

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 10726 / November 7, 2019

SECURITIES EXCHANGE ACT OF 1934
Release No. 87483 / November 7, 2019

INVESTMENT ADVISERS ACT OF 1940
Release No. 5408 / November 7, 2019

ADMINISTRATIVE PROCEEDING File
No. 3-19599

In the Matter of

**MORGAN STANLEY SMITH
BARNEY LLC,**

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT
TO SECTION 8A OF THE SECURITIES
ACT OF 1933, SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF
1934, AND SECTION 203(e) 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 8A of the Securities Act of 1933 (“Securities Act”), Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”), and Section 203(e) 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, MSSB 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, MSSB consents to the entry of this Order Instituting Administrative and Cease-and-

Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 15(b) of the Securities Exchange Act of 1934, and Section 203(e) 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 MSSB’s Offer, the Commission finds that:

Summary

1. From at least July 2009 through December 2016 (the “Relevant Period”), in connection with investment recommendations to certain retirement plan and charitable organization brokerage customers (“Eligible Customers”)¹, MSSB represented that, in the process of selecting the most economical share class, it used “share class limits and other tools,” including a share class selection calculator, designed to provide customers with the least costly mutual fund share class. While MSSB did have a share class selection calculator for this purpose, there were three issues: (1) the share class calculator had two operating errors that caused it not to provide the most beneficial share class to Eligible Customers in two specific circumstances; (2) from July 2009 to mid-2012, MSSB did not use the share class calculator for certain legacy retirement plan brokerage customers and other tools employed did not consistently provide the most beneficial share class to Eligible Customers; and (3) MSSB failed to code the share class calculator to provide the lowest share class available to charitable organizations eligible for sales charge waivers and did not otherwise have a mechanism for doing so. As a result, MSSB recommended and sold these Eligible Customers more expensive share classes when less expensive share classes were available, contrary to MSSB’s representations to those Eligible Customers. MSSB’s recommendations of more expensive share classes negatively impacted the overall return on the Eligible Customers’ investments. In addition, MSSB received greater compensation from the Eligible Customers’ purchases when selecting the more expensive share class. MSSB has provided remediation to impacted customers.

2. Under the circumstances described above, MSSB violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. These provisions prohibit, respectively, obtaining money or property by means of any untrue statement of material fact and engaging in a course of business which operates as a fraud or deceit in the offer or sale of securities.

Respondent

3. **MSSB** is a limited liability company organized under the laws of Delaware with its principal office and place of business in Purchase, New York. MSSB is a dually-registered investment adviser and broker-dealer formed in 2009 pursuant to a combination of the Global

¹ The term “Eligible Customers” may include, among other things, customers that held the following type of retirement accounts: 401(k) plans, 403(b) plans, profit-sharing plans, defined benefit plans, and certain IRA accounts. Eligible Customers also include accounts held by tax- exempt, non-profit organizations. Approximately sixty percent of the Eligible Customers held legacy Smith Barney accounts that MSSB had acquired in 2009 in the joint venture with Citigroup.

Wealth Management Group, a business unit of Morgan Stanley & Co. (“Morgan Stanley”), and the Smith Barney division of Citigroup Global Markets, Inc. (“Smith Barney”), a subsidiary of Citigroup Inc.

Background

4. Mutual funds often offer different fund share classes that each represent a common interest in an investment portfolio, but differ in the amount and types of sales charges and fees a fund investor may incur. For funds that have sales charges or sales “loads,” the timing and amount of sales loads typically vary between share classes. These sales charges are normally assessed as a percentage of an investor’s investment. For example, Class A shares often are subject to an up-front sales charge in addition to ongoing marketing and distribution fees, known as Rule 12b-1 fees. Class B and Class C shares often do not have an up-front sales charge, but have higher Rule 12b-1 fees. Class R shares have no up-front sales charges but may have sub-classes with Rule 12b-1 fees greater than, equal to, or less than those of Class A shares.

5. Many mutual funds provide sales charge waivers for Class A shares to qualified retirement accounts. Certain mutual funds also provide sales charge waivers for Class A shares to qualified charitable accounts. Such waivers are important to investors because they allow investors to buy shares at the fund’s current net asset value. Even when not eligible to purchase load-waived Class A shares, qualified retirement customers may be eligible to purchase Class R shares. Eligibility requirements for load-waived Class A shares and R shares, if available, vary by fund family and are disclosed in the prospectus and statement of additional information for each relevant fund.

6. The sales charges and fees associated with different share classes affect mutual fund shareholders’ returns. A mutual fund investor eligible for a sales charge waiver in Class A shares will likely obtain a higher return by investing in Class A shares than incurring the ongoing sales-related costs associated with Class B and Class C shares in the same fund. However, in the absence of a sales charge waiver, the investor may be better off investing in Class R shares (if eligible) rather than Class A, B, or C shares because of the impact of the sales charge in Class A shares on the return and the lower ongoing fees and expenses associated with certain Class R shares.

