

12/3/09

COMMISSIONERS
KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

ERNEST G. JOHNSON
EXECUTIVE DIRECTOR



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ARIZONA CORPORATION COMMISSION

ORIGINAL

MEMORANDUM

TO: Kristin K. Mayes, Chairman
Gary Pierce, Commissioner
Paul Newman, Commissioner
Sandra D. Kennedy, Commissioner
Bob Stump, Commissioner

FROM: Matthew J. Neubert, Director of Securities

DATE: November 13, 2009

RE: Morgan Stanley & Co. Incorporated
Docket No. S-03536A-09-0503

cc: Ernest G. Johnson, Executive Director

Arizona Corporation Commission

DOCKETED

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DOCKETED BY [Signature]

ARIZONA CORPORATION COMMISSION
DOCKET CONTROL

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The Securities Division recommends that the Corporation Commission enter the attached Order to Cease and Desist, Order for Administrative Penalties, and Consent to Same by Respondent Morgan Stanley & Co. Incorporated ("Consent Order"). The Consent Order relates to activities of Morgan Stanley & Co. Incorporated ("Morgan Stanley") regarding the offer and sale of auction rate securities. The proposed Consent Order imposes an administrative penalty in the amount of \$496,120.81.

As you are aware, as a result of the February 2008 wide spread auction failures in the auction rate securities market, in March 2008 the North American Securities Administrators Association (NASAA) formed a multistate task force, with which the Securities Division participated, to investigate the auction rate securities market. The investigations focused on the sales practices of securities salesmen and the supervision of those salesmen by their broker-dealers. Morgan Stanley agreed in principle to a national settlement. In order to provide for uniformity among the states, the NASAA task force created a model consent order. The findings of fact and conclusions of law contained in the attached proposed Consent Order were negotiated between Morgan Stanley and the lead task force state.

The principal components of the settlement are:

- Payment of administrative penalties in the amount of \$35 million dollars, apportioned among the states.
- An offer to purchase from eligible customers at par auction rate securities that were purchased from Morgan Stanley prior to February 13, 2008.

- Payment of the difference between par and the price at which an individual investor sold the auction rate securities to each individual investor who sold auction rate securities below par between February 13, 2008, and August 13, 2008.
- Refund to municipal issuers refinancing fees an issuer paid for refinancing its auction rate securities between February 11, 2008, and the date of this order, if Morgan Stanley acted as underwriter for the primary offering between August 1, 2007, and February 11, 2008.
- Efforts to expeditiously provide liquidity solutions for institutional investors.

In light of the significant effort undertaken by the NASAA task force members in investigating Morgan Stanley and the relief Morgan Stanley has provided to investors in auction rate securities, the Securities Division believes that entry of the proposed Consent Order is in the public interest.

Originator: Matthew J. Neubert

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

In the matter of

MORGAN STANLEY & CO.
INCORPORATED (CRD #8209),

Respondent.

DOCKET NO. S-03536A-09-0503

DECISION NO. _____

ORDER TO CEASE AND DESIST, ORDER
FOR ADMINISTRATIVE PENALTIES, AND
CONSENT TO SAME

BY: RESPONDENT MORGAN STANLEY
& CO. INCORPORATED

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

WHEREAS, coordinated investigations of the activities of Morgan Stanley in connection with the marketing and sale of auction rate securities ("ARS") have been conducted by a multistate task force composed of members of the North American Securities Administrators Association Inc. ("NASAA"); and

WHEREAS, Morgan Stanley has cooperated with regulators conducting the investigations by responding to inquiries, providing documentary evidence and other materials, and providing regulators with access to facts relating to the investigations; and

WHEREAS, Morgan Stanley has advised regulators of its agreement to resolve the investigations relating to its marketing and sale of ARS to retail investors; and

WHEREAS, Morgan Stanley agrees to, among other things, reimburse certain purchasers of auction rate securities, implement certain changes with respect to its marketing and sale of ARS, and make certain payments; and

