

1 THE PEOPLE OF THE STATE OF CALIFORNIA  
2 BY AND THROUGH THE COMMISSIONER OF CORPORATIONS

3		
4		
5	In the matter of:	)
6	<b>MORGAN STANLEY &amp; CO.</b>	)
7	<b>INCORPORATED</b>	)
8	Respondents.	)
9		)
10		)
11		)
12		)
13		)
14	_____	)

**FINDINGS OF FACT**  
**CONCLUSIONS OF LAW**  
**ADMINISTRATIVE CONSENT ORDER**

15  
16 WHEREAS, Morgan Stanley & Co. Incorporated ("Morgan Stanley") is a broker-dealer  
17 registered in the state of California; and

18 WHEREAS, coordinated investigations of the activities of Morgan Stanley in connection with  
19 the marketing and sale of auction rate securities ("ARS") have been conducted by a multistate task  
20 force composed of members of the North American Securities Administrators Association Inc.  
21 ("NASAA"); and

22 WHEREAS, Morgan Stanley has cooperated with regulators conducting the investigations by  
23 responding to inquiries, providing documentary evidence and other materials, and providing  
24 regulators with access to facts relating to the investigations; and

25 WHEREAS, Morgan Stanley has advised regulators of its agreement to resolve the  
26 investigations relating to its marketing and sale of ARS to retail investors; and

27 WHEREAS, Morgan Stanley agrees to, among other things, reimburse certain purchasers of  
28 auction rate securities, implement certain changes with respect to its marketing and sale of ARS, and

1 make certain payments; and

2 WHEREAS, Morgan Stanley elects to permanently waive any right to a hearing and appeal  
3 under California Corporations Code sections 25532(d) and 25609 with respect to this Administrative  
4 Order (the "Order");

5 WHEREAS, Morgan Stanley admits the jurisdiction of the California Department of  
6 Corporations; acknowledges, without admitting or denying the truth thereof, that the following  
7 allegations contained in the Notice of Hearing shall be adopted as the California Department of  
8 Corporation's Findings of Fact; and consents to the entry of this Order by the California Department  
9 of Corporations:

10 NOW, THEREFORE, the California Department of Corporations, as administrator of the  
11 California Corporate Securities Law, hereby enters this Order:

12 **I.**

13 **FINDINGS OF FACT**

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

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

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

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

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

1           5.       In connection with the sale of ARS, certain Morgan Stanley salespeople told certain  
2 investors that ARS were “just like cash” and “liquid with seven days notice.”

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

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

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

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

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

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

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

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

14 **Failure to Supervise**

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

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

21 **II.**

22 **CONCLUSIONS OF LAW**

23  
24 15. The California Department of Corporations has jurisdiction over this matter pursuant  
25 to the California Corporate Securities Law.

26 The California Department of Corporations finds that the above conduct subjects Morgan  
27 Stanley to sanctions under Title 10, Ch. 3, section 260.218 of the California Code of Regulations for  
28 failure to observe high standards of commercial honor and just and equitable principles of trade and

1 Title 10, Ch. 3, section 260.218.4(a) of the California Code of Regulations for failure to supervise its  
2 employees with regard to the sale of securities.

3 16. The California Department of Corporations finds the following relief appropriate and  
4 in the public interest.

5 **III.**

6 **ORDER**

7 On the basis of the Findings of Fact, Conclusions of Law, and Morgan Stanley's consent to  
8 the entry of this Order, for the sole purpose of settling this matter prior to a hearing and without  
9 Morgan Stanley admitting or denying the Findings of Fact or Conclusions of Law,

10 **IT IS HEREBY ORDERED:**

11 1. This Order concludes the investigation by the California Department of Corporations  
12 and any other action that the California Department of Corporations could commence under  
13 applicable California law on behalf of California as it relates to Morgan Stanley's marketing and sale  
14 of auction rate securities to Morgan Stanley's Retail ARS Investors, as defined below. Specifically  
15 excluded from and not covered by this paragraph are any claims by the California Department of  
16 Corporations arising from or relating to the Order provisions contained herein.

