

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER, AND CONSENT
NO. 2020065102001**

TO: Department of Enforcement
Financial Industry Regulatory Authority (FINRA)

RE: Morgan Stanley Smith Barney LLC (Respondent)
Member Firm
CRD No. 149777

Pursuant to FINRA Rule 9216, Respondent Morgan Stanley Smith Barney LLC (Morgan Stanley) submits this Letter of Acceptance, Waiver, and Consent (AWC) for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Respondent alleging violations based on the same factual findings described in this AWC.

I.

ACCEPTANCE AND CONSENT

A. Morgan Stanley accepts and consents to the following findings by FINRA without admitting or denying them:

BACKGROUND

Morgan Stanley has been a FINRA member since May 2009. The firm is headquartered in Purchase, New York, and as of December 2023, had approximately 27,000 registered representatives and approximately 1,000 branches. It is a full-service brokerage firm, and conducts, among other things, a general and municipal securities business with retail and high-net worth customers.

In March 2015, pursuant to AWC No. 2013038306401, Morgan Stanley consented to a censure and a fine of \$675,000 (\$124,406.93 of which was imposed jointly and severally with Morgan Stanley & Co. LLC) for violating Municipal Securities Rulemaking Board (MSRB) Rules G-27, G-17, and G-8 by failing to implement adequate supervisory procedures to address short positions in tax-exempt municipal bonds that corresponded to long positions in customer accounts or to provide adequate guidance or oversight on covering municipal short positions, and inaccurately representing to customers that the interest they received on municipal bonds that the firm did not hold was non-taxable when it was paid by the firm and thus taxable as ordinary income.¹

¹ For more information about the firm, including prior regulatory events, visit BrokerCheck® at www.finra.org/brokercheck.

OVERVIEW

From December 2016 through August 2021, Morgan Stanley violated MSRB Rule G-12(h) by failing to cancel or close out 239 failed inter-dealer municipal securities transactions totaling approximately \$9 million within 20 calendar days after settlement date. Additionally, from January 2016 through August 2021, Morgan Stanley violated Section 15(c)(3) of the Securities Exchange Act of 1934, Exchange Act Rule 15c3-3(d)(2), and FINRA Rule 2010, by failing to take prompt steps to obtain physical possession or control of 247 short positions in municipal securities totaling approximately \$9.4 million resulting from failed inter-dealer municipal securities transactions.

From January 2016 through September 2021, Morgan Stanley also violated MSRB Rule G-27 by failing to establish and maintain a supervisory system, including written supervisory procedures (WSPs), reasonably designed to achieve compliance with: (1) the timely close-out requirements under MSRB Rule G-12(h) relating to failed inter-dealer municipal securities transactions; and (2) the requirement under Exchange Act Rule 15c3-3(d)(2) that the firm take prompt steps to obtain physical possession or control of municipal securities aged more than 30 calendar days that the firm failed to receive.

FACTS AND VIOLATIVE CONDUCT

This matter originated from a firm examination conducted by FINRA Member Supervision.

Background on Municipal Securities and Short Positions

Municipal bonds are debt securities issued by states, cities, towns, counties, and other governmental entities to finance certain public projects.

A FINRA member firm is “short” municipal securities when its customers have purchased municipal securities that are not within the firm’s physical possession or control. Firms may be short municipal securities when, among other reasons, the firm fails to receive securities it purchased to fulfill a customer’s municipal securities order. In the event that the firm is short municipal securities that its customers have purchased, the firm, rather than the municipality, makes the interest payments to the customer.

Morgan Stanley failed to comply with the close-out requirements of MSRB Rule G-12(h).

MSRB Rule G-12 establishes uniform industry practices for the processing, clearance, and settlement of transactions in municipal securities between brokers, dealers, and municipal securities dealers. MSRB Rule G-12(h) requires firms to cancel or close out failed inter-dealer municipal securities transactions no later than 10 calendar days after settlement date, with the buyer having the discretion to grant a one-time extension of 10 calendar days to the seller before completing the close-out.² In all instances, however,

² A “close-out” generally refers to the procedure a purchaser takes to complete a municipal securities transaction if the seller does not deliver the securities by the settlement date.

inter-dealer fails must be closed out within no more than a total of 20 calendar days after settlement date.

