STATE OF WASHINGTON
DEPARTMENT OF FINANCIAL INSTITUTIONS
SECURITIES DIVISION

IN THE MATTER OF DETERMINING whether there has been a violation of the Securities Act of Washington by: MORGAN STANLEY DW INC.; ARUN SARDANA; MICHAEL T. MORIARTY; and LORENZO D. ASCOLI, Respondents.	Order No.: S-02-030-03-SC01 STATEMENT OF CHARGES AND NOTICE OF INTENT TO ENTER AN ORDER TO SUSPEND REGISTRATIONS, IMPOSE FINES, CHARGE COSTS, AND ORDER DISGORGEMENT Case No. S-02-030

THE STATE OF WASHINGTON TO:

Morgan Stanley DW Inc., CRD #7556
825 Third Ave, 29th Floor
New York, NY 10022

Arun Sardana, CRD #2628077
2 Wisconsin Circle, Ste. 330
Chevy Chase, MD 20815

Michael T. Moriarty, CRD #2355008
2 Wisconsin Circle, Ste. 330
Chevy Chase, MD 20815

Lorenzo D. Ascoli, CRD #2102705
Banc Of America Investment Services
5550 Friendship Blvd.
Chevy Chase, MD 20815

STATEMENT OF CHARGES

Please take notice that the Securities Administrator of the State of Washington has reason to believe that the Respondents, Morgan Stanley DW Inc., Arun Sardana, Michael T. Moriarty, and Lorenzo D. Ascoli, have each violated the Securities Act of Washington. The Securities Administrator believes those violations justify the suspension of Arun Sardana and Michael T. Moriarty's securities salesperson registrations and investment adviser representative registrations pursuant to RCW

21.20.110(1) and the entry of an order against the Respondents imposing fines pursuant to RCW 21.20.110(1). The Securities Administrator further believes those violations justify the entry of an order against Morgan Stanley DW Inc. charging costs pursuant to RCW 21.20.110(7) and ordering disgorgement pursuant to RCW 21.20.110(8). The Securities Administrator finds as follows:

TENTATIVE FINDINGS OF FACT

RESPONDENTS

1. Morgan Stanley DW Inc. ("MSDW") is a broker-dealer with its principal place of business in New York, NY. MSDW is currently registered with the Washington State Securities Division as a broker-dealer and has been continuously so registered since 1983. MSDW is currently registered with the U.S. Securities and Exchange Commission as a federal covered investment adviser and has been continuously so registered since 1976. MSDW is one of the nation's largest full-service brokerage firms, offering a wide range of investment planning services and investment products. MSDW was formed in May 1997 with the merger of Morgan Stanley Group Inc. and Dean, Witter, Discover & Co. After the merger, MSDW had over 45,000 employees and 409 offices in 22 countries. Driven by a bull market, MSDW aggressively recruited new brokers in an effort to surpass Merrill Lynch in total number of brokers. As of September 1999, MSDW had almost five hundred branch offices nationwide and over 12,000 securities salespersons, known as "financial advisors." Assets under management by MSDW's retail brokerage were $529 billion.

2. Arun Sardana ("Sardana") is a registered securities salesperson with MSDW. He is currently registered as a securities salesperson with the Washington State Securities Division and has been continuously so registered since February 23, 1996. He has been registered with the Washington State Securities Division as an investment adviser representative since April 2001, but was not previously

so registered. Since August 1999, Sardana has been employed by MSDW in their Chevy Chase, MD branch office. From 1995 to 1999, Sardana was employed by Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") as a securities salesperson in their Rockville, MD branch office. Sardana resides in Maryland.

3. Michael T. Moriarty ("Moriarty") is a registered securities salesperson with MSDW. He is currently registered as a securities salesperson with the Washington State Securities Division and has been continuously so registered since August 23, 1999. He has been registered with the Washington State Securities Division as an investment adviser representative since April 2001, but was not previously so registered. Since August 1999, Moriarty has been employed by MSDW in their Chevy Chase, MD branch office. From 1993 to 1999, Moriarty was employed by Merrill Lynch as a securities salesperson in their Rockville, MD branch office. Moriarty resides in Maryland.

4. Lorenzo Ascoli ("Ascoli") was the branch manager of the Chevy Chase, MD branch of MSDW from March 1997 until August 2002. As branch manager, Ascoli was the direct supervisor of the registered representatives in that office, including Sardana and Moriarty. Ascoli began his employment in the securities industry in 1990 when he joined Dean Witter Reynolds Inc. as a securities salesperson. He was promoted to branch manager of the Albany, NY branch in May 1995. He left MSDW in August 2002 to become the head of the Private Bank at Bank of America for the entire Washington, DC area. Ascoli holds Series 3, 7, 8, 63 and 65 licenses. Ascoli resides in Maryland.

NATURE OF RESPONDENTS' CONDUCT

Sardana and Moriarty's Unsuitable Recommendations

Summary

5. Sardana and Moriarty marketed investment management and financial planning services to Microsoft Corporation ("Microsoft") employees holding substantial grants of employee stock options. Sardana and Moriarty represented that each client would receive advice and guidance specifically tailored to his or her unique financial needs and goals. In actuality, Sardana and Moriarty recommended substantially the same securities and investment strategies, without regard to the personal financial needs and goals of the individual clients. Sardana and Moriarty made investment recommendations that exposed these clients to an unsuitable level of risk and ultimately caused them to incur substantial losses.

Sardana and Moriarty's Conduct

6. Starting in approximately 1999, while employed at Merrill Lynch, Sardana and Moriarty developed a business plan that targeted affluent individuals who were employees or former employees of Microsoft. This plan allowed Sardana and Moriarty to earn considerable income from a small number of high net-worth clients. In order to successfully target these clients, Sardana and Moriarty concluded that they needed to join a brokerage firm that provided them a higher level of sales support than they were receiving at Merrill Lynch.

7. Also in 1999, while at Merrill Lynch, Sardana and Moriarty formed a partnership. Both were responsible for servicing the investment needs of their clients and they shared equally any profits earned.

8. In connection with MSDW's aggressive recruiting efforts described above, MSDW presented Sardana and Moriarty with a lucrative offer of employment to join MSDW's Chevy Chase, Maryland branch in 1999. MSDW promised Sardana and Moriarty a level of sales support not provided by Merrill Lynch. This included salaries for two sales assistants and a computer network that would allow them to share their contact management software. They were also offered a large signing bonus of $625,000 each, provided they acquired $90 million in assets under management.

9. On August 23, 1999, Sardana and Moriarty left Merrill Lynch to join MSDW. Prior to leaving Merrill Lynch, Sardana and Moriarty had approximately 1,000 accounts. Sardana and Moriarty transferred only 50 or 60 accounts from Merrill Lynch to MSDW, which were primarily Microsoft clients, in order to help them reshape their business to focus on current and former Microsoft employees.

10. As MSDW financial advisors, Sardana and Moriarty marketed customized financial planning services to Microsoft employees, including at least 14 Washington state residents. The investment advice given to three of these residents is described subsequently (the "Microsoft clients"). Sardana and Moriarty promoted a comprehensive plan for the Microsoft clients to achieve financial security. In addition to recommending investments, Sardana and Moriarty offered the Microsoft clients tax and estate planning services as a package. To this end, Sardana and Moriarty teamed with a certified public accountant and an estate planning attorney to visit potential clients. Sardana and Moriarty represented that they would be the "quarterbacks" of this team of professionals. By promising customized, comprehensive financial planning, Sardana and Moriarty convinced the Microsoft clients to choose MSDW.

11. Rather than provide the Microsoft clients customized planning, Sardana and Moriarty offered a standard set of investment recommendations. To begin with, they recommended that customers

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

use a fee-based account offered by MSDW, the "Choice Fee" account. In Choice Fee accounts, the customers were charged a fee based on a percentage of the total assets in their accounts, rather than being charged a per-trade commission. In a Choice Fee account, the amount of a customer's margin loan was included in the total value of assets used to calculate Choice fees, thereby giving Sardana and Moriarty an incentive for recommending a margin-intensive investment strategy.

12. Part of the Microsoft clients' compensation included grants of non-qualified employee stock options. These options gave an employee the right to purchase a set number of shares (the "grant") at a given price (the "exercise price"). A portion of the stock grant vested over time, allowing an employee to exercise the vested shares. The option to purchase the shares expired within a specified period of time, usually seven or ten years after receipt of the grant. The Microsoft clients indicated that they were interested in diversifying their investments and preserving their capital for retirement or other long-term investment goals. The Microsoft clients were also concerned about the effect of the upcoming Department of Justice ruling (the "DOJ Ruling") that had the potential to split Microsoft into separate companies and possibly depress the price of Microsoft stock. Sardana and Moriarty represented that they had experience working with similarly situated clients, and that they would design a strategy that would meet the clients' needs.

