

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 79794 / January 13, 2017**

**INVESTMENT ADVISERS ACT OF 1940**  
**Release No. 4607 / January 13, 2017**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-17773**

**In the Matter of**

**Morgan Stanley Smith Barney,  
LLC**

**Respondent.**

**ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS,  
PURSUANT TO SECTION 15(b) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
AND SECTIONS 203(e) AND 203(k) OF THE  
INVESTMENT ADVISERS ACT OF 1940,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS AND A CEASE-  
AND-DESIST ORDER**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”), and Sections 203(e) and 203(k) 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, 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 Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-desist Order (“Order”), as set forth below.

### III.

On the basis of this Order and Respondent's Offer, the Commission finds<sup>1</sup> that:

#### **Summary**

1. These proceedings arise out of errors by MSSB in advisory client fee billing, custody examination violations, and books and records violations under the Advisers Act. MSSB is a dually registered investment adviser and broker-dealer that was formed in 2009 pursuant to a combination of the advisory businesses of the Global Wealth Management Group, a business segment of Morgan Stanley & Co. ("Morgan Stanley"), and the Smith Barney division ("Citi Smith Barney") of Citigroup Global Markets, Inc. ("CGMI"), a subsidiary of Citigroup Inc.

2. Between approximately 2002 and 2016, MSSB and its predecessor Morgan Stanley inadvertently overcharged more than 149,000 advisory client accounts a total of \$16,169,215 in advisory fees due primarily to coding and other errors in its billing systems and processes. There are 36 different categories of errors resulting in overcharges. Six of the error categories, which account for 58% of the fees overbilled, originated with Citi Smith Barney and 30 originated with Morgan Stanley or MSSB. MSSB also violated the custody rule under the Advisers Act as it relates to the annual surprise custody examination. Further, MSSB violated the books and records provisions of the Advisers Act and rules thereunder with respect to maintenance of client contracts. Finally, MSSB failed to adopt and implement reasonably designed compliance policies and procedures to prevent these violations of the Advisers Act.

#### **Respondent**

3. MSSB is a wholly owned subsidiary of Morgan Stanley Smith Barney Holdings, LLC, and an indirectly wholly owned subsidiary of Morgan Stanley, a Delaware limited liability company with its principal executive offices in New York, New York, whose shares are traded on the New York Stock Exchange. MSSB has been dually registered as an investment adviser and broker-dealer with the Commission since May 2009 and is headquartered in Purchase, New York.

#### **Background**

4. In 2009, Morgan Stanley and Citi Smith Barney each contributed assets, clients, and accounts to the joint venture (the "legacy Morgan Stanley" or "legacy Citi Smith Barney" assets, clients or accounts, respectively). The resulting MSSB, then-owned 51% by Morgan Stanley and 49% by Citigroup Inc., had a then-combined 1.3 million advisory accounts and \$212 billion in regulatory assets under management.

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<sup>1</sup> The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.

5. Between 2009 and 2012, MSSB provided its advisory services through separate channels: the Citi Smith Barney channel, which provided the investment advisory programs previously provided by Citi Smith Barney; and the Morgan Stanley channel, which provided the investment advisory programs previously provided by Morgan Stanley's Global Wealth Management Group. For a period of time following the joint venture, MSSB also maintained separate billing systems: the Asset Management Billing Menu, which was Citi Smith Barney's legacy billing system; and the Unified Billing System, which was Morgan Stanley's legacy billing system.

6. From May 2011 through May 2013, MSSB converted all of the accounts that were contributed to the joint venture to a single billing system and platform. The legacy Morgan Stanley accounts were converted to the common billing system and platform in May 2011 and May 2013, and the legacy Citi Smith Barney accounts were converted to the common billing system and platform between February and July 2012. In 2012, Morgan Stanley increased its ownership stake in MSSB by 14% and, on June 28, 2013, Morgan Stanley purchased Citigroup Inc.'s remaining interest in the joint venture. MSSB is now 100% owned by Morgan Stanley.

