

COMMONWEALTH OF MASSACHUSETTS  
OFFICE OF THE SECRETARY OF THE COMMONWEALTH  
SECURITIES DIVISION  
ONE ASHBURTON PLACE, ROOM 1701  
BOSTON, MASSACHUSETTS 02108

SECRETARY OF  
COMMONWEALTH

2009 JAN 31 AM 8:58

IN THE MATTER OF: )

MERRILL LYNCH, PIERCE, FENNER )

& SMITH INCORPORATED, )

CARL KIPPER AND MANUEL CHOY )

RESPONDENTS. )

DOCKET NO. 2008-0001

ADMINISTRATIVE COMPLAINT

I. PRELIMINARY STATEMENT

The Enforcement Section ("Enforcement Section") of the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth ("Division") files this complaint ("Complaint") in order to commence an adjudicatory proceeding against Merrill Lynch, Pierce, Fenner & Smith, Incorporated ("Merrill" or "Merrill Lynch"), Carl Kipper and Manuel Choy (collectively, "Respondents") for violating M.G.L. c. 110A, the Massachusetts Uniform Securities Act (the "Act") and 950 CMR 10.00 *et seq.* ("Regulations"). This Complaint is focused on Merrill Lynch's sale, through agents Kipper and Choy, of certain esoteric financial instruments known as Collateral Debt Obligations ("CDOs") to the City of Springfield, Massachusetts, which were unsuitable for the City and which, within months after the sale, became illiquid and lost almost all of their market value.

The Enforcement Section seeks an order instructing Respondents to permanently cease and desist from committing any further violations of the Act and Regulations, to pay

an administrative fine in an amount and upon such terms and conditions as the Director or Hearing Officer may determine, to order Respondents to disgorge all profits attributable to the alleged wrongdoing, to censure Respondents, to appoint an independent consultant to review the systemic supervisory breakdowns and incentives within Merrill that allowed the alleged wrongdoing to occur, and to take any other action that the Director or Hearing Officer may deem appropriate in the public interest and necessary for the protection of Massachusetts investors.

---

## II. SUMMARY

Merrill Lynch is one the largest underwriters and distributors of Collateralized Debt Obligations (“CDOs”) in the world. CDOs are esoteric financial instruments that function as debt instruments collateralized by certain assets. Many of the CDOs issued by Merrill Lynch were collateralized by pools of subprime and other mortgage loans. In certain CDOs—including those discussed in this Complaint—the collateral consists of pieces of other CDOs and other complex products known as “synthetic securities”. CDOs collateralized by other CDOs are often referred to as “CDO-squared”. The business of packaging and issuing CDOs and CDO-squared transactions has been a highly lucrative one for Merrill Lynch and other underwriters until large parts of the CDO market froze and crashed in the summer of 2007.

The City of Springfield is a city that was formed in Massachusetts in 1852 by decree of the General Court of The Commonwealth of Massachusetts. In recent years, it has struggled financially and, in fact, went into a \$20 million deficit in fiscal year 2004. In response to this deficit, the Massachusetts General Court enacted a special act (Chapter 169) in July 2004 which established the Springfield Finance Control Board (the “Finance

Control Board”) with comprehensive authority over City financial operations and personnel. In 2006 the City staged a miraculous turnaround after undergoing an in-depth rearrangement of its financial structure which resulted in a \$21.4 million surplus at the end of the fiscal year.

In November 2006, the City of Springfield hired Merrill Lynch, through its Albany, New York office, to invest its surplus cash. The City, through the Finance Control Board, hired Carl Kipper and Manuel Choy. The Merrill Lynch/Springfield relationship resulted from a longstanding friendship between Kipper and Stephen Lisauskas (“Lisauskas”), Executive Director of the Finance Control Board. The accounts—at least by the terms of the Merrill Lynch account documents—were not discretionary accounts. It was understood that Merrill was supposed to invest only in safe money-market-like investments authorized by City personnel that would protect the City’s principal.