7. Sales charges and fees associated with different share classes also affect a broker-dealer’s revenue earned from selling mutual fund shares. Broker-dealers typically retain all or a portion of the sales charges and Rule 12b-1 fees charged to their customers. For example, broker-dealers generally receive higher ongoing fees when their customers hold Class B or Class C shares as compared to Class A or Class R shares. Broker-dealers therefore may earn more compensation when recommending a share class to a customer if the customer’s purchase of that share class will increase a broker-dealer’s revenue when compared to another share class in the same fund that the broker-dealer could recommend to the customer.

MSSB’s Share Class Selection Representations and Conduct

8. In 2008, Morgan Stanley developed and implemented an automated mutual fund share class selection system (the “MFSCI”), which was incorporated into Morgan Stanley’s (and

later MSSB's) order entry system. As marketed to customers, the MFSCI was designed so that customers received the most cost effective share class by analyzing customer-specific data points, such as the customer's current mutual fund family holdings and planned future purchases, and the anticipated time horizon of the investment. The MFSCI also incorporated fund-specific information programmed into the system by MSSB personnel, including each fund's share class offerings, the fees and expenses associated with each share class, eligibility criteria for specialized share classes, and any available discounts. MSSB's financial advisors used the MFSCI when executing mutual fund transactions on behalf of Eligible Customers. In approximately July 2012, MSSB began using the MFSCI for its legacy Smith Barney Eligible Customers.

9. During the Relevant Period, MSSB had a process for selecting mutual fund share classes. At account opening, MSSB provided customers with a disclosure document entitled "Important New Account Information," and a brochure entitled "Mutual Fund Share Classes and Compensation," which was also available through its main webpage, a link to which was included in trade confirmations that MSSB mailed to each Eligible Customer following the execution of the customer's order. Both documents stated: "Your Financial Advisor is available to help you decide which class of shares is generally the most economical for you. Morgan Stanley Smith Barney also employs share class limits and other tools to assist with the share class selection process." In January 2015, MSSB revised the brochure to include the following: "the firm employs an order entry share class selection calculator designed to provide customers with the least costly share class option over the anticipated holding period of the investment."

10. During the Relevant Period, MSSB and its financial advisors relied on MFSCI to select the lowest cost share class available to Eligible Customers. There were three issues with this. First, the MFSCI had operating and design flaws that resulted in the MFSCI selecting and MSSB recommending and selling available share classes that were more expensive than the share classes for which customers were eligible in two specific circumstances: (a) retirement accounts with recurring trades that were transferred from other brokerage firms failed to receive the analysis performed by MFSCI, causing some of these Eligible Customers not to receive an available sales charge waiver; and (b) when MSSB financial advisors failed to confirm whether retirement accounts met certain minimum eligibility criteria, as required, such that the customer failed to receive the available sales charge waiver. MSSB failed to adequately test and validate the MFSCI to determine whether it worked as designed, i.e., that it was selecting the lowest cost share class option for Eligible Customers. As a result, MSSB failed to detect these flaws despite MSSB's reliance on the program and representations to its Eligible Customers. Second, MSSB did not begin to use the MFSCI for its legacy Smith Barney Eligible Customers until mid-2012. While Smith Barney did employ other share class limits and order entry blocks to assist financial advisors in providing the most economical share class to Eligible Customers, these tools did not consistently provide the most economical share class available. Third, during the Relevant Period, MSSB failed to code the MFSCI to provide sales charge waivers for its charitable organization customers, resulting in certain of those customers not receiving waivers for which they were eligible.

11. As a result, from at least July 2009 through December 2016, MSSB failed to determine whether certain customers were eligible to purchase load-waived Class A shares or Class R shares. MSSB failed to provide available sales charge waivers to approximately 16,748

Eligible Customers with retirement accounts during the Relevant Period. Similarly, MSSB failed to provide available sales charge waivers to approximately 1,772 Eligible Customers with charitable accounts during the Relevant Period. The vast majority of these involved transactions in which Eligible Customers could have purchased load-waived Class A shares, but MSSB recommended and sold them Class A shares with an up-front sales charge or Class B or Class C shares with a contingent deferred sales charge (“CDSC”) (a deferred sales charge the purchaser pays if the purchaser sells the shares during a specified time period following the purchase) and higher ongoing fees and expenses than the load-waived Class A shares. In addition, MSSB failed to provide certain Eligible Customers the opportunity to purchase Class R shares, resulting in the Eligible Customers instead purchasing Class A shares with an up-front sales charge or a Class B or Class C share with a CDSC and higher ongoing fees and expenses.

