Financial Services Authority

FINAL NOTICE

To: **Morgan Stanley & Co International Plc ("Morgan Stanley")**

Of: **25 Cabot Square, London, E14 4QA**

Dated: **13 May 2009**

TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives you final notice about a requirement to pay a financial penalty.

1. THE ACTION

1.1 The FSA gave Morgan Stanley a Decision Notice dated 1 April 2009 which notified Morgan Stanley that pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act"), the FSA had decided to impose a financial penalty of £1.4 million on Morgan Stanley for breaches of Principles 2 and 3 of the FSA's Principles for Businesses ("the Principles") which occurred between November 2007 and May 2008 ("the Relevant Period").

1.2 Morgan Stanley has confirmed that it will not be referring the matter to the Financial Services and Market Tribunal.

1.3 Accordingly, for the reasons set out below and having agreed with Morgan Stanley the facts and matters relied on, the FSA imposes a financial penalty on Morgan Stanley in the amount of £1.4 million.

1.4 This penalty is discounted by 30% pursuant to the stage 1 early settlement discount scheme. Were it not for this discount, the FSA would have imposed a financial penalty of £2 million on Morgan Stanley.

2. REASONS FOR THE ACTION

Summary

2.1 In the Relevant Period, Morgan Stanley breached Principle 2 by failing to conduct its business with due skill, care and diligence and breached Principle 3 by failing to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

2.2 On 18 June 2008 Morgan Stanley reported its results for the second quarter of 2008. The results announcement included reference to a "*$120 million negative adjustment to marks previously taken in a trader's books that did not comply with Firm policies*". The breaches referred to in this Notice relate to and arise out of the mis-marking referred to in that announcement. The trader in question, Mr Matthew Sebastian Piper ("Mr Piper") was based on Morgan Stanley's Investment Grade Trading ("IGT") desk, part of the Credit Trading line of business of Morgan Stanley’s Interest Rates, Credit & Currency (IRCC) department. His book consisted of certain illiquid financial products ("the Illiquid Products").

2.3 In breach of Principle 2, Morgan Stanley failed to use effectively its existing controls over what was a complex business dealing in sophisticated financial products. It failed to ensure adequate supervision of the business of the IGT desk despite Mr Piper’s books presenting significant risks in terms of notional size and illiquidity. As a result, Morgan Stanley failed to price certain positions held by Mr Piper accurately and failed to prevent or detect his mis-marking in a timely manner.

2.4 In breach of Principle 3, Morgan Stanley failed to respond sufficiently fast to changing conditions in the credit markets (namely an increase in volatility and a decrease in liquidity) by making adjustments to its existing systems and controls which would have enabled it to detect the mis-marking of the Illiquid Products in a timely manner, despite Mr Piper’s books presenting significant risks as described above.

Relevant Statutory and Regulatory Provisions

2.5 The FSA is authorised pursuant to section 206 of the Act, if it considers that an authorised person has contravened a requirement imposed on him by or under the Act, to impose on him a penalty in respect of the contravention, of such amount as it considers appropriate.

2.6 Pursuant to section 2(2) and section 3 of the Act, one of the FSA's statutory objectives is maintaining confidence in the financial system.

2.7 The eleven Principles, which are requirements imposed under section 138 of the Act, represent a general statement of the fundamental obligations of FSA firms under the regulatory system.

2.8 Principle 2 of the Principles states that:

"A firm must conduct its business with due skill, care and diligence."

Principle 3 of the Principles states that:

"A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems."

2.9 The FSA's approach to exercising its main enforcement powers is set out in the Enforcement Guide.

Relevant Context

2.10 The FSA considers that firms should take care to price financial instruments correctly. Particular care must be taken to price complex and/or illiquid products accurately and ensure that individuals with a potential incentive to mis-mark are properly supervised and controlled. If a firm does not have the resources to adequately supervise an activity it should not undertake it.

2.11 The FSA has previously warned of the risks surrounding the mis-marking of financial instruments and the actions of so-called rogue traders. In the Financial Risk Outlook dated January 2007, the FSA warned about the risks associated with illiquid financial instruments which are difficult to value and the inherent conflicts of interest that arise when the same party makes investment decisions and also plays a key role in the pricing of the same investments, particularly where that party's remuneration may be linked to investment performance.

Facts and matters relied on

2.12 Morgan Stanley is a company authorised by the FSA and is part of a major global financial group whose headquarters are in New York.

