

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

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4:41 pm, Aug 26, 2014

In the Matter of:)
)
)

Merrill Lynch, Pierce, Fenner
& Smith Incorporated)

Respondent.)
)
)

14-22

CFTC Docket No. _____

ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTIONS
6(c) AND 6(d) OF THE COMMODITY EXCHANGE ACT, AS
AMENDED, MAKING FINDINGS AND IMPOSING REMEDIAL
SANCTIONS

I.

The Commodity Futures Trading Commission (“Commission”) has reason to believe that from at least January 1, 2010 through April 2013 (the “Relevant Period”), Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill” or “Respondent”) violated Commission Regulation (“Regulation”) 166.3, 17 C.F.R. § 166.3 (2013). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether Respondent engaged in the violations set forth herein and to determine whether any order should be issued imposing remedial sanctions.

II.

In anticipation of the institution of an administrative proceeding, Respondent has submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. Without admitting or denying any of the findings or conclusions herein, Respondent consents to the entry of this Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act (“Act”), as Amended, Making Findings and Imposing Remedial Sanctions (“Order”) and acknowledges service of this Order.¹

¹ Respondent consents to the entry of this Order and to the use of these findings in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party; provided, however, that Respondent does not consent to the use of the Offer, or the findings or conclusions in this Order consented to in the Offer, as the sole basis for any other proceeding brought by the Commission, other than in a proceeding in bankruptcy or to enforce the terms of this Order. Nor does Respondent consent to the use of the Offer or this Order, or the findings or conclusions in this Order consented to in the Offer, by any other party in any other proceeding.

III.

The Commission finds the following:

A. SUMMARY

During the Relevant Period, Merrill failed to supervise diligently its officers', employees', and agents' processing of exchange and clearing fees charged to its customers, in violation of Regulation 166.3. As a result, Merrill's reconciliation process for identifying and correcting discrepancies between the invoices from the exchange clearinghouses and the amounts charged to customers has been inaccurate and faulty since at least January 1, 2010, and led to instances in which Merrill appears to have overcharged some customers and undercharged others. Where Merrill has confirmed that there was an overcharge to a customer, the customer's account has been adjusted, but Merrill has been unable to fully resolve some discrepancies. Additionally, during the Relevant Period, Merrill did not hire qualified personnel to conduct and oversee the fee reconciliations or provide adequate training to existing personnel regarding fee reconciliations.

B. RESPONDENT

Merrill Lynch, Pierce, Fenner & Smith Incorporated is a Delaware corporation, registered futures commission merchant ("FCM") and approved swap firm located in New York, New York. Merrill is also a registered broker-dealer with the U.S. Securities and Exchange Commission. According to its CFTC form 1-FR, as of December 31, 2013, Merrill's net capital was \$11.5 billion.

C. FACTS

1. **Merrill's Fee Collection Process**

Customer transactions executed on exchanges are subject to payment of exchange and clearing fees that are applied to each transaction in the normal course of business. Merrill receives invoices for these fees from the exchange clearinghouses, which Merrill passes on to its customers. The fees charged by exchanges vary based on the different memberships held by traders, and in addition the exchanges have instituted various incentive programs which provide fee discounts or rebates based on monthly trading volumes in certain contracts. Amounts due under these programs are determined at the end of each month, when the total trading volume across all FCMs for the past month is known. Accordingly, Merrill charges its customers fees on a transaction by transaction basis and then engages in manual processing at the end of each month to compute discounts and credit them to its customer accounts.

Merrill's fee group is responsible for reconciling all customer and firm exchange and clearing fees for each exchange where Merrill is a clearing member, as well as setting up the commercial post-trade processing software to process fees across those exchanges. For each exchange where Merrill is a clearing member, Merrill maintains a separate clearing fees payable account through which it collects clearing fees, including fees from customers; to remit to a

particular exchange. Merrill also maintains separate fee accounts to collect and remit National Futures Association (“NFA”) fees to the NFA.

The fee group is responsible, on a monthly basis, for reconciling all sub-ledger accounts in its post-trade processing software that collect and remit customer and firm clearing, exchange and pit brokerage to the various exchanges where Merrill is a clearing member as well as fees owed to the NFA. In order to complete a reconciliation of these accounts, the fee group compares the actual invoices billed by the exchange with the balances of the applicable sub-ledger accounts in the post-trade processing software. As part of the reconciliation process the fee group is responsible for the research and reconciliation of any variances or differences (i.e., “breaks”) located in the sub-ledger accounts, itemization and aging of those breaks, and identification and preparation of journal entries in the sub-ledger accounts to resolve the differences. Once the sub-ledger accounts are reconciled by the fee group, any adjustments to the balances in those accounts are automatically reflected in Merrill’s general ledger.

