FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 20120346239-03

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

RE: Morgan Stanley & Co. LLC, Respondent
Broker-Dealer
CRD No. 8209

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Morgan Stanley & Co. LLC (the "Firm" or "Respondent") 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 herein.

I.
ACCEPTANCE AND CONSENT

A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

1. MSCO, a wholly-owned subsidiary of Morgan Stanley Domestic Holdings, Inc., is a Delaware limited liability company headquartered in New York, New York. The Firm provides services to corporate and broker-dealer clients and institutional investors, and acts as an agency broker-dealer, providing market access and execution services to market participants ("Market Access Clients") for a wide variety of products.

2. The Firm has been registered as a member of FINRA since June 5, 1970. Its registration remains in effect. The Firm does not have relevant disciplinary history

SUMMARY

3. In Matter No. 20130354628, the Trading Examinations Unit of FINRA's Department of Market Regulation ("Market Regulation") conducted an examination of the Firm on behalf of FINRA during which it reviewed the Firm's risk management controls and supervisory procedures for compliance with Rule 15c3-5 of the Securities Exchange Act of 1934 ("SEA") (the "Market Access Rule").[1]

4. The above matter was one of several investigations, which included Matter No. 20120346239, conducted by Market Regulation on behalf of FINRA and other self-

[1] The SEC adopted Rule 15c3-5 effective July 14, 2011. *See* 17 C.F.R. § 240.15c3-5, *Risk Management Controls for Brokers or Dealers with Market Access*, 75 Fed. Reg. 69792, 69792 (Nov. 15, 2010) (Final Rule Release).

regulatory organizations, including Cboe BZX Exchange, Inc., Cboe BYX Exchange, Inc., Cboe EDGA Exchange, Inc., Cboe EDGX Exchange, Inc., Miami International Securities Exchange, LLC, The NASDAQ Stock Market LLC, New York Stock Exchange, Inc., and NYSE Arca, Inc. (collectively, the "SROs"), to review the Firm's compliance with the Market Access Rule and the relevant supervisory rules of the SROs, including NASD Rule 3010 (for conduct occurring prior to December 1, 2014) and FINRA Rules 3110 (for conduct occurring on or after December 1, 2014) and 2010, during the period of July 14, 2011 through July 2017 (the "Review Period").

5. As a result of Market Regulation's investigations, it was determined that, during the Review Period, MSCO failed to establish, document, and maintain a system of risk management controls and supervisory procedures, including written supervisory procedures and an adequate system of follow-up and review, reasonably designed to manage the financial, regulatory, and other risks of its market access business.

6. Specifically, between November 30, 2011[2] and July 2017, the Firm failed to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to prevent the entry of orders that exceed pre-set credit thresholds in the aggregate for each customer and the broker or dealer, in violation of SEA Rules 15c3-5(c)(1)(i) and NASD Rule 3010 (for conduct occurring prior to December 1, 2014) and FINRA Rules 3110 (for conduct occurring on or after December 1, 2014) and 2010.

FACTS AND VIOLATIVE CONDUCT

Applicable Rules

7. During the Review Period, SEA Rule 15c3-5(b) required broker-dealers that provide market access to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of their market access business.[3]

8. During the Review Period, SEA Rule 15c3-5(c)(1)(i) required market access broker-dealers to have financial risk management controls and supervisory procedures reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit and capital thresholds in the aggregate for each customer and the broker or dealer and, where appropriate, more finely-tuned by sector, security, or otherwise by rejecting orders if such orders would exceed the applicable credit or capital thresholds.

9. During the Review Period, NASD Rule 3010 and FINRA Rule 3110 required members to establish, maintain and enforce written supervisory procedures that are reasonably designed to achieve compliance with applicable federal securities laws and regulations, and NASD and FINRA Rules.

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[2] On June 27, 2011, the SEC extended the compliance date for SEA Rule 15c3-5(c)(1)(i) to November 30, 2011. Exchange Act Release No. 34-64748, 76 Fed. Reg. 38293 (June 30, 2011).

[3] Rule 15c3-5 requires that broker-dealers providing market access must "appropriately control the risks associated with market access so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system." 75 Fed. Reg. 69792, 69792 (Nov. 15, 2010); *see* 17 C.F.R. § 240.15c3-5.

10. During the Review Period, FINRA Rule 2010 required members, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade.

Overview of MSCO's Market Access Systems

11. During the Review Period, MSCO provided and maintained market access, and executed millions of trades per day for Market Access Clients.

