MORGAN STANLEY
Form 10-Q
May 07, 2012
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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 March 31, 2012

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** (Address of principal executive offices, including zip code)	(I.R.S. Employer Identification No.)	(Registrant s telephone number, including area 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 April 30, 2012, there were 1,977,775,881 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 March 31, 2012

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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 its Audit Committee; Internal Audit Subcommittee; Compensation, Management Development and Succession Committee; Nominating and Governance Committee; and Risk 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 information.

Morgan Stanley s Code of Ethics and Business Conduct applies to all directors, officers and employees, including its Chief Executive Officer, Chief Financial Officer and Deputy Chief Financial 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 LLC (NYSE) 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)

	March 31, 2012	December 31, 2011
Assets		
Cash and due from banks ($534 and $511 at March 31, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities generally not available to the Company)	$ 10,133	$ 13,165
Interest bearing deposits with banks	28,592	34,147
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	30,152	29,454
Financial instruments owned, at fair value (approximately $144,873 and $140,749 were pledged to various parties at March 31, 2012 and December 31, 2011, respectively):		
U.S. government and agency securities	59,690	63,449
Other sovereign government obligations	32,235	29,059
Corporate and other debt ($3,442 and $3,007 at March 31, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities, generally not available to the Company)	69,518	68,923
Corporate equities	59,063	47,966
Derivative and other contracts	40,016	48,064
Investments ($1,797 and $1,666 at March 31, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities, generally not available to the Company)	8,329	8,195
Physical commodities	9,573	9,697
Total financial instruments owned, at fair value	278,424	275,353
Securities available for sale, at fair value	32,528	30,495
Securities received as collateral, at fair value	17,728	11,651
Federal funds sold and securities purchased under agreements to resell (includes $318 and $112 at fair value at March 31, 2012 and December 31, 2011, respectively)	136,451	130,155
Securities borrowed	141,610	127,074
Receivables:		
Customers	38,962	33,977
Brokers, dealers and clearing organizations	5,718	5,248
Fees, interest and other	10,263	9,444
Loans (net of allowances of $26 and $17 at March 31, 2012 and December 31, 2011, respectively)	16,729	15,369
Other investments	4,688	4,832
Premises, equipment and software costs (net of accumulated depreciation of $5,079 and $4,852 at March 31, 2012 and December 31, 2011, respectively) ($231 and $234 at March 31, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities, generally not available to the Company)	6,410	6,457
Goodwill	6,700	6,686
Intangible assets (net of accumulated amortization of $994 and $910 at March 31, 2012 and December 31, 2011, respectively) (includes $99 and $133 at fair value at March 31, 2012 and December 31, 2011, respectively)	4,170	4,285
	11,772	12,106

Other assets ($343 and $446 at March 31, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities, generally not available to the Company)		
Total assets	$ 781,030	$ 749,898

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)

