MORGAN STANLEY
Form 10-Q
August 07, 2009
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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 ¨ (Do not check if a smaller reporting company)	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.

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QUARTERLY REPORT ON FORM 10-Q

For the quarter ended June 30, 2009

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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.

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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.

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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.

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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.

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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.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in millions)

	Six Months Ended June 30, 2009 (unaudited)	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.

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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.

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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.

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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

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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.

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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.