

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT**

NO. 20120347147 - 01

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

RE: Morgan Stanley Smith Barney LLC, Respondent
Broker-Dealer
CRD No. 149777

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Morgan Stanley Smith Barney LLC (the "firm") 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 the firm alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. The firm 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

The firm has been a member of FINRA since May 19, 2009, and its registration remains in effect.

RELEVANT DISCIPLINARY HISTORY

The firm has no relevant disciplinary history.

SUMMARY

In connection with 20120347147, the staff of the Market Regulation Department (the “staff”) reviewed the firm’s compliance with best execution requirements for National Market System (“NMS”) securities during the period January 1, 2012 through September 30, 2013 (the “NMS review period”).

In connection with 20120352216, the staff reviewed the firm’s compliance with order protection requirements for over-the-counter (“OTC”) securities during the period January 1, 2012 through September 30, 2013 (the “OP review period”).

In connection with 20140434333, the staff reviewed the firm’s compliance with best execution requirements for OTC securities during the period April 1, 2014 through November 30, 2014 (the “OTC review period”).

In connection with 20150465578, the staff reviewed the firm’s compliance with FINRA rules relating to the execution of held market orders for the period April 1, 2015 through September 30, 2015 (the “2Q15 and 3Q15 periods”).

Based on the foregoing reviews, the staff determined that the firm violated FINRA Rules 7230A, 5320, 5310, 4511(a), and 2010; NASD Rule 3010; and Section 17(a) of the Securities Exchange Act of 1934 (“Exchange Act”) and SEC Rule 17a-3 thereunder.

FACTS AND VIOLATIVE CONDUCT

20120347147 (Jan. 2012 – Sept. 2013 NMS Best Execution review)

Background. The trades the staff selected for review mainly involved exchange-traded preferred securities, the orders for which were placed through a Financial Advisor (“FA”), who would typically gather together several orders from different customers in response to being shown an offer from the trading desk for preferred securities (“Preferreds Desk”). The FA would then aggregate the orders and communicate the aggregate amount to the firm’s fixed income sales department (“Sales Department”), which served as a liaison between the FA and the Preferreds Desk. These communications took place typically by phone, and then were memorialized when the FA subsequently entered the individual orders into the firm’s trading system. Trades effected in this fashion are referred to herein as “verbal trades.”

At the end of this “verbal trade” process, the time of order receipt captured by the firm’s order management system reflected the time the order was entered into the system, rather than the time the order was actually received from the customer. Likewise, the time of execution populated in the firm’s order management system reflected the time the trader entered the execution into the system, rather than the time of the trade execution. The actual order receipt time and execution time were not recorded. The incorrect execution times likewise were reported from the order management system to the FINRA Trade

Reporting Facility (“TRF”). Also as a result of this process, some or all of the “verbal trades” were not reported to the TRF in a timely fashion. During a sample month selected by the staff from the 21-month NMS review period, there were a total of 483 trades that may have been “verbal trades.”

In addition, to facilitate orders in connection with these “verbal trades” and ensure they were routed to the Preferreds Desk where they could be aggregated and executed together at the price previously communicated by the Preferreds Desk, the FA denoted the orders as “Not Held.” The firm acknowledges that in certain instances orders were marked as “Not Held” even though the customers did not instruct the firm to handle the orders on a “Not-Held” basis. Moreover, the firm’s supervisory system, which included an equity best execution surveillance tool that could identify potential violations for further review, did not consider “Not Held” orders. As a result, even if the order entry and execution times had been recorded correctly—in which case the “verbal trades” could have been subjected to a reliable best execution analysis—the firm’s surveillance tool was not programmed to review them.

Violations.

