



STATE OF NEW YORK
OFFICE OF THE ATTORNEY GENERAL

LETITIA JAMES
ATTORNEY GENERAL

DIVISION OF ECONOMIC JUSTICE
INVESTOR PROTECTION BUREAU

October 28, 2021

James J. Benjamin, Jr.
Estela Díaz
Akin Gump Strauss Hauer & Feld LLP
Bank of America Tower, One Bryant Park
New York, NY 10036

Re: *Investigation of Morgan Stanley & Co., LLC ("MSCO") and Morgan Stanley Smith Barney LLC ("MSSB") (together, "Morgan Stanley")*

Dear Mr. Benjamin and Ms. Díaz:

As you know, our office ("OAG") opened an investigation in 2018 into Morgan Stanley's compliance with its best execution obligations in connection with municipal bonds traded by its retail wealth management business.

As discussed below, OAG has determined that resolution of this investigation is appropriate given the information gathered in the investigation, Morgan Stanley's commitment to continue to review and enhance its processes for ensuring best execution, and the other relief agreed to by the parties.

Morgan Stanley's Best Execution Obligations

Morgan Stanley is required under applicable federal regulations to provide best execution on its clients' municipal bond orders and to periodically review its best execution policies and procedures.

In the municipal bond context, Municipal Securities Rulemaking Board ("MSRB") Rule G-18(a) specifically requires securities dealers to "use reasonable diligence to ascertain the best market for the subject security and buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions."¹

¹ MSRB Rule G-18 is "substantively consistent" with FINRA Rule 5310, which governs best execution for transactions in equity and fixed income markets generally, but it was specifically tailored to the municipal securities market. Implementation Guidance on MSRB Rule G-18 ("IG"), § I.1.

Assessing whether a securities dealer has used “reasonable diligence” under MSRB Rule G-18 depends on the facts and circumstances of the transaction. Six non-exclusive factors are considered: “(1) the character of the market for the security (*e.g.*, price, volatility, and relative liquidity); (2) the size and type of transaction; (3) the number of markets checked; (4) the information reviewed to determine the current market for the subject security or similar securities; (5) the accessibility of quotations; and (6) the terms and conditions of the customer’s inquiry or order, including any bids or offers, that result in the transaction, as communicated to the dealer.” MSRB Rule G-18. Depending on the circumstances, these factors may be implicated when a broker assesses whether to “work” an order, also known as “bidding back,” which involves negotiating with a counterparty in an attempt to secure more favorable pricing.

MSRB Rule G-18 requires dealers to “make every effort to execute a customer transaction promptly, taking into account prevailing market conditions” and provides that “[i]n certain market conditions a dealer may need more time to use reasonable diligence to ascertain the best market for the subject security.” MSRB Rule G-18 Supplementary Material ¶ .03. As explained in the MSRB’s Rule G-18 Implementation Guidance: “Taking a relatively shorter time can suggest a lack of reasonable diligence to ascertain the best market, while taking a relatively longer time can suggest a failure to execute promptly. There is no specific amount of time that is too short or too long to effect a customer transaction; it necessarily will depend on the particular facts and circumstances.” IG § VI.1.

Consistent with these requirements, Morgan Stanley represented to its clients that it would provide best execution on their municipal bond orders.

Issues Examined During the Investigation

During the investigation, OAG explored Morgan Stanley’s execution process for municipal bond transactions for retail brokerage customers during the period 2015 through 2018 (the “Review Period”) and its compliance with its best execution obligations in connection with such transactions.

The investigation showed that in or around 2014, the trading desk for MSSB, which operates Morgan Stanley’s wealth management business, began to be integrated into the trading desk for MSCO. The integration process continued for some time thereafter. In connection with the integration process and thereafter, certain Morgan Stanley financial advisors (“FAs”) working with retail customers raised questions within Morgan Stanley about the nature of the execution process for municipal bond transactions for retail brokerage customers. Particular issues raised by these FAs, and explored during OAG’s investigation, included: (a) trader responsiveness and the speed of execution; and (b) the trading desk’s willingness to “work” orders (*i.e.* negotiating with counterparties in an attempt to secure more favorable pricing, also known as “bidding back”).

During the investigation, Morgan Stanley provided extensive information to OAG regarding the firm’s order handling and best execution processes, particular transactions and issues

that were the subject of inquiries from FAs, and data and analysis regarding fill rates and timeliness of execution for retail municipal bond transactions during the Review Period.

The data showed that:

- a. Executed Buy Orders. Morgan Stanley represented to OAG that its traders aim to complete municipal bond buy orders within 15 minutes. While 94% of orders to purchase municipal bonds were filled or rejected within 15 minutes during the Review Period, nearly 10,000 municipal bond orders took longer than one hour to execute.
- b. Executed Sell Orders. In 2017, Morgan Stanley adopted a 30-minute auction format for municipal bond sales to satisfy its duty of reasonable diligence under best execution. Traders had discretion to extend the auction period depending on the circumstances, and there were sometimes periods of delay in the execution process outside of the trader's control. Typically, but not always, FAs submitted sell orders before the auction occurred. Over the Review Period, over 50,000 sell orders were executed in 15 minutes or less. On the other hand, over the same time period, over 214,000 sell orders took over one hour to execute.
- c. Rejected orders. Morgan Stanley also produced data on orders it rejected. Over the Review Period, over 9,000 buy orders and over 62,000 sell orders took over one hour to reject. Over the Review Period, over 22,000 buy orders and over 62,000 sell orders were rejected in less than five minutes. Finally, Morgan Stanley lacked any timing information for over 30,000 rejected sell orders.

