

NEW YORK STOCK EXCHANGE LLC

NYSE HEARING BOARD DECISION 06-220
MORGAN STANLEY & CO., INCORPORATED
MEMBER ORGANIZATION

December 18, 2006

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Violated NYSE Rules 342(a) and (b) by failing to provide for, maintain, and implement appropriate blocks and inhibitors within electronic trading systems reasonably designed to prevent erroneous orders from being routed to NYSE Floor; and failing to have adequate procedures for training, supervision and control of traders, which resulted in trader's execution of erroneous order that caused significant disruption in numerous issues on Floor – Consent to censure, \$300,000 fine, and undertaking.

Appearances:

For the Division of Enforcement
Linda S. Riefberg, Esq.
Myles L. Orosco, Esq.
Howard Grinsberg, Esq.
Naveen Zaidi, Esq.

For Respondent
Joyce Tavoulaareas, Esq.

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A Hearing Officer on behalf of the New York Stock Exchange LLC ("NYSE") considered a Stipulation of Facts and Consent to Penalty entered into between NYSE Regulation, Inc.'s Division of Enforcement ("Enforcement") and Morgan Stanley & Co., Incorporated ("Respondent," "MS&Co.," or the "Firm"), an NYSE member organization. Without admitting or denying guilt, Respondent consented to a finding by the Hearing Officer that it violated NYSE Rules 342(a) and (b) in that Respondent failed to provide for, maintain, and implement appropriate blocks and inhibitors within its electronic trading systems that were reasonably designed to prevent erroneous orders from being routed to the NYSE Floor and failed to have adequate procedures for training, supervision and control of its traders, which resulted in a trader's execution of an erroneous order that caused significant disruption in numerous issues on the NYSE Floor.

For the sole purpose of settling this disciplinary proceeding, without adjudication of any issues of law or fact, and without admitting or denying any allegations or findings referred to

in the Stipulation of Facts and Consent to Penalty, Respondent stipulates to certain facts, the substance of which follows:*

Background and Jurisdiction

1. MS&Co. is a registered broker-dealer with its principal offices located in New York, New York. MS&Co. is a wholly owned subsidiary of Morgan Stanley. MS&Co. is a member of the NYSE and a financial services firm that provides investment-banking services to businesses and engages in retail and institutional sales to its customers.
2. On October 14, 2005, the Division of Market Surveillance (“MS”) of NYSE Regulation referred this matter to Enforcement. The focus of the referral was whether MS&Co. failed to provide adequate controls with respect to order entry, which enabled one of its traders to send an erroneous order to the NYSE Floor, causing significant market disruption.
3. By letter dated February 7, 2006, Enforcement notified MS&Co. that the aforementioned matter had been referred to Enforcement by MS.

Prior Relevant Discipline

4. In Morgan Stanley & Co. Incorporated, Decision 03-224 (NYSE Hearing Board Dec. 18, 2003), the Hearing Board disciplined the Firm for its failure to adequately control its trader’s activities that resulted in a significant order imbalance in certain NYSE issues and a disruption of the normal operation of the auction market in those securities. MS&Co. was censured and fined \$800,000 for, among other violations, failing to supervise MS&Co. traders and its trading systems to ensure compliance with NYSE Rules.¹ Specifically, the Firm failed to supervise a registered representative (“RR”), who had erroneously placed three orders for one million *shares* each, totaling \$300 million, instead of placing three orders for \$1 million each, totaling \$3 million. The Hearing Board found that despite a red warning on the RR’s monitor alerting him as to the size of his order, the Firm allowed its traders to “simply override the alert.” In addition, the Firm failed “to have a system in place to notify management when a trader attempts to place an order that triggers the alert.”

* Hearing Officer Note: The facts, allegations, and conclusions contained in paragraphs 1 to 24 are taken from the executed Stipulation of Facts and Consent to Penalty between Enforcement and Respondent. No changes have been made to the stipulated paragraphs by the Hearing Officer.

¹ The Hearing Board found that the Firm also violated NYSE Rules 476(a)(11), 97, 132.30(9), 410B, 80A and NYSE market-on-close and limit-on-close order entry and cancellation procedures and policy as set forth in NYSE Information Memoranda 98-20 and 99-51.

