

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2014041196601**

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

RE: Morgan Stanley Smith Barney LLC, Respondent
CRD No. 149777

Pursuant to FINRA Rule 9216 of FINRA’s Code of Procedure, Respondent Morgan Stanley Smith Barney LLC (“Morgan Stanley,” 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. Morgan Stanley 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 has been a FINRA member firm since May 2009. The Firm was created through the merger of the Global Wealth Management Group of Morgan Stanley & Co. LLC (CRD No. 8209) and the Smith Barney Division of Citigroup Global Markets Inc. (CRD No. 7059) into a joint venture. Morgan Stanley is headquartered in Purchase, New York. As of October 2018, the Firm had over 23,900 registered persons and approximately 758 branch offices.

RELEVANT DISCIPLINARY HISTORY

Morgan Stanley has no formal relevant disciplinary history with the Securities and Exchange Commission, any state securities regulator, or any self-regulatory organization.

OVERVIEW

Beginning in 2011, Morgan Stanley failed to develop and implement an anti-money laundering (“AML”) program that was reasonably designed to achieve and monitor the Firm’s compliance with the requirements of the Bank Secrecy Act (“BSA”) and its

implementing regulations. Specifically, the Firm failed to establish and implement policies and procedures that were reasonably expected to detect and cause the reporting of potentially suspicious activity in the following three respects:

- First, from January 2011 until at least April 2016, several of the systems that the Firm used to send and receive wire transfer information suffered from significant flaws. Specifically, those systems failed to transmit certain wire information to the Firm's automated AML surveillance system ("Transaction Monitoring System" or "TMS"), undermining that system's surveillance of tens of billions of dollars of wire and foreign currency transfers, including transfers to and from countries known for having high money laundering risk.
- Second, from January 2011 to December 2013, the Firm failed to devote sufficient resources to review alerts generated by the Firm's automated AML system, and as a result, the Firm's AML analysts often closed alerts without sufficiently conducting and/or documenting their investigations of the potentially suspicious wire transfers that generated the alerts.
- Third, from January 2011 to December 2013, the Firm's AML Department failed to reasonably monitor customers' deposits and trades of low-priced securities ("penny stock") for potential AML issues, including insider trading and market manipulations, despite the fact that the Firm's customers deposited approximately 2.7 billion shares of penny stock, which resulted in subsequent sales totaling approximately \$164 million, in that time period.

By virtue of the foregoing, Morgan Stanley violated FINRA Rules 3310(a) and 2010.

In addition, from January 2011 to December 2013, Morgan Stanley failed to establish and maintain a supervisory system reasonably designed to achieve compliance with Section 5 of the Securities Act of 1933 ("Section 5") and applicable rules and regulations. Specifically, the Firm divided responsibility for vetting its customers' deposits and sales of penny stock among its branch management and its Compliance and Executive Financial Services ("EFS") departments without reasonable coordination among them. Instead, the Firm primarily relied on its customers' representations that the penny stock they sought to deposit was not restricted from sale, and the representations of issuers' counsel that the customers' sales complied with an exemption from the registration requirements. As a result, the Firm failed to reasonably evaluate the customers' penny stock transactions for red flags indicative of potential Section 5 violations. Based on the foregoing, Morgan Stanley violated NASD Rule 3010(a) and FINRA Rule 2010.

Finally, in 2012 and 2013, Morgan Stanley had in place but failed to implement its policies, procedures, and internal controls reasonably designed to achieve compliance with the BSA and its implementing regulations by failing to conduct risk-based reviews of the correspondent accounts of certain foreign financial institutions ("FFIs"), as required by the BSA and its implementing regulations and the Firm's policies and procedures. As a result, Morgan Stanley violated FINRA Rules 3310(b) and 2010.

FACTS AND VIOLATIVE CONDUCT

I. Origin of the Matter

This matter arose out of firm examinations and cause examinations referred to FINRA's Department of Enforcement by FINRA's Department of Member Supervision, including its AML Investigations Unit.

