

**FINANCIAL INDUSTRY REGULATORY AUTHORITY  
LETTER OF ACCEPTANCE, WAIVER AND CONSENT  
NO. 2015045603201**

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

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

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Respondent Merrill Lynch, Pierce, Fenner & Smith Inc. 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 herein.

**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 Lynch, Pierce, Fenner & Smith Inc. (the "Firm" or "Respondent") became a FINRA member on January 26, 1937. The Firm is a global investment banking and brokerage firm with its principal place of business in New York, New York. It employs approximately 30,000 registered representatives and has more than 3,700 branch offices.

**RELEVANT DISCIPLINARY HISTORY**

Respondent does not have any relevant disciplinary history with the Securities and Exchange Commission, any state securities regulators, FINRA, or any other self-regulatory organization.

**OVERVIEW**

Between May 2012 and September 2017, Merrill Lynch reported at least 11,625 short sales to a Trade Reporting Facility ("TRF") without a required short sale indicator, in violation of FINRA Rules 6182 and 2010.

In addition, on July 14, 2015, the Firm incorrectly marked thirty-two principal sell orders as long sales, when the Firm should have marked the orders as short sales. The issue that caused these mismarked orders persisted for a period of at least ten months. As a result, the Firm violated Rule 200(g) of Regulation SHO and FINRA Rule 2010.

In connection with the above, between May 2012 and September 2017, the Firm failed to establish and maintain a supervisory system reasonably designed to achieve compliance with FINRA Rule 6182 and Rule 200(g) of Regulation SHO. As a result, the Firm violated FINRA Rules 3110 (for conduct occurring on or after December 1, 2014) and 2010 and NASD Rule 3010 (for conduct occurring prior to December 1, 2014).

Between approximately 2014 and 2018, the Firm failed to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of short sale orders at prices at or below the national best bid during a short sale circuit breaker, in violation of Rule 201(b) of Regulation SHO, FINRA Rules 2010 and 3110 (for conduct occurring on or after December 1, 2014), and NASD Rule 3010 (for conduct occurring prior to December 1, 2014).

Finally, during the period of July 2007 through March 2015, the Firm reported as many as 6,174,868 non-media transactions<sup>1</sup> in National Market System (“NMS”) equity securities to the FINRA/Nasdaq Trade Reporting Facility (“FNTRF”) with inaccurate capacity codes. The transactions were incorrectly reported as “principal” transactions, when they should have been reported as “riskless principal” transactions. As a result, the Firm violated FINRA Rules 7230A and 2010 (for conduct occurring on or after December 15, 2008) and NASD Rules 6130 and 2110 (for conduct occurring prior to December 15, 2008).

## **FACTS AND VIOLATIVE CONDUCT**

### **A. The Firm’s Violations of FINRA Rule 6182**

FINRA Rule 6182 provides that, “[p]ursuant to applicable trade reporting rules, members must indicate on trade reports submitted to FINRA whether a transaction is a short sale or a short sale exempt transaction.” This rule applies to transactions in all NMS stocks and requires that all short sale transactions in such securities reported to FINRA “carry a ‘short sale’ indicator (or a ‘short sale exempt’ indicator . . .).” A violation of Rule 6182 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.”

FINRA TRFs provide member firms with a mechanism by which to report transactions effected other than on an exchange. The data members report to TRFs has a direct impact on the accuracy of public information FINRA disseminates. Additionally, the inaccurate reporting of required trade information may negatively impact FINRA’s surveillance patterns. FINRA relies on the accuracy of trade reporting to reconstruct and review the activities of market participants in order to safeguard the integrity of the

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<sup>1</sup> A non-media transaction is not included in publicly-disseminated trade reports.

securities markets and protect investors. Accurate recordkeeping also enables member firms to establish and maintain a supervisory system reasonably designed to achieve compliance with applicable securities laws and regulations.

#### Improper Trade Reporting Related to the Convertibles Desk

In a review of a sample of fifty exceptions generated for Merrill Lynch during the three month period of September through December 2014, seventeen trades, or thirty-four percent of the sample, were entered into OATS as short sales but improperly reported to a TRF without a short sale indicator. Those seventeen trades occurred on the Firm's Convertibles Desk and resulted from a coding error in the order management system used by that desk ("Convertibles Desk OMS"). Specifically, when the Firm filled a customer short sale order as principal, the Convertibles Desk OMS was not coded to properly report the customer side short sale indicator to a TRF. As a result, these trades were properly entered into OATS as short sales but reported to a TRF without the corresponding short sale indicator.

