# Re Morgan Stanley Canada

**IN THE MATTER OF:**

**The Universal Market Integrity Rules**

**and**

**Morgan Stanley Canada Limited**

2011 IIROC 45

Investment Industry Regulatory Organization of Canada
Hearing Panel (Ontario District Council)

Heard: July 25, 2011
Decision: July 27, 2011
(11 paras.)

**Hearing Panel:**
The Honourable Fred Kaufman, C.M., Q.C. (Chair), Donald Lawson, Ted Norris
**Appearance:**
Charles Corlett, Enforcement Counsel
Danielle Royal, for the Respondent

## REASONS FOR THE DECISION RENDERED AT THE CONCLUSION OF THE HEARING

### Introduction

¶ 1 At a hearing held in Toronto, Ontario, on July 25, 2011, the parties presented the Hearing Panel with a Settlement Agreement (the "Agreement") which provided, in part, as follows:

***A. INTRODUCTION***

1. On June 1, 2008, IIROC consolidated the regulatory and enforcement functions of the Investment Dealers Association of Canada and Market Regulation Services Inc. (RS). Pursuant to the *Administrative and Regulatory Services Agreement* between RS and IIROC, effective June 1, 2008, RS has retained IIROC to provide services for RS to carry out its regulatory functions.
2. The Enforcement Department Staff (Staff) of the Investment Industry Regulatory Organization of Canada (IIROC) has conducted an investigation (the Investigation) into the conduct of Morgan Stanley Canada Limited (the Respondent).
3. The Investigation has disclosed matters for which IIROC seeks certain sanctions against the Respondent pursuant to Rule 10.5 of the Universal Market Integrity Rules (UMIR).
4. If this Offer of Settlement is accepted by the Respondent, the resulting settlement agreement (the Settlement Agreement), which has been negotiated in accordance with Part 3 of UMIR Policy 10.8, is conditional upon the approval by a hearing panel appointed pursuant to IIROC Transitional Rule No.1, Schedule C.1 (the Hearing Panel).

5. The Respondent agrees to waive all rights under UMIR to a hearing or to an appeal or review if the Settlement Agreement is approved by the Hearing Panel.

6. The Respondent consents to be subject to the jurisdiction of IIROC and its relevant disciplinary process and rules in relation to this matter.

7. Staff and the Respondent jointly recommend that the Hearing Panel accept this Settlement Agreement.

**B. AGREEMENT AS TO REQUIREMENTS CONTRAVENED**

8. The Respondent agrees that between August 2007 and December 2007 and between July 2008 and December 2008 it failed to comply with its trading supervision obligations contrary to UMIR 7.1 and Policy 7.1.

**C. ADMITTED FACTS**

9. For the purposes of this Settlement Agreement, Staff and the Respondent agree with and rely upon the admitted facts and conclusions which are set out in the Statement of Allegations attached as Appendix "A" to this Settlement Agreement.

**D. DISPOSITION**

10. For the contraventions in paragraph 8 above, Staff and the Respondent have agreed upon disposition as follows:

    (i) a fine of $175,000.00 payable by the Respondent to IIROC; and

    (ii) costs of $15,000.00 payable by the Respondent to IIROC.

11. If this Settlement Agreement is accepted by a Hearing Panel, the Respondent agrees to pay the amounts referred to in paragraph 10 within 30 days of such acceptance.

¶ 2 The details, as set out in Appendix "A" of the Agreement, are as follows:

I. REQUIREMENTS CONTRAVENED

1. It is alleged that Morgan Stanley Canada Limited ("Morgan Stanley Canada") has committed the following contravention:

    (i) Between August 2007 and December 2007 (the "2007 Relevant Period") and between July 2008 and December 2008 (the "2008 Relevant Period") (collectively, the "Relevant Periods") it failed to comply with its trading supervision obligations contrary to UMIR 7.1 and Policy 7.1.

2. Schedule "A" sets out the text of the relevant UMIR Requirements.

II. RELEVANT FACTS AND CONCLUSIONS

**Overview**

3. During the Relevant Periods, Morgan Stanley Canada failed to take adequate steps to identify and address potentially manipulative and deceptive trading by a direct market access client of its U.S. parent, Morgan Stanley & Co. Incorporated ("Morgan Stanley & Co.").