2.13 Morgan Stanley's risk management control function as regards Credit Trading includes the Valuation Review Group ("VRG"); the Global Product Control Group ("GPC"), the Market Risk Department ("MRD") and an embedded risk management function.

2.14 The role of the VRG was to test the books and records of the firm by reviewing traders' end of month marks independently of the relevant business unit, while day-to-day responsibility for the integrity of Morgan Stanley's books and records rested with the GPC. The GPC's responsibilities included, inter alia, validating traders' profit and loss (P&L) figures.

2.15 In April 2008 the VRG introduced an enhanced mark verification process with respect to the Illiquid Products (the enhanced verification process) and began a general review Mr Piper's marks. This review led Morgan Stanley to question particular marks made by Mr Piper. Mr Piper then admitted that he had been mis-marking his positions. As a result he was suspended and Morgan Stanley's senior management commissioned a review into the marking of his positions. This review identified serious weaknesses in the implementation, operation and management of Morgan Stanley's systems and controls.

Key Review Findings

Supervision of Mr Piper within Credit Trading

Inadequate use of expertise on the Illiquid Products

2.16 Mr Piper was the sole individual at Morgan Stanley making markets in the Illiquid Products. Morgan Stanley failed to ensure that there was adequate reliance on independent sources of expertise in respect of the Illiquid Products within Credit Trading (i.e. other than Mr Piper) to the extent necessary to ensure appropriate supervision of Mr Piper's books during the Relevant Period. In consequence, Morgan Stanley did not apply the independent internal resource to adequately supervise the trading of the Illiquid Products. This failure occurred despite (i) Mr Piper's books presenting significant risks and (ii) the fact the volume of trading in the Illiquid Products had increased in the period leading up to the time when conditions in the credit market were becoming more difficult (increase in volatility and a decrease in liquidity).

Undue reliance placed on flawed existing processes by supervisors who also lacked awareness of their responsibilities

2.17 In undertaking supervision of Mr Piper undue reliance was placed on daily P&L reports and the monthly mark review process although these processes were of limited value in relation to Mr Piper's positions, especially in the changing market conditions. Supervisors were unaware of their responsibility to review Mr Piper's valuation of his positions independently of the VRG.

Uncertainty as to supervisory responsibility

2.18 There was uncertainty as to supervisory responsibility for Mr Piper in the second half of the Relevant Period when much of the mis-marking took place. Mr Piper's reporting lines were split, with two senior traders assuming responsibility for his P&L and risk reporting respectively. However, there was a lack of clarity as to the date from which the reporting line changes would take effect and there was no clear handover procedure. There was general confusion among those responsible for supervising Mr Piper over this period as to their respective roles.

Risk management control functions

Flaws in the mark review process and its application

2.19 The primary tool in the VRG's test of relevant marks (prior to the enhanced verification process introduced in April 2008) was the monthly mark review process. The usual method of valuation used in the mark review of Mr Piper's positions was comparison to external consensus prices derived from an independent pricing resource. Where this data was not available the VRG would consider a range of less satisfactory valuations. In the relevant period there was a significant decline in external consensus prices for certain of Mr Piper's positions. Morgan Stanley knew that the way in which to address this was by (i) ensuring an analytical review of the parameters used by Mr Piper to mark his positions was conducted and/or (ii) implementing the enhanced verification process as the next best valuation tool to test Mr Piper's positions. However, there was no analytical review of the parameters being used by Mr Piper and the enhanced verification process was not implemented until April 2008.

2.20 In November 2007, in the absence of external consensus data or other valuations for certain of Mr Piper's positions, Morgan Stanley developed a stress test for those positions. However this stress test was inadequate, wrongly applied and inaccurately described in the monthly mark review reports which were disseminated to senior management, such that it would not have been clear from the wording of the monthly mark review reports that the availability of external data to test Mr Piper's positions was declining nor that certain of his positions were being stress tested.

2.21 As part of the mark review process traders had a right to challenge valuations used by the VRG by providing the VRG with alternative reference data, which the VRG had the discretion to accept or reject. Since traders were able to choose which valuations to challenge, the process was open to manipulation particularly as the market became more volatile. Morgan Stanley failed to ensure sufficiently experienced management oversight of the process which increased the chances of any such manipulation going undetected.

