UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 79606 / December 20, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-17737

In the Matter of **MORGAN STANLEY & CO. LLC,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Morgan Stanley & Co. LLC ("Respondent" or "MS&Co").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that

Summary

1. Exchange Act Rule 15c3-3 ("Rule 15c3-3"), 17 CFR 240.15c3-3, also known as the Customer Protection Rule, establishes a regulatory framework that requires broker-dealers to take certain steps to safeguard the funds and securities entrusted to them by their customers. For customer cash, Rule 15c3-3 requires that broker-dealers deposit the net amount owed to customers into a separate customer reserve account ("Reserve Account"). The purpose of this requirement is to prevent customer cash from being used to finance a broker-dealer's business or trading activities unrelated to servicing its securities customers and to segregate the cash so that it can be promptly returned to customers in the event of the broker-dealer's failure. The Customer Protection Rule also prevents broker-dealers from using transactions with affiliated entities to reduce the amount that they are required to deposit into their Reserve Accounts.

2. As customers of the financial services firm Morgan Stanley ("MS") sought to enter equity swaps with the firm's prime brokerage platform to obtain synthetic exposure to less liquid, emerging markets equity securities, MS's global prime brokerage business ("Prime Broker"), in turn, would purchase the underlying equities to hedge its market exposure. Beginning in 2012, the Prime Broker sought a means to finance these hedges in the manner in which it finances customer cash positions, thereby reducing costs—and correspondingly increasing profits—in connection with the establishment of these hedges. The solution was to create an affiliate, Morgan Stanley Equity Financing Limited ("MSEFL"), to sign MSEFL up as a prime brokerage customer of MS&Co, a U.S. broker-dealer subsidiary of MS, and to provide MSEFL financing via margin loans from MS&Co. Ultimately, the funds from these margin loans were used to finance the hedges.

3. From March 2013 to May 2015, the Prime Broker used MSEFL to finance securities acquired as hedges to equity swaps with its customers, which had the effect of reducing the amount MS&Co was required to deposit into its Reserve Account.

4. MS&Co personnel failed to appreciate that this use of an affiliate and this use of customer cash to finance the purchase of hedges violated the Customer Protection Rule. While the securities financed through MSEFL were acquired as hedges to customers' equity swaps, the securities were firm positions that were purchased to hedge the firm's market exposure. The Customer Protection Rule and guidance issued by the SEC staff state that transactions with affiliates of a broker-dealer may not serve to reduce the amount that the broker-dealer is required to deposit in its Reserve Account.

5. MS&Co inaccurately calculated its Reserve Account requirement under Rule 15c3-3 by including the margin loans to MSEFL in its calculations. These incorrect calculations also

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1 The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

resulted in it making inaccurate records and submitting inaccurate reports to the Commission. Accordingly, MS&Co willfully violated Sections 15(c)(3) and 17(a)(1) of the Exchange Act and Rules 15c3-3(e), 17a-5(a), and 17a-5(d) thereunder.

6. In response to the Commission's investigation, MS&Co provided substantial cooperation to Commission staff. MS&Co also has voluntarily undertaken steps to review the processes responsible for the calculation requirements of Rule 15c3-3 and is taking remedial steps to improve those processes.

Respondent

7. **Morgan Stanley & Co. LLC** is a Delaware limited liability company with its principal place of business in New York, NY. It is a wholly owned subsidiary of MS. MS&Co has been registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act since 1970 and is a Financial Industry Regulatory Authority member.

Other Relevant Entity

8. **Morgan Stanley Equity Financing Limited** is a United Kingdom private limited company incorporated on July 6, 2012. It is a subsidiary of Morgan Stanley Longcross Limited, which is a subsidiary of Morgan Stanley & Co. International plc ("MSIP"), a United Kingdom broker-dealer and wholly owned subsidiary of Morgan Stanley. During the relevant time period, MSEFL was an affiliate and a prime brokerage customer of MS&Co.

