

BEFORE THE ARKANSAS SECURITIES COMMISSIONER

CASE NO. S-09-024

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ARKANSAS SECURITIES DEPT.

IN THE MATTER OF

Order No. S-09-024-10-CO09

MORGAN STANLEY & CO.
INCORPORATED (CRD #8209)

CONSENT ORDER

WHEREAS, Morgan Stanley & Co. Incorporated ("Morgan Stanley") is a broker-dealer registered in the state of Arkansas; 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 Arkansas Securities Act, Ark. Code Ann. §§ 23-42-101 through 23-42-509, and the Arkansas Administrative Procedures Act, Ark. Code Ann. §§ 25-15-201 through 25-15-219, with respect to this Consent Order ("Order");

1 WHEREAS, Morgan Stanley admits the jurisdiction of the Arkansas Securities
2 Commissioner; acknowledges, without admitting or denying the truth thereof, that the following
3 allegations contained in the Notice of Hearing shall be adopted as the Arkansas Securities
4 Commissioner's Findings of Fact; and consents to the entry of this Order by the Arkansas
5 Securities Commissioner:

6 NOW, THEREFORE, the Arkansas Securities Commissioner, as administrator of the
7 Arkansas Securities Act, hereby enters this order:

8 I.

9 **FINDINGS OF FACT**

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

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

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

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

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

25 5. In connection with the sale of ARS, certain Morgan Stanley salespeople told certain
26 investors that ARS were "just like cash" and "liquid with seven days notice."

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

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

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

22 9. Starting in August 2007, the credit crisis and other deteriorating market conditions
23 strained the auction rate securities market. Some institutional investors withdrew from the market,
24 decreasing demand for auction rate securities.

25 10. The resulting market dislocation should have been evident to Morgan Stanley.
26 Morgan Stanley's support bids filled the increasing gap in the demand in its auctions for auction

1 rate securities, sustaining the impression that the demand for auction rate securities had not
2 decreased. As a result, Morgan Stanley's auction rate securities inventory grew significantly,
3 requiring Morgan Stanley to raise its risk management limits on its auction rate securities
4 inventory.

5 11. From the Fall of 2007 through February of 2008, demand for auction rate securities
6 continued to erode and Morgan Stanley's auction rate securities inventory reached unprecedented
7 levels. Morgan Stanley eventually became aware of the increasing strains in the auction rate
8 securities market, and recognized the potential for widespread market failure. Morgan Stanley
9 never disclosed these increasing risks of owning or purchasing auction rate securities to its
10 customers.

11 12. In February 2008, Morgan Stanley and other firms stopped supporting the auctions.
12 Without the benefit of support bids, the auction rate securities market collapsed, leaving investors
13 who had been led to believe that these securities were cash alternative investments appropriate for
14 managing short-term cash needs, holding long-term or perpetual securities that could not be sold at
15 par value until and if the auctions cleared again.

16 **Failure to Supervise**

17 13. Although ARS are complex products, Morgan Stanley did not provide its sales or
18 marketing staff with the training necessary to adequately explain these products or the mechanics
19 of the auction process to their customers.

20 14. Morgan Stanley did not adequately train all of its brokers and financial advisers
21 regarding the potential illiquidity of ARS, including the fact that Morgan Stanley may stop
22 supporting the market.

23 **II.**

24 **CONCLUSIONS OF LAW**

25 15. Arkansas Securities Commissioner has jurisdiction over this matter pursuant to Ark.
26 Code Ann. § 23-42-205.

1 4. Morgan Stanley shall cease and desist from violating the Arkansas Securities Act
2 and will comply with the Arkansas Securities Act.

3 5. Morgan Stanley shall pay the aggregate sum of \$35 million dollars to participating
4 jurisdictions.

5 6. Within ten (10) calendar days following the entry of this Order, Morgan Stanley
6 shall pay the sum of \$156,785.18 in two payments as follows: (1) \$15,678.51 to the Arkansas State
7 Fund at the Investor Protection Trust, a non-profit organization devoted to investor education; and
8 (2) \$141,107.29 payable to the Arkansas Securities Department. This amount constitutes the state
9 of Arkansas's allocated share of the total settlement payment described in the preceding paragraph.

