MORGAN STANLEY
Form 10-Q
August 09, 2010
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2010

OR

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

EXCHANGE ACT OF 1934

Commission File Number 1-11758

(Exact Name of Registrant as specified in its charter)

Delaware	**1585 Broadway**	**36-3145972**	**(212) 761-4000**
(State or other jurisdiction of incorporation or organization)	**New York, NY 10036**	(I.R.S. Employer Identification No.)	(Registrant s telephone number, including area code)
	(Address of principal executive offices, including zip code)		

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

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

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

Large Accelerated Filer x	Accelerated Filer ¨
Non-Accelerated Filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of July 31, 2010, there were 1,396,968,554 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 June 30, 2010

Table of Contents

Table of Contents		Page
Part I Financial Information		
Item 1.	Financial Statements (unaudited)	1
	Condensed Consolidated Statements of Financial Condition June 30, 2010 and December 31, 2009	1
	Condensed Consolidated Statements of Income Three and Six Months Ended June 30, 2010 and 2009	3
	Condensed Consolidated Statements of Comprehensive Income Three and Six Months Ended June 30, 2010 and 2009	4
	Condensed Consolidated Statements of Cash Flows Six Months Ended June 30, 2010 and 2009	5
	Condensed Consolidated Statements of Changes in Total Equity Six Months Ended June 30, 2010 and 2009	6
	Notes to Condensed Consolidated Financial Statements (unaudited)	8
	Note 1. Introduction and Basis of Presentation	8
	Note 2. Summary of Significant Accounting Policies	10
	Note 3. Morgan Stanley Smith Barney Holdings LLC	17
	Note 4. Fair Value Disclosures	19
	Note 5. Securities Available for Sale	41
	Note 6. Collateralized Transactions	42
	Note 7. Variable Interest Entities and Securitization Activities	43
	Note 8. Goodwill and Net Intangible Assets	53
	Note 9. Long-Term Borrowings	54
	Note 10. Derivative Instruments and Hedging Activities	55
	Note 11. Commitments, Guarantees and Contingencies	64
	Note 12. Regulatory Requirements	68
	Note 13. Total Equity	70
	Note 14. Earnings per Common Share	72
	Note 15. Interest Income and Interest Expense	73
	Note 16. Employee Benefit Plans	74
	Note 17. Income Taxes	74
	Note 18. Segment and Geographic Information	75
	Note 19. Japan Securities Joint Venture	79
	Note 20. Discontinued Operations	80
	Note 21. Subsequent Events	80
	Report of Independent Registered Public Accounting Firm	81
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	82
	Introduction	82
	Executive Summary	84
	Certain Factors Affecting Results of Operations, Total Equity and Earnings Per Common Share	91
	Business Segments	95
	Accounting Developments	107
	Other Matters	108
	Critical Accounting Policies	111
	Liquidity and Capital Resources	116

Table of Contents

		Page
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	128
Item 4.	Controls and Procedures	139
	Financial Data Supplement (Unaudited)	140
Part II Other Information		
Item 1.	Legal Proceedings	144
Item 1A.	Risk Factors	145
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	145
Item 6.	Exhibits	146

Table of Contents

AVAILABLE INFORMATION

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

Morgan Stanley s internet site is *www.morganstanley.com*. You can access Morgan Stanley s Investor Relations webpage at *www.morganstanley.com/about/ir*. Morgan Stanley makes available free of charge, on or through its Investor Relations webpage, its proxy statements, Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, as amended (the Exchange Act), as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. Morgan Stanley also makes available, through its Investor Relations webpage, via a link to the SEC s internet site, statements of beneficial ownership of Morgan Stanley s equity securities filed by its directors, officers, 10% or greater shareholders and others under Section 16 of the Exchange Act.

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

- Amended and Restated Certificate of Incorporation;
- Amended and Restated Bylaws;
- Charters for its Audit Committee; Internal Audit Subcommittee; Compensation, Management Development and Succession Committee; Nominating and Governance Committee; and Risk Committee;
- Corporate Governance Policies;
- Policy Regarding Communication with the Board of Directors;
- Policy Regarding Director Candidates Recommended by Shareholders;
- Policy Regarding Corporate Political Contributions;
- Policy Regarding Shareholder Rights Plan;
- Code of Ethics and Business Conduct;
- Code of Conduct; and

Integrity Hotline information.

Morgan Stanley s Code of Ethics and Business Conduct applies to all directors, officers and employees, including its Chief Executive Officer, Chief Financial Officer and Finance Director and Controller. 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)

	June 30, 2010	December 31, 2009
Assets		
Cash and due from banks	$ 8,770	$ 6,988
Interest bearing deposits with banks	27,577	25,003
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	21,930	23,712
Financial instruments owned, at fair value (approximately $124 billion and $101 billion were pledged to various parties at June 30, 2010 and December 31, 2009, respectively):		
U.S. government and agency securities	63,976	62,215
Other sovereign government obligations	29,403	25,445
Corporate and other debt ($4,010 at June 30, 2010 related to consolidated variable interest entities, generally not available to the Company)	86,546	90,454
Corporate equities	53,994	57,968
Derivative and other contracts	53,853	49,081
Investments ($1,167 at June 30, 2010 related to consolidated variable interest entities, generally not available to the Company)	9,164	9,286
Physical commodities	5,694	5,329
Total financial instruments owned, at fair value	302,630	299,778
Securities available for sale	19,367	
Securities received as collateral, at fair value	14,781	13,656
Federal funds sold and securities purchased under agreements to resell	144,862	143,208
Securities borrowed	178,859	167,501
Receivables:		
Customers	27,738	27,594
Brokers, dealers and clearing organizations	8,291	5,719
Fees, interest and other	10,454	11,164
Loans	7,764	7,259
Other investments	5,601	3,752
Premises, equipment and software costs (net of accumulated depreciation of $4,097 and $3,734 at June 30, 2010 and December 31, 2009, respectively) ($429 at June 30, 2010 related to consolidated variable interest entities, generally not available to the Company)	6,100	7,067
Goodwill	6,749	7,162
Intangible assets (net of accumulated amortization of $451 and $275 at June 30, 2010 and December 31, 2009, respectively) (includes $139 and $137 at fair value at June 30, 2010 and December 31, 2009, respectively)	4,924	5,054
Other assets ($95 at June 30, 2010 related to consolidated variable interest entities, generally not available to the Company)	13,059	16,845
Total assets	$ 809,456	$ 771,462

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (CONTINUED)

(dollars in millions, except share data)

(unaudited)

	June 30, 2010	December 31, 2009
Liabilities and Equity		
Commercial paper and other short-term borrowings (includes $1,522 and $791 at fair value at June 30, 2010 and December 31, 2009, respectively)	$ 3,835	$ 2,378
Deposits (includes $4,487 and $4,967 at fair value at June 30, 2010 and December 31, 2009, respectively)	61,368	62,215
Financial instruments sold, not yet purchased, at fair value:		
U.S. government and agency securities	21,100	20,503
Other sovereign government obligations	22,885	18,244
Corporate and other debt	8,957	7,826
Corporate equities	24,599	22,601
Derivative and other contracts	47,648	38,209
Total financial instruments sold, not yet purchased, at fair value	125,189	107,383
Obligation to return securities received as collateral, at fair value	14,781	13,656
Securities sold under agreements to repurchase	185,134	159,401
Securities loaned	26,524	26,246
Other secured financings (includes $7,493 and $8,102 at fair value at June 30, 2010 and December 31, 2009, respectively) ($2,816 at June 30, 2010 related to consolidated variable interest entities and are non-recourse to the Company)	7,735	8,102
Payables:		
Customers	117,883	117,058
Brokers, dealers and clearing organizations	6,917	5,423
Interest and dividends	2,519	2,597
Other liabilities and accrued expenses	15,602	20,849
Long-term borrowings (includes $37,029 and $37,610 at fair value at June 30, 2010 and December 31, 2009, respectively)	182,810	193,374
	750,297	718,682
Commitments and contingencies		
Equity		
Morgan Stanley shareholders equity:		
Preferred stock	9,597	9,597
Common stock, $0.01 par value;		
Shares authorized: 3,500,000,000 at June 30, 2010 and December 31, 2009;		
Shares issued: 1,487,850,163 at June 30, 2010 and December 31, 2009;		
Shares outstanding: 1,397,007,417 at June 30, 2010 and 1,360,595,214 at December 31, 2009	15	15
Paid-in capital	7,649	8,619
Retained earnings	38,210	35,056
Employee stock trust	3,666	4,064
Accumulated other comprehensive loss	(354)	(560)
Common stock held in treasury, at cost, $0.01 par value; 90,842,746 shares at June 30, 2010 and 127,254,949 shares at December 31, 2009	(4,104)	(6,039)
Common stock issued to employee trust	(3,666)	(4,064)

Total Morgan Stanley shareholders equity	51,013	46,688
Non-controlling interests	8,146	6,092
Total equity	59,159	52,780
Total liabilities and equity	$ 809,456	$ 771,462

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 June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenues:				
Investment banking	$ 1,080	$ 1,266	$ 2,140	$ 2,139
Principal transactions:				
Trading	3,346	1,732	7,097	3,087
Investments	(52)	(125)	317	(1,275)
Commissions	1,316	973	2,577	1,743
Asset management, distribution and administration fees	1,974	1,158	3,937	2,024
Other	134	390	427	637
Total non-interest revenues	7,798	5,394	16,495	8,355
Interest income	1,755	1,648	3,503	3,893
Interest expense	1,603	1,845	2,970	4,154
Net interest	152	(197)	533	(261)
Net revenues	7,950	5,197	17,028	8,094
Non-interest expenses:				
Compensation and benefits	3,887	3,803	8,305	5,781
Occupancy and equipment	403	373	795	710
Brokerage, clearing and exchange fees	371	267	719	515
Information processing and communications	416	313	811	595
Marketing and business development	153	120	287	230
Professional services	497	384	892	687
Other	545	521	1,025	790
Total non-interest expenses	6,272	5,781	12,834	9,308
Income (loss) from continuing operations before income taxes	1,678	(584)	4,194	(1,214)
Provision for (benefit from) income taxes	217	(319)	653	(914)
Income (loss) from continuing operations	1,461	(265)	3,541	(300)
Discontinued operations:				
Gain from discontinued operations	891	480	791	225
Provision for income taxes	368	182	337	82
Net income from discontinued operations	523	298	454	143
Net income (loss)	1,984	33	3,995	(157)
Net income (loss) applicable to non-controlling interests	24	(116)	259	(129)
Net income (loss) applicable to Morgan Stanley	$ 1,960	$ 149	$ 3,736	$ (28)
Earnings (loss) applicable to Morgan Stanley common shareholders	$ 1,578	$ (1,256)	$ 2,990	$ (1,834)

Amounts applicable to Morgan Stanley:								
Income (loss) from continuing operations	$	1,437	$	(138)	$	3,282	$	(155)
Net gain from discontinued operations		523		287		454		127
Net income (loss) applicable to Morgan Stanley	$	1,960	$	149	$	3,736	$	(28)
Earnings (loss) per basic common share:								
Income (loss) from continuing operations	$	0.84	$	(1.36)	$	1.96	$	(1.82)
Net gain from discontinued operations		0.36		0.26		0.31		0.11
Earnings (loss) per basic common share	$	1.20	$	(1.10)	$	2.27	$	(1.71)
Earnings (loss) per diluted common share:								
Income (loss) from continuing operations	$	0.80	$	(1.36)	$	1.82	$	(1.82)
Net gain from discontinued operations		0.29		0.26		0.26		0.11
Earnings (loss) per diluted common share	$	1.09	$	(1.10)	$	2.08	$	(1.71)
Average common shares outstanding:								
Basic		1,317,686,493		1,138,444,490		1,316,147,257		1,075,092,850
Diluted		1,748,208,948		1,138,444,490		1,687,528,753		1,075,092,850

See Notes to Condensed Consolidated Financial Statements.

3

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in millions)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	**2009**	**2010**	**2009**
Net income (loss)	$ 1,984	$ 33	$ 3,995	$ (157)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments(1)	23	118	37	58
Amortization of cash flow hedges(2)	2	5	5	8
Net unrealized gain on securities available for sale(3)	107		87	
Pension and postretirement related adjustments(4)	105	4	109	9
Comprehensive income (loss)	$ 2,221	$ 160	$ 4,233	$ (82)
Net income (loss) applicable to non-controlling interests	24	(116)	259	(129)
Other comprehensive (loss) income applicable to non-controlling interests	44	(3)	32	(3)
Comprehensive income applicable to Morgan Stanley	$ 2,153	$ 279	$ 3,942	$ 50

(1) Amounts are net of (benefit from) provision for income taxes of $(19) million and $(241) million for the quarters ended June 30, 2010 and 2009, respectively, and $70 million and $(211) million for the six months ended June 30, 2010 and 2009, respectively.

(2) Amounts are net of provision for income taxes of $2 million for the quarters ended June 30, 2010 and 2009, and $3 million and $4 million for the six months ended June 30, 2010 and 2009, respectively.

(3) Amounts are net of provision for income taxes of $90 million for the quarter ended June 30, 2010 and $76 million for the six months ended June 30, 2010.

