

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 20080157171**

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

RE: Morgan Stanley & Co. Incorporated, Respondent
CRD No. 8209

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Morgan Stanley & Co., Incorporated ("Respondent" or "the Firm" or "MS & Co. Inc.") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Respondent alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. Respondent 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

MS & Co. Inc. and its predecessors have been members of FINRA since 1936. MS & Co. Inc. maintains its principal place of business in New York, New York and has branch offices throughout the country. During the relevant time period, MS & Co. Inc. engaged in a general securities business that included retail and institutional brokerage services, trading and advisory services. MS & Co. Inc. trades securities for institutional and individual clients as well as for proprietary accounts.

RELEVANT DISCIPLINARY HISTORY

MS & Co. Inc. has previously been disciplined on a number of occasions for violations of Rules pertaining to supervisory procedures, including the following:

- In August 2010, MS & Co. Inc. consented to an \$800,000 fine. The sanctions were based on findings that MS & Co. Inc. had inadequate policies and procedures in place to ensure that it made accurate disclosures under FINRA's rules governing research analyst conflicts of interest, and to ensure compliance with a previously-imposed undertaking. (Letter of Acceptance, Waiver and Consent 2008013782301).
- In March 2009, MS & Co. Inc. consented to a \$3 million fine, and agreed to pay restitution of over \$2 million to retiree or potential retiree clients. The sanctions were based on FINRA's findings that MS & Co. Inc. failed to adequately supervise the activities of certain brokers, who had failed to provide appropriate risk disclosures and suitable recommendations with respect to their handling of IRA rollover/retirement accounts. (Letter of Acceptance, Waiver and Consent 2006005132302).
- In September 2007, MS & Co. Inc. consented to a \$3 million fine and establishment of a reimbursement fund of \$9.5 million. The sanctions were based on findings that MS & Co. Inc. had failed to establish and maintain written procedures reasonably designed to preserve required records and to ensure that MS & Co. Inc. conducted adequate searches in response to regulatory inquiries and discovery requests. (Letter of Acceptance, Waiver and Consent 2005001449202).
- In New York Stock Exchange Hearing Board Decision 07-66, published in June 2007, MS & Co. Inc. consented to findings that it violated the NYSE supervisory rule. Among other deficiencies, the Firm failed to provide for appropriate supervisory controls regarding the monitoring of client accounts for suitability of investments, including guardian accounts established for minors pursuant to court orders implementing medical malpractice settlements. MS & Co. Inc. also lacked written supervisory procedures for reviewing and approving block trades. MS & Co. Inc. consented to a censure, a \$500,000 fine, and an undertaking.

OVERVIEW

During the period of 2004-2007 (the "Relevant Time Period"), MS & Co. Inc. violated FINRA rules by failing to establish adequate written supervisory procedures and failing to reasonably supervise two different types of transactions.

These transactions, referred to as "Total Return Swaps" and "off-shore Stock Loans," were designed to generate for certain off-shore clients a perceived tax advantage related to dividend income on U.S. equities. The advantage was known by various terms throughout the industry, including "dividend uplift," "dividend enhancement," or "yield enhancement." These terms represented the amount that would have been withheld in taxes on a dividend, but that the client obtained through a transaction with MS & Co. Inc. and/or its affiliates. In both types of transactions, the client did not hold the stock on the dividend record date. Instead, MS & Co. Inc. structured the subject transactions as swaps or loans, and provided yield enhancement as part of a securities derivative or stock loan-related payment.

With respect to the Total Return Swaps, the Firm failed to establish and to enforce adequate written procedures and operational controls. As a result, the Firm was unable to substantiate the validity of the yield enhancement payment.

With respect to the off-shore Stock Loans, the Firm failed to establish written supervisory procedures, and lacked effective working control of business operations that involved Firm clients, client securities that were custodied in accounts at the Firm, and Firm personnel.

Based on the above supervisory failures, MS & Co. Inc. violated NASD Rules 3010 and 2110.

FACTS AND VIOLATIVE CONDUCT

Failure to Supervise

NASD Rule 3010 requires member firms to establish and maintain a system, including written procedures, to supervise the activities of its employees. Further, this system must be reasonably designed to achieve compliance with applicable securities laws and regulations.

