

STATE OF MAINE  
OFFICE OF SECURITIES  
121 STATE HOUSE STATION  
AUGUSTA, ME 04333

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4 In the matter of )  
5 MORGAN STANLEY & CO. ) CONSENT ORDER  
6 INCORPORATED , )  
7 Respondent. ) No. 03-106  
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WHEREAS, Morgan Stanley & Co. Incorporated (“Morgan Stanley”) is a broker-dealer licensed in the state of Maine;

WHEREAS, coordinated investigations into Morgan Stanley’s practices, procedures and conduct respecting the preparation and issuance by Morgan Stanley’s U.S. equity research analysts (“research analysts”) of research, analysis, ratings, recommendations and communications concerning common stocks of publicly traded companies covered by such analysts (“research coverage”), during the period 1999 through 2001, including without limitation, commencement and discontinuance of research coverage, actual or potential conflicts of interests affecting research coverage, research analysts or termination of research analysts, and statements, opinions, representations or non-disclosure of material facts in research coverage (the “investigations”) have been conducted by a multi-state task force and a joint task force of the U.S. Securities and Exchange Commission, the New York Stock Exchange, and the National Association of Securities Dealers (collectively, the “regulators”);

WHEREAS, Morgan Stanley has cooperated with regulators conducting the investigations by responding to inquiries, providing documentary evidence and other materials, and providing regulators with access to facts relating to the investigations;

WHEREAS, Morgan Stanley has advised regulators of its agreement to resolve the investigations;



1 tool to gain investment banking business. As a result, Morgan Stanley research analysts were  
2 faced with a conflict of interest between helping generate investment banking business for Morgan  
3 Stanley and their responsibilities to publish objective research reports that, if unfavorable to actual  
4 or potential banking clients, could prevent Morgan Stanley from winning that banking business.

5 4. As lead underwriter in various stock offerings, Morgan Stanley also complied with the  
6 issuers' directives to pay portions of the underwriting fees to other broker-dealers that served as  
7 underwriters or syndicate members to publish research reports on the issuer. Morgan Stanley did  
8 not take steps to ensure that these broker-dealers disclosed these payments in their research reports.  
9 Further, Morgan Stanley did not cause the payments to be disclosed in the offering documents or  
10 elsewhere as being for research.

11 5. Morgan Stanley also failed to reasonably supervise its analysts regarding the content of  
12 their research reports.

### 13 **I. 1. BACKGROUND**

#### 14 **A. The Investment Banking Function at Morgan Stanley**

15 6. The investment banking division at Morgan Stanley advised corporate clients and helped  
16 them execute various financial transactions, including the issuance of stock and other securities.  
17 Morgan Stanley frequently served as the lead underwriter in initial public offerings ("IPOs") -- the  
18 first public issuance of stock of a company that has not previously been publicly traded -- and  
19 follow-on offerings of securities.

20 7. During the relevant period, investment banking was an important source of revenues and  
21 profits for Morgan Stanley. In 2000, investment banking generated more than \$4.8 billion in  
22 revenues, or approximately twenty-four percent of Morgan Stanley's total net revenues.

#### 23 **B. The Role of Research Analysts at Morgan Stanley**

24 8. Research analysts at Morgan Stanley covered a broad range of industry sectors and  
25 published periodic reports on certain companies within those sectors. Analysts typically reviewed  
26 the performance of their covered companies, evaluated their business prospects, and provided

1 analysis and projections concerning whether they presented good investment opportunities.  
2 Through 2001, Morgan Stanley's equity research department had a system calling for rating  
3 covered companies, from most to least positive, as "Strong Buy," "Outperform," "Neutral," or  
4 "Underperform." Analyst reports were disseminated to Morgan Stanley clients by mail and  
5 facsimile and by financial advisors. Certain research reports were made available to retail clients  
6 who set up accounts on Morgan Stanley's web site and, similarly, institutional clients were able to  
7 access Morgan Stanley's research reports via accounts on Morgan Stanley's web site. In addition,  
8 certain industry reports were available on Morgan Stanley's public web site. Certain institutional  
9 clients of Morgan Stanley could also access research reports through the First Call subscription  
10 service. The financial news media on occasion also reported Morgan Stanley analysts' ratings.

11 9. Morgan Stanley analysts also played an important role in assessing potential investment  
12 banking transactions, in particular IPOs. Morgan Stanley's stated objective was to "take public" as  
13 lead underwriter the leading companies in their respective industry sectors and to have its research  
14 analysts serve as gatekeepers to the IPO process by investigating whether companies were  
15 appropriate IPO candidates. Research analysts who endorsed an IPO candidate typically  
16 participated in the competition to obtain the investment banking business and, if Morgan Stanley  
17 was selected as lead underwriter, helped market the IPO to institutional investors, explained the  
18 IPO to the firm's institutional and retail sales forces, and then issued research on the company.

19 10. Senior analysts at Morgan Stanley published individual research reports without pre-  
20 publication review by research department supervisors. While reports were reviewed for  
21 grammatical errors and for compliance with certain legal requirements, there was no system for  
22 reviewing the recommendations or price targets included in the reports of senior analysts prior to  
23 their publication.