II. The Firm's Failures Related to its AML Program

FINRA Rule 3310 requires member firms to "develop and implement a written anti-money laundering program reasonably designed to achieve and monitor ... compliance with the requirements of the Bank Secrecy Act (31 U.S.C. 5311, *et seq.*), and the implementing regulations promulgated thereunder by the Department of the Treasury." Among other AML program requirements is the mandate set forth in FINRA Rule 3310(a) that firms "[e]stablish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the implementing regulations thereunder."

In April 2002, FINRA issued Notice to Members ("NTM") 02-21, which reminded broker-dealers of these obligations, and further advised broker-dealers that their AML procedures must address a number of areas, including monitoring "trading and the flow of money into and out of ... account[s]." NTM 02-21 also advised broker-dealers "to look for signs of suspicious activity that suggest money laundering" – or, "red flags" – and if they detect "red flags," to "perform additional due diligence before proceeding with the transaction." In August 2002, FINRA issued NTM 02-47, which set forth the suspicious activity reporting rule promulgated by the Department of the Treasury for the securities industry. NTM 02-47 further advised broker-dealers of their duty to file a suspicious activity report ("SAR") for any transactions raising suspicions of illegal activity occurring after December 30, 2002.

As described below, Morgan Stanley failed to establish and implement AML policies and procedures that were reasonably expected to detect and cause the reporting of suspicious transactions.

A. The Firm Failed to Conduct Reasonable Surveillance of Wire and Foreign Currency Transfers

Morgan Stanley uses a number of automated systems to process and to monitor wire and foreign currency transfers sent to and received by its customers. However, from January 2011 until at least April 2016, some of the systems for processing wires were impacted by significant design limitations and programming flaws, which affected the transmission of certain transaction-related information to the Firm's automated Transaction Monitoring System. As a consequence, Morgan Stanley failed to surveil hundreds of thousands of wire and foreign currency transfers – which transmitted tens of billions of

dollars – including money transfers to and from jurisdictions that the Firm deemed to have high money laundering risk.

TMS was a key part of Morgan Stanley’s AML program during the relevant period. TMS was a proprietary system designed to conduct AML surveillance after the Firm transmitted customers’ outgoing wires or credited incoming wires to customers’ accounts. TMS monitored for potentially suspicious wires by comparing them to Firm-designed parameters, known as “scenarios,” which identified patterns of transactions indicative of suspicious activity. In order for TMS to work properly, it needed to receive data from various other Firm systems. During the relevant period, however, multiple Morgan Stanley systems failed to provide certain data to TMS for monitoring as intended. As a result, TMS did not review that data for outgoing and incoming wires and foreign currency transfers for indications of suspicious activity.

For example, the Firm used two programs, called Global Currency and FX Ion, to facilitate its customers’ transmission and receipt of foreign currencies. Morgan Stanley operated Global Currency, and contracted with a vendor to operate FX Ion. For more than five years, both Global Currency and FX Ion failed to transmit key data to TMS. As a result, Morgan Stanley failed to surveil through TMS at least 140,000 wires that it sent or received via these programs. The wires transmitted nearly \$43 billion, including approximately \$3.2 billion sent to or received from high-risk jurisdictions.

As another example, in December 2014, the Firm instituted a program that automated the settlement of certain incoming wires, but failed to assure that the program sent that wire data to TMS. Consequently, from December 2014 through April 2016, the Firm failed to surveil through TMS approximately 267,000 incoming wires that transmitted approximately \$30.4 billion (which equaled approximately 65% of the incoming wires to its Morgan Stanley Wealth Management customers during that period). More than 16,000 of those wires, transmitting more than \$1.8 billion, came from countries that the Firm had designated as high-risk jurisdictions.

Similarly, a Firm system for processing outgoing wires, known as the Outgoing Wire Transfer System (“OWTR”), also failed to send certain wire data to TMS as intended. As a result, from January 2014 to August 2015, Morgan Stanley sent out more than \$25.5 billion (including \$1.2 billion to high-risk jurisdictions) through approximately 91,000 outgoing wires that were not surveilled through TMS for the jurisdiction of the recipient account.

