

**UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION**

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3:14 pm, Sep 28, 2017

_____)
In the Matter of:)
)
Morgan Stanley & Co. LLC,)
)
)
Respondent.)
_____)

CFTC Docket No. 17-28

**ORDER INSTITUTING PROCEEDINGS PURSUANT TO
SECTION 6(c) AND 6(d) OF THE COMMODITY EXCHANGE ACT, MAKING
FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Commodity Futures Trading Commission (“Commission”) has reason to believe that Morgan Stanley & Co. LLC (“MSCO” or “Respondent”) has violated Commission Regulation 166.3, 17 C.F.R. § 166.3 (2017). Therefore, the Commission deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted to determine whether MSCO has engaged in the violations as set forth herein and to determine whether any order should be issued imposing remedial sanctions.

II.

In anticipation of the institution of this administrative proceeding, MSCO has submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. Without admitting or denying any of the findings or conclusions herein, MSCO consents to the entry of this Order Instituting Proceedings Pursuant to Section 6(c) and (d) of the Commodity Exchange Act, Making Findings, and Imposing Remedial Sanctions (“Order”) and acknowledges service of this Order.¹

¹ Respondent consents to the entry of this Order and the use of these findings in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party; provided, however, that Respondent does not consent to the use of the Offer, or the findings or conclusions consented to in this Order, as the sole basis for any other proceeding brought by the Commission, other than in a proceeding in bankruptcy or to enforce the terms of this Order. Nor does Respondent consent to the use of the Offer or this Order, or the findings or conclusions consented to in the Offer or this Order, by any other party in any other proceeding.

III.

The Commission finds the following:

A. SUMMARY

From at least 2009 through April 2016 (the “relevant period”), MSCO failed in certain respects to implement and maintain adequate systems and procedures for the reconciliation of exchange and clearing fees invoiced to MSCO by the CME Group (“CME”) and other exchanges with those charged by MSCO to certain customers in connection with futures and options transactions (collectively, “fee reconciliation procedures”) that MSCO cleared for its customers. While MSCO developed a robust system for reconciling fees owed to exchanges during the relevant period, it failed to timely identify and correct certain discrepancies between invoices from the exchanges and the amounts ultimately charged to customers for transactions on those exchanges, in violation of Regulation 166.3, 17 C.F.R. § 166.3 (2017).

B. RESPONDENT

Morgan Stanley & Co. LLC is a Delaware limited liability company with its principal place of business in New York, New York. It has been registered with the Commission as a futures commission merchant (“FCM”) since 1982 and as a provisionally registered swap dealer since 2012.

C. FACTS

Customer transactions executed on exchanges are subject to payment of exchange and clearing fees (“exchange fees”) that are applied to each transaction in the normal course of business. FCMs such as MSCO receive invoices for these fees from the exchanges, and the FCMs typically assess these fees to their customers. Frequently, MSCO customers are charged a set commission, plus the specific amount of exchange fees incurred in connection with their trading. The fees charged by exchanges vary based upon, among other things, the different and changing applicable rates, surcharges and fee structures associated with different exchange products, the different memberships held by customers, and the customer’s monthly trading volumes in certain contracts. Exchanges rely upon FCMs to operationally administer these programs.

Prior to 2010, MSCO recognized the need to ensure that the increasingly complex structure for exchange fees was managed by dedicated personnel using automated systems, especially because exchanges traditionally assessed fees on an aggregated, and not on a trade-level, basis. Consequently, MSCO developed and began implementing a proprietary, automated system to identify, process, and reconcile exchange fees (MSCO’s “proprietary fee system”). At that same time, MSCO determined that exchange fees should be managed and reconciled by centralized, specialized teams that operate independently of MSCO’s business units.