As shown below, with respect to the Total Return Swaps and off-shore Stock Loans that were designed to generate yield enhancement on U.S. equities, MS & Co. Inc. failed to establish and/or enforce effective written supervisory procedures. The Firm also failed to adequately supervise the activities of MS & Co. Inc. personnel and business operations regarding these transactions. Accordingly, MS & Co. Inc. violated NASD Rule 3010 and NASD Rule 2110.

Total Return Swaps and Off-Shore Stock Loans

Total Return Swaps

A swap is a contractual arrangement between two parties who agree to exchange cash flows that replicate the economics of owning an underlying equity (or index or basket of stocks). The buyer of a swap has the risks and benefits of owning the underlying equity, while the seller of the swap has countervailing risks and benefits. Thus, the buyer pays the seller if the underlying equity goes down in value, and the seller pays the buyer if the underlying equity goes up in value. In the swaps at issue here, the "total return" that the buyer received also included an amount equivalent to any dividends.

Under regulations in effect during the Relevant Period, payments of dividends on U.S. equities held by an offshore investor were taxed, but dividend equivalent payments made to the same recipient under a swap agreement were not. This distinction gave offshore investors incentive to enter into swaps involving U.S. equities before the dividend record date. Broker-dealers competed for the swaps business of those investors.

Structure of the Total Return Swap Transactions

MS & Co. Inc. took part in the swap transactions at issue along with an affiliate, Morgan Stanley Capital Services, Inc. ("MSCSI"), which is not a FINRA-regulated broker-dealer. During the Relevant Time Period, certain off-shore clients of MS & Co. Inc. and/or MSCSI used Total Return Swaps involving MS & Co. Inc. to achieve such yield enhancement.

In the Total Return Swaps that are the subject of this AWC, an off-shore client sold to MS & Co. Inc., as principal, or through MS & Co. Inc., as agent, shares of a dividend-paying security (or index or basket) of a U.S. issuer (or issuers). These sales took place shortly before the dividend record date. At the same time as this sale, the client entered into a swap with MSCSI. The swap referenced the same equity as the security sold to or through MS & Co. Inc. To hedge its investment in the swap, MSCSI purchased, from MS & Co. Inc. as principal, or through MS & Co. Inc., as agent, shares of the equity security underlying the swap. In accord with the swap, MSCSI made periodic payments to the off-shore client, who was the counterparty. These periodic payments were based on the income the stock generated, and included payment of the yield enhancement amount.

The swap was terminated later, generally at the request of the off-shore client. At the swap's termination, MSCSI sold the stock that it had held as a hedge. In certain cases, the client also reacquired the equity after the swap's termination and those instances comprise the Total Return Swaps that are the subject of this AWC.

Failure to Supervise Total Return Swaps

A yield enhancement payment would be improper if the client retained beneficial ownership of the stock throughout the life of the swap. The client would retain such ownership if the Total Return Swap was effectively a repurchase or stock loan agreement. Moreover, independent stock sales and purchases would be reported and recorded differently than repurchase or stock loan agreements.

To support the legitimacy of its affiliate's yield enhancement payment, the Firm had to be able to substantiate that the client surrendered beneficial ownership of the stock during the life of the swap, and that the reacquisition of the stock was independent of the swap. Whether the client engaged in market risk in these transactions is a key factor in determining the propriety of the yield enhancement payment.

Because of the supervisory failures discussed immediately below, however, MS & Co. Inc. was unable to substantiate the propriety of the yield enhancement payments in the Total Return Swaps. The Firm failed to establish and maintain written supervisory procedures that were reasonably designed to ensure compliance with applicable laws and regulations. The Firm's procedures were inadequate in some respects, and in other respects were not appropriately enforced by MS & Co. Inc.

Areas in which the Firm exhibited such supervisory deficiencies involved the following: the use of "crosses;" short-term transactions; and market-on-close pricing.

