FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2012032967901

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

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

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

I.

ACCEPTANCE AND CONSENT

A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA 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 FINRA:

BACKGROUND

Merrill Lynch has been a FINRA member since 1937. It is a full-service broker-dealer with its principal offices in New York, New York. The Firm employs over 33,900 registered individuals and maintains approximately 3,298 branch offices. In January 2009, the Firm was acquired by Bank of America Corporation ("BAC").

OVERVIEW

Beginning in or around September 1, 2010 and continuing through July 5, 2011 (the "Relevant Period"), Merrill Lynch sold approximately $168 million of structured notes known as Strategic Return Notes ("SRNs") linked to a proprietary volatility index, without adequately disclosing certain fixed costs. Merrill Lynch's disclosures made it appear as if its volatility product had relatively low fixed costs.

Merrill Lynch emphasized in offering materials that investors would be subject to a 2% sales commission and a 0.75% annual fee in connection with the SRNs. Merrill Lynch failed to adequately disclose a third fixed, regularly occurring cost included in its proprietary volatility

index known as the "Execution Factor" (distinct from "holding" or "decay" costs associated with daily calculation of the underlying index which are variable and depend on market conditions). As a result, Merrill Lynch's disclosures in the offering materials of the fixed costs associated with the SRNs were materially misleading.

Based on the foregoing, Merrill Lynch violated FINRA Rule 2010 by violating Section 17(a)(2) of the Securities Act of 1933 (negligent omissions); NASD Rules 2210(d) (communications with the public); and 3010(a) (supervision). The Firm's violations of the NASD Rules also constitute violations of FINRA Rule 2010.

FACTS AND VIOLATIVE CONDUCT

Strategic Return Notes

Volatility products are complex financial instruments marketed and sold to both retail and institutional clients; this case arises from Merrill Lynch's retail sales of SRNs, which were the first structured volatility product offered and sold to retail investors by BAC through Merrill Lynch. A number of other large financial institutions marketed similar volatility products during the same time period.

During the Relevant Period, Merrill Lynch sold approximately $168 million in the SRNs, approximately $150 million through initial offerings and approximately $18 million in secondary trades. The public offering price was $10 per unit and the underwriting discount was $0.20. Proceeds from the offering were approximately $147 million. In addition to its underwriting fee, the Firm received additional compensation through an "Index Adjustment Factor," accruing at a rate of .75% per annum, and from sales of the SRNs in the secondary market. All told, Merrill Lynch received approximately $5.5 million from the sale of the SRNs.

Merrill Lynch was principally responsible for preparation of the offering documents. These included the following registration statements filed with the Commission by BAC: a Prospectus dated April 20, 2009; a Medium Term Notes, Series L, Prospectus Supplement dated April 21, 2009; nine Final Pricing Supplements for offerings issued on October 4, 2010, November 8, 2010, December 3, 2010, December 31, 2010, February 7, 2011, March 7, 2011, April 4, 2011, May 9, 2011 and July 5, 2011 (collectively the Pricing Supps); and a fact sheet entitled "Investable Volatility Index" that was filed with the Commission as a free-writing prospectus. (Together with the Pricing Supps, Offering Documents).

The SRNs had a five-year term and permitted earlier redemption as specified in the Pricing Supps. The SRNs paid no interest. Investors were entitled to a cash payment at maturity or during specified redemption periods dependent upon the level of the VOL.

According to the Pricing Supps, the VOL "provides a measure of market volatility in the equity markets" and "is designed to measure the return of an investment in the forward implied volatility of the S&P 500 index for a three-month period with a mid-point approximately five months in the future." The VOL does so by reference to publicly available levels of implied

volatility on the S&P 500 index, and uses those levels to calculate levels of forward implied volatility over different intervals of time.

The VOL then treated those levels of forward implied volatility like assets that were bought and sold as part of a hypothetical portfolio. The hypothetical portfolio is rebalanced every business day to maintain a constant exposure to the specified forward implied volatility. In the rebalancing process, a fixed cost known as the "Execution Factor" is applied to each synthetic purchase of forward implied volatility as part of the Index calculation.

