
FINAL NOTICE

To: **Merrill Lynch International**

Of: **Merrill Lynch Financial Centre, 2 King Edward Street, London, EC1A 1HQ**

Date: **4 August 2006**

TAKE NOTICE: The Financial Services Authority (“the FSA”) of 25 The North Colonnade, Canary Wharf, London, E14 5HS gives you final notice about a requirement to pay a financial penalty:

1. ACTION

1.1. For the reasons listed below, and pursuant to section 206 of the Financial Services and Markets Act 2000 (“the Act”), the FSA proposes to impose a financial penalty upon you, Merrill Lynch International (“Merrill Lynch”) in the sum of £150,000 in respect of a breach of Rule 5.49 of the Securities & Futures Authority (“SFA”) and SUP 17.6.2R of the FSA Rules.

2. REASONS FOR THE ACTION

2.1. From September 1996 to December 2001, Merrill Lynch breached SFA Rule 5.49 by failing to accurately report the capacity in which it executed transactions in non-UK European equities when reporting transactions to the SFA. From December 2001 until January 2006, Merrill Lynch breached FSA Rule SUP 17.6.2R by failing to accurately report the capacity in which it executed transactions in non-UK European equities when reporting transactions to the FSA.

3 **FACTS AND MATTERS RELIED ON**

- 3.1 Merrill Lynch acquired Smith New Court in 1995. The two firms' systems and processes were integrated in September 1996, at which time, Merrill Lynch introduced execution services in European equities for customers of the firms' US broker dealer affiliate (the "US affiliate").

- 3.2 When dealing with US clients of the US affiliate who wish to buy or sell international equities, Merrill Lynch deals in the market as principal, and then books an equal and opposite trade with its US affiliate. The US affiliate then books a further back to back trade with its client to complete the commercial sequence and reflect the full nature of the transaction. While Merrill Lynch acts as *principal* in this process, its transaction reports have shown its status as *agent*. From 1996 to date, Merrill Lynch has had systems in place to make transaction reports to the SFA and later to FSA, and has been aware of the applicable requirements to make transaction reports in relation to them.

- 3.3 Until December 2001, Merrill Lynch was required to comply with SFA Rule 5.49 which required the firm to supply the SFA with details of transactions it executed including the capacity in which it conducted transactions. From December 2001 onwards, Merrill Lynch has been required to comply with FSA rule 17.6.2R which requires an authorised firm to include in its transaction reports the capacity in which its transactions were executed.

- 3.4 Between September 1996 and January 2006, Merrill Lynch executed 1.2 million transactions in non-UK European equities. These transactions were incorrectly reported to the SFA and, from December 2001 onwards, to the FSA by Merrill Lynch, by reason of the capacity indicator incorrectly recording the trades as agent rather than principal. The significance of the indicator being incorrectly set was that Merrill Lynch has been reporting transactions from the client's perspective instead of the firm's perspective.

- 3.5 The incorrect capacity indicators originate from the creation of the transaction flow in September 1996, when the Principal/Agent flag was coded. The firm had assumed that the initial testing had confirmed this aspect of reporting, and the testing programme focused on

establishing the completeness of the report without considering whether the flag had been correctly set. This assumption, which was at the root of the problem, was never re-visited.

- 3.6 Merrill Lynch received a Private Warning Letter dated 7 November 2002 from the FSA in respect of the firm's failure to report certain transactions.
- 3.7 As a result of this lapse, Merrill Lynch formed a working group in November 2002 to review the mechanisms used to report transactions to the FSA, and examine the processes that support those mechanisms. This evolved into the Transaction Reporting Oversight Group which first met in February 2003.
- 3.8 Steps introduced by the Transaction Reporting Oversight Group included annual refresher training for staff involved in reporting, and quarterly attestations of testing processes. Systems and controls in place between November 2002 and the first quarter of 2005 comprised high level reviews of the process. No checks were directed towards the content of the transaction reports submitted in accordance with the regulatory rules.
- 3.9 By the end of 2004, formal schemes were prepared to test the completeness of reporting across the firm. Until then, identified errors had mostly related to the omission of reports rather than the accuracy of fields. The emphasis changed to tests for each specific business process. Managers responsible for the cash equity process submitted attestations for Q1, Q2 and Q4 2005. Knowledge of previously identified errors was used to direct the deployment of resources against known risks, with other aspects of reporting assumed to be correct, in the absence of contrary indications. This testing process was not sufficiently thorough, because it failed to check the content of the transaction reports submitted by the various reporting systems and to look for risks.
- 3.10 During 2004 and 2005, Merrill Lynch increased its focus on transaction reporting issues, enhancing resources, the seniority of those involved, and using external consultants. Merrill Lynch took these steps following further discussions with the FSA about a particular series of transactions in 2003/4.
- 3.11 In December 2005, as a result of the increased sensitivity to, and focus on, transaction reporting, Merrill Lynch became aware of the reporting failures which are the subject of this

Notice. Trade breaks between the firm and its US affiliate were identified in relation to one entity whose static data details had been incorrectly updated. Dealing capacity was one of the required trade attributes which had not been applied. An assessment of the impact of the data failure on the downstream processes, including transaction reporting, was suggested. Verification of the dealing capacity with which trades were reported with the US affiliate showed that transactions involving European products were incorrectly sent with an agency flag.