	March 31, 2012	December 31, 2011
Liabilities and Equity		
Deposits (includes $1,980 and $2,101 at fair value at March 31, 2012 and December 31, 2011, respectively)	$ 66,441	$ 65,662
Commercial paper and other short-term borrowings (includes $1,321 and $1,339 at fair value at March 31, 2012 and December 31, 2011, respectively)	2,017	2,843
Financial instruments sold, not yet purchased, at fair value:		
U.S. government and agency securities	25,589	19,630
Other sovereign government obligations	26,354	17,141
Corporate and other debt	8,547	8,410
Corporate equities	27,725	24,497
Derivative and other contracts	42,765	46,453
Physical commodities		16
Total financial instruments sold, not yet purchased, at fair value	130,980	116,147
Obligation to return securities received as collateral, at fair value	23,366	15,394
Securities sold under agreements to repurchase (includes $347 and $348 at fair value at March 31, 2012 and December 31, 2011, respectively)	107,330	104,800
Securities loaned	34,431	30,462
Other secured financings (includes $13,081 and $14,594 at fair value at March 31, 2012 and December 31, 2011, respectively) ($1,918 and $2,316 at March 31, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities and are non-recourse to the Company)	21,435	20,719
Payables:		
Customers	119,045	117,241
Brokers, dealers and clearing organizations	12,143	4,082
Interest and dividends	2,712	2,292
Other liabilities and accrued expenses ($117 and $121 at March 31, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities and are non-recourse to the Company)	13,815	15,944
Long-term borrowings (includes $43,224 and $39,663 at fair value at March 31, 2012 and December 31, 2011, respectively)	176,723	184,234
	710,438	679,820
Commitments and contingent liabilities (see Note 11)		
Equity		
Morgan Stanley shareholders equity:		
Preferred stock	1,508	1,508
Common stock, $0.01 par value;		
Shares authorized: 3,500,000,000 at March 31, 2012 and December 31, 2011;		
Shares issued: 2,038,893,979 at March 31, 2012 and 1,989,377,171 at December 31, 2011;		
Shares outstanding: 1,978,337,922 at March 31, 2012 and 1,926,986,130 at December 31, 2011	20	20
Paid-in capital	22,930	22,836
Retained earnings	40,118	40,341
Employee stock trust	3,252	3,166
Accumulated other comprehensive loss	(60)	(157)
	(2,192)	(2,499)

Common stock held in treasury, at cost, $0.01 par value; 60,556,057 shares at March 31, 2012 and 62,391,041 shares at December 31, 2011		
Common stock issued to employee trust	(3,252)	(3,166)
Total Morgan Stanley shareholders equity	62,324	62,049
Noncontrolling interests	8,268	8,029
Total equity	70,592	70,078
Total liabilities and equity	$ 781,030	$ 749,898

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 March 31, 2012	Three Months Ended March 31, 2011
Revenues:		
Investment banking	$ 1,063	$ 1,214
Principal transactions:		
Trading	2,407	2,977
Investments	85	329
Commissions and fees	1,177	1,439
Asset management, distribution and administration fees	2,152	2,083
Other	110	(474)
Total non-interest revenues	6,994	7,568
Interest income	1,542	1,859
Interest expense	1,601	1,853
Net interest	(59)	6
Net revenues	6,935	7,574
Non-interest expenses:		
Compensation and benefits	4,431	4,285
Occupancy and equipment	392	397
Brokerage, clearing and exchange fees	403	401
Information processing and communications	459	440
Marketing and business development	146	142
Professional services	412	403
Other	489	605
Total non-interest expenses	6,732	6,673
Income from continuing operations before income taxes	203	901
Provision for (benefit from) income taxes	54	(244)
Income from continuing operations	149	1,145
Discontinued operations:		
Gain (loss) from discontinued operations	27	(28)
Provision for (benefit from) income taxes	42	(13)
Net gain (loss) from discontinued operations	(15)	(15)
Net income	$ 134	$ 1,130
Net income applicable to noncontrolling interests	228	162
Net income (loss) applicable to Morgan Stanley	$ (94)	$ 968

Earnings (loss) applicable to Morgan Stanley common shareholders	$	(119)	$	736
Amounts applicable to Morgan Stanley:				
Income (loss) from continuing operations	$	(78)	$	984
Net gain (loss) from discontinued operations		(16)		(16)
Net income (loss) applicable to Morgan Stanley	$	(94)	$	968
Earnings (loss) per basic common share:				
Income (loss) from continuing operations	$	(0.05)	$	0.52
Net gain (loss) from discontinued operations		(0.01)		(0.01)
Earnings (loss) per basic common share	$	(0.06)	$	0.51
Earnings (loss) per diluted common share:				
Income (loss) from continuing operations	$	(0.05)	$	0.51
Net gain (loss) from discontinued operations		(0.01)		(0.01)
Earnings (loss) per diluted common share	$	(0.06)	$	0.50
Average common shares outstanding:				
Basic		1,876,961,836		1,456,015,979
Diluted		1,876,961,836		1,472,307,592

