



State of Wisconsin
Department of Financial Institutions

Jim Doyle, **Governor**

Lorrie Keating Heinemann, **Secretary**

SENT VIA E-MAIL

January 15, 2010

J. David Montague
First Vice President
Global Regulatory Affairs
Merrill, Lynch, Pierce, Fenner & Smith, Inc.
222 Broadway, 16th Floor
New York, New York 10038

Re: Merrill, Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch")/ Wisconsin
Administrative Consent Order Based on NASAA Auction Rate Securities
Multi-State Investigation & Global Settlement (File No. S-09141(EX))


Dear Mr. Montague:

Attached in pdf form is an electronic, signed version of the Administrative Consent Order for Wisconsin as executed and issued January 15, 2010 by the Wisconsin Securities Division Administrator in the above-captioned proceeding.

We understand that pursuant to numbered paragraph 4. of Section III of the Consent Order, within 10 days of the signing and issuance of the Final Order, the Respondent will pay to the Division the monetary penalty established for Wisconsin in the prescribed amount of \$ 1,155,234.37 in a check made payable to the Wisconsin Department of Financial Institutions.

If you have any questions, you may contact me by return e-mail or call me at my direct dial telephone number (608) 266-3414.

Sincerely,


Randall E. Schumann
Legal Counsel for the Division

cc: Patricia D. Struck, Division Administrator

Division of Securities

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1 of the issues contained in this Order, Merrill Lynch, without admitting or denying the Statement of
2 Facts and Conclusions of Law contained in this Order, and without an adjudication of any issue of
3 law or fact, consents to the entry of this Order.

4 NOW, THEREFORE, the Division, as administrator of the Wisconsin Uniform Securities
5 Law, hereby enters this Order:

6 **I.**

7 **STATEMENT OF FACTS**

8 **A. Background Mechanics of Auction Rate Securities.**

9 1. ARS as a general term refers to long-term debt or equity instruments tied to short-
10 term interest rates that are reset periodically through an auction process.

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

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

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

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

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

21 7. If there are not enough purchasers the auction fails, no shares change hands, and the
22 rate resets to a rate that is prescribed in the instrument's offering documents.

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

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

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

3 9. Merrill Lynch additionally used research pieces to market ARS to customers.

4 10. Financial advisers (“FAs”) would often forward Merrill Lynch marketing pieces to
5 customers to reassure them of the safety and value of the instruments.

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

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

12 13. Merrill Lynch’s policies and procedures did disclose some important elements of its
13 ARS program, including that Merrill Lynch plays multiple roles in the ARS market, that Merrill
14 Lynch’s interest may differ from those of its clients who purchased ARS, that Merrill Lynch is
15 permitted but not obligated to submit orders for its own account and routinely does, and that a
16 purchaser’s ability to sell the purchaser’s ARS may be limited.

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

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

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

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

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

2 • **Auction Market Securities provide many advantages for**
3 **investors**

- 4 • Large and liquid market with over \$306 billion currently
5 outstanding
- 6 • High quality credits with over 92% of the market rated AAA
- 7 • Incremental yield to comparable securities such as
8 commercial paper and money market funds
- 9 • Taxable, tax advantaged and tax exempt investment options

10 18. A triple-A rating is a long term credit rating.

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

13 20. A number of the collateralized debt obligations and other auction rate securities
14 underwritten and offered by Merrill Lynch carried the AAA rating from major rating agencies.

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

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

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

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

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

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

**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.

1 27. Merrill Lynch’s ARS program was funded by issuers of ARS, who paid Merrill
2 Lynch fees to underwrite securities and remarket them.

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

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

8 30. The ARS that Merrill Lynch underwrote then sold to its clients consisted of auction
9 preferred shares (“APS”), with perpetual maturity, with dividends that reset every 7 to 35 days at
10 auction, or long-term debt instruments, issued by municipalities and student loan organizations
11 with maturities of 20-40 years with interest rates that reset through the same process.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

26 42. 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.

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

1 44. The ARS with high maximum rates, typically municipal auction rate certificates
2 (“ARCS”) with maximum rates in the range of 12-15%, have drawn investor interest and have
3 cleared without Merrill Lynch’s support.

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

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

9 46. When Merrill Lynch underwrote an issue of ARS, it typically served as the broker-
10 dealer or remarketing agent for the issue.

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

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

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

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

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

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

24 53. In August of 2007 Merrill Lynch withdrew its support for certain CDO-backed
25 ARS.

26 54. 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