

STATE OF ALABAMA  
ALABAMA SECURITIES COMMISSION

In the matter of )  
 )  
MERRILL LYNCH, PIERCE, FENNER ) ADMINISTRATIVE CONSENT ORDER  
& SMITH INCORPORATED, ) NO. CO-2009-0025  
 )  
Respondent. )  
 )  
 )

WHEREAS, Merrill, Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") is a broker-dealer registered in the state of Alabama, with a Central Registration Depository ("CRD") number of 7691; and

WHEREAS, coordinated investigations into Merrill Lynch's activities in connection with its marketing and sale of financial instruments known as auction rate securities ("ARS") to retail and other customers have been conducted by a multistate task force; and

WHEREAS, Merrill Lynch has cooperated with regulators conducting the investigations by responding to inquiries, providing documentary evidence and other materials, and providing regulators with access to facts relating to the investigations; and

WHEREAS, Merrill Lynch has advised regulators of its agreement to resolve the investigations relating to its marketing and sale of ARS on the terms specified in this Administrative Consent Order (the "Order"); and

WHEREAS, Merrill Lynch agrees to implement certain changes with respect to its marketing and sale of ARS, and to make certain payments in accordance with the terms of this Order; and

WHEREAS, Merrill Lynch elects to permanently waive any right to a hearing and appeal under Section 8-6-25 Code of Alabama 1975, with respect to this Order; and

WHEREAS, solely for the purposes of terminating the multistate task force investigations, including the investigation by Commission , and in settlement of the issues contained in this Order, Merrill Lynch, without admitting or denying the Statement of Facts and Conclusions of Law contained in this Order, and without an adjudication of any issue of law or fact, consents to the entry of this Order.

1 NOW, THEREFORE, the Alabama Securities Commission ("Commission"), as administrator  
2 of the Title 8, Chapter 6, Code of Alabama 1975, the Alabama Securities Act ("Act"), hereby enters  
3 this Order:

4 **I.**

5 **STATEMENT OF FACTS**

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

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

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

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

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

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

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

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

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

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

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

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

1           10. Financial advisers ("FAs") would often forward Merrill Lynch marketing pieces to  
2 customers to reassure them of the safety and value of the instruments.

3           11. FAs who sold ARS were not required to provide customers with disclosures; instead,  
4 customers would receive customer's trade confirmations directing customers to where they could  
5 access Merrill Lynch's "Auction Rate Practices and Procedures."

6           12. On March 15, 2006, Merrill Lynch ended its practice of sending ARS purchasers a  
7 "Master Purchasers Letter". The Master Purchasers Letter was a disclosure document that all  
8 purchasers of ARS had been required to sign and return to Merrill Lynch.

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

14           14. Yet, since Merrill Lynch FAs were not required to affirmatively disclose these practices  
15 prior to selling a client an ARS; purchasers were largely unaware of Merrill Lynch's practices in  
16 supporting its ARS program.

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

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

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

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

- 26           • 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

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

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

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

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

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

23. 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.

24. 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.

25. 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.

26. 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.

**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.

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

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

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

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

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

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

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

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

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

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

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

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

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

6                               b.     Merrill Lynch Underwrote Auction Rate Securities With Restrictive  
7                                       Maximum Rates, Which Allowed The Securities To Achieve AAA  
8                                       Ratings.

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

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

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

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

22           42.     Once Merrill Lynch stopped placing support bids in the auctions for which it was the  
23     lead broker-dealer, there were auction failures across its program.

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

25           44.     The ARS with high maximum rates, typically municipal auction rate certificates  
26     ("ARCS") with maximum rates in the range of 12-15%, have drawn investor interest, and have cleared  
   without Merrill Lynch's support.

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

4                     c.       Merrill Lynch Additionally Received Fees To Remarket The Auction  
5                               Rate Securities It Underwrote.