The Firm discovered some of the above-described system deficiencies while responding to FINRA staff’s inquiries, and discovered others independently and brought them to FINRA staff’s attention. In some instances, Morgan Stanley knew, or should have known, that certain wire and foreign currency transfer activity was not being monitored by TMS as intended, but failed to take timely remedial action. For example, the Firm knew in 2012 that an issue with OWTR caused correspondent banks to reject some outgoing wires to foreign banks, but the Firm did not consider whether the issue affected

TMS until late 2014, when the Firm began a review to respond to FINRA staff's inquiries.

Perhaps most significantly, starting in 2013, the Firm retained a consultant to test the integrity of the data that its systems sent to TMS. In or around August 2015, the consultant identified multiple "high-risk" issues to the Firm, that is, issues that could negatively impact the effectiveness of TMS. One such issue was that foreign currency transactions on the FX Ion platform did not transmit data to TMS, resulting in the Firm's complete failure to surveil transactions from that platform through TMS. In late 2016, the consultant was again utilized, this time to assist with testing potential data transmission issues identified by the Firm. The consultant identified additional data transmission problems that undermined TMS' surveillance of transactions that occurred via Global Currency and FX Ion. This issue was not remediated until at least February 2017.

B. The Firm Failed to Reasonably Investigate Potentially Suspicious Wire Transfers

When TMS identified potentially suspicious asset movements, including wire transfers to or from high-risk jurisdictions, it generated alerts that were sent to the Firm's AML analysts. Analysts were supposed to then review the wires that triggered the alerts to determine whether they involved potentially suspicious activity that warranted further investigation, and were supposed to document their reviews, for the purpose of determining whether the Firm should file SARs with the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the Treasury Department.

However, from January 2011 to December 2013, the Firm's AML analysts sometimes failed to conduct reasonable due diligence and/or document their reviews of TMS alerts in a manner reasonably expected to detect and cause the reporting of suspicious transactions. Analysts' written comments about the alerts at times failed to explain the investigative steps they took to reach their conclusion to close the alerts. The comments also sometimes failed to address whether the transaction at issue had a business or other legal purpose that would explain why further investigation was unwarranted.

The Firm's AML analysts had extraordinary workloads that likely contributed to their unreasonable reviews. From January 2011 to December 2013, the Firm employed, at most, only 24 AML analysts (including consultants), who were tasked each day with reviewing the Firm's significant volume of TMS alerts, in addition to performing other AML-related duties.

C. The Firm Failed to Reasonably Monitor Trading in Penny Stock for AML Issues

From January 2011 to December 2013, Morgan Stanley customers deposited approximately 2.7 billion shares of penny stock,¹ which resulted in subsequent sales totaling approximately \$164 million. During that time period, the Firm did not establish and implement policies and procedures reasonably expected to detect and cause the reporting of suspicious transactions in penny stock.

First, the Firm's written procedures were not reasonable. They required registered representatives and branch management to identify red flags surrounding penny stock deposits and liquidations, but did not instruct them to notify the Firm's AML Department if they found any such red flags. Meanwhile, the Firm's AML Department procedures did not address the Department's review of customers' deposits and liquidations of penny stock.

With respect to the Firm's systems, the Firm's AML Department did not use automated surveillance tools to monitor for potentially suspicious trading in penny stock. Instead, the Firm relied, in part, on its branch management to conduct manual reviews of daily trade blotters.² The Firm's Compliance Department reviewed a report that monitored deposits of large blocks of penny stock; although the Compliance Department referred potentially suspicious securities transactions to the Firm's AML Department for further review, it made only 114 such referrals from January 2011 to December 2013, and several of those arose from regulatory requests and news stories. During the relevant period, the Firm also relied on its Compliance Department to monitor for potential insider trading, but that Department only reviewed the *Wall Street Journal* "Market Movers" list of stocks with a 10% change in their end of day price. The reviewer then manually reviewed trading in those securities by Firm clients. The Compliance Department therefore did not generally consider intra-day price swings or review trading in penny stock, which typically are not exchange-listed.

As a result of the Firm's unreasonable policies and procedures, from January 2011 to December 2013, Firm customers deposited and sold penny stock under circumstances that should have raised red flags that the securities may not have been registered under securities laws or otherwise exempt from registration, or that the trades were potentially manipulative. As one example, a Morgan Stanley customer that purported to be a "holding company" of corporate stock made five deposits of stock certificates totaling more than 45 million shares of a marijuana-industry penny stock issuer in a two-month

¹ "Penny stock" are equity securities issued by a small company, priced under \$5 per share and typically traded over-the-counter. See Securities and Exchange Commission Penny Stock Rules, available at <http://www.sec.gov/answers/penny.htm>. Morgan Stanley used a similar definition of penny stock in its compliance procedures.