(4) Amounts are net of provision for income taxes of $66 million and $4 million for the quarters ended June 30, 2010 and 2009, respectively, and $68 million and $8 million for the six months ended June 30, 2010 and 2009, respectively.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in millions)

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
	(unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ 3,995	$ (157)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Compensation payable in common stock and options	671	627
Depreciation and amortization	1,191	363
Gain on business dispositions	(514)	(480)
Gain on repurchase of long-term debt		(487)
Insurance reimbursement	(88)	
Loss on assets held for sale	951	
Impairment charges and other-than-temporary impairment charges	27	408
Changes in assets and liabilities:		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	1,782	2,396
Financial instruments owned, net of financial instruments sold, not yet purchased	7,242	(16,344)
Securities borrowed	(11,358)	(19,801)
Securities loaned	278	3,422
Receivables, loans and other assets	265	(2,462)
Payables and other liabilities	858	(9,586)
Federal funds sold and securities purchased under agreements to resell	(1,654)	910
Securities sold under agreements to repurchase	25,733	(278)
Net cash provided by (used for) operating activities	29,379	(41,469)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (payments for) proceeds from:		
Premises, equipment and software costs	(436)	(1,879)
Business acquisitions, net of cash acquired	(1,028)	(1,860)
Business dispositions, net of cash disposed	800	565
MUFG transaction	283	
Purchases of securities available for sale	(19,233)	
Net cash used for investing activities	(19,614)	(3,174)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from (payments for):		
Short-term borrowings	1,457	(7,072)
Derivatives financing activities	(64)	(71)
Other secured financings	(367)	(2,391)
Deposits	(847)	11,027
Excess tax benefits associated with stock-based awards	3	11
Net proceeds from:		
Morgan Stanley public offerings of common stock		6,212
Issuance of common stock	2	29
Issuance of long-term borrowings	13,757	28,805
Payments for:		
Long-term borrowings	(17,570)	(24,675)
Redemption of Series D Preferred stock		(10,000)
Repurchases of common stock for employee tax withholding	(275)	(19)
Cash dividends	(582)	(1,078)

Net cash (used for) provided by financing activities	(4,486)	778
Effect of exchange rate changes on cash and cash equivalents	(923)	201
Net increase (decrease) in cash and cash equivalents	4,356	(43,664)
Cash and cash equivalents, at beginning of period	31,991	78,670
Cash and cash equivalents, at end of period	$ 36,347	$ 35,006
Cash and cash equivalents include:		
Cash and due from banks	$ 8,770	$ 9,184
Interest bearing deposits with banks	27,577	25,822
Cash and cash equivalents, at end of period	$ 36,347	$ 35,006

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for interest were $3,302 million and $4,631 million for the six months ended June 30, 2010 and 2009, respectively.

Cash payments for income taxes were $236 million and $182 million for the six months ended June 30, 2010 and 2009, respectively.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY

Six Months Ended June 30, 2010

(dollars in millions)

(unaudited)

	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non-controlling Interests	Total Equity
BALANCE AT DECEMBER 31, 2009	$ 9,597	$ 15	$ 8,619	$ 35,056	$ 4,064	$ (560)	$ (6,039)	$ (4,064)	$ 6,092	$ 52,780
Net income				3,736					259	3,995
Dividends				(582)						(582)
Shares issued under employee plans and related tax effects			(1,687)		(398)		2,210	398		523
Repurchases of common stock							(275)			(275)
Net change in cash flow hedges						5				5
Pension and postretirement adjustments						109				109
Foreign currency translation adjustments						5			32	37
Gain on MUFG transaction			717							717
Change in net unrealized gain (loss) on securities available for sale						87				87
Increases in non-controlling interest related to MUFG transaction									1,130	1,130
Increases for issuances of shares by a subsidiary of the Company									51	51
Increases for the sale of a subsidiary s shares by the Company									62	62
Increase in non-controlling interests related to the consolidation of certain real estate partnerships sponsored by the Company									468	468
Decrease in non-controlling interests related to dividends of non-controlling interests									(14)	(14)
Other increases in non-controlling interests									66	66
BALANCE AT JUNE 30, 2010	$ 9,597	$ 15	$ 7,649	$ 38,210	$ 3,666	$ (354)	$ (4,104)	$ (3,666)	$ 8,146	$ 59,159

See Notes to Condensed Consolidated Financial Statements.

6

Table of Contents

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY (Continued)

Six Months Ended June 30, 2009

(dollars in millions)

(unaudited)

	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non-controlling Interest	Total Equity
BALANCE AT DECEMBER 31, 2008	$ 19,168	$ 12	$ 459	$ 36,154	$ 4,312	$ (420)	$ (6,620)	$ (4,312)	$ 703	$ 49,456
Net income (loss)				(28)					(129)	(157)
Dividends				(747)					(11)	(758)
Shares issued under employee plans and related tax effects			130		(149)		496	149		626
Repurchases of common stock							(19)			(19)
Morgan Stanley public offerings of common stock		3	6,209							6,212
Preferred stock extinguished and exchanged for common stock	(503)		705	(202)						
Repurchase of Series D preferred stock	(9,068)			(932)						(10,000)
Gain on MSSB transaction			1,711							1,711
Net change in cash flow hedges						8				8
Pension and other postretirement adjustments.						9				9
Foreign currency translation adjustments						61			(3)	58
Increases in non-controlling interests related to MSSB transaction									4,533	4,533
Decreases in non-controlling interests related to disposition of a subsidiary									(229)	(229)
Other increases in non-controlling interests									13	13
BALANCE AT JUNE 30, 2009	$ 9,597	$ 15	$ 9,214	$ 34,245	$ 4,163	$ (342)	$ (6,143)	$ (4,163)	$ 4,877	$ 51,463

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Introduction and Basis of Presentation.

The Company. Morgan Stanley (or the Company), a financial holding company, is a global financial services firm that maintains significant market positions in each of its business segments Institutional Securities, Global Wealth Management Group and Asset Management.

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

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

Global Wealth Management Group, which includes the Company s 51% interest in Morgan Stanley Smith Barney Holdings LLC (MSSB) (see Note 3), 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.

Asset Management provides global asset management products and services in equity, fixed income, alternative investments, which includes hedge funds and funds of funds, and merchant banking, which includes real estate, private equity and infrastructure, to institutional and retail clients through proprietary and third-party distribution channels (see Discontinued Operations Retail Asset Management Business herein). Asset Management also engages in investment activities.

Discontinued Operations.

Retail Asset Management Business. On June 1, 2010, the Company completed the sale of substantially all of its retail asset management business (Retail Asset Management), including Van Kampen Investments, Inc., to Invesco Ltd. (Invesco). Further to a revised definitive agreement dated May 28, 2010, the Company received $800 million in cash and approximately 30.9 million shares of Invesco stock upon sale, resulting in a cumulative after-tax gain of $673 million, of which $514 million was recorded in the quarter ended June 30, 2010. The remaining gain of $159 million, representing tax basis benefits, was recorded primarily in the quarter ended December 31, 2009. The results of Retail Asset Management are reported as discontinued operations within the Asset Management business segment for all periods presented.

The Company recorded the 30.9 million shares, representing approximately a 7% non-controlling interest in Invesco, as securities available for sale (see Note 5 for further information.)

Revel Entertainment Group, LLC. On March 31, 2010, the Board of Directors authorized a plan of disposal by sale for Revel Entertainment Group, LLC (Revel), a development stage enterprise and subsidiary of the Company that is primarily associated with a development property in Atlantic City, New Jersey. Total assets of Revel included in the Company s condensed consolidated statement of financial condition at June 30, 2010 approximated $240 million. The results of Revel are reported as discontinued operations for all periods presented within the Institutional Securities business segment. The six months ended June 30, 2010 includes a loss of approximately $951 million in connection with such planned disposition.

MSCI Inc. In May 2009, the Company divested all of its remaining ownership interest in MSCI Inc. (MSCI). The results of MSCI are reported as discontinued operations through the date of sale within the Institutional Securities business segment.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Crescent. Discontinued operations for the three and six months ended June 30, 2009 included operating results related to Crescent Real Estate Equities Limited Partnership (Crescent), a former real estate subsidiary of the Company. The Company completed the disposition of Crescent in the fourth quarter of 2009, whereby the Company transferred its ownership interest in Crescent to Crescent s primary creditor in exchange for full release of liability on the related loans. The results of Crescent are reported as discontinued operations within the Asset Management business segment.

Discover. On June 30, 2007, the Company completed the spin-off of its business segment Discover Financial Services (DFS) to its shareholders. On February 11, 2010, DFS paid the Company $775 million in complete satisfaction of its obligations to the Company regarding the sharing of proceeds from the lawsuit against Visa and MasterCard. The payment was recorded as a gain in discontinued operations for the six months ended June 30, 2010.

See Note 20 for additional information on discontinued operations.

Basis of Financial Information. The condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions regarding the valuations of certain financial instruments, the valuation of goodwill, compensation, 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.

Certain reclassifications have been made to prior period amounts to conform to the current period s presentation.

All material intercompany balances and transactions have been eliminated.

The condensed consolidated financial statements should be read in conjunction with the Company s consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009 (the Form 10-K). The condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for the fair presentation of the results for the interim period. The results of operations for interim periods are not necessarily indicative of results for the entire year.

Consolidation. The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest, including certain variable interest entities (VIEs) (see Note 7). The Company adopted accounting guidance for non-controlling interests on January 1, 2009. Accordingly, for consolidated subsidiaries that are less than wholly owned, the third-party holdings of equity interests are referred to as non-controlling interests. The portion of net income attributable to non-controlling interests for such subsidiaries is presented as Net income (loss) applicable to non-controlling interests on the condensed consolidated statements of income, and the portion of the shareholders equity of such subsidiaries is presented as Non-controlling interests in the condensed consolidated statements of financial condition and condensed consolidated statements of changes in total equity.

For entities where (1) the total equity investment at risk is sufficient to enable the entity to finance its activities without additional support and (2) the equity holders bear the economic residual risks and returns of the entity and have the power to direct the activities of the entity that most significantly affect its economic performance, the Company consolidates those entities it controls either through a majority voting interest or otherwise. For

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

entities that do not meet these criteria, commonly known as VIEs, 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.

Notwithstanding the above, under accounting guidance prior to January 1, 2010, certain securitization vehicles, commonly known as qualifying special purpose entities (QSPEs), were not consolidated by the Company if they met certain criteria regarding the types of assets and derivatives they could hold and the range of discretion they could exercise in connection with the assets they held. These entities are now subject to the consolidation requirements for VIEs.

For investments in entities in which the Company does not have a controlling financial interest but has significant influence over operating and financial decisions, the Company generally applies the equity method of accounting with net gains and losses recorded within Other revenues. Where the Company has elected to measure certain eligible investments at fair value in accordance with the fair value option, net gains and losses are recorded within Principal transactions Investments (see Note 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. Incorporated (MS&Co.), Morgan Stanley Smith Barney LLC, Morgan Stanley & Co. International plc (MSIP), Morgan Stanley MUFG Securities, Co., Ltd. (MSMS), Morgan Stanley Bank, N.A. and Morgan Stanley Investment Advisors Inc.

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

Effective January 1, 2010, the Company reclassified dividend income associated with trading and investing activities to Principal transactions Trading or Principal transactions Investments depending upon the business activity. Previously, these amounts were included in Interest and dividends on the condensed consolidated statements of income. These reclassifications were made in connection with the Company s conversion to a financial holding company. Prior periods have been adjusted to conform to the current presentation.

2. Summary of Significant Accounting Policies.

Revenue Recognition.

Investment Banking. Underwriting revenues and advisory fees from mergers, acquisitions and restructuring transactions are recorded when services for the transactions are determined to be substantially completed, generally as set forth under the terms of the engagement. Transaction-related expenses, primarily consisting of

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

legal, travel and other costs directly associated with the transaction, are deferred and recognized in the same period as the related investment banking transaction revenue. Underwriting revenues are presented net of related expenses. Non-reimbursed expenses associated with advisory transactions are recorded within Non-interest expenses.

Commissions. The Company generates commissions from executing and clearing customer transactions on stock, options and futures markets. Commission revenues are recognized in the accounts on trade date.

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees are recognized over the relevant contract period. Sales commissions paid by the Company in connection with the sale of certain classes of shares of its open-end mutual fund products are accounted for as deferred commission assets. The Company periodically tests the deferred commission assets for recoverability based on cash flows expected to be received in future periods. In certain management fee arrangements, the Company is entitled to receive performance-based fees (also referred to as incentive fees) when the return on assets under management exceeds certain benchmark returns or other performance targets. In such arrangements, performance fee revenue is accrued (or reversed) quarterly based on measuring account/fund performance to date versus the performance benchmark stated in the investment management agreement. Performance-based fees are recorded within Principal transactions investments or Asset management, distribution and administration fees depending on the nature of the arrangement. The amount of performance-based fee revenue at risk of reversing if fund performance falls below stated investment management agreement benchmarks was approximately $140 million at June 30, 2010 and approximately $122 million at December 31, 2009.

Principal Transactions. See Financial Instruments and Fair Value below for principal transactions revenue recognition discussions.

Financial Instruments and Fair Value.

A significant portion of the Company s financial instruments is carried at fair value with changes in fair value recognized in earnings each period. A description of the Company s policies regarding fair value measurement and its application to these financial instruments follows.

Financial Instruments Measured at Fair Value. All of the instruments within Financial instruments owned and Financial instruments sold, not yet purchased, are measured at fair value, either through the fair value option election (discussed below) or as required by other accounting guidance. These financial instruments primarily represent the Company s trading and investment activities and include both cash and derivative products. In addition, certain debt and equity securities classified as Securities available for sale are measured at fair value in accordance with accounting guidance for certain investments in debt and equity securities. Furthermore, Securities received as collateral and Obligation to return securities received as collateral are measured at fair value as required by other accounting guidance. Additionally, certain Commercial paper and other short-term borrowings (primarily structured notes), certain Deposits, Other secured financings and certain Long-term borrowings (primarily structured notes and certain junior subordinated debentures) are measured at fair value through the fair value option election.

Gains and losses on all of these instruments carried at fair value are reflected in Principal transactions Trading revenues, Principal transactions Investment revenues or Investment banking revenues in the condensed consolidated statements of income, except for Securities available for sale (see Securities Available for Sale section herein and Note 5) and derivatives accounted for as hedges (see Hedge Accounting section herein and Note 10). Interest income and expense are recorded within the condensed consolidated statements of income depending on the nature of the instrument and related market conventions. When interest is included as a

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

component of the instruments fair value, interest is included within Principal transactions Trading or Principal transactions Investments. Otherwise, it is included within Interest income or Interest expense. Dividend income is recorded in Principal transactions Trading or Principal transactions Investments depending on the business activity. The fair value of over-the-counter (OTC) financial instruments, including derivative contracts related to financial instruments and commodities, is presented in the accompanying condensed consolidated statements of financial condition on a net-by-counterparty basis, when appropriate. Additionally, the Company nets fair value of cash collateral paid or received against fair value amounts recognized for net derivative positions executed with the same counterparty under the same master netting arrangement.

Fair Value Option. The fair value option permits the irrevocable fair value option election on an instrument-by-instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. The Company applies the fair value option for eligible instruments, including certain loans and lending commitments, certain equity method investments, certain structured notes, certain junior subordinated debentures, certain time deposits and certain other secured financings.

Fair Value Measurement Definition and Hierarchy. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (*i.e.*, the exit price) in an orderly transaction between market participants at the measurement date.

