NASD
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. CAF030028

TO: Department of Enforcement
NASD

RE: Merrill Lynch, Pierce, Fenner & Smith Incorporated,
Respondent, CRD No. 7691

Pursuant to Rule 9216 of the NASD Code of Procedure, Respondent Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Respondent" or "Merrill Lynch") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described in Part II below. This AWC is submitted on the condition that, if accepted, NASD will not bring any future actions against Respondent alleging violations based on the same factual findings.

Respondent understands that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by NASD's Department of Enforcement and National Adjudicatory Council ("NAC"), pursuant to NASD Rule 9216;

2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and

3. If accepted:

   a. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by NASD, or any other regulator, against Respondent;

   b. this AWC will be made available through NASD's public disclosure program in response to public inquiries about Respondent's disciplinary record;

   c. NASD may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-2; and

   d. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any allegation in this AWC or creating the impression that the AWC is without factual basis.

> Nothing in this provision affects the testimonial obligations or right of Respondent to take factual or legal positions in litigation or other legal proceedings in which NASD is not a party.

Merrill Lynch also understands that its experience in the securities industry and its disciplinary history may be factors that will be considered in deciding whether to accept this AWC.

Merrill Lynch, a registered broker-dealer, has been a member of NASD since 1937. Its principal offices are located in New York City. Merrill Lynch engages in a full-service securities business, including retail and institutional sales, investment banking services, trading, and research. Merrill Lynch has no prior, relevant, disciplinary history; however, Merrill Lynch has entered into a prior settlement agreement with the New York Attorney General relating to many of the same factual findings set forth herein.

I.

WAIVER OF PROCEDURAL RIGHTS

Merrill Lynch specifically and voluntarily waives the following rights granted under NASD's Code of Procedure:

A. To have a Formal Complaint issued specifying the allegations against it;

B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;

C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and,

D. To appeal any such decision to the NAC and then to the U.S. Securities and Exchange Commission ("Commission") and a U.S. Court of Appeals.

Further, Merrill Lynch specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Merrill Lynch further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of Rule 9143 or the separation of functions prohibitions of Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

II.

ACCEPTANCE AND CONSENT

Merrill Lynch hereby accepts and consents, without admitting or denying the allegations or findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of NASD, or to which NASD is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by NASD:

A. Summary

During the period January 1, 1999 to December 31, 2001 (the "relevant period"), as enumerated below, Merrill Lynch published research reports on two Internet companies that violated antifraud provisions of the federal securities laws, and published research reports on five other Internet companies that expressed views inconsistent with the analysts' privately expressed negative views in violation of NASD's advertising rules. Those rules require that, among other things, published research reports have a reasonable basis, present a fair picture of the investment risks and benefits, and not make exaggerated or unwarranted claims.

On various occasions during the relevant period, Merrill Lynch allowed its investment banking function to exercise undue influence over research analysts, thereby resulting in conflicts of interest for its research analysts, and it failed to manage these conflicts in an adequate or appropriate manner. These circumstances arose from a combination of forces, including the following: (i) Merrill Lynch's investment banking division unduly influenced the analysts' decisions regarding whether to provide research coverage for a particular stock and how to rate that stock; (ii) Merrill Lynch encouraged research analysts to participate regularly in investment banking's marketing activities prior to the publication of research, and coordinated their research coverage with investment banking; (iii) in certain instances, Merrill Lynch investment bankers and actual and prospective investment banking clients reviewed draft research reports and ratings before publication, and Merrill Lynch used research in conjunction with investment banking to generate banking business; and (iv) Merrill Lynch's compensation of research analysts was influenced by the analysts' contributions to investment banking revenue.

Merrill Lynch's policies and procedures that were intended to maintain the independence of research analysts from investment banking were inadequate to ensure its research analysts issued objective research and were not compromised by the conflicts of interest described above. As a result, Merrill Lynch failed to adequately supervise the activities and conduct of its research analysts.

B. Overview of Internet Research at Merrill Lynch

During the relevant period, Merrill Lynch divided its research analysts into sectors that each covered a discrete industry, and published written research reports on selected companies within each sector. The three basic types of research reports issued by Merrill Lynch -- bulletins, comments, and in-depth reports – differed in length and level of detail. Bulletins did not include models, charts or other exhibits that would typically be included in a comment or in-depth report.

From February 1999 through December 2001, Merrill Lynch employed Henry Blodget as a senior research analyst to cover the Internet sector and to head a group of analysts who issued, and who assisted him in issuing, research reports and ratings on Internet companies. The Internet research group covered Internet and similar technology stocks during this period. Blodget was First Vice-President and Managing Director for Merrill Lynch and the senior research analyst for the Internet sector. The analyst principally responsible for each research report published by Merrill Lynch on covered Internet companies was usually listed first on the report.

Merrill Lynch divided the Internet sector into the following three subsectors: (i) consumer Internet, e-commerce and new media; (ii) Internet infrastructure services; and (iii) business to business Internet companies. Blodget wrote, reviewed and/or consulted with other analysts regarding research generated by the Internet sector, and was the senior research analyst on all but a handful of the research reports discussed below.

Each Merrill Lynch research report included an investment rating that was intended to reflect the analyst's opinion on how the stock would perform. During 1999 to May 2001, Merrill Lynch stated that it used the following five-point rating system:

1 - Buy
2 - Accumulate
3 - Neutral
4 - Reduce
5 - Sell

Merrill Lynch, however, did not rate any Internet stock a 5, and rated only one Internet stock a 4, during the relevant period. With respect to each of the research reports discussed below, the descriptive word(s) (e.g., "Buy", "Accumulate", etc.) representing the analyst's intermediate and long-term ratings appeared in the upper right corner of the research report in bold, capital letters, and in a font larger than in the text of the research report.

The descriptive words were to reflect the analyst's opinion of the stock's price appreciation potential over the intermediate term (0 to 12 months from the date of rating) and long term (more than 12 months from the date of rating): 1 – Buy (more than 20% appreciation), 2 – Accumulate (10-20% appreciation), 3 – Neutral (between 10% depreciation and 10% appreciation), 4 – Reduce (10-20% depreciation), and 5 – Sell (more than 20% depreciation). Although some of Merrill Lynch's research reports disclosed the stock appreciation percentages associated with the intermediate and long-term ratings, none of the research reports discussed below contained such disclosure.

During the relevant period, Merrill Lynch's published ratings had four elements: (i) a risk rating from "A" (low risk) through "D" (high risk); (ii) a rating for the intermediate term; (iii) a rating for the long term; and (iv) a dividend rating. With respect to each of the research reports discussed below, Merrill Lynch rated each company "D" (high risk).