However, in April and June of 2007, Kipper and Choy invested approximately \$14,000,000 of the City’s money into three CDOs, the “Centre Square CDO”, the “South Coast Funding V CDO” and the “Tabs CDO” (collectively, the “Springfield CDOs”). The Springfield CDOs were purchased from Merrill’s Auction Rate Market Sheet, which was a list of commercial paper and other short-term debt instruments Merrill Lynch circulated periodically to its agents for them to sell. The CDOs sold to the City were purchased from Merrill’s own inventory. The largest position was \$12,600,000 in the Centre Square CDO, which had been underwritten by Merrill Lynch. Merrill Lynch received underwriting fees in connection with underwriting the CDO and remarketing fees in connection with selling pieces of it.

The City did not authorize these specific CDO purchases in advance. Kipper and Choy were, apparently, verbally instructed to pick instruments that yielded more than Merrill's money market account as long as the products were triple-A rated by the major credit rating agencies and as long as the date at which the next auction of the instruments was supposed to occur fit with the City's cash flow needs.

At the time of the sale, Kipper and Choy did not discuss the risks of owning CDOs with the City, even though those risks were well known to Merrill Lynch. The basic fact that these instruments were CDOs was not even disclosed to the City until months after the sale. These instruments appeared on the City's account statements through June 2007 as "Centre Square Ltd.", "South Coast FNDG VA-2" and "TABS 2004-1 LTD SER A-2". In July 2007, the exact same investments quietly began to appear on the account statements as "Centre Square CDO PVT", "S Coast FD V CDO PVT" and "TABS CDO PVT". At the time of the sales, Kipper and Choy did not look at the disclosure documents for these CDOs. Nor did they make any attempt to understand what these CDOs were collateralized with. Nor did they evaluate the liquidity and other risks inherent in purchasing the CDOs or discuss the nature of these CDOs or the risks associated with owning them with City officials.

In order to purchase the CDOs in question, the purchaser had to be, under the federal securities laws, a "Qualified Institutional Buyer". This is because of the extremely complex and risky nature of the investments. The offering document for the Centre Square CDO stated, under a paragraph titled "Investor Suitability":

An investment in the Offered Securities will not be appropriate for all investors. Structured investment products, like the Offered Securities, are complex instruments, and typically involve a high degree of risk and are

intended for sale only to sophisticated investors who are capable of understanding and assuming the risks involved.

Merrill, through Choy, sent a form to the City that would allow the City to certify that it was a Qualified Institutional Buyer. The City filled out the form, faxed it to Mr. Choy, who, in turn, faxed it to the Auction Market Securities Trading desk at Merrill Lynch. In the form, the City certified that it was a Qualified Institutional Buyer because it was an "Investment Company". No one at Merrill Lynch questioned this description or classification of Springfield. In addition, the City certified that it was a "conduit (such as a bank, foreign bank, broker dealer or investment advisor)". No one at Merrill Lynch questioned that certification. The City was thus qualified—for Merrill's purposes—as a Qualified Institutional Buyer and therefore, on Merrill's books, was able to purchase the CDOs that Merrill was eager to sell.

Within months after Merrill's sale of these CDOs to the City, the auction market for them began to dry up and their market value began to plummet. For example, the Centre Square CDO had been purchased in late April 2007. By August 2007, it was listed on the City's account statements as having an "estimated market value" of only 84 percent of its purchase price. By September, it was down to 50 percent; by October it was down to 30 percent; and by December 2007, it was down to 5 percent. The South Coast and Tabs CDOs experienced similar extreme downward spirals. The City requested that these CDOs be sold, but City officials were informed that the auctions had failed and that there were no buyers.

After a meeting at which the City communicated its concerns regarding these products, Merrill responded to those complaints via a letter dated November 29, 2007 from James Mann, First Vice President and Assistant General Counsel of Merrill Lynch.

In the letter, attached hereto as Exhibit 7, Merrill disclaimed responsibility for these investments:

While Merrill Lynch is disappointed with the unfortunate disappearance of liquidity in the residential mortgage-backed CDO markets, Merrill Lynch has no legal responsibility to the City concerning the financial performance of this investment. The City's account is not a discretionary or advisory account. The City made its own investment decisions.

This Complaint, among other things, alleges that these highly-risky and esoteric CDOs were unsuitable for the City of Springfield, that Merrill Lynch did not properly disclose to the City the risks of owning these CDOs, and that the sale was inappropriate and illegal. This Complaint requests, among other things, that the Director or Hearing Officer appoint an independent consultant to review the systemic supervisory breakdowns and incentives within Merrill Lynch that allowed these activities to occur and go undetected until the City complained.

