Merrill Lynch & Co., Inc.: Ethical and Legal Implosions Pre - 2009 Bank of America Merger

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Abstract

Prior to being acquired by Bank of America Corporation in 2008 during the 2007-2009 global financial crisis, Merrill Lynch & Company, Incorporated (now called Merrill under Bank of America's investment and wealth management division) was the epitome of sound, legal and ethical business principles and practices. What made this brokerage firm distinct from its competitors was its widely renowned "Mother Merrill" culture, which consisted of collaborative teamwork, mentorship, client service and ethical communication. From the beginning of the early 2000's leading up to early 2007, deceptive business practices, risky mortgage assets, and dealings fueled by self-interest and advancement pervaded this time-honored, storied enterprise. What was once an independent, iconic franchise that originally was designed to bring "Wall Street to Main Street" to the average investor, is now a tragic tale of self-inflicted greed, excess, corporate ignorance, and internal erosion of business ethics. These factors have only served to accelerate and exacerbate the firm's financial and legal woes. This paper examines and analyzes the ethical ramifications concerning corporate leadership at Merrill Lynch, the role subprime mortgage originators play in the firm's venture into the non-prime asset market, and whether or not the firm was complicit in insider trading before the 2008 Bank of America merger.

Keywords

Corporate Social Responsibility, Business Ethics, Merrill Lynch, Risk Management, Insider Trading, Investment Banking, Securities Law, Subprime Lending

E. Stanley O'Neal's Necessary Evils: An Introduction

The decline and eradication of Merrill Lynch's moral compass along with its Mother Merrill ethos began in early 2002. At the time, E. Stanley O'Neal, the president of later chairman and chief executive officer (CEO), took the initiative of ruthlessly firing experienced executives in key senior positions. He replaced them with individuals who had little to no experience in risk management or investment banking. O'Neal also worked aggressively to cut down Merrill Lynch's bloated cost structure and dismissed a total of 24,000 employees and 19 executives. According to Eric Weiner of National Public

Radio, this was a third of Merrill's workforce. He also writes that this level of cost-cutting was unpopular among employees (Weiner, 2007). This decision, according to O'Neal, was a necessary evil. At the time of his appointment, the firm was spending excessively and had thin profit margins (Thornton, 2001). This established an environment and climate of poor accountability and lack of oversight, which allowed for unethical business decisions and practices among top Merrill management. As authors note in the International Research Journal of Marketing and Economics, business leaders, especially CEOs, have greater power and therefore have a greater chance of making unethical decisions to produce group goals (Hardy et al, 2016). They also state that CEOs hold a disproportionate amount of responsibility in both setting goals and inspiring collective action to attain organizational goals (Hardy et al, 2016). Ultimately, CEOs are perceived to be accountable for business mishaps as well as successes. This assessment is accurate and can be seen in O'Neal's decision-making process and actions. Merrill's board of directors charged O'Neal solely to make Merrill Lynch profitable and modernize the firm's operations. O'Neal did indeed meet his goal of maximizing profits, but only out of antagonism, favoritism, short-sightedness, and deception.

Merrill Lynch wasn't the only investment bank on Wall Street to nurture this hyper-competitive climate of bringing in "easy money" under questionable pretenses. Household names on Wall Street such as JPMorgan Chase, Citigroup, Bear Stearns, Lehman Brothers, Morgan Stanley and Goldman Sachs also perpetuated this "winner take all" mentality. This was all done at the expense of seasoned risk professionals and frontline employees. Another necessary evil O'Neal had undertaken was eliminating the Mother Merrill culture without establishing a new one to improve employee morale, encourage accountability, boost profitability, and enhance the firm's branding, image, and credibility in the financial marketplace. Before the O'Neal regime, Merrill Lynch's Mother Merrill culture, largely one of paternalism, clubbiness, and community, embodied certain aspects of corporate social responsibility (CSR), which the website Investopedia defines as a "self-regulating business model that helps a company be socially accountable to itself, its stakeholders, and the public." Companies who engage in CSR have an awareness of how their business impacts swaths of society, especially the social and economic aspects.

Merrill Lynch, founded by visionary businessman Charles E. Merrill in January 1914, integrated and practiced CSR by "bringing Wall Street to Main Street," a credo by which Merrill democratized the stock market. This was done by including the average investor with a small account on Main Street as both clients in his enterprise and in the stock market, which traditionally caters to wealthy Wall Street clients and professionals alike. In his journal entry for the Journal of the North American Management Society, John

D. Farlin, Ph.D., notes that in 1911 Merrill wrote an article for Leslie's Illustrated Weekly under his trademark theme "Mr. Average Investor" before launching his brokerage firm. This average investor wrote on to teach readers how to consider the customer's goals and risk tolerance. Merrill used advertising in all of its forms to amplify his vision and mission of transforming the average citizen into a participating investor in the stock market (Farlin, 2008). This is a model example of CSR. Even before the term entered into the mainstream business vocabulary, and long after Merrill's day and age, he considered the social and economic impact he and his eponymous firm would have not only on his future clients, but also on his future employees, business partners, and the public at large. Fast forward to the 2000s, there is little to no indication of CSR in the O'Neal regime. The embattled former chairman and CEO of Merrill Lynch focused only on the economic impact and outcome of the firm, its clients, its shareholders, and the financial markets, all at the expense of his longtime senior management team and society at large.