In or around 2010, MSCO began utilizing one component of its proprietary fee system, a rules-based engine, to calculate the amount charged to a customer for each specific transaction (the “customer rule”). In or around 2012, MSCO began utilizing that same rules-based engine to calculate the amount MSCO believes it owes an exchange for each specific transaction (the “exchange rule”). In addition to the rules based engine, MSCO’s proprietary fee system also

includes automated reconciliation software. Since at least 2012, MSCO has utilized this software to determine if the amount MSCO is billed by each exchange matches the amount MSCO believes it owes that exchange, specifically by comparing the exchange invoice and the aggregate output of exchange rule(s) for trading on that exchange.

For a substantial majority of the relevant period, MSCO's automated system was not designed to detect instances where it may have overcharged customers for exchange fees applied to transactions in the normal course of business. Beginning in 2012, MSCO relied on its process for establishing customer and exchange rules and its practice of reconciling exchange rules with exchange invoices to detect errors. It was not until 2015, and after MSCO became aware that it had in fact overcharged certain customers for exchange fees, that MSCO modified the automated processes in its proprietary fee system to directly detect instances where the customer rule exceeded the exchange rule for any given transaction. Specifically, MSCO modified a routinely generated exception report to identify instances where the customer rule was greater than the exchange rule for any given transaction, meaning that MSCO was potentially overcharging customers. Prior to that time, the reports generated from MSCO's proprietary fee system only identified instances where the exchange rule was greater than the customer rule, meaning that MSCO was potentially undercharging a customer, or where the customer rule was missing.

Moreover, after MSCO modified the exception report, MSCO failed to adequately identify and review at least one known discrepancy between the exchange rule (i.e., the amount MSCO believed it owed an exchange for a trade) and the customer rule (i.e., the amount charged to a customer for that same trade) highlighted in that report. This omission allowed at least one category of overcharges to persist even after MSCO personnel detected the discrepancy between the relevant rules, because MSCO personnel failed to appreciate the nature of the discrepancy and need to make corrections.

MSCO's faulty process for reconciling exchange fees and related failure to identify and correct certain discrepancies between the amount invoiced by exchanges for transactions and the amount MSCO ultimately charged customers for those same transactions caused three separate categories of overcharges that collectively spanned seven years.

The first category of overcharges took place over a period of approximately two years, between October 2012 and September 2014, when MSCO erroneously imposed an additional \$2 per contract charge on certain block trade transactions executed on ICE Futures US and cleared on ICE Futures Europe (collectively "ICE"). Because the applicable exchange rules reflected the actual fee charged by ICE and did not include the additional \$2 charge included in the applicable customer rules, MSCO's reconciliation software did not detect this error. MSCO identified the overcharges in September 2014, in connection with a manual review of aspects of its proprietary fee system. MSCO subsequently determined that it had overcharged nine customers \$204,227 in connection with ICE block trade transactions between October 2012 and September 2014. MSCO has fully refunded the affected customers.

The second category of overcharges took place over a period of years dating to 2009, when MSCO erroneously overcharged certain customers for "give-up" transactions on the Chicago Futures Exchange ("CFE"), Italian Derivatives Market ("IDM"), and Osaka Securities Exchange ("OSE"). The fee structure on the CFE, IDM, and OSE differs from the more traditional "clearing broker pays all fees" rule utilized by most exchanges in that the exchange

(or trading) fee is paid by the executing broker. Because MSCO's proprietary fee system did not accurately reflect the fees charged by these exchanges, MSCO overcharged 109 customers located in the United States \$1,013,469 in fees related to give-up transactions on the CFE, IDM, and OSE, and customers of a MSCO affiliate were overcharged \$478,256 in fees related to give-up transactions on those exchanges. MSCO identified the problem in January 2015, and subsequently refunded the affected customers.

The third category of overcharges involved a set of overcharges dating to 2011. MSCO had miscoded the customer rules for e-mini index option transactions on the CME, specifically by failing to pass on a lowered rate imposed by the exchange in or around 2011. MSCO first identified the failure to pass on the lower rate for e-mini options to customers in June 2015, and erroneously identified the different charges shown in the exchange and customer rules as a known discrepancy in its proprietary fee system. MSCO subsequently received a customer inquiry in the ordinary course regarding possible overcharges, which prompted a further review of the e-mini option fees in April 2016. As a result of the erroneous customer rule, MSCO overcharged seventy-three customers in the United States \$332,486 in fees related to e-mini option transactions on the CME, and customers of a MSCO affiliate were overcharged \$960,791 in fees related to e-mini option transactions on the CME.