1 **I. 2. THE RELATIONSHIP BETWEEN INVESTMENT BANKING AND RESEARCH**  
2 **CREATED CONFLICTS OF INTEREST FOR MORGAN STANLEY RESEARCH**  
3 **ANALYSTS**

4 11. Certain practices at Morgan Stanley created or maintained conflicts of interest for the firm's  
5 research analysts with respect to investment banking considerations. These conflicts arose from  
6 the inherent tension between the analysts' involvement in helping to win investment banking  
7 business for Morgan Stanley and their responsibilities to publish objective research that, if negative  
8 as to prospective banking clients, could prevent the firm from winning the banking business.

9 **A. Morgan Stanley Marketed Research Coverage, Including, at Times, Implicitly**  
10 **Favorable Coverage, in Competing for Investment Banking Business**

11 12. Morgan Stanley typically competed with other investment banks for selection as the lead  
12 underwriter, or "bookrunner," for securities offerings, including IPOs and follow-on offerings.  
13 Significant financial rewards were at stake in these competitions. Sole or joint bookrunners  
14 generally received the largest portion of underwriting fees, which were typically divided among the  
15 participating investment banks. The bookrunner also established the allocation of shares in an  
16 offering and typically retained the greatest number of shares for itself. The typical IPO generated  
17 millions of dollars in investment banking fees for the bookrunner.

18 13. The process of selecting the lead underwriter typically culminated in a series of  
19 presentations by competing investment banks called a "bakeoff," in which investment banks  
20 competing for the business in a particular offering met with the issuer to present their qualifications  
21 and offer investment banking and other services. As part of these presentations, investment banks  
22 often provided issuers with a "pitchbook," which typically described the investment bank's  
23 credentials and services. In selecting the lead underwriters, issuers assessed a host of factors,  
24 including the strength and quality of the bankers' research coverage. Issuers sought research  
25 coverage of their stocks, believing such coverage would enhance the credibility of their businesses,  
26 potentially lead to higher stock prices, and increase their exposure to the investing public.

1 14. Between 1999 and 2001, as part of the package of services it offered to issuers to win  
2 investment banking business from certain issuers, Morgan Stanley typically committed that its  
3 analysts would initiate (or continue) research coverage of the issuer if Morgan Stanley won the  
4 banking competition. In so doing, Morgan Stanley used its analysts as a marketing tool to help  
5 secure banking business. The promise of future research coverage was often a critical selling point  
6 that enabled Morgan Stanley to obtain millions of dollars in investment banking fees. Research  
7 coverage was part of a package of services for which Morgan Stanley was compensated in those  
8 investment banking deals.

9 15. Analysts played an important role in Morgan Stanley's pitches for banking business. Along  
10 with investment bankers and others, analysts were typically presented as part of the Morgan  
11 Stanley "team" that would consummate the transaction. The pitchbooks typically identified the  
12 analysts on the team and dedicated several pages to the analysts' experience, credentials, and  
13 specific role in the contemplated transaction. Analysts drafted portions of the pitchbook and  
14 almost always attended the presentations for IPO business. The pitchbooks typically compared  
15 Morgan Stanley analysts favorably to their counterparts at competing firms, citing their rankings in  
16 analyst polls and other measures

17 16. Morgan Stanley typically identified its analysts as a favorable factor that issuers should  
18 consider in selecting Morgan Stanley for investment banking business. For example, in describing  
19 one reason Loudcloud, Inc., should name Morgan Stanley as bookrunner for its 1999 IPO, the  
20 pitchbook referred to two senior analysts as a "dream team" who would "articulate Loudcloud's  
21 story to investors in a way that no other investment bank can match." Another pitchbook described  
22 two senior analysts as "the most powerful combination in the extended enterprise space . . . ever."

23 17. In its pitches to obtain investment banking business, Morgan Stanley typically promised  
24 future research coverage as among the package of services it would provide. For example, in a  
25 pitchbook provided to iBeam Broadcasting Corp. to obtain its IPO business, Morgan Stanley said it  
26 would "provide ongoing research coverage and aftermarket trading" and, in another instance, said

1 “coverage would be initiated immediately after the quiet period. Additional research reports will  
2 follow on a regular basis thereafter.” Morgan Stanley won the iBeam IPO business and received  
3 investment banking fees of approximately \$3.8 million. Another pitchbook, in a chronology of  
4 how the IPO would unfold, stated: “Research coverage initiated on day 26,” which was the day  
5 research coverage could be initiated by an underwriter following an IPO. Morgan Stanley made  
6 comparable commitments to other prospective banking clients. Another Morgan Stanley  
7 pitchbook, provided to Transmeta Corp. in July 2000 in connection with its IPO, said “we view  
8 research as an ongoing commitment,” and offered to “continue regular publication of research  
9 reports.” Morgan Stanley won the Transmeta IPO business and received investment banking fees  
10 of approximately \$9.5 million. In other pitchbooks, Morgan Stanley emphasized its “aftermarket  
11 support” services, which it expressly described as including future research coverage. For  
12 example, a pitchbook presented to AT&T Latin America said Morgan Stanley “is committed to  
13 bolstering an IPO’s performance in the aftermarket through extensive equity research and active  
14 market-making.” (Emphasis added.) Morgan Stanley pitchbooks often identified the specific  
15 number of reports its analysts published on other companies, giving implicit guidance on how  
16 many reports issuers could expect to receive if they selected Morgan Stanley as lead banker.

