

**FINANCIAL INDUSTRY REGULATORY AUTHORITY  
LETTER OF ACCEPTANCE, WAIVER AND CONSENT  
NO. 2008015963801**

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

RE: Morgan Stanley & Co. LLC (BD No. 8209),  
Respondent

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Morgan Stanley & Co. LLC ("Morgan Stanley," "Respondent," or the "Firm") 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 Morgan Stanley 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 is a full-service broker-dealer and has been a member of FINRA since 1970. In 2009, the Global Wealth Management Group ("GWMG") of Morgan Stanley and the Smith Barney Division of Citigroup Global Market, Inc. were contributed to Morgan Stanley Smith Barney Holdings LLC. Morgan Stanley Smith Barney LLC (BD No. 149777) ("MSSB"), a subsidiary of Morgan Stanley Smith Barney Holdings LLC, was a newly formed broker-dealer and became a FINRA member in May 2009.

The conduct that is the subject of this AWC took place at the GWMG division of Morgan Stanley before it became a part of MSSB.

**RELEVANT DISCIPLINARY HISTORY**

Morgan Stanley's relevant disciplinary history includes a FINRA settlement on April 26, 2011, in which Morgan Stanley was censured and fined \$100,000 and consented to the findings that it

failed to establish adequate procedures and an effective supervisory system to ensure that the Firm applied appropriate sales charge discounts for unit investment trust purchases in certain instances.

### OVERVIEW

Between September 2006 and August 2008 (the "Review Period"), Morgan Stanley failed to have a reasonable supervisory system and procedures in place to notify supervisors whether structured product purchases complied with the Firm's internal guidelines related to concentration (the size of an investment in relation to the customer's liquid net worth) and minimum net worth. As a result, the Firm did not detect many structured product purchases by customers who did not meet the Firm's own internal guidelines related to concentration and minimum net worth. The staff's review of a sample of structured product purchases revealed fourteen unsuitable recommendations for eight customers.

### FACTS AND VIOLATIVE CONDUCT

Structured products are securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency. Structured products typically have two components—a note and a derivative (often an option). There are many types of structured products. Some structured products offer a guarantee of return of principal at maturity, subject to issuer credit risk. Many structured products pay an interest or coupon rate substantially above the prevailing market rate; others do not pay a coupon and have no guarantee of a supplemental payment at maturity. Structured products also frequently cap or limit the upside participation in the reference asset, particularly if some principal protection is offered or if the security pays an above-market rate of interest. In order to receive the benefit of a return of principal, the security must be held to maturity, which can be five or more years after issuance. These lengthy holding periods increase the risk that an issuer may default on the repayment of principal. In addition, notes that guarantee a return of principal (i.e., principal protected products) may yield no positive return depending on the performance of the underlying asset. As stated above, principal protection is provided by the issuer and is subject to the issuer's solvency. Such inherent "issuer risk," in addition to other characteristics of structured products, underscores the importance of ensuring that customers invest an appropriate amount of their assets in such products.

#### *Regulatory Guidance*

In September 2005, FINRA<sup>1</sup> issued Notice to Members 05-59 as a result of concerns that broker-dealers were deficient in fulfilling sales practice obligations when selling structured products, particularly to retail customers. The Notice advised that some structured products present risks similar to that of options, and that firms should develop procedures to ensure that the structured products sold to investors matched those investors' appetite for risk. FINRA also reminded

---

<sup>1</sup> As of July 30, 2007, NASD and New York Stock Exchange Regulation, Inc., consolidated their member regulation functions and began operating under a new corporate name, the Financial Industry Regulatory Authority ("FINRA"). References in this document to FINRA include, where appropriate, NASD.

firms to perform a reasonable basis suitability determination on a structured product before recommending the product, as well as a customer-specific suitability determination. The Notice also stated that firms should ensure they have procedures to determine which customer accounts are eligible to purchase structured products.

### ***Morgan Stanley's Structured Product Business***

Between September 2006 and August 2008, Morgan Stanley GWMG customers effected approximately 224,000 structured product purchases, of which 90% involved proprietary structured products.

Morgan Stanley offered its customers a range of structured products, which the Firm characterized as principal protected, leveraged exposure, yield enhancement, or access investments. Principal protected products represented approximately 51% of the Firm's structured product commission revenue. Leveraged and yield enhancement products represented 19% and 18%, respectively. The Firm created and offered proprietary products in each of these categories. Examples of these proprietary structured products purchased by customers at the Firm during the Review Period include the PBS, SPARQS, RevCons, and PLUS.<sup>2</sup>

### ***During the Review Period the Firm Failed to Establish a Reasonable System to Supervise Structured Product Sales***

Between September 2006 and July 2007, Morgan Stanley did not have a firm-wide structured product-specific suitability policy. Instead, the Firm had an overall suitability guideline that directed supervisors to consider concentration when reviewing all securities purchases. In addition, the Firm issued "selling memoranda" specific to each of its proprietary structured product offerings. Some of the selling memoranda included a 10% concentration guideline with respect to the specific issue and a \$100,000 minimum net worth recommendation. In July 2007,

---

<sup>2</sup> PBS, or Protected Buy-Write Securities offer the return of principal at maturity and variable, periodic income. The PBS invests assets in an equity component and zero coupon bonds and allows for the use of leverage to increase the equity component. The PBS interest could be zero and there is limited appreciation possibility.

