FINANCIAL INDUSTRY REGULATORY AUTHORITY LETTER OF ACCEPTANCE, WAIVER AND CONSENT NO. 20060056031-01

TO: Department of Market Regulation

Financial Industry Regulatory Authority ("FINRA")

RE: Morgan Stanley & Co. Incorporated, Respondent

Broker-Dealer CRD No. 8209

Morgan Stanley Smith Barney LLC, Respondent Broker-Dealer

CRD No. 149777

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Morgan Stanley & Co. Incorporated and Morgan Stanley Smith Barney (collectively, "DEAN" or the "firm") ¹ submit 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 the firm alleging violations based on the same factual findings described herein.

T.

ACCEPTANCE AND CONSENT

A. The firm 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

Morgan Stanley & Co. Incorporated became a member of FINRA on June 5, 1970, and its registration remains in effect. Morgan Stanley Smith Barney LLC became a member of FINRA on May 19, 2009, and its registration remains in effect. Morgan Stanley Smith Barney LLC was created as a joint venture combining the retail wealth management

¹ The firm used the MPID "DEAN" when it reported each of the transactions at issue in this Letter of Acceptance, Waiver and Consent. The MPID "DEAN" corresponded to the firm name Morgan Stanley DW Inc. and CRD No. 7556. Morgan Stanley DW Inc. became a member of FINRA on October 16, 1936, and merged with Morgan Stanley & Co. Incorporated for registration purposes effective August 28, 2007.

businesses of Morgan Stanley and Citigroup. Morgan Stanley, through direct and indirect subsidiaries, including Morgan Stanley & Co. LLC, is the majority owner of Morgan Stanley Smith Barney LLC.

RELEVANT DISCIPLINARY HISTORY

On August 21, 2006, FINRA accepted an AWC in which Morgan Stanley DW Inc. was censured and fined \$50,000 for violations of NASD Rules 2110, 2440 and IM-2440 that occurred during the period May 13, 2004 through May 3, 2005.

On August 1, 2007, FINRA accepted an AWC in which Morgan Stanley DW Inc. was censured and fined \$1.5 million and ordered to pay restitution of \$3,927,646 for violations of NASD Rules, including NASD Rules 2440 and IM-2440, that occurred during the period February 1 through June 22, 2001.

On August 28, 2009, FINRA accepted an AWC in which Morgan Stanley & Co. Incorporated was censured and fined \$90,000 and agree to pay restitution of \$40,604.81 for violations of NASD Rules 2110, 2440 and IM-2440 and MSRB Rules G-17 and G-30(a) that occurred during the period January 1 through December 31, 2003.

SUMMARY

The matters below involve reviews conducted during the period 2003 to present by the Fixed Income staff of the Department of Market Regulation (the "staff") of DEAN's pricing of corporate and municipal bond transactions as well as a supervisory review of the systems and procedures in place to review customer markups and markdowns.

In connection with 20060056031, the staff reviewed DEAN's pricing of corporate bond transactions during the period October 1 through December 31, 2005 (the "fourth quarter 2005").

In connection with 20070107244, the staff reviewed DEAN's pricing of municipal bond transactions during the period January 1 through March 31, 2007 (the "first quarter 2007").

In connection with 20070113043, the staff reviewed DEAN's pricing of corporate bond transactions during the period July 1 through September 30, 2007 (the "third quarter 2007").

In connection with 20080123676, the staff reviewed DEAN's pricing of municipal bond transactions during the period October 1 through December 31, 2007 (the "fourth quarter 2007").

In connection with 20080145053, the staff reviewed DEAN's pricing of corporate bond transactions during the period April 1 through June 30, 2008 (the "second quarter 2008").

In connection with 20090177486, the staff reviewed DEAN's pricing of municipal bond transactions during the period July 1 through September 30, 2008 (the "third quarter 2008").

In connection with 20090198018, the staff reviewed DEAN's pricing of corporate bond transactions during the period January 1 through March 31, 2009 (the "first quarter 2009").