MSRB Rule G-12(h)(i)(E) provides three options to the purchasing dealer to close out inter-dealer fails: (1) purchase (buy-in) at the current market all or any part of the securities necessary to complete the transaction; (2) accept from the seller in satisfaction of the seller's obligation under the original contract (which shall be concurrently cancelled) a transaction in municipal securities which are comparable to those originally bought in quantity, quality, yield or price, and maturity; or (3) require the seller to repurchase the securities in a transaction on terms which provide that the seller pay an amount which includes accrued interest.

Firms were notified of the new close-out requirements for municipal securities in August 2016 when the MSRB issued Regulatory Notice 2016-21, advising that MSRB Rule G-12(h) would be amended effective November 16, 2016, to require that failed inter-dealer transactions in municipal securities be canceled or closed out within no more than 20 calendar days after settlement date.³ The notice explained that this close-out period was intended to reduce the "systemic risk" created by failed, and therefore still open, inter-dealer municipal transactions. It further reminded firms that, although they may be reluctant to seek a solution other than a buy-in, the alternative close-out solutions under the rule should be considered as part of a timely inter-dealer fail resolution given that municipal securities often are not readily available for a buy-in.

Notwithstanding the close-out requirements of MSRB Rule G-12(h), Morgan Stanley failed to close out certain of its inter-dealer fails-to-receive within 20 calendar days as required. Although the rule provides three options through which firms can close out fails, including purchasing (or buying-in) the subject security, the firm relied almost exclusively on repeated buy-in attempts until a position was covered—even when the firm knew that these attempts were not successful within the 20-calendar day limit.

From December 2016 through August 2021, the firm failed to timely close out 239 failed inter-dealer municipal transactions aged over 20 calendar days with a total value of \$9,007,188. The average age of these fails was approximately 150 days, with approximately 30% aged over 100 days at the time of close-out, including six fails aged over 1,000 days. The firm's number of aged fails also increased during this period, with the firm maintaining a total of 130 aged fails with a value of approximately \$6 million in 2019 and 2020 alone.

By failing to timely close out failed inter-dealer municipal securities transactions, Morgan Stanley violated MSRB Rule G-12(h).

³ Following the amendment to MSRB Rule G-12(h), any municipal fails arising after November 16, 2016 were required to be closed-out within 20 calendar days, with December 7, 2016 the earliest date of a required close-out under the rule.

Morgan Stanley failed to take prompt steps to obtain possession or control of customer securities resulting from failed inter-dealer municipal securities transactions.

Exchange Act § 15(c)(3) and Exchange Act Rule 15c3-3(d)(2) require that if a broker-dealer determines from its books and records that it does not have the requisite amount of a particular security in its possession or control under Exchange Act Rule 15c3-3(d), and such security is included on its books or records as failed to receive for more than 30 calendar days, then it shall, not later than the business day following the day on which it makes that determination, take prompt steps to obtain physical possession or control of these failed securities through a buy-in procedure or otherwise. Subpart (n) of the rule allows firms to apply to FINRA to extend the 30-calendar day period of time for the broker-dealer to take action to buy-in a security, which application may be granted if FINRA is satisfied that the firm is acting in good faith and exceptional circumstances exist warranting approval.

A violation of Exchange Act § 15(c)(3) and Exchange Act Rule 15c3-3(d)(2) is also a violation of FINRA Rule 2010, which requires members, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade.

For municipal securities, Morgan Stanley primarily engaged in repeated buy-in attempts to resolve and obtain possession or control of municipal securities it failed to receive, even when the firm knew that its buy-in attempts were not successful.⁴ As a result, from January 2016 through August 2021, the firm failed to take the required prompt steps to obtain possession or control of 247 municipal securities it had failed to receive for more than 30 calendar days, with a total value of \$9,429,736.⁵ The average duration of the firm's fails-to-receive aged more than 30 calendar days during this period was approximately 177 days, approximately 35% of which aged more than 100 days at the time of their resolution, including six fails-to-receive aged over 1,000 days, 16 fails-to-receive aged from 500 to 999 days, and 65 fails-to-receive aged from 100 to 499 days.