17 2. This Order is entered into solely for the purpose of resolving the investigation into  
18 Morgan Stanley's marketing and sale of auction rate securities, and is not intended to be used for any  
19 other purpose.

20 3. This Order shall be binding upon Morgan Stanley and its successors and assigns as  
21 well as to successors and assigns of relevant affiliates with respect to all conduct subject to the  
22 provisions above and all future obligations, responsibilities, undertakings, commitments, limitations,  
23 restrictions, events, and conditions.

24 4. Morgan Stanley shall desist and refrain from violating Title 10, Ch. 3, sections  
25 260.218 and 260.218.4(a) of the California Code of Regulations and will comply with Title 10, Ch. 3,  
26 sections 260.218 and 260.218.4(a) of the California Code of Regulations.

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



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

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

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

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

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

28

1 **Review of Customer Accounts**

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

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

8 17. No later than December 11, 2008, Morgan Stanley shall pay any Retail ARS Investor  
9 that Morgan Stanley can reasonably identify who sold Eligible ARS below par between February 13,  
10 2008, and August 13, 2008, the difference between par and the price at which the Retail ARS  
11 investor sold the Eligible ARS.

12 **Claims for Consequential Damages**

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

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

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

21 c. Any Morgan Stanley Retail ARS Investor who chooses to pursue such claims  
22 shall bear the burden of proving that they suffered consequential damages and that such  
23 damages were caused by the investors' inability to access funds consisting of Eligible ARS  
24 holdings purchased at Morgan Stanley; and

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

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

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

11 **Institutional Investors**

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

16 22. Beginning December 11, 2008, and within 45 days of the end of each quarter  
17 thereafter, Morgan Stanley shall submit a written report to a representative specified by NASAA  
18 outlining the efforts in which Morgan Stanley has engaged and the results of those efforts with  
19 respect to Morgan Stanley institutional investors' holdings in Eligible ARS. Morgan Stanley shall, at  
20 the option of the representative specified by NASAA, confer with such representative no less  
21 frequently than quarterly to discuss Morgan Stanley's progress. Such quarterly meetings shall  
22 continue until no later than December 2009. Following every quarterly meeting, the representative  
23 shall advise Morgan Stanley of any concerns and, in response, Morgan Stanley shall detail the steps  
24 that Morgan Stanley plans to implement to address such concerns. The reporting or meeting  
25 deadlines set forth above may be amended upon Morgan Stanley's request if written permission is  
26 received from the representative specified by NASAA.

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1           27.    This Order and any dispute related thereto shall be construed and enforced in  
2 accordance with, and governed by, the laws of the state of California without regard to any choice of  
3 law principles.

4           28.    Evidence of a violation of this Order proven in a court of competent jurisdiction shall  
5 constitute prima facie proof of a violation of Title 10, Ch. 3, sections 260.218 and 260.218.4(a) of the  
6 California Code of Regulations, in any civil action or proceeding hereafter commenced by the  
7 California Department of Corporations against Morgan Stanley.

8           29.    Should the California Department of Corporations prove in a court of competent  
9 jurisdiction that a material breach of this Order by Morgan Stanley has occurred, Morgan Stanley  
10 shall pay to the California Department of Corporations the cost, if any, of such determination and of  
11 enforcing this Order including without limitation legal fees, expenses, and court costs.

12           30.    If Morgan Stanley fails to make the payment specified in paragraph 6, the California  
13 Department of Corporations may, at its sole discretion, pursue any legal remedies, including but not  
14 limited to, initiating an action to enforce the Order, revoking Morgan Stanley's registration within the  
15 state, or terminating this Order.

