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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

DOCKETED

MAR 27 2008

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

DOCKETED BY	nr
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In the matter of)
 MORGAN STANLEY & CO.)
 INCORPORATED,)
 1585 Broadway)
 New York, NY 10036-8293)
 CRD # 8209)
 Respondent.)

DOCKET NO. S-03536A-08-0123

DECISION NO. 70216

ORDER TO CEASE AND DESIST, ORDER FOR ADMINISTRATIVE PENALTIES, AND CONSENT TO SAME BY: RESPONDENT MORGAN STANLEY & CO. INCORPORATED

WHEREAS, Morgan Stanley & Co. Incorporated ("MS&Co" or "Respondent") is a dealer registered in the state of Arizona; and

WHEREAS, Morgan Stanley DW Inc. ("MSDW"), formerly known as Dean Witter, Discover & Co. ("Dean Witter"), was a dealer registered in the state of Arizona¹; and

WHEREAS, in May 2005, MSDW & MS&Co, collectively referred to as Morgan Stanley, discovered deficiencies in some of their order entry systems that permitted the execution of transactions for certain types of securities without checking to determine whether the transactions

¹ Morgan Stanley, the product of a 1997 merger of Morgan Stanley Group Inc. and Dean Witter, Discover & Co., is a Delaware corporation whose common stock trades on the New York Stock Exchange. Morgan Stanley & Co. Incorporated is a wholly owned subsidiary of Morgan Stanley. Morgan Stanley DW Inc., formerly know as Dean Witter, Discover & Co., was a wholly owned subsidiary of Morgan Stanley until April 1, 2007, when Morgan Stanley DW Inc. merged into Morgan Stanley & Co. Incorporated to form a single broker-dealer.

1 complied with applicable securities registration requirements under state securities laws (“Blue Sky
2 laws”); and

3 WHEREAS, immediately upon discovery of the deficiencies, Morgan Stanley formed a
4 team to examine the issues and correct the problems; and

5 WHEREAS, Morgan Stanley conducted an internal investigation into the reasons why the
6 affected order entry systems were not functioning properly and voluntarily provided the results of
7 the internal investigation to members of a multi-state task force (collectively, the “State
8 Regulators”); and

9 WHEREAS, Morgan Stanley self-reported the Blue Sky problem to all affected state and
10 federal regulators; and

11 WHEREAS, the State Regulators have conducted a coordinated investigation into the
12 activities of Morgan Stanley, and its predecessors, in connection with Morgan Stanley sales of
13 securities over a several year period that did not satisfy the Blue Sky laws; and

14 WHEREAS, Morgan Stanley identified transactions that were executed in violation of the
15 Blue Sky laws as a result of the system deficiencies and offered rescission to such customers with
16 terms and conditions that are consistent with the provisions set out in the Securities Act of Arizona,
17 A.R.S. §§ 44-1801 *et seq.* (“Securities Act”); and

18 WHEREAS, Morgan Stanley has since adopted policies and procedures, as well as further
19 actions, designed to ensure compliance with all legal and regulatory requirements regarding Blue
20 Sky laws, including applicable state securities laws and regulations; and

21 WHEREAS, Morgan Stanley has advised the State Regulators of its agreement to resolve
22 the investigation relating to its practices of complying with state Blue Sky laws; and

23 WHEREAS, Morgan Stanley, elects to permanently waive any right to a hearing and appeal
24 under Articles 11 and 12 of the Securities Act with respect to this Order To Cease And Desist,
25 Order For Administrative Penalties, and Consent to Same (“Order”). Respondent admits the
26 jurisdiction of the Arizona Corporation Commission (“Commission”); neither admits nor denies

1 the Findings of Fact and Conclusions of Law contained in this Order; and consents to the entry of
2 this Order by the Commission.

