

MORGAN STANLEY  
Form 10-Q  
November 04, 2013  
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 September 30, 2013*

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

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

Large Accelerated Filer

Accelerated Filer

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Non-Accelerated Filer

(Do not check if a smaller reporting company)

Smaller reporting company

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

As of October 31, 2013, there were 1,951,340,420 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 September 30, 2013*

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 September 30, 2013 and December 31, 2012</u>	1
	<u>Condensed Consolidated Statements of Income Three and Nine Months Ended September 30, 2013 and 2012</u>	2
	<u>Condensed Consolidated Statements of Comprehensive Income Three and Nine Months Ended September 30, 2013 and 2012</u>	3
	<u>Condensed Consolidated Statements of Cash Flows Nine Months Ended September 30, 2013 and 2012</u>	4
	<u>Condensed Consolidated Statements of Changes in Total Equity Nine Months Ended September 30, 2013 and 2012</u>	5
	<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	7
	<u>Report of Independent Registered Public Accounting Firm</u>	98
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	99
	<u>Introduction</u>	99
	<u>Executive Summary</u>	100
	<u>Business Segments</u>	110
	<u>Accounting Developments</u>	126
	<u>Other Matters</u>	127
	<u>Critical Accounting Policies</u>	129
	<u>Liquidity and Capital Resources</u>	133
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	150
Item 4.	<u>Controls and Procedures</u>	165
	<u>Financial Data Supplement (unaudited)</u>	166
<b><u>Part II Other Information</u></b>		
Item 1.	<u>Legal Proceedings</u>	172
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	176
Item 6.	<u>Exhibits</u>	176

**Table of Contents**

**AVAILABLE INFORMATION**

Morgan Stanley files annual, quarterly and current reports, proxy statements and other information with the U.S. 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 its Investor Relations webpage, its proxy statements, Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. Morgan Stanley also makes available, through its Investor Relations webpage, via a link to the SEC's internet site, statements of beneficial ownership of Morgan Stanley's equity securities filed by its directors, officers, 10% or greater shareholders and others under Section 16 of the Exchange Act.

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

Amended and Restated Certificate of Incorporation;

Amended and Restated Bylaws;

Charters for its Audit Committee; Operations and Technology Committee; Compensation, Management Development and Succession Committee; Nominating and Governance Committee; and Risk Committee;

Corporate Governance Policies;

Policy Regarding Communication with the Board of Directors;

Policy Regarding Director Candidates Recommended by Shareholders;

Policy Regarding Corporate Political Contributions;

Policy Regarding Shareholder Rights Plan;

Code of Ethics and Business Conduct;

Code of Conduct; and

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### Integrity Hotline information.

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

**Table of Contents****Part I Financial Information.****Item 1. Financial Statements.****MORGAN STANLEY****Condensed Consolidated Statements of Financial Condition****(dollars in millions, except share data)****(unaudited)**

	<b>September 30, 2013</b>	<b>December 31, 2012</b>
<b>Assets</b>		
Cash and due from banks (\$465 and \$526 at September 30, 2013 and December 31, 2012, respectively, related to consolidated variable interest entities generally not available to the Company)	\$ 14,333	\$ 20,878
Interest bearing deposits with banks	43,448	26,026
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	37,392	30,970
Trading assets, at fair value (approximately \$150,255 and \$147,348 were pledged to various parties at September 30, 2013 and December 31, 2012, respectively; \$2,994 and \$3,505 related to consolidated variable interest entities, generally not available to the Company at September 30, 2013 and December 31, 2012, respectively)	273,658	267,603
Securities available for sale, at fair value	46,866	39,869
Securities received as collateral, at fair value	16,042	14,278
Federal funds sold and securities purchased under agreements to resell (includes \$868 and \$621 at fair value at September 30, 2013 and December 31, 2012, respectively)	133,988	134,412
Securities borrowed	139,169	121,701
Customer and other receivables	57,710	64,288
Loans (net of allowances of \$166 and \$106 at September 30, 2013 and December 31, 2012, respectively)	37,734	29,046
Other investments	5,083	4,999
Premises, equipment and software costs (net of accumulated depreciation of \$6,205 and \$5,525 at September 30, 2013 and December 31, 2012, respectively) (\$213 and \$224 at September 30, 2013 and December 31, 2012, respectively, related to consolidated variable interest entities, generally not available to the Company)	6,008	5,946
Goodwill	6,591	6,650
Intangible assets (net of accumulated amortization of \$1,509 and \$1,250 at September 30, 2013 and December 31, 2012, respectively) (includes \$8 and \$7 at fair value at September 30, 2013 and December 31, 2012, respectively)	3,514	3,783
Other assets (\$523 and \$593 at September 30, 2013 and December 31, 2012, respectively, related to consolidated variable interest entities, generally not available to the Company)	10,687	10,511
<b>Total assets</b>	<b>\$ 832,223</b>	<b>\$ 780,960</b>
<b>Liabilities</b>		
Deposits (includes \$1,411 and \$1,485 at fair value at September 30, 2013 and December 31, 2012, respectively)	\$ 104,807	\$ 83,266
Commercial paper and other short-term borrowings (includes \$1,623 and \$725 at fair value at September 30, 2013 and December 31, 2012, respectively)	2,333	2,138
Trading liabilities, at fair value	122,645	120,122
Obligation to return securities received as collateral, at fair value	20,899	18,226
Securities sold under agreements to repurchase (includes \$554 and \$363 at fair value at September 30, 2013 and December 31, 2012, respectively)	139,398	122,674
Securities loaned	32,807	36,849
Other secured financings (includes \$6,145 and \$9,466 at fair value at September 30, 2013 and December 31, 2012, respectively) (\$587 and \$976 at September 30, 2013 and December 31, 2012, respectively, related to consolidated variable entities and are non-recourse to the Company)	14,528	15,727
Customer and other payables	152,091	127,722
Other liabilities and accrued expenses (\$75 and \$117 at September 30, 2013 and December 31, 2012, respectively, related to consolidated variable interest entities and are non-recourse to the Company)	16,669	14,928
Long-term borrowings (includes \$36,719 and \$44,044 at fair value at September 30, 2013 and December 31, 2012, respectively)	157,805	169,571

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Total liabilities	763,982	711,223
Commitments and contingent liabilities (see Note 12)		
<b>Redeemable noncontrolling interests (see Notes 3 and 14)</b>		4,309
<b>Equity</b>		
Morgan Stanley shareholders' equity:		
Preferred stock	2,370	1,508
Common stock, \$0.01 par value:		
Shares authorized: 3,500,000,000 at September 30, 2013 and December 31, 2012;		
Shares issued: 2,038,893,979 at September 30, 2013 and December 31, 2012;		
Shares outstanding: 1,953,350,711 at September 30, 2013 and 1,974,042,123 at December 31, 2012	20	20
Additional Paid-in capital	24,235	23,426
Retained earnings	42,237	39,912
Employee stock trust	1,753	2,932
Accumulated other comprehensive loss	(1,014)	(516)
Common stock held in treasury, at cost, \$0.01 par value; 85,543,268 shares at September 30, 2013 and 64,851,856 shares at December 31, 2012	(2,720)	(2,241)
Common stock issued to employee trust	(1,753)	(2,932)
Total Morgan Stanley shareholders' equity	65,128	62,109
Nonredeemable noncontrolling interests	3,113	3,319
Total equity	68,241	65,428
Total liabilities, redeemable noncontrolling interests and equity	\$ 832,223	\$ 780,960

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****MORGAN STANLEY****Condensed Consolidated Statements of Income****(dollars in millions, except share and per share data)****(unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>Revenues:</b>				
Investment banking	\$ 1,160	\$ 1,152	\$ 3,687	\$ 3,319
Trading	2,259	607	7,847	5,478
Investments	728	290	1,254	438
Commissions and fees	1,080	988	3,465	3,205
Asset management, distribution and administration fees	2,390	2,257	7,140	6,677
Other	204	141	700	403
Total non-interest revenues	7,821	5,435	24,093	19,520
Interest income	1,311	1,379	4,131	4,244
Interest expense	1,200	1,534	3,631	4,618
Net interest	111	(155)	500	(374)
Net revenues	7,932	5,280	24,593	19,146
<b>Non-interest expenses:</b>				
Compensation and benefits	3,968	3,928	12,289	11,989
Occupancy and equipment	375	386	1,131	1,152
Brokerage, clearing and exchange fees	416	359	1,300	1,167
Information processing and communications	405	493	1,323	1,439
Marketing and business development	151	138	448	439
Professional services	449	476	1,347	1,365
Other	829	983	2,059	1,939
Total non-interest expenses	6,593	6,763	19,897	19,490
Income (loss) from continuing operations before income taxes	1,339	(1,483)	4,696	(344)
Provision for (benefit from) income taxes	339	(525)	1,226	(247)
Income (loss) from continuing operations	1,000	(958)	3,470	(97)
<b>Discontinued operations:</b>				
Gain (loss) from discontinued operations	16	(11)	(55)	68
Provision for (benefit from) income taxes	(2)	(13)	(25)	43
Net gain (loss) from discontinued operations	18	2	(30)	25
Net income (loss)	\$ 1,018	\$ (956)	\$ 3,440	\$ (72)
Net income applicable to redeemable noncontrolling interests		8	222	8
Net income applicable to nonredeemable noncontrolling interests	112	59	370	446



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Net income (loss) applicable to Morgan Stanley	\$	906	\$	(1,023)	\$	2,848	\$	(526)
Earnings (loss) applicable to Morgan Stanley common shareholders	\$	880	\$	(1,047)	\$	2,619	\$	(599)
Amounts applicable to Morgan Stanley:								
Income (loss) from continuing operations	\$	888	\$	(1,008)	\$	2,878	\$	(525)
Net gain (loss) from discontinued operations		18		(15)		(30)		(1)
Net income (loss) applicable to Morgan Stanley	\$	906	\$	(1,023)	\$	2,848	\$	(526)
Earnings (loss) per basic common share:								
Income (loss) from continuing operations	\$	0.45	\$	(0.55)	\$	1.39	\$	(0.32)
Net gain (loss) from discontinued operations		0.01				(0.02)		
Earnings (loss) per basic common share	\$	0.46	\$	(0.55)	\$	1.37	\$	(0.32)
Earnings (loss) per diluted common share:								
Income (loss) from continuing operations	\$	0.44	\$	(0.55)	\$	1.36	\$	(0.32)
Net gain (loss) from discontinued operations		0.01				(0.02)		
Earnings (loss) per diluted common share	\$	0.45	\$	(0.55)	\$	1.34	\$	(0.32)
Dividends declared per common share	\$	0.05	\$	0.05	\$	0.15	\$	0.15
Average common shares outstanding:								
Basic		1,909,350,788		1,889,300,631		1,906,097,564		1,883,813,883
Diluted		1,964,812,610		1,889,300,631		1,952,146,477		1,883,813,883

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****MORGAN STANLEY****Condensed Consolidated Statements of Comprehensive Income****(dollars in millions)****(unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net income (loss)	\$ 1,018	\$ (956)	\$ 3,440	\$ (72)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments(1)	\$ 125	\$ 43	\$ (321)	\$ (88)
Amortization of cash flow hedges(2)	1	2	3	5
Change in net unrealized gains (losses) on securities available for sale(3)	33	62	(336)	84
Pension, postretirement and other related adjustments(4)	4	(4)	15	15
<b>Total other comprehensive income (loss)</b>	<b>\$ 163</b>	<b>\$ 103</b>	<b>\$ (639)</b>	<b>\$ 16</b>
Comprehensive income (loss)	\$ 1,181	\$ (853)	\$ 2,801	\$ (56)
Net income applicable to redeemable noncontrolling interests		8	222	8
Net income applicable to nonredeemable noncontrolling interests	112	59	370	446
Other comprehensive income (loss) applicable to redeemable noncontrolling interests		(1)		(1)
Other comprehensive income (loss) applicable to nonredeemable noncontrolling interests	8	29	(141)	5
<b>Comprehensive income (loss) applicable to Morgan Stanley</b>	<b>\$ 1,061</b>	<b>\$ (948)</b>	<b>\$ 2,350</b>	<b>\$ (514)</b>

(1) Amounts are net of provision for (benefit from) income taxes of \$(124) million and \$(150) million for the quarters ended September 30, 2013 and 2012, respectively, and \$176 million and \$26 million for the nine months ended September 30, 2013 and 2012, respectively.