Some of Merrill Lynch's research reports also assigned to the stock a price target, which was intended to reflect the price at which the analyst believed the stock would trade within the next twelve months or, on occasion, within a longer period of time.

C. Research Analysts Were Subjected To Conflicts of Interest

In the manner described below, Merrill Lynch investment bankers unduly influenced research analysts, thereby creating conflicts of interest for the research analysts. Merrill Lynch failed to manage these conflicts in an adequate or appropriate manner.

1. Merrill Lynch research analysts assisted investment banking

Merrill Lynch's research department provided a service function within the firm and was not an independent profit center. Merrill Lynch funded its research department through firm revenues received from a number of businesses at the firm, including investment banking. Merrill Lynch's investment banking department generated substantial revenues for Merrill Lynch. Merrill Lynch encouraged its research analysts to assist investment banking activities. Merrill Lynch expected research analysts to vet initial public offerings, review and opine on other prospective investment banking deals, attend "pitch" sessions with investment bankers in which the bankers competed for the issuer's investment banking business, and talk with institutional investors about those issuers. When the Internet research group could not support favorable research ratings, it vetoed the investment banking deals.

Merrill Lynch's investment banking group used the Internet research group's ratings and coverage to support its business. In March 1999, within weeks of joining Merrill Lynch, Blodget circulated to research management and senior investment bankers an e-mail entitled "Managing the Banking Calendar for Internet Research." In that e-mail, Blodget stated,

> [w]e are now up to 11-12 Internet banking transactions in the pipeline . . . . The current schedule for this week . . . is 85% banking, 15% research . . . .

Blodget estimated that his team would devote the majority of its time that week to assisting in investment banking efforts, and cautioned that if he failed "to allocate at least 50% of [his] time and the overall research team's time" to performing research and institutional marketing, then his, and his team's, reputation among institutional investors might suffer.

If Merrill Lynch secured the mandate, the Internet sector analysts sometimes helped market investment banking deals to institutional investors by attending "roadshows." During roadshows, the issuer's management and Merrill Lynch investment bankers solicited interest in the offering from institutional investors. Internet sector analysts also attended "non-deal roadshows" for existing clients to promote interest in their company's stock. As a senior intermediate Internet group analyst stated to Blodget, among others, in a May 17, 2000 e-mail:

> We are taking InfoSpace . . . on a non-deal roadshow to introduce the new CEO. This company is very important to us from a banking perspective, in addition to our institutional franchise. . . . These non-deal roadshows are very important in my view in that they . . . have tremendous halo effect on our banking efforts.

During the relevant period, Merrill Lynch's Internet research group assigned consistently positive intermediate and long-term ratings on the Internet stocks it covered. During the relevant period, the overwhelming majority of stocks covered by Merrill Lynch's Internet research group had a "1" (buy) or a "2" (accumulate) rating. Merrill Lynch infrequently used a "3" (neutral) rating. As a junior analyst explained to the management of an investment banking client in September 2000, Merrill Lynch's ratings

> range from 1-5, but we don't cover anything below a 3.

In a June 2000 e-mail, a senior intermediate analyst wrote to Blodget in connection with a company on which Merrill Lynch was then planning to but ultimately did not initiate coverage:

> I am personally afraid of the impact we will have on the stock if we do a 3-1 so am leaning towards a 2-2 which is still our lowest rating.

2. The existing or potential investment banking relationship factored into the decision to initiate research coverage

Whether Merrill Lynch had or wanted investment banking business from a company was a factor in the decision to initiate research coverage on that company, and in the instance described below, an important factor. While Blodget headed the Internet group, Merrill Lynch initiated coverage predominantly on existing or prospective investment banking clients. Blodget noted that the selection of a company for research coverage was

> based on the company's status in the industry, the number of shareholders, the long term prognosis, and/or a banking relationship.

In an April 2000 e-mail, a Merrill Lynch investment banker asked,

> Do you think we should aggressively link coverage with banking – that is what we did with Go2Net (Henry [Blodget] was involved) . . . .

In a July 2000 e-mail, a junior analyst in the Internet group observed:

> We listened to gotonet call last night – investors didn't like weakish traffic and ad growth. I don't understand what makes biz model tick. They beat estimates in part due to decreased share count, increased interest income and a low tax rate . . . . i imagine we will pick it up if there is some banking revenue attached.[1]

3. Certain prospective ratings and research reports with ratings were shared with investment bankers and issuers

Merrill Lynch did not prohibit all interaction between research and investment banking. Rather, its internal policies prohibited the dissemination of ratings and research reports with ratings to investment bankers and to issuers prior to publication. The Merrill Lynch Policies and Procedures Manual in effect during 1999 to 2001 imposed the following restrictions on pending research:

> Pending initial opinions, estimate or opinion changes, and decisions to issue research reports or comments may not be disclosed by any means to anyone, either inside or outside the Firm, until the information is disseminated in the appropriately prescribed manner. Exceptions are limited to [certain Merrill Lynch personnel] and, under limited circumstances, management of the subject company.[2] This prohibition is intended to avoid the misuse of market-sensitive information and the appearance of impropriety.

In the instances described below, Merrill Lynch's research analysts violated such policies by disseminating research reports with ratings to investment bankers and issuers prior to their publication. Merrill Lynch did not adequately monitor research analysts' communications to detect and prevent such dissemination.

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1 Merrill Lynch did not in fact initiate research coverage on Go2Net. In October 2000, Go2Net was sold to InfoSpace, a company on which Merrill Lynch provided research coverage, and Merrill Lynch provided advisory services to Go2Net between July and October 2000 in connection with the sale.

2 Certain of these exceptions allowed investment bankers and company management to review unpublished research reports to verify factual accuracy, or after the market closed but before publication of the research. None of the instances cited herein, however, qualified for any of the exceptions listed in Merrill Lynch's Policies and Procedures Manual.

a. Sharing unpublished ratings with investment bankers

In August 2000, a junior analyst in the Internet group sent the following e-mail to a Merrill Lynch research manager and Blodget:

> The following chart lays out Henry's [Henry Blodget's] universe and the ratings we would like to change. I have spoken to the [Merrill Lynch investment] banker . . . on this . . . as these are all B2C names—and he is fine with it.

In an e-mail dated November 12, 2000, Blodget gave the following advance notice to a Merrill Lynch investment banker:

> based on what I'm hearing, we will probably be taking CMGI to at least a 2-2 after they report guidance Monday night.