17 18. Further, Morgan Stanley at times implicitly suggested that analysts would provide favorable  
18 research coverage, pending completion of due diligence, by noting analysts’ past favorable  
19 coverage and/or emphasizing its enthusiastic support for the issuer. For example, when Morgan  
20 Stanley sought investment banking business from Convergys Corp., the company already had been  
21 covered for two years by a senior Morgan Stanley analyst who, as the pitchbook mentioned four  
22 times, considered Convergys to have been the analyst’s “#1 stock pick” over those years. (During  
23 that time period, the stock price had appreciated 98%.) The May 2001 pitchbook then described  
24 the analyst as the “voice of the issuing company,” who would work “in tandem” with Convergys  
25 management to position its story to investors. In the following month, June 2001, the senior  
26

1 analyst downgraded Convergys from Strong Buy to Outperform, still a favorable rating, then later  
2 upgraded Convergys back to Strong Buy in December 2001.

3 19. In other instances, Morgan Stanley pitchbooks identified a particular analyst's history of  
4 issuing Strong Buy or Outperform ratings on other companies. Some pitchbooks also identified  
5 instances in which other stocks covered by Morgan Stanley analysts increased in price following  
6 their IPOs. For example, the Morgan Stanley pitchbook provided to Transmeta Corp. in July 2000  
7 emphasized how one analyst's "support" of eight semiconductor IPOs since 1997 had "resulted in  
8 unparalleled performance in the public market," and included a line graph showing a dramatic  
9 increase in the stocks' price from 1998 through March 2000.

10 20. In another instance, after Loudcloud management informed Morgan Stanley in 1999 that  
11 research coverage was a key factor in its selection of the bookrunner for its IPO, Morgan Stanley's  
12 head of worldwide investment banking informed the issuer in an e-mail that the firm had  
13 "developed a successful model which combines the best of technology and telecom research at  
14 Morgan Stanley to properly position Loudcloud in the capital markets; specifically, enthusiastic  
15 sponsorship" by two research analysts who covered Loudcloud's sector. He added: "I commit to  
16 putting the entire franchise behind Loudcloud to achieve the best valuation and after market  
17 performance, as well as unmatched strategic advice post-IPO." Morgan Stanley won the  
18 Loudcloud IPO business and received investment banking fees of approximately \$4.7 million.

19 21. In addition to pitchbooks, Morgan Stanley occasionally provided draft or "mock" research  
20 reports to issuers to provide an example of how analysts might describe the issuer to investors. The  
21 draft or mock reports described the issuers in favorable terms without including ratings or price  
22 targets.

23 22. Morgan Stanley's commitments to provide research coverage were not limited to pitches  
24 for IPO business. Morgan Stanley obtained investment banking business for follow-on offerings of  
25 companies that its analysts did not cover in part by promising to initiate future coverage.

26



1 23. Morgan Stanley consistently honored its commitments to provide research coverage,  
2 initiating or maintaining coverage when it won the investment banking business.

3 24. In Morgan Stanley's annual performance evaluation process, some analysts and bankers  
4 noted their success in obtaining banking fees by promising future research coverage. For example,  
5 in a November 3, 1999 e-mail, an investment banker listed several banking transactions that he said  
6 Morgan Stanley had won because it committed that a particular highly-rated analyst would initiate  
7 research coverage. Specifically, the banker wrote that Morgan Stanley had won two transactions  
8 totaling \$13.4 million in fees from Veritas Software Corp. "just for promising that [the senior  
9 analyst] would pick up coverage after the deals." The banker observed that this had "enraged"  
10 competing firms, which said it was "unprecedented" to give an underwriter with no previous  
11 research coverage such a high share of the fees. The banker added: "The response from the CEO  
12 to those firms -- 'you don't have [the senior analyst].'" Other analyst evaluations as well as other  
13 internal Morgan Stanley documents identified additional instances in which it was stated that  
14 Morgan Stanley won investment banking business in large part because its analysts committed to  
15 initiate coverage.

16 **B. Investment Banking Concerns Influenced Morgan Stanley's Decisions**  
17 **Whether to Initiate or Continue Research Coverage**

18 25. The decision to initiate or continue research coverage of certain companies was influenced,  
19 at least in part, by whether those companies were actual or prospective investment banking clients  
20 of Morgan Stanley.

21 26. In one instance, in May 2001, the liaison between the research and investment banking  
22 divisions was advised that a poultry company, Pilgrim's Pride, was seeking equity research  
23 coverage in connection with a prospective high-yield offering. The liaison made clear that Morgan  
24 Stanley should not commit to providing coverage until it received a certain amount of investment  
25 banking fees from the company:  
26

1 Be careful with this one. Under no circumstances should we commit  
2 unless we get the books and at least \$3-5mm in fees, with the money  
3 in the bank before we pick up coverage. We can tell them it will go  
4 in the queue and we cannot promise them a rating. It costs about  
5 \$1 mm to pick up coverage of a stock and there are also meaningful  
6 ongoing expenses to maintain.