### **III. JURISDICTION AND AUTHORITY**

1. The Massachusetts Securities Division is a division of the Office of the Secretary of the Commonwealth with jurisdiction over matters relating to securities, as provided for by the Act. The Act authorizes the Division to regulate: 1) the offers, sales, and purchases of securities; 2) those individuals offering and/or selling securities; and 3) those individuals and entities transacting business as investment advisers within the Commonwealth.

2. The Division brings this action pursuant to the enforcement authority conferred upon it by section 407A of the Act and M.G.L. c. 30A, wherein the Division has the authority to conduct an adjudicatory proceeding to enforce the provisions of the Act and all Regulations and rules promulgated thereunder.

3. This proceeding is brought in accordance with sections 101, 204 and 407A of the Act and its Regulations. Specifically, the acts and practices constituting violations occurred within the Commonwealth of Massachusetts.

4. The Division specifically reserves the right to amend this Complaint and/or bring additional administrative complaints to reflect information developed during the current and ongoing investigation.

---

#### IV. RELEVANT TIME PERIOD

5. Except as otherwise expressly stated, the conduct described herein occurred during the approximate period of April 1, 2006 through the present.

#### V. RESPONDENTS

6. Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill Lynch” or “Merrill”) is a Financial Industry Regulatory Authority (“FINRA”)<sup>1</sup> registered broker-dealer headquartered at 4 World Financial Center, New York, New York 10281. Merrill Lynch is registered as a broker-dealer with The Commonwealth of Massachusetts, and has a Central Registration Depository (“CRD”) number 7691.

7. Carl J. Kipper (“Kipper”) is the Vice President, Global Private Client Group for Merrill Lynch located at 30 South Pearl Street, Albany, New York 12207. During a portion of the relevant time period, Kipper was an Assistant Vice President of the Global Private Client Group for Merrill Lynch. Kipper has a CRD identification number of 4298886. Kipper is registered as a broker-dealer agent and currently possesses Series 7 and Series 66 registrations.

---

<sup>1</sup> FINRA was created in July 2007 through the consolidation of the National Association of Securities Dealers (“NASD”) and the member regulation, enforcement and arbitration functions of the New York Stock Exchange (“NYSE”).

8. Manuel Choy (“Choy”) is a Wealth Management Advisor in the Global Private Client Group for Merrill Lynch located at 449 Route 146, Clifton Park, New York 12065. During a portion of the relevant time period, Choy was located at 30 South Pearl Street, Albany, New York 12207. Choy has a CRD identification number of 4464917. Choy is registered as a broker dealer agent and currently possesses Series 7 and Series 66 registrations.

---

## VI. FACTS AND ALLEGATIONS

### A. Merrill Lynch’s Relationship with the City of Springfield

9. In December, 2006, the City of Springfield opened up three different accounts with Merrill Lynch.

10. Steven Lisauskas, Executive Director of the Springfield Finance Control Board had a personal relationship with Kipper. They had met years earlier when Mr. Lisauskas was working with Mr. Kipper’s wife.

11. In the summer and early fall of 2006, Kipper and Lisauskas exchanged emails and telephone calls in which Lisauskas helped orchestrate Kipper and Choy’s presentation to pitch for the City’s money management business. See Composite Exhibit 1.

12. In September 2006, as a result of Kipper and Lisauskas’ conversations, Kipper and Choy had an informal meeting with Lisauskas, Salvatore Calvanese (the City’s Treasurer), Mary Tzambazakis (the CFO for the City), and Mark Ianello (the City’s Auditor). The purpose of this meeting was to make introductions, talk about Merrill Lynch and the types of short-term investment vehicles Merrill Lynch could offer to the City.

13. Subsequently, as a result of further discussions between Kipper and Lisauskas, Kipper and Choy were invited to present more formally to the same group.

14. In November 2006, Kipper and Choy made a formal marketing pitch to the same group. Included in the pitch was a document, generated by Merrill Lynch, called "Introduction to Auction Market Securities," a copy of which, as produced to the Division by Merrill Lynch, is attached hereto as Exhibit 2. In this document, Merrill states that it "is strongly committed to the auction market securities marketplace, acting as the lead dealer on over 703 issues and participating in close to 822 additional issues."