3 NOW THEREFORE, the Arizona Corporation Commission ("Commission") hereby enters
4 this Order:

5 I.

6 **FINDINGS OF FACT**

7 **Preliminary Statement**

8 On or about August of 2005, Morgan Stanley notified the North American Securities
9 Administrators Association ("NASAA"), as well as the Arizona Corporation Commission's
10 Securities Division, that it learned that certain order entry systems in place at its primary retail
11 broker-dealer, MSDW, did not check whether certain securities transactions complied with Blue
12 Sky law registration requirements. The Blue Sky surveillance problem included most fixed income
13 securities and certain equity securities sold to customers in solicited and non-exempt transactions,
14 from at least 1995.

15 Morgan Stanley discovered the Blue Sky issue in late May 2005. Shortly thereafter,
16 Morgan Stanley commissioned an internal investigation to determine the origins and reasons for
17 the oversight. Morgan Stanley discovered that its surveillance systems were deficient for the
18 following reasons:

19 • Salesman workstations, the automated trading system used at Morgan Stanley, did
20 not have any type of Blue Sky block, or other exception report, for trades involving fixed income
21 securities;

22 • Morgan Stanley's Blue Sky surveillance system covered only securities contained in
23 its Blue Sky databases, which were maintained separately for MSDW and MS&Co. As such, if the
24 surveillance system did not locate a particular security in the Blue Sky database, the systems would
25 allow the transaction to proceed without further checking or creating any exception report noting
26 the inability to locate Blue Sky registration confirmation;

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**Automation of Trading Systems in 1995 Did Not Correct
Blue Sky Compliance Issue**

6. In 1995, Dean Witter began developing its automated order entry system, called the Financial Advisor Workstation ("Workstation"). In addition to using the Workstation to enter customer orders, Financial Advisors ("FAs") could use it to look up the Blue Sky status of securities in BSKS. After a customer order was entered on the Workstation, the system compared securities (by CUSIP number) with information in BSKS and automatically blocked trades not meeting specified requirements, including transactions that potentially posed Blue Sky issues.

7. However, the Workstation design team noted that the system was not designed to block fixed income securities and noted that such a feature would be added in a later phase:

...As previously discussed, the Order Entry System will perform the Blue Sky validation on-line. Initially, the Blue Sky and Compliance edits will be built into the **Equity Ticket, while Blue Sky validation in Fixed Income Ticket will be added in a later phase.** (emphasis added)

8. Until May 2005, no one on the Workstation design team or anyone else at the firm followed up on whether or when fixed income securities would be added to the Blue Sky validation process.

9. FAs using the Workstation to research the Blue Sky status of fixed income products did not receive either the requested Blue Sky information or a warning message to contact Compliance, which resulted in the processing of fixed income transactions without the performance of proper Blue Sky checks.

10. In response to early complaints about the Workstation's slowness, MSDW programmed the system to execute an order for equity securities regardless of whether the system had completed Blue Sky screening. However, the system compared all such trades at the end of the day to BSKS and listed possibly violative transactions on the T+1 exception report.

11. In addition, MSDW did not include surveillance for Blue Sky compliance in the various trading platforms that it subsequently built out to support MSDW's managed account

1 business. Although MSDW initially built and revised these systems over time, it failed to
2 incorporate Blue Sky surveillance into these systems.

3 12. During the automation process in 1995, MSDW's Blue Sky Manager advised the
4 Compliance Director and the Deputy Compliance Director that the new automated system would
5 require her to monitor more than 15,000 equity securities, rather than about 1,500 equity securities
6 that she previously monitored.

7 13. During this time, the Firm, the Compliance Director, and his deputy failed to
8 recognize the significant compliance issue that existed due to the pre-automation system not
9 providing Blue Sky checks on many equities or fixed income securities.

10 14. To assist the Blue Sky Manager, MSDW bought a newly available automated Blue
11 Sky information feed covering only equities from an outside vendor, Blue Sky Data Corp
12 ("BSDC") on April 11, 1996 (an information feed for fixed income securities was not available
13 until 1997). Upon buying the service, MSDW terminated the Blue Sky Manager's only assistant.