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

Condensed Consolidated Statements of Comprehensive Income

(dollars in millions)

(unaudited)

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Net income	$ 134	$ 1,130
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustments(1)	$ 20	$ 37
Amortization of cash flow hedges(2)	2	1
Net unrealized gain (loss) on Securities available for sale(3)	(19)	(36)
Pension, postretirement and other related adjustments(4)	2	5
Total other comprehensive income	$ 5	$ 7
Comprehensive income	$ 139	$ 1,137
Net income applicable to noncontrolling interests	228	162
Other comprehensive income (loss) applicable to noncontrolling interests	(92)	(34)
Comprehensive income applicable to Morgan Stanley	$ 3	$ 1,009

(1) Amounts are net of provision for (benefit from) income taxes of $4 million and $(68) million for the quarters ended March 31, 2012 and 2011, respectively.
(2) Amounts are net of provision for income taxes of $1 million and $2 million for the quarters ended March 31, 2012 and 2011, respectively.
(3) Amounts are net of (benefit from) income taxes of $(13) million and $(24) million for the quarters ended March 31, 2012 and 2011, respectively.
(4) Amounts are net of provision for (benefit from) income taxes of $2 million and $(4) million for the quarters ended March 31, 2012 and 2011, respectively.

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

Condensed Consolidated Statements of Cash Flows

(dollars in millions)

(unaudited)

	Three Months Ended March 31, 2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 134	$ 1,130
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Deferred income taxes		
Loss on equity method investees	32	660
Compensation payable in common stock and options	372	340
Depreciation and amortization	375	379
Gain on sale of securities available for sale	(1)	(12)
(Gain) loss on retirement of long-term debt	(14)	23
Impairment charges and other-than-temporary impairment charges	12	3
Changes in assets and liabilities:		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	(698)	(2,752)
Financial instruments owned, net of financial instruments sold, not yet purchased	14,176	7,568
Securities borrowed	(14,536)	(4,207)
Securities loaned	3,969	6,990
Receivables, loans and other assets	(6,784)	(7,417)
Payables and other liabilities	11,115	1,350
Federal funds sold and securities purchased under agreements to resell	(6,296)	(14,670)
Securities sold under agreements to repurchase	5,575	9,293
Net cash provided by (used for) operating activities	7,431	(1,322)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net proceeds from (payments for):		
Premises, equipment and software costs	(212)	(409)
Purchases of securities available for sale	(3,487)	(3,357)
Sales, maturities and redemptions of securities available for sale	1,003	6,311
Net cash provided by (used for) investing activities	(2,696)	2,545
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from (payments for):		
Commercial paper and other short-term borrowings	(826)	46
Distributions related to noncontrolling interests	(7)	(7)
Derivatives financing activities	(169)	89
Other secured financings	(1,674)	2,312
Deposits	779	(317)
Net proceeds from:		
Excess tax benefits associated with stock-based awards	34	29
Issuance of long-term borrowings	5,320	14,285
Payments for:		
Long-term borrowings	(16,043)	(13,046)
Repurchases of common stock for employee tax withholding	(183)	(273)
Cash dividends	(112)	(302)
Net cash provided by (used for) financing activities	(12,881)	2,816

Effect of exchange rate changes on cash and cash equivalents	93	644
Effect of cash and cash equivalents related to variable interest entities	(534)	310
Net increase in cash and cash equivalents	(8,587)	4,993
Cash and cash equivalents, at beginning of period	47,312	47,615
Cash and cash equivalents, at end of period	$ 38,725	$ 52,608
Cash and cash equivalents include:		
Cash and due from banks	$ 10,133	$ 8,120
Interest bearing deposits with banks	28,592	44,488
Cash and cash equivalents, at end of period	$ 38,725	$ 52,608

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for interest were $1,169 million and $1,697 million for the quarters ended March 31, 2012 and 2011, respectively.

