

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**  
**January 30, 2009**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13356**

**In the Matter of**

**MICHAEL A. CALLAWAY,**

**Respondent.**

**ORDER INSTITUTING  
ADMINISTRATIVE AND CEASE-AND-  
DESIST PROCEEDINGS PURSUANT TO  
SECTIONS 203(f) AND 203(k) OF THE  
INVESTMENT ADVISERS ACT OF 1940  
AND SECTION 15(b)(6) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) and Section 15(b)(6) of the Securities Exchange Act of 1934 (“Exchange Act”), against Michael A. Callaway (“Respondent” or “Callaway”).

**II.**

After an investigation, the Division of Enforcement alleges that:

**A.     RESPONDENT**

1.       Respondent was employed by Merrill Lynch, Pierce, Fenner & Smith Inc. (“Merrill Lynch”), as a registered investment adviser, from 1976 to 2008. During the relevant period, respondent was Senior Vice President and Financial Advisor, an investment adviser representative, and head of a team of approximately ten Merrill Lynch employees, including three other investment adviser representatives, which provided advisory services to approximately 100 public pension fund clients in Florida. During the relevant period, Merrill Lynch was also a registered broker-dealer and Respondent was licensed with FINRA as a registered representative of the Merrill Lynch broker-dealer. Respondent, 56 years old, is a resident of Ponte Vedra, Florida.

**B. OTHER RELEVANT ENTITIES<sup>1</sup>**

2. **Merrill Lynch** is the wholly-owned principal operating subsidiary of the holding company, Merrill Lynch & Co. Merrill Lynch has been registered with the Commission as a broker-dealer since March 12, 1959, and as an investment adviser since December 8, 1978.

3. **Merrill Lynch Consulting Services** is an advisory program offered under the auspices of Merrill Lynch's Global Wealth Management Group, and provides advisory services to high net worth and institutional clients, including public pension funds.

4. **The Callaway Team** was a team of approximately ten Merrill Lynch employees headed by Respondent. It included four investment adviser representatives, who were also associated with the Merrill Lynch broker-dealer. The team provided advisory services to approximately 100 public pension clients in Florida. Until 2005, this group operated out of Merrill Lynch's Jacksonville, Florida office. In 2005, the group moved to Merrill Lynch's Ponte Vedra South office.

**C. FACTS**

5. From at least 2000 through 2005 ("the relevant period"), Merrill Lynch, through its Consulting Services program, provided advisory services to high net worth and institutional clients, including public pension funds. As an integral part of these services, it assisted clients in developing appropriate investment policies and in identifying asset allocations to meet their individual needs. Merrill Lynch Consulting Services also helped clients to monitor performance of their investment portfolios by providing periodic reports and helped clients to identify and evaluate new money managers so that the clients could select one or more such managers for the discretionary management of their accounts.

6. During the relevant period, Respondent, as part of the Merrill Lynch Consulting Services program, and the Callaway Team provided advisory services to close to 100 public pension fund clients in Florida, including many municipal employees, police and firefighters' pension funds. The headquarters for Merrill Lynch Consulting Services was located in Jersey City, New Jersey, and provided support to this office and to other investment adviser representatives throughout the country who provided advisory services.

7. Under Section 206 of the Advisers Act, an investment adviser may not make materially false and misleading statements. During the relevant period, Respondent, as an investment adviser representative of Merrill Lynch, misrepresented the process used to identify new money managers to the firm's advisory clients. Additionally, Respondent made materially misleading statements to at least one client relating to transition management services provided to

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<sup>1</sup> The following related administrative proceedings were instituted today: In the Matter of Merrill Lynch, Pierce, Fenner & Smith Inc. and In the Matter of Jeffrey Swanson.

that client. Respondent thereby aided and abetted and caused Merrill Lynch's violations of Section 206 of the Advisers Act.

8. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interests to its advisory clients.<sup>2</sup> During the relevant time period, Respondent, as an investment adviser representative of Merrill Lynch, caused Merrill Lynch's violations of Section 206 of the Advisers Act by failing to ensure that material conflicts relating to the recommendation of directed brokerage and transition management were disclosed to the firm's advisory clients.