16           31.    If in any proceeding, after notice and opportunity for a hearing, a court of competent  
17 jurisdiction, including an administrative proceeding by a state securities administrator, finds that  
18 there was a material breach of this Order, the California Department of Corporations, at its sole  
19 discretion, may terminate the Order. If Morgan Stanley defaults on any other obligation under this  
20 Order, the California Department of Corporations may, at its sole discretion, pursue legal remedies to  
21 enforce the Order or pursue an administrative action, including but not limited to, an action to revoke  
22 Morgan Stanley's registration within the state. Morgan Stanley agrees that any statute of limitations  
23 or other time related defenses applicable to the subject of the Order and any claims arising from or  
24 relating thereto are tolled from and after the date of this Order. In the event of such termination,  
25 Morgan Stanley expressly agrees and acknowledges that this Order shall in no way bar or otherwise  
26 preclude the California Department of Corporations from commencing, conducting or prosecuting  
27 any investigation, action, or proceeding, however denominated, related to the Order, against Morgan  
28 Stanley, or from using in any way any statements, documents or other materials produced or provided

1 by Morgan Stanley prior to or after the date of this Order, including, without limitation, such  
2 statements, documents or other materials, if any, provided for purposes of settlement negotiations,  
3 except as may otherwise be provided in a written agreement with the California Department of  
4 Corporations.

5 32. Morgan Stanley shall cooperate fully and promptly with the California Department of  
6 Corporations and shall use its best efforts to ensure that all the current and former officers, directors,  
7 trustees, agents, members, partners, and employees of Morgan Stanley (and of any of Morgan  
8 Stanley's parent companies, subsidiaries, or affiliates) cooperate fully and promptly with the  
9 California Department of Corporations in any pending or subsequently initiated investigation,  
10 litigation, or other proceeding relating to auction rate securities and/or the subject matter of the Order.  
11 Such cooperation shall include, without limitation, and on a best efforts basis:

12 a. production, voluntarily and without service of subpoena, upon the request of the  
13 California Department of Corporations, of all documents or other tangible evidence requested  
14 by the California Department of Corporations and any compilations or summaries of  
15 information or data that the California Department of Corporations requests that Morgan  
16 Stanley (or the Morgan Stanley's parent companies, subsidiaries, or affiliates) prepare, except  
17 to the extent such production would require the disclosure of information protected by the  
18 attorney-client and/or work product privileges;

19 b. without the necessity of a subpoena, having the current (and making all reasonable  
20 efforts to cause the former) officers, directors, trustees, agents, members, partners, and  
21 employees of Morgan Stanley (and of any of the Morgan Stanley's parent companies,  
22 subsidiaries, or affiliates) attend any Proceedings (as hereinafter defined) in California or  
23 elsewhere at which the presence of any such persons is requested by the California  
24 Department of Corporations and having such current (and making all reasonable efforts to  
25 cause the former) officers, directors, trustees, agents, members, partners, and employees  
26 answer any and all inquiries that may be put by the California Department of Corporations to  
27 any of them at any proceedings or otherwise, except to the extent such production would  
28 require the disclosure of information protected by the attorney-client and/or work product

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privileges. "Proceedings" include, but are not limited to, any meetings, interviews, depositions, hearings, trials, grand jury proceedings, or other proceedings;

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

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

In the event Morgan Stanley fails to comply with paragraph 32 of the Order, the California Department of Corporations shall be entitled to specific performance, in addition to any other available remedies.

Dated this 18th day of November, 2009.

PRESTON DuFAUCHARD  
California Corporations Commissioner

By \_\_\_\_\_  
ALAN S. WEINGER  
Deputy Commissioner  
Enforcement Division

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

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

6 Morgan Stanley admits the jurisdiction of the California Department of Corporations, neither  
7 admits nor denies the Findings of Fact and Conclusions of Law contained in this Order; and consents to  
8 entry of this Order by the California Department of Corporations as settlement of the issues contained  
9 in this Order.

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

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

15 Eric F. Grossman represents that he/she is Managing Director of Morgan  
16 Stanley and that, as such, has been authorized by Morgan Stanley to enter into this Order for and on  
17 behalf of Morgan Stanley.

18 Dated this 12 day of November, 2009.

19 MORGAN STANLEY & CO. INCORPORATED

20 By: \_\_\_\_\_  
21 Title: Managing Director

22 STATE OF \_\_\_\_\_ )  
23 \_\_\_\_\_ )  
24 County of \_\_\_\_\_ )

25 SUBSCRIBED AND SWORN TO before me this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_.

26 \_\_\_\_\_  
27 Notary Public

28 My commission expires \_\_\_\_\_