

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 90046 / September 30, 2020

ADMINISTRATIVE PROCEEDING
File No. 3-20103

In the Matter of

**MORGAN STANLEY &
CO. LLC,**

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b) AND 21C OF THE
SECURITIES EXCHANGE ACT OF 1934,
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 15(b) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Morgan Stanley & Co. LLC (“Respondent” or “MS&Co”).

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 Sections 15(b) and 21C of the Securities Exchange Act of 1934, 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 finds¹ that

Summary

1. These proceedings concern MS&Co's violations of the order marking requirements of Regulation SHO ("Reg SHO") of the Exchange Act resulting from its improper use of aggregation units in structuring the firm's prime brokerage swaps business.

2. Reg SHO requires that a person, including a broker-dealer, net all of its positions in a particular equity security to determine whether it is net "long." 17 CFR § 242.200(c). For example, if a broker-dealer has a long position of 1000 shares in ABC stock and one trading desk sells 500 shares of ABC, the broker-dealer's long position would decrease to 500 shares. Then, if a different trading desk sells 1000 shares of ABC, the broker-dealer would have a short position of 500 shares.

3. Reg SHO also requires that a person, including a broker-dealer, mark all sales of equity securities as "long," "short," or "short exempt" and that sales only be marked long when the seller is deemed to own the security being sold, among other requirements. *Id.* § 242.200(g). Therefore, if a broker-dealer has a net long position of 1000 shares in ABC stock and sells 500 shares of ABC, the broker-dealer may be able to mark that sale as a long sale, if other requirements are met. Conversely, if a broker-dealer has a net short position of 1000 shares in ABC stock and sells 500 shares of ABC, the broker-dealer would be required to mark that sale as a short sale and would be subject to the various other requirements of Reg SHO, including the short sale price test, locate, and close out requirements. Therefore, this order marking requirement works in conjunction with, and serves as a crucial safeguard to ensuring compliance with, these other requirements of Reg SHO.

4. For broker-dealers, Reg SHO contains an exception to the requirement that a broker-dealer net all of its "long" and "short" positions in an equity security across the entire firm if such broker-dealer establishes an "aggregation unit(s)" consistent with the requirements of Rule 200(f). *Id.* § 242.200(f). If an aggregation unit of such broker-dealer qualifies for the exception, then such broker-dealer may separately net its "long" and "short" positions in a particular security within such aggregation unit.

5. In order to qualify for the exception, a broker-dealer must meet four requirements. One of those requirements is that the broker-dealer have "a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity." *Id.* § 242.200(f)(1). A written plan of organization is required in order to show that each aggregation unit is "independent and engaged in separate trading strategies without regard to other trading units." Exchange Act Release No. 50103, 2004 WL 1697019, at *6 (Jul. 28, 2004). In

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.

addition, although a variety of factors could evidence independence, there are four factors in particular noted by the Commission that could demonstrate the requisite independence of a broker-dealer's aggregation units: "separate management structures, location, business purpose, and profit and loss treatment." *Id.* at *6 n.25.

6. As part of Morgan Stanley's swaps business, the firm offers customers the ability to gain synthetic exposure to equity securities by entering into swaps. Morgan Stanley runs its swaps business as a financing business. It earns revenue by charging customers a spread on each swap and seeks to have no exposure to the underlying security. Therefore, the firm's broker-dealer MS&Co simultaneously hedges the synthetic exposure by purchasing or selling the securities referenced in the swaps. And, in selling these swaps, the firm competes with other businesses operating under the same securities regulations.

7. Since the adoption and effective date of Reg SHO in 2004, MS&Co has improperly operated its swaps business without netting certain "long" and "short" positions as required by Rule 200(c) of Reg SHO. Specifically, when the firm sold a customer long exposure to an equity security, one part of MS&Co (the "Long Unit") purchased the referenced equity securities in order to hedge that short synthetic exposure in the swap. When the swap expired or was unwound by a client that had long swap exposure, MS&Co sold those equity securities, while always marking those orders as long sales. On the other hand, when the firm sold a customer short exposure to an equity security, another part of MS&Co (the "Short Unit") short sold the referenced equity securities in order to hedge that long synthetic exposure in the swap – treating them as short in connection with Reg SHO's short sale requirements. When the swap expired or was unwound by a client that had short swap exposure, MS&Co bought those equity securities to cover the earlier short sale.

8. The Long and Short Units were not independent from one another. They had identical management structures, with the same front-line supervisor overseeing both Units, and traders from both Units sat side-by-side, with traders from one Unit routinely substituting for traders in the other Unit during absences. Furthermore, the Long and Short Units had the same business purpose of hedging the firm's synthetic exposure to equity securities created by swaps transactions, differentiated only in that the Long Unit held long hedges while the Short Unit held short hedges.