The investigation also showed that Morgan Stanley did not maintain in readily accessible form or regularly review data concerning the amount of time it took for orders to be executed or rejected. Nor did it maintain meaningful data concerning: (a) the circumstances under which orders were rejected; or (b) how frequently, and the circumstances under which, the municipal bond trading desk chose to work orders, or chose not to do so.

Morgan Stanley's Enhanced Best Execution Procedures

During the Review Period and thereafter, Morgan Stanley has made enhancements to its processes for ensuring compliance with the firm's best execution obligations. For example, in August 2020, MSSB reorganized its Best Execution committee structure and created a new Fixed Income Best Execution Committee. That committee, which already tracked MSSB's execution rate metrics in its prior form, reviews execution rate metrics as well as information about the reason for rejected orders. In addition, since September 2019, MSCO's Munis Best Execution Committee has reviewed data on the timeliness of purchase and sales orders on a monthly basis, tracking: (i) average time for a trader to send a financial advisor an indication of interest after an advisor has submitted a request to sell a municipal bond; (ii) average time for a trader to send a sell order out for bids for a municipal bond without an indication of interest; and (iii) average time for a trader to execute a financial advisor's order to buy a municipal bond.

Morgan Stanley's Proposed Enhanced Procedures and Cooperation

Morgan Stanley independently took steps to improve its best execution procedures (as described above) and has proposed to implement other enhancements to address the issues identified by the OAG.

In addition, Morgan Stanley, among other things, voluntarily conducted an internal review and provided multiple presentations to report its findings.

Resolution of this Investigation

OAG finds that a resolution of its investigation is appropriate. In resolution of this investigation, Morgan Stanley agrees to the following:

1. Morgan Stanley shall implement the following enhancements, effective March 31, 2022:

a. Bidding Back.

- i. MSCO shall add policy language to the key compliance manual for municipal securities traders that will memorialize and document the current practice of bidding back and describe the factors that traders should consider when determining to bid for a bond.
- ii. MSCO shall review the policy language in the compliance manual on an annual basis.
- iii. Morgan Stanley shall offer training, on an annual basis, to retail municipal bond traders and FAs regarding its approach to bidding back.
- iv. On a quarterly basis, Morgan Stanley shall review a sample of trades in which the FA requested that the trader bid back. Morgan Stanley shall review a minimum of ten trades each quarter.

b. Rejected Orders

- i. MSSB shall continue to track rejection rate metrics through its Fixed Income Best Execution Committee. MSSB shall expand its tracking to include tracking of orders rejected by financial advisors and tracking the timeliness of rejections.
- ii. MSSB shall also assess whether any particular FAs experience more rejections than others. A control function within MSSB will review a sample of trades for FAs identified with higher rejection rates than others. The results of this review shall be shared with the MSSB Fixed Income Best Ex Committee.

- iii. MSCO shall track the percentage of rejection rates for buy and sell orders on the municipal bond desk on a trailing twelve-month average basis. A first-line risk function within MSCO shall review a sample of rejected trades on a monthly basis to understand the reasons trades were rejected and whether the orders were handled in a timely manner. MSCO shall document the outcome of this review which will be shared with the MSCO Best Ex Committee and the MSSB Fixed Income Best Ex Committee.

c. Timeliness of Executed Orders

- i. The MSCO Munis Best Execution Committee shall continue to review data regarding the timeliness of purchase and sale orders and shall also track, on a monthly basis, the average time it takes for a trader to respond to a financial advisor's order to sell a municipal bond.
 - ii. For orders to purchase and sell municipal bonds, Morgan Stanley shall track the percentage of orders for which it took a trader longer than 15 minutes to respond.
 - A. For orders to purchase municipal bonds, response time will be measured from the time of order entry to order execution.
 - B. For orders to sell municipal bonds, trader response time will be measured from the time of order entry to the time that the trader either provides an indication of interest or sends the bonds out for bid.
 - iii. For orders to sell municipal bonds, Morgan Stanley will measure the time from order entry to order execution to assess whether Morgan Stanley's processes could be enhanced to reduce the time it takes for orders to sell to be executed. Morgan Stanley shall review a sample of ten trades per quarter that took longer than one hour from the time of order entry to order execution.
 - iv. A first-line risk function within MSCO and MSSB shall review a sample of trades that fall into each of the above categories listed in subparts (ii) and (iii).
2. Morgan Stanley shall provide the OAG with a report detailing its compliance with the requirements set forth above by June 30, 2022. This report shall be in writing and shall set forth in detail the manner and form of compliance with this agreement. On March 31, 2025, Morgan Stanley shall provide OAG with a report summarizing the status of the enhancements listed in 1(a), (b), and (c) above, and a summary of the metrics relevant to those enhancements. This report shall be signed by the MSCO Global Head of Fixed Income Division Business Unit Risk Management and the Head of Morgan Stanley Wealth Management Fixed Income.

This Letter Agreement is not intended to subject Morgan Stanley to, or form the basis for, any disqualifications contained in the federal securities laws, including Regulation A and Rules 504 and 506 of Regulation D under the Securities Act of 1933, or the Commodity Exchange Act, the rules and regulations thereunder, the rules and regulations of any self-regulatory organizations, or various states' securities laws, including any disqualifications from replying upon registration exemptions or safe harbor provisions. This Letter Agreement is not a final order of any court.

Sincerely,



Kevin Wallace

Senior Enforcement Counsel

Roger Waldman

Senior Enforcement Counsel

Jeffrey A. Novack

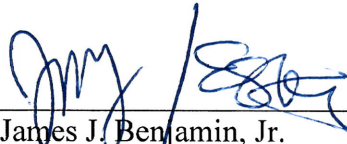
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Agreed to by:



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