

CBOE BZX EXCHANGE, INC.
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 20120346239-07

TO: Cboe BZX Exchange, Inc.
c/o Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: Morgan Stanley & Co. LLC, Respondent
Broker-Dealer
CRD No. 8209

Pursuant to Rule 8.3 of the Rules of Cboe BZX Exchange, Inc. ("BZX" or the "Exchange"), Morgan Stanley & Co. LLC, (CRD No. 8209) ("MSCO" or the "Firm") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, BZX will not bring any future actions against the Firm alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. The Firm hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of BZX, or to which BZX is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by BZX:

BACKGROUND

1. MSCO, a wholly-owned subsidiary of Morgan Stanley Domestic Holdings, Inc., is a Delaware limited liability company headquartered in New York, New York. The Firm provides services to corporate and broker-dealer clients and institutional investors, and acts as an agency broker-dealer, providing market access and execution services to market participants ("Market Access Clients") for a wide variety of products.
2. The Firm has been registered as a member of BZX since October 23, 2008, and with FINRA since June 5, 1970. Its registrations remain in effect. The Firm does not have a relevant disciplinary history.

Summary

3. In Matter No. 2013038442, the Market Analysis Section of FINRA's Department of Market Regulation ("Market Regulation") reviewed 40 Order by Order Price Collar alerts¹ related to orders submitted to the Exchange by the Firm between November 2012 and May 2014, and the Firm's compliance with Rule 15c3-5 of the Securities Exchange Act of 1934 ("SEA") (the "Market Access Rule").²
4. In Matter No. 20140413759, Trading Analysis Staff of Market Regulation reviewed potentially manipulative trading executed through MSCO and occurring on the Exchange between October 2012 and November 2013, and the Firm's risk management controls and supervisory procedures for compliance with the Market Access Rule.
5. In Matter No. 20160523215, Trading Analysis Staff of Market Regulation reviewed potentially violative or manipulative trading executed through MSCO and occurring on the Exchange on September 2, 2016, and the Firm's compliance with the Market Access Rule between August 2013 and March 2017.
6. In Matter No. 20130392621, the Trading Analysis Section of Market Regulation reviewed potentially violative or manipulative trading activity executed through MSCO and occurring on the Exchange between October 2012 and November 2013, and the Firm's compliance with the Market Access Rule.
7. The above matters were part of several investigations, which included Matter No. 20120346239, conducted by Market Regulation on behalf of the Exchange and other self-regulatory organizations, including Cboe BYX Exchange, Inc., Cboe EDGA Exchange, Inc., Cboe EDGX Exchange, Inc., FINRA, Miami International Securities Exchange, LLC, The NASDAQ Stock Market LLC, New York Stock Exchange, Inc., and NYSE Arca, Inc. (collectively, the "SROs"), to review the Firm's compliance with the Market Access Rule and the supervisory rules of the relevant SROs, including BZX Rules 5.1, 5.2, 5.3 and 3.1, during the period of July 14, 2011³ through July 2017 (the "Review Period").
8. As a result of Market Regulation's investigations, it was determined that, during the Review Period, MSCO failed to establish, document, and maintain a system of risk management controls and supervisory procedures, including written supervisory procedures and an adequate system of follow-up and review, reasonably designed to manage the financial, regulatory, and other risks of its market access business.
9. Specifically, during the Review Period, the Firm failed to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to prevent the entry of erroneous orders by rejecting orders that exceed

¹ Price Collar alerts are generated by the submission of a limit order in excess of 10% through the other side of the NBBO.

² The SEC adopted Rule 15c3-5 effective July 14, 2011. See 17 C.F.R. § 240.15c3-5, *Risk Management Controls for Brokers or Dealers with Market Access*, 75 Fed. Reg. 69792 (Nov. 15, 2010) (Final Rule Release).

³ Certain conduct involving the supervision of wash-trading activity on BZX began in April 2011. See paragraphs 28 through 35.

appropriate price or size parameters, or that indicate duplicative orders, in violation of SEA Rules 15c3-5(b) and (c)(1)(ii), and BZX Rules 5.1, 5.2, 5.3 and 3.1.