Overview

5. On September 1, 2004, a customer contacted MS&Co. to unwind a portion of an existing swap. An MS&Co. affiliate, Morgan Stanley Capital Services, was the counterparty to the existing customer swap. As the counterparty to the swap, the MS&Co. affiliate hedged its exposure by acquiring and maintaining a short position in the shares of common stock underlying the basket. As a portion of the customer swap was unwound, an MS&Co. trader attempted to cover a portion of the MS&Co. affiliate's short position. Specifically, at approximately 9:32 a.m., the MS&Co. trader entered an agency order on behalf of the MS&Co. affiliate to buy 100,000 units of the basket to cover a portion of the short position. However, the tool used to create the basket had a built in multiplier of 1,000 for the particular basket being created. When the trader typed in 100,000 units instead of 100 units, he erroneously created a basket with a notional value of approximately \$10.8 billion instead of \$10.8 million. As a result, erroneous orders for approximately 677,427,600 shares were transmitted for execution. Approximately 81,455,744 shares, or approximately 12% of the order with a market value of \$875,344,997, were executed. With respect to the NYSE, the erroneous order consisted of approximately 273,283,200 shares in 702 NYSE-listed stocks. Of the 702 NYSE-listed stocks, however, orders in only 692 of those stocks, or approximately 12,724,661 shares (approximately 4% of the NYSE portion of the order), were executed on the NYSE Floor. For at least 15 minutes in certain NYSE listed stocks, this error caused significant market disruption in that specialists were unable to update message boards relating to certain of the listed stocks and were unable to effect other trades until the accuracy of the erroneous orders could be verified.

Facts

6. In February 2004, one of MS&Co.'s employees joined the Firm's Swap Desk, and after a training period with experienced trades on the Swap Desk, started effecting transactions as a trader on the Firm's Swap Desk in April 2004.²
7. On September 1, 2004, a customer contacted MS&Co. to unwind a portion of an existing swap. An MS&Co. affiliate, Morgan Stanley Capital Services, was the counterparty to the existing customer swap. As the counterparty to the swap, the MS&Co. affiliate hedged its exposure by acquiring and maintaining a short position in the shares of common stock underlying the basket. As a portion of the customer swap was unwound, an MS&Co. trader attempted to cover a portion of the MS&Co. affiliate's short position. Specifically, at approximately 9:32 a.m., the MS&Co. trader entered an agency order on behalf of the MS&Co. affiliate to buy 100,000 units of the basket to cover a portion of the short position. However, the tool used to create the basket had a built in multiplier of 1,000 for the particular basket being created. As a result, the order had a notional value of approximately \$10.8 billion instead of \$10.8 million.

² The Firm executes program trades at various trading desks, one of which is the Swap Desk. Swaps are privately negotiated agreements between two parties to exchange cash flows at specified intervals (payment dates) during the agreed upon life of the contract (maturity) and are available in and between all active financial markets.

8. When entering the order, the trader, who was unfamiliar with creating this type of basket with the tools he was using, conferred with his supervisor. As the trader created the basket, he forgot that the tool he was using had a built-in multiplier of 1,000 for that basket. The trader's supervisor telephonically assisted the trader with the creation of the basket. Although the supervisor mistakenly instructed the trader to type in 100,000 units, the supervisor nonetheless asked the trader whether the notional value of the order that appeared on the trader's monitor was approximately \$10.8 million.
9. The trader erroneously confirmed to the supervisor that the notional dollar value of the basket appearing on his monitor was approximately \$10.8 million. The trader had three opportunities to look at the notional value on his monitor prior to placing the order. The trader, however, erroneously confirmed the order without verifying its correct notional value. As a result, the trader erroneously placed an order to purchase a basket of stocks with a notional value of approximately \$10.8 billion. The supervisor, however, was able to, but did not review, the order to verify its accuracy including the accuracy of the notional amount of the order, before the trader transmitted it for execution.
10. An Executive Director responsible for managing the trading infrastructure noticed the unusual size of the order and called the trader's supervisor to determine whether the order was an error. At about the same time, the trader discovered the mistake and attempted to cancel the order. Approximately five minutes after the order was entered, the Executive Director and the trader's supervisor were able to cancel the unfilled portion of the order from the main server.
11. The erroneous order consisted of approximately 1,935 different stocks: 1,182 NASDAQ issues, 702 NYSE issues, and 51 AMEX issues. By the time the Firm canceled the orders, a portion of the erroneous orders, approximately 1,920 issues totaling 677,427,600 shares with a total market value of \$10,116,397,038, had already been sent for execution. Before the order was cancelled, approximately 81,455,744 shares, (or approximately 12% of the total order), with a market value of \$875,344,997, were executed. With respect to the NYSE, the order consisted of approximately 273,283,200 shares in 702 NYSE-listed stocks. Of the 702 NYSE-listed stocks, however, orders in only 692 of those stocks, or approximately 12,724,661 shares (approximately 4% of the NYSE portion of the order), were executed on the NYSE Floor. This error caused significant market disruption in certain NYSE listed securities as explained below.

The Error's Impact on the Market and the Firm

11. On September 1, 2004, as a result of a trader's error, MS&Co. inundated the Floor with numerous large orders to purchase 692 NYSE listed securities. For at least 15 minutes in certain NYSE listed stocks, this error caused significant market disruption in that specialists were unable to update message boards relating to certain of the assigned listed stocks and were unable to effect other trades until the accuracy of the erroneous orders could be verified.

12. At approximately 9:35 a.m., an NYSE Floor Governor alerted the On-Floor Surveillance Unit (“OFSU”) staff that MS&Co. had entered a large buy program. At the same time, the NYSE Board of Executive members and other Floor Governors contacted MS&Co.’s senior officers. Subsequently, the OFSU staff was advised that MS&Co. had inadvertently entered large buy orders in numerous securities. MS&Co. advised OFSU staff that once the Firm had realized the error, it entered cancellations and sell orders to offset the erroneous trades.

