

SFC fines two Merrill Lynch entities \$3.5 million for systems and controls failings

31 May 2010

The Securities and Futures Commission (SFC) has fined Merrill Lynch (Asia Pacific) Limited and Merrill Lynch Futures (Hong Kong) Limited (collectively Merrill Lynch) (Note 1) \$3,500,000 for systems and controls failings associated with the mis-marking activities in a trading book.

The SFC's investigation found that during the period from December 2007 to October 2008, a managing director of Merrill Lynch had mis-marked a trading book in exotics options (Book) by manipulating the volatility marks in the valuation model, and accessed the computer system without authority to alter pricing parameters on various occasions. The mis-marking activities, which did not apply to any other books, resulted in the value of the Book being inflated by approximately US\$25 million and caused the actual loss in the Book to be wrongly reported internally.

The SFC found that Merrill Lynch did not have adequate internal controls procedures in place to manage the risks associated with mis-marking, in that:

- there was uncertainty as to supervisory responsibilities over the trader and the Book;
- the price verification mechanism applied to other trading books was not applied to the Book;
- there were inadequate checks and balances over the Book to mitigate operation risks including risks associated with fraud and dishonest activities;
- there was insufficient safeguard over information security and integrity as regards the Book;
- trading and valuation policies were not sufficiently implemented over the Book; and
- senior management failed to adequately manage the risks associated with the Book.

"Licensed corporations must have effective procedures in place to manage risks of trading books. For books that deal in illiquid assets which have low price transparency, more robust measures must be in place. The proper implementation of an effective risk management framework could have enabled Merrill Lynch to detect the mis-marking earlier," said Mr Mark Steward, the SFC's Executive Director of Enforcement.

Merrill Lynch accepts that its systems and controls fell short of those expected in respect of the Book.

The SFC accepts that Merrill Lynch's misconduct was not intentional and Merrill Lynch has taken remedial steps to address the compliance weaknesses. In deciding on the sanctions, the SFC took into account Merrill Lynch's co-operation in resolving the case.

End

Note:

1. Merrill Lynch (Asia Pacific) Limited is licensed under the Securities and Futures Ordinance (SFO) to carry on Type 1 (dealing in securities), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 7 (providing automated trading services) regulated activities. Merrill Lynch Futures (Hong Kong) Limited is licensed to carry on Type 2 (dealing in futures contracts) regulated activity under the SFO.