

**COMMONWEALTH OF MASSACHUSETTS
OFFICE OF THE SECRETARY OF THE COMMONWEALTH
SECURITIES DIVISION
ONE ASHBURTON PLACE, ROOM 1701
BOSTON, MASSACHUSETTS 02108**

IN THE MATTER OF:)
)
)

MERRILL LYNCH, PIERCE, FENNER)
& SMITH, INCORPORATED,)
)

RESPONDENT.)
)
_____)

DOCKET NO. 2008-0058

ADMINISTRATIVE COMPLAINT

I. PRELIMINARY STATEMENT

The Enforcement Section (“Enforcement Section”) of the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth (“Division”) files this complaint (“Complaint”) in order to commence an adjudicatory proceeding against Merrill Lynch, Pierce, Fenner & Smith, Incorporated (“Merrill Lynch”) for violating M.G.L. c. 110A, the Massachusetts Uniform Securities Act (the “Act”) and 950 CMR 10.00 *et seq.* (“Regulations”).

The Enforcement Section seeks an order (a) requiring Merrill Lynch to permanently cease and desist from committing any further violations of the Act and Regulations, (b) requiring Merrill Lynch to offer rescission of sales of ARS at par (or restitution to investors who have already sold these instruments below par) on the terms and conditions that a Hearing Officer deems appropriate, (c) censuring Merrill Lynch, (d) requiring Merrill Lynch to pay an administrative fine in an amount and upon such terms and conditions as a Hearing Officer may determine, and (e) requiring Merrill

Lynch to take any other action that a Hearing Officer may deem appropriate in the public interest and necessary for the protection of Massachusetts investors.

II. SUMMARY

This Administrative Complaint addresses the manner in which Merrill Lynch conducted its auction rate securities business, as well as how it interacted with its research department, and charges the firm with separate counts of fraud and dishonest and unethical conduct for creating and implementing a sales and marketing scheme which significantly misstated not only the nature of auction rate securities (“ARS”), but also the overall stability of the auction market, resulting in thousands of investors being abandoned with illiquid investments.

Particularly egregious, was the manner in which Merrill Lynch co-opted its supposedly independent Research Department to assist in sales efforts geared towards reducing its inventory of ARS. Specifically, Merrill Lynch permitted its Sales and Trading, including Auction Desk, managers to unduly influence and pressure the Research Department in a number of ways. First, it allowed Sales and Trading to directly request and advocate for written research to be published endorsing the safety and high quality of nearly all types of ARS and recommending investors buy ARS. In one instance, a Managing Director in charge of the Merrill Lynch’s auction desk, Frances Constable (“Constable”), directly emailed Martin Mauro (“Mauro”), a Fixed Income Analyst in the Research Department, with the following:

Any renewed research focusing on the high quality of closed end fund preferreds of ALL tax status, auction municipal bonds and student loan backed bonds, wrapped around the value added proposition with today’s rates would be extremely helpful.

Managers in Financial Products Group understood the value of positive research aiding in a sales effort. As one Manager put it to a Research Department employee when he was requesting a research piece be published, “[c]alls are helpful, however, attendance is usually not great. **Something published instead of or in addition to a call would have a better impact.**” (Emphasis added)

Further, when Sales and Trading, including Auction Desk personnel, did not agree with the tone or context of a published research piece, Merrill Lynch managers, permitted Sales and Trading to insist the published report to be retracted and replaced with a more sales friendly piece. In one specific instance in August 2007, a research piece was published in Merrill Lynch’s Fixed Income Digest primarily for the purpose of highlighting the differences in liquidity features for auction rate preferreds (“APS”) and Variable Rate Demand Obligations (“VRDOs”) in light of certain recent failed auctions. The primary distinction noted by the author, Mauro, was that VRDOs have a hard put, while APS do not. Upon reading Mauro’s research report, Constable immediately called him and demanded a retraction and clarification on the grounds that it was misleading. Mauro initially refused to retract the report because he thought it was accurate. Constable elevated the complaint to her boss, John Price and another Research Analyst, Kevin Conery (“Conery”). She also emailed persons in the Financial Products Group with the following all caps message:

**I HAD NOT SEEN THIS PIECE UNTIL JUST NOW
AND IT MAY SINGLE HANDEDLY UNDERMINE
THE AUCTION MARKET. IF YOU ARE GETTING
ANY CALLS, PLEASE LET ME KNOW. I HAVE
ASKED FOR AN IMMEDIATE CLARIFICATION TO
BE PUBLISHED AND A RETRACTION OF THIS.**

(Emphasis added). The Research Department agreed to retract and re-write the piece. The re-written piece was markedly different in both focus and scope from the original and its conclusion contained a glowing endorsement of the ARS, “as a buying opportunity for investors who are looking for short-term instruments.”

Pressure and objections from the Auction Desk had lasting effects on the Research Department’s published opinions. For example in January 2008, after completing changes to a draft research piece involving ARS, the author requested someone review his work before it was published to ensure that it did not upset the Auction Desk,

I want to make sure that research cannot be accused of causing a run on the auction desk, like was the case in August. I think we have sufficiently covered that risk, but would like his thoughts.

Undue influence over the Research Department did not end there. Other times, Auction Desk personnel attempted to directly influence how Research responded to FA questions during sales calls with Merrill Lynch sales staff. In one instance in August 2007, Conery was a featured speaker and was answering FA questions in a “Q&A” style sales conference call. Constable had also dialed in to the call and was listening in. After one question was asked, which apparently was not to Constable’s liking, she emailed or instant messaged Conery and stated: **“Shut this guy down. Suggest he call outside this call. He is focusing attention away from your positive message.”** (Emphasis added).

Merrill Lynch also permitted Sales and Trading managers, including Auction Desk personnel, to communicate to members of the Research Department (in violation

of company policies and procedures) sensitive confidential information concerning inventory levels, marketing initiatives and enhanced sales incentives offered to Financial Advisors (“FAs”) to sell ARS.

Year end employment reviews of certain Research Analysts also took into account the level of support that analyst provided to his “business partners” at the Auction Desk. Further, certain managers in Sales and Trading had direct input in the year-end employment evaluations of at least one Research Analyst. This input directly had the potential to influence the level of bonus awarded to the Research Analyst.

Management regularly incorporated the supposedly independent Research Analysts into sales efforts and relied on them to actively engage and motivate sales staff to sell ARS, even in times when market conditions existed that called into question the suitability of ARS to those customers that needed ready liquidity. In participating in these sales calls, Research Analysts routinely soft-pedaled significant negative events affecting liquidity in the auction markets, and omitted material information in which a reasonable investor would need to form an objective opinion as to the suitability of the investment. These actions took place up to and including the time in which Merrill Lynch intentionally withdrew from the auction market. For instance, on February 7, 2008, some five days before Merrill Lynch decided to voluntarily withdraw from the auction market, Conery participated in a Closed End Fund monthly conference call with FAs to discuss recent market events. In discussing whether all closed-end funds auctions were suspect or likely to fail, Conery disagreed and told FAs, in part:

One thing I would say is that it does highlight, and we said this on and off for the past several years, is that investor in

the auction market should know their broker/dealer and should know whether or not their broker/dealer is committed to the product.

I will tell you Merrill Lynch, certainly by all indications, is committed to this product. I would have to let the desk people speak for themselves, but given the fact that through all this turmoil they continue to plod away, I think that shows that the firm is committed to it.

After conceding that Merrill Lynch was not willing to guarantee continued commitment to the auction business (“there are no guarantees in anything”), Conery added,

But is it an area we think represents a good, conservative, reasonable investment? Yes, it is. We are quite comfortable with buying Aaa one week closed-end paper. We are quite comfortable buying Aaa one month closed-end fund paper, whether its taxable or tax exempt we feel pretty good about it. But I will be the first to say that the rumors out there flying are pretty wild or pretty amazing. If you listen to them all it would probably drive you nuts, because I know it’s driving me nuts, but you need to differentiate between what’s rumor and what’s fact.

On the evening of February 12, 2008, Merrill Lynch executives decided to cease supporting its auction rate securities program and intentionally allowed the vast majority of their auctions to fail the following day. However, the apocalyptic market events that led to the failures in the auction market in mid-February, which left investors with illiquid auction rate securities, were no surprise to Merrill Lynch’s senior management. Indeed, Merrill Lynch had known for a period of several months that the auction markets were not functioning properly and were in fact, in significant danger of collapsing. Buyers had been exiting the market in droves and inventory was accumulating to critical tipping points. As one executive confided to a personal acquaintance in an email on November 19, 2007,

Market is collapsing. No more \$2k dinners at CRU!! The Financials are being invicerated! (sic) More firings over at Citi...Inventory flooding the street. Going to be a great '08 trading environment.

Two days later, Constable in an email to Price and others relayed the difficulty of merely clearing all Merrill Lynch's Auctions in light of the negative news and dismal auction market conditions,

Any combination of a negative Bloomberg article about auction illiquidity, the ongoing downdraft of press about the monoline insurers that guarantee the entire municipal space in our market, equity prices of the dealer community and the GSEs undergoing a death spiral undermining retail investors confidence in our ability to support the auction business and two times the number of daily auctions might have been deadly but we got them all today.

One manager simply responded, "Thank you Frances. A Herculean effort..." As inventory continued to grow, even the perceptions of Merrill Lynch's investment banking issuer clients had to take a back seat to the acuteness of the inventory problem. As Constable confided to Price in an email from November 26, 2007 pertaining to the continued investor selling and difficulty of pricing inventory to sell,

The gloves are off and we are not concerned about issuer perception of [Merrill Lynch's] abilities and the competition. Gotta Move these microwave ovens!!"

In light of all this, when the decision finally came to stop supporting the auction market, Merrill Lynch customers were seemingly of little concern. Witness testimony before the Division confirms that Merrill Lynch's decision to stop broadly supporting its auction program was made without any consideration or analysis of its effect on retail and other customers holding the securities.

Deficiencies in the auction market were present even at its inception and set the course for ultimate failure in a liquidity challenged market. First, the auction process itself was fundamentally flawed in that true auctions were not being conducted. Instead, Merrill Lynch, who made a market in auction rate securities, regularly submitted support bids for the entire notional value of the amount of auction rate securities being offered at auction. The result was that Merrill Lynch's support bids were commonly filled in order to prevent a failed auction, thereby concealing the true level of investor demand, or lack thereof, for the products. Broker-dealer support created a false impression that there were deep pools of liquidity in the auction market and rendered potentially misleading claims that auctions never fail.

Another structural problem that existed was that terms were structured in a manner that precluded secondary market value in the event of an auction failure. Maximum rates, those interest rates that would be applied in the event of an auction failure, were set at low levels which were favorable to issuers, but in the case of broad auction failures, provided issuers with little incentive to seek alternative financing in order to redeem the ARS shares. The establishment of low maximum rates directly contributed to issuers' efforts in successfully obtaining AAA ratings for their securities from credit rating agencies. Merrill Lynch stressed the AAA rating of its ARS in its marketing effort, billing them as ultra conservative investments. But when Merrill Lynch stopped supporting its auctions, investors came to realize the low maximum rate which had allowed the securities to receive a AAA rating rendered their holdings unmarketable and illiquid.

On the investor side, interest rates were not high enough to compensate interested investors for their increased liquidity risk. Merrill Lynch had little or no incentive to negotiate for higher maximum rates to balance the market interests, as it was collecting significant underwriting fees from issuers at the outset on the investment banking side. In fact, Merrill Lynch reaped a total of approximately \$90 million dollars in total profits from its auction rate program for the years 2006 and 2007. Thus, Merrill Lynch, by working the investment banking side, had a significant interest in keeping its issuer clients happy in hopes of securing future business with those clients.

Merrill Lynch's dual role in representing issuers and investors purchasing ARS created significant and inherent conflicts of interest which could not be reconciled. Time after time, when confronted with conflicts of interest, Merrill Lynch was consistent in that it placed its own interests ahead of its investor clients. For instance, Merrill Lynch marketed ARS as safe, cash like, and liquid investments. It categorized ARS as "Other Cash" on customer statements, even after the market imploded. Moreover, it trained its FAs to market ARS as a "Cash Management tool" to their clients. Despite its promotion of ARS as "cash like," Merrill Lynch had express knowledge that without its support bids being filled, many auctions would have failed and thus, the securities were likely anything, but "cash like."