- 3.12 On 6 January 2006, Merrill Lynch self-reported the transaction failures to the FSA, following which the firm has fully co-operated with the FSA's investigation. Merrill Lynch completed a systems change to correct the capacity indicator on 16 January 2006, and has revised the testing mandate to include all mandatory fields.
- 3.13 Since December 2005, Merrill Lynch embarked upon a total system review, quickly committing substantial resources to the project and placing significant senior management focus on the issues notified to the FSA. The firm has devised a methodology for a 100% check of all transaction flows to avoid any recurrent or new reporting oversight in the future. The firm's review will be assessed by external consultants to ensure that it applies methodology and implements standards consistent with industry best practice.

4 RELEVANT STATUTORY PROVISIONS AND GUIDANCE

- 4.1 Section 206 of FSMA authorises the FSA to impose a financial penalty if it considers that an authorised person has contravened a requirement imposed on him by or under FSMA.
- 4.2 Merrill Lynch is an authorised person under FSMA and prior to December 2001 the firm was subject to the rules of the FSA.
- 4.3 Article 8 of the Financial Services and Markets Act 2000 (Transitional Provisions and Savings) (Civil Remedies, Discipline, Criminal Offences etc) (No 2) Order 2001 ("the Order") enables the FSA to take disciplinary action against an authorised firm for misconduct prior to December 2001 (N2).

4.4 Breach of Rule 5.49 of the Securities and Futures Authority Rules ("the SFA Rules") constitutes an act of misconduct within the meaning of rule 7.23A(3)(a) of the SFA Rules.

5 RULE BREACHES

5.1 Merrill Lynch breached Rule 5.49 SFA Rules: Rule 5.49(1) states that a firm must supply to the SFA, in accordance with and subject to the provisions below, details about transactions (including own account transactions) in investments which it effects: 5.49(8) states that a transaction will be taken to have been reported...only if all the mandatory fields set out in Appendix 17 can be properly implied or have been completed correctly. Appendix 17 requires firms to state the capacity (principal or agent) in which it executed reportable transactions.

5.2 Merrill Lynch breached FSA Rule SUP 17.4R by failing to submit transaction reports in accordance with the requirements set out in SUP 17.6.2R and SUP 17 Annex 2. SUP 17.4R states that when a firm (whether on its own account or on behalf of another) enters into a reportable transaction, it must make a transaction report (as set out in SUP 17.6) to the FSA. SUP 17.6.2R(3) states that a transaction report must include all the fields identified in SUP Annex 2 for the relevant reporting system. SUP 17 Annex 2 [1] (6) includes a requirement to state whether a firm dealt as principal or agent.

6 RELEVANT GUIDANCE ON SANCTION

6.1 In deciding to take the proposed action, the FSA has had regard to guidance published in the Enforcement ("ENF") module of the FSA Handbook, and in particular:

6.1.1 **ENF 11**, which sets out the FSA's general approach to discipline;

6.1.2 **ENF 11.4**, which sets out the criteria for determining whether to take disciplinary action; and

6.1.3 **ENF 13**, which sets out the FSA's approach to imposing a financial penalty.

7 SANCTION

- 7.1 In all the circumstances, and having regard to the factors set out in paragraphs 7.2 and 7.3 below, the FSA has concluded that the imposition on Merrill Lynch of a financial penalty of £150,000 (discounted to take account of early settlement) is appropriate and proportionate.
- 7.2 In proposing to impose a financial penalty of £150,000, the FSA has taken into account the relevant circumstances of the breach, including the following factors:
- 7.2.1 The period of time during which Merrill Lynch made inaccurate transaction reports, being 9 years from September 1996 to January 2006 inclusive;
- 7.2.2 The estimated number of transactions inaccurately reported, being 1.2 million;
- 7.3 The FSA has also taken into account the following mitigating factors in favour of Merrill Lynch:
- 7.3.1 Merrill Lynch's failure was not deliberate or reckless;
- 7.3.2 Merrill Lynch has taken substantial steps to improve its systems and controls to ensure that going forward transaction reports are accurate (including a total systems review, the efficacy of which will be assessed by external consultants);
- 7.3.3 Merrill Lynch reported the matter to the FSA; and
- 7.3.4 Merrill Lynch has co-operated fully with the FSA in respect of this matter.

8 DECISION MAKERS

- 8.1 The decision which gave rise to the obligation to give this notice was made by the Executive Settlement Decision Makers on behalf of the FSA.

9 IMPORTANT NOTICES

- 9.1 This Final Notice is given to you under section 390 of the Act.

Manner of and time for Payment

9.2 The financial penalty must be paid in full by Merrill Lynch to the FSA by no later than 5pm on Thursday 17 August 2006, being 14 days from the date of this Final Notice.

If the financial penalty is not paid

9.3 If all or any of the financial penalty is outstanding on Thursday 17 August 2006, the FSA may recover the outstanding amount as a debt owed by Merrill Lynch and due to the FSA.

Publicity

9.4 Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this Notice relates. Under those provisions, the FSA must publish such information about the matter to which this Notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair or prejudicial to the interests of consumers.

9.5 The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

9.6 For more information concerning this matter generally, you should contact Kevin Quinlan (020 7066 1334).

Jamie Symington

Head of Wholesale Department

FSA Enforcement