



REGULATORY UPDATE 10/2009

SPECIAL EDITION: Merrill Lynch Irish entity fined €2.75 million over \$461 million loss at its London office

This newsletter is available online at:

http://www.complianceireland.com/documents/CI_Newsletter_Oct09_10_web.pdf
<http://www.complianceireland.com/Newsletter.html>

Today, Friday 23 October 2009, the Financial Regulator announced that it has fined Merrill Lynch International Bank Limited (registered in Ireland) €2,750,000 due to two failures by its traders to appropriately value their positions. These failures occurred at the London Branch of Merrill Lynch International Bank Limited (Merrill Lynch).

The first incident occurred between December 2008 and February 2009 and the second incident occurred between May and August 2009. These two failures resulted in a **total loss of \$461.3 million** (\$456 million loss and \$5.3 million loss). Details of the second failure came to light during the Financial Regulator's investigation.

Common to both incidents was a failure to:

- have in place a well defined and transparent line of supervisory responsibility;
- supervise the trader's activity; and
- have in place an adequate month-end independent price verification process.

Merrill Lynch also failed to manage effectively market risk limits in respect of the trader's activities.

In addition to the monetary penalty of €2.75 million, Merrill Lynch has been reprimanded by the Financial Regulator. The Financial Regulator has confirmed that Merrill Lynch promptly notified the Financial Regulator in respect of each incident, commissioned full investigations and subsequently submitted detailed reports of each investigation to the regulator. Merrill Lynch fully co-operated with the Financial Regulator. Merrill Lynch has reportedly taken complete remedial action to fully rectify the breaches.

Settlement Agreement at <http://www.complianceireland.com/documents/Settlement-Agreement-between-the-Financial-Regulator-and-Merrill-Lynch-International-Bank-20.pdf>

Comment: *The fine is an interesting one. It is very large by Irish standards notwithstanding Merrill Lynch co-operated with the regulator. Perhaps the severity of the fine, given there appears to be no allegations of customer loss, relates to the Financial Regulator writing to banks and financial institutions as far back as June 2008 requiring them to confirm to the regulator that they had their trading activities in order. Firms were required to conduct a review of their trading operations and report to the Financial Regulator any control issues needing to be strengthened.*

Specifically the Financial Regulator required these firms to confirm that they:

- continuously monitor limits assigned to traders,
- review their internal controls over traders activities,
- review their management reporting lines and information channels,
- review their technology security, and
- review their compliance/governance oversight arrangements.

The Financial Regulator's letter followed on from the Committee of European Banking Supervisors investigation into the €5 billion loss at Société Générale allegedly caused by Jerome Kerviel. Read more at

http://www.complianceireland.com/documents/CEBS_survey_Kerviel_governance_good_practice.pdf

Presumably all firms which provided positive responses to the Financial Regulator will, given the fine against Merrill Lynch, revisit their responses in mid-2008 to determine whether the confirmations given remain correct. See **Compliance Ireland's** briefing paper on the Financial Regulator's 2008 review of trading activities at <http://www.complianceireland.com/documents/CI-Briefing-Note-Risk-Management-and-Internal-Controls-Jul08.pdf>

The fine against Merrill Lynch is the second highest to date issued by the Irish regulator. In October 2008 the regulator fined Quinn Insurance Limited and its then chairman, Sean Quinn totalling €3.45 million (€3.25 million and €200,000 respectively) see page 14 of our November 2008 Newsletter at http://www.complianceireland.com/documents/CI_Newsletter_November08_web.pdf. Our tally of settlements & fines released to the public by the Financial Regulator shows that fines of €7,082,000 have been issued following 21 announced regulatory sanctions against 29 persons in total. (see <http://www.complianceireland.com/Resources.html#Enforcement>)

Today's fine is the second time that a group company underneath the Merrill Lynch brand has been fined for internal control failures in Europe. In August 2006, the UK Financial Services Authority fined Merrill Lynch International £150,000 for failing to accurately report transactions to the FSA which were critical to the regulator's ability to maintain confidence in the financial markets and reduce financial crime. The Merrill Lynch brand has been fined numerous other times in the past, particularly in the United States, including a \$100 million fine in 2002.