Merrill Lynch's Costly Venture into Subprime Mortgage Securitization and CDO Creation

From 2003 to mid-2006 the U.S. economy enjoyed a boom fueled by the real estate market as broker-dealers, insurers, and subprime mortgage lenders capitalized on the market by investing in residential properties, mortgage-backed securities, and issuing mortgages through subsidiaries to homebuyers below the credit score spectrum. At this time, the investment banking industry was no longer confined by the dictates of the Glass-Steagall Act of 1933, which had separated commercial banking activity from investment banking activity. This law was later repealed by Congress in 1999, opening the door for the investment banking industry to delve into financial activities, such as investing in hedge funds and advising clients and retail investors simultaneously. While Merrill Lynch was late to the party in the subprime mortgage market in 2000, by 2006 it had become the largest manufacturer and seller of mortgage-backed securities (MBS) and collateralized debt obligations (CDOs). These are complex financial vehicles that, as Roger Yu defines in an article for USA Today, "are put together with underlying debts, such as mortgages, and pay investors based on the cash flow brought in by the assets."

In 2006 Merrill Lynch acquired First Franklin Financial Corporation and its affiliated lending units for $1.3 billion as a source of its mortgage originating and securitizing operations for its CDO and MBS businesses. First Franklin Financial, founded in 1981 in San Jose, California, specialized in servicing and lending subprime mortgages. This subprime wholesaler was

previously owned by National City Corporation, a Cleveland-based bank that was heavily involved in the subprime mortgage business starting in the late 1990's, with $10 billion in toxic assets in its balance sheet. The bank would later be entangled in financial trouble. According to author Randy Roguski, there were ten actions that executives at National City didn't think through enough. One was focusing solely on mortgage lending through third-party brokers, as well as the 1999 acquisition of First Franklin Financial from a Bank of America subsidiary for $266 million. Another action would be not selling its subprime subsidiary sooner to Merrill Lynch for $1.3 billion. In addition to this, Merrill Lynch bought First Franklin because the subprime lender had become worthless in the eyes of National City, which suggests that the Cleveland-based bank hastily sold its asset in a fire sale. This would be a harbinger of what was to become of Merrill Lynch as an independent entity.

From a researcher's perspective, it should be noted that during the dealmaking and acquisition process between the Bank of America subsidiary, National City, and Merrill Lynch, that there was little to no pushback or intervention from federal or state regulators. Specifically, agencies such as the Federal Reserve system, the U.S. Federal Trade Commission (FTC) or the U.S. Securities and Exchange Commission (SEC) were notably passive. Furthermore, there was never any indication that both parties did their due diligence or bother to look at the history, past performance, and track record of the subsidiaries and their parent company whose performances had fluctuated with the real estate market bubble. They also did not consult with their corporate constituencies or legal counsel about the deal being made between the two firms prior to the sale. In short, the acquisition of First Franklin Financial from the Bank of America subsidiary to National City to Merrill Lynch demonstrated how quick, effortless, and unregulated the investment banking and subprime lending industries were at the time. In terms of new mergers and acquisition, this is significant when compared to the traditional lending industry, which must seek prior written approval from the U.S. Housing and Urban Development (HUD) before pursuing a merger or acquisition.

As multiple media reports suggest, lack of oversight and review from federal and state agencies along with lowered mortgage underwriting standards and contributed to the unethical processes of the subprime lending industry. Unsurprisingly, as authors examined in their legal assessment of the subprime lending crisis in Risk Management magazine, subprime lenders with lax or inappropriate sales policies such as First Franklin Financial "faced a wave of individual predatory lending claims" (Houlihan & Smith, 2007). They continue to note that these lenders and their individual board members have also faced a growing number of security class action suits from stockholders alleging that false and misleading public filings affected their investment

decisions and incurred economic loss when the lender's stock value dropped (Houlihan & Smith, 2007). Nevertheless, financial, legal and ethical consequences caught up with these predatory lenders during and after they went out of business. As Fordham University School of Law professor David Schmudde writes in his article for the Fordham Journal of Corporate and Financial Law, the city of Cleveland, where National City is headquartered, has sued banks and financial institutions under the state public nuisance law. This law asserts that the financial institutions created a public nuisance in areas of Cleveland because their loans led to widespread abandonment of homes (Schmudde, 2009).