14 15. The new BSDC equity feed resulted in a substantial increase of information (from
15 1,500 to 15,000 covered equities) causing the volume of possible Blue Sky violations appearing on
16 the daily T+1 exception report to increase substantially, which overwhelmed the Blue Sky
17 Manager.

18 **Blue Sky Problem Not Detected Following The Merger**

19 16. On or about May 31, 1997, Dean Witter merged with Morgan Stanley Group, Inc.
20 After the merger, the Blue Sky problems continued.

21 17. The predecessor Morgan Stanley Group, Inc., had conducted a retail business,
22 including Blue Sky checking, through its relatively small Private Wealth Management Group
23 ("PWM"), which served ultra-high net worth clients.

24 18. After the merger, the combined firm kept the two predecessor firms' trading
25 systems (including the corresponding Blue Sky systems) running in parallel—one for MSDW and
26 the other for PWM. Beginning in 1998, Morgan Stanley assigned MSDW's Blue Sky Manager to

1 monitor the PWM Blue Sky system as well, even though the Blue Sky Manager had difficulties
2 with the increased review responsibilities created by the MSDW T+1 exception reports.

3 19. The two Blue Sky systems produced different, but similar, exception reports that
4 identified transactions with possible Blue Sky violations. For PWM this included all such trades,
5 and for MSDW this included trades that had not been stopped by the front-end block then in place.

6 20. Morgan Stanley's Blue Sky databases contained only a small amount of fixed
7 income Blue Sky information entered manually over the years and did not cross-reference the
8 information they each separately contained.

9 21. Beginning sometime in 1997, BSDC began offering a fixed income Blue Sky
10 information feed, and on December 15, 1997, BSDC contacted Morgan Stanley to solicit the new
11 fixed income feed. Morgan Stanley elected to add BSDC's fixed income feed to the PWM Blue
12 Sky System, but not to MSDW's Blue Sky system.

13 22. For the next eight (8) years, although some of Morgan Stanley's employees in its
14 compliance department were aware that MSDW did not have an adequate fixed income Blue Sky
15 registration verification system, neither Morgan Stanley, nor any of its employees took any action
16 to rectify the situation.

17 **Blue Sky Violations Not Detected By Internal Audit**

18 23. Morgan Stanley's Internal Audit Department commenced an audit of Blue Sky
19 surveillance in the Fall of 2002. Internal Audit noted that the "objective of the audit was to assess
20 whether adequate internal controls and procedures exist[ed] to ensure that Product Surveillance
21 activity for ...Blue Sky...[was] properly performed, documented, and monitored, in accordance
22 with [Morgan Stanley] policy, applicable laws and regulatory requirements."

23 24. The audit workpapers stated that a control objective was to assure that the Blue Sky
24 unit monitored "equity security trading activity" and "market maker securities and those securities
25 recommended by Morgan Stanley's Research Department," but they did not mention the need to
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1 monitor fixed income trading activity nor securities beyond those where Morgan Stanley made a
2 market or provided research coverage.

3 25. A review of the Internal Audit revealed that fixed income, as well as other types of
4 transactions, were reviewed. In particular, workpapers show an October 29, 2002 trade in a
5 particular bond that noted: "Bond originally was not blue sky available," but found this trade was
6 appropriately resolved, from a Blue Sky perspective, by "Signed Solicitation letter obtained from
7 client acknowledging unsolicited order."

8 26. Despite the fact that some fixed income transactions were reviewed, the Internal
9 Audit failed to recognize that there were no hard blocks when a security was not found in the Blue
10 Sky database.

11 27. While the workpapers from the Internal Audit concluded that Morgan Stanley's
12 performance was "adequate" for most Blue Sky surveillance activities, the workpapers also
13 concluded that performance was "inadequate" in the area of communicating Blue Sky surveillance
14 findings to management and commented that "there is no evidence of analysts/supervisory review
15 over Surveillance Reports."