The overall stability of the auction market was apparently only as strong as its weakest link as certain Merrill Lynch managers obsessed over any event or information that might spread fear and contagion throughout the auction market. For instance, as noted above, Managing Director of the Auction Desk, Constable expressed the opinion that one single neutral research report released by Merrill Lynch in August 2007, was

enough to “single handedly undermine the auction market.” On another occasion, in late September 2007, Constable expressed the opinion that a proposed firm wide ban on offering enhanced production credits as incentives to FAs for selling ARS would be the auction desk’s “death-knell” if implemented. Late in January, after having been forwarded a negative story regarding a recent auction failure, Constable simply forwarded the piece to Price with the note, “[i]ts like the Sorcerer’s Apprentice...cant someone make these people stop bucketing us with water...” Finally, Constable felt that failure of one or two broker dealers in the auction market would make it a “fait accompli” that the entire auction market would fail. These privately held opinions of Merrill Lynch’s management were in stark contrast to the aggressive public sales and marketing campaign touting the safety and quality of the auction market securities that the company promoted to its sales staff and investors.

Moreover, disclosures by Merrill Lynch regarding the true nature of and risks common to ARS were not adequately disclosed to customers, particularly retail customers. Merrill Lynch did not provide any notice or documentation to customers outlining risks or the nature of ARS at the time of, or prior to, sale. Rather, Merrill Lynch instead placed a vague reference on its Trade Confirmation slips which referred to a website at which customers who already purchased ARS could go to read about Merrill Lynch’s “Auction Rate Practices and Procedures.” Only if the investor visited the website after purchasing the ARS, would he or she be able to review Merrill Lynch’s Auction Rate Practices and Procedures, which included an explanation of risks surrounding the ARS market. Merrill Lynch FAs routinely represented these instruments to clients as fully-liquid, principal protected and cash-like. Merrill Lynch

failed to disclose to customers that ARS were only liquid at the time of sale because the auction market was artificially supported and manipulated by Merrill Lynch to maintain the appearance of liquidity and stability.

Beginning in August 2007, tightening in the credit markets began causing disruptions in certain ARS auctions, which caused Merrill Lynch to make the decision to cease submitting support bids for some of the riskier ARS it had underwritten and was trying to remarket, resulting in a number of auction failures. The following weeks saw many institutional and corporate cash participants withdraw from the auction markets. The immediate impact to broker-dealers, such as Merrill Lynch, who maintained a large auction market business, was a significant increase in the number of sellers and a reduction in willing auction market bidders, which resulted in less liquidity for the auction market. In order to try and maintain a balance in the market, Merrill Lynch stepped in, as it typically did, and ensured liquidity by placing ever increasing support bids in order to successfully clear its auctions and maintain its business.

As Fall progressed into Winter, continued negative market events required Merrill Lynch to devote more of its capital in the form of support bids to ensure successful auctions. In response to pushback from Merrill Lynch's Risk Management Division, Merrill Lynch implemented a series of measures designed to reduce its own exposure to ARS, while providing misleading assurances, primarily through sales calls and research reports, to investors regarding the auction market's outlook and resiliency. Merrill Lynch was providing its sales force, and consequently its customers, with half-truths about the nature of its ARS market during the Fall of 2007 and into February,

2008. Most of these customers are now left holding on to these now illiquid instruments.

The Enforcement Section seeks an order (a) requiring Merrill Lynch to permanently cease and desist from committing any further violations of the Act and Regulations, (b) requiring Merrill Lynch to offer rescission of sales of ARS at par (or restitution to investors who have already sold these instruments below par) on the terms and conditions that a Hearing Officer deems appropriate, (c) censuring Merrill Lynch, (d) requiring Merrill Lynch to pay an administrative fine in an amount and upon such terms and conditions as a Hearing Officer may determine, and (e) requiring Merrill Lynch to take any other action that a Hearing Officer may deem appropriate in the public interest and necessary for the protection of Massachusetts investors.

III. JURISDICTION AND AUTHORITY

1. The Massachusetts Securities Division is a division of the Office of the Secretary of the Commonwealth with jurisdiction over matters relating to securities, as provided for by the Act. The Act authorizes the Division to regulate: 1) the offers, sales, and purchases of securities; 2) those individuals offering and/or selling securities; and 3) those individuals and entities transacting business as investment advisers within the Commonwealth.

2. The Division brings this action pursuant to the enforcement authority conferred upon it by section 407A of the Act and M.G.L. c. 30A, wherein the Division has the authority to conduct an adjudicatory proceeding to enforce the provisions of the Act and all Regulations and rules promulgated thereunder.

3. This proceeding is brought in accordance with sections 101, 204 and 407A of the Act and its Regulations. Specifically, the acts and practices constituting violations occurred within the Commonwealth of Massachusetts.

4. The Division specifically reserves the right to amend this Complaint and/or bring additional administrative complaints to reflect information developed during the current and ongoing investigation.

IV. RESPONDENT

5. Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill Lynch”) is a registered broker-dealer and investment adviser, registered and notice filed with Massachusetts, with a Central Registration Depository (“CRD”) number of 7691.

V. OTHER RELATED PERSONS OR ENTITIES

6. Kevin J. Conery (“Conery”) is a person, registered as an agent of Merrill Lynch, with a CRD number of 1422703. Conery serves in the position of Senior Director Preferred Strategist in the Research Department at Merrill Lynch.

7. Frances M. Constable (“Constable”) is a natural person, registered as an agent of Merrill Lynch with at CR D number of 1467372. Constable is a Managing Director in charge of Merrill Lynch’s Auction Rate Securities Trading Desk (“Auction Desk”).

8. John Price (“Price”) is a natural person, registered as an agent of Merrill Lynch, with a CRD number of 1707529. Price serves as the Head of Americas Credit and Trading at Merrill Lynch.

9. Martin Mauro (“Mauro”) is a natural person, registered as an agent of Merrill Lynch, with a CRD number of 2743020. Mauro is a Fixed Income Strategist and Research Analyst with Merrill Lynch.

VI. FACTS AND ALLEGATIONS

A. Background Mechanics of Auction Rate Securities.

a. Dutch Auction Process

10. At auction ARS always trade at par, with the yield of the instruments being adjusted by the movements of interest rates set by a Dutch auction.

11. In the Dutch auction, a security holder had three options, the holder could: (1) hold; (2) purchase or sell; or (3) purchase and hold at rate.

12. Investors looking to acquire ARS bid into the auction at the rate and quantity that they were willing to hold the securities.

13. Orders for the available quantity of ARS are then filled, starting with the lowest bid rate up until all the shares offered for sale in the auction are allocated.

14. The rate at which the final share from the auction is allocated is the clearing rate, and sets the rate to be paid for the entire issue until the next auction.

15. If there are not enough purchasers the auction fails, no shares change hands, and the rate resets to a rate which is prescribed in the instrument’s offering documents.

b. Types of Auction Rate Securities

16. References to ARS herein shall include three separate categories of instruments: Auction Preferred Shares of closed-end funds, municipal auction rate certificates and student loan auction rate certificates.

i. Auction Preferred Shares (“APS”)

17. APS are equity instruments without a stated maturity issued by closed-end funds. They are collateralized by the assets in that fund and typically receive ratings from the major rating agencies. Interest rates are intended to be set in a Dutch auction process with auction cycles typically of 7 or 28 days. Typically, they have a maximum rate, based off of a short term index, above which the interest rate cannot be set in an auction.

ii. Municipal Auction Rate Certificates (“Municipal ARCS”)

18. Municipal ARCS are debt instruments (typically municipal bonds) issued by governmental entities with a long-term nominal maturity and a floating interest rate that is intended to be reset through a Dutch auction process. They receive long-term ratings from the major rating agencies and are often backed by monoline insurance.

iii. Student Loan-Backed Auction Rate Certificates (“Student Loan ARCS”)

19. Student Loan ARCS are long-term debt instruments issued by trusts which hold student loans. Interest rates are supposed to be set in a Dutch auction process and yet typically they have a maximum rate above which the interest rate cannot be set in an auction. They receive long-term ratings from the major rating agencies.

c. Difference Between ARS and Variable Rate Demand Obligations

20. Variable rate demand obligations (“VRDOs”) are floating rate obligations with a long-term maturity, but have a coupon that is reset periodically (e.g.

daily or weekly). Unlike ARS, the investor in VRDOs has the option to put the bonds back to the trustee or tender agent at any time with specified notice (typically seven days). The put price is par plus accrued interest.

d. ARS Not Eligible to be Purchased by Money-Market Funds

21. Because ARS do not have the put that VRDOs have, they are considered to be long-term debt and are not eligible to be purchased by money-market funds.

B. Merrill Lynch Marketed And Sold Auction Rate Securities As Safe, Liquid Short-Term Investments.

1. Merrill Lynch Marketed Auction Rate Securities as Safe, Liquid Investments.

22. Merrill Lynch marketed and sold ARS as money market like instruments, which were safe and liquid.

23. In testimony to the Division, a Merrill Lynch FA who sold ARS to customers, described ARS as “a money market alternative with a AAA rate and a shorter duration.”

24. When asked by the Division to explain how ARS worked the FA provided, “They have a, again, AAA rating, they mature every- can mature every seven, 20 days, they have higher yield than most alternatives with a short maturity.”

25. In testimony to the Division, another Merrill Lynch FA was asked whether he discussed liquidity of ARS with his client and he provided, “just the ability to get in and out of them in a 7 to 30 day time frame.”

26. When asked whether he discussed “any potential risks of investing in auction rate securities” with the client at the time he made the investment, he answered, “no.”

27. The FA further testified that he was unaware that Merrill Lynch was supporting the market.

28. Merrill Lynch additionally used research pieces to market ARS to customers.

29. FAs would often forward Merrill Lynch marketing pieces to customers to reassure them of the safety and value of the instruments.

30. On August 22, 2007, Mauro wrote in a research piece, “Yields on auction market securities have risen to levels that we find very attractive.”

31. On December 3, 2007, Mauro wrote in a research piece, under the heading “Are auction market securities safe?”

We are comfortable with the safety of auction market securities, and view the present backup in rates as a buying opportunity for investors looking for short-term instruments.

(See Exhibit 1)

32. On January 28, 2008, Jon Maier wrote in a research piece,

Last week we saw the first failed auction for an Auction Rate Preferred issue since 1990. It was a relatively small number of shares that failed. Six subsequent auctions for the same fund were successful. **We do not believe this failed auction is cause for alarm**, but it is an event that has occurred and it is noteworthy. (emphasis added)

(See Exhibit 2)

33. On February 1, 2008, Mauro wrote in a research piece, under the heading “For cash holdings: auction market securities,”

Naturally, most investors need to keep some portion of their portfolios in liquid, cash-like instruments. We find auction market securities (AMS) to be a better alternative

than money funds for these purposes for investors with larger amounts to invest.

(See Composite Exhibit 3)

34. On February 4, 2008, Conery wrote in a research piece, “[w]e consider CEF (Closed End Fund) auction rate securities to be the conservative’s conservative security.” (See Composite Exhibit 3)

35. On February 8, 2008, Conery wrote in a research piece, “[w]e still find auction rate securities to be attractive as tax-exempt oriented investors looking at one-week AAA-rated paper can pick up 45 bps over the benchmark SIFMA/BMA Index and taxable investors can pick up 93 bps over one-week LIBOR.” (See Composite Exhibit 3)

36. FAs who sold ARS were not required to provide customers with disclosures, instead customers would receive customer’s trade confirmations directing customers to where they could access Merrill Lynch’s “Auction Rate Practices and Procedures.”

37. On March 15, 2006 Merrill Lynch ended its practice of sending ARS purchasers a “Master Purchasers Letter.” The Master Purchasers Letter was a disclosure document which all purchasers of ARS had been required to sign and return to Merrill Lynch.

38. Merrill Lynch’s policies and procedures did disclose some important elements of its ARS program, including that Merrill Lynch plays multiple roles in the ARS market, that Merrill Lynch’s interest may differ from those of its clients who purchased ARS, that Merrill Lynch is permitted but not obligated to submit orders for

its own account and routinely does, and that a purchaser's ability to sell their ARS may be limited.

39. Yet, since Merrill Lynch FAs were not required to affirmatively disclose these practices prior to selling a client ARS, purchasers were largely unaware of Merrill Lynch's practices in supporting its ARS program.

40. Merrill Lynch did not undertake any analysis of whether any customers actually went to the website discussing its practices and procedures to review them.

2. Merrill Used Triple-A Rating as a Selling Point for Auction Rate Securities Even After it had Allowed to Fail Certain Triple-A Rated Auction Rate Securities.

41. The fact that its ARS carried a AAA rating was an important marketing point for Merrill Lynch. The AAA rating on ARS was routinely touted in marketing materials, as well as research pieces which discussed ARS and their safety.

