

MORGAN STANLEY
Form 10-Q
May 07, 2009
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 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 (Address of principal executive offices, including zip code)	(I.R.S. Employer Identification No.)	(Registrant's telephone number, including area code)
	November 30		

(Former fiscal year, if changed since last report)

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 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 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):

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Large Accelerated Filer
Non-Accelerated Filer

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

As of April 30, 2009, there were 1,081,842,362 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, 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

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Integrity Hotline.

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

Table of Contents**Part I Financial Information.****Item 1. Financial Statements.****MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****(dollars in millions, except share data)****(unaudited)**

	March 31, 2009	December 31, 2008	November 30, 2008
Assets			
Cash and due from banks	\$ 8,019	\$ 13,354	\$ 11,276
Interest bearing deposits with banks	40,522	65,316	67,378
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	23,094	24,039	25,446
Financial instruments owned, at fair value (approximately \$70 billion, \$73 billion and \$62 billion were pledged to various parties at March 31, 2009, December 31, 2008 and November 30, 2008, respectively):			
U.S. government and agency securities	26,997	28,012	20,251
Other sovereign government obligations	23,899	21,084	20,071
Corporate and other debt	82,687	87,294	88,484
Corporate equities	34,260	42,321	37,174
Derivative and other contracts	79,149	89,418	99,766
Investments	9,482	10,385	10,598
Physical commodities	2,484	2,126	2,204
Total financial instruments owned, at fair value	258,958	280,640	278,548
Securities received as collateral, at fair value	7,088	5,231	5,217
Federal funds sold and securities purchased under agreements to resell	120,540	122,709	106,419
Securities borrowed	92,589	88,052	85,785
Receivables:			
Customers	25,894	29,265	31,294
Brokers, dealers and clearing organizations	6,545	6,250	7,259
Other loans	6,698	6,547	6,528
Fees, interest and other	6,635	7,258	7,034
Other investments	3,816	3,709	3,309
Premises, equipment and software costs (net of accumulated depreciation of \$3,206, \$3,073 and \$3,003 at March 31, 2009, December 31, 2008 and November 30, 2008, respectively)	6,018	5,095	5,057
Goodwill	2,226	2,256	2,243
Intangible assets (net of accumulated amortization of \$228, \$208 and \$200 at March 31, 2009, December 31, 2008 and November 30, 2008, respectively) (includes \$159, \$184 and \$220 at fair value at March 31, 2009, December 31, 2008 and November 30, 2008, respectively)	849	906	947
Other assets	16,532	16,137	15,295
Total assets	\$ 626,023	\$ 676,764	\$ 659,035

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (Continued)**

(dollars in millions, except share data)

(unaudited)

	March 31, 2009	December 31, 2008	November 30, 2008
Liabilities and Shareholders Equity			
Commercial paper and other short-term borrowings (includes \$1,074, \$1,246 and \$1,412 at fair value at March 31, 2009, December 31, 2008 and November 30, 2008, respectively)	\$ 3,411	\$ 10,102	\$ 10,483
Deposits (includes \$10,677, \$9,993 and \$6,008 at fair value at March 31, 2009, December 31, 2008 and November 30, 2008, respectively)	59,922	51,355	42,755
Financial instruments sold, not yet purchased, at fair value:			
U.S. government and agency securities	7,854	11,902	10,156
Other sovereign government obligations	10,866	9,511	9,360
Corporate and other debt	8,832	9,927	9,361
Corporate equities	18,445	16,840	16,547
Derivative and other contracts	54,088	68,554	73,521
Physical commodities		33	
Total financial instruments sold, not yet purchased, at fair value	100,085	116,767	118,945
Obligation to return securities received as collateral, at fair value	7,088	5,231	5,217
Securities sold under agreements to repurchase	69,641	92,213	102,401
Securities loaned	19,106	14,580	14,821
Other secured financings, at fair value	10,515	12,539	12,527
Payables:			
Customers	108,213	123,617	115,225
Brokers, dealers and clearing organizations	1,719	1,585	3,141
Interest and dividends	3,022	3,305	2,584
Other liabilities and accrued expenses	11,986	16,179	15,963
Long-term borrowings (includes \$31,258, \$30,766 and \$28,830 at fair value at March 31, 2009, December 31, 2008 and November 30, 2008, respectively)	182,108	179,835	163,437
	576,816	627,308	607,499
Commitments and contingencies			
Equity			
Morgan Stanley shareholders equity:			
Preferred stock	19,208	19,168	19,155
Common stock, \$0.01 par value;			
Shares authorized: 3,500,000,000 at March 31, 2009, December 31, 2008 and November 30, 2008;			
Shares issued: 1,211,701,552 at March 31, 2009, December 31, 2008 and November 30, 2008;			
Shares outstanding: 1,081,607,788 at March 31, 2009, 1,074,497,565 at December 31, 2008 and 1,047,598,394 at November 30, 2008	12	12	12
Paid-in capital	429	459	1,619
Retained earnings	35,577	36,154	38,096
Employee stock trust	4,167	4,312	3,901
Accumulated other comprehensive loss	(471)	(420)	(125)