The Firm learned of the coding issue after FINRA staff inquired about it in May 2016. The coding issue began on April 14, 2014, when the Firm implemented the Convertibles Desk OMS, and lasted until October 24, 2016, when the Firm implemented a fix. Accordingly, the issue persisted for more than two-and-a-half years, causing a total of 10,625 trades, across 294 unique securities, to be improperly reported to a TRF without a short sale indicator.

#### Improper Trade Reporting Related to the Firm's Agency Cross Trades

The sample of fifty exceptions discussed above also included one instance whereby a trade was entered into OATS as a long sale but reported to a TRF with a short sale indicator. This error resulted from a systemic programming issue when a Firm trader attempted to cross two or more customer orders on an agency basis, while providing a partial principal fill to one or more customers. In such an instance, the programming issue caused the agency cross trade to be reported in the same manner as the principal fill.

The programming issue affecting agency cross trades began on August 27, 2013 and was not fixed until September 16, 2017. The Firm did not discover this problem until FINRA staff inquired about it in July 2017. During the four years, the Firm improperly reported 995 long sales to a TRF with a short sale indicator.

#### Improper Trade Reporting Related to the Firm's Booking Tool

In early 2015, a FINRA inquiry flagged five transactions in five different stocks as having been improperly reported to a TRF in July 2015. Certain Firm traders at the time were authorized to effect transfers of shares to different but affiliated legal entities under the common control of that trader or trading desk. These transfers were effected via an application called the "Booking Tool." The transactions resulted in changes in beneficial

ownership for the positions in question, triggering the Firm's requirement to report the transactions as trades.

These affiliate transfers were completed manually after market-close via the Booking Tool, and the transactions were manually reported to the TRF. However, the Booking Tool was not programmed to automatically capture the transferring affiliates' positions in the equities subject to transfer. When reporting these transactions to a TRF, traders did not check whether the transferring (*i.e.*, selling) entity was long or short the stock, and the Firm reported all such transfers as long sales. The five transactions flagged during the TFCE Exam should have been reported to a TRF with a short sale indicator, as the selling entity was short the security at the time of transfer.

The issue began on May 15, 2012, when the Firm implemented the Booking Tool, and an initial fix was implemented on February 24, 2017 following a FINRA inquiry.

Based on the foregoing, between May 15, 2012 and September 16, 2017, the Firm improperly reported at least 11,625 short sales to a TRF without the required short sale indicator, in violation of FINRA Rules 6182 and 2010.

#### **B. The Firm's Violations of Rule 200(g) of Reg SHO**

Rule 200(g) of Regulation SHO requires broker-dealers to "mark all sell orders of any equity security as 'long,' 'short,' or 'short exempt.'" The broker-dealer selling an equity security may only mark an order as "long" in the event that the "seller is deemed to own the security being sold" and either (i) the security to be delivered is in the physical possession or control of the broker or dealer; or (ii) it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction. A violation of Rule 200(g) is also a violation of FINRA Rule 2010.

Question and Answer 2.5 on the SEC's Frequently Asked Questions ("FAQs") Concerning Regulation SHO clarify that "where a seller is net long 1,000 shares and simultaneously enters multiple orders to sell 1,000 shares owned, only one such order would constitute a long sale."<sup>2</sup> This is because after the first order is entered to sell 1,000 shares, "it is no longer reasonable to expect that delivery can be made by settlement date on additional orders to sell the same shares."<sup>3</sup> Accordingly, Rule 200(g) requires that only one such order in that scenario can be marked as a long sale; the remaining sell-side orders in that security must be marked as short sales.

During a FINRA inquiry, the staff found that the Firm incorrectly marked thirty-two principal sell orders in shares of a single company as long sales, when the Firm should have marked the trades as short sales. The sell orders occurred on July 14, 2015 and were entered within milliseconds of one another, in connection with a specific hedging

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<sup>2</sup> See U.S. Securities and Exchange Commission, Division of Market Regulation, Responses to FAQs Concerning Regulation SHO, Question 2.5, updated as of August 28, 2009.

<sup>3</sup> *Id.*

strategy. The mismarking issue occurred as a result of a timing error related to the Firm's order management and position management systems. Due to the speed of entry of the sell orders, the Firm's position management system was unable to timely update the selling entity's net position on a per-order basis. When the selling entity's position changed from long to short—taking into account the orders already entered, or “in flight”—any sell orders entered thereafter were improperly marked as long sales. This deficiency was limited to a single specific hedging strategy.

As with the other issues discussed above, the Firm did not discover this error until a FINRA inquiry in May 2016. Upon learning of the error, the Firm suspended the hedging strategy that led to the mismarking of orders. By virtue of the foregoing, the Firm violated Rule 200(g) of Regulation SHO and FINRA Rule 2010.