15. Exhibit 2 also lists, under the heading "Advantages of Auction market Securities", "**High degree of principal protection.**" One of the reasons listed for the high degree of principal protection was that "successful auctions allow investors to exchange securities at par".

16. Choy and Kipper testified that they never discussed with the City the possibility of a failed auction.

17. Immediately after the formal sales presentation, Merrill was hired to manage a portion of the City's cash. Mr. Kipper testified that on the drive home from Springfield to Albany, Mr. Lisauskas called him to tell inform him that Merrill had been awarded \$50,000,000 to manage for the City of Springfield.

18. Account No. 808-02313 was opened on November 20, 2006.

19. Account No. 808-02318 was opened on November 27, 2006

20. Account No. 808-04056 was opened on January 25, 2007.

21. Specifically, in response to a request from the Division, Merrill produced the signature pages of those account opening documents.

22. In response to a subsequent request for the entire copies of those documents, Merrill's attorneys, in a letter dated January 29, 2008, stated:

With respect to your request for complete account opening documents, we enclose documents stamped ML 05598 through ML 05625 . . . . This is an exemplar of the BIA/WCMA Account Application Booklet that is standard to all accounts of the same type in effect at the relevant time. It contains the pages that were not included with the account opening materials previously produced, which were unique to the City of Springfield.

---

23. Upon information and belief, based on Merrill's production and the statement quoted in the preceding paragraph, at the time the accounts were opened, Merrill did not provide the City with complete copies of the account opening documents, but only provided the City with the signature pages to sign.

24. Upon information and belief, the terms of the account are contained in a document titled "BIA Financial Service and WCMA Financial Service Account Agreement and Program Description Booklet".

25. Although certain account application documents were produced, the documents referenced in the preceding paragraph have not been produced by Merrill.

26. The account-opening form for Account No. 808-04056 stated that the "Investment Preference/Account Risk Factor" was "moderate". However, Choy and Kipper testified that that entry was not accurate because it was their understanding that the City required that its money managed conservatively.

27. The Springfield accounts were not discretionary accounts. Although the terms of the account have not been produced by Merrill, Choy's testimony and the November 29, 2007 letter from James Mann (See Exhibit 7) indicate that neither Kipper nor Choy were authorized to execute trades on their own discretion.

B. The CDOs

28. The CDOs that Merrill sold to the City of Springfield were not the conservative, principal protected instruments that the City had sought when it opened its accounts with Merrill Lynch.

29. The Centre Square CDO was a highly complex instrument that, according to its Offering Circular, should only be sold to sophisticated investors.

30. Selected pages of the Centre Square CDO offering document are attached hereto as Exhibit 3.

31. On the front of the Offering Circular, it states that the Centre Square CDO was “Backed by a Portfolio of CDO Securities and Related Synthetic Securities”.

32. The Offering Circular lists 45 pages of risk factors.

33. Those risk factors included, among others, the following:

Investor Suitability. An investment in the Offered Securities will not be appropriate for all investors. Structured investment products, like the Offered Securities, are complex instruments, and typically involve a high degree of risk and are intended for sale only to sophisticated investors who are capable of understanding and assuming the risks involved. . . .

Limited Liquidity. There is currently no market for the Offered Securities. Although the Initial Purchaser [Merrill Lynch] may from time to time make a market in the Offered Securities, the Initial Purchaser is under no obligation to do so. If the Initial Purchaser [Merrill Lynch] commences any market-making, it may discontinue the same at any time. There can be no assurance that a secondary market for any of the Offered Securities will develop, or if a secondary market does develop, that it will provide the holders of such Offered Securities with liquidity of investment or that it will continue for the life of the Offered Securities. . . . .

Nature of Collateral. It is expected that the Collateral will consist primarily of CDO Securities, with up to 100% of the Pledged Collateral Debt Securities consisting of CDO Securities and Synthetic Securities the Reference Obligations of which are CDO Securities. The remainder of the Collateral will consist of RMBS and CMBS. The Collateral consisting of Synthetic Securities may include credit linked notes, total return swaps

and credit default swaps the Reference Obligations a to which are CDO securities, RMBS, CMBS or a specified pool or index of financial assets. The underlying assets of the CDO Securities will include other CDO securities, asset-backed securities, commercial and corporate bank loans (including senior loans, middle market loans and small business loans), bonds (including investment grade bonds, emerging market bonds and high yield bonds) and other debt securities (including trust preferred securities and sovereign debt) and derivative instruments.