² Although the applicable procedures instructed branch management to review the trade blotter for certain types of trades that might require further investigation generally, including purchases of penny stock, the procedures did not specifically instruct branch management to review those trades for suspicious activity or identify any indicia of suspicious activity.

period. The customer began selling the stock one day after its first deposit, and sold all of its stock within three months, for proceeds of nearly \$3 million. While it held stock at the Firm, the customer posted on a blog that it had aided the issuer in “going public” and announced, falsely, its intent to keep the stock as a long-term investment. Press releases, web sites, and subscription services also touted the issuer, and the stock’s price and trading volume significantly increased. The customer did not meet the Firm’s standards for the deposit of penny stock, but the Firm, as allowed for in its procedures, granted an exception to the customer upon a request by the branch office that managed the customer’s account. The Firm did not have independent information that the customer’s stock was registered or that the sales were exempt from registration requirements; rather, the Firm seemingly relied on the customer’s own representations and opinion letters from the issuer’s counsel.

By failing to establish and implement policies and procedures that were reasonably expected to detect and cause the reporting of suspicious transactions, Morgan Stanley violated FINRA Rules 3310(a) and 2010.

III. The Firm’s Supervisory Failures Related to Section 5

NASD Rule 3010(a) required firms to “establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.”

Section 5, in relevant part, prohibits the sale of any security unless a registration statement is in effect or there is an applicable exemption from the registration requirements. In January 2009, FINRA issued Regulatory Notice (“RN”) 09-05, which identified certain red flags that should alert member firms to the possibility that a customer is participating in an illegal distribution of a security in violation of Section 5. As set forth in RN 09-05, “problems can arise when firms fail to recognize or take appropriate steps when confronted with ‘red flags’ that signal the possibility of an illegal, unregistered distribution.” RN 09-05 also reminded firms that “FINRA, the SEC and the courts have repeatedly held that firms cannot rely on outside counsel, clearing firms, transfer agents, issuers, or issuer’s counsel to discharge their obligations to undertake an inquiry” about their customers and the source of their securities. Moreover, RN 09-05 instructed firms that the fact that securities were issued by a transfer agent without a restrictive legend does not mean that those securities can be resold immediately and without limitation.

From January 2011 to December 2013, the Firm failed to establish and maintain a supervisory system reasonably designed to achieve compliance with Section 5. The Firm divided responsibility with respect to deposits and sales of penny stock among three groups: (1) branch management; (2) the Compliance Department, whose approval was required to deposit penny stock; and (3) EFS, the department at the Firm whose approval was required to sell restricted and control securities, including penny stock. None of these groups, alone or together, conducted a searching inquiry to determine whether

penny stock deposited at the Firm was eligible for immediate resale to the public. Instead, the Firm unduly relied on customers' self-certifications and issuers' counsel's representations that the stock was freely tradeable. Additionally, the three groups failed to consistently communicate with each other – even when one determined that a customer might own restricted securities.

For example, during the relevant period, branch management required customers to complete a form, known as the Shareholder Representation Letter (“SRL”), which asked customers to state whether their stock was restricted, but generally the branch management did not obtain any documents to evaluate the accuracy of the customers' representations. The Firm's written procedures required branch management to provide the SRL to the Compliance Department for its review, but branch management sometimes failed to do so. In other instances, the Compliance Department permitted customers to deposit potentially restricted or control penny stock on the condition that branch management contacted EFS regarding any future sales of that stock, but the Compliance Department at times did not notify EFS about those conditional approvals or identify in Firm systems that EFS approval was required for any resale. Consequently, branches at times did not follow the Compliance directive to contact EFS regarding the sale of restricted or control penny stock.