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Common stock held in treasury, at cost, \$0.01 par value; 130,093,764 shares at March 31, 2009, 137,203,987 shares at December 31, 2008 and 164,103,158 shares at November 30, 2008	(6,233)	(6,620)	(7,926)
Common stock issued to employee trust	(4,167)	(4,312)	(3,901)
Total Morgan Stanley shareholders equity	48,522	48,753	50,831
Non-controlling interests	685	703	705
Total equity	49,207	49,456	51,536
Total liabilities and equity	\$ 626,023	\$ 676,764	\$ 659,035

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

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

(unaudited)

	Three Months Ended March 31,		One Month Ended December 31, 2008
	2009	2008	
Revenues:			
Investment banking	\$ 886	\$ 971	\$ 198
Principal transactions:			
Trading	1,091	2,793	(1,714)
Investments	(1,272)	(516)	(205)
Commissions	772	1,265	215
Asset management, distribution and administration fees	984	1,473	335
Other	432	1,015	238
Total non-interest revenues	2,893	7,001	(933)
Interest and dividends	2,524	12,712	1,145
Interest expense	2,375	11,796	1,017
Net interest	149	916	128
Net revenues	3,042	7,917	(805)
Non-interest expenses:			
Compensation and benefits	2,082	3,843	615
Occupancy and equipment	342	292	125
Brokerage, clearing and exchange fees	269	470	101
Information processing and communications	296	311	99
Marketing and business development	118	197	37
Professional services	326	369	117
Other	494	397	110
Total non-interest expenses	3,927	5,879	1,204
Income (loss) before income taxes	(885)	2,038	(2,009)
(Benefit from) provision for income taxes	(695)	606	(724)
Net income (loss)	\$ (190)	\$ 1,432	\$ (1,285)
Net income (loss) applicable to non-controlling interests	\$ (13)	\$ 19	\$ 3
Net income (loss) applicable to Morgan Stanley	\$ (177)	\$ 1,413	\$ (1,288)
Earnings (losses) applicable to Morgan Stanley common shareholders	\$ (578)	\$ 1,311	\$ (1,624)
Earnings (losses) per basic common share	\$ (0.57)	\$ 1.27	\$ (1.62)

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Earnings (losses) per diluted common share	\$	(0.57)	\$	1.26	\$	(1.62)
Average common shares outstanding:						
Basic		1,011,741,210		1,034,342,428		1,002,058,928
Diluted		1,011,741,210		1,039,026,879		1,002,058,928

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(dollars in millions)

	Three Months Ended March 31, 2009 2008 (unaudited)		One Month Ended December 31, 2008 (unaudited)
Net income (loss)	\$ (190)	\$ 1,432	\$ (1,285)
Other comprehensive income (loss), net of tax:			
Foreign currency translation adjustments(1)	(59)	42	(96)
Net change in cash flow hedges(2)	3	3	2
Net gain (loss) related to pension and other postretirement adjustments(3)			(200)
Amortization of net loss related to pension and postretirement benefits(4)	7	5	
Amortization of prior service credit related to pension and postretirement benefits(5)	(2)	(1)	(1)
Comprehensive income (loss)	\$ (241)	\$ 1,481	\$ (1,580)
Comprehensive income (loss) applicable to non-controlling interests	\$ (13)	\$ 19	\$ 3
Comprehensive income (loss) applicable to Morgan Stanley	\$ (228)	\$ 1,462	\$ (1,583)

- (1) Amounts are net of provision for (benefit from) income taxes of \$31 million and \$(161) million for the quarters ended March 31, 2009 and March 31, 2008, respectively, and \$(52) million for the one month period ended December 31, 2008.
- (2) Amounts are net of provision for (benefit from) income taxes of \$2 million for the quarters ended March 31, 2009 and March 31, 2008, respectively, and \$1 million for the one month period ended December 31, 2008.
- (3) Amounts are net of provision for (benefit from) income taxes of \$(132) million for the one month period ended December 31, 2008.
- (4) Amounts are net of provision for (benefit from) income taxes of \$4 million and \$3 million for the quarters ended March 31, 2009 and March 31, 2008, respectively.
- (5) Amounts are net of provision for (benefit from) income taxes of \$(1) million for the quarters ended March 31, 2009 and March 31, 2008.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**MORGAN STANLEY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(dollars in millions)