### **MATERIAL MISREPRESENTATIONS CONCERNING THE MANAGER IDENTIFICATION PROCESS**

9. During the relevant period, Respondent misrepresented the process used to identify new money managers for clients in breach of his fiduciary duty to those clients. Respondent, in written communications, emphasized the extensive in-house resources and research that was available through Merrill Lynch to match each individual client with appropriate money managers for that client's needs. For example, in the summer of 2005, in response to heightened public scrutiny of the pension consulting industry, Merrill Lynch prepared responses to ten questions that the Commission and the Department of Labor jointly proposed in a press release dated June 1, 2005. In August 2005, a copy of those responses was mailed, under cover of Respondent's signature, to all of his Consulting Services clients along with their quarterly investment reports. That document states in part:

When assisting Consulting Services clients in selecting investment managers, Merrill Lynch screens potential manager choices from a universe of over 1,000 investment managers . . . . [I]t is important to understand that these managers generally undergo a variety of screening processes, by, or under the direction of, a dedicated "home office" team solely responsible for such tasks. This team analyzes manager information derived from proprietary and non-proprietary sources to be able to offer a choice of managers best able to meet client needs and goals.

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<sup>2</sup> SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180, 191-92 (1963) (The Advisers Act reflects "a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which is not disinterested."); In re O'Brien Partners, Inc., Advisers Act Release No. 1772 (Oct. 27, 1998) (" . . . since even potential conflicts of interest are material and must be disclosed, [the investment adviser] was required to disclose its receipt of third-party payments, even if it had concluded that the payments did not influence the manner in which it advised its clients."); In the Matter of Feeley & Willcox Asset Management Corp., Advisers Act Release No. 2143 (July 10, 2003) ("It is the client, not the adviser, who is entitled to make the determination whether to waive the adviser's conflict. Of course, if the adviser does not disclose the conflict, the client has no opportunity to evaluate, much less waive, the conflict.").

10. Respondent explained the manager search process to clients in terms of Merrill Lynch's vast resources, and in a manner suggesting that the centralized nature of the process protected against conflicts of interest. He sent letters to several clients stating:

All of our decisions regarding the recommendation of investment management firms are based on the in-depth quantitative and qualitative analysis provided by our 22 member manager research team headquartered in New Jersey. Our recommendations are unbiased and made only with our clients' best interest in mind.

I choose to remain at Merrill Lynch after 28 years because . . . our manager research team provides us the tools and resources to deliver to you with confidence manager recommendations that are well researched, objective and devoid of inappropriate influence.

11. Contrary to written representations to clients and prospective clients, Respondent and others on his team recommended money managers whom he knew were not identified, vetted or approved by Merrill Lynch Consulting Services in New Jersey before they were first recommended to clients. Those money managers included several direct real estate managers, even though Respondent was aware that these managers had not, and would not be, identified, vetted or approved by Merrill Lynch Consulting Services in New Jersey.

12. Moreover, the Callaway Team's manager searches differed significantly from the way Respondent and his team described them to clients and prospective clients. Respondent and his team did not rely on the New Jersey office to analyze and recommend potential managers for his Consulting Services clients' specific needs. Rather, he and his team conducted the manager search process themselves using a short list (the "Callaway short list") of managers, which had been developed by the Callaway Team. This list consisted of approximately sixty money managers divided into ten or eleven categories of managers, each containing approximately six money managers, therefore potentially giving rise to a limited universe of recommendations. The list also contained money managers who had not been vetted by Merrill Lynch Consulting Services in New Jersey.

13. When one of the Callaway Team's Consulting Services clients requested a new manager search, an associate in the Callaway Team, working at the direction of Respondent or another investment adviser representative on the team, would refer to the pre-existing Callaway short list, seek input from Respondent and sometimes from Merrill Lynch Consulting Services in New Jersey, obtain information on the money managers on the list from publicly available databases, and compile this information into a booklet to be presented to the client. These search reports were not reviewed by Merrill Lynch Consulting Services. Rather, Respondent decided, sometimes with non-client-specific input from Merrill Lynch Consulting Services, which money managers from the Callaway short list to present to the clients.

14. Respondent also failed to disclose his use of the vacation homes of principals of another money management firm that was on the Callaway short list. Respondent recommended this manager despite concerns about poor performance that were raised by some of Respondent's Consulting Services clients. This money manager directed a large percentage of the Callaway Team's client trading to Merrill Lynch for which Merrill Lynch Consulting Services and the Callaway Team received production credits. Because material facts relating to Respondent's relationship with this money management firm were not disclosed, clients were unable to evaluate whether his recommendation of this money management firm was disinterested. Respondent knew, or was reckless in not knowing, that these facts should have been disclosed to Consulting Services clients.<sup>3</sup>

15. Furthermore, Respondent had relationships with other money managers that he recommended to Consulting Services clients. He had received production credits, purportedly for Merrill Lynch research, from two money managers whom he recommended to Consulting Services clients. Moreover, Respondent had an agreement with one of those money managers whereby the manager would direct a certain amount of brokerage in their mutual client accounts to Merrill Lynch for which the Callaway Team received production credits.

16. Based on the above, Respondent knowingly or recklessly made misrepresentations to Merrill Lynch Consulting Services clients.

