UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 4649 / February 14, 2017

ADMINISTRATIVE PROCEEDING
File No. 3-17845

In the Matter of **MORGAN STANLEY SMITH BARNEY, LLC** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO 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 Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Morgan Stanley Smith Barney, LLC ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Respondent admits the facts set forth in Sections III. B and C. below, and acknowledges that its conduct violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, admits the Commission's jurisdiction over it and the subject matter of these proceedings, and consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to 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:

A. Summary

From mid-2010 to mid-2015, Morgan Stanley Smith Barney, LLC ("MSSB") solicited advisory clients with over 600 non-discretionary advisory accounts to purchase single-inverse exchange-traded funds ("ETFs"), without implementing MSSB's written compliance policies and procedures, which were designed to prevent violations of the of the Advisers Act, including its antifraud provisions.

MSSB's compliance policies and procedures, which were adopted in March 2010, had two key requirements before advisory clients with non-discretionary accounts purchased single-inverse ETFs: (1) each client was to sign a Client Disclosure Notice, which explained certain risks associated with investing in these securities and the Client Disclosure Notice was to be maintained; and (2) a MSSB supervisor was to conduct risk reviews to evaluate the suitability of these investments for that advisory client. For about 44% of the approximately 1,400 non-discretionary advisory accounts that purchased single-inverse ETFs on a solicited basis, a Client Disclosure Notice was not signed by the client prior to the purchase of single-inverse ETFs. In addition, for clients whose purchases of a single-inverse ETF were executed without obtaining a signed Client Disclosure Notice, the risk reviews were either deficient or not conducted. MSSB also failed to implement other of its compliance policies and procedures for non-discretionary advisory clients investing in these securities, including that the positions be monitored on an ongoing basis, that the purchase of single-inverse ETFs be a hedge, and that financial advisors complete single-inverse ETF training.

Many of MSSB's non-discretionary advisory clients held the securities for months or years, despite the fact that the Client Disclosure Notice stated that single-inverse ETFs are typically unsuitable for investors who plan to hold them for longer than one trading session unless used as part of a trading or hedging strategy. MSSB solicited some of these clients to purchase single-inverse ETFs in retirement accounts with long-term time horizons. Many of the clients experienced losses associated with their investments in the single-inverse ETFs.

MSSB knew the solicitation of these securities was a concern for regulators. MSSB's parent company, Morgan Stanley & Co. LLC ("Morgan Stanley"), was sanctioned by FINRA in May 2012 and by the New Jersey Bureau of Securities in July 2013 for its lack of compliance policies prior to June 2009 specifically addressing the sale of non-traditional ETFs, including the single-inverse ETFs at issue in this Order. At the time it settled these matters, Morgan Stanley publicly stated that after June 2009, it took several steps to remedy its deficient supervisory

[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.

systems and policies. In 2010, MSSB adopted similar compliance policies and procedures for non-traditional ETFs to meet investment advisor and broker-dealer requirements.

Nevertheless, MSSB was aware of weaknesses and deficiencies in the implementation of its compliance policies and procedures. For example, a 2010 exam conducted by the SEC's Office of Compliance Inspections and Examinations ("OCIE") identified weaknesses with MSSB's documentation of risk reviews and its monitoring of the hedging requirement, yet MSSB failed to take sufficient corrective measures. MSSB's internal testing from 2012 to 2014 also showed compliance deficiencies with non-discretionary advisory accounts in at least 12 offices. In addition, an MSSB 2013 internal audit report noted inadequate monitoring of MSSB's implementation of its single-inverse ETF policy.