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

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

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

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

18 10. "Retail ARS Investors," for the purposes of this Order, shall mean:

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

22 ii. Charities and nonprofits with Internal Revenue Code Section 501(c)(3)
23 status that purchased Eligible ARS at Morgan Stanley; and

24 iii. Small Businesses that purchased Eligible ARS at Morgan Stanley. For
25 purposes of this provision, "Small Businesses" shall mean Morgan Stanley customers not
26 otherwise covered in paragraph 10(i) and (ii) above that had \$10 million or less in assets in

1 their accounts with Morgan Stanley, net of margin loans, as determined by the customer's
2 aggregate household position(s) at Morgan Stanley as of August 31, 2008, or, if the
3 customer was not a customer of Morgan Stanley as of August 31, 2008, as of the date that
4 the customer terminated its customer relationship with Morgan Stanley. Notwithstanding
5 any other provision, "Small Businesses" does not include broker-dealers or banks acting as
6 conduits for their customers.

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

13 12. Morgan Stanley shall have undertaken its best efforts to identify and provide notice
14 to Retail ARS Investors who invested in Eligible ARS that were not clearing as of September 30,
15 2008, of the relevant terms of this Order by October 20, 2008.

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

23 14. If at any time between January 12, 2009, and December 31, 2009, a Retail ARS
24 Investor who did not accept the Buyback Offer contacts Morgan Stanley and affirms that he or she
25 did not receive notice of the Buyback Offer prior to January 11, 2009, Morgan Stanley will
26 purchase the Eligible ARS of such investor.

1 15. No later than October 20, 2008, Morgan Stanley shall have established: a) a
2 dedicated toll-free telephone assistance line, with appropriate staffing, to provide information and
3 to respond to questions concerning the terms of this Order; and b) a public Internet page on its
4 corporate Web site(s), with a prominent link to that page appearing on Morgan Stanley's relevant
5 homepage(s), to provide information concerning the terms of this Order and, via reasonable means,
6 to respond to questions concerning the terms of this Order. Morgan Stanley shall maintain the
7 telephone assistance line and Internet page through December 31, 2009.

8 **Review of Customer Accounts**

9 16. For a period of two years from the date of this Order, upon request from any firm
10 that is repurchasing auction rate securities, Morgan Stanley shall take reasonable steps to provide
11 notice of that firm's offer to repurchase auction rate securities to Morgan Stanley customers that
12 Morgan Stanley can reasonably identify, that hold such auction rate securities subject to the other
13 firm's repurchase.

14 **Relief for Investors Who Sold Below Par**

15 17. No later than December 11, 2008, Morgan Stanley shall pay any Retail ARS
16 Investor that Morgan Stanley can reasonably identify who sold Eligible ARS below par between
17 February 13, 2008, and August 13, 2008, the difference between par and the price at which the
18 Retail ARS investor sold the Eligible ARS.

19 **Claims for Consequential Damages**

20 18. Notwithstanding this Order, an investor may pursue any claims related to the sale of
21 auction rate securities via any method normally available to the investor. However, if the investor
22 is pursuing claims related exclusively to consequential damages, Morgan Stanley shall provide the
23 investor with the option to proceed in arbitration according to the following provisions:

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

1 b. Morgan Stanley shall pay all applicable FINRA forum and FINRA filing
2 fees;

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

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

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

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

20 **Institutional Investors**

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

25 22. Beginning December 11, 2008, and within 45 days of the end of each quarter
26 thereafter, Morgan Stanley shall submit a written report to a representative specified by NASAA

1 outlining the efforts in which Morgan Stanley has engaged and the results of those efforts with
2 respect to Morgan Stanley institutional investors' holdings in Eligible ARS. Morgan Stanley shall,
3 at the option of the representative specified by NASAA, confer with such representative no less
4 frequently than quarterly to discuss Morgan Stanley's progress. Such quarterly meetings shall
5 continue until no later than December 2009. Following every quarterly meeting, the representative
6 shall advise Morgan Stanley of any concerns and, in response, Morgan Stanley shall detail the
7 steps that Morgan Stanley plans to implement to address such concerns. The reporting or meeting
8 deadlines set forth above may be amended upon Morgan Stanley's request if written permission is
9 received from the representative specified by NASAA.