Two days later, on November 14, 2000, Merrill Lynch, through Blodget, in fact downgraded CMGI from a 2-1 to a 3-2.

b. Sharing unpublished reports and ratings with covered companies

Prior to initiating research coverage on GoTo.com, Inc. ("GoTo") (discussed in greater detail below), a research analyst shared the prospective rating with both investment bankers and the company. On November 21, prior to initiating coverage of GoTo, a junior Internet research analyst e-mailed Blodget to report,

> GoTo has gotten back to me and says they are 'comfortable' with the discussions we had with them, and with coming out with a 3-1 [rating], etc. given that we would be downgrading LOOK at the same time so the ratings are the same.[3]

As the date for initiating coverage of GoTo drew closer, the same junior analyst e-mailed the investment bankers,

> Research mgmnt [ ] wants to go with a 3-2 on GoTo.

Another Merrill Lynch analyst who was not in the Internet group also shared unpublished research reports with his covered company – Tyco International Ltd.

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[3] In an e-mail dated July 28, 2001 from Blodget to the junior analyst, Blodget stated: "Some of the communication with the GoTo people and the bankers prior to the initiation may have been a technical violation of the firm's written policies and procedures (which, I have now learned, say the company/bankers should not be told what the proposed rating is or will be, even if the company isn't currently under coverage) . . . ."

("Tyco"). In a February 23, 2001 e-mail from the analyst to the Tyco CFO, the analyst attached an unpublished research report and stated: "PLEASE REVIEW ASAP. I WILL NOT SEND IT OUT UNTIL I HEAR FROM YOU FIRST! LOYAL TYCO EMPLOYEE!" That same day, the analyst sent an e-mail to another Tyco investor relations employee attaching the same draft research report and stated: "I WANTED TO GET THIS OUT ASAP . . . ! PLEASE REVIEW AND COMMENT. "

4. Research analysts' contributions to investment banking factored into their performance evaluations and compensation

Investment banking revenues generated in an analyst's sector were a factor in evaluating that analyst's performance and, consequently, in determining that analyst's compensation. In November 2000, Merrill Lynch's research management requested that all equity analysts submit a report detailing their contributions to investment banking during the year and highlighting instances where their research coverage played a role in originating and securing an underwriting mandate or advisory work on mergers and acquisitions. Blodget's e-mail response highlighted his Internet group's involvement in over 52 completed or potential investment banking transactions and included among his team's activities: pitching the client, marketing the offering, and providing research "coverage for future banking." Blodget estimated that from December 1999 to November 2000, the Internet research group was involved in activities relating to investment banking deals that produced approximately $115 million of revenue for Merrill Lynch.

5. Research analysts were subjected to pressure from investment bankers

Merrill Lynch research management acknowledged the problem of investment banking influence over research analysts in the following October 2000 e-mail to Blodget:

> Wireless Internet Ratings. Major issue. . . . I would like to discuss this topic with you directly to gather facts about this issue over the last year. I then need to have a philosophical discussion with [other research managers] about this. I think we are off base on how we rate stocks and how much we bend backwards to accommodate banking, etc. Breaking the link between writing and rating is a partial solution but I think the issue is much deeper.

In November 2000, the Merrill Lynch senior analyst who covered Aether, a wireless Internet company, with Blodget circulated an e-mail to a research manager, copied to other research managers and Blodget, entitled, "Mobile Internet: Reducing Intermediate Term Rating to Accumulate, Maintaining Long Term Buy." In that e-mail, the analyst attached a draft note that announced the simultaneous downgrade of Aether, InfoSpace and OpenWave from 1-1 to 2-1, and outlined the following four choices:

> First, we can downgrade to 2-1, and go out with the [draft report] below . . . . Second, we can keep Aether at a 1-1 . . . and downgrade [OpenWave] and [InfoSpace] for the reasons cited. (People would invariably ask the question why aren't we downgrading Aether.) Third, we can downgrade [OpenWave] and [InfoSpace] and say nothing about Aether. Fourth, we can keep them all at 1-1s . . . (I sound flip but I am not being so – if banking is our top concern I'd just like us all to agree on it.)

This e-mail prompted research management to conduct a meeting among research management, the analyst who wrote the e-mail, the Merrill Lynch investment bankers who managed the Aether relationship, and Blodget. During that call, investment bankers argued against the proposed downgrade, and urged the analyst to meet with Aether management. Shortly thereafter, research management, the senior analyst and Blodget met with Aether management, who argued against the downgrade. Instead of downgrading Aether, in December 2000, Merrill Lynch published separate research reports maintaining a 1-1 rating on Aether, and downgrading OpenWave and InfoSpace.

Shortly thereafter, Blodget e-mailed the investment bankers who managed the Aether relationship, and copied the senior analyst for Aether and another Internet group analyst:

> The more I read of these, the less willing I am to cut companies any slack, regardless of the predictable temper-tantrums, threats, and/or relationship damage that are likely to follow. . . . If there is no new email forthcoming from [research management on how to apply ratings to] sensitive banking clients/situations, we are going to just start calling the stocks (stocks, not companies) including [Aether], like we see them, no matter what the ancillary business consequences are.

D. Merrill Lynch published research on GoTo and InfoSpace that violated anti-fraud provisions of the federal securities laws

As described below, certain of Merrill Lynch's research reports for GoTo and InfoSpace, Inc. ("InfoSpace") expressed views that were contrary to the analysts' privately expressed negative views of the stocks and did not disclose those negative views, thereby making those reports fraudulent.

1. GoTo (GOTO)

GoTo, now known as Overture Services Inc., is an Internet advertising services company that introduces consumers and businesses that search the Internet to advertisers who provide products, services and information. In September 2000, Merrill Lynch pursued and secured a mandate for a private placement for GoTo's European subsidiary. In connection with that mandate, Merrill Lynch initiated research coverage on GoTo.

a. Initiation of coverage on GoTo

The initial research report on GoTo was published in January 2001 and expressed views contrary to the privately expressed negative views of Blodget and his fellow analysts during the period November 2000 to January 2001. On November 15, 2000, a junior analyst e-mailed Blodget and stated,

> [another firm] initiated on GoTo.com with a buy . . . i guess they are angling for the M&A [mergers and acquisitions] business too!

The next day, while working on the initiation of coverage report, Blodget e-mailed a junior analyst and queried,

> What is your honest take on the stock? No reason to own it . . . or going a lot lower[?] [In my humble opinion], I think the first [rating] should be a 2[-]2 . . . the second a 3…

Later that day, the junior analyst responded:

> . . . I think both – no reason to own now. . . . totally could go lower. who are we trying to please by doing a 2-2 ? I don't want to be a whore for f-ing mgmnt. if 2-2 means that we are putting half of merrill retail into this stock because they are out accumulating it, then I don't think that's the right thing to do. we are losing people money and I don't like it. [hypothetical retail clients] john and mary smith are losing their retirement because we don't want [GoTo's CFO] to be mad at us. [Merrill Lynch's investment banking relationship manager for GoTo] said he is fine with a 3-2 (I said to him the whole idea that we are independent from banking is a big lie – without banking this would be a 3-2 and he said "no—you guys are independent you can do what you want – I'm fine with that["] –I would put it back to the company to convince you that there is a reason you should own this at 54x [year 2002 earnings per share]. . . so that's my feeling. . . .