2. Merrill’s Failure To Accurately Calculate Fees

In December 2012, the director of the fee group brought to his manager’s attention that he was not able to balance the November 2012 exchange and clearing fees reconciliations prompting senior management of futures operations to review the November and December 2012 clearing and exchange fee reconciliations. The review brought to light weaknesses in the reconciliations regarding the amount of exchange and clearing fees Merrill collected from its customers and the amount of exchange and clearing fees the exchange charged Merrill. This prompted Merrill to conduct an internal review of reconciliations performed by the fee group. The review confirmed that Merrill’s reconciliation processes and procedures could not achieve their objective of reconciling the sub-ledger accounts in Merrill’s books and records to the clearing and exchange fee invoices Merrill received from the clearing houses. The conclusions of the review were escalated internally in early 2013. At the same time, a project was established to develop the necessary reconciliation improvements and review static data potentially impacting fee calculations. Through this initiative, improvements in clearing, exchange, and pit brokerage fee reconciliation processes and procedures as well as improvements in static data maintenance were implemented beginning in 2013.

3. Remediation of Fee Reconciliation Process

In April 2013, senior management of futures operations fired the fee group’s supervisor. Other supervisors at Merrill, including the replacement supervisor for the fee group, impressed upon members of the fee group that they needed to identify the cause of any breaks in the fee reconciliations and fix them immediately. The replacement supervisor for the fee group, hired in July 2013, however, was also fired from Merrill in January 2014. However, as a result of an internal reorganization, his duties relating to the fee group had been assumed by a new Vice President Manager in November 2013.

Between April 2013 and March 2014, Merrill retained two outside consulting firms to review its fee reconciliation process, analyze static data and review and correct past fee reconciliations. These consultants worked on implementing procedures for reconciling exchange

and clearing fees to pass on to Merrill's customers and to determine the total amount of money Merrill may have overcharged its customers for Chicago Board of Trade ("CBOT") and CME exchange and clearing fees during a specified period. Initially, Merrill planned to review CME and CBOT fee reconciliations for 2013 before deciding whether to review additional prior years. However, after consultation with the Commission, Merrill has now reviewed fee reconciliations for CME fees from January 2010 through October 2013 and CBOT fees from January 2011 to October 2013 and determined that they were not done properly, and as a result Merrill over-accrued fees from some clients and under-accrued fees from others. These fee reconciliations show that Merrill paid more than \$318 million in exchange and clearing fees to the CME and CBOT during that time, but had unexplained over-accruals of approximately \$451,318 (0.14% of fees paid) from 196 clients.

4. Merrill's Lack of Training and Procedures Regarding Processing of Exchange and Clearing Fees Charged to Customers.

Throughout the Relevant Period, Merrill did not provide any completed procedures manuals regarding fee reconciliations to its staff. Until at least April 2013, Merrill's procedures regarding how to conduct reconciliations of clearing and exchange fees charged to customers or to detect inaccuracies in the fees charged consisted of a one page check-list. Employees did not receive any meaningful training regarding how to conduct fee reconciliations until 2013. Within the fee group, the minimal written fee reconciliation procedures Merrill had were viewed as "not fit for purpose" because they were "fundamentally flawed". Ultimately, if any fee reconciliation procedures existed, the fee group did not understand them and had not been properly trained in accounting and controls. In March 2013, Merrill began implementing improved reconciliation procedures and working on a lengthy document to reflect these procedures, which was completed in May 2014.

IV.

LEGAL DISCUSSION

A. Merrill Failed to Properly Supervise Its Employees

Regulation 166.3, 17 C.P.R. § 166.3 (2013), requires:

Each Commission registrant, except an associated person who has no supervisory duties, must diligently supervise the handling by its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business as a Commission registrant.

A violation under Regulation 166.3 is an independent violation for which no underlying violation is necessary. See *In re FCStone LLC*, No. 13-24, at 8 (CFTC May 29, 2013); *In re Collins*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,194 at 45,744 (CFTC

Dec. 10, 1997).