Exclusion of the VRG

2.22 In early 2008 the role that the VRG had previously played in obtaining external consensus data for Mr Piper's positions (which role had enabled the VRG to exercise some control in obtaining external consensus data for comparison of marks) was circumvented. This was done by the VRG being excluded from the process of deciding what data to submit to the external consensus data provider and thus from the results obtained. The VRG did not challenge its exclusion at a sufficiently senior level and the matter was not appropriately escalated.

Limited critical analysis of Mr Piper's P&L and poor internal communication

2.23 Mr Piper's positions were divided amongst two books and there was inadequate critical analysis of the P&L for these books. The structure of the GPC was such that separate teams were responsible for P&L attribution of each of Mr Piper's books. Although P&L was produced separately for the two books, the resulting P&L was looked at in the aggregate. As the two books were negatively correlated to each other, the result of looking at the two books together meant that if there was a large P&L movement for one book, it was not investigated if it was offset by a large P&L movement in the opposite direction for the other book as would usually be the case. P&L movements that netted off when Mr Piper's books were looked at together were not considered by the GPC to be unusual nor were they investigated further even if the movements were significant.

2.24 There was a lack of internal communication and appropriate supervision within the GPC as to the degree of critical analysis that would be applied by product controllers during the P&L process. Whilst junior GPC staff understood that their role was to ensure that P&L was fully attributed, reconciled and explained in accordance with the firm's systems, senior product controllers expected that juniors would undertake analysis of P&L and whether it was consistent with changes in risk and market movement. In particular there was a lack of understanding among junior controllers of volatility as a driver for the P&L.

2.25 Further, although Morgan Stanley was aware of the limitations in the VRG mark review of certain of Mr Piper's positions and the fact that compensating controls would involve the P&L production process assisting in forming a view as to the reasonableness of marks, this was not properly communicated to those involved in the day to day preparation of the P&L for Mr Piper's books who believed the VRG's mark review process to be wholly responsible for testing the reasonableness of marks.

Counterparty complaint against Mr Piper not escalated

2.26 A counterparty complained to Morgan Stanley on at least two occasions that certain of the indications of value it had received from Morgan Stanley were inconsistent with information disseminated by Mr Piper to the market (in broker runs). These complaints were not appropriately escalated.

3. CONCLUSIONS

3.1 The FSA agrees with the findings of the Morgan Stanley review. By reason of the facts and matters set out above, Morgan Stanley breached Principle 2 and Principle 3 in the Relevant Period by failing to conduct its business with due skill, care and diligence and by failing to take reasonable care to organise and control its affairs responsibly and effectively and to implement adequate risk management systems.

<u>Principle 2 (skill, care and diligence)</u>

3.2 In breach of Principle 2, Morgan Stanley failed to use effectively its existing controls over what was a complex business dealing in sophisticated financial products. In particular:

3.2.1 Morgan Stanley failed to ensure that there was adequate reliance on independent sources of expertise in respect of the Illiquid Products within Credit Trading (i.e. other than Mr Piper) and because of this placed undue reliance on the flawed existing review processes;

3.2.2 There was also a lack of awareness amongst supervisors of Mr Piper as to their responsibility for reviewing Mr Piper's valuations of his positions independently of the VRG;

3.2.3 As a result of poorly implemented changes in reporting lines there was uncertainty as to supervisory responsibility for Mr Piper in the second half of the Relevant Period which is likely to have contributed to circumstances which facilitated mis-marking by Mr Piper;

3.2.4 The stress test developed in November 2007 was (as well as being inadequate – see 3.3 below) wrongly applied and inaccurately described to senior management;

3.2.5 Morgan Stanley failed to ensure sufficiently experienced management oversight of the mark review process thus increasing the prospects of certain parts of the process being manipulated;

3.2.6 The VRG was excluded from a key part of the review process but failed to adequately challenge or escalate its exclusion;

3.2.7 There was inadequate critical analysis of Mr Piper's P&L and a lack of communication between the senior and junior GPC staff as to the amount of analysis that should be undertaken of traders' P&L generally and the role of the GPC in assessing the reasonableness of marks;

3.2.8 Complaints received in relation to Mr Piper's broker runs were not properly escalated;

3.2.9 As a result Morgan Stanley failed to price certain positions held by Mr Piper accurately and failed to prevent or detect his mis-marking in a timely manner.