(2) Amounts are net of provision for income taxes of \$1 million and \$1 million for the quarters ended September 30, 2013 and 2012, respectively, and \$2 million and \$3 million for the nine months ended September 30, 2013 and 2012, respectively.

(3) Amounts are net of provision for (benefit from) income taxes of \$23 million and \$46 million for the quarters ended September 30, 2013 and 2012, respectively, and \$(230) million and \$63 million for the nine months ended September 30, 2013 and 2012, respectively.

(4) Amounts are net of provision for income taxes of \$2 million and \$8 million for the quarters ended September 30, 2013 and 2012, respectively, and \$13 million and \$18 million for the nine months ended September 30, 2013 and 2012, respectively.

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****MORGAN STANLEY****Condensed Consolidated Statements of Cash Flows****(dollars in millions)****(unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ 3,440	\$ (72)
Adjustments to reconcile net income to net cash provided by operating activities:		
(Income) loss on equity method investees	(339)	24
Compensation payable in common stock and options	850	898
Depreciation and amortization	1,084	1,218
Gain on business dispositions	(34)	(108)
Gain on sale of securities available for sale	(43)	(53)
Impairment charges	182	224
Provision for credit losses on lending activities	116	127
Other non-cash adjustments to net income	31	1
Changes in assets and liabilities:		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	(6,422)	607
Trading assets, net of Trading liabilities	(5,944)	31,556
Securities borrowed	(17,468)	(11,471)
Securities loaned	(4,042)	5,458
Customer and other receivables and other assets	6,761	(23,746)
Customer and other payables and other liabilities	21,500	9,765
Federal funds sold and securities purchased under agreements to resell	424	(6,127)
Securities sold under agreements to repurchase	16,724	14,465
<b>Net cash provided by operating activities</b>	<b>16,820</b>	<b>22,766</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from (payments for):		
Premises, equipment and software costs	(944)	(865)
Business dispositions, net of cash disposed	569	1,536
Loans, net	(6,046)	(1,739)
Purchases of securities available for sale	(20,497)	(17,492)
Sales, maturities and redemptions of securities available for sale	12,812	8,200
Other investing activities	117	6
<b>Net cash used for investing activities</b>	<b>(13,989)</b>	<b>(10,354)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net proceeds from (payments for):		
Commercial paper and other short-term borrowings	195	(720)
Noncontrolling interests	(549)	(186)
Other secured financings	(1,395)	(4,291)
Deposits	21,541	5,095
Proceeds from:		
Excess tax benefits associated with stock-based awards	8	42
Derivatives financing activities	244	220
Issuance of Series E Preferred Stock	854	
Issuance of long-term borrowings	24,766	16,196
Payments for:		
Long-term borrowings	(31,084)	(36,386)
Derivatives financing activities	(237)	(118)

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Repurchases of common stock	(451)	(222)
Purchase of additional stake in Morgan Stanley Smith Barney Holdings LLC	(4,725)	(1,890)
Cash dividends	(358)	(349)
Net cash provided by (used for) financing activities	8,809	(22,609)
Effect of exchange rate changes on cash and cash equivalents	(298)	(42)
Effect of cash and cash equivalents related to variable interest entities	(465)	(487)
Net increase (decrease) in cash and cash equivalents	10,877	(10,726)
Cash and cash equivalents, at beginning of period	46,904	47,312
Cash and cash equivalents, at end of period	\$ 57,781	\$ 36,586
Cash and cash equivalents include:		
Cash and due from banks	\$ 14,333	\$ 18,239
Interest bearing deposits with banks	43,448	18,347
Cash and cash equivalents, at end of period	\$ 57,781	\$ 36,586

### SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for interest were \$3,372 million and \$3,423 million for the nine months ended September 30, 2013 and 2012, respectively.

Cash payments for income taxes were \$598 million and \$330 million for the nine months ended September 30, 2013 and 2012, respectively.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

## MORGAN STANLEY

## Condensed Consolidated Statements of Changes in Total Equity

Nine Months Ended September 30, 2013

(dollars in millions)

(unaudited)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non- redeemable Non- controlling Interests	Total Equity
<b>BALANCE AT DECEMBER 31, 2012</b>	\$ 1,508	\$ 20	\$ 23,426	\$ 39,912	\$ 2,932	\$ (516)	\$ (2,241)	\$ (2,932)	\$ 3,319	\$ 65,428
Net income applicable to Morgan Stanley				2,848						2,848
Net income applicable to nonredeemable noncontrolling interests									370	370
Dividends				(372)						(372)
Shares issued under employee plans and related tax effects			817		(1,179)		(28)	1,179		789
Repurchases of common stock							(451)			(451)
Foreign currency translation adjustments						(180)			(141)	(321)
Net change in cash flow hedges						3				3
Change in net unrealized losses on securities available for sale						(336)				(336)
Pension, postretirement and other related adjustments						15				15
Issuance of Series E Preferred Stock	862		(8)							854
Morgan Stanley Smith Barney Holdings LLC redemption value adjustment				(151)						(151)
Other net decreases									(435)	(435)
<b>BALANCE AT SEPTEMBER 30, 2013</b>	\$ 2,370	\$ 20	\$ 24,235	\$ 42,237	\$ 1,753	\$ (1,014)	\$ (2,720)	\$ (1,753)	\$ 3,113	\$ 68,241

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****MORGAN STANLEY****Condensed Consolidated Statements of Changes in Total Equity (Continued)****Nine Months Ended September 30, 2012****(dollars in millions)****(unaudited)**

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non- Redeemable Non- controlling Interests	Total Equity
<b>BALANCE AT DECEMBER 31, 2011</b>	\$ 1,508	\$ 20	\$ 22,836	\$ 40,341	\$ 3,166	\$ (157)	\$ (2,499)	\$ (3,166)	\$ 8,029	\$ 70,078
Net loss applicable to Morgan Stanley				(526)						(526)
Net income applicable to nonredeemable noncontrolling interests									446	446
Dividends				(374)						(374)
Shares issued under employee plans and related tax effects			473		(187)		495	187		968
Repurchases of common stock							(222)			(222)
Foreign currency translation adjustments						(88)				(88)
Net change in cash flow hedges						5				5
Change in net unrealized gains on securities available for sale						84				84
Pension, postretirement and other related adjustments						10			5	15
Purchase of additional stake in Morgan Stanley Smith Barney Holdings LLC			(107)						(1,718)	(1,825)
Reclassification to redeemable noncontrolling interests									(4,296)	(4,296)
Other net increases									905	905
<b>BALANCE AT SEPTEMBER 30, 2012</b>	\$ 1,508	\$ 20	\$ 23,202	\$ 39,441	\$ 2,979	\$ (146)	\$ (2,226)	\$ (2,979)	\$ 3,371	\$ 65,170

See Notes to Condensed Consolidated Financial Statements.

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**Table of Contents**

**MORGAN STANLEY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Introduction and Basis of Presentation.**

**The Company.** Morgan Stanley, a financial holding company, is a global financial services firm that maintains significant market positions in each of its business segments Institutional Securities, Wealth Management and Investment 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. Unless the context otherwise requires, the terms Morgan Stanley or the Company mean Morgan Stanley (the Parent ) together with its consolidated subsidiaries.

Effective with the quarter ended June 30, 2013, the Global Wealth Management Group and Asset Management business segments were re-titled Wealth Management and Investment Management, respectively.

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

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

*Wealth Management* provides brokerage and investment advisory services to individual investors and small-to-medium sized businesses and institutions covering various investment alternatives; financial and wealth planning services; annuity and other insurance products; credit and other lending products; cash management services; retirement services; and trust and fiduciary services and engages in fixed income trading, which primarily facilitates clients' trading or investments in such securities.

*Investment Management* provides a broad array of investment strategies that span the risk/return spectrum across geographies, asset classes and public and private markets to a diverse group of clients across the institutional and intermediary channels as well as high net worth clients.

***Discontinued Operations.***

*Quilter.* On April 2, 2012, the Company completed the sale of Quilter & Co. Ltd. ( Quilter ), its retail wealth management business in the United Kingdom ( U.K. ). The results of Quilter are reported as discontinued operations within the Wealth Management business segment for all periods presented.

*Saxon.* On October 24, 2011, the Company announced that it had reached an agreement to sell Saxon, a provider of servicing and subservicing of residential mortgage loans, to Ocwen Financial Corporation. The transaction, which was restructured as a sale of Saxon's assets during the first quarter of 2012, was substantially completed in the second quarter of 2012. The results of Saxon are reported as discontinued operations within the Institutional Securities business segment for all periods presented.

Prior period amounts have been recast for discontinued operations. See Note 21 for additional information on discontinued operations.

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

**Table of Contents**

**MORGAN STANLEY**

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

Intercompany balances and transactions have been eliminated.

In the quarter ended March 31, 2013, the Company renamed Principal transactions Trading revenues as Trading revenues and Principal transactions Investments revenues as Investments revenues in the condensed consolidated statements of income, and Financial instruments owned as Trading assets, Financial instruments sold, not yet purchased as Trading liabilities, Receivables as Customer and other receivables Payables as Customer and other payables in the condensed consolidated statements of financial condition.

The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 (the Form 10-K). The condensed consolidated financial statements reflect all adjustments of a normal recurring nature that are, in the opinion of management, necessary for the fair presentation of the results for the interim period. The results of operations for interim periods are not necessarily indicative of results for the entire year.

**Consolidation.** The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest, including certain variable interest entities (VIE) (see Note 7). For consolidated subsidiaries that are less than wholly owned, the third-party holdings of equity interests are referred to as noncontrolling interests. The portion of net income attributable to noncontrolling interests for such subsidiaries is presented as either Net income (loss) applicable to redeemable noncontrolling interests or Net income (loss) applicable to nonredeemable noncontrolling interests in the condensed consolidated statements of income. The portion of the shareholders' equity of such subsidiaries that is redeemable is presented as Redeemable noncontrolling interests outside of the equity section in the condensed consolidated statements of financial condition. The portion of the shareholders' equity of such subsidiaries that is nonredeemable is presented as Nonredeemable noncontrolling interests, a component of total equity, in the condensed consolidated statements of financial condition.

For entities where (1) the total equity investment at risk is sufficient to enable the entity to finance its activities without additional support and (2) the equity holders bear the economic residual risks and returns of the entity and have the power to direct the activities of the entity that most significantly affect its economic performance, the Company consolidates those entities it controls either through a majority voting interest or otherwise. For VIEs (*i.e.*, entities that do not meet these criteria), the Company consolidates those entities where the Company has the power to make the decisions that most significantly affect the economic performance of the VIE and has the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE, except for certain VIEs that are money market funds, investment companies or are entities qualifying for accounting purposes as investment companies. Generally, the Company consolidates those entities when it absorbs a majority of the expected losses or a majority of the expected residual returns, or both, of the entities.

For investments in entities in which the Company does not have a controlling financial interest but has significant influence over operating and financial decisions, the Company generally applies the equity method of accounting with net gains and losses recorded within Other revenues. Where the Company has elected to measure certain eligible investments at fair value in accordance with the fair value option, net gains and losses are recorded within Investments revenues (see Note 4).

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

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



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**Table of Contents**

**MORGAN STANLEY**

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

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

**2. Significant Accounting Policies.**

For a detailed discussion about the Company's significant accounting policies, see Note 2 to the consolidated financial statements for the year ended December 31, 2012 included in the Form 10-K.

During the nine months ended September 30, 2013, no updates were made to the Company's significant accounting policies.

**Condensed Consolidated Statements of Cash Flows.**

For purposes of the condensed consolidated statements of cash flows, cash and cash equivalents consist of Cash and due from banks and Interest bearing deposits with banks, which are highly liquid investments with original maturities of three months or less, held for investment purposes, and readily convertible to known amounts of cash.

In the nine months ended September 30, 2012, the Company's significant non-cash activities included approximately \$1.1 billion of net assets received from Citigroup, Inc. (Citi) related to Citi's required equity contribution in connection with the Morgan Stanley Smith Barney Holdings LLC (Wealth Management JV) platform integration (see Notes 3 and 14).