4. In particular, Morgan Stanley Canada failed to make adequate inquiries of the direct market access client and conduct a thorough analysis of the trading by the client. This was due in large part to the failure to adequately summarize and document testing results for artificial pricing.

5. No Morgan Stanley & Co. or Morgan Stanley Canada traders were involved with the handling of the potentially manipulative and deceptive orders.

**Background**

6. Morgan Stanley Canada is registered as an investment dealer and is a Participant under UMIR.

7. Morgan Stanley Canada provides dealer-sponsored access or direct market access to IIROC-regulated marketplaces to its U.S. parent, Morgan Stanley & Co., and by extension to its clients, pursuant to Marketplace Rules (for example, TSX Rule 2-501 and Policy 2-501) and ATS access requirements and allows trading under Morgan Stanley Canada's trading number.

8. In providing direct market access to IIROC-regulated marketplaces, a Participant is not relieved from any obligations under UMIR with respect to the supervision of trading activities by a direct market access client. The Participant retains full responsibility for any order entered by a direct market access client even where that order is directly routed to a marketplace.

9. During the Relevant Periods, an institutional hedge fund client of Morgan Stanley & Co. (the "Hedge Fund") engaged in potentially manipulative and deceptive trading by entering a significant number of "high closing" trades for the shares of PRW.UN, a TSX-listed issuer (the "Security").

10. IIROC determined that during the 2007 Relevant Period, the Hedge Fund executed trades that constituted the high closing price for the Security on 81 out of 104 trading days. IIROC determined that during the 2008 Relevant Period, the Hedge Fund executed trades that constituted the high closing price for the Security on 103 of 126 trading days.

**Failure to take adequate steps to identify and address potentially manipulative trading**

11. Morgan Stanley Canada delegated certain of its UMIR-related compliance testing and reviews to Morgan Stanley & Co. This delegation was acceptable according to regulatory requirements but Morgan Stanley Canada retained the ultimate responsibility for ensuring that trading supervision obligations under UMIR were being met.

12. In or about April 2007, Morgan Stanley & Co. commenced using Compliance Explorer, a third-party real-time market surveillance system, to assist in conducting daily, weekly and monthly trading reviews to identify potential improper trading activity.

13. During the Relevant Periods, Compliance Explorer generated numerous "pattern alerts", relating to the Hedge Fund's trading in respect of the Security.

14. Morgan Stanley & Co.'s procedures in place during the Relevant Periods required only that a sample of the Compliance Explorer alerts be reviewed. Based upon this sampling methodology, of the eight alerts relating to the Hedge Fund's trading in respect of the Security during the 2007 Relevant Period, Morgan Stanley & Co. reviewed only an October 31, 2007 alert for "price ramping/marking the close". Morgan Stanley Canada referred the October 31, 2007 alert to Morgan Stanley & Co. Morgan Stanley Canada and Morgan Stanley & Co. concluded that the activity was not high closing because the Hedge Fund had purchased shares of the Security during the day. Based upon that determination, Morgan Stanley Canada and Morgan Stanley & Co. did not undertake a further review of the Hedge Fund's trading activity in the Security in the prior months at that time.

15. A further review of the Hedge Fund's trading activity would have revealed additional instances of potentially manipulative and deceptive trading activity by the Hedge Fund in August, September and October 2007.

16. On November 14, 2007, Morgan Stanley Canada received an inquiry from IIROC asking for the identity of the beneficial owner of trades in PRW.UN in October 2007. Morgan Stanley & Co. responded to that inquiry by providing the identity of the Hedge Fund.