#### **FAILURE TO DISCLOSE CONFLICT OF INTEREST CONCERNING DIRECTED BROKERAGE**

17. During the relevant period, Respondent failed to ensure that the conflicts of interest inherent in the recommendation of directed brokerage to Consulting Services clients was disclosed. Merrill Lynch Consulting Services and, consequently, Respondent had a financial incentive to recommend that Consulting Services clients enter into a directed brokerage relationship. Merrill Lynch Consulting Services charged for its pension consulting services on a fixed fee basis. Clients could pay in cash, referred to as "hard dollars," or through "directed brokerage."<sup>4</sup> Merrill Lynch Consulting Services and Respondent received a portion of these directed brokerage commissions and continued to receive them even after the Consulting Services fee was satisfied.

18. Respondent recommended that Consulting Services clients establish a directed brokerage relationship with Merrill Lynch's institutional trading desk as part of the process of

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<sup>3</sup> Production credits entitled Merrill Lynch Consulting Services, Respondent and the Callaway Team to share in the generated commissions.

<sup>4</sup> Directed brokerage is an arrangement whereby the clients directed money managers to execute trades through Merrill Lynch's institutional trading desk, consistent with their best execution obligations. In return, these clients received credit for a portion of the commissions generated by these trades against the hard dollar fee owed to Merrill Lynch Consulting Services.

establishing new accounts on behalf of those clients. The majority of the Callaway Team Consulting Services clients had such relationships.

19. Merrill Lynch Consulting Services and, consequently, Respondent often received significantly more fees from the directed brokerage commissions generated from trading activity in the Callaway Team's Consulting Services client accounts than the fees they would have received if those clients had paid strictly with hard dollars because money managers continued to direct brokerage to Merrill Lynch even after their client's Consulting Services hard dollar fee was satisfied. For example, in one instance a Callaway Team client who was obligated to pay a \$7,500 annual hard dollar fee generated almost \$175,000 in production credits.<sup>5</sup> Other examples include a Callaway Team Consulting Services client generating over \$100,000 in production credits when its hard dollar fee was \$15,000; and another Callaway Team Consulting Services client generating production credits of \$145,000 with a hard dollar fee of \$32,000.

20. Some of the Callaway Team Consulting Services clients, many of whom were not knowledgeable about their trading options, did not appreciate the extent to which Merrill Lynch Consulting Services and, consequently, Respondent stood to gain additional fees from a client's directed brokerage relationship with Merrill Lynch. For example, in 2005, one client agreed to increase its hard dollar fee from \$15,000 to \$20,000 because the client believed that Respondent was "getting almost nothing" and it needed to do something to make sure that he was compensated for his services. In fact, in 2004 this client generated revenues of \$103,000 to Merrill Lynch Consulting Services, of which the Callaway Team was credited with approximately \$46,000. Likewise, the chairman for another Callaway Team Consulting Services client stated that he would be "shocked" to learn that the fund generated fees in excess of \$100,000 in 2004. That year, this particular client's hard dollar fee was \$45,000; the fund generated production credits to Merrill Lynch Consulting Services of \$118,000. The Callaway Team Consulting Services clients who established a directed brokerage relationship with Merrill Lynch were unable to assess all of Merrill Lynch Consulting Services', and, consequently, Respondent's motivations in recommending the use of directed brokerage to pay for services and therefore were unable to assess the recommendation.

21. Based on the above, Respondent, at a minimum, negligently failed to ensure that the conflicts of interest inherent in the recommendation of directed brokerage were disclosed to the Consulting Services clients he served.

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<sup>5</sup> This client's offset rate was .5 therefore \$15,000 of production credits was required to offset its hard dollar fee of \$7,500. Hence, roughly \$160,000 of production credits was generated to Merrill Lynch Consulting Services above the hard dollar fee.

**FAILURE TO DISCLOSE CONFLICT OF INTEREST AND MATERIALLY MISLEADING STATEMENTS CONCERNING TRANSITION MANAGEMENT**

22. During the relevant period, Respondent recommended to certain Consulting Services clients that they use Merrill Lynch for transition management. Transition management is a service offered by Merrill Lynch's transition management group, a separate unit from Merrill Lynch Consulting Services, to clients in the process of terminating one money manager and hiring another.<sup>6</sup>

23. Respondent and other members of the Callaway Team recommended Merrill Lynch transition management services numerous times to Consulting Services clients. Between July 2000 and the end of 2005, at least nine Callaway Team Consulting Services clients used Merrill Lynch for transition management services on approximately 19 separate occasions generating over \$735,000 worth of production credits to Merrill Lynch Consulting Services, of which the Callaway Team received approximately \$330,000.