Background

A. The Issue: Financing Firm Hedges of Customer Swaps

9. Within MS, there are several subsidiary broker-dealers. Among them are MS&Co, which is a U.S. broker-dealer subsidiary of MS, and MSIP, which is a U.K. broker-dealer subsidiary. Across these broker-dealers, MS offers its customers a prime brokerage platform, including access to Delta One Structured Products ("DSP") desks that offer customers synthetic exposure to specific securities through derivatives. For example, to meet customer demand for synthetic exposure to equity securities—*i.e.*, exposure to price changes in an equity security without owning that equity security itself—a DSP desk will enter into an equity swap with a customer.[2]

10. A customer entering into an equity swap with a DSP desk can take a long or short position vis-à-vis the underlying equity. If the customer goes long, then it is exposed to the same performance as if it owned the equity. Conversely, if the customer short sells the underlying equity through an equity swap, it obtains short exposure to that equity.

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[2] The equity swaps at issue are agreements whereby two parties agree to the periodic exchange of future cash flows over a specified period of time, with one party making payments based on a fixed or floating (*e.g.*, LIBOR) rate and with one or the other party making payments based on the performance of a designated equity.

11. When entering into an equity swap with a customer, the DSP desk seeks to remain as neutral as possible in terms of its own market exposure. To hedge its exposure to the equity swap customer, the DSP desk generally would purchase the underlying equity for an equity swap where the customer had long exposure and would short sell the underlying equity where the customer had short exposure ("DSP Hedge").[3]

12. MS imposed a cost on trading desks for using firm capital to purchase their positions, including DSP Hedges. MS makes capital available to its trading desks but charges an interest rate on this capital, known as a proxy rate, that typically is higher than the interest that external third parties charge for collateralized loans. To avoid being assessed this more expensive internal financing rate, MS can finance its positions externally through a securities lending agreement. For example, MS&Co often rehypothecates customer margin securities in order to generate financing for customer margin loans.[4]

13. In connection with the Prime Broker's international synthetics business in particular, a portion of the DSP Hedges were less liquid, emerging markets equities ("EM DSP Hedges"), and as a result, they were more difficult to finance externally.

14. Although a broker-dealer may rehypothecate liquid securities and use the funds obtained to finance less liquid positions, the equity swaps traded in connection with the international synthetics business were largely booked in MSIP which held only a limited amount of liquid securities. Because the EM DSP Hedges exceeded MSIP's liquid securities available for rehypothecation, the DSP desks were required to pay MS's proxy rate to finance the EM DSP Hedges.

15. MS&Co held a substantial amount of liquid customer margin securities that were eligible for rehypothecation under Rule 15c3-3. Recognizing that MS&Co had a surplus of liquid customer margin securities and MSIP had a deficit for rehypothecation purposes, Prime Broker personnel began to explore whether DSP desks could access external financing that MS&Co could generate through rehypothecation in order to more cheaply finance the EM DSP Hedges.

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3 Short selling is the practice of selling securities that are not currently owned and subsequently purchasing them, which is known as "covering" the short position. In the event of an interim price decline prior to covering, the short seller will profit, since the cost of purchase will be less than the proceeds which were received upon the initial short sale. Conversely, the short position will result in a loss if the price of the shorted security rises prior to covering. The broker-dealer clearing the short sale must borrow the securities in order to effect delivery upon execution of the short sale.

4 Rehypothecation is the practice of using the assets held as collateral for a client to finance the client's positions. This allows a broker-dealer to re-lend customer margin securities held as collateral. If a customer purchases securities through a margin loan extended by a U.S. broker-dealer, the securities purchased are treated as collateral for the margin loan and are eligible for rehypothecation, within limits set forth in Rule 15c3-3. Fully paid and excess margin securities may not be rehypothecated under Rule 15c3-3.

16. Within certain limits, the Customer Protection Rule allows a broker-dealer to finance one customer's margin activity with another customer's assets, but does not allow one broker-dealer's customer activity to finance another broker-dealer's activities. As described below, the Prime Broker conceived of an affiliate that would transact with MS&Co, on one hand, and the DSP desks, on the other hand, for the purpose of providing financing for the EM DSP Hedges that was below the proxy rate.