17. In March 2008, trades by the Hedge Fund generated further high closing price alerts. Morgan Stanley & Co. referred these high closing alerts to Morgan Stanley Canada concerning the Hedge

Fund's trading in the Security from February 4, 2008 to March 4, 2008. At Morgan Stanley Canada's direction, Morgan Stanley & Co. contacted the Hedge Fund to inquire about the end of day trading in the Security. The Hedge Fund offered what Morgan Stanley & Co. perceived was a reasonable explanation for the trading activity, explaining that it was using limit orders to unwind and re-establish its position in the Security. Neither Morgan Stanley & Co. nor Morgan Stanley Canada took any further action at the time with respect to the Hedge Fund's trading activity.

18. At the end of July 2008, based upon a review of the Compliance Explorer high closing report for the month of July 2008, Morgan Stanley & Co. notified Morgan Stanley Canada that the Hedge Fund had established the closing price for the Security on 9 out of the last 20 trading days. After Morgan Stanley Canada identified some of the trading as potentially manipulative, Morgan Stanley & Co. again contacted the Hedge Fund to inquire about the trading activity. The Hedge Fund was asked to spread its strategy over the course of the entire day. Representatives of Morgan Stanley Canada and Morgan Stanley & Co. discussed monitoring the Hedge Fund's relevant trading activity going forward.

19. The Hedge Fund's trading in the Security continued to generate high closing alerts throughout the rest of the 2008 Relevant Period without any additional inquiries or analysis by Morgan Stanley Canada or Morgan Stanley & Co.

**Failure to adequately summarize and document testing results**

20. During the Relevant Periods, the Regulatory Control Group ("RCG") at Morgan Stanley & Co. (in performance of its delegated functions) conducted regular testing of trading activities in order to meet the UMIR Requirements. Following this testing RCG forwarded to a representative of Morgan Stanley Canada a monthly checklist listing the reviews conducted pursuant to both UMIR and the Dealer Member Rules (prior to June 1, 2008, the IDA By-laws).

21. During the Relevant Periods, the UMIR trading issues that were discussed between Morgan Stanley & Co. and Morgan Stanley Canada regarding the Hedge Fund's trading in the Security were not documented on any of the monthly checklists provided to Morgan Stanley Canada, and no summary was kept of any UMIR issues discussed with the RCG.

22. In March 2009, IIROC conducted a Trading Conduct Review of Morgan Stanley Canada and in the report issued in July 2009 found that the reviews being conducted for artificial pricing were not adequately quantified and summarized and that the sample size for TSX/TSX-V listed securities was inadequate for the testing of artificial pricing for a firm of its size.

23. The RCG was not adequately summarizing and documenting testing results in part because Morgan Stanley Canada failed to communicate certain UMIR Requirements to Morgan Stanley & Co.

**Remedial steps taken by Morgan Stanley Canada**

24. Since 2009, Morgan Stanley Canada has implemented several enhancements to its compliance and supervisory program with regard to the UMIR Requirements, including:

    (i) creating and implementing a revised monthly report that quantifies and summarizes UMIR testing results, highlighting potential exceptions, formal regulatory inquiries, informal regulatory inquiries, open investigations, warning letters, potential violation alert notices and gatekeeper reports;

    (ii) substantially increasing the sample size for testing of trading on IIROC-regulated marketplaces including, among other things, the review of pattern alerts and high closing pattern alerts;

(iii) in November 2010, hiring a dedicated, full-time Chief Compliance Officer for Morgan Stanley Canada;

(iv) clarifying and revising applicable procedures regarding the review of Compliance Explorer alerts including implementing procedures whereby Morgan Stanley Canada reviews certain Compliance Explorer alerts and ensuring that where Compliance Explorer alerts are reviewed by Morgan Stanley & Co., issues are communicated to Morgan Stanley Canada and escalated as appropriate;

(v) creating a Training Manual for DMA clients which includes a section on UMIR 2.2 Manipulative and Deceptive Activities and regarding Morgan Stanley Canada's Gatekeeper Reporting obligations; and

(vi) enhancing supervisory processes and procedures including enhanced training of supervisory delegates who are now required to complete the Trader Training Course offered by the Canadian Securities Institute.