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

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

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

12          49.     Prior to every auction for which Merrill Lynch was the sole or lead broker-dealer,  
13 Merrill Lynch would provide "price talk," a range of bids provided to FAs indicating where Merrill  
14 Lynch expected auctions to clear.

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

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

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

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

22          54.     When placing a support bid, Merrill Lynch would bid for the entire notional value of the  
23 issue being auctioned, regardless of the size or volume of buy, sell, or hold orders Merrill Lynch had  
24 received.

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

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

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

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

5           59. Investors were not provided with information about the level of support from Merrill  
6 lynch that was required to clear the auction.

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

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

10           1. Weakness in the Credit Markets Initiated Inventory Concerns In Summer Of  
11 2007.

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

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

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

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

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

25           66. The Auction Desk and the Financial Products Group, along with several of the  
26 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



1 auctions, reduce the rates of important issuers, and maintain a strong interest in ARS among the Merrill  
2 Lynch FAs all over the country.

3 2. Communications With Issuers And Others Expressing Concern About The  
4 Auction Markets.

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

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

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

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

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

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

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

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

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

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

25 E. **Merrill Lynch's Consolidated Effort to Reduce Inventory – A Three Pronged**  
26 **Approach.**

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

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

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

9           78. During the call, there was no discussion regarding the risk of any type of auction  
10 failure, or the likelihood or possibility that any market dislocation could result in retail customers' cash  
11 becoming illiquid.

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

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

18           2. FA Incentives - Increased Production Credits Sales Drive.

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

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

1  
2 3. Coordination with Research

3 a. Proactive Involvement From The Supposedly Independent Research  
4 Department To Aid In Sales Efforts.

5 83. Merrill Lynch's Research Department played a pivotal role in assisting sales of Auction  
6 Rate Securities.

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

10 b. Improper Information Sharing --Between Research and Sales and  
11 Trading.

12 85. The task force's investigation revealed frequent communications among research, sales,  
13 and trading staff.

14 86. Merrill Lynch Policy & Procedures Manual (the "Policies Manual") employs a so-  
15 called "Chinese Wall," which is designed to prevent "the misuse of material non-public information"  
16 and to prevent "even the appearance of impropriety."

17 87. The "Chinese Wall" is designed to "restrict and monitor the flow of information  
18 between the various areas of [Merrill Lynch] such as Global Research, Sales [and] Trading," among  
19 others "to avoid the misuse of such information and the appearance of impropriety as well as to  
20 manage potential conflicts of interest..."

21 88. Among those departments that constitute the "Private Side of the Wall" include:  
22 "Investment Banking, including Global Capital Markets and Financing (Equity Capital Markets and  
23 Debt Capital Markets)," and "other departments or individuals that regularly receive inside  
24 information," while the Research Division is on the "Public Side of the Wall."

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

90. Such information was discussed.

1           **F.     Improper Influence And Pressure Over Supposedly Independent Research**  
2           **Personnel.**

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

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

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

10           **G.     Events Leading To Merrill Lynch's Decision To Stop Broadly Supporting Its**  
11           **Auction Program.**

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

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

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

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

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

23           99.     On or about February 1, 2008, Merrill Lynch's Research Department published a  
24           volume of its Fixed Income Digest, entitled "Preserve Income Lock in Yields." The cover page  
25           included a section entitled "Preserve Income". The last sentence of the section provided: "For funds  
26           that investors need to keep liquid, we continue to find the best value in auction market securities."  
Inside the research piece, there was a subheading: "For Cash Holdings: auction market securities,"  
which recommended, [n]aturally, most investors need to keep some portion of their portfolios in liquid

1 cash-like instruments. We find auction market securities (AMS) to be better alternative than money  
2 funds for these purposes for investors with larger amounts to invest.” The section was followed  
3 immediately by another section dedicated to: “Answering Your Questions About Auction Market  
4 Securities” which responded to common questions relating to the auction markets at the time.

