

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER, AND CONSENT
NO. 2016050801702**

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

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

Pursuant to FINRA Rule 9216, Respondent Merrill Lynch, Pierce, Fenner & Smith Inc. (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.¹

OVERVIEW

From September 2013 until July 2016, Merrill violated Rule 204 of Regulation SHO and FINRA Rule 2010 by improperly netting the trading activity of five affiliated broker-dealer customers when determining their close-out obligations and claiming pre-fail credit.

In addition, from January 2005 until January 2015, Merrill violated Rule 200(f) of Regulation SHO by including securities positions held by the firm's foreign and non-broker-dealer affiliates when calculating the net positions of two independent trading units (also known as aggregation units or AGUs). From January 2005 until July 2017, Merrill also failed to establish and maintain a supervisory system, including WSPs, reasonably

¹ For more information about the firm, including prior regulatory events, visit BrokerCheck® at www.finra.org/brokercheck.

designed to achieve compliance with Rule 200(f) of Regulation SHO, in violation of NASD Rules 3010 and 2110, and FINRA Rules 3110 and 2010.²

FACTS AND VIOLATIVE CONDUCT

This matter originated from examinations conducted by FINRA Member Supervision.

Merrill's Improper Application of the Multi-day Approach

Rule 204(a) of Regulation SHO requires broker-dealers to take action to close out fail-to-deliver (FTD) positions resulting from short sales in equity securities by either borrowing or purchasing securities of like kind and quantity by the beginning of regular trading hours on the settlement day following the settlement date.³

Rule 204(e) of Regulation SHO allows broker-dealers to reduce their Rule 204(a) delivery obligations by claiming "pre-fail credit" for purchase or borrow activity done after the trade date, but prior to the settlement date,⁴ provided certain conditions are met.

In a No-Action Letter dated September 6, 2013, the SEC's Division of Trading and Markets staff published regulatory guidance allowing broker-dealers to claim pre-fail credit using the "Multi-day Approach," by aggregating net purchases done across multiple days leading up to the applicable close-out date, provided the broker-dealer could demonstrate on its books and records that it had net purchases for each day and met other certain conditions.⁵

A violation of Rule 204 of Regulation SHO is also a violation of FINRA Rule 2010, which (like its predecessor NASD Rule 2110) requires members to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business.

From September 2013 through July 2016, when taking action to close out FTDs as required by Rule 204(a), Merrill misapplied the Multi-day Approach on at least 6,000 occasions when calculating the pre-fail credits and close-out obligations of five separate but affiliated broker-dealer customers (Correspondents).

One of the specified conditions for the Multi-day Approach contained in the SEC No Action Letter is that a broker-dealer "Participant using Attribution would not use net purchases of a Correspondent to claim Credit for a fail that is not Attributable to that Correspondent." However, from September 2013 through July 2016, the firm netted the trading accounts of the five Correspondents and then calculated the FTDs attributable to their trading on a collective basis. Merrill also combined the Correspondents' pre-settlement date purchases and used the combined positions to calculate the pre-fail credit

² FINRA Rule 3110 superseded NASD Rule 3010 on December 1, 2014. FINRA Rule 2010 superseded NASD Rule 2110 on December 15, 2008.

³ During the relevant period, for a short sale transaction in an equity security, Rule 204 required participants in a registered clearing agency to take action to address FTDs by the beginning of regular trading hours on T+4 (trade date plus three business days).

⁴ That is, purchases or borrows on T+1, T+2 or T+3.

⁵ When enacted, Rule 204(e) allowed a broker-dealer to claim pre-fail credit for purchase or borrow activity that took place on a single date (e.g., T+1, T+2, or T+3).

available under Rule 204(e). Merrill then applied the resulting pre-fail credit to reduce the number of shares it bought to close out FTDs resulting from the Correspondents' trading. Merrill's application of the Multi-day Approach applied pre-fail credit without regard to the Correspondents' respective pre-settlement purchases and short positions, and allowed the Correspondents to use purchases made by another Correspondent to reduce their close-out obligations when they had a short position in the purchased security.

Therefore, Merrill violated Rule 204 of Regulation SHO and FINRA Rule 2010.

