

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 75083 / June 1, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16567

In the Matter of

**Merrill Lynch, Pierce, Fenner &
Smith Incorporated and Merrill
Lynch Professional Clearing
Corporation,**

Respondents.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
PURSUANT TO SECTIONS 15(b) AND 21C
OF THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant Sections 15(b) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch Professional Clearing Corporation (“Respondents” or “Merrill”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Merrill admits the findings set forth in Section III below, acknowledges that its conduct violated the federal securities laws, admits the Commission’s jurisdiction over it and the subject matter of these proceedings, and consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

Summary

1. These proceedings concern Merrill's violations of Regulation SHO (Reg SHO") of the Exchange Act, in connection with its practices relating to its execution of short sales. As described more fully below, the violations arose from two separate issues concerning Merrill's use of its "easy to borrow" lists.

Respondents

2. Respondent Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S), headquartered in New York, New York, is dually-registered with the Commission as a broker-dealer and investment adviser. It is a subsidiary of Bank of America Corporation. The activity that is the subject of this recommendation pertains to the broker-dealer side of Merrill's business.

3. Respondent Merrill Lynch Professional Clearing Corporation (MLPro), headquartered in New York, New York, is registered with the Commission as a broker-dealer. MLPro is a wholly-owned subsidiary of MLPF&S.

Background

A. Reg SHO

4. Regulation SHO ("Reg SHO") of the Exchange Act governs short sales. A short sale is any sale of a security which the seller does not own, or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.

5. Rule 203(b) of Reg SHO prohibits a broker-dealer from accepting a short sale order in an equity security from another person or effecting a short sale in an equity security for its own account unless the broker-dealer has borrowed the security, entered into a bona-fide arrangement to borrow the security, or has "reasonable grounds" to believe that the security can be borrowed so that it can be delivered on the delivery date. This is generally referred to as the "locate" requirement. Rule 203(b) also requires the broker-dealer to document its compliance with the "locate" requirement.

6. The Commission has articulated that, absent countervailing factors, easy to borrow ("ETB") lists may provide reasonable grounds to believe that the security sold short is available for borrowing as required in Rule 203(b) without having to contact the source of borrowed securities directly. While broker-dealers with lending desks use their own criteria to determine whether or not a security should be included on its ETB list, the information used to

generate the ETB list must be less than 24 hours old, and securities on the list must be readily available such that it would be unlikely that a failure to deliver would occur.¹

7. Merrill failed to comport with this guidance when executing transactions in reliance on ETB lists in two separate but important ways.

8. First, Merrill's execution platforms were designed to continue accepting short sale orders in reliance on its lending desk's ETB list even where Merrill had determined, through placement of the stock on Merrill's Watch List, that "countervailing factors" existed that rendered Merrill's reliance on the list as a locate source unreasonable. The countervailing factors consisted of Merrill's knowledge of events that occurred throughout the day after the issuance of the ETB list that had, or were deemed likely by Merrill to have, the potential to impact a particular stock's availability such that Merrill added the stock to its Watch List. In recognition of these countervailing factors, Merrill's practice (in accordance with an unwritten policy) was that its lending desk could not rely on the ETB list exclusively to grant "locates" under such circumstances. However, even though Merrill's policy prevented the lending desk from granting locates in such circumstances solely on the basis of the ETB list, Merrill allowed its execution platforms to continue to execute short sales solely in reliance on the ETB list in such circumstances. As a consequence, Merrill's conduct violated Rule 203(b) of Reg SHO in that Merrill purported to rely on ETB list locates that could not provide the requisite reasonable grounds to believe the affected securities could be borrowed for delivery on the delivery date as required under the Rule. Moreover, by recording the ETB list as the locate source with respect to short sale orders accepted and executed after Merrill had already determined to cut off ETB list locates for a security, Merrill further violated Rule 203(b) by failing to document an appropriate locate.

9. Second, because of a flaw in Merrill's systems, in certain instances, Merrill used data that was more than 24 hours old for purposes of constructing its ETB lists. As a result, multiple securities were included on ETB lists on days when they should not have been, leading to Merrill accepting and executing short sale orders based on inappropriate reliance on defective ETB lists, such that Merrill did not have reasonable grounds to believe the security could be borrowed for delivery. Because in some circumstances the ETB list used older data, but Merrill did not institute and maintain procedures reasonably designed to detect the disparity in its own ETB list, Merrill's conduct violated the requirement under Rule 203(b) of Reg SHO. Had Merrill had the proper systems in place, it could have discovered its reliance on ETB lists containing information that was greater than 24 hours old.

B. Merrill's ETB Practice

10. Merrill, as a broker-dealer, executes transactions, including short sales. As such, Merrill is subject to the requirements of Reg SHO.