	Three Months Ended March 31,		One Month Ended
	2009 (unaudited)	2008 (unaudited)	December 31, 2008 (unaudited)
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	\$ (190)	\$ 1,432	\$ (1,285)
Adjustments to reconcile net income (loss) to net cash (used for) provided by operating activities:			
Compensation payable in common stock and options	204	657	79
Depreciation and amortization	155	81	104
Loss (gain) on business dispositions	19	(698)	
Impairment charges	278		
Changes in assets and liabilities:			
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	945	(1,552)	1,407
Financial instruments owned, net of financial instruments sold, not yet purchased	1,711	6,499	2,412
Securities borrowed	(4,537)	(19,204)	(2,267)
Securities loaned	4,526	(34,993)	(241)
Receivables and other assets	2,771	6,902	1,479
Payables and other liabilities	(18,000)	55,257	10,625
Federal funds sold and securities purchased under agreements to resell	2,169	(31,442)	(16,290)
Securities sold under agreements to repurchase	(22,572)	16,978	(10,188)
Net cash (used for) provided by operating activities	(32,521)	(83)	(14,165)
CASH FLOWS FROM INVESTING ACTIVITIES			
Net (payments for) proceeds from:			
Premises, equipment and software costs	(1,127)	(520)	(107)
Business acquisition, net of cash acquired		(8)	
Business dispositions	(8)	752	
Net cash (used for) provided by investing activities	(1,135)	224	(107)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net (payments for) proceeds from:			
Short-term borrowings	(6,691)	(4,353)	(381)
Derivatives financing activities	(53)	(1,448)	(3,354)
Other secured financings	(2,024)	15,115	12
Deposits	8,567	4,001	8,600
Excess tax benefits associated with stock-based awards	10	39	
Net proceeds from:			
Issuance of common stock	19	207	4
Issuance of long-term borrowings	19,433	8,859	13,590
Payments for:			
Repayments of long-term borrowings	(14,414)	(13,260)	(5,694)
Repurchases of common stock for employee tax withholding	(14)	(55)	(3)
Cash dividends	(645)	(314)	
Net cash provided by financing activities	4,188	8,791	12,774
Effect of exchange rate changes on cash and cash equivalents	(661)	685	1,514

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Net (decrease) increase in cash and cash equivalents	(30,129)	9,617	16
Cash and cash equivalents, at beginning of period	78,670	24,659	78,654
Cash and cash equivalents, at end of period	\$ 48,541	\$ 34,276	\$ 78,670
Cash and cash equivalents include:			
Cash and due from banks	\$ 8,019	\$ 11,077	\$ 13,354
Interest bearing deposits with banks	40,522	23,199	65,316
Cash and cash equivalents, at end of period	\$ 48,541	\$ 34,276	\$ 78,670

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for interest were \$2,360 million and \$11,594 million for the quarters ended March 31, 2009 and March 31, 2008, respectively, and \$867 million for the one month period ended December 31, 2008.

Cash payments for income taxes were \$97 million and \$157 million for the quarters ended March 31, 2009 and March 31, 2008, respectively, and \$113 million for the one month period ended December 31, 2008.

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY

For the One Month Ended December 31, 2008 and the Three Months Ended March 31, 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 NOVEMBER 30, 2008	\$ 19,155	\$ 12	\$ 1,619	\$ 38,096	\$ 3,901	\$ (125)	\$ (7,926)	\$ (3,901)	\$ 705	\$ 51,536
Net income (loss)				(1,288)					3	(1,285)
Dividends				(641)					(5)	(646)
Issuance of common stock			(1,305)				1,309			4
Repurchases of common stock							(3)			(3)
Preferred stock accretion	13			(13)						
Compensation payable in common stock and options			150		411			(411)		150
Net excess tax benefits (shortfall) associated with stock-based awards			(4)							(4)
Employee tax withholdings and other			(1)							(1)
Net change in cash flow hedges						2				2
Pension and other postretirement adjustments						(201)				(201)
Foreign currency translation adjustments						(96)				(96)
BALANCE AT DECEMBER 31, 2008	\$ 19,168	\$ 12	\$ 459	\$ 36,154	\$ 4,312	\$ (420)	\$ (6,620)	\$ (4,312)	\$ 703	\$ 49,456
Net income (loss)				(177)					(13)	(190)
Dividends				(360)					(5)	(365)
Issuance of common stock			(103)				122			19
Repurchases of common stock							(14)			(14)
Preferred stock accretion	40			(40)						
Compensation payable in common stock and options			92		(145)		279	145		371
Net excess tax benefits (shortfall) associated with stock-based awards			(19)							(19)
Net change in cash flow hedges						3				3
SFAS No. 158 pension adjustment						5				5
Foreign currency translation adjustments						(59)				(59)
BALANCE AT MARCH 31, 2009	\$ 19,208	\$ 12	\$ 429	\$ 35,577	\$ 4,167	\$ (471)	\$ (6,233)	\$ (4,167)	\$ 685	\$ 49,207

