

MORGAN STANLEY  
Form 10-Q  
July 09, 2008  
Table of Contents

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 May 31, 2008*

OR

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

EXCHANGE ACT OF 1934

Commission File Number 1-11758

(Exact Name of Registrant as specified in its charter)

**Delaware**

**1585 Broadway**

**36-3145972**

**(212) 761-4000**

(State or other jurisdiction of  
incorporation or organization)

**New York, NY 10036**

(I.R.S. Employer Identification No.)

(Registrant's telephone number,  
including area code)

(Address of principal executive  
offices, including zip code)

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

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

Large Accelerated Filer

Non-Accelerated Filer

(Do not check if a smaller reporting company)

Accelerated Filer

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 June 30, 2008, there were 1,109,013,816 shares of the Registrant's Common Stock, par value \$0.01 per share, outstanding.

**Table of Contents**

## QUARTERLY REPORT ON FORM 10-Q

For the quarter ended May 31, 2008

Table of Contents		Page
<b><u>Part I Financial Information</u></b>		
Item 1.	<u>Financial Statements (unaudited)</u>	1
	<u>Condensed Consolidated Statements of Financial Condition May 31, 2008 and November 30, 2007</u>	1
	<u>Condensed Consolidated Statements of Income Three and Six Months Ended May 31, 2008 and 2007</u>	3
	<u>Condensed Consolidated Statements of Comprehensive Income Three and Six Months Ended May 31, 2008 and 2007</u>	4
	<u>Condensed Consolidated Statements of Cash Flows Six Months Ended May 31, 2008 and 2007</u>	5
	<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	6
	<u>Note 1. Basis of Presentation and Summary of Significant Accounting Policies</u>	6
	<u>Note 2. Fair Value Disclosures</u>	21
	<u>Note 3. Collateralized Transactions</u>	28
	<u>Note 4. Securitization Activities and Variable Interest Entities</u>	30
	<u>Note 5. Derivative Contracts</u>	35
	<u>Note 6. Goodwill and Net Intangible Assets</u>	36
	<u>Note 7. Long-Term Borrowings</u>	37
	<u>Note 8. Commitments, Guarantees and Contingencies</u>	38
	<u>Note 9. Shareholders' Equity</u>	43
	<u>Note 10. Earnings per Common Share</u>	45
	<u>Note 11. Employee Benefit Plans</u>	46
	<u>Note 12. Income Taxes</u>	46
	<u>Note 13. Segment Information</u>	47
	<u>Note 14. Discontinued Operations</u>	50
	<u>Note 15. Business Dispositions</u>	51
	<u>Report of Independent Registered Public Accounting Firm</u>	52
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	53
	<u>Introduction</u>	53
	<u>Results of Operations</u>	54
	<u>Impact of Credit Market Events</u>	70
	<u>Other Matters</u>	78
	<u>Critical Accounting Policies</u>	79
	<u>Liquidity and Capital Resources</u>	82
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	94
Item 4.	<u>Controls and Procedures</u>	104

**Table of Contents**

	Page
<b><u>Part II Other Information</u></b>	
Item 1. <u>Legal Proceedings</u>	105
Item 1A. <u>Risk Factors</u>	106
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	107
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	107
Item 6. <u>Exhibits</u>	107

**Table of Contents**

**AVAILABLE INFORMATION**

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

Morgan Stanley's internet site is [www.morganstanley.com](http://www.morganstanley.com). You can access Morgan Stanley's Investor Relations webpage at [www.morganstanley.com/about/ir](http://www.morganstanley.com/about/ir). Morgan Stanley makes available free of charge, on or through our 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](http://www.morganstanley.com/about/company/governance). Morgan Stanley posts the following on its Corporate Governance webpage:

Amended and Restated Certificate of Incorporation;

Bylaws;

Charters for our Audit Committee, 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. ( NYSE ) on its internet site. You can request a copy of these documents, excluding exhibits, at no cost, by contacting Investor Relations, 1585 Broadway, New York, NY 10036 (212-761-4000). The information on Morgan Stanley's internet site is not incorporated by reference into this report.

**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)**

	May 31, 2008	November 30, 2007
	(unaudited)	
<b>Assets</b>		
Cash and cash equivalents	\$ 23,782	\$ 25,598
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements (including securities at fair value of \$15,270 at May 31, 2008 and \$31,354 at November 30, 2007)	53,393	61,608
Financial instruments owned, at fair value (approximately \$140 billion and \$131 billion were pledged to various parties at May 31, 2008 and November 30, 2007, respectively):		
U.S. government and agency securities	26,498	23,887
Other sovereign government obligations	32,467	21,606
Corporate and other debt	130,943	147,724
Corporate equities	89,075	87,377
Derivative contracts	92,305	77,003
Investments	15,451	14,270
Physical commodities	3,654	3,096
Total financial instruments owned, at fair value	390,393	374,963
Securities received as collateral, at fair value	25,528	82,229
Collateralized agreements:		
Securities purchased under agreements to resell	165,928	126,887
Securities borrowed	257,796	239,994
Receivables:		
Customers	58,172	76,352
Brokers, dealers and clearing organizations	15,035	16,011
Other loans	3,769	11,629
Fees, interest and other	8,628	8,320
Other investments	5,886	4,524
Premises, equipment and software costs, at cost (net of accumulated depreciation of \$3,282 at May 31, 2008 and \$3,449 at November 30, 2007)	4,856	4,372
Goodwill	2,988	3,024
Intangible assets (net of accumulated amortization of \$218 at May 31, 2008 and \$175 at November 30, 2007) (includes \$344 at fair value at May 31, 2008 and \$428 at fair value at November 30, 2007)	902	1,047
Other assets	14,172	8,851
<b>Total assets</b>	<b>\$ 1,031,228</b>	<b>\$ 1,045,409</b>

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

(dollars in millions, except share data)

	May 31, 2008	November 30, 2007 (unaudited)
<b>Liabilities and Shareholders' Equity</b>		
Commercial paper and other short-term borrowings (includes \$6,427 at fair value at May 31, 2008 and \$3,068 at fair value at November 30, 2007)	\$ 23,816	\$ 34,495
Deposits (includes \$35 at fair value at May 31, 2008 and \$3,769 at fair value at November 30, 2007)	35,227	31,179
Financial instruments sold, not yet purchased, at fair value:		
U.S. government and agency securities	11,278	8,221
Other sovereign government obligations	19,033	15,627
Corporate and other debt	6,784	7,592
Corporate equities	46,632	30,899
Derivative contracts	77,439	71,604
Physical commodities	582	398
<b>Total financial instruments sold, not yet purchased, at fair value</b>	<b>161,748</b>	<b>134,341</b>
Obligation to return securities received as collateral, at fair value	25,528	82,229
Collateralized financings:		
Securities sold under agreements to repurchase	136,998	162,840
Securities loaned	45,981	110,423
Other secured financings (includes \$28,237 at fair value at May 31, 2008 and \$27,772 at fair value at November 30, 2007)	29,878	27,772
Payables:		
Customers	293,344	203,453
Brokers, dealers and clearing organizations	6,146	10,454
Interest and dividends	4,056	1,724
Other liabilities and accrued expenses	23,289	24,606
Long-term borrowings (includes \$45,502 at fair value at May 31, 2008 and \$38,392 at fair value at November 30, 2007)	210,724	190,624
	996,735	1,014,140
Commitments and contingencies		
Shareholders' equity:		
Preferred stock	1,100	1,100
Common stock, \$0.01 par value;		
Shares authorized: 3,500,000,000 at May 31, 2008 and November 30, 2007;		
Shares issued: 1,211,701,552 at May 31, 2008 and November 30, 2007;		
Shares outstanding: 1,108,865,416 at May 31, 2008 and 1,056,289,659 at November 30, 2007	12	12
Paid-in capital	340	1,902
Retained earnings	39,581	38,045
Employee stock trust	7,468	5,569
Accumulated other comprehensive loss	(218)	(199)
Common stock held in treasury, at cost, \$0.01 par value;		
102,836,136 shares at May 31, 2008 and 155,411,893 shares at November 30, 2007	(6,322)	(9,591)
Common stock issued to employee trust	(7,468)	(5,569)
<b>Total shareholders' equity</b>	<b>34,493</b>	<b>31,269</b>

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Total liabilities and shareholders' equity	\$ 1,031,228	\$ 1,045,409
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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)

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007	2008	2007
	(unaudited)		(unaudited)	
<b>Revenues:</b>				
Investment banking	\$ 1,049	\$ 1,913	\$ 2,158	\$ 3,140
<b>Principal transactions:</b>				
Trading	1,403	4,838	4,793	8,996
Investments	(464)	1,004	(810)	1,884
Commissions	1,155	1,123	2,354	2,128
Asset management, distribution and administration fees	1,464	1,596	3,014	3,075
Interest and dividends	10,117	15,400	24,082	29,571
Other	1,799	321	2,116	593
<b>Total revenues</b>	<b>16,523</b>	<b>26,195</b>	<b>37,707</b>	<b>49,387</b>
<b>Interest expense</b>	<b>10,013</b>	<b>15,671</b>	<b>22,875</b>	<b>28,869</b>
<b>Net revenues</b>	<b>6,510</b>	<b>10,524</b>	<b>14,832</b>	<b>20,518</b>
<b>Non-interest expenses:</b>				
Compensation and benefits	2,960	4,994	7,031	9,769
Occupancy and equipment	329	279	615	539
Brokerage, clearing and exchange fees	448	366	892	727
Information processing and communications	312	286	617	563
Marketing and business development	207	199	390	352
Professional services	472	510	851	929
Other	336	366	776	659
<b>Total non-interest expenses</b>	<b>5,064</b>	<b>7,000</b>	<b>11,172</b>	<b>13,538</b>
<b>Income from continuing operations before gains (losses) from unconsolidated investees and income taxes</b>				
	1,446	3,524	3,660	6,980
<b>Gains (losses) from unconsolidated investees</b>	<b>19</b>	<b>(20)</b>	<b>21</b>	<b>(46)</b>
<b>Provision for income taxes</b>	<b>439</b>	<b>1,141</b>	<b>1,104</b>	<b>2,257</b>
<b>Income from continuing operations</b>	<b>1,026</b>	<b>2,363</b>	<b>2,577</b>	<b>4,677</b>
<b>Discontinued operations:</b>				
<b>Net gain from discontinued operations</b>		<b>349</b>		<b>913</b>
<b>Provision for income taxes</b>		<b>130</b>		<b>336</b>
<b>Net gain on discontinued operations</b>		<b>219</b>		<b>577</b>
<b>Net income</b>	<b>\$ 1,026</b>	<b>\$ 2,582</b>	<b>\$ 2,577</b>	<b>\$ 5,254</b>
<b>Preferred stock dividend requirements</b>	<b>\$ 14</b>	<b>\$ 17</b>	<b>\$ 31</b>	<b>\$ 34</b>

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Earnings applicable to common shareholders	\$	1,012	\$	2,565	\$	2,546	\$	5,220
<b>Earnings per basic common share:</b>								
Income from continuing operations	\$	0.97	\$	2.35	\$	2.47	\$	4.63
Gain on discontinued operations				0.22				0.58
Earnings per basic common share	\$	0.97	\$	2.57	\$	2.47	\$	5.21
<b>Earnings per diluted common share:</b>								
Income from continuing operations	\$	0.95	\$	2.24	\$	2.40	\$	4.41
Gain on discontinued operations				0.21				0.55
Earnings per diluted common share	\$	0.95	\$	2.45	\$	2.40	\$	4.96
<b>Average common shares outstanding:</b>								
Basic		1,038,145,038		996,544,761		1,029,473,636		1,002,894,369
Diluted		1,067,184,178		1,045,643,087		1,062,525,833		1,051,684,753

See Notes to Condensed Consolidated Financial Statements.

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

(dollars in millions)

	Three Months Ended May 31, 2008 (unaudited)		Six Months Ended May 31, 2008 (unaudited)	
	2008	2007	2008	2007
Net income	\$ 1,026	\$ 2,582	\$ 2,577	\$ 5,254
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments(1)	(92)	5	(37)	(97)
Net change in cash flow hedges(2)	5	3	9	11
Minimum pension liability adjustment(3)				2
Net amortization of actuarial loss(4)	5		10	
Net amortization of prior-service credit(5)	(2)		(3)	
Comprehensive income	\$ 942	\$ 2,590	\$ 2,556	\$ 5,170

(1) Amounts are net of (benefit from) income taxes of \$(4) million and \$(24) million for the quarters ended May 31, 2008 and 2007, respectively. Amounts are net of provision for (benefit from) income taxes of \$(69) million and \$13 million for the six months ended May 31, 2008 and 2007, respectively.

(2) Amounts are net of provision for income taxes of \$2 million and \$3 million for the quarters ended May 31, 2008 and 2007, respectively. Amounts are net of provision for income taxes of \$4 million and \$7 million for the six months ended May 31, 2008 and 2007, respectively.

(3) Amount is net of provision for income taxes of \$2 million for the six months ended May 31, 2007.

(4) Amount is net of provision for income taxes of \$3 million for the quarter ended May 31, 2008.  
Amount is net of provision for income taxes of \$6 million for the six months ended May 31, 2008.

(5) Amount is net of (benefit from) income taxes of \$(1) million for the quarter ended May 31, 2008.  
Amount is net of (benefit from) income taxes of \$(2) million for the six months ended May 31, 2008.

See Notes to Condensed Consolidated Financial Statements.

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

(dollars in millions)

	<b>Six Months Ended May 31,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(unaudited)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 2,577	\$ 5,254
Adjustments to reconcile net income to net cash used for operating activities:		
(Gains) losses from unconsolidated investees	(21)	46
Compensation payable in common stock and options	1,267	1,266
Depreciation and amortization	209	254
Provision for consumer loan losses		399
Gains on business dispositions	(1,500)	(168)
Changes in assets and liabilities:		
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements	8,408	(17,546)
Financial instruments owned, net of financial instruments sold, not yet purchased	20,567	(35,451)
Securities borrowed	(17,802)	47,418
Securities loaned	(64,442)	(3,041)
Receivables and other assets	20,184	(45,980)
Payables and other liabilities	84,768	16,599
Securities purchased under agreements to resell	(39,041)	31,736
Securities sold under agreements to repurchase	(25,842)	(15,491)
Net cash used for operating activities	(10,668)	(14,705)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net (payments for) proceeds from:		
Premises, equipment and software costs	(810)	(607)
Business acquisitions, net of cash acquired	(174)	(1,167)
Business dispositions	1,523	476
Net principal disbursed on consumer loans		(4,697)
Sales of consumer loans		5,301
Purchases of securities available for sale		(7,975)
Net cash provided by (used for) investing activities	539	(8,669)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net (payments for) proceeds from:		
Short-term borrowings	(10,679)	4,441
Derivatives financing activities	(910)	(89)
Other secured financings	2,106	(8,547)
Deposits	4,048	15,214
Tax benefits associated with stock-based awards	114	181
Net proceeds from:		
Issuance of common stock	352	602
Issuance of long-term borrowings	30,939	40,395
Issuance of junior subordinated debentures related to China Investment Corporation	5,579	
Payments for:		
Repayments of long-term borrowings	(22,810)	(14,160)
Redemption of Capital Units		(66)
Repurchases of common stock through open market share repurchase program		(2,609)
Repurchases of common stock for employee tax withholding	(68)	(216)
Cash dividends	(626)	(608)

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Net cash provided by financing activities	8,045	34,538
Effect of exchange rate changes on cash and cash equivalents	268	16
Net (decrease) increase in cash and cash equivalents	(1,816)	11,180
Cash and cash equivalents, at beginning of period	25,598	20,606
Cash and cash equivalents, at end of period	\$ 23,782	\$ 31,786

### SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for interest were \$21,305 million and \$28,715 million for the six month periods ended May 31, 2008 and 2007, respectively.

Cash payments for income taxes were \$348 million and \$1,969 million for the six month periods ended May 31, 2008 and 2007, respectively.

See Notes to Condensed Consolidated Financial Statements.

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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

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

**The Company.** Morgan Stanley (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; research; 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.

***Discontinued Operations.***

*Discover.* On June 30, 2007, the Company completed the spin-off (the Discover Spin-off) of its business segment Discover Financial Services (DFS). The results of DFS prior to the Discover Spin-off are reported as discontinued operations for all periods presented.

*Quilter Holdings Ltd.* The results of Quilter Holdings Ltd. (Quilter) are reported as discontinued operations for all periods presented through its sale on February 28, 2007. The results of Quilter were formerly included in the Global Wealth Management Group business segment.

See Note 14 for additional information on discontinued operations.

***Basis of Financial Information.*** The condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions regarding the valuations of certain financial instruments, the outcome of litigation and tax matters, incentive-based compensation 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.

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, 2007 (the Form 10-K). The condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for the fair statement of the results for the interim period. The results of operations for interim periods are not necessarily indicative of results for the entire year.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**Consolidation.** The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries, other entities in which the Company has a controlling financial interest and certain variable interest entities ( VIEs ).

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, except in instances where the Company has elected to measure certain eligible investments at fair value as defined in Statement of Financial Accounting Standards ( SFAS ) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS No. 159 ) (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.

The Company's cost infrastructure supporting its businesses varies by activity. In some cases, these costs are directly attributable to one line of business, and, in other cases, such costs relate to multiple businesses. As such, when assessing the performance of its businesses, the Company does not consider these costs separately but rather assesses performance in the aggregate along with the related revenues.

Therefore, the Company's pricing structure considers various items, including the level of expenses incurred directly and indirectly to support the cost infrastructure, the risk it incurs in connection with a transaction, the overall client relationship and the availability in the market for the particular product and/or service. Accordingly, the Company does not manage or capture the costs associated with the products or services sold or its general and administrative costs by revenue line, in total or by product.

**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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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

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 recorded 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. 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' investments 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 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, certain 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 instruments carried at fair value are reflected in Principal transactions' trading revenues or Principal transactions' investments revenues in the condensed consolidated statements of income. 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' investments revenues. Otherwise, they are included within Interest and dividend income or Interest expense.

Fair Value Option. The Company adopted the provisions of SFAS No. 159, effective December 1, 2006. SFAS No. 159 provides entities the option to measure certain financial assets and financial liabilities at fair value with changes in fair value recognized in earnings each period. SFAS No. 159 permits the 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 certain eligible



**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

instruments, including certain loans and loan commitments, certain equity method investments, certain structured notes and certain junior subordinated debentures, certain certificates of deposits and certain Other secured financings.

**Fair Value Measurement Definition and Hierarchy.** The Company adopted the provisions of SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ), effective December 1, 2006. Under this standard, 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 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 reliability 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. Examples of assets and liabilities utilizing Level 1 inputs are: most U.S. Government securities; certain U.S. agency securities; certain other sovereign government obligations; and exchange-traded equity securities and listed derivatives that are actively traded.

Level 2 Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly. Examples of assets and liabilities utilizing Level 2 inputs are: certain U.S. agency securities; municipal bonds; corporate bonds; certain corporate loans and loan commitments; certain residential and commercial mortgage-related instruments (including loans, securities and derivatives); most over-the-counter ( OTC ) derivatives; physical commodities; mortgage servicing rights; deposits; and most structured notes.

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement. Examples of assets and liabilities utilizing Level 3 inputs are: certain corporate loans and loan commitments; certain residential and commercial mortgage-related instruments (including loans, securities and derivatives); real estate and private equity investments; and long-dated or complex OTC derivatives.

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, 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. 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



**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

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 market participants would use in pricing the asset or liability at the measurement date. 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).

*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 the Company and others are willing to pay for an asset. Ask prices represent the lowest price that the Company and others are 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, creditworthiness of the counterparty, option volatility and currency rates. In accordance with SFAS No. 157, the impact of the Company's own credit spreads is also considered when measuring the fair value of liabilities, including OTC derivative contracts. Where appropriate, valuation adjustments are made to account for various factors, including bid-ask spreads, credit quality, market liquidity and the unit of account. These adjustments are subject to judgment, are applied on a consistent basis and are based upon observable inputs where available. The Company subjects all valuations and models to a review process on a periodic basis.

**Financial Instruments Owned/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. To the extent these securities are actively traded, they are categorized in Level 1 of the fair value hierarchy. Callable agency issued debt securities are valued through 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 certificates. TBA securities are generally valued using quoted market prices or are benchmarked thereto. Fair value of mortgage pass-through certificates are model driven with respect to the comparable TBA security. Callable agency issued debt securities and mortgage pass-throughs are generally categorized in Level 2 of the fair value hierarchy.

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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

Financial Instrument Owned/Financial Instruments Sold, Not Yet Purchased - Other Sovereign Government Obligations. The fair value of foreign sovereign government obligations is generally based on quoted prices in active markets. When 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.

Financial Instruments Owned/Financial Instruments Sold, Not Yet Purchased - 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. The spread data used are for the same maturity as the bond. If the spread data do not reference the issuer, then data that reference a comparable issuer is 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 key inputs. Corporate bonds 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 hierarchy.

Corporate Loans and Loan Commitments. The fair value of corporate loans is estimated using recently executed transactions, market price quotations (where observable) and market observable credit default swap levels along with proprietary valuation models and default recovery analysis where such transactions and quotations are unobservable. The fair value of contingent corporate loan 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. While certain corporate loans, closed loan commitments and revolving loans are Level 2 instruments, certain other corporate loans and contingent corporate loan commitments are categorized in Level 3 of the fair value 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. The valuation of mortgage loans depends upon the exit market for the loan. Loans not intended for securitization are valued based on the analysis of the underlying collateral performance, capital structure and market spreads for comparable positions as prices and/or spreads for specific credits tend to be unobservable. Where comparables do not exist, such loans are valued based on origination price and collateral performance (credit events) since origination. These loans are classified in Levels 2 or 3 of the fair value hierarchy.

The Company may hold certain loan products and mortgage products with the intent to securitize them. When structuring of the related securitization is substantially complete, such that the value likely to be realized in a current transaction is consistent with the price that a securitization entity will pay to acquire these products, the Company marks them to the expected securitized value. Factors affecting the value of loan and mortgage products intended to be securitized include, but are not limited to, loan type, underlying property type and geographic location, loan interest rate, loan to value ratios, debt service coverage ratio, updated cumulative loan loss data, prepayment rates, yields, investor demand, any significant market volatility since the last securitization, and credit enhancement. While these valuation factors may be supported by historical and actual external observations, the determination of their value as it relates to specific positions may require significant judgment. These instruments are classified in Levels 2 or 3 of the fair value hierarchy.



**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

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

Retained Interests in Securitization Transactions. The Company engages in securitization activities related to various types of loans and bonds. The Company may retain interests in securitized financial assets in the form of one or more tranches of the securitization. To determine fair values, observable inputs are used if available. Observable inputs, however, may not be available for certain retained interests so 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 there are no significant unobservable inputs, retained interests are categorized in Level 2 of the fair value hierarchy. When unobservable inputs are significant to the fair value measurement, albeit generally supportable by historical and actual benchmark data, retained interests are categorized in Level 3 of the fair value hierarchy.

Financial Instruments Owned/Financial Instruments Sold, Not Yet Purchased 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.

Financial Instruments Owned/Financial Instrument Sold, Not Yet Purchased Derivative 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 modeled using a series of techniques, including closed-form analytic formulae, 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 swap and option contracts. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. A substantial majority of OTC derivative products valued by the Company using pricing models fall into this category and are categorized within Level 2 of the fair value hierarchy.

Other derivative products, typically the newest and most complex products, 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, mortgage-related credit default swaps, basket credit



**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

default swaps and CDO-squared positions 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 mortgage-related CDOs, for which observability of external price data is extremely limited, are valued based on an evaluation of the market for similar positions as indicated by primary and secondary market activity in the cash CDO and synthetic CDO markets. 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.

Mortgage-related credit default swaps are valued based on data from comparable credit instruments in the cash market and trades in comparable swaps as benchmarks, as prices and spreads for the specific credits subject to valuation tend to be of limited observability.

For basket credit default swaps and CDO-squared positions, the correlation between reference credits is often a significant input into the pricing model, in addition to several other more observable inputs such as credit spread, interest and recovery rates. As the correlation input is unobservable for each specific swap, it is benchmarked to standardized proxy baskets for which external data are available.

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 spread curves, volatility of the underlying commodities and, in some cases, the 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.

**Financial Instruments Owned 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. The transaction price is used as the best estimate of fair value at inception. Thereafter, valuation is based on an assessment of each underlying investment, incorporating valuations that consider the evaluation of financing and sale transactions with third parties, expected cash flows and market-based information, including comparable company transactions, performance multiples and changes in market outlook, among other factors. These nonpublic investments are included in Level 3 of the fair value hierarchy because they trade infrequently, and, therefore, the fair value is unobservable.

**Financial Instruments Owned/Financial Instruments Sold, Not Yet Purchased Physical Commodities.** The Company trades various physical commodities, including crude oil and refined products, 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.