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

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

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

15 **H. Merrill Lynch Has Marked Down Its Own Inventory of Auction Rate Securities,**  
16 **But Still has Not Marked Down The Estimated Value Of The Auction Rate**  
17 **Securities On Its Clients’ Account Statements.**

18 103. Merrill Lynch has marked down the value of its own inventory of auction rate  
19 securities, yet has not marked down the value of those same auction rate securities in its client  
20 statements.

21 104. According to client statements received by the task force, auction rate securities listed  
22 on client statements have not been marked down to reflect their illiquidity. Their “estimated market  
23 value” is still listed as 100 percent of par. Certain of the exact same instruments held by Merrill Lynch  
24 in its inventory have been marked down from par.

25 **II.**

26 **CONCLUSIONS OF LAW**

1. The Commission has jurisdiction over this matter pursuant to Section 8-6-3 and 8-6-4 Code of Alabama 1975, the Alabama Securities Act.

2. The above conduct is in violation of Section 8-6-17(b)(4) and Section 8-6-3 (j) (10), Code of Alabama 1975, the Alabama Securities Act.

3. The Commission finds the following relief appropriate and in the public interest.

### III.

## ORDER

On the basis of the Statement of Facts, Conclusions of Law, and Merrill Lynch's consent to the entry of this Order,

IT IS HEREBY ORDERED:

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

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

3. Merrill Lynch will CEASE AND DESIST from violating the Alabama Securities Act ("Act") and will comply with the Act.

4. Merrill Lynch shall pay fines and/or penalties totaling \$125 million (the "Total Penalty") to the Commonwealth of Massachusetts and the other states, which shall be allocated at the Commonwealth of Massachusetts and the other states' discretion, to resolve all underlying conduct relating to the sale of auction rate securities. Merrill Lynch shall pay \$1,044,975.20 of the Total Penalty to the Commission. The payment to the State of Alabama shall be paid in four (4) separate checks in the form of certified or bank checks made as follows: 1.) Respondents shall pay \$500,000.00 to the Alabama Securities Commission as reimbursement of direct and indirect costs and

1 expenses of the Commission's cost for investigating this matter in accordance with Section 8-6-19 (k)  
2 (1), Code of Alabama 1975; 2.) Respondents shall pay \$400,000.00 to the Alabama District Attorney  
3 Association, a non-profit corporation; 3.) Respondents shall pay \$119,975.20 to the Investor  
4 Protection Trust, a non-profit corporation and such funds are designated specifically for investor  
5 education and investor protection in the state of Alabama as directed by the Alabama Securities  
6 Commission in its sole discretion; 5) Respondents shall pay \$25,000.00 to the North American  
7 Securities Administrators Association. All checks shall be delivered to the office of the Alabama  
8 Securities Commission. In the event another state securities regulator determines not to accept  
9 Respondents' settlement offer, the total amount of the payment to the Commission shall not be  
10 affected, and shall remain at \$1,044,975.20.

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

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

20 "Eligible Investors," for purposes of this Settlement, shall mean:

21 (i) Natural persons (including their IRA accounts, testamentary trust and estate accounts,  
22 custodian UGMA and UTMA accounts, and guardianship accounts) who purchased Eligible Auction  
23 Rate Securities at Merrill Lynch:

24 (ii) All small business and not for profit clients in Merrill Lynch's Global Wealth  
25 Management Group who purchased Eligible Auction Rate Securities at Merrill Lynch that had \$100  
26 million or less in assets in their accounts with Merrill Lynch, net of margin loans, as of August 7,  
2008, or, if the customer was not a customer of Merrill Lynch as of August 7, 2008, as of the date that

1 the customer terminated its customer relationship with Merrill Lynch. Notwithstanding any other  
2 provision, "small business and not for profit clients" does not include broker-dealers or banks acting as  
3 conduits for their customers.