On January 4, 2001 the junior analyst e-mailed the investment bankers,

> Research mgmnt [] wants to go with a 3-2 on GoTo.[4]

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4 Ratings on initiation of coverage were approved by Research Management and Research Compliance.

One of the bankers responded to Blodget and the junior analyst:

> Briefly, in talking to [Research Compliance] yesterday, I thought the strategy was to go out with the 3-1 as soon as the stock hit $10; if it doesn't, I don't think anybody has an interest in seeing initiation at a 3-2.

Blodget replied to the bankers:

> my concern is that waiting for $10 is waiting for godot[5]…

During the following week, GoTo traded intraday above $10 and, on January 11, 2001, Merrill Lynch initiated coverage on Goto at a 3-1 (neutral-buy), the same rating reflected in the e-mail from investment banking. Merrill Lynch's initiation piece reported that

> GoTo has a pay-for-performance model, which should help it gain share in the current environment. . . . It is growing quickly and probably has enough cash to make it to break-even (estimated in 1Q02) . . . . Given the current weak environment for online advertising, we do not see any near term catalysts. We expect the market to improve in 2H 2001, however, and we believe that GoTo will be a survivor.

On the same day Merrill Lynch initiated coverage, an institutional client e-mailed Blodget to ask,

> What's so interesting about Goto except banking fees????

Blodget replied,

> nothin.

The initial research report on GoTo expressed views contrary to the research analysts' privately expressed negative views as described above, and did not disclose those contrary views, including Blodget's belief that GoTo was "interesting" only for the banking fees it could generate. As a result, the January 11th research report was fraudulent.

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5 The reference here was to the Samuel Beckett play *Waiting for Godot*. In that play, the central story line involves two characters who continuously wait for the arrival of an individual named Godot. He never comes.

b. Subsequent research on GoTo

On April 25, 2001, Merrill Lynch upgraded GoTo from 3-1 to 2-1 (accumulate-buy), based on GoTo's very strong first quarter results and Merrill Lynch's observation that GoTo had "execut[ed] extremely well in a tough environment." The upgrade set a price objective of $18-19 from GoTo's then current trading price of $11.57.

On May 4, 2001, GoTo closed at $21.92. In a May 6, 2001 e-mail, an institutional client asked Blodget for buy recommendations that were "compelling currently"; Blodget responded:

> I would have said GoTo and HOMS but both have had very strong runs and are overdone, in my opinion.

On May 22 and 23, 2001, when GoTo closed at $23.90 and $23.43, respectively, Merrill Lynch issued additional research reports that reiterated GoTo's 2-1 rating and stated,

> We believe a few stocks are attractive. . . . we are recommending . . . GoTo. . . .

These research reports expressed views contrary to the views privately expressed by Blodget in his May 6th e-mail, and did not disclose Blodget's view that the stock price was overdone.

In mid-May 2001, Merrill Lynch's investment bankers pitched to GoTo the idea of doing a secondary equity offering, underwritten by Merrill Lynch, and set a May 31 meeting date to discuss this possibility. However, on May 25, GoTo's CEO and CFO advised a Merrill Lynch investment banker that GoTo was leaning toward selecting a firm other than Merrill Lynch to do the underwriting work. That same day, in an internal e-mail, a Merrill Lynch investment banker remarked:

> I was very dismayed to learn that [GoTo was] leaning toward [another firm] as the lead bookrunning manager, particularly given the tremendous effort we have put forth on the Company's behalf. Not only did Henry Blodget initiate on the stock when it was flirting with penny stock status but he recently upgraded it and sponsored a set of meetings for management in New York which dramatically moved the stock price. . . . we have the #1 ranked Internet research analyst in Henry Blodget . . . .

A few hours later, a research analyst e-mailed to Blodget draft downgrade bullets for GoTo:

> H, I don't think I've downgraded a stock on valuation since the mid-90's. Anyway, I threw together these bullets in a note on my hard drive so that we are ready to pull the trigger quickly. Do you think we need more than bullets? I didn't think so since this downgrade would be based solely on valuation? Let me know.

The downgrade bullets explained that,

> GoTo has doubled since our upgrade about a month ago. We are downgrading the stock due to valuation . . . . we believe it is prudent to take some money off the table.

Blodget's immediate e-mail response was,

> beautiful fuk *[sic]* em.

While Merrill Lynch's May 22nd and May 23rd research reports maintained GoTo's 2-1 rating and recommended GoTo as "attractive", the research analysts' May 25th e-mail stated an intention to downgrade GoTo based on valuation concerns – meaning that they viewed the stock as expensive. GoTo's stock price, however, remained relatively constant from May 21 to May 31, 2001. In fact, on May 22nd and May 23rd, when Merrill Lynch issued research reports recommending the stock, GoTo closed at $23.90 and $23.43, respectively and on May 25th, the date of the e-mail, GoTo closed at $22.75. Accordingly, the May 22nd and May 23rd research reports also expressed views that were contrary to the views privately expressed in the May 25th e-mail, and did not disclose those contrary views. As a result, the May 22nd and 23rd research reports were fraudulent.

Merrill Lynch did not publish the GoTo downgrade on May 25. On the morning of June 6th, GoTo issued a press release announcing its follow-on offering and naming its underwriters, which did not include Merrill Lynch. Blodget and his fellow analyst believed that news of GoTo's secondary offering would have a near term negative impact on GoTo's stock price. That same morning, Merrill Lynch issued its report downgrading GoTo from 2-1 to 3-1 in substantially the same form as the draft bullets in the May 25th e-mail.[6] The June 6th research report did not disclose the analysts' belief that news of GoTo's secondary offering would have a near term negative impact on GoTo's stock price.

2. InfoSpace (INSP)

InfoSpace is an Internet information infrastructure services company that provides technologies to Web sites, merchants and wireless devices. Merrill Lynch maintained a

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[6] From May 25th to June 6th, GoTo's stock price closed at $22.75 (May 25th), $22.96 (May 29th), $21.05 (May 30th), $22.36 (May 31st), $23.43 (June 1st), $25.99 (June 4th), $26.64 (June 5th) and $23.78 (June 6th).