#### **MSSB Inadvertently Overcharged Fees to Legacy Citi Smith Barney Advisory Accounts**

7. From 2009 through 2015, for 15,152 advisory client accounts, MSSB inadvertently charged advisory fees in excess of what had been disclosed to, and agreed by, its legacy Citi Smith Barney clients.

8. In 2009, when the accounts were assigned to MSSB in connection with the joint venture, MSSB utilized Citi Smith Barney's legacy fee billing system to bill legacy Citi Smith Barney accounts without conducting any review to ensure that the fee information in that system was accurate and consistent with clients' advisory agreements. In 2012, when the Citi Smith Barney fee billing information was converted, or copied, to MSSB's new fee billing system, MSSB limited its review to ensuring that fee billing information was correctly converted, or copied, and did not confirm that the fee information was accurate and consistent with information disclosed to, and agreed by, its clients. As a result, six categories of fee billing inaccuracies that resided on Citi Smith Barney's billing system were continued by MSSB, and two of the six categories of errors caused incorrect fee rates to transfer onto MSSB's new fee billing system in 2012.

9. The six categories of billing errors occurred in several ways. Under certain circumstances, when client accounts in one advisory program were transferred between branches, a system feature caused client advisory fees to default to the highest available account fee; thus, clients who had negotiated lower rates began to pay the higher advisory fee rate, resulting in overcharges to 5,270 client accounts. For other clients, fees were not adjusted as required in order to level fees (i.e., make fees the same for all assets) for ERISA individual retirement account clients, resulting in overcharges to 468 accounts. Moreover, negotiated discounted fee rates were not immediately input into the billing system, resulting in overcharges to 8,953 accounts. In addition, 104 accounts were not reimbursed advance-billed fees when clients terminated accounts.

Finally, MSSB charged 132 ERISA accounts for the investment advisory fees of another account within the household in violation of ERISA rules and internal policies and procedures.

10. MSSB received a total of \$9,437,750 in excess fees as a result of these billing errors. MSSB has reimbursed this amount, in addition to \$1,164,513 in interest, to affected clients.

**MSSB Inadvertently Overcharged Fees to Legacy Morgan Stanley and MSSB Advisory Accounts**

11. From 2002 to 2009 and from 2009 to 2016, for 134,240 client accounts, Morgan Stanley and MSSB, respectively, inadvertently charged fees in excess of what was disclosed to, and agreed by their clients, as a result of 30 fee billing issues that carried over from Morgan Stanley or originated with MSSB (“MSSB Originating Fee Issues”).

12. Those fee billing errors occurred in programs within MSSB’s advisory business, including TRAK, Consulting and Evaluation Services, Investment Management Services, Fiduciary Services, Portfolio Management and the Select Unified Managed Account program. Some of these fee billing errors resulted from coding or other systems errors, while others were caused by administrative errors, including the failure to input negotiated lower fee rates into the billing system.

13. Each of these 30 fee billing errors occurred in different ways. For instance, MSSB charged advisory fees in certain programs for mutual fund and third-party money manager holdings for which MSSB provided research coverage, but continued to charge those advisory fees even after it dropped coverage on those funds and managers, contrary to its client disclosures (“IAR Research Issue”). Separately, MSSB charged outside manager fees on assets that were held in a money market sleeve of MSSB’s Select Unified Managed Accounts program that did not utilize an outside manager, due to a computer coding error.

14. Of the 30 MSSB Originating Fee Issues, 19 were identified through MSSB’s internal controls and procedures, two were discovered by the Commission’s examination staff during a 2013-2014 on-site inspection, and nine came to MSSB’s attention through a client or financial advisor inquiry. MSSB fully researched each fee billing error to identify the accounts and the amounts by which they were overbilled, and fully remediated all impacted clients.