In a "cross" trade, the parties conduct the securities transaction directly with each other, and execute it in the over-the-counter market. In the Total Return Swaps, the "cross in" occurred when the client sold the stock to MS & Co. Inc. at the start of the transaction. The "cross back" occurred when the client reacquired the stock from MS & Co. Inc. after the swap was unwound. Although the procedures broadly prohibited clients who had "crossed in" stock from "crossing back," the procedures permitted, and MS & Co. Inc. participated in, transactions where the stock had been crossed in and was crossed back to clients at the close of the swap, if the clients merely orally represented that the shares were needed to cover a short position. MS & Co. Inc. and/or MSCSI undertook no efforts beyond obtaining oral representations to determine whether clients were in fact covering short positions, or if they were re-establishing physical positions after they received the yield enhancement payment. Based on this failure, in a significant number of instances, the Firm was unable to substantiate the client's exposure to market risk and that the sale and purchase of the equity were independent from each other.

Additionally, although the Firm's procedures anticipated that swaps remain open for a minimum term, typically one year, swaps were often terminated early at the client's request. For example, in 2005, 638 swaps were open for less than 45 days and, of these, 379 were open for less than 20 days. Further, among swaps that were open for less than 45 days, MS & Co. Inc. permitted crossing on both sides of the transaction in 73 instances in 2003, 145 instances in 2004, and 175 instances in 2005.¹ MS & Co. Inc. also permitted Total Return Swaps that were crossed on both sides and were either closed, or both opened and closed, within two weeks of the ex-dividend date, on 57 instances in 2005, seven in 2006, and three in 2007. Allowing clients to cross in and out, particularly when they did so in trades that bracketed the dividend dates, enabled clients to re-establish their original securities position in a manner that minimized their market risk.

Further, in cases where there was no "crossing back," the procedures failed to prevent counterparties from unwinding a swap at the closing price of the underlying equity. In practice, this allowed clients to re-establish their securities positions at minimal market risk. Clients engaged in such a practice knew they could unwind the swap and purchase the same amount of the securities at the same, or nearly the same, price.

In sum, because of the above-described deficiencies in its written supervisory procedures and supervision, MS & Co. Inc. was unable to substantiate that yield enhancement payments on U.S. equities had been properly made. These supervisory failures violated NASD Rule 3010 and NASD Rule 2110.

¹ In 2005, the procedures were changed and MS & Co. Inc. and MSCSI began phasing out all "crossing back." In or about the end of 2007, MS & Co. Inc. and MSCSI ceased crossing stock back for all clients.

The Off-Shore Stock Loans

Stock Loans and Dividend Payments

In a typical stock loan transaction, the borrower and the lender establish the terms of the transaction. These terms include the lending fee, which is the cost the borrower will pay to borrow the securities. When a stock loan occurs, the lender no longer retains the right to receive dividends on the security that has been lent. Instead, the borrower typically agrees to pay a "substitute dividend" amount to the lender.

The off-shore Firm clients who were the lenders in the off-shore Stock Loans were two entities, who were hedge fund advisors, and the six hedge funds that they controlled. Any dividends on U.S. equities held by these investors were subject to withholding tax. The off-shore Stock Loan program sought to qualify these investors for yield enhancement by having them loan their shares in advance of the record date.

The Process Involved in the Off-Shore Stock Loans at Issue

The off-shore Stock Loans were structured by employees of a British affiliate of the Firm, Morgan Stanley & Co. International Plc. ("MS London"). In the off-shore Stock Loans at issue in this AWC, stock in U.S. companies on which a dividend was expected to be declared was "sourced," or made available for borrowing, from the accounts of MS & Co. Inc. clients ("MS & Co. Inc.'s off-shore stock loan clients").

The shares involved were held in custody for the off-shore stock loan clients at MS & Co. Inc., and the off-shore Stock Loan transactions were reflected in the books and records of MS & Co. Inc. MS & Co. Inc. employees were involved in facilitating and processing these stock loans from approximately February 2005 through 2006. The off-shore Stock Loan transactions also involved: MS London employees; MS & Co. Inc.'s Cayman Island affiliate, MSDW Equity Finance Services I (Cayman) Limited ("Cayco"),² and additional off-shore counterparties. The Firm did not develop written supervisory procedures for the off-shore Stock Loans.