III. CONCLUSION

*25.* ***In circumstances where a Participant is providing direct market access to clients, the Participant retains full responsibility for any order entered. A Participant must be aware of, and specifically address, the additional risk exposure posed by orders entered by direct market access clients.***

*26.* ***Morgan Stanley Canada's failure to adequately address the potentially manipulative trading of the Hedge Fund, a Morgan Stanley & Co. direct market access client, who may have had an interest in "high closing" the Security for the purposes of portfolio valuation or other improper purpose, was largely the result of inadequate review of the trading, and insufficient sample sizing and documentation of testing results.***

27. Although inquiries were made by Morgan Stanley & Co. and Morgan Stanley Canada in respect of the trading activities of the Hedge Fund, the actions taken were not sufficient in part due to a lack of clarity about how such potential contraventions should be documented and escalated and ambiguous lines of responsibility and authority.

**The Universal Market Integrity Rules**

¶ 3 Rule 7.1 provides as follows:

**7.1 Trading Supervision Obligations**

**(1) Each Participant shall adopt written policies and procedures to be followed by directors, officers, partners and employees of the Participant that are adequate, taking into account the business and affairs of the Participant, to ensure compliance with these Rules and each Policy.**

**(2) Prior to the entry of an order on a marketplace by a Participant, the Participant shall comply with:**

**(a) applicable regulatory standards with respect to the review, acceptance and approval of orders;**

**(b) the policies and procedures adopted in accordance with subsection (1); and**

**(c) all requirements of these Rules and each Policy.**

(3) Each Participant shall appoint a head of trading who shall be responsible to supervise the trading activities of the Participant in a marketplace.

(4) The head of trading together with each person who has authority or supervision over or responsibility to the Participant for an employee of the Participant shall fully and properly supervise such employee as necessary to ensure the compliance of the employee with these Rules and each Policy.

¶ 4 This rule is amplified and explained in IIROC's policy statement:

POLICY 7.1 – TRADING SUPERVISION OBLIGATIONS

***Part 1 – Responsibility for Supervision and Compliance***

*For the purposes of Rule 7.1, a Participant shall supervise its employees, directors and officers and, if applicable, partners to ensure that trading in securities on a marketplace (an Exchange, QTRS or ATS) is carried out in compliance with the applicable Requirements (which includes provisions of securities legislation, UMIR, the Trading Rules and the Marketplace Rules of any applicable Exchange or QTRS). An effective supervision system requires a strong overall commitment on the part of the Participant, through its board of directors, to develop and implement a clearly defined set of policies and procedures that are reasonably designed to prevent and detect violations of Requirements. The board of directors of a Participant is responsible for the overall stewardship of the firm with a specific responsibility to supervise the management of the firm. On an ongoing basis, the board of directors must ensure that the principal risks for non-compliance with Requirements have been identified and that appropriate supervision and compliance procedures to manage those risks have been implemented.*

*Management of the Participant is responsible for ensuring that the supervision system adopted by the Participant is effectively carried out. The head of trading and any other person to whom supervisory responsibility has been delegated must fully and properly supervise all employees under their supervision to ensure their compliance with Requirements. If a supervisor has not followed the supervision procedures adopted by the Participant, the supervisor will have failed to comply with their supervisory obligations under Rule 7.1(4).*

*When the Market Regulator reviews the supervision system of a Participant (for example, when a violation occurs of Requirements), the Market Regulator will consider whether the supervisory system is reasonably well designed to prevent and detect violations of Requirements and whether the system was followed.*

*The compliance department is responsible for monitoring and reporting adherence to rules, regulations, requirements, policies and procedures. In doing so, the compliance department must have a compliance monitoring system in place that is reasonably designed to prevent and detect violations. The compliance department must report the results from its monitoring to the Participant's management and, where appropriate, the board of directors, or its equivalent. Management and the board of directors must ensure that the compliance department is adequately funded, staffed and empowered to fulfill these responsibilities.*

***The obligation to supervise applies whether the order is entered on a marketplace:***

- ***by a trader employed by the Participant,***
- ***by an employee of the Participant through an order routing system,***
- ***directly by a client and routed to a marketplace through the trading system of the Participant, or***
- ***by any other means.***

***In performing the trading supervision obligations, the Participant will act as a "gatekeeper" to help prevent and detect violations of applicable Requirements.***