7 27. Morgan Stanley analysts on occasion also declined to cover some companies that  
8 refused to award investment banking business to Morgan Stanley. One senior analyst wrote in a  
9 2000 self-evaluation that the analyst had declined Sabre Group's requests for research coverage for  
10 four years and that the analyst had "insisted that we first be mandated on a large investment  
11 banking transaction." Generally, analysts select which of the many companies in a sector they will  
12 cover. This senior analyst did not consider Sabre to be one the analyst needed to cover, unless  
13 Morgan Stanley were to be mandated on an investment banking transaction. When Sabre provided  
14 Morgan Stanley with banking business in connection with its spin-off from AMR Corp., the analyst  
15 initiated coverage of Sabre with an Outperform rating in March 2000.

16 28. Morgan Stanley also declined to initiate coverage of Concord/EFS, Inc. Concord  
17 initially retained Morgan Stanley as bookrunner for a 1999 secondary offering, but then hired a  
18 different bank as bookrunner after Morgan Stanley declined Concord's request that it commit to  
19 initiating coverage with a "Strong Buy" rating. Though Concord continued to offer part of that  
20 investment banking business to Morgan Stanley, Morgan Stanley withdrew, and it did not initiate  
21 research coverage of Concord at that time. In the fall of 2000, Morgan Stanley sought investment  
22 banking business from Concord in connection with another secondary offering. Concord's  
23 management told Morgan Stanley's senior analyst that it wanted an advance view of the analyst's  
24 initial rating. After completing two to three months of preliminary due diligence, the analyst told  
25 Concord that, if coverage were to be initiated at that time, the analyst tentatively would issue a  
26 "Strong Buy" up to a certain valuation level. Morgan Stanley also provided Concord with a draft  
research report, which, according to an e-mail written by an investment banker, was part of Morgan  
Stanley's "marketing efforts." When Morgan Stanley was not awarded the 2000 investment

1 banking business, its analyst did not initiate coverage at that time, despite the analyst's initial view  
2 that Concord had emerged as a leader in its industry that preliminarily merited a "Strong Buy."

3 29. Morgan Stanley also initiated coverage of eBay, Inc., in part with the hope of  
4 obtaining investment banking business. After Morgan Stanley initially lost the IPO business for  
5 eBay in 1998, a senior Morgan Stanley analyst met with eBay's chief executive officer and  
6 provided a draft research report on the company. After Morgan Stanley nevertheless lost the IPO  
7 business, the analyst initiated coverage on eBay on its first day of trading with an Outperform  
8 rating. The analyst was the only one covering eBay, since firms in the underwriting syndicate were  
9 prohibited from initiating coverage until after the 25-day "quiet period" had expired. It is the only  
10 time that the senior analyst initiated coverage of a company on its first day of trading. Later, in  
11 1999 and again in 2001, eBay awarded two banking transactions to Morgan Stanley, with total fees  
12 of approximately \$1.2 million. In the senior analyst's self-evaluation for 2000, the analyst stated,  
13 as part of the analyst's "philosophy" for Morgan Stanley's "Internet banking efforts," that "when  
14 we miss a winning IPO, we should work like crazy (with tons of ideas) to secure a spot as M&A  
15 advisor (USWeb/CKS) or book running manager on follow-on offerings (eBay)."

16 **C. Morgan Stanley Research Analysts Performed Investment Banking**  
17 **Functions**

18 30. Morgan Stanley research analysts performed a number of investment banking-related  
19 functions. They identified potential IPO and merger and acquisition transaction candidates for the  
20 investment banking department, participated in soliciting investment banking business for the firm,  
21 and participated in road shows and other efforts to sell Morgan Stanley-underwritten IPOs and  
22 secondary offerings to institutional investors. At times, analysts also had discussions about  
23 business strategy with investment banking clients directly, and one senior analyst was described as  
24 a relationship manager with certain investment banking clients.

25 31. Morgan Stanley kept a record of each analyst's contribution to investment banking  
26 revenues. Each year, a "Revenue Share Analysis" was prepared that listed every investment

1 banking transaction in which each analyst had participated, the revenues from each transaction, a  
2 rating on a scale of 1 to 5 (5 being “critical” to the deal) of the analyst’s contribution to the  
3 transaction, and a calculation of the analyst’s “share” of the credit for the revenues secured from  
4 the transaction. The Revenue Share Analysis also recorded investment gains on Morgan Stanley  
5 investments in companies covered by the analyst.

6 32. One senior analyst’s involvement in investment banking activities was such that several  
7 investment bankers at the firm regarded the analyst as tantamount to an investment banker. One  
8 banker wrote that the analyst was the most committed and focused banker with whom he had ever  
9 worked. Another wrote that the analyst was a “commercial animal” who would do anything  
10 appropriate to win underwriting mandates. The analyst’s supervisor wrote in 1999 that the  
11 analyst’s focus was primarily on banking and that, notwithstanding the growing demand for the  
12 analyst’s time on investment banking matters, the analyst needed to devote more attention to  
13 institutional investors and the firm’s institutional sales force.