In practice, the loans were processed in the following manner. Acting on either a standing or a specific order from the client, MS London employees notified MS & Co. Inc. employees to initiate the operations involved. MS & Co. Inc. back office employees then transferred custody of the shares from accounts at MS & Co. Inc. to Cayco.³ There, MS London employees, acting on behalf of Cayco, lent the shares to another borrower. After the dividend record date, the borrower returned the shares to Cayco, which returned the shares through the above-described series to the account of MS & Co. Inc.'s client. The borrower also made its stock lending fee

² Cayco was chartered as a corporation in the Cayman Islands. It was wholly owned by MSDW Offshore Equity Services, a United States corporation that was owned by MS & Co. Inc.'s parent company, and the Cayco Board of Directors was comprised in whole or part of employees of MS & Co. Inc. and its affiliates based in New York and London.

³ Cayco had limited capital, no premises in the Cayman Islands, and no employees of its own. Cayco functioned as a passive vehicle for the stock lending transactions that were processed through it. Transactions for Cayco were processed by MS London employees.

payments and substitute dividend payments to Cayco. Cayco and then MS & Co. Inc. passed those payments through the series described above to MS & Co. Inc.'s off-shore stock loan client, minus fees as negotiated.

Tax withholding rates varied based on where the party entitled to the dividend was located. For the MS & Co. Inc. off-shore stock loan clients, the withholding rate was 30%. According to MS & Co. Inc.'s understanding of tax guidance, withholding of taxes on dividends was not required if: (1) a transaction was structured as a stock loan; and (2) all the parties to that loan were otherwise subject to the same tax withholding rate. Cayco was used in the off-shore Stock Loan transactions, and directed to lend only to off-shore borrowers, specifically to meet the latter criterion. MS & Co. Inc. allowed affiliates to initiate and conduct the off-shore Stock Loan transactions without sufficient oversight from MS & Co. Inc.

Failure to Supervise Off-Shore Stock Loans

Although these stock lending transactions involved MS & Co. Inc. clients and employees, and involved securities held in accounts at MS & Co. Inc., these operations were undertaken without written supervisory procedures for these transactions. In the absence of written procedures and without working control and sufficient oversight of these operations, MS & Co. Inc. was unable to supervise effectively this aspect of its business, and, in particular, to substantiate that these transactions were conducted in a manner that made certain that yield enhancement was appropriate.

In or about 2005, MS & Co. Inc. commenced a review of the off-shore Stock Loans. Following that review, at or about year-end 2006, MS & Co. Inc. determined to stop sourcing U.S. equities for such transactions from MS & Co. Inc.'s off-shore stock loan clients. The Firm reached this decision because of its concerns about its ability to maintain adequate controls over these operations.

In sum, MS & Co. Inc. failed to establish written supervisory procedures for the off-shore Stock Loans and failed to supervise reasonably these operations, in violation of NASD Rules 3010 and 2110.

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

1. a censure; and
2. a fine of \$575,000.

Respondent agrees to pay the monetary sanctions upon notice that this AWC has been accepted and that such payment is due and payable. Respondent has submitted an Election of Payment form showing the method by which Respondent proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim that Respondent is unable to pay, now or at any time hereafter, the monetary sanctions 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 Respondent;
- B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the 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.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Respondent understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule

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:

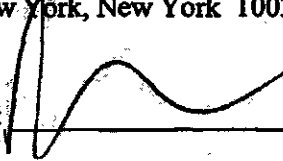
1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against Respondent;
2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about Respondent's 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 has been given a full opportunity to ask questions about it; that the Firm 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.

Date: May 24 2011

Respondent
Morgan Stanley & Co. Incorporated
1585 Broadway
New York, New York 10036-8293

By: 

Matthew E. Berke
Managing Director

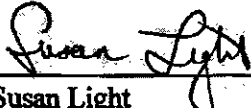
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Counsel for Respondent

Accepted by FINRA:

June 28, 2011
Date

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


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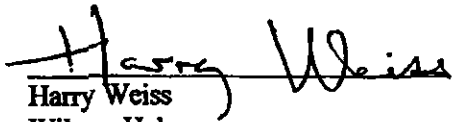
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Date: May 24, 2011

Respondent
Morgan Stanley & Co. Incorporated
1585 Broadway
New York, New York 10036-8293

By: _____

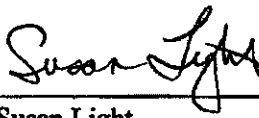
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Counsel for Respondent

Accepted by FINRA:

June 28, 2011
Date

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


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