UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 83571 / June 29, 2018

INVESTMENT ADVISERS ACT OF 1940
Release No. 4953 / June 29, 2018

ADMINISTRATIVE PROCEEDING
File No. 3-18566

In the Matter of **Morgan Stanley Smith Barney LLC,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, 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 Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Morgan Stanley Smith Barney LLC ("MSSB" or "Respondent").

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 Section 15(b) of the Securities and Exchange Act of 1934 and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940,

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. These proceedings arise out of MSSB's failure to adopt policies and procedures reasonably designed to prevent MSSB personnel from misusing and misappropriating funds in client accounts. From at least 2009 to the present, MSSB permitted its investment adviser representatives and registered representatives, which MSSB referred to as financial advisors ("FAs"), to initiate third-party disbursements from client accounts of outgoing wire transfers and journals of up to $100,000 per day per account based on the FA's attestation on an internal electronic form that the FA had received a verbal request from the client by phone or in-person and providing certain details about the request. While MSSB policies provided for certain reviews prior to issuing the disbursements, such reviews were not reasonably designed to detect or prevent an FA making false attestations about having received a verbal client request to transfer funds to a third-party for the FA's benefit.

2. MSSB's insufficient policies and procedures contributed to its failure to detect or prevent an FA from misappropriating funds from client accounts over a period of nearly a year. From December 2015 until November 2016, Barry F. Connell ("Connell"), while employed as an FA, initiated over $7 million in unauthorized transactions out of the accounts of four of his advisory clients by making false attestations on approximately 90 internal electronic forms to initiate third-party transfers between certain client accounts and third-party wires from client accounts for his benefit, as well as by his unauthorized use of approximately 20 client account checks. Through these unauthorized transactions, Connell misappropriated over $5 million from the client accounts to fund his lavish lifestyle.[2] MSSB did not detect that any of these transactions were unauthorized for nearly a year until the defrauded clients contacted MSSB with questions about their accounts. Accordingly, MSSB also failed reasonably to supervise Connell.

Respondent

3. **MSSB** is a Delaware limited liability company with its principal place of business in Purchase, New York. MSSB has been a registered with the Commission as both a broker-dealer

[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.

[2] On February 3, 2017, the Commission filed a civil injunctive action and the United States Attorney's Office for the Southern District of New York filed criminal charges against Connell. Securities and Exchange Commission v. Barry F. Connell, No.17-cv-00831 (LGS) (S.D.N.Y) and United States v. Barry Connell, No. 17-cr-116 (RMB) (S.D.N.Y.). Both actions are currently pending.

and investment adviser since May 2009. MSSB is an indirect wholly-owned subsidiary of Morgan Stanley.

Background

4. MSSB is dually-registered as an investment adviser and broker-dealer and its FAs, such as Connell, provide services in both capacities. MSSB applied the same policies, procedures, and systems relating to third-party disbursements to both brokerage and advisory accounts. Third-party disbursements are wires, journals (i.e., cash or securities movements between MSSB accounts), and checks that transfer funds to a person other than the account holder such that the funds at issue change ownership. A same-name disbursement would be a transfer of funds where the same person is the account holder on both accounts. Third-party disbursements create a higher potential risk of fraud than same-name transfers because funds are no longer in the possession of the account holder. As a registered investment adviser, MSSB was subject to Rule 206(4)-7 of the Advisers Act, known as the compliance rule. Among other things, the compliance rule requires advisers to adopt and implement policies and procedures reasonably designed to prevent violations by the firm and its supervised persons, such as Connell. As noted in the adopting release for the compliance rule, the Commission stated its expectation that an adviser's policies and procedures at a minimum would address a number of items, including "[s]afeguarding of client assets from conversion or inappropriate use by advisory personnel."[3]

5. Beginning in approximately June 2015, a married couple aged 81 and 77, their adult daughter, and a trust for which the daughter serves as co-trustee opened investment advisory accounts at MSSB for which Connell acted as the designated FA and had discretion over investment decisions in such accounts. The clients entered into written investment advisory agreements with MSSB concerning such accounts under which MSSB and Connell would provide investment advice and manage their investments in exchange for an advisory fee. As their investment adviser, MSSB and Connell owed these clients an affirmative fiduciary duty of utmost good faith and MSSB was required under the compliance rule to, among other things, have policies and procedures reasonably designed to safeguard their assets from conversion or other inappropriate use by Connell.