Relevant Statements

The Cover Page and the Key Features sections of the retail Pricing Supps disclosed certain fixed costs associated with the SRNs. The Cover Page represented that "Return [will be] reduced by a 2% sales charge and an Index Adjustment Factor that will accrue daily at the rate of 0.75% per annum." The Key Features section of the Pricing Supps represented that the "SRNs provide a positive return for investors if the level of the [Index], adjusted as described below, increases by at least the sum of (i) approximately 2% and (ii) the accrued Index Adjustment Factor . . . the level of the Index will be reduced by the Index Adjustment Factor of 0.75% per annum . . ." The Key Features section further represented that the Index Adjustment Factor would lower the level of the VOL by 3.67% over the five year term of the note.

In addition, the Key Features section of the retail Pricing Supps represented that, as a result of the cumulative and combined effects of the sales charge and Index Adjustment Factor, "in order for you to receive at least the $10 Original Offering Price per unit on the maturity date, the level of the Index must increase by more than 5.93% from the Starting Value." The fixed costs represented by the 2% sales charge and the 0.75% Index Adjustment Factor were described multiple times in the Pricing Supps, in narrative language which explained the amount of each fixed cost, what it was multiplied against and how often it applied.

Execution Factor

Merrill Lynch did not adequately disclose in the Offering Documents an additional regularly occurring fixed cost, known as the "Execution Factor," that was included in the Index. The Execution Factor increased by 1.5% the cost, or level, of each unit of forward implied volatility being purchased as part of that day's rebalancing. Because the hypothetical portfolio completely turned over each quarter, the Execution Factor imposed a cost of 1.5% on the Index each quarter. The Index also included a feature called the Index Multiplier, which increased the daily Index calculation by 120%, including the effect of the Execution Factor.

The Pricing Supps included a 4-page narrative description of the VOL. The Execution Factor was not mentioned in that narrative description of the Index. Under the heading "[t]he method by which the Index is calculated includes features which may reduce the amount payable on the SRNs," The Risk Factors section of the Pricing Supps provided in relevant part: "The methodology of the Index includes an 'Execution Factor' that is designed to reflect the transaction costs that would be incurred in attempting to implement an investment strategy that replicates the Index. The Execution Factor has the effect of reducing the actual level of the Index

on any given Index Business Day." Because the forward implied volatility levels from which the Index is calculated do not themselves account for transaction costs, the Execution Factor was intended by Merrill Lynch to represent the transaction costs that would be incurred by an investor pursuing a strategy that replicates the Index.

Annex A to the Pricing Supps included a six-step mathematical formula used to calculate the level of the VOL. The following description of the Execution Factor was provided at step four of the Index calculation: "The Execution Factor is equal to 1.015 and is designed to reflect the transaction costs that would be incurred in implementing a strategy that replicates the Index. The Execution Factor is only applied to the equation where *n1* or *n2* is to be increased from the level *n1 t-1* or *n2 t-1*, respectively." A Sample Annex A is attached hereto.

The free writing prospectus, or fact sheet, that accompanied the Pricing Supps did not adequately describe the Execution Factor.

A reasonable retail investor would have considered it important to the total mix of information available when purchasing the SRNs that the Execution Factor imposed a transaction cost of 1.5% of the Index value each quarter, accruing on a daily basis. Merrill Lynch's failure to adequately disclose the Execution Factor rendered its cost disclosures relating to the fixed 2% sales charge and 0.75% Index Adjustment Fee of the SRNs materially misleading.

Violations

1. **FINRA Rule 2010 — Merrill Lynch Negligently Omitted Material Facts Concerning the Notes in Certain Sections of the Offering Documents**

As described above, Merrill Lynch did not adequately disclose the Execution Factor and therefore violated FINRA Rule 2010 by virtue of violating Section 17(a)(2) of the Securities Act which prohibits obtaining money or property by means of omissions of material facts in the offer or sale of securities.

2. **NASD Rule 2210(d) — Merrill Lynch's Offering Documents Were Not Fair and Balanced**

As one of the Offering Documents, the fact sheet is a communication with the public subject to NASD Rule 2210. As set forth above, the fact sheet together with the Pricing Supps were not fair and balanced and failed to provide a sound basis for evaluation of the SRNs by not adequately disclosing the Execution Factor. Accordingly, Merrill Lynch violated NASD Rule 2210(d) and FINRA Rule 2010.