42. Marketing materials produced by the ARS desk promoted ARS as follows:

- **Auction Market Securities provide many advantages for investors**
 - Large and liquid market with over \$306 billion currently outstanding
 - High quality credits with over 92% of the market rated AAA
 - Incremental yield to comparable securities such as commercial paper and money market funds
 - Taxable, tax advantaged and tax exempt investment options

43. A triple-A rating is a long term credit rating.

44. The AAA rating on Merrill Lynch's ARS do not speak to an investor's ability to liquidate the instrument through auction at par.

45. A number of the CDO-backed and other auction rate securities underwritten and offered by Merrill Lynch carried the AAA rating from major rating agencies.

46. In August 2007, as described below, Merrill ceased supporting the auctions of a number of its triple-A rated auction rate securities.

47. Those securities became illiquid and subsequently lost most of their market value.

48. Despite the fact that Merrill had failed a number of triple-A auction-rate securities in August 2007, subsequent to August 2007, Merrill continued to use the AAA rating as a selling point for auction rate securities.

49. For example, a marketing presentation called Auction Market Securities dated September 25, 2007, prepared by Constable, referred to closed end auction market preferred shares as “generally rated AAA with very few exceptions”. With respect to municipal auction market debt, it states, “Majority of issues are rated AAA based on a financial guarantee provided by a AAA insurer.” With respect to Student Loan Backed Auction Market debt, it states, “Ratings primarily AAA (excluding subordinated tranches)”.

50. In her testimony before the Division, Constable confirmed that triple-A ratings were an important selling point for these securities.

51. Merrill Lynch was aware—yet did not disclose to investors--that certain auction rate securities retained their triple-A rating after their auctions had failed.

52. Merrill Lynch was aware—yet did not disclose to investors--that the triple-A rating did not provide protection against Merrill deciding to no longer support its auction program.

53. Nonetheless, Merrill Lynch relied heavily on the triple-A rating to convince investors the auction rate securities it was selling were safe and principal protected.

54. At one point, in an email dated August 17, 2007, Constable stated that they were “Drumming up rating agency report machine in support of the industry.” (See Exhibit 4)

3. Massachusetts Merrill Lynch Customers Impacted By The Firm’s Decision To No Longer Broadly Support Its Auction Rate Business.

55. The Division alleges that many Massachusetts clients of Merrill Lynch have been negatively impacted by the Firm’s decision to no longer broadly support its auction rate business. The following investors are examples of that class of victims.

a. Client A

56. Client A called the Division after Merrill Lynch had ceased supporting its auction rate program.

57. Client A had invested with the Karabelas/Sherman office of Merrill Lynch located in Newton, MA.

58. Prior to investing Client A informed his financial advisors of the temporary nature of his investments, as the funds would be needed as capital for Client A’s real estate investment enterprise.

59. Client A informed his advisors that yield on the investment was of secondary importance to having the principal available for investment when requested.

60. In response to Client A's concerns, Merrill Lynch informed Client A that the instruments he was investing in were liquid and safe, and that his funds would be available upon seven days request.

61. No risks of auction rate securities generally or the particular auction rate securities sold to Client A were made to Client A prior to his purchase of those auction rate securities.

62. Based upon his advisor's representations between December 28, 2007 and January 15, 2008 Client A invested \$903,263.00 with Merrill Lynch, \$900,000.00 of which was invested in auction rate securities.

63. On or about February 20, 2008, Client A requested that \$850,000.00 be returned to him, and was subsequently informed by Merrill Lynch that his funds were no longer liquid and he could not access his money.

64. Client A has informed the Division that his business is suffering severe hardship due to missed opportunities from having its money being locked up in auction rate securities.

65. On Client A's June 30, 2008 statement, Merrill Lynch had still listed the "estimated market value" as 100 percent of the par value of the securities.

b. Client B

66. Client B called the Division after Merrill had ceased supporting its auction rate program.

67. Client B approached Merrill Lynch in March of 2007 looking to invest the proceeds from the sale of his house.

68. Prior to investing Client B informed his FA of the temporary nature of his investments, as the funds would be needed to finance the construction of a home in Massachusetts.

69. Client B's financial advisor recommended ARS, describing them as just like money market instruments, were AAA rated, liquid, and safe, and he would just have to wait 7 to 28 days to access his money, and in return could get a higher yield on his investment.

70. In testimony before the Division, Client B's FA testified that he did not discuss the liquidity risks of ARS with Client B.

71. Client B's FA further testified that he did not ever discuss the possibility that Merrill Lynch might cease to support the auctions.

72. Based upon his advisor's representations Client B invested 1,200,000.00 in ARS with Merrill Lynch.

73. Between March 2007 and February 2008, Client B liquidated \$400,000 of his ARS holdings to finance construction of his house. On February 12, 2008, Client B was no longer able to access his funds, and was forced to sell stocks to finance his house.

74. In late May and early June 2008, \$250,000.00 worth of Client B's ARS were redeemed by the issuer.

75. Client B still holds \$550,000.00 of ARS which he can not liquidate. On his April 31, 2008, statement, Merrill Lynch still listed his ARS holdings at par.

76. Client B was never told that an auction was what created liquidity for the products.

77. Client B was never told that Merrill's participation in the auctions had previously prevented the auctions from failing.

78. Client B was never told of the possibility of an auction failure, and its implications including loss of liquidity, and the possibility of principal loss.

c. Client C

79. Client C, a Massachusetts resident, maintains a Merrill Lynch brokerage account for the purpose of personal investment.

80. Client C sought a safe place for thirty percent of his investment assets.

81. Client C and his Merrill Lynch FA discussed Money-Markets and Certificate of Deposits as possible investments.

82. Client C's Merrill Lynch FA suggested that he consider placing the money in instruments that he described as being as safe as a Certificate of Deposit.

83. Client C's Merrill Lynch FA did not advise Client C of the existence of any disclosure documents nor did he advise Client C to read any disclosure documents prior to considering the instruments.

84. In reliance upon his Merrill Lynch FA's recommendation and representations about the instruments, Client C purchased ARS in November 2007.

85. The instruments Client C purchased were not described as ARS.

86. Client C was never told that an auction was what created liquidity for the products.

87. Client C was never told that Merrill's participation in the auctions had previously prevented the auctions from failing.

88. Client C was never told about the implications of an auction failure including the default rates that the products would pay, the risk of illiquidity and the possibility of principal loss.

89. Following the auction failures in mid February of 2008, Client C has only been able to liquidate half of his ARS.

d. Client D

90. Client D, a Massachusetts corporation, maintains a Merrill Lynch brokerage account for the purpose of holding working capital.

91. Client D is a start up company that is concentrating on developing and marketing plastics technology.

92. Client D sought a safe place to keep the entirety of the remaining money that had been raised from shareholders that the company was using as working capital.

93. Client D informed their Merrill Lynch FA that this was the entirety of their working capital, that it needed to be in a safe investment and that they needed to be able to access it regularly to handle day to day operations expenses.

94. Client D's Merrill Lynch FA advised Client D to consider a product that he described as being liquid every seven or thirty days, that had no risk and that had a AAA credit rating.

95. In testimony before the Division, Client D's FA testified that he did not discuss the liquidity risks of ARS with Client D.

96. Client D's Merrill Lynch FA did not advise Client D of the existence of any disclosure documents nor did he advise Client D to read any disclosure documents prior to considering the instruments.

97. In reliance upon the FA's recommendation and representations about the instrument, Client D instructed the FA to purchase the instruments which were ARS for their account in February 2007.

98. The instruments Client D purchased were not described to Client D as auction rate securities.

99. Client D was never told that an auction was what created liquidity for the products.

100. Client D was never told that Merrill's participation in the auctions had previously prevented the auctions from failing.

101. Client D was never told about the implications of an auction failure including the default rates that the products would pay, the risk of illiquidity and the possibility of principal loss.

102. Upon information and belief, following the auction failures in mid February of 2008, Client D has been able to liquidate less than half of their auction rate securities.

C. Merrill Lynch's Auction Rate Securities Program Stands in Contrast to its Representations to Customers.

1. Merrill Lynch's Auction Rate Program Provided Issuers with Inexpensive Financing and Generated Substantial Fees for Merrill Lynch.

103. Merrill Lynch's ARS program was funded by issuers of ARS, who paid Merrill Lynch fees to underwrite securities and remarket them.

104. The ARS market allowed issuers to achieve long-term financing at short term rates.

105. The Merrill Lynch ARS program had four branches, an investment bank which underwrote ARS, the ARS desk which acted as a remarketing agent for the securities, a sales force which sold ARS to retail and other clients, and a research division which assisted the ARS desk in placing ARS.

106. The ARS which Merrill Lynch underwrote then sold to its clients consisted of APS, with perpetual maturity, with dividends that reset every 7 to 35 days at auction, or long-term debt instruments, issued by municipalities and student loan organizations with maturities of 20-40 years with interest rates that reset through the same process.

107. Due to the upward sloping yield curve, issuers of long-term instruments would typically have to pay higher interest rates.

108. By supporting the auction mechanism, both in its role as a remarketing agent and by purchasing ARS at auction to avoid failures, Merrill Lynch allowed issuers to have long-term financing at short-term rates.

109. Purchasers of ARS were willing to accept short term rates because they believed they would have access to their principal on short term notice at the next auction, and they would get a slightly higher rate than a money market fund because they would have to wait till the next auction to access their money.

110. This belief was cultivated by Merrill Lynch and other broker dealers who used their own capital to ensure auctions did not fail, and generally touted the 20 year track record of very rare failures, and creating the impression with investors that there was a deep liquid market for the securities.

111. Due to the practice of Merrill Lynch and other broker dealers of placing support bids, for the 20 years prior to August of 2007 there had been only a handful of failed auctions which prevented investors from accessing their principal.

2. Merrill Lynch Generated Significant Fees by Underwriting Auction Rate Securities with Constrictive Maximum Rates and Selling them to Clients.

a. Merrill Lynch Generated Significant Fees Underwriting Auction Rate Securities and Distributing Them To Clients.

112. The investment bank at Merrill Lynch generated significant fees from underwriting new issuances of ARS. From 2001 through 2008 Merrill Lynch underwrote approximately \$13 billion of APS, earning \$130 million of underwriting fees.

113. As of the end of January 2008, Merrill Lynch had the largest APS of any brokerage, acting as lead manager on \$24.63 billion, or 42% of the total market. (See, Exhibit 5)

114. The investment bank typically received a fee of one percent of the issuance to initial distribute shares through its network of FAs to clients of Merrill Lynch.

115. For the years 2006-2007, Merrill Lynch reaped approximately \$90 Million dollars in profits from its ARS business.

116. In order to help move new issues Merrill Lynch awarded FAs who placed new ARS issues with a placement credits.

117. During the underwriting process Merrill Lynch would work with issuers to structure the terms of the instrument, often in consultation with the ARS desk.

b. Merrill Lynch Underwrote Auction Rate Securities With Restrictive Maximum Rates, Which Allowed The Securities To Achieve AAA Ratings.

118. Upon information and belief 92% of the auction rate securities which Merrill Lynch underwrote received a AAA rating from rating agencies such as Fitch and Moodys, and 97% had ratings of AA or better.

119. Merrill Lynch's witness with the most knowledge of its investment banking program relative to underwriting auction rate preferred shares from closed end funds was not aware of a single instance where Merrill Lynch declined to underwrite an APS based on the maximum rate.

120. AAA ratings from agencies such as Fitch and Moodys signify the rating agencies assessment that there is a high likelihood that the security will pay interest or dividends as well as principal when due in a timely manner.

121. Rating agencies such as Fitch and Moodys evaluate an entity's assets and liabilities to determine its ability to make payments as proscribed.

122. Maximum rate provisions place a ceiling on the rate of interest at which an auction can clear, and additionally provide the rate the issuer must pay should auctions fail.

123. When evaluating whether an issuer could make payments as due on its ARS, rating agencies would look at the terms of the instrument to determine how much interest it may be obligated to pay. The maximum rate places an absolute cap on the interest or dividend the instrument will pay, restricting its potential obligations, therefore making it easier for the instrument to achieve a AAA rating.

124. Since ARS are traded at par at auction, the yield on the instruments can only be adjusted through the interest or dividend rate.

125. The maximum interest rate which was built into ARS, to allow them to achieve AAA ratings, also placed an absolute cap on the instrument's yield at auction.

126. Once Merrill Lynch stopped placing support bids in the auctions for which it was the lead broker dealer, there were auction failures across its program.

127. When auctions fail the rate resets to the maximum rate.

128. The ARS with high maximum rates, typically Municipal ARCS with maximum rates in the range of 12-15%, have drawn investor interest and have cleared without Merrill Lynch's support.

129. The ARS with low maximum rates, typically taxable and tax exempt APS with maximum rates in the range of 3-5%, have not drawn investor interest and without Merrill Lynch's support have continued to fail, leaving investors with illiquid instruments.

c. Merrill Lynch Additionally Received Fees To Remarket The Auction Rate Securities It Underwrote.