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY

For the Three Months Ended March 31, 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			1,413	19	1,432
Dividends			(314)	(7)	(321)
Issuance of common stock			207		207
Repurchases of common stock			(55)		(55)
Compensation payable in common stock and options			925		925
Net excess tax benefits associated with stock-based awards			36		36
Employee tax withholdings and other			3		3
Net change in cash flow hedges			3		3
SFAS No. 158 pension adjustment			(15)		(15)
FIN 48 tax adjustment			(45)		(45)
Foreign currency translation adjustments			42		42
BALANCE AT MARCH 31, 2008	\$ 1,100	\$ 12	\$ 32,865	\$ 1,583	\$ 35,560

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; benchmark indices and risk management analytics; and investment activities.

Global Wealth Management Group 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.

Change in Fiscal Year End.

On December 16, 2008, the Board of Directors of the Company approved a change in the Company's fiscal year end from November 30 to December 31 of each year. This change to the calendar year reporting cycle began January 1, 2009. As a result of the change, the Company had a one month transition period in December 2008. The unaudited results for the one month period ended December 31, 2008 are included in this report. The Company has also included selected unaudited results for the one month period ended December 31, 2007 for comparative purposes in Note 18. The audited results for the one month period ended December 31, 2008 will be included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

In addition, the results for the quarter ended March 31, 2009 are compared with the results of the quarter ended March 31, 2008, which have been recast on a calendar basis due to the change in the Company's fiscal year end from November 30 to December 31.

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

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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 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.

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 4).

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 SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159) net gains and losses are recorded within Principal transactions - investments (see Note 2).

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

The Company's 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) and Morgan Stanley Investment Advisors Inc.

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

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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 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 7). 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. SFAS No. 159 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. Under the provisions of SFAS No. 157, Fair Value Measurements (SFAS No. 157), effective December 1, 2006, 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. SFAS No. 157 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the observability of inputs as follows:

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

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

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

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

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

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Valuation Techniques. Many cash and OTC contracts have bid and ask prices that can be observed in the marketplace. Bid prices reflect the highest price that a party is willing to pay for an asset. Ask prices represent the lowest price that a party is willing to accept for an asset. For financial instruments whose inputs are based on bid-ask prices, the Company does not require that the fair value estimate always be a predetermined point in the bid-ask range. The Company's policy is to allow for mid-market pricing and adjusting to the point within the bid-ask range that meets the Company's best estimate of fair value. For offsetting positions in the same financial instrument, the same price within the bid-ask spread is used to measure both the long and short positions.

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

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

See Note 2 for a description of valuation techniques applied to the major categories of financial instruments measured at fair value.

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

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

For further information on financial assets and liabilities that are measured at fair value on a recurring and non-recurring basis, see Note 2.

Hedge Accounting.

The Company applies hedge accounting under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133) using various derivative financial instruments and non-U.S. dollar-denominated debt used to hedge interest rate and foreign exchange risk arising from assets and liabilities not held at fair value as part of asset liability management. These derivative financial instruments are included within Financial instruments owned Derivative and other contracts or Financial instruments sold, not yet purchased Derivative and other contracts in the condensed consolidated statements of financial condition.

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

For further information on derivative instruments and hedging activities, see Note 7.

Condensed Consolidated Statements of Cash Flows.

For purposes of the condensed consolidated statements of cash flows, cash and cash equivalents consist of Cash and due from banks and Interest bearing deposits with banks, which are highly liquid investments with original maturities of three months or less and readily convertible to known amounts of cash. The Company's significant non-cash activities include assumed liabilities, in connection with business acquisitions, of \$22 million in the quarter ended March 31, 2008.

Securitization Activities.

The Company engages in securitization activities related to commercial and residential mortgage loans, corporate bonds and loans, U.S. agency collateralized mortgage obligations and other types of financial assets (see Note 4). Generally, such transfers of financial assets are accounted for as sales when the Company has relinquished control over the transferred assets. The gain or loss on sale of such financial assets depends, in part, on the previous carrying amount of the assets involved in the transfer allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale. Transfers that are not accounted for as sales are treated as secured financings (failed sales).

Earnings per Common Share.