4 6. Tranche I Eligible Investors. No later than September 26, 2008, Merrill Lynch shall  
5 have offered to purchase at par, plus any accrued but unpaid interest or dividends, Eligible Auction  
6 Rate Securities for which auctions are not successfully auctioning from Eligible Investors who had less  
7 than \$4 million in assets at Merrill Lynch as of August 7, 2008. Merrill Lynch's offer to purchase such  
8 securities from Eligible Investors will remain open from October 1, 2008, through January 15, 2010,  
9 and Merrill Lynch shall promptly purchase such securities from any Eligible Investor who accepts this  
10 offer between January 2, 2009, and January 15, 2010.

11 For purposes of this Settlement, legal entities forming an investment vehicle for closely related  
12 individuals, including but not limited to IRA accounts, Trusts, Family Limited Partnerships and other  
13 legal entities performing a similar function, charities and non-profits, and small businesses who had  
14 less than \$4 million in assets at Merrill Lynch shall be covered by Section III.5(i).

15 7. Tranche II Eligible Investors. No later than December 18, 2008, Merrill Lynch shall  
16 have offered to purchase at par, plus any accrued but unpaid interest or dividends, Eligible Auction  
17 Rate Securities from other Eligible Investors who purchased Eligible Auction Rate Securities from  
18 Merrill Lynch prior to February 13, 2008, and who had less than \$100 million in assets at Merrill  
19 Lynch as of August 7, 2008.

20 Merrill Lynch's offer to purchase such securities from Eligible Investors shall remain open  
21 from January 2, 2009 through January 15, 2010, and Merrill Lynch shall promptly purchase such  
22 securities from any investor who accepts this offer between January 2, 2009, and January 15, 2010.

23 8. Asset Amounts. Merrill Lynch shall calculate investor asset amounts as of August 7,  
24 2008, for all Eligible Investors with assets with Merrill Lynch as of that date. For Eligible Investors  
25 with no assets at Merrill Lynch as of that date, Merrill Lynch shall calculate investor asset amounts as  
26 of the date such investor removed their assets from Merrill Lynch.



1           9.     Notice and Assistance. Merrill Lynch shall provide prompt notice to customers of the  
2 settlement terms, and Merrill Lynch shall establish a dedicated telephone assistance line, with  
3 appropriate staffing, to respond to questions from customers concerning the terms of the settlement.

4           10.    Relief for Eligible Investors Who Sold Below Par. No later than October 1, 2008, any  
5 investor covered by Section III.5 that Merrill Lynch can reasonably identify who sold Eligible Auction  
6 Rate Securities below par between February 13, 2008, and October 1, 2008, shall be paid by Merrill  
7 Lynch the difference between par and the price at which such investor sold the Eligible Auction Rate  
8 Securities.

9           11.    Consequential Damages Claims. No later than October 1, 2008, Merrill Lynch shall  
10 make reasonable efforts promptly to notify those Eligible Investors covered by Section III.5 above who  
11 own Eligible Auction Rate Securities, pursuant to the terms of the settlement, that an independent  
12 arbitrator, under the auspices of the Financial Industry Regulatory Authority (FINRA), shall be  
13 available for the exclusive purpose of arbitrating any Eligible Investor's consequential-damages claim.  
14 Merrill Lynch shall consent to participate in the North American Securities Administrators  
15 Association's ("NASAA") Special Arbitration Procedures (the "SAP") established specifically for  
16 arbitrating any Eligible Investor's consequential damages claim arising from their inability to sell  
17 Eligible Auction Rate Securities. Nothing in this Offer shall serve to limit or expand any party's rights  
18 or obligations as provided under the SAP. Arbitration shall be conducted before a single non-industry  
19 arbitrator and Merrill Lynch will pay all forum and filing fees.