1. During the NMS review period, the firm routinely failed to show the correct time of order receipt and/or execution on the memorandum of brokerage orders for trades in NMS stock executed through the “verbal trade” process by the Preferreds Desk. The conduct described in this paragraph constitutes separate and distinct violations of Section 17(a) of the Exchange Act, SEC Rule 17a-3, and FINRA Rule 4511.
2. During the NMS review period, the firm routinely failed to report the correct time of execution to the TRF for trades in NMS stocks executed through the “verbal trade” process by the Preferreds Desk. In addition, the firm failed to transmit such trades to the TRF within the time required by FINRA Rule 7230A. The conduct described in this paragraph constitutes separate and distinct violations of FINRA Rule 7230A.
3. During the NMS review period, the firm’s supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to certain applicable securities laws and regulations, and/or the Rules of FINRA, concerning recordation of order receipt time and execution time, trade reporting, and best execution requirements as they pertain to NMS preferred securities. Specifically, the firm’s supervisory system did not include written supervisory procedures providing for (1) the identification of the person(s) responsible for supervision with respect to the applicable rules; (2) a statement of the supervisory steps to be taken by the identified person(s); (3) a statement as to how often such person(s) should take such steps; and (4) a statement as to how the completion of the steps included in the written supervisory procedures should be documented. The conduct described in this paragraph constitutes violations of NASD Rule 3010 and FINRA Rule 2010.

20120352216 (Jan. 2012 – Sept. 2013 OTC Order Protection review)

Background. During the OP review period, the firm had incorrectly taken the view that OTC preferred securities were exempt from FINRA Rule 5320 and therefore the firm had no “Manning obligations”¹ with respect to such securities. As a result of this interpretation, the firm’s traders were permitted to manually disable the firm’s automated trading ahead protection function (“auto-Manning”) in the firm’s order management system for customer orders in OTC preferreds. This was done by marking orders in OTC preferreds with an “MX” (Manning Exempt) flag. Orders marked MX were not subjected to trading ahead protection nor were they included in supervisory reviews designed to identify potential instances of trading ahead. Moreover, the firm had no supervisory procedures in place to ensure that its traders were appending the MX flag for a valid reason.

Violations.

4. In 1,851 instances during the OP review period, the firm failed to contemporaneously or partially execute 683 customer orders in 66 OTC securities after it traded each subject security for its own market-making account at a price that would have satisfied each customer’s limit order. The conduct described in this paragraph constitutes separate and distinct violations of FINRA Rules 5320 and 2010.
5. During the OP review period, the firm’s supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to certain applicable securities laws and regulations, and/or the Rules of FINRA, concerning FINRA Rule 5320 (trading ahead) as it pertains to executed and unexecuted orders in OTC preferred securities. Specifically, the firm’s supervisory system did not include written supervisory procedures providing for (1) the identification of the person(s) responsible for supervision with respect to the applicable rules; (2) a statement of the supervisory steps to be taken by the identified person(s); (3) a statement as to how often such person(s) should take such steps; and (4) a statement as to how the completion of the steps included in the written supervisory procedures should be documented. The conduct described in this paragraph constitutes violations of NASD Rule 3010 and FINRA Rule 2010.

¹ As set forth in NTM 05-69, “FINRA IM 2110-2, Trading Ahead of Customer Limit Order (commonly referred to as the ‘Manning Rule’) generally prohibits firms from trading for their own account at prices that would satisfy a customer’s limit order, unless the member immediately thereafter executes the customer limit order.”

20140434333 (Apr. – Nov. 2014 OTC Best Execution review)

6. In 74 transactions for or with a customer in preferred securities, the firm failed to use reasonable diligence to ascertain the best inter-dealer market and failed to buy or sell in such market so that the resultant price to its customer was as favorable as possible under prevailing market conditions. The conduct described in this paragraph constitutes separate and distinct violations of FINRA Rules 5310 and 2010.
7. During the OTC review period, the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to certain applicable securities laws and regulations, and/or the Rules of FINRA, concerning best execution requirements as they pertain to new issue non-convertible preferred OTC securities. Specifically, the firm's supervisory system did not include written supervisory procedures providing for (1) the identification of the person(s) responsible for supervision with respect to the applicable rules; (2) a statement of the supervisory steps to be taken by the identified person(s); (3) a statement as to how often such person(s) should take such steps; and (4) a statement as to how the completion of the steps included in the written supervisory procedures should be documented. The conduct described in this paragraph constitutes violations of NASD Rule 3010 and FINRA Rule 2010.