WHEREAS, Morgan Stanley elects to permanently waive any right to a hearing and appeal under Articles 11 and 12 of the Securities Act of Arizona, A.R.S. § 44-1801 *et seq.* ("Securities

1 Act") with respect to this Order to Cease and Desist, Order for Administrative Penalties, and
2 Consent to Same (the "Order");

3 WHEREAS, Morgan Stanley admits the jurisdiction of the Arizona Corporation
4 Commission ("Commission"); acknowledges, without admitting or denying the truth thereof, the
5 Findings of Fact and Conclusions of Law contained in this Order, and consents to the entry of this
6 Order by the Commission:

7 NOW, THEREFORE, the Commission, as administrator of the Securities Act, hereby
8 enters this order:

9 I.

10 **FINDINGS OF FACT**

11 **Unethical Practices in the Offer and Sale of Auction Rate Securities**

12 1. Auction rate securities are financial instruments that include auction preferred
13 shares of closed-end funds, municipal auction rate bonds, and various asset-backed auction rate
14 bonds (collectively referred to herein as "ARS"). ARS are long-term instruments where the
15 interest/dividend is reset weekly or monthly.

16 2. Morgan Stanley participated in the marketing and sale of ARS.

17 3. In certain instances, Morgan Stanley, through its salespeople, advised certain clients
18 that ARS were safe, liquid investments, when in fact auction rate securities had significant liquidity
19 risks associated with them.

20 4. Representatives of Morgan Stanley represented to certain customers of Morgan
21 Stanley that ARS were short-term investments. In fact, because ARS are bonds with long-term
22 maturities, their short-term liquidity was dependent on the successful operation of a bidding
23 process known as a Dutch auction. Certain representatives of Morgan Stanley failed to disclose to
24 certain customers with short-term liquidity needs that they might be unable to sell their ARS if the
25 auction process failed.

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1 5. In connection with the sale of ARS, certain Morgan Stanley salespeople told certain
2 investors that ARS were “just like cash” and “liquid with seven days notice.”

3 6. Morgan Stanley marketed ARS to investors within a brochure entitled "Money
4 Market Instruments." Within this brochure, ARS are listed under the subsection "Other Short-
5 Term Instruments."

6 7. Since it began participating in the auction rate securities market, Morgan Stanley
7 submitted support bids—purchase orders for the entirety of an auction rate security issue for which
8 it acted as the sole or lead broker. Support bids were Morgan Stanley proprietary orders that would
9 be filled, in whole or in part, if there was otherwise insufficient demand in an auction. When
10 Morgan Stanley purchased auction rate securities through support bids, auction rate securities were
11 then owned by Morgan Stanley and the holdings were recorded on Morgan Stanley's balance sheet.
12 For risk management purposes, Morgan Stanley imposed limits on the amounts of auction rate
13 securities it could hold in inventory.

14 8. Because many investors could not ascertain how much of an auction was filled
15 through Morgan Stanley proprietary trades, they could not determine if auctions at Morgan Stanley
16 were clearing because of normal marketplace demand, or because Morgan Stanley was making up
17 for the lack of demand through support bids. Generally, investors were also not aware that the
18 liquidity of the auction rate securities as to which Morgan Stanley was the managing broker-dealer
19 depended upon Morgan Stanley's continued use of support bids. While Morgan Stanley could track
20 its own inventory as a measure of the supply and demand for its auction rate securities, ordinary
21 investors had no comparable ability to assess the operation of Morgan Stanley's auctions. There
22 was no way for such investors to monitor supply and demand in the market or to assess when
23 broker-dealers might decide to stop supporting the market, thereby causing its collapse.

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1 3. This Order shall be binding upon Respondent Morgan Stanley and its successors
2 and assigns as well as the successors and assigns of relevant affiliates with respect to all conduct
3 subject to the provisions above and all future obligations, responsibilities, undertakings,
4 commitments, limitations, restrictions, events, and conditions.