13. Sardana and Moriarty represented that they would develop a customized portfolio for each client. Rather than do so, Sardana and Moriarty made nearly identical initial investment recommendations to the Microsoft clients. While these recommendations increased the profits of Sardana and Moriarty and those of MSDW, they also exposed the Microsoft clients to excessive risk. Their basic recommendation consisted of four parts:

i. Exercise the bulk of vested employee stock options and use margin to pay the exercise price and minimum tax withholding;

ii. Sell a portion of the Microsoft shares to invest primarily in the technology and telecommunications sectors;

iii. Carry a large margin balance that would be paid off from capital gains in the stock holdings; and

iv. Protect the concentrated position in Microsoft by trading derivatives using a sophisticated strategy known as a collar. The derivatives strategy involved a combination of selling covered calls and buying covered puts.

14. When a customer buys stock on margin, he or she obtains a loan from the brokerage that is secured by the assets in his or her brokerage account. A customer pays interest on the amount borrowed. Margin allows a customer to leverage his or her investments by increasing the amount of stock he or she can purchase. Margin is a form of speculation, since the customer borrows the money in the hopes that the value of the securities purchased will appreciate. If the value of the stock in the account declines, the customer may receive a "margin call" from the brokerage. In order to satisfy a call, the customer must either transfer cash into the account or sell securities to cover the call. Margin is risky because a stock price may drop so much that even if a customer sells <u>all</u> of his or her shares, the money raised will not be sufficient to repay the loan to the brokerage.

15. In connection with the marketing of their investment management services, Sardana and Moriarty presented potential clients with a spreadsheet (the "options spreadsheet") showing four possible scenarios for handling their stock options: 1) do nothing, 2) exercise and sell sufficient number of shares to cover taxes and exercise price, 3) exercise and sell all shares, and 4) exercise using a margin loan to

pay taxes and exercise price. The options spreadsheet was designed to be shown on a laptop during a client meeting. Based on certain assumptions such as size of grant, exercise price, tax rate and growth rate, the spreadsheet offered a comparison of the potential value of the account after a set period of time, such as five years. The higher the assumed growth rate, the more attractive the scenario of exercising using a margin loan became. A common growth rate they showed the Microsoft clients was 20%. Sardana and Moriarty later admitted that it would not be reasonable for an investor to expect such a growth rate. By showing the Microsoft clients a spreadsheet assuming growth in the value of the underlying securities, Sardana and Moriarty made the "exercise using a margin loan" scenario the most attractive to the Microsoft clients. Sardana and Moriarty's recommended strategy of incurring a large margin loan to pay the option exercises price and tax withholding required continued upward price movements in the underlying securities. In the event of stagnant prices in the underlying securities, the customer could continue to pay margin interest indefinitely. In the event of declining prices in the underlying securities, the debt to equity ratio could rise such that the customer would be required to sell all of the underlying securities to repay the margin debt. If the price decline was precipitous enough, the sale of the securities could be insufficient to repay the margin debt and the customer would be forced to liquidate other assets, such as savings accounts, to repay the margin debt.

16. When exercising employee stock options through Microsoft, employees were responsible for paying the cost of exercise, as well as a federal tax withholding. Non-qualified stock options are taxed at the ordinary income tax rate as of the date of exercise. Sardana and Moriarty recommended that clients withhold the minimum federal tax of 28%, despite the fact that the clients owed tax at the highest tax rate of 39.6% in April of the following year. This strategy recommended by Sardana and Moriarty was an aggressive form of leverage. The client could buy additional securities with the difference

between the future tax liability and the current tax paid, approximately 12% of the value of his or her stock option exercise. Sardana and Moriarty represented that the value of these additional securities purchased would hopefully increase over and above the amount needed to satisfy the tax liability due in April of the following year. However, Sardana and Moriarty failed to disclose the risk that if the value of the stock fell, they would be forced to sell whatever securities were necessary to satisfy the tax liability.

17. Sardana and Moriarty recommended that clients sell a portion of their Microsoft stock in order to purchase two stock "disciplines" that they designed while at Merrill Lynch. Sardana and Moriarty marketed their recommended securities in a document entitled "Investment Management." The Investment Management document advertised Sardana and Moriarty as providing "professional money management services" that were "customized" for a client's personal goals and risk tolerance. The document contained four lists or "disciplines," the Fixed Income Discipline (a laddered bond portfolio), the Large-Cap Value Discipline (a list of value stocks managed by MSDW), the Large-Cap Growth Discipline (also know as the "Core Growth" discipline), and the Aggressive Growth Discipline. Although four disciplines were included in the Investment Management document, Sardana and Moriarty recommended only the Core Growth and Aggressive Growth Disciplines to the Microsoft clients. The Core Growth Discipline consisted of 10-12 stocks primarily in the technology and telecommunications sectors. The Aggressive Growth discipline consisted of speculative companies without proven technologies in "emerging" sectors of the economy, including wireless, broadband and business to business (B2B) sectors. Many of the recommended Aggressive Growth stocks were small market capitalization companies, which caused their stock price to be more volatile. Sardana and Moriarty failed to disclose that these stocks were speculative technology and telecommunications companies and that

their stock prices were highly volatile. Sardana and Moriarty frequently changed the stocks comprising the Aggressive Growth discipline in an attempt to market the most popular new technology companies.

18. In connection with the marketing of their investment management services, Sardana and Moriarty recommended that the Microsoft clients protect their concentrated Microsoft stock positions with an option contract strategy known as a collar. A collar is a derivatives strategy that combines the selling of a covered call option contract with the buying of a protective put option contract. A collar thereby creates a ceiling on the value of the concentrated position while also creating a floor on the stock price and limiting the potential losses on the stock if the stock price declines. In theory, Sardana and Moriarty represented the collar strategy as a plan to preserve the wealth of the Microsoft clients. While the collar strategy was effective as a marketing tool, in reality it was too complicated for the Microsoft clients to understand and implement. Concentrated stock positions create significant wealth, but they are also highly risky because the value of a client's portfolio may change significantly with fluctuations in the price of a single stock. This risk is compounded if the stock portfolio is leveraged with a margin loan, as the accounts of the Microsoft clients were. In addition to failing to understand the recommended derivatives strategy, clients failed to understand the risk of not implementing the collar. Without a collar or some other type of protective action, a client could lose a significant portion of his or her net worth if the value of Microsoft stock declined. When a client rejected the collar, Sardana and Moriarty failed to recommend an alternative protection of the client's Microsoft position, thereby exposing the client to significant market risk.

19. Sardana and Moriarty failed to recommend that clients adequately diversify their investments. They did not recommend the purchase of bonds, nor did they recommend the purchase of less volatile common stock of nationally known companies whose value was stable and reliable. The

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

majority of their recommended stocks were positively correlated, meaning that their values were likely to either rise or fall together. In addition, recommending the use of margin to exercise options, as opposed to recommending the sale of sufficient shares to pay the exercise price and the tax liability, exposed the clients to significant market risk due to maintaining a large margin loan secured primarily by one technology stock, Microsoft. This risk was compounded by the recommendation for clients to purchase only equities, primarily in the technology and telecommunications sectors. Sardana and Moriarty misrepresented this strategy as "diversification," when, if fact, their strategy of recommending the accumulation of substantial margin debt, combined with recommending investment in stock portfolios that were overconcentrated in speculative companies, was a high risk and undiversified investment strategy.

20. The risk of the strategy is further illustrated by the level of return that was necessary in order for a Microsoft client to simply break even in an account. To break even, a client would need to achieve a level of return sufficient to cover the costs of paying margin interest and Choice fees. Assuming that the customers paid margin interest at a rate of 8.25%[1] annually and Choice fees at a rate of 1%[2] annually, the accounts needed to earn 9.25% annually simply to cover these costs. In recommending this strategy, Sardana and Moriarty were assuming that the growth in the stock market during the years of the bull market of the late 1990's would continue indefinitely. Such a recommendation was inherently speculative.

21. MSDW defines a "normal" asset allocation as investing approximately 60% of one's assets in equities, 35% in bonds and 5% in cash. Sardana defines a moderate-risk portfolio as one that is 60%

[1]The actual margin interest rate paid by the Microsoft clients varied. At times the clients paid a higher margin interest rate.

equities and 40% bonds, a conservative portfolio as one that is 50% equities and 50% bonds, and an aggressive portfolio as one that is 70-80% equities and 20-30% bonds. The benefit of investing in both equities and bonds is that those investments are in general not positively correlated, meaning that their values to do not rise and fall at the same time. Investing in positively correlated investments increases the risk of loss. Sardana and Moriarty, despite awareness of the importance of asset allocation, recommended investments only in equities that were overconcentrated in the technology and telecommunications sectors.

Unsuitable Recommendations to Tiffany T.

Financial Status, Experience, and Investment Objectives

22. At the time she met Sardana and Moriarty, Tiffany T.[3] was a 35 year-old Microsoft program manager. In 2000, her husband was self-employed as a picture framer and their total annual income was approximately $90,000. They were almost entirely reliant on her income from Microsoft. They had virtually no savings and owned a house in Seattle with a mortgage of $245,000. They also owned Employee Stock Purchase Plan shares of Microsoft worth approximately $50,000-$60,000, and a 401(k) retirement plan worth approximately $40,000-$50,000.

23. Tiffany and her husband's primary financial goal was to diversify out of Microsoft and preserve the value of Tiffany's Microsoft stock options. They did not have immediate, short-term investment goals. Instead, they were seeking advice on long-term capital preservation and financial planning. They wanted to start a family and they were also concerned about retirement. They were not seeking an aggressive investment strategy.