¹ *Short Sales*, Exchange Act Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48008 at 48014.

11. Merrill also operates a securities lending desk that provides locates for its customers. Merrill's lending desk routinely communicates with lenders, customers, and brokers in the course of each trading day, and monitors market developments that could impact the availability of securities for locates and settlement.

12. In the course of its duties, Merrill's lending desk determines before the start of each trading day, through application of a proprietary formula, whether a security is "Easy to Borrow." If a security satisfies the formula based on information then known, Merrill includes that security on an ETB list that it generates daily and disseminates to customers and to its own execution platforms early in the morning.

13. Once Merrill includes a security on an ETB list, both the lending desk (through either an automated or manual process) and its own execution platforms rely on the security's presence on the ETB list in order to satisfy Merrill's locate duty under Reg SHO to execute a short sale in that security.

14. As a general practice, Merrill did not redistribute its ETB list to its execution platforms following the original dissemination of the list first thing in the morning notwithstanding any subsequent developments in the marketplace that might impact availability of the stocks on the list.

15. However, on numerous occasions, through the course of the lending desk's ordinary business activity, the firm learned of developments that actually did, or had the potential to, restrict availability in particular stocks, including certain stocks that had been included on the daily ETB list earlier in the morning, prompting Merrill to add the stock to its "Watch List."

16. Merrill's lending desk practices required that if questions developed intraday about availability of a particular stock on the ETB list, the stock would be placed onto a separate list known as the "Watch List." As described in Merrill's "Business Requirements" document, an information technology staff document drafted in consultation with the securities lending desk in describing implementation of a new version of the Watch List in 2009 for the firm's Locates system, Watch List securities are "securities that have limited availability and should not be provided on the ETB's or automated locates as the inventory should be closely managed." Accordingly, for any stock added to the Watch List intraday, the lending desk was no longer permitted to rely on the ETB list for any new locate requests for that stock, but was instead required to find other, non-ETB list, sources for locate requests, such as by contacting a lending source directly. As a result, placing a security on the Watch List removed the security from the ETB list for locate purposes and meant that, in Merrill's estimation, reliance on the ETB list alone did not provide reasonable grounds to believe that the security in question could be borrowed so that it could be delivered on the delivery date.

17. The next day, securities placed on the Watch List during the prior day would not be included in that following day's new ETB list.

18. From at least 2008 to present, however, when a stock was placed on the Watch List due to intraday market developments and, as a result, the lending desk ceased relying on the ETB list to source a locate for that stock, Merrill nevertheless continued to allow its execution platforms to execute short sales in purported reliance on the ETB List.

19. At the times Merrill accepted short sale orders in a security for execution on the basis of the firm's ETB list while the same stock was on the Watch List, the ETB list did not provide the requisite reasonable grounds to believe that the security could be borrowed so that it could be delivered on delivery date because Merrill had information that led its securities lending desk to determine that the ETB list should not be relied on for locates in that security. In sourcing locates to the ETB list for Watch List securities, Merrill did not properly document its compliance with the locate requirement under Reg SHO.

20. For example, on January 17, 2008, Merrill lending desk traders, having determined that a security could no longer reasonably be considered ETB, placed a stock on the Watch List. As the lending desk traders were seeking supply from individual lenders, the lenders were telling Merrill that they had no shares available, with messages such as "no good," "I am sorry, nothing available," and "short shares." With this knowledge, however, Merrill allowed its execution platforms to continue to execute short sales totaling 46,617 shares of the same security in reliance on the ETB list.

21. Similarly, on September 8, 2008, during the heart of the financial crisis, Merrill lending desk traders determined that a security could no longer reasonably be considered ETB and placed the stock in question on the Watch List. Mid-day, Merrill traders recognized with respect to that security, "Up to this point banks and brokers still aren't willing to lend any stock." Nevertheless, Merrill's execution platforms executed short sales totaling 1,358,036 shares of the security, absent reasonable grounds to do so, in reliance on the ETB list.

22. On May 22, 2012, Merrill's lending desk determined that a security could no longer be considered ETB and placed the stock in question on the Watch List, requiring a manual locate for all short sale orders other than those placed through the execution platforms. The stock was one in which Merrill saw that short-selling demand had "increased significantly" after a large plunge in the stock price; that the available borrow had "tightened throughout the day;" that borrow rates were "as deep as neg. 2%;" that short interest was more than 25% of the float; and that the "street is starting to experience recalls." Nonetheless, Merrill's execution platforms executed short sales totaling 840,080 shares of the security, absent reasonable grounds to do so, in reliance on the ETB list, which was the documented locate source.