1-1 (buy-buy) rating on InfoSpace from January through December 2000, when it was downgraded to a 2-1 (accumulate-buy). From March 2000 to December 2000, Merrill Lynch included InfoSpace on its monthly "Favored 15" list. The Favored 15 list is a list of 15 stocks covered by Merrill Lynch that are each rated 1-1 and that satisfy certain other technical and quantitative criteria. InfoSpace's stock price declined throughout 2000 and into early 2001, from $140 on January 27, 2000, to $40.56 on September 15, 2000, to $21.94 on October 9, 2000, to $13.81 on December 11, 2000 and to $8.59 on January 9, 2001.

On June 15, 2000, while Merrill Lynch maintained a 1-1 rating on InfoSpace, Merrill Lynch's Internet research analysts raised questions about the stock. Specifically, an analyst e-mailed Blodget and a second senior intermediate analyst an article entitled, "Why One Short-Seller is Attracted to InfoSpace." The second analyst replied,

> thanks . . . a lot of people have been calling me on inside selling . . . i checked it out – its not that bad . . . [InfoSpace's Chairman] owns 29% of company and has sold three times over past year . . . i don't think that's a big deal . . . i would sell.

That same day, Blodget responded to the second analyst as follows:

> . . . enormous skepticism about this one now. . . . got questions yesterday about the exact extent of svces/content that [InfoSpace] provides to "50% of global and 80% of US carriers." AT&T apparently saying "they give us maps and directories, not a 'platform' – whooptedo. In three yrs, the $1/sub will be $0.10/sub." stock obviously caught in backlash of [the InfoSpace Chairman's] hyperbole, unfortunately. just like ICGE . . . .

On July 10, 2000, Go2Net asked Merrill Lynch to serve as its financial advisor in connection with a proposed sale of Go2Net to InfoSpace, and Merrill Lynch agreed. On July 11, 2000, Merrill Lynch issued an "update report" on InfoSpace, reiterating the 1-1 buy rating, but not disclosing the questions raised in the June 15th e-mail.

That same day, apparently in response to the newly issued report, a Merrill Lynch financial consultant sent Blodget the following e-mail:

> it seems that InfoSpace is your favorite stock. Should we worry that the chairman has sold over 1MM shares before their quarterly earnings? Are we planning a secondary for the stock?

Later that day, Blodget forwarded the e-mail to a senior intermediate analyst complaining,

> ugh. i'm getting killed on this thing.

Two days later, on July 13, 2000, Blodget e-mailed the same research analyst and stated,

> I don't mean to be a pain on this one, but this stock is a powder keg, given how aggressive we were on it earlier this year and given the "bad smell" comments that so many institutions are bringing up. . . .

Later that day, the analyst replied,

> Fair point. But here's how I look at it. I still believe in the story long-term and secondly, we addressed the issues without crushing the stock which we would have done and angered everyone. Also, it is not as smelly as the hedgies say – they're just looking for a short.

The following day, July 14, 2000, InfoSpace's Chairman e-mailed the same research analyst to confide that InfoSpace was contemplating an investment in the company "U.S. Search." The research analyst advised him as follows,

> We need to talk about this. . . . I am concerned the market will not react favorably to any news that [InfoSpace] funds US Search. My BEST advice to you is to let [your competitors] win this one – there will be plenty of deals for you to do and [InfoSpace] cannot afford this kind of scrutiny right now – the stock is under a lot of pressure.

On or about October 2000, another senior analyst assumed coverage of InfoSpace, but Blodget continued to participate in the research process and his name continued to appear on the research reports beneath the name of the senior analyst. On the morning of October 20, 2000, Blodget received an e-mail from a Merrill Lynch financial consultant asking about the buy rating and a $100 price target on InfoSpace (at a time it was trading in the $20 price range), and a Dow Jones News Service article stating that InfoSpace had published a handwritten annual report in a "high school exam format." Blodget immediately forwarded the e-mail to the senior analyst for InfoSpace and said,

> I am so tired of getting these. Can we please reset this [InfoSpace] stupid price target and rip this piece of junk off whatever list it's on. If you have to downgrade it, downgrade it.

That same morning, the financial consultant sent another e-mail to Blodget explaining that he had read InfoSpace's 1999 annual report and that he believed it was not as bad as the newspaper article had indicated. Again, that same morning, Blodget forwarded the e-mail to the senior analyst for InfoSpace and remarked,

> Phew. Still would love to reset the price target to $30 or something. . .

At the time of the October 20th e-mail exchanges, InfoSpace was still rated 1-1.

On December 5, 2000, the senior analyst advised him,

> happy day -- insp off the favored 15,

to which Blodget replied,

> oh my god. I can't believe it took until now.

On December 11, 2000, Merrill Lynch downgraded InfoSpace to 2-1 (accumulate-buy).

On December 19, 2000, the senior analyst forwarded to Blodget a news article entitled, "InfoSpace VP Sues Chairman Over Stock Option Promise," and added,

> not that this is any news . . . but thank god we downgraded while in the doubledigits [sic].

Blodget responded

> My god. What a sleazebag.

Seven minutes later, Blodget sent the following e-mail:

> I think you can go ahead and downgrade on this [if] you feel like taking to neutral. I've seen enough of [the InfoSpace Chairman's] alleged sleazery [sic] that I'm officially not comfortable with him still involved with co. . . . I would actually forward this to [Merrill Lynch research management] – they may insist that you cut it.

Merrill Lynch's research reports on InfoSpace dated July 11, August 7, September 15, October 9, October 23, October 25, October 26, October 31, November 6, November 7, and December 20, 2000, and January 8 and January 9, 2001, were contrary to the analysts' privately expressed negative views as described above, and did not disclose those contrary views, including Blodget's concerns about the InfoSpace Chairman's conduct and continuing management of the company. Nor did these reports disclose that a Merrill Lynch analyst had expressed concern that the market would not react favorably to a proposed InfoSpace transaction and had advised InfoSpace against entering into that transaction. As a result, these research reports were fraudulent.

E. Merrill Lynch Published Research That Violated the NASD Advertising Rules

Under NASD's advertising rules, Merrill Lynch must have a reasonable basis for its recommendations, and its communications must present a fair and balanced picture of the risks and benefits of investing in the covered companies, and must not make exaggerated or unwarranted claims. As discussed below, Merrill Lynch published research reports on 24/7 Media, Inc., Lifeminders, Inc., Homestore.com, Inc., Excite@Home, and Internet Capital Group, Inc. that violated NASD's advertising rules, as well as the NASD rule that requires members to observe high standards of commercial honor and just and equitable principles of trade.