12. MSSB earned more revenue from customer purchases of Class A shares with an up-front sales charge or Class B or Class C shares with a CDSC and higher ongoing expenses as compared to load-waived Class A shares and no-load Class R shares for which the customers were eligible. The selection of more expensive share classes for Eligible Customers negatively impacted the customers’ overall investment returns. In the context of multiple-share-class mutual funds, in which the only reason for the differences in rate of return among classes is the cost structures of investments in the different classes, misrepresentations about MSSB’s ability to select the most economical share class would accordingly be important to a reasonable investor.

13. MSSB’s failure to discover and correct the MFSCI’s flaws rendered misleading its representations that it used “share class limits and other tools” in the process of selecting the “most economical” share class, and, beginning in January 2015, that its share class calculator was “designed to provide customers with the least costly share class option.” MSSB has identified the Eligible Customers who purchased more expensive shares than those shares for which they were eligible. MSSB has completed full remediation of approximately 99% of the overcharges to those customers, by crediting the accounts of current customers and mailing reimbursement checks or otherwise directing payments as instructed by former customers.² MSSB has also corrected the flaws in the MFSCI system.

14. From July 2009 onward, Eligible Customers paid a total of \$12,252,833 in up-front sales charges, CDSCs, and higher ongoing fees and expenses from purchases of mutual fund share classes for which they did not receive an applicable sales charge waiver or did not otherwise receive the most cost-effective share class for which they were eligible that was available on MSSB’s platform during the Relevant Period. MSSB has issued payments of this amount (including \$1,576,749 in interest) to Eligible Customers. The total remediation for transactions in which Eligible Customers should have received a no-load Class R share was approximately \$5,840,069, and the total remediation for transactions in which Eligible Customers should have received a load-waived Class A share was approximately \$7,989,513. MSSB’s reimbursement payments include a total of \$7,558,409 relating to transactions during

² Despite reasonable efforts, MSSB is unable to locate and/or contact 226 former MSSB account holders, representing \$45,758.99 in remediation proceeds.

the applicable statutory limitations period³ and a total of \$6,271,173 before that period. MSSB also offered conversion to all Eligible Customers holding share classes with higher ongoing fees and expenses to the share classes with the lowest expenses for which they are eligible, at no cost to the customers.

MSSB's Remedial Efforts

15. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by MSSB and cooperation afforded the Commission staff.

Violations

16. As a result of the conduct described above, MSSB willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, which prohibit any person in the offer or sale of securities from obtaining money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make statements made not misleading, and from engaging in any practice or course of business which operates or would operate as a fraud or deceit in the offer or sale of securities, respectively.⁴ Negligence is sufficient to establish violations of Sections 17(a)(2) and (3) of the Securities Act. *See Aaron v. SEC*, 446 U.S. 680, 696-97 (1980). As a result of these violations, certain Eligible Customers incurred up-front sales charges, CDSCs, and higher ongoing fees and expenses, and MSSB received additional revenue.

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 8A of the Securities Act, Section 15(b) of the Exchange Act, and Section 203(e) 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 Sections 17(a)(2) and 17(a)(3) of the Securities Act.
- B. Respondent MSSB is censured.
- C. Respondent MSSB shall, within 30 days of the entry of this Order, pay disgorgement of \$42,389.41, prejudgment interest of \$3,369.58, and pay a civil money penalty of \$1,500,000 to the Securities and Exchange Commission. The Commission may distribute civil

³ The applicable limitations period under 28 U.S.C. § 2462 for disgorgement in this matter runs from August 16, 2012 to the present.

⁴ "Willfully," for purposes of imposing relief under Section 15(b) of the Exchange Act and Section 203(e) of the Advisers Act, "means no more than 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." *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965).

money penalties collected in this proceeding if, in its discretion, the Commission orders the establishment of a Fair Fund pursuant to 15 U.S.C. § 7246, Section 308(a) of the Sarbanes-Oxley Act of 2002. The Commission will hold funds paid pursuant to this paragraph in an account at the United States Treasury pending a decision whether the Commission, in its discretion, will seek to distribute funds or, subject to Exchange Act Section 21F(g)(3), transfer them to the general fund of the United States Treasury. 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 MSSB may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent MSSB 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 MSSB 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 Morgan Stanley Smith Barney LLC 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 simultaneously sent to C. Dabney O'Riordan, Co-Chief, Asset Management Unit, Securities and Exchange Commission, Los Angeles Regional Office, 444 South Flower Street, Suite 900, Los Angeles, CA 90071, or such other person or address as the Commission staff may provide.

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 these proceedings. 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 these proceedings.

By the Commission.

Vanessa A. Countryman
Secretary