[2] The actual Choice Fee rate paid by the Microsoft clients varied slightly depending on the level of assets in the account, as discussed in paragraph 11.

24. Prior to opening an account with MSDW, Tiffany and her husband had virtually no investment experience. Before joining Microsoft in 1995, Tiffany participated in an employee stock purchase plan offered by a previous employer. The value of the stock she purchased through the plan was approximately $50,000, which she rolled into a retirement account when she ended her employment. While employed at Microsoft, Tiffany had twice exercised a small portion of her vested options. The first exercise was for a down payment on their house in Seattle ($60,000). The second was to buy a car ($15,000). In both of those stock option exercises, Tiffany instructed Microsoft to sell sufficient shares to cover the exercise price and federal tax withholding, allowing her to receive the proceeds of the sale as cash.

25. Tiffany was referred to Sardana and Moriarty by a co-worker who was their client. On or about December 16, 1999, Sardana met with Tiffany to learn more about her financial situation and investment goals. Tiffany told Sardana she had approximately 33,500 options. Of those, only 20,961 were vested, i.e. exercisable. Sardana suggested that Tiffany defer the decision on options exercise until the next year for tax reasons.

Recommendations to Tiffany T.

26. Sardana and Moriarty recommended a strategy of exercising nearly all vested options, a strategy with significant tax consequences for the clients. On or about January 26, 2000, Sardana and Moriarty met with Tiffany in Seattle. They recommended that she exercise her 1995 and 1996 Microsoft stock option grants, a total of 16,661 shares or almost 80% of her total exercisable shares. Tiffany and her husband had originally planned on exercising only her 1995 grant of 6,940 shares. However, Sardana

---

[3] The full names of the customers are omitted for privacy protection purposes.

told her that they represented only clients of a higher net worth and therefore they would need to exercise her 1995 and 1996 grants. Tiffany would not have exercised her 1996 grant at that time, had it not been for Sardana's representation that she would need to open an account with a minimum value of $1,000,000.

27. Prior to meeting Sardana and Moriarty, Tiffany and her husband had not heard of trading on margin. Tiffany and her husband were uncomfortable with obtaining a margin loan from MSDW. However, they were convinced by Sardana and Moriarty to use margin to leverage their stock holdings. According to Sardana and Moriarty, Tiffany could make more in profit on her stock holdings than she would pay MSDW in interest charged on the margin balance. In his notes on Tiffany and her husband, Sardana recognized that Tiffany was "not comfortable with [a] large margin balance." Sardana convinced Tiffany to use margin by saying they would always have the ability to pay down margin later. As explained previously, a customer may not be able to pay down a margin loan if the value of the securities securing the loan falls below the amount owed to the brokerage.

28. On February 4, 2000, Sardana recommended that Tiffany consider protecting her Microsoft holdings through buying puts. Tiffany had never traded options and did not understand this strategy. Based on conversations with co-workers, she thought options trading was a tool to generate short-term income. Given that her investment objectives were long-term and she was not seeking immediate income, she saw no benefit to buying puts. Therefore, she rejected the use of an options trading strategy.

29. On February 15, 2000, MSDW sent paperwork to Microsoft on behalf of Tiffany authorizing the exercise of 16,661 shares of Microsoft at $98.5625 per share and with a 28% federal tax withholding for a total cost of $630,588.40. The cost of exercise and tax withholding was paid for by MSDW with a margin loan secured by Tiffany's brokerage account. Tiffany and her husband were

uncomfortable with withholding only the minimum federal tax and preferred to pay the full tax due up front. However, they relied on what they believed to be Sardana and Moriarty's expert advice because they were not knowledgeable about investing.

30. Sardana and Moriarty recommended that Tiffany sell 6,500 shares of Microsoft, in part to pay down margin and in part to "diversify" into Core Growth stocks. One of Tiffany and her husband's primary goals was to diversify out of Microsoft so that their entire net worth was not concentrated in Microsoft stock. They were not experienced in picking stocks and relied on Sardana and Moriarty as advisers. They knew for certain that they did not want to invest in "dot.com" stocks due to the risk, but did not know how to pick other stocks. They believed that Sardana and Moriarty recommended diversified investments that would protect the wealth built up by Tiffany as a result of her many years of service at Microsoft. In addition, they believed that Sardana and Moriarty had customized their recommendations for their specific situation. In fact, rather than a portfolio customized to meet their particular investment objectives, Tiffany's portfolio consisted of stocks from "disciplines" that Sardana and Moriarty recommended to all of the Microsoft clients. Further, Sardana and Moriarty represented their investment recommendations as achieving diversification, when in fact they recommended wholly equities, primarily in the technology and telecommunications sectors.

31. On February 22, 2000, Sardana and Moriarty sold 6,500 shares of Microsoft for Tiffany at $93.6875 per share, generating proceeds of $608,969. They immediately purchased 11 Core Growth stocks (all the stocks on the Core Growth list except Microsoft) in equal dollar amounts for a total investment of $355,616. Almost all of these trades were marked "solicited" on the order tickets, as

Sardana and Moriarty had recommended the purchase of the securities.[4] As of the end of February, Tiffany's margin loan amount was $377,271 or 30% of her overall asset value.

32. On March 15, 2000, Sardana met with Tiffany to recommend selling more Microsoft shares to further "diversify." He recommended selling another 50% of her Microsoft and investing in Aggressive Growth stocks. Again, on March 30, 2000, Sardana recommended that Tiffany sell 50% of her Microsoft shares and "diversify" to hedge against a negative DOJ ruling. On March 31, 2000, Tiffany agreed to sell 5,000 shares of Microsoft to invest additional money in the Core Growth stocks and in ten Aggressive Growth stocks. The sale of the Microsoft generated $528,170. Sardana and Moriarty then invested $198,498 in 11 Core Growth stocks and $349,469 in 10 Aggressive Growth stocks. All Aggressive Growth companies were highly speculative technology and telecommunications companies without proven earnings track records. Almost all of these trades were marked "solicited" on the order tickets. Tiffany's margin balance also increased to $393,211 or 32% of asset value. Again, Sardana and Moriarty represented their recommendations as achieving diversification, when in fact their recommendations caused Tiffany's portfolio become further concentrated in the technology and telecommunications sectors.

33. The value of Tiffany's account began to immediately decline due to stock price declines in the technology and telecommunications sectors. Tiffany contacted Sardana and Moriarty with concerns about her margin debt, which was nearing $400,000. At the same time, the value of the securities securing the margin loan was declining from almost $1.5 million in March 2000, to $1.2 million in April, to $1 million in May. Consequently, by the end of May, Tiffany's margin to equity percentage had risen

[4] By Sardana's admission, the two trades marked "unsolicited" should have been marked "solicited," since they were purchased based on their recommendation.

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

to 37%. In May of 2000, Sardana reassured Tiffany by minimizing her risk of a margin call. On June 2, 2000, Tiffany began to suggest selling Microsoft in order to decrease her margin loan. Later that day, Tiffany requested the sale of 2,500 shares of Microsoft, which generated $164,838 in proceeds, thereby reducing her margin debt to $233,079. Due to Sardana and Moriarty's inaction, Tiffany was forced to continually request strategies to eliminate her margin debt.

34. By January 2001, per Tiffany's instructions due to her concern about losses, Sardana and Moriarty liquidated the majority of her equity holdings. At that point in time, Sardana and Moriarty began to recommend that Tiffany utilize the services of professional money managers to manage her portfolio. Sardana and Moriarty recommended professional money managers because they realized that they did not have the time and expertise to effectively manage the Microsoft clients' portfolios. This realization came in part as a result of the downturn in the market in 2000, the first such downturn that Sardana and Moriarty had experienced as securities salespersons.

35. In April 2001, Tiffany and her husband paid $155,000 to the Internal Revenue Service. They were unaware that they would have a tax bill of such proportions. Sardana and Moriarty suggested that they use margin to pay the tax bill, advice that Tiffany and her husband rejected. Had Tiffany and her husband followed Sardana and Moriarty's advice, they would have immediately incurred a $155,000 liability to MSDW after having reduced their margin balance to zero. In addition, their margin to equity percentage would have increased dramatically to 34%.

36. In the approximately 18 months Tiffany and her husband had an account with MSDW, they lost $266,619.91 or 20% of their initial account value. Over the life of her account, Tiffany paid $15,089.24 in margin loan interest and $13,876.27 in quarterly Choice account fees.

Unsuitable Recommendations to Barbara and Brad S.

Financial Status, Experience, and Investment Objectives

37. At the time they met Sardana and Moriarty, Barbara and Brad S. were 32 year-old Microsoft employees. Barbara was a program manager. Brad was a product manager with Microsoft until June 1999 when he left to join Seattle start-up company Loudeye Technologies (then Encoding.com). As of September 1999, Barbara and Brad had a combined household income of $150,000. They had two young children. Barbara and Brad's assets consisted of approximately $10,000 in savings, Employee Stock Purchase Plans through Microsoft that held approximately $100,000 of Microsoft stock, stock holdings in a brokerage account worth approximately $9,000, and a total of $300,000 in their 401(k) retirement plans, also almost wholly invested in Microsoft stock. Barbara and Brad owned a home on which they owed approximately $190,000.