B. The Proposed Solution: Affiliated Entity MSEFL

17. In early 2012, senior personnel from the Prime Broker developed a transaction structure centered on the use of an affiliate of MS&Co to hold the EM DSP Hedges, which it would purchase with funds obtained from margin loans extended by MS&Co. Following some initial meetings with relevant stakeholders regarding the broad contours of this idea, a New Product Approval ("NPA") process was initiated in April 2012.[5]

18. The affiliate—which eventually became MSEFL—would be a prime brokerage customer of MS&Co. Through this relationship, MSEFL would receive margin loans from MS&Co. MS&Co would fund these margin loans through the rehypothecation of its other customers' liquid margin securities.

19. The EM DSP Hedges would trade in an MS account for global DSP desks, but would settle in MSEFL's prime brokerage account. Therefore, the funds from the margin loans from MS&Co would be used to purchase or to borrow the EM DSP Hedges. In addition, the DSP desks would transfer the economics of the relevant, underlying equity swaps to MSEFL via a total return swap. The mechanics of the proposed transaction structure were as follows:

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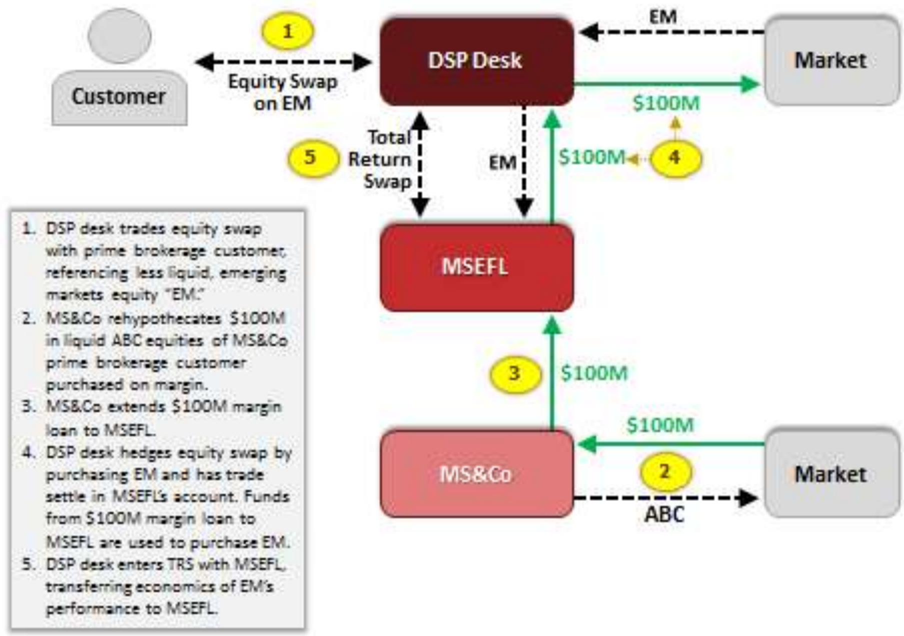
5 NPA is an MS process instituted upon the proposal of new, reintroduced, or modified products, services, or businesses in order to allow control functions to formally review such proposals.

Fig. A



20. The Prime Broker estimated that, by avoiding MS's proxy rate, MSEFL could achieve cost savings of up to $34 million per year. The Prime Broker's use of MSEFL was ultimately more limited, and the Prime Broker thus did not realize this amount of savings.

21. From April to August 2012, the NPA was reviewed by stakeholders, including the Legal and Compliance Division and the Financial Control Group, which is responsible for ensuring MS&Co maintains sufficient funds to safeguard customer cash under Rule 15c3-3.