In determining fair value, the Company uses various valuation approaches and establishes a hierarchy for inputs used in measuring fair value that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company s assumptions about the assumptions other market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the observability of inputs as follows:

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

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

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

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

The Company considers prices and inputs that are current as of the measurement date, including during periods of market dislocation. In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3 (see Note 4). In addition, a downturn in market conditions could lead to further declines in the valuation of many instruments.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Fair value for many cash and OTC contracts is derived using pricing models. Pricing models take into account the contract terms (including maturity) as well as multiple inputs, including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, option volatility and currency rates. Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality and model uncertainty. Adjustments for liquidity risk adjust model derived mid-market levels of Level 2 and Level 3 financial instruments for the bid-mid or mid-ask spread required to properly reflect the exit price of a risk position. Bid-mid and mid-ask spreads are marked to levels observed in trade activity, broker quotes or other external third-party data. Where these spreads are unobservable for the particular position in question, spreads are derived from observable levels of similar positions. The Company applies credit-related valuation adjustments to its short-term and long-term borrowings (including structured notes and junior subordinated debentures) for which the fair value option was elected and to OTC derivatives. The Company considers the impact of changes in its own credit spreads based upon observations of the Company s secondary bond market spreads when measuring fair value for short-term and long-term borrowings. For OTC derivatives, the impact of changes in both the Company s and the counterparty s credit standing is considered when measuring fair value. In determining the expected exposure, the Company simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party credit default swap (CDS) spread data. Where CDS spread data is unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty s credit rating or CDS spread data that references a comparable counterparty may be utilized. The Company also considers collateral held and legally enforceable master netting agreements that mitigate the Company s exposure to each counterparty. Adjustments for model uncertainty are taken for positions whose underlying models are reliant on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible. The Company generally subjects all valuations and models to a review process initially and on a periodic basis thereafter.

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

See Note 4 for a description of valuation techniques applied to the major categories of financial instruments measured at fair value.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

For further information on financial assets and liabilities that are measured at fair value on a recurring and non-recurring basis, see Note 4.

Hedge Accounting.

The Company applies hedge accounting using various derivative financial instruments and non-U.S. dollar-denominated debt to hedge interest rate and foreign exchange risk arising from assets and liabilities not held at fair value as part of asset/liability and currency management. These derivative financial instruments are included within Financial instruments owned Derivative and other contracts or Financial instruments sold, not yet purchased Derivative and other contracts in the condensed consolidated statements of financial condition.

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

For further information on derivative instruments and hedging activities, see Note 10.

Condensed Consolidated Statements of Cash Flows.

For purposes of the condensed consolidated statements of cash flows, cash and cash equivalents consist of Cash and due from banks and Interest bearing deposits with banks, which are highly liquid investments with original maturities of three months or less and readily convertible to known amounts of cash. The Company s significant non-cash activities include assets acquired of approximately $0.4 billion and assumed liabilities of approximately $0.1 billion in connection with a business acquisition and approximately $0.6 billion of equity securities received in connection with the sale of Retail Asset Management, in the six months ended June 30, 2010. The Company s significant non-cash activities include assets acquired of $10.5 billion and assumed liabilities of $3.2 billion, in connection with business acquisitions in the six months ended June 30, 2009.

Repurchase and Securities Lending Transactions.

Securities borrowed or purchased under agreements to resell and securities loaned or sold under agreements to repurchase are treated as collateralized financings. Securities purchased under agreements to resell (reverse repurchase agreements) and Securities sold under agreements to repurchase (repurchase agreements) are carried on the condensed consolidated statements of financial condition at the amounts at which the securities will be subsequently sold or repurchased, plus accrued interest. Where appropriate, transactions with the same counterparty are reported on a net basis. Securities borrowed and securities loaned are recorded at the amount of cash collateral advanced or received.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Securitization Activities.

The Company engages in securitization activities related to commercial and residential mortgage loans, corporate bonds and loans, U.S. agency collateralized mortgage obligations and other types of financial assets (see Note 7). Such transfers of financial assets are generally accounted for as sales when the Company has relinquished control over the transferred assets and does not consolidate the transferee. The gain or loss on sale of such financial assets depends, in part, on the previous carrying amount of the assets involved in the transfer (generally at fair value) and the sum of the proceeds and the fair value of the retained interests at the date of sale. Transfers that are not accounted for as sales are treated as secured financings (failed sales).

Earnings per Common Share.

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

Effective October 13, 2008, as a result of an adjustment to Equity Units sold to a wholly owned subsidiary of China Investment Corporation Ltd. (CIC), the Company calculates EPS in accordance with the accounting guidance for determining EPS for participating securities. The accounting guidance for participating securities and the two-class method of calculating EPS addresses the computation of EPS by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company along with common shareholders according to a predetermined formula. The two-class method requires the Company to present EPS as if all of the earnings for the period are distributed to Morgan Stanley common shareholders and any participating securities, regardless of whether any actual dividends or distributions are made. The amount allocated to the participating securities is based upon the contractual terms of their respective contract and is reflected as a reduction to Net income applicable to Morgan Stanley common shareholders for both the Company s basic and diluted EPS calculations (see Note 14). The two-class method does not impact the Company s actual net income applicable to Morgan Stanley or other financial results. Unless contractually required by the terms of the participating securities, no losses are allocated to participating securities for purposes of the EPS calculation under the two-class method.

Due to the ability to redeem the junior subordinated debentures underlying the Equity Units as described in Note 21, the Equity Units are included in the diluted EPS calculation using the more dilutive of the two-class method or if-converted method for the quarter ended June 30, 2010. The same methodology will be used prospectively through the remaining life of the Equity Units.

Under current accounting guidance, unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of EPS pursuant to the two-class method described above. Share-based payment awards that pay dividend equivalents subject to vesting are not deemed participating securities and are included in diluted shares outstanding (if dilutive) under the treasury stock method.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Goodwill and Intangible Assets.

Goodwill and indefinite-lived intangible assets are not amortized and are reviewed annually (or more frequently when certain events or circumstances exist) for impairment. Other intangible assets are amortized over their estimated useful lives and reviewed for impairment.

Deferred Compensation Arrangements.

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

Employee Loans.

At June 30, 2010 and December 31, 2009, the Company had $5.8 billion and $3.5 billion, respectively, of loans outstanding primarily to certain MSSB employees that are included in Receivables Fees, interest and other on the condensed consolidated statements of financial condition. These loans are full-recourse, require periodic payments and have repayment terms ranging from 4 to 12 years.

Securities Available for Sale (AFS).

During the quarter ended March 31, 2010, the Company established a portfolio of debt securities that are classified as securities available for sale. During the quarter ended June 30, 2010, the Company classified certain marketable equity securities received in connection with the Company s sale of Retail Asset Management as AFS securities (see Note 1). AFS securities are reported at fair value in the condensed consolidated statement of financial condition with unrealized gains and losses reported in Accumulated other comprehensive income (loss), net of tax. Interest and dividend income, including amortization of premiums and accretion of discounts, is included in Interest income in the condensed consolidated statement of income. Realized gains and losses on AFS securities are reported in earnings (see Note 5). The Company utilizes the first-in, first-out method as the basis for determining the cost of AFS securities.

Other-than-temporary impairment. AFS securities in unrealized loss positions resulting from the current fair value of a security being less than amortized cost, are analyzed as part of the Company s ongoing assessment of other-than-temporary impairment (OTTI).

For AFS debt securities, the Company incurs a loss in the condensed consolidated statement of income for the OTTI if the Company has the intent to sell the security or it is more likely than not the Company will be required to sell the security before recovery of its amortized cost basis as of the reporting date. For those debt securities the Company does not expect to sell or expect to be required to sell, the Company must evaluate whether it expects to recover the entire amortized cost basis of the debt security. In the event of a credit loss, only the amount of impairment associated with the credit loss is recognized in income. Unrealized losses relating to factors other than credit are recorded in Accumulated other comprehensive income (loss), net of tax.

For AFS equity securities, the Company considers various factors including the intent and ability to hold the equity security for a period of time sufficient for recovery to amortized cost in evaluating whether an OTTI exists. When the Company lacks that intent and ability, the equity security is considered other-than-temporarily impaired and the security will be written down to fair value, with the full difference between fair value and amortized cost recognized in earnings.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounting Developments.

Transfers of Financial Assets and Extinguishments of Liabilities and Consolidation of Variable Interest Entities. In June 2009, the Financial Accounting Standards Board (the FASB) issued accounting guidance which changed the way entities account for securitizations and special-purpose entities. The accounting guidance amended the accounting for transfers of financial assets and requires additional disclosures about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. It eliminated the concept of a QSPE and changed the requirements for derecognizing financial assets.

The accounting guidance also amended the accounting for consolidation and changed how a reporting entity determines when a VIE that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a reporting entity is required to consolidate a VIE is based on, among other things, the other entity s purpose and design and the reporting entity s ability to direct the activities of the other entity that most significantly impact the other entity s economic performance. In February 2010, the FASB finalized a deferral of these accounting changes, effective January 1, 2010, for certain interests in money market funds, investment companies or in entities qualifying for accounting purposes as investment companies (the Deferral). The Company will continue to analyze consolidation under other existing authoritative guidance for entities subject to the Deferral. The adoption of the accounting guidance on January 1, 2010 did not have a material impact on the Company s condensed consolidated statement of financial condition.

3. Morgan Stanley Smith Barney Holdings LLC.

Smith Barney. On May 31, 2009, the Company and Citigroup Inc. (Citi) consummated the combination of the Company s Global Wealth Management Group and the businesses of Citi s Smith Barney in the U.S., Quilter Holdings Ltd in the U.K., and Smith Barney Australia (Smith Barney). In addition to the Company s contribution of respective businesses to MSSB, the Company paid Citi $2,755 million in cash. The combined businesses operate as Morgan Stanley Smith Barney. Pursuant to the terms of the amended contribution agreement, dated at May 29, 2009, certain businesses of Smith Barney and Morgan Stanley will be contributed to MSSB subsequent to May 31, 2009 (the delayed contribution businesses). Morgan Stanley and Citi will each own their delayed contribution businesses until they are transferred to MSSB and gains and losses from such businesses will be allocated to the Company s and Citi s respective share of MSSB s gains and losses. The Company owns 51% and Citi owns 49% of MSSB.

At May 31, 2009, the Company included MSSB in its condensed consolidated financial statements. The results of MSSB are included within the Global Wealth Management Group business segment. See Note 3 to the consolidated financial statements for the year ended December 31, 2009 included in the Form 10-K for further information on Smith Barney.

Citi Managed Futures. Citi contributed its managed futures business and certain related proprietary trading positions to MSSB on July 31, 2009 (Citi Managed Futures). The Company paid Citi approximately $300 million in cash in connection with this transfer. At July 31, 2009, Citi Managed Futures was wholly-owned and consolidated by MSSB, of which the Company owns 51% and Citi owns 49%.

See Note 3 to the consolidated financial statements for the year ended December 31, 2009 included in the Form 10-K for further information on Citi Managed Futures.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Pro forma condensed combined financial information

The following unaudited pro forma condensed combined financial information presents the results of operations of the Company as they may have appeared if the closing of MSSB and Citi Managed Futures had been completed on January 1, 2009 (dollars in millions, except share data).

	Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
	(unaudited)	
Net revenues	$ 6,317	$ 10,900
Total non-interest expenses	6,641	11,758
Loss from continuing operations before income taxes	(324)	(858)
Benefit from income taxes	(267)	(847)
Loss from continuing operations	(57)	(11)
Discontinued operations:		
Gain from discontinued operations	480	225
Provision for income taxes	182	82
Gain on discontinued operations	298	143
Net income	$ 241	$ 132
Net income applicable to non-controlling interests	11	45
Net income applicable to Morgan Stanley	$ 230	$ 87
Loss applicable to Morgan Stanley common shareholders	$ (1,175)	$ (1,719)
(Loss) earnings per basic common share:		
Loss from continuing operations	$ (1.29)	$ (1.71)
Gain on discontinued operations	0.26	0.11
Loss per basic common share	$ (1.03)	$ (1.60)
(Loss) earnings per diluted common share:		
Loss from continuing operations	$ (1.29)	$ (1.71)
Gain on discontinued operations	0.26	0.11
Loss per diluted common share	$ (1.03)	$ (1.60)

The unaudited pro forma condensed combined financial information is presented for illustrative purposes only and does not indicate the actual financial results of the Company had the closing of Smith Barney and Citi Managed Futures been completed on January 1, 2009, nor is it indicative of the results of operations in future periods. Included in the unaudited pro forma combined financial information for the quarter and six months ended June 30, 2009 were pro forma adjustments to reflect the results of operations of Smith Barney and Citi Managed Futures as well as the impact of amortizing certain purchase accounting adjustments such as amortizable intangible assets. The pro forma condensed

financial information does not indicate the impact of possible business model changes nor does it consider any potential impacts of market conditions, expense efficiencies or other factors.

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.

Financial Instruments Owned and Financial Instruments Sold, Not Yet Purchased

U.S. Government and Agency Securities

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

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

Other Sovereign Government Obligations

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

Corporate and Other Debt

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

Residential Mortgage-Backed Securities (RMBS), Commercial Mortgage-Backed Securities (CMBS), and other Asset-Backed Securities (ABS). RMBS, CMBS and other ABS may be valued based on price or spread data obtained from observed transactions or independent external parties such as vendors or brokers. When position-specific external price data are not observable, the fair value determination may require benchmarking to similar instruments and/or analyzing expected credit losses, default and recovery rates. In evaluating the fair value of each security, the Company considers security collateral-specific attributes including payment priority, credit enhancement levels, type of collateral, delinquency rates and loss severity among other factors. In addition for RMBS borrowers, FICO scores and the level of documentation for the loan are also considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral compositions and cash flow structure of each deal. Key inputs to these models are

market spreads, forecasted credit losses, default and

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

prepayments rates for each asset category. Valuation levels of RMBS and CMBS indices are also used as an additional data point for benchmarking purposes or to price outright index positions.

RMBS, CMBS and other ABS are categorized in Level 3 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; otherwise, they are categorized in Level 2 of the fair value hierarchy.