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

Effective October 13, 2008, as a result of the adjustment to Equity Units sold to a wholly owned subsidiary of China Investment Corporation Ltd. (CIC) (see Note 10), the Company calculates earnings per common share in accordance with the Emerging Issues Task Force (EITF) No. 03-6, Participating Securities and the Two-Class Method under FASB Statement No. 128, Earnings per Share (EITF 03-6). EITF 03-6 addresses the computation of earnings per share by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company along with common shareholders according to a predetermined formula. The two-class method requires the Company to present earnings per common share as if all of the earnings for the period are distributed to Morgan Stanley common shareholders and any participating securities, regardless of whether any actual dividends or distributions are made. The amount allocated to the participating securities is based upon the contractual terms of their respective contract and is reflected as a reduction to Net income applicable to Morgan Stanley common shareholders for

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both the Company's basic and diluted earnings per share calculations (see Note 11). The two-class method does not impact the Company's actual net income applicable to Morgan Stanley or other financial results. Unless contractually required by the terms of the participating securities, no losses are allocated to participating securities for purposes of the earnings per share calculation under the two-class method.

In June 2008, the FASB issued FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share under the two-class method as described in SFAS No. 128, *Earnings per Share*. Under the guidance in FSP EITF 03-6-1, unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. FSP EITF 03-6-1 became effective for the Company on January 1, 2009. All prior-period earnings per share data presented have been adjusted retrospectively. The adoption of FSP EITF 03-6-1 reduced basic earnings per share by \$0.08 and \$0.01 for the quarter ended March 31, 2008 and the one month period ended December 31, 2008, respectively, and reduced diluted earnings per share by \$0.06 and \$0.01 for the quarter ended March 31, 2008 and the one month period ended December 31, 2008, respectively.

Deferred Compensation Arrangements.

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

Accounting Developments.

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

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

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

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

Transfers of Financial Assets and Extinguishments of Liabilities and Consolidation of Variable Interest Entities. In September 2008, the FASB issued for comment revisions to SFAS No. 140 and FASB Interpretation No. 46, as revised (FIN 46R), *Consolidation of Variable Interest Entities*. The changes proposed include a removal of the scope exemption from FIN 46R for QSPEs, a revision of the current risks and rewards-based FIN 46R consolidation model to a qualitative model based on control and a requirement that consolidation of VIEs be reevaluated on an ongoing basis. Although the revised standards have not yet been finalized, these changes may have a significant impact on the Company's condensed consolidated financial statements as the Company may be required to consolidate QSPEs to which the Company has previously sold assets. In addition, the Company may also be required to consolidate other VIEs that are not currently consolidated based on an analysis under the current FIN 46R consolidation model. The proposed revisions, as currently drafted, would be effective for fiscal years that begin after November 15, 2009.

Disclosures about Postretirement Benefit Plan Assets. In December 2008, the FASB issued FSP FAS 132(R)-1, *Employers' Disclosures about Postretirement Benefit Plan Assets* (FSP FAS 132(R)-1). FSP FAS 132(R)-1 amends SFAS No. 132 (Revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, to provide guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. The disclosures about plan assets required by this FSP shall be provided for fiscal years ending after December 15, 2009.

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

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

FSP FAS 107-1 and APB 28-1 amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments and APB Opinion No. 28, Interim Financial Reporting by requiring an entity to provide qualitative and quantitative information on a quarterly basis about fair value estimates for any financial instruments not measured on the balance sheet at fair value. The Company plans to adopt the disclosure requirements of FSP FAS 107-1 and APB 28-1 in the second quarter of 2009.

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

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

Other Sovereign Government Obligations

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

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Corporate and Other Debt

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

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

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

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

Commercial Mortgage-Backed Securities (CMBS), Residential Mortgage-Backed Securities (RMBS), and other Asset-Backed Securities (ABS). CMBS, RMBS and other ABS may be valued based on external price or spread data. When position-specific external price data are not observable, the valuation is based on prices of comparable bonds. Valuation levels of CMBS and RMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions. CMBS, RMBS and other ABS are categorized in Level 3 if external prices or spread inputs are unobservable or if the comparability assessment involves significant subjectivity related to property type differences, cash flows, performance and other inputs; otherwise, they are categorized in Level 2 of the fair value hierarchy.

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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

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rate notes, priced at par due to the auction mechanism. Beginning in fiscal 2008, uncertainties in the credit markets have resulted in auctions failing for certain types of ARS. Once the auctions failed, ARS could no longer be valued using observations of auction market prices. Accordingly, the fair value of ARS is determined using independent external market data where available and an internally developed methodology to discount for the lack of liquidity and non-performance risk in the current market environment.

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

Retained Interests in Securitization Transactions. Fair value for retained interests in securitized financial assets (in the form of one or more tranches of the securitization) is determined using observable prices or, in cases where observable prices are not available for certain retained interests, the Company estimates fair value based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved. When observable prices are available, retained interests are categorized in Level 2 of the fair value hierarchy. In the absence of observable prices, retained interests are categorized in Level 3 of the fair value hierarchy.