38. Both Barbara and Brad joined Microsoft soon after graduation from college. Barbara was employed at Microsoft since 1990, with a starting salary of $18,000, and had moved up through various positions to become a program manager. Brad was employed at Microsoft from 1992 through June 1999, with a starting salary of $18,500. Upon leaving Microsoft, Brad held 5,753 Microsoft employee options that he was required to exercise no later than September 18, 1999 or else he would lose his right to exercise. As of February 2000, Barbara held 15,638 exercisable stock options. Of those, 2,800 options were scheduled to expire in a year and a half, in July 2001.

39. Prior to opening an account with MSDW, Barbara and Brad had minimal investment experience. In 1998 or 1999, they opened a brokerage account at Salomon Smith Barney through a friend of Brad's. They had infrequent contact with the broker. In that account they purchased shares in four companies, investing a total of approximately $9,000.

40. Barbara and Brad were referred to Sardana and Moriarty by a co-worker of Barbara's who was their client. When Barbara and Brad first met Sardana, Barbara had just given birth to their second child. She was hoping to leave Microsoft in January of 2000 to care for their two young children. They were unsure of whether their financial position would allow such an early retirement and were seeking expert advice.

41. Barbara and Brad were hoping to allow Barbara to retire within at least three to five years, pay off their home and provide for the education of their two children. In addition, they were worried about the future of Microsoft and being so heavily invested in only one company. They wanted to diversify out of Microsoft into other types of investments so that if the stock did poorly, they could preserve the value of their assets. They described their investment objective as seeking preservation of capital.

Recommendations to Barbara and Brad S.

42. Sardana and Moriarty recommended that Brad exercise his 5,753 Microsoft options on margin, rather than by selling stock to cover the exercise price and tax withholding. On or about September 1, 1999, Sardana recorded a note to call Brad prior to September 18, 1999 (the date his options were set to expire) "to recommend exercise and hold on margin." Sardana and Moriarty also recommended that Brad withhold only the minimum federal tax of 28% at exercise. On September 2, 1999, Sardana sent an email to Brad and Barbara instructing them to complete the exercise form with a withholding of 28%.

43. Barbara and Brad were not comfortable with carrying a margin balance. They discussed margin with Sardana on a number of occasions. Sardana encouraged them to carry a margin balance by emphasizing the upside on the stock and saying that in order to realize the highest gains they should

leverage their holdings. According to Sardana, if the stock price continued to rise, one would realize more gain if one exercised on margin than if one used funds to pay down the margin loan. Neither Sardana nor Moriarty told Barbara and Brad that they were being paid on the margin balance. Barbara and Brad believed they were only paid on the net asset value in the account. Although Sardana mentioned that there was risk associated with margin, he did not disclose what the risks of margin were. Prior to investing with MSDW, Barbara and Brad had not invested on margin.

44. Sardana and Moriarty recommended that Barbara exercise the bulk of her vested stock options. In September 1999, Sardana recommended that Barbara exercise 12,251 shares of her exercisable Microsoft options, or 86% of her exercisable options.

45. On or about September 14, 1999, Sardana met with Barbara and Brad in Bellevue, WA to discuss Sardana and Moriarty's recommended investment strategy. Sardana provided them with a written agenda entitled "Initial Financial/Estate Planning Meeting with Barbara and Brad S." that promoted the importance of investment planning with a three part strategy: 1) leveraging their stock options to create "financial independence"; 2) proactively managing risk to "preserve" their financial independence so that they could "sleep well at night"; and 3) "managing" the "tax bite" from exercise of stock options.

46. On or about November 8, 1999, Barbara and Brad transferred 5,753 shares of Microsoft stock to their MSDW account, the result of Brad's stock option exercise. On or about November 16, 1999, Sardana recommended that Barbara exercise and hold her options in the coming year to "get use of 12% tax money for 16 months." Sardana also recommended that they sell 50% of Brad's Microsoft holdings and "diversify" into Sardana and Moriarty's Core Growth stocks. On December 8, 1999,

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

Sardana sent Barbara and Brad an e-mail stating, “keep in mind that we are looking at growth and aggressive growth strategies,” which included a list of stocks entitled Investment Management.

47. On or about January 29, 2000, Sardana again met with Barbara and Brad in Bellevue to recommend investing with MSDW. Sardana recommended that Brad “diversify” out of Microsoft into growth stocks. On or about February 22, 2000, Moriarty sent an e-mail to Barbara and Brad recommending that Brad sell 3,500 of 5,753 shares for $335,000 in cash. He recommended that Brad use the proceeds to invest $250,000 into Core Growth stocks. Moriarty recommended that Barbara exercise and hold virtually all of her vested shares. Moriarty also recommended that Barbara sell 7,000 of those shares of Microsoft immediately and invest 75% of the proceeds in the Core Growth portfolio and 25% in the Aggressive Growth portfolio.

48. On March 9, 2000, Barbara and Brad’s MSDW account received 14,348 shares of Microsoft, the result of Barbara’s option exercise. On March 15, 2000, Sardana and Moriarty sold 10,500 shares of Microsoft generating net proceeds of $1,058,625. The transaction was marked solicited.

49. On March 15, 2000, Sardana and Moriarty invested $344,082 in 12 Core Growth stocks and $344,645 in 12 Aggressive Growth stocks for Barbara and Brad, an approximately 50/50 split between Core and Aggressive Growth investments. The majority of the trades were marked solicited. By March 31, 2000, Barbara and Brad’s account had a margin debit balance of $319,105 or 19% of their asset value. As they did with Tiffany, Sardana and Moriarty represented their recommendations as achieving diversification, when in fact they recommended wholly equities, primarily in the technology and telecommunications sectors.

50. In late March and early April 2000, the value of Barbara and Brad’s account began to decline. As a result, Sardana and Moriarty recommended that Barbara and Brad sell a portion of their

Microsoft shares in order to pay down margin for the short term, while waiting to continue to buy more technology stocks at lower prices. For example, on April 4, 2000, Moriarty stated in an email, "due to MSFT recent downturn" we recommend that you sell 3,000 shares of your MSFT (30% of your holdings or $270,000) "to eliminate most of your margin debt and give us cash to invest in good stocks at reduced prices." When asked what they would invest in, Moriarty responded, "Build on your current holdings in ARBA [Ariba], CIEN [Ciena], JDSU [JDS Uniphase], VRTS [Veritas] --with $25,000 each (a total of $100,000)." All four stocks were speculative high technology and telecommunications companies on their Aggressive Growth list.

51. Sardana and Moriarty continued to recommend that Barbara and Brad reduce their Microsoft position and increase their Core Growth holdings. On or about June 28, 2000, Sardana and Moriarty sold 2,000 shares of Microsoft that generated proceeds of $154,744.84. On July 11, 2000, Barbara and Brad agreed with Sardana and Moriarty's recommendation to invest $100,000 in Core Growth stocks and $40,000 in three managed futures funds. That day, Sardana and Moriarty purchased 11 Core Growth stocks and Oracle Corporation, another high technology stock. The majority of these trades were marked "solicited."

52. As the value of technology and telecommunications stocks continued to slide through the fall of 2000, the value of Barbara and Brad's portfolio decreased and their margin debt as a percentage of equity rose quickly. By December 2000, Barbara and Brad owed MSDW almost $400,000 or 47% of their total asset value. The total value of the securities securing their margin loan had declined from a high of over $1.6 million in March 2000 to $836,797.16 in December 2000.

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

53. In the approximately 18 months Barbara and Brad had an account with MSDW, they lost $869,540.89 or almost ½ of their initial account value. Over the life of their account, Barbara and Brad paid $32,996.33 in margin loan interest and $16,096.79 in Choice account fees.

Unsuitable Recommendations to Marilyn B.

Financial Status, Experience, and Investment Objectives

54. At the time she met Sardana and Moriarty, Marilyn B. was a 43 year-old Microsoft employee who worked in the marketing department. Marilyn and her husband James L. had two children, one of whom was a special needs child. Marilyn began working at Microsoft in 1989. James owned a commercial video business. In 1999, their annual household income was approximately $140,000. As of late 1999, Marilyn had approximately 57,049 vested Microsoft stock options.

55. Marilyn and James were referred to Sardana and Moriarty by a co-worker of Marilyn's who was their client. Marilyn and James were conservative investors whose primary financial goals were diversifying their portfolio, paying off of a construction loan, and providing for the education of their children. Marilyn also hoped to retire early. Their primary investment objectives were to preserve capital and generate income.

56. Prior to opening an account with MSDW, their investment experience was limited to individual retirement accounts that were primarily invested in Microsoft stock. As of December 5, 1999, they held approximately $1,360,000 in various retirement accounts, of which 70% was Microsoft stock. They had approximately $43,000 in savings. They also had a $1,200,000 construction loan on their new home, of which they wanted to pay off $950,000 and keep a mortgage of $250,000.