**Accounting Developments.**

***Disclosures about Offsetting Assets and Liabilities.*** In January 2013, the Financial Accounting Standards Board (the FASB) issued an accounting update that clarified the intended scope of the new balance sheet offsetting disclosures to derivatives, repurchase agreements, and securities lending transactions to the extent that they are either offset in the financial statements or subject to an enforceable master netting arrangement or similar agreement. These disclosure requirements became effective for the Company beginning on January 1, 2013. Since these amended principles require only additional disclosures concerning offsetting and related arrangements, adoption has not affected the Company's condensed consolidated statements of income or financial condition (see Notes 6 and 11).

***Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income.*** In February 2013, the FASB issued an accounting update that created new disclosure requirements requiring entities to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. generally accepted accounting principles (GAAP) to be reclassified in its entirety to net income. The disclosure requirements became effective for the Company beginning on January 1, 2013. Since these amended principles require only additional disclosures concerning amounts reclassified out of accumulated other comprehensive income, adoption has not affected the Company's condensed consolidated statements of comprehensive income or notes to the condensed consolidated financial statements (see Note 14).

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

*Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes.* In July 2013, the FASB issued an accounting update that included amendments permitting the Fed Funds Effective Swap Rate to be used as a U.S. benchmark interest rate for hedge accounting purposes, in addition to interest rates on direct Treasury obligations of the U.S. government and the London Interbank Offered Rate ( LIBOR ). The amendments also removed the restriction on using different benchmark rates for similar hedges. The amendments became effective for the Company for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of this accounting guidance did not have a material impact on the Company's condensed consolidated financial statements.

**3. Morgan Stanley Smith Barney Holdings LLC.**

On May 31, 2009, the Company and Citi consummated the combination of each institution's respective wealth management business. The combined businesses operated as the Wealth Management JV through June 2013.

Prior to September 2012, the Company owned 51% and Citi owned 49% of the Wealth Management JV. On September 17, 2012, the Company purchased an additional 14% stake in the Wealth Management JV from Citi for \$1.89 billion, increasing the Company's interest from 51% to 65%. In addition, in September 2012, the terms of the Wealth Management JV agreement regarding the purchase of the remaining 35% interest were amended, which resulted in a reclassification of approximately \$4.3 billion from nonredeemable noncontrolling interests to redeemable noncontrolling interests during the third quarter of 2012. Prior to September 17, 2012, Citi's results related to its 49% interest were reported in net income (loss) applicable to nonredeemable noncontrolling interests in the condensed consolidated statements of income. Subsequent to the purchase of the additional 14% stake, Citi's results related to its 35% interest were reported in net income (loss) applicable to redeemable noncontrolling interests in the condensed consolidated statements of income. In connection with the Company's acquisition of the additional 14% stake in the Wealth Management JV and pursuant to an amended deposit sweep agreement between Citi and the Company, in October 2012 \$5.4 billion of deposits held by Citi relating to customer accounts were transferred to the Company's depository institutions at no premium based on a valuation agreement reached between Citi and the Company, and as such were no longer swept to Citi.

In June 2013, the Company received final regulatory approval to acquire the remaining 35% stake in the Wealth Management JV. On June 28, 2013, the Company purchased the remaining 35% interest for \$4.725 billion, increasing the Company's interest from 65% to 100%. The Company recorded a negative adjustment to retained earnings of approximately \$151 million (net of tax) to reflect the difference between the purchase price for the 35% interest in the Wealth Management JV and its carrying value. This adjustment negatively impacted the calculation of basic and diluted earnings per share for the nine months ended September 30, 2013 (see Note 15).

Additionally, in conjunction with the purchase of the remaining 35% interest, in June 2013 the Company redeemed all of the Class A Preferred Interests in the Wealth Management JV owned by Citi and its affiliates for approximately \$2.028 billion and repaid to Citi \$880 million in senior debt.

Concurrent with the acquisition of the remaining 35% stake in the Wealth Management JV, the deposit sweep agreement between Citi and the Company was terminated. During the quarter ended September 30, 2013, approximately \$21 billion of deposits held by Citi relating to customer accounts were transferred to the Company's depository institutions. At September 30, 2013, approximately \$35 billion of deposits will be transferred to the Company's depository institutions on an agreed upon basis through June 2015 (see Note 22).

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**Table of Contents**

**MORGAN STANLEY**

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

**4. Fair Value Disclosures.**

***Fair Value Measurements.***

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

*Trading Assets and Trading Liabilities.*

*U.S. Government and Agency Securities.*

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

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

*Other Sovereign Government Obligations.*

Foreign sovereign government obligations are valued using quoted prices in active markets when available. These bonds are generally categorized in Level 1 of the fair value hierarchy. If the market is less active or prices are dispersed, these bonds are categorized in Level 2 of the fair value hierarchy.

*Corporate and Other Debt.*

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

Residential Mortgage-Backed Securities ( RMBS ), Commercial Mortgage-Backed Securities ( CMBS ) and other Asset-Backed Securities ( ABS ). RMBS, CMBS and other ABS may be valued based on price or spread data obtained from observed transactions or independent external parties such as vendors or brokers. When position-specific external price data are not observable, the fair value determination may require benchmarking to similar instruments and/or analyzing expected credit losses, default and recovery rates, and/or applying discounted cash flow techniques. In evaluating the fair value of each security, the Company considers security collateral-specific attributes, including payment priority, credit enhancement levels, type of collateral, delinquency rates and loss severity. In addition, for RMBS borrowers, Fair Isaac Corporation ( FICO ) scores and the level of documentation for the loan are also

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considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category. Valuation levels of RMBS and CMBS indices are also used as an additional data point for benchmarking purposes or to price outright index positions.

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

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

Corporate Bonds. The fair value of corporate bonds is determined using recently executed transactions, market price quotations (where observable), bond spreads, credit default swap spreads, at the money volatility and/or volatility skew obtained from independent external parties such as vendors and brokers adjusted for any basis difference between cash and derivative instruments. The spread data used are for the same maturity as the bond. If the spread data do not reference the issuer, then data that reference a comparable issuer are used. When position-specific external price data are not observable, fair value is determined based on either benchmarking to similar instruments or cash flow models with yield curves, bond or single-name credit default swap spreads and recovery rates as significant inputs. Corporate bonds are generally categorized in Level 2 of the fair value hierarchy; in instances where prices, spreads or any of the other aforementioned key inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

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

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

Mortgage Loans. Mortgage loans are valued using observable prices based on transactional data or third-party pricing for identical or comparable instruments, when available. Where position-specific external prices are not observable, the Company estimates fair value based on benchmarking to prices and rates observed in the primary market for similar loan or borrower types or based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved

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

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

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

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

*Corporate Equities.*

**Exchange-Traded Equity Securities**. Exchange-traded equity securities are generally valued based on quoted prices from the exchange. To the extent these securities are actively traded, valuation adjustments are not applied, and they are categorized in Level 1 of the fair value hierarchy; otherwise, they are categorized in Level 2 or Level 3 of the fair value hierarchy.

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

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

*Derivative and Other Contracts.*

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



**Table of Contents**

**MORGAN STANLEY**

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

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

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

Other derivative products, including complex products that have become illiquid, require more judgment in the implementation of the valuation technique applied due to the complexity of the valuation assumptions and the reduced observability of inputs. This includes certain types of interest rate derivatives with both volatility and correlation exposure and credit derivatives including credit default swaps on certain mortgage-backed or asset-backed securities, basket credit default swaps and CDO-squared positions (a CDO-squared position is a special purpose vehicle that issues interests, or tranches, that are backed by tranches issued by other CDOs) where direct trading activity or quotes are unobservable. These instruments involve significant unobservable inputs and are categorized in Level 3 of the fair value hierarchy.

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

For basket credit default swaps and CDO-squared positions, the correlation input between reference credits is unobservable for each specific swap or position and is benchmarked to standardized proxy baskets for which correlation data are available. The other model inputs such as credit spread, interest rates and recovery rates are observable. In instances where the correlation input is deemed to be significant, these instruments are categorized in Level 3 of the fair value hierarchy; otherwise, these instruments are categorized in Level 2 of the fair value hierarchy.

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

For further information on derivative instruments and hedging activities, see Note 11.



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**Table of Contents**

**MORGAN STANLEY**

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

*Investments.*

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

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

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

*Physical Commodities.*

The Company trades various physical commodities, including crude oil and refined products, natural gas, base and precious metals, and agricultural products. Fair value for physical commodities is determined using observable inputs, including broker quotations and published indices. Physical commodities are categorized in Level 2 of the fair value hierarchy; in instances where significant inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

*Securities Available for Sale.*

Securities available for sale are composed of U.S. government and agency securities (*e.g.*, U.S. Treasury securities, agency-issued debt, agency mortgage pass-through securities and collateralized mortgage obligations), CMBS, Federal Family Education Loan Program (FFELP) student loan asset-backed securities, auto loan asset-backed securities, corporate bonds and equity securities. Actively traded U.S. Treasury securities, non-callable agency-issued debt securities and equity securities are generally categorized in Level 1 of the fair value hierarchy. Callable agency-issued debt securities, agency mortgage pass-through securities, collateralized mortgage obligations, CMBS, FFELP student loan asset-backed securities, auto loan asset-backed securities and corporate bonds are generally categorized in Level 2 of the fair value hierarchy. For further information on securities available for sale, see Note 5.

*Deposits.*

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

*Commercial Paper and Other Short-Term Borrowings/Long-Term Borrowings.*

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Structured Notes. The Company issues structured notes that have coupon or repayment terms linked to the performance of debt or equity securities, indices, currencies or commodities. Fair value of structured

**Table of Contents**

**MORGAN STANLEY**

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

notes is determined using valuation models for the derivative and debt portions of the notes. These models incorporate observable inputs referencing identical or comparable securities, including prices to which the notes are linked, interest rate yield curves, option volatility and currency, commodity or equity prices. Independent, external and traded prices for the notes are considered as well. The impact of the Company's own credit spreads is also included based on the Company's observed secondary bond market spreads. Most structured notes are categorized in Level 2 of the fair value hierarchy.

*Securities Purchased under Agreements to Resell and Securities Sold under Agreements to Repurchase.*

The fair value of a reverse repurchase agreement or repurchase agreement is computed using a standard cash flow discounting methodology. The inputs to the valuation include contractual cash flows and collateral funding spreads, which are estimated using various benchmarks, interest rate yield curves and option volatilities. In instances where the unobservable inputs are deemed significant, reverse repurchase agreements and repurchase agreements are categorized in Level 3 of the fair value hierarchy; otherwise, they are categorized in Level 2 of the fair value hierarchy.

The following fair value hierarchy tables present information about the Company's assets and liabilities measured at fair value on a recurring basis at September 30, 2013 and December 31, 2012.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2013.**

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) (dollars in millions)	Counterparty and Cash Collateral Netting	Balance at September 30, 2013
<b>Assets at Fair Value</b>					
Trading assets:					
U.S. government and agency securities:					
U.S. Treasury securities	\$ 38,453	\$ 8	\$	\$	\$ 38,461
U.S. agency securities	2,030	21,381			23,411
Total U.S. government and agency securities	40,483	21,389			61,872
Other sovereign government obligations	24,605	7,076	2		31,683
Corporate and other debt:					
State and municipal securities		1,580			1,580
Residential mortgage-backed securities		2,525	90		2,615
Commercial mortgage-backed securities		1,343	150		1,493
Asset-backed securities		875	99		974
Corporate bonds		16,862	537		17,399
Collateralized debt obligations		263	1,380		1,643
Loans and lending commitments		9,364	4,098		13,462
Other debt		5,669	21		5,690
Total corporate and other debt		38,481	6,375		44,856
Corporate equities(1)	86,385	1,199	243		87,827
Derivative and other contracts:					
Interest rate contracts	2,129	585,689	2,880		590,698
Credit contracts		46,729	2,942		49,671
Foreign exchange contracts	21	55,992	129		56,142
Equity contracts	1,254	53,406	1,448		56,108
Commodity contracts	2,886	12,197	2,264		17,347
Other		36			36
Netting(2)	(5,321)	(664,134)	(5,657)	(59,452)	(734,564)
Total derivative and other contracts	969	89,915	4,006	(59,452)	35,438
Investments:					
Private equity funds		1	2,449		2,450
Real estate funds		6	1,523		1,529
Hedge funds		373	431		804
Principal investments	29	672	2,338		3,039
Other	187	71	494		752
Total investments	216	1,123	7,235		8,574
Physical commodities		3,408			3,408