...

---

Reliable sources of statistical information do not exist with respect to the default rates for many of the types of Collateral Debt Securities eligible to be purchased by the Issuer. In addition, historical economic performance of a particular type of Collateral Debt Securities is not necessarily indicative of its future performance. Prospective purchasers of the Offered Securities should consider and determine for themselves the likely level of defaults and the level of recoveries on the Collateral Debt Securities and the resulting consequences on their investment in the Offered Securities. [Emphasis added]

CDO Securities. All or most of the Collateral Debt Securities acquired by the issuer will consist of CDO Securities or Synthetic Securities the reference Obligations of which are CDO Securities. . . . CDO Securities generally have underlying risks similar to many of the risks set forth in these Risk Factors for the Offered Securities, such as interest rate mismatches, trading and reinvestment risk and tax considerations. Each CDO Security, however, will involve risks specific to the particular CDO Security and its Underlying Portfolio. . . .

34. None of the risks associated with the Centre Square CDO (or the Tabs CDO or the South Coast Funding CDO) were disclosed by Kipper, Choy or anyone else at Merrill Lynch to the City of Springfield at time of purchase of the CDOs. In fact, Mr. Choy testified that he did not review the Offering Circular for the Centre Square CDO until after the product began to lose value.

35. Merrill's underwriting fees earned in connection with the Centre Square CDO were in excess of \$10,000,000.

36. Merrill also earned approximately \$500,000 in remarketing fees by selling pieces of the Centre Square CDO to the City of Springfield and other purchasers.

37. Merrill's underwriting fees earned in connection with the South Coast CDO was in excess of \$16,000,000.

38. Merrill also earned over \$800,000 in remarketing fees by selling the Centre Square CDO to the City of Springfield and other purchasers.

39. Merrill's underwriting fees earned in connection with the Tabs CDO were approximately \$2,000,000.

40. Merrill also earned over \$450,000 in remarketing fees by selling the Tabs CDO to the City of Springfield and other purchasers.

41. As discussed below, the portions of these CDOs sold by Merrill to the City of Springfield have lost approximately \$13,000,000 in estimated market value.

C. Sale of the CDOs to the City

42. After the City's Merrill accounts were established, Kipper and Choy began to purchase investment products for the City. In addition to putting money into Merrill Lynch's premier money market funds, Kipper and Choy purchased products off of Merrill Lynch's Auction Market Rate Sheet.

43. An example of the Auction Rate Market Sheet is attached hereto as Exhibit 4.

44. The Auction Market Rate Sheet listed securities that Merrill sought to sell, either from its own inventory or on behalf of another party.

45. The Auction Market Rate Sheet listed certain rudimentary pieces of information regarding the security, including the name of the issuer, the interest rate the product was paying, the rating the product had received from rating agencies, and the date of the next auction for the product (which was the date at which the product presumably could be sold).

46. Included in the Auction Market Rate Sheet were certain pieces of inventory marked in red. A footnote on the sheet stated “Red indicates private placement. May also require investors to be a Qualified Purchaser (QP) and/or Qualified Institutional Buyer (QIB).”

47. The Centre Square, Tabs and South Coast Funding CDOs were only available to Qualified Institutional Buyers.

48. Choy sent a form to Salvatore Calvanese, the City’s Treasurer, in March 2007 that would allow the City to certify that it was a Qualified Institutional Buyer.

49. Mr. Calvanese filled out the form and then faxed it to Mr. Choy, who then faxed it to Derek Sin at Merrill’s Auction Market Securities Desk. See Exhibit 5.

50. The form (Exhibit 5) was titled “QIBLIST CERTIFICATION/CERTIFICATE OF RULE 144A QUALIFIED INSTITUTIONAL BUYER AND SECTION 3(C)(7) QUALIFIED PURCHASER”. On the form, Salvatore Calvanese certified, among other things, that:

In connection with a purchase or purchases of privately offered securities pursuant to Rule 144A under the Securities Act of 1933, the undersigned certifies that it is familiar with Rule 144A, agrees that persons selling securities to the undersigned in reliance on Rule 144A may rely on the information contained in this certificate and represents and warrants that:

(i) It is a Qualified Institutional buyer (“QIB”) (as described in Annex A hereto) of the following type: **Investment Company**”.