Accordingly, MSSB failed to adequately implement its compliance policies and procedures, which were designed to prevent unsuitable recommendations of single-inverse ETFs for advisory clients with non-discretionary advisory accounts. MSSB's failure to adequately implement its compliance policies and procedures was a violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

B. Respondent

1. Morgan Stanley Smith Barney, LLC, ("MSSB") is a wholly owned subsidiary of Morgan Stanley Smith Barney Holdings, LLC, and an indirectly wholly owned subsidiary of Morgan Stanley, a Delaware limited liability company with its principal executive offices in New York, New York and whose shares are traded on the New York Stock Exchange. MSSB is headquartered in Purchase, New York and has been dually registered as an investment advisor and broker-dealer with the Commission since May 2009, following its formation through a joint venture of Morgan Stanley's Global Wealth Management Group and Citigroup Inc.'s Smith Barney businesses.

C. Facts

a. Background Information on Non-Traditional ETFs

2. ETFs are open-end investment companies whose shares list and trade on national securities exchanges at market prices. Non-traditional ETFs include leveraged, inverse, or inverse leveraged ETFs, which seek, after fees and expenses, to deliver a multiple, the inverse, or a multiple of the inverse, respectively, of the performance of an underlying index or benchmark for a specified period (usually a single day).

b. The Solicitation of Inverse ETFs was a Concern for Regulators

3. In June 2009, MSSB received FINRA Regulatory Notice 09-31 which reminded brokerage firms of their sales practice obligations in connection with leveraged and inverse ETFs, including single-inverse ETFs. The notice stated:

> In particular, recommendations to customers must be suitable and based on a full understanding of the terms and features of the product recommended… and firms must have adequate supervisory procedures in place to ensure that these obligations are met.

4. The notice also stated that most inverse ETFs "reset" daily, "meaning that they are designed to achieve their stated objectives on a daily basis. Due to the effect of compounding, their performance over longer periods of time can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time." This effect, the notice explained, can be magnified in volatile markets. Therefore, "inverse and leveraged ETFs typically are not suitable for retail clients who plan to hold them for more than one trading session, particularly in volatile markets."

5. MSSB's parent company, Morgan Stanley, was sanctioned by FINRA in May 2012 and by the New Jersey Bureau of Securities in July 2013 for its lack of compliance policies prior to June 2009 specifically addressing the sale of non-traditional ETFs, including the single-inverse ETFs at issue in this Order. At the time it settled these matters, on a neither admit nor deny basis, Morgan Stanley publicly stated that after June 2009, it took several steps to remedy its deficient supervisory systems and policies.

6. After the FINRA notice, MSSB adopted compliance policies and procedures that were designed to guard against unsuitable recommendations and provide disclosures of risks associated with investing in non-traditional ETFs.

c. MSSB's Compliance Policies and Procedures Related to Single-Inverse ETFs

7. MSSB initially adopted a policy in August 2009 that prohibited its financial advisors from recommending the purchase of non-traditional ETFs, including single-inverse ETFs, to advisory clients.

8. In March 2010, MSSB amended this policy to allow financial advisors to recommend eight specific single-inverse ETFs in non-discretionary advisory accounts, but only when certain conditions were met.

9. The March 2010 policy required MSSB to obtain a signed "Client Disclosure Notice" from the client prior to placing a trade in a single-inverse ETF in a non-discretionary advisory account. The Client Disclosure Notice explained certain risks associated with single-inverse ETFs, including that the products are typically unsuitable for clients who plan to hold them for longer than one trading session unless used as part of a trading or hedging strategy, and that the performance of these products over holding periods greater than one day can differ significantly from the inverse of the relevant underlying index or benchmark over the same period of time. Clients were required to sign the notice and to acknowledge those risks and agree that he or she was interested in making the investment. The Client Disclosure Notice was to be maintained as part of MSSB's branch or client files.

10. The policy also required the financial advisor to consider whether the investment would be appropriate for the client given general suitability considerations, such as net worth and investment experience. In addition, the policy required financial advisors to complete training on non-traditional ETFs prior to recommending the investment.

11. As an additional measure, prior to a client's purchase of a single-inverse ETF in a non-discretionary advisory account, a manager was required to conduct a risk review and to sign the order ticket to document approval. As part of the risk review, the reviewer was required to consider, among other things:

- The client's investment experience, including experience (if any) investing in ETFs and similar products;
- For non-discretionary advisory accounts, whether the client had signed the required disclosure notice;
- Whether the client's stated investment objectives and time horizon were consistent with the transaction;
- The size of the transaction/position relative to the client's stated income, liquid net worth and existing exposure to the benchmark/index being hedged; and
- Any other considerations determined to be relevant.

