MORGAN STANLEY
Form 10-Q
August 07, 2009
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2009

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

Commission File Number 1-11758

(Exact Name of Registrant as specified in its charter)

Delaware	**1585 Broadway**	**36-3145972**	**(212) 761-4000**
(State or other jurisdiction of incorporation or organization)	**New York, NY 10036**	(I.R.S. Employer Identification No.)	(Registrant s telephone number, including area code)
	(Address of principal executive offices, including zip code)		

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer x	Accelerated Filer ¨
Non-Accelerated Filer ¨	Smaller reporting company ¨
(Do not check if a smaller reporting company)	

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of July 31, 2009, there were 1,359,166,836 shares of the Registrant s Common Stock, par value $0.01 per share, outstanding.

Table of Contents

QUARTERLY REPORT ON FORM 10-Q

For the quarter ended June 30, 2009

Table of Contents		Page
Part I Financial Information		
Item 1.	Financial Statements (unaudited)	1
	Condensed Consolidated Statements of Financial Condition June 30, 2009, December 31, 2008 and November 30, 2008	1
	Condensed Consolidated Statements of Income Three and Six Months Ended June 30, 2009 and 2008	3
	Condensed Consolidated Statements of Comprehensive Income Three and Six Months Ended June 30, 2009 and 2008	4
	Condensed Consolidated Statements of Cash Flows Six Months Ended June 30, 2009 and 2008	5
	Condensed Consolidated Statements of Changes in Total Equity For the Six Months Ended June 30, 2009	6
	Condensed Consolidated Statement of Changes in Total Equity For the Six Months Ended June 30, 2008	7
	Notes to Condensed Consolidated Financial Statements (unaudited)	8
	Note 1. Basis of Presentation and Summary of Significant Accounting Policies	8
	Note 2. Morgan Stanley Smith Barney Holdings LLC	17
	Note 3. Fair Value Disclosures	21
	Note 4. Collateralized Transactions	38
	Note 5. Securitization Activities and Variable Interest Entities	40
	Note 6. Goodwill and Net Intangible Assets	48
	Note 7. Long-Term Borrowings	50
	Note 8. Derivative Instruments and Hedging Activities	50
	Note 9. Commitments, Guarantees and Contingencies	59
	Note 10. Regulatory Requirements	64
	Note 11. Total Equity	67
	Note 12. Earnings per Common Share	70
	Note 13. Interest and Dividends and Interest Expense	71
	Note 14. Other Revenues	72
	Note 15. Employee Benefit Plans	72
	Note 16. Income Taxes	72
	Note 17. Segment and Geographic Information	73
	Note 18. Joint Venture	76
	Note 19. Discontinued Operations	77
	Note 20. Subsequent Events	77
	Report of Independent Registered Public Accounting Firm	78
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	79
	Introduction	79
	Executive Summary	81
	Certain Factors Affecting Results of Operations and Earnings Per Common Share	88
	Equity Capital-Related Transactions	91
	Business Segments	91
	Other Matters	102
	Critical Accounting Policies	106
	Liquidity and Capital Resources	111
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	124
Item 4.	Controls and Procedures	137
	Financial Data Supplement (Unaudited)	138

Table of Contents

		Page
Part II Other Information		
Item 1.	Legal Proceedings	139
Item 1A.	Risk Factors	140
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	141
Item 4.	Submission of Matters to a Vote of Security Holders	142
Item 5.	Other Information	143
Item 6.	Exhibits	143

Table of Contents

AVAILABLE INFORMATION

Morgan Stanley files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (the SEC). You may read and copy any document we file with the SEC at the SEC s public reference room at 100 F Street, NE, Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for information on the public reference room. The SEC maintains an internet site that contains annual, quarterly and current reports, proxy and information statements and other information that issuers (including Morgan Stanley) file electronically with the SEC. Morgan Stanley s electronic SEC filings are available to the public at the SEC s internet site, *www.sec.gov*.

Morgan Stanley s internet site is *www.morganstanley.com*. You can access Morgan Stanley s Investor Relations webpage at *www.morganstanley.com/about/ir*. Morgan Stanley makes available free of charge, on or through its Investor Relations webpage, its proxy statements, Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, as amended (the Exchange Act), as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. Morgan Stanley also makes available, through its Investor Relations webpage, via a link to the SEC s internet site, statements of beneficial ownership of Morgan Stanley s equity securities filed by its directors, officers, 10% or greater shareholders and others under Section 16 of the Exchange Act.

Morgan Stanley has a Corporate Governance webpage. You can access information about Morgan Stanley s corporate governance at *www.morganstanley.com/about/company/governance*. Morgan Stanley posts the following on its Corporate Governance webpage:

- Amended and Restated Certificate of Incorporation;
- Amended and Restated Bylaws;
- Charters for our Audit Committee; Internal Audit Subcommittee; Compensation, Management Development and Succession Committee; and Nominating and Governance Committee;
- Corporate Governance Policies;
- Policy Regarding Communication with the Board of Directors;
- Policy Regarding Director Candidates Recommended by Shareholders;
- Policy Regarding Corporate Political Contributions;
- Policy Regarding Shareholder Rights Plan;
- Code of Ethics and Business Conduct;
- Code of Conduct; and

Integrity Hotline.
Morgan Stanley s Code of Ethics and Business Conduct applies to all directors, officers and employees, including its Chief Executive Officer, its Chief Financial Officer and its Controller and Principal Accounting Officer. Morgan Stanley will post any amendments to the Code of Ethics and Business Conduct and any waivers that are required to be disclosed by the rules of either the SEC or the New York Stock Exchange, Inc. on its internet site. You can request a copy of these documents, excluding exhibits, at no cost, by contacting Investor Relations, 1585 Broadway, New York, NY 10036 (212-761-4000). The information on Morgan Stanley s internet site is not incorporated by reference into this report.

Table of Contents

Part I Financial Information.

Item 1. Financial Statements.

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(dollars in millions, except share data)

(unaudited)

	June 30, 2009	December 31, 2008	November 30, 2008
Assets			
Cash and due from banks	$ 9,184	$ 13,354	$ 11,276
Interest bearing deposits with banks	25,822	65,316	67,378
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	21,643	24,039	25,446
Financial instruments owned, at fair value (approximately $78 billion, $73 billion and $62 billion were pledged to various parties at June 30, 2009, December 31, 2008 and November 30, 2008, respectively):			
U.S. government and agency securities	63,717	28,012	20,251
Other sovereign government obligations	26,768	21,084	20,071
Corporate and other debt	87,802	87,294	88,484
Corporate equities	42,582	42,321	37,174
Derivative and other contracts	58,372	89,418	99,766
Investments	8,825	10,385	10,598
Physical commodities	3,343	2,126	2,204
Total financial instruments owned, at fair value	291,409	280,640	278,548
Securities received as collateral, at fair value	9,872	5,231	5,217
Federal funds sold and securities purchased under agreements to resell	121,799	122,709	106,419
Securities borrowed	107,853	88,052	85,785
Receivables:			
Customers	28,410	29,265	31,294
Brokers, dealers and clearing organizations	5,098	6,250	7,259
Other loans	5,814	6,547	6,528
Fees, interest and other	11,348	7,258	7,034
Other investments	3,796	3,709	3,309
Premises, equipment and software costs (net of accumulated depreciation of $4,108, $3,073 and $3,003 at June 30, 2009, December 31, 2008 and November 30, 2008, respectively)	6,548	5,095	5,057
Goodwill	6,836	2,256	2,243
Intangible assets (net of accumulated amortization of $272, $208 and $200 at June 30, 2009, December 31, 2008 and November 30, 2008, respectively) (includes $173, $184 and $220 at fair value at June 30, 2009, December 31, 2008 and November 30, 2008, respectively)	5,553	906	947
Other assets	15,972	16,137	15,295
Total assets	$ 676,957	$ 676,764	$ 659,035

See Notes to Condensed Consolidated Financial Statements.

1

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (Continued)

(dollars in millions, except share data)

(unaudited)

	June 30, 2009	December 31, 2008	November 30, 2008
Liabilities and Equity			
Commercial paper and other short-term borrowings (includes $1,062, $1,246 and $1,412 at fair value at June 30, 2009, December 31, 2008 and November 30, 2008, respectively)	$ 3,030	$ 10,102	$ 10,483
Deposits (includes $9,171, $9,993 and $6,008 at fair value at June 30, 2009, December 31, 2008 and November 30, 2008, respectively)	62,382	51,355	42,755
Financial instruments sold, not yet purchased, at fair value:			
U.S. government and agency securities	21,072	11,902	10,156
Other sovereign government obligations	17,244	9,511	9,360
Corporate and other debt	7,150	9,927	9,361
Corporate equities	21,649	16,840	16,547
Derivative and other contracts	43,435	68,554	73,521
Physical commodities	11	33	
Total financial instruments sold, not yet purchased, at fair value	110,561	116,767	118,945
Obligation to return securities received as collateral, at fair value	9,872	5,231	5,217
Securities sold under agreements to repurchase	91,935	92,213	102,401
Securities loaned	18,002	14,580	14,821
Other secured financings, at fair value	10,148	12,539	12,527
Payables:			
Customers	105,731	123,617	115,225
Brokers, dealers and clearing organizations	5,407	1,585	3,141
Interest and dividends	2,674	3,305	2,584
Other liabilities and accrued expenses	18,960	16,179	15,963
Long-term borrowings (includes $35,309, $30,766 and $28,830 at fair value at June 30, 2009, December 31, 2008 and November 30, 2008, respectively)	186,792	179,835	163,437
	625,494	627,308	607,499
Commitments and contingencies			
Equity			
Morgan Stanley shareholders equity:			
Preferred stock	9,597	19,168	19,155
Common stock, $0.01 par value;			
Shares authorized: 3,500,000,000 at June 30, 2009, December 31, 2008 and November 30, 2008;			
Shares issued: 1,487,850,163 at June 30, 2009, 1,211,701,552 at December 31, 2008 and November 30, 2008;			
Shares outstanding: 1,359,204,010 at June 30, 2009, 1,074,497,565 at December 31, 2008 and 1,047,598,394 at November 30, 2008	15	12	12
Paid-in capital	9,214	459	1,619
Retained earnings	34,245	36,154	38,096
Employee stock trust	4,163	4,312	3,901
Accumulated other comprehensive loss	(342)	(420)	(125)

Common stock held in treasury, at cost, $0.01 par value; 128,646,153 shares at June 30, 2009, 137,203,987 shares at December 31, 2008 and 164,103,158 shares at November 30, 2008	(6,143)	(6,620)	(7,926)
Common stock issued to employee trust	(4,163)	(4,312)	(3,901)
Total Morgan Stanley shareholders equity	46,586	48,753	50,831
Non-controlling interests	4,877	703	705
Total equity	51,463	49,456	51,536
Total liabilities and equity	$ 676,957	$ 676,764	$ 659,035

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(dollars in millions, except share and per share data)

(unaudited)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(unaudited)		(unaudited)	
Revenues:				
Investment banking	$ 1,281	$ 1,288	$ 2,167	$ 2,259
Principal transactions:				
Trading	1,971	2,094	3,062	4,888
Investments	(115)	(308)	(1,387)	(824)
Commissions	975	1,116	1,747	2,381
Asset management, distribution and administration fees	1,282	1,473	2,266	2,946
Other	505	315	836	1,224
Total non-interest revenues	5,899	5,978	8,691	12,874
Interest and dividends	1,393	9,196	3,917	21,906
Interest expense	1,881	9,063	4,251	20,851
Net interest	(488)	133	(334)	1,055
Net revenues	5,411	6,111	8,357	13,929
Non-interest expenses:				
Compensation and benefits	3,875	3,108	5,911	6,911
Occupancy and equipment	376	325	715	614
Brokerage, clearing and exchange fees	290	421	559	891
Information processing and communications	317	300	603	605
Marketing and business development	127	196	244	391
Professional services	405	487	727	852
Other	640	388	1,125	776
Total non-interest expenses	6,030	5,225	9,884	11,040
(Losses) income from continuing operations before income taxes	(619)	886	(1,527)	2,889
(Benefit from) provision for income taxes	(333)	192	(1,037)	785
(Loss) income from continuing operations	(286)	694	(490)	2,104
Discontinued operations:				
Gain from discontinued operations (including gain on disposal of $499 million in the three and six months ended June 30, 2009)	515	761	537	797
Provision for income taxes	196	296	204	310
Gain on discontinued operations	319	465	333	487
Net income (loss)	$ 33	$ 1,159	$ (157)	$ 2,591
Net (loss) income applicable to non-controlling interests	$ (116)	$ 16	$ (129)	$ 35
Net income (loss) applicable to Morgan Stanley	$ 149	$ 1,143	$ (28)	$ 2,556

(Losses) earnings applicable to Morgan Stanley common shareholders	$ (1,256)	$ 1,062	$ (1,834)	$ 2,374
Amounts applicable to Morgan Stanley:				
(Losses) income from continuing operations	$ (159)	$ 689	$ (345)	$ 2,084
Net gain from discontinued operations after tax	308	454	317	472
Net income (loss) applicable to Morgan Stanley	$ 149	$ 1,143	$ (28)	$ 2,556
(Losses) earnings per basic common share:				
(Loss) income from continuing operations	$ (1.37)	$ 0.61	$ (2.00)	$ 1.86
Gain on discontinued operations	0.27	0.41	0.29	0.43
(Loss) earnings per basic common share	$ (1.10)	$ 1.02	$ (1.71)	$ 2.29
(Losses) earnings per diluted common share:				
(Loss) income from continuing operations	$ (1.37)	$ 0.61	$ (2.00)	$ 1.85
Gain on discontinued operations	0.27	0.41	0.29	0.43
(Losses) earnings per diluted common share	$ (1.10)	$ 1.02	$ (1.71)	$ 2.28
Average common shares outstanding:				
Basic	1,138,444,490	1,041,178,821	1,075,092,850	1,037,760,625
Diluted	1,138,444,490	1,044,720,912	1,075,092,850	1,041,873,895

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in millions)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(unaudited)		(unaudited)	
Net income (loss)	$ 33	$ 1,159	$ (157)	$ 2,591
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments(1)	118	(92)	58	(50)
Net change in cash flow hedges(2)	5	6	8	9
Amortization of net loss related to pension and postretirement benefits(3)	5	5	12	10
Amortization of prior service credit related to pension and postretirement benefits(4)	(1)	(1)	(3)	(2)
Comprehensive income (loss)	$ 160	$ 1,077	$ (82)	$ 2,558
Net income (loss) applicable to non-controlling interests	(116)	16	(129)	35
Other comprehensive income (loss) applicable to non-controlling interests	(3)	(5)	(3)	(5)
Comprehensive income applicable to Morgan Stanley	$ 279	$ 1,066	$ 50	$ 2,528

(1) Amounts are net of provision for (benefit from) income taxes of $(241) million and $(5) million for the quarters ended June 30, 2009 and June 30, 2008, respectively. Amounts are net of provision for (benefit from) income taxes of $(211) million and $(166) million for the six month periods ended June 30, 2009 and June 30, 2008, respectively.

(2) Amounts are net of provision for (benefit from) income taxes of $2 million and $4 million for the quarters ended June 30, 2009 and June 30, 2008, respectively. Amounts are net of provision for (benefit from) income taxes of $4 million and $6 million for the six month periods ended June 30, 2009 and June 30, 2008, respectively.

(3) Amounts are net of provision for income taxes of $5 million and $3 million for the quarters ended June 30, 2009 and June 30, 2008, respectively. Amounts are net of provision for income taxes of $9 million and $6 million for the six month periods ended June 30, 2009 and June 30, 2008, respectively.

(4) Amounts are net of provision for (benefit from) income taxes of $(1) million for the quarter ended June 30, 2008. Amounts are net of provision for (benefit from) income taxes of $(1) million and $(2) million for the six month periods ended June 30, 2009 and June 30, 2008, respectively.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in millions)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ (157)	$ 2,591
Adjustments to reconcile net income (loss) to net cash (used for) provided by operating activities:		
Compensation payable in common stock and options	627	1,279
Depreciation and amortization	363	238
(Gain) on business dispositions	(480)	(1,500)
Impairment charges	408	
Changes in assets and liabilities:		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	2,396	(6,357)
Financial instruments owned, net of financial instruments sold, not yet purchased	(16,344)	52,926
Securities borrowed	(19,801)	(31,718)
Securities loaned	3,422	(61,770)
Receivables and other assets	(2,462)	13,496
Payables and other liabilities	(10,073)	82,799
Federal funds sold and securities purchased under agreements to resell	910	(3,095)
Securities sold under agreements to repurchase	(278)	(13,668)
Net cash (used for) provided by operating activities	(41,469)	35,221
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (payments for) proceeds from:		
Premises, equipment and software costs	(1,879)	(973)
Business acquisitions, net of cash acquired	(1,860)	(174)
Business dispositions	565	1,523
Net cash (used for) provided by investing activities	(3,174)	376
CASH FLOWS FROM FINANCING ACTIVITIES		
Net (payments for) proceeds from:		
Short-term borrowings	(7,072)	(10,206)
Derivatives financing activities	(71)	146
Other secured financings	(2,391)	2,529
Deposits	11,027	3,394
Excess tax benefits associated with stock-based awards	11	63
Net proceeds from:		
Morgan Stanley public offerings of common stock	6,212	
Issuance of common stock	29	264
Issuance of long-term borrowings	28,805	26,685
Payments for:		
Repayments of long-term borrowings	(24,675)	(20,783)
Redemption of Series D Preferred Stock	(10,000)	
Repurchases of common stock for employee tax withholding	(19)	(64)
Cash dividends	(1,078)	(626)
Net cash (used for) provided by financing activities	778	1,402
Effect of exchange rate changes on cash and cash equivalents	201	1,105
Net (decrease) increase in cash and cash equivalents	(43,664)	38,104

Cash and cash equivalents, at beginning of period	78,670	24,659
Cash and cash equivalents, at end of period	$ 35,006	$ 62,763
Cash and cash equivalents include:		
Cash and due from banks	$ 9,184	$ 7,317
Interest bearing deposits with banks	25,822	55,446
Cash and cash equivalents, at end of period	$ 35,006	$ 62,763

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for interest were $4,631 million and $20,303 million for the six month periods ended June 30, 2009 and June 30, 2008, respectively.

Cash payments for income taxes were $181 million and $475 million for the six month periods ended June 30, 2009 and June 30, 2008, respectively.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY

For the Six Months Ended June 30, 2009

(dollars in millions)

(unaudited)

	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non-controlling Interest	Total Equity
BALANCE AT DECEMBER 31, 2008	$ 19,168	$ 12	$ 459	$ 36,154	$ 4,312	$ (420)	$ (6,620)	$ (4,312)	$ 703	$ 49,456
Net income (loss)				(28)					(129)	(157)
Dividends				(747)					(11)	(758)
Issuance of common stock			(176)				217			41
Repurchases of common stock							(19)			(19)
Morgan Stanley public offerings of common stock		3	6,209							6,212
Preferred stock extinguished and exchanged for common stock	(503)		705	(202)						
Repurchase of Series D preferred stock	(9,068)			(932)						(10,000)
Gain on MSSB transaction			1,711							1,711
Compensation payable in common stock and options			333		(149)		279	149		612
Net excess tax benefits (shortfall) associated with stock-based awards			(27)							(27)
Net change in cash flow hedges						8				8
Pension and other postretirement adjustments.						9				9
Foreign currency translation adjustments						61			(3)	58
Increases in non-controlling interests related to MSSB transaction									4,533	4,533
Decreases in non-controlling interests related to disposition of a subsidiary									(229)	(229)
Other increases in non-controlling interests									13	13
BALANCE AT JUNE 30, 2009	$ 9,597	$ 15	$ 9,214	$ 34,245	$ 4,163	$ (342)	$ (6,143)	$ (4,163)	$ 4,877	$ 51,463

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY

For the Six Months Ended June 30, 2008

(dollars in millions)

(unaudited)

	Preferred Stock	Common Stock	Other Morgan Stanley Common Equity	Non-controlling Interest	Total Equity
BALANCE AT DECEMBER 31, 2007	$ 1,100	$ 12	$ 30,665	$ 1,571	$ 33,348
Net income			2,556	35	2,591
Dividends			(622)	(33)	(655)
Issuance of common stock			264		264
Repurchases of common stock			(64)		(64)
Net excess tax benefits associated with stock-based awards			(12)		(12)
Compensation payable in common stock and options			1,446		1,446
Employee tax withholdings and other			(4)		(4)
Net change in cash flow hedges			9		9
Pension and other postretirement adjustments			8		8
Foreign currency translation adjustments			(45)	(5)	(50)
Other			(60)		(60)
Increases in non-controlling interests related to sales of subsidiary s shares by Morgan Stanley				66	66
Decreases in non-controlling interests related to disposition of a subsidiary				(514)	(514)
Other net increases in non-controlling interests				7	7
BALANCE AT JUNE 30, 2008	$ 1,100	$ 12	$ 34,141	$ 1,127	$ 36,380

See Notes to Condensed Consolidated Financial Statements.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation and Summary of Significant Accounting Policies.

The Company. Morgan Stanley (or the Company) is a global financial services firm that maintains significant market positions in each of its business segments Institutional Securities, Global Wealth Management Group and Asset Management.

A summary of the activities of each of the Company s business segments is as follows:

Institutional Securities includes capital raising; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; and investment activities.

Global Wealth Management Group, which includes the Company s 51% interest in Morgan Stanley Smith Barney Holdings LLC (MSSB), provides brokerage and investment advisory services covering various investment alternatives; financial and wealth planning services; annuity and other insurance products; credit and other lending products; cash management services; retirement services; and trust and fiduciary services.

Asset Management provides global asset management products and services in equity, fixed income, alternative investments, which includes hedge funds and funds of funds, and merchant banking, which includes real estate, private equity and infrastructure, to institutional and retail clients through proprietary and third-party distribution channels. Asset Management also engages in investment activities.

Discontinued Operations.

MSCI. In May 2009, the Company divested all of its remaining ownership interest in MSCI Inc. (MSCI). The results of MSCI are reported as discontinued operations for all periods presented. The results of MSCI were formerly included in the continuing operations of the Institutional Securities business segment.

See Note 19 for additional information on discontinued operations.

Basis of Financial Information. The condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions regarding the valuations of certain financial instruments, the valuation of goodwill, the outcome of litigation and tax matters, incentive-based accruals and other matters that affect the condensed consolidated financial statements and related disclosures. The Company believes that the estimates utilized in the preparation of the condensed consolidated financial statements are prudent and reasonable. Actual results could differ materially from these estimates.

Certain reclassifications have been made to prior-period amounts to conform to the current period s presentation. All material intercompany balances and transactions have been eliminated.