3. **NASD Rule 3010 - Supervisory Failures with Respect to the Sale of SRNs**

As described above, Merrill Lynch failed to maintain supervisory procedures reasonably designed to ensure compliance with applicable disclosure standards in connection with the sale of the SRNs. Based on the foregoing, Merrill Lynch violated NASD Rule 3010(a) and FINRA Rule 2010.

B. Merrill Lynch also consents to the imposition of the following sanctions:

1. A censure; and

2. A fine in the amount of $5 million.

Merrill Lynch agrees to pay the monetary sanctions upon notice that this AWC has been accepted and that such payment is due and payable. Merrill Lynch has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Merrill Lynch specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanctions imposed in this matter.

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

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

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

B. To be notified of the 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 National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, 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.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA 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.

III.

OTHER MATTERS

Respondent understands that:

A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;

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

C. If accepted:

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

2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about my disciplinary record;

3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and

4. 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 finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's: (i) testimonial obligations; or (ii) right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent 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 FINRA, nor does it reflect the views of FINRA or its staff.

The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that Respondent has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

06/08/2016
Date (mm/dd/yyyy)

Respondent
Merrill Lynch, Pierce, Fenner & Smith Incorporated

By: Joaquin M. Senn
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Accepted by FINRA:

6/23/16
Date

Signed on behalf of the
Director of ODA, by delegated authority

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Index Calculation

Calculating the Index

For each scheduled Index Business Day, the Index is calculated as follows

Step 1: Calculate the Forward Implied Volatility levels from the Index Components

On each Index Business Day, three Forward Implied Volatility levels can be computed from the Index Components. The Index Components on any given day can be identified in chronological order as "IC1," "IC2," "IC3," and "IC4," with IC1 representing the Index Component closest to the Index Business Day. For example, on June 6, 2010, which is prior to the expiration date in June 2010, IC1 represented VXJUN (with an expiration date in June 2010), IC2 represented VXSEP, IC3 represented VXDEC, and IC4 represented VXMAR. In contrast, on June 24, 2010, which is after the expiration date in June 2010, IC1 represented VXSEP, IC2 represented VXDEC, IC3 represented VXMAR, and IC4 represented VXJUN (with an expiration date in June 2011).

The three Forward Implied Volatility levels, identified as "FIVA," "FIVB," and "FIVC," are computed according to the following formulas:

$$FIVA = \sqrt{\frac{t_2 \times IC2^2 - t_1 \times IC1^2}{(t_2 - t_1)}}$$

$$FIVB = \sqrt{\frac{t_3 \times IC3^2 - t_2 \times IC2^2}{(t_3 - t_2)}}$$

$$FIVC = \sqrt{\frac{t_4 \times IC4^2 - t_2 \times IC3^2}{(t_4 - t_3)}}$$

with t_1, t_2, t_3, and t_4 representing the portion of a calendar year, calculated using minutes, from the current time on the applicable Index Business Day to 9:30 a.m. (New York City Time) on the Listed Expiration Date (as described on page PS-15) for IC1, IC2, IC3, and IC4, respectively.

Step 2: Determine the appropriate Forward Implied Volatilities to use for the Index calculation

The Index uses two of the three Forward Implied Volatilities. The two Forward Implied Volatilities used for the Index Calculation are defined as *FIV1* and *FIV2*.

On each Index Business Day, *FIV1* and *FIV2* are identified using the process below:

The Index Calculation Agent calculates the average time to maturity ("ATT") for each Forward Implied Volatility. The ATT represents the average of the time to maturity for the two Index Components used in calculating a Forward Implied Volatility:

$$ATT_A = \frac{t_1^d + t_2^d}{2}$$

$$ATT_B = \frac{t_2^d + t_3^d}{2}$$

$$ATT_C = \frac{t_3^d + t_4^d}{2}$$

where: t_1^d, t_2^d, t_3^d, and t_4^d represent the portions of a calendar year, calculated using actual days/365, from the applicable Index Business Day until the Listed Expiration Date for IC1, IC2, IC3, and IC4, respectively.