By failing to take prompt steps to obtain possession or control of municipal securities it failed to receive, Morgan Stanley violated Exchange Act § 15(c), Exchange Act Rule 15c3-3(d)(2), and FINRA Rule 2010.

Morgan Stanley failed to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with MSRB and Exchange Act Rules.

MSRB Rule G-27(a) requires brokers, dealers, and municipal securities dealers to supervise the conduct of their municipal securities activities to ensure compliance with MSRB Rules and applicable provisions of the Exchange Act and Exchange Act rules

⁴ Following an initial distribution period, municipal securities generally trade in an over-the-counter dealer market. The average municipal security is less liquid than the average corporate bond and may not always be available for purchase in the secondary market.

⁵ Exchange Act Rule 15c3-3(e) requires broker-dealers to maintain a reserve of funds or qualified securities in an account of a bank that is at least equal in value to the net cash owed to customers. From January 2016 through August 2021, the amount deposited by Morgan Stanley in its customer reserve account was sufficient to cover the associated par value of the firm's municipal security short positions resulting from its fails-to-receive.

thereunder. MSRB Rule G-27(b) requires brokers, dealers, and municipal securities dealers to establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations and MSRB Rules. MSRB Rule G-27(c) requires brokers, dealers, and municipal securities dealers to adopt, maintain, and enforce WSPs that are reasonably designed to ensure that the conduct of their municipal securities activities complies with MSRB Rules and the Exchange Act, and to amend their WSPs as appropriate within a reasonable time after changes to applicable rules and to communicate those changes throughout their organization.

In 2015 and 2016, regulatory notices described firms' obligations to close out fails-to-receive and take prompt steps to obtain possession or control of short positions in municipal securities. Despite this regulatory guidance, the firm's supervisory system, including WSPs, was not reasonably designed to achieve compliance with the firm's obligations to timely close out failed inter-dealer municipal securities transactions as required by MSRB Rule G-12(h) and to take prompt steps to obtain possession or control of municipal securities that it failed to receive as required by Exchange Act Rule 15c3-3(d)(2).

Specifically, in August 2016, the MSRB notified firms that MSRB Rule G-12(h) would be amended effective November 16, 2016 to require that failed inter-dealer municipal securities transactions be canceled or closed out within no more than a total of 20 calendar days.

Although the firm was aware of the effective date of the amendment, from December 2016 through September 2021, the firm failed to establish and maintain a supervisory system, including WSPs, reasonably designed to ensure compliance with the 20 calendar-day close-out requirement. The firm's WSPs did not require that fails-to-receive be closed out within 20 calendar days as required by MSRB Rule G-12(h) or reference the alternative close-out options under MSRB Rule G-12(h)(i)(E). Instead, the firm undertook repeated buy-in attempts regardless of the 20-calendar day limit even when the firm had actual knowledge of unsuccessful buy-ins causing the 20-calendar day limit to elapse. Moreover, the firm's supervisory system did not reasonably track whether failed inter-dealer municipal securities transactions were closed out timely and did not monitor the firm's compliance with MSRB Rule G-12(h).

As discussed above, from December 2016 through August 2021, the firm had over 200 municipal fails-to-receive aged over 20 calendar days, with a total value of approximately \$9 million.

In February 2015, FINRA notified certain member firms, including Morgan Stanley, that all previous extensions of time granted pursuant to Exchange Act Rule 15c3-3(n) relating to municipal securities were revoked. FINRA also requested that Morgan Stanley provide its plan to alleviate its existing possession or control deficits in municipal securities.

In July 2015, FINRA issued Regulatory Notice 15-27, which stated that member firms' WSPs should include processes for detecting, resolving, and preventing the consequences of municipal short positions and fails-to-receive, and comply with Exchange Act Rule 15c3-3's requirement to take prompt steps to obtain physical possession or control of municipal securities that are short for more than 30 calendar days. The Regulatory Notice

further stated that while the rule requires firms to take timely curative action to obtain possession or control of securities allocated to a short position for more than 30 calendar days, firms should not view this 30-calendar day period as a “safe harbor” for resolving firm short positions in municipal securities.