130. When Merrill Lynch underwrote an issue of ARS it typically served as the broker dealer or remarketing agent for the issue.

131. Merrill Lynch would typically receive a fee of 25 basis points of the value of the ARS for which it acted as remarketing agent.

132. Merrill Lynch would share a portion of this fee with FAs in order to incentivize them to place clients into ARS.

133. Prior to every auction for which Merrill Lynch was the sole or lead broker-dealer, Merrill Lynch would provide “price talk,” a range of bids provided to FAs indicating where Merrill Lynch expected auctions to clear.

134. All ARS for which Merrill Lynch acted as sole broker-dealer were placed through Merrill Lynch FAs.

135. Under Merrill Lynch’s ARS program, as remarketing agent the ARS desk had the option but not the obligation to bid in auctions.

136. Until August of 2007 Merrill Lynch had a policy of placing support bids into every auction for which it was sole or lead broker dealer.

137. In August of 2007 Merrill Lynch withdrew its support for certain CDO backed ARS.

138. When placing a support bid, Merrill Lynch would bid for the entire notional value of the issue being auctioned, regardless of the size or volume of buy, sell or hold orders Merrill Lynch had received.

139. Merrill Lynch’s support bids were sometimes entered on a tiered rate structure.

140. The ARS desk would determine what quantities to bid at what rates based on an assessment of its ability to turn around and sell the ARS it purchased off inventory between auctions.

141. By placing support bids for the entire notional value of the issue being auctioned Merrill Lynch ensured that no auctions in its ARS program would fail.

142. Merrill Lynch often set the rate at which the auctions would clear with its support bids.

143. For the period of January 3, 2006 through May 27, 2008, 5892 auctions for which Merrill Lynch was the sole lead dealer would have failed but for Merrill Lynch's support bid.

144. Investors were not provided with the volume of shares which moved at auction.

145. Investors were not provided with information about the level of support from Merrill Lynch which was required to clear the auction.

146. Investors were not informed of how many ARS Merrill Lynch was carrying on its own inventory as a result of supporting auctions.

D. Auction Rate Securities Inventory Concerns At Merrill Lynch

1. Weakness in the Credit Markets Initiated Inventory Concerns In Summer Of 2007.

147. Beginning in late July 2007, certain negative market influences surrounding collateralized debt obligations ("CDOs") and collateralized loan obligations ("CLOs") and a credit crunch began to negatively impact Merrill Lynch's auction market business.

148. As investors began selling these ARS due to concerns about their credit quality (despite the fact that many were triple-A rated), Merrill Lynch purchased ARS into its own inventory to make sure those auctions did not fail.

149. At a certain point, Merrill Lynch decided to limit the amount of inventory of these instruments it was taking on and ceased submitting support bids, thus allowing the auctions to fail.

150. Merrill Lynch FAs began to seek answers to questions concerning ARS as early as August 7, 2007.

151. FAs from all over the United States sent emails and made telephone calls to request information from the Global Markets & Investment Banking staff managing the Merrill Lynch Auction Trading Desk.

152. Initial questions from FAs arose from the failure of auctions for 2 CDO issues.

153. FA, James Fletcher of Las Cruces, NM expressed concerns about how his clients would react to the Martin Mauro research note on VRDOs of August 21, 2007. He asked Constable on August 22, 2007, “If there is other information out there to educate them it would be helpful.” (See Exhibit 6)

154. FA Terri Ucci of Chicago, IL asked Constable about the “disconnect” in the “current yields” and requested that the Auction Desk “share the rationale behind the dislocation” to handle “uncertainty w/ clients.” (See Exhibit 7)

155. Some of these emails were relayed from the Global Bank Group to Constable on the Auction Desk. “Hi Frances- I’m getting a few of these types of questions from FAs. Do you want to give me some talking points so I can try to answer them? I’m sure you guys are getting inundated on the desk.” (See Exhibit 8)

156. On August 21, 2007, Constable emailed Tina Singh in the Financial Products Group to request a list of individuals “within Steve Bodurtha/Mitch Cox’s world” to include on daily axe sheets. Constable wanted, “to make sure that we have covered everyone that speaks to GPC FAs and investors about the intrinsic value and stability of auction market securities, particularly now when rates are high and **investors are *freaking out*.**” (See Exhibit 9) (Emphasis added)

157. The Auction Desk and the Financial Products Group, along with several of the supposedly independent research analysts for closed-end funds and Fixed Income/Cash, organized and participated in Sales Calls during the second and third week of August 2007 in an effort to clear auctions, reduce the rates of important issuers, and maintain a strong interest in ARS among the Merrill Lynch FAs all over the country.

158. By August 21, 2007, “inventory creep” (as a result of Merrill Lynch having to submit more and more support bids to prevent auction failures) was a major concern for Constable. She wrote that evening to Price and Auction Desk trading staff members, Robert Tomeny, Jim Brewer, Derek Sin, and Keith Raymond that –

we have had a more robust round of selling across the entire spectrum of product.....To attempt to combat inventory creep and to encourage greater retail participation and the attraction of new buyers in our market, I have meetings planned with Mark Berry and the institutional sales force tomorrow at 7:15 to push the closed end funds and student loans.....We have scheduled a meeting with GPC [Global Private Client] National Sales for next Wednesday to discuss the cash alternatives that investors should consider to be the gold standard versus T-Bills. We simply need to buy time to get new buyers encouraged.

(See Exhibit 10)

159. Serious concerns are evident even as early as August 13, 2007, when Constable wrote to Price, Jeff Schultz, COO FICC, and Phyllis Vecchione, in the Office of General Counsel, to “put out a request to CDO Structuring and Origination to provide us with whatever resources we require on CDO auction tranches that become illiquid through failed auctions.” (See Exhibit 11)

2. Merrill Lynch's Auction Desk and the Auction Market Became Hypersensitive To Negative News or Announcements Concerning The Credit Crunch And Tightening Liquidity.

160. Negative headlines concerning sub-prime mortgage concerns, asset backed securities, CDOs and CLOs caused great anxiety for Constable and Merrill Lynch's Auction Desk and were treated as though each and every story alone could topple the auction market.

161. For instance, in September 2007, the Auction Desk was forwarded an email from a Merrill Lynch FA who received a worried email inquiry from a customer. The customer had attached a copy of a recent investor alert announcement issued by SVB Asset Management, which was issued to advise investors of "emerging issues in the ARS marketplace." The notice spoke of volatility in the auction market over the past few weeks, recent "failed auctions," as well as "challenges stemming from a lack of market liquidity." (See Exhibit 12)

162. Auction Desk trader, Derek Sin, forwarded the email to auction desk personnel with the statement "HERE WE GO ...IT BEGINS... Constable forwarded the email chain to Conery stating: "SVB back in our face!!! Can Capital Advisors be far behind?" (Id.)

163. Constable's response was apparently in reference to Lance Pan, a Director of Credit Research with Capital Advisors Group, and known ARS critic, who had previously published a report that, among other things, detailed liquidity risks of ARS in cash portfolios in 2005.

164. The risks highlighted by Capital Advisors Group and SVB Asset Management were eerily similar to the kinds of risk the auction market would actually

experience in the months and days immediately preceding Merrill Lynch's decision to pull out of the auction market.

165. Interestingly, Conery, Merrill Lynch's own Research Analyst, who is supposed to be objective, replied to Constable: "I think this [memo by SVB Asset Management] could have been worse, say ala Lance Pan. Actually, I have been pleasantly surprised the media has never covered this." (Id.)

3. Communications With Issuers And Others Expressing Concern About The Auction Markets.

166. As early as August 3, 2007, senior management of Merrill Lynch was requesting a sample term sheet for AMPS to understand the liquidity and downgrade risk. (See Exhibit 13)

167. In August 2007, representatives from major issuers in the closed-end fund investment world were also trying to get a sense of the risks and demand reductions for their preferred shares.

168. On August 14, a representative of Aberdeen Asset Management, a significant closed-end fund manager, wrote to Constable asking whether there was sufficient demand for a successful auction "given the recent market volatility."

169. While working vigorously throughout August 2007 to maintain confidence in the AMPS product among the army of Merrill Lynch FAs, on August 14, Constable responded to the Aberdeen representative that he should feel free to call "for a full blown discussion of liquidity events in our market and around the room."

170. None of these growing risks concerning weak demand in the ARS market were disclosed to Merrill Lynch clients during the third quarter of 2007.

171. On August 16, referring to the Auction Trading Desk, Constable wrote an email to Jill Katz-Schildkraut of IBK-NY, about the state of the markets for ARS:

Come on down and visit us in the vomitorium!! Thanks for the piece though [referring to Fitch Comments concerning monocline soft capital facilities]. We will be sure to provide it to all those holders who, according to the article, are likely to get caught up in this latest round of likely “fails.” Ouch.

(See, Exhibit 14)

172. The previous week, on August 9, Constable emailed another person: “Markets are shutting down bit by bit. We have 5 failed auctions so far, with three more likely today.”

173. Constable was consistent in advising the IBK people to hold off on new issues for the closed-end fund companies. She understood that the auction markets did not need new supply.

174. On August 20, she wrote to Marjoleine Slappendel, “Before we commit to any new business, lets give people the bad news about the choppiness in the market and urge a bit of a wait and see to gauge ongoing market appetite.” (See Exhibit 15)

175. Constable was reminded by Doug Mellert on August 15 that he “understood the necessity to move product.”

176. Randolph B. Randolph of Merrill Lynch Debt Capital Markets (GMI – CAPMKTS) reported heightened concerns from “John and Fred” at MBIA on August 13: “They are obviously concerned about a failed auction and the ramifications thereof – They see a program failure as having potential franchise ramifications.” (See Exhibit 16)

177. Upon information and belief, Merrill Lynch began, in late 2007, discussing with issuers, including the Commonwealth of Massachusetts, concerns with the auction markets.

178. By November, Merrill Lynch's Municipal Banking group began sounding the alarm with the Health Care Finance group and with Constable.

179. Edward Malmstrom on November 28 reported to John Lawlor, Edward Curland, Kenneth Vallrugo and Constable that:

At the end of this email chain you will see a message from Ken Kaufman, one of the most important FAs in our industry, that word is out that we are not supporting our auction programs. We have to be competitive or we will lose our best clients and put at risk a very profitable health care franchise.

(See Exhibit 17)

180. Curland responded: "We just have to sit down and figure out the B/S cost of doing business and make sure the client will provide sufficient revenue opportunities." (See Exhibit 17)

181. Vallrugo of Health Care Finance sought to organize a meeting "as sooner is better is later.....we are getting a real beating from the FAs and clients." Constable informed this group that they could meet "Right after I get the risk police the info they need to keep us in biz....." (See Exhibit 17)

182. Earlier in November, on the 6th, Constable reported to Price and a large group from GMI – NYMUNI that,

we anticipate further fallout and cant predict what investor behavior might be to the ongoing negative noise. We are obviously very committed to the markets and are doing what we think will help to preserve the markets in what is a prudent defensive posture. Nonchalantly waiving in

additional supply [referring to new issues] seems cavalier at best.

(See Exhibit 18)

4. Merrill Lynch Surpasses Its Inventory Limit In September 2007, As ARS Market Conditions Worsened.

183. In late September, inventory levels rose significantly and the Auction Desk was fast approaching its limit of \$1 billion dollars. In a September 27, 2007 email to John Price, Constable noted: “We are shoveling as fast as we can... Net, net. I think we should be viewed as under our 1bn target, albeit with a few asterisk.” (See Exhibit 19)

184. Market conditions continued to worsen for ARS in November. On November 19, 2007, Price confided in one personal email,

Thanks...Will call later. Market is collapsing. No more \$2k dinners at CRU!! The Financials are being invicerated! (sic) More firings over at Citi...Inventory flooding the street. Going to be a great '08 trading environment. All we have to do is live!!

(See Exhibit 20)

185. On November 19, 2007, Constable emailed Price with the following:

AMS desk barraged by issuers asking why their rates are climbing as well as investors expressing concern about muni [guaranteed] by monolines. Negative tone prevails. Inventory up by 100MM. We are offering discounts as well as 25 and 50 bp credit specials in an effort to move inventory.