C. The Problem with the Proposed Solution: The Customer Protection Rule

22. Rule 15c3-3 imposes restrictions and responsibilities on a broker-dealer that are designed to safeguard its customers' cash and securities so that these assets can be promptly returned if the broker-dealer fails. As to customer cash, Rule 15c3-3 requires a broker-dealer to maintain a reserve of funds and/or certain qualified securities in its Reserve Account that is at least equal in value to the net cash owed to customers. 17 CFR 240.15c3-3(e). The amount required to be maintained in the Reserve Account is based upon a computation typically performed on a weekly basis, which is calculated pursuant to a formula contained in Exhibit A to Rule 15c3-3 ("Reserve Formula").[6] *See id.* 240.15c3-3a. Subject to some adjustments, Rule 15c3-3 requires that a broker-dealer hold an amount equal to at least the excess of "credits" over "debits" in its Reserve Account. *Id.* 240.15c3-3(e). The term "credits" refers to the amount of cash the broker-dealer owes its customers or cash derived from the use of customer securities, while "debits" refers to amounts the customers owe the broker-dealer, for example due to margin loans extended to customers. *See id.* 240.15c3-3a.

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[6] During the relevant period, MS&Co performed this computation on a daily basis.

23. The proposed transaction structure involving MSEFL was problematic for two reasons. First, the stated intent and objective of Rule 15c3-3 is to "eliminat[e] . . . the use by broker-dealers of customer funds and securities to finance firm overhead and such firm activities as trading and underwriting through the separation of customer related activities from other broker-dealer operations." Exch. Act Rel. No. 9775, 1972 WL 125434, at *1 (Sept. 14, 1972).[7] The EM DSP Hedges were used to hedge the Prime Broker's risk arising out of equity swaps with the Prime Broker's customers, which was transferred to MSEFL, an affiliate of MS&Co. As a result, the financing of the EM DSP Hedges was inconsistent with Rule 15c3-3.

24. Second, as described below, the transaction structure allowed for the impermissible reduction of the Reserve Account through the debits of an affiliate.

25. The margin loans from MS&Co to MSEFL established a potential debit that MS&Co intended to use to reduce its Reserve Account by the same amount as the margin loans. In mid-August 2012, however, Prime Broker personnel identified a problem with the inclusion of this debit in the Reserve Formula.

26. Because broker-dealers could potentially seek to reduce their Reserve Account requirement through affiliates, Rule 15c3-3 also limits a broker-dealer's ability to include debits generated by the activity of affiliates. Note E(4) of the Reserve Formula ("Note E(4)") provides that the debits of affiliates should be excluded "unless the broker or dealer can demonstrate that such debit balances are directly related to credit items in the formula." In other words, debits attributable to an affiliate's positions can be included in a broker-dealer's Reserve Formula only to the extent that there are directly related credits attributable to those positions. This limitation imposed by Note E(4) is designed to ensure that debits related to affiliate activity, on a net basis, will not reduce a broker-dealer's Reserve Account requirement.

27. The debit resulting from the margin loans to MSEFL had no directly related credit and thus would have improperly reduced MS&Co's Reserve Account. Initially, MS&Co believed that the credits resulting from the rehypothecation of MS&Co's other customers' liquid margin securities could be considered directly related. But, as the Financial Control Group advised, "the credit must arise from the rehypothecating of the affiliates [sic] own collateral to be deemed directly related." As such, the Prime Broker concluded that it could not achieve the desired cost savings because of the absence of a directly related credit and considered further options to determine whether it could operationalize MSEFL.

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[7] *See also id.* (one objective of the Rule was to "inhibit the unwarranted expansion of a broker-dealer's business through the use of customers' funds by prohibiting the use of those funds except for designated purposes"); Exch. Act Rel. No. 21651, 50 FR 2690-01 at 2690 (Jan. 18, 1985) (Rule 15c3-3 "forbid[s] brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers; *e.g.*, a firm is virtually precluded from using customer funds to buy securities for its own account").