The condensed consolidated financial statements should be read in conjunction with the Company s consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended November 30, 2008 (the Form 10-K). The condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for the fair statement of the results for the interim period. The results of operations for interim periods are not necessarily indicative of results for the entire year.

Consolidation. The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest including

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

certain variable interest entities (VIEs). The Company adopted Statement of Financial Accounting Standards (SFAS) No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51 (SFAS No. 160) on January 1, 2009. Accordingly, for consolidated subsidiaries that are less than wholly owned, the third-party holdings of equity interests are referred to as non-controlling interests. The portion of net income attributable to non-controlling interests for such subsidiaries is presented as Net income (loss) applicable to non-controlling interests on the condensed consolidated statements of income, and the portion of the shareholders equity of such subsidiaries is presented as Non-controlling interests on the condensed consolidated statements of financial condition and condensed consolidated statements of changes in total equity.

For entities where (1) the total equity investment at risk is sufficient to enable the entity to finance its activities independently and (2) the equity holders bear the economic residual risks of the entity and have the right to make decisions about the entity s activities, the Company consolidates those entities it controls through a majority voting interest or otherwise. For entities that do not meet these criteria, commonly known as VIEs, the Company consolidates those entities where the Company is deemed to be the primary beneficiary when it absorbs a majority of the expected losses or a majority of the expected residual returns, or both, of such entities.

Notwithstanding the above, certain securitization vehicles, commonly known as qualifying special purpose entities (QSPEs), are not consolidated by the Company if they meet certain criteria regarding the types of assets and derivatives they may hold, the types of sales they may engage in and the range of discretion they may exercise in connection with the assets they hold (see Note 5).

For investments in entities in which the Company does not have a controlling financial interest but has significant influence over operating and financial decisions, the Company generally applies the equity method of accounting with net gains and losses recorded within Other revenues. Where the Company has elected to measure certain eligible investments at fair value in accordance with the fair value option net gains and losses are recorded within Principal transactions investments (see Note 3).

Equity and partnership interests held by entities qualifying for accounting purposes as investment companies are carried at fair value.

The Company s significant U.S. and international subsidiaries include Morgan Stanley & Co. Incorporated (MS&Co.), Morgan Stanley & Co. International plc (MSIP), Morgan Stanley Japan Securities Co., Ltd. (MSJS), Morgan Stanley Investment Advisors Inc. and MSSB.

Income Statement Presentation. The Company, through its subsidiaries and affiliates, provides a wide variety of products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. In connection with the delivery of the various products and services to clients, the Company manages its revenues and related expenses in the aggregate. As such, when assessing the performance of its businesses, the Company considers its principal trading, investment banking, commissions, and interest and dividend income, along with the associated interest expense, as one integrated activity for each of the Company s separate businesses.

Revenue Recognition.

Investment Banking. Underwriting revenues and advisory fees from mergers, acquisitions and restructuring transactions are recorded when services for the transactions are determined to be completed, generally as set forth under the terms of the engagement. Transaction-related expenses, primarily consisting of legal, travel and other costs directly associated with the transaction, are deferred and recognized in the same period as the related

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

investment banking transaction revenue. Underwriting revenues are presented net of related expenses. Non-reimbursed expenses associated with advisory transactions are recorded within Non-interest expenses.

Commissions. The Company generates commissions from executing and clearing customer transactions on stock, options and futures markets. Commission revenues are recognized in the accounts on trade date.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees are recognized over the relevant contract period. Sales commissions paid by the Company in connection with the sale of certain classes of shares of its open-end mutual fund products are accounted for as deferred commission assets. The Company periodically tests the deferred commission assets for recoverability based on cash flows expected to be received in future periods. In certain management fee arrangements, the Company is entitled to receive performance-based fees (also referred to as incentive fees) when the return on assets under management exceeds certain benchmark returns or other performance targets. In such arrangements, performance fee revenue is accrued (or reversed) quarterly based on measuring account/fund performance to date versus the performance benchmark stated in the investment management agreement. Performance-based fees are recorded within Principal transactions investment revenues or Asset management, distribution and administration fees depending on the nature of the arrangement.

Financial Instruments and Fair Value.

A significant portion of the Company s financial instruments is carried at fair value with changes in fair value recognized in earnings each period. A description of the Company s policies regarding fair value measurement and its application to these financial instruments follows.

Financial Instruments Measured at Fair Value. All of the instruments within Financial instruments owned and Financial instruments sold, not yet purchased, are measured at fair value, either through the fair value option election (discussed below) or as required by other accounting pronouncements. These financial instruments primarily represent the Company s trading and investment activities and include both cash and derivative products. In addition, Securities received as collateral and Obligation to return securities received as collateral are measured at fair value as required by other accounting pronouncements. Additionally, certain Commercial paper and other short-term borrowings (primarily structured notes), certain Deposits, Other secured financings and certain Long-term borrowings (primarily structured notes and certain junior subordinated debentures) are measured at fair value through the fair value option election.

Gains and losses on all of these financial instruments carried at fair value are reflected in Principal transactions trading revenues, Principal transactions investment revenues or Investment banking revenues in the condensed consolidated statements of income, except for derivatives accounted for as hedges (see Hedge Accounting section herein and Note 8). Interest income and expense and dividend income are recorded within the condensed consolidated statements of income depending on the nature of the instrument and related market conventions.
When interest and dividends are included as a component of the instruments fair value, interest and dividends are included within Principal transactions trading revenues or Principal transactions investment revenues. Otherwise, they are included within Interest and dividend income or Interest expense. The fair value of over-the-counter (OTC) financial instruments, including derivative contracts related to financial instruments and commodities, is presented in the accompanying condensed consolidated statements of financial condition on a net-by-counterparty basis, when appropriate. Additionally, the Company nets fair value of cash collateral paid or received against fair value amounts recognized for net derivative positions executed with the same counterparty under the same master netting arrangement.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Fair Value Option. The fair value option permits the irrevocable fair value option election on an instrument-by-instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. The Company applies the fair value option for eligible instruments, including certain loans and lending commitments, certain equity method investments, certain structured notes, certain junior subordinated debentures, certain time deposits and certain other secured financings.

Fair Value Measurement Definition and Hierarchy. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (*i.e.*, the exit price) in an orderly transaction between market participants at the measurement date.

In determining fair value, the Company uses various valuation approaches and establishes a hierarchy for inputs used in measuring fair value that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company s assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the observability of inputs as follows:

Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Valuation adjustments and block discounts are not applied to Level 1 instruments. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgment.

Level 2 Valuations based on one or more quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

The availability of observable inputs can vary from product to product and is affected by a wide variety of factors, including, for example, the type of product, whether the product is new and not yet established in the marketplace, the liquidity of markets and other characteristics particular to the transaction. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. Accordingly, the degree of judgment exercised by the Company in determining fair value is greatest for instruments categorized in Level 3.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market dislocation. In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3 (see Note 3). In addition, a downturn in market conditions could lead to further declines in the valuation of many instruments.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, for disclosure purposes the level in the fair value hierarchy within which the fair value measurement falls in its entirety is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

Valuation Techniques. Many cash and OTC contracts have bid and ask prices that can be observed in the marketplace. Bid prices reflect the highest price that a party is willing to pay for an asset. Ask prices represent the lowest price that a party is willing to accept for an asset. For financial instruments whose inputs are based on

11

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

bid-ask prices, the Company does not require that the fair value estimate always be a predetermined point in the bid-ask range. The Company s policy is to allow for mid-market pricing and adjusting to the point within the bid-ask range that meets the Company s best estimate of fair value. For offsetting positions in the same financial instrument, the same price within the bid-ask spread is used to measure both the long and short positions.

Fair value for many cash and OTC contracts is derived using pricing models. Pricing models take into account the contract terms (including maturity) as well as multiple inputs, including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, option volatility and currency rates. Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality and model uncertainty. Credit valuation adjustments are applied to both cash instruments and OTC derivatives. For cash instruments, the impact of changes in the Company s own credit spreads is considered when measuring the fair value of liabilities and the impact of changes in the counterparty s credit spreads is considered when measuring the fair value of assets. For OTC derivatives, the impact of changes in both the Company s and the counterparty s credit standing is considered when measuring fair value. In determining the expected exposure, the Company considers collateral held and legally enforceable master netting agreements that mitigate the Company s exposure to each counterparty. All valuation adjustments are subject to judgment, are applied on a consistent basis and are based upon observable inputs where available. The Company generally subjects all valuations and models to a review process initially and on a periodic basis thereafter.

Fair value is a market-based measure considered from the perspective of a market participant rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, the Company s own assumptions are set to reflect those that the Company believes market participants would use in pricing the asset or liability at the measurement date.

See Note 3 for a description of valuation techniques applied to the major categories of financial instruments measured at fair value.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis. Certain of the Company s assets are measured at fair value on a non-recurring basis. The Company incurs impairment charges for any writedowns of these assets to fair value. A downturn in market conditions could result in impairment charges in future periods.

For assets and liabilities measured at fair value on a non-recurring basis, fair value is determined by using various valuation approaches. The same hierarchy as described above, which maximizes the use of observable inputs and minimizes the use of unobservable inputs by generally requiring that the observable inputs be used when available, is used in measuring fair value for these items.

For further information on financial assets and liabilities that are measured at fair value on a recurring and non-recurring basis, see Note 3.

Hedge Accounting.

The Company applies hedge accounting using various derivative financial instruments and non-U.S. dollar-denominated debt used to hedge interest rate and foreign exchange risk arising from assets and liabilities not held at fair value as part of asset and liability management. These derivative financial instruments are included within Financial instruments owned Derivative and other contracts or Financial instruments sold, not yet purchased Derivative and other contracts in the condensed consolidated statements of financial condition.

The Company s hedges are designated and qualify for accounting purposes as one of the following types of hedges: hedges of changes in fair value of assets and liabilities due to the risk being hedged (fair value hedges),

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

and hedges of net investments in foreign operations whose functional currency is different from the reporting currency of the parent company (net investment hedges).

For further information on derivative instruments and hedging activities, see Note 8.

Condensed Consolidated Statements of Cash Flows.

For purposes of the condensed consolidated statements of cash flows, cash and cash equivalents consist of Cash and due from banks and Interest bearing deposits with banks, which are highly liquid investments with original maturities of three months or less and readily convertible to known amounts of cash. The Company s significant non-cash activities include assets acquired of $10.5 billion and assumed liabilities, in connection with business acquisitions, of $3.2 billion in the six month period ended June 30, 2009. The six month period ended June 30, 2008 included assumed liabilities of $77 million. During the quarter ended June 30, 2008, the Company consolidated real estate limited partnership assets and liabilities of approximately $4.6 billion and $3.8 billion, respectively.

Securitization Activities.

The Company engages in securitization activities related to commercial and residential mortgage loans, corporate bonds and loans, U.S. agency collateralized mortgage obligations and other types of financial assets (see Note 5). Generally, such transfers of financial assets are accounted for as sales when the Company has relinquished control over the transferred assets. The gain or loss on sale of such financial assets depends, in part, on the previous carrying amount of the assets involved in the transfer allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale. Transfers that are not accounted for as sales are treated as secured financings (failed sales).

Earnings per Common Share.

Basic earnings per common share (EPS) is computed by dividing income available to Morgan Stanley common shareholders by the weighted average number of common shares outstanding for the period. Income available to Morgan Stanley common shareholders represents net income applicable to Morgan Stanley reduced by preferred stock dividends, amortization and the acceleration of discounts on preferred stock issued and allocations of earnings to participating securities. Common shares outstanding include common stock and vested restricted stock unit awards where recipients have satisfied either the explicit vesting terms or retirement-eligible requirements. Diluted EPS reflects the assumed conversion of all dilutive securities.

Effective October 13, 2008, as a result of the adjustment to Equity Units sold to a wholly owned subsidiary of China Investment Corporation Ltd. (CIC) (see Note 11), the Company calculates EPS in accordance with accounting guidance for determining EPS for participating securities. The accounting guidance for participating securities and the two-class method of calculating EPS addresses the computation of EPS by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company along with common shareholders according to a predetermined formula. The two-class method requires the Company to present EPS as if all of the earnings for the period are distributed to Morgan Stanley common shareholders and any participating securities, regardless of whether any actual dividends or distributions are made. The amount allocated to the participating securities is based upon the contractual terms of their respective contract and is reflected as a reduction to Net income applicable to Morgan Stanley common shareholders for both the Company s basic and diluted EPS calculations (see Note 12). The two-class method does not impact the Company s actual net income applicable to Morgan Stanley or other financial results. Unless contractually required by the terms of the participating securities, no losses are allocated to participating securities for purposes of the EPS calculation under the two-class method.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

In June 2008, the FASB issued accounting guidance on whether share-based payment transactions are participating securities. This accounting guidance addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing EPS under the two-class method as described in the accounting guidance for calculating EPS. Under this accounting guidance, unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of EPS pursuant to the two-class method. The accounting guidance on whether share-based payment transactions are participating securities became effective for the Company on January 1, 2009. All prior-period EPS data presented have been adjusted retrospectively. The adoption of FASB Staff Position Emerging Issues Task Force (FSP EITF) 03-6-1 reduced basic EPS by $0.07 and $0.15 for the quarter and six month period ended June 30, 2008, respectively, and reduced diluted EPS by $0.04 and $0.10 for the quarter and six month period ended June 30, 2008, respectively.

Goodwill and Intangible Assets.

Goodwill and indefinite-lived intangible assets are not amortized and are reviewed annually (or more frequently when certain events or circumstances exist) for impairment. Other intangible assets are amortized over their estimated useful lives and reviewed for impairment.

Deferred Compensation Arrangements.

Deferred Compensation Plans. The Company also maintains various deferred compensation plans for the benefit of certain employees that provide a return to the participating employees based upon the performance of various referenced investments. The Company often invests directly, as a principal, in such referenced investments related to its obligations to perform under the deferred compensation plans. Changes in value of such investments made by the Company are recorded primarily in Principal transactions Investments. Expenses associated with the related deferred compensation plans are recorded in Compensation and benefits.

Accounting Developments.

Dividends on Share-Based Payment Awards. In June 2007, the EITF reached consensus on Issue No. 06-11, Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards (EITF No. 06-11). EITF No. 06-11 requires that the tax benefit related to dividend equivalents paid on restricted stock units that are expected to vest be recorded as an increase to additional paid-in capital. The Company adopted EITF No. 06-11 prospectively effective December 1, 2008. The Company previously accounted for this tax benefit as a reduction to its income tax provision. The adoption of EITF No. 06-11 did not have a material impact on the Company s condensed consolidated financial statements.

Transfers of Financial Assets and Repurchase Financing Transactions. In February 2008, the FASB issued FSP Financial Accounting Standards (FAS) 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP FAS No. 140-3). The objective of FSP FAS No. 140-3 is to provide implementation guidance on accounting for a transfer of a financial asset and repurchase financing. Under the guidance in FSP FAS No. 140-3, there is a presumption that an initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement (*i.e.,* a linked transaction) for purposes of evaluation under SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (SFAS No. 140). If certain criteria are met, however, the initial transfer and repurchase financing shall not be evaluated as a linked transaction and shall be evaluated separately under SFAS No. 140. The adoption of FSP FAS 140-3 on December 1, 2008 did not have a material impact on the Company s condensed consolidated financial statements.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Determination of the Useful Life of Intangible Assets. In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP FAS 142-3). FSP FAS 142-3 removes the requirement of SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142) for an entity to consider, when determining the useful life of an acquired intangible asset, whether the intangible asset can be renewed without substantial cost or material modifications to the existing terms and conditions associated with the intangible asset. FSP FAS 142-3 replaced the previous useful-life assessment criteria with a requirement that an entity shall consider its own experience in renewing similar arrangements. If the entity has no relevant experience, it would consider market participant assumptions regarding renewal. The adoption of FSP FAS 142-3 on January 1, 2009 did not have a material impact on the Company s condensed consolidated financial statements.

Instruments Indexed to an Entity s Own Stock. In June 2008, the FASB ratified the consensus reached by the EITF on Issue No. 07-5, Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock (EITF No. 07-5). EITF No. 07-5 provides guidance for determining whether an equity-linked financial instrument (or embedded feature) is indexed to an entity s own stock. EITF No. 07-5 applies to any freestanding financial instrument or embedded feature that has all of the characteristics of a derivative or freestanding instrument that is potentially settled in an entity s own stock (with the exception of share-based payment awards within the scope of SFAS 123(R) Share-Based Payment). To meet the definition of indexed to own stock, an instrument s contingent exercise provisions must not be based on (a) an observable market, other than the market for the issuer s stock (if applicable), or (b) an observable index, other than an index calculated or measured solely by reference to the issuer s own operations, and the variables that could affect the settlement amount must be inputs to the fair value of a fixed-for-fixed forward or option on equity shares. The adoption of EITF No. 07-5 on January 1, 2009 did not change the classification or measurement of the Company s financial instruments.

Disclosures about Postretirement Benefit Plan Assets. In December 2008, the FASB issued FSP FAS 132(R)-1, Employers Disclosures about Postretirement Benefit Plan Assets (FSP FAS 132(R)-1). FSP FAS 132(R)-1 amends SFAS No. 132 (Revised 2003), Employers Disclosures about Pensions and Other Postretirement Benefits, to provide guidance on an employer s disclosures about plan assets of a defined benefit pension or other postretirement plan. The disclosures about plan assets required by this FSP will be effective December 31, 2009 for the Company.

Guidance and Disclosures on Fair Value Measurements. In April 2009, the FASB issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (FSP FAS 157-4) and FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments (FSP FAS 107-1 and APB 28-1).

FSP FAS 157-4 provides additional application guidance in determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms what SFAS No. 157, Fair Value Measurements states is the objective of fair value measurement to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. Specifically, it reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. The Company adopted FSP FAS 157-4 in the quarter ended June 30, 2009. The adoption did not have a material impact on the Company s condensed consolidated financial statements.

FSP FAS 107-1 and APB 28-1 amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments and APB Opinion No. 28, Interim Financial Reporting by requiring an entity to provide qualitative and

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

quantitative information on a quarterly basis about fair value estimates for any financial instruments not measured on the balance sheet at fair value. The Company adopted the disclosure requirements of FSP FAS 107-1 and APB 28-1 in the quarter ended June 30, 2009.

Subsequent Events. In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS No. 165). The objective of SFAS No. 165 is to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date that is, whether that date represents the date the financial statements were issued or were available to be issued. The Company evaluates subsequent events through the date that the Company s financial statements are issued, which is the date the Company files Quarterly Reports on Form 10-Q and its Annual Reports on Form 10-K with the Securities and Exchange Commission (SEC). The Company adopted SFAS No. 165 in the quarter ended June 30, 2009. The adoption of SFAS No. 165 did not have a material impact on the Company s condensed consolidated financial statements.

Transfers of Financial Assets and Extinguishments of Liabilities and Consolidation of Variable Interest Entities. In June 2009, the FASB issued SFAS No. 166, Accounting for Transfers of Financial Assets (SFAS No. 166), and SFAS No. 167, Amendments to FASB Interpretation No. 46(R) (SFAS No. 167), which change the way entities account for securitizations and special-purpose entities.

SFAS No. 166 amends SFAS No. 140 and will require additional disclosures about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. It eliminates the concept of a QSPE and changes the requirements for derecognizing financial assets.

SFAS No. 167 amends FASB Interpretation No. 46, as revised (FIN 46R), Consolidation of Variable Interest Entities, and changes how a reporting entity determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a reporting entity is required to consolidate another entity is based on, among other things, the other entity s purpose and design and the reporting entity s ability to direct the activities of the other entity that most significantly impact the other entity s economic performance.

The adoption of SFAS No. 166 and SFAS No. 167 may have a significant impact on the Company s condensed consolidated financial statements as the Company may be required to consolidate QSPEs to which the Company has previously sold assets. In addition, the Company may also be required to consolidate other VIEs that are not currently consolidated or de-consolidate entities currently consolidated based on an analysis under the current accounting guidance. SFAS No. 166 and SFAS No. 167 will be effective for the Company on January 1, 2010.

FASB Accounting Standards Codification™. In July 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 (SFAS No. 168). SFAS No. 168 establishes the FASB Accounting Standards Codification™ (Codification) to become the source of authoritative U.S. generally accepted accounting principles (U.S. GAAP) recognized by the FASB to be applied by nongovernmental entities. All existing accounting standard documents are superseded. All other accounting literature not included in the Codification will be considered non-authoritative. The Codification does not change current GAAP. SFAS No. 168 and the Codification are effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company plans to adopt the Codification in the quarter ended September 30,

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

2009. The Company does not expect the adoption to have a material impact on the Company s condensed consolidated financial statements. References to authoritative U.S. GAAP literature, however, in the Company s financial statements, notes thereto and Quarterly Reports on Form 10-Q and Annual Reports on Form 10-K will be updated to reflect new Codification references.

2. Morgan Stanley Smith Barney Holdings LLC.

On May 31, 2009 (the Closing Date), the Company and Citigroup Inc. (Citi) consummated the previously announced combination of the Company s Global Wealth Management Group and the businesses of Citi s Smith Barney in the U.S., Quilter in the U.K., and Smith Barney Australia (Smith Barney). In addition to the Company s contribution of respective businesses to MSSB, the Company paid Citi $2,755 million in cash. The combined businesses operate as Morgan Stanley Smith Barney Holdings LLC (MSSB), which the Company consolidates. Pursuant to the terms of the amended contribution agreement, certain businesses of Smith Barney and Morgan Stanley will be contributed to MSSB subsequent to May 31, 2009 (the delayed contribution businesses). Citi will own the delayed contribution businesses until they are transferred to MSSB and gains and losses from such businesses will be allocated to the Company s and Citi s respective share of MSSB s gains and losses.

The Company owns 51% and Citi owns 49% of MSSB, with the Company appointing four directors to the MSSB board and Citi appointing two directors. As part of the acquisition, the Company has the option (i) following the third anniversary of the Closing Date to purchase a portion of Citi s interest in MSSB representing 14% of the total outstanding MSSB interests, (ii) following the fourth anniversary of the Closing Date to purchase a portion of Citi s interest in MSSB representing an additional 15% of the total outstanding MSSB interests and (iii) following the fifth anniversary of the Closing Date to purchase the remainder of Citi s interest in MSSB. The Company may call all of Citi s interest in MSSB upon a change in control of Citi. Citi may put all of its interest in MSSB to the Company upon a change in control of the Company or following the later of the sixth anniversary of the Closing Date and the one-year anniversary of the Company s exercise of the call described in clause (ii) above. The purchase price for the call and put rights described above is the fair market value of the purchased interests determined pursuant to an appraisal process.

