

STATE OF WISCONSIN
DEPARTMENT OF FINANCIAL INSTITUTIONS
DIVISION OF SECURITIES

In the matter of)
)
MORGAN STANLEY & CO.) ADMINISTRATIVE CONSENT ORDER
INCORPORATED (CRD #8209))
)
Respondent.) Case No. S-09152(EX)
)
)

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

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

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

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

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

WHEREAS, Morgan Stanley elects to permanently waive any right to a hearing and appeal under sec. 551.61, Wis. Stats., the Hearings and Judicial Review statute applicable to the conduct during the relevant period with respect to this Administrative Consent Order (the "Order");

WHEREAS, Morgan Stanley admits the jurisdiction of the Division of Securities ("Division") of the Wisconsin Department of Financial Institutions; acknowledges, without admitting or denying the truth thereof, that the following allegations contained in the Notice of

1 Hearing shall be adopted as the Division's Findings of Fact; and consents to the entry of this Order
2 by the Division:

3 NOW, THEREFORE, the Division, as administrator of the Wisconsin Uniform Securities
4 Law applicable during the relevant time period, hereby enters this order:

5 I.

6 **FINDINGS OF FACT**

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

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

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

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

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

22 5. In connection with the sale of ARS, certain Morgan Stanley salespeople told certain
23 investors that ARS were "just like cash" and "liquid with seven days notice."

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

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

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

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

22 10. The resulting market dislocation should have been evident to Morgan Stanley.
23 Morgan Stanley's support bids filled the increasing gap in the demand in its auctions for auction
24 rate securities, sustaining the impression that the demand for auction rate securities had not
25 decreased. As a result, Morgan Stanley's auction rate securities inventory grew significantly,
26

1 requiring Morgan Stanley to raise its risk management limits on its auction rate securities
2 inventory.

3 11. From the Fall of 2007 through February of 2008, demand for auction rate securities
4 continued to erode and Morgan Stanley's auction rate securities inventory reached unprecedented
5 levels. Morgan Stanley eventually became aware of the increasing strains in the auction rate
6 securities market, and recognized the potential for widespread market failure. Morgan Stanley
7 never disclosed these increasing risks of owning or purchasing auction rate securities to its
8 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
17 of 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 15. The Division has jurisdiction over this matter pursuant to the Wisconsin Uniform
24 Securities Law (the "Act") and secs. 551.61 and 551.63(1) and (2), Wis. Stats., thereunder
25 applicable during the relevant time period with respect to this Order.
26