12. The policy permitted the recommendation of these securities only as part of a hedging strategy, but not for speculation purposes. In April 2014, the hedging requirement was dropped.

13. The policy further required financial advisors to monitor the index/benchmark, the performance of the ETF relative to the index, and to consider whether the hedge position was appropriately sized given the client's portfolio exposure.

d. MSSB's Failure to Implement its Policies and Procedures Related to Single-Inverse ETFs

14. Between early-2010 and mid-2015, the period during which the policy required a signed Client Disclosure Notice and risk review, MSSB financial advisors solicited purchases of single-inverse ETFs in approximately 1,400 non-discretionary advisory accounts. MSSB failed, however, to obtain signed Client Disclosure Notices from a number of clients prior to their purchase of the single-inverse ETFs. The Client Disclosure Notices were required to be maintained under MSSB's single-inverse ETF policy and the books and records provisions under the Advisers Act. MSSB, however, could not produce to the staff Client Disclose Notices for about 44% of the accounts. MSSB failed to obtain confirmation, through the Client Disclosure Notices, that certain clients understood the risks but were nonetheless interested in purchasing single-inverse ETFs.

15. A significant number of clients for whom no Client Disclosure Notice was on file experienced losses associated with the single-inverse ETF investments. Over 80% of these

accounts held the ETFs for at least 30 days. Some of the clients were solicited to purchase single-inverse ETFs in retirement accounts with long-term time horizons.

16. As noted above, under MSSB's policy, the financial advisors were responsible for monitoring these single-inverse ETF positions. A significant number of these ETF investments, however, remained in accounts for extended periods of time, despite the fact that MSSB's Client Disclosure Notice stated that these ETF investments are typically unsuitable for investors who plan to hold them longer than one trading session unless used as part of a trading or hedging strategy.

17. MSSB's failure to obtain signed Client Disclosure Notices from clients violated its policies and procedures designed to prevent violations of the Advisers Act.

18. In addition, under MSSB's policy, the manager conducting the risk review was to consider whether the client had signed the required disclosure notice prior to purchasing the single-inverse ETF. For clients whose purchases of single-inverse ETFs were executed without obtaining signed Client Disclosure Notices, the risk reviews were either deficient or not conducted.

19. Furthermore, MSSB had not adequately implemented the policy requirement that single-inverse ETFs be used solely as a hedge . An August 2013 MSSB internal memorandum noted that the requirement that single-inverse ETFs only be used for hedging purposes was highly subjective, not easily determined by a risk officer, and not enforceable.

e. MSSB Was On Notice of Continuing Compliance Issues

20. Over the period from late-2010 to mid-2015, MSSB was on notice of weaknesses and deficiencies in the implementation of its policies relating to single-inverse ETFs. For example, in 2010, OCIE conducted an examination of MSSB and identified weaknesses and best practice recommendations regarding the firm's monitoring of transactions in single-inverse ETFs. Specifically, OCIE identified weaknesses with MSSB's documentation of risk reviews and monitoring of the hedging requirement, yet MSSB did not take corrective measures.

21. First, OCIE noted that there was no documentation that the risk reviews detailed in the firm's procedures were conducted. OCIE recommended that the firm enhance its procedures to require documentation of the risk review process before allowing a client to trade in single-inverse ETFs. MSSB responded to OCIE's comments, stating that they "do not believe further enhancements to [their] procedures are necessary."

22. Second, OCIE identified that MSSB did not monitor all single-inverse ETF positions held over 30 days to check for compliance with its policy that these securities be held for hedging purposes and as a short-term investment. OCIE recommended that the firm implement procedures to ensure that these securities be held only for hedging purposes at time of purchase and on an ongoing basis. MSSB similarly responded it did not believe further enhancements to its procedures were necessary.

