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

AMENDED CONSENT ORDER

I.

PRELIMINARY STATEMENT

This Amended Consent Order ("Order") is entered into by the Massachusetts Securities Division ("Division") and Merrill, Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") in connection with an Administrative Proceeding filed by the Massachusetts Securities Division (the "Division") against Merrill Lynch. This Order supersedes any prior Consent Order entered in this action.

On July 31, 2008, the Massachusetts Securities Division (the "Division") filed an administrative complaint (the "Administrative Complaint") against Merrill Lynch alleging violations of the Massachusetts Uniform Securities Act (the "Act") See Docket No. 2008-0058. The Administrative Complaint focused on Merrill Lynch's sale of financial instruments known as auction rate securities ("ARS") to retail and other customers.

This Order is the final settlement of those allegations set forth in the Administrative Complaint. On April 7, 2009, Merrill Lynch submitted an Offer of Settlement for the purpose of settling those allegations set forth in the administrative complaint with prejudice.

Solely for purposes of settling these proceedings, Merrill Lynch, without admitting or denying the Statement of Facts as set out herein in Section IV and Conclusions of Law in Section V and without an adjudication of any issue of law or fact, consents to the entry of this Consent Order ("Order") by the Division, consistent with this Offer, settling the pending administrative proceeding against Merrill Lynch (Docket No. 2008-0058) with prejudice. In connection with Merrill Lynch's Offer pursuant to this matter, the Division agrees to fully resolve another enforcement action against Merrill Lynch, Docket No. E-2008-0001, without Merrill Lynch admitting the Findings of Fact or Conclusions of Law, but which shall be addressed by a separate Consent Order under its own docket number.

II.

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.

III.

RESPONDENT

2. 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.

IV.

STATEMENT OF FACTS

A. Background Mechanics of Auction Rate Securities.

1. Dutch Auction Process

3. 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.

4. 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.

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

6. 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.

7. 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.

8. 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.

2. Types of Auction Rate Securities

9. 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.

a. Auction Preferred Shares ("APS")

10. 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.

b. Municipal Auction Rate Certificates ("Municipal ARCS")

11. 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.

c. Student Loan-Backed Auction Rate Certificates ("Student Loan ARCS")

12. 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.

3. Difference Between ARS and Variable Rate Demand Obligations

13. 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.

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

14. 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.

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

16. 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."

17. 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."

18. 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."

19. 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."

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

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

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

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

24. 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)[1]

25. 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)

26. 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)

27. 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)

28. 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-

[1] All references to exhibits herein will be references to the respective exhibits to the Administrative Complaint filed on July 31, 2008 against Respondent. For example, reference to Exhibit 1 herein shall be a reference to Exhibit 1 to the Administrative Complaint.

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)

29. 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."

30. 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.

31. Merrill Lynch's policies and procedures did disclose some important elements of is 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.

32. 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.

33. 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. <u>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</u>.

34. 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.

35. 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

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

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

38. 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.

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

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

41. 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.

42. 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)."

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

44. 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.

45. 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.

46. 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.

47. 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.

48. 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

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

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

51. 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.

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

53. 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.

54. 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.

55. 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.

56. 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.

57. 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.

58. On Client A's June 30, 3008 statement, Merrill Lynch had still listed the . "estimated market value" as 100 percent of the par value of the securities.

b. <u>Client B</u>

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

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

61. 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.

62. 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.

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

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

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

66. 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.

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

68. 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.

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

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

71. 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

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

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

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

75. 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.

76. 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.

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

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

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

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

81. 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.

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

d. Client D

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

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

85. 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.

86. 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.

87. 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.

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

89. 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.

90. 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.

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

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

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

94. 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.

95. 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.

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

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

98. 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.

99. 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.

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

101. 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.

102. 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.

103. 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.

104. 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. <u>Merrill Lynch Generated Significant Fees by Underwriting Auction Rate Securities with Constrictive Maximum Rates and Selling them to Clients.</u>

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

105. 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.

106. 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)

107. 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.

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

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

110. 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.

111. 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.

112. 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.

113. 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.

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

115. Maximum rate previsions 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.

116. 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.

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

118. 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.

119. 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.

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

121. 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.

122. 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.

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

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

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

126. 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.

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

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

129. 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.

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

131. 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.

132. Merrill Lynch's support bids were sometimes entered on a tiered rate structure.

133. 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.

134. 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.

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

136. 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.

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

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

139. 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.

140. 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.

141. 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.

142. 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.

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

144. 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.

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

146. 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)

147. 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)

148. 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)

149. 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)

150. 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.

151. 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)

152. 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.

153. 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.

154. 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)

155. 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.)

156. 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.

157. 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.

158. 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. <u>Communications With Issuers And Others Expressing Concern About The Auction Markets</u>.

159. 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)

160. 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.

161. 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."

162. 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."

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

164. 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)

165. 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."

166. 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.

167. 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)

168. Constable was reminded by Doug Mellert on August 15 that he "understood the necessity to move product."

169. 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)

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

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

172. 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)

173. 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)

174. 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)

175. 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. <u>Merrill Lynch Surpasses Its Inventory Limit In September 2007, As ARS Market Conditions Worsened</u>.

176. 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)

177. 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)

178. 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)

179. 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)

180. 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 roughtly half of each...."

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

(See Exhibit 22)

181. 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)

182. 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)

183. 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)

184. 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)

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

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

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

188. 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)

189. 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."

190. 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.

191. In an email dated December 4, 2007 from Constable to Derek Sin responding to issues that the financers 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)

192. 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.

193. 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.

194. 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)

195. 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."

196. 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..."

197. In 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."

198. 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).

199. 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.

200. 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."

201. 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."

202. 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).

203. 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."

204. 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."

205. 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)

206. 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**"

207. 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."

208. 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."

209. 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.

210. 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.

211. 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.

212. 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.

213. 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. <u>FA Incentives - Increased Production Credits Sales Drive</u>.

214. 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.