Cash payments for income taxes were $145 million and $250 million for the quarters ended March 31, 2012 and 2011, respectively.

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

Condensed Consolidated Statements of Changes in Total Equity

Three Months Ended March 31, 2012

(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 Interests	Total Equity
BALANCE AT DECEMBER 31, 2011	$ 1,508	$ 20	$ 22,836	$ 40,341	$ 3,166	$ (157)	$ (2,499)	$ (3,166)	$ 8,029	$ 70,078
Net income				(94)					228	134
Dividends				(129)						(129)
Shares issued under employee plans and related tax effects			94		86		490	(86)		584
Repurchases of common stock							(183)			(183)
Net change in cash flow hedges						2				2
Pension, postretirement and other related adjustments						2				2
Foreign currency translation adjustments						112			(92)	20
Change in net unrealized gains on securities available for sale						(19)				(19)
Other increases in noncontrolling interests									103	103
BALANCE AT MARCH 31, 2012	$ 1,508	$ 20	$ 22,930	$ 40,118	$ 3,252	$ (60)	$ (2,192)	$ (3,252)	$ 8,268	$ 70,592

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

Condensed Consolidated Statements of Changes in Total Equity (Continued)

Three Months Ended March 31, 2011

(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 Interests	Total Equity
BALANCE AT DECEMBER 31, 2010	$ 9,597	$ 16	$ 13,521	$ 38,603	$ 3,465	$ (467)	$ (4,059)	$ (3,465)	$ 8,196	$ 65,407
Net income				968					162	1,130
Dividends				(302)						(302)
Shares issued under employee plans and related tax effects			(1,336)		3		1,877	(3)		541
Repurchases of common stock							(273)			(273)
Net change in cash flow hedges						1				1
Pension, postretirement and other related adjustments						5				5
Foreign currency translation adjustments						71			(34)	37
Change in net unrealized losses on securities available for sale						(36)				(36)
Other decreases in noncontrolling interests									(2)	(2)
BALANCE AT MARCH 31, 2011	$ 9,597	$ 16	$ 12,185	$ 39,269	$ 3,468	$ (426)	$ (2,455)	$ (3,468)	$ 8,322	$ 66,508

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Introduction and Basis of Presentation.

The Company. Morgan Stanley, a financial holding 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. Unless the context otherwise requires, the terms Morgan Stanley and the Company mean Morgan Stanley and its consolidated subsidiaries.

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

Institutional Securities provides 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 to individual investors and small-to-medium sized businesses and institutions 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 and engages in fixed income principal trading, which primarily facilitates clients trading or investments in such securities.

Asset Management provides a broad array of investment strategies that span the risk/return spectrum across geographies, asset classes and public and private markets to a diverse group of clients across the institutional and intermediary channels as well as high net worth clients (see Discontinued Operations Retail Asset Management Business herein).

Discontinued Operations.

Saxon. On October 24, 2011, the Company announced that it had reached an agreement to sell Saxon, a provider of servicing and subservicing of residential mortgage loans, to Ocwen Financial Corporation. During the first quarter of 2012, the transaction was restructured as a sale of Saxon s assets, the first phase of which was completed in the second quarter of 2012. The remaining operations of Saxon are expected to be wound down within the year. The Company expects to incur incremental wind-down costs in future periods. The results of Saxon are reported as discontinued operations within the Institutional Securities business segment for all periods presented.

Quilter. On April 2, 2012, the Company closed the sale of Quilter Holdings Ltd. (Quilter), its retail wealth management business in the United Kingdom (U.K.). The Company has classified Quilter as held for sale within the Global Wealth Management Group business segment and the results of its operations are presented as discontinued operations for all periods presented.

Prior period amounts have been recast for discontinued operations. See Note 20 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 United States of America (U.S.), which require the Company to make estimates and assumptions regarding the valuations of certain financial instruments, the valuation of goodwill and intangible assets, compensation, deferred tax assets, the outcome of litigation and tax matters, 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.

