

**FINANCIAL INDUSTRY REGULATORY AUTHORITY  
LETTER OF ACCEPTANCE, WAIVER AND CONSENT  
NO. 2016050801701**

TO: Department of Enforcement  
Financial Industry Regulatory Authority (FINRA)

RE: Merrill Lynch, Pierce, Fenner & Smith Incorporated (Respondent)  
Member Firm  
BD No. 7691

Pursuant to FINRA Rule 9216, Respondent Merrill Lynch, Pierce, Fenner & Smith Incorporated (Merrill) submits this Letter of Acceptance, Waiver and Consent (AWC) for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Respondent alleging violations based on the same factual findings described in this AWC.

**I.  
ACCEPTANCE AND CONSENT**

- A. Respondent hereby accepts and consents, without admitting or denying the findings and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

**BACKGROUND**

Merrill has been a FINRA member since 1937. Merrill is headquartered in New York, New York, and operates over 4,000 branch offices employing approximately 31,000 registered representatives. Merrill is a full-service brokerage firm, providing sales and trading, research, and underwriting services to institutional and retail customers.<sup>1</sup>

**OVERVIEW**

From February 2015 through June 2021, Merrill violated Municipal Securities Rulemaking Board (MSRB) Rule G-27 by failing to establish and maintain a supervisory system, including written procedures, reasonably designed to address short positions in municipal securities and their effects on customers who hold them. By failing to take prompt steps to bring short positions in municipal securities within its control within 30 days, Merrill also violated Exchange Act Rule 15c3-3(d)(4) and FINRA Rule 2010.

By failing to provide its customers with notice clearly identifying their receipt of substitute interest payments, and the potential tax liability resulting from these payments, Merrill violated MSRB Rule G-17 during the same time period.

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<sup>1</sup> For more information about the firm, including prior regulatory events, visit BrokerCheck® at [www.finra.org/brokercheck](http://www.finra.org/brokercheck).

## **FACTS AND VIOLATIVE CONDUCT**

This matter originated from a firm examination conducted by FINRA Member Supervision.

### **The Relevant Rules**

MSRB Rule G-27 requires each broker, dealer, and municipal securities dealer to supervise the conduct of their municipal securities activities and to ensure compliance with MSRB Rules and the Exchange Act. MSRB Rule G-27 further requires municipal securities dealers to establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations and MSRB Rules, and to adopt, maintain, and enforce written supervisory procedures (WSPs) that are reasonably designed to ensure that the conduct of municipal securities activities complies with MSRB Rules and the Exchange Act.

MSRB Rule G-17 provides that, in the conduct of its municipal securities activities, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

Exchange Act Rule 15c3-3(d)(4) requires that no later than one business day after 30 calendar days broker dealers must take prompt steps to obtain physical possession or control of securities that are included on the broker dealer's books or records that allocate to a short position of the broker or dealer or a short position for another person. Subpart (n) of the rule allows firms to apply to FINRA to extend the period of time for the broker-dealer to take action to buy-in a security, which application may be granted if FINRA is satisfied that the firm is acting in good faith and exceptional circumstances exist warranting approval.

A violation of Exchange Act Rule 15c3-3(d)(4) also constitutes a violation of FINRA Rule 2010, which requires members to observe high standards of commercial honor and just and equitable principles of trade.

### **Background on Municipal Securities**

The interest earned on municipal securities is exempt from federal (and, at times, state and local) taxes when received from the municipal issuer. However, FINRA member firms may be short municipal securities that are held in customer accounts due to duplicative or erroneous orders, a partial redemption or call, or delayed delivery of the security by the counterparty, among other reasons.<sup>2</sup> When this occurs, the firm is the source of the interest payments to the customers. This "substitute" interest is not tax-exempt. As a result, customers are deprived of the favorable tax status associated with their municipal security investments and exposed to potential tax liability.

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<sup>2</sup> Following an initial distribution period, municipal securities generally trade in an over-the-counter dealer market. The average municipal security is less liquid than the average corporate bond and may not always be available for purchase in the secondary market.