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

57. On or about January 28, 2000, Sardana met with Marilyn at the Hyatt in Bellevue, WA. Based on Sardana's notes from the meeting, Marilyn's goals were to "conserve assets," "diversify" and retire with $200,000 annually in income from her investments.

Recommendations to Marilyn B.

58. On or about March 9, 2000, Sardana and Moriarty prepared and sent a document to Marilyn and James entitled "Preliminary Investment Considerations for Marilyn B. and Jim. L." In this document, Sardana and Moriarty recommended that Marilyn exercise and sell approximately 28,000 Microsoft stock options and exercise and hold on margin another 28,600, based on the assumption that she would leave Microsoft in August 2000. They also recommended that Marilyn invest the proceeds of the Microsoft sale in primarily technology and telecommunications stocks – 75% in the Core Growth discipline and 25% in the Aggressive Growth discipline. In addition, they recommended that Marilyn use the options collar strategy to hedge her remaining Microsoft position.

59. On March 28, 2000, Marilyn exercised 35,624 Microsoft options, or 62% of her total exercisable options. The closing price of Microsoft that day was $104.31 and the total value of the newly exercised shares was $3,713,802. Based on Sardana and Moriarty's recommendation, she used a margin loan from MSDW to pay the exercise price and federal tax withholding, incurring a margin balance of over $780,000 or 32% of their total asset value.

60. Due to what Sardana labeled a "bad market" in April, on or around April 27, 2000, Sardana recommended that Marilyn wait to diversify out of Microsoft. Over the next few weeks, Microsoft's price declined, and as a consequence of her entirely concentrated and highly leveraged portfolio, so did the value of Marilyn's account. Neither Sardana nor Moriarty spoke with Marilyn and James during this time.

61. On May 17, 2000, Sardana sent an e-mail to Marilyn and James, entitled "Downside Protection/Hedging Microsoft." The e-mail recommended the sale of "5,264 shares of Microsoft outright to pay down margin. This will reduce your margin to about 15% of your portfolio – a very manageable situation." The e-mail also recommended the sale of covered calls and the purchase of covered puts to create a collar on the remaining 25,000 Microsoft shares. Marilyn and James declined this recommendation, due to the fact they did not understand the options collar strategy. Sardana and Moriarty failed to recommend an alternative protection for Marilyn's concentrated Microsoft portfolio.

62. By the end of May, as a result of the continuing decline in the value of her portfolio, Marilyn's margin to equity percentage had risen to 56%. On June 1, 2000, due to concern with their high margin balance, Marilyn and James sold 17,800 shares of Microsoft at approximately $61.00 per share, generating proceeds of $1,094,551. On June 26, 2000, Sardana sold an additional 2,650 shares of Microsoft so that Marilyn and James could close on their home mortgage, generating proceeds of $214,643.

63. On July 26, 2000, unhappy with their MSDW account, Marilyn and James transferred their remaining 15,174 shares of Microsoft to another brokerage. On July 26, 2000, Microsoft closed at $67.81 per share. In the approximately four months Marilyn and James had an account with Sardana and Moriarty, they suffered a total loss on their account of over $1.3 million or approximately 37% of their initial account value. Over the short life of the account, Marilyn and James paid $14,547.03 in margin loan interest and $8,827.96 in Choice account fees.

Results of Unsuitable Recommendations

64. The Microsoft clients were seeking experts in the financial services industry. They wanted to diversify their concentrated portfolios and preserve their wealth to provide for the future financial

well-being of their families. Sardana and Moriarty marketed themselves as experts who developed a wealth preservation strategy that would enable their clients to achieve those goals. In reality, Sardana and Moriarty recommended a risky strategy that placed all of their clients' assets in equities. Their clients' assets were further concentrated in two sectors of the market, technology and telecommunications. The success of this strategy depended upon a rising market and continued growth in the technology and telecommunications sectors, the only sort of market Sardana and Moriarty experienced since they became securities salespersons in the 1990's. In recommending such a strategy, Sardana and Moriarty ignored a basic principle of investing, asset allocation. Sardana and Moriarty also failed to recommend adequate protection for the Microsoft clients' concentrated Microsoft stock positions. Over the approximately 18 months Tiffany and her husband had an account with MSDW, they lost 20% of their initial account value. In the approximately 18 months Barbara and Brad had an account with MSDW, they lost almost ½ of their initial account value. In the approximately four months Marilyn and her husband had an account with Sardana and Moriarty, they lost approximately 37% of their initial account value. As a result of Sardana and Moriarty's recommendations, the wealth of their clients was dissipated rather than preserved.

<u>Failure to Supervise</u>

Summary

65. MSDW and its branch managers are required to reasonably supervise securities salespersons employed by MSDW. This supervision must be designed to prevent and detect potential violations of applicable securities laws, such as unsuitable investment recommendations. Ascoli did not reasonably supervise Sardana and Moriarty when he failed to take any corrective action despite his knowledge of the extreme risk to which Sardana and Moriarty's Microsoft clients were exposed. Ascoli

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

knew that the Microsoft clients had substantial margin loans, were invested primarily in the technology and telecommunications sectors, and held unprotected concentrated stock positions in Microsoft. Despite this knowledge, Ascoli failed to contact the Microsoft clients to discuss the risks of their investments and to ascertain if these risks were acceptable and suitable for them. MSDW also failed to reasonably supervise Sardana and Moriarty. The regional compliance officer for the Chevy Chase branch failed to follow established procedures by failing to monitor Ascoli's execution of his supervisory duties. In addition, MSDW's account surveillance and supervisory system was inadequate because there were insufficient procedures in place to monitor violations of the suitability rule. Consequently, when Ascoli failed to adequately perform his supervisory duties, the Microsoft clients were left vulnerable to the unsuitable recommendations of Sardana and Moriarty.

MSDW's Supervisory Structure

General Structure

66. There are three layers of supervision in the MSDW supervisory structure: branch managers, regional directors, and national sales personnel. MSDW's compliance department supports and assists this supervisory structure, in part by performing account surveillance to assure that the supervisory system functions properly. The branch managers are the first line of supervision and are primarily responsible for ensuring that financial advisors are in compliance with both federal and state securities laws and regulations.

Branch Managers

67. Branch managers, through their direct supervision of MSDW's financial advisors, play the most important role in the MSDW supervisory system. Consequently, MSDW branch managers must devote a substantial portion of their day-to-day activities to compliance matters. MSDW policy dictates

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

that a branch manager "not only provides the surveillance needed for the protection of the public…but also ensures the branch's clients are receiving appropriate service and investment advice."

Regional Directors

68. MSDW branch managers are supervised by one of several regional directors across the country. Regional directors oversee the branches and have the ultimate authority to hire and fire branch managers in their region. Regional directors do not, however, perform any compliance surveillance of branches.[5] Regional directors have supervisory responsibility for initiating corrective action against a financial advisor if the branch manager fails to take appropriate action.

National

69. MSDW regional directors report to MSDW's Director of Investor Advisory Services ("IAS").[6] The Director of IAS reports to the President and Chief Operating Officer of the Individual Investor Group ("IIG").[7] The President and Chief Operating Officer of IIG reports to the Chairman of the Board of Directors and Chief Executive Officer of MSDW.

Compliance Department

70. MSDW's compliance department supports the firm's efforts to prevent and detect improper conduct on the part of the firm's thousands of brokers. The compliance department performs a variety of tasks designed to support branch managers in the performance of their compliance-related supervisory duties. The compliance department's job functions include: determining what securities rules and regulations are applicable; communicating those requirements to firm employees through training,

---

[5] An exception exists for a regional director's review of the activity of "producing" branch managers, i.e. managers who service customer accounts.

[6] IAS is Morgan Stanley's retail securities business in the United States.

newsletters, and the issuance of policies and procedures; and monitoring for compliance with applicable rules through its surveillance reports and reviews. The compliance department assigns a regional compliance officer to every region. The regional compliance officer acts as the liaison between the compliance department and the branch managers in each region.

71. Ultimately, the role of the compliance department is to support financial advisors and the persons who supervise the financial advisors. The compliance department does not have direct supervision of branch managers and financial advisors through responsibility for hiring, firing and ordering corrective action. The compliance department, however, may recommend that a branch manager take a particular course of action to correct a compliance problem. If a branch manager fails to implement corrective action, the compliance department must then bring the matter to the attention of the regional director. If the regional director fails to take appropriate action, the compliance department must bring the matter to the attention of national sales. Therefore, the compliance department plays an important oversight role if a branch manager fails to adequately execute his supervisory duties.

Ascoli's Failure to Supervise

Ascoli's Recruitment of Sardana and Moriarty

72. Ascoli, in accordance with the MSDW's goal of increasing the number of financial advisors in their retail brokerage network, spent much of his time recruiting financial advisors, such as Sardana and Moriarty.[8] Sardana initially contacted Ascoli in early to mid-1999 about leaving Merrill Lynch to

[7] IIG, one of four MSDW divisions, offers securities and investment products supported by MSDW's investment banking, research, investment management, execution and operational resources. The other three MSDW divisions are Institutional Securities, Investment Management, and Discover Financial Services.