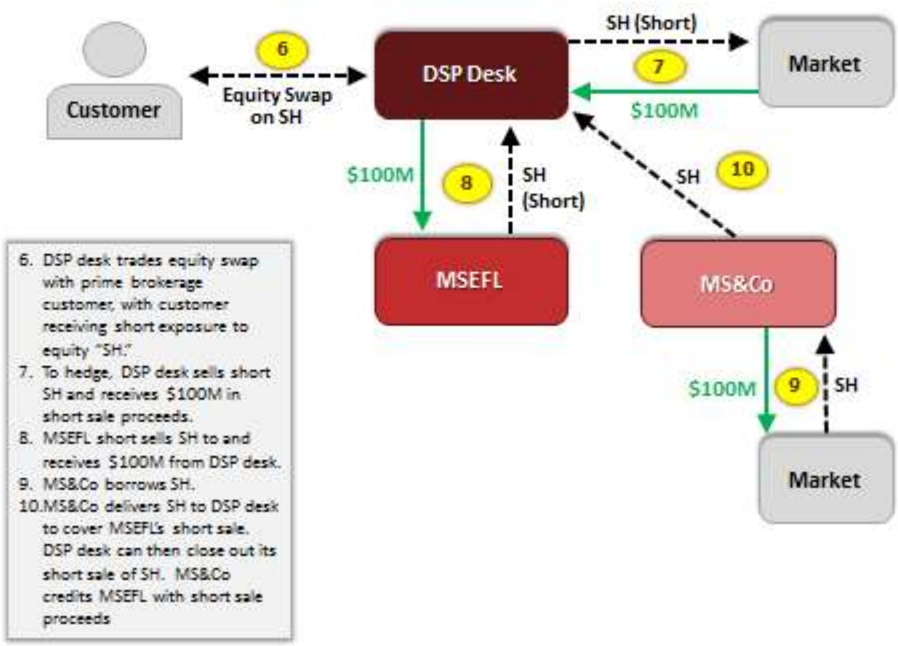
D. The Proposed Fix: Transferring Short Sale Proceeds to MSEFL

28. In an effort to keep the debit that would be generated by MS&Co's margin loan to MSEFL in the Reserve Formula, the Prime Broker explored whether they could identify directly related credits to add to the transaction structure. In or about early September 2012, the Prime Broker considered whether the problem might be resolved by having the DSP desk transfer separate short sale positions—the proceeds of which are credits in the Reserve Formula—to MSEFL.

29. As mentioned above, the DSP desks could trade equity swaps that offered customers either long or short synthetic exposure to underlying equities. When a DSP desk offered short exposure through an equity swap, the DSP desk would establish the DSP Hedge by shorting the underlying equity and, in doing so, receive short sale proceeds.

30. To implement this updated transaction structure, MSEFL would sell short to the DSP desk the underlying equities that the DSP desk had shorted to establish the DSP Hedge. The DSP desk would use the proceeds from its own short sales to pay MSEFL for these equities. MS&Co would then borrow the underlying equities and deliver them to the DSP desk to cover MSEFL's short sales, and MS&Co would credit MSEFL with short sale proceeds. The DSP desk, in turn, could then close out its short sales. The revised transaction structure included the following additional elements:

Fig. B



E. The Problem with the Proposed Fix: The Customer Protection Rule

31. Prior to its approval and implementation, MS&Co did not realize that this updated transaction structure achieved a result contrary to Rule 15c3-3 generally and the purpose of Note E(4).

32. MS&Co intended for MSEFL's short sale proceeds to serve as the directly related credit for purposes of the debit resulting from the margin loans to MSEFL. Therefore, MS&Co believed that it could now offset that debit in its Reserve Formula.

33. When MS&Co borrowed the underlying equities to execute the short sale, however, that borrow was included as a debit in its Reserve Formula. Therefore, MS&Co was claiming that a credit (the short sale proceeds) was directly related to MSEFL's debit (the margin loan from MS&Co) even though that same credit already generated a separate, offsetting debit (the stock borrow).

34. MS&Co was improperly using the same credit to offset two different debits—specifically, relying on a credit that already offset another debit in order to serve as the directly related credit for purposes of the separate affiliate debit. Further, MS&Co did not comply with Note E(4), which is designed to ensure that net affiliate activity does not decrease a broker-dealer's Reserve Account requirement.

35. FINRA's Interpretations of Financial and Operational Rules includes guidance reflecting advice from Commission staff that specifically speaks to this point: "A short sale credit balance . . . may not be used for netting purposes with a debit balance with the same customer in arriving at the excludable debit balance portion from the reserve formula pursuant to Note[] E(4) . . . ." FINRA Interpretations of Financial and Operational Rules, Rule 15c3-3(Exhibit A – Note E(6))/011 (NYSE Interpretation Memo No. 04-3 (June 2004)) (describing advice from SEC Staff).