SPARQS, or Stock Participation Accreting Redemption Quarterly-Pay Securities, are short-term callable securities. Customers receive income; however, the SPARQS are callable, usually beginning at six months. This limits appreciation potential because the call price may be significantly less than the market price of the referenced asset at the call date.

RevCons, or reverse convertibles, are interest bearing notes in which principal repayment is linked to a reference asset, such as a stock. At maturity, if the value of the reference asset is below a certain level (i.e., a trigger), the investor may receive less than a full return of principal. The diminished principal repayment could be in the form of shares of stock put to the investor or their cash equivalent.

PLUS are Performance Leveraged Upside Securities. They provide investors leveraged exposure relative to an underlying asset's actual performance. PLUS do not pay interest and are not principal protected. In addition, PLUS offer a maximum payment at maturity that limits appreciation potential.

the firm developed standard concentration and net worth guidelines, which were posted on its structured products website. Despite the concentration and net worth guidelines, the Firm sold structured products at concentrated levels and to customers who did not meet the firm's minimum net worth recommendation.

Morgan Stanley failed to create reasonable systems or procedures to notify supervisors whether structured product purchases complied with the Firm's internal guidelines. The Firm placed the responsibility with branch supervisors to ensure, among other things, that structured product purchase recommendations by Financial Advisors were suitable. During the Review Period, Morgan Stanley had no reports or tools for sales supervisors or compliance personnel that were specific to structured products, or which highlighted and detected single concentrated structured product purchases. As a result, of the 224,000 structured product purchases between September 2006 and August 2008, more than 28,000 were in net amounts that exceeded 25% of the customer's disclosed liquid net worth and more than 2,600 were effected by customers with stated net worth less than \$100,000.

Throughout the Review Period, supervisors used a daily transaction report that listed all transactions by, *inter alia*, security name effected by the branch office on the prior trading day, which supervisors were instructed to review and approve on a daily basis. While that report included structured product purchases, it did not identify them as such.

FINRA staff reviewed a sample of daily transaction reports for structured product purchases that did not meet the Firm's concentration guidelines and/or minimum net worth recommendation. Most of these reports did not reflect evidence that supervisory action was taken in connection with the specific non-conforming purchases. The Firm's supervisory deficiencies, such as those highlighted above, were not limited to any particular branch or region.

Through this conduct, the Firm violated NASD Conduct Rules 3010 and 2110.

#### ***Unsuitable Recommendations of Structured Product Purchases to Retail Customers***

The staff's review of a sample of structured product purchases revealed fourteen unsuitable recommendations for eight customers. In addition to exceeding the Firm's concentration guidelines, the fourteen identified transactions were inconsistent with the customers' financial situation and investment objectives. The Firm previously entered into settlements with these customers based on their purchases of structured products. As a result of those settlements, Morgan Stanley paid customers approximately \$329,000.

Through this conduct, the Firm violated NASD Conduct Rules 2310 and 2110.

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

- Censure; and

- A fine in the amount of \$600,000.

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. 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 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 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, Morgan Stanley 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.

Morgan Stanley further specifically and voluntarily waive 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

Morgan Stanley understands that:

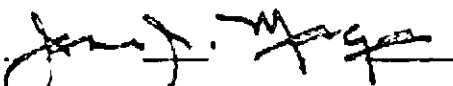
- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
- C. If accepted:
  - 1. this AWC will become part of my permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against Respondent;
  - 2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about my 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. 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.
- 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 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 have 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 the Firm to submit it.

12.7.11  
Date

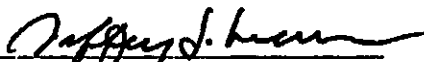
Morgan Stanley & Co. LLC (BD No. 8209),

By: 

Print Name and Title:

JAMES J. MARJAN  
MANAGING DIRECTOR

Reviewed by:

  
Counsel for Respondent

Print Name: JEFFREY SILVERMAN

Accepted by FINRA:

\_\_\_\_\_  
Date

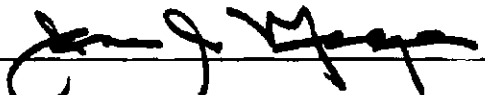
Signed on behalf of the  
Director of ODA, by delegated authority

\_\_\_\_\_  
Kathryn M. Wilson  
Principal Regional Counsel  
FINRA Department of Enforcement  
One World Financial Center  
200 Liberty Street - 11th Floor  
New York, NY 10281-1003  
212-858-4298 (phone); 212-858-4770 (fax)

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 the Firm to submit it.

Dec. 7, 2011  
Date

Morgan Stanley & Co. Inc. (BD No. 8209),

By:   
Print Name and Title:

JAMES J. MANGAN  
MANAGING DIRECTOR  
GLOBAL CO-HEAD OF LITIGATION

Reviewed by:

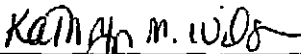
\_\_\_\_\_  
Counsel for Respondent

Print Name: \_\_\_\_\_

Accepted by FINRA:

January 5, 2012  
Date

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

  
Kathryn M. Wilson  
Principal Regional Counsel  
FINRA Department of Enforcement  
One World Financial Center  
200 Liberty Street - 11th Floor  
New York, NY 10281-1003  
212-858-4298 (phone); 212-858-4770 (fax)