10. Additionally, during the Review Period, the Firm failed to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to ensure compliance with all regulatory requirements,⁴ including supervising customer trading to detect and prevent potentially violative and manipulative activity, in violation of SEA Rules 15c3-5(b) and (c)(2), and BZX Rules 5.1, 5.2, 5.3 and 3.1.

Violative Conduct

Applicable Rules

11. During the Review Period, SEA Rule 15c3-5(b) required broker-dealers that provide market access to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of their market access business.⁵
12. During the Review Period, SEA Rule 15c3-5(c)(1)(ii) required market access broker-dealers to have financial risk management controls and supervisory procedures reasonably designed to prevent the entry of erroneous orders, by rejecting orders that exceed appropriate price or size parameters, on an order-by-order basis or over a short period of time, or that indicate duplicative orders.
13. During the Review Period, SEA Rule 15c3-5(c)(2) required market access broker-dealers to have regulatory risk management controls and supervisory procedures reasonably designed to ensure compliance with all regulatory requirements.
14. During the Review Period, BZX Rules 5.1, 5.2 and 5.3 required, among other things, that each member firm establish, maintain and enforce written procedures to enable it to properly supervise the activities of associated persons to ensure compliance with applicable securities laws and regulations and BZX Rules.
15. During the Review Period, BZX Rule 3.1 provided that member firms, in the conduct of their business, shall observe high standards of commercial honor and just and equitable principles of trade.

Overview of MSCO's Market Access Systems

16. During the Review Period, MSCO provided and maintained market access and executed millions of trades per day for Market Access Clients.

⁴ See 75 Fed. Reg. at 69797-98 (noting that "regulatory requirements" include "post-trade obligations to monitor for manipulation and other illegal activity."). See also FINRA's 2009 Priorities Letter (Mar. 9, 2009) (referencing NASD Notice to Members 04-66 (Sep. 2004), which specifically noted the need to ensure that orders entered by a firm or its customers via the firm's trading systems are representative of bona fide trading and quote activity).

⁵ Rule 15c3-5 requires that broker-dealers providing market access must "appropriately control the risks associated with market access so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system." 75 Fed. Reg. at 69792.

17. During the Review Period, MSCO had a number of different Divisions through which orders were sent to various markets. These Divisions included the Firm's Institutional Equities Division, which conducted traditional agency and principal business, and offered electronic trading services to its Market Access Clients.
18. During the Review Period, MSCO used a variety of systems (e.g., order management systems, algorithms, etc.) through which its Market Access Clients and traders entered orders for routing to and execution on various U.S. securities markets, including the SROs. Those systems contained controls to which the orders submitted were subjected. In addition, MSCO assigned and applied various controls to individual Market Access Clients and traders to which orders submitted by those clients and traders were subjected before submission to the various markets.
19. MSCO generally implemented one or more of the following pre-trade controls: a duplicate order control; a single order notional control (i.e., the value of an order, which is generally calculated by multiplying the share price by the amount of shares); a single order quantity control; a liquidity control (i.e., a percentage of the estimated daily volume in a symbol); and an average daily trading volume ("ADTV") control. The combination of controls and the limits at which these controls were set varied depending upon the Market Access Client or trader. Moreover, the Firm monitored its Market Access Clients and traders' orders on a post-trade basis for compliance with regulatory requirements, including among other things, potentially manipulative activity.