**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.



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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**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 described in this section for the derivative and debt features 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 rates. The impact of the Company's own credit spreads also is included based on the Company's observed secondary bond market spreads. Most structured notes are categorized in Level 2 of the fair value hierarchy.

*Fair Value Measurement Other.*

The fair value of 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.

***Hedge Accounting.***

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

The Company's hedges are designated and qualify for accounting purposes as one of the following types of hedges: hedges of changes in fair value of assets and liabilities due to the risk being hedged (fair value hedges), 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 all hedges where hedge accounting is being applied, effectiveness testing and other procedures to ensure the ongoing validity of the hedges are performed at least monthly. The impact of hedge ineffectiveness on the condensed consolidated statements of income, primarily related to fair value hedges, was a gain of \$98 million and \$114 million for the quarter and six month period ended May 31, 2008, respectively, and \$47 million and \$60 million for the quarter and six month period ended May 31, 2007, respectively. The amount excluded from the assessment of hedge effectiveness was immaterial. If a derivative is de-designated as a hedge, it is thereafter accounted for as a financial instrument used for trading.

**Fair Value Hedges Interest Rate Risk.** In the first quarter of fiscal 2007, the Company began using regression analysis to perform an ongoing prospective and retrospective assessment of the effectiveness of these hedging relationships (*i.e.*, the Company applied the long-haul method of hedge accounting). A hedging relationship is deemed effective if the fair values of the hedging instrument (derivative) and the hedged item (debt liability) change inversely within a range of 80% to 125%. The Company considered the impact of valuation adjustments related to the Company's own credit spreads and counterparty credit spreads to determine whether they are material to the fair value of the individual derivatives designated in hedging relationships and whether they would cause the hedging relationship to be ineffective.

Previously, the Company's designated fair value hedges consisted primarily of interest rate swaps designated as fair value hedges of changes in the benchmark interest rate of fixed rate borrowings, including both certificates of



**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

deposit and senior long-term borrowings. For these hedges, the Company ensured that the terms of the hedging instruments and hedged items matched and that other accounting criteria were met so that the hedges were assumed to have no ineffectiveness (*i.e.*, the Company applied the shortcut method of hedge accounting). The Company also used interest rate swaps as fair value hedges of the benchmark interest rate risk of host contracts of equity-linked notes that contained embedded derivatives. For these hedging relationships, regression analysis was used for the prospective and retrospective assessments of hedge effectiveness.

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

*Fair Value Hedges Credit Risk.* Until the fourth quarter of fiscal 2007, the Company had designated a portion of a credit derivative embedded in a non-recourse structured note liability as a fair value hedge of the credit risk arising from a loan receivable to which the structured note liability was specifically linked. Regression analysis was used to perform prospective and retrospective assessments of hedge effectiveness for this hedge relationship. The changes in the fair value of the derivative and the changes in the fair value of the hedged item provided offset of one another and, together with any resulting ineffectiveness, were recorded in Principal transactions trading revenues. This hedge was terminated in the fourth quarter of fiscal 2007 upon derecognition of both the hedging instrument and the hedged item.

*Cash Flow Hedges.* The Company applies cash flow hedge accounting to interest rate swaps designated as hedges of the variability of future cash flows from floating rate liabilities due to the benchmark interest rate. The Company uses regression analysis to perform an ongoing prospective and retrospective assessment of the effectiveness of these hedging relationships. Changes in fair value of these interest rate swaps are recorded to Net change in cash flow hedges as a component of Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, to the extent they are effective. Amounts recorded to Accumulated other comprehensive income (loss) are then reclassified to Interest expense as interest on the hedged borrowings is recognized. Any ineffective portion of the change in fair value of these instruments is recorded to Interest expense.

Before the sale of the aircraft leasing business in 2006, the Company applied hedge accounting to interest rate swaps used to hedge variable rate long-term borrowings associated with this business. Changes in the fair value of the swaps were recorded in Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects, and then reclassified to Interest expense as interest on the hedged borrowings was recognized.

In connection with the sale of the aircraft leasing business, the Company de-designated the interest rate swaps associated with this business effective August 31, 2005 and no longer accounts for them as cash flow hedges. Amounts in Accumulated other comprehensive income (loss) related to those interest rate swaps continue to be reclassified to Interest expense since the related borrowings remain outstanding.

*Net Investment Hedges.* The Company utilizes forward foreign exchange contracts and non-U.S. dollar-denominated debt to manage the currency exposure relating to its net investments in non-U.S. dollar functional currency operations. No hedge ineffectiveness is recognized in earnings since the notional amounts of the hedging instruments equal the portion of the investments being hedged, and, where forward contracts are used, the currencies being exchanged are the functional currencies of the parent and investee; where debt instruments

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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

are used as hedges, they are denominated in the functional currency of the investee. The gain or loss from revaluing hedges of net investments in foreign operations at the spot rate is deferred and reported within Accumulated other comprehensive income (loss) in Shareholders' equity, net of tax effects. The forward points on the hedging instruments are recorded in Interest and dividend revenues.

***Condensed Consolidated Statements of Cash Flows.***

For purposes of these statements, cash and cash equivalents consist of cash and highly liquid investments not held for resale with maturities, when purchased, of three months or less. In connection with business acquisitions, the Company assumed liabilities of \$77 million and \$7,679 million in the six month periods ended May 31, 2008 and 2007, respectively. At May 31, 2008, the Company consolidated real estate limited partnership assets and liabilities of approximately \$4.6 billion and \$3.8 billion, respectively.

***Securitization Activities.***

The Company engages in securitization activities related to commercial and residential mortgage loans, corporate bonds and loans, U.S. agency collateralized mortgage obligations and other types of financial assets (see Note 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 accounted for as secured borrowings.

***Gains (losses) from Unconsolidated Investees.***

The Company invests in unconsolidated investees that provide funds to develop low income communities, renewable energy sources and other structured transactions. These structures provide the Company with tax benefits and are not integral to the operations of the Company. The Company accounts for these investments under the equity method with gains and losses from these investments recorded within Gains (losses) from unconsolidated investees and the applicable tax credits, expenses and benefits recorded within Provision for income taxes.

***Deferred Compensation Arrangements.***

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.***

***Accounting for Uncertainty in Income Taxes.*** In July 2006, the Financial Accounting Standards Board (the "FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," an interpretation of FASB Statement No. 109 ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As a result of the adoption of FIN 48 on December 1, 2007, the Company recorded a cumulative effect adjustment of approximately \$92 million as a decrease to the opening balance of Retained earnings as of December 1, 2007 (see Note 12).

*Employee Benefit Plans.* In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS No. 158). In fiscal 2007, the Company adopted SFAS No. 158's requirement to recognize the overfunded or underfunded status of its defined benefit and postretirement plans as an asset or liability. In the first quarter of fiscal 2008, the Company recorded an after-tax charge of approximately \$13 million (\$21 million pre-tax) to Shareholders' equity upon early adoption of SFAS No. 158's other requirement to use the fiscal year-end date as the measurement date.

*Offsetting of Amounts Related to Certain Contracts.* In April 2007, the FASB issued FASB Staff Position (FSP) No. FIN 39-1, *Amendment of FASB Interpretation No. 39*, (FSP FIN 39-1). FSP FIN 39-1 amends certain provisions of FIN 39, *Offsetting of Amounts Related to Certain Contracts*, and permits companies to offset fair value amounts recognized for cash collateral receivables or payables against fair value amounts recognized for net derivative positions executed with the same counterparty under the same master netting arrangement. In accordance with the provisions of FSP FIN 39-1, the Company offset cash collateral receivables and payables against net derivative positions as of May 31, 2008. The adoption of FSP FIN 39-1 on December 1, 2007 did not have a material impact on the Company's condensed consolidated financial statements.

*Dividends on Share-Based Payment Awards.* In June 2007, the Emerging Issues Task Force (EITF) reached consensus on Issue No. 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* (EITF Issue No. 06-11). EITF Issue 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 currently accounts for this tax benefit as a reduction to its income tax provision. EITF Issue No. 06-11 is to be applied prospectively for tax benefits on dividends declared in fiscal years beginning after December 15, 2007. The Company does not expect the adoption of EITF Issue No. 06-11 to have a material impact on the Company's condensed consolidated financial statements.

*Business Combinations.* In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS No. 141(R)). SFAS 141(R) requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to disclose to investors and other users all of the information needed to evaluate and understand the nature and financial effect of the business combination. SFAS No. 141(R) applies to all transactions or other events in which the Company obtains control of one or more businesses, including those sometimes referred to as true mergers or mergers of equals and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after December 1, 2009.

*Noncontrolling Interests.* In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* an amendment of Accounting Research Bulletin No. 51 (SFAS No. 160). SFAS No. 160 requires reporting entities to present noncontrolling (minority) interests as equity (as opposed to as a liability or mezzanine equity) and provides guidance on the accounting for transactions between an entity

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

and noncontrolling interests. SFAS No. 160 applies prospectively as of December 1, 2009, except for the presentation and disclosure requirements which will be applied retrospectively for all periods presented. The Company is currently evaluating the potential impact of adopting SFAS No. 160.

*ASF Framework.* In December 2007, the American Securitization Forum ( ASF ) issued the Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans (the ASF Framework ). The overall purpose of the ASF Framework is to provide recommended guidance for servicers to streamline borrower evaluation procedures and to facilitate the effective use of all forms of foreclosure and loss prevention efforts, including refinancings, forbearances, workout plans, loan modifications, deeds-in-lieu and short sales or short payoffs. The ASF Framework is focused on subprime first-lien adjustable rate residential mortgages loans that have an initial fixed rate period of 36 months or less, are included in securitized pools, were originated between January 1, 2005 and July 31, 2007, and have an initial interest rate reset date between January 1, 2008 and July 31, 2010 ( subprime ARM loans ).

The ASF Framework categorizes the population of subprime ARM loans into three segments. Segment 1 includes current loans, as defined, where the borrower is likely to be able to refinance into an available mortgage product. It is expected that borrowers in this category should refinance their loans, if they are unable or unwilling to meet their reset payment. Segment 2 includes current loans where the borrower is unlikely to be able to refinance and meet specific criteria related to Fair Isaac Corporation (or FICO ) scores and the expected payment increase due to the initial adjustment of the interest rate. Borrowers in this segment are eligible for a fast track loan modification under which the interest rate will be kept at the existing rate, generally for five years following the upcoming reset. The ASF Framework indicates that for Segment 2 loans, the servicer can presume that the borrower would be unable to pay pursuant to the original terms of the loan after the interest rate reset, and thus, borrower default on the loan is reasonably foreseeable in absence of a modification. Segment 3 includes loans where the borrower is not current or which do not otherwise qualify for Segment 1 or Segment 2. For loans in this category, the servicer will determine the appropriate loss mitigation approach in a manner consistent with the applicable servicing standard in the transaction documents, but without employing the fast track procedures described under Segment 2.

In January 2008, the Office of Chief Accountant (the OCA ) of the Securities and Exchange Commission (the SEC ) issued a letter (the OCA Letter ) addressing accounting issues that may be raised by the ASF Framework. The OCA letter concluded that the SEC would not object to continuing off-balance sheet accounting treatment for QSPEs that hold Segment 2 subprime ARM loans modified pursuant to the ASF Framework.

For those current loans that are accounted for off-balance sheet that are modified, but not as part of the ASF Framework above, the servicer must perform on an individual basis an analysis of the borrower and the loan to provide sufficient evidence to demonstrate that default on the loan is imminent or reasonably foreseeable.

The Company adopted the ASF Framework during the first quarter of fiscal 2008, but has not yet modified a significant volume of loans using the ASF Framework. The Company does not expect that its application of the ASF Framework will impact the off-balance sheet status of Company-sponsored QSPEs that hold Segment 2 subprime ARM loans and is currently evaluating the potential impact on its condensed consolidated statements of income. The total amount of assets owned by Company-sponsored QSPEs that hold subprime ARM loans (including those loans that are not serviced by the Company) as of May 31, 2008, was approximately \$39.3 billion. Of this amount, approximately \$15.0 billion relates to subprime ARM loans serviced by the Company. The Company's retained interests in Company sponsored QSPEs that hold subprime ARM loans totaled approximately \$68 million as of May 31, 2008.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

*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 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 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. FSP FAS 140-3 is effective for the Company on December 1, 2008. The Company is currently evaluating the potential impact of adopting FSP FAS 140-3.

*Disclosures about Derivative Instruments and Hedging Activities.* In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* ( SFAS No. 161 ). SFAS No. 161 amends and expands the disclosure requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and requires entities to provide enhanced qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair values and amounts of gains and losses on derivative contracts, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 will be effective for the Company's fiscal 2009 interim and annual consolidated financial statements.

*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 considers its own experience in renewing similar arrangements. If the entity has no relevant experience, it would consider market participant assumptions regarding renewal. FSP FAS 142-3 is effective for the Company on December 1, 2009. The Company is currently evaluating the potential impact of adopting FSP FAS 142-3.

*Earnings Per Share.* 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 is effective for the Company on December 1, 2009. All prior-period earnings per share data presented shall be adjusted retrospectively. Early application is not permitted. The Company is currently evaluating the potential impact of adopting FSP EITF 03-6-1.

*QSPEs.* In April 2008, the FASB voted to eliminate QSPEs from the guidance in SFAS No. 140. Although the revised standard has not been finalized, this change may have a significant impact on the Company's condensed consolidated financial statements as the Company may be required to consolidate assets previously sold to a QSPE, and may not be able to derecognize assets sold to similar types of structures after the revised standard is issued. This proposed revision could be effective as early as December 2008.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

In connection with the proposed changes to SFAS No. 140, the FASB also is proposing three key changes to the consolidation model in FASB Interpretation No. 46, as revised ( FIN 46R ), Consolidation of Variable Interest Entities. First, the FASB will now include former QSPEs in the scope of FIN 46R. In addition, the FASB supports amending FIN 46R to change the method of analyzing which party to a VIE should consolidate the VIE to a primarily qualitative determination of control instead of the current risks and rewards model. Finally, the proposed amendment is expected to require all VIEs and their primary beneficiaries to be reevaluated quarterly. The current rules require reconsideration only when specified reconsideration events occur.

The Company will be evaluating the impact of these changes on the Company's condensed consolidated financial statements once the actual guidelines are finalized.



**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****2. Fair Value Disclosures.*****Fair Value Measurements.***

The Company's assets and liabilities recorded at fair value have been categorized based upon a fair value hierarchy in accordance with SFAS No. 157. See Note 1 for a discussion of the Company's policies regarding this 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 May 31, 2008 and November 30, 2007:

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

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance as of May 31, 2008
	(dollars in millions)				
<b>Assets</b>					
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements	\$ 15,270	\$	\$	\$	\$ 15,270
Financial instruments owned:					
U.S. government and agency securities	8,231	17,993	274		26,498
Other sovereign government obligations	26,530	5,909	28		32,467
Corporate and other debt	91	101,177	29,675		130,943
Corporate equities	81,608	6,246	1,221		89,075
Derivative contracts(1)	2,264	130,429	25,276	(65,664)	92,305
Investments	839	1,892	12,720		15,451
Physical commodities		3,654			3,654
<b>Total financial instruments owned</b>	<b>119,563</b>	<b>267,300</b>	<b>69,194</b>	<b>(65,664)</b>	<b>390,393</b>
Securities received as collateral	20,320	5,204	4		25,528
Intangible assets(2)		344			344
<b>Liabilities</b>					
Commercial paper and other short-term borrowings	\$	\$ 6,427	\$	\$	\$ 6,427
Deposits		35			35
Financial instruments sold, not yet purchased:					
U.S. government and agency securities	10,700	578			11,278
Other sovereign government obligations	12,219	6,814			19,033
Corporate and other debt	10	5,898	876		6,784
Corporate equities	46,026	486	120		46,632
Derivative contracts(1)	2,582	109,338	11,127	(45,608)	77,439
Physical commodities		582			582
<b>Total financial instruments sold, not yet purchased</b>	<b>71,537</b>	<b>123,696</b>	<b>12,123</b>	<b>(45,608)</b>	<b>161,748</b>

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Obligation to return securities received as collateral	20,320	5,204	4	25,528
Other secured financings		24,906	3,331	28,237
Long-term borrowings		39,687	5,815	45,502

- (1) 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.
- (2) Amount represents mortgage servicing rights (MSRs) accounted for at fair value (see Note 4).

**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, 2007**

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) (dollars in millions)	Counterparty and Cash Collateral Netting	Balance as of November 30, 2007
<b>Assets</b>					
Cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements	\$ 31,354	\$	\$	\$	\$ 31,354
Financial instruments owned:					
U.S. government and agency securities	11,038	12,189	660		23,887
Other sovereign government obligations	15,834	5,743	29		21,606
Corporate and other debt	223	110,443	37,058		147,724
Corporate equities	82,592	3,549	1,236		87,377
Derivative contracts(1)	4,526	90,654	21,601	(39,778)	77,003
Investments	953	249	13,068		14,270
Physical commodities		3,096			3,096
<b>Total financial instruments owned</b>	<b>115,166</b>	<b>225,923</b>	<b>73,652</b>	<b>(39,778)</b>	<b>374,963</b>
Securities received as collateral	68,031	14,191	7		82,229
Intangible assets(2)		428			428
<b>Liabilities</b>					
Commercial paper and other short-term borrowings	\$	\$ 3,068	\$	\$	\$ 3,068
Deposits		3,769			3,769
Financial instruments sold, not yet purchased:					
U.S. government and agency securities	8,208	13			8,221
Other sovereign government obligations	9,633	5,994			15,627
Corporate and other debt	16	6,454	1,122		7,592
Corporate equities	29,948	935	16		30,899
Derivative contracts(1)	7,031	86,968	15,663	(38,058)	71,604
Physical commodities		398			398
<b>Total financial instruments sold, not yet purchased</b>	<b>54,836</b>	<b>100,762</b>	<b>16,801</b>	<b>(38,058)</b>	<b>134,341</b>
Obligation to return securities received as collateral	68,031	14,191	7		82,229
Other secured financings		25,451	2,321		27,772
Long-term borrowings		37,994	398		38,392

(1) 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.

(2) Amount represents MSRs accounted for at fair value (see Note 4).



**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realized and unrealized gains and losses for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realized or unrealized gains and 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 and losses for assets and liabilities within the Level 3 category presented in the tables below may include changes in fair value that were attributable to both observable (*e.g.*, changes in market interest rates) and unobservable (*e.g.*, changes in unobservable long-dated volatilities) inputs.

**Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended May 31, 2008**

	Beginning Balance	Realized Gains or (Losses)(1)	Unrealized Gains or (Losses)(1)	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
(dollars in millions)							
<b>Assets</b>							
Financial instruments owned:							
U.S. government and agency securities	\$ 581	\$ (8)	\$ (8)	\$ (16)	\$ (245)	\$ (46)	\$ 274
Other sovereign government obligations	15	4	(5)	(1)		14	28
Corporate and other debt(2)(3)	31,622	29	(1,563)	(1,534)	(1,824)	1,411	29,675
Corporate equities	1,957	(110)	18	(92)	(548)	(96)	1,221
Net derivative contracts(2)(3)(4)	15,841	5	(2,536)	(2,531)	3,967	(3,128)	14,149
Investments	12,070	(6)	(160)	(166)	845	(29)	12,720
Securities received as collateral	13				(9)		4
<b>Liabilities</b>							
Financial instruments sold, not yet purchased:							
Corporate and other debt	\$ 604	\$ 71	\$ 353	\$ 424	\$ 730	\$ (34)	\$ 876
Corporate equities	552	(16)	(200)	(216)	(394)	(254)	120
Obligation to return securities received as collateral	13				(9)		4
Other secured financings	1,616				1,715		3,331
Long-term borrowings	5,964	(8)	155	147	34	(36)	5,815

(1) Realized and unrealized gains (losses) are primarily included in Principal transactions trading in the condensed consolidated statements of income. Unrealized gains (losses) relate to Level 3 assets and liabilities still held by the Company at May 31, 2008.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

- (2) The net losses from Corporate and other debt were primarily due to writedowns on certain asset-backed securities and collateralized debt obligation ( CDO ) cash positions.

The net losses from Net derivative contracts were primarily driven by bespoke basket default swaps, writedowns on super senior CDO positions and losses from proprietary trading.

These results are only a component of the overall trading strategies of these businesses and do not take into consideration any related financial instruments that have been classified by the Company within the Level 1 and/or Level 2 categories. For example, the Company recorded gains on single name credit default swaps recorded in Level 2 Net derivative contracts.

- (3) The Company reclassified certain Corporate and other debt from Level 2 to Level 3. These reclassifications included transfers primarily related to certain commercial mortgage backed securities, commercial whole loans and corporate loans and loan commitments. The reclassifications were due to a reduction in the volume of recently executed transactions and market price quotations for these instruments such that the inputs for these instruments became unobservable. Partially offsetting the reclassifications to Level 3 were reclassifications from Level 3 to Level 2 of certain Corporate and other debt. These reclassifications included transfers primarily related to corporate loans and loan commitments as some liquidity re-entered the market for these specific positions and inputs for these instruments became observable. The Company reclassified certain OTC derivatives from Level 3 to Level 2. These reclassifications included transfers primarily related to tranche index default swaps as inputs became observable.
- (4) Amounts represent Financial instruments owned derivative contracts net of Financial instrument sold, not yet purchased derivative contracts.

**Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended May 31, 2007**

	Beginning Balance	Realized Gains or (Losses)(1)	Unrealized Gains or (Losses)(1)	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
	(dollars in millions)						
<b>Assets</b>							
Financial instruments owned:							
U.S. government and agency securities	\$ 148	\$ (4)	\$	\$ (4)	\$ (73)	\$ (8)	\$ 63
Other sovereign government obligations	911	(6)	(19)	(25)	(862)		24
Corporate and other debt	36,351	(1,060)	(152)	(1,212)	88	37	35,264
Corporate equities	1,239	(93)	181	88	188	(11)	1,504
Net derivative contracts(2)	276	(252)	1,513	1,261	116	265	1,918
Investments	6,176	289	565	854	1,611	(113)	8,528
Other assets	2,268		36	36	142		2,446
<b>Liabilities</b>							
Financial instruments sold, not yet purchased:							
Corporate and other debt	\$ 68	\$ (92)	\$ (3)	\$ (95)	\$ (219)	\$ 145	\$ 89
Corporate equities	15	5	(15)	(10)	38		63
Other secured financings	6,088				2,260		8,348
Long-term borrowings	544	(1)	(50)	(51)	(149)		446

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- (1) Realized and unrealized gains (losses) are included in Principal transactions trading in the condensed consolidated statements of income except for amounts of \$852 million and \$2 million related to Financial instruments owned investments, which are included in Principal transactions investments and Other revenues, respectively. In addition, \$36 million related to Other assets is associated with DFS and included in discontinued operations. Unrealized gains (losses) relate to Level 3 asset and liabilities still held by the Company at May 31, 2007.
- (2) Amounts represent Financial instruments owned derivative contracts net of Financial instruments sold, not yet purchased derivative contracts.

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

	<b>Beginning Balance</b>	<b>Realized Gains or (Losses)(1)</b>	<b>Unrealized Gains or (Losses)(1)</b>	<b>Total Realized and Unrealized Gains or (Losses)(1)</b>	<b>Purchases, Sales, Other Settlements and Issuances, net</b>	<b>Net Transfers In and/or (Out) of Level 3</b>	<b>Ending Balance</b>
	<b>(dollars in millions)</b>						
<b>Assets</b>							
Financial instruments owned:							
U.S. government and agency securities	\$ 660	\$ (2)	\$ 45	\$ 43	\$ (374)	\$ (55)	\$ 274
Other sovereign government obligations	29	3	(5)	(2)	1		28
Corporate and other debt(2)(3)	37,058	1,236	(4,976)	(3,740)	(6,238)	2,595	29,675
Corporate equities	1,236	(96)	15	(81)	271	(205)	1,221
Net derivative contracts(2)(4)	5,938	217	5,855	6,072	5,031	(2,892)	14,149
Investments(5)	13,068	(1)	(239)	(240)	1,625	(1,733)	12,720
Securities received as collateral	7				(3)		4
<b>Liabilities</b>							
Financial instruments sold, not yet purchased:							
Corporate and other debt(2)	\$ 1,122	\$ 51	\$ (146)	\$ (95)	\$ (305)	\$ (36)	\$ 876
Corporate equities	16	(29)	(292)	(321)	33	(250)	120
Obligation to return securities received as collateral	7				(3)		4
Other secured financings	2,321				1,010		3,331
Long-term borrowings(6)	398	(8)	13	5	5,590	(168)	5,815

(1) Realized and unrealized gains (losses) are primarily included in Principal transactions trading in the condensed consolidated statements of income. Unrealized gains (losses) relate to Level 3 assets and liabilities still held by the Company at May 31, 2008.