Pursuant to the amended contribution agreement, dated as of May 29, 2009, and the Managed Futures Contribution and Interest Purchase Agreement, dated as of July 31, 2009, Citi contributed its managed futures business and certain related proprietary trading positions to MSSB on July 31, 2009, and the Company paid Citi approximately $300 million in connection with this transfer. The Company accounted for this transaction using the acquisition method of accounting. As this acquisition was recently completed, the Company is in the process of valuing the assets acquired and liabilities assumed.

As of May 31, 2009, the Company includes MSSB in its condensed consolidated financial statements. The results of MSSB are included within the Global Wealth Management Group business segment. See Note 11 for further information on MSSB.

The Company accounted for the transaction using the acquisition method of accounting. The fair value of the total consideration transferred to Citi amounted to approximately $6,087 million and the preliminary fair value of Citi s equity in MSSB was approximately $3,973 million. The acquisition method of accounting prescribes the full goodwill method even in business combinations in which the acquirer holds less than 100% of the equity interests in the acquiree at acquisition date. Accordingly, the full fair value of Smith Barney was allocated to the fair value of assets acquired and liabilities assumed to derive the preliminary goodwill amount of approximately

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

$5,029 million, which represents synergies of combining the two businesses. The Company is still finalizing the valuation of the intangible assets and the fair value of the Company s contributed businesses into MSSB. When finalized, the amount of total consideration transferred, non-controlling interest, intangible assets and acquisition-related goodwill could change.

The following table summarizes the preliminary allocation of the purchase price to the net assets of Smith Barney as of May 31, 2009 (dollars in millions).

Total fair value of consideration transferred	$ 6,087
Total fair value of non-controlling interest	3,973
Total fair value of Smith Barney(1)	10,060
Total fair value of net assets acquired	5,031
Preliminary acquisition-related goodwill(2)	$ 5,029

(1) Total fair value of Smith Barney is inclusive of control premium.
(2) Goodwill is recorded within the Global Wealth Management business segment. The Company is currently evaluating the amount of goodwill deductible for tax purposes.

Condensed statement of assets acquired and liabilities assumed. The following table summarizes the preliminary fair values of the assets acquired and liabilities assumed as of the acquisition date. The allocation of the purchase price is preliminary and subject to further adjustment as the valuation of certain intangible assets is still in process.

	At May 31, 2009 (dollars in millions)
Assets	
Cash and due from banks	$ 895
Financial instruments owned	22
Receivables	1,891
Intangible assets	4,890
Other assets	531
Total assets acquired	$ 8,229
Liabilities	
Financial instrument sold, not yet purchased	76
Long-term borrowings	2,320
Other liabilities and accrued expenses	802
Total liabilities assumed	3,198
Net assets acquired	$ 5,031

In addition, the Company recorded a receivable of approximately $1.1 billion relating to the fair value of the Smith Barney delayed contribution businesses as of May 31, 2009 from Citi. Such amount is presented in the condensed consolidated statements of financial condition as a reduction from Non-controlling interests.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Amortizable intangible assets include the following as of May 31, 2009:

	At May 31, 2009 (dollars in millions)	Estimated useful life (in years)
Customer relationships	$ 4,000	15
Technology	411	5
Research	176	5
Intangible lease asset	24	1-10
Total	$ 4,611	

The Company also recorded an indefinite-lived intangible asset of approximately $279 million related to the Smith Barney trade name.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Pro forma condensed combined financial information

The following unaudited pro forma condensed combined financial information presents the results of operations of the Company as they may have appeared if the closing of MSSB had been completed on January 1, 2009 and January 1, 2008 (dollars in millions, except share data).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(unaudited)		(unaudited)	
Net revenues	$ 6,972	$ 8,233	$ 11,581	$ 18,135
Total non-interest expenses	7,414	7,271	12,817	14,839
(Losses) income from continuing operations before income taxes	(442)	962	(1,236)	3,296
(Benefit from) provision for income taxes	(301)	207	(984)	864
(Loss) income from continuing operations	(141)	755	(252)	2,432
Discontinued operations:				
Gain from discontinued operations	515	761	537	797
Provision for income taxes	196	296	204	310
Gain on discontinued operations	319	465	333	487
Net income (loss)	$ 178	$ 1,220	$ 81	$ 2,919
Net (loss) income applicable to non-controlling interests	$ (19)	$ 65	$ (4)	$ 122
Net income (loss) applicable to Morgan Stanley	$ 197	$ 1,155	$ 85	$ 2,797
Earnings (losses) applicable to Morgan Stanley common shareholders	$ (1,208)	$ 1,074	$ (1,721)	$ 2,601
Amounts applicable to Morgan Stanley:				
(Losses) income from continuing operations	$ (111)	$ 701	$ (232)	$ 2,325
Net gain from discontinued operations after tax	308	454	317	472
Net income (loss) applicable to Morgan Stanley	$ 197	$ 1,155	$ 85	$ 2,797
(Losses) earnings per basic common share:				
(Loss) income from continuing operations	$ (1.33)	$ 0.62	$ (1.90)	$ 2.08
Gain on discontinued operations	0.27	0.41	0.29	0.43
(Loss) earnings per basic common share	$ (1.06)	$ 1.03	$ (1.61)	$ 2.51
(Losses) earnings per diluted common share:				
(Loss) income from continuing operations	$ (1.33)	$ 0.62	$ (1.90)	$ 2.07

Gain on discontinued operations	0.27	0.41	0.29	0.43
(Losses) earnings per diluted common share	$ (1.06)	$ 1.03	$ (1.61)	$ 2.50

The unaudited pro forma condensed combined financial information is presented for illustrative purposes only and does not indicate the actual financial results of the Company had the closing of MSSB been completed, nor is it indicative of the results of operations in future periods. Included in the unaudited pro forma combined financial information for the quarters and six month periods ended June 30, 2009 and June 30, 2008, were pro forma adjustments to reflect the results of operations of Smith Barney as well as the impact of amortizing certain purchase accounting adjustments such as intangible assets. The pro forma condensed financial information does not indicate the impact of possible business model changes nor does it consider any potential impacts of current market conditions, expense efficiencies or other factors.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

3. Fair Value Disclosures.

Fair Value Measurements.

A description of the valuation techniques applied to the Company s major categories of assets and liabilities measured at fair value on a recurring basis follows.

Financial Instruments Owned and Financial Instruments Sold, Not Yet Purchased

U.S. Government and Agency Securities

U.S. Treasury Securities. U.S. treasury securities are valued using quoted market prices. Valuation adjustments are not applied. Accordingly, U.S. treasury securities are generally categorized in Level 1 of the fair value hierarchy.

U.S. Agency Securities. U.S. agency securities are comprised of two main categories consisting of agency issued debt and mortgage pass-throughs. Non-callable agency issued debt securities are generally valued using quoted market prices. Callable agency issued debt securities are valued by benchmarking model-derived prices to quoted market prices and trade data for identical or comparable securities. Mortgage pass-throughs include certain To-be-announced (TBA) securities and mortgage pass-through pools. TBA securities are generally valued using quoted market prices or are benchmarked thereto. Fair value of mortgage pass-through pools are model driven with respect to spreads of the comparable TBA security. Actively traded non-callable agency issued debt securities and TBA securities are categorized in Level 1 of the fair value hierarchy. Callable agency issued debt securities and mortgage pass-through certificates are generally categorized in Level 2 of the fair value hierarchy.

Other Sovereign Government Obligations

Foreign sovereign government obligations are valued using quoted prices in active markets when available. To the extent quoted prices are not available, fair value is determined based on a valuation model that has as inputs interest rate yield curves, cross-currency basis index spreads, and country credit spreads for structures similar to the bond in terms of issuer, maturity and seniority. These bonds are generally categorized in Levels 1 or 2 of the fair value hierarchy.

Corporate and Other Debt

State and Municipal Securities. The fair value of state and municipal securities is estimated using recently executed transactions, market price quotations and pricing models that factor in, where applicable, interest rates, bond or credit default swap spreads and volatility. These bonds are generally categorized in Level 2 of the fair value hierarchy.

Residential Mortgage-Backed Securities (RMBS), Commercial Mortgage-Backed Securities (CMBS), and other Asset-Backed Securities (ABS). RMBS, CMBS and other ABS may be valued based on external price or spread data. When position-specific external price data are not observable, the valuation is based on prices of comparable bonds. Valuation levels of RMBS and CMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions.

Fair value for retained interests in securitized financial assets (in the form of one or more tranches of the securitization) is determined using observable prices or, in cases where observable prices are not available for certain retained interests, the Company estimates fair value based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved.

RMBS, CMBS and other ABS, including retained interests in these securitized financial assets, are categorized in Level 3 if external prices or spread inputs are unobservable or if the comparability

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

assessment involves significant subjectivity related to property type differences, cash flows, performance and other inputs; otherwise, they are categorized in Level 2 of the fair value hierarchy.

Corporate Bonds. The fair value of corporate bonds is estimated using recently executed transactions, market price quotations (where observable), bond spreads or credit default swap spreads adjusted for any basis difference between cash and derivative instruments. The spread data used are for the same maturity as the bond. If the spread data does not reference the issuer, then data that reference a comparable issuer are used. When observable price quotations are not available, fair value is determined based on cash flow models with yield curves, bond or single name credit default swap spreads and recovery rates based on collateral values as significant inputs. Corporate bonds are generally categorized in Level 2 of the fair value hierarchy; in instances where prices, spreads or any of the other aforementioned key inputs are unobservable, they are categorized in Level 3 of the hierarchy.

Collateralized Debt Obligations (CDOs). The Company holds CDOs where the collateral primarily is synthetic and references either a basket credit default swap or CDO-squared. The correlation input between reference credits within the collateral is unobservable and is benchmarked to standardized proxy baskets for which correlation data are available. The other model inputs such as credit spreads, interest rates and recovery rates are observable. CDOs are categorized in Level 2 of the fair value hierarchy when the correlation input is insignificant. In instances where the correlation input is deemed to be significant, these instruments are categorized in Level 3 of the fair value hierarchy.

Corporate Loans and Lending Commitments. The fair value of corporate loans is estimated using recently executed transactions, market price quotations (where observable) and market observable credit default swap spread levels adjusted for any basis difference between cash and derivative instruments, along with proprietary valuation models and default recovery analysis where such transactions and quotations are unobservable. The fair value of contingent corporate lending commitments is estimated by using executed transactions on comparable loans and the anticipated market price based on pricing indications from syndicate banks and customers. The valuation of these commitments also takes into account certain fee income. Corporate loans and lending commitments are generally categorized in Level 2 of the fair value hierarchy; in instances where prices or significant spread inputs are unobservable, they are categorized in Level 3 of the hierarchy.

Mortgage Loans. Mortgage loans are valued using prices based on trade data for identical or comparable instruments. Where observable prices are not available, the Company estimates fair value based on benchmarking to prices and rates observed in the primary market for similar loan or borrower types, or based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved. Due to the subjectivity involved in comparability assessment related to mortgage loan vintage, geographical concentration, prepayment speed and projected loss assumptions, the majority of loans are classified in Level 3 of the fair value hierarchy.

Auction Rate Securities (ARS). The Company primarily holds investments in Student Loan Auction Rate Securities (SLARS) and Municipal Auction Rate Securities (MARS) with interest rates that are reset through periodic auctions. SLARS are ABS backed by pools of student loans. MARS are municipal bonds often wrapped by municipal bond insurance. ARS were historically traded and valued as floating rate notes, priced at par due to the auction mechanism. Beginning in fiscal 2008, uncertainties in the credit markets have resulted in auctions failing for certain types of ARS. Once the auctions failed, ARS could no longer be valued using observations of auction market prices. Accordingly, the fair value of ARS is determined using independent external market data where available and

an internally developed methodology to discount for the lack of liquidity and non-performance risk in the current market environment.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Inputs that impact the valuation of SLARS are the underlying collateral types, amount of leverage in each structure, credit rating and liquidity considerations. Inputs that impact the valuation of MARS are independent external market data, the maximum rate, quality of underlying issuers/insurers and evidence of issuer calls. MARS are generally categorized in Level 2 as the valuation technique relies on observable external data. The majority of SLARS are generally categorized in Level 3 of the fair value hierarchy.

In the fair value hierarchy tables below, SLARS are presented within ABS and MARS are presented within state and municipal securities.

Corporate Equities

Exchange-Traded Equity Securities. Exchange-traded equity securities are generally valued based on quoted prices from the exchange. To the extent these securities are actively traded, valuation adjustments are not applied and they are categorized in Level 1 of the fair value hierarchy.

Derivative and Other Contracts

Listed Derivative Contracts. Listed derivatives that are actively traded are valued based on quoted prices from the exchange and are categorized in Level 1 of the fair value hierarchy. Listed derivatives that are not actively traded are valued using the same approaches as those applied to OTC derivatives; they are generally categorized in Level 2 of the fair value hierarchy.

OTC Derivative Contracts. OTC derivative contracts include forward, swap and option contracts related to interest rates, foreign currencies, credit standing of reference entities, equity prices or commodity prices.

Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be either observed or modeled using a series of techniques, and model inputs from comparable benchmarks, including closed-form analytic formula, such as the Black-Scholes option-pricing model, and simulation models or a combination thereof. Many pricing models do not entail material subjectivity because the methodologies employed do not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets, as is the case for generic interest rate swaps, certain option contracts and certain credit default swaps. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. A substantial majority of OTC derivative products valued by the Company using pricing models fall into this category and are categorized within Level 2 of the fair value hierarchy.

Other derivative products include complex products that have become illiquid, require more judgment in the implementation of the valuation technique applied due to the complexity of the valuation assumptions and the reduced observability of inputs. This includes derivative interests in certain mortgage-related CDO securities, basket credit default swaps, CDO-squared positions and certain types of ABS credit default swaps where direct trading activity or quotes are unobservable. These instruments involve significant unobservable inputs and are categorized in Level 3 of the fair value hierarchy.

Derivative interests in complex mortgage-related CDOs and credit default swaps, for which observability of external price data is extremely limited, are valued based on an evaluation of the market and model input parameters sourced from similar positions as indicated by primary and secondary market activity. Each position is evaluated independently taking into consideration the underlying collateral performance and pricing, behavior of the tranche under various cumulative loss and prepayment scenarios, deal structures (*e.g.*, non-amortizing reference obligations, call features) and liquidity. While these factors may be supported by historical and actual external observations, the determination of their value as it relates to specific positions nevertheless requires significant judgment.

23

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

For basket credit default swaps and CDO-squared positions, the correlation input between reference credits is unobservable for each specific swap and is benchmarked to standardized proxy baskets for which correlation data are available. The other model inputs such as credit spread, interest rates and recovery rates are observable. In instances where the correlation input is deemed to be significant, these instruments are categorized in Level 3 of the fair value hierarchy.

The Company trades various derivative structures with commodity underlyings. Depending on the type of structure, the model inputs generally include interest rate yield curves, commodity underlier curves, implied volatility of the underlying commodities and, in some cases, the implied correlation between these inputs. The fair value of these products is estimated using executed trades and broker and consensus data to provide values for the aforementioned inputs. Where these inputs are unobservable, relationships to observable commodities and data points, based on historic and/or implied observations, are employed as a technique to estimate the model input values. Commodity derivatives are generally categorized in Level 2 of the fair value hierarchy; in instances where significant inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

For further information on derivative instruments and hedging activities, see Note 8.

Investments

Investments in Private Equity, Real Estate and Hedge Funds. The Company s investments include direct private equity investments and investments in private equity funds, real estate funds and hedge funds. Initially, the transaction price is generally considered by the Company as the exit price and is the Company s best estimate of fair value. Thereafter, valuation is based on an assessment of each underlying investment, considering rounds of financing and third-party transactions, expected cash flows and market-based information, including comparable company transactions, trading multiples and changes in market outlook, among other factors. In determining the fair value of externally managed funds, the Company also considers the net asset value of the fund provided by the fund manager. These nonpublic investments are included in Level 3 of the fair value hierarchy because, due to infrequent trading, exit prices tend to be unobservable and reliance is placed on the above methods.

Physical Commodities

The Company trades various physical commodities, including crude oil and refined products, natural gas, base and precious metals and agricultural products. Fair value for physical commodities is determined using observable inputs, including broker quotations and published indices. Physical commodities are categorized in Level 2 of the fair value hierarchy.

Commercial Paper and Other Short-term Borrowings/Long-Term Borrowings

Structured Notes. The Company issues structured notes that have coupons or repayment terms linked to the performance of debt or equity securities, indices, currencies or commodities. Fair value of structured notes is estimated using valuation models for the derivative and debt portions of the notes. These models incorporate observable inputs referencing identical or comparable securities, including prices that the notes are linked to, interest rate yield curves, option volatility, and currency, commodity or equity rates. The impact of the Company s own credit spreads is also included based on the Company s observed secondary bond market spreads. Most structured notes are categorized in Level 2 of the fair value hierarchy.

Deposits

Time Deposits. The fair value of certificates of deposit is estimated using third-party quotations. These deposits are categorized in Level 2 of the fair value hierarchy.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The following fair value hierarchy tables present information about the Company s assets and liabilities measured at fair value on a recurring basis as of June 30, 2009, December 31, 2008 and November 30, 2008. See Note 1 for a discussion of the Company s policies regarding this fair value hierarchy.

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of June 30, 2009

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at June 30, 2009
			(dollars in millions)		
Assets					
Financial instruments owned:					
U.S. Treasury securities	$ 14,035	$ 347	$	$	$ 14,382
U.S. agency securities	24,016	25,291	28		49,335
Total U.S. government and agency securities	38,051	25,638	28		63,717
Other sovereign government obligations	21,577	5,188	3		26,768
State and municipal securities		2,856	1,705		4,561
Residential mortgage-backed securities		2,682	820		3,502
Commercial mortgage-backed securities		1,439	1,506		2,945
Asset-backed securities		2,558	1,827		4,385
Corporate bonds		30,020	2,449		32,469
Collateralized debt obligations		1,368	508		1,876
Loans and lending commitments		13,065	19,436		32,501
Other debt		4,074	1,489		5,563
Total corporate and other debt(1)		58,062	29,740		87,802
Corporate equities(2)	37,582	3,899	1,101		42,582
Derivative and other contracts(3)	3,599	112,886	19,779	(77,892)	58,372
Investments	438	215	8,172		8,825
Physical commodities		3,343			3,343
Total financial instruments owned	101,247	209,231	58,823	(77,892)	291,409
Securities received as collateral	9,327	528	17		9,872
Intangible assets(4)			173		173
Liabilities					
Commercial paper and other short-term borrowings	$	$ 1,062	$	$	$ 1,062
Deposits		9,171			9,171
Financial instruments sold, not yet purchased:					
U.S. Treasury securities	18,877	416			19,293
U.S. agency securities	1,379	400			1,779
Total U.S. government and agency securities	20,256	816			21,072
Other sovereign government obligations	15,805	1,439			17,244
State and municipal securities		6			6
Commercial mortgage-backed securities			4		4
Asset-backed securities			4		4
Corporate bonds	16	3,281	132		3,429

Collateralized debt obligations		2			2
Unfunded lending commitments		1,170	303		1,473
Other debt		2,146	86		2,232
Total corporate and other debt	16	6,605	529		7,150
Corporate equities(2)	19,610	2,017	22		21,649
Derivative and other contracts(3)	6,297	70,896	7,173	(40,931)	43,435
Physical commodities		11			11
Total financial instruments sold, not yet purchased	61,984	81,784	7,724	(40,931)	110,561
Obligation to return securities received as collateral	9,327	528	17		9,872
Other secured financings(1)	19	5,666	4,463		10,148
Long-term borrowings		29,409	5,900		35,309

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

(1) Approximately $6.6 billion of assets is included in Corporate and other debt and approximately $5.3 billion of related liabilities is included in Other secured financings related to consolidated VIEs or non-consolidated VIEs (in the cases where the assets were transferred by the Company to the VIE and the transfers were accounted for as secured financings). The Company cannot unilaterally remove the assets from the VIEs as these assets are not generally available to the Company. The related liabilities issued by these VIEs are non-recourse to the Company. Approximately $6.1 billion of these assets and approximately $4.1 billion of these liabilities are included in Level 3 of the fair value hierarchy. See Note 5 for additional information on consolidated and non-consolidated VIEs, including retained interests in these entities that the Company holds.
(2) The Company holds or sells short for trading purposes, equity securities issued by entities in diverse industries and size.
(3) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 8.
(4) Amount represents mortgage servicing rights (MSRs) accounted for at fair value. See Note 5 for further information on MSRs.

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2008

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at December 31, 2008
			(dollars in millions)		
Assets					
Financial instruments owned:					
U.S. government and agency securities	$ 10,150	$ 17,735	$ 127	$	$ 28,012
Other sovereign government obligations	16,118	4,965	1		21,084
Corporate and other debt(1)	99	52,277	34,918		87,294
Corporate equities	37,807	3,538	976		42,321
Derivative and other contracts(2)	1,069	156,224	37,711	(105,586)	89,418
Investments	417	270	9,698		10,385
Physical commodities		2,126			2,126
Total financial instruments owned	65,660	237,135	83,431	(105,586)	280,640
Securities received as collateral	4,623	578	30		5,231
Intangible assets(3)			184		184
Liabilities					
Commercial paper and other short-term borrowings	$	$ 1,246	$	$	$ 1,246
Deposits		9,993			9,993
Financial instruments sold, not yet purchased:					
U.S. government and agency securities	11,133	769			11,902
Other sovereign government obligations	7,303	2,208			9,511
Corporate and other debt	17	6,102	3,808		9,927
Corporate equities	15,064	1,749	27		16,840
Derivative and other contracts(2)	3,886	118,432	14,329	(68,093)	68,554
Physical commodities		33			33
Total financial instruments sold, not yet purchased	37,403	129,293	18,164	(68,093)	116,767

Obligation to return securities received as collateral	4,623	578	30	5,231
Other secured financings(1)		6,391	6,148	12,539
Long-term borrowings		25,293	5,473	30,766

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

(1) Approximately $8.9 billion of assets is included in Corporate and other debt and approximately $7.9 billion of related liabilities is included in Other secured financings related to consolidated VIEs or non-consolidated VIEs (in the cases where the assets were transferred by the Company to the VIE and the transfers were accounted for as secured financings). The Company cannot unilaterally remove the assets from the VIEs; these assets are not generally available to the Company. The related liabilities issued by these VIEs are non-recourse to the Company. Approximately $8.1 billion of these assets and approximately $5.9 billion of these liabilities are included in Level 3 of the fair value hierarchy. See Note 5 for additional information on consolidated and non-consolidated VIEs, including retained interests in these entities that the Company holds.