**Merrill Failed to Establish and Maintain a Supervisory System, Including Written Procedures, Reasonably Designed to Achieve Compliance with MSRB and Exchange Act Rules.**

In February 2015, FINRA notified certain member firms, including Merrill, that all previous extensions of time granted for Rule 15c3-3(d)(4) requests relating to municipal securities were revoked. FINRA also advised Merrill to take prompt action to cover its existing short positions in municipal securities by the end of the month. In March 2015, Merrill informed FINRA that it had 255 short positions aged more than 30 days and not within the firm's possession or control, including 83 short positions in municipal securities.

In July 2015, FINRA issued Regulatory Notice 15-27. Among other things, Regulatory Notice 15-27 reminded member firms that their WSPs must include processes for detecting, resolving, and preventing the consequences of municipal short positions and comply with Exchange Act Rule 15c3-3's requirement to take prompt steps to obtain physical possession or control of municipal securities that are short more than 30 days.

Between March and December 2015, the number of short positions in municipal securities on Merrill's books and records that were aged more than 30 days increased from 83 to 231. The 231 short positions had an associated par value of \$29,599,788, and many were aged for a year or longer.

In September 2015, and again in May 2016, FINRA advised Merrill that it needed to implement supervisory systems and WSPs reasonably designed to promptly detect and resolve short positions in municipal securities, and prevent their consequences, such as the payment of substitute interest. FINRA also informed Merrill it needed to provide notice to customers of the taxable status of the substitute interest they received.

However, from approximately February 2015 until October 2016, Merrill did not establish or maintain supervisory systems or WSPs specifically designed to detect and resolve short positions in municipal securities on the firm's books and records, or to prevent their effects on customers who hold these securities.

Merrill implemented supervisory systems and WSPs specifically designed to detect and resolve short positions in municipal securities in October 2016. However, the supervisory systems and WSPs were not reasonably designed to achieve compliance with the requirements of MSRB Rule G-17 and Exchange Act Rule 15c3-3(d)(4) or prevent the consequences of short positions in municipal securities. For example, Merrill's supervisory systems were designed only to prevent short positions originating from retail transactions in certain fixed rate bonds and did not consider or address short positions created by other causes. Because the WSPs only required the firm to assess the need for substitute interest shortly before the scheduled interest payment (*i.e.*, coupon payment date), in practice, the calculation of substitute interest was the firm's primary means for identifying short positions in municipal securities.

As of September 2016, Merrill had 164 short positions in municipal securities with an associated par value of \$27,726,712 that were aged over 30 days. Through June 6, 2017, the associated par value of Merrill's short positions exceeded \$28 million. From July 2017 through December 2018, Merrill's aged short positions ranged from 130 to 190 with an associated par value ranging from \$3.1 million to \$7.2 million. As of May 2019, seven of

the 83 municipal securities short positions the Firm first identified in March 2015 in response to FINRA's inquiry remained outside of the firm's possession or control. By June 2021, Merrill had 69 municipal securities short positions with an associated par value of \$2,182,854.00.<sup>3</sup>

Merrill's failure to implement supervisory systems and procedures designed to detect and resolve short positions in municipal securities, and to prevent their consequences, and to take prompt steps to bring short positions in municipal securities within its control, was not reasonable considering the municipal securities business the firm conducted.

In September 2020, Merrill began enhancements to its supervisory systems, WSPs, and customer disclosures. As of June 2021, Merrill amended its processes to address short positions when created and communicated its revised processes and WSPs to its registered representatives.

Therefore, Merrill violated MSRB Rule G-27, Exchange Act Rule 15c3-3(d)(4) and FINRA Rule 2010.

**Merrill's Notice to Purchasers of Municipal Securities Did Not Comply with MSRB Rule G-17's Fair Dealing Requirement.**

From January 2015 through December 2018, the aged short positions in municipal securities described above required Merrill to pay at least \$796,000 in substitute interest to more than 1,500 customers. In February 2015 and September 2015, FINRA informed Merrill it needed to provide prompt disclosures to its customers holding municipal securities of their receipt of substitute interest. Regulatory Notice 15-27 also reminded member firms of their obligation to ensure communications with customers regarding municipal securities transactions are not false or misleading and to correct any inaccurate or misleading communications regarding the tax status of interest payments.

