

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2011029683301**

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

RE: Morgan Stanley Smith Barney LLC, Respondent
Member Firm
CRD No. 149777

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Respondent Morgan Stanley Smith Barney LLC ("MSSB" or "Respondent") 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 MSSB 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

MSSB was created on June 1, 2009, through the contribution of the Global Wealth Management Group of Morgan Stanley & Co. Incorporated ("Morgan Stanley") and the Smith Barney Division ("Smith Barney") of Citigroup Global Markets, Inc. ("Citigroup") into a joint venture that owned MSSB. In June of 2013, Morgan Stanley completed the purchase of Citigroup's portion of the joint venture and became the sole owner of the business. As of March 2014, MSSB had approximately 25,000 registered individuals and 830 branches.

OVERVIEW

During the period June 1, 2009, through December 31, 2011 ("the relevant period"), MSSB paid more than \$100 million in commissions to approximately 780 former registered representatives who had retired from Morgan Stanley, Smith Barney, or MSSB. At the time of these payments, many of the individuals were not registered or associated with a registered firm. The payments were made under a program that allowed payments to unregistered, retired representatives in compliance with a No-Action Letter issued by the Securities and Exchange Commission in November 2008. The No-Action Letter stated that the staff would not recommend enforcement action to the SEC

for violations of Section 15(a) of the Securities Exchange Act of 1934 if the conditions set out in the letter were met.

Prior to making payments to these unregistered, retired representatives, MSSB adopted procedures that required the creation and maintenance of certain documents called for by the No-Action Letter. The required documents included written acknowledgements by retired representatives upon enrolling in the program that they could not solicit securities transactions as well as annual certifications from the retired representatives affirming that they had not contacted customers for securities-related purposes. In addition, MSSB's procedures required that the firm contact the retired representatives' former customers annually to confirm that the retired representatives had not provided investment advice or solicited trades in securities. In addition to being called for by the No-Action Letter, compliance with these procedures would have permitted MSSB to detect whether the retired representatives were acting as unregistered brokers in violation of Section 15(a) of the Exchange Act and whether MSSB was making payments in violation of NASD Rule 2420.

MSSB, however, failed on a widespread basis to comply with its own procedures and, therefore, failed to create or maintain documentation called for by the No-Action Letter as to a significant proportion of the retired representatives it paid during the relevant period. As a result, MSSB was not able to determine whether payments it made to numerous retired representatives complied with the terms of the No-Action Letter or instead may have violated Section 15(a) or NASD Rule 2420.

By failing to establish, maintain, and enforce written procedures to supervise the payment of continuing commissions to retired representatives that were reasonably designed to achieve compliance with Section 15(a) of the Exchange Act and NASD Rule 2420, and by failing to detect widespread non-compliance with its existing procedures for the creation and maintenance of certain documentation required by the 2008 No-Action Letter, MSSB violated NASD Rule 3010. As a result of violating NASD Rule 3010, MSSB also violated FINRA Rule 2010.

FACTS AND VIOLATIVE CONDUCT

FACTS

Background on Payment of Continuing Commissions, the SEC's 2008 No-Action Letter, and NASD IM-2420-2

Payment of transaction-based compensation, or commissions from securities transactions, to MSSB's retired representatives could violate Section 15(a) of the Exchange Act and NASD Rule 2420 because the retired representatives are not registered with the SEC or associated with a registered firm.

Section 15(a) of the Exchange Act generally prohibits an individual from effecting securities transactions for customers without first being registered with the SEC as a broker or being associated with a firm that is registered as a broker. A violation may be

established by an unregistered individual's receipt of transaction-based compensation (*i.e.*, commissions). Similarly, NASD Rule 2420 prohibits FINRA members from paying any commissions or fees derived from securities transactions to any individual who may be acting as an unregistered broker.

In November 2008, the SEC's Division of Trading and Markets issued a No-Action Letter indicating that the staff would not recommend an enforcement action under Section 15(a) of the Exchange Act against a firm or a retired representative relating to continuing the payment of commissions to a retired representative so long as the firm, the retired representative, and the receiving representative (*i.e.*, the individual who would continue to service the accounts after the retired representative left the firm) met certain conditions before and during the payment of continuing commissions to the retired representative. As relevant to this AWC, the conditions set out in the No-Action Letter on the retired representative and the firm included:

- The retired representative must not contact former customers for the purpose of soliciting them to enter into securities transactions, discussing any transactions, or providing securities-related services or advice. The retired representative must acknowledge this limitation in writing;
- The retired representative must certify at least annually to the firm that he or she has adhered to the requirements and conditions of the continuing commission arrangement—*e.g.*, that he or she has not contacted customers for securities-related purposes; and
- The firm must contact a representative sample of the retired representative's former customers—including a significant set of high-grossing customer accounts—at least annually to confirm that the retired representative has not provided investment advice or solicited trades in securities in any way.¹

Since 1998, NASD IM-2420-2 has stated that payment of continuing commissions to retired representatives "will not be deemed in violation of Association Rules [*e.g.*, NASD Rule 2420], provided that bona fide contracts call for such payment." NASD IM-2420-2 further notes, among other things, that a contract for the payment of continuing commissions shall not under any circumstances be deemed to permit the solicitation of

¹ The No-Action Letter imposed additional conditions, including:

- The retiring representative must have been continuously employed by or otherwise associated with the firm for not less than three years;
- The retiring representative must demonstrate that he or she conducted himself or herself in a manner exhibiting appropriate standards of professionalism and ethical conduct;
- If a retiring representative had been named in investment-related complaints during the three years prior to retirement, the firm must determine in its reasonable judgment that the representative was not responsible for the conduct or that it involved non-sales practice allegations;
- The retiring representative must not be subject to statutory disqualification;
- The firm must establish parameters for a reasonable time period following retirement and a percentage scale regarding the sharing of commissions; and
- Various other criteria imposed on the receiving representative.

new business or the opening of new accounts by individuals who are not registered and that any arrangement for the payment of continuing commissions must conform with applicable laws (e.g., Section 15(a) of the Exchange Act).

MSSB's System to Supervise Its Payment of Continuing Commissions

Before the creation of MSSB, both Morgan Stanley and Smith Barney separately had programs through which each firm paid retired representatives continuing commissions. After the creation of MSSB on June 1, 2009, the merged firm continued the practice of paying retired representatives commissions based on transactions undertaken by those representatives' former customers. The retired representatives would be paid a portion of the commissions for such transactions for a set period of time after the representative's retirement, generally three-to-five years. During the first six months following the creation of MSSB, the firm continued to use the legacy Smith Barney and legacy Morgan Stanley programs. The legacy programs formally were merged in January 2010 to create the Former Financial Advisor Program ("FFAP"). MSSB conducted the programs because it believed the payments facilitated the transfer of a retired representative's accounts to a successor registered representative while also providing the retired representative with a stream of income for a defined period of time following retirement.

MSSB's FFAP and its predecessor programs used similar systems and procedures during the relevant period. MSSB did not have a section of its written supervisory procedures addressing the payment of continuing commissions under the FFAP or predecessor programs, nor did MSSB have any centralized method for supervising such payments. Instead, MSSB's procedures consisted of written instructions sent by the firm's Human Resources Department to the branches where the retiring representatives had worked. Consistent with the requirements of the 2008 No-Action Letter, these procedures required the branch offices to obtain from the retired representatives at the time of enrollment written acknowledgement that they could not solicit securities transactions. The procedures also required branches to obtain annual certifications from the retired representatives confirming that they had adhered to all the requirements of their continuing commission agreements—including a certification that they had not contacted customers for securities purposes or engaged in the securities business in any way. MSSB's procedures also required that branch offices send initial and annual letters to customers explaining that their retired representatives should not provide financial advice and asking the customers to contact the firm if their former representatives had provided investment advice or solicited securities trades.

MSSB's Human Resources Department and individual branch offices worked together to arrange a retired representative's initial enrollment in one of the continuing commissions programs. Once a retired representative was enrolled in one of the programs, however, the individual branches were responsible for ongoing compliance with the programs' documentation requirements—including the creation and maintenance of retired representative certifications, the initial customer letters, and the annual customer letters.

MSSB Paid Retired Representatives in Excess of \$100,000,000 in Continuing Commissions Without Complying with Its Procedures or the 2008 No-Action Letter.

During the relevant period, approximately 780 retired representatives from approximately 500 different MSSB branch offices participated in the firm's continuing commissions programs—either the FFAP or one of the legacy Smith Barney or legacy Morgan Stanley programs. MSSB paid in excess of \$100,000,000 in continuing commissions to these retired representatives during the relevant period.

MSSB, however, failed on a widespread basis to enforce its procedures regarding the creation and maintenance of the retired representative certifications and customer letters described above. MSSB failed to create or maintain the required retired representative certifications or customer letters for a significant proportion of the retired representatives to whom it paid continuing commissions.