(2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 8.

(3) Amount represents MSRs accounted for at fair value. See Note 5 for further information on MSRs.

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of November 30, 2008

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at November 30, 2008
			(dollars in millions)		
Assets					
Financial instruments owned:					
U.S. government and agency securities	$ 5,930	$ 14,115	$ 206	$	$ 20,251
Other sovereign government obligations	9,148	10,920	3		20,071
Corporate and other debt(1)	47	53,977	34,460		88,484
Corporate equities	32,519	3,748	907		37,174
Derivative and other contracts(2)	2,478	150,033	40,852	(93,597)	99,766
Investments	536	330	9,732		10,598
Physical commodities	2	2,202			2,204
Total financial instruments owned	50,660	235,325	86,160	(93,597)	278,548
Securities received as collateral	4,402	800	15		5,217
Intangible assets(3)			220		220
Liabilities					
Commercial paper and other short-term borrowings	$	$ 1,412	$	$	$ 1,412
Deposits		6,008			6,008
Financial instruments sold, not yet purchased:					
U.S. government and agency securities	9,474	682			10,156
Other sovereign government obligations	5,140	4,220			9,360
Corporate and other debt	18	5,400	3,943		9,361
Corporate equities	16,418	108	21		16,547
Derivative and other contracts(2)	5,509	115,621	13,228	(60,837)	73,521
Total financial instruments sold, not yet purchased	36,559	126,031	17,192	(60,837)	118,945
Obligation to return securities received as collateral	4,402	800	15		5,217
Other secured financings(1)		6,780	5,747		12,527
Long-term borrowings		23,413	5,417		28,830

(1) Approximately $9.0 billion of assets is included in Corporate and other debt and approximately $7.2 billion of related liabilities is included in Other secured financings related to consolidated VIEs or non-consolidated VIEs (in the cases where the assets were

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

transferred by the Company to the VIE and the transfers were accounted for as secured financings). The Company cannot unilaterally remove the assets from the VIEs; these assets are not generally available to the Company. The related liabilities issued by these VIEs are non-recourse to the Company. Approximately $7.7 billion of these assets and approximately $5.0 billion of these liabilities are included in Level 3 of the fair value hierarchy. See Note 5 for additional information on consolidated and non-consolidated VIEs, including retained interests in these entities that the Company holds.

(2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 8.

(3) Amount represents MSRs accounted for at fair value. See Note 5 for further information on MSRs.

The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the quarters and six month periods ended June 30, 2009 and June 30, 2008. Level 3 instruments may be offset with instruments classified in Level 1 and Level 2. As a result, the realized and unrealized gains or (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realized and unrealized gains or (losses) on hedging instruments that have been classified by the Company within the Level 1 and/or Level 2 categories. Additionally, both observable and unobservable inputs may be used to determine the fair value of positions that the Company has classified within the Level 3 category. As a result, the unrealized gains or (losses) during the period for assets and liabilities within the Level 3 category presented in the tables below may include changes in fair value during the period that were attributable to both observable (*e.g.*, changes in market interest rates) and unobservable (*e.g.*, changes in unobservable long-dated volatilities) inputs.

The following tables reflect gains or (losses) for all assets and liabilities categorized as Level 3 for the quarters and six month periods ended June 30, 2009 and June 30, 2008, respectively. For assets and liabilities that were transferred into Level 3 during the period, gains or (losses) are presented as if the assets or liabilities had been transferred into Level 3 as of the beginning of the period; similarly, for assets and liabilities that were transferred out of Level 3 during the period, gains or (losses) are presented as if the assets or liabilities had been transferred out as of the beginning of the period.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended June 30, 2009

	Beginning Balance at March 31, 2009	Total Realized and Unrealized Gains or (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at June 30, 2009	Unrealized Gains or (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2009(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. agency securities	$ 17	$ (1)	$ 12	$	$ 28	$
Other sovereign government obligations	2			1	3	
State and municipal securities	1,887	25	(207)		1,705	(7)
Residential mortgage-backed securities	988	(16)	(41)	(111)	820	(15)
Commercial mortgage-backed securities	2,443	(215)	(680)	(42)	1,506	(204)
Asset-backed securities	4,519	108	(2,961)	161	1,827	30
Corporate bonds	2,370	(39)	161	(43)	2,449	(180)
Collateralized debt obligations	972	88	(236)	(316)	508	49
Loans and lending commitments	17,108	630	48	1,650	19,436	570
Other debt	1,201	256	33	(1)	1,489	245
Total corporate and other debt	31,488	837	(3,883)	1,298	29,740	488
Corporate equities	946	366	(302)	91	1,101	(172)
Net derivative and other contracts(3)	16,521	(3,510)	(1,098)	693	12,606	(3,101)
Investments	8,834	(166)	(487)	(9)	8,172	(97)
Securities received as collateral	3		14		17	
Intangible assets	159	14			173	13
Liabilities						
Financial instruments sold, not yet purchased:						
Commercial mortgage-backed securities	$ 4	$	$	$	$ 4	$
Asset-backed securities	1,636	109	(1,523)		4	108
Corporate bonds	58	(11)	63		132	(9)
Collateralized debt obligations	16	1	(15)			
Unfunded lending commitments	208	(134)	(37)	(2)	303	(128)
Other debt	28	(4)	54		86	(1)
Total corporate and other debt	1,950	(39)	(1,458)	(2)	529	(30)
Corporate equities	74	(26)	(83)	5	22	(12)
Obligation to return securities received as collateral	3		14		17	
Other secured financings	4,264	52	20	231	4,463	52
Long-term borrowings	5,671	(224)	1	4	5,900	(224)

(1) Total realized and unrealized gains or (losses) are primarily included in Principal transactions trading in the condensed consolidated statements of income except for $(166) million related to Financial instruments owned investments, which is included in Principal transactions investments.
(2) Amounts represent unrealized gains or (losses) for the quarter ended June 30, 2009 related to assets and liabilities still outstanding at June 30, 2009.
(3) Net derivative and other contracts represent Financial instruments owned derivative and other contracts net of Financial instruments sold, not yet purchased derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 8.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Financial instruments owned Corporate and other debt. The net gains in Corporate and other debt were primarily driven by corporate loans.

During the quarter ended June 30, 2009, the Company reclassified approximately $1.3 billion of certain Corporate and other debt from Level 2 to Level 3. The reclassifications were primarily related to certain corporate loans. The reclassifications were due to a reduction in market price quotations for these or comparable instruments, or a lack of available broker quotes, such that unobservable inputs had to be utilized for the fair value measurement of these instruments. The key unobservable inputs include assumptions to establish comparability to bonds, loans or swaps with observable price/spread levels.

Financial instruments owned Net derivative and other contracts. The net losses in Net derivative and other contracts were primarily driven by tightening of credit spreads on underlying reference entities of single name and basket credit default swaps.

During the quarter ended June 30, 2009, the Company reclassified approximately $700 million of certain Derivatives and other contracts from Level 2 to Level 3. These reclassifications of certain Derivatives and other contracts were related to interest rate swaps and bespoke basket default swaps, for which some inputs were unobservable and deemed significant.

Financial instruments owned Investments. The net losses from investments were primarily related to investments associated with the Company s real estate products.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended June 30, 2008

	Beginning Balance at March 31, 2008	Total Realized and Unrealized Gains or (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at June 30, 2008	Unrealized Gains or (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2008(2)
			(dollars in millions)			
Assets						
Financial instruments owned:						
U.S. government and agency securities	$ 438	$ (37)	$ (91)	$ (38)	$ 272	$ (27)
Other sovereign government obligations	25	(2)	(18)	(3)	2	
Corporate and other debt	38,241	(1,527)	(4,113)	1,438	34,039	(1,809)
Corporate equities	1,547	(2)	(98)	(159)	1,288	(14)
Net derivative and other contracts(3)	12,749	(272)	2,791	885	16,153	(121)
Investments	11,866	(137)	609	148	12,486	(189)
Securities received as collateral	27		(25)		2	
Intangible assets	4				4	
Liabilities						
Financial instruments sold, not yet purchased:						
Corporate and other debt	$ 908	$ 221	$ 472	$ 50	$ 1,209	$ 274
Corporate equities	514	(184)	(405)	(232)	61	(182)
Obligation to return securities received as collateral	27		(25)		2	
Other secured financings	7,241	977	1,684	1,169	9,117	977
Long-term borrowings	5,834	100	(60)		5,674	97

(1) Total realized and unrealized gains or (losses) are primarily included in Principal transactions trading in the condensed consolidated statements of income except for $(137) million related to Financial instruments owned investments, which is included in Principal transactions investments.
(2) Amounts represent unrealized gains or (losses) for the quarter ended June 30, 2008 related to assets and liabilities still outstanding at June 30, 2008.
(3) Net derivative and other contracts represent Financial instruments owned derivative and other contracts net of Financial instruments sold, not yet purchased derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 8.

Financial instruments owned Corporate and other debt. The net losses from Corporate and other debt were primarily driven by certain mortgage-related products.

The sales of Corporate and other debt were primarily related to whole loans and CMBS.

During the quarter ended June 30, 2008, the Company reclassified certain Corporate and other debt from Level 2 to Level 3 because certain significant inputs for the fair value measurement became unobservable. These reclassifications included transfers primarily related to certain mortgage-related products and corporate loans and lending commitments.

Financial instruments owned Net derivative and other contracts. The Company reclassified certain OTC derivatives from Level 2 to Level 3. The reclassifications primarily related to tranche-indexed credit default swaps. The reclassifications were due to a reduction in the availability of transaction data and broker quotes.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Six Months Ended June 30, 2009

	Beginning Balance at December 31, 2008	Total Realized and Unrealized Gains or (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at June 30, 2009	Unrealized Gains or (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2009(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. agency securities	$ 127	$ (3)	$ (73)	$ (23)	$ 28	$
Other sovereign government obligations	1	2	(4)	4	3	(2)
State and municipal securities	2,065	3	(289)	(74)	1,705	(8)
Residential mortgage-backed securities	1,251	(93)	(156)	(182)	820	(111)
Commercial mortgage-backed securities	3,130	(609)	(1,035)	20	1,506	(634)
Asset-backed securities	968	(42)	505	396	1,827	(85)
Corporate bonds	3,088	(318)	(74)	(247)	2,449	(508)
Collateralized debt obligations	982	(21)	(202)	(251)	508	(66)
Loans and lending commitments	19,701	(1,898)	533	1,100	19,436	(1,786)
Other debt	3,733	340	(927)	(1,657)	1,489	292
Total corporate and other debt	34,918	(2,638)	(1,645)	(895)	29,740	(2,906)
Corporate equities	976	332	(365)	158	1,101	(201)
Net derivative and other contracts(3)	23,382	(2,346)	100	(8,530)	12,606	229
Investments	9,698	(1,484)	13	(55)	8,172	(1,372)
Securities received as collateral	30		(13)		17	
Intangible assets	184	(12)	1		173	13
Liabilities						
Financial instruments sold, not yet purchased:						
Commercial mortgage-backed securities	$ 1	$ 1	$ 4	$	$ 4	$ 1
Asset-backed securities	4	1	1		4	
Corporate bonds	320	(9)	(101)	(96)	132	(9)
Unfunded lending commitments	36	(131)	136		303	(131)
Other debt	3,447	1	(935)	(2,425)	86	2
Total corporate and other debt	3,808	(137)	(895)	(2,521)	529	(137)
Corporate equities	27	(8)	(5)	(8)	22	(8)
Obligation to return securities received as collateral	30		(13)		17	
Other secured financings	6,148	1,143	(628)	86	4,463	1,143
Long-term borrowings	5,473	(337)	83	7	5,900	(354)

(1) Total realized and unrealized gains or (losses) are primarily included in Principal transactions trading in the condensed consolidated statements of income except for $(1,484) million related to Financial instruments owned investments, which is included in Principal transactions investments.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

(2) Amounts represent unrealized gains or (losses) for the quarter ended June 30, 2009 related to assets and liabilities still outstanding at June 30, 2009.
(3) Net derivative and other contracts represent Financial instruments owned derivative and other contracts net of Financial instruments sold, not yet purchased derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 8.

Financial instruments owned Corporate and other debt. The net losses in Corporate and other debt were primarily driven by certain corporate loans and lending commitments and certain commercial mortgage-backed securities.

During the six month period ended June 30, 2009, the Company reclassified approximately $0.9 billion of certain Corporate and other debt from Level 3 to Level 2. The reclassifications were primarily related to certain other debt. Their fair value was highly correlated with similar instruments in an observable market and, due to market deterioration, unobservable inputs were no longer deemed significant. These reclassifications were partly offset by the reclassification of certain corporate loans from Level 2 to Level 3. The reclassifications were due to a reduction in market price quotations for these or comparable instruments, or a lack of available broker quotes, such that unobservable inputs had to be utilized for the fair value measurement of these instruments. The key unobservable inputs include assumptions to establish comparability to bonds, loans or swaps with observable price/spread levels.

Financial instruments owned Net derivative and other contracts. The net losses in Net derivative and other contracts were primarily driven by tightening of credit spreads on underlying reference entities of single name and basket credit default swaps.

During the six month period ended June 30, 2009, the Company reclassified approximately $8.5 billion of certain Derivatives and other contracts from Level 3 to Level 2. These reclassifications of certain Derivatives and other contracts were related to single name mortgage-related credit default swaps and credit default swaps on certain classes of CDOs. The primary reason for the reclassifications is that, due to market deterioration, the values associated with the unobservable inputs, such as correlation, for these derivative contracts were no longer deemed significant to the fair value measurement. In addition, certain corporate tranche-indexed credit default swaps were reclassified due to increased availability of transaction data, broker quotes and/or consensus pricing.

Financial instruments owned Investments. The net losses from investments were primarily related to investments associated with the Company s real estate products.

Financial instruments sold, not yet purchased Corporate and other debt. During the six month period ended June 30, 2009, the Company reclassified approximately $2.5 billion of certain Corporate and other debt from Level 3 to Level 2. These reclassifications primarily related to contracts referencing commercial mortgage-backed securities, subprime CDO and other subprime ABS securities. Their fair value was highly correlated with similar instruments in an observable market and, due to market deterioration, the values associated with the unobservable inputs were no longer deemed significant to the fair value measurement.

Other secured financings. The net gains in Other secured financings were primarily due to net gains on liabilities resulting from securitizations recognized on balance sheet. These net gains were offset by net losses in Financial instruments owned Corporate and other debt.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Six Months Ended June 30, 2008

	Beginning Balance at December 31, 2007	Total Realized and Unrealized Gains or (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at June 30, 2008	Unrealized Gains or (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2008(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. government and agency securities	$ 622	$ 28	$ (242)	$ (136)	$ 272	$ (3)
Other sovereign government obligations	15	(4)	(18)	9	2	
Corporate and other debt	39,707	(5,323)	(3,108)	2,763	34,039	(5,417)
Corporate equities	1,717	(170)	(370)	111	1,288	(31)
Net derivative and other contracts(3)	5,486	7,201	3,790	(324)	16,153	6,737
Investments	12,758	(374)	1,369	(1,267)	12,486	(498)
Securities received as collateral	71		(69)		2	
Intangible assets	3	1			4	1
Liabilities						
Financial instruments sold, not yet purchased:						
Corporate and other debt	$ 717	$ 5	$ 432	$ 65	$ 1,209	$ (11)
Corporate equities	175	(301)	(302)	(113)	61	(300)
Obligation to return securities received as collateral	71		(69)		2	
Other secured financings	6,160	910	3,191	676	9,117	910
Long-term borrowings	5,829	91	(64)		5,674	86

(1) Total realized and unrealized gains or (losses) are primarily included in Principal transactions trading in the condensed consolidated statements of income except for $(374) million related to Financial instruments owned investments, which is included in Principal transactions investments.
(2) Amounts represent unrealized gains or (losses) for the quarter ended June 30, 2008 related to assets and liabilities still outstanding at June 30, 2008.
(3) Net derivative and other contracts represent Financial instruments owned derivative and other contracts net of Financial instruments sold, not yet purchased derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 8.

Financial instruments owned Corporate and other debt. The net losses from Corporate and other debt were primarily driven by certain mortgage-related products and by corporate loans and lending commitments.

The sales from Corporate and other debt were primarily related to whole loans and CMBS.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

During the six month period ended June 30, 2008, the Company reclassified certain Corporate and other debt from Level 2 to Level 3 because certain significant inputs for the fair value measurement became unobservable. These reclassifications included transfers primarily related to certain mortgage-related products and corporate loans and lending commitments.

Financial instruments owned Net derivative and other contracts. The net gains from Net derivative contracts were primarily driven by certain basket and single name credit default swaps.

The purchases in Net derivative contracts were primarily driven by certain basket and single name credit default swaps.

Financial instruments owned Investments. The Company reclassified investments from Level 3 to Level 2 because certain significant inputs for the fair value measurement were identified and, therefore, became observable.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis.

Certain assets were measured at fair value on a non-recurring basis and are not included in the tables above. These assets may include certain loans, certain equity method investments, certain premises and equipment, certain intangible assets and certain real estate investments.

The following table presents, by caption on the condensed consolidated statement of financial position, the fair value hierarchy for those assets measured at fair value on a non-recurring basis for which the Company recognized an impairment charge for the quarter and six month period ended June 30, 2009.

		Fair Value Measurements Using:				
	Carrying Value at June 30, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Losses) for the Three Months Ended June 30, 2009(1)	Total (Losses) for the Six Months Ended June 30, 2009(1)
				(dollars in millions)		
Receivables Other loans(2)	$ 664	$	$	$ 664	$ (84)	$ (182)
Other investments(3)	24			24	(7)	(51)
Premises, equipment and software costs(4)	8			8		(5)
Intangible assets(5)	7			7	(3)	(9)
Other assets(6)	147			147	(36)	(161)
Total	$ 850	$	$	$ 850	$ (130)	$ (408)

(1) Impairment losses are recorded within Other expenses in the condensed consolidated statement of income except for impairment losses related to Receivables Other loans and Other investments, which are included in Other revenues.
(2) Loans held for investment and held for sale with a carrying amount of $748 million were written down to their fair value of $664 million as of June 30, 2009, resulting in an impairment charge of $84 million in the quarter ended June 30, 2009, calculated based upon the fair value of the collateral. Loans held for

investment and held for sale with a carrying amount of $846 million were written down to their fair value of $664 million as of June 30, 2009, resulting in an impairment charge of $182 million in the six month period ended June 30, 2009, calculated based upon the fair value of the collateral. The fair value of the collateral was determined using internal expected recovery models.

(3) Equity method investments with a carrying amount of $31 million were written down to their fair value of $24 million as of June 30, 2009, resulting in an impairment charge of $7 million in the quarter ended June 30, 2009. Equity method investments with a carrying amount of $75 million were written down to their fair value of $24 million as of June 30, 2009, resulting in an impairment charge of $51 million in the six month period ended June 30, 2009. Impairment losses recorded were determined primarily using discounted cash flow models.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

(4) Equipment with a carrying value of $13 million was written down to its fair value of $8 million as of June 30, 2009, resulting in an impairment charge of $5 million in the six month period ended June 30, 2009.
(5) Intangible assets other than goodwill with a carrying amount of $10 million were written down to fair value of $7 million as of June 30, 2009, resulting in an impairment charge of $3 million in the quarter ended June 30, 2009, recorded within the Asset Management business segment. Intangible assets other than goodwill with a carrying amount of $16 million were written down to fair value of $7 million as of June 30, 2009, resulting in an impairment charge of $9 million in the six month period ended June 30, 2009, recorded within the Asset Management business segment (see Note 6).
(6) Buildings and property with a carrying amount of $183 million were written down to their fair value of $147 millions of June 30, 2009, resulting in an impairment charge of $36 million in the quarter ended June 30, 2009. Buildings and property with a carrying amount of $308 million were written down to their fair value of $147 million, resulting in an impairment charge of $161 million in the six month period ended June 30, 2009. Fair values were generally determined using discounted cash flow models or third-party appraisals and valuations. This charge relates to the Asset Management business segment.

There were no liabilities measured at fair value on a non-recurring basis during the quarter and six month period ended June 30, 2009.

In addition, there were no assets or liabilities measured at fair value on a non-recurring basis for which the Company recognized an impairment charge during the quarter and six month period ended June 30, 2008.

Fair Value Option.

The Company elected the fair value option for certain eligible instruments that are risk managed on a fair value basis. The following tables present net gains or (losses) due to changes in fair value for items measured at fair value pursuant to the fair value option election for the quarters and six month periods ended June 30, 2009 and June 30, 2008.

	Principal Transactions: Trading	Net Interest Revenue	Gains (Losses) Included in Net Revenues
		(dollars in millions)	
Three Months Ended June 30, 2009			
Commercial paper and other short-term borrowings	$ (126)	$	$ (126)
Deposits	10	(87)	(77)
Long-term borrowings	(3,391)	(187)	(3,578)
Three Months Ended June 30, 2008			
Commercial paper and other short-term borrowings	$ 270	$	$ 270
Deposits	1	(5)	(4)
Long-term borrowings	576	(215)	361
Six Months Ended June 30, 2009			
Commercial paper and other short-term borrowings	$ (42)	$	$ (42)
Deposits	(77)	(179)	(256)
Long-term borrowings	(4,796)	(327)	(5,123)
Six Months Ended June 30, 2008			
Commercial paper and other short-term borrowings	$ 196	$ (4)	$ 192
Deposits	5	(29)	(24)
Long-term borrowings	2,680	(383)	2,297

In addition to the amounts in the above table, as discussed in Note 1, all of the instruments within Financial instruments owned or Financial instruments sold, not yet purchased are measured at fair value, either through the election of the fair value option, or as required by other accounting pronouncements.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The following table presents information on the Company s short-term and long-term borrowings (including structured notes and junior subordinated debentures), loans and unfunded lending commitments for which the fair value option was elected:

(Losses) Gains Due to Changes in Instrument Specific Credit Spreads

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(dollars in millions)			
Short-term and long-term borrowings(1)	$(2,286)	$ (326)	$ (3,926)	$ 1,565
Loans(2)	3,718	412	3,644	(1,248)
Unfunded lending commitments(3)	(144)	251	(142)	95

(1) Gains or (losses) were attributable to widening or (tightening), respectively, of the Company s credit spreads and were determined based upon observations of the Company s secondary bond market spreads. The remainder of changes in overall fair value of the short-term and long-term borrowings is attributable to changes in foreign currency exchange rates and interest rates and movements in the reference price or index for structured notes.
(2) Instrument-specific credit gains or (losses) were determined by excluding the non-credit components of gains and losses, such as those due to changes in interest rates.
(3) Gains or (losses) were generally determined based on the differential between estimated expected client and contractual yields at each respective period end.