20               Arbitrations asserting consequential damages of less than \$1 million will be decided through a  
21 single chair-qualified public arbitrator who will be appointed through the FINRA list selection process  
22 for single arbitrator cases. In arbitrations where the consequential damages claimed are greater than or  
23 equal to \$1 million, the parties can, by mutual agreement, expand the panel to include three public  
24 arbitrators who will be appointed through FINRA's list procedure.

25               Any Eligible Investors who choose to pursue such claims through the SAP shall bear the  
26 burden of proving that they suffered consequential damages and that such damages were caused by  
their inability to access funds invested in Eligible Auction Rate Securities at Merrill Lynch as of

1 February 13, 2008. In the SAP, Merrill Lynch shall be able to defend itself against such claims;  
2 provided, however, that: Merrill Lunch shall not contest liability for the illiquidity of the underlying  
3 ARS position or use as part of its defense any decision by an Eligible Investor not to borrow money  
4 from Merrill Lynch. Special or punitive damages shall not be available in the SAP<sup>1</sup>.

5 All customers, including but not limited to Eligible Investors who avail themselves of the relief  
6 provided pursuant to this Order, may pursue any remedies against Merrill Lynch available under the  
7 law. However, Eligible Investors that elect to utilize the SAP are limited to the remedies available in  
8 that process and may not bring or pursue a claim relating to Eligible Auction Rate Securities in another  
9 forum.

10 12. Institutional Investors Not Covered By Section III.5. Merrill Lynch shall endeavor to  
11 continue to work with issuers and other interested parties, including regulatory and other authorities  
12 and industry participants, to expeditiously and on a best efforts basis provide liquidity solutions for  
13 investors who purchased Eligible Auction Rate Securities from Merrill Lynch and are not entitled to  
14 participate in the buyback described in Section III.5 above (referred to herein as "Institutional  
15 Investors").

16 Beginning January 2, 2009, and then quarterly after that, Merrill Lynch shall submit a written  
17 report to a representative specified by NASAA outlining the efforts in which Merrill Lynch has  
18 engaged and the results of those efforts with respect to Merrill Lynch Institutional Investors' holdings  
19 in Eligible Auction Rate Securities. Merrill Lynch shall confer with the representative no less  
20 frequently than quarterly to discuss Merrill Lynch's progress to date. Such quarterly reports shall be  
21 submitted within 20 days following the end of each quarter and continue until no later than January 15,  
22 2010. Following every quarterly report, the representative shall have the option of requiring a meeting  
23 between the State and Merrill Lynch to advise Merrill Lynch of any concerns and, in response, Merrill  
24 Lynch shall detail the steps that Merrill Lynch plans to implement to address such concerns. The

25 <sup>1</sup> However, it is agreed by the parties that "consequential damages" shall have a meaning separate and apart from  
26 "punitive or special damages." Under no circumstances should this provision be read to mean that a consequential damages  
claim may not be maintained due to any state law, which may categorize consequential damages as a subset within punitive  
and/or special damages.

1 reporting or meeting deadlines set forth above may be amended with written permission from the  
2 representative.

3 13. Relief for Municipal Issuers. Merrill Lynch shall refund refinancing fees to municipal  
4 auction rate issuers that issued such Eligible Auction Rate Securities in the initial primary market  
5 through Merrill Lynch between August 1, 2007, and February 13, 2008, and refinanced those securities  
6 through Merrill Lynch after February 13, 2008. Refinancing fees are those fees paid to Merrill Lynch  
7 in connecting with a refinancing and are exclusive of legal fees and any other fees or costs not paid to  
8 Merrill Lynch in connection with the transaction.

9 14. No Disqualification. The Order entered pursuant to this Offer hereby waives any  
10 disqualification contained in the laws of Alabama, or rules or regulations thereunder, including any  
11 disqualifications from relying upon the registration exemptions or safe harbor provisions that Merrill  
12 Lynch or any of its affiliates may be subject to. The Order entered pursuant to this Offer also is not  
13 intended to subject Merrill Lynch or any of its affiliates to any disqualifications contained in the  
14 federal securities laws, the rules and regulations thereunder, the rules and regulations of self regulatory  
15 organizations or various states' or U.S. Territories' securities laws, including, without limitation, any  
16 disqualifications from relying upon the registration exemptions or safe harbor provisions. In addition,  
17 this Order is not intended to form the basis for any such disqualifications.