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 year ended December 31, 2011 (the Form 10-K). The condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for the fair presentation 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 certain variable interest entities (VIE) (see Note 6). For condensed consolidated subsidiaries that are less than wholly owned, the third-party holdings of equity interests are referred to as noncontrolling interests. The portion of net income attributable to noncontrolling interests for such subsidiaries is presented as Net income (loss) applicable to noncontrolling interests in the condensed consolidated statements of income, and the portion of the shareholders equity of such subsidiaries is presented as Noncontrolling interests in 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 without additional support and (2) the equity holders bear the economic residual risks and returns of the entity and have the power to direct the activities of the entity that most significantly affect its economic performance, the Company consolidates those entities it controls either through a majority voting interest or otherwise. For VIEs (i.e., entities that do not meet these criteria), the Company consolidates those entities where the Company has the power to make the decisions that most significantly affect the economic performance of the VIE and has the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE, except for certain VIEs that are money market funds, investment companies or are entities qualifying for accounting purposes as investment companies. Generally, the Company consolidates those entities when it absorbs a majority of the expected losses or a majority of the expected residual returns, or both, of the entities.

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 regulated U.S. and international subsidiaries include Morgan Stanley & Co. LLC (MS&Co.), Morgan Stanley Smith Barney LLC, Morgan Stanley & Co. International plc (MSIP), Morgan Stanley MUFG Securities, Co., Ltd. (MSMS), Morgan Stanley Bank, N.A. and Morgan Stanley Private Bank, National Association.

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, primarily in its Institutional Securities business segment, the Company considers its principal trading, investment banking, commissions and fees and interest income, along with the associated interest expense, as one integrated activity.

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Significant Accounting Policies.

For a detailed discussion about the Company s significant accounting policies, see Note 2 to the consolidated financial statements for the year ended December 31, 2011 included in the Form 10-K.

During the quarter ended March 31, 2012, other than the following, no other updates were made to the Company s significant accounting policies.

Financial Instruments and Fair Value Valuation Process.

The Valuation Review Group (VRG) within the Financial Control Group (FCG) is responsible for the Company s fair value valuation policies, processes and procedures. VRG is independent of the business units and reports to the Chief Financial Officer (CFO), who has final authority over the valuation of the Company s financial instruments. VRG implements valuation control processes to validate the fair value of the Company s financial instruments measured at fair value including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to assure that the valuation approach utilized is appropriate and consistently applied and the assumptions are reasonable.

The Company s control processes include:

Model Review. VRG, in conjunction with the Market Risk Department (MRD) and, where appropriate, the Credit Risk Management Department, both of which report to the Chief Risk Officer, independently review the valuation model s theoretical soundness, the appropriateness of the valuation methodology and calibration techniques developed by the business units using observable inputs. Where inputs are not observable, VRG reviews the appropriateness of the proposed valuation methodology to ensure it is consistent with how a market participant would arrive at the unobservable input. The valuation methodologies utilized in the absence of observable inputs may include extrapolation techniques and the use of comparable observable inputs. As part of the review, VRG develops a methodology to independently verify the fair value generated by the business unit s valuation model. Before trades are executed using new valuation models, those models are required to be independently reviewed. All of the Company s valuation models are subject to an independent annual review.

Independent Price Verification. The business units are responsible for determining the fair value of financial instruments using approved valuation models and valuation methodologies. Generally on a monthly basis, VRG independently validates the fair values of financial instruments determined using valuation models by determining the appropriateness of the inputs used by the business units and testing compliance with the documented valuation methodologies approved in the model review process described above.

