

[Securities Regulation Daily Wrap Up, TOP STORY—Merrill Lynch misused customer cash, agrees to pay \\$415M in settlement, \(Jun. 23, 2016\)](#)

Securities Regulation Daily Wrap Up

[Click to open document in a browser](#)

By [Amanda Maine, J.D.](#)

The SEC announced a settlement with Merrill Lynch over allegations that the firm misused customer assets to finance its own business activities in violation of the Customer Protection Rule. Merrill Lynch agreed to pay \$415 million to settle the SEC's charges and admitted that its conduct violated the federal securities laws. The SEC also charged Merrill Lynch with using illegal language in employee severance agreements designed to impede employees from providing information to the SEC. In a separate proceeding, the SEC and FINRA fined Merrill Lynch for misleading customers regarding its volatility-linked structured notes (*In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated*, Release Nos. [34-78141](#) and [33-10103](#), June 23, 2016).

In conjunction with its action against Merrill Lynch, the SEC [announced](#) a new [Customer Protection Rule Initiative](#). The Initiative encourages broker-dealers that have failed to comply with the Customer Protection Rule to self-report their violations to the SEC in return for a recommendation of favorable settlement terms.

Leveraged conversion trades. The SEC's order finds that Merrill Lynch used trades known within the company as Leveraged Conversion Trades ("Trades") to reduce the amount of cash it was required to deposit in a customer reserve account. The Trades lacked economic substance and defined terms and improperly reduced by billions of dollars the amount Merrill Lynch was required to deposit in its customer reserve account. From 2009 to 2012, Merrill Lynch used these funds to finance its business activities. If Merrill Lynch had failed when these trades were in use, customers would have been exposed to a shortfall of cash, according to the SEC.

Liens on accounts. In addition to the risk Merrill Lynch subjected its customers to with the leveraged conversion trades, the firm also violated the Customer Protection Rule by holding up to \$58 billion of customer securities in a clearing account that was subject to a general lien by one of its clearing banks between 2009 and 2015. Over \$6 billion in customer securities in Europe, Asia, and Australia were also subject to liens and did not contain documentation disclosing this risk. If Merrill Lynch had collapsed during this period, the liens could have prevented customers from getting their securities back. The SEC observed that this scenario could further damage public confidence in the U.S. securities industry in the wake of the financial crisis.

Regulatory reporting head charged. The SEC also announced that it has instituted administrative proceedings against Merrill Lynch's Head of Regulatory Reporting for aiding and abetting Merrill Lynch's violations. The SEC alleged that he knowingly reduced the amount Merrill Lynch reserved by billions of dollars as a result of the Trades, despite knowing that regulators had significant unanswered questions about the Trades. He was also reckless and negligent for failing to accurately disclose the purpose of the Trades to regulators and ignoring requests from regulators for information that would have put an abrupt end to the Trades, according to the SEC.

Misleading structured notes documents. In a separate proceeding, the SEC announced that Merrill Lynch agreed to pay \$10 million for making misleading statements in offering materials for its structured notes that were linked to a proprietary volatility index. The offering materials described two costs related to the volatility index, but did not mention a third cost, called the "execution factor," which imposed a cost of 1.5 percent of the index value each quarter. FINRA also [fined](#) Merrill Lynch \$5 million for negligent disclosure. Merrill Lynch did not admit or deny the structured note charges.

Confidentiality severance provisions. Finally, the SEC alleged that certain Merrill Lynch severance agreements did not permit departing employees to voluntarily disclose information to regulators in violation of Rule 21F-17. A clause added later did not prohibit initiating communications with government authorities, but

limited the types of information that could be conveyed to the severance agreement itself or "underlying facts and circumstances." The SEC advised that Merrill Lynch had engaged in significant remediation in response to the Rule 21F-17 violation. In particular, Merrill Lynch revised its policies and procedures, implemented a mandatory whistleblower training program for its employees, and agreed to provide to its employees a summary of their rights under the SEC's Whistleblower Program, the SEC noted.

The releases are [No. 34-78141](#) (customer protection rule) and [No. 33-10103](#) (structured notes).

Companies: Merrill Lynch, Pierce, Fenner & Smith Incorporated; Merrill Lynch Professional Clearing Corp.

MainStory: TopStory Enforcement BrokerDealers ExchangesMarketRegulation FINRANews SecuritiesOfferings WhistleblowerNews SECNewsSpeeches