Contractual Principal Amount Over Fair Value

	At June 30, 2009	At December 31, 2008	At November 30, 2008
		(dollars in billions)	
Short-term and long-term debt borrowings(1)	$ 3.7	$ 5.7	$ 7.5
Loans(2)	27.2	31.0	30.5
Loans 90 or more days past due(2)(3)	19.6	19.8	19.8

(1) These amounts do not include structured notes where the repayment of the initial principal amount fluctuates based on changes in the reference price or index.
(2) The majority of this difference between principal and fair value amounts emanates from the Company s distressed debt trading business, which purchases distressed debt at amounts well below par.
(3) The aggregate fair value of loans that were 90 or more days past due as of June 30, 2009, December 31, 2008 and November 30, 2008 was $1.9 billion, $2.0 billion and $2.0 billion, respectively.

Financial Instruments Not Measured at Fair Value.

Some of the Company s financial instruments are not measured at fair value on a recurring basis but nevertheless are recorded at amounts that approximate fair value due to their liquid or short-term nature. Such financial assets and financial liabilities include: Cash and due from banks, Cash deposited with clearing organizations or segregated under federal and other regulations or requirements, Interest bearing deposits with banks, Federal funds sold and Securities purchased under agreements to resell, Securities borrowed, Securities sold under agreements to repurchase, Securities loaned, Receivables customers, Receivables brokers, dealers and clearing organizations, Payables customers, Payables brokers, dealers and clearing organizations, certain Commercial paper and other short-term borrowings, and certain Deposits.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The Company s long-term borrowings are recorded at historical amounts unless elected under the fair value option or designated as a hedged item in a fair value hedge. For long-term borrowings not measured at fair value, the fair value of the Company s long-term borrowings was estimated using either quoted market prices or discounted cash flow analyses based on the Company s current borrowing rates for similar types of borrowing arrangements. At June 30, 2009, the carrying value of the Company s long-term borrowings was approximately $8.6 billion higher than fair value. At November 30, 2008, the carrying value of the Company s long-term borrowings was approximately $25.0 billion higher than fair value.

4. Collateralized Transactions.

Securities purchased under agreements to resell (reverse repurchase agreements) and Securities sold under agreements to repurchase (repurchase agreements), principally government and agency securities, are carried at the amounts at which the securities subsequently will be resold or reacquired as specified in the respective agreements; such amounts include accrued interest. Reverse repurchase agreements and repurchase agreements are presented on a net-by-counterparty basis, when appropriate. The Company s policy is generally to take possession of securities purchased under agreements to resell. Securities borrowed and Securities loaned are carried at the amounts of cash collateral advanced and received in connection with the transactions. Other secured financings include the liabilities related to transfers of financial assets that are accounted for as financings rather than sales, consolidated VIEs where the Company is deemed to be the primary beneficiary, and certain equity-referenced securities and loans where in all instances these liabilities are payable solely from the cash flows of the related assets accounted for as Financial instruments owned (see Note 5).

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financings. Pledged financial instruments that can be sold or repledged by the secured party are identified as Financial instruments owned (pledged to various parties) in the condensed consolidated statements of financial condition. The carrying value and classification of financial instruments owned by the Company that have been loaned or pledged to counterparties where those counterparties do not have the right to sell or repledge the collateral were as follows:

	At June 30, 2009	At December 31, 2008	At November 30, 2008
		(dollars in millions)	
Financial instruments owned:			
U.S. government and agency securities	$ 12,576	$ 9,134	$ 7,701
Other sovereign government obligations	6,096	2,570	626
Corporate and other debt	13,809	21,850	33,037
Corporate equities	7,050	4,388	5,726
Total	$ 39,531	$ 37,942	$ 47,090

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers needs and to finance the Company s inventory positions. The Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. government and agency securities, other sovereign government obligations, corporate and other debt, and corporate equities. The Company receives collateral in the form of securities in connection with reverse repurchase agreements,

38

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

securities borrowed and derivative transactions, and customer margin loans. In many cases, the Company is permitted to sell or repledge these securities held as collateral and use the securities to secure repurchase agreements, to enter into securities lending and derivative transactions or for delivery to counterparties to cover short positions. At June 30, 2009, December 31, 2008 and November 30, 2008, the fair value of financial instruments received as collateral where the Company is permitted to sell or repledge the securities was $331 billion, $290 billion and $294 billion, respectively, and the fair value of the portion that had been sold or repledged was $257 billion, $214 billion and $227 billion, respectively.

The Company additionally receives securities as collateral in connection with certain securities for securities transactions in which the Company is the lender. In instances where the Company is permitted to sell or repledge these securities, the Company reports the fair value of the collateral received and the related obligation to return the collateral in the condensed consolidated statements of financial condition. At June 30, 2009, December 31, 2008 and November 30, 2008, $10 billion, $5 billion and $5 billion, respectively, were reported as Securities received as collateral and an Obligation to return securities received as collateral in the condensed consolidated statements of financial condition. Collateral received in connection with these transactions that was subsequently repledged was approximately $9 billion, $4 billion and $5 billion at June 30, 2009, December 31, 2008 and November 30, 2008, respectively.

The Company manages credit exposure arising from reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Company, in the event of a customer default, the right to liquidate collateral and the right to offset a counterparty s rights and obligations. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralized. Where deemed appropriate, the Company s agreements with third parties specify its rights to request additional collateral. Customer receivables generated from margin lending activity are collateralized by customer-owned securities held by the Company. For these transactions, adherence to the Company s collateral policies significantly limits the Company s credit exposure in the event of customer default. The Company may request additional margin collateral from customers, if appropriate, and, if necessary, may sell securities that have not been paid for or purchase securities sold but not delivered from customers.

At June 30, 2009, December 31, 2008 and November 30, 2008, cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements were as follows:

	June 30, 2009	December 31, 2008	November 30, 2008
		(dollars in millions)	
Cash	$ 21,643	$ 24,039	$ 25,446
Securities(1)	8,721	38,670	33,642
Total	$ 30,364	$ 62,709	$ 59,088

(1) Securities deposited with clearing organizations or segregated under federal and other regulations or requirements are sourced from Federal funds sold and securities purchased under agreements to resell and Financial instruments owned in the condensed consolidated statements of financial condition.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

5. Securitization Activities and Variable Interest Entities.

Securitization Activities and Qualifying Special Purpose Entities.

Securitization Activities. In a securitization transaction, the Company transfers assets (generally commercial or residential mortgage loans or U.S. agency securities) to a special purpose entity (an SPE), sells to investors most of the beneficial interests, such as notes or certificates, issued by the SPE and in many cases retains other beneficial interests. In many securitization transactions involving commercial mortgage loans, the Company transfers a portion of the assets transferred to the SPE with unrelated parties transferring the remaining assets.

The purchase of the transferred assets by the SPE is financed through the sale of these interests. In some of these transactions, primarily involving residential mortgage loans in the U.S. and Europe and commercial mortgage loans in Europe, the Company serves as servicer for some or all of the transferred loans. In many securitizations, particularly involving residential mortgage loans, the Company also enters into derivative transactions, primarily interest rate swaps or interest rate caps, with the SPE.

In most of these transactions, the SPE meets the criteria to be a QSPE under the accounting guidance for the transfer and servicing of financial assets. The Company does not consolidate QSPEs if they meet certain criteria regarding the types of assets and derivatives they may hold, the activities in which they may engage and the range of discretion they may exercise in connection with the assets they hold. The determination of whether an SPE meets the criteria to be a QSPE requires considerable judgment, particularly in evaluating whether the permitted activities of the SPE are significantly limited and in determining whether derivatives held by the SPE are passive and not excessive.

The primary risk retained by the Company in connection with these transactions generally is limited to the beneficial interests issued by the SPE that are owned by the Company, with the risk highest on the most subordinate class of beneficial interests. Where the QSPE criteria are met, these beneficial interests generally are included in Financial instruments owned Corporate and other debt and are measured at fair value. The Company does not provide additional support in these transactions through contractual facilities, such as liquidity facilities, guarantees, or similar derivatives.

Although not obligated, the Company generally makes a market in the securities issued by SPEs in these transactions. In these market-making transactions, the Company offers to buy these securities from, and sell these securities to, investors. Securities purchased through these market-making activities are not considered to be retained interests, although these beneficial interests generally are included in Financial instruments owned Corporate and other debt securities and are measured at fair value.

The Company enters into derivatives, generally interest rate swaps and interest rate caps with a senior payment priority in many securitization transactions. The risks associated with these and similar derivatives with SPEs are essentially the same as similar derivatives with non-SPE counterparties and are managed as part of the Company s overall exposure.

See Note 8 for further information on derivative instruments and hedging activities.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

QSPEs. The following tables present information as of June 30, 2009 and December 31, 2008 regarding QSPEs to which the Company acting as principal, has transferred assets and received sales treatment, and QSPEs sponsored by the Company to which the Company has not transferred assets (dollars in millions):

	At June 30, 2009			
	Residential Mortgage Loans	Commercial Mortgage Loans	U.S. Agency Collateralized Mortgage Obligations	Other
QSPE assets (unpaid principal balance)(1)	$ 59,741	$ 111,280	$ 25,917	$ 3,843
Retained interests (fair value):				
Investment grade	$ 196	$ 214	$ 155	$
Non-investment grade	68	234		
Total retained interests (fair value)	$ 264	$ 448	$ 155	$
Interests purchased in the secondary market (fair value):				
Investment grade	$ 148	$ 351	$ 2	$ 75
Non-investment grade	88	56		16
Total interests purchased in the secondary market (fair value)	$ 236	$ 407	$ 2	$ 91
Derivatives (fair value)	$ 299	$ 325	$	$ 1,338
Assets serviced (unpaid principal balance)	20,097	8,585		

(1) Amount includes $57.6 billion of assets transferred to the QSPEs by unrelated transferors.

	At December 31, 2008			
	Residential Mortgage Loans	Commercial Mortgage Loans	U.S. Agency Collateralized Mortgage Obligations	Other
QSPE assets (unpaid principal balance)(1)	$ 65,344	$ 112,557	$ 28,380	$ 2,684
Retained interests (fair value):				
Investment grade	$ 500	$ 482	$ 102	$
Non-investment grade	33	100		
Total retained interests (fair value)	$ 533	$ 582	$ 102	$
Interests purchased in the secondary market (fair value):				
Investment grade	$ 42	$ 156	$ 8	$ 23
Non-investment grade	49	14		12
Total interests purchased in the secondary market (fair value)	$ 91	$ 170	$ 8	$ 35

Derivatives (fair value)	$ 488	$ 515	$	$ 1,156
Assets serviced (unpaid principal balance)	23,211	8,196		

(1) Amount includes $57.8 billion of assets transferred to the QSPEs by unrelated transferors.

Transferred assets are carried at fair value prior to securitization, and any changes in fair value are recognized in the condensed consolidated statements of income. The Company may act as underwriter of the beneficial interests issued by securitization vehicles. Underwriting net revenues are recognized in connection with these transactions. The Company may retain interests in the securitized financial assets as one or more tranches of the

41

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

securitization. These retained interests are included in the condensed consolidated statements of financial condition at fair value. Any changes in the fair value of such retained interests are recognized in the condensed consolidated statements of income. Net gains at the time of securitization were not material during the six month period ended June 30, 2009 and the one month period ended December 31, 2008.

During the six month periods ended June 30, 2009 and June 30, 2008, the Company received proceeds from new securitization transactions of $2.0 billion and $5.0 billion, respectively. During the six month periods ended June 30, 2009 and June 30, 2008, the Company received proceeds from cash flows from retained interests in securitization transactions of $1.3 billion and $1.4 billion, respectively.

The Company provides representations and warranties that certain assets transferred in securitization transactions conform to specific guidelines (see Note 9).

Mortgage Servicing Rights. The Company may retain servicing rights to certain mortgage loans that are sold through its securitization activities. These transactions create an asset referred to as MSRs, which totaled approximately $173 million and $184 million as of June 30, 2009 and December 31, 2008, respectively, and are included within Intangible assets and carried at fair value in the condensed consolidated statements of financial condition.

SPE Mortgage Servicing Activities. The Company services residential mortgage loans in the U.S. and Europe and commercial mortgage loans in Europe owned by SPEs, including SPEs sponsored by the Company and SPEs not sponsored by the Company. Most of these SPEs meet the requirements for QSPEs. The Company generally holds retained interests in Company-sponsored QSPEs. In some cases, as part of its market making activities, the Company may own some beneficial interests issued by both Company-sponsored and non-Company sponsored SPEs.

The Company provides no credit support as part of its servicing activities. The Company is required to make servicing advances to the extent that it believes that such advances will be reimbursed. Reimbursement of servicing advances is a senior obligation of the SPE, senior to the most senior beneficial interests outstanding. Outstanding advances are included in Other assets and are recorded at cost. Advances as of June 30, 2009 and December 31, 2008 totaled approximately $2.3 billion and $2.4 billion, respectively, net of reserves of approximately $14 million and $10 million, respectively.

The following table presents information about the Company s mortgage servicing activities for SPEs to which the Company transferred loans as of June 30, 2009 and December 31, 2008 (dollars in millions):

	At June 30, 2009			
	Residential Mortgage QSPEs	Residential Mortgage Failed Sales	Commercial Mortgage QSPEs	Commercial Mortgage Consolidated SPEs
Assets serviced (unpaid principal balance)	$ 20,097	$ 819	$ 8,585	$ 2,363
Amounts past due 90 days or greater (unpaid principal balance)(1)	$ 7,480	$ 343	$ 2	$ 4
Percentage of amounts past due 90 days or greater(1)	37.2%	41.8%		0.2%
Credit losses	$ 1,083	$ 21	$	$

(1) Includes loans that are at least 90 days contractually delinquent, loans for which the borrower has filed for bankruptcy, loans in foreclosure and real estate owned.

42

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

	At December 31, 2008			
	Residential Mortgage QSPEs	Residential Mortgage Failed Sales	Commercial Mortgage QSPEs	Commercial Mortgage Consolidated SPEs
Assets serviced (unpaid principal balance)	$ 23,211	$ 890	$ 8,196	$ 2,349
Amounts past due 90 days or greater (unpaid principal balance)(1)	$ 7,586	$ 308	$	$
Percentage of amounts past due 90 days or greater(1)	32.7%	34.6%		
Credit losses	$ 181	$ 11	$	$

(1) Includes loans that are at least 90 days contractually delinquent, loans for which the borrower has filed for bankruptcy, loans in foreclosure and real estate owned.

The Company also serviced residential and commercial mortgage loans for SPEs sponsored by unrelated parties with unpaid principal balances totaling $23 billion and $25 billion as of June 30, 2009 and December 31, 2008, respectively.

Variable Interest Entities. Accounting guidance for consolidation of VIEs applies to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. QSPEs currently are not subject to consolidation. The primary beneficiary of a VIE is the party that absorbs a majority of the entity s expected losses, receives a majority of its expected residual returns or both, as a result of holding variable interests. The Company consolidates entities of which it is the primary beneficiary.

The Company is involved with various entities in the normal course of business that may be deemed to be VIEs. The Company s variable interests in VIEs include debt and equity interests, commitments, guarantees and derivative instruments. The Company s involvement with VIEs arises primarily from:

Interests purchased in connection with market making and retained interests held as a result of securitization activities.

Guarantees issued and residual interests retained in connection with municipal bond securitizations.

Loans and investments made to VIEs that hold debt, equity, real estate or other assets.

Derivatives entered into with VIEs.

Structuring of credit-linked notes (CLNs) or other asset-repackaged notes designed to meet the investment objectives of clients.

Other structured transactions designed to provide tax-efficient yields to the Company or its clients.

The Company determines whether it is the primary beneficiary of a VIE upon its initial involvement with the VIE. This determination is based upon an analysis of the design of the VIE, including the VIE s structure and activities and the variable interests owned by the Company.

The Company reassesses whether it is the primary beneficiary of a VIE upon the occurrence of certain reconsideration events. If the Company s initial assessment results in a determination that it is not the primary beneficiary of a VIE, then the Company reassesses this determination upon the occurrence of:

Changes to the VIE s governing documents or contractual arrangements in a manner that reallocates the obligation to absorb the expected losses or the right to receive the expected residual returns of the VIE between the current primary beneficiary and the other variable interest holders, including the Company.

Acquisition by the Company of additional variable interests in the VIE.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

If the Company s initial assessment results in a determination that it is the primary beneficiary, then the Company reassesses this determination upon the occurrence of:

Changes to the VIE s governing documents or contractual arrangements in a manner that reallocates the obligation to absorb the expected losses or the right to receive the expected residual returns of the VIE between the current primary beneficiary and the other variable interest holders, including the Company.

A sale or disposition by the Company of all or part of its variable interests in the VIE to parties unrelated to the Company.

The issuance of new variable interests by the VIE to parties unrelated to the Company.

Except for consolidated VIEs included in other structured financings in the tables below, the Company accounts for the assets held by the entities primarily in Financial instruments owned and the liabilities of the entities as Other secured financings in the condensed consolidated statements of financial condition. The Company includes assets held by consolidated VIEs included in other structured financings in the tables below primarily in Receivables, Premises, equipment and software costs and Other assets and the liabilities primarily as Other liabilities and accrued expenses and Payables in the condensed consolidated statements of financial condition. Except for consolidated VIEs included in other structured financings, the assets and liabilities are measured at fair value, with changes in fair value reflected in earnings.

The assets owned by many consolidated VIEs cannot be removed unilaterally by the Company and are not generally available to the Company. The related liabilities issued by many consolidated VIEs are non-recourse to the Company. In certain other consolidated VIEs, the Company has the unilateral right to remove assets or provides additional recourse through derivatives such as total return swaps, guarantees or other forms of involvement.

The following tables present information as of June 30, 2009 and December 31, 2008 about VIEs which the Company consolidates (dollars in millions):

	At June 30, 2009				
	Mortgage and Asset-backed Securitizations	Credit and Real Estate	Commodities Financing	Other Structured Financings	Total
VIE assets that the Company consolidates	$ 3,559	$ 3,337	$ 739	$ 883	$ 8,518
VIE liabilities	1,838	688	631	277	3,434
Maximum exposure to loss:					
Debt and equity interests	$ 1,718	$ 2,633	$	$ 622	$ 4,973
Derivatives and other contracts	486	905	919		2,310
Commitments and guarantees				290	290
Total maximum exposure to loss	$ 2,204	$ 3,538	$ 919	$ 912	$ 7,573

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

	At December 31, 2008				
	Mortgage and Asset-backed Securitizations	Credit and Real Estate	Commodities Financing	Other Structured Financings	Total
VIE assets that the Company consolidates	$ 4,307	$ 4,121	$ 809	$ 1,664	$ 10,901
VIE liabilities	2,473	1,505	766	801	5,545
Maximum exposure to loss:					
Debt and equity interests	$ 1,834	$ 2,605	$	$ 882	$ 5,321
Derivatives and other contracts	517	2,348	1,307		4,172
Commitments and guarantees				330	330
Total maximum exposure to loss	$ 2,351	$ 4,953	$ 1,307	$ 1,212	$ 9,823

The following tables present information about non-consolidated VIEs in which the Company had significant variable interests or served as the sponsor and had any variable interest as of June 30, 2009 and December 31, 2008 (dollars in millions):

	At June 30, 2009				
	Mortgage and Asset-backed Securitizations	Credit and Real Estate	Municipal Tender Option Bond Trusts	Other Structured Financings	Total
VIE assets that the Company does not consolidate	$ 739	$ 17,486	$ 214	$ 5,743	$ 24,182
Maximum exposure to loss:					
Debt and equity interests	$ 25	$ 3,548	$ 59	$ 919	$ 4,551
Derivatives and other contracts		5,205			5,205
Commitments and guarantees		200	58	527	785
Total maximum exposure to loss	$ 25	$ 8,953	$ 117	$ 1,446	$ 10,541
Carrying value of exposure to loss:					
Debt and equity interests	$ 25	$ 3,548	$ 59	$ 781	$ 4,413
Derivatives and other contracts		1,748			1,748
Commitments and guarantees		131		25	156

45

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

	At December 31, 2008				
	Mortgage and Asset-backed Securitizations	**Credit and Real Estate**	**Municipal Tender Option Bond Trusts**	**Other Structured Financings**	**Total**
VIE assets that the Company does not consolidate	$ 1,629	$ 18,456	$ 2,173	$ 8,068	$ 30,326
Maximum exposure to loss:					
Debt and equity interests	$ 38	$ 4,420	$ 1,145	$ 880	$ 6,483
Derivatives and other contracts		5,156			5,156
Commitments and guarantees			320	564	884
Total maximum exposure to loss	$ 38	$ 9,576	$ 1,465	$ 1,444	$ 12,523
Carrying value of exposure to loss:					
Debt and equity interests	$ 38	$ 4,420	$ 1,145	$ 703	$ 6,306
Derivatives and other contracts		1,453			1,453
Commitments and guarantees				36	36

The Company s maximum exposure to loss often differs from the carrying value of the VIE s assets. The maximum exposure to loss is dependent on the nature of the Company s variable interest in the VIEs and is limited to the notional amounts of certain liquidity facilities, other credit support, total return swaps, written put options, and the fair value of certain other derivatives and investments the Company has made in the VIEs. Liabilities issued by VIEs generally are non-recourse to the Company. Where notional amounts are utilized in quantifying maximum exposure related to derivatives, such amounts do not reflect fair value writedowns already recorded by the Company.

The Company s maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Company may utilize to hedge these risks associated with the Company s variable interests.

Municipal Tender Option Bond Trusts. In a municipal tender option bond transaction, the Company, on behalf of a client, transfers a municipal bond to a trust. The trust issues short-term securities which the Company as the remarketing agent sells to investors. The client retains a residual interest. The short-term securities are supported by a liquidity facility pursuant to which the investors may put their short-term interests. In some programs, the Company provides this liquidity facility; in most programs, a third-party provider will provide such liquidity facility. The Company may purchase short-term securities in its role either as remarketing agent or liquidity provider. The client can generally terminate the transaction at any time. The liquidity provider can generally terminate the transaction upon the occurrence of certain events. When the transaction is terminated, the municipal bond is generally sold or returned to the client. Any losses suffered by the liquidity provider upon the sale of the bond are the responsibility of the client. This obligation generally is collateralized. In prior periods, the Company established trusts in connection with its proprietary trading activities and consolidated those trusts. As of June 30, 2009 and December 31, 2008, no proprietary trusts were outstanding.