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Total trading assets	152,658	162,591	17,861	(59,452)	273,658
Securities available for sale	19,854	27,012			46,866
Securities received as collateral	15,981	61			16,042
Federal funds sold and securities purchased under agreements to resell		868			868
Intangible assets(3)			8		8
Total assets measured at fair value	\$ 188,493	\$ 190,532	\$ 17,869	\$ (59,452)	\$ 337,442

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

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at September 30, 2013
(dollars in millions)					
<b>Liabilities at Fair Value</b>					
Deposits	\$	\$ 1,411	\$	\$	\$ 1,411
Commercial paper and other short-term borrowings		1,620	3		1,623
Trading liabilities:					
U.S. government and agency securities:					
U.S. Treasury securities	16,432				16,432
U.S. agency securities	3,041	127			3,168
Total U.S. government and agency securities	19,473	127			19,600
Other sovereign government obligations	21,468	2,375			23,843
Corporate and other debt:					
State and municipal securities		32			32
Residential mortgage-backed securities			4		4
Commercial mortgage-backed securities		4			4
Corporate bonds		8,191	5		8,196
Collateralized debt obligations		6			6
Unfunded lending commitments		154	4		158
Other debt		277	9		286
Total corporate and other debt		8,664	22		8,686
Corporate equities(1)	31,842	496	10		32,348
Derivative and other contracts:					
Interest rate contracts	2,527	560,796	2,570		565,893
Credit contracts		45,344	2,232		47,576
Foreign exchange contracts	9	56,668	164		56,841
Equity contracts	893	59,261	3,079		63,233
Commodity contracts	3,236	12,505	1,409		17,150
Other		203	1		204
Netting(2)	(5,321)	(664,134)	(5,657)	(37,617)	(712,729)
Total derivative and other contracts	1,344	70,643	3,798	(37,617)	38,168
Total trading liabilities	74,127	82,305	3,830	(37,617)	122,645
Obligation to return securities received as collateral	20,829	70			20,899
Securities sold under agreements to repurchase		404	150		554
Other secured financings		5,885	260		6,145
Long-term borrowings		34,406	2,313		36,719
Total liabilities measured at fair value	\$ 94,956	\$ 126,101	\$ 6,556	\$ (37,617)	\$ 189,996

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- (1) The Company holds or sells short for trading purposes equity securities issued by entities in diverse industries and of varying size.
- (2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 11.
- (3) Amount represents mortgage servicing rights ( MSR ) accounted for at fair value. See Note 7 for further information on MSRs.

### **Transfers Between Level 1 and Level 2 During the Quarter and Nine Months Ended September 30, 2013.**

For assets and liabilities that were transferred between Level 1 and Level 2 during the period, fair values are ascribed as if the assets or liabilities had been transferred as of the beginning of the period.

In the quarter and nine months ended September 30, 2013, there were no material transfers between Level 1 and Level 2.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Assets and Liabilities Measured at Fair Value on a Recurring Basis at December 31, 2012.**

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at December 31, 2012
	(dollars in millions)				
<b>Assets at Fair Value</b>					
Trading assets:					
U.S. government and agency securities:					
U.S. Treasury securities	\$ 24,662	\$ 14	\$	\$	\$ 24,676
U.S. agency securities	1,451	27,888			29,339
Total U.S. government and agency securities	26,113	27,902			54,015
Other sovereign government obligations	37,669	5,487	6		43,162
Corporate and other debt:					
State and municipal securities		1,558			1,558
Residential mortgage-backed securities		1,439	45		1,484
Commercial mortgage-backed securities		1,347	232		1,579
Asset-backed securities		915	109		1,024
Corporate bonds		18,403	660		19,063
Collateralized debt obligations		685	1,951		2,636
Loans and lending commitments		12,617	4,694		17,311
Other debt		4,457	45		4,502
Total corporate and other debt		41,421	7,736		49,157
Corporate equities(1)	68,072	1,067	288		69,427
Derivative and other contracts:					
Interest rate contracts	446	819,581	3,774		823,801
Credit contracts		63,234	5,033		68,267
Foreign exchange contracts	34	52,729	31		52,794
Equity contracts	760	37,074	766		38,600
Commodity contracts	4,082	14,256	2,308		20,646
Other		143			143
Netting(2)	(4,740)	(883,733)	(6,947)	(72,634)	(968,054)
Total derivative and other contracts	582	103,284	4,965	(72,634)	36,197
Investments:					
Private equity funds			2,179		2,179
Real estate funds		6	1,370		1,376
Hedge funds		382	552		934
Principal investments	185	83	2,833		3,101
Other	199	71	486		756
Total investments	384	542	7,420		8,346
Physical commodities		7,299			7,299
Total trading assets	132,820	187,002	20,415	(72,634)	267,603
Securities available for sale	14,466	25,403			39,869



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Securities received as collateral	14,232	46			14,278
Federal funds sold and securities purchased under agreements to resell		621			621
Intangible assets(3)			7		7
Total assets measured at fair value	\$ 161,518	\$ 213,072	\$ 20,422	\$ (72,634)	\$ 322,378

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

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at December 31, 2012
(dollars in millions)					
<b>Liabilities at Fair Value</b>					
Deposits	\$	\$ 1,485	\$	\$	\$ 1,485
Commercial paper and other short-term borrowings		706	19		725
Trading liabilities:					
U.S. government and agency securities:					
U.S. Treasury securities	20,098	21			20,119
U.S. agency securities	1,394	107			1,501
Total U.S. government and agency securities	21,492	128			21,620
Other sovereign government obligations	27,583	2,031			29,614
Corporate and other debt:					
State and municipal securities		47			47
Residential mortgage-backed securities			4		4
Corporate bonds		3,942	177		4,119
Collateralized debt obligations		328			328
Unfunded lending commitments		305	46		351
Other debt		156	49		205
Total corporate and other debt		4,778	276		5,054
Corporate equities(1)	25,216	1,655	5		26,876
Derivative and other contracts:					
Interest rate contracts	533	789,715	3,856		794,104
Credit contracts		61,283	3,211		64,494
Foreign exchange contracts	2	56,021	390		56,413
Equity contracts	748	39,212	1,910		41,870
Commodity contracts	4,530	15,702	1,599		21,831
Other		54	7		61
Netting(2)	(4,740)	(883,733)	(6,947)	(46,395)	(941,815)
Total derivative and other contracts	1,073	78,254	4,026	(46,395)	36,958
Total trading liabilities	75,364	86,846	4,307	(46,395)	120,122
Obligation to return securities received as collateral	18,179	47			18,226
Securities sold under agreements to repurchase		212	151		363
Other secured financings		9,060	406		9,466
Long-term borrowings		41,255	2,789		44,044
Total liabilities measured at fair value	\$ 93,543	\$ 139,611	\$ 7,672	\$ (46,395)	\$ 194,431

(1) The Company holds or sells short for trading purposes equity securities issued by entities in diverse industries and of varying size.

(2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions

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classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 11.

(3) Amount represents MSRs accounted for at fair value. See Note 7 for further information on MSRs.

### **Transfers Between Level 1 and Level 2 During the Quarter Ended September 30, 2012.**

*Trading assets Derivative and other contracts and Trading liabilities Derivative and other contracts.* During the quarter ended September 30, 2012, the Company reclassified approximately \$1.2 billion of derivative assets and approximately \$1.5 billion of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange. Also during the quarter ended September 30, 2012, the Company reclassified approximately \$0.5 billion of derivative assets and approximately \$0.5 billion of derivative liabilities from Level 1 to Level 2 as transactions in these contracts did not occur with sufficient frequency and volume to constitute an active market.

**Table of Contents**

**MORGAN STANLEY**

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

**Transfers Between Level 1 and Level 2 During the Nine Months Ended September 30, 2012.**

*Trading assets Derivative and other contracts and Trading liabilities Derivative and other contracts.* During the nine months ended September 30, 2012, the Company reclassified approximately \$2.7 billion of derivative assets and approximately \$2.6 billion of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange. Also during the nine months ended September 30, 2012, the Company reclassified approximately \$0.3 billion of derivative assets and approximately \$0.3 billion of derivative liabilities from Level 1 to Level 2 as transactions in these contracts did not occur with sufficient frequency and volume to constitute an active market.

**Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis.**

The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the quarters and nine months ended September 30, 2013 and 2012, respectively. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realized and unrealized gains (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realized and unrealized gains (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 (losses) during the period for assets and liabilities within the Level 3 category presented in the tables below may include changes in fair value during the period that were attributable to both observable (*e.g.*, changes in market interest rates) and unobservable (*e.g.*, changes in unobservable long-dated volatilities) inputs.

For assets and liabilities that were transferred into Level 3 during the period, gains (losses) are presented as if the assets or liabilities had been transferred into Level 3 at the beginning of the period; similarly, for assets and liabilities that were transferred out of Level 3 during the period, gains (losses) are presented as if the assets or liabilities had been transferred out at the beginning of the period.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Quarter Ended September 30, 2013.**

	Beginning Balance at June 30, 2013	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at September 30, 2013	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2013(2)
<b>Assets at Fair Value</b>									
Trading assets:									
Other sovereign government obligations	\$ 4	\$	\$ 2	(4)	\$	\$	\$	\$ 2	\$
Corporate and other debt:									
Residential mortgage-backed securities	19	(2)	72	(3)			4	90	(3)
Commercial mortgage-backed securities	181	(2)	39	(61)			(7)	150	5
Asset-backed securities	108		13	(23)			1	99	
Corporate bonds	509	43	76	(79)			(12)	537	36
Collateralized debt obligations	1,333	60	269	(206)		(55)	(21)	1,380	28
Loans and lending commitments	5,243	(72)	530	(112)		(1,279)	(212)	4,098	(111)
Other debt	12		14	(5)				21	
Total corporate and other debt	7,405	27	1,013	(489)		(1,334)	(247)	6,375	(45)
Corporate equities	256	(25)	38	(20)			(6)	243	(3)
Net derivative and other contracts(3):									
Interest rate contracts	16	262	4		(72)	11	89	310	111
Credit contracts	685	(259)	41		(46)	(146)	435	710	(448)
Foreign exchange contracts	(96)	6				61	(6)	(35)	6
Equity contracts	(1,284)	(309)	102		(190)	39	11	(1,631)	(429)
Commodity contracts	781	45	4		(1)	23	3	855	73
Other	(6)					5		(1)	(2)
Total net derivative and other contracts	96	(255)	151		(309)	(7)	532	208	(689)
Investments:									
Private equity funds	2,286	213	24	(74)				2,449	163
Real estate funds	1,422	159	18	(76)				1,523	196
Hedge funds	407	5	7	(17)			29	431	5
Principal investments	2,822	84	10	(125)			(453)	2,338	71
Other	385	16	3				90	494	16
Total investments	7,322	477	62	(292)			(334)	7,235	451
Intangible assets	9					(1)		8	
<b>Liabilities at Fair Value</b>									
	\$	\$	\$	\$	\$	\$	\$ 3	\$ 3	\$

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Commercial paper and other short-term borrowings								
Trading liabilities:								
Corporate and other debt:								
Residential mortgage-backed securities	4						4	
Corporate bonds	42	(15)	(64)	26		(14)	5	(17)
Unfunded lending commitments	8	4					4	4
Other debt	11	1	(1)				9	
Total corporate and other debt	65	(10)	(65)	26		(14)	22	(13)
Corporate equities	16	(5)	(19)	8			10	(9)
Securities sold under agreements to repurchase	148	(2)					150	(2)
Other secured financings	256	(5)				(1)	260	(5)
Long-term borrowings	2,705	(98)			188	(344)	(334)	2,313
								(89)

- (1) Total realized and unrealized gains (losses) are primarily included in Trading revenues in the condensed consolidated statements of income except for \$477 million related to Trading assets Investments, which is included in Investments revenues.
- (2) Amounts represent unrealized gains (losses) for the quarter ended September 30, 2013 related to assets and liabilities still outstanding at September 30, 2013.

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

(3) Net derivative and other contracts represent Trading assets Derivative and other contracts net of Trading liabilities Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 11.

**Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Nine Months Ended September 30, 2013.**

	Beginning Balance at December 31, 2012	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at September 30, 2013	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2013(2)
<b>Assets at Fair Value</b>									
Trading assets:									
Other sovereign government obligations	\$ 6	\$	\$ 3	\$ (8)	\$	\$	\$ 1	\$ 2	\$
Corporate and other debt:									
Residential mortgage-backed securities	45	29	85	(45)			(24)	90	8
Commercial mortgage-backed securities	232	6	78	(166)				150	7
Asset-backed securities	109	1	4	(15)				99	
Corporate bonds	660	64	327	(462)		(12)	(40)	537	15
Collateralized debt obligations	1,951	276	612	(1,405)		(53)	(1)	1,380	118
Loans and lending commitments	4,694	(308)	1,607	(316)		(1,838)	259	4,098	(306)
Other debt	45	(3)	15	(36)				21	1
Total corporate and other debt	7,736	65	2,728	(2,445)		(1,903)	194	6,375	(157)
Corporate equities	288	(36)	142	(164)			13	243	(4)
Net derivative and other contracts(3):									
Interest rate contracts	(82)	237	10		(86)	185	46	310	157
Credit contracts	1,822	(1,133)	184		(278)	(369)	484	710	(1,187)
Foreign exchange contracts	(359)	117				215	(8)	(35)	106
Equity contracts	(1,144)	(293)	123	(1)	(232)	(156)	72	(1,631)	(369)
Commodity contracts	709	90	40		(19)	36	(1)	855	124
Other	(7)	(4)				10		(1)	(6)
Total net derivative and other contracts	939	(986)	357	(1)	(615)	(79)	593	208	(1,175)
Investments:									
Private equity funds	2,179	432	96	(258)				2,449	409
Real estate funds	1,370	287	61	(195)				1,523	402
Hedge funds	552	5	46	(154)			(18)	431	6
Principal investments	2,833	96	106	(286)			(411)	2,338	63
Other	486	36	3	(30)			(1)	494	37

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Total investments	7,420	856	312	(923)	(430)	7,235	917
Intangible assets	7	7			(6)	8	3



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

	Beginning Balance at December 31, 2012	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at September 30, 2013	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2013(2)
<b>Liabilities at Fair Value</b>									
Commercial paper and other short-term borrowings	\$ 19	\$	\$	\$	\$	\$ (1)	\$ (15)	\$ 3	\$
Trading liabilities:									
Corporate and other debt:									
Residential mortgage-backed securities	4							4	
Corporate bonds	177	(5)	(154)	76			(99)	5	(5)
Unfunded lending commitments	46	42						4	42
Other debt	49	13	(31)	2			2	9	6
<b>Total corporate and other debt</b>	<b>276</b>	<b>50</b>	<b>(185)</b>	<b>78</b>			<b>(97)</b>	<b>22</b>	<b>43</b>
Corporate equities	5	(1)	(19)	24			(1)	10	(10)
Securities sold under									
agreements to repurchase	151	1						150	1
Other secured financings	406	23			13	(136)		260	16
Long-term borrowings	2,789	(87)			875	(468)	(970)	2,313	(89)

- (1) Total realized and unrealized gains (losses) are primarily included in Trading revenues in the condensed consolidated statements of income except for \$856 million related to Trading assets Investments, which is included in Investments revenues.
- (2) Amounts represent unrealized gains (losses) for the nine months ended September 30, 2013 related to assets and liabilities still outstanding at September 30, 2013.
- (3) Net derivative and other contracts represent Trading assets Derivative and other contracts net of Trading liabilities Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 11.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for Quarter Ended September 30, 2012.**

	Beginning Balance at June 30, 2012	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at September 30, 2012	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2012(2)
<b>Assets at Fair Value</b>									
Trading assets:									
Other sovereign government obligations	\$ 1	\$	\$ 1	\$	\$	\$	\$ 1	\$ 3	\$
Corporate and other debt:									
State and municipal securities	3	1		(2)				2	
Residential mortgage-backed securities	24	1	1	(4)			(2)	20	(1)
Commercial mortgage-backed securities	256	13	7	(54)		(99)	3	126	8
Asset-backed securities	9	1						10	1
Corporate bonds	745	50	86	(157)			33	757	51
Collateralized debt obligations	1,457	92	569	(200)			113	2,031	127
Loans and lending commitments	7,794	183	1,098	(366)		(674)	(210)	7,825	148
Other debt	13		12	(2)			(12)	11	
<b>Total corporate and other debt</b>	<b>10,301</b>	<b>341</b>	<b>1,773</b>	<b>(785)</b>		<b>(773)</b>	<b>(75)</b>	<b>10,782</b>	<b>334</b>
Corporate equities	482	9	48	(95)			(73)	371	9
Net derivative and other contracts(3):									
Interest rate contracts	(172)	(282)	5		(10)	187	173	(99)	(76)
Credit contracts	3,842	(791)	22		(17)	(266)	(167)	2,623	(870)
Foreign exchange contracts	(224)	(101)				(12)	(74)	(411)	(102)
Equity contracts	(1,173)	(2)	126	(12)	(57)	32	(249)	(1,335)	(8)
Commodity contracts	937	(84)	11		(3)	(5)	(88)	768	(28)
Other	(27)					6	18	(3)	
<b>Total net derivative and other contracts</b>	<b>3,183</b>	<b>(1,260)</b>	<b>164</b>	<b>(12)</b>	<b>(87)</b>	<b>(58)</b>	<b>(387)</b>	<b>1,543</b>	<b>(1,084)</b>
Investments:									
Private equity funds	2,005	162	127	(48)				2,246	153
Real estate funds	1,326	44	20	(36)				1,354	30
Hedge funds	533	19	42	(46)			16	564	14
Principal investments	3,047	1	33	(50)			(5)	3,026	3
Other	543	4	11	(9)			(73)	476	5
<b>Total investments</b>	<b>7,454</b>	<b>230</b>	<b>233</b>	<b>(189)</b>			<b>(62)</b>	<b>7,666</b>	<b>205</b>
Securities received as collateral							4	4	
Intangible assets	8					(2)		6	



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

	Beginning Balance at June 30, 2012	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at September 30, 2012	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2012(2)
<b>Liabilities at Fair Value</b>									
Commercial paper and other short-term borrowings	\$ 2	\$	\$	\$	\$	\$	\$ 12	\$ 14	\$
Trading liabilities:									
Corporate and other debt:									
Residential mortgage-backed securities	4							4	
Corporate bonds	127	(26)	(116)	56			(2)	91	(45)
Collateralized debt obligations	1			1			(1)	1	
Unfunded lending commitments	51	(11)						62	(11)
Other debt	63	2	(6)					55	2
Total corporate and other debt	246	(35)	(122)	57			(3)	213	(54)
Corporate equities	47	26	(21)				12	12	(3)
Obligation to return securities received as collateral							20	20	
Securities sold under agreements to repurchase	185	(13)						198	(13)
Other secured financings	470	(22)				(76)		416	(22)
Long-term borrowings	2,210	(215)			259	(223)	(7)	2,454	(231)

- (1) Total realized and unrealized gains (losses) are primarily included in Trading revenues in the condensed consolidated statements of income except for \$230 million related to Trading assets Investments, which is included in Investments revenues.
- (2) Amounts represent unrealized gains (losses) for the quarter ended September 30, 2012 related to assets and liabilities still outstanding at September 30, 2012.
- (3) Net derivative and other contracts represent Trading assets Derivative and other contracts net of Trading liabilities Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 11.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Nine Months Ended September 30, 2012.**

	Beginning Balance at December 31, 2011	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at September 30, 2012	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2012(2)
<b>Assets at Fair Value</b>									
Trading assets:									
U.S. agency securities	\$ 8	\$	\$	\$ (7)	\$	\$	\$ (1)	\$	\$
Other sovereign government obligations	119		2	(118)				3	
Corporate and other debt:									
State and municipal securities		2		(3)			3	2	
Residential mortgage-backed securities	494	(24)	4	(267)			(187)	20	(36)
Commercial mortgage-backed securities	134	36	123	(65)		(100)	(2)	126	28
Asset-backed securities	31	1	9	(31)				10	
Corporate bonds	675	8	367	(314)			21	757	(1)
Collateralized debt obligations	980	193	1,215	(321)			(36)	2,031	147
Loans and lending commitments	9,590	54	2,592	(2,205)		(2,019)	(187)	7,825	(144)
Other debt	128	15	8	(140)				11	9
Total corporate and other debt	12,032	285	4,318	(3,346)		(2,119)	(388)	10,782	3
Corporate equities	417	(2)	153	(184)			(13)	371	3
Net derivative and other contracts(3):									
Interest rate contracts	420	(338)	98		(15)	7	(271)	(99)	(85)
Credit contracts	5,814	(1,733)	46		(421)	(533)	(550)	2,623	(2,048)
Foreign exchange contracts	43	(163)				(142)	(149)	(411)	(221)
Equity contracts	(1,234)	156	272	(5)	(122)	(205)	(197)	(1,335)	143
Commodity contracts	570	152	17		(8)	29	8	768	145
Other	(1,090)	59				238	790	(3)	56
Total net derivative and other contracts	4,523	(1,867)	433	(5)	(566)	(606)	(369)	1,543	(2,010)
Investments:									
Private equity funds	1,936	176	271	(138)			1	2,246	134
Real estate funds	1,213	107	137	(104)			1	1,354	179
Hedge funds	696	26	61	(135)			(84)	564	19
Principal investments	2,937	25	267	(199)			(4)	3,026	(6)
Other	501	(16)	40	(10)			(39)	476	(15)

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Total investments	7,283	318	776	(586)	(125)	7,666	311
Physical commodities	46				(46)		
Securities received as collateral						4	4
Intangible assets	133	(40)		(83)	(4)	6	(6)

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

	Total						Ending		Unrealized	
	Beginning	Realized	Unrealized		Sales	Issuances	Settlements	Net	Level 3	
	Balance	and	Gains					Transfers	Assets/	
	at	Unrealized	at					September 30,	Liabilities	
	December 31,	at	December 31,					September 30,	Outstanding at	
	2011	(Losses)	(1)	Purchases				2012	September 30,	
									2012(2)	
	(dollars in millions)									
<b>Liabilities at Fair Value</b>										
Commercial paper and other short-term borrowings	\$ 2	\$ (2)	\$	\$	\$	\$	(2)	\$ 12	\$ 14	\$ (1)
Trading liabilities:										
Other sovereign government obligations	8			(8)						
Corporate and other debt:										
Residential mortgage-backed securities	355	(4)	(355)						4	(4)
Corporate bonds	219	(44)	(254)	119			(37)	91	(53)	
Collateralized debt obligations				1					1	
Unfunded lending commitments	85	23						62	23	
Other debt	73	3		40			(55)	55	5	
Total corporate and other debt	732	(22)	(609)	160			(55)	(37)	213	(29)
Corporate equities	1	2	(22)	15				20	12	(2)
Obligation to return securities received as collateral								20	20	
Securities sold under agreements to repurchase	340	(10)					(152)		198	(10)
Other secured financings	570	(33)			55	(220)	(22)		416	(33)
Long-term borrowings	1,603	(444)			585	(181)	3		2,454	(429)

- (1) Total realized and unrealized gains (losses) are primarily included in Trading revenues in the condensed consolidated statements of income except for \$318 million related to Trading assets Investments, which is included in Investments revenues.
- (2) Amounts represent unrealized gains (losses) for the nine months ended September 30, 2012 related to assets and liabilities still outstanding at September 30, 2012.
- (3) Net derivative and other contracts represent Trading assets Derivative and other contracts net of Trading liabilities Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 11.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Quantitative Information about and Sensitivity of Significant Unobservable Inputs Used in Recurring Level 3 Fair Value Measurements at September 30, 2013 and December 31, 2012.**

The disclosures below provide information on the valuation techniques, significant unobservable inputs and their ranges and averages for each major category of assets and liabilities measured at fair value on a recurring basis with a significant Level 3 balance. The level of aggregation and breadth of products cause the range of inputs to be wide and not evenly distributed across the inventory. Further, the range of unobservable inputs may differ across firms in the financial services industry because of diversity in the types of products included in each firm's inventory. The following disclosures also include qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs.

At September 30, 2013.