[8] At the time he became branch manager of the Chevy Chase branch, the branch had approximately 30 financial advisors. By the time he left in late 2002, Ascoli had more than doubled the number of financial advisors in the Chevy Chase branch, to approximately 70.

join MSDW. Over the next few months, Ascoli met with Sardana and Moriarty to discuss their business plan and investment strategies, as outlined previously in paragraphs 10 through 21.

73. As a branch manager, Ascoli was compensated with a salary, a monthly supplement to the salary based on the profitability of the branch, and a year-end bonus. It was projected that Sardana and Moriarty would add approximately $100 million dollars in assets under management to the Chevy Chase branch, representing a 5% increase in overall assets under management.[9] This increase in assets would boost the profitability of the branch, and as a consequence, Ascoli's compensation. Sardana and Moriarty's business plan was especially lucrative because it focused on a small number of high net-worth clients who would provide predictable, ongoing revenue to the firm in the form of quarterly Choice Fees and margin loan interest. In addition to helping increase the branch profitability, Sardana and Moriarty's business plan would help Ascoli meet his year-end "Challenge Goal" of opening a designated number of Choice Fee accounts during the calendar year. In an effort to steer clients into fee accounts, as opposed to traditional commission-based accounts, MSDW offered an incentive to its branch managers to open a set number of Choice Fee accounts in 1999. Recruiting Sardana and Moriarty to join the Chevy Chase branch helped Ascoli to meet his 1999 Challenge Goal for Choice Fee accounts.

74. Ascoli and MSDW were in competition with other firms to recruit Sardana and Moriarty. Sardana and Moriarty contacted a number of brokerage firms in the suburban Washington, DC/Maryland area to explore employment opportunities. Sardana and Moriarty received a competing offer of employment from Salomon Smith Barney. Ascoli was aware of the competing offer and sought to hire Sardana and Moriarty for the Chevy Chase branch of MSDW.

---

[9] The Chevy Chase's branch had an estimated $2 billion dollars in assets under management in 1999 and 2000.

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

75. As part of his efforts to recruit Sardana and Moriarty to join MSDW, Ascoli set up meetings in approximately June of 1999 at MSDW's offices in New York. At these meetings, Sardana and Moriarty met with several people, including the Regional Director responsible for the Chevy Chase branch, Christopher Amo ("Amo") and the Associate Regional Director, Jeffrey T. Stannard ("Stannard"). Amo and Stannard promoted the strengths of MSDW relative to other brokerage firms. Sardana and Moriarty discussed their business plan that targeted Microsoft clients and their investment strategies. At this or other meetings with Amo, they discussed the possibility of "syndicating" Sardana and Moriarty's business model for MSDW financial advisors in other regions to target employees of companies holding employee stock options.

76. After the meeting in New York, Ascoli and MSDW extended an offer of employment to Sardana and Moriarty, which they accepted in August of 1999. The offer included exclusive use of two sales assistants, purchase of computer equipment, an allowance for annual marketing expense, the credit of certain fees for clients transferring from Merrill Lynch, an award trip, a travel and entertainment expense account, and free office parking. In addition, Sardana and Moriarty were offered a lucrative signing bonus, as described previously in paragraph 8.

Ascoli's Supervisory Role

77. Ascoli, as branch manager, played the most important role in the supervision of financial advisors such as Sardana and Moriarty through the routine execution of his supervisory responsibilities. These duties included, but were not limited to: approving all new accounts for customers of the branch, reviewing all outgoing correspondence, reviewing all transactions on a daily basis, reviewing and monitoring accounts, approving margin trading and margin loan balances, and contacting clients when

appropriate.[10] Ascoli was also responsible for resolving any issues brought to his attention by the compliance department. In addition to his routine responsibilities, Ascoli spoke with Sardana and Moriarty regularly to discuss the success of their business model and to learn more about their Microsoft clients.

Ascoli's Approval of the Clients' New Accounts

78. Ascoli reviewed and approved every new account opened at the branch. Pursuant to MSDW's policies and procedures, in determining whether to approve a new account, the branch manager must be familiar with the financial advisor's relationship with the client and must review essential facts about the client. The branch manager and financial advisor are obligated to exercise due diligence to learn, record and update client information. The branch manager must also review the financial status, experience and investment objectives of the client gathered by the financial advisor, discuss the information with the financial advisor, and contact the client if suitability questions remain.

79. Until approximately early 2000, Ascoli reviewed a one-page form that was completed by the financial advisor with basic details about the client, including name, age, marital status, occupation, number of dependents, investment objectives,[11] investment experience, income, net worth, and mortgage. This form was not provided to the client, nor did the client review or sign the form. This form is commonly referred to as the "new account form." In 2000, MSDW transitioned to an online version of the new account form that captured similar information on the client.

---

[10] This section does not attempt to summarize or describe all of MSDW's policies and procedures. It describes only the policies and procedures relevant to this matter.

[11] In 1999, MSDW required a financial advisor to rank on the form, in order of priority, the following four objectives: income, aggressive income, capital appreciation and speculation. MSDW did not define these four objectives for their financial advisors, branch managers or customers. Ascoli described capital appreciation as a "catch-all," because the desire of anyone who opens an account is for the value of his or her account to increase. According to Ascoli, in an account with capital appreciation as the objective, the financial advisor would attempt to increase the value of the account without engaging in overly aggressive trading.

80. Through approving their new accounts, Ascoli became more familiar with the Microsoft clients and their financial status and investment objectives. Ascoli did not once contact the Microsoft clients to verify the accuracy of the information recorded on their new account forms, nor did he discuss the new account forms with Sardana and Moriarty.

Ascoli's Approval of Outgoing Correspondence to the Clients

81. Ascoli was required to review and approve all correspondence to customers of the Chevy Chase branch, including but not limited to documents such as the Investment Management document, options spreadsheet, Initial Financial/Estate Planning Meeting with Barbara and Brad S., and Preliminary Investment Considerations for Marilyn B. and Jim L. By Ascoli's own admission, he did not approve each and every version of the documents created by Sardana and Moriarty for a particular client. If Ascoli was "comfortable" with a given document and had seen it in the past, he did not necessarily review its subsequent use. MSDW provides a number of guidelines for a branch manager to conduct his review of outgoing correspondence. Among these guidelines are the following:

i. "Projections or predictions must be clearly labeled as estimates. A reference to the basis of the estimates should be given or be made available upon request."

ii. "The risks of an investment and the fact that it can go down as well as up must be stated."

82. Ascoli reviewed and approved a version of the Investment Management document, described previously in paragraph 17, provided to the Microsoft clients. The document details the investment disciplines Sardana and Moriarty created and used to solicit Microsoft clients. The two disciplines recommended by Sardana and Moriarty, the Large-Cap Growth Discipline (or Core Growth Discipline) and the Aggressive Growth Discipline, were composed of equities primarily in the

technology and telecommunications sectors. If the Microsoft clients were to invest in only these two disciplines, their portfolios would not be properly diversified and would be placed at great risk in the event of a market correction. Ascoli failed to discuss this potential lack of diversification with Sardana and Moriarty, nor did he discuss with them the risk of a portfolio invested solely in equities. In addition, Ascoli did not discuss with them the further increase in risk when the equities were concentrated in such volatile sectors as technology and telecommunications.

83. Ascoli reviewed and approved the options spreadsheet, described previously in paragraph 15, shown to the Microsoft clients. Sardana and Moriarty used the options spreadsheet to persuade their clients to exercise their stock options using a margin loan. The options spreadsheet contained a projected growth rate of 20% for the stock underlying the option exercise. Sardana, Moriarty, and Ascoli admitted that it was unreasonable to expect such a growth rate. This growth rate, however, was not labeled as an estimate and the risks of not meeting this growth rate were not explained on the spreadsheet. In fact, the projected 20% growth rate was misleading and represented a strategy that was not appropriate for the Microsoft clients' financial situations and goals. Ascoli failed to discuss the use of this growth rate with Sardana and Moriarty. Nor did Ascoli discuss with them the need for explaining the risk to the client and, at the very least, including a risk disclosure in the options spreadsheet.

84. Ascoli reviewed and approved a version of the Initial Financial/Estate Planning Meeting document, such as the one provided to Barbara and Brad S. described previously in paragraph 45. In this document, Sardana and Moriarty market themselves as assisting clients in developing an investment and estate planning strategy that would lead to financial independence and enable them to "sleep well at night." In reality, the document did not accurately portray the strategies Sardana and Moriarty later

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

recommended. Ascoli failed to discuss the representations made in the document with Sardana and Moriarty, nor did he discuss with them the basis for the representations.

85. Ascoli reviewed and approved a version of the Preliminary Investment Considerations document, such as the one provided to Marilyn B. and James L. described previously in paragraph 58. In this document, Sardana and Moriarty recommended that they invest in only two disciplines, the Core Growth and Aggressive Growth disciplines. Implementation of such recommendations would have caused their portfolio to lack diversification and would have placed their investments at significant risk. Ascoli failed to discuss these speculative recommendations with Sardana and Moriarty, nor did he discuss with them the suitability of those recommendations for Marilyn and James.