(2) The net gains from Net derivative contracts and the net losses from Corporate and other debt resulted from market movements primarily associated with credit products and various credit linked instruments, respectively. The net gains in Level 3 Net derivative contracts were primarily driven by certain credit default swaps and other instruments associated with the Company's credit products and securitized products activities. The net losses in Level 3 Corporate and other debt were primarily driven by certain asset-backed securities, including residential and commercial mortgage loans, and by corporate loans and loan commitments.

These results are only a component of the overall trading strategies of these businesses and do not take into consideration any related financial instruments that have been classified by the Company within the Level 1 and/or Level 2 categories. For example, the Company recorded offsetting net losses in Level 2 Net derivative contracts, which were primarily associated with the Company's credit products and securitized products activities.

(3) 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 loan commitments. The Company reclassified certain OTC derivatives from Level 3 to Level 2. These reclassifications included transfers primarily related to tranche index default swaps as inputs became observable.

(4) Amounts represent Financial instruments owned derivative contracts net of Financial instruments sold, not yet purchased derivative contracts.

(5) 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.



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- (6) Amounts included in the Purchases, sales, other settlements and issuances, net column primarily relates to the issuance of junior subordinated debentures related to China Investment Corporation investment (see Note 9).

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Six Months Ended May 31, 2007**

	<b>Beginning Balance</b>	<b>Realized Gains or (Losses)(1)</b>	<b>Unrealized Gains or (Losses)(1)</b>	<b>Total Realized and Unrealized Gains or (Losses)(1)</b>	<b>Purchases, Sales, Other Settlements and Issuances, net</b>	<b>Net Transfers In and/or (Out) of Level 3</b>	<b>Ending Balance</b>
	(dollars in millions)						
<b>Assets</b>							
Financial instruments owned:							
U.S. government and agency securities	\$ 2	\$ (4)	\$ (6)	\$ (10)	\$ 79	\$ (8)	\$ 63
Other sovereign government obligations	162	3	7	10	(148)		24
Corporate and other debt(2)	33,941	(1,001)	(216)	(1,217)	2,546	(6)	35,264
Corporate equities	1,040	(208)	333	125	358	(19)	1,504
Net derivative contracts(2)(3)	30	(760)	2,568	1,808	(219)	299	1,918
Investments(4)	3,879	306	1,128	1,434	3,341	(126)	8,528
Securities received as collateral	40				(40)		
Other assets	2,154		32	32	260		2,446
<b>Liabilities</b>							
Financial instruments sold, not yet purchased:							
Corporate and other debt(2)	\$ 185	\$ (103)	\$ (6)	\$ (103)	\$ (386)	\$ 187	\$ 89
Corporate equities	9	(4)	(6)	(10)	39	5	63
Obligation to return securities received as collateral	40				(40)		
Other secured financings	4,724				3,624		8,348
Long-term borrowings	464	(6)	(98)	(104)	(122)		446

- (1) Realized and unrealized gains (losses) are included in Principal transactions trading in the condensed consolidated statements of income except for amounts of \$1,423 million and \$11 million related to Financial instruments owned investments, which are included in Principal transactions investments and Other revenues. In addition, the \$32 million related to Other assets is associated with DFS and included in discontinued operations. Unrealized gains (losses) relate to Level 3 assets and liabilities still held by the Company at May 31, 2007.
- (2) The net gains from Net derivative contracts and net losses from Corporate and other debt resulted from market movements primarily associated with credit products and various credit linked instruments, respectively. Such results are only a component of the overall trading strategies of the credit products business, and do not take into consideration any related financial instruments that have been classified by the Company within Level 1 and/or Level 2 categories.
- (3) Amounts represent Financial instruments owned derivative contracts net of Financial instruments sold, not yet purchased derivative contracts.
- (4) The net gains from Financial instruments owned investments were primarily related to investments associated with the Company's real estate products and private equity portfolio.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)*****Fair Value Option.***

The following tables present gains and (losses) due to changes in fair value for items measured at fair value pursuant to the fair value option election for the quarters and six month periods ended May 31, 2008 and 2007. In addition to the amounts below, as discussed in Note 1, all of the instruments within Financial instruments owned or Financial instruments sold, not yet purchased are measured at fair value, either through the election of SFAS No. 159 or as required by other accounting pronouncements. Changes in the fair value of these instruments are recorded in Principal transactions trading and Principal transactions investments revenues.

<b>Three months ended May 31, 2008</b>	<b>Principal Transactions: Trading</b>	<b>Net Interest Revenue (dollars in millions)</b>	<b>Gains (losses) Included in the Three Months Ended May 31, 2008</b>
Commercial paper and other short-term borrowings	\$ (57)	\$	\$ (57)
Deposits	(3)		(3)
Long-term borrowings	(80)	(330)	(410)

<b>Three months ended May 31, 2007</b>	<b>Principal Transactions: Trading</b>	<b>Net Interest Revenue (dollars in millions)</b>	<b>Gains (losses) Included in the Three Months Ended May 31, 2007</b>
Commercial paper and other short-term borrowings	\$ (95)	\$ (5)	\$ (100)
Deposits	(3)		(3)
Long-term borrowings	(160)	(129)	(289)

<b>Six months ended May 31, 2008</b>	<b>Principal Transactions: Trading</b>	<b>Net Interest Revenue (dollars in millions)</b>	<b>Gains (losses) Included in the Six Months Ended May 31, 2008</b>
Commercial paper and other short-term borrowings	\$ 151	\$ (2)	\$ 149
Deposits	(9)		(9)
Long-term borrowings	384	(528)	(144)

<b>Six months ended May 31, 2007</b>	<b>Principal Transactions: Trading</b>	<b>Net Interest Revenue (dollars in millions)</b>	<b>Gains (losses) Included in the Six Months Ended May 31, 2007</b>
Commercial paper and other short-term borrowings	\$ (100)	\$ (5)	\$ (105)
Deposits	1		1
Long-term borrowings	(24)	(178)	(202)

As of May 31, 2008 and November 30, 2007, the aggregate contractual principal amount of loans for which the fair value option was elected exceeded the fair value of such loans by approximately \$28,984 million and \$28,880 million, respectively. The aggregate fair value of loans that

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were 90 or more days past due as of May 31, 2008 and November 30, 2007 was \$3,404 million and \$6,588 million, respectively. The aggregate contractual principal amount of such loans 90 or more days past due exceeded their fair value by approximately \$21,444 million and \$23,501 million at May 31, 2008 and November 30, 2007, respectively. This difference in amount primarily emanates from the Company's distressed debt trading business, which purchases distressed debt at amounts well below par.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

For the quarter and six month period ended May 31, 2008, changes in the fair value of loans for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were a gain of \$346 million and a loss of \$1,292 million, respectively. Instrument-specific credit losses were determined by excluding the non-credit components of gains and losses, such as those due to changes in interest rates. For the quarter and six month period ended May 31, 2007, changes in the fair value of loans for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were estimated to be an immaterial unrealized loss.

For the quarter and six month period ended May 31, 2008, the estimated changes in the fair value of the Company's short-term and long-term borrowings, including structured notes and junior subordinated debentures, for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were gains of approximately \$99 million and \$996 million, respectively. The gains were attributable to the widening of the Company's credit spreads and was determined based upon observations of the Company's secondary bond market spreads. For the quarter and six month period ended May 31, 2007, the estimated changes in the fair value of the Company's short-term and long-term borrowings, including structured notes and junior subordinated debentures, for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were not material. As of May 31, 2008 and November 30, 2007, the aggregate contractual principal amount of long-term debt instruments for which the fair value option was elected exceeded the fair value of such instruments by approximately \$3,321 million and \$1,572 million, respectively.

The estimated change in the fair value of other liabilities for which the fair value option was elected that was attributable to changes in instrument-specific credit spreads were gains of approximately \$156 million and \$114 million, respectively, in the quarter and six month period ended May 31, 2008. The gains were primarily related to leveraged loan contingent commitments. The gains were generally determined based on the differential between estimated expected client yields at May 31, 2008 and contractual yields. For the quarter and six month period ended May 31, 2007, the estimated changes in the fair value of other liabilities for which the fair value option was elected that were attributable to changes in instrument-specific credit spreads were not material.

**3. Collateralized Transactions.**

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

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

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

	At May 31, 2008	At November 30, 2007
	(dollars in millions)	
Financial instruments owned:		
U.S. government and agency securities	\$ 6,199	\$ 7,134
Other sovereign government obligations	5,946	333
Corporate and other debt	37,337	32,530
Corporate equities	5,010	1,133
Total	\$ 54,492	\$ 41,130

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers' needs and to finance the Company's inventory positions. The Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. government and agency securities, other sovereign government obligations, corporate and other debt, and corporate equities. The Company receives collateral in the form of securities in connection with reverse repurchase agreements, securities borrowed and derivative transactions, and customer margin loans. In many cases, the Company is permitted to sell or repledge these securities held as collateral and use the securities to secure repurchase agreements, to enter into securities lending and derivative transactions or for delivery to counterparties to cover short positions. At May 31, 2008 and November 30, 2007, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$953 billion and \$948 billion, respectively, and the fair value of the portion that had been sold or repledged was \$711 billion and \$708 billion, respectively.

The Company additionally receives securities as collateral in connection with certain securities for securities transactions in which the Company is the lender. In instances where the Company is permitted to sell or repledge these securities, the Company reports the fair value of the collateral received and the related obligation to return the collateral in the condensed consolidated statements of financial condition. At May 31, 2008 and November 30, 2007, \$26 billion and \$82 billion, respectively, were reported as Securities received as collateral and an Obligation to return securities received as collateral in the condensed consolidated statements of financial condition. Collateral received in connection with these transactions that was subsequently repledged was approximately \$23 billion and \$72 billion at May 31, 2008 and November 30, 2007, respectively.

The Company manages credit exposure arising from reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Company, in the event of a customer default, the right to liquidate collateral and the right to offset a counterparty's rights and obligations. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralized. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral. Customer receivables generated from margin lending activity are



**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

collateralized by customer-owned securities held by the Company. For these transactions, adherence to the Company's collateral policies significantly limits the Company's credit exposure in the event of customer default. The Company may request additional margin collateral from customers, if appropriate, and, if necessary, may sell securities that have not been paid for or purchase securities sold but not delivered from customers.

**4. Securitization Activities and Variable Interest Entities.**

**Securitization Activities.** The Company engages in securitization activities related to commercial and residential mortgage loans, U.S. agency collateralized mortgage obligations, corporate bonds and loans, municipal bonds and other types of financial assets. Special purpose entities (SPEs), also known as VIEs, are typically used in such securitization transactions. The Company does not consolidate certain securitization vehicles, commonly known as QSPEs, 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. The determination of whether an SPE meets the criteria to be a QSPE requires considerable judgment, particularly in evaluating whether the permitted activities of the SPE are significantly limited and in determining whether derivatives held by the SPE are passive and nonexcessive. See Note 1 for further information on QSPEs.

The following table presents the total assets of and retained interests in QSPEs to which the Company acting as principal, has transferred assets and received sales treatment:

	At May 31, 2008	
	QSPE Assets	Retained Interests
	(dollars in millions)	
Residential mortgage loans	\$ 74,662	\$ 1,055
Commercial mortgage loans	115,109	662
U.S. agency collateralized mortgage obligations	29,869	228
Other	3,826	
<b>Total</b>	<b>\$ 223,466</b>	<b>\$ 1,945</b>

Transferred assets are carried at fair value prior to securitization, and any changes in fair value are recognized in the condensed consolidated statements of income. The Company may act as underwriter of the beneficial interests issued by securitization vehicles. Underwriting net revenues are recognized in connection with these transactions. The Company may retain interests in the securitized financial assets as one or more tranches of the securitization. These retained interests are included in the condensed consolidated statements of financial condition at fair value. Any changes in the fair value of such retained interests are recognized in the condensed consolidated statements of income. Net gains at the time of securitization were not material in the six month period ended May 31, 2008.



**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

The following tables present information on the Company's residential mortgage loan, commercial mortgage loan and U.S. agency collateralized mortgage obligation securitization transactions. Key economic assumptions and the sensitivity of the current fair value of the retained interests to immediate 10% and 20% adverse changes in those assumptions as of May 31, 2008 and November 30, 2007 were as follows (dollars in millions):

**At May 31, 2008:**

	<b>Residential Mortgage Loans</b>	<b>Commercial Mortgage Loans</b>	<b>U.S. Agency Collateralized Mortgage Obligations</b>
Investment grade retained interests	\$ 831	\$ 524	\$ 228
Non-investment grade retained interests	224	138	
<b>Total retained interests (carrying amount/fair value)</b>	<b>\$ 1,055</b>	<b>\$ 662</b>	<b>\$ 228</b>
Weighted average life (in months)	66	37	50
Range	1.3 - 230	2.5 - 114	1.8 - 264
Weighted average discount rate (per annum)	17.14%	10.65%	7.61%
Range	3.00 - 99.20%	2.00 - 27.17%	0.46 - 50.43%
Impact on fair value of 10% adverse change	\$ (31)	\$ (13)	\$ (4)
Impact on fair value of 20% adverse change	\$ (59)	\$ (26)	\$ (8)
Weighted average credit losses(1)(2)	12.37%	8.18%	0.00%
Range	0.00 - 25.00%	0.00 - 24.87%	0.00 - 0.00%
Impact on fair value of 10% adverse change	\$ (22)	\$ (8)	\$
Impact on fair value of 20% adverse change	\$ (42)	\$ (15)	\$
Weighted average prepayment speed assumption ( PSA )(3)	831		277
Range	0 - 1,200PSA		167 - 522PSA
Impact on fair value of 10% adverse change(4)	\$ (18)	\$	\$ (4)
Impact on fair value of 20% adverse change(4)	\$ (35)	\$	\$ (9)

(1) Residential mortgage loans credit loss rate stated in terms of cumulative loss rate. Commercial mortgage loans credit loss rate stated in terms of annualized loss rate.

(2) Credit losses are computed only on positions for which expected credit loss is either a key assumption in the determination of fair value or is not reflected in the discount rate.

(3) Commercial mortgage loans typically contain provisions that either prohibit or economically penalize the borrower from prepaying the loan for a specified period of time.

(4) Amounts for residential mortgage loans exclude positive valuation effects from immediate 10% and 20% changes.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****At November 30, 2007:**

	<b>Residential Mortgage Loans</b>	<b>Commercial Mortgage Loans</b>	<b>U.S. Agency Collateralized Mortgage Obligations</b>
Investment grade retained interests	\$ 2,048	\$ 678	\$ 826
Non-investment grade retained interests	1,167	406	
<b>Total retained interests (carrying amount/fair value)</b>	<b>\$ 3,215</b>	<b>\$ 1,084</b>	<b>\$ 826</b>
Weighted average life (in months)	49	57	51
Range	1-322	0.5-139	1-271
Weighted average discount rate (per annum)	12.55%	8.48%	6.04%
Range	1.12 - 74.10%	3.00 - 16.83%	0.75 - 18.12%
Impact on fair value of 10% adverse change	\$ (114)	\$ (14)	\$ (16)
Impact on fair value of 20% adverse change	\$ (218)	\$ (28)	\$ (31)
Weighted average credit losses(1)(2)	4.52%	3.24%	0.00%
Range	0.00 - 12.00%	0.00 - 13.69%	0.00 - 0.00%
Impact on fair value of 10% adverse change	\$ (215)	\$ (5)	\$
Impact on fair value of 20% adverse change	\$ (371)	\$ (10)	\$
Weighted average prepayment speed assumption( PSA )(3)	1,173		301
Range	188 - 2,250PSA		167 - 718PSA
Impact on fair value of 10% adverse change(4)	\$ (118)	\$	\$ (7)
Impact on fair value of 20% adverse change(4)	\$ (194)	\$	\$ (19)

(1) Residential mortgage loans credit loss rate stated in terms of cumulative loss rate. Commercial mortgage loans credit loss rate stated in terms of annualized loss rate.

(2) Credit losses are computed only on positions for which expected credit loss is either a key assumption in the determination of fair value or is not reflected in the discount rate.

(3) Commercial mortgage loans typically contain provisions that either prohibit or economically penalize the borrower from prepaying the loan for a specified period of time.

(4) Amounts for residential mortgage loans exclude positive valuation effects from immediate 10% and 20% changes.

The weighted average assumptions and parameters used initially to value retained interests in relation to securitizations that were still held by the Company as of May 31, 2008 were as follows:

	<b>Residential Mortgage Loans</b>	<b>Commercial Mortgage Loans</b>	<b>U.S. Agency Collateralized Mortgage Obligations</b>
Weighted average life (in months)	72	48	60
Weighted average discount rate (rate per annum)	9.28%	7.07%	6.21%
Weighted average credit losses(1)(2)	0.33%	1.63%	
Weighted average prepayment speed assumptions	1,634PSA		281PSA

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- (1) Residential mortgage loans credit loss rate stated in terms of cumulative loss rate. Commercial mortgage loans credit loss rate stated in terms of annualized loss rate.
- (2) Credit losses are computed only on positions for which expected credit loss is either a key assumption in the determination of fair value or is not reflected in the discount rate.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

The tables above do not include the offsetting benefit of any financial instruments that the Company may utilize to hedge risks inherent in its retained interests. In addition, the sensitivity analysis is hypothetical and should be used with caution. Changes in fair value based on a 10% or 20% variation in an assumption generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the retained interests is calculated independently of changes in any other assumption; in practice, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities. In addition, the sensitivity analysis does not consider any corrective action that the Company may take to mitigate the impact of any adverse changes in the key assumptions.

During the six month periods ended May 31, 2008 and 2007, the Company received proceeds from new securitization transactions of \$6.2 billion and \$33.7 billion, respectively, and cash flows from retained interests in securitization transactions of \$2.1 billion and \$3.2 billion, respectively.

**Variable Interest Entities.** FIN 46R applies to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The primary beneficiary of a VIE is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns or both, as a result of holding variable interests. The Company consolidates entities in which it is the primary beneficiary. For those entities deemed to be QSPEs (as defined in SFAS No. 140), the Company does not consolidate the entity. See Note 1 regarding the characteristics of QSPEs.

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

Purchased, sold and retained interests in connection with market making and securitization activities.

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

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

Derivatives entered into with variable interest entities.

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

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

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

The following table presents information about the Company's total assets and maximum exposure to loss associated with VIEs as of May 31, 2008 which the Company consolidates. The Company generally accounts for the assets held by the entities as Financial instruments owned and the liabilities of the entities as Other secured financings in the condensed consolidated statements of financial condition (dollars in millions):

	At May 31, 2008				
	Maximum Exposure to Loss in Consolidated VIEs				
	VIE Assets That the Company Consolidates	Debt and Equity Interests	Derivatives	Commitments and Guarantees	Total
Mortgage and asset-backed securitizations	\$ 5,814	\$ 1,566	\$ 5	\$	\$ 1,571
Municipal bond trusts	826			833	833
Credit and real estate	5,404	3,978	2,312		6,290
Commodities financing	1,057		235		235
Other structured transactions	14,903	13,256		9	13,265
	\$ 28,004	\$ 18,800	\$ 2,552	\$ 842	\$ 22,194

The following table presents information about the Company's total assets and maximum exposure to loss associated with non-consolidated VIEs as of May 31, 2008 in which the Company had significant variable interests (dollars in millions):

	At May 31, 2008				
	Maximum Exposure to Loss in Non-consolidated VIEs				
	VIE Assets That the Company Does not Consolidate	Debt and Equity Interests	Derivatives	Commitments and Guarantees	Total
Mortgage and asset-backed securitizations	\$ 6,715	\$ 88	\$ 68	\$	\$ 156
Municipal bond trusts	432	275		80	355
Credit and real estate	9,176	4,916	722	11	5,649
Other structured transactions	10,923	2,185		498	2,683
	\$ 27,246	\$ 7,464	\$ 790	\$ 589	\$ 8,843

The Company's maximum exposure to loss often differs from the carrying value of the VIE's assets. The maximum exposure to loss is dependent on the nature of the Company's variable interest in the VIEs and is limited to the notional amounts of certain liquidity facilities, other credit support, total return swaps, written put options, and the fair value of certain other derivatives and investments the Company has made in the VIEs. Where notional amounts are utilized in quantifying maximum exposure related to derivatives, such amounts do not reflect writedowns already recorded by the Company. The Company's maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Company may utilize to hedge these risks associated with the Company's variable interests.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

***Mortgage Servicing Rights.*** The Company may retain servicing rights to certain mortgage loans that are sold through its securitization activities. These transactions create an asset referred to as MSR, which totaled approximately \$344 million as of May 31, 2008 and are included within Intangible assets in the condensed consolidated statements of financial condition.

The Company generally utilizes information provided by third parties in order to determine the fair value of its MSRs. The valuation of MSRs consist of projecting servicing cash flows and discounting such cash flows using an appropriate risk-adjusted discount rate. These valuations require estimation of various assumptions, including future servicing fees, credit losses and other related costs, discount rates and mortgage prepayment speeds. The Company also compares the estimated fair values of the MSRs from the valuations with observable trades of similar instruments or portfolios. Due to subsequent changes in economic and market conditions, the actual rates of prepayments, credit losses and the value of collateral may differ significantly from the Company's original estimates. Such differences could be material. If actual prepayment rates and credit losses were higher than those assumed, the value of the Company's MSRs could be adversely affected. The Company may hedge a portion of its MSRs through the use of financial instruments, including certain derivative contracts.

**5. Derivative Contracts.**

In the normal course of business, the Company enters into a variety of derivative contracts related to financial instruments and commodities. The Company uses these instruments for trading and investment purposes, as well as for asset and liability management. These instruments generally represent future commitments to swap interest payment streams, exchange currencies, or purchase or sell commodities and other financial instruments on specific terms at specified future dates. Many of these products have maturities that do not extend beyond one year, although swaps, options and equity warrants typically have longer maturities. For further discussion of these matters, refer to Note 6 to the consolidated financial statements for the fiscal year ended November 30, 2007 included in the Form 10-K.

Future changes in interest rates, foreign currency exchange rates or the fair values of the financial instruments, commodities or indices underlying these contracts ultimately may result in cash settlements exceeding fair value amounts recognized in the condensed consolidated statements of financial condition. The amounts in the following table represent the fair value of exchange traded and OTC options and other contracts (including interest rate, foreign exchange, and other forward contracts and swaps) for derivatives for trading and investment and for asset and liability management, net of offsetting positions in situations where netting is appropriate. The asset amounts are not reported net of non-cash collateral, which the Company obtains with respect to certain of these transactions to reduce its exposure to credit losses. In accordance with the provisions of FSP FIN 39-1, the Company offsets cash collateral receivables and payables of \$30 billion and \$50 billion, respectively, against net derivative positions as of May 31, 2008.

Credit risk with respect to derivative instruments arises from the failure of a counterparty to perform according to the terms of the contract. The Company's exposure to credit risk at any point in time is represented by the fair value of the contracts reported as assets. The Company monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral when deemed necessary.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

The Company's derivatives (both listed and OTC), net of cash collateral, as of May 31, 2008 and November 30, 2007 are summarized in the table below, showing the fair value of the related assets and liabilities by product:

Product Type	At May 31, 2008		At November 30, 2007	
	Assets	Liabilities	Assets	Liabilities
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts	\$ 40,548	\$ 20,857	\$ 33,804	\$ 19,515
Foreign exchange forward contracts and options	7,454	6,914	7,755	9,372
Equity securities contracts (including equity swaps, warrants and options)	18,583	26,924	19,913	27,887
Commodity forwards, options and swaps	25,720	22,744	15,531	14,830
<b>Total</b>	<b>\$ 92,305</b>	<b>\$ 77,439</b>	<b>\$ 77,003</b>	<b>\$ 71,604</b>

**6. Goodwill and Net Intangible Assets.**

Changes in the carrying amount of the Company's goodwill and intangible assets for the six month period ended May 31, 2008 were as follows:

	Institutional Securities	Global Wealth Management Group	Asset Management	Total
<b>Goodwill:</b>				
<b>Balance at November 30, 2007</b>	\$ 1,555	\$ 297	\$ 1,172	\$ 3,024
Foreign currency translation adjustments	(31)	11		(20)
Goodwill acquired during the period and other	28		(3)	25
Goodwill disposed of during the period and other(1)	(2)	(39)		(41)
<b>Balance at May 31, 2008</b>	<b>\$ 1,550</b>	<b>\$ 269</b>	<b>\$ 1,169</b>	<b>\$ 2,988</b>

(1) Global Wealth Management Group activity primarily represents goodwill disposed of in connection with the Company's sale of Morgan Stanley Wealth Management S.V., S.A.U. (see Note 15).