(See Exhibit 21)

186. Constable summarized the inventory as surpassing the \$2.32 billion dollars overall. Price responded: ‘Thank you...**we need to get smaller unfortunately – using any means possible. Please keep up the outstanding efforts.**’ (See Exhibit 21)

187. On November 21, 2007, Constable emailed Price and others and reported the extremely difficult time the Auction Desk had in successfully conducting the auctions for the day. Constable's email provided:

Auction Market inventory at [close of business] 11/21/2007 was reflective of a double auction day when the market conducted over 1400 auctions, **a scarcity of investors** to snap up cheaply priced inventory **and the ongoing negative perception of securities that populate the auction market** and the behavior of the dealer participants. Any combination of a negative Bloomberg article about auction illiquidity, the ongoing downdraft of press about the monoline insurers that guarantee the entire municipal space in our market, equity prices of the dealer community and the GSEs undergoing a death spiral undermining retail investors confidence in our ability to support the auction business and two times the number of daily auctions might have been deadly but we got them all today. The most positive thing that can be said is that we did not fail the two DRD repacks we sole manage for GS and MER today, albeit, we went long roughly half of each...."

One recipient of the email acknowledged the obvious with this comment, "Thank you Frances. A Herculean effort..."

(See Exhibit 22)

188. On November 26, 2007, Constable updated Price as to inventory levels and noting that the auction desk continued to see investor selling and that rates had reset between 4.00% and 4.25%, versus SIFMA index of 3.58%. Price responded by asking whether it was possible to "cheapen the levels close to the fail rates to clear more product?" to which Constable replied:

That would be too scary, as the fail rates are generally 12%. We are working it higher to at least be consistent with where we have T.E. closed end funds. The gloves are off and we are not concerned about issuer perception of [Merrill Lynch's] abilities and the competition. Gotta Move these microwave ovens.!!

(See Exhibit 23)

189. On December 4, 2007, Price emailed NY Corporate and CDS Trading with the following email:

TRADING – WE NEED TO REDUCE BALANCE SHEET INTO YEAR END. THE DESK IS OVER IT'S (sic) TARGET BY \$3BLN AND WE NEED TO GET DOWN. PLEASE EXAMINE CRFF AS IT HAS BECOME TOO LARGE.

(See Exhibit 24)

190. On December 11, 2007, Constable emailed Price and others,

Muni inventory at \$1.209 Bn of the above, and over the limit....Lots of individual selling across the books today as well. Took in nearly \$46MM of AAA rated 49 day DRD closed end fund for DN allowing it to set at 6.50%. Crazy cheap for this bellweather DRD auction. FFELP backed student loan paper rated AAA traded in the auction today at 1M Libor+140. Makes no sense. Where is the smart institutional money? Anyone have any idea how to engage GMI sales? We are conducting a GWM national sales call tomorrow....

(See Exhibit 25)

191. On December 19, 2007, Price updated upper management, including David Sobotka (Senior Vice President, Head of Fixed Income Currency and Commodities Group (“FICC”)), Scott Brown (FICC Principal) and cc: to Jeff Schulz (FICC COO) regarding inventory levels (and later forwarded a power point presentation and a copy of the email to Ming Lee (Market Risk Management)). In the email, Price provided the following initial commentary:

Attached please find an AMPS presentation that was prepared earlier this month. **Please be aware that the contagion that has engulfed all has been especially harsh on the AMPS product. Previously it was a business that used very little Balance Sheet with a high**

ROA...Inventory higher yesterday. Fighting hard to get it down, Munis \$1.3 bln, AMPS \$1.8 bln.

(See Exhibit 26) (Emphasis added)

192. In addition, Merrill Lynch had certain lenders which provided financing for its inventory of auction rate securities.

193. Those lenders had previously accepted auction rate securities as collateral for the loans.

194. In the Fall of 2007, certain of these lenders became uncomfortable with the liquidity of auction rate securities and ceased accepting them as collateral.

195. Specifically, in an email dated November 16, 2007 from Constable to Price, titled "Auction Market Inventory at COB 11/1/07 and Prospects for Repo," states in relevant part:

Several years ago, I worked with Mike Johnson (Global repo COO) to set up a Tri-party repo facility for our AAA rated taxable book, which we bifurcated into the debt repo schedule and equity repo schedule, due to the nature of our book containing both AAA rated notes (student loan and other structured) and AAA preferred shares of closed end funds. Repo customers could choose to accept either or both as collateral and for years our entire AAA taxable book was being funded at roughly FF+7-8. With the turbulence in the auction markets over the summer, most of those investors have moved to the sidelines. Our book is currently being partially financed through the MLPA general collateral pool where last night \$373MM was financed at Libor flat.

(See Exhibit 27)

196. When asked about that email, Price testified, in relevant part: "I believe that with the turbulence of the investors that would have accepted action and other collateral were moving to the sidelines."

197. Constable confirmed in her testimony that at least one of the providers of financing of Merrill Lynch's inventory ceased accepting auction rate securities as collateral.

198. In an email dated December 4, 2007 from Constable to Derek Sin responding to issues that the financiers of Merrill's inventory had, Constable suggested, in order to make the auction rate inventory more palatable, that "We will extract any issues that have failed in the auctions, even though they are still rated AAA or AA." (See Exhibit 28)

199. Merrill did not inform its retail and other customers, to whom it was marketing auction rate securities as principal protected cash-like instruments, that entities that financed its inventory no longer accepted certain auction rate securities (even some rated AAA) as collateral.

E. Merrill Lynch's Consolidated Effort to Reduce Inventory – A Three Pronged Approach.

1. Calming Fears, Providing Assurances And Motivating Additional Sales Of Auction Rate Securities Through Sales Calls with FAs.

200. Just after the first hint of investor concern with the auction market, the Auction Desk and Sales and Trading immediately mobilized to stem the tide of negative news. Constable and other managers moved quickly to set up sales calls to provide assurances to FAs and to motivate future sales of ARS.

201. The sales calls were successful. In an email to Price on the evening of August 15, 2007, in a report, titled, "[B]eware the Ides of August," Constable tracked the pending inventory and added this comment:

Noteworthy: Didn't hear of any failed auctions today.
WHEW!! Retail salesforce comforted with my brief call

on GPC National sales call at noon and in depth discussion and Q&A on the auction markets with Kevin Conery and Jon Maier.

(See Exhibit 29)

202. In the Q&A call conducted on August 15, 2007, which was very well attended with over 200 listeners, Conery stated that the, “turmoil, confusion, [and] fear in the auction market” should be viewed “ultimately as a positive, especially for the [Global Private Client] system...and “that we view it as a an opportunity.” Conery further advised FAs, “[a]nd we suggest that you take advantage of this to the extent you can.”

203. In responding to a question from an FA regarding how Merrill Lynch’s “inventory was reacting” to the recent turmoil in the auction market, Conery said, that while he thought that was a better question for the Auction Desk, he also stated: “In fact, in times like these, that inventory is higher. My understanding is... they got a larger...commitment from the powers that be here...”

204. late November, upper management and risk management reviewed the Auction Desk’s growing inventory and implemented a reduction plan, referred to as a “Balance Sheet Initiative.”

205. On November 30, 2007, in response to Director of Municipal Marketing, Thomas J. Murray’s (“Murray”) suggestion to have a National Sales conduct a conference call to assist the Auction Desk in selling ARS and suggesting offering the services of Research and the Auction Desk to assist. Constable responded:

I just dislocated my shoulder raising my arm to volunteer!!! Thanks for putting this out to Chris [Dupuy] and Brian. We had such a national call back in August with Marty [Mauro] and Mona at the onset of the ‘crisis’

and it was backed up with fresh research and was well received. We saw almost instantaneous improvement in our trading levels and a commensurate reduction in inventory. It is **critical for the sales force to know that management is behind these products as they represent the best products for bringing new cash into the firm.**

(See Exhibit 30) (Emphasis added).

206. In late November and early December, with inventory backing up and reaching new highs at Merrill Lynch, a decision was made to do another national sales call. The formula would be similar to the successful call made previously in August. Auction Desk personnel would be joined by a member or members of the Research Department to reassure and motivate FAs to concentrate on selling Auction Desk inventory.

207. In the December 12, national sales call, Constable and Conery were joined on the call with Murray, the Director of Municipal Marketing. A transcript of the call revealed that Murray said he asked the National Sales Director, Chris Dupuy, for some time on the call to address “an awful lot of cross current out there in the marketplace” and that there was “nobody better to speak to it than Marty [Mauro] and Kevin [Conery] on this.”

208. Murray continued: “The other part is that there are some opportunities that grow out of what have been some severe dislocations really since August and magnified by year end pressures.”

209. After mentioning that the inventory positions of Merrill Lynch were “larger than normal,” Murray stated, “**Anything that is being mentioned here is really because there’s a real opportunity here. Nothing is being suggested with the**

idea of a fire-sale-type approach. The idea is because it's good for the customer."

(Emphasis added).

210. Conery's comments consisted of soft pedaling the weakness of the ARS market by failing to point out any negative points relative to liquidity that Research knew was occurring. Instead, Conery stated that the pressure on the Auction Market since August combined with seasonal year end spike in rates... "have made things that were already attractive even more attractive."

211. Conery emphasized that Closed End Funds had been Research's top choice since August. Conery called the CEF ARS sector, "the conservative's conservative investment in the auction market."

212. Constable was on the call to speak about "a couple of specific opportunities in the auction area." Her comments consisted of:

I just want to give you a couple of quick bullet points, point out some relative value, and **then reassure everyone that we are working in concert with research to provide the best ideas and to give assurance as to the solidity and ongoing endurance of some terrific markets.**

(Emphasis added)

213. Constable referenced a slide presentation that was provided to all the call participants, "give[s] you some background and should help you present to your sales force in the offices there of why **these should be considered a great cash management gathering tool.**"

214. During the call, Constable noted that corporations at year end "sort of... maybe [are] stepping to the sidelines or maybe are taking their existing cash and

looking for opportunities, so this is the time to encourage them to come in because rates have never been more attractive.”

215. Constable reminded listeners during the call, “[w]e have research supporting our recommendations and the value of this marketplace, so you should feel very confident that this is a great place to put your investors at this time.”

216. During the call, there was no discussion regarding the risk of any type of auction failure, or the likelihood or possibility that any market dislocation could result in retail customers’ cash becoming illiquid.

217. Moreover, there was no discussion about the possibility that Merrill Lynch could decide at any time to stop its support of the auction market or to otherwise withdraw from supporting the auctions that it sole managed or co-managed.

218. There was no mention of the fact that with the pressures that existed in the credit market since August 2007, any auction failure by any auction dealer could spread contagion to the rest of the market.

219. Instead, Conery and Mauro’s comments were muted, in concert with the wishes of management, to minimize or eliminate any risk associated with ARS, and instead focus only on the positives to assist in management’s organized sales campaign to reduce Merrill’s inventory position and reduce Merrill’s risk of loss in the event of further market dislocation.

220. The effect of the call simply reinforced Constable’s intent to communicate to the sales force “that management was fully behind these products.” Further, that management sought to induce the sales staff to rely on management’s

representation that Merrill's auction market was a safe place for FAs to recommend clients with cash management needs.

2. FA Incentives - Increased Production Credits Sales Drive.

221. At various times during the second half of 2007, Merrill Lynch provided incentives in the form of enhanced production credits as a means of motivating FAs to sell ARS to customers and reduce Merrill Lynch's inventory. Typically, FAs earned 12.5 bps on an annualized basis for investments in ARS. FAs would then earn a percentage of the 12.5 bps according to a payout grid.

222. During periods where enhanced credits were awarded, FAs could earn as much as 8 times that amount (or 100 bps) for sales of ARS. Other enhanced payouts could include payouts of 25 bps, or 50 bps. Similar to regular production credits earned, FAs enhanced production credits would be applied to the grid resulting in FAs being paid a certain pre-determined percentage of the enhanced production credit.

223. Enhanced production credits reportedly would apply only to the initial auction period and would automatically reset to the default 12.5 bps at the next auction cycle.

224. The use of enhanced production credits as a means of motivating FAs to sell ARS was not universally accepted at Merrill Lynch. A September 27, 2007 email from Constable to Price included a discussion surrounding the practice and highlighted Merrill Lynch's internal debate over whether such incentives should have been used.

Constable expressed the importance of using ARS inventory to Price:

We are of course being criticized for our 25, 50 and 100 bp extra pcs. Stu Wexler came around with the text of an email that he wants to send out to all Fas which I am convinced would be our **death knell** if it goes out. We

need to sit down before anything else is sent and determine what part of our market is bullet proof and beyond the scope of any type of failure, which should be the bulk of what we trade and decide if it is so unsuitable for us to use sales credits as incentives. I am near the end of my rope on this line of thinking.

(See Exhibit 19)(Emphasis added)

225. On November 21, 2007, Mitch Cox, of Merrill Lynch's Financial Products Group, sent an email to Price, among others, and instructed, in part, "[w]hile GMI has offered to increase PCs on VRP production, I do not think that such an increase will be necessary (or advisable) at this time." Cox offered to revisit the issue in the new year "when our forecast is more conducive to a broader floating rate marketing initiative."