23. On January 14, 2014, Merrill's lending desk determined that a security could no longer be considered ETB and placed the stock in question on the Watch List, requiring a manual locate for all short sale orders other than those placed through the execution platforms. The stock was one in which Merrill saw that "[s]hort demand spiked;" borrow rates were "trending deeper," with shares for lending trading "in limited size; short interest was approximately 20% of the float; and recall activity "has increased." Nonetheless, Merrill's execution platforms executed short sales totaling 75,544 shares of the security, absent reasonable grounds to do so, in reliance on

the ETB list, which was the documented locate source.²

24. Since approximately January 2010, Merrill lending desk traders who place securities on the Watch List must record a “Reason Code” indicating the circumstances underlying the decision for Watch List inclusion. The list of possible Reason Codes includes situations such as “Bad Feeds Limited,” “Corp Action,” “Large Fails,” “No Borrow,” “Recalls,” “Special Div,” and “HTB” [Hard to Borrow]. Numerous Watch List securities since then have been recorded with those codes and others. Merrill did not disclose this information to the staff of the Division of Enforcement (the “Staff”) until the Staff learned about the codes from a witness during testimony.

25. In April 2014, at a time when Merrill was aware of the ongoing Staff investigation into Merrill’s lending desk practices and the Watch List, Merrill convened a meeting to discuss changing the Reason Codes, with discussion focusing on using a generic non-descriptive code to replace codes that explicitly identified borrowing difficulty as the grounds for Watch List placement.

26. Following that discussion, lending desk traders were instructed to switch all current Reason Codes in their database to “Other” and to only use the “Other” code when placing any new securities on the Watch List. Accordingly, although securities that were on the Watch List as of the end of April 2014 do not presently have specific Reason Codes associated with them, the complete audit trail reflects that those securities had been given a specific Reason Code when originally placed on the list.

27. Merrill’s acceptance of new short sale orders in purported reliance on the firm’s ETB list after having learned of facts indicating that such reliance was no longer reasonable constituted a violation of Rule 203(b) of Reg SHO, because the orders were accepted without reasonable grounds to believe the security could be borrowed and those locates were inaccurately documented with an “ETB List” locate reference.

28. Merrill has informed the Staff that it is implementing systems enhancements pursuant to which its lending desk will notify its execution platforms when a stock is added to the Watch List and its execution platforms will then stop relying on the Merrill ETB list as the locate source when accepting short sale orders for that stock.

² These are but a few of the many examples from the documents produced to the Division that demonstrate that throughout the relevant period, Merrill was allowing its execution platforms to use an ETB List locate for short sales, even after securities had been placed on the Watch List by Merrill stock lending desk personnel because of concerns about diminishing availability of the stock for borrowing.

C. Merrill's "Stale Feed" Problems

29. Merrill has regularly received electronic availability feeds and messages that it uses for determining whether a security should be included on the firm's ETB list.

30. If a lender were to submit availability for a security one day, but then submit nothing the following day, the systems were designed to interpret the lack of a submission to mean that the particular lender had no availability.

31. However, due to a flaw in Merrill's system, if a lender simply omitted a security from its list, rather than interpreting the omission to mean that the lender had no availability, under certain circumstances the system would look back to the last known number submitted from that lender and incorporate that value in its assessment of the overall availability of the security.

32. Because of this flaw, Merrill's systems in certain instances inadvertently used data that was older than 24 hours old for purposes of constructing its ETB lists. At times, the inclusion of the stale feed data resulted in securities being included on an ETB list when they otherwise should not have been. Merrill, in turn, relied on its ETB list for executing short sales in certain of these securities, in violation of Reg SHO's locate requirement.

33. Personnel at Merrill became aware of this problem in 2008 and attempted to fix it. However, various iterations of the problem persisted and the firm did not completely eradicate "stale" availability data from its systems until 2012.

34. Because Merrill could have discovered and prevented its reliance on ETB lists containing information greater than 24 hours old, but did not institute and maintain procedures reasonably designed to do so, its reliance on such ETB lists violated Rule 203(b) of Reg SHO.

Violations

35. As a result of the conduct described above, Merrill willfully³ violated Rule 203(b) of Regulation SHO.

Undertakings

36. Respondents have undertaken to:

A. Retain, at Respondents' expense and within thirty (30) days of the issuance of this Order, a qualified independent consultant (the "Consultant") not unacceptable to the Staff.

³ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

Respondents shall require the Consultant to conduct a comprehensive review of their policies, procedures and practices with respect to their acceptance of short sale orders for execution or effecting of short sales in reliance on Merrill's ETB list and Merrill's procedures to monitor compliance therewith, to satisfy its obligations under Rule 203(b) of Reg SHO to (i) accept short sale orders or effect short sales in equity securities only if it has borrowed the securities or entered into a bona fide arrangement to borrow the securities or has reasonable grounds to believe that securities can be borrowed for delivery when due; and (ii) document compliance with Rule 203(b)(1).