Other interesting twists to the Merrill Lynch fine are that:

1. one of the Irish bank's non-executive directors is Dr Liam O'Reilly, former chief executive of the Financial Regulator. Dr O'Reilly, who stepped down from the regulator in 2006, is also a non-executive director of Irish Life & Permanent plc which was reprimanded and fined €600,000 in relation to breaches of regulatory reporting requirements back on 3 September 2009 – see <http://www.complianceireland.com/HotTopics.html#ILPSettlementSep09>. There is no allegation that Dr O'Reilly or indeed any directors of either entity were responsible for the breaches. However these regulatory actions do highlight unfortunate consequences when senior regulators, especially the chief executives, retire from their regulatory roles only to assume non-executive directorships at the same institutions they were responsible for regulating. The Financial Regulator itself has said time and time again, especially in its Fit & Proper Code, that the Boards and directors are ultimately responsible for the governance and compliance standards within their companies. Another regulatory action against Irish Life & Permanent plc might arise subject to the closure of the Financial Regulator's investigation into circular loans to Anglo Irish Bank, which the Financial Regulator stated in February this year were completely unacceptable. Critics of the culture of poor governance at Irish banks may soon have further ammunition to support their claims that the problems in the Irish banking industry are DNA type rooted problems which can only be eradicated if Irish banks are swept totally clean of the people (directors, senior management and staff) that either orchestrated or turned a blind eye (either at the time of occurrence or at later dates when knowledge came to pass) to such events.

2. *Merrill Lynch Ireland should, technically be in financial trouble, given that it reportedly made a pretax loss on ordinary activities of \$1.47 billion in 2008 (compared to a compared to a pretax profit on ordinary activities of \$854 million in 2007). But given its ownership by Bank of America (BoA), since September 2008, it should easily be able to weather its losses and the fine. Merrill Lynch's parent company BoA and the SEC were severely criticised when US Federal Court Judge Jed S Rakoff rejected their settlement agreement under which BoA would pay a \$33 million fine relating to alleged material lies (neither admitted or denied) by BoA, and to further refrain from making future false statements, to its shareholders. The alleged lies related to statements by BoA that it would obtain shareholder consent before paying bonuses to executives of the newly acquired Merrill Lynch group. It transpired that BoA had in fact already agreed a \$5.8 billion bonus pool. The bonus pool was 12% of the total consideration paid by BoA for Merrill Lynch. (see <http://www.nytimes.com/2009/09/15/business/15bank.html>, judgment at <http://www.scribd.com/doc/19738938/Judges-Rejection-of-SECBank-of-America-Settlement> and <http://www.irishtimes.com/newspaper/finance/2009/10/21/1224257148973.html>)*
3. *Merrill Lynch Ireland was appointed by the Irish Government to provide advice on the banking crises from September 2008. A report by the Comptroller and Auditor General recorded that Merrill Lynch earned advisory fees of €7.3 million (page 59 of the Annual Report, 2008). Merrill Lynch advised upon "structural issues in financial markets" and then advised on investing National Pensions Reserve Fund monies into Irish banks. Merrill Lynch was appointed by the National Treasury Management Agency upon the instructions of the Finance Minister (Brian Lenihan). The appointment was made on an exclusive basis which expired in June 2008 at which time RM Rothschild took over. A smart move in hindsight, or perhaps foresight, as it would not have looked too good for the Irish Government to be seen employing someone disciplined for internal control and trading oversight failures effectively responsible for advising the same government on investing €77 billion of taxpayers' money. (see <http://www.independent.ie/national-news/state-paid-out-e15m-for-advisers-over-banking-crisis-1884880.html>, http://www.audgen.gov.ie/documents/annualreports/2008/Annual_Report_2008Rev_En.pdf and http://www.nama.ie/Publications/2009/Second_Stage_Speech_16SEP09.pdf)*
4. *The head of Merrill Lynch's Irish operations, Mike Ryan, departs for Qatar in October 2009 to take up the role of managing director (reporting to the chief executive officer) at the Qatar Financial Centre Regulatory Authority. Philip Thorpe, managing director of the QFCRA, stated that the QFCRA "was delighted that we have been able to recruit someone of Michael Ryan's calibre to take up this important role. His broad experience of financial services issues and his expertise in regulation and compliance will be of great value to the Regulatory Authority in our efforts to build upon the reputation of Qatar as a first class destination for financial services business." Given the recent regulatory compliance issues involving both Bank of America and Merrill Lynch, Mr Ryan should be more than qualified in understanding the regulatory complexities and conflicts of interest inherent in global banking institutions and to assist bringing about changes in culture at such organisations. It is a pity that Ireland, either at the Financial Regulator or another government agency, could not offer Mike Ryan a similar challenge to that of Qatar given the wholesale regulatory and banking reform so badly needed here. (see http://www.qfcra.com/Press%20Releases/2009/QFCRA_2009_17%20QFCRA%20appoints%20New%20Senior%20Executive.pdf)*

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