(See Exhibit 31)

226. Price forwarded the Cox email to Constable with the instructions to, "[p]lease take off the incremental PC's we have added until we get the go ahead to add them..." Constable replied,

"We will offer 25 bp which is still incremental but in line with our significant growth in inventory today as a result of the double auctions due to Thanksgiving. Derek [Sin] will resend the email without any specific mention of additional PCs, although the 25 bp will be in the PC column."

(See Exhibit 31)

227. In her testimony before the Division, Constable testified that no final decision was made as to whether enhanced production credits should be discontinued and that the practice continued production credits were "adjusted as we saw fit."

228. Constable's conclusion was that offering of enhanced production credits for sales of ARS was a valuable tool in motivating sales because it kept FAs focused on the product.

3. Coordination with Research

a. Proactive Involvement From The Supposedly Independent Research Department To Aid In Sales Efforts.

229. Merrill Lynch's Research Department played a pivotal role in assisting sales of Auction Rate Securities.

230. On at least two occasions during the Fall of 2007, Sales and Trading and the Auction Desk made direct and specific requests for the Research Department to draft favorable research pieces regarding the auction market to assist in Sales.

231. On August 14, 2007, William Kubeck, a Manager in the Financial Products Group made a request to Fran Faulkner in Research, for some research to be written to assist in a sales effort. Kubeck noted:

Calls are helpful, however, attendance is usually not great. **Something published instead of or in addition to a call would have a better impact.** Perhaps this could be released as a special edition Fixed Income Digest report outlining current events as they relate to this market and what FAs should be telling clients.

(See Exhibit 32) (Emphasis added)

232. On August 20, 2007, Auction Desk employee, Robert Tomeny, made a direct request via email to Conery for research regarding certain auction rate securities that had auction failures. He asked Conery, "[a]ny chance you guys can update that old Centaur research piece Bess and Stuart Rosmiller published to include the auction

rate series.” Tomeny wanted to have something he “could send out to auction investors that describe[d] the structure in its entirety.”

233. On November 30, 2007, Constable emailed Mauro in Research and updated him as to the lack of confidence existing in the auction market and then directly requested and suggested a positive research piece she wanted published. The communication stated:

As you know, rates across our market have been backing up, due to a combination of a **renewed crumbling of confidence on the part of investors** as they absorb the recent spate of bad headlines about monoline insurers (sic), bank and dealer exposure to subprime and their hits to earnings and a general lack of understanding of all our short term cash management alternatives. In the old “flight to T-Bills”, the recurring conversation here on the AMS desk is a line out of “Marathon Man”—“Is it safe?”. **Any renewed research focusing on the high quality of closed end fund preferreds of ALL tax status, auction municipal bonds and student loan backed bonds, wrapped around the value added proposition with today’s rates would be extremely helpful.**

I have already responded back to Tom Murray, agreeing to participate in another national sales call sponsored by Chris Dupuy. It cant come soon enough!! If you want to talk through any of the data, please let me know.

(See Exhibit 33) (Emphasis added)

234. On other occasions, Auction Desk personnel likely had prior notice that research was being drafted regarding the auction market before its publication was announced.

235. For instance, on the morning of August 9, 2007, Constable emailed Conery with a simple one line message which stated: “Research today?” (See Exhibit 34)

236. Later that evening, shortly after 7:30 pm, after apparently not receiving any response, Constable followed up with another e-mail to Conery which contained four full lines of question marks. (See Exhibit 35)

237. In her testimony before the Division, Constable could not recall the “context” of the two emails, but confirmed that she and the Auction Desk should only be informed that a research piece is being published until after it was published.

238. On August 10, 2007, Conery and the Research Department published a significant piece related to the Auction Market entitled: “Turmoil and Opportunity in Auction Market.” The report explained recent auction failures and took great care in distinguishing “144A” or private placement auction failures involving qualified institutional buyers, from individual investors who were, “relatively unharmed as they have been largely active in the more conservative and public sectors.”

239. Conery’s focus was to distinguish the recent failures and emphasize that those failures were “likely to be fairly contained within...CLO/CDO issues and certain issues guaranteed by non-Aaa/AAA rated financial guarantors.” In the end, Conery took the opportunity to endorse purchases of ARS when he opined: “We believe there could be many opportunities to take advantage of relative value situations without taking on undue or excessive amounts of credit or liquidity risk.”

240. In the days and weeks that followed, Constable and/or other members of the Auction Desk provided Conery's August 10th Report to FAs and customers seeking clarity of recent events in the auction market.

b. **Improper Information Sharing –Between Research and Sales and Trading.**

241. The Division's investigation revealed that Conery had frequent communications with John Price, Merrill Lynch's Head of Americas Credit and Trading at Merrill Lynch, and the direct supervisor of Constable and her ARS Auction Desk.

242. Merrill Lynch Policy & Procedures Manual (the "Policies Manual") employs a so-called "Chinese Wall," which is designed to prevent "the misuse of material non-public information" and to prevent "even the appearance of impropriety."

243. The "Chinese Wall" is designed to "restrict and monitor the flow of information between the various areas of [Merrill Lynch] such as Global Research, Sales [and] Trading," among others "to avoid the misuse of such information and the appearance of impropriety as well as to manage potential conflicts of interest..."

244. Among those departments that constitute the "Private Side of the Wall" include: "Investment Banking, including Global Capital Markets and Financing (Equity Capital Markets and Debt Capital Markets)," and "other departments or individuals that regularly receive inside information," while the Research Division is on the "Public Side of the Wall."

245. "Confidential Information" is defined in the Policy as "[n]on-public information that is received or created by Merrill Lynch in the course of its business activities."

246. “Material Information” is defined in the Policies and Procedures as that information in which “there is a substantial likelihood that a reasonable investor would consider the information important in deciding whether or not to purchase, hold, or sell a security or other financial instrument,” and includes “liquidity problems, defaults or other credit-related problems or events” and “increases or declines in orders for the company’s securities.”

247. “Proprietary Information” is defined as “[n]on public information of whatever type that is created or obtained by Merrill Lynch for the firm’s business purposes.” Examples of Proprietary Information include, “unpublished research information, opinions, and recommendations” and “non-public information about Merrill Lynch’s securities trading positions and securities products,” “Merrill Lynch’s intentions regarding its proprietary accounts, investment, trading, lending activities or financial strategies or decisions.”

248. Among the categories of information that cannot be discussed between Sales or Trading and Research are the levels or amounts of inventory that Merrill Lynch maintained for its own account.

249. During its investigation, the Division interviewed Conery and reviewed his work notebooks (the “Notebooks”), which he maintained as part of his business records. The Notebooks were maintained in chronological order and recorded information such as telephone calls and subject matter discussed.

250. In their testimony before the Division, both Price and Conery confirmed that the two communicated with each other directly from time to time, sometimes by

telephone. The Notebook contained a significant number of references to “J.P.,” which the Division understands to mean John Price.

251. On July 24, 2007, Conery was informed of and noted “[h]eavy supply, low liquidity + wide spreads” relative to the auction market and acknowledged “current volatility... Supply – shifting story – pent up issuer [illegible]...-Biggest shift to \$25 par market...” Conery also noted that new issues for 2007 were “historically high.”

252. On August 7, 2007, in a discussion with Price, Conery noted in his journal that “liquidity providers” were “looking for out.” Further, Conery took note of “several failed auction[s]...”

253. On October 2, 2007, just one week after hearing from Constable that the auction desk had reached its inventory ceiling of \$1 billion dollars, Price notified Conery that inventory reached “\$1 billion last week” and that “Finance[s] are challenged...”

254. On November 20, 2007, just one day after Price and the Auction Desk received its inventory reduction instructions from Scott Brown and the Fixed Income Currency and Commodities Group, Conery recorded a discussion with Price in the Notebook that reflects a detailed discussion regarding the specific breakdown of Merrill Lynch’s ARS inventory position and the plan to reduce. The entry provided:

JP – year end...-liquidity – Bal sheet – issues early...-
Auction market preferred...-prefer + private
placement...\$ Tax...\$816 tax-exempt...90 taxable
muni...\$101 – tax exempt prefer...total \$ 2.318 Billion

255. The same day, on November 20, 2007, Conery's Notebook reflected a notation that he learned of Merrill Lynch providing sales incentives to FAs in the form of enhanced production credits.

256. Later on the same day, Conery's Notebook reflects a follow up discussion with Price in which he notes considerable difficulties with interest spreads and liquidity in the auction markets. Specifically, the entry provided: "JP – Wider this morning...-liquidity large problem."

257. On January 8, 2008, Conery received a briefing from Price regarding the status of the auction market: The notes provided, in part:

JP: Front-end – unfreezing a bit...-some extendible getting done...-CP _ will be smaller size but clean...- Push – Retail CDs... DRD + Retail

-Customer participation – Very little...- Could go wider...-View that Wall Street firm will have to have distressed underwriting at fire sale prices...-Desk – Short – across every desk...-Liquidity – Cash will trade at premium...-tighter balances...

258. Finally, throughout the time period of August 2007 to February 2008, Conery was also regularly provided copies of Merrill Lynch's daily sales listings, known as "axe sheets," which contained significant non-public information, including but not limited to, Merrill Lynch's inventory positions as well as the production credits that were available to FAs who were selling the product. By being informed on a daily basis of what was available for sale, Conery could compare the axe sheets to see trends in Merrill Lynch's inventory positions as well as the time periods in which so called enhanced sales credits were being applied to FA sales.

259. Conery also had frequent, unmonitored and unfettered access to all of Merrill Lynch's Auction Desk personnel, and frequently visited the Auction Desk without any supervision of information or conversations he was privy to.

E. Improper Influence And Pressure Over Supposedly Independent Research Personnel.

260. Merrill Lynch permitted its Sales and Trading and Auction Desk personnel to have undue influence over its Research Department regarding its coverage of the auction market.

261. In addition to the direct requests of Sales and Trading and the Auction Desk to Research for positive published material related to the auction market (noted in Section E (3)(a) above), undue influence was also exercised over the content of the published research reports.

262. In particular, in late August 2007, Constable objected to and demanded a retraction of one research piece, which she alleged "could single handedly undermine the Auction Market."

263. The research piece in question was written and published on August 21, 2007, by Mauro, a Fixed Income Strategist and Phil Fisher, a Municipal Strategist, in Merrill Lynch's Research Department. The piece, entitled, "Liquidity Features of Short-Term Municipal Securities," was published in Merrill Lynch's Fixed Income Digest primarily for the purpose of highlighting the differences in liquidity features for auction rate preferreds and Variable Rate Demand Obligations ("VRDOs") and certain recent failed auctions. The primary distinction noted by Mauro was that VRDOs have a hard put – or a demand feature built in that "assures investors of being able to receive the par value plus accrued interest back at the reset date, barring some event that

impairs the ability of the institution that provides the put to be able to make good on the agreement.” Mauro then noted that Auction rate preferreds have no hard put and that holders of securities without hard puts need to rely on other buyers in the market to redeem the security at par.” (See Exhibit 36)

264. Conery did not participate in or contribute to the drafting of Mauro’s August 21st published report.

265. Upon reading Mauro’s research report, Constable immediately called Mauro and demanded a retraction and clarification on the grounds that it was misleading to speak about failures in a municipal market research piece when the failures were limited to auction rate securities backed by CDO’s and CLO’s.

266. In her testimony before the Division, Constable acknowledged that while the information contained in the report was factually correct, she felt it was presented out of context since the title of the report referenced “Municipal securities” and that there were no auction failures up to that point were restricted to CLO/CDO issues.

267. Constable testified that she spoke with Mauro on the morning of August 22nd, and objected to the piece. Constable testified that Mauro refused to retract the report at that time on the grounds that it was accurate.

268. After failing to get Mauro to retract the report on her own, Constable next went to the Auction Desk and showed the piece to her boss, John Price.

269. Although Constable “felt strongly” enough about the piece to bring it to her boss’ attention, in her testimony before the Division, Constable stated she could not remember making any request for action to Price. In fact, Constable could not recall

anything that was discussed with Price, other than she brought it to his attention. Price, in his testimony, denied knowledge of the conversation with Constable and even denied knowledge of the existence of the Mauro research piece.

270. Constable then called Conery and asked him to review the report. Later the same day, Constable wrote to Tina Singh and Tom Lee in Financial Products Group stating in all caps:

I HAD NOT SEEN THIS PIECE UNTIL JUST NOW
AND IT MAY **SINGLE HANDEDLY UNDERMINE
THE AUCTION MARKET**. IF YOU ARE GETTING
ANY CALLS, PLEASE LET ME KNOW. I HAVE
ASKED FOR AN IMMEDIATE CLARIFICATION TO
BE PUBLISHED AND A RETRACTION OF THIS.