Due to the deterioration in the broader credit markets, the Company performed an interim impairment test of goodwill in the first and second quarters of fiscal 2008, which did not result in an impairment.

Institutional Securities	Global Wealth Management Group	Asset Management	Total
(dollars in millions)			

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<b>Intangible Assets:</b>				
Amortizable intangible assets at November 30, 2007	\$ 386	\$	\$ 233	\$ 619
Foreign currency translation adjustments	(2)			(2)
Intangible assets acquired during the period and other	26		2	28
Intangible assets disposed of during the period and other(1)	(54)		(4)	(58)
Amortization expense	(24)		(5)	(29)
<b>Amortizable intangible assets at May 31, 2008</b>	<b>332</b>		<b>226</b>	<b>558</b>
Mortgage servicing rights(see Note 4)	344			344
<b>Balance at May 31, 2008</b>	<b>\$ 676</b>	<b>\$</b>	<b>\$ 226</b>	<b>\$ 902</b>

(1) Institutional Securities activity primarily represents intangible assets disposed of in connection with the Company's sale of a controlling interest in a previously consolidated commodities subsidiary.



**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****7. Long-Term Borrowings.**

Long-term borrowings as of May 31, 2008 consisted of the following (dollars in millions):

	U.S. Dollar	Non-U.S. Dollar	At May 31, 2008
Due in 1 year	\$ 28,788	\$ 6,298	\$ 35,086
Due in 2 years	17,013	7,840	24,853
Due in 3 years	16,825	9,699	26,524
Due in 4 years	8,576	8,279	16,855
Due in 5 years	6,678	19,523	26,201
Due in 6 years	6,446	17,374	23,820
Due in 7 years	3,771	570	4,341
Due in 8 years	5,031	7,135	12,166
Due in 9 years	8,915	7,400	16,315
Due in 10 years	8,911	3,375	12,286
Thereafter	8,368	3,909	12,277
Total	\$ 119,322	\$ 91,402	\$ 210,724

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

	At May 31, 2008	At November 30, 2007
	(dollars in millions)	
Senior debt	\$ 196,230	\$ 181,733
Subordinated debt	4,027	4,015
Junior subordinated debentures	10,467	4,876
Total	\$ 210,724	\$ 190,624

During the six month period ended May 31, 2008, the Company issued notes with a carrying value at quarter-end aggregating \$37.2 billion, including non-U.S. dollar currency notes aggregating \$11.5 billion. During the six month period ended May 31, 2008, \$22.8 billion of notes were repaid.

The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately 6.3 years at May 31, 2008.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****8. Commitments, Guarantees and Contingencies.****Commitments.**

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

	Years to Maturity				Total May 31, 2008
	Less than 1	1-3	3-5	Over 5	
	(dollars in millions)				
Letters of credit and other financial guarantees obtained to satisfy collateral requirements	\$ 10,373	\$ 178	\$ 1	\$ 1	\$ 10,552
Investment activities	1,138	473	21	695	2,327
Primary lending commitments(1)	10,909	9,040	25,093	6,929	51,971
Secondary lending commitments(1)	130	65	276	148	619
Commitments for secured lending transactions	2,432	3,436	2,440	85	8,393
Commitments to enter into reverse repurchase agreements	60,871				60,871
Commercial and residential mortgage-related commitments(1)	4,454				4,454
Underwriting commitments	10,818				10,818
Other commitments(2)	146	13	2	433	594
Total	\$ 101,271	\$ 13,205	\$ 27,832	\$ 8,291	\$ 150,599

(1) These commitments are recorded at fair value within Financial instruments owned and Financial instruments sold, not yet purchased in the condensed consolidated statements of financial condition (see Note 2).

(2) Other commitments include amounts related to a forward purchase agreement entered into by the Company with a client in connection with a leveraged financing arrangement.

**Letters of Credit and Other Financial Guarantees Obtained to Satisfy Collateral Requirements.** The Company has outstanding letters of credit and other financial guarantees issued by third-party banks to certain of the Company's counterparties. The Company is contingently liable for these letters of credit and other financial guarantees, which are primarily used to provide collateral for securities and commodities borrowed and to satisfy various margin requirements in lieu of depositing cash or securities with these counterparties.

**Investment Activities.** The Company enters into commitments associated with its real estate, private equity and principal investment activities, which include alternative products.

**Lending Commitments.** Primary lending commitments are those which are originated by the Company whereas secondary lending commitments are purchased from third parties in the market. The commitments include lending commitments that are made to investment grade and non-investment grade companies in connection with corporate lending and other business activities.

**Commitments for Secured Lending Transactions.** Secured lending commitments are extended by the Company to companies and are secured by real estate or other physical assets of the borrower. Loans made under these arrangements typically are at variable rates and generally provide

for over-collateralization based upon the creditworthiness of the borrower.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

*Commitments to Enter into Reverse Repurchase Agreements.* The Company enters into forward starting securities purchased under agreements to resell (agreements that have a trade date as of or prior to May 31, 2008 and settle subsequent to quarter end) that are primarily secured by collateral from U.S. government agency securities and other sovereign government obligations.

*Commercial and Residential Mortgage-Related Commitments.* The Company enters into forward purchase contracts involving residential mortgage loans, residential mortgage loan commitments to individuals and residential home equity lines of credit. In addition, the Company enters into commitments to originate commercial and residential mortgage loans.

*Underwriting Commitments.* The Company enters into certain underwriting commitments, in which it is committed to subscribe for shares where the shares are not otherwise subscribed.

*Other Commitments.* Other commitments generally include commercial loan commitments to small businesses and commitments related to securities-based lending activities in connection with the Company's Global Wealth Management Group business segment.

**Guarantees.**

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

Type of Guarantee	Maximum Potential Payout/Notional Years to Maturity				Total	Carrying Amount (Asset)/ Liability	Collateral/ Recourse
	Less than 1	1-3	3-5	Over 5			
Notional amount of derivative contracts	\$ 1,077,553	\$ 1,247,297	\$ 2,596,015	\$ 2,243,746	\$ 7,164,611	\$ 240,367	\$ 47
Standby letters of credit and other financial guarantees issued(1)	1,011	1,066	2,404	4,081	8,562	(118)	4,698
Market value guarantees	5			654	659	62	145
Liquidity facilities(2)	17,790	1,326	818	342	20,276	23	19,940
General partner guarantees	47	113	40	285	485	15	

(1) Approximately \$1.6 billion of standby letters of credit are also reflected in the Commitments table above in primary and secondary lending commitments.

(2) The maximum potential payout amount includes liquidity facilities to asset-backed commercial paper conduits of \$707 million.

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

*Derivative Contracts.* Certain derivative contracts meet the accounting definition of a guarantee, including certain written options, contingent forward contracts and credit default swaps. Although the Company's derivative arrangements do not specifically identify whether the derivative counterparty retains the underlying asset, liability or equity security, the Company has disclosed information regarding all derivative contracts that



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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

could meet the accounting definition of a guarantee. The maximum potential payout for certain derivative contracts, such as written interest rate caps and written foreign currency options, cannot be estimated, as increases in interest or foreign exchange rates in the future could possibly be unlimited. Therefore, in order to provide information regarding the maximum potential amount of future payments that the Company could be required to make under certain derivative contracts, the notional amount of the contracts has been disclosed. In certain situations, collateral may be held by the Company for those contracts that meet the definition of a guarantee. Generally, the Company sets collateral requirements by counterparty so that the collateral covers various transactions and products and is not allocated specifically to individual contracts. Therefore, the collateral amount disclosed in the table above only includes contracts where the specific collateral can be identified.

The Company records all derivative contracts at fair value. Aggregate market risk limits have been established, and market risk measures are routinely monitored against these limits. The Company also manages its exposure to these derivative contracts through a variety of risk mitigation strategies, including, but not limited to, entering into offsetting economic hedge positions. The Company believes that the notional amounts of the derivative contracts generally overstate its exposure.

*Standby Letters of Credit and other Financial Guarantees Issued.* In connection with its corporate lending business and other corporate activities, the Company provides standby letters of credit and other financial guarantees to counterparties. Such arrangements represent obligations to make payments to third parties if the counterparty fails to fulfill its obligation under a borrowing arrangement or other contractual obligation.

*Market Value Guarantees.* Market value guarantees are issued to guarantee return of principal invested to fund investors associated with certain European equity funds and to guarantee timely payment of a specified return to investors in certain affordable housing tax credit funds. The guarantees associated with certain European equity funds are designed to provide for any shortfall between the market value of the underlying fund assets and invested principal and a stipulated return amount. The guarantees provided to investors in certain affordable housing tax credit funds are designed to return an investor's contribution to a fund and the investor's share of tax losses and tax credits expected to be generated by a fund.

*Liquidity Facilities.* The Company has entered into liquidity facilities with SPEs and other counterparties, whereby the Company is required to make certain payments if losses or defaults occur. Primarily, the Company acts as liquidity provider to municipal bond securitization SPEs and for standalone municipal bonds in which the holders of beneficial interests issued by these SPEs or the holders of the individual bonds, respectively, have the right to tender their interests for purchase by the Company on specified dates at a specified price. The Company often may have recourse to the underlying assets held by the SPEs in the event payments are required under such liquidity facilities as well as make-whole or recourse provisions with the trust sponsors.

*General Partner Guarantees.* As a general partner in certain private equity and real estate partnerships, the Company receives distributions from the partnerships according to the provisions of the partnership agreements. The Company may, from time to time, be required to return all or a portion of such distributions to the limited partners in the event the limited partners do not achieve a certain return as specified in various partnership agreements, subject to certain limitations.

*Other Guarantees and Indemnities.*

In the normal course of business, the Company provides a variety of other guarantees and indemnifications, which are described below.

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



**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

for junior subordinated debentures. The Company has directly guaranteed the repayment of the trust preferred securities to the holders thereof to the extent that the Company has made payments to a Morgan Stanley Trust on the junior subordinated debentures. In the event that the Company does not make payments to a Morgan Stanley Trust, holders of such series of trust preferred securities would not be able to rely upon the guarantee for payment of those amounts. The Company has not recorded any liability in the condensed consolidated financial statements for these guarantees and believes that the occurrence of any events (*i.e.*, nonperformance on the part of the paying agent) that would trigger payments under these contracts is remote. See Note 13 to the consolidated financial statements for the fiscal year ended November 30, 2007 included in the Form 10-K for details on the Company's junior subordinated debentures.

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

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

**Securitized Asset Guarantees.** As part of the Company's Institutional Securities securitization activities, the Company provides representations and warranties that certain securitized assets conform to specified guidelines. The Company may be required to repurchase such assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines. Due diligence is performed by the Company to ensure that asset guideline qualifications are met, and, to the extent the Company has acquired such assets to be securitized from other parties, the Company seeks to obtain its own representations and warranties regarding the assets. The maximum potential amount of future payments the Company could be required to make would be equal to the current outstanding balances of all assets subject to such securitization activities. Also, in connection with originations of residential mortgage loans under the Company's FlexSource® program, the Company may permit borrowers to pledge marketable securities as collateral instead of requiring cash down payments for the purchase of the underlying residential property. Upon sale of the residential mortgage loans, the Company may provide a surety bond that reimburses the purchasers for shortfalls in the borrowers' securities accounts up to certain limits if the collateral maintained in the securities accounts (along with the associated real estate collateral) is insufficient to cover losses that purchasers experience as a result of defaults by borrowers on



**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

the underlying residential mortgage loans. The Company requires the borrowers to meet daily collateral calls to ensure the marketable securities pledged in lieu of a cash down payment are sufficient. At May 31, 2008 and November 30, 2007, the maximum potential amount of future payments the Company may be required to make under its surety bond was \$126 million and \$122 million, respectively. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these representations and warranties and reimbursement agreements and believes that the probability of any payments under these arrangements is remote.

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

***Contingencies.***

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

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

The Company contests liability and/or the amount of damages as appropriate in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss, if any, related to such matters, how or if such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief, if any, might be. Subject to the foregoing, the Company believes, based on current knowledge and after consultation with counsel, that the outcome of such pending matters will not have a material adverse effect on the condensed consolidated financial condition of the Company, although the outcome of such matters could be material to the Company's operating results and cash flows for a particular future period, depending on, among other things, the level of the Company's revenues or income for such period. Legal reserves have been established in accordance with SFAS No. 5, *Accounting for Contingencies* (SFAS No. 5). Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change.

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**9. Shareholders Equity.**

**Regulatory Requirements.** The Company is a consolidated supervised entity ( CSE ) as defined by the SEC. As such, the Company is subject to group-wide supervision and examination by the SEC and to minimum capital requirements on a consolidated basis and in accordance with the Basel II Accord.

MS&Co. is a registered broker-dealer and registered futures commission merchant and, accordingly, is subject to the minimum net capital requirements of the SEC, the Financial Industry Regulatory Authority and the Commodity Futures Trading Commission. MS&Co. has consistently operated in excess of these requirements. MS&Co.'s net capital totaled \$10,639 million at May 31, 2008, which exceeded the amount required by \$7,320 million. MSIP, a London-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Authority, and MSJS, a Tokyo-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Agency. MSIP and MSJS consistently operated in excess of their respective regulatory capital requirements.

Under regulatory capital requirements adopted by the Federal Deposit Insurance Corporation (the FDIC ) and other bank regulatory agencies, FDIC-insured financial institutions must maintain (a) 3% to 4% of Tier 1 capital, as defined, to average assets ( leverage ratio ), (b) 4% of Tier 1 capital, as defined, to risk-weighted assets ( Tier 1 risk-weighted capital ratio ) and (c) 8% of total capital, as defined, to risk-weighted assets ( total risk-weighted capital ratio ). At May 31, 2008, the leverage ratio, Tier 1 risk-weighted capital ratio and total risk-weighted capital ratio of each of the Company's FDIC-insured financial institutions exceeded these regulatory minimums.

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

Morgan Stanley Derivative Products Inc. ( MSDP ) and Cournot Financial Products LLC ( Cournot ), which are triple-A rated derivative products subsidiaries, maintain certain operating restrictions that have been reviewed by various rating agencies. Both entities are operated such that creditors of the Company should not expect to have any claims on either the assets of MSDP or the assets of Cournot, unless and until the obligations of such entity to its own creditors are satisfied in full. Creditors of MSDP or Cournot, respectively, should not expect to have any claims on the assets of the Company or any of its affiliates, other than the respective assets of MSDP or Cournot.

MS&Co. is required to hold tentative net capital in excess of \$1 billion and net capital in excess of \$500 million in accordance with the market and credit risk standards of Appendix E of Rule 15c3-1. MS&Co. is also required to notify the SEC in the event that its tentative net capital is less than \$5 billion. As of May 31, 2008, MS&Co. had tentative net capital in excess of the minimum and the notification requirements.

During the second quarter of fiscal 2008, Morgan Stanley Senior Funding, Inc. ( MSSF ), which provides loans or lending commitments (including bridge financing) to selected corporate clients, transferred certain loans to

**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

Ascension Loan Vehicle, LLC ( Ascension ). MSSF and Ascension are both wholly owned subsidiaries of the Company. MSSF transferred such loans so that they could be securitized and, in turn, made eligible to be pledged with the Federal Reserve. Certain of the securitized interests in Ascension were transferred to Morgan Stanley Darica Funding, LLC ( MSDF ), a wholly owned subsidiary of the Company, during the third quarter of fiscal 2008. Ascension and MSDF, which are special purpose vehicle subsidiaries of the Company, maintain certain operating restrictions that have been reviewed by various rating agencies. Ascension and MSDF are structured as separate legal entities and operated such that creditors of the Company or any affiliate of the Company, including MSSF, but excluding Ascension and MSDF, should not reasonably expect to have any claims on the assets of Ascension and MSDF, respectively. Such assets include loans that have been sold, and participation interests that have been granted, by MSSF to Ascension in an aggregate approximate amount of \$2 billion as of May 31, 2008. Such amounts may increase or decrease. Securitized interests in Ascension were transferred to MSDF in the aggregate approximate amount of \$460 million during the third quarter of fiscal 2008. Creditors of Ascension and MSDF should not reasonably expect to have any claims on the assets of the Company or any of its affiliates, including MSSF, other than the assets of Ascension and MSDF, respectively.

**Treasury Shares.** During the six month period ended May 31, 2008, the Company did not purchase any of its common stock through the open market share repurchase program. During the six month period ended May 31, 2007, the Company purchased approximately \$2.6 billion of its common stock through open market purchases at an average cost of \$79.57 per share.

**China Investment Corporation Investment.** In December 2007, the Company sold Equity Units which included contracts to purchase Company common stock to a wholly owned subsidiary of China Investment Corporation ( CIC ), for approximately \$5,579 million. CIC s ownership in the Company s common stock, including the maximum number of shares of common stock to be received by CIC upon settlement of the stock purchase contracts, will be 9.9% or less of the Company s total shares outstanding based on the total shares that were outstanding on November 30, 2007. CIC is a passive financial investor and has no special rights of ownership nor a role in the management of the Company. A substantial portion of the investment proceeds were treated as Tier 1 capital for regulatory capital purposes.

The present value of the future contract adjustment payments due under the stock purchase contracts was approximately \$400 million and was recorded in Other liabilities and accrued expenses with a corresponding decrease recorded in Paid-in capital, a component of Shareholders equity in the Company s condensed consolidated statement of financial condition in the first quarter of fiscal 2008. The other liability balance related to the stock purchase contracts will accrete over the term of the stock purchase contract using the effective yield method with a corresponding charge to Interest expense. When the contract adjustment payments are made under the stock purchase contracts, they will reduce the other liability balance.

For a more detailed summary of the Equity Units, including the junior subordinated debentures issued to support trust common and trust preferred securities and the stock purchase contracts, refer to Note 28 to the consolidated financial statements for the fiscal year ended November 30, 2007 included in the Form 10-K.

Prior to the issuance of common stock upon settlement of the stock purchase contract, the impact of the Equity Units is reflected in the Company s earnings per diluted common share using the treasury stock method, as defined by SFAS No. 128, Earnings Per Share. Under the treasury stock method, the number of shares of common stock included in the calculation of earnings per diluted common share are calculated as the excess, if any, of the number of shares expected to be issued upon settlement of the stock purchase contract based on the

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

average market price for the last 20 days of the reporting period, less the number of shares that could be purchased by the Company with the proceeds to be received upon settlement of the contract at the average closing price for the reporting period.

Dilution of net income per share occurs (i) in reporting periods when the average closing price of common shares is over \$57.6840 per share or (ii) in reporting periods when the average closing price of common shares for a reporting period is between \$48.0700 and \$57.6840 and is greater than the average market price for the last 20 days ending three days prior to the end of such reporting period.

There was no dilutive impact for the quarter ended May 31, 2008. The dilutive impact for the six month period ended May 31, 2008 was approximately 128,000 shares.

**10. Earnings per Common Share.**

Basic earnings per share (EPS) is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the assumed conversion of all dilutive securities. The following table presents the calculation of basic and diluted EPS (in millions, except for per share data):

	<b>Three Months</b>		<b>Six Months</b>	
	<b>Ended</b>		<b>Ended</b>	
	<b>May 31,</b>		<b>May 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Basic EPS:</b>				
Income from continuing operations	\$ 1,026	\$ 2,363	\$ 2,577	\$ 4,677
Net gain on discontinued operations		219		577
Preferred stock dividend requirements	(14)	(17)	(31)	(34)
<b>Net income applicable to common shareholders</b>	<b>\$ 1,012</b>	<b>\$ 2,565</b>	<b>\$ 2,546</b>	<b>\$ 5,220</b>
Weighted average common shares outstanding	1,038	997	1,029	1,003
<b>Earnings per basic common share:</b>				
Income from continuing operations	\$ 0.97	\$ 2.35	\$ 2.47	\$ 4.63
Gain on discontinued operations		0.22		0.58
<b>Earnings per basic common share</b>	<b>\$ 0.97</b>	<b>\$ 2.57</b>	<b>\$ 2.47</b>	<b>\$ 5.21</b>
<b>Diluted EPS:</b>				
Net income applicable to common shareholders	\$ 1,012	\$ 2,565	\$ 2,546	\$ 5,220
Weighted average common shares outstanding	1,038	997	1,029	1,003
Effect of dilutive securities:				
Stock options and restricted stock units	29	49	34	49
<b>Weighted average common shares outstanding and common stock equivalents</b>	<b>1,067</b>	<b>1,046</b>	<b>1,063</b>	<b>1,052</b>

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Earnings per diluted common share:				
Income from continuing operations	\$ 0.95	\$ 2.24	\$ 2.40	\$ 4.41
Gain on discontinued operations		0.21		0.55
Earnings per diluted common share	\$ 0.95	\$ 2.45	\$ 2.40	\$ 4.96

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

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

	<b>Three Months Ended May 31,</b>		<b>Six Months Ended May 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	<b>(shares in millions)</b>			
Number of antidilutive securities (including stock options and restricted stock units) outstanding at end of period	78	17	78	18

In addition, for information on the dilutive impact related to CIC, see Note 9.

Cash dividends declared per common share were \$0.27 and \$0.54 for the quarter and six month periods ended May 31, 2008 and 2007, respectively.

**11. Employee Benefit Plans.**

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

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

	<b>Three Months Ended May 31,</b>		<b>Six Months Ended May 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	<b>(dollars in millions)</b>			
Service cost, benefits earned during the period	\$ 28	\$ 29	\$ 56	\$ 58
Interest cost on projected benefit obligation	36	33	73	66
Expected return on plan assets	(33)	(31)	(65)	(62)
Net amortization of actuarial loss	8	10	16	20
Net amortization of prior-service credit	(2)	(2)	(5)	(5)
Net periodic benefit expense	\$ 37	\$ 39	\$ 75	\$ 77

**12. Income Taxes.**

The Company adopted FIN 48 on December 1, 2007 and recorded a cumulative effect adjustment of approximately \$92 million as a decrease to the opening balance of Retained earnings as of December 1, 2007.

The total amount of unrecognized tax benefits as of the date of adoption of FIN 48 was approximately \$2.7 billion. Of this total, approximately \$1.7 billion (net of federal benefit of state issues, competent authority and foreign tax credit offsets) represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective tax rate in future periods.

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The Company recognizes the accrual of interest related to unrecognized tax benefits in Provision for income taxes in the condensed consolidated statements of income. The Company recognizes the accrual of penalties (if any) related to unrecognized tax benefits in income before income taxes. The amount of penalties accrued is immaterial. Interest expense included in income taxes as of December 1, 2007 was approximately \$223 million, net of federal and state income tax benefits.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

It is reasonably possible that significant changes in the gross balance of unrecognized tax benefits may occur within the next twelve months. It is difficult to estimate the range of such changes; however, the Company does not expect that any change in the gross balance of unrecognized tax benefits would have a material impact on its effective tax rate over the next twelve months.

The Company is under continuous examination by the Internal Revenue Service (the IRS) and other tax authorities in certain countries, such as Japan and the United Kingdom, and states in which the Company has significant business operations, such as New York. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years examinations. The Company has established unrecognized tax benefits that the Company believes are adequate in relation to the potential for additional assessments. Once established, the Company adjusts unrecognized tax benefits only when more information is available or when an event occurs necessitating a change. The Company believes that the resolution of tax matters will not have a material effect on the condensed consolidated statements of financial condition of the Company, although a resolution could have a material impact on the Company's condensed consolidated statements of income for a particular future period and on the Company's effective income tax rate for any period in which such resolution occurs.