20150465578 (2Q15 and 3Q15 MOT review)

8. In 100 instances, the firm failed to execute orders in preferred securities fully and promptly; and in 23 of those same 100 instances, the firm failed to use reasonable diligence to ascertain the best inter-dealer market and failed to buy or sell in such market so that the resultant price to its customer was as favorable as possible under prevailing market conditions. The conduct described in this paragraph constitutes separate and distinct violations of FINRA Rules 5310 and 2010.

B. The firm also consents to the imposition of the following sanctions:

A censure and a fine of \$500,000 (\$200,000 for the supervision violations in 20120347147, 20120352216, and 20140434333; \$105,000 for the recordkeeping and trade reporting violations in 20120347147; \$160,000 for the trading ahead violations in 20120352216; \$10,000 for the best execution violations in 20140434333; and \$25,000 for the MOT violations in 20150465578) and restitution to investors in the total amount of \$103,219.25, in connection with the transactions referenced in paragraphs I.A.4, 6 and 8, plus interest at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. 6621(a)(2), from the date of the violative conduct until the date this AWC is accepted by the National Adjudicatory Council. A registered principal on behalf of the Respondent firm shall submit satisfactory proof of payment of the restitution, or of reasonable and documented efforts undertaken to effect restitution. Such proof shall be submitted to the **Compliance Assistant, Legal Section, Market Regulation Department, 9509 Key West Avenue, Rockville, MD 20850**, either by letter that identifies the Respondent and case number, or by email from a work-related account of the registered principal of the firm to MarketRegulationComp@finra.org. This proof shall be provided to FINRA no later than 120 days after acceptance of this AWC.²

If for any reason Respondent cannot locate any customer who is owed restitution after reasonable and documented efforts within 120 days from the date the AWC is accepted, or such additional period agreed to by FINRA staff in writing, Respondent shall forward any undistributed restitution and interest to the appropriate escheat, unclaimed-property or abandoned-property fund for the state in which the customer is known to have last resided. Respondent shall provide satisfactory proof of such action to FINRA in the manner described above, within 14 days of forwarding the undistributed restitution and interest to the appropriate state authority.

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

The imposition of a restitution order or any other monetary sanction herein, and the timing of such ordered payments, does not preclude customers from pursuing their own actions to obtain restitution or other remedies.

The firm agrees to pay the monetary sanction(s) upon notice that this AWC has been accepted and that such payment(s) are due and payable. It has submitted an Election of

² FINRA has not imposed undertakings in this matter because the firm has addressed the supervisory and training deficiencies identified by the staff during its reviews.

Payment form showing the method by which it proposes to pay the fine imposed.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

II.

WAIVER OF PROCEDURAL RIGHTS

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

- A. To have a Complaint issued specifying the allegations against the firm;
- 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, the firm specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, 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.

The firm 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

The firm understands that:

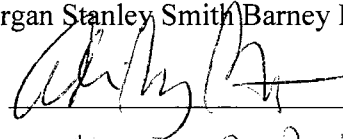
- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;

- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against the firm; and
- C. If accepted:
1. this AWC will become part of the firm's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against the firm;
 2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
 3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and
 4. The firm 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. The firm 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 the firm'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. The firm may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. The firm 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 it has agreed to the AWC's 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.

8/3/17
Date

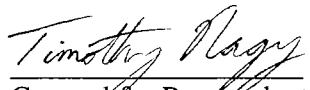
Respondent
Morgan Stanley Smith Barney LLC

By: 

Name: Alison D Patten

Title: Managing Director

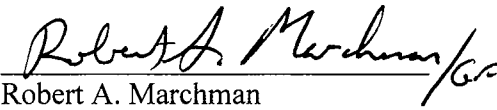
Reviewed by:


Counsel for Respondent
TIMOTHY NAGY
SIDLEY AUSTIN, LLP

Accepted by FINRA:

8/20/17
Date

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


Robert A. Marchman
Executive Vice President
Department of Market Regulation