14 33. The analyst’s own self-evaluation prominently mentioned the analyst’s assistance to  
15 investment banking in selecting and generating investment banking business and large fees, stating:  
16 “Bottom line, my highest and best use is to help MSDW win the best Internet IPO mandates (and  
17 to ensure that we have the appropriate analysts and bankers to serve the companies well). . . .”  
18 (emphasis in original). It also prominently listed the deals and revenues from the analyst’s  
19 investment-banking connected efforts:

20 **Internet Investment Banking, a Record Year with \$205MM+**  
21 **YTD Revenue, [20+] Pending Financings, Co-Coverage**  
22 **(Leverage) in 85% of Cases, 6 of 6 Tech IBD Revenue**  
23 **Generating Clients, Internet Category was #1 Revenue**  
24 **Generator in Tech IBD (\$505MM YTD Tech Revenue). . .**  
25 (Emphasis in original.)

24 OK, the numbers (see Attachment A): Forty investment banking  
25 transactions (\$143MM in fees) . . .

26 It’s notable that 96% of the \$205MM in revenue was derived from  
clients new to the firm since 1995! Exceptions were America Online,

1 Compaq, Hearst and Sotheby's. And I have been very involved in  
2 this business. (Emphasis added.)

3 **D. Investment Banking Was an Important Factor in Determining Research**  
4 **Analysts' Compensation**

5 34. From 1999 through 2001, participation in investment banking activities was a factor in  
6 determining the total compensation awarded to some Morgan Stanley research analysts. These  
7 analysts thus faced a conflict of interest between helping win investment banking business for  
8 Morgan Stanley and publishing negative research that could prevent Morgan Stanley from winning  
9 that banking business.

10 35. The annual salaries paid to senior Morgan Stanley analysts and other senior Morgan  
11 Stanley personnel typically were comparatively small components of their total annual  
12 compensation. The majority of their total annual compensation was paid in the form of a bonus. In  
13 2000, one senior analyst received a year-end bonus that was 90 times greater than the analyst's  
14 base salary.

15 36. The total compensation paid to analysts was based in part on Morgan Stanley's total  
16 revenues for a particular year, including the investment banking fees that Morgan Stanley received.  
17 Thus, the success or failure of the investment banking division determined, in part, the total amount  
18 of funds available to pay employee compensation in any given year, including analyst  
19 compensation.

20 **1. Analysts Rated Their Contributions to Investment Banking**

21 37. The level of contribution to investment banking transactions was an important factor in the  
22 annual evaluations of Morgan Stanley's analysts and compensation decisions.

23 38. As part of the annual performance evaluation process, analysts were asked to submit self-  
24 evaluations that, among other things, discussed their contributions to Morgan Stanley. Analysts  
25 often included in their self-evaluations a discussion of their involvement in investment banking,  
26 including a description of specific transactions, the fees generated, and the role the analyst played

1 in each deal. For example, one-quarter of the 1999 self-evaluation of one analyst was dedicated to  
2 the analyst's role in investment banking activities, and identified forty transactions that year that  
3 had generated a total of \$143 million in fees.

4 39. As part of the evaluation process, the analysts also provided a rating of their contributions  
5 to specific banking transactions. Analysts were instructed to complete a Transaction Summary  
6 Worksheet ("TSW") in which they graded their roles in specific deals on a scale of 1-5.

7 Instructions provided to each analyst described the rating system as follows:

8 5 = critical to deal

9 4 = important to development and execution

10 3 = solid contribution

11 2 = limited contribution

12 1 = contribution limited to providing research coverage

13 40. Analysts were also instructed to comment on important aspects of any transaction,  
14 including, for example, whether the "promise of coverage was critical to winning" the mandate.  
15 The instructions informed analysts that supplying the information called for in the TSWs was an  
16 "important part" of their annual evaluation process.

## 17 **2. Investment Bankers Evaluated Analysts' Performance**

18 41. Morgan Stanley also solicited and received the investment bankers' assessment of the  
19 analysts' performance on the same transactions. Morgan Stanley's liaison between the research  
20 and investment banking divisions compiled and summarized the bankers' evaluations of the  
21 analysts' role in each deal and then prepared a final TSW listing for each transaction that provided  
22 a joint evaluation of the analysts' contributions to each deal.

23 42. Finally, as part of Morgan Stanley's "360 degree" review process, in which employees  
24 confidentially reviewed one another, investment bankers submitted written opinions of analysts  
25 with whom they worked.

26 43. Investment bankers thus played a role in the annual evaluation of research analysts by  
providing substantive information that was considered in the year-end evaluation process and input  
into the determination of the analysts' compensation for that year. The investment bankers' role in

1 the evaluation process created a conflict of interest for analysts, who hoped for positive evaluations  
2 from investment bankers at the same time that they were charged with issuing objective research  
3 reports that, if negative, could have impeded Morgan Stanley's ability to win future investment  
4 banking business from the covered companies.