<u>Principle 3 (management and control)</u>

3.3 In breach of Principle 3 Morgan Stanley failed to respond sufficiently fast to changing conditions in the credit markets (namely an increase in volatility and a decrease in liquidity) by making adjustments to its existing systems and controls which would have enabled it to detect the mis-marking of the Illiquid Products in a timely manner, despite Mr Piper's books presenting significant risks and the fact that existing processes were inadequate in relation to certain of Mr Piper's positions. In particular Morgan Stanley failed to (i) ensure that an analytical review of the parameters used by Mr Piper to mark his positions was conducted and/or (ii) implement the enhanced verification process until April 2008. As a result there was a failure to recognise until May 2008 that certain positions held by Mr Piper were substantially over-valued.

4. SANCTION

4.1 The FSA's policy on the imposition of financial penalties and public censures is set out in the FSA's Decision Procedure & Penalties manual ("DEPP") and Enforcement Guide. In determining the financial penalty, the FSA has had regard to this guidance. The principal purpose of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefit of compliant behaviour.

4.2 The FSA considers that the seriousness of this matter merits the imposition of a significant financial penalty. The factors which have been taken into account in determining the financial penalty to be imposed on Morgan Stanley include:

4.2.1 There is a high risk that market confidence will be damaged by the sudden and unexpected write down and revaluation of securities. It is therefore appropriate to impose significant fines on firms whose skill, care and diligence in carrying out proper supervision and oversight and whose management and control of businesses fall below expected standards in order to ensure that firms develop and maintain robust internal policies and procedures;

4.2.2 The failures highlighted in this Notice were of a serious nature. The illiquid nature of the products traded should have led to particularly tight controls in this area. Mis-marking existed for approximately five months and resulted in Morgan Stanley overvaluing its positions by at least $120 million. Morgan Stanley was aware that there were limitations in the process for verifying Mr Piper's positions but did not introduce an effective process that would identify the mis-marking until April 2008;

4.2.3 There was a failure adequately to manage the risks of potential mis-marking arising from the conflicts of interest whereby Mr Piper played a key role in pricing securities although these prices were likely to have an effect on the calculation of his personal remuneration; and

4.2.4 In determining the level of financial penalty the FSA has had regard to the size and financial resources of Morgan Stanley. Morgan Stanley is a major financial institution and should have high levels of systems and controls commensurate with the requirement adequately to supervise a complex global business with a high level of risk.

4.3 In determining the level of financial penalty the FSA has taken into account the following mitigating factors:

4.3.1 Morgan Stanley identified irregularities in the marking of certain of Mr Piper's positions and the need to revalue those positions;

4.3.2 Morgan Stanley ensured prompt public disclosure when it become aware of the mis-marking;

4.3.3 Morgan Stanley's senior management commissioned, on an expedited basis, a detailed review of the causes of the write down. The firm has taken steps and committed significant resource to address the weaknesses identified. These measures include comprehensive remediation and firm-wide training programs for trading supervisors to educate them as to their responsibilities. Internal disciplinary action has also been taken; and

4.3.4 The positions which were the subject of the write down and mis-marking were proprietary positions; and Morgan Stanley informed the FSA promptly of these issues, has kept the FSA informed of developments and has been co-operative and shown a willingness to take a critical view of its systems and controls.

Conclusions

4.4 The FSA considers in all the circumstances that the seriousness of the breaches of Principles 2 and 3 by Morgan Stanley merits a substantial financial penalty. In determining the financial penalty the FSA has considered the need to deter market participants from engaging in this type of activity. The FSA has also had regard to penalties in other similar cases.

4.5 The FSA proposes to impose a financial penalty of £1.4 million. This takes into account the 30% stage 1 early settlement discount.

5. DECISION MAKER

5.1 The decision which gave rise to the obligation to give this Final Notice was made by the Settlement Decision Makers on behalf of the FSA.

6. IMPORTANT

6.1 This Final Notice is given to Morgan Stanley in accordance with section 390 of the Act.

Manner and time of payment

6.2 The financial penalty must be paid in full by Morgan Stanley to the FSA by no later than 27 May 2009, 14 days from the date of this Final Notice.

If the financial penalty is not paid

6.3 If all or any of the financial penalty is outstanding on 28 May 2009, the FSA may recover the outstanding amount as a debt owed by Morgan Stanley and due to the FSA.

Publicity

6.4 Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to Morgan Stanley or prejudicial to the interests of consumers.

6.5 The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

6.6 For more information concerning this matter generally, contact Karen Lee (Tel: 020 7066 1316) or Dan Enraght-Moony (Tel: 020 7066 0166) of the Enforcement Division of the FSA.

Jamie Symington
Head of Department
FSA Enforcement Division