1. 24/7 Media, Inc. (TFSM)

24/7 Media, Inc. ("24/7") is an Internet company that provides marketing services to Internet advertisers. After closing a secondary offering for 24/7 on May 3, 1999, Merrill Lynch published a May 12, 1999 research report rating 24/7 a 2-1, when 24/7 traded at $45.00. On August 12, 1999, Merrill Lynch upgraded the stock to 1-1. As of December 31, 1999, 24/7 was trading at $56.25. On January 26 2000, 24/7 reached a high of $64.62. During the course of 2000, 24/7's stock price plummeted. On August 7, 2000, Blodget downgraded the rating to a 2-2 "accumulate", and on November 9, he changed the rating to a "neutral" 3-3. On December 29, 2000, the stock closed at $0.53.

On March 6, 2000, a junior analyst e-mailed Blodget a draft research report on 24/7 that, among other things, referred to the launch of 24/7's "Connect" proprietary advertising software. The analyst stated,

> Try these on for size – trying to be oblique to help stock in anticipation of downgrade on wed – so we can say we were expecting great Q4 – w/ 20 mm names they should be making tons on email – we'd take opportunity to lighten position until co. brings all of assets onto one platform, go to accumulate. also would be surprised if EPS comes in much better than [$]0.46 . . . . if worse, another excuse to downgrade.

The following day, March 7, 2000, Blodget issued the report in substantially identical form as the previous day's e-mail draft and maintained a 1-1 on 24/7. The March 7th report was inconsistent with the privately expressed negative view in the above-noted March 6th e-mail and did not disclose the junior analyst's appraisal that 24/7 would report lower than expected 4th quarter results, that the analyst expected to downgrade 24/7 on that news, or that the analyst then believed that investors should "lighten position" or sell the stock. Two days later, 24/7 reported its fourth quarter results, which exceeded the Internet group's expectations. Merrill Lynch maintained its 1-1 rating on 24/7 until August 7, 2000, when it downgraded 24/7 to 2-2.

On October 10, 2000, Blodget privately expressed a negative view about 24/7's key product -- its "Connect" proprietary advertising software. That day, another analyst e-mailed to Blodget a news article entitled "24/7 Media working to repair technology glitch." The article highlighted glitches in 24/7's "Connect" advertising software, resulting in the reporting of inaccurate results to 24/7's clients. The analyst remarked,

> Don't know if you saw this, nothing revolutionary – but it probably confirms what you and [another fellow analyst] have talked about for some time.

That same day, Blodget responded,

> That it's a pos [piece of shit]? yes.

On August 11, 2000, Merrill Lynch published a research report rating 24/7 a 2-2. In that report, Blodget's only mention of Connect was to explain that 24/7 had yet to complete its full rollout, but that 24/7 was then serving over 80% of its U.S. network ads through Connect. Merrill Lynch's November 8, 2000 report maintained the 2-2 rating and noted,

> We hope to hear more about traction at Connect, including any new business from competitors based on Connect's capabilities as opposed to those won on price.

Merrill Lynch's August 11 and November 8, 2000 research reports were inconsistent with Blodget's privately expressed negative view of the company's key product in his October 10, 2000 e-mail.

2. Lifeminders, Inc. (LFMN)

LifeMinders, Inc. ("LFMN") is an online direct marketing company specializing in outbound messaging, both e-mail and wireless. Merrill Lynch initiated coverage of LFMN on September 28, 2000 with a 2-1, when LFMN traded at $22.69. At that time, Merrill Lynch was pursuing an investment banking relationship with LFMN. Blodget described his team's contribution to the investment banking effort on LFMN as "coverage for future banking."

After Merrill Lynch initiated research coverage, LFMN's price declined to the $10 range in October and the $3-5 range in December. On December 4, 2000, Blodget e-mailed a fellow analyst,

> LFMN at $4. I can't believe what a POS [piece of shit] that thing is. Shame on me/us for giving them any benefit of doubt.

Merrill Lynch's research report on LFMN dated December 21, 2000, which reiterated a 2-1 rating, was inconsistent with Blodget's privately expressed negative view of LFMN in his December 4th e-mail.

3. Homestore.com, Inc. (HOMS)

Homestore.com, Inc. ("HOMS") is a collection of Internet websites that focus on the home and real estate-related information and advertising products and services. Shortly after closing a follow-on offering for HOMS, Merrill Lynch initiated coverage on HOMS on September 8, 1999 with a 2-1 rating, when HOMS traded at $47.50. By February 1, 2000, the date Merrill Lynch closed a second equity offering for HOMS, the stock price had risen to $97. On March 6, 2000, Merrill Lynch upgraded HOMS to 1-1, when the stock price had fallen to $67. Merrill Lynch maintained its 1-1 rating until July 9, 2001 when it downgraded HOMS to 2-1 and the stock price was $35.29.

On April 26, 2001, Merrill Lynch issued a research report reiterating the 1-1 rating on HOMS and setting a price objective of $35 (from its current price of $28.73). On May 4, 2001, HOMS closed at $34.70. On May 6, 2001, when an institutional client asked Blodget for recommendations that were "compelling currently", Blodget responded:

> I would have said GoTo and HOMS but both have had very strong runs and are overdone, in my opinion.

On May 10, 2001 Merrill Lynch issued a research report reiterating the 1-1 rating on HOMS, then trading at $32.56. Both the April 26th and May 10th reports were inconsistent with the views expressed in Blodget's May 6, 2001 e-mail.

4. Excite@Home (ATHM)

Excite@Home ("ATHM") is a broadband network services company that provides high-speed Internet, data and content services to consumers. In June 1999, At Home Corporation acquired Excite and became Excite@Home. Blodget assumed coverage of ATHM from another analyst in April 1999 with a 2-1 rating, and continued coverage after At Home's acquisition of Excite in June 1999, when the stock price was $97. Merrill Lynch acted as a financial advisor to At Home in connection with the acquisition of Excite. On July 20, 2000, when the stock price was $29, Merrill Lynch downgraded ATHM to 2-2.

By December 21, 2000, ATHM's stock price had fallen to $4. On January 29, 2001, while Merrill Lynch still had a 2-2 rating on ATHM, Blodget expressed a view to a financial consultant that he did not think there was any reason to buy more shares of ATHM. Specifically, when a Merrill Lynch financial consultant e-mailed Blodget and asked if he would recommend buying more shares of ATHM at its then-current level (approximately $8), Blodget responded,

> I don't think it goes much lower, but I also don't think there's any reason to buy more of it… as a standalone business, it's falling apart.

On January 26, 2001, Merrill Lynch published a research report on ATHM that maintained a 2-2 rating and noted

> [ATHM] 3Q had a weak quarter, as expected, and gave a dismal outlook for 2001. However, the company believes it can hit double digit EBITDA margins in 2H . . . . [ATHM] might be on the right track , but never-ending state of flux makes forecasting (and investing) difficult. Pieces of the company remain attractive for acquisition, but we believe the value as a consolidated operating business continues to decline. If indeed the company is able to turn EBITDA positive and hit the double-digit margin targets in the back half of the year, the stock should act favorably. However, at this point, we have neither the visibility nor confidence in this happening, and maintain our "wait and see stance."