Merrill Included the Securities Positions of Foreign and Non-Broker Dealer Affiliates in Its Net Position Calculations for Two AGUs

Rule 200(f) of Regulation SHO allows a broker-dealer to create independent trading units, or AGUs, and determine its net position in a security at the AGU level provided the broker-dealer meets the four conditions specified in the rule. However, Rule 200(f) does not permit a broker-dealer to include the securities positions of its non-US or non-registered broker-dealer affiliates in this calculation.⁶

A violation of Rule 200(f) of Regulation SHO is also a violation of NASD Rule 2110 and FINRA Rule 2010.

Merrill's trading desks are organized by written plan into separate AGUs structured around desks engaging in common trading objectives or strategies. The securities positions in the trading accounts of an AGU are netted together automatically by Merrill's systems to determine the total net position of that AGU, which is then used to determine whether the AGU's sales should be marked long or short.

Traders in two of Merrill's AGUs used equity securities transactions with three of the firm's foreign and non-broker dealer affiliates (Affiliates) as integral parts of their derivatives trading to hedge exposure. However, from January 2005 until January 2015, Merrill did not exclude the trading positions of the Affiliates when determining the AGUs' total net securities positions and whether the AGUs' orders should be marked long or short.⁷

In January 2015, Merrill adjusted its automated processes to ensure the Affiliates' trading positions were excluded from the position calculation for the two AGUs. Until then, Merrill did not accurately calculate the net positions of, or assess long and short sales by, the two AGUs.⁸

Therefore, Merrill violated Rule 200(f) of Regulation SHO, NASD Rule 2110, and FINRA Rule 2010.

⁶ In Exchange Act Release No. 50103 (July 2004), the SEC stated that "[t]he Commission has determined not to extend aggregation unit netting to entities that lack self-regulatory oversight and are not subject to Commission examination."

⁷ For example, during a four-month period, one of the AGUs effected approximately 3.5 million trades in the Affiliates' accounts.

⁸ The firm could not determine the number of long and short sales that were inaccurately marked.

Merrill Failed to Establish and Maintain a Supervisory System, Including Written Procedures, Reasonably Designed to Achieve Compliance with Rule 200(f)

FINRA Rule 3110, and its predecessor NASD Rule 3010, requires member firms to establish and maintain a supervisory system, including WSPs, reasonably designed to supervise the activities of each registered representative, registered principal, and other associated person of the firm and achieve compliance with applicable securities laws and regulations, and FINRA and NASD rules.

A violation of NASD Rule 3010 or FINRA Rule 3110 is also a violation of NASD Rule 2110 and FINRA Rule 2010.

From January 2005 through July 2017, Merrill did not establish or maintain supervisory systems or WSPs reasonably designed to prevent the inclusion of the Affiliates' securities positions in its calculation of the net positions for its AGUs. The firm's WSPs discussed Rule 200 of Reg SHO generally, but did not reference the SEC guidance or otherwise consider whether the trading conducted by the AGUs on behalf of the Affiliates affected the calculation of the AGUs' net positions. The WSPs also did not task any individual with responsibility for ensuring that the firm's net position calculation and automated systems complied with Rule 200(f), or require review of the AGUs' composition as it related to the trading the firm conducted with or on behalf of the Affiliates.

In January 2015, Merrill enhanced its supervisory reports to reflect the account within the AGU that the securities position was booked to, and the legal entity to which the securities position belonged. However, Merrill did not amend its WSPs to address Rule 200(f)'s requirement as it relates to the Affiliates until July 2017.

Therefore, Merrill violated NASD Rules 3010 and 2110 and FINRA Rules 3110 and 2010.

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

- a censure and
- \$850,000 fine.

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

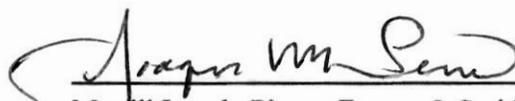
Respondent understands that:

- 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.

9/22/2021
Date


Merrill Lynch, Pierce, Fenner & Smith Inc.
Respondent

Print Name: JOAQUIN M. SENA
Title: Deputy General Counsel

Reviewed by:



Kevin J. Campion
Counsel for Respondent
Sidley Austin LLP
1501 K Street, N.W.
Washington, D.C. 20005

Accepted by FINRA:

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



10/6/2021

Date

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