16 28. In its final report dated July 31, 2003, the Internal Audit concluded, in part, that
17 there were "[n]o control deficiencies noted" in the areas of "Exception Reporting" ("Review of
18 daily exception reports") and "Management Oversight / Monitoring" ("Supervision of Compliance
19 analyst activities to ensure the adequacy of investigation and corrective action").

20 29. After noting that the audit "evaluated the existence and the adequacy of the design
21 of the monitoring mechanisms employed to ensure that key controls are operating effectively," the
22 report concluded that there were "[n]o findings...that warranted discussion with the Board Audit
23 Committee."

24 **The State Of Blue Sky Systems Existing In Early 2005**

25 30. At the beginning of 2005, MSDW had in place an up-front order entry block, but it
26 covered only transactions involving equities, certificates of deposit, mutual funds, managed

1 futures, insurance, and unit investment trusts. The block did not cover fixed income securities,
2 apart from certificates of deposit.

3 31. MSDW's Blue Sky system did not contain information for all securities (especially
4 fixed income) and failed to include any sort of "security-not-found" exception report to flag
5 transactions in securities not contained in the Blue Sky database, resulting in no surveillance for
6 such transactions.

7 32. MS&Co's PWM Group operated on a different platform that never included any
8 automated block to prevent execution of transactions possibly violating Blue Sky requirements.
9 Instead, MS&Co's PWM system automatically generated a T+1 exception report covering both
10 equities and fixed income securities containing possible Blue Sky violations.

11 33. At the beginning of 2005, MSDW's Blue Sky policies and procedures had remained
12 fundamentally unchanged for a decade. While the policies articulated the obligation of individual
13 FAs and branch managers to check for Blue Sky compliance, MSDW did not provide the FAs and
14 branch managers with the proper tools to assist them in fulfilling their Blue Sky responsibilities,
15 and did not require adequate monitoring systems to check for Blue Sky compliance.

16 34. Moreover, Morgan Stanley did not adequately staff the Blue Sky Manager's office
17 with sufficient resources and personnel to assist and supervise all security transactions.

18 **Recognition Of The Blue Sky Surveillance Problem, Morgan Stanley's Self-Reporting To**
19 **Regulators And Remediation Efforts**

20 35. At the end of 2004, Morgan Stanley hired a new Compliance employee in the
21 Policies and Procedures Group. The employee came with considerable experience in Blue Sky and
22 other surveillance related matters and soon was charged with managing certain surveillance
23 functions.

24 36. On or about May 23, 2005, during a review of MSDW's Blue Sky compliance
25 surveillance, the employee learned that while MSDW had an equity Blue Sky feed from BSDC, it
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1 received no similar feed for fixed income securities. The employee reported the situation to
2 MSDW's new Head of Compliance the following day.

3 37. Upon hearing the report, the Head of Compliance directed the employee to have
4 MSDW acquire the fixed income feed from BSDC as soon as possible. MSDW began receiving
5 the fixed income feed from BSDC on May 30, 2005.

6 38. Morgan Stanley then took steps to assess the significance and extent of the gaps in
7 surveillance. A team of persons was formed in June 2005 to examine the issues and worked
8 through the balance of June and July in an effort to identify the deficiencies and to begin to
9 immediately correct the problems. In doing so, the team created a list of Blue Sky compliance
10 requirements for all trading platforms and identified a list of Blue Sky compliance gaps.

11 39. On August 12, 2005, an Executive Director in the Regulatory Group of Morgan
12 Stanley's Law Division began the process of self-reporting the Blue Sky problem to state
13 regulators. Over the next couple of weeks, the Executive Director notified regulators in all fifty
14 (50) states, the District of Columbia and Puerto Rico, as well as the National Association of
15 Securities Dealers ("NASD"). The head of the Regulatory Group had already given preliminary
16 notice to the New York Stock Exchange ("NYSE").