In connection with 20090197505, the staff reviewed DEAN's pricing of municipal bond transactions during the period April 1 through June 30, 2009 (the "second quarter 2009").

In connection with 20100218961, the staff reviewed DEAN's pricing of corporate bond transactions during the period October 1 through December 31, 2009 (the "fourth quarter 2009").

In connection with 20100233785, the staff reviewed DEAN's pricing of municipal bond transactions during the period January 1 through March 31, 2010 (the "first quarter 2010").

In connection with 20100252973, the staff reviewed DEAN's pricing of corporate bond transactions during the period July 1 through September 30, 2010 (the "third quarter 2010").

In connection with 20110265381, the staff reviewed DEAN's pricing of municipal bond transactions during the period October 1 through December 31, 2010 (the "fourth quarter 2010").

In connection with 20090194434, the staff also reviewed DEAN's supervisory system for reviewing markups and markdowns charged to customers from January 1, 2003 to present (the "supervision review period").

FACTS AND VIOLATIVE CONDUCT

Markups and Markdowns

20060056031 (CRD No. 8209)²

1. During the fourth quarter 2005, in eight pairs of transactions, DEAN sold (bought) corporate bonds to (from) customers and failed to sell (buy) such bonds at a price that was fair, taking into consideration all relevant circumstances, including market conditions with respect to each at the time of the transaction, the expense involved and that the firm was entitled to a profit. The markups and markdowns for these paired transactions ranged from 4.06 percent to 10.61 percent. The conduct described in this paragraph constitutes separate and distinct violations of NASD Rules 2110, 2440 and IM-2440.

20070107244 (CRD No. 8209)

2. During the first quarter 2007, in six pairs of transactions, DEAN sold municipal securities for its own account to a customer at an aggregate price (including any markup) that was not fair and reasonable, taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction. The markups for these six pairs of transactions ranged from 3.01 percent to 4.29 percent. The conduct described in this paragraph constitutes separate and distinct violations of MSRB Rules G-17 and G-30(a).

20070113043 (CRD No. 8209)

3. During the third quarter 2007, in 47 pairs of transactions, DEAN sold (bought) corporate bonds to (from) customers and failed to sell (buy) such bonds at a price that was fair, taking into consideration all relevant circumstances, including market conditions with respect to each at the time of the transaction, the expense involved and that the firm was entitled to a profit. The markups and markdowns for these paired transactions ranged from 3.38 percent to 10 percent. The conduct described in this paragraph constitutes separate and distinct violations of NASD Rules 2110, 2440 and IM-2440-1 and 2440-2.

² This matter originated under CRD No. 7556. As noted above, CRD No. 7556 merged with CRD No. 8209 effective August 28, 2007. As a result, matter 20060056031 is being resolved under Morgan Stanley & Co. Incorporated's CRD No. 8209 as successor in interest to Morgan Stanley DW Inc.

20080123676 (CRD No. 8209)

4. During the fourth quarter 2007, in 13 pairs of transactions, DEAN sold municipal securities for its own account to a customer at an aggregate price (including any markup) that was not fair and reasonable, taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction. The markups for these 13 pairs of transactions ranged from 3.07 percent to 8.49 percent. The conduct described in this paragraph constitutes separate and distinct violations of MSRB Rules G-17 and G-30(a).

20080145053 (CRD No. 8209)

5. During the second quarter 2008, in 10 pairs of transactions, DEAN bought corporate bonds from customers and failed to buy such bonds at a price that was fair, taking into consideration all relevant circumstances, including market conditions with respect to each at the time of the transaction, the expense involved and that the firm was entitled to a profit. The markdowns for these 10 pairs of transactions ranged from 3.40 percent to 3.83 percent. The conduct described in this paragraph constitutes separate and distinct violations of NASD Rules 2110, 2440 and IM-2440-1 and 2440-2.