9. The Long and Short Units did not have separate trading strategies or objectives without regard to each other, but rather had the same trading strategy or objective: to hedge synthetic exposure established through the swap business. MS&Co's bifurcation of its related hedging activity into separate Units allowed the equity sales of one Unit to be uniformly marked "short" and those of the other Unit to be uniformly marked "long." This bifurcation contravenes Reg SHO's requirement that a broker-dealer net all "long" and "short" positions together in a particular security.

10. Because the Long and Short Units were not independent and did not have separate trading strategies or objectives, the Units were not eligible for the exception in Rule 200(f) of Reg SHO and MS&Co should have, at a minimum, netted the "long" and "short" positions of both Units together or netted the "long" and "short" positions of both Units across the entire broker-dealer.

11. Accordingly, MS&Co violated Rule 200(g) of Reg SHO by improperly marking certain sell orders.

Respondent

12. Morgan Stanley & Co. LLC is a Delaware limited liability company with its principal place of business in New York, NY. It is a wholly owned subsidiary of Morgan Stanley (the “firm”). MS&Co has been registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act since 1970 and is a Financial Industry Regulatory Authority member.

Background

Aggregation Units Pursuant to Regulation SHO

13. On July 28, 2004, the Commission adopted certain rules comprising Reg SHO, 17 CFR §§ 242.200-203, which, according to its Adopting Release, “defines ownership of securities, specifies aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities ‘long,’ ‘short,’ or ‘short exempt.’” 2004 WL 1697019, at *1.

14. Although the Adopting Release notes that “[h]istorically, a multi-service broker-dealer was considered one entity, so all of its positions were aggregated to determine the firm’s net position,” it further acknowledges that “firm-wide aggregation often interfered with the trading of independent units within the broker-dealer.” *Id.* at *6. As such, the Adopting Release recognizes that prior to Reg SHO’s adoption, “[t]he staff of the Division of Market Regulation therefore issued a no-action letter allowing multi-service broker-dealers to aggregate their positions within defined trading units.” *Id.*

15. Accordingly, Rule 200(f) of Reg SHO states that “[i]n order to determine its net position, a broker or dealer shall aggregate all of its positions in a security unless it qualifies for independent trading unit aggregation, in which case each independent trading unit shall aggregate all of its positions in a security to determine its net position.” 17 CFR § 242.200(f).

16. Rule 200(f) sets forth four requirements for “[i]ndependent trading unit aggregation:”

- (1) The broker or dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity;
- (2) Each aggregation unit within the firm determines, at the time of each sale, its net position for every security that it trades;

- (3) All traders in an aggregation unit pursue only the particular trading objective(s) or strategy(s) of that aggregation unit and do not coordinate that strategy with any other aggregation unit; and
- (4) Individual traders are assigned to only one aggregation unit at any time.

Id.

17. With respect to the first requirement, the Adopting Release states that “we require a written plan of organization as a means to demonstrate that each unit is independent and engaged in separate trading strategies without regard to other trading units.” 2004 WL 1697019, at *6. Additionally, footnote 25 of the Adopting Release provides that “the independence of the units would be evidenced by a variety of factors, such as separate management structures, location, business purpose, and profit and loss treatment.” *Id.* at *6 n.25.

18. Further, the third requirement states that, to avail itself of the use of an aggregation unit, all traders in that aggregation unit only pursue the strategy or objective assigned to the particular trading unit and without coordination with any other aggregation unit. 17 CFR § 242.200(f)(3).

Long and Short Units Did Not Have Separate Trading Strategies or Objectives

19. Since Reg SHO’s adoption and effective date in 2004, MS&Co has improperly relied on the exception to firmwide netting of all of its positions in a particular equity security through its use of the Long and Short Units.

20. The Long Unit is described in MS&Co’s written plan of organization as follows: “Engages in financing transactions in a variety of equity and equity related instruments by providing long equity linked exposure, both with clients and other swap market participants. Also actively involved in structuring customized financing, yield enhancement and hedging transactions for clients and the Firm.” Essentially, the Long Unit exists to purchase equity securities to facilitate “long” swaps with customers. When the equity swap is unwound or expires, the Long Unit marks the relevant equity securities sales as long sales.

21. The Short Unit is described in MS&Co’s written plan of organization as follows: “Engages in financing transactions in a variety of equity and equity related instruments by providing short equity linked exposure, both with clients and other swap market participants. Also actively involved in structuring customized financing, yield enhancement and hedging transactions for clients and the Firm.” Essentially, the Short Unit exists to facilitate “short” swaps with customers. When the equity swap is unwound or expires, the Short Unit buys the relevant equity securities to cover the earlier short sale.

22. The Long and Short Units operate to serve the same purpose: to support the firm’s swaps business. As a result, both the Long and Short Units have the same trading strategy or objective.