5 4. Morgan Stanley shall cease and desist from violating the Securities Act and will
6 comply with the Securities Act.

7 5. Within ten (10) calendar days following the entry of this Order, Morgan Stanley
8 shall pay to the state of Arizona the sum of Four Hundred Ninety-six Thousand One Hundred
9 Twenty and 81/100 Dollars (\$496,120.81), which amount constitutes Arizona's allocated share of
10 the total settlement amount of \$35 Million Dollars.

11 6. In the event another state securities regulator determines not to accept Morgan
12 Stanley's settlement offer, the total amount of the payment to the state of Arizona shall not be
13 affected.

14 **Requirement to Repurchase ARS from Retail ARS Investors**

15 7. Morgan Stanley shall provide liquidity to Retail ARS Investors by buying back, at
16 par, in the manner described below, Eligible ARS that were not clearing as of September 30, 2008.

17 8. "Eligible ARS," for the purposes of this Order, shall mean auction rate securities
18 purchased at Morgan Stanley prior to February 13, 2008.

19 9. "Retail ARS Investors," for the purposes of this Order, shall mean:

20 i. Natural persons (including their IRA accounts, testamentary trust and estate
21 accounts, custodian UGMA and UTMA accounts, and guardianship accounts) who
22 purchased Eligible ARS at Morgan Stanley;

23 ii. Charities and nonprofits with Internal Revenue Code Section 501(c)(3)
24 status that purchased Eligible ARS at Morgan Stanley; and
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1 iii. Small Businesses that purchased Eligible ARS at Morgan Stanley. For
2 purposes of this provision, "Small Businesses" shall mean Morgan Stanley customers not
3 otherwise covered in paragraph 9(i) and (ii) above that had \$10 million or less in assets in
4 their accounts with Morgan Stanley, net of margin loans, as determined by the customer's
5 aggregate household position(s) at Morgan Stanley as of August 31, 2008, or, if the
6 customer was not a customer of Morgan Stanley as of August 31, 2008, as of the date that
7 the customer terminated its customer relationship with Morgan Stanley. Notwithstanding
8 any other provision, "Small Businesses" does not include broker-dealers or banks acting as
9 conduits for their customers.

10 10. Morgan Stanley shall offer to purchase, at par plus accrued and unpaid
11 dividends/interest, from Retail ARS Investors their Eligible ARS that were not clearing as of
12 September 30, 2008 ("Buyback Offer"), and explain to such Retail ARS Investors what they must
13 do to accept, in whole or in part, the Buyback Offer. The Buyback Offer shall remain open until at
14 least January 11, 2009 ("Offer Period"). Morgan Stanley may in its sole discretion extend the
15 Offer Period beyond this date.

16 11. Morgan Stanley shall have undertaken its best efforts to identify and provide notice
17 to Retail ARS Investors who invested in Eligible ARS that were not clearing as of September 30,
18 2008, of the relevant terms of this Order by October 20, 2008.

19 12. Retail ARS Investors may accept the Buyback Offer by notifying Morgan Stanley at
20 any time before midnight, Eastern Time, January 11, 2009, or such later date and time as Morgan
21 Stanley may in its sole discretion decide to extend the Offer Period. For Retail ARS Investors who
22 accept the Buyback Offer prior to December 11, 2008, Morgan Stanley shall have purchased their
23 Eligible ARS by December 15, 2008. Morgan Stanley shall have purchased the Eligible ARS of all
24 other Retail ARS Investors who accept the Buyback Offer within the Offer Period, on or before
25 January 16, 2009.