	Balance at September 30, 2013 (dollars in millions)	Valuation Technique(s)	Significant Unobservable Input(s) / Sensitivity of the Fair Value to Changes in the Unobservable Inputs	Range(1)	Averages(2)
<b>Assets</b>					
Trading assets:					
Corporate and other debt:					
Residential mortgage-backed securities					
	\$ 90	Comparable pricing	Comparable bond price /(A)	40 to 100 points	89 points
Commercial mortgage-backed securities					
	150	Comparable pricing	Comparable bond price / (A)	40 to 96 points	72 points
Asset-backed securities					
	99	Discounted cash flow	Discount rate / (C)	32%	32%
Corporate bonds					
	537	Comparable pricing	Comparable bond price /(A)	2 to 151 points	68 points
Collateralized debt obligations					
	1,380	Comparable pricing(6) Correlation model	Comparable bond price /(A) Credit correlation / (B)	18 to 97 points 28 to 50%	68 points 45%
Loans and lending commitments					
	4,098	Corporate loan model	Credit spread / (C)	42 to 905 basis points	268 basis points
		Margin loan model	Credit spread / (C)(D) Volatility skew / (C)(D)	16 to 300 basis points -2%	197 basis points -2%
		Option model	Comparable bond price /(A)(D) At the money volatility /(A)	80 to 120 points 31%	100 points 31%
		Comparable pricing(6)	Comparable loan price /(A)	0 to 158 points	76 points
Corporate equities(3)					
	243	Net asset value(6)	Discount to net asset value /(C)	0 to 93%	49%
		Comparable pricing	Comparable equity price /(A)	0 to 100%	50%
		Comparable pricing	Comparable price / (A)	0 to 100 points	44 points
		Market approach	EBITDA multiple / (A)	5 to 9 times	7 times
Net derivative and other contracts:					
Interest rate contracts					
	310	Option model	Interest rate volatility concentration liquidity multiple / (C)(D)	0 to 7 times	2 times



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			Comparable bond price / (A)(D)	5 to 99 points	52 points / 52 points(4)
			Interest rate - Foreign exchange correlation / (A)(D)	2 to 63%	37% /44%(4)
			Interest rate volatility skew / (A)(D)	24 to 51%	43% /35%(4)
			Interest rate quanto correlation /(A)(D)	-22 to 33%	-4% /-17%(4)
			Interest rate curve correlation /(A)(D)	35 to 92%	72% /79%(4)
			Inflation volatility / (A)(D)	77 to 83%	80% /79%(4)
Credit contracts	710	Comparable pricing	Cash synthetic basis / (C)(D)	2 to 5 points	4 points
			Comparable bond price / (C)(D)	0 to 80 points	24 points
		Correlation model(6)	Credit correlation / (B)	27 to 91%	52%
Foreign exchange contracts(5)	(35)	Option model	Comparable bond price / (A)(D)	5 to 99 points	52 points / 52 points(4)
			Interest rate quanto correlation /(A)(D)	-22 to 33%	-4% /-17%(4)
			Interest rate curve correlation /(A)(D)	35 to 92%	72% /79%(4)
			Interest rate - Foreign exchange correlation /(A)(D)	2 to 63%	37% /44%(4)
			Interest rate volatility skew / (A)(D)	24 to 51%	43% /35%(4)
			Interest rate curve / (A)(D)	1%	1% / 1%(4)

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

	<b>Balance at September 30, 2013 (dollars in millions)</b>	<b>Valuation Technique(s)</b>	<b>Significant Unobservable Input(s) / Sensitivity of the Fair Value to Changes in the Unobservable Inputs</b>	<b>Range(1)</b>	<b>Averages(2)</b>
Equity contracts(5)	(1,631)	Option model	At the money volatility / (A)(D)	18 to 44%	31%
			Volatility skew / (C)(D)	-2 to 0%	-1%
			Equity - Equity correlation / (C)(D)	40 to 99%	71%
			Equity - Foreign exchange correlation / (C)(D)	-50 to -11%	-22%
			Equity - Interest rate correlation / (C)(D)	3 to 70%	40%/36%(4)
Commodity contracts	855	Option model	Forward power price / (C)(D)	\$10 to \$108 per Megawatt hour	\$38 per Megawatt hour
			Commodity volatility / (A)(D)	11 to 28%	13%
			Cross commodity correlation / (C)(D)	43 to 98%	97%
<b>Investments(3):</b>					
Principal investments	2,338	Discounted cash flow	Implied weighted average cost of capital / (C)(D)	9 to 12%	11%
			Exit multiple / (A)(D)	7 to 9 times	8 times
		Discounted cash flow(6)	Capitalization rate / (C)(D)	6 to 11%	7%
			Equity discount rate / (C)(D)	10 to 30%	22%
		Market approach	EBITDA multiple / (A)	4 to 16 times	9 times
Other	494	Discounted cash flow	Implied weighted average cost of capital / (C)(D)	10%	10%
			Exit multiple / (A)(D)	7 times	7 times
		Market approach(6)	EBITDA multiple / (A)	8 to 9 times	9 times
<b>Liabilities</b>					
<b>Trading liabilities:</b>					
Securities sold under agreements to repurchase	\$ 150	Discounted cash flow	Funding spread / (A)	134 to 136 basis points	135 basis points
Other secured financings	260	Comparable pricing(6)	Comparable bond price / (A)	99 to 102 points	99 points
		Discounted cash flow	Funding spread / (A)	136 basis points	136 basis points
Long-term borrowings	2,313	Option model	At the money volatility / (A)(D)	22 to 33%	27%
			Volatility skew / (A)(D)	-1 to 0%	0%
			Equity - Equity correlation / (A)(D)	50 to 97%	68%
			Equity - Foreign exchange correlation / (A)(D)	-70 to 17%	-17%

EBITDA - Earnings before interest, taxes, depreciation and amortization

- (1) The ranges of significant unobservable inputs are represented in points, percentages, basis points, times or megawatt hours. Points are a percentage of par; for example, 96 points would be 96% of par. A basis point equals 1/100th of 1%; for example, 905 basis points would equal 9.05%.
- (2) Amounts represent weighted averages except where simple averages and the median of the inputs are provided (see footnote 4 below). Weighted averages are calculated by weighting each input by the fair value of the respective financial instruments except for long-term borrowings and derivative instruments where inputs are weighted by risk.
- (3) Investments in funds measured using an unadjusted NAV are excluded.
- (4) The data structure of the significant unobservable inputs used in valuing Interest rate contracts, Foreign exchange contracts and certain Equity contracts may be in a multi-dimensional form, such as a curve or surface, with risk distributed across the structure. Therefore, a simple average and median, together with the range of data inputs, may be more appropriate measurements than a single point weighted average.
- (5) Includes derivative contracts with multiple risks (*i.e.*, hybrid products).
- (6) This is the predominant valuation technique for this major asset or liability class.



**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Sensitivity of the fair value to changes in the unobservable inputs:**

- (A) Significant increase (decrease) in the unobservable input in isolation would result in a significantly higher (lower) fair value measurement.  
 (B) Significant changes in credit correlation may result in a significantly higher or lower fair value measurement. Increasing (decreasing) correlation drives a redistribution of risk within the capital structure such that junior tranches become less (more) risky and senior tranches become more (less) risky.  
 (C) Significant increase (decrease) in the unobservable input in isolation would result in a significantly lower (higher) fair value measurement.  
 (D) There are no predictable relationships between the significant unobservable inputs.

At December 31, 2012.

	Balance at December 31, 2012 (dollars in millions)	Valuation Technique(s)	Significant Unobservable Input(s) / Sensitivity of the Fair Value to Changes in the Unobservable Inputs	Range(1)	Weighted Average
<b>Assets</b>					
Trading assets:					
Corporate and other debt:					
Commercial mortgage-backed securities					
	\$ 232	Comparable pricing	Comparable bond price /(A)	46 to 100 points	76 points
Asset-backed securities	109	Discounted cash flow	Discount rate / (C)	21%	21%
Corporate bonds	660	Comparable pricing	Comparable bond price /(A)	0 to 143 points	24 points
Collateralized debt obligations					
	1,951	Comparable pricing	Comparable bond price /(A)	15 to 88 points	59 points
		Correlation model	Credit correlation / (B)	15 to 45%	40%
Loans and lending commitments					
	4,694	Corporate loan model	Credit spread / (C)	17 to 1,004 basis points	281 basis points
		Comparable pricing	Comparable bond price /(A)	80 to 120 points	104 points
		Comparable pricing	Comparable loan price /(A)	55 to 100 points	88 points
Corporate equities(2)					
	288	Net asset value	Discount to net asset value /(C)	0 to 37%	8%
		Comparable pricing	Discount to comparable equity price /(C)	0 to 27 points	14 points
		Market approach	EBITDA multiple / (A)	6 times	6 times
Net derivative and other contracts:					
Interest rate contracts					
	(82)	Option model	Interest rate volatility concentration liquidity multiple / (C)(D)	0 to 8 times	See (3)
			Comparable bond price / (A)(D)	5 to 98 points	
			Interest rate - Foreign exchange correlation / (A)(D)	2 to 63%	
			Interest rate volatility skew / (A)(D)	9 to 95%	
			Interest rate quanto correlation / (A)(D)	-53 to 33%	
			Interest rate curve correlation / (A)(D)	48 to 99%	
			Inflation volatility / (A)(D)	49 to 100%	

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			Forward commercial paper rate-LIBOR basis / (A)	-18 to 95 basis points	
Credit contracts	1,822	Discounted cash flow Comparable pricing	Cash synthetic basis / (C)	2 to 14 points	See (4)
			Comparable bond price / (C)	0 to 80 points	
		Correlation model	Credit correlation / (B)	14 to 94%	
Foreign exchange contracts(5)	(359)	Option model	Comparable bond price / (A)(D)	5 to 98 points	See (6)
			Interest rate quanto correlation / (A)(D)	-53 to 33%	
			Interest rate - Credit spread correlation / (A)(D)	-59 to 65%	
			Interest rate - Foreign exchange correlation / (A)(D)	2 to 63%	
			Interest rate volatility skew / (A)(D)	9 to 95%	

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

	Balance at December 31, 2012 (dollars in millions)	Valuation Technique(s)	Significant Unobservable Input(s) / Sensitivity of the Fair Value to Changes in the Unobservable Inputs	Range(1)	Weighted Average
Equity contracts(5)	(1,144)	Option model	At the money volatility / (C)(D) Volatility skew / (C)(D) Equity - Equity correlation / (C)(D) Equity - Foreign exchange correlation / (C)(D) Equity - Interest rate correlation / (C)(D)	7 to 24% -2 to 0% 40 to 96% -70 to 38% 18 to 65%	See (7)
Commodity contracts	709	Option model	Forward power price / (C)(D) Commodity volatility / (A)(D) Cross commodity correlation / (C)(D)	\$28 to \$84 per Megawatt hour 17 to 29% 43 to 97%	
Investments(2):					
Principal investments	2,833	Discounted cash flow	Implied weighted average cost of capital / (C)(D) Exit multiple / (A)(D)	8 to 15% 5 to 10 times	9% 9 times
		Discounted cash flow	Capitalization rate / (C)(D) Equity discount rate / (C)(D)	6 to 10% 15 to 35%	7% 23%
		Market approach	EBITDA multiple / (A)	3 to 17 times	10 times
Other	486	Discounted cash flow	Implied weighted average cost of capital / (C)(D) Exit multiple / (A)(D)	11% 6 times	11% 6 times
		Market approach	EBITDA multiple / (A)	6 to 8 times	7 times
<b>Liabilities</b>					
Trading liabilities:					
Corporate and other debt:					
Corporate bonds	\$ 177	Comparable pricing	Comparable bond price / (A)	0 to 150 points	50 points
Securities sold under agreements to repurchase	151	Discounted cash flow	Funding spread / (A)	110 to 184 basis points	166 basis points
Other secured financings	406	Comparable pricing	Comparable bond price / (A)	55 to 139 points	102 points
		Discounted cash flow	Funding spread / (A)	183 to 186 basis points	184 basis points
Long-term borrowings	2,789	Option model	At the money volatility / (A)(D) Volatility skew / (A)(D) Equity - Equity correlation / (A)(D) Equity - Foreign exchange correlation / (A)(D)	20 to 24% -1 to 0% 50 to 90% -70 to 36%	24% 0% 77% -15%

(1) The ranges of significant unobservable inputs are represented in points, percentages, basis points, times or megawatt hours. Points are a percentage of par; for example, 100 points would be 100% of par. A basis point equals 1/100th of 1%; for example, 1,004 basis points would equal 10.04%.

(2) Investments in funds measured using an unadjusted NAV are excluded.

(3) See Note 4 to the consolidated financial statements for the year ended December 31, 2012 included in the Form 10-K for a qualitative discussion of the wide unobservable input ranges for comparable bond prices, interest rate volatility skew, interest rate quanto correlation and forward commercial paper rate-LIBOR basis.

