and 20 years. Upon its identification of employees lacking certain required registrations, Respondent instructed those individuals to either stop performing activities requiring such registration permanently or until they were advised that their registration(s) was/were effective.

**The Firm's Failure to Fully Comply with a Previous Undertaking**

41. In Exchange HPD 00-109, dated June 29, 2000, Respondent consented to a censure, \$250,000 fine and an undertaking for, among other things, failing to file and/or to file promptly Forms U-4 and amendments to Forms U-4 with the Exchange. Respondent failed to make the necessary Form U-4 filings for five employees who were required to be registered. The filings were between six months and eight years late. In addition and similar to the current matter, the HPD stated that employees with ineffective registrations had acted in a registered capacity for extended periods of time.
42. In connection with the undertaking, Respondent was required to conduct a review of its systems and procedures regarding reporting events pursuant to Exchange Rules 345 and 351 and to prepare a written report addressing, among other things, Respondent's review of its systems and procedures regarding Form U-4 filings and enhancements made to prevent a recurrence of the violations. The report noted the responsibilities of both the RD and HR as they relate to the hire, transfer, termination and/or registration of employees and explained that Respondent established a link between the HR and RD databases in order to keep the RD apprised of all terminations.
43. The report represented that in addition to tracking terminations for registration purposes, "[n]ew hires and changes within the organization that require registration or may affect registration status are also communicated to [the RD] from appropriate sources. [The RD] keeps a list of pending filings to ensure that each required filing is made on a timely basis." Respondent also stated that it had updated its HR database, developed a company-wide set of job codes that specified all positions requiring registration and established a notification system designed to identify new employees who might require registration. Respondent reported that it was "reducing the possibility that an unregistered person will occupy a position requiring registration."
44. Despite its statement in the written report about developing a company-wide set of job codes, Respondent did not follow all of the new procedures it represented were put in place and Respondent's enhancements did not alleviate its problems regarding the proper registration of employees. Specifically, in late 2001, Respondent discontinued its job code notification system that specified all positions requiring registration because it was unwieldy and ineffective. Moreover, Respondent's remaining procedures did not otherwise "reduc[e] the possibility that an unregistered person will occupy a position requiring registration." While the Firm has put in place a manual process to identify existing and new employees who require registration and to obtain such registrations, as a result of Enforcement's investigation, to date

Respondent has not implemented another automated system that would have accomplished the improvements that were represented in the written report. As such, Respondent has failed to fully comply with the undertaking imposed by Exchange HPD 00-109. Respondent has informed Enforcement that it is currently revising its existing registration procedures and systems or creating new procedures and systems.

### **Retention and Review of Electronic Mail and Other Communications**

45. Exchange Rule 440 requires that “every member organization shall make and preserve books and records as the Exchange may prescribe and as prescribed by Rule 17a-3. The record keeping format, medium and retention period shall comply with Rule 17a-4 under the Securities Exchange Act of 1934.”
46. SEA Rule 17a-4(b)(4) requires that every broker and dealer shall preserve for a period of not less than three years, the first two years in an accessible place: “Originals of all communications received and copies of all communications sent . . . by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such.”

### **E-mail Preservation and Retention**

47. In the 2001 and 2002 SPRU Reports, Respondent was the subject of repeat findings by Exchange examiners that indicated Respondent had failed to preserve or retain electronic communications in a manner consistent with the requirements of Exchange Rule 440, Section 17(a) of the SEA and Rule 17a-4 thereunder.
48. Specifically, during the period covered by the 2001 SPRU Report, Respondent did not have certain of its e-mail stored in a “write once read many” (“WORM”) format, as required by SEA Rule 17a-4(f)(2)(ii). Specifically, internal e-mails of some individuals employed outside of Respondent’s U.S. Private Client Group had been stored on back-up tapes and were not retained in WORM format.
49. In connection with an Enforcement investigation concerning events between January 1999 and June 2000, the Exchange requested the e-mails of six employees. Because Respondent did not maintain certain of the back-up tapes on which it had stored the e-mails, Respondent was not able to produce all of these requested e-mails. In the same matter, Respondent also encountered difficulties producing in a timely manner certain additional e-mails that it had retained. In another matter of interest to the Exchange relating to events that occurred in November 2003, Respondent was unable to locate and produce the email of an institutional sales person, as requested. In these two matters, despite having produced responsive e-mails that were retained, the failure of Respondent to preserve or retain certain e-mail impacted the ability of Enforcement to investigate issues of interest to the Exchange.
50. The failure to preserve, retain or locate the emails in these matters is a violation of Exchange Rule 440, Section 17(a) of the SEA and SEA Rule 17a-4.