(See Exhibit 37) (Emphasis added)

271. At some point in time during the day on August 22, 2007, the Research Department agreed to retract the report and issue a new or replacement report in its place. Email communications confirm that Conery made significant suggested changes that were adopted almost verbatim by Mauro.

272. The new report was published on August 23, 2007, but was dated August 22, 2007. While the report still contained similar information contained in Mauro's initial report regarding VRDOs having a hard put and ARS not having a hard put, the overall emphasis had changed and significant additions were added to the new piece. For instance, the cover page of the Report changed the focus of the piece from distinctions in liquidity between VRDOs and ARS to recommending that investors buy auction market securities, VRDOs and R-Floats. The new piece provided, in part,:

Auction market securities, VRDOs, and R-FLOATS are alternatives to money market funds. **Yields on these**

securities have risen in recent weeks over what we believe are misplaced concerns. Although rates could remain volatile, we think these securities offer good value now.

(See Exhibit 38) (Emphasis Added)

273. Other distinctions between the two research pieces included the following:

- In the first paragraph of the revised piece, “**degree of liquidity**” was replaced with “**point out how liquidity is provided** in the major alternatives to money market funds.”
- Second paragraph includes changes which reiterate a previous research piece’s opinion that “the current rise in auction yields as a buying opportunity.”
- An excerpt section in the margin notes: “Yields on auction market securities have risen to levels that **we find very attractive.**”
- The new report included an added section on Closed End Funds: “Each auction program has a least one broker dealer associated with it. **The liquidity is enhanced by the broker dealer’s market making activities. Typically, the broker acts in a principal capacity as it conducts its market support activities, although it is only contractually obligated to act as an agent.**”
- The new report changed prior version’s reference to “several failed auctions” to “some.” In addition, a distinction is added that all failures involved private placement (144a issuers) with a bold sentence stating:

“None of the recent failed auctions involved securities held by individual investors.”

- The new report included an assurance that “the securities sold to individual investors have no direct exposure to [subprime mortgages CDOs/CLOs].”

(Compare Exhibits 37 & 38) (Emphasis added)

274. On August 23, 2007, after the re-written research piece was released, and the auctions were concluded for the day, Constable noted in an email to Price and others:

...Revised research from Marty Mauro promoting short term alternatives to money market funds and the liquidity features of auction and other municipal products in conjunction with Kevin Conery’s research of last week **have been essential tools in our sales arsenal.**

(See Exhibit 39)(Emphasis added)

275. Mauro’s experience with Constable, had lasting effects on Conery and others in the Research Department. In January 2008, after completing some suggested changes to a draft research report, Conery asked fellow Research Analyst, Jon Maier to have someone else review his suggested changes before publishing the report.

Specifically, Conery stated:

I’d really appreciate you showing this to Marty [Mauro] before hand. **I want to make sure that research cannot be accused of causing a run on the auction desk, like was the case in August. I think we have sufficiently covered that risk, but would like his thoughts.**

(See Exhibit 40) (Emphasis added)

276. Conery’s comments illustrate perfectly the repressive conditions under which research reports that touched upon issues facing the Auction Market were

crafted. Simply stated, objectivity had to be tempered and shaped to understate negative market events and known risks affecting ARS in order to minimize the potential adverse consequences to Merrill Lynch's marketing and sales of ARS.

277. Conery and Mauro also understood that their research reports would be scrutinized by the Auction Desk and they sought and relished the Desk's approval. On December 7, 2007, Conery emailed Mauro and another Research Department employee and noted the following: "FYI, I was at the IAD holiday party last night. Got some glowing comments on the auction market report from such people as Frances Constable and Doug Mellert..." (See Exhibit 41)

278. Conery had co-authored a Research piece published in the Fixed Income Digest Special Edition, with Mauro entitled, "Enduring Value in Auction Securities" which was released the day before on December 6, 2007. The piece featured recommendations endorsing ARS, while arguing the "Credit fears are largely misplaced in the auction market," and that "we remain convinced that auction market preferreds of closed-end funds are a conservatives' conservative security." (See Exhibit 42)

279. Other times, Auction Desk Personnel attempted to directly influence how Research responded to FA questions during sales calls. In one instance in August 2007, Conery was answering FA questions in a "Q&A" style sales call. Constable had also dialed in to the call and was listening in. After one question was asked, which apparently was not to Constable's liking, she emailed, or instant messaged Conery and stated: "**Shut this guy down. Suggest he call outside this call. He is focusing attention away from your positive message.**" (See Exhibit 43) (Emphasis added)

280. Conery himself, viewed his position as a Research Analyst in large part as being a source to assist Merrill Lynch's Auction Desk's business of selling ARS. On December 12, 2007, he responded to an email from his supervisor in the Research Department, Mary Rooney, who was seeking input for Conery's year-end review. Conery highlighted his service to the Auction Desk by stating,, in part: "auction market – integral and well coordinated with the auction desk...A large number of conference[s] helped to significantly improve liquidity and lower inventory levels."

281. In her official Performance Review Form of Conery, which was signed by both Rooney and Conery , Rooney incorporated Conery's suggestions.

282. The Performance Review evaluated Conery for competency in four key areas: Strategic Thinking; Business Results; People Leadership and Personal Effectiveness. With regard to Conery's performance toward the "Business Results" of the firm, Rooney noted:

Kevin has a strong partnership with the Auction Rate Preferred business. This market was under extreme stress this year due to the credit/liquidity crunch. Kevin worked closely with his business partners to communicate key issues facing a rather opaque market place. Here he engaged in proactive and timely interchange with sales, and corporate cash clients, and GPC. Ultimately, his work contributed to better liquidity and lower inventory levels in the marketplace. (Emphasis added)

283. In the wake of his performance review at year end, Conery was awarded a significant six-figure bonus for his job performance in 2007.

284. The Performance Review also included a "Cross Comments" Section which described Conery's "Strengths" and "Development Needs" as described by co-

workers. Significantly, the Review Committee for Conery included members of the Auction Desk including Constable and her supervisor, Price.

285. One developmental need expressed by an evaluator was: “Feel Kevin can be too connected to the trading desks/should be allowed to be more independent. I don’t see this as a Kevin issue but rather a desk issue and the pressure they exert for his support.”

286. Conery’s close relationship and loyalty to the Auction Desk was illustrated in one email exchange with Auction Desk trader, Derek Sin in early December 2007. Sin originally forwarded a recent Merrill published research piece that was “worth a read” and attributed the publication to Martin Mauro and “other ML Research analysts.” Conery mockingly protested the snub of not being specifically mentioned as being a contributor to the publication noting that the last time Mauro wrote anything on his own: “can you say run on the auction market? And that was when he thought he was endorsing auction securities.” Sin responded, in part, “Don’t worry, we know who our friends are...” to which Conery responded: “You better.”

287. By assisting the Auction Desk with research, sales calls and client conversations, Constable clearly viewed Conery as being part of “the team.” One instance that best illustrates that point occurred on January 28, 2008, shortly before the Auction Market imploded. An Institutional Advisory Division representative in California sent Constable a very glowing endorsement of Conery in the wake of Conery’s time spent in a conference call with the representative’s corporate clients. Conery had spent quite a bit of time explaining various auction products to the company’s Treasurer and “handled the client’s difficult questions” concerning the

auction market. The representative ended her note with the following: “Our clients now feel they have a much better understanding of the issues, and are reassured about their investments in muni Closed End Funds.” Constable forwarded the email to, among others, Conery’s boss in the Research Department and her own boss, John Price noting, in part: “Kevin has always held himself out in a climate-agnostic capacity. It is great to have him on the team...” (See Exhibit 44)

288. Rooney then forwarded the email chain to Conery and informed him: “Kevin – Excellent feedback from the Auction Rate Desk. Many of the investors in the product are important corporate clients to our firm. Nice Work! Rgds, Mary.” (Id.)

289. Despite the confidence Conery apparently instilled in the client, less than three weeks later, Merrill Lynch would intentionally allow most of its auctions to fail leaving thousands of investors with illiquid investments.

290. In a Form 10-Q Quarterly Report, filed with the Securities and Exchange Commission, a company with the same name as the one referenced in the email reported holding over \$110 million in illiquid ARS and recorded a temporary impairment charge of over \$5 Million.

F. Events Leading To Merrill Lynch’s Decision To Stop Broadly Supporting Its Auction Program.

291. Concerns surrounding the auction market grew more ominous going into the new year and Merrill Lynch’s Auction Desk personnel began to brace for the worst. For instance, on January 9, 2008, Auction Desk Senior Trader, Jim Brewer, emailed Edward Curland (GMI NYMUNI) a list of ARS issues that were insured by insurance companies that were at risk for downgrade by the rating agencies and those issues’

dim prospects of successfully clearing in upcoming auctions should the downgrades occur. Brewer advised:

Ed-

The attached file contains the lead managed XL & FGIC Insured issues we currently trade on the auction desk. It seems increasingly likely that these two monoline insurers are going to be downgraded. **We anticipate that if that happens there will be a wave of selling in these issues that we will be unable to support causing the auctions to fail. If any of these issues fail one can make the assumption that it will spread to the other sectors of our market regardless of the insurer or ratings.** Is anyone proactively working on a contingency plan in the event that these issues are downgraded?

(See Exhibit 45) (Emphasis added)

292. Two days later, Constable emailed her colleagues on the Auction Desk with a copy of an internal Risk Management document in which the firm was analyzing options to reduce risks associated with certain auction market preferred inventory. One page of the analysis, which was marked “For Internal Use Only” and “Confidential – Not For Distribution” dealt with Merrill Lynch’s so called “risky preferred” auction market preferred stock and provided in part:

OPTIONS TO REDUCE RISK

...Option #3: Fail future auctions

Pros: ML balance sheet will be capped at levels today.

Cons: ML cannot fail our own paper and may be forced to take that back.

(See Exhibit 46)

293. On the same date, Price replied to a Risk Manager with respect to Exhibit 46, and objected to an extent and reminded the manager that the so called “risky preferreds” had been quite lucrative to the firm and specifically stated: “let’s not

forget how much \$\$\$ this business contributed to the firm in '04, '05. '06 and who got paid from it – SSG.” (See Exhibit 47)

294. In the same email, Price referred to August 2007 as “when the carnage began” in Merrill Lynch’s auction program. (Id.)

295. Likewise, Inventory concerns at Merrill Lynch continued. In one January 18, 2008 email Constable sent to GMI Sales, she stated:

Mike and team: It’s a double day and we have to also buy back many of the securities from the MLI account early this morning, not to mention we are about to get shellacked from terrified investors and we **HAVE TO SELL INVENTORY!!**”

(See Exhibit 48) (Emphasis in original)

296. On January 23, 2008, word began circulating among broker-dealers that Lehman Brothers had a number of auctions fail the previous day. In responding to a question from a Merrill Lynch investment banker regarding an issuer client who had concerns regarding the auction market, Brewer opined:

Ian –
Lehman failed 5 auctions yesterday – this is unprecedented. I am not sure what to tell [the issuer client] but, in my opinion, **we have to let [the client] know that we feel the auction market is going to get worse not better and they would be best served exiting the market.**

(See Exhibit 49) (Emphasis added)

297. Similar concerns were not shared with FAs or retail customers.

298. On the same day, Conery notified his boss, Mary Rooney of the Lehman auction failures. “...Fyi, new crisis brewing on the auction

side. We've had 3 parties confirm that Lehman is dropping out of the auction business. Nothing like adding further illiquidity to an already illiquid market..." When asked to opine on the probable outlook for the market, Conery replied: "Challenged, but prob OK in the safer sectors. If- y in the lesser credit/structures." (Exhibit 50)

299. Also, on January 23, 2007, Conery emailed Maier and stated, "It's really ugly out there. It could make you long for the calm days of this past August." (See Exhibit 51)

300. Meanwhile, Merrill Lynch's Research Department continued to issue research pieces that sought to accentuate the positives of the auction market while minimizing the negatives.