The following are the major tax jurisdictions in which the Company and its affiliates operate and the earliest tax year subject to examination:

<b>Jurisdiction</b>	<b>Tax Year</b>
United States	1999
New York State and City	2002
Hong Kong	2002
United Kingdom	2004
Japan	2004

**13. Segment Information.**

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

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

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



**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

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

<b>Three Months Ended May 31, 2008</b>	<b>Institutional Securities</b>	<b>Global Wealth Management Group</b>	<b>Asset Management (dollars in millions)</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
Net revenues excluding net interest	\$ 3,749	\$ 2,200	\$ 512	\$ (55)	\$ 6,406
Net interest	(124)	236	(24)	16	104
<b>Net revenues</b>	<b>\$ 3,625</b>	<b>\$ 2,436</b>	<b>\$ 488</b>	<b>\$ (39)</b>	<b>\$ 6,510</b>
Income from continuing operations before gains from unconsolidated investees and income taxes	\$ 679	\$ 989	\$ (227)	\$ 5	\$ 1,446
Gains from unconsolidated investees	19				19
Provision for (benefit from) income taxes	160	370	(94)	3	439
<b>Income from continuing operations(1)</b>	<b>\$ 538</b>	<b>\$ 619</b>	<b>\$ (133)</b>	<b>\$ 2</b>	<b>\$ 1,026</b>

<b>Three Months Ended May 31, 2007</b>	<b>Institutional Securities</b>	<b>Global Wealth Management Group</b>	<b>Asset Management (dollars in millions)</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
Net revenues excluding net interest	\$ 7,862	\$ 1,483	\$ 1,517	\$ (67)	\$ 10,795
Net interest	(433)	159	(8)	11	(271)
<b>Net revenues</b>	<b>\$ 7,429</b>	<b>\$ 1,642</b>	<b>\$ 1,509</b>	<b>\$ (56)</b>	<b>\$ 10,524</b>
Income from continuing operations before losses from unconsolidated investees and income taxes	\$ 2,950	\$ 264	\$ 303	\$ 7	\$ 3,524
Losses from unconsolidated investees	(20)				(20)
Provision for income taxes	932	102	105	2	1,141
<b>Income from continuing operations(2)</b>	<b>\$ 1,998</b>	<b>\$ 162</b>	<b>\$ 198</b>	<b>\$ 5</b>	<b>\$ 2,363</b>

<b>Six Months Ended May 31, 2008</b>	<b>Institutional Securities</b>	<b>Global Wealth Management Group</b>	<b>Asset Management (dollars in millions)</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
Net revenues excluding net interest	\$ 9,062	\$ 3,595	\$ 1,078	\$ (110)	\$ 13,625
Net interest	776	447	(47)	31	1,207
<b>Net revenues</b>	<b>\$ 9,838</b>	<b>\$ 4,042</b>	<b>\$ 1,031</b>	<b>\$ (79)</b>	<b>\$ 14,832</b>
	\$ 2,796	\$ 1,243	\$ (388)	\$ 9	\$ 3,660

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Income from continuing operations before gains from  
unconsolidated investees and income taxes

	21				21
Gains from unconsolidated investees	787	465	(152)	4	1,104
Provision for (benefit from) income taxes					
<b>Income from continuing operations(1)</b>	<b>\$ 2,030</b>	<b>\$ 778</b>	<b>\$ (236)</b>	<b>\$ 5</b>	<b>\$ 2,577</b>

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

<b>Six Months Ended May 31, 2007</b>	<b>Institutional Securities</b>	<b>Global Wealth Management Group</b>	<b>Asset Management (dollars in millions)</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
Net revenues excluding net interest	\$ 14,194	\$ 2,858	\$ 2,888	\$ (124)	\$ 19,816
Net interest	397	295	(11)	21	702
<b>Net revenues</b>	<b>\$ 14,591</b>	<b>\$ 3,153</b>	<b>\$ 2,877</b>	<b>\$ (103)</b>	<b>\$ 20,518</b>
Income from continuing operations before losses from unconsolidated investees and income taxes	\$ 5,795	\$ 490	\$ 682	\$ 13	\$ 6,980
Losses from unconsolidated investees	(46)				(46)
Provision for income taxes	1,810	189	254	4	2,257
<b>Income from continuing operations(2)</b>	<b>\$ 3,939</b>	<b>\$ 301</b>	<b>\$ 428</b>	<b>\$ 9</b>	<b>\$ 4,677</b>

<b>Net Interest</b>	<b>Institutional Securities</b>	<b>Global Wealth Management Group</b>	<b>Asset Management (dollars in millions)</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
<b>Three Months Ended May 31, 2008</b>					
Interest and dividends	\$ 9,793	\$ 319	\$ 16	\$ (11)	\$ 10,117
Interest expense	9,917	83	40	(27)	10,013
<b>Net interest</b>	<b>\$ (124)</b>	<b>\$ 236</b>	<b>\$ (24)</b>	<b>\$ 16</b>	<b>\$ 104</b>
<b>Three Months Ended May 31, 2007</b>					
Interest and dividends	\$ 15,193	\$ 298	\$ 29	\$ (120)	\$ 15,400
Interest expense	15,626	139	37	(131)	15,671
<b>Net interest</b>	<b>\$ (433)</b>	<b>\$ 159</b>	<b>\$ (8)</b>	<b>\$ 11</b>	<b>\$ (271)</b>

<b>Net Interest</b>	<b>Institutional Securities</b>	<b>Global Wealth Management Group</b>	<b>Asset Management (dollars in millions)</b>	<b>Intersegment Eliminations</b>	<b>Total</b>
<b>Six Months Ended May 31, 2008</b>					
Interest and dividends	\$ 23,453	\$ 621	\$ 31	\$ (23)	\$ 24,082
Interest expense	22,677	174	78	(54)	22,875
<b>Net interest</b>	<b>\$ 776</b>	<b>\$ 447</b>	<b>\$ (47)</b>	<b>\$ 31</b>	<b>\$ 1,207</b>
<b>Six Months Ended May 31, 2007</b>					
Interest and dividends	\$ 29,214	\$ 572	\$ 43	\$ (258)	\$ 29,571

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Interest expense	28,817	277	54	(279)	28,869
Net interest	\$ 397	\$ 295	\$ (11)	\$ 21	\$ 702

<b>Total Assets(3)</b>	<b>Institutional Securities</b>	<b>Global Wealth Management Group</b>	<b>Asset Management</b>	<b>Total</b>
		<b>(dollars in millions)</b>		
At May 31, 2008	\$ 992,362	\$ 22,907	\$ 15,959	\$ 1,031,228
At November 30, 2007	\$ 1,005,452	\$ 27,518	\$ 12,439	\$ 1,045,409

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)**

- (1) Income from continuing operations includes \$120 million (\$171 million pre-tax), \$0.11 per diluted share, due to the reversal of valuation adjustments related to interest rate derivatives, and a cumulative negative adjustment of \$84 million (\$120 million pre-tax), \$0.08 per diluted share, resulting from incorrect valuations of a London-based trader's positions related to prior quarters. These amounts are included in the Institutional Securities business segment.
- (2) See Note 14 for a discussion of discontinued operations.
- (3) Corporate assets have been fully allocated to the Company's business segments.

The Company operates in both U.S. and non-U.S. markets. The Company's non-U.S. business activities are principally conducted through European and Asian locations. The following table presents selected income statement information of the Company's operations by geographic area. The net revenues disclosed in the following table reflect the regional view of the Company's consolidated net revenues, on a managed basis, based on the following methodology:

Institutional Securities: investment banking client location, equity capital markets client location, debt capital markets revenue recording location, sales & trading trading desk location.

Global Wealth Management Group: global representative coverage location.

Asset Management: client location, except for the merchant banking business, which is based on asset location.

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007	2008	2007
	(dollars in millions)			
<b>Net revenues</b>				
Americas	\$ 3,517	\$ 6,049	\$ 7,340	\$ 12,121
Europe, Middle East, and Africa	2,071	2,970	5,338	5,672
Asia	922	1,505	2,154	2,725
Total	\$ 6,510	\$ 10,524	\$ 14,832	\$ 20,518

**14. Discontinued Operations.**

**Discover.** On June 30, 2007, the Company completed the Discover Spin-off. The Company distributed all of the outstanding shares of DFS common stock, par value \$0.01 per share, to the Company's stockholders of record as of June 18, 2007. The results of DFS prior to the Discover Spin-off are included within discontinued operations for the quarter and six months ended May 31, 2007.

Net revenues included in discontinued operations related to DFS were \$1,035 million and \$2,060 million for the quarter and six months ended May 31, 2007, respectively.

The results of discontinued operations include interest expense that was allocated based upon borrowings that were specifically attributable to DFS operations through intercompany transactions existing prior to the Discover Spin-off. For the quarter and six months ended May 31, 2007,

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the amount of interest expense reclassified to discontinued operations was approximately \$57 million and \$145 million, respectively.

**Quilter.** On February 28, 2007, the Company sold Quilter, its standalone U.K. mass affluent business that was formerly included within the Global Wealth Management Group business segment. The results of Quilter are included within discontinued operations for all periods presented through the date of sale. The results for discontinued operations in the quarter ended February 28, 2007 also included a pre-tax gain of \$168 million (\$109 million after-tax) on disposition.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****Summarized financial information for the Company's discontinued operations:**

The table below provides information regarding amounts included within discontinued operations for the quarter and six month period ended May 31, 2007 (dollars in millions):

	<b>Three Months Ended May 31, 2007</b>	<b>Six Months Ended May 31, 2007</b>
	<b>(dollars in millions)</b>	
Pre-tax gain on discontinued operations		
DFS	\$ 349	\$ 739
Quilter		174
Total	\$ 349	\$ 913

**15. Business Dispositions.**

**MSCI.** In the second quarter of fiscal 2008, the Company sold approximately 28 million of its MSCI Inc. ( MSCI ) shares in a secondary offering. The Company received net proceeds of approximately \$780 million and recognized a pre-tax gain of \$732 million, net of professional fee expenses of approximately \$12 million in conjunction with the sale of this investment. Subsequent to the secondary offering, the Company owns approximately 53 million shares of MSCI's class B common stock, which represents approximately 85% of the combined voting power of all classes of MSCI's voting stock. The Company consolidates MSCI for financial reporting purposes.

On July 2, 2008, although the Company has not yet committed to a plan, it announced that it intends to sell a portion of its ownership interest in MSCI. The Company may ultimately divest its entire interest in MSCI.

MSCI is a provider of investment decision support tools to investment institutions worldwide and is included within the Institutional Securities business segment.

**Morgan Stanley Wealth Management S.V., S.A.U.** In the second quarter of fiscal 2008, the Company sold Morgan Stanley Wealth Management S.V., S.A.U. ( MSWM S.V. ), its Spanish onshore mass affluent wealth management business. The Company recognized a pre-tax gain of approximately \$698 million, net of transaction-related charges of approximately \$50 million. The results of MSWM S.V. are included within the Global Wealth Management Group business segment through the date of sale.

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**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of Morgan Stanley:

We have reviewed the accompanying condensed consolidated statement of financial condition of Morgan Stanley and subsidiaries (the Company) as of May 31, 2008, and the related condensed consolidated statements of income and comprehensive income for the three-month and six-month periods ended May 31, 2008 and May 31, 2007, and the condensed consolidated statements of cash flows for the six-month periods ended May 31, 2008 and 2007. These interim financial statements are the responsibility of the management of the Company.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of the Company as of November 30, 2007, and the related consolidated statements of income, comprehensive income, cash flows and changes in shareholders' equity for the fiscal year then ended (not presented herein) included in Morgan Stanley's Annual Report on Form 10-K; and in our report dated January 28, 2008, which report contains an explanatory paragraph relating to the adoption, in fiscal 2005, of Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment and effective December 1, 2005, the change in accounting policy for recognition of equity awards granted to retirement-eligible employees, an explanatory paragraph relating to, in fiscal 2006, the application of Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, an explanatory paragraph relating to the adoption, in fiscal 2007, of SFAS No. 157, Fair Value Measurements and SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 and an explanatory paragraph relating to the adoption, in fiscal 2007, of SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R), we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial condition as of November 30, 2007 is fairly stated, in all material respects, in relation to the consolidated statement of financial condition from which it has been derived.

As discussed in Note 1 and in Note 12 to the condensed consolidated interim financial statements, effective December 1, 2007, the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109.

/s/ Deloitte & Touche LLP  
New York, New York  
July 8, 2008



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**Table of Contents**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. Introduction.**

Morgan Stanley (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. 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. A summary of the activities of each of the segments 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; research; 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.

The discussion of the Company's results of operations below may contain forward-looking statements. These statements, which reflect management's beliefs and expectations, are subject to risks and uncertainties that may cause actual results to differ materially. For a discussion of the risks and uncertainties that may affect the Company's future results, please see Forward-Looking Statements immediately preceding Part I, Item 1, Competition and Regulation in Part I, Item 1, Risk Factors in Part I, Item 1A and Certain Factors Affecting Results of Operations in Part II, Item 7 of the Company's Annual Report on Form 10-K for the fiscal year ended November 30, 2007 (the Form 10-K), Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's 2008 Quarterly Reports on Form 10-Q and other items throughout the Form 10-K, Forms 10-Q and the Company's 2008 Current Reports on Form 8-K.

The Company's results of operations for the quarters and six month periods ended May 31, 2008 and 2007 are discussed below.

**Discontinued Operations.**

On June 30, 2007, the Company completed the spin-off of Discover Financial Services (DFS) to its shareholders. DFS results are included within discontinued operations for the quarter and six month period ended May 31, 2007. The results of Quilter Holdings Ltd. (Quilter), Global Wealth Management Group's former mass affluent business in the U.K., are also reported as discontinued operations for the first quarter of fiscal 2007. See Note 14 to the condensed consolidated financial statements.

**Table of Contents****Results of Operations.****Executive Summary.****Financial Information.**

	At or for the Three Months Ended May 31,		At or for the Six Months Ended May 31,	
	2008	2007(1)	2008	2007(1)
<b>Net revenues (dollars in millions):</b>				
Institutional Securities	\$ 3,625	\$ 7,429	\$ 9,838	\$ 14,591
Global Wealth Management Group	2,436	1,642	4,042	3,153
Asset Management	488	1,509	1,031	2,877
Intersegment Eliminations	(39)	(56)	(79)	(103)
Consolidated net revenues	\$ 6,510	\$ 10,524	\$ 14,832	\$ 20,518
<b>Income before income taxes (dollars in millions)(2):</b>				
Institutional Securities	\$ 679	\$ 2,950	\$ 2,796	\$ 5,795
Global Wealth Management Group	989	264	1,243	490
Asset Management	(227)	303	(388)	682
Intersegment Eliminations	5	7	9	13
Consolidated income before income taxes	\$ 1,446	\$ 3,524	\$ 3,660	\$ 6,980
<b>Consolidated net income (dollars in millions)</b>	<b>\$ 1,026</b>	<b>\$ 2,582</b>	<b>\$ 2,577</b>	<b>\$ 5,254</b>
<b>Earnings applicable to common shareholders (dollars in millions)(3)</b>	<b>\$ 1,012</b>	<b>\$ 2,565</b>	<b>\$ 2,546</b>	<b>\$ 5,220</b>
<b>Earnings per basic common share:</b>				
Income from continuing operations	\$ 0.97	\$ 2.35	\$ 2.47	\$ 4.63
Gain on discontinued operations		0.22		0.58
Earnings per basic common share	\$ 0.97	\$ 2.57	\$ 2.47	\$ 5.21
<b>Earnings per diluted common share:</b>				
Income from continuing operations	\$ 0.95	\$ 2.24	\$ 2.40	\$ 4.41
Gain on discontinued operations		0.21		0.55
Earnings per diluted common share	\$ 0.95	\$ 2.45	\$ 2.40	\$ 4.96
<b>Regional net revenues (dollars in millions)(4):</b>				
Americas	\$ 3,517	\$ 6,049	\$ 7,340	\$ 12,121
Europe, Middle East and Africa	2,071	2,970	5,338	5,672
Asia	922	1,505	2,154	2,725
Consolidated net revenues	\$ 6,510	\$ 10,524	\$ 14,832	\$ 20,518

**Statistical Data.**

<b>Book value per common share(5)</b>	<b>\$ 30.11</b>	<b>\$ 36.52</b>	<b>\$ 30.11</b>	<b>\$ 36.52</b>
<b>Average common equity (dollars in billions)(6):</b>				

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Institutional Securities	\$ 24.0	\$ 22.8	\$ 24.2	\$ 21.4
Global Wealth Management Group	1.5	1.6	1.5	1.7
Asset Management	3.4	3.4	3.6	3.2
Total from operating segments	28.9	27.8	29.3	26.3
Discontinued operations		5.4		5.5
Unallocated capital	3.9	4.2	2.7	4.6
Consolidated	\$ 32.8	\$ 37.4	\$ 32.0	\$ 36.4

**Table of Contents***Statistical Data (Continued).*

	At or for the Three Months Ended May 31,		At or for the Six Months Ended May 31,	
	2008	2007(1)	2008	2007(1)
<b>Return on average common equity(6):</b>				
Consolidated	12%	27%	16%	29%
Institutional Securities	9%	35%	17%	37%
Global Wealth Management Group	172%	40%	105%	36%
Asset Management	N/M	23%	N/M	27%
<b>Effective income tax rate from continuing operations</b>	<b>30.0%</b>	<b>32.6%</b>	<b>30.0%</b>	<b>32.5%</b>
<b>Worldwide employees</b>	<b>46,390</b>	<b>45,845</b>	<b>46,390</b>	<b>45,845</b>
<b>Average liquidity (dollars in billions)(7):</b>				
Parent company liquidity	\$ 74	\$ 38	\$ 73	\$ 42
Bank and other subsidiary liquidity	61	30	56	24
<b>Total liquidity</b>	<b>\$ 135</b>	<b>\$ 68</b>	<b>\$ 129</b>	<b>\$ 66</b>
<b>Capital ratios(8):</b>				
Total capital ratio	18.6%		18.6%	
Tier 1 ratio	12.4%		12.4%	
<b>Consolidated assets under management or supervision by asset class (dollars in billions):</b>				
Equity(9)	\$ 327	\$ 344	\$ 327	\$ 344
Fixed income(9)	261	210	261	210
Alternatives(10)	73	58	73	58
Private Equity	3	2	3	2
Infrastructure	4	1	4	1
Real Estate	38	26	38	26
Subtotal	706	641	706	641
Unit trusts	14	16	14	16
Other(9)	52	55	52	55
Total assets under management or supervision(11)	772	712	772	712
Share of minority interest assets(12)	7	5	7	5
<b>Total</b>	<b>\$ 779</b>	<b>\$ 717</b>	<b>\$ 779</b>	<b>\$ 717</b>
<b>Institutional Securities:</b>				
Mergers and acquisitions completed transactions (dollars in billions)(13):				
Global market volume	\$ 97.0	\$ 360.1	\$ 214.2	\$ 513.8
Market share	17.0%	39.2%	21.4%	35.9%
Rank	9	1	8	1
Mergers and acquisitions announced transactions (dollars in billions)(13):				
Global market volume	\$ 178.7	\$ 489.1	\$ 197.1	\$ 716.2
Market share	22.2%	38.8%	17.5%	39.3%
Rank	6	1	7	1
Global equity and equity-related issues (dollars in billions)(13):				
Global market volume	\$ 14.3	\$ 20.2	\$ 16.9	\$ 26.0

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Market share	8.1%	8.7%	7.2%	7.7%
Rank	4	3	4	5

**Table of Contents****Statistical Data (Continued).**

	At or for the Three Months Ended May 31,		At or for the Six Months Ended May 31,	
	2008	2007(1)	2008	2007(1)
<b>Global debt issues (dollars in billions)(13):</b>				
Global market volume	\$ 64.4	\$ 141.6	\$ 109.5	\$ 203.1
Market share	4.5%	6.5%	4.7%	6.2%
Rank	8	5	7	5
<b>Global initial public offerings (dollars in billions)(13):</b>				
Global market volume	\$ 3.3	\$ 6.4	\$ 3.7	\$ 8.0
Market share	7.0%	8.3%	6.5%	7.7%
Rank	6	3	7	3
Pre-tax profit margin(14)	19%	40%	28%	40%
<b>Global Wealth Management Group:</b>				
Global representatives	8,350	8,137	8,350	8,137
Annualized net revenue per global representative (dollars in thousands)(15)	\$ 810	\$ 814	\$ 786	\$ 786
<b>Client assets by segment (dollars in billions):</b>				
\$10 million or more	\$ 235	\$ 223	\$ 235	\$ 223
\$1 million \$10 million	276	268	276	268
Subtotal \$1 million or more	511	491	511	491
\$100,000 \$1 million	176	180	176	180
Less than \$100,000	22	24	22	24
Client assets excluding corporate and other accounts	709	695	709	695
Corporate and other accounts	30	33	30	33
Total client assets	\$ 739	\$ 728	\$ 739	\$ 728
Fee-based assets as a percentage of total client assets(16)	26%	29%	26%	29%
Client assets per global representative (dollars in millions)(17)	89	89	89	89
Bank deposits (dollars in millions)(18)	\$ 34,334	\$ 18,226	\$ 34,334	\$ 18,226
Pre-tax profit margin(14)	41%	16%	31%	16%
<b>Asset Management:</b>				
Assets under management or supervision (dollars in billions)(19)	\$ 605	\$ 560	\$ 605	\$ 560
Percent of fund assets in top half of Lipper rankings(20)	35%	52%	35%	52%
Pre-tax profit margin(14)	N/M	20%	N/M	24%

N/M Not Meaningful

- (1) Certain prior-period information has been reclassified to conform to the current period's presentation.
- (2) Amounts represent income from continuing operations before gains (losses) from unconsolidated investees, income taxes and gain from discontinued operations.
- (3) Earnings applicable to common shareholders are used to calculate earnings per share information. The three months ended May 31, 2008 and 2007 reflect a preferred stock dividend of \$14 million and \$17 million, respectively. The six month periods ended May 31, 2008 and 2007 reflect a preferred stock dividend of \$31 and \$34 million, respectively.
- (4) Reflects the regional view of the Company's consolidated net revenues, on a managed basis, based on the following methodology:  
Institutional Securities: investment banking client location, equity capital markets client location, debt capital markets revenue recording location, sales and trading trading desk location. Global Wealth Management Group: global representative coverage location. Asset Management: client location, except for the merchant banking business, which is based on asset location.
- (5)

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Book value per common share equals common shareholders' equity of \$33,393 million at May 31, 2008 and \$38,411 million at May 31, 2007, divided by common shares outstanding of 1,109 million at May 31, 2008 and 1,052 million at May 31, 2007.

- (6) The computation of average common equity for each business segment is based upon an economic capital framework that estimates the amount of equity capital required to support the businesses over a wide range of market environments while simultaneously satisfying regulatory, rating agency and investor requirements. The economic capital framework will evolve over time in response to changes in the business and regulatory environment and to improvements in modeling techniques. The effective tax rates used in the computation of segment return on average common equity were determined on a separate entity basis.

**Table of Contents**

- (7) For a discussion about average liquidity, see *Liquidity and Capital Resources* *Liquidity Reserves* herein.
- (8) For a discussion about capital ratios, see *Liquidity and Capital Resources* *Regulatory Requirements* herein.
- (9) Equity and fixed income amounts include assets under management or supervision associated with the Asset Management and Global Wealth Management Group business segments. Other amounts include assets under management or supervision associated with the Global Wealth Management Group business segment.
- (10) Amounts reported for Alternatives include the Company's invested equity in those funds and include a range of alternative investment products such as hedge funds, funds of hedge funds and funds of private equity funds.
- (11) Revenues and expenses associated with these assets are included in the Company's Asset Management, Global Wealth Management Group and Institutional Securities business segments.
- (12) Amounts represent Asset Management's proportional share of assets managed by entities in which it owns a minority interest.
- (13) Source: Thomson Financial, data as of June 4, 2008. The data for the three months ended May 31, 2008 and 2007 are for the periods from March 1 to May 31, 2008 and March 1 to May 31, 2007, respectively. The data for the six month periods ended May 31, 2008 and 2007 are for the periods from January 1 to May 31, 2008 and January 1 to May 31, 2007, respectively, as Thomson Financial presents these data on a calendar-year basis.
- (14) Percentages represent income from continuing operations before gains (losses) from unconsolidated investees and income taxes, as a percentage of net revenues.
- (15) Annualized net revenue per global representative amounts equal Global Wealth Management Group's net revenues (excluding the sale of MSWM S.V., S.A.U.) divided by the quarterly average global representative headcount for the periods presented.
- (16) The decline in fee-based assets as a percent of total client assets largely reflected the termination on October 1, 2007 of the Company's fee-based (fee-in-lieu of commission) brokerage program pursuant to a court decision vacating a Securities and Exchange Commission (SEC) rule that permitted fee-based brokerage. Client assets that were in the fee-based program primarily moved to commission-based brokerage accounts, or at the election of some clients, into other fee-based advisory programs, including Morgan Stanley Advisory, a nondiscretionary account launched in August 2007.
- (17) Client assets per global representative equal total period-end client assets divided by period-end global representative headcount.
- (18) Bank deposits are held at certain of the Company's Federal Deposit Insurance Corporation (the FDIC) insured depository institutions for the benefit of retail clients through their accounts.
- (19) Amounts include Asset Management's proportional share of assets managed by entities in which it owns a minority interest.
- (20) Source: Lipper, one-year performance excluding money market funds as of May 31, 2008 and 2007, respectively.