Notwithstanding the above guidance, from January 2016 through September 2021, the firm failed to establish and maintain a supervisory system, including WSPs, reasonably designed to achieve compliance with its obligations. Neither the firm’s WSPs nor its supervisory system addressed resolving and obtaining possession or control of municipal securities that it failed to receive. For short positions resulting from failed inter-dealer municipal securities transactions, until 2021 the firm attempted to resolve and obtain possession or control of municipal securities that it failed to receive by continuously issuing new buy-in notices even when aged fails-to-receive remained unresolved for well over 30 calendar days.

Moreover, through December 2018, the firm continued to file extension requests for short positions caused by fails-to-receive aged over 30 calendar days despite FINRA’s prior instruction in February 2015 that such extensions would not be accepted and therefore could not have been a means of complying with the firm’s possession or control obligations. The firm also did not update its WSPs until January 2021 to reflect the firm’s inability to file extension requests for municipal bonds.

Because the firm failed to take prompt steps to obtain possession or control of municipal securities it failed to receive that had aged over 30 calendar days, and for much of the period continued to rely on extension requests, the firm failed in certain instances to obtain the requisite possession or control and to limit the consequences of aged short positions in municipal securities resulting from fails-to-receive. The firm’s system and procedures remained unreasonable despite the multiple regulatory notices emphasizing the importance of promptly closing out municipal short positions and reminding firms of their obligations concerning the prompt resolution of municipal short positions.

The firm modified its system and processes for addressing municipal fails-to-receive in June 2021, and it updated its WSPs to codify the changes in September 2021.

By failing to establish and maintain a supervisory system, including WSPs, reasonably designed to address compliance with MSRB Rule G-12(h), and Exchange Act Rule 15c3-3(d)(2), Morgan Stanley violated MSRB Rule G-27.

B. Respondent also consents to the imposition of the following sanctions:

- a censure; and
- a \$1,600,000 fine (\$1,200,000 of which pertains to the violations of MSRB Rules G-12(h) and G-27).

Respondent agrees to pay the monetary sanction upon notice that this AWC has been accepted and that such payment is due and payable. Respondent has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim an inability to pay, now or at any time after the execution of this AWC, the monetary sanction imposed in this matter.

The sanctions imposed in this AWC shall be effective on a date set by FINRA.

II. **WAIVER OF PROCEDURAL RIGHTS**

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

- A. To have a complaint issued specifying the allegations against it;
- B. To be notified of the complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made, and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council (NAC) and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudice of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III. **OTHER MATTERS**

Respondent understands that:


- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs (ODA), pursuant to FINRA Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
- C. If accepted:

1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future action brought by FINRA or any other regulator against Respondent;
2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
3. FINRA may make a public announcement concerning this agreement and its subject matter in accordance with FINRA Rule 8313; and
4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party. Nothing in this provision affects Respondents' testimonial obligations in any litigation or other legal proceedings.

D. Respondent may attach a corrective action statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this statement. This statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA.

The undersigned, on behalf of Respondent, certifies that a person duly authorized to act on Respondent's behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that Respondent has agreed to the AWC's provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth in this AWC and the prospect of avoiding the issuance of a complaint, has been made to induce Respondent to submit this AWC.

January 8, 2024
Date



Morgan Stanley Smith Barney LLC
Respondent

Print Name: S. Anthony Taggart

Title: Managing Director

Reviewed by:



Susan Schroeder, Esq.
Counsel for Respondent
Wilmer Cutler Pickering Hale and Dorr LLP
7 World Trade Center
250 Greenwich Street
New York, New York 10007

Accepted by FINRA:

Signed on behalf of the
Director of ODA, by delegated authority

Date

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Accepted by FINRA:

Signed on behalf of the
Director of ODA, by delegated authority



February 14, 2024

Date

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