17 40. Upon receiving the fixed income feed from BSDC, MSDW made necessary system
18 enhancements and conducted testing of the system enhancements, resulting in MSDW putting the
19 fixed income feed into production on June 20, 2005. The changes permitted a daily updating of
20 MSDW's internal Blue Sky database and allowed fixed income exceptions to appear on the daily
21 T+1 report.

22 41. On or about July 15, 2005, MSDW developed a "security-not-found" report to
23 address instances where the BSDC feed may not contain data for a particular security. This report,
24 generated on a T+1 basis, identifies all transactions in securities (by CUSIP number) not
25 recognized by the Blue Sky database that could potentially violate Blue Sky laws. Currently the
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1 security-not-found report covers both equities and fixed income transactions entered through the
2 equity and fixed income order entry platforms on the Workstations.

3 42. On a daily basis, Compliance personnel analyze the security-not-found report to
4 ascertain the Blue Sky registration or exemption status of the flagged transaction and make a
5 determination regarding the Blue Sky status of the identified transactions prior to settlement date.
6 If they discover a transaction that violated Blue Sky restrictions, they instruct the branch that
7 effected the transaction to cancel it. When analyzing the report, Compliance personnel also update
8 the Blue Sky database to include relevant information about the securities they research.

9 43. On or about July 29, 2005, MSDW programmed a hard block – *i.e.* a block an FA
10 cannot override—that prevents the entry of fixed income transactions that could violate Blue Sky
11 regulations.

12 44. MSDW has also refined the process to filter out transactions that qualify for certain
13 exemptions that span all Blue Sky jurisdictions. By eliminating the covered transactions, the
14 system yields a smaller and more manageable pool of securities with potential Blue Sky issues for
15 manual review by the Compliance Department.

16 45. Additionally, MSDW directed its IT Department to examine all of MSDW's trading
17 platforms to determine the nature and scope of the Blue Sky compliance problem.

18 The review uncovered a gap in Blue Sky coverage for MSDW's managed account
19 platforms to the extent that such platforms include affiliated money managers or accommodate
20 salesman discretionary trading. MSDW has taken the necessary steps to close the gaps in the
21 managed account platforms, and has incorporated trading in the managed account platforms into
22 the securities-not-found report.

23 46. By the end of 2005, Morgan Stanley remedied all of the previously identified Blue
24 Sky compliance gaps in both MSDW and PWM systems.

25 47. Morgan Stanley hired additional Compliance Department employees to staff its
26 Blue Sky function. In particular, the new personnel include a new Blue Sky manager who is

1 dedicated exclusively to Blue Sky compliance. A full time temporary employee was hired to assist
2 the Blue Sky manager and Morgan Stanley subsequently hired this individual as a permanent full-
3 time employee. Morgan Stanley also assigned a back-up person to cover the Blue Sky Manager's
4 responsibilities in the event of absences.

5 48. At great expense, Morgan Stanley conducted a review of millions of historical
6 transactions and identified those that were executed in violation of the Blue Sky laws as a result of
7 the system deficiencies and offered rescission to customers with terms and conditions that are
8 consistent with the provisions from the state securities statutes that correspond to the state of
9 residence of each affected customer.

10 **II.**

11 **CONCLUSIONS OF LAW**

12 1. The Commission has jurisdiction over this matter pursuant to Article XV of the
13 Arizona Constitution and the Securities Act.

14 2. Respondent offered or sold securities within or from Arizona, within the meaning of
15 A.R.S. §§ 44-1801(15), 44-1801(21), and 44-1801(26).

16 3. Respondent's failure to maintain adequate systems to reasonably ensure compliance
17 with Blue Sky laws resulted in the sale of unregistered securities in violation of A.R.S. § 44-1841.

18 4. Respondent failed to reasonably supervise its agents or employees, within the
19 meaning of A.R.S. § 44-1961(A)(12).

20 5. Respondent's conduct is grounds for a cease and desist order pursuant to A.R.S.
21 § 44-1961 and A.R.S. § 44-2032.