Ascoli's Approval of Transactions and Monitoring of Accounts

86. As a branch manager at MSDW, Ascoli was responsible for the review of all transactions executed at the branch. In order to conduct this review, the branch manager reviewed a report called the Transaction Activity Report (TAR). The TAR was a daily report that summarized all the trading activity for a particular branch for that day. In addition to the daily review, a branch manager was also required to regularly review and monitor, on at least an annual basis, all accounts within the branch. According to MSDW policy, "[t]hese reviews are designed to detect and prevent violations of Company policy or regulatory requirements."

87. Ascoli reviewed and approved all of the transactions described previously for the Microsoft clients. Ascoli failed to discuss a single transaction in the clients' accounts with Sardana and Moriarty, nor did he contact the Microsoft clients to discuss the trades in their accounts. Further, Ascoli was responsible for reviewing and monitoring their accounts. There is no evidence that Ascoli reviewed or monitored these accounts, despite his knowledge that these clients' accounts were speculative in nature,

were not diversified, were subject to significant market risk, and had unprotected concentrated stock positions in Microsoft.

Ascoli's Approval and Monitoring of Margin

88. As a MSDW branch manager, Ascoli was required to review and approve the use of margin in all accounts.[12] Additionally, Ascoli was required to periodically review margin loan balances (or "margin debit balances").[13]

89. In general, Ascoli perceived no compliance issue with accounts with high margin debit balances. Ascoli stated that he only became concerned when "equity percentages in the account were dropping precipitously below 20 percent, where an account was in danger of going actually into a negative situation." In addition, Ascoli stated that only "consistent margin calls would be a trigger" to contact a client to discuss their margin situation.

90. Ascoli approved margin trading for the Microsoft clients. He also reviewed and approved their margin debit balances on a monthly basis. Because the Microsoft clients were invested primarily in the technology and telecommunications sectors, they were at a greatly increased risk of loss if the growth in these sectors slowed or reversed. In addition, because Sardana and Moriarty's investment strategy employed the use of a margin loan to exercise stock options that would be paid off from capital appreciation in the underlying investments, the risk to the customer was compounded for reasons discussed previously in paragraphs 14 and 15. Despite Ascoli's purported review of both the margin debit balances and the underlying investments in the client accounts, he never questioned Sardana or Moriarty about their initial recommendations to utilize margin or the maintenance of high margin debit

[12] Margin levels above $250,000 also require separate approvals higher up the supervisory structure, which is explained subsequently.
[13] This review is explained subsequently.

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

balances. Ascoli's perfunctory review and approval of the large margin debit balances in the accounts of Sardana and Moriarty's Microsoft clients was unreasonable given the risks clients faced if a market correction were to occur.

Ascoli's Failure to Contact Clients

91. Ascoli was responsible for contacting clients if a potential problem was detected in their accounts. He was also responsible for discussing any potential issues with the financial advisor assigned to the accounts. MSDW procedures mandated that a branch manager maintain a file for each client contacted, including copies of letters, memoranda of phone conversations or meetings with the client, and memoranda of discussions with the client's financial advisor.

92. Despite the fact that MSDW's procedures dictating when a branch manager should contact clients were inadequate (as discussed subsequently), Ascoli's knowledge of Sardana and Moriarty's strategies and target clients created an obligation for him to contact the Microsoft clients. Contacting the Microsoft clients was necessary to ascertain that the clients knew the risks of the investment strategy being implemented in their accounts by Sardana and Moriarty.[14] Through his review of the documents, transactions, and discussions with Sardana and Moriarty, Ascoli was aware of serious issues with the accounts of the Microsoft clients. Despite this awareness, Ascoli never contacted any of the Microsoft clients to discuss the risk of their investment portfolios, nor did he discuss their accounts with Sardana and Moriarty.

---

[14] It also appears that Ascoli did not maintain files for clients who were actually contacted, in violation of MSDW's procedures. While letters sent to clients were retained, conversations were not recorded in any intelligible fashion. Ascoli claimed to have recorded his conversations with clients in his personal Daytimer, but a review of his Daytimer revealed only sporadic and illegible notes. Thus, there was no method to verify whether clients were actually contacted. More importantly, it seems highly unlikely that this system assisted Ascoli in tracking accounts that he was required, under firm procedures, to closely monitor.

Ascoli's Failure to Act on the Compliance Department's Warning

93. Ascoli discussed Sardana and Moriarty's sales practices with the MSDW compliance department, but failed to take action. At some point in early 2000, a conversation took place between Ascoli and the Assistant Director of Retail Compliance, Thomas Nelli ("Nelli"). As Assistant Director of Retail Compliance, Nelli was two steps removed from the head of the entire compliance department. His job duties included oversight of the surveillance of all accounts in the MSDW regions. Ascoli had known Nelli for several years and viewed him as a trustworthy resource with regards to compliance issues.

94. During the conversation, Ascoli explained to Nelli that one of his financial advisor's clients was a Microsoft employee with a concentrated position in Microsoft stock. The client was in the process of selling a multi-million dollar position of Microsoft stock in order to invest in ten to twenty technology stocks. Ascoli contacted Nelli because he was uncomfortable with what he portrayed as the client's desire to put himself in an undiversified position through buying only stocks in the technology sector. According to Ascoli, the financial advisor did <u>not</u> recommend the trades and the trades would be marked unsolicited. Ascoli did not disclose the name of the financial advisor or the client. Nelli instructed Ascoli to contact the client to make sure that the client understood that such a strategy would not result in a diversified portfolio, as it would be totally reliant on the technology sector. Nelli was concerned that if the technology sector took "a dive," the client's portfolio would decline significantly in value. Ascoli agreed to contact the client. Approximately one week later, Nelli and Ascoli spoke again. At that time, Ascoli told Nelli that he had spoken to the client.

95. There is no record of any conversation that Ascoli had with any Microsoft client of Sardana and Moriarty. Therefore, despite being warned by a senior member of MSDW's compliance department

that the strategy recommended by Sardana and Moriarty was undiversified and therefore highly risky, Ascoli failed to act. Ascoli's failure to act on this warning, by contacting the Microsoft clients to ensure they understood the nature and extent of the risks their portfolios were exposed to, constitutes deficient supervision.

MSDW's Failure to Supervise

The Compliance Department's Failure to Follow Established Procedures

96. MSDW monitored its branch managers to ensure that they were adequately supervising financial advisors through a checklist (the "supervisory log"). The branch manager was required to complete the supervisory log monthly. The branch manager then forwarded the completed supervisory log to the regional compliance officer ("RCO") for his or her review. The RCO was then obligated to review the supervisory log and to follow-up with the branch manager if a problem was detected or the supervisory log was incomplete.

97. The supervisory log was a checklist that evidenced a branch manager's execution of his or her supervisory duties, such as reviewing correspondence, reviewing customer complaints, and contacting active clients.[15] According to MSDW policy, "[o]ne of the purposes of this log is to provide documentation which may help protect the Manager from charges of failure to supervise." Branch managers were required to attach a list of clients contacted, whether by phone, letter, or meeting. The branch manager was required to initial each item in the supervisory log monthly and the branch manager was required to sign the supervisory log. By signing the log, the branch manager certified that he had completed the activities in the log.

[15] It should be noted that branch manager's duties were not limited to what is in the log, as MSDW's procedures made it clear that the branch manager "is responsible for making inquiries and investigations outside the scope of this checklist."

98. From at least September 1999 through May 2000, Ascoli failed to complete the supervisory log and the RCO assigned to the Chevy Chase branch failed to correct the deficiency. This failure by the RCO is important because the regional director did not independently supervise the branch manager. During the relevant time period, Ascoli failed to date the supervisory logs, failed to initial the logs, did not attach a single client contact letter to the logs, and failed to attach a list of clients contacted. Despite these significant omissions, the RCO did not contact Ascoli to discuss the supervisory logs, including Ascoli's failure to contact clients. Given the size of the Chevy Chase branch, it is unlikely that a branch manager could adequately supervise the thousands of accounts throughout a nine-month period of time without contacting a single client. In fact, it appears Ascoli contacted no clients during this time period. Had the RCO followed-up with Ascoli, the RCO would have discovered that Ascoli was not adequately supervising the financial advisors in the Chevy Chase branch.

MSDW's Failure to Establish Adequate Procedures

Inadequate Branch Manager Procedures

99. MSDW did not have branch manager procedures reasonably designed to prevent and detect violations of the suitability rule. The compliance department produced only one exception report (the Customer Activity Report or "CAR").[16] Branch managers relied heavily upon this single report to detect violations of the suitability rule. However, the CAR was primarily designed to detect only excessive trading and provided little information that would lead to the discovery of other potential violations of the suitability rule.

[16] An exception report is a report produced by a broker-dealer to review for unusual activity in customer accounts. Exception reports are critical to monitoring and supervising accounts because they allow for the early detection and prevention of problems in the accounts of customers.

100. The CAR was generated on a monthly basis by MSDW's compliance department and distributed to its branch managers. The CAR listed all accounts within a given branch that met or exceeded sixteen defined selection criteria. There were fifteen selection criteria that addressed equities trading, and one that addressed options trading. All of the selection criteria targeted what MDSW deemed "active" accounts. To that end, the criteria were designed to detect a pattern of excessive trading and included such parameters as number of transactions, amount of commissions, commission versus equity percentage, and turnover ratio.