The certifications and letters that MSSB failed to create or maintain were necessary to comply with the terms of the 2008 No-Action Letter. They also were necessary to permit MSSB to detect whether the retired representatives were acting as unregistered brokers in violation of, among other things, Section 15(a)(1) of the Exchange Act. As a result of its failure to enforce its procedures, MSSB paid over \$100 million in continuing commissions to approximately 780 retired representatives, many of whom were not registered, without adhering to the terms of the No-Action Letter. MSSB thus did not have an effective mechanism to determine whether those payments were being made in compliance with Section 15(a) of the Exchange Act and NASD Rule 2420.

MSSB's Changes to the FFAP

In late 2010 and 2011, MSSB's Compliance Department conducted assessments of the FFAP and its predecessor programs that identified the deficiencies described above. After these assessments, MSSB made changes to the FFAP and how MSSB supervised it that were intended to correct the deficiencies. In or about March 2012, MSSB sent letters to former customers of retired representatives, informing them that retired representatives "[are] legally prohibited from providing investment advice" and asking the customers to contact the firm if they had "received investment advice from" a retired representative. MSSB did not receive any responses from customers indicating that retired representatives had contacted them for securities-related purposes. Also in or about March 2012, MSSB obtained from all retired representatives in the program certifications stating that they had not provided any "clients with any investment advice since the inception of the [FFAP] agreement." In addition, MSSB designated personnel to oversee the firm's process for obtaining annual retired representative certifications on a national level and centralized the process for contacting the retired representatives' former clients annually—rather than leaving such efforts exclusively to individual branches.

VIOLATIONS

NASD Rule 3010(a) requires that "[e]ach member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other

associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.” NASD Rule 3010(b) requires that each member firm “establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD.”

Here, MSSB established written procedures that required branch personnel to create and maintain certain documents in connection with the payment of continuing commissions to retired representatives under its FFAP and predecessor programs. As described above, the documents required by MSSB’s written procedures were necessary in order for MSSB to comply with the SEC’s 2008 No-Action Letter and with NASD IM-2420-2.

However, MSSB failed to enforce its written procedures, resulting in a widespread failure to create or maintain certain required documents (*i.e.*, certifications from retired representatives, initial and annual letters to clients) during the relevant period. MSSB failed to create or maintain the required documentation for a significant proportion of the retired representatives to whom it paid continuing commissions. MSSB’s failure to enforce its own procedures—and its failure to detect promptly its non-compliance—led to the widespread failure to comply with important requirements set forth in the SEC’s 2008 No-Action Letter. This failure also prevented MSSB from effectively supervising the payment of continuing commissions to retired representatives to ensure the firm’s compliance with Section 15(a) of the Exchange Act and NASD Rule 2420.

Thus, MSSB violated NASD Rule 3010 by (i) failing to establish, maintain, and enforce written procedures to supervise the FFAP and predecessor programs that were reasonably designed to achieve compliance with Section 15(a) of the Exchange Act and NASD Rule 2420, and (ii) failing to detect non-compliance with its existing procedures. As a result of violating NASD Rule 3010, MSSB also violated FINRA Rule 2010.

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

- a censure and
- a fine of \$1,000,000.

In addition, Respondent agrees to comply with the following undertakings:

(1) Respondent will conduct a review of its systems and written procedures used to supervise the FFAP or similar program involving the payment of commissions to retired representatives to determine: (A) that those systems and written procedures are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD and FINRA Rules and (B) that those systems and written procedures have been adequately revised to address and correct the deficiencies described in this AWC.

(2) Within 120 calendar days of the issuance of this AWC, an officer of MSSB shall certify to FINRA in writing that MSSB has conducted the review described in paragraph (1) and that, as of the date of the certification, MSSB has in place written supervisory procedures that address and correct the violations described in this AWC. This certification must be submitted to the undersigned and shall be accompanied by a description of the reviews and revisions undertaken by MSSB. The Department of Enforcement may, upon a showing of good cause and its sole discretion, extend the time for compliance with this provision.

Respondent agrees to pay the monetary sanction 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 it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanction imposed in this matter.

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

- A. To have a Complaint issued specifying the allegations against it;
- B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, 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: (i) testimonial obligations; or (ii) 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 Respondent, 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 Respondent has agreed to its provisions voluntarily;

and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce Respondent to submit it.

Morgan Stanley Smith Barney LLC

June 9, 2014
Date

By: Harry T. Walters
Harry T. Walters
Managing Director

Reviewed by:

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Counsel for Respondent

Accepted by FINRA:

July 3, 2014
Date

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

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