The Index Calculation Agent compares the ATT values for FIVA, FIVB, and FIVC, and identifies the ATT value that is both closest to and less than 5/12. The Forward Implied Volatility to which this ATT pertains is defined as *FIV1*. The ATT of *FIV1* is defined as ATT_1.

The Index Calculation Agent compares the ATT values for FIVA, FIVB, and FIVC and identifies the ATT value that is both closest to and greater than or equal to 5/12. The Forward Implied Volatility to which this ATT pertains is defined as *FIV2*. The ATT of *FIV2* is defined as ATT_2.

Step 3. Determine the weights for FIV1 and FIV2

The Index Calculation Agent calculates the Forward Implied Volatility weights w_1, and w_2, for the Forward Volatilities *FIV1* and *FIV2*

respectively, such that (i) $w_1 ATT_1 + w_2 ATT_2$ is approximately 5/12 and (ii) $w_1 + w_2 = 1$. The weights are designed to keep the weighted ATT values of the Forward Implied Volatilities used for the Index calculation at approximately 5/12. As time passes (over a period of approximately three months), w_1 will decrease to approach 0, and w_2 will increase to approach 1. On the day (defined as a "New Contract Day") when ATT_2 declines from being greater than 5/12 to being less than 5/12, the Forward Implied Volatilities are rolled, such that the Forward Implied Volatility defined as *FIV2* becomes *FIV1* and the next Forward Implied Volatility becomes *FIV2*.

If the Index Business Day is a New Contract Date, then $w_1 = 1$ and $w_2 = 0$.

Otherwise:

$$w_1 = \frac{ATT_2 - \frac{5}{12}}{ATT_2 - ATT_1} \text{ and } w_2 = 1 - w_1$$

Step 4: Determine the number of contracts for FIV1 and FIV2

The contracts n_1^t and n_2^t represent the amount of theoretical investment the Index has in *FIV1* and *FIV2*, respectively. The contracts are adjusted daily to keep the exposure to *FIV1* and *FIV2* consistent with the weightings w_1 and w_2, and to account for transaction costs which would be incurred in implementing a strategy that replicates the Index.

Calculate n_1^t and n_2^t for *FIV1* and *FIV2*:

For n_1^t:

$$n_1^t = n_1^{t-1} + \frac{w_1^t S_t - n_1^{t-1} FIV1}{FIV1 * ExecutionFactor} \text{ when } w_1^t S_t - n_1^{t-1} FIV1 > 0.$$

Otherwise, including on the Base Date (December 31, 2004):

$$n_1^t = \frac{w_1 S_t}{FIV1}$$

For n_2^t:

$$n_2^t = n_2^{t-1} + \frac{w_2 S_t - n_2^{t-1} FIV2}{FIV2 * ExecutionFactor} \text{ when } w_2 S_t - n_2^{t-1} FIV2 > 0.$$

Otherwise, including on the Base Date (December 31, 2004):

$$n_2^t = \frac{w_2 S_t}{FIV2}$$

where:

$$S_t = n_1^{t-1} FIV1 + n_2^{t-1} FIV2$$

The Execution Factor is equal to 1.015 and is designed to reflect the transaction costs that would be incurred in implementing a strategy that replicates the Index. The Execution Factor is only applied to the equation where n_1 or n_2 is to be increased from the level of n_1^{t-1} or n_2^{t-1}, respectively.

Step 5: Calculate the simple return of the Index on the Index Business Day

The simple return of the Index, r_t, is equal to:

$$r_t = \frac{S_t - S_{t-1}}{S_{t-1}}$$

Step 6: Calculate the Index closing level

The Index closing level, I_t, is equal to:

$$I_t = I_{t-1} * (1 + Index\ Multiplier * r_t + IA_t)$$

where

Index Multiplier = 120%

Interest accrual $IA_t = Rate_{t-1} \times \frac{1}{360} \times d$

where $Rate_{t-1}$ is the closing level of the one-month U.S. Treasury bill yield on Index Business Day $t-1$, and d is the number of calendar days from, but excluding, Index Business Day $t-1$, to and including, Index Business Day t.

I_t is rounded to 2 decimal places.