12. During the Review Period, MSCO had a number of different Divisions through which orders were sent to various markets. These Divisions included the Firm's Institutional Equities Division ("IED"), which conducted traditional agency and principal business, and offered electronic trading services to its Market Access Clients.

13. During the Review Period, MSCO used a variety of systems (*e.g.*, order management systems, algorithms, etc.) through which its Market Access Clients and traders entered orders for routing to and execution on various U.S. securities markets, including the SROs. Those systems contained controls and filters to which the orders submitted were subjected. In addition, MSCO assigned and applied various controls to individual Market Access Clients and traders to which orders submitted by those clients and traders were subjected before submission to the various markets.

Inadequate Pre-Set Credit Limits

14. During the period of November 30, 2011 through July 2017, the Firm failed to establish risk management controls and supervisory procedures reasonably designed to prevent the entry of orders that exceeded pre-set credit thresholds on a customer basis for its IED Market Access Clients[4] whose order flow was classified as "high-touch" and instead relied on an overall MSCO credit limit. "High-touch" order flow is characterized as such because this order flow typically involves human interaction (*i.e.*, it passes through a Firm trader or sales trader) prior to being submitted to the market, as opposed to "low-touch" order flow that typically does not involve human interaction as it can be submitted directly to the market without being handled by Firm personnel.

15. In the Adopting Release for the Market Access Rule, the SEC stated that "[u]nder Rule 15c3-5(c)(1)(i), a broker-dealer's controls and procedures must be reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker dealer."[5] The SEC further stated that with regard to establishing pre-set credit and capital thresholds, it "expects that broker-dealers will make such determinations based on appropriate due diligence as to the customer's business, financial condition, trading patterns, and other matters, and document that decision."[6] Additionally, according to the SEC, while broker-dealers have flexibility in establishing appropriate credit or capital limits based on the exercise of reasonable business

[4] During the above-referenced period, IED was MSCO's primary division for handling client equity orders.
[5] 17. C.F.R. 240.15c3-5, *Risk Management Controls for Brokers or Dealers with Market Access*, 75 Fed. Reg. 69792, 69802 (Nov. 15, 2010) (Final Rule Release).
[6] *Id.*

judgment, the broker-dealer should be prepared to demonstrate why the chosen threshold meaningfully limits the financial exposure potentially generated by that customer's trading activity, and the process by which it monitors the continued appropriateness of the threshold.[7]

16. The Firm established one aggregate capital limit based on MSCO's excess net capital from which it assigned sub-limits to MSCO traders and sales traders who handled orders on behalf of IED high-touch Market Access Clients in an agency capacity. The aggregate capital limit and these sub-limits were not based upon or related to, among other things, the business, financial condition, or trading patterns of the Firm's IED high-touch Market Access Clients. Further, these sub-limits were in lieu of establishing individual credit limits based on appropriate due diligence for each IED high-touch Market Access Client.

17. Additionally, the Firm failed to have any automated pre-trade soft or hard-blocks to prevent the submission of orders that breached the Firm's aggregate capital limit as applied to the IED high-touch Market Access Clients. Instead, the Firm's system generated alerts that required manual intervention in order to prevent orders from accessing the market.

18. Under this alert system, designated IED personnel received notice of escalating alerts when IED's collective high-touch orders and executions reached certain escalated percentages of the pre-set aggregate limit. Such designated personnel were responsible for monitoring these alerts in real-time and determining whether and when to manually prevent the entry of additional orders. Because there was no automated control, an order was only prevented from accessing the market if such personnel manually implemented a hard-block. The Firm's controls, therefore, were not designed to automatically prevent orders in excess of the aggregate limit from accessing the market.

19. The Firm improperly relied on IED personnel to perform a real-time review of alerts and the manual prevention of the submission of orders that would cause the Firm to breach its aggregate capital limit. By failing to have automated pre-trade hard blocks, the Firm would not necessarily prevent the submission of an order that would cause the aggregate limit to be breached. As such, the alerts would not impede the submission of orders unless they prompted IED personnel to halt an order, and thus the Firm did not satisfy SEA Rule 15c3-5's requirement that pre-trade controls be automated.[8]

20. In February 2015, the Firm amended its procedures by establishing customer-specific aggregate credit limits for IED high-touch Market Access Clients in addition to IED's aggregate limit. At that time, however, the Firm did not establish its customer-specific aggregate credit limits based on the financial characteristics of the Market Access Client. The Firm later revised the customer specific aggregate limits to take into account the Market Access Client's financial characteristics and completed that process by July 2017. While the Firm also implemented a hard-block that would automatically be triggered when

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[7] *Id.*; *see also, Division of Trading and Markets: Responses to Frequently Asked Questions Concerning Risk Management Controls for Brokers or Dealers with Market Access* (April 15, 2014), Question 8.