On March 8, 2001, Merrill Lynch published a research report on ATHM that reiterated the 2-2 rating and noted that the "[t]one was very upbeat" at ATHM's latest conference. Both the January 26th and March 8th reports were inconsistent with Blodget's privately expressed negative views in his January 29, 2001 e-mail.

5. Internet Capital Group, Inc. (ICGE)

Internet Capital Group, Inc. ("ICG") is a holding company, an "incubator" with owner positions in numerous partner companies, most of which are focused on Business to Business ("B2B") e-commerce. ICG allocates capital to promising B2B opportunities, then provides partner companies with strategic and operational guidance with the aim of building market leaders. ICG was designed to facilitate strategic relationships and share best practices, advantages not enjoyed by stand-alone B2B start-ups.

Merrill Lynch initiated coverage of ICG on August 30, 1999 with a 2-1 rating, when ICG traded at $53.50. By the end of 1999, ICG was trading at $164. In early 2000, ICG reached a high of $212, but then fell sharply to $23.13 on September 25, 2000 and $11 on November 10, 2000. Merrill Lynch maintained a 2-1 rating on ICG during that time period.

On October 5, 2000, when ICG was trading in the $12 –15 range, Blodget made the following statement about the direction of ICG's stock price in an internal e-mail to the research analyst covering ICG with Blodget:

> Going to 5.

During that same e-mail exchange, Blodget also remarked,

> Sure hope [the co-founders of ICG] taking some dough off table.

The next day, on October 6, 2000, a Merrill Lynch financial consultant e-mailed Blodget for advice on ICG. Blodget replied,

> No hopeful news to relate, I'm afraid. This has been a disaster… There really are no 'operations' here to fall back on, so there really is no 'floor' to the stock… We see nothing that will turn this around near-term. The company needs to restructure its operations and raise additional cash, and until it does that, there is nothing positive to say.

Merrill Lynch's September 25, 2000 research report reiterated a 2-1 rating and expressed concern that current market conditions, the need for financing, ICG's vertical market maker focus and potential year-end tax-loss selling could keep pressure on the stock. Although this report stated that ICG needed cash and that its then current investments were not optimal, it also expressed strong approval of ICG's new CFO and stated that a successful financing and the sale of non-strategic assets could be potential positive catalysts for the stock.

On November 9, 2000, Merrill Lynch downgraded ICG from 2-1 to 2-2, following ICG's announcement of its third quarter results and its plans to downsize its operations, reduce cash burn and intensify its focus on the execution of a core set of 15 "developed" partner companies. On November 10, 2000, Merrill Lynch issued a report reiterating the 2-2 rating. Although Blodget's October 6, 2000 e-mail expressed concerns about ICG in the "near term" and Blodget's November 10 report stated that ICG could remain under pressure "over the intermediate term," the November 9, 2000 downgrade did not adjust the intermediate term rating, but only the long-term rating for ICG.

Merrill Lynch's September 25th, November 9th and November 10th research reports on ICG were inconsistent with Blodget's privately expressed negative views in his October 5th and 6th e-mails.

F. Merrill Lynch Failed to Supervise its Research Analysts

In the instances cited herein, Merrill Lynch's supervisory systems proved inadequate to prevent violations of the federal securities laws and NASD rules. Merrill Lynch failed reasonably to establish and maintain adequate procedures to detect and prevent undue investment banking influence on research analysts, and to ensure compliance with its internal policies regarding analyst independence. Merrill Lynch failed to supervise adequately the participation of research analysts in investment banking activities, and failed to manage the conflicts of interest created thereby in an adequate or appropriate manner. Merrill Lynch's supervisory systems were also inadequate and not reasonably designed to achieve compliance with the federal securities laws, NASD rules and Merrill Lynch policies cited herein that prohibit misleading statements or material omissions in published research reports.

In addition, although Merrill Lynch's policies and procedures prohibited the dissemination of material non-public information as well as dissemination of other market sensitive information such as unpublished research reports and ratings, Merrill Lynch did not maintain a supervisory system sufficient to enforce those policies and procedures because Merrill Lynch's supervisory systems were not reasonably designed to monitor the external communications of its research analysts so as to detect and prevent the improper dissemination of ratings, or reports with ratings, as described above or in the instances described below.

A Merrill Lynch analyst who was not in the Internet group improperly gave advance notice of his stock ratings on Tyco and SPX Corporation ("SPX") to three institutional clients prior to the publication of those ratings. In an e-mail dated September 7, 1999 to an institutional client, the analyst stated, "I will be launching coverage on Thursday morning. I will rate Tyco and SPX 1-1." In another e-mail dated September 8, 1999 to a different institutional client, the analyst stated: "Also FYI, we will be initiating coverage with a 1-1 buy rating tomorrow!" A third e-mail to another institutional client conveyed the same advance notice of the analyst's stock ratings.

The same analyst also improperly disseminated material, nonpublic information concerning the acquisition of a Siemens business unit by Tyco. The analyst heard a rumor sometime prior to September 1999 (from hedge fund clients) that Tyco intended to purchase a Siemens business unit. The analyst followed-up on this rumor on September 25, 1999, when he sent an e-mail to Tyco Investor Relations, attaching a draft Merrill Lynch research report dated for release on September 28, 1999 and asking, "Please help fill in the blanks on the Siemens unit!" The stated reason for the report was "Accretion Could Be $0.07 in Year 1" – meaning that Tyco's acquisition of the Siemens unit could add 7¢/share in the first year of ownership. As a result of this e-mail and his subsequent communications with Tyco, by September 25, 1999, the analyst possessed material, non-public information from Tyco.

The analyst selectively disseminated this information to certain institutional clients. On September 27, 1999, the analyst e-mailed an institutional client and stated: "FYI. It is likely that Tyco will announce the purchase of the Siemens connector operation early Tuesday morning for about $1.2 [billion] for $900 [million] in sales . . . Accretion could be about $0.05 - $0.07 in the first 12 months." This e-mail was materially accurate in terms of the purchase price, expected sales revenue from the purchase, and expected accretion to Tyco's EPS. On September 27, 1999 at 4:00 p.m., the analyst e-mailed an updated research bulletin to Tyco Investor Relations, wherein some of the missing information regarding the acquisition had been supplied. This research was also dated for release on September 28, 1999.