From February 2015 to June 2017, Merrill provided customers who received substitute interest with a "gross-up" (adjusted) payment each year to address any resulting federal taxes. The customers' account statements and Form 1099s described the substitute interest and gross-up payments associated with the municipal securities held by the customers as "Misc. Income." In June 2017, Merrill updated the language in its customers' account statements to include a specific reference to the taxable nature of these substitute interest payments.

Until then, Merrill did not provide these customers with express notice that the substitute interest paid to them was taxable. As a result, customers receiving these payments prior to June 2017 were unable, among other things, to render an informed decision on whether they wished to continue holding the security, cancel the trade, or purchase a comparable security so as to avoid receiving taxable interest. In June 2021, Merrill provided customers with notice that their receipt of substitute interest may also create state and local tax liability, and

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<sup>3</sup> Exchange Act Rule 15c3-3(e) requires broker-dealers to maintain a reserve of funds or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers. During the relevant period, the amount deposited by Merrill in its customer reserve account was sufficient to cover the par value associated with the municipal security short positions.

how the “gross up” payment aims to cover any federal, state, or local tax liabilities customers may incur.

By virtue of the foregoing, Merrill violated MSRB Rule G-17.

B. Respondent also consents to the imposition of the following sanctions:

- a censure;
- a fine of \$1,500,000 (\$1,000,000 of which pertains to the violation of MSRB Rules G-17 and G-27); and
- an undertaking requiring Merrill to submit, within 180 days of the issuance of the Notice of Acceptance of this AWC, a certification in writing by one or more principal(s) and officer(s) of Merrill with supervisory authority over the areas described in this AWC that, as of the date of the certification: (i) Merrill’s supervisory systems and written procedures are reasonably designed to achieve compliance with MSRB Rules G-17 and G-27 and Exchange Act Rule 15c3-3(d)(4) in connection with the matters described in this AWC; and (ii) Merrill’s revised WSPs have been distributed to all firm personnel with responsibilities for compliance with MSRB Rules G-17 and G-27 and Exchange Act Rule 15c3-3(d)(4).

Respondent agrees to pay the monetary sanction upon notice that this AWC has been accepted and that such payment is due and payable. Respondent has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time after the execution of this AWC, the monetary sanction imposed in this matter.

The sanctions imposed herein shall be effective on a date set by FINRA.

## **II.** **WAIVER OF PROCEDURAL RIGHTS**

Respondent specifically and voluntarily waives the following rights granted under FINRA’s Code of Procedure:

- A. To have a complaint issued specifying the allegations against it;
- B. To be notified of the complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made, and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council (NAC) and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person’s or

body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

Respondent further specifically and voluntarily waives any right to claim that a person violated the *ex parte* prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

### **III. OTHER MATTERS**

Respondent understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs (ODA), pursuant to FINRA Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
- C. If accepted:
  - 1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future action brought by FINRA or any other regulator against Respondent;
  - 2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
  - 3. FINRA may make a public announcement concerning this agreement and its subject matter in accordance with FINRA Rule 8313; and
  - 4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's testimonial obligations or right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.
- D. Respondent may attach a corrective action statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this statement. This statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA.

The undersigned, on behalf of Respondent, certifies that a person duly authorized to act on Respondent's behalf has read and understands all of the provisions of this AWC and has been given

a full opportunity to ask questions about it; that Respondent has agreed to the AWC's provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth in this AWC and the prospect of avoiding the issuance of a complaint, has been made to induce Respondent to submit this AWC.

Sept. 3, 2021

Date

Mark L. Keene

Merrill Lynch, Pierce, Fenner & Smith Incorporated  
Respondent

Print Name: MARK L. KEENE

Title: ASSOCIATE  
GENERAL COUNSEL

Reviewed by:



Nader Salehi  
Counsel for Respondent  
Sidley Austin LLP  
1501 K Street, N.W.  
Washington, D.C. 20005

Accepted by FINRA:

10/4/2021

Date

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



Tiffany A. Buxton, Director  
FINRA Department of Enforcement  
200 Liberty Street, 11<sup>th</sup> Floor  
New York, NY 10281