

NASD
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. EAF0401500001

TO: Department of Enforcement
NASD

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

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

Morgan Stanley understands that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by NASD's Department of Enforcement and National Adjudicatory Council ("NAC") Review Subcommittee or Office of Disciplinary Affairs ("ODA"), pursuant to NASD Rule 9216;
2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
3. If accepted:
 - a. This AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by the NASD or any other regulator against it;
 - b. This AWC will be made available through NASD's public disclosure program in response to public inquiries about its disciplinary record;
 - c. NASD may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-2; and
 - d. 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. Nothing in this provision affects Respondent's testimonial obligations or right to take legal or factual positions in litigation or other legal proceedings in which the NASD is not a party.

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Morgan Stanley also understands that its experience in the securities industry and disciplinary history may be factors that will be considered in deciding whether to accept this AWC. That experience and history are as follows:

Morgan Stanley has been a member of NASD since June 5, 1970. Its principal offices are located in New York, New York. The Firm is a full service broker-dealer serving institutional and retail clients including publishing research. Currently, Morgan Stanley publishes approximately 1,350 research reports per month covering over 2,000 equities.

Morgan Stanley has the following relevant disciplinary history:

On April 21, 2003, pursuant to Letter of Acceptance, Waiver and Consent No. CAF 030025, NASD made findings (which Morgan Stanley neither admitted nor denied) that Morgan Stanley failed to manage conflicts of interest between its investment banking and research analyst operations in violation of NASD Rule 2110, made undisclosed payments for research to other firms involved in an underwriting in violation of NASD Rule 2210(d)(1), and failed to supervise its research analysts in violation of NASD Rule 3010. In connection with this settlement, Morgan Stanley consented to pay a total of \$125,000,000, which included a fine of \$25,000,000, disgorgement of \$25,000,000 and a payment of \$75,000,000 for the procurement of independent research.

I.

WAIVER OF PROCEDURAL RIGHTS

Morgan Stanley specifically and voluntarily waives the following rights granted under NASD's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against it;
- B. To be notified of the Formal 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 NAC and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Morgan Stanley 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.

Morgan Stanley further specifically and voluntarily waives any right to claim that a person violated the *ex parte* prohibitions of Rule 9143 or the separation of functions

prohibitions of 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.

II.

ACCEPTANCE AND CONSENT

Morgan Stanley 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 NASD, or to which NASD 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 NASD:

SUMMARY

In research reports published at various times from March 2003 to July 2005 (the "relevant period"), Morgan Stanley violated NASD and SEC rules relating to (i) disclosures in certain research reports of its ratings distribution; (ii) disclosures in certain research reports of its analyst industry views; and (iii) the form of certain disclosures in certain of its exchange traded fund ("ETF") reports.

Morgan Stanley's violations occurred notwithstanding NASD's notice to the Firm that its disclosure practices did not comply with NASD requirements. NASD's Advertising Regulation Department ("NASD Advertising"), notified Morgan Stanley twice, once in 2003 and again in 2004, that its equity research reports failed to contain clear and prominent disclosures required by NASD rules. Morgan Stanley responded to NASD that it would correct these deficiencies. Contrary to the Firm's assertions, the Firm failed to comply with its disclosure requirements and failed to take prudent and reasonable steps to detect and prevent its research disclosure violations. Indeed, it was not until July 2005, months after the last warning from NASD, that the Firm completed its effort to remedy its defective disclosures.

NASD Advertising also notified Morgan Stanley in April 2004 that the manner of its ETF disclosures did not comply with NASD rules. From April 2004 to March 2005, NASD Advertising sent Morgan Stanley 21 additional notices on seven separate dates that the Firm's ETF disclosures failed to comply with applicable rules. Despite these repeated notices, Morgan Stanley did not complete its effort to correct its defective ETF disclosures until May 2005.

Morgan Stanley failed to modify its deficient disclosures in a timely manner. As a result of Morgan Stanley's defective disclosure and supervisory practices, the Firm published more than 28,000 equity research reports and 190 ETF reports that failed to disclose clearly and prominently required information in violation of NASD Rules 2711(h), 3010, and 2110.

MORGAN STANLEY'S DISCLOSURE FAILURES

1. Morgan Stanley Failed to Disclose Adequately the Percentage of all Securities to Which It Would Assign a "Buy," "Hold/Neutral" or "Sell" Rating

NASD Rule 2711(h)(5)(A) requires members, regardless of the rating system employed, to "disclose in each research report the percentage of all securities rated by the member to which the member would assign a 'buy,' 'hold/neutral' or 'sell' rating." Rule 2711(h)(5) went into effect on September 9, 2002, preceded by Notice to Members 02-39 dated June 26, 2002, which contained the text of the rule and guidance concerning the rule's disclosure requirements. Additionally, Rule 2711(h)(10) requires that disclosures and references to disclosures "be clear, comprehensive and prominent." Rule 2711(h)(10) went into effect on July 9, 2002.