**Second Quarter 2008 Performance.**

**Company Results.** The Company recorded net income of \$1,026 million in the quarter ended May 31, 2008, a 60% decrease from the comparable fiscal 2007 period. Results for the quarter ended May 31, 2008 included a pre-tax gain of \$732 million related to the secondary offering of MSCI Inc. and a pre-tax gain of \$698 million related to the sale of Morgan Stanley Wealth Management S.V., S.A.U. (MSWM S.V.) (see Note 15 to the condensed consolidated financial statements). The current quarter also included a gain associated with the sale of a controlling interest in a previously consolidated commodities subsidiary. Net revenues (total revenues less interest expense) declined 38% to \$6,510 million as difficult market conditions and unfavorable positioning in the Company's fixed income sales and trading and corporate lending businesses negatively impacted the current quarter's results. Non-interest expenses of \$5,064 million, including severance expense of approximately \$245 million related to staff reductions, decreased 28% from the second quarter of last year primarily due to lower compensation and benefits costs. Diluted earnings per share were \$0.95 compared with \$2.45 in last year's second quarter. Compensation and benefits expense decreased 41%, primarily reflecting lower incentive-based compensation accruals due to lower net revenues in the Company's Institutional Securities and Asset Management business segments. Diluted earnings per share from continuing operations were \$0.95 compared with \$2.24 in last year's second quarter. The annualized return on average common equity was 12.3% compared with 27.4% in the second quarter of last year. The return on average common equity from continuing operations was 12.3% compared with 29.4% in the second quarter of last year.

For the six month period ended May 31, 2008, net income was \$2,577 million, a 51% decrease from \$5,254 million a year ago. Net revenues decreased 28% to \$14,832 million and non-interest expenses, including severance expense of approximately \$406 million related to staff reductions, decreased 17% to \$11,172 million. Diluted earnings per share were \$2.40 compared with \$4.96 a year ago. The annualized return on average common equity for the six month period was 15.9% compared with 28.7% in the prior-year period. Results for the six month period ended May 31, 2008 included the aforementioned gains related to MSCI Inc. and MSWM S.V. Results for the six month period ended May 31, 2007 included a gain of \$168 million (\$109 million after-tax) in discontinued operations related to the sale of Quilter on February 28, 2007 (see Note 14 to the condensed consolidated financial statements).



**Table of Contents**

The Company's effective income tax rate from continuing operations was 30.0% for both the quarter and six month period ended May 31, 2008 compared with 32.6% and 32.5% for the quarter and six month period ended May 31, 2007, respectively. The decrease in both periods primarily reflected a lower level of earnings, partially offset by an increase in the rate due to lower estimated domestic tax credits.

At May 31, 2008, the Company had 46,390 employees worldwide compared with 45,845 (excluding DFS employees) at the end of the second quarter of last year and 48,256 at November 30, 2007.

***Institutional Securities.*** Institutional Securities recorded income from continuing operations before gains (losses) from unconsolidated investees and income taxes of \$679 million, a 77% decrease from last year's second quarter. Net revenues declined 51% to \$3,625 million primarily related to lower results in sales and trading and investment banking. Non-interest expenses decreased 34% to \$2,946 million from last year's second quarter, reflecting lower compensation costs, partially offset by higher brokerage and clearing expenses and other business-related activities.

Investment banking revenues decreased 49% from the second quarter of fiscal 2007 to \$875 million, reflecting declines in industry-wide activity resulting in lower revenues from merger, acquisition and restructuring activities and lower revenues from fixed income and equity underwriting transactions. Advisory fees from merger, acquisition and restructuring transactions were \$367 million, a decrease of 49% from the comparable period of fiscal 2007. Underwriting revenues decreased 48% to \$508 million.

Equity sales and trading revenues decreased 11% to \$2,103 million. Higher revenues from derivative products, prime brokerage and equity cash products were offset by lower proprietary trading results. Equity sales and trading revenues also benefited by approximately \$90 million from the widening of the Company's credit spreads on certain long-term and short-term borrowings that are accounted for at fair value. Fixed income sales and trading revenues were \$414 million, 85% below the \$2,738 million recorded in the second quarter of fiscal 2007, primarily reflecting lower revenues from interest rate, credit and currency products and commodities, and net losses in mortgage loan products. Within interest rate, currency and credit products continued dislocation in the credit markets resulted in a loss in credit products, compared with a significant gain a year ago. Higher net revenues in foreign exchange and interest rates, reflecting higher customer flow and higher levels of volatility, partly offset the loss in credit products. Commodities results declined from a year ago reflecting losses in North American electricity and lower net revenues in oil liquids resulting from unfavorable positioning, partly offset by higher customer flow and net revenues recognized on structured transactions.

In the second quarter of fiscal 2008, other sales and trading losses of \$519 million were primarily related to loans and commitments largely related to event-driven lending transactions to non-investment grade companies, as losses on hedges were partly offset by mark to market gains (see Impact of Credit Market Events herein).

Principal transaction net investment losses aggregating \$257 million were recognized in the quarter ended May 31, 2008 as compared with net investment gains of \$396 million in the quarter ended May 31, 2007. The losses were primarily related to net losses from the Company's investments in passive limited partnership interests associated with the Company's real estate funds and investments that benefit certain employee deferred compensation and co-investment plans, and other principal investments.

***Global Wealth Management Group.*** Global Wealth Management Group recorded income from continuing operations before income taxes of \$989 million, as compared with \$264 million in the second quarter of fiscal 2007. Net revenues were \$2,436 million, a 48% increase from last year's second quarter, primarily reflecting a gain related to the sale of MSWM S.V. (see Note 15 to the condensed consolidated financial statements). Excluding the sale of MSWM S.V., net revenues were \$1.7 billion, an increase of 4% from a year ago. The increase in net revenues was primarily due to higher net interest revenue from growth in the bank deposit program and stronger transactional revenues reflecting higher fixed income trading volume, partly offset by lower asset management, distribution and administration fees. The decline in asset management revenues reflects

**Table of Contents**

the termination of certain fee-based brokerage programs in the fourth quarter of fiscal 2007 and a change in the classification of sub-advisory fees due to modifications of certain customer agreements, partly offset by growth in other fee-based products. Total non-interest expenses were \$1,447 million, a 5% increase from last year's second quarter. Compensation and benefits expense increased 9%, primarily reflecting higher incentive-based compensation accruals due to higher net revenues, bonuses paid to certain key employees upon completion of the sale of MSWM S.V. and investment in the business. Non-compensation costs decreased 5%, as higher levels of business activity were more than offset by a change in the classification of sub-advisory fees due to modifications of certain customer agreements. Total client assets were \$739 billion, an \$11 billion increase from last year's second quarter. In addition, client assets in fee-based accounts were \$194 billion, an 8% decrease from last year's second quarter and decreased as a percentage of total client assets to 26% from 29%. The decline in fee-based assets as a percent of total client assets largely reflected the termination on October 1, 2007 of the Company's fee-based (fee-in-lieu of commission) brokerage program pursuant to a court decision vacating an SEC rule that permitted fee-based brokerage. At May 31, 2008, the number of global representatives was 8,350, an increase of 213 from a year ago.

**Asset Management.** Asset Management recorded a loss before income taxes of \$227 million in the second quarter of fiscal 2008 as compared with income before income taxes of \$303 million in the second quarter of last year. Net revenues of \$488 million decreased 68% from last year's second quarter, primarily due to principal transaction net losses in the real estate and private equity businesses compared with strong gains posted in the second quarter of last year. The current quarter also included principal transaction trading losses of approximately \$86 million related to securities issued by structured investment vehicles included in the Company's condensed consolidated statements of financial condition. Asset management, distribution and administration fees were lower primarily due to lower performance fees in the Company's alternatives business. Non-interest expenses decreased 41% to \$715 million from last year's second quarter. Compensation and benefits expense decreased primarily reflecting lower incentive based compensation accruals due to lower net revenues including losses associated with investments for the benefit of the Company's employee deferred compensation and co-investment plans. Assets under management or supervision within Asset Management of \$605 billion were up \$45 billion, or 8%, from a year ago, primarily driven by net customer inflows in fixed income money market products, alternatives and infrastructure as well as net customer inflows and asset appreciation in real estate.

**Global Market and Economic Conditions in the Quarter and Six Month Period Ended May 31, 2008.**

In the U.S., the slowdown of economic growth continued during the second quarter of fiscal 2008. During the quarter, credit markets experienced dislocation, illiquidity and wider credit spreads. Continued concerns about the impact of monoline insurers, residential and commercial mortgage loan products and structured investment vehicles caused the broader credit markets to deteriorate further. The U.S. unemployment rate at the end of the second quarter of fiscal 2008 increased to 5.5% from 4.7% at the end of fiscal 2007. In the U.S., equity market indices ended the quarter higher, while ending the six month period lower. Concerns about future economic growth, high oil prices, lower consumer sentiment, the adverse developments in the credit markets and mixed corporate earnings continued to challenge the U.S. economy and the equity markets. The Federal Reserve Board (the Fed) lowered both the benchmark interest rate and discount rate by an aggregate of 1.00% in the quarter and 2.50% in the six month period, including an unscheduled 0.75% interest rate reduction in January 2008. Also, during the quarter, the Fed lowered the primary credit rate by 0.25%. The Fed acted to continue to provide additional liquidity and stability to the financial markets and to contain the negative economic impact related to the credit markets. Although providing liquidity and stability to the financial markets was a primary objective, the Fed also remains concerned about inflationary pressures. During the quarter, the potential systemic impact from The Bear Stearns Companies Inc.'s near-bankruptcy led the Fed to act by announcing new lending facilities, which are now available to primary broker-dealers, including the Company.

In Europe, economic growth continued to slow during the second quarter of fiscal 2008 as export demand decreased, housing prices declined and the disruption in the global financial markets continued. In Europe, equity

## **Table of Contents**

market indices ended the quarter higher, while ending the six month period lower. Concerns about the economic outlook and difficult conditions in the credit markets continued to challenge the European economy and the equity markets. The European Central Bank ( ECB ) left the benchmark interest rate unchanged during the quarter and the six month period. The ECB remains concerned about global inflation. Subsequent to quarter end, the ECB raised the benchmark interest rate by 0.25%. The Bank of England lowered the benchmark interest rate by 0.25% during the quarter and decreased the benchmark interest rate by an aggregate of 0.75% in the six month period.

In Japan, economic growth moderated as demand for exports were adversely impacted by higher energy and production costs. The level of unemployment remained relatively low. Japanese equity market indices ended the quarter higher, while ending the six month period lower. The Bank of Japan left the benchmark interest rate unchanged during the quarter and the six month period. Economies elsewhere in Asia expanded, particularly in China, which benefited from strength in exports, domestic demand for capital projects and continued globalization. In China, equity market indices in the quarter were lower and in the six month period were substantially lower. China's strong rate of economic growth caused inflationary concerns. The People's Bank of China left the benchmark lending rate unchanged during the quarter and increased the benchmark interest rate by 0.18% in the six month period.

### **Business Segments.**

The remainder of Results of Operations is presented on a business segment basis before discontinued operations. Substantially all of the Company's operating revenues and operating expenses can be directly attributed to its business segments. Certain revenues and expenses have been allocated to each business segment, generally in proportion to its respective net revenues, non-interest expenses or other relevant measures.

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the business segment results to the Company's consolidated results. Income before taxes in Intersegment Eliminations primarily represents the effect of timing differences associated with the revenue and expense recognition of commissions paid by Asset Management to the Global Wealth Management Group associated with sales of certain products and the related compensation costs paid to the Global Wealth Management Group's global representatives. Income before taxes recorded in Intersegment Eliminations was \$5 million and \$7 million in the quarters ended May 31, 2008 and 2007, respectively, and \$9 million and \$13 million in the six month periods ended May 31, 2008 and 2007, respectively.

**Table of Contents****INSTITUTIONAL SECURITIES****INCOME STATEMENT INFORMATION**

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007	2008	2007
(dollars in millions)				
<b>Revenues:</b>				
Investment banking	\$ 875	\$ 1,704	\$ 1,855	\$ 2,736
<b>Principal transactions:</b>				
Trading	1,309	4,705	4,703	8,734
Investments	(257)	396	(398)	746
Commissions	813	766	1,653	1,457
Asset management, distribution and administration fees	34	25	65	50
Interest and dividends	9,793	15,193	23,453	29,214
Other	975	266	1,184	471
<b>Total revenues</b>	<b>13,542</b>	<b>23,055</b>	<b>32,515</b>	<b>43,408</b>
<b>Interest expense</b>	<b>9,917</b>	<b>15,626</b>	<b>22,677</b>	<b>28,817</b>
<b>Net revenues</b>	<b>3,625</b>	<b>7,429</b>	<b>9,838</b>	<b>14,591</b>
<b>Total non-interest expenses</b>	<b>2,946</b>	<b>4,479</b>	<b>7,042</b>	<b>8,796</b>
<b>Income from continuing operations before gains (losses) from unconsolidated investees and income taxes</b>				
	679	2,950	2,796	5,795
<b>Gains (losses) from unconsolidated investees</b>	<b>19</b>	<b>(20)</b>	<b>21</b>	<b>(46)</b>
<b>Provision for income taxes</b>	<b>160</b>	<b>932</b>	<b>787</b>	<b>1,810</b>
<b>Income from continuing operations</b>	<b>\$ 538</b>	<b>\$ 1,998</b>	<b>\$ 2,030</b>	<b>\$ 3,939</b>

**Investment Banking.** Investment banking revenues for the quarter ended May 31, 2008 decreased 49% from the comparable period of fiscal 2007, reflecting declines in industry-wide activity resulting in lower revenues from merger, acquisition and restructuring activities and lower revenues from fixed income and equity underwriting transactions. Advisory fees from merger, acquisition and restructuring transactions were \$367 million, a decrease of 49% from the comparable period of fiscal 2007. Underwriting revenues were \$508 million, a decrease of 48% from the comparable period of fiscal 2007. Equity underwriting revenues decreased 40% to \$298 million. Fixed income underwriting revenues decreased 57% to \$210 million.

At May 31, 2008, the backlog for investment banking transactions increased from the end of the previous quarter. The backlog of merger, acquisition and restructuring transactions and equity and fixed income underwriting transactions is subject to the risk that transactions may not be completed due to challenging or unforeseen economic and market conditions, adverse developments regarding one of the parties to the transaction, a failure to obtain required regulatory approval, or a decision on the part of the parties involved not to pursue a transaction or the pace of completed transactions taking longer than in the past.

Investment banking revenues in the six month period ended May 31, 2008 decreased 32% from the comparable period of fiscal 2007 due to lower revenues from fixed income and equity underwriting transactions and lower revenues from merger, acquisition and restructuring activities.

**Sales and Trading.** Sales and trading revenues are composed of principal transaction trading revenues, commissions and net interest revenues (expenses). In assessing the profitability of its sales and trading activities, the Company views principal trading, commissions and net interest revenues (expenses) in the aggregate. In



**Table of Contents**

addition, decisions relating to principal transactions are based on an overall review of aggregate revenues and costs associated with each transaction or series of transactions. This review includes, among other things, an assessment of the potential gain or loss associated with a transaction, including any associated commissions, dividends, the interest income or expense associated with financing or hedging the Company's positions, and other related expenses.

Total sales and trading revenues decreased 60% in the quarter ended May 31, 2008 from the comparable period of fiscal 2007.

Sales and trading revenues include the following:

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008(1)	2007(1)	2008(1)	2007(1)
	(dollars in millions)			
Equity	\$ 2,103	\$ 2,374	\$ 5,570	\$ 4,692
Fixed income	414	2,738	3,183	6,059
Other	(519)	(74)	(1,621)	(163)
Total sales and trading revenues	\$ 1,998	\$ 5,038	\$ 7,132	\$ 10,588

(1) Amounts include Principal transactions trading, Commissions and Net interest revenue (expenses). Other sales and trading net revenues primarily include net losses from loans and closed pipeline commitments related to investment banking, corporate lending and other corporate activities.

Equity sales and trading revenues decreased 11% to \$2,103 million in the second quarter of fiscal 2008. The decrease was primarily driven by lower revenues from principal trading strategies, partially offset by higher revenues from derivative products, prime brokerage and equity cash products. Revenues from derivative products, prime brokerage and equity cash products reflected higher customer flows and high levels of volatility. Prime brokerage revenues were higher reflecting an increase in global client asset balances.

Equity sales and trading revenues also benefited from the widening of the Company's credit spreads on financial instruments that are accounted for at fair value, including, but not limited to, those for which the fair value option was elected pursuant to Statement of Financial Accounting Standards (SFAS) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159) on December 1, 2006 (see Note 2 to the condensed consolidated financial statements). Equity sales and trading revenues included approximately \$90 million due to the widening of the Company's credit spreads during the quarter resulting from the decrease in the fair value of certain of the Company's long-term and short-term borrowings, primarily structured notes, for which the fair value option was elected.

Fixed income sales and trading revenues were \$414 million, 85% lower than the second quarter of fiscal 2007. The second quarter of fiscal 2008 reflected lower revenues from interest rate, credit and currency products, losses in residential and commercial mortgage loan products and lower revenues from commodities.

Interest rate, credit and currency product revenues decreased 47% in the second quarter of fiscal 2008 reflecting a loss in credit products and lower revenues in emerging markets, partially offset by higher revenues from interest rate and foreign exchange products. The results also included losses of \$390 million related to exposure to monoline insurers (see Impact of Credit Market Events Monoline Insurers herein). The loss from credit trading products reflected the continued dislocation in the credit markets as well as a cumulative negative adjustment of \$120 million resulting from incorrect valuations of a London-based trader's positions related to prior quarters. Revenues from interest rate and foreign exchange products benefited from higher customer flows, higher levels of market volatility and the reversal of \$171 million of valuation adjustments related to interest rate derivatives. Writedowns on mortgage proprietary trading products of approximately \$400 million were primarily due to a broadening decline in the residential and commercial mortgage sector. The decline in the Company's

**Table of Contents**

mortgage loan product activities reflected the difficult market conditions, as well as continued concerns in the subprime mortgage loan sector. See *Impact of Credit Market Events* herein. Commodity revenues declined 47%, primarily due to losses from North American electricity and lower revenues from oil liquids resulting from unfavorable positioning, partially offset by higher customer flows and net revenues recognized on structured transactions. Fixed income sales and trading revenues also benefited from the widening of the Company's credit spreads on financial instruments that are accounted for at fair value, including, but not limited to, those for which the fair value option was elected (see Note 2 to the condensed consolidated financial statements). Revenues increased by approximately \$11 million due to the widening of the Company's credit spreads during the quarter resulting from the decrease in the fair value of certain of the Company's long-term and short-term borrowings, such as structured notes, for which the fair value option was elected.

In addition to the equity and fixed income sales and trading revenues discussed above, sales and trading revenues include the net revenues from the Company's corporate lending activities. In the second quarter of fiscal 2008, other sales and trading losses were \$519 million. Included in the \$519 million were net losses of approximately \$500 million associated with loans and commitments largely related to event-driven lending to non-investment grade companies as mark-to-market gains of approximately \$430 million were offset by losses on hedges of approximately \$900 million. Ineffectiveness in hedges was due to the basis risk between the specific characteristics of loans and loan commitments and index-based hedges (see *Impact of Credit Market Events* herein).

Total sales and trading revenues decreased 33% in the six month period ended May 31, 2008 from the comparable period of fiscal 2007, reflecting lower fixed income sales and trading revenues and losses in other sales and trading revenues, partially offset by higher equity sales and trading revenues. Equity sales and trading revenues increased 19% primarily due to higher revenues from derivative products, prime brokerage and equity cash products, partially offset by lower revenues from principal trading strategies. Fixed income sales and trading revenues decreased 47% primarily due to losses in residential and commercial mortgage loan products. The losses in other sales and trading revenues were driven by markdowns of loans and loan commitments associated with the Company's corporate lending activities. The losses included markdowns of loan commitments associated with event-driven lending that were accepted by the borrower but not yet closed. These losses were primarily related to the illiquid market conditions that primarily existed during the first quarter of fiscal 2008. The valuation of these commitments could change in future periods depending on, among other things, the extent that they are renegotiated or repriced or if the associated acquisition transaction does not occur. In addition, the Company's leveraged finance business originates and distributes loans and commitments and intends to distribute its current positions; however, this is taking substantially longer than in the past. Widening credit spreads for non-investment grade loans could result in additional writedowns for these loans and commitments. The fair value measurement of loan commitments takes into account certain fee income that is attributable to the contingent commitment contract. For further information about the Company's corporate lending activities, see Item 3, *Quantitative and Qualitative Disclosures about Market Risk - Credit Risk*.

***Principal Transactions - Investments.*** Principal transaction net investment losses aggregating \$257 million and \$398 million were recognized in the quarter and six month period ended May 31, 2008, as compared with net investment gains of \$396 million and \$746 million in the quarter and six month period ended May 31, 2007. The decrease was primarily related to net losses from the Company's investments in passive limited partnership interests associated with the Company's real estate funds and investments that benefit certain employee deferred compensation and co-investment plans, and other principal investments. The gains in the fiscal 2007 periods primarily related to realized and unrealized net gains associated with certain of the Company's investments, including investments in passive limited partnership interests associated with the Company's real estate funds.

***Other.*** Other revenues aggregating \$975 million and \$1,184 million were recognized in the quarter and six month period ended May 31, 2008, as compared with \$266 million and \$471 million in the quarter and six month period ended May 31, 2007. The fiscal 2008 periods included revenues of approximately \$744 million related to the secondary offering of MSCI Inc. during the second quarter of fiscal 2008 (see Note 15 to the condensed consolidated financial statements) and a gain associated with the sale of a controlling interest in a previously

**Table of Contents**

consolidated commodities subsidiary. The increase in Other revenues in the six month period also reflected higher revenues from sales of benchmark indices and risk management analytic products.

***Non-Interest Expenses.*** Non-interest expenses decreased 34% and 20% in the quarter and six month period ended May 31, 2008, primarily reflecting a decrease in compensation and benefits expense, partially offset by higher non-compensation expenses. Compensation and benefits expense decreased 54% and 34% in the quarter and six month period, respectively, primarily reflecting lower incentive-based compensation accruals due to lower net revenues, partially offset by severance-related expenses of \$203 million and \$333 million in the quarter and six month period ended May 31, 2008. Excluding compensation and benefits expense, non-interest expenses increased 15% and 19% in the quarter and six month period, reflecting higher brokerage and clearing expenses and other business-related activities. Occupancy and equipment expenses increased 20% and 15% in the quarter and six month period, primarily reflecting higher rent and occupancy costs in Europe, Middle East, Africa and Asia. Brokerage, clearing and exchange fees increased 31% and 28% in the quarter and six month period, primarily reflecting increased equity and fixed income trading activity. Information processing and communications expense increased 12% and 14% in the quarter and six month period, primarily due to higher market data and data processing costs. Professional services expenses increased 21% and 13% in the quarter and six month period, primarily due to higher consulting and legal costs. Other expenses increased 27% in the six month period, primarily reflecting higher regulatory and litigation costs.



Table of Contents

## GLOBAL WEALTH MANAGEMENT GROUP

## INCOME STATEMENT INFORMATION

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007	2008	2007
	(dollars in millions)			
<b>Revenues:</b>				
Investment banking	\$ 152	\$ 164	\$ 256	\$ 330
<b>Principal transactions:</b>				
Trading	210	133	387	262
Investments	(3)	20	(7)	18
Commissions	346	357	709	672
Asset management, distribution and administration fees	694	769	1,410	1,498
Interest and dividends	319	298	621	572
Other	801	40	840	78
<b>Total revenues</b>	<b>2,519</b>	<b>1,781</b>	<b>4,216</b>	<b>3,430</b>
Interest expense	83	139	174	277
<b>Net revenues</b>	<b>2,436</b>	<b>1,642</b>	<b>4,042</b>	<b>3,153</b>
<b>Total non-interest expenses</b>	<b>1,447</b>	<b>1,378</b>	<b>2,799</b>	<b>2,663</b>
Income from continuing operations before income taxes	989	264	1,243	490
Provision for income taxes	370	102	465	189
<b>Income from continuing operations</b>	<b>\$ 619</b>	<b>\$ 162</b>	<b>\$ 778</b>	<b>\$ 301</b>

**Investment Banking.** Investment banking revenues decreased 7% and 22% in the quarter and six month period ended May 31, 2008, primarily due to lower underwriting activity across equity and unit trust products, partially offset by an increase in fixed income underwriting activity. The equity underwriting results in the six month period ended May 31, 2007 primarily related to closed end fund offerings.

**Principal Transactions Trading.** Principal transaction trading revenues increased 58% and 48% in the quarter and six month period ended May 31, 2008, primarily due to higher revenues from municipal and corporate fixed income securities, partially offset by losses associated with investments that benefit certain employee deferred compensation plans. The six month period ended May 31, 2008 also included higher revenues from government fixed income securities.

**Principal Transactions Investments.** Principal transaction net investment revenues decreased 115% and 139% in the quarter and six month period ended May 31, 2008. The quarter and six month period ended May 31, 2007 reflected net gains from certain of the Company's investments in exchanges and memberships.

**Commissions.** Commission revenues decreased 3% in the quarter ended May 31, 2008, reflecting lower client activity. Commission revenues increased 6% in the six month period ended May 31, 2008, reflecting higher client activity.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees decreased 10% and 6% in the quarter and six month period ended May 31, 2008, primarily reflecting the discontinuance of certain fee-based brokerage programs in the fourth quarter of fiscal 2007 and a change in the classification of sub-advisory fees due to modifications of certain customer agreements, partially offset by growth in other fee-based products.