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- (4) See Note 4 to the consolidated financial statements for the year ended December 31, 2012 included in the Form 10-K for a qualitative discussion of the wide unobservable input ranges for comparable bond prices and credit correlation.
- (5) Includes derivative contracts with multiple risks (*i.e.*, hybrid products).
- (6) See Note 4 to the consolidated financial statements for the year ended December 31, 2012 included in the Form 10-K for a qualitative discussion of the wide unobservable input ranges for comparable bond prices, interest rate quanto correlation, interest rate-credit spread correlation and interest rate volatility skew.
- (7) See Note 4 to the consolidated financial statements for the year ended December 31, 2012 included in the Form 10-K for a qualitative discussion of the wide unobservable input range for equity-foreign exchange correlation.

**Table of Contents**

**MORGAN STANLEY**

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

**Sensitivity of the fair value to changes in the unobservable inputs:**

- (A) Significant increase (decrease) in the unobservable input in isolation would result in a significantly higher (lower) fair value measurement.
- (B) Significant changes in credit correlation may result in a significantly higher or lower fair value measurement. Increasing (decreasing) correlation drives a redistribution of risk within the capital structure such that junior tranches become less (more) risky and senior tranches become more (less) risky.
- (C) Significant increase (decrease) in the unobservable input in isolation would result in a significantly lower (higher) fair value measurement.
- (D) There are no predictable relationships between the significant unobservable inputs.

The following provides a description of significant unobservable inputs included in the September 30, 2013 and December 31, 2012 tables above for all major categories of assets and liabilities:

*Comparable bond price* - a pricing input used when prices for the identical instrument are not available. Significant subjectivity may be involved when fair value is determined using pricing data available for comparable instruments. Valuation using comparable instruments can be done by calculating an implied yield (or spread over a liquid benchmark) from the price of a comparable bond, then adjusting that yield (or spread) to derive a value for the bond. The adjustment to yield (or spread) should account for relevant differences in the bonds such as maturity or credit quality. Alternatively, a price-to-price basis can be assumed between the comparable instrument and bond being valued in order to establish the value of the bond. Additionally, as the probability of default increases for a given bond (*i.e.*, as the bond becomes more distressed), the valuation of that bond will increasingly reflect its expected recovery level assuming default. The decision to use price-to-price or yield/spread comparisons largely reflects trading market convention for the financial instruments in question. Price-to-price comparisons are primarily employed for CMBS, CDOs, mortgage loans and distressed corporate bonds. Implied yield (or spread over a liquid benchmark) is utilized predominately for non-distressed corporate bonds, loans and credit contracts.

*Correlation* - a pricing input where the payoff is driven by more than one underlying risk. Correlation is a measure of the relationship between the movements of two variables (*i.e.*, how the change in one variable influences a change in the other variable). Credit correlation, for example, is the factor that describes the relationship between the probability of individual entities to default on obligations and the joint probability of multiple entities to default on obligations.

*Credit spread* - the difference in yield between different securities due to differences in credit quality. The credit spread reflects the additional net yield an investor can earn from a security with more credit risk relative to one with less credit risk. The credit spread of a particular security is often quoted in relation to the yield on a credit risk-free benchmark security or reference rate, typically either U.S. Treasury or LIBOR.

*Volatility skew* - the measure of the difference in implied volatility for options with identical underliers and expiry dates but with different strikes. The implied volatility for an option with a strike price that is above or below the current price of an underlying asset will typically deviate from the implied volatility for an option with a strike price equal to the current price of that same underlying asset.

*Volatility* - the measure of the variability in possible returns for an instrument given how much that instrument changes in value over time. Volatility is a pricing input for options and, generally, the lower the volatility, the less risky the option. The level of volatility used in the valuation of a particular option depends on a number of factors, including the nature of the risk underlying that option (*e.g.*, the volatility of a particular underlying equity security may be significantly different from that of a particular underlying commodity index), the tenor and the strike price of the option.



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*EBITDA multiple / Exit multiple* - is the Enterprise Value to EBITDA ratio, where the Enterprise Value is the aggregate value of equity and debt minus cash and cash equivalents. The EBITDA multiple reflects

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**Table of Contents**

**MORGAN STANLEY**

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

the value of the company in terms of its full-year EBITDA, whereas the exit multiple reflects the value of the company in terms of its full year expected EBITDA at exit. Either multiple allows comparison between companies from an operational perspective as the effect of capital structure, taxation and depreciation/amortization is excluded.

*Forward commercial paper rate - LIBOR basis* - the basis added to the LIBOR rate when the commercial paper yield is expressed as a spread over the LIBOR rate. The basis to LIBOR is dependent on a number of factors, including, but not limited to, collateralization of the commercial paper, credit rating of the issuer, and the supply of commercial paper. The basis may become negative, i.e., the return for highly-rated commercial paper, such as asset-backed commercial paper, may be less than LIBOR.

*Cash synthetic basis* - the measure of the price differential between cash financial instruments ( cash instruments ) and their synthetic derivative-based equivalents ( synthetic instruments ). The range disclosed in the table above signifies the number of points by which the synthetic bond equivalent price is higher than the quoted price of the underlying cash bonds.

*Interest rate curve* - the term structure of interest rates (relationship between interest rates and the time to maturity) and a market s measure of future interest rates at the time of observation. An interest rate curve is used to set interest rate derivative cash flows and is a pricing input used in discounting of any OTC derivative cash flow.

*Implied weighted average cost of capital ( WACC )* - the WACC implied by the current value of equity in a discounted cash flow model. The model assumes that the cash flow assumptions, including projections, are fully reflected in the current equity value while the debt to equity ratio is held constant. The WACC theoretically represents the required rate of return to debt and equity investors, respectively.

*Capitalization rate* - the ratio between net operating income produced by an asset and its market value at the projected disposition date.

*Funding spread* - the difference between the general collateral rate (which refers to the rate applicable to a broad class of U.S. Treasury issuances) and the specific collateral rate (which refers to the rate applicable to a specific type of security pledged as collateral, such as a municipal bond). Repurchase agreements are discounted based on collateral curves. The curves are constructed as spreads over the corresponding overnight index swap ( OIS )/LIBOR curves, with the short end of the curve representing spreads over the corresponding OIS curves and the long end of the curve representing spreads over LIBOR.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Fair Value of Investments that Calculate Net Asset Value.*

The Company's Investments measured at fair value were \$8,574 million and \$8,346 million at September 30, 2013 and December 31, 2012, respectively. The following table presents information solely about the Company's investments in private equity funds, real estate funds and hedge funds measured at fair value based on NAV at September 30, 2013 and December 31, 2012, respectively.

	At September 30, 2013		At December 31, 2012	
	Fair Value	Unfunded Commitment	Fair Value	Unfunded Commitment
	(dollars in millions)			
Private equity funds	\$ 2,450	\$ 577	\$ 2,179	\$ 644
Real estate funds	1,529	149	1,376	221
Hedge funds(1):				
Long-short equity hedge funds	466		475	
Fixed income/credit-related hedge funds	71		86	
Event-driven hedge funds	39		52	
Multi-strategy hedge funds	228	3	321	3
Total	\$ 4,783	\$ 729	\$ 4,489	\$ 868

- (1) Fixed income/credit-related hedge funds, event-driven hedge funds, and multi-strategy hedge funds are redeemable at least on a six-month period basis primarily with a notice period of 90 days or less. At September 30, 2013, approximately 40% of the fair value amount of long-short equity hedge funds is redeemable at least quarterly, 40% is redeemable every six months and 20% of these funds have a redemption frequency of greater than six months. The notice period for long-short equity hedge funds at September 30, 2013 is primarily greater than six months. At December 31, 2012, approximately 36% of the fair value amount of long-short equity hedge funds is redeemable at least quarterly, 38% is redeemable every six months and 26% of these funds have a redemption frequency of greater than six months. The notice period for long-short equity hedge funds at December 31, 2012 is primarily greater than six months.

*Private Equity Funds.* Amount includes several private equity funds that pursue multiple strategies including leveraged buyouts, venture capital, infrastructure growth capital, distressed investments, and mezzanine capital. In addition, the funds may be structured with a focus on specific domestic or foreign geographic regions. These investments are generally not redeemable with the funds. Instead, the nature of the investments in this category is that distributions are received through the liquidation of the underlying assets of the fund. At September 30, 2013, it is estimated that 8% of the fair value of the funds will be liquidated in the next five years, another 57% of the fair value of the funds will be liquidated between five to 10 years and the remaining 35% of the fair value of the funds have a remaining life of greater than 10 years.

*Real Estate Funds.* Amount includes several real estate funds that invest in real estate assets such as commercial office buildings, retail properties, multi-family residential properties, developments or hotels. In addition, the funds may be structured with a focus on specific geographic domestic or foreign regions. These investments are generally not redeemable with the funds. Distributions from each fund will be received as the underlying investments of the funds are liquidated. At September 30, 2013, it is estimated that 3% of the fair value of the funds will be liquidated within the next five years, another 53% of the fair value of the funds will be liquidated between five to 10 years and the remaining 44% of the fair value of the funds have a remaining life of greater than 10 years.

*Hedge Funds.* Investments in hedge funds may be subject to initial period lock-up restrictions or gates. A hedge fund lock-up provision is a provision that provides that, during a certain initial period, an investor may not make a withdrawal from the fund. The purpose of a gate is to restrict the level of redemptions that an investor in a particular hedge fund can demand on any redemption date.

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*Long-short Equity Hedge Funds.* Amount includes investments in hedge funds that invest, long or short, in equities. Equity value and growth hedge funds purchase stocks perceived to be undervalued and sell

**Table of Contents**

**MORGAN STANLEY**

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

stocks perceived to be overvalued. Investments representing approximately 14% of the fair value of the investments in this category cannot be redeemed currently because the investments include certain initial period lock-up restrictions. The remaining restriction period for these investments subject to lock-up restrictions was primarily two years or less at September 30, 2013. Investments representing approximately 19% of the fair value of the investments in long-short equity hedge funds cannot be redeemed currently because an exit restriction has been imposed by the hedge fund manager. The restriction period for these investments subject to an exit restriction was primarily less than one year at September 30, 2013.

*Fixed Income/Credit-Related Hedge Funds.* Amount includes investments in hedge funds that employ long-short, distressed or relative value strategies in order to benefit from investments in undervalued or overvalued securities that are primarily debt or credit related. At September 30, 2013, there were no restrictions on redemptions.

*Event-Driven Hedge Funds.* Amount includes investments in hedge funds that invest in event-driven situations such as mergers, hostile takeovers, reorganizations, or leveraged buyouts. This may involve the simultaneous purchase of stock in companies being acquired and the sale of stock in its acquirer, with the expectation to profit from the spread between the current market price and the ultimate purchase price of the target company. At September 30, 2013, there were no restrictions on redemptions.

*Multi-strategy Hedge Funds.* Amount includes investments in hedge funds that pursue multiple strategies to realize short- and long-term gains. Management of the hedge funds has the ability to overweight or underweight different strategies to best capitalize on current investment opportunities. At September 30, 2013, investments representing approximately 47% of the fair value of the investments in this category cannot be redeemed currently because the investments include certain initial period lock-up restrictions. The remaining restriction period for these investments subject to lock-up restrictions was primarily two years or less at September 30, 2013. Investments representing approximately 9% of the fair value of the investments in multi-strategy hedge funds cannot be redeemed currently because an exit restriction has been imposed by the hedge fund manager. The restriction period for these investments subject to an exit restriction was indefinite at September 30, 2013.