5 **3. Investment Banking Was the Factor Accorded the Greatest**  
6 **Weight by Management in Reviewing Management's Initial**  
7 **Determination of Proposed Analysts' Compensation**

8 44. In 1999 and 2000, analyst compensation was set primarily by a managing director in the  
9 equity research division. The managing director made an initial determination of proposed  
10 compensation for all analysts and ranked the analysts based on that determination. The managing  
11 director then ranked the analysts based on their composite scores in nine categories. The managing  
12 director then compared the two rankings before forwarding the compensation recommendations to  
13 superiors.

14 45. The nine categories used to rank the analysts included the amount of investment banking  
15 revenues attributed to analysts based on their involvement in transactions (relative weight of 33%)  
16 and eight other categories related to core research activities, including: (1) poll rankings from the  
17 *Institutional Investor* and other sources (19%); (2) poll ranking from institutional equity division  
18 sales (12%); (3) firm activities and ability to be a team player (11%); (4) the "hit ratio" in vote  
19 gathering from institutional clients (7%); (5) rank in vote gathering from institutional clients (7%);  
20 (6) stock picking (active portfolio vs. passive portfolio) (6%); (7) stock picking (active portfolio vs.  
21 index portfolio) (3%); and (8) poll ranking from retail sales (2%). Thus, the managing director  
22 assigned a one-third weight to investment banking revenues -- the highest weight given to any  
23 single category.

24 46. The impact that an analyst's contribution to investment banking revenues could have on the  
25 determination of the analyst's compensation is shown by the compensation of one Morgan Stanley  
26 senior analyst in 1999 and 2000. In 1999, the analyst who received the highest compensation

1 among Morgan Stanley research analysts had a composite score that ranked only 11<sup>th</sup> overall, but  
2 ranked first in investment banking revenues.

3 47. In 2000, the same analyst continued to rank first in investment banking revenues: the total  
4 investment banking revenues that the analyst helped Morgan Stanley obtain more than doubled. In  
5 most other categories, however, the analyst's performance declined from 1999, and the analyst's  
6 composite score dropped to 19th overall. In 2000, the analyst ranked only 70th out of 111 analysts  
7 in stock picking, and the analyst's self-evaluation conceded that 2000 had been the analyst's worst  
8 stock-picking year in fifteen years. Nevertheless, this analyst's total salary and bonus for 2000  
9 increased by approximately \$8.7 million as compared to 1999, again ranking first among all  
10 Morgan Stanley analysts.

11 **I. 3. MORGAN STANLEY DID NOT DISCLOSE THAT IT PAID**  
12 **\$2.7 MILLION OF UNDERWRITING FEES AT ISSUERS' DIRECTION TO**  
13 **OTHER INVESTMENT BANKS TO PROVIDE RESEARCH COVERAGE**

14 48. In at least twelve stock offerings in which it was selected as lead underwriter from 1999  
15 through 2001, Morgan Stanley paid \$2.7 million of the underwriting fees to approximately twenty-  
16 five investment banks. Internal Morgan Stanley documents described these payments as "research  
17 guarantees" or "guaranteed economics for research." Other internal Morgan Stanley documents  
18 noted instances in which the bank receiving the payment "will write." Morgan Stanley made these  
19 payments from the offering proceeds at the direction of the issuers.

20 49. These "research guarantee" payments included more than \$670,000 paid to three  
21 investment banks in connection with an offering by Veritas Software Corp. in December 1999;  
22 more than \$816,000 paid to seven banks in connection with an Agile Software Corp. offering in  
23 December 1999; and more than \$440,000 paid to five banks in connection with an offering by  
24 Atmel Corp. in February 2000. The individual disbursements ranged from two payments of just  
25 over \$6,000 each to three payments of more than \$225,000 each.



1 50. The issuers' registration statements and other offering documents identified the other banks  
2 as part of the underwriting syndicates and as receiving payments, but did not specifically disclose  
3 the payments as being for research. Morgan Stanley did not take steps to ensure that these banks  
4 disclosed these payments in their research reports. Morgan Stanley also did not cause the  
5 payments to be disclosed in offering documents or elsewhere as having been for research.

6 **I. 4. MORGAN STANLEY FAILED REASONABLY TO**  
7 **SUPERVISE ITS SENIOR RESEARCH ANALYSTS**

8 **A. Morgan Stanley Had No System for Reviewing**  
9 **the Ratings Issued by Its Senior Analysts**

10 51. Morgan Stanley failed reasonably to supervise its senior research analysts. The firm  
11 required only non-officer-level analysts to submit their initial ratings and proposed changes in  
12 ratings for review by the Stock Selection Committee. Senior analysts -- principals and managing  
13 directors -- were not subject to this requirement. In addition, Morgan Stanley had no effective  
14 system in place for reviewing the ratings of its senior analysts against changed conditions.