See Exhibit 5 [Emphasis added].

51. Mr. Calvanese also certified that the city “is a conduit (such as a bank, foreign bank, broker/dealer or investment advisor) and that all purchases of new issues are, and will be, in compliance with the Rule”. See Exhibit 5

52. Mr. Choy did not question or challenge these certifications.

53. Mr. Sin did not question or challenge these certifications.

54. Upon information and belief, no one at Merrill questioned or challenged there certifications.

55. Mr. Choy testified that he was not familiar with Rule 144A.

56. After this form was submitted, Choy and Kipper purchased the Centre Square, Tabs and South Coast CDOs for the City’s account. These specific investments were not discussed with the City prior to their purchase.

57. Typically, Mr. Calvanese (who was Kipper’s and Choy’s primary operating contact within the City) would be apprised of specific investments after they were made.

See Composite Exhibit 6.

58. Neither Kipper nor Choy entered into any due diligence with respect to the Centre Square, Tabs or South Coast Funding CDOs other than inquiring as to their name, the yield they were paying, their rating by the rating agencies and when the next auction date was.

59. Neither Choy, Kipper nor anyone else at Merrill Lynch engaged in any review of the suitability the purchase of the Centre Square, Tabs or South Coast CDOs for the City of Springfield beyond glancing at the name, the yield on the product, their rating by the rating agencies and when the next auction date was.

60. At the time the sales were made, the sales were not reviewed or questioned by Kipper's or Choy's supervisor, or by anyone else at Merrill Lynch.

61. At the time of the sales neither Kipper nor Choy (nor anyone else at Merrill Lynch) discussed the risks of owning these CDOs with anyone at the City.

62. At the time of the sales, Kipper and Choy neither reviewed the prospectuses for the Springfield CDOs nor provided them to the City.

---

63. At the time of the sales, neither Kipper nor Choy (nor anyone else at Merrill Lynch) disclosed that the issuer of the Centre Square CDO was Merrill Lynch.

64. At the time of the sales, neither Kipper nor Choy (nor anyone else at Merrill Lynch) discussed the possibility that an auction might fail with respect to these CDOs.

65. At the time of the sales, the City was not informed that the Springfield investments were CDOs.

66. To the contrary, these instruments appeared on the City's account statements through June 2007 as "Centre Square Ltd.", "South Coast FNDG VA-2" and "TABS 2004-1 LTD SER A-2".

67. In July 2007 the exact same investment products quietly began to appear on the account statements as "Centre Square CDO PVT", "S Coast FD V CDO PVT" and "TABS CDO PVT".

68. Upon information and belief, this change was neither flagged nor explained to the City.

69. Upon information and belief, the Centre Square CDO, South Coast Funding CDO and Tabs CDO are not investments that a city may make under the applicable provisions of the Massachusetts General Laws.

70. In a subpoena to Merrill Lynch, the Division requested “all Documents evidencing analyses by Merrill Lynch of the legality, suitability and/or appropriateness of [the Centre Square, Tabs and South Coast CDO] investments for the City of Springfield”.

---

Merrill Lynch has not produced any documents evidencing any such analysis.

D. The CDOs' Precipitous Drop in Value

71. Within months after Merrill's sale of these CDOS to the City, the market for them began to dry up and their market value began to plummet.

72. For example, the \$10,000,000 of the Centre Square CDO had been purchased in by Merrill for the City on April 24, 2007, with an additional \$2,625,000 purchased on April 27, 2007.

73. By August 2007, it was listed on the City's account statements as having an “estimated market value” of only 84 percent of its purchase price.

74. By September, it was down to 50 percent; by October it was down to 30 percent; and by December 2007, it was down to 5 percent.

75. Merrill purchased \$700,000 of the South Coast Funding V CDO on June 29, 2007.

76. By August 2007, it was listed on the City's account statements as having an “estimated market value” of only 91.69 percent of its purchase price.

77. By September, it was down to 90 percent; by October it was down to 80 percent; and by December 2007, it was down to 30 percent.

78. Merrill purchased \$625,000 of the TABS 2004-1 CDO for the City on April 27, 2007.

79. By August 2007, it was listed on the City's account statements as having an "estimated market value" of only 93.24 percent of its purchase price.