Corporate Bonds. The fair value of corporate bonds is estimated using recently executed transactions, market price quotations (where observable), bond spreads or credit default swap spreads 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 observable price quotations are not available, fair value is determined based on cash flow models with yield curves, bond or single name credit default swap spreads and recovery rates as significant inputs. Corporate bonds are generally categorized in Level 2 of the fair value hierarchy; in instances where prices, spreads or any of the other aforementioned key inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

Collateralized Debt Obligations (CDOs). The Company holds cash CDOs that typically reference a tranche of an underlying synthetic portfolio of single name credit default swaps. The collateral is usually ABS or other corporate bonds. Credit correlation, a primary input used to determine the fair value of a cash CDO, is usually unobservable and derived using a benchmarking technique. The other model inputs such as credit spreads, including collateral spreads, and interest rates are typically observable. CDOs are categorized in Level 2 of the fair value hierarchy when the credit correlation input is insignificant. In instances where the credit correlation input is deemed to be significant, these instruments are categorized in Level 3 of the fair value hierarchy.

Corporate Loans and Lending Commitments. The fair value of corporate loans is estimated 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 estimated by using executed transactions on comparable loans and the anticipated market price based on pricing indications from syndicate banks and customers. The valuation of these commitments also takes into account certain fee income. Corporate loans and lending commitments are generally categorized in Level 2 of the fair value hierarchy; in instances where prices or significant spread inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

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

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

20

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Corporate Equities.

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

Derivative and Other Contracts.

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

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

Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be either observed or modeled using a series of techniques, and model inputs from comparable benchmarks, including closed-form analytic 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 within 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 derivative interests in certain mortgage-related CDO securities, certain types of ABS credit default swaps, basket credit default swaps, and CDO-squared positions (a CDO-squared position is a special purpose vehicle that issues interests, or

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

For basket credit default swaps and CDO-squared positions, the correlation input between reference credits is unobservable for each specific swap 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.

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 estimated using executed trades and broker and consensus data to provide values for the aforementioned inputs. Where these inputs are unobservable, relationships to observable commodities and data points, based on historic and/or implied observations, are employed as a technique to estimate the model input values. Commodity derivatives are generally categorized in Level 2 of the fair value hierarchy; in instances where significant inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

For further information on derivative instruments and hedging activities, see Note 10.

Investments.

The Company s investments include investments in private equity funds, real estate funds, hedge funds and direct equity investments. Direct equity 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 internally and externally managed funds, the Company considers the net asset value 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.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

Securities Available for Sale.

Securities available for sale primarily include U.S. government and agency securities and equity securites. The U.S. government and agency securities and equity securities are valued using quoted prices in active markets and, accordingly, are categorized in Level 1 of the fair value hierarchy. For further information on securities available for sale, see Note 5.

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

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 notes is estimated using valuation models for the derivative and debt portions of the notes. These models incorporate observable inputs referencing identical or comparable securities, including prices that the notes are linked to, interest rate yield curves, option volatility, and currency, commodity or equity rates. Independent, external and traded prices for the notes are also considered. 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.

Deposits.

Time Deposits. The fair value of certificates of deposit is estimated using third-party quotations. These deposits are generally 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 June 30, 2010 and December 31, 2009. See Note 2 for a discussion of the Company s policies regarding this fair value hierarchy.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2010

	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 June 30, 2010
Assets					
Financial instruments owned:					
U.S. government and agency securities:					
U.S. Treasury securities	$ 17,580	$	$	$	$ 17,580
U.S. agency securities	12,750	33,645	1		46,396
Total U.S. government and agency securities	30,330	33,645	1		63,976
Other sovereign government obligations	22,995	6,335	73		29,403
Corporate and other debt:					
State and municipal securities		3,030	221		3,251
Residential mortgage-backed securities		3,505	476		3,981
Commercial mortgage-backed securities		2,534	613		3,147
Asset-backed securities		2,590	101		2,691
Corporate bonds		38,759	1,344		40,103
Collateralized debt obligations		2,334	1,513		3,847
Loans and lending commitments		13,047	12,747		25,794
Other debt		1,922	1,810		3,732
Total corporate and other debt		67,721	18,825		86,546
Corporate equities(1)	49,271	4,377	346		53,994
Derivatives and other contracts:					
Interest rate contracts	3,102	749,564	1,147		753,813
Credit contracts		114,826	22,710		137,536
Foreign exchange contracts	1	60,459	458		60,918
Equity contracts	3,926	39,960	1,094		44,980
Commodity contracts	7,135	56,101	1,431		64,667
Other		104	185		289
Netting(2)	(11,564)	(906,486)	(13,033)	(77,267)	(1,008,350)
Total derivatives and other contracts	2,600	114,528	13,992	(77,267)	53,853
Investments(3):					
Private equity funds			1,839		1,839
Real estate funds		10	1,643		1,653
Hedge funds		894	910		1,804
Principal investments	421	5	2,575		3,001
Other	353	70	444		867
Total investments	774	979	7,411		9,164
Physical commodities		5,694			5,694
Total financial instruments owned	105,970	233,279	40,648	(77,267)	302,630
Securities available for sale:					
Debt securities:					
U.S. government and agency securities	18,847				18,847
Equity securities(4)	520				520

Total securities available for sale	19,367				19,367
Securities received as collateral	14,023	758			14,781
Intangible assets(5)			139		139
Liabilities					
Commercial paper and other short-term borrowings	$	$ 1,515	$ 7	$	$ 1,522
Deposits		4,473	14		4,487
Financial instruments sold, not yet purchased:					
U.S. government and agency securities:					
U.S. Treasury securities	17,987				17,987
U.S. agency securities	3,076	37			3,113
Total U.S. government and agency securities	21,063	37			21,100
Other sovereign government obligations	20,149	2,736			22,885

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) (dollars in millions)	Counterparty and Cash Collateral Netting	Balance at June 30, 2010
Corporate and other debt:					
State and municipal securities		9			9
Residential mortgage-backed securities			2		2
Commercial mortgage-backed securities		1			1
Asset-backed securities		31			31
Corporate bonds		6,824	80		6,904
Unfunded lending commitments		493	335		828
Other debt		961	221		1,182
Total corporate and other debt		8,319	638		8,957
Corporate equities(1)	23,042	1,552	5		24,599
Derivatives and other contracts:					
Interest rate contracts	3,374	721,837	631		725,842
Credit contracts		105,257	14,609		119,866
Foreign exchange contracts	4	64,547	387		64,938
Equity contracts	3,977	43,574	2,092		49,643
Commodity contracts	7,850	55,109	1,417		64,376
Other		441	1,224		1,665
Netting(2)	(11,564)	(906,486)	(13,033)	(47,599)	(978,682)
Total derivative and other contracts	3,641	84,279	7,327	(47,599)	47,648
Total financial instruments sold, not yet purchased	67,895	96,923	7,970	(47,599)	125,189
Obligation to return securities received as collateral	14,023	758			14,781
Other secured financings	1,516	4,067	1,910		7,493
Long-term borrowings		30,520	6,509		37,029

(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 10.
(3) In June 2010, the Company voluntarily contributed $25 million to certain other investments in funds that it manages in connection with upcoming rule changes regarding net asset value disclosures for money market funds. Based on current liquidity and fund performance, the Company does not expect to provide additional voluntary support to non-consolidated funds that it manages.
(4) In connection with the Company s sale of Retail Asset Management to Invesco, the Company received equity securities of Invesco. For further information regarding these securities available for sale, see Note 5.
(5) Amount represents mortgage servicing rights (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 June 30, 2010.

Financial instruments owned Derivative and other contracts and Financial instruments sold, not yet purchased Derivative and other contracts. During the quarter ended June 30, 2010, the Company reclassified approximately $1.5 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.

Financial instruments owned Corporate equities. During the quarter ended June 30, 2010, the Company reclassified approximately $0.5 billion of certain Corporate equities from Level 2 to Level 1 as transactions in these securities occurred with sufficient frequency and volume to constitute an active market. During the quarter ended June 30, 2010, the Company reclassified approximately $1.0 billion of certain Corporate equities from Level 1 to Level 2 as transactions in these securities did not occur with sufficient frequency and volume to constitute an active market.

Transfers Between Level 1 and Level 2 During the Six Months Ended June 30, 2010.

Financial instruments owned Derivative and other contracts and Financial instruments sold, not yet purchased Derivative and other contracts. During the six months ended June 30, 2010, the Company reclassified approximately $1.8 billion of derivative assets and approximately $1.9 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.

Financial instruments owned Corporate equities. During the six months ended June 30, 2010, the Company reclassified approximately $1.1 billion of certain Corporate equities from Level 2 to Level 1 as transactions in these securities occurred with sufficient frequency and volume to constitute an active market.

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, 2009

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) (dollars in millions)	Counterparty and Cash Collateral Netting	Balance at December 31, 2009
Assets					
Financial instruments owned:					
U.S. government and agency securities:					
U.S. Treasury securities	$ 15,394	$	$	$	$ 15,394
U.S. agency securities	19,670	27,115	36		46,821
Total U.S. government and agency securities	35,064	27,115	36		62,215
Other sovereign government obligations	21,080	4,362	3		25,445
Corporate and other debt:					
State and municipal securities		3,234	713		3,947
Residential mortgage-backed securities		4,285	818		5,103
Commercial mortgage-backed securities		2,930	1,573		4,503
Asset-backed securities		4,797	591		5,388
Corporate bonds		37,363	1,038		38,401
Collateralized debt obligations		1,539	1,553		3,092
Loans and lending commitments		13,759	12,506		26,265
Other debt		2,093	1,662		3,755
Total corporate and other debt		70,000	20,454		90,454
Corporate equities(1)	49,732	7,700	536		57,968
Derivatives and other contracts(2)	2,310	102,466	14,549	(70,244)	49,081
Investments	743	930	7,613		9,286
Physical commodities		5,329			5,329
Total financial instruments owned	108,929	217,902	43,191	(70,244)	299,778
Securities received as collateral	12,778	855	23		13,656
Intangible assets(3)			137		137
Liabilities					
Commercial paper and other short-term borrowings	$	$ 791	$	$	$ 791
Deposits		4,943	24		4,967
Financial instruments sold, not yet purchased:					
U.S. government and agency securities:					
U.S. Treasury securities	17,907	1			17,908
U.S. agency securities	2,573	22			2,595
Total U.S. government and agency securities	20,480	23			20,503
Other sovereign government obligations	16,747	1,497			18,244
Corporate and other debt:					
State and municipal securities		9			9
Commercial mortgage-backed securities		8			8
Asset-backed securities		63	4		67
Corporate bonds		5,812	29		5,841
Collateralized debt obligations			3		3
Unfunded lending commitments		732	252		984

Other debt		483	431		914
Total corporate and other debt		7,107	719		7,826
Corporate equities(1)	18,125	4,472	4		22,601
Derivative and other contracts(2)	3,383	67,847	6,203	(39,224)	38,209
Total financial instruments sold, not yet purchased	58,735	80,946	6,926	(39,224)	107,383
Obligation to return securities received as collateral	12,778	855	23		13,656
Other secured financings		6,570	1,532		8,102
Long-term borrowings		30,745	6,865		37,610

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(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 10.
(3) Amount represents MSRs accounted for at fair value. See Note 7 for further information on MSRs.

The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter and six months ended June 30, 2010 and for the quarter and six months ended June 30, 2009, 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 Three Months Ended June 30, 2010

	Beginning Balance at March 31, 2010	Total Realized and Unrealized Gains (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at June 30, 2010	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2010(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. agency securities	$ 1	$	$ (5)	$ 5	$ 1	$
Other sovereign government obligations	80	(1)	70	(76)	73	
Corporate and other debt:						
State and municipal securities	398	19	(180)	(16)	221	1
Residential mortgage-backed securities	625	(37)	(97)	(15)	476	(42)
Commercial mortgage-backed securities	779	23	133	(322)	613	13
Asset-backed securities	149	8	(75)	19	101	6
Corporate bonds	1,145	86	154	(41)	1,344	79
Collateralized debt obligations	1,512	(25)	40	(14)	1,513	42
Loans and lending commitments	13,503	(40)	152	(868)	12,747	(64)
Other debt	1,921	(61)	(28)	(22)	1,810	(68)
Total corporate and other debt	20,032	(27)	99	(1,279)	18,825	(33)
Corporate equities	536	(33)	(183)	26	346	(1)
Net derivatives and other contracts:						
Interest rate contracts	384	310	(132)	(46)	516	311
Credit contracts	7,952	315	265	(431)	8,101	499
Foreign exchange contracts	206	(1)	(134)		71	(2)
Equity contracts	(701)	(137)	(191)	31	(998)	(129)
Commodity contracts	90	(152)	53	23	14	(126)
Other	(579)	(402)	(40)	(18)	(1,039)	(352)
Total net derivative and other contracts(3)	7,352	(67)	(179)	(441)	6,665	201
Investments:						
Private equity funds	1,634	82	123		1,839	21
Real estate funds	1,751	4	(115)	3	1,643	109
Hedge funds	1,027	(29)	5	(93)	910	(29)
Principal investments	2,700	(132)	7		2,575	(83)
Other	434	64	(60)	6	444	3
Total investments	7,546	(11)	(40)	(84)	7,411	21
Intangible assets	175	(15)	(21)		139	(27)
Liabilities						
Commercial paper and other short-term borrowings	$ 300	$	$ (293)	$	$ 7	$
Deposits	15	1			14	
Financial instruments sold, not yet purchased:						
Corporate and other debt:						

Residential mortgage-backed securities		(6)	(4)		2	(5)
Asset-backed securities	4		(4)			
Corporate bonds	17	14	80	(3)	80	19
Unfunded lending commitments	213	(110)	12		335	(110)
Other debt	317	15	(81)		221	13
Total corporate and other debt	551	(87)	3	(3)	638	(83)
Corporate equities	13	1	(4)	(3)	5	
Other secured financings	1,811	69	5	163	1,910	69
Long-term borrowings	6,728	92	20	(147)	6,509	92

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(1) Total realized and unrealized gains (losses) are primarily included in Principal transactions Trading in the condensed consolidated statements of income except for $(11) million related to Financial instruments owned Investments, which is included in Principal transactions Investments.
(2) Amounts represent unrealized gains (losses) for the quarter ended June 30, 2010 related to assets and liabilities still outstanding at June 30, 2010.
(3) Net derivative and other contracts represent Financial instruments owned Derivative and other contracts net of Financial instruments sold, not yet purchased Derivative and other contracts. For further information on Derivative instruments and hedging activities, see Note 10.

Financial instruments owned Corporate and other debt. During the quarter ended June 30, 2010, the Company reclassified approximately $1.9 billion of certain Corporate and other debt, primarily corporate loans, from Level 3 to Level 2. The Company reclassified the corporate loans as external prices and/or spread inputs for these instruments became observable.