Corporate Equities

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

Derivative and Other Contracts

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

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

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

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

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

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

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

For further information on derivative instruments and hedging activities, see Note 7.

Investments

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

Physical Commodities

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

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Deposits

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

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

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

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

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****Assets and Liabilities Measured at Fair Value on a Recurring Basis as of March 31, 2009**

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) (dollars in millions)	Counterparty and Cash Collateral Netting	Balance at March 31, 2009
Assets					
Financial instruments owned:					
U.S. government and agency securities	\$ 11,357	\$ 15,623	\$ 17	\$	\$ 26,997
Other sovereign government obligations	19,733	4,164	2		23,899
Corporate and other debt(1)	78	51,121	31,488		82,687
Corporate equities	30,012	3,302	946		34,260
Derivative and other contracts(2)	2,995	147,166	25,966	(96,978)	79,149
Investments	407	241	8,834		9,482
Physical commodities		2,484			2,484
Total financial instruments owned	64,582	224,101	67,253	(96,978)	258,958
Securities received as collateral	6,651	434	3		7,088
Intangible assets(3)			159		159
Liabilities					
Commercial paper and other short-term borrowings	\$	\$ 1,074	\$	\$	\$ 1,074
Deposits		10,677			10,677
Financial instruments sold, not yet purchased:					
U.S. government and agency securities	5,846	2,008			7,854
Other sovereign government obligations	10,421	445			10,866
Corporate and other debt	20	6,862	1,950		8,832
Corporate equities	17,898	473	74		18,445
Derivative and other contracts(2)	6,944	90,013	9,445	(52,314)	54,088
Total financial instruments sold, not yet purchased	41,129	99,801	11,469	(52,314)	100,085
Obligation to return securities received as collateral	6,651	434	3		7,088
Other secured financings(1)	17	6,234	4,264		10,515
Long-term borrowings		25,587	5,671		31,258

- (1) Approximately \$6.5 billion of assets is included in Corporate and other debt and approximately \$5.2 billion of related liabilities is included in Other secured financings related to consolidated VIEs or non-consolidated VIEs (in the cases where the assets were transferred by the Company to the VIE and the transfers were accounted for as secured financings). The Company cannot unilaterally remove the assets from the VIEs; these assets are not generally available to the Company. The related liabilities issued by these VIEs are non-recourse to the Company. Approximately \$6.0 billion of these assets and approximately \$3.7 billion of these liabilities are included in Level 3 of the fair value hierarchy. See Note 4 for additional information on consolidated and non-consolidated VIEs, including retained interests in these entities that the Company holds.
- (2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 7.

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(3) Amount represents mortgage servicing rights (MSRs) accounted for at fair value. See Note 4 for further information on MSRs.

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	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at December 31, 2008
	(dollars in millions)				
Assets					
Financial instruments owned:					
U.S. government and agency securities	\$ 10,150	\$ 17,735	\$ 127	\$	\$ 28,012
Other sovereign government obligations	16,118	4,965	1		21,084
Corporate and other debt(1)	99	52,277	34,918		87,294
Corporate equities	37,807	3,538	976		42,321
Derivative and other contracts(2)	1,069	156,224	37,711	(105,586)	89,418
Investments	417	270	9,698		10,385
Physical commodities		2,126			2,126
Total financial instruments owned	65,660	237,135	83,431	(105,586)	280,640
Securities received as collateral	4,623	578	30		5,231
Intangible assets(3)			184		184
Liabilities					
Commercial paper and other short-term borrowings	\$	\$ 1,246	\$	\$	\$ 1,246
Deposits		9,993			9,993
Financial instruments sold, not yet purchased:					
U.S. government and agency securities	11,133	769			11,902
Other sovereign government obligations	7,303	2,208			9,511
Corporate and other debt	17	6,102	3,808		9,927
Corporate equities	15,064	1,749	27		16,840
Derivative and other contracts(2)	3,886	118,432	14,329	(68,093)	68,554
Physical commodities		33			33
Total financial instruments sold, not yet purchased	37,403	129,293	18,164	(68,093)	116,767
Obligation to return securities received as collateral	4,623	578	30		5,231
Other secured financings(1)		6,391	6,148		12,539
Long-term borrowings		25,293	5,473		30,766

(1) Approximately \$8.9 billion of assets is included in Corporate and other debt and approximately \$7.9 billion of related liabilities is included in Other secured financings related to consolidated VIEs or non-consolidated VIEs (in the cases where the assets were transferred by the Company to the VIE and the transfers were accounted for as secured financings). The Company cannot unilaterally remove the assets from the VIEs; these assets are not generally available to the Company. The related liabilities issued by these VIEs are non-recourse to the Company. Approximately \$8.1 billion of these assets and approximately \$5.9 billion of these liabilities are included in Level 3 of the fair value hierarchy. See Note 4 for additional information on consolidated and non-consolidated

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VIEs, including retained interests in these entities that the Company holds.