6. From at least December 2015, Connell secretly began misappropriating funds from the advisory accounts of the daughter and trust by initiating numerous unauthorized third-party wires and checks to individuals and entities to cover his personal expenses and fund his lavish lifestyle. Connell also made a series of unauthorized cash journals from the couple's advisory accounts to augment the existing funds in the daughter's and trust's accounts, which he then misappropriated. Specifically, Connell falsely represented to an assistant, referred to as a Client Service Associate ("CSA"), that the clients had provided verbal instructions to transfer funds and provided the details needed to initiate the transfers to the assistant, who submitted the requests in MSSB's systems. In total, Connell misused clients' funds by initiating approximately 110 unauthorized transactions totaling $7 million, and misappropriated over $5 million through these transactions for his own benefit.

[3] Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204 (Dec. 17, 2003).

MSSB's Policies and Procedures for Third-Party Disbursements Were Not Reasonably Designed

7. From at least 2009 to the present, MSSB's policies and procedures permitted its FAs to initiate certain types of third-party disbursements, including wires and journals, from client accounts of up to $100,000 per day per account based on the FA's attestation of having received a verbal request from the client. As a result, there was a risk that MSSB FAs could misappropriate client funds by making false attestations. For third-party wire transfers or third-party journals in which the MSSB FA represented having received a verbal request from the client by phone or in-person, the FA (such as Connell) or the assisting CSA, completed an internal electronic form and provided certain information, including the identity of the requestor, the person who spoke to the requestor, the date and time of the request, the reason for the request, the amount to be transferred, the date of the transfer, and the recipient bank information (the "Verbal Request Forms").

8. After initiating a request for a third-party wire or journal of up to $100,000 per day per account through Verbal Request Forms, MSSB's policies and procedures provided for a process to review the request, which was primarily performed by MSSB's Service Review Unit ("SRU"), a centralized business unit dedicated to reviewing money movements.[4] The required review focused on confirming that the information required on the electronic form was complete.

9. MSSB's policies, procedures, and systems had limited mechanisms to detect or prevent an FA from fraudulently making third-party disbursements from a client's account of up to $100,000 per day per account through falsified Verbal Request Forms. Specifically, the relevant MSSB policies and procedures for Verbal Request Forms involving third-party disbursements of up to $100,000 per day per account did not prescribe or require any means of authenticating or testing whether a third-party wire or journal had been requested by the client, irrespective of the number or aggregate amount of such third-party disbursements over a period of days or weeks. For example, in these circumstances, MSSB did not require a client signature or letter of authorization, and, therefore, there was no client signature on the request to compare to account opening records. MSSB also did not require a call back to the client for such requests and did not have policies or procedures to conduct such a call on a sample basis. Similarly, MSSB did not record calls, nor did it require calls requesting such third-party disbursements to be made to firm telephones for which records might be obtained to verify that a call had taken place at the date and time specified on the Verbal Request Form.

10. MSSB's policies, procedures, and systems involved generating certain types of "exception" reports for review by supervisors. However, none of these reports were designed in a manner that could reasonably detect misuse or misappropriation of client assets by MSSB FAs who falsely attested on a Verbal Request Form to having received a verbal instruction from a client for third-party disbursements of up to $100,000 per day per account. In addition, for all wire transfers (but not cash journals between MSSB accounts), MSSB did use a fraud software program that assessed wires against certain risk indicators and would trigger an alert if a wire exceeded

[4] MSSB's policies and procedures also provided that the review process could be performed by designated branch supervisors.

certain thresholds set by MSSB, which would then require further review by a fraud analyst prior to MSSB executing the wire transfer. However, the fraud software was not reasonably calibrated to analyze risks created by MSSB's practice of allowing FAs to initiate third-party wires of up to $100,000 per day per client account based on the FA's attestation of having received a verbal request from the client. In practice, the fraud software did not trigger alerts on any of the more than 50 unauthorized third-party wires Connell initiated by falsely representing he had received a verbal client request.