The Company also reclassified approximately $0.6 billion of certain Corporate and other debt from Level 2 to Level 3. The Company reclassified corporate loans as external prices and/or spread inputs became unobservable.

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 Six Months Ended June 30, 2010

	Beginning Balance at December 31, 2009	Total Realized and Unrealized Gains (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at June 30, 2010	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2010(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. agency securities	$ 36	$	$ (35)	$	$ 1	$
Other sovereign government obligations	3	(1)	63	8	73	(1)
Corporate and other debt:						
State and municipal securities	713	(56)	(436)		221	(58)
Residential mortgage-backed securities	818	12	(392)	38	476	(6)
Commercial mortgage-backed securities	1,573	128	(774)	(314)	613	28
Asset-backed securities	591	3	(491)	(2)	101	9
Corporate bonds	1,038	(44)	256	94	1,344	(53)
Collateralized debt obligations	1,553	122	(171)	9	1,513	60
Loans and lending commitments	12,506	76	629	(464)	12,747	126
Other debt	1,662	185	(14)	(23)	1,810	160
Total corporate and other debt	20,454	426	(1,393)	(662)	18,825	266
Corporate equities	536	67	(161)	(96)	346	21
Net derivatives and other contracts:						
Interest rate contracts	387	300	(146)	(25)	516	302
Credit contracts	8,824	(163)	383	(943)	8,101	340
Foreign exchange rate contracts	254	(102)	(123)	42	71	(308)
Equity contracts	(689)	(208)	(184)	83	(998)	(161)
Commodity contracts	7	(68)	14	61	14	66
Other	(437)	(575)	(12)	(15)	(1,039)	(511)
Total net derivative and other contracts(3)	8,346	(816)	(68)	(797)	6,665	(272)
Investments:						
Private equity funds	1,628	139	72		1,839	116
Real estate funds	1,087	186	350	20	1,643	289
Hedge funds	1,678	(218)	(270)	(280)	910	(220)
Principal investments	2,642	(105)	38		2,575	(87)
Other	578	47	(180)	(1)	444	(3)
Total investments	7,613	49	10	(261)	7,411	95
Securities received as collateral	23		(23)			
Intangible assets	137	24	(22)		139	4
Liabilities						
Commercial paper and other short-term borrowings	$	$	$ 7	$	$ 7	$
Deposits	24	2		(8)	14	2
Financial instruments sold, not yet purchased:						
Corporate and other debt:						

Residential mortgage-backed securities		(1)	1		2	(1)
Commercial mortgage-backed securities		1	1			
Asset-backed securities	4		(4)			
Corporate bonds	29	(1)	22	28	80	8
Collateralized debt obligations	3		(3)			
Unfunded lending commitments	252	(140)	(57)		335	(138)
Other debt	431	20	(175)	(15)	221	20
Total corporate and other debt	719	(121)	(215)	13	638	(111)
Corporate equities	4	(1)	(7)	7	5	1
Obligation to return securities received as collateral	23		(23)			
Other secured financings	1,532	(67)	222	89	1,910	(80)
Long-term borrowings	6,865	99	(26)	(231)	6,509	99

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(1) Total realized and unrealized gains (losses) are primarily included in Principal transactions Trading in the condensed consolidated statements of income except for $49 million related to Financial instruments owned Investments, which is included in Principal transactions Investments.
(2) Amounts represent unrealized gains (losses) for the six months ended June 30, 2010 related to assets and liabilities still outstanding at June 30, 2010.
(3) Net derivative and other contracts represent Financial instruments owned Derivative and other contracts net of Financial instruments sold, not yet purchased Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 10.

Financial instruments owned Corporate and other debt. During the six months ended June 30, 2010, the Company reclassified approximately $1.4 billion of certain Corporate and other debt, primarily corporate loans, from Level 3 to Level 2. The Company reclassified the corporate loans as external prices and/or spread inputs for these instruments became observable.

The Company also reclassified approximately $0.8 billion of certain Corporate and other debt from Level 2 to Level 3. The Company reclassified corporate loans as external prices and/or spread inputs became unobservable.

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 Three Months Ended June 30, 2009

	Beginning Balance at March 31, 2009	Total Realized and Unrealized Gains or (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at June 30, 2009	Unrealized Gains or (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2009(2)
			(dollars in millions)			
Assets						
Financial instruments owned:						
U.S. agency securities	$ 17	$ (1)	$ 12	$	$ 28	$
Other sovereign government obligations	2			1	3	
State and municipal securities	1,887	25	(207)		1,705	(7)
Residential mortgage-backed securities	988	(16)	(41)	(111)	820	(15)
Commercial mortgage-backed securities	2,443	(215)	(680)	(42)	1,506	(204)
Asset-backed securities	4,519	108	(2,961)	161	1,827	30
Corporate bonds	2,370	(39)	161	(43)	2,449	(180)
Collateralized debt obligations	972	88	(236)	(316)	508	49
Loans and lending commitments	17,108	630	48	1,650	19,436	570
Other debt	1,201	256	33	(1)	1,489	245
Total corporate and other debt	31,488	837	(3,883)	1,298	29,740	488
Corporate equities	946	366	(302)	91	1,101	(172)
Net derivative and other contracts(3)	16,521	(3,510)	(1,098)	693	12,606	(3,101)
Investments	8,834	(166)	(487)	(9)	8,172	(97)
Securities received as collateral	3		14		17	
Intangible assets	159	14			173	13
Liabilities						
Financial instruments sold, not yet purchased:						
Commercial mortgage-backed securities	$ 4	$	$	$	$ 4	$
Asset-backed securities	1,636	109	(1,523)		4	108
Corporate bonds	58	(11)	63		132	(9)
Collateralized debt obligations	16	1	(15)			
Unfunded lending commitments	208	(134)	(37)	(2)	303	(128)
Other debt	28	(4)	54		86	(1)
Total corporate and other debt	1,950	(39)	(1,458)	(2)	529	(30)
Corporate equities	74	(26)	(83)	5	22	(12)
Obligation to return securities received as collateral	3		14		17	
Other secured financings	4,264	52	20	231	4,463	52
Long-term borrowings	5,671	(224)	1	4	5,900	(224)

(1) Total realized and unrealized gains (losses) are primarily included in Principal transactions Trading in the condensed consolidated statements of income except for $(166) million related to Financial instruments owned Investments, which is included in Principal transactions Investments.
(2) Amounts represent unrealized gains (losses) for the quarter ended June 30, 2009 related to assets and liabilities still outstanding at June 30, 2009.
(3) Net derivative and other contracts represent Financial instruments owned Derivative and other contracts net of Financial instruments sold, not yet purchased Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 10.

Financial instruments owned Corporate and other debt. The net gains in Corporate and other debt were primarily driven by corporate loans.

During the quarter ended June 30, 2009, the Company reclassified approximately $1.3 billion of certain Corporate and other debt from Level 2 to Level 3. The reclassifications were primarily related to certain corporate loans. The reclassifications were due to a reduction in market price quotations for these or comparable

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

instruments, or a lack of available broker quotes, such that unobservable inputs had to be utilized for the fair value measurement of these instruments. The key unobservable inputs include assumptions to establish comparability to bonds, loans or swaps with observable price/spread levels.

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

During the quarter ended June 30, 2009, the Company reclassified approximately $700 million of certain Derivatives and other contracts from Level 2 to Level 3. These reclassifications of certain Derivatives and other contracts were related to interest rate swaps and bespoke basket default swaps, for which some inputs were unobservable and deemed significant.

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

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 Six Months Ended June 30, 2009

	Beginning Balance at December 31, 2008	Total Realized and Unrealized Gains or (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at June 30, 2009	Unrealized Gains or (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2009(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. agency securities	$ 127	$ (3)	$ (73)	$ (23)	$ 28	$
Other sovereign government obligations	1	2	(4)	4	3	(2)
State and municipal securities	2,065	3	(289)	(74)	1,705	(8)
Residential mortgage-backed securities	1,251	(93)	(156)	(182)	820	(111)
Commercial mortgage-backed securities	3,130	(609)	(1,035)	20	1,506	(634)
Asset-backed securities	968	(42)	505	396	1,827	(85)
Corporate bonds	3,088	(318)	(74)	(247)	2,449	(508)
Collateralized debt obligations	982	(21)	(202)	(251)	508	(66)
Loans and lending commitments	19,701	(1,898)	533	1,100	19,436	(1,786)
Other debt	3,733	340	(927)	(1,657)	1,489	292
Total corporate and other debt	34,918	(2,638)	(1,645)	(895)	29,740	(2,906)
Corporate equities	976	332	(365)	158	1,101	(201)
Net derivative and other contracts(3)	23,382	(2,346)	100	(8,530)	12,606	229
Investments	9,698	(1,484)	13	(55)	8,172	(1,372)
Securities received as collateral	30		(13)		17	
Intangible assets	184	(12)	1		173	13
Liabilities						
Financial instruments sold, not yet purchased:						
Commercial mortgage-backed securities	$ 1	$ 1	$ 4	$	$ 4	$ 1
Asset-backed securities	4	1	1		4	
Corporate bonds	320	(9)	(101)	(96)	132	(9)
Unfunded lending commitments	36	(131)	136		303	(131)
Other debt	3,447	1	(935)	(2,425)	86	2
Total corporate and other debt	3,808	(137)	(895)	(2,521)	529	(137)
Corporate equities	27	(8)	(5)	(8)	22	(8)
Obligation to return securities received as collateral	30		(13)		17	
Other secured financings	6,148	1,143	(628)	86	4,463	1,143
Long-term borrowings	5,473	(337)	83	7	5,900	(354)

(1)

Total realized and unrealized gains (losses) are primarily included in Principal transactions Trading in the condensed consolidated statements of income except for $(1,484) million related to Financial instruments owned Investments, which is included in Principal transactions Investments.

(2) Amounts represent unrealized gains (losses) for the six months ended June 30, 2009 related to assets and liabilities still outstanding at June 30, 2009.

(3) Net derivative and other contracts represent Financial instruments owned Derivative and other contracts net of Financial instruments sold, not yet purchased Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 10.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

During the six months ended June 30, 2009, the Company reclassified approximately $0.9 billion of certain Corporate and other debt from Level 3 to Level 2. The reclassifications were primarily related to certain other debt. Their fair value was highly correlated with similar instruments in an observable market and, due to market deterioration, unobservable inputs were no longer deemed significant. These reclassifications were partly offset by the reclassification of certain corporate loans from Level 2 to Level 3. The reclassifications were due to a reduction in market price quotations for these or comparable instruments, or a lack of available broker quotes, such that unobservable inputs had to be utilized for the fair value measurement of these instruments. The key unobservable inputs include assumptions to establish comparability to bonds, loans or swaps with observable price/spread levels.

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

During the six months ended June 30, 2009, the Company reclassified approximately $8.5 billion of certain Derivatives and other contracts from Level 3 to Level 2. These reclassifications of certain Derivatives and other contracts were related to single name mortgage-related credit default swaps and credit default swaps on certain classes of CDOs. The primary reason for the reclassifications is that, due to market deterioration, the values associated with the unobservable inputs, such as correlation, for these derivative contracts were no longer deemed significant to the fair value measurement. In addition, certain corporate tranche-indexed credit default swaps were reclassified due to increased availability of transaction data, broker quotes and/or consensus pricing.

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

Financial instruments sold, not yet purchased Corporate and other debt. During the six months ended June 30, 2009, the Company reclassified approximately $2.5 billion of certain Corporate and other debt from Level 3 to Level 2. These reclassifications primarily related to contracts referencing commercial mortgage-backed securities, subprime CDO and other subprime ABS securities. Their fair value was highly correlated with similar instruments in an observable market and, due to market deterioration, the values associated with the unobservable inputs were no longer deemed significant to the fair value measurement.

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

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fair Value of Investments that Calculate Net Asset Value.

The following table presents information about the Company s investments in private equity funds, real estate funds and hedge funds measured at fair value based on net asset value at June 30, 2010 and December 31, 2009, respectively.

	At June 30, 2010		At December 31, 2009	
	Fair Value	Unfunded Commitment	Fair Value	Unfunded Commitment
	(dollars in millions)			
Private equity funds	$ 1,585	$ 1,202	$ 1,728	$ 1,251
Real estate funds	887	536	823	674
Hedge funds(1):				
Long-short equity hedge funds	1,053		1,597	
Fixed income/credit-related hedge funds	347		407	
Event-driven hedge funds	144		146	
Multi-strategy hedge funds	205		235	
Total	$ 4,221	$ 1,738	$ 4,936	$ 1,925

(1) Fixed income/credit-related hedge funds, event-driven hedge funds, and multi-strategy hedge funds are redeemable at least on a quarterly basis with a notice period of ninety days or less. At June 30, 2010, approximately 46% of the fair value amount of long-short equity hedge funds is redeemable at least quarterly, 23% is redeemable every six months and 31% of these funds have a redemption frequency of greater than six months. At December 31, 2009, approximately 36% of the fair value amount of long-short equity hedge funds is redeemable at least quarterly, 15% is redeemable every six months and 49% of these funds have a redemption frequency of greater than six months. The notice period for long-short equity hedge funds is primarily within 120 days.

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 June 30, 2010, it is estimated that 8% of the fair value of the funds will be liquidated in the next five years, another 38% of the fair value of the funds will be liquidated between five to ten years and the remaining 54% of the fair value of the funds have a remaining life of greater than ten 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 June 30, 2010, it is estimated that 23% of the fair value of the funds will be liquidated within the next five years, another 26% of the fair value of the funds will be liquidated between five to ten years and the remaining 51% of the fair value of the funds have a remaining life of greater than ten 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 which 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.

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

36

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

stocks perceived to be overvalued. Investments representing approximately 39% 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 100% of investments subject to lock-up restrictions ranged from one to three years at June 30, 2010. Investments representing approximately 32% 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 100% of investments subject to an exit restriction is expected to be less than a year at June 30, 2010.

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 over-valued securities that are primarily debt or credit related. At June 30, 2010, investments representing approximately 19% of the fair value of the investments in fixed income/credit-related hedge funds cannot be redeemed currently because the investments include certain initial period lock-up restrictions. The remaining restriction period for these investments was three years or less at June 30, 2010.

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, hoping to profit from the spread between the current market price and the ultimate purchase price of the target company. At June 30, 2010, investments representing approximately 65% of the 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 was two years or less at June 30, 2010.