20090177486 (CRD No. 8209)

6. During the third quarter 2008, in 92 pairs of transactions, DEAN sold municipal securities for its own account to a customer at an aggregate price (including any markup) that was not fair and reasonable, taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction. The markups for these 92 pairs of transactions ranged from 3.56 percent to 5.73 percent. The conduct described in this paragraph constitutes separate and distinct violations of MSRB Rules G-17 and G-30(a).

20090198018 (CRD No. 149777)

7. During the first quarter 2009, in 109 pairs of transactions, DEAN sold (bought) corporate bonds to (from) customers and failed to sell (buy) such bonds at a price that was fair, taking into consideration all relevant circumstances, including market

conditions with respect to each at the time of the transaction, the expense involved and that the firm was entitled to a profit. The markups and markdowns for these paired transactions ranged from 3.78 percent to 13.84 percent. The conduct described in this paragraph constitutes separate and distinct violations of FINRA Rule 2010 and NASD Rules 2440 and IM-2440-1 and 2440-2.

20090197505 (CRD No. 149777)

8. During the second quarter 2009, in 28 pairs of transactions, DEAN sold municipal securities for its own account to a customer at an aggregate price (including any markup) that was not fair and reasonable, taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction. The markups for these 28 pairs of transactions ranged from 3.03 percent to 6.25 percent. The conduct described in this paragraph constitutes separate and distinct violations of MSRB Rules G-17 and G-30(a).

20100218961 (CRD No. 149777)

9. During the fourth quarter 2009, in 11 pairs of transactions, DEAN sold (bought) corporate bonds to (from) customers and failed to sell (buy) such bonds at a price that was fair, taking into consideration all relevant circumstances, including market conditions with respect to each at the time of the transaction, the expense involved and that the firm was entitled to a profit. The markdown for one transaction pair was 3.70 percent, and the markups for the remaining 10 pairs of transactions ranged from 3.62 percent to 5.86 percent. The conduct described in this paragraph constitutes separate and distinct violations of FINRA Rule 2010 and NASD Rules 2440 and IM-2440-1 and 2440-2.

20100233785 (CRD No. 149777)

10. During the first quarter 2010, in 24 pairs of transactions, DEAN sold municipal securities for its own account to a customer at an aggregate price (including any markup) that was not fair and reasonable, taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction. The markups for these 24 pairs of transactions ranged from 3.15 percent to 4.42 percent. The conduct described in this paragraph constitutes separate and distinct violations of MSRB Rules G-17 and G-30(a).

20100252973 (CRD No. 149777)

11. During the third quarter 2010, in six pairs of transactions, DEAN sold corporate bonds to customers and failed to sell such bonds at a price that was fair, taking into consideration all relevant circumstances, including market conditions with respect to each at the time of the transaction, the expense involved and that the firm was entitled to a profit. The markups for these six pairs of transactions ranged from 3.13 percent to 5.13 percent. The conduct described in this paragraph constitutes separate and distinct violations of FINRA Rule 2010 and NASD Rules 2440 and IM-2440-1 and 2440-2.

20110265381 (CRD No. 149777)

12. During the fourth quarter 2010, in 30 pairs of transactions, DEAN purchased municipal securities for its own account from a customer and/or sold municipal securities for its own account to a customer at an aggregate price (including any markdown or markup) that was not fair and reasonable, taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction. The markdown for one transaction pair was 4.57 percent and the markups for the remaining 31 pairs of transactions ranged from 3.24 percent to 4.81 percent. The conduct described in this paragraph constitutes separate and distinct violations of MSRB Rules G-17 and G-30(a).

Supervision

20090194434 (CRD Nos. 8209 and 149777)

- 13. During the supervision review period, the firm implemented several supervisory reports (Sales Credit Recap Report, MSRB/TRACE Variance Reports, Cross Broker-Dealer Report, and Principal Variance Report) that it used to review markups and markdowns charged to its customers. Nonetheless, the firm's supervisory system was inadequate for the following reasons:
 - a. The firm's exception reports were not designed to include markups/markdowns that were below five percent, but that nonetheless may have been excessive.
 - b. Prior to August of 2009, the firm's policies and procedures did not identify markups and markdowns by aggregating the sales credit charged to the customer with the wholesale desk compensation for purposes of determining whether a markup or markdown was excessive.