A violation of Regulation 166.3 is demonstrated by showing either that: (1) the registrant's supervisory system was generally inadequate; or (2) the registrant failed to perform its supervisory duties diligently. *In re Rosenthal Collins Group, LLC*, [2012 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 32,166 at 69,269 (CFTC Apr. 12, 2012); *In re Murlas Commodities*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,485 at 43,161 (CFTC Sept. 1, 1995); *In re GNP Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 at 39,219 (CFTC Aug. 11, 1992) (providing that, even if an adequate supervisory system is in place, Regulation 166.3 can still be violated if the supervisory system is not diligently administered); *In re Paragon Futures Assoc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,266 at 38,850 (CFTC Apr. 1, 1992) (“The focus of any proceeding to determine whether Rule 166.3 has been violated will be on whether [a] review [has] occurred and, if it did, whether it was diligent.”); *Samson Refining Co. v. Drexel Burnham Lambert, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,596 at 36,566 (CFTC Feb. 16, 1990) (noting that, under Regulation 166.3, an FCM has a “duty to develop procedures for the detection and deterrence of possible wrongdoing by its agents”) (internal quotation omitted). Evidence of violations that “should be detected by a diligent system of supervision, either because of the nature of the violations or because the violations have occurred repeatedly” is probative of a failure to supervise. *In re Paragon Futures Assoc.*, ¶ 25,266 at 38,850.

During the Relevant Period, with respect to the processing of exchange and clearing fees charged to Merrill's customers, Merrill both employed an inadequate supervisory system and failed to perform its supervisory duties diligently, in violation of Regulation 166.3. Supervisors of the fee group who conducted the reconciliations were not properly trained or qualified to conduct or supervise others conducting fee reconciliations. Additionally, other than a one page check-list, Merrill did not have procedures in place regarding how to conduct fee reconciliations during the Relevant Period, and the fee group did not receive specialized training on how to conduct fee reconciliations until 2013 even though the fee group had been conducting these reconciliations since at least January 2010.

Further, the fee group and its supervisors, who were charged with performing the reconciliations, were not qualified or properly trained to conduct fee reconciliations. Merrill was required to ensure the accuracy of the clearing and exchange fees charged to customers; instead, Merrill allowed its officers, agents, and employees to establish and maintain clearing and exchange fee reconciliations that were inaccurate and faulty. Merrill also failed to detect that it appears to have been overcharging or undercharging certain customers clearing and exchange fees and that its fee reconciliations were inaccurate and faulty until late 2012. Merrill should have monitored its officers, employees, and agents responsible for the fee reconciliations more closely to ensure that they were being done accurately and that the employees conducting and supervising the conduct of the reconciliations were adequately trained and had sufficient procedures in place.

V.

FINDINGS OF VIOLATION

Based on the foregoing, the Commission finds that, during the Relevant Period, Merrill violated Regulation 166.3, 17 C.F.R. §166.3.

VI.

OFFER OF SETTLEMENT

Respondent has submitted the Offer in which it, without admitting or denying the findings and conclusions herein:

- A. Acknowledges receipt of service of this Order;
- B. Admits the jurisdiction of the Commission with respect to all matters set forth in this Order and for any action or proceeding brought or authorized by the Commission based on violation of or enforcement of this Order;
- C. Waives:
 - 1. the filing and service of a complaint and notice of hearing;
 - 2. a hearing;
 - 3. all post-hearing procedures;
 - 4. judicial review by any court;
 - 5. any and all objections to the participation by any member of the Commission's staff in the Commission's consideration of the Offer;
 - 6. any and all claims that it may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (2006) and 28 U.S.C. § 2412 (2006), and/or the rules promulgated by the Commission in conformity therewith, Part 148 of the Commission's Regulations, 17 C.P.R. §§ 148.1-30 (2011), relating to, or arising from, this proceeding;
 - 7. any and all claims that it may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, §§ 201-253, 110 Stat. 847, 857-868 (1996), as amended by Pub. L. No. 110-28, § 8302, 121 Stat. 112, 204-205 (2007), relating to, or arising from, this proceeding; and
 - 8. any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief;

- D. Stipulates that the record basis on which this Order is entered shall consist solely of the findings contained in this Order to which Respondents have consented in the Offer;
- E. Consents, solely on the basis of the Offer, to the Commission's entry of this Order that:
1. makes findings by the Commission that Respondent violated Regulation 166.3, 17 C.P.R. § 166.3;
 2. orders Respondent to cease and desist from violating Regulation 166.3, 17 C.F.R. § 166.3;
 3. orders Respondent to pay a civil monetary penalty in the amount of one million two hundred thousand dollars (\$1,200,000) plus post-judgment interest; and
 4. orders Respondent and its successors and assigns to comply with its undertakings as set forth below in Section VII of this Order.