### **C. The Firm's Supervision**

#### The Firm's Supervision of Trade Reporting

FINRA Rule 3110(a) and NASD Rule 3010(a) require member firms to establish and maintain a supervisory system, including written supervisory procedures, reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules related to the member's business. A violation of FINRA Rule 3110 and NASD Rule 3010 also constitutes a violation of FINRA Rule 2010.

At all relevant times, Merrill Lynch had a general policy in place addressing trade reporting and designated “Trading Supervisors” to review reports in order to monitor compliance with trade reporting requirements. The Firm's WSPs required Trading Supervisors to review a trade report on a daily basis to “detect patterns of improper trade reporting” but provided inadequate guidance on how to review for such patterns, including by providing no guidance on what constituted a pattern and failing to require a review of the accuracy of short sale indicators. None of the Firm's exception reports or surveillance alerts applicable to the above systems flagged trades that were reported to a TRF with missing or inaccurate short sale indicators. As a result, the Firm's systems, including its policies and procedures, in the area of short sale trade reporting were not reasonably designed to achieve compliance with the Firm's trade reporting obligations.

#### **i. Convertibles Desk OMS**

During the time period at issue, the Firm's Convertibles desk had a WSP specifically addressing trade reporting. The policy required Trading Supervisors to effect a daily check for “trade reporting issues” by comparing stock executions “against the prior day's equity prints in Bloomberg.” The Trading Supervisor was required to evidence this review by initialing a supervisory checklist. The WSP specified that the trades to be “checked” were those that resulted from the Firm “crossing a client order away from an exchange” but failed to address situations in which the Firm filled a customer short sale as principal. In addition, the WSP made no specific mention of the short sale modifier.

The Firm's supervisory checklist also stated that the Trading Supervisor would receive daily email alerts for trades rejected by a TRF, but the TRF did not reject trades solely due to missing or inaccurate short sale indicators. As a result, trades violating Rule 6182 would not be rejected by the TRF or be included in the supervisor's daily alert email. The seventeen trades improperly reported by the Firm's Convertibles Desk did not appear on any exception report.

ii. Booking Tool

The Firm had no specific trade reporting WSP in effect for the traders or units that used the Booking Tool. Traders responsible for affiliate transfers were not required to check the selling entity's net position to determine whether a transfer should be reported with a short sale indicator. As a result, the Firm improperly reported at least five transfers effected via the Booking Tool. Those five trades also did not appear on any trade reporting exception report.

The Firm's Supervision of Order Marking

The Firm's WSPs related to order marking required that the Trading Supervisor, on a weekly basis, review a random sample of at least five principal sell orders from the order management system in question. The Trading Supervisor was required to compare the long or short indicator on each order reviewed with the net position reflected in the order management system in order to "ensure that the Firm order tickets/records are accurate and in accordance with books and records regulatory requirements." This random sampling, which failed to detect the timing error that caused the Firm to mismark thirty-two principal sell orders, was unreasonable given the small size of the sample. As a result, between May 2012 and September 2017, Merrill Lynch failed to establish a supervisory system and written supervisory procedures reasonably designed to achieve compliance with applicable trade reporting and order marking rules. The Firm thereby violated FINRA Rules 3110(a) and 2010, and NASD Rule 3010(a) (for conduct occurring prior to December 1, 2014).

**D. Violation of Rule 201(b) of Reg SHO**

Rule 201(b) of Regulation SHO requires that trading centers<sup>4</sup> establish, maintain, and enforce written policies and procedures reasonably designed to "prevent the execution or display of a short sale order . . . at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from [its] closing price" as of the prior day (the "short sale circuit breaker" or "SSCB"). The purpose of Rule 201(b) is to restrict short selling where a stock is experiencing substantial downward price pressure, enabling long sellers to sell ahead of short sellers when a short sale circuit breaker is in effect.

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<sup>4</sup> A trading center includes any broker-dealer that "executes orders internally by trading as principal or crossing orders as agent." Here, the Firm acted as a trading center when the Convertibles Desk filled customer short sale orders as principal. The Firm likewise operated as a trading center when it effected affiliate transfers via the Booking Tool.

The Firm's systems, policies and procedures related to Rule 201(b) were deficient with respect to both the Convertibles Desk OMS and the Booking Tool between 2014 and 2018.