- 14. Based on the foregoing facts, the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to the applicable securities laws and regulations, and the Rules of FINRA, concerning both corporate and municipal markups and markdowns. The conduct described in paragraphs 13 and 14 constitutes a violation of NASD Rules 3010 and 2110, and FINRA Rule 2010 (on and after December 15, 2008), and MSRB Rules G-17 and G-27.
- B. The firm also consents to the imposition of the following sanctions:
 - A censure.
 - A fine of \$1,000,000 (consisting of \$650,000 for violations of NASD Rules 2110, 2440 and IM-2440, 2440-1 and 2440-2, and FINRA Rule 2010, and MSRB Rules G-17 and G-30(a), and \$350,000 for violations of NASD Rules 3010 and 2110, and FINRA Rule 2010 (on and after December 15, 2008), and MSRB Rules G-17 and G-27). The \$1,000,000 fine amount is apportioned evenly between CRD Nos. 8209 and 149777. MSRB is allocated \$500,000 of the \$1,000,000 fine.
 - An undertaking to revise Morgan Stanley Smith Barney LLC's written supervisory procedures with respect to the areas described in paragraphs I.A.13 above. Within 90 business days of acceptance of this AWC by the National Adjudicatory Council ("NAC"), a registered principal of the firm shall submit to the COMPLIANCE ASSISTANT, LEGAL SECTION, MARKET REGULATION DEPARTMENT, 9509 KEY WEST AVENUE, ROCKVILLE, MD 20850, a signed, dated letter, or an e-mail from a work-related account of the registered principal to MarketRegulationComp@finra.org, providing the following information: (1) a reference to this matter; (2) a representation that the firm has revised its written supervisory procedures to address the deficiencies described in paragraphs I.A.13; and, (3) the date the revised procedures were implemented.

The firm 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.

The firm 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 firm also agrees to make restitution to the investors in the total amount of \$371,475.98 (of which \$198,828.45 is allocated to MSRB), plus interest at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. 6621(a)(2), from the date of the violative conduct until the date this AWC is accepted by the National Adjudicatory Council. A registered principal of the firm shall submit satisfactory proof of payment of the restitution, or of reasonable and documented efforts undertaken to

LEGAL SECTION, MARKET REGULATION DEPARTMENT, 9509 KEY WEST AVENUE, ROCKVILLE, MD 20850 or in an e-mail from a work-related account of the registered principal to <u>MarketRegulationComp@finra.org</u>, no later than 120 days after acceptance of this AWC. If for any reason, Respondent cannot locate any customer after reasonable and documented efforts within such period, or such additional period agreed to by the staff, Respondent shall forward any undistributed restitution and interest to the appropriate escheat, unclaimed-property or abandoned-property fund for the state in which the customer is known to have last resided.

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

П.

WAIVER OF PROCEDURAL RIGHTS

The firm 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, the firm specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, 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.

The firm 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.

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OTHER MATTERS

The firm 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 the firm; and

C. If accepted:

- 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 response to public inquiries about the firm's disciplinary record;
- 3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and
- 4. The firm 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. The firm 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 right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.
- D. The firm 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.

 $\frac{9/3\delta/2011}{\text{Date}}$

Respondent

Morgan Stanley & Co. Incorporated

Name: TAMES J. MANGA

Title: MANAGING DIRECTOR

Respondent

Morgan Stanley Smith Barney LLC

Ву: _________

Name: Ian Bernstein

Title: Managing Director

Reviewed by:

Counsel for Respondents

Accepted by FINRA:

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

Thomas R. Gira
Executive Vice President
Department of Market Regulation