Although there is no evidence that National City, First Franklin Financial, or Merrill Lynch have been sued for predatory lending, the financial and legal climate these firms were operating in suggests that local government, consumers, and investors are now wise to the illusory ruse of the subprime lending and investment banking industries. There is an understanding that it is an open season for any market participant that played a notable role in the crisis. Ultimately, as it has been widely reported by multiple media outlets covering the mortgage industry, Merrill Lynch as a parent company has shut down First Franklin Financials subprime lending operations and two of its subsidiary units in 2008, and as a combined entity with Bank of America reached a settlement agreement with numerous state and federal officials, unwinding ill-gotten gains from their subprime enterprises in 2014, as company documents show. As for National City, the former parent company of First Franklin Financial, it was brought down to its knees as the real estate bubble burst in 2007 and were acquired by PNC Financial in 2010 with assistance from the federal government.

Insider Trading: Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc.

Throughout its century-old history as a Wall Street mainstay, Merrill Lynch and its founding workforce had a reputable standing as prudent, forward-thinking, financial statesmen. As stated previously, the brokerage's Mother Merrill culture was one of collaborative teamwork, mentorship, and client service. However, starting from the late 1960s to as recently as 2011, several of Merrill Lynch's employees mostly from the firm's trading desk and senior management team had been accused of a variety of egregious white-collar crimes and deceptive business practices such as insider trading. According to the U.S. Securities and

Exchange Commission's (SEC) website, under the Securities Exchange Act of 1934, insider trading is illegal "when a person trades a security while in possession of material nonpublic information in violation of a duty to withhold the information or refrain from trading." On the other hand,

Investopedia explains insider trading is legal "if the insider makes a trade and reports it to the SEC, but insider trading is illegal when the material information is still nonpublic." In other words, acting on a trade armed with the advanced knowledge of the activity or outcome of security can be seen as an unfair advantage and leverage to the trader (the insider). The trader's actions, no matter how large or small, can have unintended negative effects not only on the company issuing the targeted security and its share price, but also in the capital markets at large.

According to Christopher M. McCarthy of the St. John's Law Review, one of the most notable insider trading cases is Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 495 F.2d 228 (2d Cir. 1974), in which the court held that "the recipients of inside information (also known as "tippees") who buy or sell securities without disclosure of the information can be held liable under Rule 10b-5, 17 C.F.R., § 240.10b-5 (1974) in a private action for damages brought by persons trading in the stock over a national securities exchange." The presiding judge of the case also ruled that the tippees of nonpublic information can be held accountable even though the tippers themselves did not trade in the security (McCarthy,1975). Because Merrill Lynch positioned itself as a prospective managing underwriter of the aircraft company Douglas in 1966, as McCarthy noted, the firm became privy to material inside information concerning Douglas' projected earnings which trended downward. As a result, both the firm and its clients profited from this inside tip, while investors without this information suffered great losses from Douglas' stock. To summarize, an underwriter is liable to private investors with whom the firm had no direct dealings. This will not be the only insider trading case that Merrill Lynch will have to contend. The firm will have dealt with another major insider trading case concerning its prominent technology sector analyst which will prove to be massively scandalous considering the dotcom boom and bust of the 1990s and early 2000s.

Summary and Conclusions

After accounting for its fluctuating ethical and legal history and its responses to challenges varying widely in severity and scope, Merrill Lynch was a firm that from its founding in 1914 all the way up until 2008 championed sensible business ethics and practices that stood the test of time. Specifically, it took pride in its workforce and network of financial advisors widely known at the time as "the thundering herd". The same can be said for Charles E. Merrill, whose goal was to bring Wall Street to Main Street and democratize the stock market for the good of all members of society. Of course, this storied brokerage house had endured trials and tribulations both large and small, from internal unscrupulous processes to shake-ups in leadership and management. However, up until its downfall and absorption into Bank of America in 2008 during the Great Recession, the vast majority of

Merrill Lynch dealings complied with the rule of law and conducted in a manner that was compliant with local, state and federal regulators. From admitting misrepresentations in its financial statements to its shareholders to consenting to new rules and regulations by policymakers and authorities, this century-old financial institution has been proven itself repeatedly, showing that it is ultimately an institution bullish on business law and ethics. It is deeply unfortunate that lack of institutional oversight and accountability, mismanagement of company resources, a Machiavellian leadership regime, misconduct among employees, and bad bets and investments all contributed to the demise of a Wall Street titan. However, it is consolable to know that what remains of Merrill Lynch is now reincarnated into what is an investment division of one of America's largest financial corporations in the world.

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