On September 27, 1999, a Tyco Investor Relations employee e-mailed the analyst a "grid", apparently prepared by Tyco, detailing the advantages of this acquisition. Later that day, the analyst received an e-mail from Tyco Investor Relations, which stated: "The attached information makes you an insider until the [Siemens] deal is announced. The information sheet at this stage is preliminary." Shortly thereafter, the analyst e-mailed the "grid" to an institutional client and wrote, "… You can't use until after announcement!"

On September 28, 1999 at 1:45 am, a Tyco Investor Relations employee e-mailed the analyst stating: "Here is the revised information sheet [on the Siemens acquisition] . . . . DO NOT PUT OUT ANY INFORMATION UNTIL THE STORY CROSSES THE WIRE—I WILL CALL YOU WHEN IT DOES. THERE HAS BEEN A DELAY, SO THE EARLIEST IT WILL BE RELEASED IS AT 7 AM EST." On September 28, 1999, Tyco officially announced its acquisition of the Siemens unit under terms materially consistent with the analyst's prior communications to individuals outside of Merrill Lynch. On September 28, 1999, the analyst issued his research report on Tyco, announcing the "all cash" acquisition of the Siemens unit.

G. Violations of Federal Securities Laws and NASD Rules

<u>Fraud: Violations of 15(c) of the Securities Exchange Act of 1934, Rule 15c1-2 thereunder and NASD Conduct Rules 2210(d)(1) and (d)(2) and 2110</u>. On the occasions described above, Merrill Lynch issued research reports on GoTo and Infospace that were materially misleading because they were contrary to Merrill Lynch research analysts' privately expressed negative views. As a result, Merrill Lynch effected transactions in, or induced the purchase or sale of, securities by means of acts deemed to be manipulative, deceptive or otherwise fraudulent devices or contrivances in violation of Sections 15(c)(1) and 15(c)(2) of the Securities Exchange Act of 1934, Rule 15c1-2 thereunder and NASD Conduct Rules 2210(d)(1) and (d)(2)[7] and 2110.[8]

<u>Advertising: Violations of NASD Conduct Rules 2210(d)(1) and (d)(2) and 2110</u>. As described above, Merrill Lynch issued research reports on 24/7 Media, Inc., Lifeminders, Inc., Homestore.com, Inc., Excite@Home, and Internet Capital Group, Inc.

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[7] NASD Conduct Rule 2210(d)(1) provides in part: "(A) All member communications with the public shall be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered. No material fact or qualification may be omitted if the omission, in the light of the context of the material presented, would cause the communication to be misleading. (B) Exaggerated, unwarranted, or misleading statements or claims are prohibited in all public communications of members. In preparing such communications, members must bear in mind that inherent in investment are risks of fluctuating prices and the uncertainty of dividends, rates of return and yield, and no member shall, directly or indirectly, publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement or a material fact or is otherwise false or misleading."

NASD Conduct Rule 2210(d)(2) provides in pertinent part that "[i]n making a recommendation in advertisements and sales literature, whether or not labeled as such, a member must have a reasonable basis for the recommendation." The rule also contains numerous other specific standards that apply to the advertisements and sales literature, which are defined to include research reports.

[8] NASD Conduct Rule 2110 provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about these companies, and/or contained opinions for which there was no reasonable basis. As a result, Merrill Lynch violated NASD Conduct Rules 2210(d)(1) and (d)(2) and 2110.

Conflicts of Interest: Violation of NASD Conduct Rule 2110. As described above, Merrill Lynch engaged in acts and practices that created or maintained inappropriate influence by investment banking over research analysts, thereby imposing conflicts of interest on its research analysts. Merrill Lynch failed to manage these conflicts in an adequate or appropriate manner. As a result, Merrill Lynch violated NASD Conduct Rule 2110.

Failure to Supervise: Violation of NASD Conduct Rule 3010. NASD Conduct Rule 3010 requires a member firm to "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association." In the instances described above, Merrill Lynch failed to manage the conflicts of interest for research analysts and to protect research analysts from undue influence by investment banking. Finally, Merrill Lynch's supervisory systems were not reasonably designed or implemented to monitor research analysts' external e-mails to detect and prevent the occurrence of the violations described herein. As a result, Merrill Lynch violated NASD Conduct Rule 3010.

H. Sanctions

Merrill Lynch also consents to the imposition, at a maximum, of the following sanctions:

1. a censure; and

2. a total payment of $200,000,000.00, as specified in the Final Judgment ordered in a related action filed by the Securities and Exchange Commission ("Final Judgment"), as follows:

    (a) $100,000,000, as a fine;

    (b) $75,000,000, to be used for the procurement of Independent Research, as described in the undertakings set forth in "Addendum A: Undertakings" to the Final Judgment ("Addendum A"); and

    (c) $25,000,000, to be used for investor education, as described in the Final Judgment.

The monetary sanctions imposed by NASD shall be reduced by the amounts paid by Respondent as described in the Final Judgment. The payment provisions of the Final Judgment and Addendum A are incorporated by reference herein.

In addition, Respondent agrees that it shall not seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to payment made pursuant to any insurance policy, with regard to all fine or penalty amounts that Defendant shall pay pursuant to section II of the Final Judgment, regardless of the use of such penalty amounts. Respondent further agrees that it shall not claim, assert, or apply for a tax deduction or tax credit with regard to any federal, state or local tax for any penalty amounts that Respondent shall pay pursuant to section II of the Final Judgment, regardless of the use of any such penalty amounts. Respondent understands and acknowledges that these provisions are not intended to imply that the NASD would agree that any other amounts the Defendant shall pay pursuant to the Final Judgment may be reimbursed or indemnified (whether pursuant to an insurance policy or otherwise) under applicable law or may be the basis for any tax deduction or tax credit with regard to any federal, state or local tax.

The sanctions imposed herein shall be effective on a date set by NASD staff.

III.

OTHER MATTERS

Merrill Lynch understands that it may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Merrill Lynch understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by NASD, nor does it reflect the views of NASD or its staff.

Merrill Lynch certifies that it has read and understands all of the provisions of this AWC and have been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, has been made to induce Merrill Lynch to submit it.

[SIGNATURES APPEAR ON FOLLOWING PAGE]

Merrill Lynch, Pierce, Fenner & Smith Incorporated

Date: 4/21/03

By: [signature]

Name: Barry J Mandel

Title: Senior Vice President

Reviewed by:

[signature]

Audrey Strauss, Esq.
Fried, Frank, Harris, Shriver & Jacobson
One New York Plaza
New York, New York 10004
Counsel for Respondent

Accepted by NASD:

On behalf of the Director of the Office of Disciplinary Affairs, through delegated authority,

4/24/03
Date

[signature]

Barry R. Goldsmith
Executive Vice President
Department of Enforcement
NASD
1801 K St., NW
Washington, DC 20006