15. MSSB received a total of \$6,731,465 in excess fees as a result of these billing errors. MSSB has reimbursed this amount along with an additional \$889,528 in performance rebates for the IAR Research Issue, plus \$417,622 in interest, to affected clients.

**MSSB Failed to Obtain Annual Surprise Custody Examinations that Satisfied the Advisers Act**

16. MSSB had custody of client funds and securities and was subject to Rule 206(4)-2 under the Advisers Act (the “Custody Rule”), including the rule’s requirement to have an independent public accountant conduct an annual surprise examination to verify the custodied

client assets. MSSB violated the Custody Rule by failing to comply with the requirements for the annual surprise examination for two consecutive years.

17. Under the Custody Rule, as it applies to MSSB, it is a fraudulent, deceptive, or manipulative act, practice or course of business for a registered investment adviser to have custody of client funds or securities unless the client funds and securities of which the adviser has custody are verified by actual examination at least once during each calendar year by an independent public accountant, pursuant to a written agreement between the adviser and the accountant, at a time that is chosen by the accountant without prior notice or announcement to the adviser and that is irregular from year to year. The Custody Rule also requires the accountant to file a certificate on Form ADV-E with the Commission within 120 days of the time chosen by the accountant, stating that it has examined the funds and securities and describing the nature and extent of the examination.

18. For its 2011 surprise custody examination, MSSB failed to enter into a written agreement with an independent public accountant to verify the client funds and securities for approximately 1,000,000 legacy Citi Smith Barney accounts over which MSSB had custody. While MSSB discovered the error the following year and engaged its independent public accountant to conduct a supplemental examination of these previously omitted client funds and securities, the Form ADV-E certificate for the supplemental exam was not filed timely under the rule.

19. For its 2012 surprise custody examination, MSSB failed to identify for its independent public accountant approximately 223 accounts that it had incorrectly classified as being custodied at an outside institution, but were in fact custodied at MSSB.

20. For its 2012 surprise custody examination, MSSB also provided its independent public accountant with a list of 7.2 million accounts that included approximately 1.3 million advisory accounts and 5.9 million brokerage accounts, without providing a legend to identify the advisory accounts that were in fact subject to the custody examination. This caused MSSB's independent public accountant to verify assets from an overinclusive population. Whereas MSSB's independent public accountant attempted to verify funds and securities from a sample of 150 advisory accounts (75 open accounts and 75 closed accounts), the overinclusive population caused it to verify assets from only 15 (*i.e.*, 10%) advisory accounts. The remaining 135 (*i.e.*, 90%) accounts in the sample were brokerage accounts. Accordingly, the number of advisory accounts sampled for the 2012 surprise custody examination was insufficient.

21. MSSB made the same error of including brokerage accounts without identifying them as such during its 2013 surprise custody examination. However, during the same 2013-2014 on-site inspection, the Commission's examination staff discovered the error before the examination was completed and MSSB was therefore able to give its independent public accountant a corrected list of advisory accounts before the custody examination closed.

**MSSB Failed to Maintain and Preserve Certain Books and Records**

22. MSSB has failed to maintain and preserve signed client contracts in an easily accessible place as required by the Advisers Act and rules thereunder, and its internal record retention policies.

23. Rules 204-2(a)(10) and (e)(1) under the Advisers Act require advisers to maintain and preserve client contracts in an easily accessible place for not less than five years from the end of the fiscal year during which the last entry was made. MSSB's written policies and procedures require MSSB to maintain client contracts for the life of the account plus six or seven years (depending on the revision date of the policy) and to keep and organize the contracts in a way that allows them to be promptly located and retrieved when necessary.

24. Since 2010, MSSB's written policies and procedures have also required that all client contracts be scanned and loaded onto MSSB's account opening portal. Since 2012, MSSB's policies and procedures have required electronically stored client contracts to be centrally searchable.