During the period in question, the Firm had a general policy requiring traders to comply with Rule 201(b) but did not have policies or procedures tailored to the Convertibles Desk OMS or the Booking Tool. In addition, while the Firm also had an automated surveillance alert to identify short sales executed at or below the current national best bid ("NBB") during an SSCB, the alert did not monitor inter-affiliate trades entered through the Booking Tool. The alert also failed to detect at least two trades placed at the Convertibles Desk that were executed at or below the NBB during an SSCB.

For trades placed at the Convertibles Desk, the Firm had no automated or manual mechanism to ensure that misreported short sale orders were not executed or displayed at prices at or below the NBB during an SSCB. Similarly, for the Booking Tool, the Firm had no automated system but instead relied on its traders to perform a manual review for Rule 201(b)'s price test restrictions. However, the Firm neither required such reviews, nor maintained records of such reviews.

As a result of the foregoing, the Firm's systems, policies and procedures were not reasonably designed with respect to trades placed at the Convertibles Desk and through the Booking Tool and the Firm violated Rule 201(b), as well as FINRA Rules 3110 and 2010 and NASD Rule 3010.

#### **E. The Firm's Inaccurate Reporting of Capacity Codes**

FINRA's Rule 7200A Series sets forth certain requirements that member firms must meet "when reporting transactions to the [FNTRF]." Rule 7230A(d) lists information that "must be provided for each transaction that is reported to the [FNTRF]," including "[a] symbol indicating whether the trade is as principal, riskless principal, or agent." Rule 7230A replaced NASD Rule 6130 in relevant part on December 15, 2008. NASD Rule 6130 likewise required member firms to include capacity codes in trade reports. Violations of FINRA Rule 7230A and NASD Rule 6130 also constitute violations of FINRA Rule 2010 and NASD Rule 2110 (for conduct occurring prior to December 15, 2008).

In 2014, FINRA staff found that Merrill Lynch had inaccurately reported 60,403 non-media transactions to the FNTRF with a "principal" capacity code, when the transactions should have been reported with a "riskless principal" code.<sup>5</sup> Those transactions were reported during the period of December 30, 2013 through January 3, 2014.

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<sup>5</sup> A "riskless principal" transaction is one in which "a member, after having received an order to buy (sell) a security, purchases (sells) the security as principal and satisfies the original order by selling (buying) as principal at the same price (the offsetting 'riskless' leg)." See *Trade Reporting FAQs*, Section 302, <https://www.finra.org/filing-reporting/market-transparency-reporting/trade-reporting-faq#302>.

The Firm's inaccurate reporting of riskless principal trades resulted from customer orders processed by the Firm's non-standard, shortened settlement flow OMS. The trades were sent to the Firm's Risk Fill Engine ("RFE"), which then sent the trades to the Firm's trade reporting system, and the trade reporting system then reported the trades to the FNTRF. When sending the trades to the trade reporting system, the RFE did not correctly transmit the "riskless principal" capacity code indicator. The trade reporting system then inaccurately reported the riskless principal trades with the system's default capacity code—the code for "principal" transactions.

The Firm informed FINRA staff that it had corrected the issue on May 1, 2014. However, FINRA staff later discovered that the issue persisted from May 5 to May 9, 2014. After FINRA staff sent Merrill Lynch another inquiry, the Firm informed FINRA staff in February 2015 that the issue had been resolved. FINRA staff again found additional instances of inaccurate capacity code reporting from February 16 to February 20, 2015.

The issue existed from July 2007 to March 2015, during which time the Firm reported as many as 6,174,868 non-media transactions in NMS securities to the FNTRF with the "principal" capacity code, when the transactions should have been marked with a "riskless principal" code.

As a result of the foregoing, the Firm violated FINRA Rules 7230A and 2010 and NASD Rules 6130 and 2110 (for conduct occurring prior to December 15, 2008).

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

A censure and fine in the amount of \$150,000.

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 an inability to pay, now or at any time hereafter, the monetary sanction imposed in this matter.

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

## 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 prejudice 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 acceptance or rejection of this AWC.

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(s); 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(s);
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 the subject matter thereof 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: (i) testimonial obligations; or (ii) 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 or its staff.

The undersigned, on behalf of the Respondent Firm, certifies that a person duly authorized to act on its 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 it 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 herein and the prospect of avoiding the issuance of a Complaint, has been made to induce it to submit it.

Merrill Lynch, Pierce, Fenner & Smith Inc.,  
Respondent

July 1, 2020

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Date

By: David Montague, Merrill Lynch

Print Name: David Montague, Merrill Lynch

Title: Associate General Counsel

Reviewed by:

*Nellie E. Hestin*

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Nellie E. Hestin  
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Accepted by FINRA:

July 22, 2020

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Date

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

*Jessica Zetwick-Skryzhynskyy*

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