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 June 30, 2010, investments representing approximately 52% 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 86% of investments subject to lock-ups was two years or less at June 30, 2010. The remaining restriction period for the other 14% of investments subject to lock-up restrictions was estimated to be greater than three years at June 30, 2010.

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. 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 six months ended June 30, 2010 and 2009.

	Principal Transactions-Trading	Interest Expense	Gains (Losses) Included in Net Revenues
		(dollars in millions)	
Three months ended June 30, 2010			
Commercial paper and other short-term borrowings	$ 55	$	$ 55
Deposits	10	(45)	(35)
Long-term borrowings	2,409	(285)	2,124
Six Months Ended June 30, 2010			
Commercial paper and other short-term borrowings	$ 68	$	$ 68
Deposits	(15)	(93)	(108)
Long-term borrowings	2,527	(484)	2,043
Three months ended June 30, 2009			
Commercial paper and other short-term borrowings	$ (126)	$	$ (126)
Deposits	10	(87)	(77)
Long-term borrowings	(3,880)	(270)	(4,150)
Six Months Ended June 30, 2009			
Commercial paper and other short-term borrowings	$ (42)	$	$ (42)
Deposits	(77)	(179)	(256)
Long-term borrowings	(4,928)	(494)	(5,422)

In addition to the amounts in the above table, as discussed in Note 2, all of the instruments within Financial instruments owned or Financial instruments sold, not yet purchased are measured at fair value, either through the election of the fair value option, or as required by other accounting guidance.

The following tables present information on the Company s short-term and long-term borrowings (including structured notes and junior subordinated debentures), loans and unfunded lending commitments for which the fair value option was elected:

Fair Value Option Gains (Losses) Due to Changes in Instrument Specific Credit Spreads

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
		(dollars in millions)		
Short-term and long-term borrowings(1)	$ 750	$ (2,286)	$ 803	$ (3,926)
Loans(2)	(348)	3,718	(1)	3,644
Unfunded lending commitments(3)	(94)	(144)	(164)	(142)

(1) Gains (losses) were attributable to widening or (tightening), respectively, of the Company s credit spreads and were determined based upon observations of the Company s secondary bond market spreads. The remainder of changes in overall fair value of the short-term and long-term borrowings as shown above is attributable to changes in foreign currency exchange rates and interest rates and movements in the reference price or index for structured notes.

(2) Instrument-specific credit gains or (losses) were determined by excluding the non-credit components of gains and losses, such as those due to changes in interest rates.

(3) Losses were generally determined based on the differential between estimated expected client and contractual yields at each respective period end.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amount by Which Contractual Principal Amount Exceeds Fair Value

	At June 30, 2010	At December 31, 2009
	(dollars in billions)	
Short-term and long-term debt borrowings(1)	$ 1.3	$ 1.9
Loans(2)	23.2	24.4
Loans 90 or more days past due in non-accrual status or both(2)(3)	20.3	21.0

(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 $3.5 billion and $3.9 billion at June 30, 2010 and December 31, 2009, respectively. The aggregate fair value of loans that were 90 or more days past due was $1.1 billion and $0.7 billion at June 30, 2010 and December 31, 2009, respectively.

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, equity method investments, premises and equipment, intangible assets and real estate investments.

The following tables present, by caption on the condensed consolidated statement 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 six months ended June 30, 2010 and 2009, respectively.

Three and Six Months Ended June 30, 2010.

		Fair Value Measurements Using:				
	Carrying Value at June 30, 2010(1)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for the Three Months Ended June 30, 2010(2)	Total Losses for the Six Months Ended June 30, 2010(2)
				(dollars in millions)		
Loans(3)	$ 622	$	$	$ 622	$ (25)	$ (28)
Other investments(4)						(5)
Intangible assets(5)	3			3	(17)	(27)
Total	$ 625	$	$	$ 625	$ (42)	$ (60)

(1)

Carrying values relate only to those assets that incurred impairment losses during the quarter ended June 30, 2010. These amounts do not include assets that incurred impairment losses during the six months ended June 30, 2010, unless the assets also experienced an impairment loss during the quarter ended June 30, 2010.

(2) Losses are recorded within Other expenses in the condensed consolidated statement of income except for fair value adjustments related to Loans and losses related to Other investments, which are included in Other revenues.

(3) Non-recurring change in fair value for loans held for investment were calculated based upon the fair value of the underlying collateral. The fair value of the collateral was determined using internal expected recovery models.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(4) Losses recorded were determined primarily using discounted cash flow models.
(5) Losses primarily related to investment management contracts and were determined using discounted cash flow models.

In addition to the losses included in the table above, the Company incurred a loss of approximately $951 million in connection with the planned disposition of Revel for the six months ended June 30, 2010 (see Note 1) which was included in discontinued operations. The loss related to Premises, equipment and software costs and was included in discontinued operations (see Note 1). The fair value of Revel, net of estimated costs to sell, included in Premises, equipment and software costs was approximately $240 million at June 30, 2010 and was classified in Level 3. Fair value was determined using discounted cash flow models.

There were no liabilities measured at fair value on a non-recurring basis during the quarter and six months ended June 30, 2010.

Three and Six Months Ended June 30, 2009.

		Fair Value Measurements Using:				
	Carrying Value at June 30, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for the Three Months Ended June 30, 2009(1)	Total Losses for the Six Months Ended June 30, 2009(1)
				(dollars in millions)		
Loans(2)	$ 664	$	$	$ 664	$ (84)	$ (182)
Other investments(3)	9			9	(4)	(9)
Premises, equipment and software costs(3)	8			8		(5)
Total	$ 681	$	$	$ 681	$ (88)	$ (196)

(1) Losses are recorded within Other expenses in the condensed consolidated statement of income except for losses related to Loans and Other investments, which are included in Other revenues.
(2) Losses for loans held for investment and held for sale were calculated based upon the fair value of the underlying collateral. The fair value of the collateral was determined using internal expected recovery models.
(3) Losses recorded were determined primarily using discounted cash flow models.

In addition to the losses included in the table above, losses of approximately $212 million (of which $42 million related to Other investments, $9 million related to Intangible assets and $161 million related to Other assets) were included in discontinued operations related to Crescent for the six months ended June 30, 2009 (see Note 1). The carrying value of Crescent assets at June 30, 2009 was $168 million (of which $14 million related to Other investments, $7 million related to Intangible assets and $147 million related to Other assets) all of which were classified in Level 3. Fair values were generally determined using discounted cash flow models or third-party appraisals and valuations.

There were no liabilities measured at fair value on a non-recurring basis during the quarter and six months ended June 30, 2009.

Financial Instruments Not Measured at Fair Value.

Some of the Company s financial instruments are not measured at fair value on a recurring basis but nevertheless are recorded at amounts that approximate fair value due to their liquid or short-term nature. Such financial assets and financial liabilities include: Cash and due from banks, Interest bearing deposits with banks, Cash deposited with clearing organizations or segregated under federal and other regulations or

requirements, Federal funds sold

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and Securities purchased under agreements to resell, Securities borrowed, Securities sold under agreements to repurchase, Securities loaned, Receivables Customers, Receivables Brokers, dealers and clearing organizations, Payables Customers, Payables Brokers, dealers and clearing organizations, certain Commercial paper and other short-term borrowings, and certain Deposits.

The Company s long-term borrowings are recorded at amortized amounts unless elected under the fair value option or designated as a hedged item in a fair value hedge. For long-term borrowings not measured at fair value, the fair value of the Company s long-term borrowings was estimated using either quoted market prices or discounted cash flow analyses based on the Company s current borrowing rates for similar types of borrowing arrangements. At June 30, 2010, the carrying value of the Company s long-term borrowings not measured at fair value was approximately $5.5 billion higher than fair value. At December 31, 2009, the carrying value of the Company s long-term borrowings not measured at fair value was approximately $1.4 billion higher than fair value.

5. Securities Available for Sale.

The following table presents information about the Company s AFS securities at June 30, 2010:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Other-than-temporary Impairment	Fair Value
			(dollars in millions)		
Debt securities available for sale:					
U.S. government and agency securities	$ 18,653	$ 194	$	$	$ 18,847
Equity securities available for sale(1)	560		40		520
Total	$ 19,213	$ 194	$ 40	$	$ 19,367

(1) In connection with the Company s sale of Retail Asset Management, the Company received equity securities of Invesco (See Note 1).

The table below presents the fair value of investments in equity securities available for sale that have been in an unrealized loss position for less than 12 months or for 12 months or longer at June 30, 2010:

At June 30, 2010	Less than 12 months		12 months or longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
			(dollars in millions)			
Equity securities available for sale	$ 520	$ 40	$	$	$ 520	$ 40

There were no debt securities available for sale in an unrealized loss position at June 30, 2010. For equity securities, the Company considers various factors including the length of time and extent to which the market value has been less than cost, as well as its intent and ability to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value and whether evidence exists to support a realizable value equal to or greater than the carrying value. The Company believes that the equity securities with an unrealized loss in Accumulated other comprehensive income were not other-than-temporarily impaired at June 30, 2010.

41

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the amortized cost and fair value of debt securities available for sale by contractual maturity dates at June 30, 2010:

At June 30, 2010	Amortized Cost	Fair Value	Annualized Average Yield
		(dollars in millions)	
U.S. government and agency securities:			
Due within 1 year	$ 3,614	$ 3,619	0.47%
After 1 year but through 5 years	15,039	15,228	1.29%
Total	$ 18,653	$ 18,847	1.14%

6. Collateralized Transactions.

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

	At June 30, 2010	At December 31, 2009
	(dollars in millions)	
Financial instruments owned:		
U.S. government and agency securities	$ 19,671	$ 18,376
Other sovereign government obligations	5,366	4,584
Corporate and other debt	13,209	13,111
Corporate equities	12,243	10,284
Total	$ 50,489	$ 46,355

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers needs and to finance the Company s inventory positions. The Company s policy is generally to take possession of Securities purchased under agreements to resell. The Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. government and agency securities, other sovereign government obligations, corporate and other debt, and corporate equities. The Company receives collateral in the form of securities in connection with reverse repurchase agreements, securities borrowed and derivative transactions, and customer margin loans. In many cases, the Company is permitted to sell or repledge these securities held as collateral and use the securities to secure repurchase agreements, to enter into securities lending and derivative transactions or for delivery to counterparties to cover short positions. At June 30, 2010 and December 31, 2009, the fair value of financial instruments received as collateral where the Company is permitted to sell or repledge the securities was $523 billion and $429 billion, respectively, and the fair value of the portion that had been sold or repledged was $386 billion and $311 billion, respectively.

The Company additionally receives securities as collateral in connection with certain securities for securities transactions in which the Company is the lender. In instances where the Company is permitted to sell or repledge

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

these securities, the Company reports the fair value of the collateral received and the related obligation to return the collateral in the condensed consolidated statements of financial condition. At June 30, 2010 and December 31, 2009, $14,781 million and $13,656 million, respectively, were reported as Securities received as collateral and an Obligation to return securities received as collateral in the condensed consolidated statements of financial condition. Collateral received in connection with these transactions that was subsequently repledged was approximately $14 billion and $13 billion at June 30, 2010 and December 31, 2009, respectively.

The Company manages credit exposure arising from reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Company, in the event of a customer default, the right to liquidate collateral and the right to offset a counterparty s rights and obligations. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralized. Where deemed appropriate, the Company s agreements with third parties specify its rights to request additional collateral. Customer receivables generated from margin lending activity are collateralized by customer-owned securities held by the Company. For these transactions, adherence to the Company s collateral policies significantly limits the Company s credit exposure in the event of customer default. The Company may request additional margin collateral from customers, if appropriate, and, if necessary, may sell securities that have not been paid for or purchase securities sold but not delivered from customers.

At June 30, 2010 and December 31, 2009, cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements were as follows:

	At June 30, 2010	At December 31, 2009
	(dollars in millions)	
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	$ 21,930	$ 23,712
Securities(1)	17,599	11,296
Total	$ 39,529	$ 35,008

(1) Securities deposited with clearing organizations or segregated under federal and other regulations or requirements are sourced from Federal funds sold and securities purchased under agreements to resell and Financial instruments owned in the condensed consolidated statements of financial condition.

Other secured financings include the liabilities related to transfers of financial assets that are accounted for as financings rather than sales, consolidated VIEs where the Company is deemed to be the primary beneficiary, and certain equity-linked notes and borrowings where in all instances these liabilities are payable from the cash flows of the related assets accounted for as Financial instruments owned (see Note 7).

7. Variable Interest Entities and Securitization Activities.

The Company is involved with various special purpose entities (SPEs) in the normal course of business. In most cases, these entities are deemed to be VIEs.

The Company applies accounting guidance for consolidation of VIEs to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. Entities that

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

previously met the criteria as QSPEs that were not subject to consolidation prior to January 1, 2010 became subject to the consolidation requirements for VIEs on that date. Excluding entities subject to the Deferral (as defined in Note 2), effective January 1, 2010, the primary beneficiary of a VIE is the party that both (1) has the power to direct the activities of a VIE that most significantly affect the VIE s economic performance and (2) has an obligation to absorb losses or the right to receive benefits that in either case could potentially be significant to the VIE. The Company consolidates entities of which it is the primary beneficiary.

The Company s variable interests in VIEs include debt and equity interests, commitments, guarantees, derivative instruments and certain fees. The Company s involvement with VIEs arises primarily from:

Interests purchased in connection with market making and retained interests held as a result of securitization activities.

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

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

Derivatives entered into with VIEs.

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

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

The Company determines whether it is the primary beneficiary of a VIE upon its initial involvement with the VIE and reassesses whether it is the primary beneficiary on an ongoing basis as long as it has any continuing involvement with the VIE. This determination is based upon an analysis of the design of the VIE, including the VIE s structure and activities, the power to make significant economic decisions held by the Company and by other parties and the variable interests owned by the Company and other parties.

The power to make the most important decisions may take a number of different forms in different types of VIEs. The Company considers servicing or collateral management decisions as representing the power to make the most important economic decisions in transactions such as securitizations or collateral debt obligations.

For many transactions, such as CLNs and other asset-repackaged notes, there are no significant economic decisions made on an ongoing basis. In these cases, the Company focuses its analysis on decisions made prior to the initial closing of the transaction and at the termination of the transaction. Based upon factors, which include an analysis of the nature of the assets, the number of investors, the standardization of the legal documentation and the level of the continuing involvement by the Company, the Company concluded in most of these transactions that decisions made prior to the initial closing were shared between the Company and the initial investors. The Company focused its control decision on any right held by the Company or investors related to the termination of the VIE.