- (2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 7.
- (3) Amount represents mortgage servicing rights (MSRs) accounted for at fair value. See Note 4 for further information on MSRs.

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****Assets and Liabilities Measured at Fair Value on a Recurring Basis as of November 30, 2008**

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

(1) Approximately \$9.0 billion of assets is included in Corporate and other debt and approximately \$7.2 billion of related liabilities is included in Other secured financings related to consolidated VIEs or non-consolidated VIEs (in the cases where the assets were transferred by the Company to the VIE and the transfers were accounted for as secured financings). The Company cannot unilaterally remove the assets from the VIEs; these assets are not generally available to the Company. The related liabilities issued by these VIEs are non-recourse to the Company. Approximately \$7.7 billion of these assets and approximately \$5.0 billion of these liabilities are included in Level 3 of the fair value hierarchy. See Note 4 for additional information on consolidated and non-consolidated VIEs, including retained interests in these entities that the Company holds.

(2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 7.

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(3) Amount represents mortgage servicing rights (MSRs) accounted for at fair value. See Note 4 for further information on MSRs.

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The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the quarters ended March 31, 2009 and March 31, 2008 and the one month period ended December 31, 2008. Level 3 instruments may be offset with instruments classified in Level 1 and Level 2. As a result, the realized and unrealized gains or (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realized and unrealized gains or (losses) on hedging instruments that have been classified by the Company within the Level 1 and/or Level 2 categories. Additionally, both observable and unobservable inputs may be used to determine the fair value of positions that the Company has classified within the Level 3 category. As a result, the unrealized gains or (losses) during the period for assets and liabilities within the Level 3 category presented in the tables below may include changes in fair value during the period that were attributable to both observable (*e.g.*, changes in market interest rates) and unobservable (*e.g.*, changes in unobservable long-dated volatilities) inputs.

The following tables reflect gains or (losses) for all assets and liabilities categorized as Level 3 for the quarters ended March 31, 2009 and March 31, 2008 and the one month period ended December 31, 2008, respectively. For assets and liabilities that were transferred into Level 3 during the period, gains or (losses) are presented as if the assets or liabilities had been transferred into Level 3 as of the beginning of the period; similarly, for assets and liabilities that were transferred out of Level 3 during the period, gains or (losses) are presented as if the assets or liabilities had been transferred out as of the beginning of the period.

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended March 31, 2009

	Beginning Balance at December 31, 2008	Total Realized and Unrealized Gains or (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at March 31, 2009	Unrealized Gains or (Losses) for Level 3 Assets/ Liabilities Outstanding at March 31, 2009(2)
Assets						
Financial instruments owned:						
U.S. government and agency securities	\$ 127	\$ (1)	\$ (86)	\$ (23)	\$ 17	\$
Other sovereign government obligations	1	(1)	(1)	3	2	(2)
Corporate and other debt	34,918	(3,314)	226	(342)	31,488	(3,501)
Corporate equities	976	(95)	(231)	296	946	(95)
Net derivative and other contracts(3)	23,382	2,363	250	(9,474)	16,521	3,132
Investments	9,698	(1,319)	510	(55)	8,834	(1,269)
Securities received as collateral	30		(27)		3	
Intangible assets	184	(25)			159	(25)
Liabilities						
Financial instruments sold, not yet purchased:						
Corporate and other debt	\$ 3,808	\$ (20)	\$ 647	\$ (2,525)	\$ 1,950	\$ (47)
Corporate equities	27	20	44	23	74	4
Obligation to return securities received as collateral	30		(27)		3	
Other secured financings	6,148	1,053	(542)	(289)	4,264	1,053
Long-term borrowings	5,473	(129)	83	(14)	5,671	(129)

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- (1) Total realized and unrealized gains or (losses) are primarily included in Principal transactions trading in the condensed consolidated statements of income except for \$(1,319) million related to Financial instruments owned investments, which is included in Principal transactions investments.

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(2) Amounts represent unrealized gains or (losses) for the quarter ended March 31, 2009 related to assets and liabilities still outstanding at March 31, 2009.

(3) Net derivative and other contracts represent Financial instruments owned derivative and other contracts net of Financial instruments sold, not yet purchased derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 7.