From March 17, 2003 through June 10, 2004, the Firm violated Rules 2711(h)(5)(A) and 2711(h)(10), by not clearly identifying the percentage of securities to which it would assign a "buy," "hold/neutral," or "sell" rating. During this time, Morgan Stanley rated stocks "overweight," "equal weight," and "underweight". In its research reports, the Firm used a chart, entitled "Global Stock Ratings Distribution" that reflected the percentage of each of its covered securities that were assigned these proprietary ratings. The chart and the proprietary ratings appeared in bold and in a relatively large font size, but the chart itself did not contain percentage distributions of securities to which the Firm would assign "buy," "hold/neutral" and "sell" ratings. Instead, in text below the proprietary ratings chart, the reports stated, in less noticeable text, that "Overweight, our most positive stock rating, most closely corresponds to a buy recommendation; Equal-weight and Underweight most closely correspond to neutral and sell recommendations, respectively."

During a routine examination in 2003, NASD Advertising notified Morgan Stanley that its ratings distribution disclosures failed to comply with NASD Rules 2711(h)(5) and 2711(h)(10) because the Firm failed to present required information in a clear, comprehensive and prominent manner and did not disclose the percentage of securities to which it would assign a "buy," "hold/neutral," or "sell" rating. By letter dated March 17, 2003, NASD Advertising instructed the Firm to modify its ratings distribution disclosures to include more prominently the required "buy," "hold/neutral" and "sell" disclosure. The Firm responded by letter dated March 31, 2003, but did not agree to modify its disclosures. In a June 16, 2003 letter, NASD Advertising reiterated that the Firm had to alter its research reports to disclose the percentage of securities to which it would assign a "buy," "hold/neutral," or "sell" rating. Following further communications, Morgan Stanley informed NASD Advertising by letter dated November 20, 2003 that it would modify its disclosures to comply with NASD requirements.

Despite the Firm's agreement in November 2003 to correct its ratings distribution disclosures, the Firm failed to make the agreed changes until June 10, 2004. Accordingly, prior to June 10, 2004, none of Morgan Stanley's research reports disclosed the required "buy," "hold/neutral" and "sell" ratings distributions as prescribed by NASD Advertising. From March 17, 2003 to June 10, 2004, Morgan Stanley

published more than 22,000 research reports containing these inadequate disclosures, in violation of NASD Rules 2711(h)(5), 2711(h)(10) and 2110.¹

2. Morgan Stanley Failed to Disclose "Analyst Industry View" Ratings in a Clear and Prominent Manner

Research reports from Morgan Stanley typically included an "Analyst Industry View," a rating system used to measure the performance of the analyst's coverage universe against a selected broad market benchmark, such as the S&P 500. Prior to November 30, 2003, however, the Firm did not indicate where in the research report an investor could find the broad market benchmark. Morgan Stanley's attempt to rectify this deficiency in November 2003 overlooked two categories of research reports. From November 30, 2003 to July 18, 2005, the Firm continued to publish both Quick Comment and Latin American reports containing defective disclosures.

The Firm's disclosures concerning its "analyst industry view" ratings violated NASD Rules 2711(h)(4), 2711(h)(10) and 2110. NASD Rule 2711(h)(4) requires members to define in "research reports each rating used by the member in its rating system."² Pursuant to Rule 2711(h)(10), ratings disclosures must be "clear, comprehensive and prominent."

Morgan Stanley failed to provide clear and prominent information concerning its "analyst industry view" ratings, thus depriving investors a sound basis for an investment decision. Under Morgan Stanley's rating system, an "Analyst Industry View" is the analyst's opinion of how the covered industry will perform versus a broader market indicator, such as the S&P 500, over a given period of time. In this rating system, an analyst industry view can be "attractive," "in-line" or "cautious." The Firm defines these ratings in the disclosure section of its research reports. For example, when an analyst rates the coverage universe "attractive," it means the analyst "expects the performance of his or her industry coverage universe to be attractive vs. the relevant broad market benchmark over the next 12-18 months."