11. Because MSSB's policies and procedures were not reasonably designed, MSSB did not take steps to reasonably monitor its FAs using Verbal Request Forms for third-party disbursements of up to $100,000 per day per account or to detect unauthorized or unusual activity in client accounts for amounts under this threshold. As a result, MSSB did not detect or prevent Connell from misusing or misappropriating a total of approximately $7 million out of the accounts of four advisory clients in approximately 110 unauthorized transactions that occurred over a period of nearly a year.

12. On November 3, 2016, a representative of the defrauded clients contacted MSSB questioning transactions in their accounts. MSSB promptly conducted an internal investigation, terminated Connell, and reported the fraud to the SEC and other law enforcement agencies. As of April 25, 2017, MSSB entered into settlement agreements with the defrauded clients in which MSSB fully repaid the clients plus interest.

13. MSSB has also developed significant enhancements to its policies, procedures, systems and controls relating to preventing or detecting conversion of client advisory and customer brokerage funds by MSSB personnel through third-party cash disbursements (the "Enhanced MSSB Policies"), increased its anti-fraud program expenditures, and hired additional fraud operations personnel. The Enhanced MSSB Policies include increased client contact, independent client call backs on a risk-based and randomly-sampled basis, revisions to the calibration of its fraud software, and other new or revised internal surveillance procedures.

Violations

14. As a result of the conduct described above, MSSB willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require, among other things, that a registered investment adviser adopt written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons.

15. As a result of the conduct described above, MSSB failed reasonably to supervise Connell, within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing his violations of Sections 206(1) and 206(2) of the Advisers Act.

MSSB's Remedial Efforts

16. In determining to accept the Offer, the Commission considered certain remedial acts promptly undertaken by Respondent and significant cooperation afforded the Commission staff.

Undertakings

17. Respondent has undertaken to:

a. Initial Certification. Within six (6) months of the date of this Order, MSSB shall require the Head of Risk for Wealth Management (the "Certifying Individual") to certify that the Enhanced MSSB Policies are fully operational (the "Initial Certification"). The Initial Certification shall be supported by exhibits sufficient to demonstrate compliance with this undertaking. The Commission staff may make reasonable requests for further evidence of compliance, and MSSB agrees to provide such evidence.

b. Final Certification. Within six (6) months after the date of the Initial Certification, MSSB shall assess the implementation and adequacy of the Enhanced MSSB Policies, together with any other relevant MSSB policies, procedures, systems and controls relating to preventing or detecting conversion of client advisory funds by MSSB personnel through all forms of third-party cash disbursements (including, but not limited to, wire transfer, journal, or checks) (collectively, the "Then-Existing Relevant MSSB Policies"). MSSB shall require the Certifying Individual to certify that he or she has reviewed and evaluated MSSB's assessment and that, after reasonable inquiry, believes that the Then-Existing Relevant MSSB Policies are adequate and sufficient to provide reasonable assurance of compliance with all relevant Commission regulations and any standards and rules of self-regulatory organizations registered with the Commission and of which MSSB is a member (the "Final Certification"). If the Certifying Individual cannot represent that the Then-Existing Relevant MSSB Policies are adequate and sufficient, then the Certifying Individual shall describe in reasonable detail the reasons for the inability to so certify. In any event, MSSB must provide the Final Certification to the Commission staff within ninety (90) days of the end of this six-month period. The Final Certification shall also describe the nature and scope of MSSB's assessment and be supported by exhibits sufficient to demonstrate compliance with this undertaking. The Commission staff may make reasonable requests for further evidence of compliance, and MSSB agrees to provide such evidence.

c. All reports and certifications described in these undertakings shall be submitted to Wendy Tepperman, Assistant Regional Director, Securities and Exchange Commission, New York Regional Office, 200 Vesey Street, Suite 400, New York, NY 10281, with a copy to the Office of Chief Counsel of the Division of Enforcement.

18. For good cause shown, the Commission staff may extend any of the procedural dates relating to the undertakings. Deadlines for procedural dates shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered to be the last day.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Section 15(b) of the Exchange Act and Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

B. Respondent is censured.

C. Respondent shall comply with the undertakings enumerated in Section III paragraph 17, above.

D. Respondent shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $3,600,000 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 MSSB as the 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 Sanjay Wadhwa, Senior Associate Director, Securities and Exchange Commission, New York Regional Office, 200 Vesey Street, Suite 400, New York, NY 10281.

E. 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