VRG uses recently executed transactions, other observable market data such as exchange data, broker/dealer quotes, third-party pricing vendors and aggregation services for validating the fair values of financial instruments generated using valuation models. VRG assesses the external sources and their valuation methodologies to determine if the external providers meet the minimum standards expected of a third-party pricing source. Pricing data provided by approved external sources is evaluated using a number of approaches; for example, by corroborating the external sources prices to executed trades, analyzing the methodology and assumptions used by the external source to generate a price and/or by evaluating how active the third-party pricing source (or originating sources used by the third-party pricing source) is in the market. Based on this analysis, VRG generates a ranking of the observable market data to ensure that the highest-ranked market data source is used to validate the business unit s fair value of financial instruments.

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For financial instruments categorized within Level 3 of the fair value hierarchy, VRG reviews the business unit s valuation techniques to ensure these are consistent with market participant assumptions.

The results of this independent price verification and any adjustments made by VRG to the fair value generated by the business units are presented to management of the three business segments (*i.e.*, Institutional Securities, Global Wealth Management Group and Asset Management), the CFO and the Chief Risk Officer on a regular basis.

Review of New Level 3 Transactions. VRG reviews the model and valuation methodology used to price all new material Level 3 transactions and both FCG and MRD management must approve the fair value of the trade that is initially recognized.

Securities Available for Sale Other-than-temporary Impairment.

For available for sale (AFS) debt securities, a credit loss exists if the present value of cash flows expected to be collected is less than the amortized cost basis of the security. When determining if a credit loss exists, the Company considers all relevant information including the length of time and the extent to which the fair value has been less than the amortized cost basis; adverse conditions specifically related to the security, an industry, or geographic area; changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors; the historical and implied volatility of the fair value of the security; the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future; failure of the issuer of the security to make scheduled interest or principal payments; any changes to the rating of the security by a rating agency and recoveries or additional declines in fair value after the balance sheet date. When estimating the present value of expected cash flows, information shall include the remaining payment terms of the security, prepayment speeds, financial condition of the issuer(s), expected defaults and the value of any underlying collateral.

For AFS equity securities, the Company considers various factors including the intent and ability to hold the equity security for a period of time sufficient to allow for any anticipated recovery in market value in evaluating whether an other-than-temporary impairment (OTTI) exists. If the equity security is considered other-than-temporarily impaired, the security will be written down to fair value, with the full difference between fair value and cost recognized in earnings.

Accounting Developments.

Reconsideration of Effective Control for Repurchase Agreements.

In April 2011, the Financial Accounting Standards Board (the FASB) issued accounting guidance that modifies the criteria that must be satisfied for a transfer of financial assets to be accounted for as a sale. If the transferor maintains effective control over the transferred assets, the transaction is to be accounted for as a financing. This guidance eliminates from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. This guidance is effective for transfers occurring on and after January 1, 2012. The adoption of this accounting guidance did not have a material impact on the Company s condensed consolidated financial statements.

Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS.

In May 2011, the FASB issued an accounting update that clarifies existing fair value measurement guidance and changes certain principles or requirements for measuring fair value or disclosing information about fair value

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measurements. This update results in common principles and requirements for measuring fair value and for disclosing information about fair value measurement in accordance with U.S. GAAP and International Financial Reporting Standards (IFRS). The guidance became effective for the Company beginning on January 1, 2012. See Note 3 for additional disclosures as required by this accounting guidance.

Goodwill Impairment Test.

In September 2011, the FASB issued accounting guidance that simplifies how entities test goodwill for impairment. This guidance allows entities an option to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Under that option, an entity no longer would be required to calculate the fair value of a reporting unit unless the entity determines, based on that qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. This guidance became effective for the Company beginning on January 1, 2012. The adoption of this accounting guidance did not have a material impact on the Company s condensed consolidated financial statements.