Upon consideration, the Commission has determined to accept the Offer.

VII.

ORDER

Accordingly, IT IS HEREBY ORDERED THAT:

- A. Respondent shall cease and desist from violating Regulation 166.3, 17 C.F.R. § 166.3 (2013).
- B. Respondent shall pay a civil monetary penalty in the amount of one million two hundred thousand dollars (\$1,200,000) within ten (10) days of the date of entry of this Order (the "CMP Obligation"). Post-judgment interest shall accrue on the CMP Obligation beginning on the date of entry of this Order and shall be determined by using the Treasury Bill rate prevailing on the date of entry of this Order pursuant to 28 U.S.C. § 1961 (2006). Respondent shall pay the CMP Obligation by electronic funds transfer, U.S. postal money order, certified check, bank cashier's check, or bank money order. If payment is to be made other than by electronic funds transfer, then the payment shall be made payable to the Commodity Futures Trading Commission and sent to the address below:

Commodity Futures Trading Commission
Division of Enforcement
ATTN: Accounts Receivables--- AMZ 340
E-mail Box: 9-AMC-AMZ-AR-
CFTC DOT/FAA/MMAC

6500 S. MacArthur Blvd.
Oklahoma City, OK 73169
Telephone: (405) 954-7262

If payment is to be made by electronic funds transfer, Respondent shall contact Nikki Gibson or her successor at the above address to receive payment instructions and shall fully comply with those instructions. Respondent shall accompany payment of the CMP Obligation with a cover letter that identifies the paying Respondent and the name and docket number of this proceeding. The paying Respondent shall simultaneously transmit copies of the cover letter and the form of payment to the Chief Financial Officer, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581.

C. Respondent and its successors and assigns shall comply with the following conditions and undertakings set forth in the Offer:

1. To the extent it has not already done so, Respondent will immediately undertake to implement strengthened processes and procedures related to futures exchange and clearing fee reconciliations that will not only improve accuracy, but detect when Respondent's customers have been charged inaccurate futures exchange and clearing fees. Within thirty (30) days of the effective date of this Order, Respondent will hire an outside consulting firm ("Consultant") that is not unacceptable to the Commission and who is knowledgeable of the Act and Regulations, possesses strong internal control expertise, including expertise on conducting futures exchange and clearing fee reconciliations and has previously provided consulting services to FCMs. The Consultant shall review and assess Respondent's processes and procedures regarding futures exchange and clearing fee reconciliations, provide training, and make recommendations to prevent future violations of the Act and Regulations, and assist Respondent in reviewing and updating its current futures exchange and clearing fee processes and procedures as necessary in order to fully comply with the Act and Regulations. Within 120 days after the effective date of this Order, the Consultant will submit to Commission staff a written report describing the processes and procedures it has recommended at that time and any deficiencies in the implementation of such processes and procedures by Respondent. The Consultant shall conduct a review of Respondent's futures exchange and clearing fee reconciliation processes and procedures 90 days after issuing this report, and every 90 days thereafter for a period of one year from the effective date of this order to determine whether Respondent has corrected the deficiencies noted in the report, and the Consultant shall submit a written report of the results of this review to Commission staff within ten (10) days after the completion of such review.

2. Public Statements: Respondent agrees that neither it nor any of its successors and assigns, agents or employees under its authority or control shall take any action or make any public statement denying, directly or indirectly, any findings or conclusions in this Order or creating, or tending to create, the impression that this Order is without a factual basis; provided, however, that nothing in this provision shall affect Respondent's: (i) testimonial obligations; or (ii) right to take legal positions in other proceedings to which the Commission is not a party. Respondent and its successors and assigns shall undertake all steps necessary to ensure that all of its agents and/or employees under its authority or control understand and comply with this agreement.
3. Cooperation with the Commission: Respondent shall cooperate fully and expeditiously with the Commission, including the Commission's Division of Enforcement, and any other governmental agency in this action, and in any investigation, civil litigation, or administrative matter related to the subject matter of this action or any current or future Commission investigation related thereto.
4. Partial Satisfaction: Respondent understands and agrees that any acceptance by the Commission of partial payment of Respondent's CMP Obligation shall not be deemed a waiver of its obligation to make further payments pursuant to this Order, or a waiver of the Commission's right to seek to compel payment of any remaining balance.

The provisions of this Order shall be effective on this date.

By the Commission



Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission

Dated: August 26, 2014