23. When customers sought “long” swaps, the firm could enter into those swaps knowing that it could always close the swaps for customers because MS&Co could sell the hedges marked as “long” sales without concern for Reg SHO’s short sale requirements.²

Long and Short Units Were Not Independent Trading Units

24. The Long and Short Units did not operate in an independent manner. For example, the Long and Short Units did not maintain separate management structures. Specifically, although the Long Unit consisted of one or two traders and the Short Unit consisted of one or two different traders, all traders reported to the same front-line supervisor (the “Supervisor”).³

25. The Supervisor had real-time access to all of the trading being executed by the traders that he supervised in the Long and Short Units and received updates on trading exceptions and other issues that arose in the day-to-day trading in those Units. Additionally, the Supervisor met weekly with the traders that he supervised in the Long and Short Units, in which they discussed specific securities being traded, including trading volumes in those securities.

26. The Long and Short Units did not have separate locations. Specifically, the one or two traders in the Long Unit sat next to the one or two traders in the Short Unit on MS&Co’s trading floor. The traders routinely filled in for each other during absences.

27. The Long and Short Units did not have separate business purposes. Specifically, as stated above, MS&Co’s written plan of organization described both the Long and Short Units as “[e]ngaging in financing transactions in a variety of equity and equity related instruments by providing . . . equity linked exposure, both with clients and other swap market participants” and as “structuring customized financing, yield enhancement and hedging transactions for clients and the Firm.” The only distinction between the two Units was that the Long Unit accomplished this business purpose with respect to requests for long exposure, whereas the Short Unit did so with respect to requests for short exposure.

* * *

² Such sales could occur without concern for Reg SHO’s short sale requirements, including as applicable the short sale price test, locate, and close out requirements. By doing this, the firm was able to operate its prime brokerage swaps business with a competitive advantage.

³ The Supervisor reported to the same supervisor (the “MS&Co MD”) for purposes of his supervision of both the Long and Short Units. In addition, for the entire time period, the Supervisor was also the supervisor of traders in another aggregation unit, and the MS&Co MD supervised the Supervisor for purposes of that aggregation unit. In August 2019, MS&Co modified its management structure to provide a new layer of separate supervisors for the Long and Short Units, both of whom were still supervised by the Supervisor, and purportedly enhanced surveillance for potential coordination between the Units but did not collapse the Long and Short Units.

28. As a result, the Long and Short Units were not independent and did not have separate trading strategies or objectives, rendering them ineligible for the exception in Rule 200(f) of Reg SHO, and all positions with respect to the Long and Short Units should have been, at a minimum, netted together, or netted with other positions across the broker-dealer, at all times.

Order Marking Requirement

29. Rule 200(g) of Reg SHO requires that “[a] broker or dealer must mark all sell orders of any equity security as ‘long,’ ‘short,’ or ‘short exempt,’” *id.* § 242.200(g), and provides that “[a]n order to sell shall be marked ‘long’ only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of this section,” among other requirements, *id.* § 242.200(g)(1).

30. In the Long Unit, MS&Co marked all sell orders of equity securities executed upon unwind or expiration of the related swap as long sales. In the Short Unit, MS&Co marked all sell orders of equity securities executed to establish its hedge to its newly-created synthetic exposure as short sales.

31. Because MS&Co failed to qualify for independent trading unit aggregation, MS&Co repeatedly mismarked certain sell orders in contravention of Reg SHO.

Violations

32. As a result of the conduct described above, MS&Co willfully⁴ violated Section 200(g) of Reg SHO, *id.* § 242.200(g), which requires a broker or dealer to mark sales of a security as “long” only if it is deemed to own the security being sold, among other requirements.

Undertaking

Respondent has undertaken to operate the Long Unit and the Short Unit as a single independent trading unit and aggregate positions in a security to determine its net position, and will complete the ongoing process of implementing all necessary system recoding, testing, and migration by not later than December 15, 2020.

Respondent shall certify in writing compliance with the undertaking set forth above. The certification shall identify the undertaking, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to Daniel Michael, Chief, Complex Financial Instruments Unit, Division of Enforcement, Securities and

⁴ “Willfully,” for purposes of imposing relief under Section 15(b), “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).

Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, NY 10281, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than ten (10) days from the date of the completion of the undertakings.

IV.

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

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent MS&Co cease and desist from committing or causing any violations and any future violations of Rule 200(g) of Regulation SHO.

B. Respondent MS&Co is censured.

C. Respondent MS&Co shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$5,000,000.00 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.

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 MS&Co 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 Daniel Michael, Chief, Complex Financial Instruments Unit, Division of Enforcement, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, NY 10281.

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 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.

E. Respondent shall comply with the undertaking enumerated above.

By the Commission.

Vanessa A. Countryman
Secretary