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 composed of three main categories consisting of agency-issued debt, agency mortgage pass-through pool securities and collateralized mortgage obligations. 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. The fair value of agency mortgage pass-through pool securities is model-driven based on spreads of the comparable To-be-announced (TBA) security. Collateralized mortgage obligations are valued using quoted market prices and trade data adjusted by subsequent changes in related indices for identical or comparable securities. Actively traded non-callable agency-issued debt securities are generally categorized in Level 1 of the fair value hierarchy. Callable agency-issued debt securities, agency mortgage pass-through pool securities and collateralized mortgage obligations 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 Level 1 or Level 2 of the fair value hierarchy.

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Corporate and Other Debt.

State and Municipal Securities. The fair value of state and municipal securities is determined 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 price or spread data obtained from observed transactions or independent external parties such as vendors or brokers. When position-specific external price data are not observable, the fair value determination may require benchmarking to similar instruments and/or analyzing expected credit losses, default and recovery rates. In evaluating the fair value of each security, the Company considers security collateral-specific attributes, including payment priority, credit enhancement levels, type of collateral, delinquency rates and loss severity. In addition, for RMBS borrowers, Fair Isaac Corporation (FICO) scores and the level of documentation for the loan are also considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category. Valuation levels of RMBS and CMBS indices are also used as an additional data point for benchmarking purposes or to price outright index positions.

RMBS, CMBS and other ABS are generally categorized in Level 2 of the fair value hierarchy. If external prices or significant spread inputs are unobservable or if the comparability assessment involves significant subjectivity related to property type differences, cash flows, performance and other inputs, then RMBS, CMBS and other ABS are categorized in Level 3 of the fair value hierarchy.

Corporate Bonds. The fair value of corporate bonds is determined using recently executed transactions, market price quotations (where observable), bond spreads or credit default swap spreads obtained from independent external parties such as vendors and brokers 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 do not reference the issuer, then data that reference a comparable issuer are used. When position-specific external price data are not observable, fair value is determined based on either benchmarking to similar instruments or cash flow models with yield curves, bond or single name credit default swap spreads and recovery rates 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 fair value hierarchy.

Collateralized Debt Obligations (CDO). The Company holds cash CDOs that typically reference a tranche of an underlying synthetic portfolio of single name credit default swaps collateralized by corporate bonds (credit-linked notes) or cash portfolio of asset-backed securities (asset-backed CDOs). Credit correlation, a primary input used to determine the fair value of credit-linked notes, is usually unobservable and derived using a benchmarking technique. The other credit-linked note model inputs such as credit spreads, including collateral spreads, and interest rates are typically observable. Asset-backed CDOs 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 asset-backed CDO position is evaluated independently taking into consideration available comparable market levels, underlying collateral performance and pricing, deal structures, as well as liquidity. Cash CDOs are categorized in Level 2 of the fair value hierarchy when either the credit correlation input is insignificant or comparable market transactions are observable. In instances where the credit correlation input is deemed to be significant or comparable market transactions are unobservable, cash CDOs are categorized in Level 3 of the fair value hierarchy.

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Corporate Loans and Lending Commitments. The fair value of corporate loans is determined using recently executed transactions, market price quotations (where observable), implied yields from comparable debt, and market observable credit default swap spread levels obtained from independent external parties such as vendors and brokers 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 determined by using executed transactions on comparable loans and the anticipated market price based on pricing indications from syndicate banks and customers. The valuation of loans and lending commitments also takes into account fee income that is considered an attribute of the contract. Corporate loans and lending commitments are categorized in Level 2 of the fair value hierarchy except in instances where prices or significant spread inputs are unobservable, in which case they are categorized in Level 3 of the fair value hierarchy. Corporate loans and lending commitments are presented within Loans and lending commitments in the fair value hierarchy table.

Mortgage Loans. Mortgage loans are valued using observable prices based on transactional data or third party pricing for identical or comparable instruments, when available. Where position-specific external prices are not observable, 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 or a methodology that utilizes the capital structure and credit spreads of recent comparable securitization transactions. Mortgage loans valued based on observable market data for identical or comparable instruments are categorized in Level 2 of the fair value hierarchy. Where observable prices are not available, due to the subjectivity involved in the comparability assessment related to mortgage loan vintage, geographical concentration, prepayment speed and projected loss assumptions, mortgage loans are categorized in Level 3 of the fair value hierarchy. Mortgage loans are presented within Loans and lending commitments in the fair value hierarchy table.