### Personal Computers

51. Exchange Rule 342.16 provides that the duties of supervisors of registered representatives should ordinarily include review of correspondence. The Rule also states that appropriate records should be maintained evidencing the carrying out of supervisory responsibilities.
52. The 2002 SPRU Report stated that in three branch offices, a total of 16 employees utilized personal laptop computers with access to the Internet via modem. While employees were required to sign an attestation that they did not communicate with customers outside of Respondent's internal systems, there was no procedure in place to test independently whether these individuals were communicating with the public through their personal laptops, or to monitor the use of the computers.
53. In January 2003, Respondent issued a policy concerning Personal Computers, Internet Access, and Protecting Client Information addressing these issues.

### Fax Machines

54. Exchange Rule 342.17 requires members and member organizations to develop written policies and procedures that are appropriate for their business, their size, structure and customers in connection with the review of communications with the public relating to their business.
55. The 2002 SPRU Report stated that in three branch offices, Respondent failed to have appropriate supervisory review of personal fax machines. As a result, branch office management failed to adequately review fax communications. In three other branch offices cited in the Report, Respondent was unable to establish that all incoming and outgoing faxes had been subject to supervisory review.
56. In May 2002, Respondent issued a memorandum requiring that management use one of three options so that communications sent by facsimile are appropriately reviewed.

### Supervisory Review of E-mail Communications

57. Exchange Rule 472 and Exchange Rules 342.16 and 342.17 require reasonable written procedures for the review of communications with the public.
58. At all relevant times, Respondent had a policy with regard to the retail branch supervisory review of e-mail communications, providing for a review of a sampling of incoming and outgoing messages.
59. The 2001 SPRU Report stated in seven branch offices of Respondent, there was an inadequate size or sample review of employee electronic mail and that in two branch offices, employees were able to use a commercial e-mail service, to communicate electronically with people outside of the branch office, thereby permitting them to communicate outside Respondent's supervisory structure. Further, in six branch offices, employees had the ability to access the internet via their own personal computers in the branch office, inconsistent with Firm policy and outside of Respondent's system, and thus without appropriate supervision.

### **The Exchange's Electronic Filing Platform**

60. Exchange Information Memorandum 03-55 dated December 16, 2003 advised all members and member organizations of a significant change to Enforcement procedures regarding the initiation and processing of preliminary investigations ("PIs").
61. The Information Memorandum stated that the use of the Exchange's Electronic Filing Platform ("EFP"), developed to facilitate filings with the Exchange, including Forms RE-3 pursuant to Exchange Rule 351(a) and Quarterly Customer Complaint reports pursuant to Exchange Rule 351(d), would be the sole means employed by Enforcement for conducting PIs. The Information Memorandum advised that all members and member organizations must be registered and set up for completing Electronic PIs by June 30, 2004. All members and member organizations were also advised that each employee responsible for submitting data to the Exchange in a PI must be a registered EFP/PI user.
62. On June 30, 2004, the EFP/PI was fully operational. Although Respondent had registered EFP user employees for other Exchange filing platforms, Respondent did not timely register for the EFP/PI program or respond to numerous EFP/PI requests sent between July 1, 2004 and September 1, 2004.
63. In September 2004, Respondent became an EFP/PI user.
64. As a result of its above referenced conduct, Respondent did not comply with the requirements set forth in Information Memorandum 03-55.

### **Reporting of Customer Complaints and Arbitration Awards**

#### **Customer Complaints**

65. Exchange Rule 345 requires certain information to be reported on Forms U-4 and U-5. Exchange Rule 351(a) requires certain information to be filed on Form RE-3. Exchange Rule 351(d) requires each member organization to report to the Exchange certain statistical information concerning customer complaints on a quarterly basis.
66. In June 2003, Respondent reported to the Exchange that, due to a system error in its internal tracking system, Respondent detected 7,823 complaints (principally sales practice related complaints) that had not been reported pursuant to Rule 351(d). Nevertheless, where necessary, these matters were reported by Respondent on Forms U-4 and RE-3.
67. Also, in June 2003, Respondent reported to the Exchange that certain operational complaints received by its Financial Advisory Center (a business unit designed to service small accounts) had not been handled in accordance with Respondent's procedures. As a result, these non-sales practice complaints were not included in Respondent's 351(d) reports to the Exchange filed between January 2002 and June 2003.

