

1 Lynch had received.

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

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

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

8 58. Investors were not provided with information about the volume of shares that  
9 moved at auction.

10 59. Investors were not provided with information about the level of support from  
11 Merrill Lynch that was required to clear the auction.

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

14 **D. Auction Rate Securities Inventory Concerns At Merrill Lynch**

15 1. Weakness in the Credit Markets Initiated Inventory Concerns In Summer Of  
16 2007.

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

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

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

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

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

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

9                     2.     Communications With Issuers And Others Expressing Concern About The  
10                     Auction Markets.

11           67.     As early as August 3, 2007, senior management of Merrill Lynch was requesting a  
12 sample term sheet for AMPS to understand the liquidity and downgrade risk.

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

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

18           70.     Upon information and belief, Merrill Lynch began, in late 2007, discussing with  
19 issuers, concerns with the auction markets.

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

22           71.     In late September, inventory levels rose significantly and the Auction Desk was fast  
23 approaching its limit of \$1 billion dollars.

24           72.     In addition, Merrill Lynch had certain lenders that provided financing for its  
25 inventory of auction rate securities.

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

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

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

6           **E.     Merrill Lynch’s Consolidated Effort to Reduce Inventory – A Three Pronged**  
7           **Approach.**

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

10          76.     Just after the first hint of investor concern with the auction market, the Auction  
11 Desk and Sales and Trading immediately mobilized to stem the tide of negative news. Managers  
12 moved quickly to set up sales calls to provide assurances to FAs and to motivate future sales of  
13 ARS.

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

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

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

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

2.     FA Incentives - Increased Production Credits Sales Drive.

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

5           82.     During periods where enhanced credits were awarded, FAs could earn as much as 8  
6 times that amount (or 100 bps) for sales of ARS. Other enhanced payouts could include payouts of  
7 25 bps, or 50 bps. Similar to regular production credits earned, FAs enhanced production credits  
8 would be applied to the grid resulting in FAs being paid a certain predetermined percentage of the  
9 enhanced production credit.

10                   3.     Coordination with Research

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

13           83.     Merrill Lynch’s Research Department played a pivotal role in assisting sales of  
14 Auction Rate Securities.

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

18                           b.     Improper Information Sharing –Between Research and Sales and  
19                                     Trading.

20           85.     The task force’s investigation revealed frequent communications among research,  
21 sales, and trading staff.

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

25           87.     The “Chinese Wall” is designed to “restrict and monitor the flow of information  
26 between the various areas of [Merrill Lynch] such as Global Research, Sales [and] Trading,”

1 among others “to avoid the misuse of such information and the appearance of impropriety as well  
2 as to manage potential conflicts of interest...”

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

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

10 90. Such information was discussed.

11 **F. Improper Influence And Pressure Over Supposedly Independent Research  
12 Personnel.**

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

15 92. In addition to the direct requests of Sales and Trading and the Auction Desk to  
16 Research for positive published material related to the auction market, undue influence was also  
17 exercised over the content of the published research reports.

18 93. Other times, Auction Desk Personnel attempted to directly influence how Research  
19 responded to FA questions during sales calls.

20 **G. Events Leading To Merrill Lynch’s Decision To Stop Broadly Supporting Its  
21 Auction Program.**

22 94. Concerns surrounding the auction market grew more ominous going into the new  
23 year and Merrill Lynch’s Auction Desk personnel began to brace for the worst.

24 95. Likewise, Inventory concerns at Merrill Lynch continued.

25 96. On January 23, 2008, word began circulating among broker-dealers that Lehman  
26 Brothers had a number of auctions fail the previous day.

97. Concerns were not shared with FAs or retail customers.

1           98.     Between the dates February 1, 2008 and February 8, 2008, staff wrote or contributed  
2 to approximately three published research pieces, including: Fixed Income Digest, “Preserve  
3 Income Lock in Yields”; Fixed Income Digest Supplement, “Auction Market Securities” and  
4 Auction Market Value Sheet, “Back to Basics In The Auction Market.” Each of these publications  
5 continued to recommend that investors should feel confident about the auction market.

6           99.     On or about February 1, 2008, Merrill Lynch’s Research Department published a  
7 volume of its Fixed Income Digest, entitled “Preserve Income Lock in Yields.” The cover page  
8 included a section entitled “Preserve Income.” The last sentence of the section provided: “For  
9 funds that investors need to keep liquid, we continue to find the best value in auction market  
10 securities.” Inside the research piece, there was a subheading: “For Cash Holdings: auction market  
11 securities,” which recommended, [n]aturally, most investors need to keep some portion of their  
12 portfolios in liquid cash-like instruments. We find auction market securities (AMS) to be better  
13 alternative than money funds for these purposes for investors with larger amounts to invest.” The  
14 section was followed immediately by another section dedicated to: “Answering Your Questions  
15 About Auction Market Securities” which responded to common questions relating to the auction  
16 markets at the time.

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

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

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



1           1.       This Order concludes the investigation by the Division and any other action that the  
2 Division could commence under applicable Wisconsin law on behalf of Wisconsin as it relates to  
3 Merrill Lynch, relating to the marketing and sales of ARS by Merrill Lynch, provided however, that  
4 excluded from and not covered by this paragraph 1 are any claims by the Division arising from or  
5 relating to the “Order” provisions contained herein.

6           2.       This Order is entered into solely for the purpose of resolving the referenced multistate  
7 investigation, and is not intended to be used for any other purpose.

8           3.       Merrill Lynch will CEASE AND DESIST from violating the Wisconsin Uniform  
9 Securities Law and will comply with the Wisconsin Uniform Securities Law.

10          4.       Merrill Lynch shall pay fines and/or penalties totaling \$125 million (the “Total  
11 Penalty”) to the Commonwealth of Massachusetts and the other states, which shall be allocated at  
12 the Commonwealth of Massachusetts and the other states’ discretion, to resolve all underlying  
13 conduct relating to the sale of auction rate securities. Merrill Lynch shall pay \$ 1,155,234.37 of  
14 the Total Penalty to the Wisconsin Department of Financial Institutions to be deposited in the Gifts,  
15 Grants, Settlements and Publications appropriation in sec. 20.144(1)(h), Wis. Stats. In the event  
16 another state securities regulator determines not to accept Respondents’ settlement offer, the total  
17 amount of the payment to the Wisconsin Department of Financial Institutions shall not be affected,  
18 and shall remain at \$ 1,155,234.37

19          5.       Definitions and Buyback Offer. Merrill Lynch will provide liquidity to Eligible  
20 Investors by buying Eligible Auction Rate Securities that have failed at auction at least once  
21 between February 13, 2008, and the date of this Offer, at par, in the manner described below.

22           “Eligible Auction Rate Securities,” for purposes of this Order, shall mean auction rate  
23 securities publicly issued by municipalities or closed-end funds or backed by student loans and  
24 purchased at Merrill Lynch on or before February 13, 2008. Notwithstanding any other provision,  
25 Eligible Auction Rate Securities shall not include privately issued or placed auction rate securities  
26 that are unregistered and/or offered pursuant to SEC Rule 144A, or other exemptions of the  
Securities Act of 1933.