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**Table of Contents**

Client assets in fee-based accounts decreased 8% to \$194 billion as of May 31, 2008 and represented 26% of total client assets compared with 29% as of May 31, 2007. The decline in fee-based assets as a percent of total client assets largely reflected the termination on October 1, 2007 of the Company's fee-based (fee-in-lieu of commission) brokerage program pursuant to a court decision vacating an SEC rule that permitted fee-based brokerage. Client assets that were in the fee-based program primarily moved to commission-based brokerage accounts, or, at the election of some clients, into other fee-based advisory programs, including Morgan Stanley Advisory, a nondiscretionary account launched in August 2007. Total client asset balances increased to \$739 billion as of May 31, 2008 from \$728 billion as of May 31, 2007, primarily due to higher client inflows. Client asset balances in households greater than \$1 million increased to \$511 billion as of May 31, 2008 from \$491 billion as of May 31, 2007.

**Net Interest.** Net interest revenues increased 48% and 52% in the quarter and six month period ended May 31, 2008, primarily due to increased customer account balances in the bank deposit program. Balances in the bank deposit program rose to \$34.3 billion as of May 31, 2008 from \$18.2 billion as of May 31, 2007.

**Other Revenues.** Other revenues were \$801 million and \$840 million in the quarter and six month period ended May 31, 2008. Both periods included \$748 million related to the sale of MSWM S.V., the Spanish onshore mass affluent wealth management business during the second quarter of fiscal 2008 (see Note 15 to the condensed consolidated financial statements).

**Non-Interest Expenses.** Non-interest expenses increased 5% in both the quarter and six month period ended May 31, 2008, primarily reflecting an increase in compensation and benefits expense, partially offset by lower non-compensation expenses. Compensation and benefits expense increased 9% and 10% in the quarter and six month period ended May 31, 2008, primarily reflecting higher incentive-based compensation accruals related to higher net revenues, bonuses paid to certain key employees upon completion of the sale of MSWM S.V. and investment in the business. The quarter and six month period ended May 31, 2008 also included severance-related expenses of \$7 million and \$26 million, respectively. Excluding compensation and benefits expense, non-interest expenses decreased 5% and 6% in the quarter and six month period. Occupancy and equipment increased 9% and 8% in the quarter and six month period primarily due to an increase in space costs and branch renovations. Marketing and business development expense increased 17% and 16% in the quarter and six month period ended primarily due to a higher level of business activity. Professional service expenses decreased 37% and 35% in the quarter and six month period ended primarily due to the change in the classification of sub-advisory fees due to modifications of certain customer agreements. Other expenses increased 19% and 13% in the quarter and six month period ended primarily driven by higher loan loss reserves and an increase in the reserve for debit card fraud.

**Table of Contents****ASSET MANAGEMENT****INCOME STATEMENT INFORMATION**

	<b>Three Months Ended May 31,</b>		<b>Six Months Ended May 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	<b>(dollars in millions)</b>			
<b>Revenues:</b>				
Investment banking	\$ 30	\$ 61	\$ 56	\$ 92
<b>Principal transactions:</b>				
Trading	(113)		(292)	
Investments	(204)	588	(405)	1,120
Commissions	5	6	9	12
Asset management, distribution and administration fees	779	844	1,624	1,612
Interest and dividends	16	29	31	43
Other	15	18	86	52
<b>Total revenues</b>	<b>528</b>	<b>1,546</b>	<b>1,109</b>	<b>2,931</b>
Interest expense	40	37	78	54
<b>Net revenues</b>	<b>488</b>	<b>1,509</b>	<b>1,031</b>	<b>2,877</b>
<b>Total non-interest expenses</b>	<b>715</b>	<b>1,206</b>	<b>1,419</b>	<b>2,195</b>
(Loss) income before income taxes	(227)	303	(388)	682
(Benefit from) provision for income taxes	(94)	105	(152)	254
<b>Net income (loss)</b>	<b>\$ (133)</b>	<b>\$ 198</b>	<b>\$ (236)</b>	<b>\$ 428</b>

**Investment Banking.** Investment banking revenues decreased 51% and 39% in the quarter and six month period ended May 31, 2008, primarily reflecting lower revenues from real estate products.

**Principal Transactions Trading.** The quarter and six month period ended May 31, 2008 primarily included losses of \$86 million and \$273 million, respectively, related to securities issued by structured investment vehicles included in the Company's condensed consolidated statements of financial condition. See [Impact of Credit Market Events Structured Investment Vehicles](#) herein for further discussion.

**Principal Transactions Investments.** Principal transaction net investment losses aggregating \$204 million and \$405 million were recognized in the quarter and six month period ended May 31, 2008 as compared with net gains of \$588 million and \$1,120 million in the quarter and six month period ended May 31, 2007. The current quarter and six month period included net investment losses associated with the Company's real estate products, including writedowns on Crescent Real Estate Equities Limited Partnership of approximately \$150 million and \$250 million, respectively. See [Impact of Credit Market Events Crescent Real Estate Equities Limited Partnership](#) herein for further discussion. The quarter and six month period ended May 31, 2007 included higher net gains on certain investments, including investments associated with the Company's real estate products, private equity portfolio and alternatives products and higher revenues associated with certain investments for the benefit of the Company's employee deferred compensation and co-investment plans.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees decreased 8% in the quarter ended May 31, 2008 and increased 1% in the six month period ended May 31, 2008. The decrease in the quarter was primarily due to lower performance fees in the alternatives business as well as lower distribution and shareholder servicing fees. The decrease in shareholder servicing fees was related to the modification of certain sub-transfer agent agreements, which resulted in an offsetting reduction to professional services expense. These decreases were partially offset by higher fund management and administration fees due to an increase in assets under management. The increase in the six month period was primarily due to higher fund management and administration fees, partially offset by lower performance and



**Table of Contents**

distribution fees. Average assets under management increased 9% to \$587 billion in the quarter ended May 31, 2008 from the prior-year period average of \$538 billion.

Asset Management's period-end and average customer assets under management or supervision were as follows:

	At May 31,		Average For the Three Months Ended May 31,		Average For the Six Months Ended May 31,	
	2008	2007(1)	2008	2007(1)	2008	2007(1)
(dollars in billions)						
<b>Assets under management or supervision by distribution channel:</b>						
Morgan Stanley Retail and Intermediary	\$ 76	\$ 80	\$ 75	\$ 77	\$ 77	\$ 76
Van Kampen Retail and Intermediary	138	155	136	148	140	146
Retail money markets	37	32	35	33	34	34
<b>Total Americas Retail</b>	<b>251</b>	<b>267</b>	<b>246</b>	<b>258</b>	<b>251</b>	<b>256</b>
U.S. Institutional	127	119	125	113	125	110
Institutional money markets	89	57	81	54	76	52
Non-U.S.	131	112	128	108	129	102
<b>Total assets under management or supervision</b>	<b>598</b>	<b>555</b>	<b>580</b>	<b>533</b>	<b>581</b>	<b>520</b>
Share of minority interest assets(2)	7	5	7	5	7	5
<b>Total</b>	<b>\$ 605</b>	<b>\$ 560</b>	<b>\$ 587</b>	<b>\$ 538</b>	<b>\$ 588</b>	<b>\$ 525</b>

	At May 31,		Average For the Three Months Ended May 31,		Average For the Six Months Ended May 31,	
	2008	2007(1)	2008	2007(1)	2008	2007(1)
(dollars in billions)						
<b>Assets under management or supervision by asset class:</b>						
Equity	\$ 239	\$ 265	\$ 234	\$ 254	\$ 243	\$ 250
Fixed income	227	187	217	182	211	180
Alternatives(3)	73	58	72	56	70	53
Unit trust	14	16	14	15	14	14
<b>Total core asset management</b>	<b>553</b>	<b>526</b>	<b>537</b>	<b>507</b>	<b>538</b>	<b>497</b>
Private equity	3	2	3	3	3	2
Infrastructure	4	1	3		3	
Real estate	38	26	37	23	37	21
<b>Total merchant banking</b>	<b>45</b>	<b>29</b>	<b>43</b>	<b>26</b>	<b>43</b>	<b>23</b>
<b>Total assets under management or supervision</b>	<b>598</b>	<b>555</b>	<b>580</b>	<b>533</b>	<b>581</b>	<b>520</b>
Share of minority interest assets(2)	7	5	7	5	7	5
<b>Total</b>	<b>\$ 605</b>	<b>\$ 560</b>	<b>\$ 587</b>	<b>\$ 538</b>	<b>\$ 588</b>	<b>\$ 525</b>

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- (1) Prior period information has been reclassified to conform to the current period's presentation.
- (2) Amounts represent Asset Management's proportional share of assets managed by entities in which it owns a minority interest.
- (3) The alternatives asset class includes a range of investment products such as hedge funds, funds of hedge funds and funds of private equity funds.

**Table of Contents**

Activity in Asset Management's assets under management or supervision were as follows:

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007(1)	2008	2007(1)
	(dollars in billions)			
<b>Balance at beginning of period</b>	\$ 577	\$ 521	\$ 597	\$ 496
Net flows by distribution channel:				
Morgan Stanley Retail and Intermediary	(1)	1	(2)	(1)
Van Kampen Retail and Intermediary	(2)	1	(5)	2
Retail money markets	4	(2)	5	(3)
Total Americas Retail	1		(2)	(2)
U.S. Institutional	1	1	2	1
Institutional money markets	13	4	20	6
Non-U.S.	1	4	2	9
Total net flows	16	9	22	14
Net market appreciation/(depreciation)	12	28	(14)	42
Total net increase	28	37	8	56
Acquisitions		1		7
Net increase in share of minority interest assets(2)		1		1
<b>Balance at end of period</b>	\$ 605	\$ 560	\$ 605	\$ 560

(1) Prior period information has been reclassified to conform to the current period's presentation.

(2) Amount represents Asset Management's proportional share of assets managed by entities in which it owns a minority interest.

Net flows in the quarter and six month period ended May 31, 2008 were primarily associated with positive flows into institutional and retail money markets, partially offset by net outflows from Van Kampen and Morgan Stanley Retail and Intermediary products.

**Other.** Other revenues decreased 17% for the quarter ended May 31, 2008 and increased 65% in the six month period ended May 31, 2008.

The decrease in the quarter was primarily due to lower revenues associated with Avenue Capital Group (Avenue), a New York-based investment manager in which the Company has a minority interest. The increase in the six month period was primarily due to revenues associated with Lansdowne Partners (Lansdowne), a London-based investment manager in which the Company has a minority interest.

**Non-Interest Expenses.** Non-interest expenses decreased 41% and 35% in the quarter and six month period ended May 31, 2008, primarily reflecting a decrease in compensation and benefits expense. Compensation and benefits expense decreased 50% and 48% in the quarter and six month period, primarily reflecting lower incentive-based compensation accruals due to lower net revenues including losses associated with investments for the benefit of the Company's employee deferred compensation and co-investment plans, partially offset by severance-related expenses of \$35 million in the quarter ended May 31, 2008. Excluding compensation and benefits expense, non-interest expenses decreased 22% and 9% in the quarter and six month period. Brokerage, clearing and exchange fees decreased 12% and 2% in the quarter and six month period ended May 31, 2008, primarily driven by lower commission expenses, partially offset by an increase in fee sharing. Professional services expense decreased 43% and 32% in the quarter and six month period ended May 31, 2008, primarily due to lower sub-advisory and sub-transfer agent fees. The decrease in sub-transfer agent expense was related to the modification of certain sub-transfer agent agreements, which resulted in an offsetting reduction to shareholder servicing revenues. Other expenses decreased 61% and 23% in the quarter and six month period ended May 31, 2008, primarily due to lower minority interest and other miscellaneous expenses.





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**Table of Contents**

**Impact of Credit Market Events.**

**Overview.**

The systematic risk reduction in the markets that occurred in the latter half of fiscal 2007 continued in the first half of fiscal 2008 after an extended period of global liquidity and historically low interest rates. Continued concerns about the impact of subprime loans caused the subprime-related and broader credit markets to deteriorate further, with lower levels of liquidity and price transparency for certain credit products. These difficult market conditions adversely affected event-driven lending transactions, U.S. subprime and non-subprime residential mortgage products, commercial real estate products, structured investment vehicles and monoline insurers.

The results for the second quarter of fiscal 2008 included net losses of approximately \$500 million (positive mark-to-market valuations of approximately \$400 million net of losses on hedges of approximately \$900 million) associated with loans and loan commitments largely related to event-driven lending transactions to non-investment grade companies. The positive mark-to-market valuations are due primarily to some liquidity re-entering the market. Ineffectiveness in hedges was due to the basis risk between the specific characteristics of loans and loan commitments and index-based hedges. The results for the six month period ended May 31, 2008 included approximately \$1.4 billion of such losses (negative mark-to-market valuations of approximately \$1.7 billion net of gains on hedges of approximately \$300 million). The losses for the six month period included markdowns of leveraged loan commitments associated with event-driven lending transactions that were accepted by the borrower but not yet closed. These losses were primarily related to the illiquid market conditions that existed during the first quarter of fiscal 2008.

The valuation of these commitments could change in future periods depending on, among other things, the extent that they are renegotiated or repriced or the associated acquisition transaction does not occur. In addition, the Company's leveraged finance business originates and distributes loans and commitments, and intends to distribute its current positions; however, this is taking longer than in the past. Widening credit spreads for non-investment grade loans could result in additional writedowns for these loans and commitments. For further information about the Company's corporate lending activities, see Item 3, Quantitative and Qualitative Disclosures about Market Risk Credit Risk herein.

In the second quarter of fiscal 2008, the Company recorded mortgage proprietary trading net writedowns of approximately \$400 million. The \$400 million included writedowns on non-subprime residential mortgages of approximately \$300 million and writedowns on commercial mortgage-backed securities and commercial whole loans of approximately \$200 million, partially offset by approximately \$100 million gains on U.S. subprime mortgage proprietary trading. See Other U.S. Subprime Mortgage-Related Exposures and Non-subprime Residential Mortgages, Commercial Mortgage-backed Securities and Commercial Whole Loans herein. The quarter also included losses of \$390 million related to monoline exposures (see Monoline Insurers herein). In the first half of fiscal 2008, the Company recorded mortgage proprietary trading net writedowns of approximately \$1.6 billion. The \$1.6 billion reflected net writedowns on U.S. subprime trading positions including super senior derivative positions and subprime residuals. The \$1.6 billion also included net writedowns on non-subprime residential mortgages.

In addition, the Company recorded losses of approximately \$100 million and \$300 million in the quarter and six month period ended May 31, 2008, respectively, related to mortgage-related securities portfolios in the Company's domestic subsidiary banks (see Subsidiary Banks herein).

The Company also recognized losses of \$86 million and \$273 million in the quarter and six month period ended May 31, 2008, respectively, related to securities issued by structured investment vehicles included in the Company's condensed consolidated statements of financial condition (see Structured Investment Vehicles herein).

The Company continues to monitor its real estate-related and lending-related positions in order to manage its exposures to these markets and businesses. As market conditions continue to evolve, the fair value of these

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**Table of Contents**

positions could further deteriorate (see Results of Operations Asset Management herein for discussion of losses related to real estate products). Additionally, given the current challenges in the financial markets, it is possible that declines in the estimated fair value of the Company's businesses may occur which could result in future goodwill impairment charges.

**U.S. Subprime Mortgage-Related Exposures.**

The Company's U.S. subprime mortgage-related trading positions consist of those related to U.S. asset-backed securities (ABS), collateralized debt obligation (CDO) securities and other mortgage-related exposures arising from investments in subprime loans, from asset-backed securities that, in whole or in part, are backed by subprime mortgage loans, and from derivatives referencing subprime mortgages or subprime mortgage-backed securities.

Subprime mortgages are loans secured by real property made to a borrower (or borrowers) with a diminished or impaired credit rating or with a limited credit history. A borrower's credit history is reflected in his credit report and routinely converted into a numerical credit score often referred to as a Fair Isaac Corporation (or FICO) score. Generally, a loan made to a borrower with a low FICO score or other credit score has historically been considered as subprime. Loans to borrowers with higher FICO scores may be subprime if the loan exhibits other high-risk factors. Such risk factors may include loans where: (a) the loan has a high loan-to-value ratio or combined loan-to-value ratios; (b) the borrower has reduced or limited income documentation; (c) the borrower has a high debt-to-income ratio; or (d) the occupancy type for the loan is other than the borrower's primary residence. There are many other risk factors, including borrowers who have purchased multiple properties or have taken previous equity withdrawal (cash out) refinancings within the last 12 to 24 month period, non-arm's length purchase transactions and unsupported or high-risk collateral properties, among others. Subprime mortgage-related securities are those securities that derive a significant portion of their value from subprime loans.

**U.S. ABS CDO Exposures.**

The Company purchases interests in and enters into derivatives with ABS CDOs. CDOs provide credit risk exposure to a portfolio of asset-backed securities (cash CDOs) or a reference portfolio of securities (synthetic CDOs). The underlying or reference portfolios consist primarily of residential mortgage-backed securities. The CDOs to which the Company has exposure were primarily structured and underwritten by third parties, although the Company also structured and underwrote CDOs, for which it received structuring and/or distribution fees, and from time to time retained interests in such CDOs.

The Company's primary exposure to ABS CDOs is to synthetic CDOs that hold or are referenced to collateral with ratings of BBB+, BBB or BBB- (mezzanine CDOs). Under credit default swap arrangements, the Company can be required to make payments in the event that securities in the referenced portfolios default or experience other credit events such as rating agency downgrades. (The characterization of these credit default swaps as super senior derives from their seniority in the capital structure of the synthetic CDO.) The Company also has exposure to ABS CDOs via other types of credit default swaps, direct investments in CDO securities, and retained interests in CDOs that the Company had underwritten. In determining the fair value of the Company's ABS CDO-related instruments the Company took into consideration prices observed from the execution of a limited number of transactions and data for relevant benchmark instruments in synthetic subprime markets. The fair value of such positions has experienced significant declines as a result of a deterioration of value in the benchmark instruments as well as market developments. These losses, as well as the Company's net CDO exposures, are quantified in the U.S. subprime-related exposures table below.

**Other U.S. Subprime Mortgage-Related Exposures.**

The Company also has exposure to the U.S. subprime mortgage market via investments in subprime mortgage loans and ABS that are backed in whole or in part by subprime mortgage loans and via derivatives referencing subprime mortgages or subprime mortgage-backed securities. With respect to whole loans, the Company purchased pools of mortgage loans from third-party originators and also originated mortgage loans through its

**Table of Contents**

retail channel and typically disposed of such loans by securitizing them. The Company typically retains certain lower-rated securities of such securitizations, often referred to as residual tranche securities. The Company effected its last subprime securitization in the fourth quarter of fiscal 2007 and has ceased the origination of subprime loans. The Company's other subprime mortgage-related trading exposures are quantified in the table below.

The Company's interests in U.S. subprime-related exposures are carried at fair value with changes recognized in earnings. The valuation methodology used for these instruments incorporated a variety of inputs, including prices observed from the execution of a limited number of trades in the marketplace; ABX and similar indices that track the performance of a series of credit default swaps based on subprime mortgages; and other market information, including data on remittances received and updated cumulative loss data on the underlying mortgages. For a further discussion of the Company's risk management policies and procedures see "Quantitative and Qualitative Disclosures about Market Risk - Risk Management" in Part II, Item 7A of the Form 10-K.

The following table provides a summary of the Company's direct U.S. subprime trading exposures (excluding amounts related to mortgage-related securities portfolios in the Company's domestic subsidiary banks (see "Subsidiary Banks" herein)) as of and for the quarter and six month period ended May 31, 2008. Net exposure as of November 30, 2007 is also presented. The Company utilizes various methods of evaluating risk in its trading and other portfolios, including monitoring Net Exposure. Net Exposure is defined as potential loss to the Company over a period of time in an event of 100% default of the referenced loan, assuming zero recovery. The value of these positions remains subject to mark-to-market volatility. Positive net exposure amounts indicate potential loss (long position) in a default scenario. Negative net exposure amounts indicate potential gain (short position) in a default scenario. Net Exposure does not take into consideration the risk of counterparty default such that actual losses could exceed the amount of Net Exposure. See Note 1 to the condensed consolidated financial statements for a description regarding valuation of these instruments. See "Quantitative and Qualitative Disclosures about Market Risk - Credit Risk" in Part II, Item 7A of the Form 10-K for a further description of how credit risk is monitored.

	Statement of Financial Condition May 31, 2008(1)	Statement of Financial Condition November 30, 2007(1)	Profit and (Loss) Three Months Ended May 31, 2008	Profit and (Loss) Six Months Ended May 31, 2008	Net Exposure May 31, 2008	Net Exposure November 30, 2007
(dollars in billions)						
<b>Super Senior Derivative Exposure:</b>						
Mezzanine	\$ (7.4)	\$ (8.7)	\$ (0.4)	\$ (0.9)	\$ 1.6	\$ 3.9
CDO squared(2)		(0.1)				0.1
Total ABS CDO super senior derivative exposure	\$ (7.4)	\$ (8.8)	\$ (0.4)	\$ (0.9)	\$ 1.6	\$ 4.0
<b>Other CDO Exposure:</b>						
ABS CDO CDS	\$ 2.1	\$ 2.7	\$ 0.1	\$ 0.6	\$ (0.8)	\$ (1.5)
ABS CDO bonds	0.7	1.1	(0.1)	(0.3)	0.7	1.1
Total other CDO exposure	\$ 2.8	\$ 3.8	\$	\$ 0.3	\$ (0.1)	\$ (0.4)
Subtotal ABS CDO-related exposure(3)	\$ (4.6)	\$ (5.0)	\$ (0.4)	\$ (0.6)	\$ 1.5	\$ 3.6
<b>U.S. Subprime Mortgage-Related Exposure:</b>						
Loans	\$ 0.4	\$ 0.6	\$	\$	\$ 0.4	\$ 0.6
Total rate-of-return swaps					0.1	
ABS bonds	1.3	2.7	(0.4)	(0.8)	1.3	2.7
ABS CDS	14.0	7.8	1.1	1.7	(3.0)	(5.1)
Subtotal U.S. subprime mortgage-related exposure	\$ 15.7	\$ 11.1	\$ 0.7	\$ 0.9	\$ (1.2)	\$ (1.8)
Total U.S. subprime trading exposure(4)	\$ 11.1	\$ 6.1	\$ 0.3	\$ 0.3	\$ 0.3	\$ 1.8

- (1) Statement of financial condition amounts are presented on a net asset/liability basis and do not take into account any netting of cash collateral against these positions. In addition, these amounts reflect counterparty netting to the extent that there are positions with the same counterparty that are subprime-related; they do not reflect any counterparty netting to the extent that there are positions with the

**Table of Contents**

same counterparty that are not subprime related. As of May 31, 2008, the \$11.1 billion is reflected in the Company's condensed consolidated statement of financial condition as follows: Financial instruments owned of \$17.5 billion and Financial instruments sold, not yet purchased of \$6.4 billion. As of November 30, 2007, the \$6.1 billion is reflected in the Company's condensed consolidated statement of financial condition as follows: Financial instruments owned of \$15.3 billion and Financial instruments sold, not yet purchased of \$9.2 billion.

- (2) Refers to CDOs where the collateral is comprised entirely of another CDO security.
- (3) In determining the fair value of the Company's ABS super senior CDO-related exposures the Company took into consideration prices observed from the execution of a limited number of transactions and data for relevant benchmark instruments in synthetic subprime markets. Deterioration of value in the benchmark instruments as well as market developments have led to significant declines in the estimates of fair value. These declines reflected increased implied losses across this portfolio. These implied loss levels are consistent with losses in the range between 18% - 41% implied by the ABX indices. These cumulative loss levels, at a severity rate of 55%, imply defaults in the range of 73% - 84% for 2005 and 2006 outstanding mortgages.
- (4) Profit and (loss) amounts for the quarter ended May 31, 2008 include mortgage proprietary trading gains of approximately \$100 million and credit trading product gains of approximately \$200 million.

**Subsidiary Banks.**

The securities portfolios of Morgan Stanley Bank (Utah) and Morgan Stanley Trust FSB (collectively, the Subsidiary Banks) include certain subprime-related securities. The portfolios contain no subprime whole loans, subprime residuals or CDOs.

At May 31, 2008 and November 30, 2007, the securities portfolios totaled \$9.3 billion and \$9.9 billion, respectively, consisting primarily of AAA-rated ABS bonds and residential mortgage-backed securities. Of these total amounts, \$4.0 billion and \$5.5 billion were subprime mortgage-related securities as of May 31, 2008 and November 30, 2007, respectively.