Inadequate Pre-Trade Erroneous Order Controls

20. Despite the various pre-trade controls that the Firm had in place during the Review Period that were designed to prevent the entry of erroneous orders, the Firm failed to implement reasonably designed pre-trade risk management controls applicable to orders submitted by certain Market Access Clients in certain circumstances, and failed to establish and implement supervisory procedures reasonably designed to prevent the entry of potentially erroneous orders during the Review Period, as set forth below.
21. Because MSCO's pre-trade controls were not reasonably designed as applied to certain of the Firm's Market Access Clients, MSCO did not prevent the transmission of certain erroneous equity and options orders to the SROs or to the Exchange, causing 54 erroneous order events (53 for equities and one for options) resulting in one trading halt and one request for a voluntary bust. The erroneous equity order events caused price movement in the related securities, including movement of up to 77% in one instance.
22. There were several primary deficiencies in MSCO's pre-trade price and size controls that resulted in the submission of the orders that caused the above mentioned erroneous order events. In some instances, the Firm did not include controls that took into account the individual characteristics of a security, such as the ADTV of a security. When it did implement an ADTV or a comparable control that took into account the individual characteristics of a security, the limits in certain circumstances were generally set too high to be effective to identify and prevent potentially erroneous orders, absent additional reasonable controls. For example, certain of the Firm's Market Access Client specific controls during the Review Period employed liquidity limits that permitted single orders

of up to a certain percentage of a symbol's predicted daily trading volume. In certain circumstances, the Firm's assigned limits combined with its estimated predicted daily trading volume would have allowed a client to enter single orders of up to several multiples of a symbol's ADTV, which was inadequate without additional reasonable controls.

23. Moreover, between June 26, 2012 and December 12, 2012, there was an error in the Firm's order entry logic that caused the Firm's liquidity check to fail to apply to aggressive (versus passive) orders.⁶ The liquidity check would make a determination as to whether an order was aggressive or passive, and then apply only to aggressive orders by comparing the size of aggressively-priced orders against historic or predicted market trading volume of the subject security. If the ratio between the order quantity and the applicable volume calculation exceeded the pre-set percentage, the order was flagged for review. The Firm intended for the passive versus aggressive determination feature to be turned off for market orders, thereby causing all market orders to be treated as aggressive orders and be subjected to a liquidity check, but it was inadvertently left on for a limited category of market orders. Thus, some market orders were determined to be passive orders and not subjected to a liquidity check.
24. Further, in at least one other circumstance where the Firm employed liquidity limits, it required another parameter be breached in order to generate an alert and was therefore not effective to identify and prevent potentially erroneous orders, absent additional reasonable controls. For example, for at least one Market Access Client, the Firm's pre-trade order controls were not reasonably designed to prevent potentially erroneous orders in lower priced securities without additional controls due to the requirement that both the liquidity control and the notional control be breached for orders under a fixed amount of shares before the order would be flagged as potentially erroneous.
25. In addition, some Firm Market Access Clients were assigned a "price away" control that applied to limit orders that prevented the entry of an order if it was priced a pre-determined percentage away from the national best bid or offer ("NBBO") for the subject security. In certain circumstances, the threshold applied by the Firm was too high to prevent the entry of potentially erroneous orders without additional reasonable controls.⁷
26. Further, in certain circumstances, the Firm's pricing control assigned limit prices that were the equivalent of the Limit Up/Limit Down ("LULD") bands,⁸ which was not reasonable to prevent the entry of potentially erroneous orders without additional reasonable controls. For example, in certain circumstances the Firm routed short sale orders to an exchange at prices equivalent to the lower end of the LULD band, which resulted in 40 orders to that

⁶ An aggressive order is an order that seeks to remove liquidity, whereas a passive order provides liquidity. For example, an aggressive buy order will generally be priced on the offer or higher, and an aggressive sell order will be priced on the bid or lower.

⁷ In situations where the NBBO may not be indicative of the true market, such as for illiquid securities where the NBBO spread can often be particularly wide, rather than use a pre-determined percentage from the NBBO, one effective practice to prevent potentially erroneous orders is to establish an alternative reference point, such as a control that measures the order price as a percentage away from the last sale. See Report on FINRA Examination Findings, December 2017, p. 10. <http://www.finra.org/industry/2017-report-exam-findings>.

⁸ The LULD mechanism is intended to prevent trades in NMS stocks from occurring outside of specified price bands, coupled with trading pauses to accommodate more fundamental price moves.

exchange that were priced between approximately 17% and 41% through the National Best Bid.

27. The acts, practices, and conduct described above in paragraphs 20 through 26 constitute violations of SEA Rules 15c3-5(b) and (c)(1)(ii), and BZX Rules 5.1, 5.2, 5.3 and 3.1.