[8] 17. C.F.R. 240.15c3-5, *Risk Management Controls for Brokers or Dealers with Market Access*, 75 Fed. Reg. 69792, 69802 (Nov. 15, 2010) (Final Rule Release) (noting that, with regard to pre-set credit and capital controls, "because the controls and procedures must be reasonably designed to prevent the entry of orders that exceed the applicable credit or capital thresholds by rejecting them, the broker-dealer's controls must be applied on an automated, pre-trade basis before orders are routed to the exchange or ATS.").

a Market Access Client reached its limit, this occurred only when an order breached 100% of a client's limit. Such a hard-block would not have prevented an IED high-touch Market Access Client from entering an order that would cause it to breach its established credit limit. Further, this control was not reflected in the Firm's written supervisory procedures ("WSPs"). While the Firm has since implemented additional changes, including employing automated hard blocks, there are still certain circumstances in which an order in excess of the client's credit limit could access the market.[9]

21. Finally, during the Review Period and continuing through April 2018, although MSCO implemented WSPs pertaining to the establishment and amendment of credit limits for IED high-touch Market Access Clients, these WSPs were not reasonably designed to achieve compliance with SEA Rule 15c3-5(c)(1)(i). During this time period, the procedures did not set forth the process of how the credit limits were to be monitored or how to address the reset of credit limits after a temporary intraday change.

22. The acts, practices, and conduct described above in paragraphs 14 through 21, constitute violations of SEA Rule 15c3-5(b) and (c)(1)(i), NASD Rule 3010 (for conduct occurring prior to December 1, 2014) and FINRA Rules 3110 (for conduct occurring on or after December 1, 2014) and 2010.

B. The Firm also consents to the imposition of the following sanctions:

1. A censure;

2. A fine in the amount of $1,100,000; of which $280,000 is payable to FINRA,[10] and

3. An undertaking requiring the Firm to address the Market Access Rule deficiencies described in this AWC and to ensure that it has implemented controls and procedures that are reasonably designed to achieve compliance with the rules and regulations cited herein.

   Within 120 days of the date of this AWC, MSCO shall submit to the COMPLIANCE ASSISTANT, DEPARTMENT OF ENFORCEMENT, 9509 KEY WEST AVENUE, ROCKVILLE, MD 20850, a written report, certified by a senior management Firm executive, to MarketRegulationComp@finra.org that provides the following information:

   i. A reference to this matter;

   ii. A representation that the Firm has addressed each of the deficiencies described above, including the specific measures or enhancements taken to address those deficiencies; and

[9] The Firm is currently implementing technological enhancements to correct this issue.
[10] The balance of the sanction will be paid to the self-regulatory organizations listed in Paragraph B.4.

iii. The date(s) this was completed.

The Department of Enforcement may, upon a showing of good cause and in its sole discretion, extend the time for compliance with these provisions.

4. Acceptance of this AWC is conditioned upon acceptance of similar settlement agreements in related matters between MSCO and each of the following self-regulatory organizations: Cboe BZX Exchange, Inc., Cboe BYX Exchange, Inc., Cboe EDGA Exchange, Inc., Cboe EDGX Exchange, Inc., Miami International Securities Exchange, LLC, The NASDAQ Stock Market LLC, the New York Stock Exchange, Inc., and NYSE Arca, Inc.

Respondent agrees to pay the monetary sanction(s) upon notice that this AWC has been accepted and that such payment(s) are due and payable. It 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 that it is unable to pay, now or at any time hereafter, the monetary sanction(s) imposed in this matter.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

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 the Firm

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 prejudgment 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 acceptance or rejection of this AWC.

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 the Firm's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against the Firm;

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 the subject matter thereof 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 the Firm's: (i) testimonial obligations; or (ii) right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. The Firm 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 or its staff.

The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its 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 it 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 herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

5/22/2018
Date

Morgan Stanley & Co. LLC, Respondent

By:
Name: James J. Mahoney
Title: Counsel to Morgan Stanley & Co LLC

Reviewed by:

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Accepted by FINRA:

Aug. 22, 2018
Date

Jacqueline Gorham, Senior Counsel
FINRA Department of Enforcement

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