15 52. Morgan Stanley's lack of an effective review system allowed some principal and managing  
16 director analysts to maintain Outperform ratings unchanged on declining stocks without any review  
17 by management. For example, in 2000 and 2001, four senior analysts maintained Outperform  
18 ratings unchanged on 13 stocks as the prices of the stocks declined by over 74 percent. The names  
19 of the stocks, their percentage declines, and the number of months without a change in the  
20 Outperform rating are shown on the following chart:

Company	Percent Price Drop While Rated Outperform	Months Without Change in Outperform Rating
Chemdex (Ventro)	96.2	8.5
Drugstore.com	95.4	30
Priceline.com	92.0	30
Ask Jeeves	90.9	16
Marimba	88.9	8.5
Homestore.com	88.7	10
Vignette	87.1	7.5
VeriSign	83.3	19.5
Akamai	82.8	10

1	Women.com	80.3	8.5
2	CNET	77.7	16.5
3	Inktomi	76.9	15
4	FreeMarkets	74.3	23

53. Not until late 2001, after complaints from Institutional Sales persons made as part of the year-end evaluation process, did management state to one of the analysts: “Don’t let your ratings get stale; change them ahead of expected price action.”

**B. Morgan Stanley’s Analysts Virtually Never Used the Lowest Rating in the Firm’s Stock Rating System**

54. From 1995 to March 2002, Morgan Stanley publicly stated that it had a four-category rating system: Strong Buy; Outperform; Neutral; and Underperform. “Underperform” was defined as follows: “Given the current price, these securities are not expected to perform as well as other stocks in the universe covered by the analyst.” Although Morgan Stanley stated that it had a four-category system, its analysts virtually never used the “Underperform” rating and, in effect, used a three-category system. From 1999 through 2001, the firm published research on approximately 1,000 North American company stocks. No more than three of the 1033 stocks covered over the course of 1999 were given an Underperform rating; no more than five of the 1058 stocks covered over the course of 2000 received that rating; and no more than six of the 1030 stocks covered over the course of 2001 were rated Underperform.

55. Morgan Stanley management was aware that analysts were not using the “Underperform” rating, but did not correct the problem until March 2002, when a new rating system was instituted.

**II.**

**CONCLUSIONS OF LAW**

1. The Office of Securities has jurisdiction over this matter pursuant to the Revised Maine Securities Act, 32 M.R.S.A. §§ 10101-10713.

2. The Securities Administrator finds that Morgan Stanley violated 32 M.R.S.A. §§ 10313(1)(G) and 10313(1)(J) in that:

1 a) The relationship between investment banking and research created conflicts of  
2 interest for Morgan Stanley research analysts;

3 b) Morgan Stanley did not disclose that it paid \$2.7 million of underwriting fees at  
4 issuers' direction to other investment banks to provide research coverage; and

5 c) Morgan Stanley failed reasonably to supervise its senior research analysts.

6 3. The Securities Administrator finds the following relief appropriate and in the public  
7 interest.

8 **III.**

9 **ORDER**

10 On the basis of the Findings of Fact, Conclusions of Law, and Morgan Stanley's consent to the  
11 entry of this Order, for the sole purpose of settling this matter, prior to a hearing and without admitting  
12 or denying any of the Findings of Fact or Conclusions of Law,

13 **IT IS HEREBY ORDERED:**

14 1. This Order concludes the investigation by the Office of Securities and any other action that the  
15 Office of Securities could commence under applicable Maine law on behalf of the Securities  
16 Administrator as it relates to Morgan Stanley relating to the subject of the investigations, provided  
17 however, that excluded from and not covered by this paragraph 1 are any claims by the Office of  
18 Securities arising from or relating to the "Order" provisions herein.

19 2. Morgan Stanley will CEASE AND DESIST from violating sections 10313(1)(G) and  
20 10313(1)(J) of the Revised Maine Securities Act, 32 M.R.S.A. §§ 10101-10713, in connection with  
21 the research practices referenced in this Order and will comply with the undertakings of Addendum  
22 A, incorporated herein by reference.

23 3. As a result of the Findings of Fact and Conclusions of Law contained in this Order, Morgan  
24 Stanley shall pay a total amount of \$125,000,000.00. This total amount shall be paid as specified  
25 in the SEC Final Judgment as follows:  
26

- 1 a. \$25,000,000 to the states (50 states, plus the District of Columbia and Puerto Rico)  
2 (Morgan Stanley’s offer to the state securities regulators hereinafter shall be called the  
3 “state settlement offer”). Upon execution of this Order, Morgan Stanley shall pay the sum  
4 of \$ 250,000 of this amount to the State of Maine Office of Securities as a civil monetary  
5 penalty pursuant to 32 M.R.S.A. § 10602(1)(E). The total amount to be paid by Morgan  
6 Stanley to state securities regulators pursuant to the state settlement offer may be reduced  
7 due to the decision of any state securities regulator not to accept the state settlement offer.  
8 In the event another state securities regulator determines not to accept Morgan Stanley’s  
9 state settlement offer, the total amount of the Maine payment shall not be affected, and shall  
10 remain at \$250,000;
- 11 b. \$25,000,000 as disgorgement of commissions, fees and other monies as specified in the  
12 SEC Final Judgment;
- 13 c. \$75,000,000, to be used for the procurement of independent research, as described in the  
14 SEC Final Judgment;
- 15 4. If payment is not made by Morgan Stanley or if Morgan Stanley defaults in any of its  
16 obligations set forth in this Order, the Office of Securities may vacate this Order, at its sole  
17 discretion, upon 10 days notice to Morgan Stanley and without opportunity for administrative  
18 hearing.
- 19 5. Morgan Stanley agrees that it shall not seek or accept, directly or indirectly, reimbursement  
20 or indemnification, including but not limited to payment made pursuant to any insurance policy,  
21 with regard to all penalty amounts that Morgan Stanley shall pay pursuant to this Order or section  
22 II of the SEC Final Judgment, regardless of whether such penalty amounts or any part thereof are  
23 added to the Distribution Fund Account referred to in the SEC Final Judgment or otherwise used  
24 for the benefit of investors. Morgan Stanley further agrees that it shall not claim, assert, or apply  
25 for a tax deduction or tax credit with regard to any state, federal or local tax for any penalty  
26 amounts that Morgan Stanley shall pay pursuant to this Order or section II of the SEC Final