10 **Relief for Municipal Issuers**

11 23. Morgan Stanley shall promptly refund to municipal issuers refinancing fees the
12 issuers paid to Morgan Stanley for the refinancing of their auction rate securities, where such
13 refinancing occurred between February 11, 2008, and the date of this Order and where Morgan
14 Stanley acted as underwriter for the primary offering of the auction rate securities between August
15 1, 2007, and February 11, 2008. Nothing in this Order precludes the Arkansas Securities
16 Commissioner from pursuing any other civil action that may arise with regard to auction rate
17 securities other than the marketing and sale of auction rate securities to retail investors.

18 **Additional Considerations**

19 24. Nothing herein shall preclude Arkansas, its departments, agencies, boards,
20 commissions, authorities, political subdivisions and corporations (collectively, "State Entities"),
21 other than the Arkansas Securities Commissioner and only to the extent set forth in paragraph 1
22 above, and the officers, agents or employees of State Entities from asserting any claims, causes of
23 action, or applications for compensatory, nominal and/or punitive damages, administrative, civil,
24 criminal, or injunctive relief against Morgan Stanley in connection with certain auction rate
25 securities practices at Morgan Stanley.

1 25. The parties admit and acknowledge that the Arkansas Securities Commissioner has
2 no authority or jurisdiction over any other state or federal agency or regulatory authority.
3 Nonetheless, the Arkansas Securities Commissioner does not intend for this Order to serve as a
4 basis for Respondents' or any of their affiliates' disqualification from registration exemptions or
5 safe harbor provisions contained in the following:

- 6 - Arkansas Securities Act, or rules or regulations thereunder;
- 7 - Federal securities laws, or the rules and regulations thereunder;
- 8 - Rules and regulations of self regulatory organizations; or
- 9 - Various states' or U.S. Territories' securities laws.

10 The Arkansas Securities Commissioner also does not intend for this Order to form a basis for
11 the disqualification of Respondents or any of their affiliates or employees from any business that
12 they are otherwise qualified or licensed to perform.
13

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

17 27. Evidence of a violation of this Order proven in a court of competent jurisdiction
18 shall constitute prima facie proof of a violation of the Arkansas Securities Act, in any civil action
19 or proceeding hereafter commenced by the Arkansas Securities Commissioner against Morgan
20 Stanley.

21 28. Should the Arkansas Securities Commissioner prove in a court of competent
22 jurisdiction that a material breach of this Order by Morgan Stanley has occurred, Morgan Stanley
23 shall pay to the Arkansas Securities Commissioner the cost, if any, of such determination and of
24 enforcing this Order including without limitation legal fees, expenses, and court costs.

25 29. If Morgan Stanley fails to make the payment specified in paragraph 6, the Arkansas
26 Securities Commissioner may, at its sole discretion, pursue any legal remedies, including but not

1 limited to initiating an action to enforce the Order, revoking Morgan Stanley's registration within
2 the state, or terminating this Order.

3 30. If in any proceeding, after notice and opportunity for a hearing, a court of competent
4 jurisdiction, including an administrative proceeding by a state securities administrator, finds that
5 there was a material breach of this Order, the Arkansas Securities Commissioner, at its sole
6 discretion, may terminate the Order. If Morgan Stanley defaults on any other obligation under this
7 Order, the Arkansas Securities Commissioner may, at its sole discretion, pursue legal remedies to
8 enforce the Order or pursue an administrative action, including but not limited to an action to
9 revoke Morgan Stanley's registration within the state. Morgan Stanley agrees that any statute of
10 limitations or other time related defenses applicable to the subject of the Order and any claims
11 arising from or relating thereto are tolled from and after the date of this Order.