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1 is pursuing claims related exclusively to consequential damages, Morgan Stanley shall provide the
2 investor with the option to proceed in arbitration according to the following provisions:

3 a. The arbitrations will be conducted by a single public arbitrator in accordance
4 with FINRA's special arbitration procedures for claims of consequential damages filed by
5 Retail ARS Investors;

6 b. Morgan Stanley shall pay all applicable FINRA forum and FINRA filing
7 fees;

8 c. Any Morgan Stanley Retail ARS Investors who choose to pursue such
9 claims shall bear the burden of proving that they suffered consequential damages and that
10 such damages were caused by the investors' inability to access funds consisting of Eligible
11 ARS holdings purchased at Morgan Stanley; and

12 d. Morgan Stanley shall be able to defend itself against such claims; provided,
13 however, that Morgan Stanley shall not contest liability related to the sale of auction rate
14 securities, and provided further that Morgan Stanley shall not be able to use as part of its
15 defense a Morgan Stanley Retail ARS Investor's decision not to borrow money from
16 Morgan Stanley.

17 18. Retail ARS Investors who elect to use the special arbitration process provided for
18 herein shall not be eligible for punitive damages.

19 19. All customers, including but not limited to Retail ARS Investors who avail
20 themselves of the relief provided pursuant to this Order, may pursue any remedies against Morgan
21 Stanley available under the law. However, Eligible Investors that elect to utilize the special
22 arbitration process set forth above are limited to the remedies available in that process and may not
23 bring or pursue a claim against Morgan Stanley or in any case where Morgan Stanley is
24 underwriter relating to Eligible ARS in another forum.

Institutional Investors

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2 20. Morgan Stanley shall endeavor to work with issuers and other interested parties,
3 including regulatory and governmental entities, to expeditiously provide liquidity solutions for
4 institutional investors that purchased auction rate securities not covered by the Retail ARS Investor
5 repurchase provisions delineated above.

6 21. Beginning December 11, 2008, and within 45 days of the end of each quarter
7 thereafter, Morgan Stanley shall submit a written report to a representative specified by NASAA
8 outlining the efforts in which Morgan Stanley has engaged and the results of those efforts with
9 respect to Morgan Stanley institutional investors' holdings in Eligible ARS. Morgan Stanley shall,
10 at the option of the representative specified by NASAA, confer with such representative no less
11 frequently than quarterly to discuss Morgan Stanley's progress. Such quarterly meetings shall
12 continue until no later than December 2009. Following every quarterly meeting, the representative
13 shall advise Morgan Stanley of any concerns and, in response, Morgan Stanley shall detail the
14 steps that Morgan Stanley plans to implement to address such concerns. The reporting or meeting
15 deadlines set forth above may be amended upon Morgan Stanley's request if written permission is
16 received from the representative specified by NASAA.

Relief for Municipal Issuers

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18 22. Morgan Stanley shall promptly refund to municipal issuers refinancing fees the
19 issuers paid to Morgan Stanley for the refinancing of their auction rate securities, where such
20 refinancing occurred between February 11, 2008, and the date of this Order and where Morgan
21 Stanley acted as underwriter for the primary offering of the auction rate securities between August
22 1, 2007, and February 11, 2008. Nothing in this Order precludes the Commission from pursuing
23 any other civil action that may arise with regard to auction rate securities other than the marketing
24 and sale of auction rate securities to retail investors.

Additional Considerations

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2 23. Nothing herein shall preclude Arizona, its departments, agencies, boards,
3 commissions, authorities, political subdivisions and corporations (collectively, "State Entities"),
4 other than the Commission and only to the extent set forth in paragraph 1 above, and the officers,
5 agents or employees of State Entities from asserting any claims, causes of action, or applications
6 for compensatory, nominal and/or punitive damages, administrative, civil, criminal, or injunctive
7 relief against Morgan Stanley in connection with certain auction rate securities practices at Morgan
8 Stanley.

9 24. This Order shall not disqualify Morgan Stanley or any of its affiliates or current or
10 former employees from any business that they otherwise are qualified or licensed to perform under
11 applicable state law and this Order is not intended to form the basis for any disqualification.