Supervision

13. NYSE Rules 342(a) and (b) require that each business activity of a member organization shall be under the supervision and control of the member organization establishing it and that the Firm establish a separate system of follow-up and review to determine that the delegated authority and responsibility of supervising each of its business activities is being properly exercised.
14. Guidance with respect to a member firm’s obligations relating to supervision and control of electronic order entry systems is set forth in NYSE Information Memo 02-48 (the “Information Memo”), which recognizes that errors resulting from electronic order entry systems could result in increased market volatility as well as significant financial risk and exposure to members and member organizations. The Information Memo recommends that member firms ensure that their electronic order entry systems have features in place that, at a minimum, validate order accuracy and establish limits and/or prohibitors to prevent orders exceeding preset size parameters from being executed.
15. MS&Co. failed to comply with NYSE Rules 342(a) and (b) in that it failed to provide for adequate internal systems, controls and mechanisms on its Swap Desk in order to prevent erroneous electronic program orders from being transmitted to the NYSE Floor, as recommended in the Information Memo.
16. The Firm did not have adequate features in place to validate order accuracy and establish limits or prohibitors to prevent orders exceeding preset parameters from being executed as evidenced by the trader’s incorrect transmittal of an order with a notional value of approximately \$10.8 billion.
17. A “pop-up” screen in the order entry system appeared on every order before it was routed for execution regardless of size, and contained the notional dollar value of the order about to be traded, and the amount of shares about to be traded. The “pop-up” that appeared for the erroneous order failed to provide adequate notification to either the trader or the Firm that an unusually large order was about to be transmitted to the NYSE Floor. The Firm’s system failed to properly validate the order’s accuracy prior to transmittal.
18. The order entry system used by the trader to enter the erroneous order offered the capability to create preset trading limits and provide a warning message in the event that a trader exceeded a preset limit. The Firm, however, neither obligated its traders and supervisors to set such trading limits nor told its traders and supervisors that such features

even existed. In addition, the Firm failed to implement procedures to ensure that traders or supervisors activated or established trading limits.

19. Although the order entry system had the capability to have preset trading limits established, neither the trader nor his supervisor were aware of this feature and therefore no trading limits were set. As a result, when the trader entered the order, there was no safeguard activated in the Firm's systems that would have alerted the trader that he was entering an incorrect and oversized order.
20. The trader was allowed to place an order for the unusually large amount of \$10.8 billion without receiving a validation "pop-up" or confirmation alert that was any different from the "pop-up" screen on a standard order. Moreover, given the Firm's lack of safeguards with respect to the order entry system used, the trader also could have placed an order for any amount, no matter how large, without receiving a different warning.
21. The order entry system used by the trader to enter the erroneous order did not have a blocking feature to prevent a trader from entering an oversized order. Likewise, the Firm did not have a policy, procedure or systemic blocking feature to prevent a trader from trading beyond a certain amount, including any trading limits set by the trader and/or his supervisor.

Additional Considerations

22. Subsequent to the erroneous electronic order entry in this matter, the Firm established pre-set trade limitations for each of its traders on the Firm's Swap Desk and has added a safeguard requiring that a trader make a manual computer entry to verify and acknowledge that an anticipated trade will exceed a pre-set limit when a red warning "pop-up" appears on the trader's screen.
23. The Firm realized a loss of approximately \$24 million as a result of the erroneous trade.
24. The Firm has begun a review of its systems and procedures relating to electronic order flow to the NYSE Floor and has taken preliminary steps to adopt policies, procedures, and systems that are reasonably designed to prevent a recurrence of significant market disruption as a result of erroneous orders being routed to the NYSE Floor.

DECISION

The Hearing Officer, in accepting the Stipulation of Facts and Consent to Penalty, found Respondent guilty as set forth above.

PENALTY

In view of the above findings, the Hearing Officer imposed the penalty consented to by Respondent of a censure, a \$300,000 fine, and an undertaking that (i) the Firm will cause its Legal and Compliance Division, in conjunction with the Firm's Risk Management and

Technology Departments, to perform a review to identify the procedures and systems of follow-up and review the Firm has in place or has adopted which are reasonably designed to prevent recurrence of the foregoing violations to ensure compliance with applicable NYSE rules and federal securities laws, to evaluate whether further enhancements or improvements to such procedures and systems are appropriate, to make any appropriate recommendations for additional procedures and systems, if necessary, and to prepare a written report (the "Report"); and (ii) the Firm's Legal and Compliance Division shall prepare the Report, within 120 days from the date this decision becomes final, addressing the aforementioned review, and the Firm shall adopt and implement any recommendations resulting from the Legal and Compliance Department's review to prevent the recurrence of the violations described herein and provide a copy of the Report to the NYSE.

For the Hearing Board

Peggy Kuo - Chief Hearing Officer