36. Although they consulted with an external subject matter expert, MS&Co personnel did not appreciate that the updated transaction structure ran contrary to Note E(4). The Financial Control Group ultimately concluded during the NPA process that "including shorts was 'benign' and wouldn't require additional explanation or 'proving.'" Consequently, on September 17, 2012, the Prime Broker "mov[ed] forward with expanding the structure to include shorts equal to the debit."

F. MS&Co Used MSEFL to Finance Firm Hedges for Over Two Years

37. The NPA received final approval on March 6, 2013, and MSEFL financed EM DSP Hedges until May 2015, when Commission staff contacted MS&Co regarding its use of MSEFL. MS&Co had controls in place intended to ensure that affiliate debits would be excluded from the Reserve Formula. Because MS&Co's practice was first to net all account debits against credits and then to exclude any affiliate net debit balance, however, MS&Co's controls did not exclude the affiliate debits offset by credits arising from short sale proceeds in MSEFL's account.

38. Consequently, MS&Co reduced the amount that it calculated it was required to deposit in its Reserve Account through its use of MSEFL by over $305 million on average and as much as approximately $752 million on a single day. Because MS&Co's improper use of credits to offset affiliate debits was not limited to MSEFL, MS&Co further reduced the amount it calculated it was required to deposit in the Reserve Account by nearly $78 million on average and as much as about $417 million on a single day.[8]

G. MS&Co Incorrectly Calculated and Reported Reserve Formula

39. MS&Co is required to submit monthly reports, known as Financial and Operational Combined Uniform Single ("FOCUS") Reports, and annual audited financial statements. These FOCUS Reports and annual audited financial statements include, among other things, a broker-dealer's Reserve Formula calculation. By improperly including debits from affiliates, MS&Co's Reserve Formula calculations were inaccurate until it corrected this error in May 2015. Consequently, information in MS&Co's FOCUS Reports and annual audited financial statements on its Reserve Formula calculations was inaccurate.

Violations

40. As a result of the conduct described above, MS&Co willfully[9] violated Section 15(c)(3) of the Exchange Act and Rule 15c3-3(e) thereunder, which require, among other things, carrying broker-dealers to compute the amount to be deposited into customer reserve accounts in accordance with the formula set forth in Exhibit A to Rule 15c3-3.

41. As a result of the conduct described above, MS&Co willfully violated Section 17(a)(1) of the Exchange Act and Rules 17a-5(a) and 17a-5(d) thereunder, which require broker-dealers to file monthly FOCUS reports and annual audited financial statements with schedules showing calculations of reserve requirements pursuant to Exhibit A to Rule 15c3-3.

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[8] During the relevant period, MS&Co maintained excess funds in its Reserve Account that mitigated or offset the impact of these reductions.

[9] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

MS&Co's Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and the substantial cooperation afforded the Commission staff. As part of its remedial efforts, Respondent performed an assessment of its systems and operations responsible for its Reserve Formula calculations and, based on that assessment, added and strengthened controls related to Rule 15c3-3 compliance. In addition, Respondent significantly increased the amount of the cushion it maintains in its Reserve Account to protect against potential deficiencies.

IV.

In view of the foregoing, the Commission deems it appropriate, in the public interest, and for the protection of investors to impose the sanctions agreed to in Respondent MS&Co's Offer.

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent MS&Co cease and desist from committing or causing any violations and any future violations Sections 15(c)(3) and 17(a)(1) of the Exchange Act and Rules 15c3-3(e), 17a-5(a), and 17a-5(d) thereunder.

B. Respondent MS&Co is censured.

C. Respondent MS&Co shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $7,500,000.00 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying MS&Co as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Michael J. Osnato, Jr., Chief, Complex Financial Instruments Unit, Division of Enforcement, Securities and Exchange Commission, 200 Vesey Street, Suite 400, New York, NY 10281.

D. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, it shall not argue that it is entitled to, nor shall it benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that it shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Brent J. Fields
Secretary