Credit Protection Purchased Through CLNs. In a CLN transaction, the Company transfers assets (generally high quality securities or money market investments) to an SPE, enters into a derivative transaction in which the SPE writes protection on an unrelated reference asset or group of assets through a credit default swap, a total return swap or similar instrument, and sells to investors the securities issued by the SPE. In some transactions, the Company may also enter into interest rate or currency swaps with the SPE. Upon the occurrence of a credit event related to the reference asset, the SPE will sell the collateral securities in order to make the payment to the Company. The Company is generally exposed to price changes on the collateral securities in the event of a credit

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

event and subsequent sale. These transactions are designed to transfer the credit risk on the reference asset to investors. In some transactions, the assets and liabilities of the SPE are recognized in the Company s condensed consolidated financial statements. In other transactions, the transfer of the collateral securities is accounted for as a sale of assets and the SPE is not consolidated. The structure of the transaction determines the accounting treatment.

The derivatives in CLN transactions consist of total return swaps, credit default swaps or similar contracts in which the Company has purchased protection on a reference asset or group of assets. Payments by the SPE are collateralized. The risks associated with these and similar derivatives with SPEs are essentially the same as similar derivatives with non-SPE counterparties and are managed as part of the Company s overall exposure.

Other Structured Financings. The Company primarily invests in equity interests issued by entities that develop and own low income communities (including low income housing projects) and entities that construct and own facilities that will generate energy from renewable resources. The equity interests entitle the Company to its share of tax credits and tax losses generated by these projects. In addition, the Company has issued guarantees to investors in certain low-income housing funds. The guarantees are designed to return an investor s contribution to a fund and the investor s share of tax losses and tax credits expected to be generated by the fund. The Company is also involved with entities designed to provide tax-efficient yields to the Company or its clients.

Collateralized Loan and Debt Obligations. A collateralized loan obligation (CLO) or a CDO is a SPE that purchases a pool of assets, consisting of corporate loans, corporate bonds, asset-backed securities or synthetic exposures on similar assets through derivatives and issues multiple tranches of debt and equity securities to investors. In the Asset Management business segment, the Company manages CLOs with assets of $2.2 billion and $2.1 billion as of June 30, 2009 and December 31, 2008, respectively, and receives a management fee for these services. Except for the management fee, the Company s maximum exposure to loss on these managed CLOs was immaterial as of June 30, 2009 and December 31, 2008. The Company s maximum exposure to loss on other CLOs and CDOs is $0.9 billion and $3.0 billion as of June 30, 2009 and December 31, 2008, respectively, excluding the exposure to the assets transferred to Ascension Loan Vehicle, LLC (Ascension), a wholly owned subsidiary of the Company (see Note 10).

Equity-Linked Notes. In an equity-linked note transaction included in the tables above, the Company typically transfers to an SPE either (1) a note issued by the Company, the payments on which are linked to the performance of a specific equity security, equity index or other index or (2) debt securities issued by other companies and a derivative contract, the terms of which will relate to the performance of a specific equity security, equity index or other index. These transactions are designed to transfer to investors the risks related to the specific equity security, equity index or other index.

Asset Management Investment Funds. The tables above do not include certain investments made by the Company held by entities qualifying for accounting purposes as investment companies.

See Note 9 for information on nonconsolidated investment funds and a lending facility provided to a real estate fund sponsored by the Company. The Company provided this facility in response to the fund s increased liquidity needs resulting from the global economic downturn.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Failed Sales.

In order to be treated as a sale of assets for accounting purposes, a transaction must meet all of the criteria stipulated in the accounting guidance for the transfer of financial assets. If the transfer fails to meet these criteria, that transfer is treated as a failed sale. In such case, the Company continues to recognize the assets in Financial instruments owned and the Company recognizes the associated liabilities in Other secured financings in the condensed consolidated statements of financial condition.

The assets transferred to many unconsolidated VIEs in transactions accounted for as failed sales cannot be removed unilaterally by the Company and are not generally available to the Company. The related liabilities issued by many unconsolidated VIEs are non-recourse to the Company. In certain other failed sale transactions, the Company has the unilateral right to remove assets or provides additional recourse through derivatives such as total return swaps, guarantees or other forms of involvement.

The following tables present information about transfers of assets treated by the Company as secured financings as of June 30, 2009 and December 31, 2008 (dollars in millions):

	At June 30, 2009			
	Residential Mortgage Loans	Commercial Mortgage Loans	Credit-Linked Notes	Other
Assets				
Unpaid principal amount	$ 405	$ 2,217	$ 1,197	$ 1,746
Fair value	158	1,956	1,048	1,600
Other secured financings				
Unpaid principal amount	224	2,089	1,105	1,746
Fair value	115	1,889	1,027	1,600

	At December 31, 2008			
	Residential Mortgage Loans	Commercial Mortgage Loans	Credit-Linked Notes	Other
Assets				
Unpaid principal amount	$ 439	$ 2,573	$ 1,333	$ 2,028
Fair value	227	2,245	1,144	1,814
Other secured financings				
Unpaid principal amount	258	2,512	1,293	2,008
Fair value	175	2,208	1,134	1,810

6. Goodwill and Net Intangible Assets.

Goodwill and net intangible assets increased during the quarter and six month period ended June 30, 2009 primarily due to the acquisition of Smith Barney that was accounted for using the acquisition method of accounting (see Note 2).

The Company tests goodwill for impairment on an annual basis and on an interim basis when certain events or circumstances exist. The Company tests for impairment at the reporting unit level, which is generally one level below its business segments. Goodwill impairment is

determined by comparing the estimated fair value of a reporting unit with its respective book value. If the estimated fair value exceeds the book value, goodwill at the reporting unit level is not deemed to be impaired. If the estimated fair value is below book value, however, further analysis is required to determine the amount of the impairment.

The estimated fair values of the reporting units are generally determined utilizing methodologies that incorporate price-to-book, price-to-earnings and assets under management multiples of certain comparable companies.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The Company completed its annual goodwill impairment testing as of June 1, 2009 and June 1, 2008, which did not result in any goodwill impairment.

Changes in the carrying amount of the Company s goodwill and intangible assets for the one month period ended December 31, 2008 and the six month period ended June 30, 2009 were as follows:

	Institutional Securities	Global Wealth Management Group (dollars in millions)	Asset Management	Total
Goodwill:				
Balance at November 30, 2008	$ 800	$ 272	$ 1,171	$ 2,243
Foreign currency translation adjustments and other	13			13
Balance at December 31, 2008	813	272	1,171	2,256
Foreign currency translation adjustments and other	4			4
Goodwill acquired during the period(1)		5,029		5,029
Goodwill disposed of during the period(2)	(453)			(453)
Balance at June 30, 2009	$ 364	$ 5,301	$ 1,171	$ 6,836

	Institutional Securities	Global Wealth Management Group (dollars in millions)	Asset Management	Total
Net Intangible Assets:				
Amortizable net intangible assets at November 30, 2008	$ 334	$	$ 393	$ 727
Foreign currency translation adjustments and other	3			3
Amortization expense	(4)		(4)	(8)
Amortizable net intangible assets at December 31, 2008	333		389	722
Mortgage servicing rights (see Note 5)	184			184
Balance of net intangible assets at December 31, 2008	$ 517	$	$ 389	$ 906
Amortizable net intangible assets at December 31, 2008	$ 333	$	$ 389	$ 722
Foreign currency translation adjustments and other	(3)		(4)	(7)
Net intangible assets acquired during the period(1)		4,611	1	4,612
Net intangible assets disposed of during the period(2)	(153)			(153)
Amortization expense	(9)	(31)	(24)	(64)
Impairment losses			(9)	(9)
Amortizable net intangible assets at June 30, 2009	168	4,580	353	5,101
Mortgage servicing rights (see Note 5)	173			173
Indefinite-lived intangible asset(1)		279		279

Balance of net intangible assets at June 30, 2009	$ 341	$ 4,859	$ 353	$ 5,553

(1) Global Wealth Management Group business segment activity primarily represents goodwill and intangible assets acquired in connection with MSSB (see Note 2).

(2) Institutional Securities business segment activity primarily represents goodwill and intangible assets disposed of in connection with MSCI (see Note 19).

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

7. Long-Term Borrowings.

The Company s long-term borrowings included the following components:

	At June 30, 2009	At December 31, 2008	At November 30, 2008
		(dollars in millions)	
Senior debt	$ 171,847	$ 165,181	$ 148,959
Subordinated debt	4,279	4,342	4,212
Junior subordinated debentures	10,666	10,312	10,266
Total	$ 186,792	$ 179,835	$ 163,437

During the six month period ended June 30, 2009, the Company issued notes with a principal amount of approximately $27 billion. The amount included non-U.S. dollar currency notes aggregating approximately $1.1 billion. These notes include the public issuance of $5.5 billion of senior unsecured notes that were not guaranteed by the Federal Deposit Insurance Corporation (FDIC). During the six month period ended June 30, 2009, $24.7 billion of notes were repaid.

The weighted average maturity of the Company s long-term borrowings, based upon stated maturity dates, was approximately 5.8 years and 6.3 years as of June 30, 2009 and December 31, 2008, respectively.

A subsidiary of the Company has loans outstanding of approximately $2.5 billion under third party financing related to Crescent Real Estate Equities Limited Partnership (Crescent). These loans are non-recourse and are secured only by Crescent s assets. Approximately $2.0 billion of the third party financing is with a single lender (the Lender) to whom the Company has provided credit support with respect to limited exceptions to the non-recourse provisions for the maximum amount of $125 million. Such Lender financing, which was originally scheduled to mature on August 3, 2009, has been extended until November 2, 2009. The subsidiary is currently in discussions with the Lender regarding the orderly transfer of collateral and asset operations and other related matters.

FDIC Temporary Liquidity Guarantee Program (TLGP).

As of June 30, 2009, the Company had commercial paper and long-term debt outstanding of $0.7 billion and $23.8 billion, respectively, under the TLGP. As of December 31, 2008, the Company had commercial paper and long-term debt outstanding of $6.4 billion and $9.8 billion, respectively, under the TLGP. These borrowings are senior unsecured debt obligations of the Company and guaranteed by the FDIC under the TLGP. The FDIC has concluded that the guarantee is backed by the full faith and credit of the U.S. government.

8. Derivative Instruments and Hedging Activities.

The Company trades, makes markets and takes proprietary positions globally in listed futures, OTC swaps, forwards, options and other derivatives referencing, among other things, interest rates, currencies, investment

grade and non-investment grade corporate credits, loans, bonds, U.S. and other sovereign securities, emerging market bonds and loans, credit indices, asset-backed security indices, property indices, mortgage-related and other asset-backed securities and real estate loan products. The Company uses these instruments for trading, as well as for asset and liability management.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The Company manages its trading positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (*e.g.*, futures, forwards, swaps and options). The Company manages the market risk associated with its trading activities on a Company-wide basis, on a worldwide trading division level and on an individual product basis.

The Company incurs credit risk as a dealer in OTC derivatives. Credit risk with respect to derivative instruments arises from the failure of a counterparty to perform according to the terms of the contract. The Company s exposure to credit risk at any point in time is represented by the fair value of the derivative contracts reported as assets. The fair value of a derivative represents the amount at which the derivative could be exchanged in an orderly transaction between market participants, and is further described in Notes 1 and 3 to the condensed consolidated financial statements.

In connection with its derivative activities, the Company may enter into master netting agreements and collateral arrangements with counterparties. These agreements provide the Company with the ability to offset a counterparty s rights and obligations, request additional collateral when necessary or liquidate the collateral in the event of counterparty default.

The table below presents a summary by counterparty credit rating and remaining contract maturity of the fair value of OTC derivatives in a gain position as of June 30, 2009. Fair value is presented in the final column net of collateral received (principally cash and U.S. government and agency securities):

OTC Derivative Products Financial Instruments Owned(1)

	Years to Maturity				Cross-Maturity and Cash Collateral Netting(3)	Net Exposure Post-Cash Collateral	Net Exposure Post-Collateral
Credit Rating(2)	**Less than 1**	**1-3**	**3-5**	**Over 5**			
	(dollars in millions)						
AAA	$ 1,063	$ 3,407	$ 4,767	$ 11,507	$ (8,850)	$ 11,894	$ 11,445
AA	7,438	8,192	6,517	17,216	(27,411)	11,952	9,635
A	9,423	12,152	8,283	24,435	(42,978)	11,315	9,790
BBB	3,510	4,463	2,678	6,886	(8,974)	8,563	6,590
Non-investment grade	3,547	4,507	3,188	4,901	(5,950)	10,193	8,332
Total	$ 24,981	$ 32,721	$ 25,433	$ 64,945	$ (94,163)	$ 53,917	$ 45,792

(1) Fair values shown represent the Company s net exposure to counterparties related to the Company s OTC derivative products. The table does not include listed derivatives and the effect of any related hedges utilized by the Company.
(2) Obligor credit ratings are determined by the Credit Risk Management Department using methodologies generally consistent with those employed by external rating agencies.
(3) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within such maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.

Hedge Accounting.

The Company applies hedge accounting using various derivative financial instruments and non-U.S. dollar-denominated debt used to hedge interest rate and foreign exchange risk arising from assets and liabilities not held at fair value as part of asset and liability management.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The Company s hedges are designated and qualify for accounting purposes as one of the following types of hedges: hedges of changes in fair value of assets and liabilities due to the risk being hedged (fair value hedges) and hedges of net investments in foreign operations whose functional currency is different from the reporting currency of the parent company (net investment hedges).

For all hedges where hedge accounting is being applied, effectiveness testing and other procedures to ensure the ongoing validity of the hedges are performed at least monthly.

Fair Value Hedges Interest Rate Risk. The Company s designated fair value hedges consisted primarily of interest rate swaps designated as fair value hedges of changes in the benchmark interest rate of fixed rate senior long-term borrowings. The Company uses regression analysis to perform an ongoing prospective and retrospective assessment of the effectiveness of these hedging relationships (*i.e.*, the Company applies the long-haul method of hedge accounting). A hedging relationship is deemed effective if the fair values of the hedging instrument (derivative) and the hedged item (debt liability) change inversely within a range of 80% to 125%. The Company considers the impact of valuation adjustments related to the Company s own credit spreads and counterparty s credit spreads to determine whether they would cause the hedging relationship to be ineffective.

For qualifying fair value hedges of benchmark interest rates, the changes in the fair value of the derivative and the changes in the fair value of the hedged liability provide offset of one another and, together with any resulting ineffectiveness, are recorded in Interest expense. When a derivative is de-designated as a hedge, any basis adjustment remaining on the hedged liability is amortized to Interest expense over the remaining life of the liability using the effective interest method.

Net Investment Hedges. The Company utilizes forward foreign exchange contracts and non-U.S. dollar denominated debt to manage the currency exposure relating to its net investments in non-U.S. dollar functional currency operations. No hedge ineffectiveness is recognized in earnings since the notional amounts of the hedging instruments equal the portion of the investments being hedged, and, where forward contracts are used, the currencies being exchanged are the functional currencies of the parent and investee; where debt instruments are used as hedges, they are denominated in the functional currency of the investee. The gain or loss from revaluing hedges of net investments in foreign operations at the spot rate is deferred and reported within Accumulated other comprehensive income (loss) in Shareholders equity, net of tax effects. The forward points on the hedging instruments are recorded in Interest and dividend revenues.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The following table summarizes the fair value of derivative instruments designated as accounting hedges and the fair value of derivative instruments not designated as accounting hedges by type of derivative contract on a gross basis as of June 30, 2009. Fair values of derivative contracts in an asset position are included in Financial instruments owned derivative and other contracts. Fair values of derivative contracts in a liability position are reflected in Financial instruments sold, not yet purchased derivative and other contracts.

	Assets at June 30, 2009		Liabilities at June 30, 2009	
	Fair Value	Notional	Fair Value	Notional
	(dollars in millions)			
Derivatives designated as accounting hedges:				
Interest rate contracts	$ 5,899	$ 69,750	$ 144	$ 7,816
Foreign exchange contracts	33	4,356	187	6,613
Total derivatives designated as accounting hedges	5,932	74,106	331	14,429
Debt instruments designated as net investment hedges(1)			4,144	4,144
Total derivatives and non-derivatives designated as accounting hedges	5,932	74,106	4,475	18,573
Derivatives not designated as accounting hedges(2):				
Interest rate contracts	656,907	15,134,652	629,170	15,222,469
Credit contracts	250,207	2,892,189	227,903	2,762,637
Foreign exchange contracts	66,241	1,126,882	64,824	1,027,148
Equity contracts	55,818	518,904	61,408	565,275
Commodity contracts	83,126	796,453	82,201	616,570
Other	984	24,027	1,479	17,150
Total derivatives not designated as accounting hedges	1,113,283	20,493,107	1,066,985	20,211,249
Total derivatives	$ 1,119,215	$ 20,567,213	$ 1,067,316	$ 20,225,678
Cash collateral netting	(70,053)		(33,091)	
Counterparty netting	(990,790)		(990,790)	
Total derivatives	$ 58,372	$ 20,567,213	$ 43,435	$ 20,225,678

(1) The notional amount for foreign currency debt instruments designated as net investment hedges represents the principal amount at current exchange rates.

(2) Notional amounts include net notionals related to long and short futures contracts of $208 billion and $738 billion, respectively. The variation margin on these futures contracts (excluded from the table above) of $2,119 million and $5 million is included in Receivables Brokers, dealers and clearing organizations and Payables Brokers, dealers and clearing organizations, respectively, on the condensed consolidated statements of financial condition.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The following tables summarize the gains or losses reported on derivative instruments designated and qualifying as accounting hedges for the quarter and six month period ended June 30, 2009.

Derivatives Designated as Fair Value Hedges.

Product Type	Classification of Gains or (Losses)	Amount of Gains or (Losses) Recognized in Income on Derivatives Three Months Ended June 30, 2009	Six Months Ended June 30, 2009	Amount of Gains or (Losses) Recognized in Income on Borrowings Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
		(dollars in millions)			
Interest rate contracts(1)	Interest expense	$ (1,351)	$ (4,110)	$ 1,404	$ 4,094
Total		$ (1,351)	$ (4,110)	$ 1,404	$ 4,094

(1) A gain of $53 million and a loss of $16 million were recognized in income related to hedge ineffectiveness during the quarter and six month period ended June 30, 2009, respectively.

Derivatives Designated as Net Investment Hedges.

Product Type	Amount of Gains or (Losses) Recognized in OCI (effective portion)(2) Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
	(dollars in millions)	
Foreign exchange contracts(1)	$ (370)	$ (247)
Debt instruments	(212)	(106)
Total	$ (582)	$ (353)

(1) A gain of $9 million was recognized in income related to amounts excluded from hedge effectiveness testing during the six month period ended June 30, 2009.

(2) No gains or (losses) were reclassified from Other comprehensive income (OCI) into income during the quarter and six month period ended June 30, 2009.

The table below summarizes gains or losses on derivative instruments not designated as accounting hedges for the quarter and six month period ended June 30, 2009:

Product Type	Amount of Gains or (Losses) Recognized in Income(1)(2) Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
	(dollars in millions)	
Interest rate contracts	$ 3,538	$ 1,217
Credit contracts	(3,825)	(1,386)
Foreign exchange contracts	(1,646)	718
Equity contracts	(2,960)	(3,309)
Commodity contracts	462	1,214
Other contracts	480	673
Total derivative instruments	$ (3,951)	$ (873)

(1) Gains or (losses) on derivative contracts not designated as hedges are primarily included in Principal transactions trading.

(2) Gains or (losses) associated with derivative contracts that have physically settled are excluded from the table above. Gains or (losses) on these contracts are reflected with the associated cash instruments, which are also included in Principal transactions trading.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The Company also has certain embedded derivatives that have been bifurcated from the related structured borrowings. Such derivatives are classified in Long-term borrowings and had a net fair value of $223 million and a notional of $3,972 million. The Company recognized losses of $28 million and gains of $17 million related to changes in the fair value of its bifurcated embedded derivatives for the quarter and six month period ended June 30, 2009, respectively.

As of June 30, 2009, December 31, 2008 and November 30, 2008, the amount of payables associated with cash collateral received that was netted against derivative assets was $70.1 billion, $88.5 billion and $76.0 billion, respectively. The amount of receivables in respect of cash collateral paid that was netted against derivative liabilities was $33.1 billion, $51.0 billion and $43.2 billion, respectively. Cash collateral receivables and payables of $82 million and $271 million, respectively, as of June 30, 2009, $1.3 billion and $92 million, respectively, as of December 31, 2008, and $1.7 billion and $4 million, respectively, as of November 30, 2008, were not offset against certain contracts that did not meet the definition of a derivative.

Credit-Risk-Related Contingencies.

In connection with certain OTC trading agreements, the Company may be required to provide additional collateral to certain counterparties in the event of a credit ratings downgrade. As of June 30, 2009, the aggregate fair value of derivative contracts that contain credit-risk-related contingent features that are in a net liability position totaled $19,269 million for which the Company has posted collateral of $15,743 million in the normal course of business. The amount of additional collateral that could be called by counterparties under the terms of collateral agreements in the event of a one-notch downgrade of the Company s long-term credit rating was approximately $616 million. An additional amount of approximately $971 million could be called in the event of a two-notch downgrade. Of these amounts, $1,260 million relates to bilateral arrangements between the Company and other parties where upon the downgrade of one party, the downgraded party must deliver incremental collateral to the other party. These bilateral downgrade arrangements are a risk management tool used extensively by the Company as credit exposures are reduced if counterparties are downgraded.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Credit Derivatives and Other Credit Contracts.