22 6. Respondent's conduct is grounds for administrative penalties under A.R.S. § 44-
23 1961 and A.R.S. § 44-2036.

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III.**ORDER**

THEREFORE, on the basis of the Findings of Fact, Conclusions of Law, and Respondent's consent to the entry of this Order, attached and incorporated by reference, for the sole purpose of settling this matter prior to a hearing, the Commission finds that the following relief is appropriate, in the public interest, and necessary for the protection of investors:

IT IS HEREBY ORDERED:

1. This Order concludes the Investigation by the Commission and any other action that the Commission could commence under the Securities Act on behalf of the state of Arizona as it relates to Respondent, Morgan Stanley, or any of its affiliates, and their current or former officers, directors, and employees, arising from or relating to the subject of the Investigation, provided, however, that excluded from and not covered by the paragraph are any claims by the Commission arising from or relating to enforcement of the Order provisions contained herein.

2. Pursuant to A.R.S. §§ 44-1961 and 44-2032, Respondent, and any of Respondent's agents, employees, successors and assigns, shall permanently cease and desist from violating the Securities Act.

3. This Order shall become final upon entry.

4. Pursuant to A.R.S. §§ 44-1961 and 44-2036, Respondent shall pay an administrative penalty in the amount of Seven Hundred Seventy-four Thousand and Seven Hundred Nine Dollars (\$774,709.00) to the "State of Arizona," which amount constitutes the state of Arizona's proportionate share of the state settlement amount of 8.5 Million Dollars (\$8,500,000.00), which shall be payable to the state of Arizona within ten (10) days of the date on which this Order becomes final.

5. If payment is not made by Respondent, the Commission may vacate this Order, at its sole discretion, upon ten (10) days notice to Respondent and without opportunity for administrative hearing.

1 6. This Order is not intended by the Commission to subject any Covered Person to any
2 disqualifications under the laws of the United States, any state, the District of Columbia or Puerto
3 Rico, including, without limitation, any disqualification from relying upon the state or federal
4 registration exemptions or safe harbor provisions. "Covered Person," means Morgan Stanley or
5 any of its affiliates and their current or former officers, directors, employees, or other persons that
6 would otherwise be disqualified as a result of the Orders (as defined below).

7 7. This Order and the order of any other State in related proceedings against Morgan
8 Stanley (collectively, the "Orders") shall not disqualify any Covered Person from any business that
9 they otherwise are qualified, licensed or permitted to perform under applicable law of the state of
10 Arizona and any disqualifications from relying upon this state's registration exemptions or safe
11 harbor provisions that arise from the Orders are hereby waived.

12 8. For any person or entity not a party to this Order, this Order does not limit or create
13 any private rights or remedies against Morgan Stanley or create liability of Morgan Stanley or limit
14 or create defenses of Morgan Stanley to any claims.

15 9. This Order and any dispute related thereto shall be construed and enforced in
16 accordance, and governed by, the laws of the state of Arizona, without regard to any choice of law
17 principles.

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10. This Order shall be binding upon Respondent and its successors and assigns. Further, with respect to all conduct subject to Paragraph 4 above and all future obligations, responsibilities, undertakings, commitments, limitations, restrictions, events, and conditions, the term "Respondent" as used here shall include Morgan Stanley's successors or assigns.

IT IS FURTHER ORDERED that this Order shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION

Laura S. Gleason

CHAIRMAN

Walter T. Miller

COMMISSIONER

Stephen W. Hatch-Miller

COMMISSIONER

R. W. [Signature]

COMMISSIONER

Gary [Signature]

COMMISSIONER

IN WITNESS WHEREOF, I, DEAN S. MILLER, Interim Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 27th day of March, 2008.

Dean S. Miller

DEAN S. MILLER
Interim Executive Director

DISSENT

DISSENT

This document is available in alternative formats by contacting Linda Hogan, ADA Coordinator, voice phone number 602-542-3931, e-mail lhogan@azcc.gov.

MN