1 Judgment, regardless of whether such penalty amounts or any part thereof are added to the  
2 Distribution Fund Account referred to in the SEC Final Judgment or otherwise used for the benefit  
3 of investors. Morgan Stanley understands and acknowledges that these provisions are not intended  
4 to imply that the Office of Securities would agree that any other amounts Morgan Stanley shall pay  
5 pursuant to the SEC Final Judgment may be reimbursed or indemnified (whether pursuant to an  
6 insurance policy or otherwise) under applicable law or may be the basis for any tax deduction or  
7 tax credit with regard to any state, federal or local tax.

8 6. This Order is not intended by the Office of Securities to subject any Covered Person to any  
9 disqualifications under the laws of any state, the District of Columbia or Puerto Rico (collectively,  
10 “State”), including, without limitation, any disqualifications from relying upon the State  
11 registration exemptions or State safe harbor provisions. "Covered Person" means Morgan Stanley,  
12 or any of its officers, directors, affiliates, current or former employees, or other persons that would  
13 otherwise be disqualified as a result of the Orders (as defined below).

14 7. The SEC Final Judgment, the NYSE Stipulation and Consent, the NASD Letter of  
15 Acceptance, Waiver and Consent, this Order and the order of any other State in related proceedings  
16 against Morgan Stanley (collectively, the “Orders”) shall not disqualify any Covered Person from  
17 any business that they otherwise are qualified, licensed or permitted to perform under the  
18 applicable law of Maine and any disqualifications from relying upon this state’s registration  
19 exemptions or safe harbor provisions that arise from the Orders are hereby waived.

20 8. The Orders shall not disqualify any Covered Person from any business that they otherwise  
21 are qualified, licensed or permitted to perform under applicable state law.

22 9. For any person or entity not a party to this Order, this Order does not limit or create any  
23 private rights or remedies against Morgan Stanley including, without limitation, the use of any e-mails  
24 or other documents of Morgan Stanley or of others regarding research practices, or limit or create  
25 liability of Morgan Stanley, or limit or create defenses of Morgan Stanley to any claims.

26 10. Nothing herein shall preclude the State of Maine, its departments, agencies, boards,

1 commissions, authorities, political subdivisions and corporations, other than the Office of  
2 Securities and only to the extent set forth in paragraph 1 above, (collectively, “State Entities”) and  
3 the officers, agents or employees of State Entities from asserting any claims, causes of action, or  
4 applications for compensatory, nominal and/or punitive damages, administrative, civil, criminal, or  
5 injunctive relief against Morgan Stanley in connection with certain research practices at Morgan  
6 Stanley.

7  
8 Dated this 2nd day of September, 2003.

9  
10 By: s/Christine A. Bruenn  
Christine A. Bruenn, Securities Administrator  
11 State of Maine Office of Securities  
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**CONSENT TO ENTRY OF ADMINISTRATIVE ORDER BY  
MORGAN STANLEY & CO. INCORPORATED**

Morgan Stanley & Co. Incorporated hereby acknowledges that it has been served with a copy of this Administrative Order, has read the foregoing Order, is aware of its right to a hearing and appeal in this matter, and has waived the same.

Morgan Stanley & Co. Incorporated admits the jurisdiction of the Office of Securities, neither admits nor denies the Findings of Fact and Conclusions of Law contained in this Order, and consents to entry of this Order by the Securities Administrator as settlement of the issues contained in this Order.

Morgan Stanley & Co. Incorporated states that no promise of any kind or nature whatsoever was made to it to induce it to enter into this Order and that it has entered into this Order voluntarily.

James P. Cusick represents that he/she is Managing Director of Morgan Stanley & Co. Incorporated and that, as such, has been authorized by Morgan Stanley & Co. Incorporated to enter into this Order for and on behalf of Morgan Stanley & Co. Incorporated.

Dated this 27th day of August, 2003.

Morgan Stanley & Co. Incorporated

By: s/James P. Cusick  
Title: Managing Director

SUBSCRIBED AND SWORN TO before me this \_\_\_\_\_ day of \_\_\_\_\_, 200\_.

\_\_\_\_\_  
Notary Public

My Commission expires:

\_\_\_\_\_