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

During the quarter ended March 31, 2009, the Company reclassified approximately \$2.3 billion of certain Corporate and other debt from Level 2 to Level 3. The reclassifications were primarily related to asset-backed securities and certain corporate loans. The reclassifications were due to a reduction in market price quotations for these or comparable instruments, or a lack of available broker quotes, such that unobservable inputs had to be utilized for the fair value measurement of these instruments. These unobservable inputs include, depending upon the position, assumptions to establish comparability to bonds, loans or swaps with observable price/spread levels, default recovery rates, forecasted credit losses and prepayment rates.

During the quarter ended March 31, 2009, the Company reclassified approximately \$2.7 billion of certain Corporate and other debt from Level 3 to Level 2. These reclassifications primarily related to commercial mortgage-backed securities, subprime CDO and other subprime ABS securities. Their fair value was highly correlated with similar instruments in an observable market and, due to market deterioration, unobservable inputs were no longer deemed significant. In addition, certain corporate loans were reclassified as more liquidity re-entered the market and external prices and spread inputs for these instruments became observable.

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

During the quarter ended March 31, 2009, the Company reclassified approximately \$9.6 billion of certain Derivatives and other contracts from Level 3 to Level 2. These reclassifications of certain Derivatives and other contracts were related to single name mortgage-related credit default swaps and credit default swaps on certain classes of CDOs. The primary reason for the reclassifications is that, due to market deterioration, unobservable inputs, such as correlation, for these derivative contracts were no longer deemed significant to the fair value measurement. In addition, certain corporate tranche-indexed credit default swaps were reclassified due to increased availability of transaction data, broker quotes and/or consensus pricing.

For further information on derivative instruments and hedging activities, see Note 7.

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

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

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

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	Beginning Balance at December 31, 2007	Total Realized and Unrealized Gains or (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net (dollars in millions)	Net Transfers In and/or (Out) of Level 3	Ending Balance at March 31, 2008	Unrealized Gains or (Losses) for Level 3 Assets/ Liabilities Outstanding at March 31, 2008(2)
Assets						
Financial instruments owned:						
U.S. government and agency securities	\$ 622	\$ 63	\$ (225)	\$ (22)	\$ 438	\$ 33
Other sovereign government obligations	15	(2)	(2)	14	25	(3)
Corporate and other debt	39,707	(3,580)	1,306	808	38,241	(3,575)
Corporate equities	1,717	(233)	(15)	78	1,547	(63)
Net derivative and other contracts(3)	5,486	8,561	38	(1,336)	12,749	7,747
Investments	12,758	(214)	656	(1,334)	11,866	(260)
Securities received as collateral	71		(44)		27	
Intangible assets	3	1			4	1
Liabilities						
Financial instruments sold, not yet purchased:						
Corporate and other debt	\$ 717	\$ (585)	\$ (392)	\$ (2)	\$ 908	\$ (625)
Corporate equities	175	(116)	256	(33)	514	(153)
Obligation to return securities received as collateral	71		(44)		27	
Other secured financings	6,160	146	1,193	34	7,241	146
Long-term borrowings	5,829	54	18	41	5,834	54

(1) Total realized and unrealized gains or (losses) are primarily included in Principal transactions trading in the condensed consolidated statements of income except for \$(214) million related to Financial instruments owned investments, which is included in Principal transactions investments.

(2) Amounts represent unrealized gains or (losses) for the quarter ended March 31, 2008 related to assets and liabilities still outstanding at March 31, 2008.

(3) Net derivative and other contracts represent Financial instruments owned derivative and other contracts net of Financial instruments sold, not yet purchased derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 7.

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

During the quarter ended March 31, 2008, the Company reclassified certain Corporate and other debt from Level 2 to Level 3 because certain significant inputs for the fair value measurement became unobservable. These reclassifications included transfers primarily related to corporate loans and lending commitments.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

Financial instruments owned Net derivative and other contracts. The net gains from Net derivative contracts were primarily driven by certain credit default swaps and other instruments associated with the Company's credit products.

The Company reclassified certain OTC derivatives from Level 3 to Level 2. These reclassifications included transfers primarily related to corporate tranche-indexed credit default swaps as inputs became observable. The reclassifications were due to increased availability of transaction data and broker quotes.

For further information on derivative instruments and hedging activities, see Note 7.

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

Table of Contents**MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the One Month Ended December 31, 2008**

	Beginning Balance at November 30, 2008	Total Realized and Unrealized Gains or (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at December 31, 2008	Unrealized Gains or (Losses) for Level 3 Assets/ Liabilities Outstanding at December 31, 2008(2)
Assets						
Financial instruments owned:						
U.S. government and agency securities	\$ 206	\$ (3)	\$ (76)	\$	\$ 127	\$ (5)
Other sovereign government obligations	3		(1)	(1)	1	
Corporate and other debt						