Except for consolidated VIEs included in other structured financings in the tables below, the Company accounts for the assets held by the entities primarily in Financial instruments owned and the liabilities of the entities as Other secured financings in the condensed consolidated statements of financial condition. The Company includes assets held by consolidated VIEs included in other structured financings in the tables below primarily in Receivables, Premises, equipment and software costs and Other assets and the liabilities primarily as Other liabilities and accrued expenses and Payables in the condensed consolidated statements of financial condition. Except for consolidated VIEs included in other

structured financings, the assets and liabilities are measured at fair value, with changes in fair value reflected in earnings.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The assets owned by many consolidated VIEs cannot be removed unilaterally by the Company and are not generally available to the Company. The related liabilities issued by many consolidated VIEs are non-recourse to the Company. In certain other consolidated VIEs, the Company has the unilateral right to remove assets or provides additional recourse through derivatives such as total return swaps, guarantees or other forms of involvement.

The following tables present information at June 30, 2010 and December 31, 2009 about VIEs that the Company consolidates. Consolidated VIE assets and liabilities are presented after intercompany eliminations and include assets financed on a non-recourse basis. As a result of the accounting guidance adopted on January 1, 2010, the Company consolidated a number of VIEs that had not previously been consolidated and de-consolidated a number of VIEs that had previously been consolidated at December 31, 2009.

	At June 30, 2010				
	Mortgage and Asset-backed Securitizations	Collateralized Debt Obligations	Managed Real Estate Partnerships	Other Structured Financings	Other
	(dollars in millions)				
VIE assets	$ 4,128	$ 87	$ 1,871	$ 647	$ 1,944
VIE liabilities	$ 3,301	$ 72	$ 136	$ 2,633	$ 699

	At December 31, 2009			
	Mortgage and Asset-backed Securitizations	Credit and Real Estate	Commodities Financing	Other Structured Financings
	(dollars in millions)			
VIE assets	$ 2,715	$ 2,629	$ 1,509	$ 762
VIE liabilities	$ 992	$ 687	$ 1,370	$ 73

In general, the Company s exposure to loss in consolidated VIEs is limited to losses that would be absorbed on the VIE s assets recognized in its financial statements, net of losses absorbed by third-party holders of the VIE s liabilities. At June 30, 2010, managed real estate partnerships reflected non-controlling interests of $1,255 million. The Company also has additional maximum exposure to losses of approximately $858 million and $533 million at June 30, 2010 and December 31, 2009, respectively. This additional exposure relates primarily to certain derivatives (*e.g.*, credit derivatives in which the Company has sold unfunded protection in synthetic collateralized debt obligations, typically for the most senior tranche, in which the total protection sold by the VIE exceeds the amount of collateral held) and commitments, guarantees and other forms of involvement.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents information about certain non-consolidated VIEs in which the Company had variable interests at June 30, 2010. Many of the VIEs included in this table met the QSPE requirements under previous accounting guidance. QSPEs were not included as non-consolidated VIEs in prior periods. The table includes all VIEs in which the Company has determined that its maximum exposure to loss is greater than specific thresholds or meets certain other criteria. The non-consolidated VIEs included in the June 30, 2010 and December 31, 2009 tables are based on different criteria.

	At June 30, 2010				
	Mortgage and Asset-backed Securitizations	Collateralized Debt Obligations	Municipal Tender Option Bonds	Other Structured Financings	Other
	(dollars in millions)				
VIE assets that the Company does not consolidate (unpaid principal balance)(1)	$ 170,936	$ 9,330	$ 7,063	$ 2,098	$ 10,418
Maximum exposure to loss:					
Debt and equity interests(2)	$ 10,848	$ 740	$ 48	$ 1,083	$ 2,563
Derivatives and other contracts	808	1,645			3,374
Commitments, guarantees and other			4,448	779	496
Total maximum exposure to loss	$ 11,656	$ 2,385	$ 4,496	$ 1,862	$ 6,433
Carrying value of exposure to loss Assets:					
Debt and equity interests(2)	$ 10,848	$ 740	$ 48	$ 833	$ 2,563
Derivatives and other contracts	784	1,251			3,314
Total carrying value of exposure to loss Assets	$ 11,632	$ 1,991	$ 48	$ 833	$ 5,877
Carrying value of exposure to loss Liabilities:					
Derivatives and other contracts	$ 24	$ 529	$	$	$ 60
Commitments, guarantees and other			24	47	309
Total carrying value of exposure to loss Liabilities	$ 24	$ 529	$ 24	$ 47	$ 369

(1) Mortgage and asset-backed securitizations include VIE assets as follows: $23.0 billion of residential mortgages; $82.0 billion of commercial mortgages; $48.0 billion of U.S. agency collateralized mortgage obligations and $18.0 billion of other consumer or commercial loans.
(2) Mortgage and asset-backed securitizations include VIE debt and equity interests as follows: $1.3 billion of residential mortgages; $2.0 billion of commercial mortgages; $6.0 billion of U.S. agency collateralized mortgage obligations and $1.5 billion of other consumer or commercial loans.

The Company s maximum exposure to loss often differs from the carrying value of the VIE s assets. The maximum exposure to loss is dependent on the nature of the Company s variable interest in the VIEs and is limited to the notional amounts of certain liquidity facilities, other credit support, total return swaps, written put options, and the fair value of certain other derivatives and investments the Company has made in the VIEs. Liabilities issued by VIEs generally are non-recourse to the Company. Where notional amounts are utilized in quantifying maximum exposure related to derivatives, such amounts do not reflect fair value writedowns already recorded by the Company.

The Company s maximum exposure to loss does not include the offsetting benefit of any financial instruments that the Company may utilize to hedge these risks associated with the Company s variable interests. In addition, the Company s maximum exposure to loss is not reduced by the amount of collateral held as part of a transaction with the VIE or any party to the VIE directly against a specific exposure to loss.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Securitization transactions generally involve VIEs. The Company owned additional securities issued by securitization SPEs for which the maximum exposure to loss is less than specific thresholds. These additional securities totaled $6.0 billion at June 30, 2010. These securities were either retained in connection with transfers of assets by the Company or acquired in connection with secondary market-making activities. Securities issued by securitization SPEs consist of $1.7 billion of securities backed primarily by residential mortgage loans, $0.9 billion of securities backed by U.S. agency collateralized mortgage obligations, $1.5 billion of securities backed by commercial mortgage loans, $1.4 billion of securities backed by collateralized debt obligations or collateralized loan obligations and $0.5 billion backed by other consumer loans, such as credit card receivables, automobile loans and student loans. The Company s primary risk exposure is limited to the securities issued by the SPE owned by the Company, with the risk highest on the most subordinate class of beneficial interests. These securities generally are included in Financial instruments owned Corporate and other debt and are measured at fair value. The Company does not provide additional support in these transactions through contractual facilities, such as liquidity facilities, guarantees, or similar derivatives. The Company s maximum exposure to loss is equal to the fair value of the securities owned.

The following table presents information about the Company s non-consolidated VIEs at December 31, 2009 in which the Company had significant variable interests or served as the sponsor and had any variable interest as of that date. The non-consolidated VIEs included in the June 30, 2010 and December 31, 2009 tables are based on different criteria.

	At December 31, 2009			
	Mortgage and Asset-backed Securitizations	Credit and Real Estate	Municipal Tender Option Bond Trusts	Other Structured Financings
	(dollars in millions)			
VIE assets that the Company does not consolidate	$ 720	$ 11,848	$ 339	$ 5,775
Maximum exposure to loss:				
Debt and equity interests	$ 16	$ 2,330	$ 40	$ 861
Derivatives and other contracts	1	4,949		
Commitments, guarantees and other		200	31	623
Total maximum exposure to loss	$ 17	$ 7,479	$ 71	$ 1,484
Carrying value of exposure to loss Assets:				
Debt and equity interests	$ 16	$ 2,330	$ 40	$ 682
Derivatives and other contracts	1	2,382		
Total carrying value of exposure to loss Assets	$ 17	$ 4,712	$ 40	$ 682
Carrying value of exposure to loss Liabilities:				
Derivatives and other contracts	$	$ 484	$	$
Commitments, guarantees and other				45
Total carrying value of exposure to loss Liabilities	$	$ 484	$	$ 45

The Company s transactions with VIEs primarily includes securitizations, municipal tender option bond trusts, credit protection purchased through CLNs, collateralized loan and debt obligations, equity-linked notes, managed real estate partnerships and asset management investment funds. Such activities are described below.

Securitization Activities. In a securitization transaction, the Company transfers assets (generally commercial or residential mortgage loans or U.S. agency securities) to an SPE, sells to investors most of the beneficial interests,

47

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

such as notes or certificates, issued by the SPE and in many cases retains other beneficial interests. In many securitization transactions involving commercial mortgage loans, the Company transfers a portion of the assets transferred to the SPE with unrelated parties transferring the remaining assets.

The purchase of the transferred assets by the SPE is financed through the sale of these interests. In some of these transactions, primarily involving residential mortgage loans in the U.S. and Europe and commercial mortgage loans in Europe, the Company serves as servicer for some or all of the transferred loans. In many securitizations, particularly involving residential mortgage loans, the Company also enters into derivative transactions, primarily interest rate swaps or interest rate caps, with the SPE.

In most of these transactions, the SPE met the criteria to be a QSPE under the accounting guidance effective prior to January 1, 2010 for the transfer and servicing of financial assets. The Company did not consolidate QSPEs if they met certain criteria regarding the types of assets and derivatives they held, the activities in which they engaged and the range of discretion they may have exercised in connection with the assets they held. SPEs that formerly met the criteria to be a QSPE are now subject to the same consolidation requirements as other VIEs.

The primary risk retained by the Company in connection with these transactions generally is limited to the beneficial interests issued by the SPE that are owned by the Company, with the risk highest on the most subordinate class of beneficial interests. These beneficial interests generally are included in Financial instruments owned Corporate and other debt and are measured at fair value. The Company does not provide additional support in these transactions through contractual facilities, such as liquidity facilities, guarantees, or similar derivatives.

Although not obligated, the Company generally makes a market in the securities issued by SPEs in these transactions. As a market maker, the Company offers to buy these securities from, and sell these securities to, investors. Securities purchased through these market-making activities are not considered to be retained interests, although these beneficial interests generally are included in Financial instruments owned Corporate and other debt and are measured at fair value.

The Company enters into derivatives, generally interest rate swaps and interest rate caps with a senior payment priority in many securitization transactions. The risks associated with these and similar derivatives with SPEs are essentially the same as similar derivatives with non-SPE counterparties and are managed as part of the Company s overall exposure.

See Note 10 for further information on derivative instruments and hedging activities.

Municipal Tender Option Bond Trusts. In a municipal tender option bond transaction, the Company, on behalf of a client, transfers a municipal bond to a trust. The trust issues short-term securities which the Company, as the remarketing agent, sells to investors. The client retains a residual interest. The short-term securities are supported by a liquidity facility pursuant to which the investors may put their short-term interests. In some programs, the Company provides this liquidity facility; in most programs, a third-party provider will provide such liquidity facility. The Company may purchase short-term securities in its role either as remarketing agent or liquidity provider. The client can generally terminate the transaction at any time. The liquidity provider can generally terminate the transaction upon the occurrence of certain events. When the transaction is terminated, the municipal bond is generally sold or returned to the client. Any losses suffered by the liquidity provider upon the sale of the bond are the responsibility of the client. This obligation generally is collateralized.

Credit Protection Purchased Through CLNs. In a CLN transaction, the Company transfers assets (generally high quality securities or money market investments) to an SPE, enters into a derivative transaction in which the SPE writes protection on an unrelated reference asset or group of assets through a credit default swap, a total

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

return swap or similar instrument, and sells to investors the securities issued by the SPE. In some transactions, the Company may also enter into interest rate or currency swaps with the SPE. Upon the occurrence of a credit event related to the reference asset, the SPE will sell the collateral securities in order to make the payment to the Company. The Company is generally exposed to price changes on the collateral securities in the event of a credit event and subsequent sale. These transactions are designed to provide investors with exposure to certain credit risk on the reference asset. In some transactions, the assets and liabilities of the SPE are recognized in the Company s condensed consolidated financial statements. In other transactions, the transfer of the collateral securities is accounted for as a sale of assets and the SPE is not consolidated. The structure of the transaction determines the accounting treatment. CLNs are included in Other in the above VIE tables.

The derivatives in CLN transactions consist of total return swaps, credit default swaps or similar contracts in which the Company has purchased protection on a reference asset or group of assets. Payments by the SPE are collateralized. The risks associated with these and similar derivatives with SPEs are essentially the same as similar derivatives with non-SPE counterparties and are managed as part of the Company s overall exposure.

Other Structured Financings. The Company primarily invests in equity interests issued by entities that develop and own low income communities (including low income housing projects) and entities that construct and own facilities that will generate energy from renewable resources. The equity interests entitle the Company to its share of tax credits and tax losses generated by these projects. In addition, the Company has issued guarantees to investors in certain low-income housing funds. The guarantees are designed to return an investor s contribution to a fund and the investor s share of tax losses and tax credits expected to be generated by the fund. The Company is also involved with entities designed to provide tax-efficient yields to the Company or its clients.

Collateralized Loan and Debt Obligations. A collateralized loan obligation (CLO) or a CDO is an SPE that purchases a pool of assets, consisting of corporate loans, corporate bonds, asset-backed securities or synthetic exposures on similar assets through derivatives and issues multiple tranches of debt and equity securities to investors.

Equity-Linked Notes. In an equity-linked note transaction included in the tables above, the Company typically transfers to an SPE either (1) a note issued by the Company, the payments on which are linked to the performance of a specific equity security, equity index or other index or (2) debt securities issued by other companies and a derivative contract, the terms of which will relate to the performance of a specific equity security, equity index or other index. These transactions are designed to provide investors with exposure to certain risks related to the specific equity security, equity index or other index. Equity-linked notes are included in Other in the above VIE tables.

Managed Real Estate Partnerships. The Company sponsors funds that invest in real estate assets. Certain of these funds are classified as VIEs primarily because the Company has provided financial support through lending facilities and other means. The Company also serves as the general partner for these funds and owns limited partnership interests in them. These funds are consolidated at June 30, 2010.