The Company enters into credit derivatives, principally through credit default swaps, under which it provides counterparties protection against the risk of default on a set of debt obligations issued by a specified reference entity or entities. A majority of the Company s counterparties are banks, broker-dealers, insurance and other financial institutions, and monoline insurers. The table below summarizes certain information regarding protection sold through credit default swaps and credit-linked notes as of June 30, 2009:

Credit Ratings of the Reference Obligation	Protection Sold Maximum Potential Payout/Notional Years to Maturity Less than 1	1-3	3-5	Over 5	Total	Fair Value (Asset)/ Liability(1)
	(dollars in millions)					
Single name credit default swaps:						
AAA	$ 618	$ 1,813	$ 9,397	$ 31,756	$ 43,584	$ 2,092
AA	14,293	26,274	43,801	37,450	121,818	2,167
A	38,152	90,730	121,633	58,371	308,886	4,322
BBB	54,855	161,016	185,166	91,178	492,215	8,136
Non-investment grade	49,128	181,822	158,969	74,485	464,404	61,823
Total	157,046	461,655	518,966	293,240	1,430,907	78,540
Index and basket credit default swaps:						
AAA	22,791	18,084	52,591	95,968	189,434	3,390
AA	70	4,871	6,010	2,970	13,921	871
A	2,485	2,903	41,585	19,046	66,019	3,130
BBB	25,823	87,872	241,081	147,965	502,741	9,931
Non-investment grade	44,855	183,588	193,256	152,920	574,619	84,806
Total	96,024	297,318	534,523	418,869	1,346,734	102,128
Total credit default swaps sold	$ 253,070	$ 758,973	$ 1,053,489	$ 712,109	$ 2,777,641	$ 180,668
Other credit contracts(2)(3)	$	$ 64	$ 91	$ 1,649	$ 1,804	$ 1,941
Credit-linked notes(3)	284	298	2,267	1,763	4,612	(1,545)
Total credit derivatives and other credit contracts	$ 253,354	$ 759,335	$ 1,055,847	$ 715,521	$ 2,784,057	$ 181,064

(1) Fair value amounts are shown on a gross basis prior to cash collateral or counterparty netting.
(2) Other credit contracts are credit default swaps that are considered hybrid instruments.
(3) Fair value amount shown represents the fair value of the hybrid instruments.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The table below summarizes certain information regarding protection sold through credit default swaps and credit-linked notes as of December 31, 2008:

Credit Ratings of the Reference Obligation	Protection Sold Maximum Potential Payout/Notional Years to Maturity Less than 1	1-3	3-5	Over 5	Total	Fair Value (Asset)/ Liability(1)
	(dollars in millions)					
Single name credit default swaps:						
AAA	$ 1,946	$ 3,593	$ 12,766	$ 37,166	$ 55,471	$ 4,438
AA	13,450	24,897	54,308	42,355	135,010	5,757
A	45,097	81,279	156,888	72,690	355,954	20,044
BBB	54,823	142,528	250,621	117,869	565,841	51,920
Non-investment grade	47,605	144,923	231,745	83,845	508,118	116,512
Total	162,921	397,220	706,328	353,925	1,620,394	198,671
Index and basket credit default swaps:						
AAA	2,989	24,821	68,390	146,105	242,305	10,936
AA	1,435	5,684	4,683	8,073	19,875	1,128
A	12,986	11,289	28,885	30,757	83,917	4,069
BBB	10,914	127,933	443,709	273,851	856,407	46,282
Non-investment grade	34,497	211,319	341,223	176,496	763,535	166,252
Total	62,821	381,046	886,890	635,282	1,966,039	228,667
Total credit default swaps sold	$ 225,742	$ 778,266	$ 1,593,218	$ 989,207	$ 3,586,433	$ 427,338
Other credit contracts(2)(3)	$ 53	$ 43	$ 188	$ 3,014	$ 3,298	$ 3,379
Credit-linked notes(3)	706	610	2,401	2,145	5,862	(1,423)
Total credit derivatives and other credit contracts	$ 226,501	$ 778,919	$ 1,595,807	$ 994,366	$ 3,595,593	$ 429,294

(1) Fair value amounts are shown on a gross basis prior to cash collateral or counterparty netting.
(2) Other credit contracts are credit default swaps that are considered hybrid instruments.
(3) Fair value amount shown represents the fair value of the hybrid instruments.

Single Name Credit Default Swaps. A credit default swap protects the buyer against the loss of principal on a bond or loan in case of a default by the issuer. The protection buyer pays a periodic premium (generally quarterly) over the life of the contract and is protected for the period. The Company in turn will have to perform under a credit default swap if a credit event as defined under the contract occurs. Typical credit events include bankruptcy, dissolution or insolvency of the referenced entity, failure to pay and restructuring of the obligations of the referenced entity. In order to provide an indication of the current payment status or performance risk of the credit default swaps, the external credit ratings, primarily Moody s credit ratings, of the underlying reference entity of the credit default swaps are disclosed.

Index and Basket Credit Default Swaps. Index and basket credit default swaps are credit default swaps that reference multiple names through underlying baskets or portfolios of single name credit default swaps. Generally, in the event of a default on one of the underlying names, the Company will have to pay a pro rata portion of the total notional amount of the credit default index or basket contract. In order to provide an

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

indication of the current payment status or performance risk of these credit default swaps, the weighted average external credit ratings, primarily Moody s credit ratings, of the underlying reference entities comprising the basket or index were calculated and disclosed.

The Company also enters into index and basket credit default swaps where the credit protection provided is based upon the application of tranching techniques. In tranched transactions, the credit risk of an index or basket is separated into various portions of the capital structure, with different levels of subordination. The most junior tranches cover initial defaults, and once losses exceed the notional of the tranche, they are passed on to the next most senior tranche in the capital structure. As external credit ratings are not always available for tranched indices and baskets, credit ratings were determined based upon an internal methodology.

Credit Protection Sold Through CLNs. The Company has invested in CLNs, which are hybrid instruments containing embedded derivatives, in which credit protection has been sold to the issuer of the note. If there is a credit event of a reference entity underlying the CLN, the principal balance of the note may not be repaid in full to the Company.

Purchased Credit Protection. For single name credit default swaps and non-tranched index and basket credit default swaps, the Company has purchased protection with a notional amount of approximately $2.0 trillion and $2.7 trillion as of June 30, 2009 and December 31, 2008, respectively, compared with a notional amount of approximately $2.3 trillion and $3.0 trillion, as of June 30, 2009 and December 31, 2008, respectively, of credit protection sold with identical underlying reference obligations. In order to identify purchased protection with the same underlying, the notional amount for individual reference obligations within non-tranched indices and baskets was determined on a pro rata basis and matched off against single name and non-tranched index and basket credit default swaps where credit protection was sold with identical underlying reference obligations. The Company may also purchase credit protection to economically hedge loans and lending commitments. In total, not considering whether the underlying reference obligations are identical, the Company has purchased credit protection of $2.9 trillion with a positive fair value of $203 billion compared with $2.8 trillion of credit protection sold with a negative fair value of $181 billion as of June 30, 2009. In total, not considering whether the underlying reference obligations are identical, the Company has purchased credit protection of $3.7 trillion with a positive fair value of $463 billion compared with $3.6 trillion of credit protection sold with a negative fair value of $430 billion as of December 31, 2008.

The purchase of credit protection does not represent the sole manner in which the Company risk manages its exposure to credit derivatives. The Company manages its exposure to these derivative contracts through a variety of risk mitigation strategies, which include managing the credit and correlation risk across single name, non-tranched indices and baskets, tranched indices and baskets, and cash positions. Aggregate market risk limits have been established for credit derivatives, and market risk measures are routinely monitored against these limits. The Company may also recover amounts on the underlying reference obligation delivered to the Company under credit default swaps where credit protection was sold.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

9. Commitments, Guarantees and Contingencies.

Commitments.

The Company s commitments associated with outstanding letters of credit and other financial guarantees obtained to satisfy collateral requirements, investment activities, corporate lending and financing arrangements, mortgage lending and margin lending as of June 30, 2009 and December 31, 2008 are summarized below by period of expiration. Since commitments associated with these instruments may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	Years to Maturity				Total at
	Less than 1	1-3	3-5	Over 5	June 30, 2009
	(dollars in millions)				
Letters of credit and other financial guarantees obtained to satisfy collateral requirements	$ 699	$ 4	$	$ 2	$ 705
Investment activities	1,053	774	431	54	2,312
Primary lending commitments Investment grade(1)(2)	8,511	16,344	10,631	270	35,756
Primary lending commitments Non-investment grade(1)(2)	480	2,877	2,224	409	5,990
Secondary lending commitments(1)	33	69	84	43	229
Commitments for secured lending transactions	735	1,107	1,972		3,814
Forward starting reverse repurchase agreements(3)	71,708				71,708
Commercial and residential mortgage-related commitments(1)	1,738				1,738
Underwriting commitments	2,094				2,094
Other commitments(4)	408	201	150		759
Total	$ 87,459	$ 21,376	$ 15,492	$ 778	$ 125,105

(1) These commitments are recorded at fair value within Financial instruments owned and Financial instruments sold, not yet purchased in the condensed consolidated statements of financial condition (see Note 3).

(2) This amount includes commitments to asset-backed commercial paper conduits of $444 million as of June 30, 2009, of which $267 million have maturities of less than one year and $177 million of which have maturities of three to five years.

(3) The Company enters into forward starting securities purchased under agreements to resell (agreements that have a trade date as of or prior to June 30, 2009 and settle subsequent to period-end) that are primarily secured by collateral from U.S. government agency securities and other sovereign government obligations. These agreements primarily settle within three business days and as of June 30, 2009, $66.4 billion of the $71.7 billion settled with three business days.

(4) Amount includes a $200 million lending facility to a real estate fund sponsored by the Company. During the quarter ended June 30, 2009, the Company recorded a $131 million mark-to-market loss on this facility in the Asset Management business segment.

	Years to Maturity				Total at
	Less than 1	1-3	3-5	Over 5	December 31, 2008
	(dollars in millions)				
Letters of credit and other financial guarantees obtained to satisfy collateral requirements	$ 1,983	$ 27	$	$ 7	$ 2,017
Investment activities	1,662	411	164	1,059	3,296

Primary lending commitments Investment grade(1)(2)	9,906	9,973	16,672	350	36,901
Primary lending commitments Non-investment grade(1)(2)	617	2,258	2,864	1,266	7,005
Secondary lending commitments(1)	57	101	202	58	418
Commitments for secured lending transactions	1,202	1,000	1,658	15	3,875
Forward starting reverse repurchase agreements(3)	33,252				33,252
Commercial and residential mortgage-related commitments(1)	2,735				2,735
Underwriting commitments	244				244
Other commitments(4)	1,902	2			1,904
Total	$ 53,560	$ 13,772	$ 21,560	$ 2,755	$ 91,647

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

(1) These commitments are recorded at fair value within Financial instruments owned and Financial instruments sold, not yet purchased in the condensed consolidated statements of financial condition (see Note 3).
(2) This amount includes commitments to asset-backed commercial paper conduits of $589 million as of December 31, 2008, of which $581 million have maturities of less than one year and $8 million of which have maturities of three to five years.
(3) The Company enters into forward starting securities purchased under agreements to resell (agreements that have a trade date as of or prior to December 31, 2008 and settle subsequent to period-end) that are primarily secured by collateral from U.S. government agency securities and other sovereign government obligations. These agreements primarily settle within three business days, and as of December 31, 2008, $32.4 billion of the $33.3 billion settled within three business days.
(4) This amount includes binding commitments to enter into margin-lending transactions of $1.1 billion as of December 31, 2008 in connection with the Company s Institutional Securities business segment.

For further description of these commitments, refer to Note 9 to the consolidated financial statements for the fiscal year ended November 30, 2008 included in the Form 10-K.

The Company sponsors several nonconsolidated investment funds for third party investors where the Company typically acts as general partner of, and investment adviser to, these funds and typically commits to invest a minority of the capital of such funds with subscribing third party investors contributing the majority. The Company s employees, including its senior officers, as well as the Company s directors may participate on the same terms and conditions as other investors in certain of these funds that the Company forms primarily for client investment, except that the Company may waive or lower applicable fees and charges for its employees. The Company has contractual capital commitments, guarantees, lending facilities and counterparty arrangements with respect to these investment funds.

Guarantees.

The table below summarizes certain information regarding the Company s obligations under guarantee arrangements as of June 30, 2009:

	Maximum Potential Payout/Notional					Carrying Amount	
	Years to Maturity						
Type of Guarantee	**Less than 1**	**1-3**	**3-5**	**Over 5**	**Total**	**(Asset)/ Liability**	**Collateral/ Recourse**
				(dollars in millions)			
Credit derivative contracts(1)(2)	$ 253,070	$ 758,973	$ 1,053,489	$ 712,109	$ 2,777,641	$ 180,668	$
Other credit contracts		64	91	1,649	1,804	1,941	
Credit-linked notes	284	298	2,267	1,763	4,612	(1,545)	
Non-credit derivative contracts(1)	697,596	373,534	162,767	256,726	1,490,623	98,982	
Standby letters of credit and other financial guarantees issued(3)	482	1,294	1,361	4,631	7,768	(32)	5,103
Market value guarantees				651	651	25	126
Liquidity facilities	4,192	152	158	296	4,798	23	5,924
General partner guarantees	42	178	35	185	440	63	
Auction rate security guarantees	127				127	8	

(1) Carrying amount of derivative contracts are shown on a gross basis prior to cash collateral or counterparty netting. For further information on derivative contracts, see Note 8.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

(2) For further information on credit derivatives, see Note 8.
(3) Approximately $1.7 billion of standby letters of credit are also reflected in the Commitments table above in primary and secondary lending commitments. Standby letters of credit are recorded at fair value within Financial instruments owned or Financial instruments sold, not yet purchased in the condensed consolidated statements of financial condition.

The table below summarizes certain information regarding the Company s obligations under guarantee arrangements as of December 31, 2008:

	Maximum Potential Payout/Notional					Carrying Amount	
	Years to Maturity						
Type of Guarantee	Less than 1	1-3	3-5	Over 5	Total	(Asset)/ Liability	Collateral/ Recourse
				(dollars in millions)			
Credit derivative contracts(1)(2)	$ 225,742	$ 778,266	$ 1,593,218	$ 989,207	$ 3,586,433	$ 427,338	$
Other credit contracts	53	43	188	3,014	3,298	3,379	
Credit-linked notes	706	610	2,401	2,145	5,862	(1,423)	
Non-credit derivative contracts(1)	684,432	385,734	195,419	274,652	1,540,237	145,609	
Standby letters of credit and other financial guarantees issued(3)	779	1,964	1,817	4,418	8,978	78	4,787
Market value guarantees				645	645	36	134
Liquidity facilities	3,152	698	188	376	4,414	25	3,741
General partner guarantees	54	198	33	150	435	29	
Auction rate security guarantees	1,747				1,747	40	

(1) Carrying amount of derivative contracts are shown on a gross basis prior to cash collateral or counterparty netting. For further information on derivative contracts, see Note 8.
(2) For further information on credit derivatives, see Note 8.
(3) Approximately $2.0 billion of standby letters of credit are also reflected in the Commitments table above in primary and secondary lending commitments.

For further description of the above guarantee arrangements, refer to Note 9 to the consolidated financial statements for the fiscal year ended November 30, 2008 included in the Form 10-K.

The Company has obligations under certain guarantee arrangements, including contracts and indemnification agreements that contingently require a guarantor to make payments to the guaranteed party based on changes in an underlying measure (such as an interest or foreign exchange rate, security or commodity price, an index or the occurrence or non-occurrence of a specified event) related to an asset, liability or equity security of a guaranteed party. Also included as guarantees are contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity s failure to perform under an agreement, as well as indirect guarantees of the indebtedness of others.

Other Guarantees and Indemnities.

In the normal course of business, the Company provides guarantees and indemnifications in a variety of commercial transactions. These provisions generally are standard contractual terms. Certain of these guarantees and indemnifications are described below.

Trust Preferred Securities. The Company has established Morgan Stanley Trusts for the limited purpose of issuing trust preferred securities to third parties and lending the proceeds to the Company in exchange

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

for junior subordinated debentures. The Company has directly guaranteed the repayment of the trust preferred securities to the holders thereof to the extent that the Company has made payments to a Morgan Stanley Trust on the junior subordinated debentures. In the event that the Company does not make payments to a Morgan Stanley Trust, holders of such series of trust preferred securities would not be able to rely upon the guarantee for payment of those amounts. The Company has not recorded any liability in the condensed consolidated financial statements for these guarantees and believes that the occurrence of any events (*i.e.*, non-performance on the part of the paying agent) that would trigger payments under these contracts is remote. See Note 11 to the consolidated financial statements for the fiscal year ended November 30, 2008 included in the Form 10-K for details on the Company s junior subordinated debentures.

Indemnities. The Company provides standard indemnities to counterparties for certain contingent exposures and taxes, including U.S. and foreign withholding taxes, on interest and other payments made on derivatives, securities and stock lending transactions, certain annuity products and other financial arrangements. These indemnity payments could be required based on a change in the tax laws or change in interpretation of applicable tax rulings or a change in factual circumstances. Certain contracts contain provisions that enable the Company to terminate the agreement upon the occurrence of such events. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these indemnifications and believes that the occurrence of any events that would trigger payments under these contracts is remote.

Exchange/Clearinghouse Member Guarantees. The Company is a member of various U.S. and non-U.S. exchanges and clearinghouses that trade and clear securities and/or derivative contracts. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange or the clearinghouse. While the rules governing different exchange or clearinghouse memberships vary, in general the Company s guarantee obligations would arise only if the exchange or clearinghouse had previously exhausted its resources. The maximum potential payout under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these agreements and believes that any potential requirement to make payments under these agreements is remote.

Guarantees on Securitized Asset and Whole Loan Sales. As part of the Company s Institutional Securities securitization and related activities, the Company provides representations and warranties that certain assets transferred in securitization transactions or sold as whole loans conform to specified guidelines. The Company may be required to repurchase such assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines. Due diligence is performed by the Company to ensure that asset guideline qualifications are met, and, to the extent the Company has acquired such assets from other parties, the Company seeks to obtain its own representations and warranties regarding the assets. In many securitization transactions, some, but not all, of the original asset sellers provide the representations and warranties directly to the purchaser, and the Company makes representations and warranties only with respect to other assets. The maximum potential amount of future payments the Company could be required to make would be equal to the current outstanding balances of assets transferred by the Company that are subject to its representations and warranties. The Company has not provided any contingent liability in the condensed consolidated financial statements for representations and warranties made in connection with securitization transactions, and it believes that the probability of any payments under those arrangements is remote.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Since 2004, the Company has sold as whole loans residential mortgage loans with an unpaid principal balance of approximately $21 billion at the time of sale. As of June 30, 2009, the Company has provided a contingent liability of $126 million in the condensed consolidated financial statements for representations and warranties and reimbursement agreements made in connection with whole loan sales. This liability is based on the Company s recent experience with such claims and its expectation for future claims.

Also, in connection with originations of residential mortgage loans under the Company s FlexSource® program, the Company may permit borrowers to pledge marketable securities as collateral instead of requiring cash down payments for the purchase of the underlying residential property. Upon sale of the residential mortgage loans, the Company may provide a surety bond that reimburses the purchasers for shortfalls in the borrowers securities accounts up to certain limits if the collateral maintained in the securities accounts (along with the associated real estate collateral) is insufficient to cover losses that purchasers experience as a result of defaults by borrowers on the underlying residential mortgage loans. The Company requires the borrowers to meet daily collateral calls to ensure the marketable securities pledged in lieu of a cash down payment are sufficient. As of June 30, 2009 and December 31, 2008, the maximum potential amount of future payments the Company may be required to make under its surety bond was $102 million and $115 million, respectively. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these representations and warranties and reimbursement agreements and believes that the probability of any payments under these arrangements is remote.

Merger and Acquisition Guarantees. The Company may, from time to time, in its role as investment banking advisor be required to provide guarantees in connection with certain European merger and acquisition transactions. If required by the regulating authorities, the Company provides a guarantee that the acquirer in the merger and acquisition transaction has or will have sufficient funds to complete the transaction and would then be required to make the acquisition payments in the event the acquirer s funds are insufficient at the completion date of the transaction. These arrangements generally cover the time frame from the transaction offer date to its closing date and, therefore, are generally short term in nature. The maximum potential amount of future payments that the Company could be required to make cannot be estimated. The Company believes the likelihood of any payment by the Company under these arrangements is remote given the level of the Company s due diligence associated with its role as investment banking advisor.

In the ordinary course of business, the Company guarantees the debt and/or certain trading obligations (including obligations associated with derivatives, foreign exchange contracts and the settlement of physical commodities) of certain subsidiaries. These guarantees generally are entity or product specific and are required by investors or trading counterparties. The activities of the subsidiaries covered by these guarantees (including any related debt or trading obligations) are included in the Company s condensed consolidated financial statements.

Contingencies.

Legal. In the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the issuers that would otherwise be the primary defendants in such cases are bankrupt or are in financial distress.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental and self-regulatory agencies regarding the Company s business, including, among other matters, accounting and operational matters, certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief.

The Company contests liability and/or the amount of damages as appropriate in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss, if any, related to such matters; how or if such matters will be resolved; when they will ultimately be resolved; or what the eventual settlement, fine, penalty or other relief, if any, might be. Subject to the foregoing, the Company believes, based on current knowledge and after consultation with counsel, that the outcome of such pending matters will not have a material adverse effect on the condensed consolidated financial condition of the Company, although the outcome of such matters could be material to the Company s operating results and cash flows for a particular future period, depending on, among other things, the level of the Company s revenues, income or cash flows for such period. Legal reserves have been established in accordance with the requirements for accounting for contingencies. Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change.

10. Regulatory Requirements.

Morgan Stanley. In September 2008, the Company became a financial holding company subject to the regulation and oversight of the Board of Governors of the Federal Reserve System (the Fed). The Fed establishes capital requirements for the Company, including well-capitalized standards, and evaluates the Company s compliance with such capital requirements. The Office of the Comptroller of the Currency establishes similar capital requirements and standards for the Company s national banks. Prior to September 2008, the Company was a consolidated supervised entity (CSE) as defined by the SEC and subject to SEC regulation.

The Company calculates its capital ratios and risk-weighted assets (RWAs) in accordance with the capital adequacy standards for financial holding companies adopted by the Fed. These standards are based upon a framework described in the International Convergence of Capital Measurement and Capital Standards, July 1988, as amended, also referred to as Basel I. During fiscal 2008, the Company calculated capital requirements on a consolidated basis in accordance with the Revised Framework, dated June 2004 (the Basel II Accord) as interpreted by the SEC. The Basel II Accord is designed to be a risk-based capital adequacy approach, which allows for the use of internal estimates of risk components to calculate regulatory capital. In December 2007, the U.S. banking regulators published a final Basel II Accord that requires internationally active banking organizations, as well as certain of its U.S. bank subsidiaries, to implement Basel II standards over the next several years. The Company will be required to implement these Basel II standards as a result of becoming a financial holding company in September 2008.