12 To the extent applicable, this Order hereby waives any disqualification from relying upon the
13 registration exemptions or registration safe harbor provisions that may be contained in the federal
14 securities laws, the rules and regulations thereunder, the rules and regulations of self-regulatory
15 organizations or any state's or U.S. Territory's securities laws. In addition, this Order is not
16 intended to form the basis for any such disqualifications. In addition, this Order is not intended to
17 form the basis of a statutory disqualification under Section 3(a)(39) of the Securities Exchange Act
18 of 1934.

19 26. This Order and any dispute related thereto shall be construed and enforced in
20 accordance with, and governed by, the laws of the state of Arizona without regard to any choice of
21 law principles.

22 27. Evidence of a violation of this Order proven in a court of competent jurisdiction
23 shall constitute prima facie proof of a violation of the Securities Act, in any civil action or
24 proceeding hereafter commenced by the Commission against Morgan Stanley.

1 28. Should the Commission prove in a court of competent jurisdiction that a material
2 breach of this Order by Morgan Stanley has occurred, Morgan Stanley shall pay to the Commission
3 the cost, if any, of such determination and of enforcing this Order including without limitation
4 legal fees, expenses, and court costs.

5 29. If Morgan Stanley fails to make the payment specified in paragraph 5, the
6 Commission may, at its sole discretion, pursue any legal remedies, including but not limited to
7 initiating an action to enforce the Order, revoking Morgan Stanley's registration within the state, or
8 terminating this Order.

9 30. If in any proceeding, after notice and opportunity for a hearing, a court of competent
10 jurisdiction, including an administrative proceeding by a state securities administrator, finds that
11 there was a material breach of this Order, the Commission, at its sole discretion, may terminate the
12 Order. If Morgan Stanley defaults on any other obligation under this Order, the Commission may,
13 at its sole discretion, pursue legal remedies to enforce the Order or pursue an administrative action,
14 including but not limited an action to revoke Morgan Stanley's registration within the state. Morgan
15 Stanley agrees that any statute of limitations or other time related defenses applicable to the subject
16 of the Order and any claims arising from or relating thereto are tolled from and after the date of this
17 Order. In the event of such termination, Morgan Stanley expressly agrees and acknowledges that
18 this Order shall in no way bar or otherwise preclude the Commission from commencing,
19 conducting or prosecuting any investigation, action, or proceeding, however denominated, related
20 to the Order, against Morgan Stanley, or from using in any way any statements, documents, or
21 other materials produced or provided by Morgan Stanley prior to or after the date of this Order,
22 including, without limitation, such statements, documents, or other materials, if any, provided for
23 purposes of settlement negotiations, except as may otherwise be provided in a written agreement
24 with the Commission.

1 31. Morgan Stanley shall cooperate fully and promptly with the Commission and shall
2 use its best efforts to ensure that all the current and former officers, directors, trustees, agents,
3 members, partners, and employees of Morgan Stanley (and of any of Morgan Stanley's parent
4 companies, subsidiaries, or affiliates) cooperate fully and promptly with the Commission in any
5 pending or subsequently initiated investigation, litigation, or other proceeding relating to auction
6 rate securities and/or the subject matter of the Order. Such cooperation shall include, without
7 limitation, and on a best efforts basis:

8 (a) production, voluntarily and without service of subpoena, upon the request of
9 the Commission, of all documents or other tangible evidence requested by the Commission
10 and any compilations or summaries of information or data that the Commission requests
11 that Morgan Stanley (or the Morgan Stanley's parent companies, subsidiaries, or affiliates)
12 prepare, except to the extent such production would require the disclosure of information
13 protected by the attorney-client and/or work-product privileges;

14 (b) without the necessity of a subpoena, having the current (and making all
15 reasonable efforts to cause the former) officers, directors, trustees, agents, members,
16 partners, and employees of Morgan Stanley (and of any of the Morgan Stanley's parent
17 companies, subsidiaries, or affiliates) attend any Proceedings (as hereinafter defined) in
18 Arizona or elsewhere at which the presence of any such persons is requested by the
19 Commission and having such current (and making all reasonable efforts to cause the
20 former) officers, directors, trustees, agents, members, partners, and employees answer any
21 and all inquiries that may be put by the Commission to any of them at any proceedings or
22 otherwise, except to the extent such production would require the disclosure of information
23 protected by the attorney-client and/or work-product privileges. "Proceedings" include, but
24 are not limited to, any meetings, interviews, depositions, hearings, trials, grand jury
25 proceedings, or other proceedings;