301. On January 28, 2008, Conery had been reviewing a research piece written by fellow Closed End Fund Research Analyst, Jon Maier. The piece dealt with the recent closed end fund auction failure from the previous week. Conery initially responded to Maier's request for Conery's suggested changes, to which Conery replied: "I'm working on it. **I was afraid some of our language would give the auction an unnecessary problem: a run.**"

(See, Exhibit 52) (Emphasis added)

302. Some thirty minutes later, Conery sent Maier the suggested changes with a note cautioning Maier to have the piece reviewed again before going out, to prevent being accused of "causing a run on the auction desk." (See Exhibit 40)

303. On January 28, 2008, after having been forwarded another negative story regarding a recent auction failure, Constable simply forwarded the piece to Price

with the note, “[i]ts like the Sorcerer’s Apprentice...cant someone make these people stop bucketing us with water...”¹ (See, Exhibit 53)

304. Between the dates February 1, 2008 and February 8, 2008, Conery wrote or contributed to approximately three published research pieces, including: Fixed Income Digest, “Preserve Income Lock in Yields”; Fixed Income Digest Supplement, “Auction Market Securities” and Auction Market Value Sheet, “Back to Basics In The Auction Market.” In each of these publications, he continued to recommend that investors should feel confident about the auction market. (See, Composite Exhibit 3)

305. On or about February 1, 2008, Merrill Lynch’s Research Department published a volume of its Fixed Income Digest, entitled “Preserve Income Lock in Yields,” Conery and Mauro were listed as contributors to the piece. The cover page included a section entitled “Preserve Income.” The last sentence of the section provided: “For funds that investors need to keep liquid, we continue to find the best value in auction market securities.” Inside the research piece, there was a subheading: “For Cash Holdings: auction market securities,” which recommended, “[n]aturally, most investors need to keep some portion of their portfolios in liquid cash-like

¹ The Sorcerer’s Apprentice is a fairly tale, perhaps made most famous in the Walt Disney classic, *Fantasia*. The tale begins as an old sorcerer departs his workshop, leaving his apprentice with chores to perform. Tired of fetching water by pail, the apprentice enchants a broomstick to do the work for him - using magic he is not yet fully trained in. The floor is soon awash with water, and the apprentice realizes that he cannot stop the broom because he does not know how. Despairing, he splits the broom in two with an axe, but each of the pieces transforms into a whole broomstick. The broomsticks take up pails and resume their work, now faster than ever. When all seems lost in a massive flood, the old sorcerer returns and quickly breaks the spell, saving the day. – Source Wikipedia

instruments. We find auction market securities (AMS) to be better alternative than money funds for these purposes for investors with larger amounts to invest.”

The section was followed immediately by another section dedicated to: “Answering Your Questions About Auction Market Securities” which responded to common questions relating to the auction markets at the time.

(See Composite Exhibit 3)

306. On February 4, 2008, the Research Department re-published the “Answering Questions” piece on its own as a supplement to the Fixed Income Digest in part, because of questions the Research Department was getting calls and that FAs were likely having a problem locating the information in the otherwise lengthy February 1, 2008 publication. (See Composite Exhibit 3)

307. On February 7, 2008, some five days before Merrill Lynch decided to voluntarily withdraw from the auction market, Conery participated in a Closed End Fund monthly conference call with FAs to discuss recent market events. In discussing whether all closed-end funds auctions were suspect or likely to fail, Conery disagreed and told FAs, in part:

One thing I would say is that it does highlight, and we said this on and off for the past several years, is that investor in the auction market should know their broker/dealer and should know whether or not their broker/dealer is committed to the product.

I will tell you Merrill Lynch, certainly by all indications, is committed to this product. I would have to let the desk people speak for themselves, but given the fact that through all this turmoil they continue to plod away, I think that shows that the firm is committed to it.

308. After conceding that Merrill Lynch was not willing to guarantee continued commitment to the auction business, (“there are no guarantees in anything”) Conery added,

But is it an area we think represents a good, conservative, reasonable investment? Yes, it is. We are quite comfortable with buying Aaa one week closed-end paper. We are quite comfortable buying Aaa one month closed-end fund paper, whether its taxable or tax exempt we feel pretty good about it. But I will be the first to say that the rumors out there flying are pretty wild or pretty amazing. If you listen to them all it would probably drive you nuts, because I know it’s driving me nuts, but you need to differentiate between what’s rumor and what’s fact.

309. During the same call, one FA asked a question that touched upon whether the recent auction failures had any consequences for Merrill Lynch, to which Conery answered: “[the Closed End Fund that experienced the prior auction failure] has so much outstanding in this sector, which is I think a testament to back up my point that I don’t think this is any sort of contagion market-wide disaster scenario.”

310. On February 8, 2008, Conery published his research piece entitled, “Back to Basics In The Auction Market.” In it, Conery continued to find ARS “to be attractive” investments. Further, Conery noted:

We continue to be impressed by the auction market’s resiliency in the face of challenging times. We recommend that investors focus on what made the auction market great to begin with, conservative and understandable credits and traditional product structure.

(See Composite Exhibit 3)

311. On the evening of February 12, 2008, Merrill Lynch executives decided to cease supporting its auction rate securities program and intentionally allowed the vast majority of their auctions to fail the following day.

312. Constable testified that after it was learned that two other broker-dealers, with significant auction market businesses, broadly failed their auctions on February 12, 2008, it was a fait accompli that the entire auction market would fail.

313. Merrill Lynch's decision to stop broadly supporting its auction program was made without any real consideration or analysis of its effect on retail and other investors holding the securities.

H. Merrill Lynch Has Marked Down Its Own Inventory of Auction Rate Securities, But Still has Not Marked Down The Estimated Value Of The Auction Rate Securities On Its Clients' Account Statements.

314. Merrill Lynch has marked down the value of its own inventory of auction rate securities, yet has not marked down the value of those same auction rate securities in its client statements.

315. In her on-the-record interview with the Division, Constable testified as follows:

Q. Ms. Constable, since February 13th, has Merrill Lynch marked down any of the auction rate securities that it holds in its own inventory?

A. Yes. And what are those valuations or those markdowns? Do they have a spread?

A. No. Not that I can -- they're all individually different.

Q. Okay. Do you have an understanding of whether since February 13th that Merrill Lynch has marked down any of the auction rate securities on client statements?

A. I don't believe so.

316. In his on-the-record interview with the Division, Price testified that from February 13 to the present, “[w]e have marked down securities, and obviously the firm marked down their CDO inventory as well, contingent capital inventory. And since February 13th we have marked closed end fund inventory, DRD inventory. Generally we have marked down all of our inventory.”

317. When asked that the percentage of mark-downs was, he responded: “Approximately anywhere from zero to ten percent on some, and some as much as twenty, twenty percent.”

318. When asked if the same markdowns have been made of the same securities that are held in client accounts, he testified: “I’m not sure.”

319. According to client statements received from the Division, auction rate securities listed on client statements have not been marked down to reflect their illiquidity. Their “estimated market value” is still listed as 100 percent of par. Certain of the exact same instruments held by Merrill Lynch in its inventory have been marked down from par.

VII. VIOLATIONS OF SECURITIES LAWS

A. COUNT I – VIOLATIONS OF §101 BY MERRILL LYNCH

320. Section 101 of the Act provides in pertinent part:

It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly:

(1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

321. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 319 above.

322. The conduct of Merrill Lynch, as described above, constitutes violations of M.G.L. c. 110A, § 101.

B. COUNT II – VIOLATIONS OF § 204 (a)(2)(B) BY MERRILL LYNCH

323. Section 204 (a)(2)(B) of the Act provides in pertinent part:

(a) The secretary may by order impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action if he finds (1) that the order is in the public interest and (2) that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser:–

(B) has willfully violated or willfully failed to comply with any provision of this chapter

324. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 323 above.

325. The conduct of Merrill Lynch as described above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(B).

C. COUNT III – VIOLATIONS OF § 204 (a)(2)(G) BY MERRILL LYNCH

326. Section 204 (a)(2)(G) of the Act provides in pertinent part:

(a) The secretary may by order impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action if he finds (1) that the order is in the public interest and (2) that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser:—

(G) has engaged in any unethical or dishonest conduct or practices in the securities, commodities or insurance business.

327. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 319 above.

328. The conduct of Merrill Lynch as described above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(G).

329. Without limiting the generality of the foregoing, the conduct of Merrill Lynch set forth above constitutes violations of the following provisions of the Regulations:

950 CMR Section 12.204 (1)(a):

(4) Recommending to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that such transaction or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer.

(6) Exercising any discretionary power in effecting a transaction for a customer's account without first obtaining written authority from the customer, unless the discretionary power relates solely to the time and/or price for the execution of the order.

...

... (14) Representing that a security is being offered to a customer "at the market" or a price relevant to the market price unless the broker-dealer knows or has reasonable grounds to believe that a market for such security exists other than that made, created or

controlled by such broker-dealer, or by any person for whom he/she is acting or with whom he is associated in such distribution, or any person controlled by, controlling or under common control with such broker-dealer.

(28) Failing to comply with any applicable provision of the NASD rules of Fair Practice.

330. Without limiting the generality of the foregoing,

applicable NASD rules include the following:

2310. Recommendations to Customers (Suitability)

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs...

IM-2310-2. Fair Dealing with Customers

(a)(1) Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public...

2760. Offerings 'At the Market'

A member who is participating or who is otherwise financially interested in the primary or secondary distribution of any security which is not admitted to trading on a national securities exchange, shall make no representation that such security is being offered to a customer "at the market" or at a price related to the market price unless such member knows or has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by such member, or by any person for whom he is acting or with whom he is associated in such distribution, or by any person controlled by, controlling or under common control with such member.

2110. Standards of Commercial Honor and Principles of Trade

A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.

2120. Use of Manipulative, Deceptive or Other Fraudulent Devices

No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.

2210. Communications with the Public

(d) Content Standards

(1) Standards Applicable to All Communications with the Public

(A) All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.

(B) No member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. No member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading. . . .

D. COUNT IV – VIOLATIONS OF § 204 (a)(2)(J) BY MERRILL LYNCH

331. Section 204 (a)(2)(J) of the Act provides in pertinent part:

The secretary may by order deny, suspend, or revoke any registration if he finds (1) that the order is in the public interest and (2) that the applicant or registrant (J) has failed reasonably to supervise agents, investment adviser representatives or other employees to assure compliance with this chapter.

332. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 319 above.

333. The conduct of Merrill Lynch, as described above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(J).

VIII. STATUTORY BASIS FOR RELIEF

Violations, Cease and Desist Orders and Costs

334. Section 407A(a) of the Act provides in pertinent part that:

(a) If the secretary determines, after notice and opportunity for a hearing, that any person has engaged in or is about to engage in any act or practice constituting a violation of any provision of this chapter or any rule or order issued thereunder, he may order such person to cease and desist from such unlawful act or practice and may take affirmative action, including the imposition of an administrative fine, the issuance of an order for accounting, disgorgement or rescission or any other relief as in his judgment may be necessary to carry out the purposes of [the Act].

335. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 319 above.

336. Merrill Lynch directly and indirectly engaged in the acts, practices, and courses of business as set forth in this Complaint above, and it is the Division's belief that Merrill Lynch will continue to engage in acts and practices similar in subject and purpose, which constitute violations if not ordered to cease and desist.

IX. PUBLIC INTEREST

For any and all of the reasons set forth above, it is in the public interest and will protect Massachusetts investors to provide the relief requested in Section X below.

X. RELIEF REQUESTED

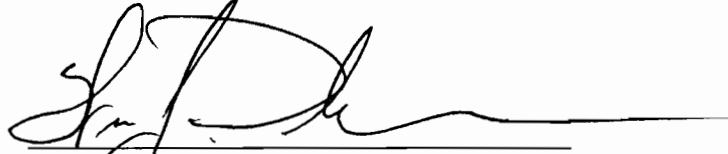
Wherefore, the Enforcement Section of the Division requests that Hearing Officer take the following action:

A. Find that all the sanctions and remedies detailed herein are in the public interest and necessary for the protection of Massachusetts investors;

B. Find as fact the allegations set forth in paragraphs 1 to 319 of the Complaint; and

C. Enter an order (a) requiring Merrill Lynch to permanently cease and desist from committing any further violations of the Act and Regulations, (b) requiring Merrill Lynch to offer rescission of sales of ARS at par (or restitution to investors who have already sold below par) on the terms and conditions that a Hearing Officer deems appropriate, (c) censuring Merrill Lynch (d) requiring Merrill Lynch to pay an administrative fine in an amount and upon such terms and conditions as a Hearing Officer may determine, and (e) requiring Merrill Lynch to take any other action that a Hearing Officer may deem appropriate in the public interest and necessary for the protection of Massachusetts investors.

**ENFORCEMENT SECTION
MASSACHUSETTS SECURITIES DIVISION**



William Donahue, Enforcement Attorney
Joshua S. Grinspoon, Enforcement Attorney
Trevor Perkins, Enforcement Attorney
Kevin Morris, Enforcement Attorney
Patrick Ahearn, Chief of Enforcement
Massachusetts Securities Division
One Ashburton Place, Room 1701
Boston, Massachusetts 02108
(617) 727-3548

Dated: July 31, 2008