80. By September, it was down to 90 percent; by October it was down to 80 percent; and by December 2007, it was down to 30 percent.

81. In the City's December account statement, the combined estimated market value for these three investments, which were purchased for an aggregate amount of \$13,925,000, was \$1,025,500. This represents a loss in estimated market value of over \$12,000,000.

E. The City's Complaints and Merrill's Response

82. In a meeting with Choy and Kipper in September 2007 to evaluate possible options in response to the secondary market collapse. The City requested that these CDOs be sold, but City officials were informed that there were no buyers and that they could not be sold at any price close to their par value.

83. The City continued to raise questions about these CDOs as they continued to lose value.

84. Merrill responded to those questions during a meeting on November 15 or 16, 2007 and then by means of a letter dated November 29, 2007 from James Mann, First Vice President and Assistant General Counsel of Merrill Lynch. In the letter, attached hereto as Exhibit 7, Merrill disclaimed responsibility for these investments:

While Merrill Lynch is disappointed with the unfortunate disappearance of liquidity in the residential mortgage-backed CDO markets, Merrill Lynch has no legal responsibility to the City concerning the financial

performance of this investment. The City's account is not a discretionary or advisory account. The City made its own investment decisions.

85. This statement was made despite the fact that, as discussed above, Choy purchased the securities without discussing them with the City before the purchase.

86. In addition, Mr. Mann stated: "The best resource for information regarding the original structure of the Centre Square securities is the private placement memorandum (the "PPM") that Centre Square prepared in connection with the initial offering. For your convenience, I enclose a copy of that PPM with this letter." See Exhibit 7.

87. No disclosure documents regarding the Centre Square, Tabs or South Coast Funding CDOs were provided to the City of Springfield at the time of purchase.

88. Mr. Mann also stated:

You have also inquired about the secondary market for the Centre Square CDO. Until August of this year, a secondary market for CDOS, including the Centre Square CDO, was available. Since August, the auctions for this instrument have not been successful, leaving no formal secondary market for this security. The current lack of liquidity for this security was not anticipated at the time the City made its investment – it results from an unexpected confluence of market conditions.

See Exhibit 7 [emphasis added].

89. The highlighted statement stands in stark contrast to Merrill Lynch's own disclosure document for Centre Square dated November 29, 2006, which (as quoted above) states:

"Limited Liquidity. There is currently no market for the Offered Securities. Although the Initial Purchaser [Merrill Lynch] may from time to time make a market in the Offered Securities, the Initial Purchaser is under no obligation to do so. If the Initial Purchaser [Merrill Lynch] commences any market-making, it may discontinue the same at any time. There can be no assurance that a secondary market for any of the Offered Securities will develop, or if a secondary market does develop, that it will

provide the holders of such Offered Securities with liquidity of investment or that it will continue for the life of the Offered Securities. . . .  
Initial Purchaser [Merrill Lynch] is under no obligation to do so . . .

90. As stated above, this disclosure document was not provided to the City.

91. As discussed above, the possibility of an auction failure was not discussed in any of Kipper or Choy's sales presentations to the City and was not disclosed to the City at the time of the sale of these CDOs.

## VII. VIOLATIONS OF SECURITIES LAWS

### A. COUNT I – VIOLATION OF §101 BY RESPONDENTS

92. Section 101 of the Act provides in pertinent part:

It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly:

- (1) to employ any device, scheme or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or
- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

93. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 92 above.

94. The conduct of Respondents, as described above, constitutes violations of M.G.L. c. 110A, § 101.

### B. COUNT II – VIOLATION OF § 204 (a)(2)(G) BY RESPONDENTS

95. Section 204 (a)(2)(G) of the Act provides in pertinent part:

(a) The secretary may by order impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action if he finds (1) that the order is in the public interest and (2) that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser:--

(G) has engaged in any unethical or dishonest conduct or practices in the securities, commodities or insurance business.

---

96. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 95 above.

97. The conduct of Respondents as described above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(G).

98. Without limiting the generality of the foregoing, the conduct of Respondents set forth above violates the following provisions of the Regulations:

950 CMR Section 12.204 (1)(a):

(4) Recommending to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that such transaction or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer.