B. Cooperate fully with the Consultant, including providing the Consultant with access to its files, books, records, and personnel as reasonably requested for the review, obtaining the cooperation of employees or other persons under Merrill's control, and permitting the Consultant to engage such assistance (whether clerical, legal, technological, or of any other expert nature) as necessary to achieve the purposes of the retention.

C. Require the Consultant to complete its review and submit a written preliminary report ("Preliminary Report") to Merrill and Commission staff within ninety (90) days of the issuance of this Order. Merrill shall require that the Preliminary Report address the issue described in paragraph A above, include a description of the review performed, the conclusions reached, recommendations for any changes in or improvements to Merrill's policies and procedures, and a procedure for implementing such recommended changes.

D. Within ninety (90) days of receipt of the Preliminary Report, adopt and implement all recommendations contained in the Preliminary Report; provided, however, that as to any recommendation that Merrill considers to be, in whole or in part, unduly burdensome or impractical, Merrill may submit in writing to the Consultant and Commission staff, within thirty (30) days of receiving the Preliminary Report, an alternative policy, practice, or procedure designed to achieve the same objective or purpose. Within forty-five (45) days of receiving the Preliminary Report, Merrill and the Consultant shall attempt in good faith to reach an agreement relating to each recommendation that Merrill considers to be unduly burdensome or impractical. Within fifteen (15) days after the discussion and evaluation by Merrill and the Consultant, Merrill shall require that the Consultant inform Merrill and Commission staff of the Consultant's final determination concerning any recommendation that Merrill considers unduly burdensome or impractical, and Merrill shall abide by the determinations of the Consultant and adopt and implement all recommendations within the 90-day time period set forth in this paragraph.

E. Within fourteen (14) days of Merrill's adoption of all of the recommendations that the Consultant deems appropriate, certify in writing to the Consultant and Commission staff that Merrill has adopted and implemented all of the Consultant's recommendations and that Merrill has established policies, practices, and procedures consistent with its obligations under Rule 203(b).

F. Require that the Consultant review Merrill's revised policies, practices, and procedures for the six month period following implementation of the Consultant's recommendations, and require that the Consultant submit a written final report ("Final Report") to

Merrill and Commission staff within thirty (30) days after the one-year anniversary of the issuance of this Order. The Final Report shall (i) describe the review made of Merrill's revised policies, practices, and procedures; (ii) describe how Merrill is implementing, enforcing, and auditing compliance with the policies, practices, and procedures; and (iii) provide an opinion of the Consultant concerning whether Merrill is adequately implementing, enforcing, and auditing compliance with the policies, practices, and procedures.

G. Require the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Merrill, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Consultant will require that any firm with which the Consultant is affiliated or of which the Consultant is a member, and any person engaged to assist the Consultant in performance of the Consultant's duties under this Order shall not, without prior written consent of Commission staff in the New York Regional Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Merrill, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

H. To ensure the independence of the Consultant, Merrill shall not have the authority to terminate the Consultant without prior written approval of Commission staff and shall compensate the Consultant and persons engaged to assist the Consultant for services rendered pursuant to this Order at their reasonable and customary rates.

I. Within fourteen (14) days after the one-year anniversary of the issuance of this Order, certify in writing to Commission staff that as of the one-year anniversary date Merrill has continued to implement and enforce all of the Consultant's recommendations and has continued to maintain policies, practices, and procedures consistent with its obligations under Rule 203(b).

J. Certify, in writing, compliance with the undertaking(s) set forth above. The certification shall identify the undertaking(s), provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to Assistant Director Adam S. Grace, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

37. For good cause shown, the Commission staff may extend any of the procedural dates relating to the undertakings. Deadlines for procedural dates shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered to be the last day.

IV.

In view of the foregoing, the Commission deems it appropriate, and in the public interest to impose the sanctions agreed to in Respondents' Offer.

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondents cease and desist from committing or causing any violations and any future violations of Rule 203(b) of Regulation SHO.

B. Respondents are censured.

C. Respondents shall, within fifteen (15) days of the entry of this Order, pay disgorgement, which represents profits gained as a result of the conduct described herein, of \$1,566,245.67 and prejudgment interest of \$334,564.65 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment must be made in one of the following ways:

- (1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondents may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Merrill as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Andrew M. Calamari, Division of Enforcement, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, New York 10281.

D. Respondents shall, within fifteen (15) days of the entry of this Order, pay a civil money penalty in the amount of \$9 million to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondents may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
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- E. Respondents shall comply with the undertakings enumerated in paragraph 36 above.

By the Commission.

Brent J. Fields
Secretary