NASD Advertising notified Morgan Stanley by letter dated March 17, 2003 that it concluded the Firm's definition of "analyst industry view" was unclear and difficult to comprehend because it failed to identify the relevant broad market benchmark. The Firm responded in March 2003 that it planned to modify its research report disclosures to address these deficiencies. Morgan Stanley, however, did not correct the cited deficiency until November 30, 2003. Accordingly, all research reports published prior to November 30, 2003 contained analyst industry view ratings without clear and prominent disclosure of the broad market benchmark.

Additionally, Morgan Stanley's efforts in November 2003 to correct its broad market benchmark disclosure did not cover two types of research reports. NASD

¹ NASD Conduct Rule 2110 provides that "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principals of trade." Violations of Rule 2711 also constitute violations of Rule 2110.

² NASD Conduct Rule 2711(h)(4) further provides that "The definition of each rating must be consistent with its plain meaning."

Advertising discovered during its second examination of Morgan Stanley's disclosure in research reports, initiated May 12, 2004, that Morgan Stanley had not corrected its Quick Comment or Latin American reports to reflect NASD Advertising's requirements regarding its "Analyst Industry View" disclosures. NASD notified the Firm of this deficiency and Morgan Stanley agreed it would correct these rating disclosures. The Firm, however, did not correct the disclosure template for its Quick Comment and Latin American equity research reports until July 18, 2005.

In sum, from March 17, 2003 to November 30, 2003, all Morgan Stanley research reports contained "Analyst Industry View" ratings but failed to indicate where in the research reports the referenced broad market benchmark could be found. Moreover, from March 17, 2003 to July 18, 2005, the Firm's Quick Comment and Latin American equity research reports contained "Analyst Industry View" ratings that omitted the referenced benchmark. During these time periods, the Firm published more than 21,000 research reports containing "Analyst Industry View" ratings that failed prominently to disclose the broad market benchmark in violation of NASD Rules 2711(h)(4), 2711(h)(10) and 2110.

3. Morgan Stanley Failed to Make Certain Disclosures in ETF Reports in the Manner Required by SEC Rule 482(b)

From March 1, 2004 to May 2, 2005, Morgan Stanley published 190 exchange trade fund ("ETF") reports that failed to make certain disclosures in the format required by SEC Rule 482(b)(5) of the Securities Act of 1933. SEC Rule 482(b)(5) provides, in relevant part, that disclosures required by the rule be "presented in a type size at least as large as and of a style different from, but at least as prominent as, that used in the major portion of the advertisement." The Firm violated SEC Rule 482(b)(5), as well as NASD Rule 2110 because it did not present ETF disclosures in a type-setting different from that used in the major portion of its ETF reports.

NASD Advertising first notified the Firm that its ETF disclosures violated SEC Rule 482(b) in six separate Review letters each dated April 8, 2004 that NASD sent in response to six ETF-related research reports filed with NASD. Morgan Stanley did not modify its ETF reports in light of NASD Advertising's Review letters. From April 28, 2004 to March 30, 2005, NASD Advertising sent Morgan Stanley twenty-one additional Review letters on seven separate dates notifying the Firm that its ETF disclosures failed to comply with SEC Rule 482(b). By letter dated April 12, 2005, Morgan Stanley advised NASD Advertising that it would modify its ETF disclosures to comply with SEC Rule 482(b). On May 2, 2005, Morgan Stanley modified its ETF reports to comply with SEC Rule 482(b)(5).

MORGAN STANLEY'S SUPERVISORY FAILURES

During the relevant period, Morgan Stanley violated NASD Conduct Rules 3010 and 2110 by failing to maintain a supervisory system reasonably designed to detect and prevent the multiple research disclosure violations described above. NASD Rule 3010 in pertinent part requires members to "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association." Morgan Stanley violated NASD Rule 3010 because its

supervisory procedures were not reasonably designed to ensure compliance with the disclosure requirements of NASD Rules 2711(h), 2110 and SEC Rule 482(b).

1. Morgan Stanley's Supervisory System Failed to Detect and Prevent Violations of NASD Disclosure Requirements

At Morgan Stanley, supervisory analysts are responsible for reviewing research reports prior to publication to ensure compliance with NASD disclosure rules. Morgan Stanley provides its supervisory analysts with written policies and procedures concerning specific NASD disclosure requirements. Morgan Stanley, however, failed to provide adequate guidance to its supervisory analysts concerning the NASD research disclosure requirements at issue in this matter, particularly the requirement that required disclosures be clearly and prominently disclosed.