In aggregate, between 2009 and April 2016, MSCO overcharged customers in the United States \$1,550,182 in connection with transactions on various exchanges, and customers of a MSCO affiliate were overcharged \$1,439,047 in connection with transactions on various exchanges. MSCO has fully refunded nearly all of the affected customers and, for the remaining, has escheated the relevant amounts or, at the customers' request, donated the relevant amount to a charity.

In late 2014, MSCO commenced a broad internal review of its fee reconciliation procedures, including the firm's proprietary fee system. MSCO completed this review in or around the summer of 2015, and now conducts an annual review of its fee reconciliation procedures. Beginning in early 2015, and in connection with that initial review, MSCO modified an automated process in its proprietary fee system to directly identify potential overcharges. MSCO represents that this functionality should continue to prevent future overcharges, and that the teams that administer MSCO's proprietary fee system will continue to receive specialized training in the reconciliation of exchange and clearing fees and be subject to experienced supervision.

IV.

LEGAL DISCUSSION

Regulation 166.3, 17 C.F.R. § 166.3 (2017), requires that every Commission registrant (except associated persons who have no supervisory duties) diligently supervise the handling by its partners, employees and agents of all activities relating to its business as a registrant. Regulation 166.3 imposes upon registrants an affirmative duty to supervise their employees and agents diligently by establishing, implementing, and executing an adequate supervisory structure and compliance program. In order to prove a violation of Regulation 166.3, the Commission must demonstrate that either: (1) the registrant's supervisory system was generally inadequate; or

(2) the registrant failed to perform its supervisory duties diligently. *In re Murlas Commodities*, CFTC No. 85-29, 1995 WL 523563, at *9 (Sept. 1, 1995); *In re Paragon Futures Assoc.*, CFTC No. 88-18, 1992 WL 74261, at *14 (Apr. 1, 1992). A violation under Regulation 166.3 is an independent violation for which no underlying violation is necessary. *In re Collins*, CFTC No. 94-13, 1997 WL 761927, at *10 (Dec. 10, 1997).

The lack of an adequate supervisory system can be established where, as here, a registrant failed to develop proper procedures for the detection of wrongdoing. *CFTC v. Trinity Fin. Grp., Inc.*, No. 92-6832-CIV 1997 WL 820970, at * 29 (S.D. Fla. Sept. 29, 1997) (controlling person failed to establish or maintain meaningful procedures for detecting fraud by firm’s employees and controlling person knew of specific incidents of misconduct, yet failed to take reasonable steps to correct the problems), *aff’d in part, vacated in part and remanded sub nom. Sidoti v. CFTC*, 178 F.3d 1132, 1137 (11th Cir. 1999); *see also In re FCStone LLC*, CFTC No. 13-24, 2013 WL 2368539, at *6 (CFTC May 29, 2013) (consent order) (“[W]hen supervisory failures exposed customers to potential risk of loss the Commission has found that such conduct violates Regulation 166.3.” (citation omitted)). Evidence of violations that “should be detected by a diligent system of supervision, either because of the nature of the violations or because the violations have occurred repeatedly” is probative of a failure to supervise. *Paragon*, 1992 WL 74261, at *14; *see also In re Interactive Brokers LLC*, CFTC No. 13-19, 2013 WL 1496929 at *3-4 (Apr. 9, 2013) (consent order) (finding that FCM violation Regulation 166.3 by failing to have any procedure in place to ensure compliance with, among other provisions, the currency denomination requirements for customer protection under Regulation 1.49 for several years).