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

The Company elected the fair value option for certain eligible instruments that are risk managed on a fair value basis to mitigate income statement volatility caused by measurement basis differences between the elected instruments and their associated risk management transactions or to eliminate complexities of applying certain accounting models. The following tables present net gains (losses) due to changes in fair value for items measured at fair value pursuant to the fair value option election for the quarters and nine months ended September 30, 2013 and 2012, respectively:

	Trading	Interest Income (Expense) (dollars in millions)	Gains (Losses) Included in Net Revenues
<i>Three Months Ended September 30, 2013</i>			
Federal funds sold and securities purchased under agreements to resell	\$ 1	\$ 3	\$ 4
Deposits	14	(17)	(3)
Commercial paper and other short-term borrowings(1)	(62)	(3)	(65)
Securities sold under agreements to repurchase	(3)	(2)	(5)
Long-term borrowings(1)	(154)	(224)	(378)
<i>Nine Months Ended September 30, 2013</i>			
Federal funds sold and securities purchased under agreements to resell	\$	\$ 6	\$ 6
Deposits	44	(50)	(6)
Commercial paper and other short-term borrowings(1)	118	(5)	113
Securities sold under agreements to repurchase	2	(5)	(3)
Long-term borrowings(1)	1,053	(752)	301
<i>Three Months Ended September 30, 2012</i>			
Federal funds sold and securities purchased under agreements to resell	\$ 3	\$ 2	\$ 5
Deposits	16	(22)	(6)
Commercial paper and other short-term borrowings(2)	(68)		(68)
Securities sold under agreements to repurchase	(13)	(1)	(14)
Long-term borrowings(2)	(3,570)	(348)	(3,918)
<i>Nine Months Ended September 30, 2012</i>			
Federal funds sold and securities purchased under agreements to resell	\$ 11	\$ 4	\$ 15
Deposits	41	(66)	(25)
Commercial paper and other short-term borrowings(2)	14		14
Securities sold under agreements to repurchase	(10)	(3)	(13)
Long-term borrowings(2)	(5,221)	(1,017)	(6,238)

- (1) Of the total gains (losses) recorded in Trading revenues for short-term and long-term borrowings for the quarter and nine months ended September 30, 2013, \$(171) million and \$(313) million, respectively, are attributable to changes in the credit quality of the Company, and the respective remainder is attributable to changes in foreign currency rates or interest rates or movements in the reference price or index for structured notes before the impact of related hedges.
- (2) Of the total gains (losses) recorded in Trading revenues for short-term and long-term borrowings for the quarter and nine months ended September 30, 2012, \$(2,262) million and \$(3,890) million, respectively, are attributable to changes in the credit quality of the Company, and the respective remainder is attributable to changes in foreign currency rates or interest rates or movements in the reference price or index for structured notes before the impact of related

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hedges.

In addition to the amounts in the above table, as discussed in Note 2 to the consolidated financial statements for the year ended December 31, 2012 included in the Form 10-K, all of the instruments within Trading assets or

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

Trading liabilities are measured at fair value, either through the election of the fair value option or as required by other accounting guidance. The amounts in the above table are included within Net revenues and do not reflect gains or losses on related hedging instruments, if any.

The Company hedges the economics of market risk for short-term and long-term borrowings (*i.e.*, risks other than that related to the credit quality of the Company) as part of its overall trading strategy and manages the market risks embedded within the issuance by the related business unit as part of the business unit's portfolio. The gains and losses on related economic hedges are recorded in Trading revenues and largely offset the gains and losses on short-term and long-term borrowings attributable to market risk.

At September 30, 2013 and December 31, 2012, a breakdown of the short-term and long-term borrowings measured at fair value on a recurring basis by business unit responsible for risk-managing each borrowing is shown in the table below:

Business Unit	Short-term and Long-term Borrowings	
	At	At
	September 30, 2013	December 31, 2012
	(dollars in millions)	
Interest rates	\$ 17,457	\$ 23,330
Equity	17,657	17,326
Credit and foreign exchange	2,688	3,337
Commodities	540	776
<b>Total</b>	<b>\$ 38,342</b>	<b>\$ 44,769</b>

The following tables present information on the Company's short-term and long-term borrowings (primarily structured notes), loans and unfunded lending commitments for which the fair value option was elected.

**Gains (Losses) due to Changes in Instrument-Specific Credit Risk.**

	Three Months			
	Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
	(dollars in millions)			
Short-term and long-term borrowings(1)	\$ (171)	\$ (2,262)	\$ (313)	\$ (3,890)
Loans(2)	35	255	150	429
Unfunded lending commitments(3)	6	319	221	804

- (1) The change in the fair value of short-term and long-term borrowings (primarily structured notes) includes an adjustment to reflect the change in credit quality of the Company based upon observations of the Company's secondary bond market spreads.
- (2) Instrument-specific credit gains (losses) were determined by excluding the non-credit components of gains and losses, such as those due to changes in interest rates.
- (3) Gains (losses) were generally determined based on the differential between estimated expected client yields and contractual yields at each respective period end.





**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Net Difference between Contractual Principal Amount and Fair Value.**

	<b>Contractual Principal Amount Exceeds Fair Value</b>	
	<b>At September 30, 2013</b>	<b>At December 31, 2012</b>
	<b>(dollars in millions)</b>	
Short-term and long-term borrowings(1)	\$ (1,513)	\$ (436)
Loans(2)	17,879	25,249
Loans 90 or more days past due and/or on non-accrual status(2)(3)	16,149	20,456

- (1) These amounts do not include structured notes where the repayment of the initial principal amount fluctuates based on changes in the reference price or index.
- (2) The majority of this difference between principal and fair value amounts emanates from the Company's distressed debt trading business, which purchases distressed debt at amounts well below par.
- (3) The aggregate fair value of loans that were in non-accrual status, which includes all loans 90 or more days past due, was \$1,885 million and \$1,360 million at September 30, 2013 and December 31, 2012, respectively. The aggregate fair value of loans that were 90 or more days past due was \$1,158 million and \$840 million at September 30, 2013 and December 31, 2012, respectively.

The tables above exclude non-recourse debt from consolidated VIEs, liabilities related to failed sales of financial assets, pledged commodities and other liabilities that have specified assets attributable to them.

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

Certain assets were measured at fair value on a non-recurring basis and are not included in the tables above. These assets may include loans, other investments, premises, equipment and software costs, and intangible assets.

The following tables present, by caption on the condensed consolidated statements of financial condition, the fair value hierarchy for those assets measured at fair value on a non-recurring basis for which the Company recognized a non-recurring fair value adjustment for the quarters and nine months ended September 30, 2013 and 2012, respectively.

**Three and Nine Months Ended September 30, 2013.**

	<b>Fair Value Measurements Using:</b>				<b>Total Gains (Losses) for the Three Months Ended September 30, 2013(1)</b>	<b>Total Gains (Losses) for the Nine Months Ended September 30, 2013(1)</b>
	<b>Carrying Value at September 30, 2013</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>		
	<b>(dollars in millions)</b>					
Loans(2)	\$ 1,507	\$	\$ 1,160	\$ 347	\$ (35)	\$ (106)
Other investments(3)(4)	55			55	(5)	(28)

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Premises, equipment and software costs(3)(4)					(17)	(23)
Intangible assets(3)(4)						(9)
<b>Total</b>	<b>\$ 1,562</b>	<b>\$</b>	<b>\$ 1,160</b>	<b>\$ 402</b>	<b>\$ (57)</b>	<b>\$ (166)</b>

- (1) Fair value adjustments related to Loans and losses related to Other investments are recorded within Other revenues whereas losses related to Premises, equipment and software costs and Intangible assets are recorded within Other expenses in the condensed consolidated statements of income.





**Table of Contents**

**MORGAN STANLEY**

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

***Financial Instruments Not Measured at Fair Value.***

The tables below present the carrying value, fair value and fair value hierarchy category of certain financial instruments that are not measured at fair value in the condensed consolidated statements of financial condition. The tables below exclude certain financial instruments such as equity method investments and all non-financial assets and liabilities such as the value of the long-term relationships with our deposit customers.

The carrying value of cash and cash equivalents, including Interest bearing deposits with banks, and other short-term financial instruments such as Federal funds sold and securities purchased under agreements to resell, Securities borrowed, Securities sold under agreements to repurchase, Securities loaned, certain Customer and other receivables and Customer and other payables arising in the ordinary course of business, Deposits, Commercial paper and other short-term borrowings and Other secured financings approximate fair value because of the relatively short period of time between their origination and expected maturity.

For longer-dated Federal funds sold and securities purchased under agreements to resell, Securities borrowed, Securities sold under agreements to repurchase, Securities loaned and Other secured financings, fair value is determined using a standard cash flow discounting methodology. The inputs to the valuation include contractual cash flows and collateral funding spreads, which are estimated using various benchmarks and interest rate yield curves.

For consumer and residential real estate loans where position-specific external price data are not observable, the fair value is based on the credit risks of the borrower using a probability of default and loss given default method, discounted at the estimated external cost of funding level. The fair value of corporate loans is determined using recently executed transactions, market price quotations (where observable), implied yields from comparable debt, and market observable credit default swap spread levels along with proprietary valuation models and default recovery analysis where such transactions and quotations are unobservable.

The fair value of long-term borrowings is generally determined based on transactional data or third party pricing for identical or comparable instruments, when available. Where position-specific external prices are not observable, fair value is determined based on current interest rates and credit spreads for debt instruments with similar terms and maturity.

**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Financial Instruments Not Measured at Fair Value at September 30, 2013 and December 31, 2012.**

At September 30, 2013.

	At September 30, 2013		Fair Value Measurements Using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(dollars in millions)					
<b>Financial Assets:</b>					
Cash and due from banks	\$ 14,333	\$ 14,333	\$ 14,333	\$	\$
Interest bearing deposits with banks	43,448	43,448	43,448		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	37,392	37,392	37,392		
Federal funds sold and securities purchased under agreements to resell	133,120	133,117		132,613	504
Securities borrowed	139,169	139,165		138,836	329
Customer and other receivables(1)	53,636	53,512		47,964	5,548
Loans(2)	37,734	37,697		9,807	27,890
<b>Financial Liabilities:</b>					
Deposits	\$ 103,396	\$ 103,396	\$	\$ 103,396	\$
Commercial paper and other short-term borrowings	710	710		656	54
Securities sold under agreements to repurchase	138,844	138,882		131,399	7,483
Securities loaned	32,807	32,868		31,999	869
Other secured financings	8,383	8,418		5,944	2,474
Customer and other payables(1)	149,005	149,005		149,005	
Long-term borrowings	121,086	124,727		116,945	7,782

(1) Accrued interest, fees and dividend receivables and payables where carrying value approximates fair value have been excluded.

(2) Includes all loans measured at fair value on a non-recurring basis.

The fair value of the Company's unfunded lending commitments, primarily related to corporate lending in the Institutional Securities business segment, that are not carried at fair value at September 30, 2013 was \$864 million, of which \$787 million and \$77 million would be categorized in Level 2 and Level 3 of the fair value hierarchy, respectively. The carrying value of these commitments, if fully funded, would be \$71.5 billion.

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

At December 31, 2012.

	At December 31, 2012		Fair Value Measurements Using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial Assets:</b>					
Cash and due from banks	\$ 20,878	\$ 20,878	\$ 20,878	\$	\$
Interest bearing deposits with banks	26,026	26,026	26,026		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	30,970	30,970	30,970		
Federal funds sold and securities purchased under agreements to resell	133,791	133,792		133,035	757
Securities borrowed	121,701	121,705		121,691	14
Customer and other receivables(1)	59,702	59,634		53,532	6,102
Loans(2)	29,046	27,263		5,307	21,956
<b>Financial Liabilities:</b>					
Deposits	\$ 81,781	\$ 81,781	\$	\$ 81,781	\$
Commercial paper and other short-term borrowings	1,413	1,413		1,107	306
Securities sold under agreements to repurchase	122,311	122,389		111,722	10,667
Securities loaned	36,849	37,163		35,978	1,185
Other secured financings	6,261	6,276		3,649	2,627
Customer and other payables(1)	125,037	125,037		125,037	
Long-term borrowings	125,527	126,683		116,511	10,172

(1) Accrued interest, fees and dividend receivables and payables where carrying value approximates fair value have been excluded.

(2) Includes all loans measured at fair value on a non-recurring basis.

The fair value of the Company's unfunded lending commitments, primarily related to corporate lending in the Institutional Securities business segment, that are not carried at fair value at December 31, 2012 was \$755 million, of which \$543 million and \$212 million would be categorized in Level 2 and Level 3 of the fair value hierarchy, respectively. The carrying value of these commitments, if fully funded, would be \$50.0 billion.



**Table of Contents****MORGAN STANLEY****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. Securities Available for Sale.**

The following tables present information about the Company's available for sale securities:

	Amortized Cost	At September 30, 2013			Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	Other-than- Temporary Impairment	
(dollars in millions)					
Debt securities available for sale:					
U.S. government and agency securities:					
U.S. Treasury securities	\$ 19,856	\$ 65	\$ 80	\$	\$ 19,841
U.S. agency securities	14,098	36	174		13,960
Total U.S. government and agency securities	33,954	101	254		