Inadequate Supervision of Customer Trading

28. Although throughout the Review Period MSCO employed a series of post-trade surveillances and reviews to detect, escalate and ultimately prevent potentially violative or manipulative trading activity, including wash trading activity, certain of these surveillances were unreasonably designed. Further, MSCO failed to have any surveillances and reviews to detect, escalate and ultimately prevent potential layering⁹ and spoofing¹⁰ activity until November 2013. Thus, in these instances, MSCO failed to comply with certain regulatory requirements by failing to adequately supervise its Market Access Clients' trading to detect potentially violative activity during the Review Period.
29. While during the Review Period, MSCO used a commercial non-proprietary Third-Party Surveillance System ("Third-Party Surveillance System") that provided three surveillance reports to review for potential wash-trading activity, MSCO did not identify certain potential wash-trading activity on the Exchange that occurred beginning in April 2011 to March 2017.
30. In particular, MSCO failed to surveil the activity of agency broker-dealer Market Access Clients for wash-trading activity beginning in April 2011 to March 2015, and as a result, the Firm failed to identify over 1,400 potential wash trades between April 2011 and May 2013.
31. In addition, between August 2013 and March 2017, due to a flaw in its surveillance logic, the Firm failed to include activity involving warrants in its wash-trading surveillance, and as a result, failed to detect at least two potential wash trades that occurred on the Exchange on September 2, 2016. The Firm's failure to include warrants in its wash-trade surveillance resulted in the failure to surveil over a million trades representing hundreds of millions of shares involving warrants for wash-trading activity.

⁹Layering is a form of market manipulation that typically includes placement of multiple limit orders on one side of the market at various price levels that are intended to create the appearance of a change in the levels of supply and demand. In some instances, layering involves placing multiple limit orders at the same or varying prices across multiple exchanges or other trading venues. An order is then executed on the opposite side of the market and most, if not all, of the multiple limit orders are immediately cancelled. The purpose of the multiple limit orders that are subsequently cancelled is to induce, or trick, other market participants to enter orders due to the appearance of interest created by the orders such that the trader is able to receive a more favorable execution on the opposite side of the market.

¹⁰Spoofing is also a manipulative trading tactic designed to induce other market participants into executing trades. Spoofing is a form of market manipulation that generally involves, but is not limited to, the market manipulator placing an order or orders with the intention of cancelling the order or orders once they have triggered some type of market movement and/or response from other market participants, from which the market manipulator might benefit by trading on the opposite side of the market.

32. Further, the parameters used by the Firm in its wash-trade Third-Party Surveillance System reports from the beginning of the Review Period to March 2015 were unreasonably designed to identify potential wash-trading activity. Pursuant to the configuration of two of the Third-Party Surveillance System reports used by the Firm at that time, several parameters had to be breached in order to generate an alert and certain of these parameters employed thresholds that were set at levels that were unreasonable to detect activity that may be indicative of wash-trading. The combination of requiring multiple thresholds to be breached along with the high levels at which the thresholds were set made it difficult to generate an alert and caused the reports to be unreasonably designed. For example, two wash-trading activity reports required each of three parameters to be breached in order for an alert to generate, including a requirement that the activity constitute a certain percentage of the daily trading volume of a symbol that was too high.
33. Finally, MSCO failed to implement post-trade surveillance reports to monitor and review customer trading activity to detect, escalate and ultimately prevent potential layering and spoofing activity until November 2013. As a result, the Firm failed to detect numerous instances of potential layering and spoofing activity on certain of the SROs and the Exchange between October 2012 and November 2013.
34. For the reasons set forth above, MSCO failed to adequately supervise and surveil its Market Access Clients' trading for potential wash-trading activity and potential layering and spoofing activity during the above-referenced periods.
35. The acts, practices, and conduct described above in paragraphs 28 through 34 constitute violations of SEA Rules 15c3-5(b) and (c)(2), beginning on July 14, 2011, and BZX Rules 5.1, 5.2, 5.3, and 3.1.