24. Respondent failed to disclose to Consulting Services clients that Merrill Lynch in its capacity as an adviser and, consequently, the Callaway Team had a financial incentive to recommend Merrill Lynch transition management. Merrill Lynch in its capacity as an adviser and, consequently, Respondent stood to make additional fees if the client chose to use Merrill Lynch transition management services inasmuch as Merrill Lynch Global Wealth Management and, consequently, the Callaway Team received a portion of the commissions generated in connection with transition management services provided by Merrill Lynch. Therefore, those clients were unable to evaluate whether the recommendation of Merrill Lynch's transition management services was disinterested.

25. Furthermore, in or about August 2003, Respondent made misleading statements to one Consulting Services client who raised questions about The Callaway Team's compensation as a result of transition management services provided to this client in 2002. In response to the client's inquiry about fees generated to the Callaway Team, Respondent provided a misleading response estimating his personal compensation to have been "impacted by some amount less than \$3,000." In reality, the transition in question generated approximately \$17,494 of production credits to the Callaway Team, an amount that was tracked, documented and easily identifiable by Callaway's associate. By responding narrowly to the client's inquiry, Respondent attempted to mislead the client into thinking the amount in question was *de minimis*.

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<sup>6</sup> Without the services of a transition manager, the money manager being terminated would sell any shares held by the client that the new money manager did not want to keep and transfer the proceeds from those sales to the client's account. The new money manager would then use these proceeds to purchase securities for its portfolio on behalf of the client. Consequently, the process of terminating and hiring a new money manager results in the generation of commissions. Merrill Lynch's transition management desk represented that it could manage a transition more efficiently and cost-effectively by offering cross trades and reduced commission costs.

26. However, the client was not satisfied with his response and pressed for additional information on the fees generated including whether Merrill Lynch Consulting Services<sup>7</sup> receives any portion of commissions generated through transition management services. Callaway responded that, “the total dollar value of the credit received by Merrill Lynch Consulting Services for the transition management services provided last year was \$17,494.” Respondent’s answer was again misleading. The transition actually generated production credits of approximately \$38,877 to Merrill Lynch Global Wealth Management Group of which approximately 45% or \$17,494 of production credits went to the Callaway Team. Again, Respondent attempted to mislead the client into thinking that the transition had a minimal impact on the Callaway Team’s compensation. Ultimately, this client demanded, and received, a credit from Respondent for a portion of the production credits that were generated to the Callaway Team as a result of its use of Merrill Lynch’s transition management services.

27. Respondent’s recommendation of transition management services to Consulting Services clients benefited Merrill Lynch in its capacity as an adviser and, consequently, Respondent and the Callaway Team in a direct and calculable way. Because he did not disclose this fact to Consulting Services clients they were unable to evaluate whether the recommendation of Merrill Lynch’s transition management services was disinterested. Consequently Respondent, at a minimum, negligently failed to ensure that the conflict of interest inherent in the recommendation of transition management services were disclosed to the Consulting Services clients he served. Moreover, Respondent provided misleading information to one Consulting Services client who raised questions about his failure to disclose the fact that the Callaway Team received compensation in connection with its transition. Subsequent to this client’s inquiry, Respondent continued to fail to disclose the fact that he and his team received a portion of the fees generated from transition management services to other clients he recommended use Merrill Lynch for transition management services. Respondent intentionally or recklessly made misrepresentations to his Consulting Services client about the fees he received in connection with transition management services.

28. In January 2007, Merrill Lynch implemented a policy prohibiting Merrill Lynch Consulting Services investment adviser representatives from recommending Merrill Lynch transition management services to their pension clients or from receiving production credits or other compensation resulting from trades in connection with transition management services that Merrill Lynch provides to their Merrill Lynch Consulting Services pension clients.

#### **D. VIOLATIONS**

29. As a result of the conduct described above, Respondent willfully aided and abetted and caused Merrill Lynch’s violations of Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging “in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”

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<sup>7</sup> The client and Callaway misunderstood which Merrill Lynch entity shared in the production credits for the advisory client referral. Global Wealth Management Group received the credits. Merrill Lynch Consulting Services is part of that business unit.



### III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 203(f) of the Advisers Act including, but not limited to, civil penalties pursuant to Section 203(i) of the Advisers Act and disgorgement pursuant to Section 203(j) of the Advisers Act, and pursuant to Section 15(b)(6) of the Exchange Act; and

C. Whether, pursuant to Section 203(k) of the Advisers Act, Respondent should be ordered to cease and desist from committing or causing violations of and any future violations of Section 206(2) of the Advisers Act.

### IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondent personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not “rule making” within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy  
Secretary