12 31. Morgan Stanley shall cooperate fully and promptly with the Arkansas Securities
13 Commissioner and shall use its best efforts to ensure that all the current and former officers,
14 directors, trustees, agents, members, partners, and employees of Morgan Stanley (and of any of
15 Morgan Stanley's parent companies, subsidiaries, or affiliates) cooperate fully and promptly with
16 the Arkansas Securities Commissioner in any pending or subsequently initiated investigation,
17 litigation, or other proceeding relating to auction rate securities and/or the subject matter of the
18 Order. Such cooperation shall include, without limitation, and on a best efforts basis:

19 a. production, voluntarily and without service of subpoena, upon the request of
20 the Arkansas Securities Commissioner, of all documents or other tangible evidence
21 requested by the Arkansas Securities Commissioner and any compilations or summaries of
22 information or data that the Arkansas Securities Commissioner requests that Morgan
23 Stanley (or the Morgan Stanley's parent companies, subsidiaries, or affiliates) prepare,
24 except to the extent such production would require the disclosure of information protected
25 by the attorney-client and/or work product privileges;

1 b. without the necessity of a subpoena, having the current (and making all
2 reasonable efforts to cause the former) officers, directors, trustees, agents, members,
3 partners, and employees of Morgan Stanley (and of any of the Morgan Stanley's parent
4 companies, subsidiaries, or affiliates) attend any Proceedings (as hereinafter defined) in
5 Arkansas or elsewhere at which the presence of any such persons is requested by the
6 Arkansas Securities Commissioner and having such current (and making all reasonable
7 efforts to cause the former) officers, directors, trustees, agents, members, partners, and
8 employees answer any and all inquiries that may be put by the Arkansas Securities
9 Commissioner to any of them at any proceedings or otherwise, except to the extent such
10 production would require the disclosure of information protected by the attorney-client
11 and/or work product privileges. "Proceedings" include, but are not limited to, any
12 meetings, interviews, depositions, hearings, trials, grand jury proceedings, or other
13 proceedings;

14 c. fully, fairly, and truthfully disclosing all information and producing all
15 records and other evidence in its possession, custody, or control (or the possession, custody,
16 or control of the Morgan Stanley parent companies, subsidiaries, or affiliates) relevant to all
17 inquiries made by the Arkansas Securities Commissioner concerning the subject matter of
18 the Order, except to the extent such inquiries call for the disclosure of information protected
19 by the attorney-client and/or work product privileges; and

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

24 33. In the event Morgan Stanley fails to comply with paragraph 31 of the Order, the
25 Arkansas Securities Commissioner shall be entitled to specific performance, in addition to any
26 other available remedies.

Dated this 25th day of March, 2010.

BY ORDER OF THE ARKANSAS SECURITIES COMMISSIONER


A. Heath Abshire, Commissioner

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2 **CONSENT TO ENTRY OF CONSENT ORDER BY MORGAN STANLEY & CO.**
3 **INCORPORATED**

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

7 Morgan Stanley admits the jurisdiction of the Arkansas Securities Commissioner, neither
8 admits nor denies the Findings of Fact and Conclusions of Law contained in this Consent Order; and
9 consents to entry of this Consent Order by the Arkansas Securities Commissioner as settlement of the
10 issues contained in this Consent Order.

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

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

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

19 Dated this 17th day of March, 2010.

20 MORGAN STANLEY & CO. INCORPORATED

21 By: [Signature]

22 Title: Executive Director

23 STATE OF New York)

24 County of New York)

25 SUBSCRIBED AND SWORN TO before me this 17 day of March, 2010.

26 [Signature]
Notary Public

My commission expires:

11/27/2013

DANA BALACEK
NOTARY PUBLIC, State of New York
No. 01BA5052647
Qualified in Suffolk County
Commission Expires Nov. 27, 2010