MSCO was required to ensure the accuracy of exchange fees charged to customers, but the development, design and implementation of its automated system failed to adequately account for, and protect against, the risk of overcharging customers for exchange fees; therefore, MSCO’s implementation of its supervisory system was inadequate within the meaning of Regulation 166.3. MSCO developed multiple fee processing systems that accounted for the risk that MSCO might be overcharged by an exchange, but failed to sufficiently account for the risk that MSCO might overcharge customers for those same transactions. Further, even after MSCO began utilizing its proprietary fee system to protect customers against overcharges by comparing the amount MSCO charged customers for any given transaction against the amount MSCO believed it owed an exchange for that same transaction, MSCO failed to review and address at least one previously recognized discrepancy between the relevant exchange and customer rules. By such acts, MSCO violated Regulation 166.3. *See also In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, CFTC No. 14-22, 2014 WL 4259211, at *2-5 (Aug. 26, 2014) (consent order) (finding that FCM’s fee reconciliation process for identifying and correcting discrepancies between the invoices from the exchange clearinghouses and the amounts charged its customers had been faulty for more than two years and ordered FCM to pay a \$1.2 million civil monetary penalty); *In re Barclays Capital, Inc.* CFTC No. 16-25, 2016 WL 4395676, *2-4 (Aug. 4, 2016) (consent order) (finding that FCM’s fee reconciliation process had been inaccurate and faulty for nearly four years and ordering FCM to pay an \$800,000 civil monetary penalty); *In re J.P. Morgan Sec. LLC*, CFTC No. 17-04, 2017 WL 150288, *2-4 (Jan. 11, 2017) (consent order) (ordering FCM that had self-reported violations and cooperated with the Commission throughout its investigation, to pay a \$900,000 CMP and retain outside consultants to overhaul its exchange and clearing fee procedures).

V.

FINDINGS OF VIOLATIONS

Based on the foregoing, the Commission finds during the relevant period Respondent violated Commission Regulation 166.3, 17 C.F.R. § 166.3 (2017).

VI.

OFFER OF SETTLEMENT

Respondent has submitted an Offer in which it, without admitting or denying the findings and conclusions herein:

- A. Acknowledges receipt of service of this Order;
- B. Admits the jurisdiction of the Commission with respect to all matters set forth in this Order and for any action or proceeding brought or authorized by the Commission based on violation of or enforcement of this Order;
- C. Waives:
 - 1. the filing and service of a complaint and notice of hearing;
 - 2. a hearing;
 - 3. all post-hearing procedures;
 - 4. judicial review by any court;
 - 5. any and all objections to the participation by any member of the Commission's staff in the Commission's consideration of the Offer;
 - 6. any and all claims that it may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (2012) and 28 U.S.C. § 2412 (2012), and/or the rules promulgated by the Commission in conformity therewith, Part 148 of the Commission's Regulations, 17 C.F.R. pt. 148 (2017), relating to, or arising from, this proceeding;
 - 7. any and all claims that it may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, §§ 201-53, 110 Stat. 847, 857-74 (codified as amended in scattered sections of 5 U.S.C. and 15 U.S.C.), relating to, or arising from, this proceeding; and
 - 8. any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief;

- D. Stipulates that the record basis on which this Order is entered shall consist solely of the findings contained in this Order to which MSCO has consented in the Offer;
- E. Consents, solely on the basis of the Offer, to the Commission's entry of this Order, that:
 - 1. makes findings by the Commission that MSCO violated Regulation 166.3, 17 C.F.R. § 166.3 (2017);
 - 2. orders MSCO to cease and desist from violating Regulation 166.3 by failing to implement and maintain adequate systems and procedures for the reconciliation of exchange and clearing fees;
 - 3. orders MSCO to pay a civil monetary penalty in the amount of five-hundred thousand dollars (\$500,000), plus post-judgment interest; and
 - 4. orders MSCO and its successors and assigns, to comply with the conditions and undertakings consented to in the Offer and as set forth in Part VII of this Order.

Upon consideration, the Commission has determined to accept the Offer.

VII.