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.

Inputs that impact the valuation of SLARS are independent external market data, the underlying collateral types, level of seniority in the capital structure, amount of leverage in each structure, credit rating and liquidity considerations. Inputs that impact the valuation of MARS are independent external market data when available, the maximum rate, quality of underlying issuers/insurers and evidence of issuer calls. ARS are generally categorized in Level 2 of the fair value hierarchy as the valuation technique relies on observable external data. SLARS and MARS are presented within Asset-backed securities and State and municipal securities, respectively, in the fair value hierarchy table.

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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; otherwise, they are categorized in Level 2 or Level 3 of the fair value hierarchy.

Unlisted Equity Securities. Unlisted equity securities are valued based on an assessment of each underlying security, considering rounds of financing and third-party transactions, discounted cash flow analyses and market-based information, including comparable company transactions, trading multiples and changes in market outlook, among other factors. These securities are generally categorized in Level 3 of the fair value hierarchy.

Fund Units. Listed fund units are generally marked to the exchange-traded price or net asset value (NAV) and are categorized in Level 1 of the fair value hierarchy if actively traded on an exchange or in Level 2 of the fair value hierarchy if trading is not active. Unlisted fund units are generally marked to NAV and categorized as Level 2; however, positions which are not redeemable at the measurement date or in the near future are categorized in Level 3 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 over-the-counter (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 formulas, 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 in Level 2 of the fair value hierarchy.

Other derivative products, including 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 certain types of interest rate derivatives with both volatility and correlation exposure and credit derivatives including credit default swaps on certain mortgage-backed or asset-backed securities, basket credit default swaps and CDO-squared positions (a CDO-squared position is a special purpose vehicle that issues interests, or tranches, that are backed by tranches issued by other CDOs) 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 credit default swaps on certain mortgage-backed or asset-backed securities, for which observability of external price data is limited, are valued based on an evaluation of the market and

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model input parameters sourced from similar positions as indicated by primary and secondary market activity. Each position is evaluated independently taking into consideration available comparable market levels as well as cash-synthetic basis, or 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, etc.) 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.

For basket credit default swaps and CDO-squared positions, the correlation input between reference credits is unobservable for each specific swap or position 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; otherwise, these instruments are categorized in Level 2 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 price curves, implied volatility of the underlying commodities and, in some cases, the implied correlation between these inputs. The fair value of these products is determined 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 10.

Investments.

The Company s investments include direct investments in equity securities as well as investments in private equity funds, real estate funds and hedge funds, which include investments made in connection with certain employee deferred compensation plans. Direct investments are presented in the fair value hierarchy table as Principal investments and Other. Initially, the transaction price is generally considered by the Company as the exit price and is the Company s best estimate of fair value.

After initial recognition, in determining the fair value of non-exchange-traded internally and externally managed funds, the Company generally considers the NAV of the fund provided by the fund manager to be the best estimate of fair value. For non-exchange-traded investments either held directly or held within internally managed funds, fair value after initial recognition is based on an assessment of each underlying investment, considering rounds of financing and third-party transactions, discounted cash flow analyses and market-based information, including comparable company transactions, trading multiples and changes in market outlook, among other factors. Exchange-traded direct equity investments are generally valued based on quoted prices from the exchange.

Exchange-traded direct equity investments that are actively traded are categorized in Level 1 of the fair value hierarchy. Non-exchange-traded direct equity investments and investments in private equity and real estate funds are generally categorized in Level 3 of the fair value hierarchy. Investments in hedge funds that are redeemable at the measurement date or in the near future are categorized in Level 2 of the fair value hierarchy; otherwise, they are categorized in Level 3 of the fair value hierarchy.

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