***Where an order is entered on a marketplace without the involvement of a trader (for example by a client with a systems interconnect arrangement in accordance with Policy 2-501 of the Toronto Stock Exchange), the Participant retains responsibility for that order and the supervision policies and procedures should adequately address the additional risk exposure which the Participant may have for orders that are not directly handled by staff of the Participant. For example, it may be appropriate for the Participant to sample for compliance testing a higher percentage of orders that have been entered directly by clients than the percentage of orders sampled in other circumstances.***

***In addition, the "post order entry" compliance testing should recognize that the limited involvement of staff of the Participant in the entry of orders by a direct access client may restrict the ability of the Participant to detect orders that are not in compliance with specific rules. For example, "post order entry" compliance testing may be focused on whether an order entered by a direct access client:***

- ***has created an artificial price contrary to Rule 2.2;***
- ***is part of a "wash trade" (in circumstances where the client has more than one account with the Participant);***
- ***is an unmarked short sale (if the trading system of the Participant does not automatically code as "short" any sale of a security not then held in the account of the client); and***
- ***has complied with order marking requirements and in particular the requirement to mark an order as from an insider or significant shareholder (unless the trading system of the Participant restricts trading activities in affected securities).***

**Decision**

¶ 5 At the conclusion of the hearing, after due deliberation, the Panel accepted the Agreement, with reasons to follow. These, then, are the Panel's reasons for accepting the Agreement.

**Reasons**

¶ 6 As the facts set out above demonstrate, there was a clear failure by the Respondent to observe the Rule and the Policy, and this to the detriment of investors at large, who have a right to rely on the closing trades of listed securities. This is a serious matter and it deserves serious punishment, which hopefully will send a clear message to the financial community.

¶ 7 As the UMIR Disciplinary Sanction Guidelines point out (in Part 1(1)), sanctions have a five-fold purpose:

a. encourage Regulated Persons to comply with all applicable securities legislation and requirements;

b. prevent fraudulent and manipulative acts and practices and deter misconduct both generally and specifically;

c. promote just and equitable principles of trade for participants and open and fair business practices by access persons; and

d. improve overall business standards in the securities industry.

e. Promote public confidence in the SRO system.

¶ 8 In cases such this, where trading supervision obligations are infringed, the guidelines recommend that panels "consider a substantial fine of up to $ 1 million per contravention." However, since the facts of each case differ, so must the penalty, and in the case before us there are substantial mitigating factors (detailed above), which indicate that the Respondent took effective steps to remedy the situation, and that there is reason to believe that, with the new arrangements in place, Rule 7.1 will be fully observed. It should also be noted, as was stressed at the hearing, that the Respondent co-operated fully with IIROC's staff, thereby avoiding a much more lengthy – and, undoubtedly, a much more costly – investigation.

¶ 9 The only relevant precedent cited is *IIROC v. Credit Suisee Securities (Canada) Inc.*, February 3, 2011, [2011] IIROC No. 10, where the Respondent, in similar circumstances, was fined $150,000 and ordered to pay costs in the amount of $15,000. However, in *Credit Suisse*, the period involved, was somewhat shorter.

¶ 10 We are also cognizant of the fact that, traditionally, hearing panels will not lightly interfere in agreements reached by the parties. As was said in *IIROC v. BMO Nesbitt Burns Inc.*, August 30, 2010, [2010] IIROC No. 39,

> It is well accepted that hearing panels should not attempt to "fine-tune" agreements reached by the parties, particularly where, as here, the two sides are evenly matched and represented by experienced and competent counsel. What is important is that the proposed agreement appears to the panel to be reasonable given the specific facts of the case, and that the proposed penalties will not only be a punishment for the party, but also a warning to others who may be tempted to conduct themselves in a similar manner.

¶ 11 In our view, the settlement, negotiated as it was by the parties assisted by capable counsel, is well within the range of appropriateness, and it should therefore be, and was, accepted by the Panel.

Given in Toronto, the 27th day of July , 2011.

Hon. Fred Kaufman, Chair

Donald Lawson, Member

Ted Norris, Member