As of June 30, 2009, the Company was in compliance with Basel I capital requirements with ratios of Tier 1 capital to RWAs of 15.8% and total capital to RWAs of 17.1% (6% and 10% being well-capitalized for regulatory purposes, respectively). In addition, financial holding companies are also subject to a Tier 1 leverage ratio (5% being well-capitalized for regulatory purposes) as defined by the Fed. The Company calculated its Tier 1 leverage ratio as Tier 1 capital divided by adjusted average total assets (which reflects adjustments for disallowed goodwill, certain intangible assets and deferred tax assets). The adjusted average total assets are derived using weekly balances for the calendar quarter. This ratio as of June 30, 2009 was 6.5%.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The following table summarizes the capital measures for the Company at June 30, 2009 and March 31, 2009 (dollars in millions):

	June 30, 2009		March 31, 2009	
	Balance	Ratio	Balance	Ratio
Tier 1 capital	$ 43,817	15.8%	$ 48,085	16.7%
Total capital	47,348	17.1%	52,354	18.2%
Risk-weighted assets	276,750		288,262	
Adjusted average assets	678,073		677,856	
Tier 1 leverage		6.5%		7.1%

The Company s Significant U.S. Bank Operating Subsidiaries. The Company s U.S. bank operating subsidiaries are subject to various regulatory capital requirements as administered by U.S. federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional, discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company s U.S. bank operating subsidiaries financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company s U.S. bank operating subsidiaries must meet specific capital guidelines that involve quantitative measures of the Company s U.S. bank operating subsidiaries assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices.

As of June 30, 2009, the Company s U.S. bank operating subsidiaries meet all capital adequacy requirements to which they are subject.

As of June 30, 2009, the Company s U.S. bank operating subsidiaries exceeded all regulatorily mandated and targeted minimum regulatory capital requirements to be well-capitalized. There are no conditions or events that management believes have changed the Company s U.S. bank operating subsidiaries category.

The table below sets forth the Company s significant U.S. bank operating subsidiaries capital as of June 30, 2009 and March 31, 2009.

	June 30, 2009		March 31, 2009	
	Amount	Ratio	Amount	Ratio
	(dollars in millions)			
Total Capital (to RWAs):				
Morgan Stanley Bank, N.A.	$ 7,681	16.1%	$ 7,559	16.7%
Morgan Stanley Trust	$ 461	52.8%	$ 405	29.0%
Tier I Capital (to RWAs):				
Morgan Stanley Bank, N.A.	$ 6,119	12.8%	$ 5,998	13.3%
Morgan Stanley Trust	$ 461	52.8%	$ 405	29.0%
Leverage Ratio:				
Morgan Stanley Bank, N.A.	$ 6,119	9.1%	$ 5,998	9.7%
Morgan Stanley Trust	$ 461	7.0%	$ 405	6.2%

Under regulatory capital requirements adopted by the U.S. federal banking agencies, U.S. depository institutions, in order to be considered well capitalized, must maintain a capital ratio of Tier 1 capital to risk-based assets of 6%, a ratio of total capital to risk-based assets of 10%, and a ratio of Tier 1 capital to average book assets (leverage ratio) of 5%. Each U.S. depository institution subsidiary of the Company must be well capitalized in order for the Company to continue to qualify as a financial holding company and to continue to engage in the

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

broadest range of financial activities permitted to financial holding companies. As of June 30, 2009, the Company s three U.S. depository institutions maintained capital at levels in excess of the universally mandated well capitalized levels. These subsidiary depository institutions maintain capital at levels sufficiently in excess of the well capitalized requirements to address any additional capital needs and requirements identified by the federal banking regulators.

MS&Co. and Other Broker-Dealers. MS&Co. is a registered broker-dealer and registered futures commission merchant and, accordingly, is subject to the minimum net capital requirements of the SEC, the Financial Industry Regulatory Authority and the Commodity Futures Trading Commission. MS&Co. has consistently operated in excess of these requirements. MS&Co. s net capital totaled $11,260 million and $9,216 million as of June 30, 2009 and December 31, 2008, respectively, which exceeded the amount required by $10,274 million and $8,366 million, respectively. Morgan Stanley Smith Barney LLC is a registered introducing broker-dealer and registered non-clearing futures commission merchant and has operated with capital in excess of its regulatory requirements. MSIP, a London-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Authority, and MSJS, a Tokyo-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Agency. MSIP and MSJS consistently operated in excess of their respective regulatory capital requirements.

MS&Co. is required to hold tentative net capital in excess of $1 billion and net capital in excess of $500 million in accordance with the market and credit risk standards of Appendix E of Rule 15c3-1. MS&Co. is also required to notify the SEC in the event that its tentative net capital is less than $5 billion. As of June 30, 2009, MS&Co. had tentative net capital in excess of the minimum and the notification requirements.

Other Regulated Subsidiaries. Certain other U.S. and non-U.S. subsidiaries are subject to various securities, commodities and banking regulations, and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. These subsidiaries have consistently operated in excess of their local capital adequacy requirements.

Morgan Stanley Derivative Products Inc. (MSDP), which is a triple-A rated derivative products subsidiary, maintains certain operating restrictions that have been reviewed by various rating agencies. On July 16, 2009, Moody s Investors Service placed MSDP, along with certain other triple-A rated derivative product companies, on review for possible downgrade. MSDP is operated such that creditors of the Company should not expect to have any claims on the assets of MSDP, unless and until the obligations to its own creditors are satisfied in full. Creditors of MSDP should not expect to have any claims on the assets of the Company or any of its affiliates, other than the respective assets of MSDP.

During the second quarter of fiscal 2008, Morgan Stanley Senior Funding, Inc. (MSSF), which provides loans or lending commitments (including bridge financing) to selected corporate clients, transferred certain loans to Ascension. MSSF and Ascension are both wholly owned subsidiaries of the Company. MSSF transferred such loans so that they could be securitized and, in turn, made eligible to be pledged with the Fed. Certain of the securitized interests in Ascension were transferred to Morgan Stanley Darica Funding, LLC (MSDF), a wholly owned subsidiary of the Company, during the third quarter of fiscal 2008. Ascension and MSDF, which are special purpose vehicle subsidiaries of the Company, maintain certain operating restrictions that have been reviewed by various rating agencies. Ascension and MSDF are structured as separate legal entities and operated such that creditors of the Company or any affiliate of the Company, including MSSF, but excluding Ascension and MSDF, should not reasonably expect to have any claims on the assets of Ascension and MSDF, respectively. Such assets include loans that have been sold, and participation interests that have been granted, by MSSF to Ascension in an aggregate approximate amount of $2.0 billion as of December 31, 2008 and $0.9 billion as of

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

June 30, 2009. Such amounts may increase or decrease. Securitized interests in Ascension were transferred to MSDF in the aggregate approximate amount of $460 million during fiscal 2008 and no additional securitized interests were transferred in the one month period ended December 31, 2008 and the six month period ended June 30, 2009. Creditors of Ascension and MSDF should not reasonably expect to have any claims on the assets of the Company or any of its affiliates, including MSSF, other than the assets of Ascension and MSDF, respectively. During the second quarter of fiscal 2009, Ascension began transferring loans to MSSF in order to unwind the Ascension loan vehicle. As of June 30, 2009, the remaining loan balance in Ascension was $923 million. On July 23, 2009, the remaining loan balance was transferred to MSSF and the bonds issued by Ascension were redeemed.

11. Total Equity.
Morgan Stanley Shareholders Equity.

Treasury Shares. During the six month periods ended June 30, 2009 and June 30, 2008, the Company did not purchase any of its common stock through the capital management share repurchase program.

China Investment Corporation Investment. In December 2007, the Company sold Equity Units that included contracts to purchase Company common stock to a wholly owned subsidiary of CIC for gross proceeds of approximately $5,579 million. As a result of the MUFG Transaction referred to below, upon settlement of the Equity Units, CIC will be entitled to receive 116,062,911 shares of the Company s common stock, subject to anti-dilution adjustments. In June 2009, to maintain its pro rata share in the Company s share capital, CIC participated in the Company s registered public offering of 85,890,277 shares by purchasing 45,290,576 shares of the Company s common stock. CIC is a passive financial investor and has no special rights of ownership nor a role in the management of the Company. A substantial portion of the investment proceeds from the offering of the Equity Units was treated as Tier 1 capital for regulatory capital purposes.

For a more detailed summary of the Equity Units, including the junior subordinated debentures issued to support trust common and trust preferred securities and the stock purchase contracts, refer to Note 11 to the consolidated financial statements for the fiscal year ended November 30, 2008 included in the Form 10-K.

Prior to the Company s sale to Mitsubishi UFJ Financial Group, Inc. (MUFG) of certain preferred stock for an aggregate purchase price of $9 billion on October 13, 2008 (MUFG Transaction), the impact of the Equity Units was reflected in the Company s earnings per diluted common share using the treasury stock method. There was no dilutive impact for the quarter and six month period ended June 30, 2008.

Effective October 13, 2008, as a result of the adjustment to the Equity Units due to the MUFG Transaction, the Equity Units are now deemed to be participating securities in that the Equity Units have the ability to participate in any dividends the Company declares on common shares above $0.27 per share during any quarterly reporting period via an increase in the number of common shares to be delivered upon settlement of the stock purchase contracts. During the quarter and six month period ended June 30, 2009, no common dividends above $0.27 per share were declared.

The Equity Units do not share in any losses of the Company for purposes of calculating EPS. Therefore, if the Company incurs a loss in any reporting period, losses will not be allocated to the Equity Units in the EPS calculation.

See Note 1 for further discussion on the two-class method and Note 12 for the dilutive impact for the quarter and six month period ended June 30, 2009.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Common Equity Offerings. During the quarter ended June 30, 2009, the Company issued common stock for approximately $6.9 billion in two registered public offerings. In connection with one of the offerings, MUFG received $0.7 billion of common stock in exchange for 640,909 shares of the Company s Series C Preferred Stock.

Preferred Stock.

The Company s preferred stock outstanding consisted of the following (dollars in millions):

Series	Dividend Rate (Annual)	Shares Outstanding at June 30, 2009	Liquidation Preference per Share	Convertible to Morgan Stanley Shares	Carrying Value At June 30, 2009	At December 31, 2008	At November 30, 2008
					(dollars in millions)		
A	N/A(1)	44,000	$ 25,000		$ 1,100	$ 1,100	$ 1,100
B	10.00%	7,839,209	1,000	310,464,033	8,089	8,089	8,089
C	10.00%(2)	519,882	1,000		408	911	911
D	5.00%(3)					9,068	9,055
Total					$ 9,597	$ 19,168	$ 19,155

(1) The Series A Preferred Stock pays a non-cumulative dividend, as and if declared by the Board of Directors of the Company, in cash, at a rate per annum equal to the greater of (1) the three-month U.S. dollar LIBOR plus 0.70% or (2) 4%.
(2) During the quarter ended June 30, 2009, 640,909 shares were redeemed with an aggregate price equal to the aggregate price exchanged by MUFG for $0.7 billion of common stock resulting in a negative adjustment of approximately $202 million in calculating earnings per basic and diluted share (see Note 12).
(3) The Series D Preferred Stock paid a compounding cumulative dividend, in cash, at the rate of 5% per annum for the first five years commencing with the issuance of the Series D Preferred Stock, and 9% thereafter on the liquidation preference of $1,000 per share. In June 2009, the Series D Preferred Stock was repurchased by the Company.

In June 2009, the Company repurchased 10,000,000 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series D, par value $0.01 per share, liquidation preference $1,000 per share (the Series D Preferred Stock) that the Company issued to the U.S. Department of the Treasury (U.S. Treasury) in October 2008, at the liquidation preference amount plus accrued and unpaid dividends, for an aggregate repurchase price of $10,086 million.

As a result of the Company s repurchasing the Series D Preferred Stock, the Company incurred a one-time negative adjustment of $850 million in its calculation of basic and diluted EPS (reduction to earnings (losses) applicable to the Company s common shareholders) for the quarter and six month period ended June 30, 2009 due to the accelerated amortization of the issuance discount on the Series D Preferred Stock.

In connection with the issuance of the Series D Preferred Stock, the Company also issued a warrant to U.S. Treasury under the Capital Purchase Program (the CPP) for the purchase of 65,245,759 shares of the Company s common stock at an exercise price of $22.99 per share. On August 5, 2009, under the terms of the CPP securities purchase agreement, the Company reached an agreement with U.S. Treasury to repurchase the warrant. The purchase price to be paid for the warrant is $950 million. This amount will reduce the Company s total equity in the third quarter of 2009.

For further information on the Company s preferred stock and warrant, refer to Note 11 to the consolidated financial statements for the fiscal year ended November 30, 2008 included in the Form 10-K.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Non-controlling Interest.

Deconsolidation of subsidiaries

During the six month period ended June 30, 2009, the Company deconsolidated MSCI in connection with the Company s disposition of its remaining ownership interest in MSCI and recognized an after-tax gain of approximately $310 million. The Company did not retain any investments in MSCI upon deconsolidation. See Note 19 for further information on discontinued operations.

During the six month period ended June 30, 2008, the Company deconsolidated certain subsidiaries and recognized gains of approximately $70 million, included in Other revenues on the condensed consolidated statements of income.

Changes in the Company s ownership interest in subsidiaries

The following table presents the effect on the Company s shareholders equity from changes in ownership of subsidiaries resulting from transactions with non-controlling interests.

	Six Months Ended June 30, 2009 (dollars in millions)
Net income (loss) applicable to Morgan Stanley	$ (28)
Transfers (to) from the non-controlling interests:	
Increase in paid-in capital in connection with MSSB	1,711
Net transfers (to) from non-controlling interests	1,711
Change from net income (loss) attributable to Morgan Stanley and transfers (to) from non-controlling interests	$ 1,683

The increase in paid-in capital results from Citi s equity interest in MSSB, to which the Company had contributed certain businesses associated with the Company s Global Wealth Management Group. The excess of the preliminary net fair value received by the Company over the increase in non-controlling interest associated with Smith Barney is reflected as an increase in paid-in capital. See Note 2 for further information regarding the MSSB transaction.

The impact on the Company s shareholders equity from transactions with non-controlling interests was not material for the six month period ended June 30, 2008.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

12. Earnings per Common Share.

Basic EPS is computed by dividing income available to Morgan Stanley common shareholders by the weighted average number of common shares outstanding for the period. Common shares outstanding include common stock and vested restricted stock unit awards where recipients have satisfied either the explicit vesting terms or retirement-eligible requirements. Diluted EPS reflects the assumed conversion of all dilutive securities. The Company calculates EPS using the two-class method (see Note 1) and determines whether instruments granted in share-based payment transactions are participating securities. The following table presents the calculation of basic and diluted EPS (in millions, except for per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Basic EPS:				
(Loss) income from continuing operations	$ (286)	$ 694	$ (490)	$ 2,104
Net gain on discontinued operations	319	465	333	487
Net income (loss)	33	1,159	(157)	2,591
Net income (loss) applicable to non-controlling interests	(116)	16	(129)	35
Net income (loss) applicable to Morgan Stanley	149	1,143	(28)	2,556
Less: Preferred dividends (Series A Preferred Stock)	(11)	(11)	(22)	(25)
Less: Preferred dividends (Series B Preferred Stock)	(196)		(392)	
Less: Preferred dividends (Series C Preferred Stock)	(13)		(42)	
Less: Partial Redemption of Series C Preferred Stock	(202)		(202)	
Less: Preferred dividends (Series D Preferred Stock)	(87)		(212)	
Less: Amortization and acceleration of issuance discount for Series D Preferred Stock (see Note 11)	(892)		(932)	
Less: Allocation of earnings to unvested restricted stock units(1)	(4)	(70)	(4)	(157)
Net income (loss) applicable to Morgan Stanley common shareholders	$ (1,256)	$ 1,062	$ (1,834)	$ 2,374
Weighted average common shares outstanding	1,138	1,041	1,075	1,038
(Losses) earnings per basic common share:				
(Loss) income from continuing operations	$ (1.37)	$ 0.61	$ (2.00)	$ 1.86
Net gain on discontinued operations	0.27	0.41	0.29	0.43
(Losses) earnings per basic common share	$ (1.10)	$ 1.02	$ (1.71)	$ 2.29
Diluted EPS:				
(Losses) earnings applicable to Morgan Stanley common shareholders	$ (1,256)	$ 1,062	$ (1,834)	$ 2,374
Weighted average common shares outstanding	1,138	1,041	1,075	1,038
Effect of dilutive securities:				
Stock options and restricted stock units(1)		4		4

Weighted average common shares outstanding and common stock equivalents	1,138	1,045	1,075	1,042
(Losses) earnings per diluted common share:				
(Loss) income from continuing operations	$ (1.37)	$ 0.61	$ (2.00)	$ 1.85
Net gain on discontinued operations	0.27	0.41	0.29	0.43
(Losses) earnings per diluted common share	$ (1.10)	$ 1.02	$ (1.71)	$ 2.28

(1) The restricted stock units participate in all of the earnings of the Company in the computation of basic EPS, and therefore, the restricted stock units are not included as incremental shares in the diluted calculation.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

The following securities were considered antidilutive and, therefore, were excluded from the computation of diluted EPS:

Number of Antidilutive Securities Outstanding at End of Period:	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(shares in millions)			
Stock options	86	81	86	81
Restricted stock units	67	65	67	65
Equity Units(1)	116	116	116	116
CPP Warrant	65		65	
Series B Preferred Stock	311		311	
Total	645	262	645	262

(1) The CIC Equity Units participate in substantially all of the earnings of the Company (*i.e.*, any earnings above $0.27 per quarter) in basic EPS (assuming a full distribution of earnings of the Company), and therefore, the CIC Equity Units generally would not be included as incremental shares in the fully diluted calculation.

13. Interest and Dividends and Interest Expense.

Details of Interest and dividends revenue and Interest expense were as follows (dollars in millions):

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Interest and dividends(1):				
Financial instruments owned(2)	$ 867	$ 1,470	$ 2,435	$ 4,346
Receivables from other loans	13	196	101	458
Interest bearing deposits with banks	63	491	176	947
Federal funds sold and securities purchased under agreements to resell and securities borrowed	133	4,096	577	8,835
Other	317	2,943	628	7,320
Total Interest and dividends revenues	$ 1,393	$ 9,196	$ 3,917	$ 21,906
Interest expense(1):				
Commercial paper and other short-term borrowings	$	$ 147	$ 37	$ 379
Deposits	100	158	250	396
Long-term debt	1,387	1,899	2,859	4,072
Securities sold under agreements to repurchase and securities loaned	394	3,745	857	8,255
Other		3,114	248	7,749

Total Interest expense	1,881	9,063	4,251	20,851
Net interest and dividends revenues	$ (488)	$ 133	$ (334)	$ 1,055

(1) Interest income and expense and dividend income are recorded within the condensed consolidated statements of income depending on the nature of the instrument and related market conventions. When interest and dividends are included as a component of the instrument s fair value, interest and dividends are included within Principal transactions trading revenues or Principal transactions investment revenues. Otherwise, they are included within Interest and dividends income or Interest expense.

(2) Interest expense on Financial instruments sold, not yet purchased is reported as a reduction of Interest and dividends revenues.

71

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

14. Other Revenues.

In fiscal 2008, the Company sold Morgan Stanley Wealth Management S.V., S.A.U., its Spanish onshore mass affluent wealth management business. Other revenues for the six month period ended June 30, 2008 included $748 million related to the sale.

15. Employee Benefit Plans.

The Company maintains various pension and benefit plans for eligible employees.

The components of the Company s net periodic benefit expense for its pension and postretirement plans were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(dollars in millions)			
Service cost, benefits earned during the period	$ 32	$ 28	$ 63	$ 56
Interest cost on projected benefit obligation	40	37	80	74
Expected return on plan assets	(31)	(33)	(61)	(66)
Net amortization of prior service costs	(1)	(2)	(4)	(4)
Net amortization of actuarial loss	10	8	21	16
Net periodic benefit expense	$ 50	$ 38	$ 99	$ 76

16. Income Taxes.

The Company is under continuous examination by the Internal Revenue Service (the IRS) and other tax authorities in certain countries, such as Japan and the U.K., and states in which the Company has significant business operations, such as New York. The IRS and Japanese tax authorities are expected to conclude the field work portion of their respective examinations during 2009. During 2009, the Company expects to come to conclusion with the U.K. tax authorities on issues through tax year 2007, including those in appeals. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years examinations. The Company has established unrecognized tax benefits that the Company believes are adequate in relation to the potential for additional assessments. Once established, the Company adjusts unrecognized tax benefits only when more information is available or when an event occurs necessitating a change. The Company believes that the resolution of tax matters will not have a material effect on the condensed consolidated statements of financial condition of the Company, although a resolution could have a material impact on the Company s condensed consolidated statements of income for a particular future period and on the Company s effective income tax rate for any period in which such resolution occurs.

It is reasonably possible that significant changes in the gross balance of unrecognized tax benefits may occur within the next twelve months. At this time, however, it is not possible to reasonably estimate the expected change to the total amount of unrecognized tax benefits and impact on the effective tax rate over the next twelve months.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

17. Segment and Geographic Information.

The Company structures its segments primarily based upon the nature of the financial products and services provided to customers and the Company s management organization. The Company provides a wide range of financial products and services to its customers in each of its business segments: Institutional Securities, Global Wealth Management Group and Asset Management. For further discussion of the Company s business segments, see Note 1.

Revenues and expenses directly associated with each respective segment are included in determining their operating results. Other revenues and expenses that are not directly attributable to a particular segment are allocated based upon the Company s allocation methodologies, generally based on each segment s respective net revenues, non-interest expenses or other relevant measures.

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the business segment results to the Company s consolidated results. Income before taxes in Intersegment Eliminations primarily represents the effect of timing differences associated with the revenue and expense recognition of commissions paid by the Asset Management business segment to the Global Wealth Management Group business segment associated with sales of certain products and the related compensation costs paid to the Global Wealth Management Group business segment s global representatives.

Selected financial information for the Company s business segments is presented below:

Three Months Ended June 30, 2009	Institutional Securities	Global Wealth Management Group	Asset Management (dollars in millions)	Intersegment Eliminations	Total
Total non-interest revenues	$ 3,600	$ 1,763	$ 643	$ (107)	$ 5,899
Net interest	(636)	160	(68)	56	(488)
Net revenues	$ 2,964	$ 1,923	$ 575	$ (51)	$ 5,411
Loss from continuing operations before income taxes	$ (307)	$ (71)	$ (239)	$ (2)	$ (619)
Benefit from income taxes	(173)	(29)	(130)	(1)	(333)
Loss from continuing operations	(134)	(42)	(109)	(1)	(286)
Discontinued operations(1):					
Gain from discontinued operations (including gain on disposal of $499 million)	515				515
Provision for income taxes	196				196
Gain on discontinued operations	319				319
Net income (loss)	$ 185	$ (42)	$ (109)	$ (1)	$ 33
Net income (loss) applicable to non-controlling interests	$ 3	$ (118)	$ (1)	$	$ (116)
Net income (loss) applicable to Morgan Stanley(2)	$ 182	$ 76	$ (108)	$ (1)	$ 149

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Three Months Ended June 30, 2008	Institutional Securities	Global Wealth Management Group	Asset Management	Intersegment Eliminations	Total
			(dollars in millions)		
Total non-interest revenues	$ 3,960	$ 1,452			