68. The 2001 SPRU Report stated that, in a review of 364 customer complaints for the period April 1, 2000 through March 30, 2001, there were approximately 140 instances where Respondent did not properly report matters or did not report matters with the correct codes in accordance with Exchange Rules 351(a) and (d).
69. The 2002 SPRU Report stated that, in a review of 501 sales practice complaints for the period January 1, 2001 through October 2002, there were approximately 75 instances where Respondent did not properly report matters or did not report matters with the correct codes in accordance with Exchange Rules 351(a) and (d).

#### Failure to Timely Report Litigation or Arbitration Judgments, Awards or Settlements

70. Exchange Rule 351(a)(7) requires each member organization to report when the member organization or its employee is a defendant or respondent in any securities or commodities-related civil litigation or arbitration is disposed of for an amount exceeding \$15,000 or, for a member organization respondent, \$25,000.
71. Respondent recently discovered that an administrative failure caused it to fail to report a significant number of litigation or arbitration judgments, awards or settlements on Forms RE-3 between August 2003 and August 2004. Respondent has informed the Exchange that approximately 536 filings (relating to 381 matters) were not made on Form RE-3 as required by Exchange Rule 351(a)(7). Specifically, about 330 Firm-related Forms RE-3 and 206 individual Forms RE-3 were not submitted to the Exchange. In almost all of these situations, Respondent did make the requisite disclosures on Forms U-5 or Forms U-4. In only 36 of these occurrences was no filing made at all relating to a customer initiated complaint.
72. In addition, on five occasions during the period January through March 2004, Respondent did file Forms RE-3 to report certain awards in arbitration proceedings, but did not do so within 30 days, in violation of Exchange Rule 351(a)(7). Some of these filings were up to five months late.

#### Failure to Update Employee's Address Information on Forms U-4

73. Registered persons are required to update information about changes in their residential addresses and business addresses, which are submitted to the Central Registration Depository ("CRD") by member organizations.
74. Respondent recently discovered that it failed to submit to the CRD such changes of address via Form U-4 amendments, as required by NYSE Rule 345.12. This failure may have lasted for at least several years.
75. Due to this problem, there are as many as 10,000 incorrect residential addresses and at least 3,700 incorrect business addresses listed for current Merrill Lynch employees in the CRD system. The CRD could also reflect incorrect residential addresses for former employees who moved while at the Firm, where such changes were not submitted by Respondent to CRD.

### **Continuing Education**

76. Exchange Rule 345A provides, in relevant part, that a member organization shall not permit any registered person to continue to perform the duties of a registered person unless such person has completed the Regulatory Element of the continuing education program within specified time frames. A registered person shall be deemed to have his registration inactive until he has complied with the requirements of this rule.
77. The 2002 SPRU Report and Respondent's response thereto identified that Respondent had ten employees deemed inactive during the period January 1, 2001 through June 2002, as a result of their failure to complete the Regulatory Element of the Securities/Industry Regulatory Council on Continuing Education program.
78. Respondent was unable to establish that these ten individuals did not receive compensation for acting in a registered capacity during their inactive period, and thus was exempt from the Continuing Education requirements.
79. With the exception of one employee who was inactive for a period of more than 80 days, each of the others individuals was inactive for a period of 12 days or less.

### **The Client Relationship Agreement**

80. During the period December 1999 through December 2000, Respondent utilized a "Client Relationship Agreement" form that did not give the client the opportunity or means to decline the margin agreement feature. As a result, clients who executed Client Relationship Agreements during the foregoing period were automatically authorized to use margin. In January 2001, the form was corrected to include a box to provide clients the opportunity to decline margin authorization. However, between January 2001 and November 2002, the "Investor Credit Line" box was lacking in terms of positioning, size and format, and did not adequately provide clients the opportunity to decline the margin authorization for their accounts.
81. In November 2002, the form was revised to address the Exchange's concerns regarding the format of the margin "decline" option.

### **Lack of Qualified Managers**

82. Exchange Rule 342.15 provides that small offices with three or fewer registered representatives that serve an order-taking function only and have no operational facilities are not required to have a qualified manager on-site if the office is under the close supervision of the main office. The 2001 SPRU Report stated that in three branch offices with more than three registered representatives, Respondent failed to maintain an on-site individual as a qualified manager in violation of Exchange Rule 342.15.

### **Failure to Supervise**

83. Exchange Rule 342(a) provides, in pertinent part that: "(e)ach office, department or business activity of a ... member organization ... shall be under supervision and

control of the member organization establishing it and of the personnel delegated such authority and responsibility.”