25. In connection with the Commission's examination staff's 2013-2014 on-site inspection, MSSB identified accounts as to which it could not electronically confirm the existence of a client contract. Upon request, MSSB attempted to locate client contracts for a sample of those identified accounts. MSSB was unable to locate signed client contracts for approximately 17% of that sample of accounts, which should have been maintained under the Advisers Act and rules thereunder, and an additional 8% of that sample of accounts, which should have been maintained under MSSB's own written document retention policies.

26. MSSB has therefore violated the Advisers Act rule that contracts be maintained in an easily accessible place for five years, its internal records maintenance policies requiring contracts to be kept in a readily retrievable manner during the life of the agreement plus a period of time thereafter.

**MSSB Failed to Adopt and Implement Written Policies and Procedures Reasonably Designed to Prevent Violations of the Advisers Act**

27. MSSB failed to adopt and implement written policies and procedures reasonably designed to prevent the above Advisers Act violations.

28. MSSB failed to adopt and implement written policies and procedures reasonably designed in light of its operations to ensure that clients were billed accurately in accordance with the terms of their advisory agreements. For example, at the time of the joint venture, MSSB did not conduct a review of the client billing information provided by Citi Smith Barney for accuracy and instead adopted Citi Smith Barney's fee billing information wholesale, along with errors in the fee billing rates.

29. MSSB also did not, as part of its periodic fee testing, conduct targeted testing of accounts with attributes, or that experienced changes, that created an increased risk of fee error, and its testing was limited to checking calculations against billing rates contained in the firm's billing system without validating such information against client contracts, fee billing histories, and other documentation.

30. MSSB also had no written policies and procedures concerning its annual surprise custody examinations, including procedures for ensuring that it provided its independent public accountants with an accurate list of custodied advisory accounts subject to the examination.

31. MSSB also failed to implement its written policies and procedures requiring advisory contracts to be kept in a readily retrievable manner during the life of the agreement plus a period of time thereafter, and its internal policy that client contracts be scanned and loaded onto the account opening portal during the account opening process.

### Violations

32. As a result of the conduct described above, MSSB willfully<sup>2</sup> violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon a client or prospective client. A violation of Section 206(2) may rest on a finding of simple negligence; scienter is not required. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992); *SEC v. Yorkville Advisors, LLC*, 12 Civ. 7728, 2013 WL 3989054, at \*3 (S.D.N.Y. Aug. 2, 2013).

33. As a result of the conduct described above, MSSB willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder. Rule 206(4)-2 provides, in pertinent part, that it is a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) for any registered investment adviser to have custody of client funds or securities unless the client funds and securities of which the adviser has custody are verified by actual examination at least once during each calendar year by an independent public accountant, pursuant to a written agreement between the adviser and the accountant, at a time that is chosen by the accountant without prior notice or announcement to the adviser and that is irregular from year to year.

34. As a result of the conduct described above, MSSB willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require, among other things, that a registered investment adviser adopt and implement written policies and procedures reasonably

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<sup>2</sup> A willful violation of the securities laws means merely “that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor “also be aware that he is violating one of the Rules or Acts.” *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

designed to prevent violations of the Advisers Act and the rules thereunder by the adviser and its supervised persons.

35. As a result of the conduct described above, MSSB willfully violated Section 204(a) of the Advisers Act and Rules 204-2(a)(10) and 204-2(e)(1) thereunder, which require that investment advisers maintain and preserve client contracts “in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record... .”

### **MSSB’s Remedial Efforts**

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent.

### **Undertakings**

Respondent MSSB has agreed to the following undertakings:

#### **36. Fee Billing Undertakings**

- a. For a period of 3 years from the date of this Order (the “Undertaking Period”), MSSB agrees to research and remediate the full scope and impact of all fee overbilling errors discovered in advisory accounts within 6 months from the date of discovery; if MSSB is unable to remediate the error within 6 months, MSSB shall make a report to the staff pursuant to paragraph 36(b) below, and shall remediate those issues as promptly as possible;
- b. During the Undertaking Period, MSSB agrees to provide a quarterly written report to the staff concerning fee overbilling errors that have been discovered in advisory accounts and that affect more than one unrelated advisory account, which report shall include or describe: (i) the nature and cause of the fee overbilling; (ii) the amounts overbilled; (iii) the number of accounts overbilled; (iv) how the error was discovered; (v) the date of discovery; (vi) the status and/or date of remediation; and (vii) the amount of the remediation with interest; and
- c. At the end of the Undertaking Period, MSSB agrees to provide a certification to the staff from a member of the Advisory Fee Accuracy Team (which team has primary responsibility for the review, investigation, remediation, tracking and reporting of billing errors in advisory accounts) that all fee billing errors discovered during the Undertaking Period in advisory accounts that affect more than one unrelated advisory account have been fully investigated and remediated.



### 37. Books and Records Undertakings

- a. MSSB agrees within 6 months of this Order to review open advisory accounts listed on MSSB\_SEC3\_00000003 and determine whether MSSB has a copy of a signed advisory agreement for those accounts;
- b. MSSB agrees within 12 months of this Order, for open advisory accounts reflected on MSSB\_SEC3\_00000003 for which MSSB cannot locate a signed advisory agreement, and for all open advisory accounts where MSSB has been unable to locate a signed advisory agreement during its periodic fee testing procedures, to: (i) disclose such fact to the client in writing; and (ii) if the client has not retained a copy of the signed advisory agreement, enter into a new advisory agreement with the client as described in paragraph 37(c) below;
- c. To enter into a new advisory agreement with a client, MSSB agrees: (i) to use all reasonable means (which shall include, without limitation, telephone calls) to contact the client and have the client enter into a new advisory agreement; and (ii) for any client who has not entered into a new advisory agreement after MSSB has complied with paragraph 37(c)(i), to send final notice to that client of the need for the client to enter into a new advisory agreement, close the account, or be subject to the terms of the current standard advisory agreement, and after 30 additional days notify the client that the account is now subject to the terms of the current standard advisory agreement. For all clients who enter into a new advisory agreement consistent with paragraph 37(c), the entry into a new advisory agreement will have no impact on the advisory fee rate charged to the account;
- d. MSSB agrees within 12 months of the Order to: (i) conduct a study to determine whether it has unilaterally amended client advisory agreements that provide for amendment through mutual assent; (ii) provide the results of such study to the staff; and (iii) in the event MSSB determines that it has unilaterally amended client advisory agreements that provide for amendment through mutual assent, notify clients who have been impacted; and
- e. MSSB agrees within 14 months of this Order to report to the staff all remedial efforts it has made with respect to the matters set forth in paragraphs 37(a) - 37(d) above.

### 38. Notice to Advisory Clients

- a. Within 10 days of the Order, MSSB agrees to prominently disclose on its website a summary of the Order and provide a hyperlink to the Order, and shall maintain those posts for twelve months; and

- b. For a period of one year from the date of this Order, to the extent that MSSB is required to deliver a brochure or a summary of material changes to existing or prospective clients pursuant to Rule 204-3 under the Advisers Act, MSSB agrees to include in the brochure or summary of material changes, notice of the entry of the Order and a website address where the Order can be viewed, and provide the client or prospective client the opportunity to request a copy of the Order, which MSSB will provide upon such request.

#### IV.

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

Accordingly, pursuant to Section 15(b) of the Exchange Act and Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent MSSB shall cease and desist from committing or causing any violations and any future violations of Sections 204(a), 206(2) and 206(4) of the Advisers Act and Rules 204-2(a)(10), 204-2(e)(1), 206(4)-2 and 206(4)-7 promulgated thereunder.

B. Respondent MSSB is censured.

C. Respondent MSSB shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of \$13,000,000 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 MSSB as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Sanjay Wadhwa, Senior Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 200 Vesey Street, New York, New York 10281-1022.

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 MSSB shall comply with the undertakings enumerated in Sections 36-38 above.

By the Commission.

Brent J. Fields  
Secretary