**Non-subprime Residential Mortgages, Commercial Mortgage-backed Securities and Commercial Whole Loans.**

The Company continues to have exposure to non-subprime residential mortgages which include prime, Alt-A (a categorization that falls between prime and subprime), European and Asian residential mortgage loans and residential mortgage-backed securities bonds (RMBS). The Company also has exposure to commercial mortgage-backed securities (CMBS) and commercial whole loans. The following tables provide a summary of the Company's non-subprime residential mortgages and CMBS and commercial whole loans exposures as of and for the quarter and six month period ended May 31, 2008. Net exposure as of November 30, 2007 is also presented.

**Non-subprime Residential Mortgages.**

	Statement of Financial Condition May 31, 2008(1)	Statement of Financial Condition November 30, 2007(1)	Profit and (Loss) Three Months Ended May 31, 2008	Profit and (Loss) Six Months Ended May 31, 2008	Net Exposure May 31, 2008	Net Exposure November 30, 2007
	(dollars in billions)					
Residential loans(2)	\$ 4.8	\$ 4.0	\$ (0.1)	\$ (0.1)	\$ 4.8	\$ 4.0
RMBS bonds(2)	4.0	8.7	(0.4)	(1.0)	4.0	8.7
RMBS backed warehouse lines	0.2	0.1			0.2	0.1
RMBS CDS	0.2	0.1			(2.3)	(1.9)
Other secured financings(3)	3.2	3.6				
Total residential non-subprime(4)	\$ 12.4	\$ 16.5	\$ (0.5)	\$ (1.1)	\$ 6.7	\$ 10.9

- (1) Statement of financial condition amounts are presented on a net asset/liability basis and do not take into account any netting of cash collateral against these positions. As of May 31, 2008, the \$12.4 billion is reflected in the Company's condensed consolidated statement of financial condition as follows: Financial instruments owned of \$12.5 billion and Financial instruments sold, not yet purchased of \$0.1 billion. As of November 30, 2007, the \$16.5 billion is reflected in the Company's condensed consolidated statement of financial condition as follows: Financial instruments owned of \$16.5 billion.
- (2) Gross and net exposure on non-subprime residential loans and bonds is approximately evenly split (50/50) between prime and Alt-A underlying collateral.



**Table of Contents**

- (3) Amounts represent assets recorded under certain provisions of SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities ( SFAS No. 140 ), and FASB Interpretation No. 46, as revised ( FIN 46R ), Consolidation of Variable Interest Entities, that function as collateral for an offsetting amount of non-recourse debt to third parties. Any retained interests in these transactions are reflected in RMBS bonds.
- (4) Profit and (loss) amounts for the quarter ended May 31, 2008 include mortgage proprietary trading losses of approximately \$(300) million and credit trading product losses of approximately \$(200) million.

**Commercial Mortgage-backed Securities and Commercial Whole Loans.**

	Statement of Financial Condition May 31, 2008(1)	Statement of Financial Condition November 30, 2007(1)	Profit and (Loss) Three Months Ended May 31, 2008	Profit and (Loss) Six Months Ended May 31, 2008	Net Exposure May 31, 2008	Net Exposure November 30, 2007
(dollars in billions)						
CMBS bonds	\$ 5.8	\$ 10.0	\$ (0.1)	\$ (0.5)	\$ 5.8	\$ 10.0
CMBS backed warehouse lines(2)	1.9	1.1			1.9	1.8
Commercial loans(2)	6.3	12.4			6.7	13.9
CMBS swaps(3)	2.0	1.0		0.9	(8.0)	(8.2)
Other secured financings(4)	6.1	7.0				
Total CMBS/Commercial whole loan exposure(5)	\$ 22.1	\$ 31.5	\$ (0.1)	\$ 0.4	\$ 6.4	\$ 17.5

- (1) Statement of financial condition amounts are presented on a net asset/liability basis and do not take into account any netting of cash collateral against these positions. As of May 31, 2008, the \$22.1 billion is reflected in the Company's condensed consolidated statement of financial condition as follows: Financial instruments owned of \$24.9 billion and Financial instruments sold, not yet purchased of \$2.8 billion. As of November 30, 2007, the \$31.5 billion is reflected in the Company's condensed consolidated statement of financial condition as follows: Financial instruments owned of \$33.2 billion and Financial instruments sold, not yet purchased of \$1.7 billion.
- (2) Amounts include unfunded loan commitments.
- (3) Amounts include credit default, index and total rate-of-return swaps.
- (4) Amounts represent assets recorded under certain provisions of SFAS 140 and FIN 46R that function as collateral for an offsetting amount of non-recourse debt to third parties. Any retained interests in these transactions are reflected in CMBS bonds.
- (5) Profit and (loss) amounts for the quarter ended May 31, 2008 include mortgage proprietary trading losses of approximately \$(200) million and credit trading product gains of approximately \$100 million.

**Special Purpose Entities and Variable Interest Entities.**

The Company's involvement with special purpose entities ( SPEs ) and variable interest entities ( VIEs ) is discussed in Note 4 to the condensed consolidated financial statements and Critical Accounting Policies Special Purpose Entities herein. In relation to subprime loans and subprime-backed securities, the Company's involvement with SPEs/VIEs consists primarily of the following:

Engaging in securitization activities related to subprime loans and subprime-backed securities;

Acting as an underwriter of beneficial interests issued by securitization vehicles;

Transferring whole loans into SPEs/VIEs;



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Holding one or more classes of securities issued by such securitization vehicles (including residual tranche securities) and possibly entering into derivative agreements with such securitization vehicles;

Purchasing and selling (in both a market-making and a proprietary-trading capacity) subprime-backed securities issued by SPEs/VIEs, whether such vehicles are sponsored by the Company or not;

Entering into derivative transactions with SPEs/VIEs (not sponsored by the Company) that hold subprime-related assets;

Providing warehouse financing to CDOs and collateralized loan obligations ( CLOs );

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## **Table of Contents**

Entering into derivative agreements with non-SPEs/VIEs, whose value is derived from securities issued by SPEs/VIEs;

Servicing assets held by SPEs/VIEs or holding servicing rights related to assets held by SPEs/VIEs that are serviced by others under subservicing arrangements; and

Serving as an asset manager to various investment funds that may invest in securities that are backed, in whole or in part, by subprime loans.

In addition, see Results of Operations Asset Management herein for Asset Management's period-end and average customer assets under management or supervision.

### **Structured Investment Vehicles.**

Structured investment vehicles ( SIVs ) are unconsolidated entities that issue various capital notes and debt instruments to fund the purchase of assets. While the Company does not sponsor or serve as asset manager to any unconsolidated SIVs, the Company does serve as investment advisor to certain unconsolidated money market funds ( the Funds ) that have investments in securities issued by SIVs. In the second half of fiscal 2007, widespread illiquidity in the commercial paper market led to market value declines and rating agency downgrades of many securities issued by SIVs, some of which were held by the Funds. As a result, the Company purchased at amortized cost approximately \$900 million of such securities from the Funds during fiscal 2007 and \$217 million of such securities during the first half of fiscal 2008. During the quarter and six month period ended May 31, 2008, the Company recorded losses of \$86 million and \$273 million, respectively, on these securities. The carrying value of the purchased securities still held by the Company as of May 31, 2008 was \$503 million. Such positions are reflected at fair value, and presented in Financial instruments owned Corporate and other debt in the condensed consolidated statements of financial condition. Subsequent to May 31, 2008, the Company has not purchased additional securities from the Funds. The Company has no obligation to purchase any additional securities from the Funds in the future. The Funds continue to have investments in securities issued by SIVs, with an aggregate face value of \$1.3 billion as of May 31, 2008 compared with \$8.2 billion as of November 30, 2007.

### **Monoline Insurers.**

Monoline insurers ( Monolines ) provide credit enhancement to capital markets transactions. The current credit environment severely affected the capacity of such financial guarantors. The Company's exposure to Monolines is limited to bonds that are insured by Monolines and as counterparties to derivative contracts. The Company's exposure to Monolines at May 31, 2008 consisted primarily of ABS bonds of \$1.0 billion in the Subsidiary Banks' portfolio (see Subsidiary Banks ) that are collateralized by first and second lien subprime mortgages enhanced by financial guarantees, \$1.3 billion in insurance municipal bond securities and \$500 million in net counterparty exposure. Net counterparty exposure of \$500 million represents gross exposure of approximately \$3.6 billion net of hedges as well as cumulative credit valuation adjustments of approximately \$900 million. The Company's exposure to Monolines at November 30, 2007 consisted primarily of ABS bonds of \$1.5 billion in the Subsidiary Banks' portfolio, \$1.3 billion in insurance municipal bond securities and \$800 million in net counterparty exposure. The results for the quarter and six month period ended May 31, 2008 included losses of \$390 million and \$990 million, respectively, related to these exposures.

### **Real Estate Investor Funds**

The Company acts as the general partner for various real estate funds and also invests in certain of these funds as a limited partner.

An affiliated entity of the Company acquired an investment in Crescent Real Estate Equities Limited Partnership ( Crescent ) in August 2007. The assets of Crescent primarily include office buildings, investments in resorts and residential developments in select markets across the United States ( Crescent properties ). The Company

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**Table of Contents**

had originally intended to include the Crescent properties in an investor fund. At the end of the second quarter of fiscal 2008, the Company modified its investment strategy based on various factors, including current market conditions, valuation, size of the investment and timing of the fund, and determined to operate Crescent and risk manage the Crescent properties.

As a result, the Company consolidated Crescent's assets and liabilities of approximately \$4.6 billion and \$3.8 billion, respectively, as of May 31, 2008. The Crescent properties, which comprise the majority of Crescent's assets, totaled approximately \$3.4 billion as of May 31, 2008 and are included within Other assets in the condensed consolidated statement of financial condition. The Company will continue to evaluate the Crescent properties and position them for sale as opportunities arise.

During the quarter and six month period ended May 31, 2008, the Company recorded writedowns on its investment in Crescent of approximately \$150 million and \$250 million, respectively, which are included in the Asset Management business segment and reflected in Principal transactions-investments in the condensed consolidated statements of income.

Beginning in the third quarter of fiscal 2008, the consolidated operating results of Crescent will be included in the Asset Management business segment.

**ASF Framework.**

In December 2007, the American Securitization Forum (ASF) issued the Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans (the ASF Framework). The overall purpose of the ASF Framework is to provide recommended guidance for servicers to streamline borrower evaluation procedures and to facilitate the effective use of all forms of foreclosure and loss prevention efforts, including refinancings, forbearances, workout plans, loan modifications, deeds-in-lieu and short sales or short payoffs. The ASF Framework is focused on subprime first-lien adjustable rate residential mortgages loans that have an initial fixed rate period of 36 months or less, are included in securitized pools, were originated between January 1, 2005 and July 31, 2007, and have an initial interest rate reset date between January 1, 2008 and July 31, 2010 (subprime ARM loans).

The ASF Framework categorizes the population of subprime ARM loans into three segments. Segment 1 includes current loans, as defined, where the borrower is likely to be able to refinance into an available mortgage product. It is expected that borrowers in this category should refinance their loans, if they are unable or unwilling to meet their reset payment. Segment 2 includes current loans where the borrower is unlikely to be able to refinance and meet specific criteria related to FICO scores and the expected payment increase due to the initial adjustment of the interest rate. Borrowers in this segment are eligible for a fast track loan modification under which the interest rate will be kept at the existing rate, generally for five years following the upcoming reset. The ASF Framework indicates that for Segment 2 loans, the servicer can presume that the borrower would be unable to pay pursuant to the original terms of the loan after the interest rate reset, and thus, borrower default on the loan is reasonably foreseeable in absence of a modification. Segment 3 includes loans where the borrower is not current or which do not otherwise qualify for Segment 1 or Segment 2. For loans in this category, the servicer will determine the appropriate loss mitigation approach in a manner consistent with the applicable servicing standard in the transaction documents, but without employing the fast track procedures described under Segment 2.

In January 2008, the Office of Chief Accountant (the OCA) of the SEC issued a letter (the OCA Letter) addressing accounting issues that may be raised by the ASF Framework. The OCA Letter concluded that the SEC would not object to continuing off-balance sheet accounting treatment for qualifying special purpose entities (QSPEs) that hold Segment 2 subprime ARM loans modified pursuant to the ASF Framework.

For those current loans that are accounted for off-balance sheet that are modified, but not as part of the ASF Framework above, the servicer must perform on an individual basis an analysis of the borrower and the loan to provide sufficient evidence to demonstrate that default on the loan is imminent or reasonably foreseeable.

**Table of Contents**

The Company adopted the ASF Framework during the first quarter of fiscal 2008, but has not yet modified a significant volume of loans using the ASF Framework. The Company does not expect that its application of the ASF Framework will impact the off-balance sheet status of Company-sponsored QSPEs that hold Segment 2 subprime ARM loans and is currently evaluating the potential impact on its condensed consolidated statements of income. The total amount of assets owned by Company-sponsored QSPEs that hold subprime ARM loans (including those loans that are not serviced by the Company) as of May 31, 2008, was approximately \$39.3 billion. Of this amount, approximately \$15.0 billion relates to subprime ARM loans serviced by the Company. The Company's retained interests in Company sponsored QSPEs that hold subprime ARM loans totaled approximately \$68 million as of May 31, 2008.

**Table of Contents****Other Matters.**

The following matters are discussed in the Company's notes to the condensed consolidated financial statements. For further information on these matters, please see the applicable note:

	<b>Note</b>
<b>Accounting Developments:</b>	
<i>Accounting for Uncertainty in Income Taxes</i>	1
<i>Employee Benefit Plans</i>	1
<i>Offsetting of Amounts Related to Certain Contracts</i>	1
<i>Dividends on Share-Based Payment Awards</i>	1
<i>Business Combinations</i>	1
<i>Noncontrolling Interests</i>	1
<i>Transfers of Financial Assets and Repurchase Financing Transactions</i>	1
<i>Disclosures about Derivative Instruments and Hedging Activities</i>	1
<i>Determination of the Useful Life of Intangible Assets</i>	1
<i>Earnings Per Share</i>	1
<i>QSPEs</i>	1
<b>Income Taxes</b>	12
<b>Discontinued Operations</b>	14
<b>Business Dispositions</b>	15

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**Table of Contents**

**Critical Accounting Policies.**

The Company's condensed consolidated financial statements are prepared in accordance with U.S. GAAP, which requires the Company to make estimates and assumptions (see Note 1 to the condensed consolidated financial statements). The Company believes that of its significant accounting policies (see Note 2 to the consolidated financial statements for the fiscal year ended November 30, 2007 included in the Form 10-K), the following involve a higher degree of judgment and complexity.

**Fair Value.**

**Financial Instruments Measured at Fair Value.** A significant number of the Company's financial instruments are carried at fair value with changes in fair value recognized in earnings each period. The Company makes estimates regarding valuation of assets and liabilities measured at fair value in preparing the condensed consolidated financial statements. These assets and liabilities include:

Financial instruments owned and Financial instruments sold, not yet purchased;

Securities received as collateral and Obligation to return securities received as collateral;

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.

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. A hierarchy for inputs is used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the observable inputs be used when available. For further information on the fair value definition, Level 1, Level 2 and Level 3 hierarchy and related valuation techniques, see Note 1 to the condensed consolidated financial statements.

The Company's Level 3 assets before the impact of cash collateral and counterparty netting across the levels of the fair value hierarchy were \$69.2 billion and \$73.7 billion as of May 31, 2008 and November 30, 2007, respectively, and represented approximately 16% as of May 31, 2008 and 15% as of November 30, 2007 of the assets measured at fair value (7% of total assets as of both periods). Level 3 liabilities before the impact of cash collateral and counterparty netting across the levels of the fair value hierarchy were \$21.3 billion and \$19.5 billion as of May 31, 2008 and November 30, 2007, respectively, and represented approximately 8% and 7%, respectively, of the Company's liabilities measured at fair value.

During the three month period ended May 31, 2008, the Company reclassified approximately \$7.2 billion of certain Corporate and other debt from Level 2 to Level 3. These reclassifications included transfers primarily related to certain commercial mortgage backed securities, commercial whole loans and corporate loans and loan commitments. The reclassifications were due to a reduction in the volume of recently executed transactions and market price quotations for these instruments such that the inputs for these instruments became unobservable. The Company reclassified approximately \$5.8 billion of certain Corporate and other debt from Level 3 to Level 2. These reclassifications included transfers primarily related to corporate loans and loan commitments as some liquidity re-entered the market for these specific positions and inputs for these instruments became observable.

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During the three month period ended May 31, 2008, the Company also reclassified approximately \$3.3 billion of certain OTC derivatives from Level 3 to Level 2. These reclassifications included transfers primarily related to tranche index default swaps as inputs became observable.

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## **Table of Contents**

See Note 2 to the condensed consolidated financial statements for further information about the Company's financial assets and liabilities that are accounted for at fair value.

*Fair Value Control Processes.* The Company employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to assure that the valuation approach utilized is appropriate and consistently applied and that the assumptions are reasonable. These control processes include reviews of the pricing model's theoretical soundness and appropriateness by Company personnel with relevant expertise who are independent from the trading desks. Additionally, groups independent from the trading divisions within the Financial Control, Market Risk and Credit Risk Departments participate in the review and validation of the fair values generated from pricing models, as appropriate. Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model.

Consistent with market practice, the Company has individually negotiated agreements with certain counterparties to exchange collateral (margining) based on the level of fair values of the derivative contracts they have executed. Through this margining process, one party or both parties to a derivative contract provides the other party with information about the fair value of the derivative contract to calculate the amount of collateral required. This sharing of fair value information provides additional support of the Company's recorded fair value for the relevant OTC derivative products. For certain OTC derivative products, the Company, along with other market participants, contributes derivative pricing information to aggregation services that synthesize the data and make it accessible to subscribers. This information is then used to evaluate the fair value of these OTC derivative products. For more information regarding the Company's risk management practices, see Quantitative and Qualitative Disclosures about Market Risk Risk Management in Part II, Item 7A of the Form 10-K.

### **Legal, Regulatory and Tax Contingencies.**

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

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

Reserves for litigation and regulatory proceedings are generally determined on a case-by-case basis and represent an estimate of probable losses after considering, among other factors, the progress of each case, prior experience and the experience of others in similar cases, and the opinions and views of internal and external legal counsel. Given the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, the Company cannot predict with certainty the loss or range of loss, if any, related to such matters, how such matters will be resolved, when they will ultimately be resolved or what the eventual settlement, fine, penalty or other relief, if any, might be.

The Company is subject to the income and indirect tax laws of the U.S., its states and municipalities and those of the foreign jurisdictions in which the Company has significant business operations. These tax laws are complex and subject to different interpretations by the taxpayer and the relevant governmental taxing authorities. The



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## **Table of Contents**

Company must make judgments and interpretations about the application of these inherently complex tax laws when determining the provision for income taxes and the expense for indirect taxes and must also make estimates about when in the future certain items affect taxable income in the various tax jurisdictions. Disputes over interpretations of the tax laws may be settled with the taxing authority upon examination or audit. The Company regularly assesses the likelihood of assessments in each of the taxing jurisdictions resulting from current and subsequent years examinations, and tax reserves are established as appropriate.

The Company establishes reserves for potential losses that may arise out of litigation and regulatory proceedings to the extent that such losses are probable and can be estimated in accordance with SFAS No. 5. The Company establishes reserves for potential losses that may arise out of tax audits in accordance with FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). Once established, reserves are adjusted when there is more information available or when an event occurs requiring a change. Significant judgment is required in making these estimates, and the actual cost of a legal claim, tax assessment or regulatory fine/penalty may ultimately be materially different from the recorded reserves, if any.

See Notes 8 and 12 to the condensed consolidated financial statements for additional information on legal proceedings and tax examinations.

### **Special Purpose Entities.**

The Company enters into a variety of transactions with SPEs, primarily in connection with securitization activities. The Company engages in securitization activities related to commercial and residential mortgage loans, U.S. agency collateralized mortgage obligations, corporate bonds and loans, municipal bonds and other types of financial instruments. In most cases, these SPEs are deemed to be VIEs. Unless a VIE is determined to be a QSPE, the Company is required to perform an analysis of each VIE at the date upon which the Company becomes involved with it to determine whether the Company is the primary beneficiary of the VIE, in which case the Company must consolidate the VIE. QSPEs are not consolidated.

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

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

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

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

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

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

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

The determination of whether an SPE meets the accounting requirements of a QSPE requires significant judgment, particularly in evaluating whether the permitted activities of the SPE are significantly limited and in determining whether derivatives held by the SPE are passive and nonexcessive. In addition, the analysis involved in determining whether an entity is a VIE, and in determining the primary beneficiary of a VIE, requires significant judgment (see Notes 1 and 4 to the condensed consolidated financial statements).



**Table of Contents**

**Liquidity and Capital Resources.**

The Company's senior management establishes the liquidity and capital policies of the Company. Through various risk and control committees, the Company's senior management reviews business performance relative to these policies, monitors the availability of alternative sources of financing, and oversees the liquidity, interest rate and currency sensitivities of the Company's asset and liability position. The Company's Treasury Department and other control groups assist in evaluating, monitoring and controlling the impact that the Company's business activities have on its condensed consolidated statements of financial condition, liquidity and capital structure.

**The Balance Sheet.**

The Company actively monitors and evaluates the composition and size of its balance sheet. A substantial portion of the Company's total assets consists of liquid marketable securities and short-term receivables arising principally from Institutional Securities sales and trading activities. The liquid nature of these assets provides the Company with flexibility in managing the size of its balance sheet.

The Company's total assets decreased to \$1,031,228 million at May 31, 2008, from \$1,045,409 million at November 30, 2007. The decrease was primarily due to decreases in securities received as collateral, customer receivables and financial instruments owned corporate and other debt, partially offset by increases in securities purchased under agreements to resell and securities borrowed. Quarter end asset balances have been lower than intra-quarter balances due to the nature of the Company's market making and client-financing activity as well as the Company's efforts to manage its asset balances and liquidity.

Within the sales and trading related assets and liabilities are transactions attributable to securities financing activities. As of May 31, 2008, securities financing assets and liabilities were \$561 billion and \$502 billion, respectively. Securities financing transactions include repurchase and resale agreements, securities borrowed and loaned transactions, securities received as collateral and obligation to return securities received, customer receivables/payables and related segregated customer cash.

Securities financing assets and liabilities also include matched book transactions with minimal market, credit and/or liquidity risk. These matched book transactions are to accommodate customers, as well as to obtain securities for the settlement and finance of inventory positions. The customer receivable/payable portion of the securities financing transactions includes customer margin loans, collateralized by customer owned securities, and customer cash, which is segregated in order to satisfy regulatory requirements. The Company's risk exposure on these transactions is mitigated by collateral maintenance policies that limit the Company's credit exposure to customers. Included within securities financing assets was \$26 billion that, in accordance with SFAS No. 140 represented equal and offsetting assets and liabilities for fully collateralized non-cash loan transactions.

Balance sheet leverage ratios are one indicator of capital adequacy when viewed in the context of a company's overall liquidity and capital policies. For a discussion of risk-based capital ratios, another indicator of capital adequacy, see Regulatory Requirements herein. The Company views the adjusted leverage ratio as a more relevant measure of financial risk than gross leverage when comparing financial services firms and evaluating leverage trends. The Company has adopted a definition of adjusted assets that excludes certain self-funded assets considered to have minimal market, credit and/or liquidity risk. These low-risk assets generally are attributable to the Company's matched book and securities lending businesses. Adjusted assets are calculated by reducing gross assets by aggregate resale agreements and securities borrowed less non-derivative short positions and assets recorded under certain provisions of SFAS No. 140 and FIN 46R. Gross assets are also reduced by the full amount of cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements.

**Table of Contents**

Leverage ratios reflect the deduction from shareholders' equity of the amount of equity used to support goodwill and intangible assets (as the Company does not view this amount of equity as available to support its risk capital needs). In addition, the Company views junior subordinated debt issued to capital trusts as a component of its capital base given the inherent characteristics of the securities including their long-dated nature, the Company's ability to defer coupon interest, and the subordinated nature of the obligations in the capital structure. The Company also receives rating agency equity credit for these securities.

The following table sets forth the Company's total assets, adjusted assets and leverage ratios as of May 31, 2008 and November 30, 2007 and for the average month-end balances during the quarter and six month period ended May 31, 2008:

	Balance at		Average Month-End Balance	
	May 31, 2008	November 30, 2007	For the Three Months Ended May 31, 2008	For the Six Months Ended May 31, 2008
	(dollars in millions, except ratio data)			
Total assets	\$ 1,031,228	\$ 1,045,409	\$ 1,096,120	\$ 1,089,760
Less: Securities purchased under agreements to resell	(165,928)	(126,887)	(162,616)	(147,184)
Less: Securities borrowed	(257,796)	(239,994)	(259,086)	(252,262)
Add: Financial instruments sold, not yet purchased	161,748	134,341	173,324	