23. In addition, MSSB's internal testing of its ETF policy, which began in 2012, found a number of deficiencies. Branch exam reports which reviewed trades executed in 2011 through 2014 identified approximately 14 clients in about 12 branch offices that were solicited by MSSB to purchase single-inverse ETFs in non-discretionary advisory accounts but for which MSSB failed to obtain a signed Client Disclosure Notice prior to the purchase. The branch exam reports identified other deficiencies, as well. In response, MSSB addressed the individual deficiencies and recirculated its policy, but it did not address the issues on a firm-wide basis.

24. As an example, a February 21, 2013 report of an exam on a single branch noted that a review of 11 inverse/leveraged ETF trades disclosed: (a) seven order tickets were not on file; (b) five Client Disclosure Notices were not on file; and (c) three financial advisors solicited ETF trades without completing the required training. MSSB took corrective action limited to the particular branch examined and the complex covering that branch. Specifically, MSSB obtained the Client Disclosure Notices after the fact, had the three financial advisors complete the training, and educated all personnel in that complex on the ETF policy and procedures.

25. MSSB's policy required the risk officer to sign the order ticket after conducting a risk review. The February 21, 2013 branch exam report noting the absence of seven order tickets on file suggests that the risk reviews were not performed. MSSB did not, however, adequately address this deficiency.

26. Additionally, during MSSB's 2013 annual review, internal audit found that management lacked effective controls to monitor the ongoing review of single-inverse ETFs. The internal audit found that tracking error variances had not been identified and addressed by management, and the process of monitoring volatility of positions held at the firm needed enhancement.

27. Internal audit also identified additional failures to obtain Client Disclosure Notices prior to 6 transactions out of a sample of 23 client accounts (26%). Furthermore, internal audit sampled client accounts that held one of the approved eight single-inverse ETFs for more than 30 days and had a greater than 5% tracking variance, positive or negative, from the value of the index. For 6 of 15 sampled accounts (40%), no actions had been taken by the branch to evaluate the positions, as required under the policy.

28. After the 2013 internal audit, MSSB took limited steps to improve implementation of its non-traditional ETF policies. For example, MSSB obtained client signatures on disclosure notices after the fact for the clients identified in the above sample of 23 client accounts, MSSB re-communicated to employees the firm's policies, and MSSB implemented a new ETF report to alert complex/branch management if single-inverse ETF positions were held for more than 30 days, so that the positions could be reviewed. Nevertheless, compliance deficiencies continued.

29. In mid-2015, after SEC enforcement staff had commenced its investigation, MSSB revised its compliance policy to prohibit the recommendation of any single-inverse ETFs to clients in non-discretionary advisory accounts.

D. Violations

30. 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 requires registered investment advisors to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.[2]

31. MSSB willfully violated these provisions by failing adequately to implement its written compliance policies designed to prevent violations of the Advisers Act antifraud provisions. MSSB's advisory compliance policies in effect from 2010 to mid-2015 were designed to ensure that recommendations of single inverse ETFs to non-discretionary advisory clients were suitable for each individual client. These compliance policies also required MSSB financial advisors to monitor the positions on an ongoing basis. MSSB, however, failed to follow these compliance policies with respect to numerous non-discretionary advisory clients nationwide. Even after an internal audit in 2013, when MSSB was aware of significant failures to implement compliance policies and procedures, MSSB failed to conduct a comprehensive analysis to identify and correct past failures to provide Client Disclosure Notices and perform risk reviews. Nor did the firm prevent future violations of its single-inverse ETF policies.

IV.

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

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

A. Respondent MSSB 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 promulgated thereunder.

B. Respondent MSSB is censured.

C. Respondent MSSB shall, within 15 days of the entry of this Order, pay a civil money penalty in the amount of $8 million ($8,000,000.00) 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.

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[2] 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)).

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 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 Antonia Chion, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

By the Commission.

Brent J. Fields
Secretary