None of Morgan Stanley's written supervisory procedures contained instructions concerning the clarity or prominence of required disclosures. In some cases, the Firm's written supervisory procedures did not clearly inform the supervisory analysts regarding actual rule requirements. For example, in a document titled "Best Practices for Supervisory Analysts," the Firm erroneously states that the ratings distribution table required by NASD Rule 2711(h)(5) must show the "percentage of all securities rated by the Firm to which the Firm has assigned 'Overweight,' 'Equal-Weight,' or 'Underweight' ratings," rather than the percentage of all securities to which the Firm would assign "buy," "hold/neutral" or "sell" ratings as required by the rule. Accordingly, the Firm failed to maintain an effective supervisory procedure reasonably designed to ensure compliance with NASD disclosure rules in violation of NASD Rules 3010 and 2110.

2. Morgan Stanley's Supervisory System Did Not Facilitate an Effective or Timely Response to NASD Advertising's Notice

Morgan Stanley failed to implement a supervisory system that facilitated an effective and timely response to NASD Advertising's regulatory guidance regarding NASD research disclosure requirements. During routine spot-check examinations conducted in 2003 and 2004, NASD Advertising discovered that certain of the Firm's research disclosures failed to comply with certain NASD disclosure rules. As described above, NASD Advertising notified the Firm of these disclosure violations and provided guidance to the Firm as to how it could correct its disclosures. Despite NASD Advertising's notice, the Firm failed to act in a timely manner to correct its research disclosures in violation of NASD Rules 3010 and 2110.

VIOLATIONS

1. Morgan Stanley's Research Report Disclosure Violations

a. Failure to Disclose Required Rating Distributions in a Clear, Comprehensive and Prominent Manner

As described above, from March 17, 2003 to June 10, 2004, Morgan Stanley violated NASD Rules 2711(h)(5), 2711(h)(10) and 2110 by publishing more than 22,000 research reports that failed to clearly, comprehensively and prominently disclose the percentage of all securities rated by the Morgan Stanley to which the Firm would assign a "buy," "hold/neutral" or "sell" rating.

b. Failure to Disclose "Analyst Industry View" Ratings in a Clear, Comprehensive and Prominent Manner

As described above, from March 17, 2003 to July 18, 2005, Morgan Stanley violated NASD Rules 2711(h)(4), 2711(h)(10) and 2110 by publishing more than 21,000 research reports that failed to clearly, comprehensively and prominently disclose "Analyst Industry View" ratings.

c. Failure to Make Certain Disclosures in ETF Reports in the Manner Required by SEC Rule 482(b)

As described above, from March 1, 2004 to May 2, 2005, Morgan Stanley violated NASD Rule 2110 and SEC Rule 482(b)(5) by publishing at least 190 ETF reports that failed to make certain disclosures required by SEC Rule 482(b) in a type setting different from that used in the major portion of the report.

2. Morgan Stanley's Supervisory Violations

As described above, during the time periods mentioned herein, Morgan Stanley violated NASD Rules 3010(a) and (b) and 2110 by failing to establish and maintain supervisory procedures reasonably designed to ensure compliance with Rules 2711(h) and related SEC disclosure rules as well as Rule 2110.

SANCTIONS

Morgan Stanley also consents to the imposition, at a maximum, of the following sanctions:

- Censure; and
- Fine in the amount of \$200,000.

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

III.

OTHER MATTERS

- A. Morgan Stanley understands that it may attach a corrective action statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Morgan Stanley 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 NASD, nor does it reflect the views of NASD or its staff.
- B. Morgan Stanley agrees to pay any monetary sanctions imposed on it upon notice that this AWC has been accepted and that such payments

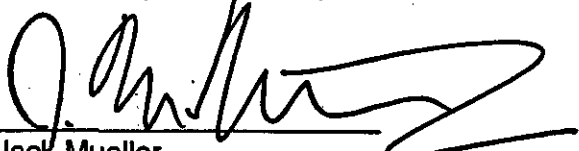
are due and payable and have attached an Election of Payment form showing the method by which it proposes to pay any fine imposed.

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

Respondent Morgan Stanley certifies that it has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, has been made to induce it to submit it.

June 1, 2006
Date

Morgan Stanley & Co. Incorporated

By: 
Jack Mueller
Managing Director

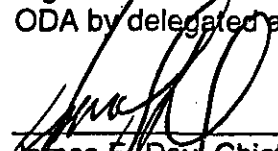
Reviewed by: 

Counsel for Morgan Stanley & Co. Incorporated

Accepted by NASD:

7/17/06
Date

Signed on behalf of the Director of
ODA by delegated authority


James E. Day, Chief Counsel
NASD Department of Enforcement