(5) Exercising any discretionary power in effecting a transaction for a customer's account without first obtaining written authority from the customer, unless the discretionary power relates solely to the time and/or price for the execution of the order.

...  
(19) Failing to disclose that the broker-dealer is affiliated with the issuer of a security before entering into a contract with or for a customer for the purchase or sale of such security. . . .

...  
(28) Failing to comply with any applicable provision of the NASD rules of Fair Practice.

99. NASD Rule 2210(d)(1)(A) states in relevant part:

All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.

### C. COUNT III – VIOLATION OF § 204 (a)(2)(J) BY MERRILL LYNCH

---

100. Section 204 (a)(2)(J) of the Act provides in pertinent part:

The secretary may by order deny, suspend, or revoke any registration if he finds (1) that the order is in the public interest and (2) that the applicant or registrant (J) has failed reasonably to supervise agents, investment adviser representatives or other employees to assure compliance with this chapter.

101. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 100 above.

102. The conduct of Respondent Merrill Lynch, as described above, constitutes violations of M.G.L. c. 110A, § 204 (a)(2)(J).

## VIII. STATUTORY BASIS FOR RELIEF

### Violations, Cease and Desist Orders and Costs

103. Section 407A(a) of the Act provides in pertinent part that:

(a) If the secretary determines, after notice and opportunity for a hearing, that any person has engaged in or is about to engage in any act or practice constituting a violation of any provision of this chapter or any rule or order issued thereunder, he may order such person to cease and desist from such unlawful act or practice and may take affirmative action, including the imposition of an administrative fine, the issuance of an order for accounting, disgorgement or rescission or any other relief as in his judgment may be necessary to carry out the purposes of [the Act].

104. The Division herein re-alleges and restates the allegations and facts set forth in paragraphs 1 through 103 above.

105. Respondents directly and indirectly engaged in the acts, practices, and courses of business as set forth in this Complaint above, and it is the Division's belief that Respondents will continue to engage in acts and practices similar in subject and purpose, which constitute violations if not ordered to cease and desist.

#### **IX. PUBLIC INTEREST**

For any and all of the reasons set forth above, it is in the public interest and will protect Massachusetts investors to:

- 1) Require Respondents to cease and desist from further violations of the Act and Regulations;
- 2) Impose an administrative fine on Respondents in an amount and upon such terms and conditions as the Director or Hearing Officer may determine;
- 3) Order Respondents to disgorge all profits attributable to the alleged wrongdoing;
- 4) Censure Respondents;
- 5) Appoint an independent consultant to review the systemic supervisory breakdowns and incentives within Merrill Lynch that allowed the alleged wrongdoing to occur; and
- 6) Take such other actions, which may be in the public interest and necessary and appropriate for the protection of Massachusetts investors.

#### **X. RELIEF REQUESTED**

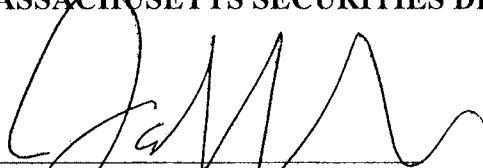
Wherefore, the Enforcement Section of the Division requests that the Director or Hearing Officer take the following action:

- A. Find that all the sanctions and remedies detailed herein are in the public interest and necessary for the protection of Massachusetts investors;
- B. Find as fact the allegations set forth in paragraphs 1 to 105 of the Complaint;
- C. Enter an order requiring Respondents to cease and desist from any further violations of the Act;
- D. **Impose an administrative fine on Respondents;**

---

- E. Order Respondents to disgorge all profits attributable to the alleged wrongdoing;
- F. Appoint an independent consultant to review the systemic supervisory breakdowns and incentives within Merrill Lynch that allowed the alleged wrongdoing to occur;
- G. Censure Respondents; and
- H. Take such further action as may be deemed just and appropriate to carry out the purposes of the Act.

**ENFORCEMENT SECTION  
MASSACHUSETTS SECURITIES DIVISION**



---

Joshua S. Grinspoon, Enforcement Attorney  
Gina Gombar, Enforcement Attorney  
Michael Regan, Enforcement Attorney  
Patrick Ahearn, Chief of Enforcement  
Massachusetts Securities Division  
One Ashburton Place, Room 1701  
Boston, Massachusetts 02108  
(617) 727-3548

Dated: February 1, 2008