During the relevant period, the Firm had insufficient controls within the branches to prevent or detect customer transactions in potentially restricted or control penny stock from being processed without review and approval by EFS. For example, branches could circumvent EFS' review prior to the sale of any such stock by simply choosing not to enter transaction information in a Morgan Stanley system used to alert EFS about customers' intentions to sell potentially restricted or control penny stock. By choosing not to enter transaction information, branches could avoid EFS review, as well as a \$300 fee that EFS charged for its review of certain physical securities. In any event, EFS' review of customers' sales of restricted or control penny stock was unreasonable. Like branch management and the Compliance Department, EFS unduly relied on customers' representations, as well as the representations of issuers' counsel, that restricted or control penny stock was registered or exempt from registration. Additionally, at least some branch managers and EFS employees erroneously believed that restricted penny stock in certificate form would always bear a legend indicating its restricted status.

Based on the foregoing conduct, Morgan Stanley violated NASD Rule 3010(a) and FINRA Rule 2010.

IV. The Firm's Failure to Conduct Periodic Reviews of the Correspondent Accounts of Certain FFIs

FINRA Rule 3310(b) requires a member firm to establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the BSA and its implementing regulations, including 31 C.F.R. § 1010.610. Firms are required pursuant to 31 C.F.R. §1010.610(a) to establish a due diligence program that includes specific, risk-based policies, procedures, and controls that are reasonably

designed to detect and report any known or suspected money laundering activity conducted through or involving any correspondent account for an FFI. Such policies, procedures, and controls are required to include “a periodic review of the correspondent account activity sufficient to determine consistency with information obtained about the type, purpose, and anticipated activity of the account.”

In 2012 and 2013, Morgan Stanley failed to conduct such reviews of account activity in the correspondent accounts of certain FFIs, as required by the BSA and its implementing regulations as well as the Firm’s policies and procedures. The Firm’s policies and procedures required it to conduct annual reviews of correspondent accounts of “high risk FFI” customers, which the Firm defined as those organized or located in “high risk” jurisdictions. Morgan Stanley, however, did not conduct annual reviews of any high-risk FFI accounts (and some other FFI accounts) in 2012 or 2013. The Firm began those reviews in December 2014, after FINRA staff asked about the Firm’s reviews.

Based on the foregoing, Morgan Stanley violated FINRA Rules 3310(b) and 2010.

OTHER FACTORS

Morgan Stanley has taken extraordinary steps and devoted substantial resources since 2013 to expand and enhance its AML policies and procedures, automated transaction monitoring system, and other AML-related programs. As part of this effort, the Firm invested substantial additional financial resources in those programs, and greatly increased its AML-related staffing. Among other steps taken to improve its programs, the Firm retained a third-party vendor, trained and vetted by the Firm, to conduct the initial reviews of all TMS-generated alerts. Additionally, the Firm developed and implemented new automated scenarios to surveil penny stock transactions and potential insider trading, and revised its policies, procedures, and controls related to pre-deposit and pre-sale reviews of penny stock. The Firm also self-reported relevant issues to the attention of FINRA staff.

Accordingly, the sanctions imposed by this AWC reflect FINRA’s consideration of these extraordinary corrective actions already taken by Morgan Stanley.

B. Morgan Stanley also consents to the imposition of the following sanctions:

1. A censure; and
2. A fine of \$10 million.

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 that it is unable to pay, now or at any time hereafter, the monetary sanction 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 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 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

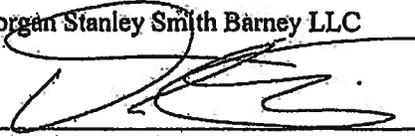
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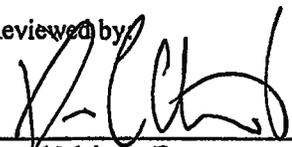
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent;
- C. If accepted:
 - 1. This AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;
 - 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 Respondent'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. 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 or its staff.

The undersigned, on behalf of Respondent, 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 Respondent has agreed to its 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 Respondent to submit it.

Morgan Stanley Smith Barney LLC

12/2/18
Date (mm/dd/yyyy)

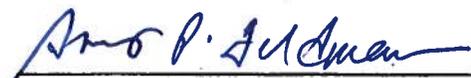

By: D. Scott Tucker
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Reviewed by

12/12/18
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Accepted by FINRA:

12/24/18
Date

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


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