101. MSDW required its branch managers to review accounts appearing regularly on the CAR and contact those clients by either phone or letter. [17] MSDW provided branch managers with a series of sample "activity" letters. The first three sample letters invited the client to contact the branch manager. The fourth, fifth, sixth and seventh letters indicated that there was a high level of trading activity in the client's account and invited the client to meet with the branch manager.[18] Due to the fact that the CAR was primarily designed to identify accounts subject to excessive trading, these sample letters provided no guidance to a branch manager on when to contact a client with regard to other suitability issues.

102. Choice Fee accounts, described in paragraph 11, were essentially excluded from the CAR. Choice Fee accounts were not selected under twelve of the criteria, all of which had a commission element. While it was possible for Choice Fee accounts to be selected under the remaining three criteria, these criteria also dealt with excessive trading by examining the value of the equities purchased versus the total equity in the account for a given time period.

[17] According to Ascoli, the CAR triggered his contact of a client. His own rule of thumb was to call a client who had appeared on a CAR three times during a twelve month time period.
[18] There were also two additional letters for clients engaging in options trading.

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

103. The inadequacy of the information provided to MSDW branch managers put a tremendous burden on them to identify suitability issues in Choice Fee accounts. The typical MSDW branch manager supervised dozens of financial advisors. Branch managers could not review all accounts on a daily basis, and therefore reasonably relied on exception reports to trigger further inquiry into the handling of a customer account. Such triggers were critical for branch managers not otherwise aware of potential issues in accounts.

104. The Microsoft clients had Choice Fee accounts that were not traded excessively, and therefore these accounts did not appear on a CAR. However, Ascoli had knowledge of Sardana and Moriarty's investment strategies, as discussed previously in paragraph 92. Without such knowledge, the CAR would have given Ascoli a false impression that no action was necessary with regards to the accounts of the Microsoft clients.

Inadequate Compliance Department Procedures

105. MSDW's compliance department procedures were not reasonably designed to prevent and detect violations of the suitability rule. The compliance department performed trading surveillance independent of the monitoring performed by the firm's branch managers. However, the compliance department's surveillance utilized identical selection criteria as those used for the CAR, as described above. Consequently, MSDW's surveillance of accounts suffered from the same limitation by focusing only on excessive trading.

106. A report similar to the CAR is generated by the compliance department on a monthly basis for account surveillance. However, unlike the branch managers who received a CAR that included accounts meeting <u>all</u> of the selection criteria, the compliance department report only utilized a subset of the CAR selection criteria.

107. There is no evidence that any of the Microsoft clients' accounts were selected for review by the compliance department. Ascoli was not contacted by the compliance department to discuss the accounts of Sardana and Moriarty. This lack of surveillance for potential unsuitable recommendations placed a substantial burden on a MSDW branch manager's ability to identify suitability issues in accounts. Had the compliance department's surveillance identified the risk to the Microsoft clients' portfolios, their losses may have been averted.

Inadequate Procedures for Approval and Monitoring of Margin

108. MSDW's procedures for approval and surveillance of margin debit balances were not reasonably designed to prevent and detect violations of the suitability rule. MSDW's supervisory procedures, with respect to margin, were focused primarily on the credit risk clients posed to the firm. The procedures were not adequately designed to review whether or not the use of margin and the level of margin were suitable for clients.

109. MSDW required management approvals for margin loans. Specifically, branch managers had sole approval authority for margin debit levels up to approximately $250,000; the branch manager, in conjunction with the regional director approved margin debits of between $250,001 and $1,000,000; and margin debits above $1,000,000 were approved at the branch, regional and national level. The financial advisor assigned to the account completed a form requesting this approval. The form contained only limited information, such as the account name and number, the financial advisor's name, the margin amount requested, and the debit balance. The form was not designed to capture information necessary to determine the suitability of margin trading for the client at issue.

110. In addition, MSDW's compliance department performed a review of margin debit balances once or twice a year. Accounts were reviewed online by a compliance analyst (the "DEBO review").

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

During the compliance analyst's DEBO review, the analyst reviewed selected accounts with high margin balances by examining the investments in the accounts, the margin to equity percentage, and the basic financial information and goals recorded in the system. If a compliance analyst concluded there was a potentially unsuitable margin position, the analyst was required to contact the branch manager to discuss the account. The DEBO review was not detailed in a written procedure. Furthermore, the review was insufficiently detailed and performed too seldom.

111. The margin levels of the Microsoft clients were approved at all the necessary levels. The compliance department reviewed margin levels for the Chevy Chase branch in March and November of 2000 and found no issue with these accounts. Given the amount of margin utilized by the clients, had there been an adequate system in place designed to review margin levels in accounts, the compliance department would have detected a margin suitability issue in these accounts.

Based upon the above Tentative Findings of Fact, the following Conclusions of Law are made:

CONCLUSIONS OF LAW

1. The offer or sale of stocks as described above by Arun Sardana and Michael T. Moriarty constitutes the offer and sale of securities as defined in RCW 21.20.005(10) and (12).

2. Arun Sardana and Michael T. Moriarty, as described above, recommended the purchase and sale of securities to Tiffany T., Barbara and Brad S. and Marilyn B. without reasonable grounds to believe that the transactions were suitable for such customers, in violation of RCW 21.20.702. Such practice is grounds for the suspension of their salesperson and investment adviser representative registrations and for the imposition of fines pursuant to RCW 21.20.110(1).

3. Arun Sardana and Michael T. Moriarty, as described above, have each acted as investment adviser representatives as defined in RCW 21.20.005(14).

4. Arun Sardana and Michael T. Moriarty, as described above, have each violated RCW 21.20.040 by acting as investment adviser representatives in the State of Washington without being so registered.

5. Lorenzo D. Ascoli, as described above, failed to reasonably supervise Arun Sardana and Michael T. Moriarty. Pursuant to RCW 21.20.110(1)(j), this failure constitutes grounds, under RCW 21.20.110(1), for the imposition of fines.

6. Morgan Stanley DW Inc., as described above, failed to reasonably supervise Arun Sardana and Michael T. Moriarty. Pursuant to RCW 21.20.110(1)(j), this failure constitutes grounds, under RCW 21.20.110(1), (7) and (8), for the imposition of fines, charging of costs, and ordering disgorgement.

NOTICE OF INTENT TO SUSPEND REGISTRATIONS

Pursuant to RCW 21.20.110(1), and based upon the above Tentative Findings of Fact and Conclusions of Law, the Securities Administrator intends to order that the securities salesperson registrations and investment adviser representative registrations of Respondents Arun Sardana and Michael T. Moriarty be suspended for a period of 90 days.

NOTICE OF INTENT TO IMPOSE FINES

Pursuant to RCW 21.20.110(1) and (4), and based upon the above Tentative Findings of Fact and Conclusions of Law, the Securities Administrator intends to order that:

a. Respondent Arun Sardana shall be liable for and pay a fine of $20,000;

b. Respondent Michael T. Moriarty shall be liable for and pay a fine of $20,000;

c. Respondent Lorenzo D. Ascoli shall be liable for and pay a fine of $20,000; and

d. Respondent Morgan Stanley DW Inc. shall be liable for and pay a fine of $120,000.

NOTICE OF INTENT TO CHARGE COSTS

Pursuant to RCW 21.20.110(7), and based upon the above Tentative Findings of Fact and Conclusions of Law, the Securities Administrator intends to order that Respondent Morgan Stanley DW Inc. shall be liable for and pay the costs, fees, and other expenses incurred in the conduct of the administrative investigation and hearing of this matter, in an amount of not less than $100,000.

NOTICE OF INTENT TO ORDER DISGORGEMENT

Pursuant to RCW 21.20.110(8), and based upon the above Tentative Findings of Fact and Conclusions of Law, the Securities Administrator intends to order that Respondent Morgan Stanley DW Inc. shall disgorge for all fees and margin loan interest paid by the Microsoft clients, in an amount of $99,141.38.

AUTHORITY AND PROCEDURE

This Order is entered pursuant to the provisions of RCW 21.20.110, and is subject to the provisions of RCW 21.20.120 and Chapter 34.05 RCW. The Respondents may each make a written request for a hearing as set forth in the NOTICE OF OPPORTUNITY TO DEFEND AND OPPORTUNITY FOR HEARING accompanying this Order. If a Respondent does not request a hearing, the Securities Administrator intends to adopt the foregoing Tentative Findings of Fact and Conclusions of Law as final, and enter a permanent order against that Respondent suspending registration, imposing fines, charging costs, and ordering disgorgement, as described above.

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760

DATED this ___4th__ day of November, 2003.

DEBORAH R. BORTNER
Securities Administrator

Approved by:

Michael E. Stevenson
Chief of Enforcement

Presented by:

Chad C. Standifer
Enforcement Attorney

Andrea Y. Sato
Enforcement Attorney

DEPARTMENT OF FINANCIAL INSTITUTIONS
Securities Division
PO Box 9033
Olympia, WA 98507-9033
360-902-8760