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1 (c) fully, fairly, and truthfully disclosing all information and producing all
2 records and other evidence in its possession, custody, or control (or the possession, custody,
3 or control of the Morgan Stanley parent companies, subsidiaries, or affiliates) relevant to all
4 inquiries made by the Commission concerning the subject matter of the Order, except to the
5 extent such inquiries call for the disclosure of information protected by the attorney-client
6 and/or work-product privileges; and

7 (d) making outside counsel reasonably available to provide comprehensive
8 presentations concerning any internal investigation relating to all matters in the Order and
9 to answer questions, except to the extent such presentations or questions call for the
10 disclosure of information protected by the attorney-client and/or work-product privileges.

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1 32. In the event Morgan Stanley fails to comply with paragraph 31 of the Order, the
2 Commission shall be entitled to specific performance, in addition to any other available remedies.

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

4 BY ORDER OF THE ARIZONA CORPORATION COMMISSION

5
6 CHAIRMAN

COMMISSIONER

7
8 COMMISSIONER

COMMISSIONER

COMMISSIONER

9 IN WITNESS WHEREOF, I, ERNEST G. JOHNSON,
10 Executive Director of the Arizona Corporation
11 Commission, have hereunto set my hand and caused the
12 official seal of the Commission to be affixed at the
13 Capitol, in the City of Phoenix, this _____ day of
14 _____, 20__.

15
16 _____
17 ERNEST G. JOHNSON
18 EXECUTIVE DIRECTOR

19
20 _____
21 DISSENT

22
23 _____
24 DISSENT

25 This document is available in alternative formats by contacting Shaylin A. Bernal, ADA
26 Coordinator, voice phone number 602-542-3931, e-mail sabernal@azcc.gov.

(mn)

CONSENT TO ENTRY OF ADMINISTRATIVE ORDER BY MORGAN STANLEY & CO. INCORPORATED

Morgan Stanley & Co. Incorporated ("Morgan Stanley") hereby acknowledges that it has been served with a copy of this Order to Cease and Desist, Order for Administrative Penalties, and Consent to Same ("Order"), has read the foregoing Order, is aware of its right to a hearing and appeal in this matter, and has waived the same.

Morgan Stanley admits the jurisdiction of the Arizona Corporation Commission ("Commission"), neither admits nor denies the Findings of Fact and Conclusions of Law contained in this Order; and consents to entry of this Order by the Commission as settlement of the issues contained in this Order.

Morgan Stanley agrees that it shall not claim, assert, or apply for a tax deduction or tax credit with regard to any state, federal, or local tax for any administrative monetary penalty that Morgan Stanley shall pay pursuant to this Order.

Morgan Stanley states that no promise of any kind or nature whatsoever was made to it to induce it to enter into this Order and that it has entered into this Order voluntarily.

S. Anthony Taggart represents that he/she is Executive Director of Morgan Stanley and that, as such, has been authorized by Morgan Stanley to enter into this Order for and on behalf of Morgan Stanley.

Dated this 11th day of November, 2009

MORGAN STANLEY & CO. INCORPORATED

By: [Signature]

Title: Executive Director

STATE OF New York
County of Suffolk

SUBSCRIBED AND SWORN TO before me this 11th day of November 12, 2009

[Signature]
Notary Public

My commission expires: 11/27/09

DANA BALACEK
NOTARY PUBLIC, State of New York
No. 01BA5052647
Qualified in Suffolk County
Commission Expires Nov. 27, 2009

Decision No. _____

1 SERVICE LIST FOR: Morgan Stanley & Co. Incorporated
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