18 15. Nothing herein shall preclude Alabama, its departments, agencies, boards, commissions,  
19 authorities, political subdivisions and corporations (collectively, "State Entities"), other than  
20 Commission and only to the extent set forth in paragraph 1 above, and the officers, agents or  
21 employees of State Entities from asserting any claims, causes of action, or applications for  
22 compensatory, nominal and/or punitive damages, administrative, civil, criminal, or injunctive relief  
23 against Merrill Lynch in connection with certain auction rate securities sales practices at Merrill  
24 Lynch.

25 16. For any person or entity not a party to the Order issued pursuant to this Offer, this Offer  
26 and the Order do not limit or create any private rights or remedies against Merrill Lynch including,  
without limitation, the use of any e-mails or other documents of Merrill Lynch or of others for auction

1 rate securities sales practices, limit or create liability of Merrill Lynch, or limit or create defenses of  
2 Merrill Lynch, to any claims.

3 17. In Consideration of the Settlement the Commission will:

4 a. Except as allowed by paragraph 17(b), terminate the investigation by the Commission  
5 and any other action that the Commission could commence on behalf of Alabama as it relates to Merrill  
6 Lynch's underwriting, marketing, and sales of Eligible Auction Rate Securities, provided, however, that  
7 excluded from and not covered by this paragraph are any claims by the Commission arising from or  
8 relating to the "Order" provisions contained herein.

9 b. Refrain from further investigation and from taking legal action, if necessary, against  
10 Merrill Lynch with respect to Institutional Investors until a date after December 31, 2009.

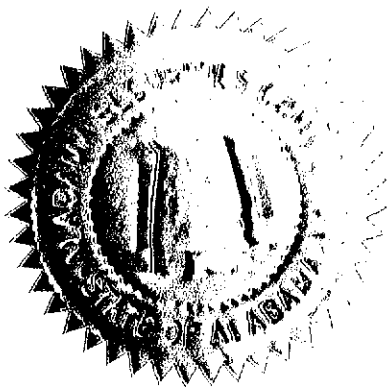
11 c. Not seek additional monetary penalties from Merrill Lynch relating to the issues raised  
12 by the Commission relating to Merrill Lynch's marketing and sale of Eligible Auction Rate Securities  
13 to investors and the firm permitting trading in auction rates securities by any individuals affiliated with  
14 Merrill Lynch.

15 18. Failure to Comply With Terms of Settlement. If after this settlement is executed,  
16 Merrill Lynch fails to comply with any of the terms set forth herein, the State may institute an action to  
17 vacate this Order. Upon issuance of an appropriate order, after an opportunity for a fair hearing, a state  
18 may reinstitute the actions and investigations referenced in this Order.

19 19. This Order and any dispute related thereto shall be construed and enforced in  
20 accordance with, and governed by, the laws of Alabama without regard to any choice of law principles.

21 20. This Order shall be binding upon Merrill Lynch and its successors and assigns as well  
22 as to successors and assigns of relevant affiliates with respect to all conduct subject to the provisions  
23 above and all future obligations, responsibilities, undertakings, commitments, limitations, restrictions,  
24 events, and conditions.

25 Dated this 11<sup>th</sup> day of September, 2009.



BY ORDER OF  
ALABAMA SECURITIES COMMISSION

A handwritten signature in dark ink, appearing to read "Joseph P. Borg", is written over a horizontal line. The signature is fluid and cursive, with a long, sweeping tail that extends to the right.

JOSEPH P BORG  
DIRECTOR

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