ORDER

Accordingly, IT IS HEREBY ORDERED THAT:

- A. MSCO shall cease and desist from violating Commission Regulation 166.3, 17 C.F.R. § 166.3 (2017);
- B. Civil Monetary Penalty: MSCO shall pay a civil monetary penalty in the amount of five-hundred thousand dollars (\$500,000), plus post-judgment interest, within ten (10) days of the date of the entry of this Order (the "CMP Obligation"). Should MSCO not satisfy its CMP Obligation within ten (10) days of the date of entry of this Order, post-judgment interest shall accrue on the CMP Obligation beginning on the date of entry of this Order and shall be determined by using the Treasury Bill rate prevailing on the date of entry of this Order pursuant to 28 U.S.C. § 1961 (2012). MSCO shall pay this penalty by electronic funds transfer, U.S. postal money order, certified check, bank cashier's check, or bank money order. If payment is to be made by other than electronic funds transfer, the payment shall be made payable to the Commodity Futures Trading Commission and sent to the address below:

Commodity Futures Trading Commission
Division of Enforcement
ATTN: Accounts Receivables
DOT/FAA/MMAC/AMZ-341

CFTC/CPSC/SEC
6500 S. MacArthur Blvd.
Oklahoma City, OK 73169
405-954-7262 office
405-954-1620 fax
nikki.gibson@faa.gov

If payment by electronic funds transfer is chosen, MSCO shall contact Nikki Gibson or her successor at the above address to receive payment instructions and shall fully comply with those instructions. MSCO shall accompany payment of the penalty with a cover letter that identifies MSCO and the name and docket number of this proceeding. MSCO shall simultaneously transmit copies of the cover letter and the form of payment to: (1) the Director, Division of Enforcement, Commodity Futures Trading Commission, Three Lafayette Center, 1155 21st Street, N.W., Washington, DC 20581, and (2) Regional Counsel, Commodity Futures Trading Commission, Chicago Regional Office, 525 West Monroe, 11th Floor, Chicago, IL 60661. In accordance with Section 6(e)(2) of the Act, 7 U.S.C. § 9a(2) (2012), if this amount is not paid in full within fifteen (15) days of the due date, MSCO shall be prohibited automatically from the privileges of all registered entities, and, if registered with the Commission, such registration shall be suspended automatically until it has shown to the satisfaction of the Commission that payment of the full amount of the penalty, with interest thereon to the date of the payment, has been made.

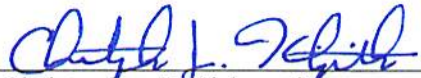
- C. MSCO and its successors and assigns shall comply with the following undertaking set forth in its Offer:
1. Public Statements: MSCO agrees that neither it nor any of its successors and assigns, agents or employees under its authority or control shall take any action or make any public statement denying, directly or indirectly, any findings or conclusions in this Order or creating, or tending to create, the impression that this Order is without a factual basis; provided, however, that nothing in this provision shall affect MSCO's: (i) testimonial obligations or (ii) right to take legal positions in other proceedings to which the Commission is not a party. MSCO and its successors and assigns shall undertake all steps necessary to ensure that all of its agents and/or employees under its authority or control understand and comply with this agreement.
 2. Cooperation with the Commission: MSCO shall cooperate fully and expeditiously with the Commission, including the Commission's Division of Enforcement, and any other governmental agency in this action, and in any investigation, civil litigation, or administrative matter related to the subject matter of this action or any current or future Commission investigation related thereto.
 3. Partial Satisfaction: MSCO understands and agrees that any acceptance by the Commission of partial payment of MSCO' CMP Obligation shall

not be deemed a waiver of its obligation to make further payments pursuant to this Order, or a waiver of the Commission's right to seek to compel payment of any remaining balance.

4. Change of Address/Phone: Until such time as MSCO satisfies in full its CMP Obligation as set forth in this Order, MSCO shall provide written notice to the Commission by certified mail of any change to its telephone number and mailing address within ten (10) calendar days of the change.

The provisions of this Order shall be effective on this date.

By the Commission.



Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission

Dated: September 28, 2017