84. Exchange Rule 342(b) provides, in pertinent part that: “(e)ach member organization shall provide for appropriate supervisory control and shall designate a ... principal executive officer to assume overall authority and responsibility for ... each office, department or business activity, and provide for appropriate procedures of supervision and control ... and... establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.”
85. In accordance with Exchange Rule 342(b), Respondent was responsible for providing for appropriate supervisory and control procedures and for establishing a separate system of follow-up and review of its business activities, including prospectus and product description delivery, employee registration, reporting to the Exchange customer complaints, arbitration awards and address changes, e-mail retention and supervision, communications with the public, the Exchange’s EFP, continuing education, and customer agreements. Respondent violated Exchange Rule 342 in that it failed to have adequate policies, procedures and systems in place to reasonably supervise each of the business activities and functions described fully in paragraphs 16 through 82 herein.

#### **Additional Factors Considered**

86. Respondent has represented to Enforcement that it has enhanced certain policies and procedures, or is in the process of doing so, as follows:
  - a. Respondent has implemented technological enhancements and increased its supervisory oversight of its delivery of prospectuses with respect to the transactions described herein and ETF product descriptions to customers. Merrill Lynch has also commenced a review of its prospectus and product description delivery policies, practices, and systems and is developing a separate system of follow-up and review to establish that prospectus and product description coding and delivery procedures are regularly monitored.
  - b. Respondent has enhanced its e-mail archival and retention system. Specifically, Respondent has expanded the use of its Compliance Archive and Review System (“CARS”), an in-house application, and all Respondent employees are now on that system. CARS is designed to capture all e-mails sent or received from each mailbox within Respondent and the archiving by CARS is performed on SEC-approved WORM media. Moreover, Respondent has taken several steps to track and retain back-up tapes containing e-mails that pre-date the foregoing CARS expansion. Finally, Respondent has updated its e-mail supervisory policies and procedures.
  - c. Respondent reported to the Exchange some of the matters that are the subject of this Stipulation and has fully cooperated with the Exchange in all respects in connection with this matter.

**DECISION**

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found Respondent 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 Respondent of a censure and a fine in the amount of \$10,000,000 and a requirement to comply with the following undertaking:

- a. Within 30 days from the date this decision becomes final, Respondent shall retain an independent consultant, not unacceptable to the Exchange (the "Consultant"), to conduct a review of Respondent's current policies, procedures, and supervisory systems (the "Review") relating to compliance with Exchange Rules 351(a) and 351(d). The Consultant shall prepare a report of its review including recommendations for additional policies, procedures and supervisory systems reasonably designed to achieve compliance with and to prevent recurrence of the violations of Exchange Rules 351(a) and 351(d).
- b. Within 150 days from the date this decision becomes final, the Review shall be completed and the Report shall be delivered to Respondent's Chief Executive Officer and to the Exchange's Division of Enforcement.
- c. Respondent shall adopt and implement any and all policies, procedures and supervisory systems recommended by the Report; provided however, that as to any recommendation of the Report which Respondent determines is, in whole or in part, unduly burdensome, Respondent may adopt, with the Consultant's written consent and approval, an alternative procedure designed to achieve the same objective or purpose as that of the recommendation in the Report ("Alternative Procedures"). Respondent shall provide the Exchange with a written representation that such Alternative Procedures have been presented to and approved by the Consultant with a description of how such Alternative Procedures achieve the same objective or purpose as the Report's original recommendations.
- d. Respondent shall, within 60 days of delivery of the Report to its Chief Executive Officer, submit to the Division of Enforcement a letter signed by the Head of Global Compliance setting forth the details of Respondent's implementation of the recommendations or the process that will, within a reasonable time specified in the letter, result in the implementation of the recommendations contained in the Report or Alternative Procedures.
- e. Respondent shall also undertake to review its procedures regarding the areas addressed in this Stipulation other than those cited in paragraph a in the penalty section. Within 150 days from the date this decision becomes final, Respondent undertakes and agrees to inform the Exchange in writing of the completion of such reviews and that it has or, within a reasonable time specified by Respondent,

will have systems and procedures in place reasonably designed to comply with the applicable laws, regulations and rules.

- f. The Exchange may extend any of the dates referred to in the penalty section for good cause shown.

In accepting the Stipulation and Consent to Penalty, the Hearing Panel considered Respondent's prior relevant disciplinary actions noted above and the failure to fully comply with a prior undertaking.

For the Hearing Panel

Vincent F. Murphy - Hearing Officer  
Panelists:  
Joseph C. Gawronski, Esq.  
John P. O'Brien