B. The Firm also consents to the imposition of the following sanctions:

1. A censure;
2. A fine in the amount of \$1,100,000, of which \$255,000 is payable to BZX;¹¹ and
3. An undertaking requiring the Firm to address the Market Access Rule deficiencies described in this AWC and to ensure that it has implemented controls and procedures that are reasonably designed to achieve compliance with the rules and regulations cited herein.

Within 120 days of the date of this AWC, MSCO shall submit to the COMPLIANCE ASSISTANT, DEPARTMENT OF ENFORCEMENT, 9509 KEY WEST AVENUE, ROCKVILLE, MD 20850, a written report, certified by a senior management Firm executive, to MarketRegulationComp@finra.org that provides the following information:

- i. A reference to this matter;

¹¹ The balance of the sanction will be paid to the self-regulatory organizations listed in Paragraph B.4.

- ii. A representation that the Firm has addressed each of the deficiencies described above, including the specific measures or enhancements taken to address those deficiencies; and
- iii. The date(s) this was completed.

The Department of Enforcement may, upon a showing of good cause and in its sole discretion, extend the time for compliance with these provisions.

- 4. Acceptance of this AWC is conditioned upon acceptance of similar settlement agreements in related matters between MSCO and each of the following self-regulatory organizations: Cboe BYX Exchange, Inc., Cboe EDGA Exchange, Inc., Cboe EDGX Exchange, Inc., FINRA, Miami International Securities Exchange, LLC, The NASDAQ Stock Market LLC, New York Stock Exchange, LLC, and NYSE Arca, Inc.

The Firm agrees to pay the monetary sanction(s) upon notice that this AWC has been accepted and that such payment(s) are due and payable. It has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

The Firm specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanction(s) imposed in this matter.

The sanctions imposed herein shall be effective on a date set by BZX.

II.

WAIVER OF PROCEDURAL RIGHTS

The Firm specifically and voluntarily waives the following rights granted under BZX Rules:

- A. To have a Statement of Charges issued specifying the allegations against it;
- B. To be notified of the Statement of Charges and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a Hearing Panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the Appeals Committee of the BZX's Board of Directors and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, the Firm specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Regulatory Officer ("CRO"), in connection with his or her participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

The Firm further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of BZX Rule 8.16, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

The Firm understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the CRO, pursuant to BZX Rule 8.3;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against the Firm; and
- C. If accepted:
 - 1. This AWC will become part of the Firm's permanent disciplinary record and may be considered in any future actions brought by BZX or any other regulator against the Firm;
 - 2. This AWC will be published on a website maintained by BZX in accordance with BZX Rule 8.18. In addition, this AWC will be made available through FINRA's public disclosure program in response to public inquiries about the Firm's disciplinary record; and
 - 3. The Firm may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. The Firm may not take any position in any proceeding brought by or on behalf of BZX, or to which BZX is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects the Firm's: (i) testimonial obligations; or (ii) right to take legal or factual positions in litigation or other legal proceedings in which BZX is not a party.
- D. The Firm may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. The Firm understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by BZX, nor does it reflect the views of BZX or its staff.

The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that it has agreed to the AWC's provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

5/29/2018
Date

Morgan Stanley & Co. LLC, Respondent

By: [Signature]
Name: James J. Marjane
Title: Counsel to Morgan Stanley & Co LLC

Reviewed by:
[Signature]
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Counsel for Respondent

6/4/2018
Date

[Signature]
Greg Hoogasian
Senior Vice President & Chief Regulatory Officer
Cboe BZX Exchange, Inc.

ELECTION OF PAYMENT FORM

The Firm intends to pay the fine proposed in the attached Letter of Acceptance, Waiver and Consent by the following method (check one):

A Firm check or bank check for the full amount; or

Wire transfer.

Respectfully submitted,

Morgan Stanley & Co. LLC, Respondent

5/29/2018

Date

By: [Signature]

Name: James J. Morgan

Title: Counsel to Morgan Stanley & Co LLC