Asset Management Investment Funds. The tables above do not include certain investments made by the Company held by entities qualifying for accounting purposes as investment companies.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Transfers of Assets with Continuing Involvement.

The following table presents information at June 30, 2010 regarding transactions with SPEs in which the Company, acting as principal, transferred assets with continuing involvement and received sales treatment. The transferees in most of these transactions formerly met the criteria for QSPEs.

	At June 30, 2010			
	Residential Mortgage Loans	Commercial Mortgage Loans	U.S. Agency Collateralized Mortgage Obligations	Credit-Linked Notes and Other
	(dollars in millions)			
SPE assets (unpaid principal balance)(1)	$ 51,643	$ 90,189	$ 19,787	$ 11,738
Retained interests (fair value):				
Investment grade	$ 66	$ 513	$ 1,529	$ 7
Non-investment grade	218	165		2,333
Total retained interests (fair value)	$ 284	$ 678	$ 1,529	$ 2,340
Interests purchased in the secondary market (fair value):				
Investment grade	$ 91	$ 376	$ 106	$ 1
Non-investment grade	78	45	1	9
Total interests purchased in the secondary market (fair value)	$ 169	$ 421	$ 107	$ 10
Derivative assets (fair value)	$ 107	$ 992	$	$ 135
Derivative liabilities (fair value)	$ 21	$	$	$ 33

(1) Amounts include assets transferred by unrelated transferors.

	At June 30, 2010			
	Level 1	Level 2	Level 3	Total
	(dollars in millions)			
Retained interests (fair value):				
Investment grade	$	$ 1,615	$ 500	$ 2,115
Non-investment grade		309	2,407	2,716
Total retained interests (fair value)	$	$ 1,924	$ 2,907	$ 4,831
Interests purchased in the secondary market (fair value):				
Investment grade	$	$ 549	$ 25	$ 574
Non-investment grade		104	29	133
Total interests purchased in the secondary market (fair value)	$	$ 653	$ 54	$ 707

Derivative assets (fair value)	$	$ 883	$ 351	$ 1,234
Derivative liabilities (fair value)	$	$ 36	$ 18	$ 54

Transferred assets are carried at fair value prior to securitization, and any changes in fair value are recognized in the condensed consolidated statements of income. The Company may act as underwriter of the beneficial interests issued by securitization vehicles. Investment banking underwriting net revenues are recognized in connection with these transactions. The Company may retain interests in the securitized financial assets as one or more tranches of the securitization. These retained interests are included in the condensed consolidated statements of financial condition at fair value. Any changes in the fair value of such retained interests are recognized in the condensed consolidated statements of income.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Net gains at the time of securitization were not material in the six months ended June 30, 2010.

During the six months ended June 30, 2010, the Company received proceeds from new securitization transactions of $10.0 billion. During the six months ended June 30, 2010, the Company received proceeds from cash flows from retained interests in securitization transactions of $2.8 billion.

The Company provides representations and warranties that certain assets transferred in securitization transactions conform to specific guidelines (see Note 11).

Failed Sales.

In order to be treated as a sale of assets for accounting purposes, a transaction must meet all of the criteria stipulated in the accounting guidance for the transfer of financial assets. If the transfer fails to meet these criteria, that transfer is treated as a failed sale. In such case, the Company continues to recognize the assets in Financial instruments owned and the Company recognizes the associated liabilities in Other secured financings in the condensed consolidated statements of financial condition.

The assets transferred to many unconsolidated VIEs in transactions accounted for as failed sales cannot be removed unilaterally by the Company and are not generally available to the Company. The related liabilities issued by many unconsolidated VIEs are non-recourse to the Company. In certain other failed sale transactions, the Company has the unilateral right to remove assets or provides additional recourse through derivatives such as total return swaps, guarantees or other forms of involvement.

The following tables present information about transfers of assets treated by the Company as secured financings at June 30, 2010 and December 31, 2009:

	At June 30, 2010			
	Commercial Mortgage Loans	Credit-Linked Notes	Equity-Linked Transactions	Other
	(dollars in millions)			
Assets				
Fair value	$ 93	$ 763	$ 1,767	$ 167
Other secured financings				
Fair value	54	761	1,767	167

	At December 31, 2009			
	Residential Mortgage Loans	Commercial Mortgage Loans	Credit-Linked Notes	Other
	(dollars in millions)			
Assets				
Unpaid principal amount	$ 376	$ 324	$ 1,059	$ 1,332
Fair value	151	291	1,012	1,294
Other secured financings				
Unpaid principal amount	267	271	1,025	1,332
Fair value	138	269	978	1,294

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Mortgage Servicing Activities.

Mortgage Servicing Rights. The Company may retain servicing rights to certain mortgage loans that are sold through its securitization activities. These transactions create an asset referred to as MSRs, which totaled approximately $139 million and $137 million at June 30, 2010 and December 31, 2009, respectively, and are included within Intangible assets and carried at fair value in the condensed consolidated statements of financial condition.

SPE Mortgage Servicing Activities. The Company services residential mortgage loans in the U.S. and Europe and commercial mortgage loans in Europe owned by SPEs, including SPEs sponsored by the Company and SPEs not sponsored by the Company. The Company generally holds retained interests in Company-sponsored SPEs. In some cases, as part of its market making activities, the Company may own some beneficial interests issued by both Company-sponsored and non-Company sponsored SPEs.

The Company provides no credit support as part of its servicing activities. The Company is required to make servicing advances to the extent that it believes that such advances will be reimbursed. Reimbursement of servicing advances is a senior obligation of the SPE, senior to the most senior beneficial interests outstanding. Outstanding advances are included in Other assets and are recorded at cost. Advances at June 30, 2010 and December 31, 2009 totaled approximately $1.6 billion and $2.2 billion, respectively, net of reserves of $15 million and $23 million at June 30, 2010 and December 31, 2009, respectively.

The following tables present information about the Company s mortgage servicing activities for SPEs to which the Company transferred loans at June 30, 2010 and December 31, 2009:

	At June 30, 2010			
	Residential Mortgage Unconsolidated SPEs	Residential Mortgage Consolidated SPEs	Commercial Mortgage Unconsolidated SPEs	Commercial Mortgage Consolidated SPEs
	(dollars in millions)			
Assets serviced (unpaid principal balance)	$ 12,253	$ 2,232	$ 7,408	$ 2,008
Amounts past due 90 days or greater (unpaid principal balance)(1)	$ 5,391	$ 831	$	$
Percentage of amounts past due 90 days or greater(1)	44.0%	37.2%		
Credit losses	$ 612	$ 40	$	$

(1) Includes loans that are at least 90 days contractually delinquent, loans for which the borrower has filed for bankruptcy, loans in foreclosure and real estate owned.

	At December 31, 2009		
	Residential Mortgage QSPEs	Residential Mortgage Failed Sales	Commercial Mortgage QSPEs
	(dollars in millions)		
Assets serviced (unpaid principal balance)	$ 18,902	$ 1,110	$ 10,901
Amounts past due 90 days or greater (unpaid principal balance)(1)	$ 7,297	$ 408	$ 5
Percentage of amounts past due 90 days or greater(1)	38.6%	36.8%	

(1) Includes loans that are at least 90 days contractually delinquent, loans for which the borrower has filed for bankruptcy, loans in foreclosure and real estate owned.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company also serviced residential and commercial mortgage loans for SPEs sponsored by unrelated parties with unpaid principal balances totaling $15 billion and $20 billion at June 30, 2010 and December 31, 2009, respectively.

8. Goodwill and Net Intangible Assets.

The Company tests goodwill for impairment on an annual basis and on an interim basis when certain events or circumstances exist. The Company tests for impairment at the reporting unit level, which is generally one level below its business segments. Goodwill impairment is determined by comparing the estimated fair value of a reporting unit with its respective book value. If the estimated fair value exceeds the book value, goodwill at the reporting unit level is not deemed to be impaired. If the estimated fair value is below book value, however, further analysis is required to determine the amount of the impairment.

The estimated fair values of the reporting units are generally determined utilizing methodologies that incorporate price-to-book, price-to-earnings and assets under management multiples of certain comparable companies.

Due to the volatility in the equity markets, the economic outlook and the Company s common shares trading below book value during the quarter ended June 30, 2010, the Company performed an impairment test for its reporting units at June 30, 2010, which did not result in any goodwill impairment. The analysis, however, did indicate that for one reporting unit, its estimated fair value did not significantly exceed its book value. At June 30, 2010, this reporting unit had a goodwill balance of approximately $400 million. The estimated fair value of the reporting unit incorporated the share price of certain publicly traded comparable companies and, accordingly, a decline in the equity markets would negatively impact the estimated fair value. Thus, a goodwill impairment could occur in future periods, should market conditions deteriorate.

Goodwill.

Changes in the carrying amount of the Company s goodwill, net of accumulated impairment losses for the six months ended June 30, 2010 were as follows:

	Institutional Securities	Global Wealth Management Group	Asset Management	Total
	(dollars in millions)			
Goodwill at December 31, 2009	$ 373	$ 5,618	$ 1,171	$ 7,162
Foreign currency translation adjustments and other	(7)	(2)		(9)
Goodwill disposed of during the period(1)			(404)	(404)
Goodwill at June 30, 2010(2)	$ 366	$ 5,616	$ 767	$ 6,749

(1) The Asset Management business segment activity represents goodwill disposed of in connection with the sale of Retail Asset Management (see Note 1).
(2) The amount of the Company s goodwill before accumulated impairments of $673 million at June 30, 2010 was $7,422 million.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Net Intangible Assets.

Changes in the carrying amount of the Company s intangible assets for the six months ended June 30, 2010 were as follows:

	Institutional Securities	Global Wealth Management Group	Asset Management	Total
	(dollars in millions)			
Amortizable net intangible assets at December 31, 2009	$ 161	$ 4,292	$ 184	$ 4,637
Mortgage servicing rights (see Note 7)	135	2		137
Indefinite-lived intangible assets		280		280
Net intangible assets at December 31, 2009	$ 296	$ 4,574	$ 184	$ 5,054
Amortizable net intangible assets at December 31, 2009	$ 161	$ 4,292	$ 184	$ 4,637
Foreign currency translation adjustments and other	(6)	1		(5)
Amortization expense	(7)	(164)	(5)	(176)
Impairment losses			(27)	(27)
Intangible assets acquired during the period(1)	80			80
Intangible assets disposed of during the period(2)			(4)	(4)
Amortizable net intangible assets at June 30, 2010	228	4,129	148	4,505
Mortgage servicing rights (see Note 7)	136	3		139
Indefinite-lived intangible assets		280		280
Net intangible assets at June 30, 2010	$ 364	$ 4,412	$ 148	$ 4,924

(1) The Institutional Securities business segment activity primarily represents certain re-insurance licenses.

(2) The Asset Management business segment activity represents intangible assets disposed of in connection with the sale of Retail Asset Management (see Note 1).

9. Long-Term Borrowings.

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

	At June 30, 2010	At December 31, 2009
	(dollars in millions)	
Senior debt	$ 168,185	$ 178,797
Subordinated debt	4,117	3,983
Junior subordinated debentures	10,508	10,594

Total	$ 182,810	$ 193,374

During the six months ended June 30, 2010, the Company issued notes with a principal amount of approximately $14 billion representing senior unsecured notes that were not guaranteed by the Federal Deposit Insurance Corporation (FDIC). The amount included non-U.S. dollar currency notes aggregating approximately $2 billion. During the six months ended June 30, 2010, approximately $18 billion of notes were repaid.

The weighted average maturity of the Company s long-term borrowings, based upon stated maturity dates, was approximately 5.7 years and 5.6 years at June 30, 2010 and December 31, 2009, respectively.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

FDIC s Temporary Liquidity Guarantee Program (TLGP).

At June 30, 2010 and December 31, 2009, the Company had long-term debt outstanding of $23.8 billion under the TLGP. These borrowings are senior unsecured debt obligations of the Company and guaranteed by the FDIC under the TLGP. The FDIC has concluded that the guarantee is backed by the full faith and credit of the U.S. government.

10. Derivative Instruments and Hedging Activities.

The Company trades, makes markets and takes proprietary positions globally in listed futures, OTC swaps, forwards, options and other derivatives referencing, among other things, interest rates, currencies, investment grade and non-investment grade corporate credits, loans, bonds, U.S. and other sovereign securities, emerging market bonds and loans, credit indices, asset-backed security indices, property indices, mortgage-related and other asset-backed securities and real estate loan products. The Company uses these instruments for trading, foreign currency exposure management, and asset and liability management.

The Company manages its trading positions by employing a variety of risk mitigation strategies. These strategies include diversification of risk exposures and hedging. Hedging activities consist of the purchase or sale of positions in related securities and financial instruments, including a variety of derivative products (*e.g.*, futures, forwards, swaps and options). The Company manages the market risk associated with its trading activities on a Company-wide basis, on a worldwide trading division level and on an individual product basis.

The Company incurs credit risk as a dealer in OTC derivatives. Credit risk with respect to derivative instruments arises from the failure of a counterparty to perform according to the terms of the contract. The Company s exposure to credit risk at any point in time is represented by the fair value of the derivative contracts reported as assets. The fair value of a derivative represents the amount at which the derivative could be exchanged in an orderly transaction between market participants, and is further described in Notes 2 and 4.

In connection with its derivative activities, the Company generally enters into master netting agreements and collateral arrangements with counterparties. These agreements provide the Company with the ability to offset a counterparty s rights and obligations, request additional collateral when necessary or liquidate the collateral in the event of counterparty default.

The tables below present a summary by counterparty credit rating and remaining contract maturity of the fair value of OTC derivatives in a gain position at June 30, 2010 and December 31, 2009, respectively. Fair value is presented in the final column net of collateral received (principally cash and U.S. government and agency securities):

OTC Derivative Products Financial Instruments Owned at June 30, 2010(1)

	Years to Maturity				Cross-Maturity and Cash Collateral	Net Exposure Post-Cash	Net Exposure Post-
Credit Rating(2)	**Less than 1**	**1-3**	**3-5**	**Over 5**	**Netting(3)**	**Collateral**	**Collateral**
				(dollars in millions)			
AAA	$ 527	$ 1,884	$ 2,759	$ 10,698	$ (6,756)	$ 9,112	$ 8,667
AA	6,124	5,474	5,368	18,184	(27,917)	7,233	6,409
A	9,026	10,209	7,269	29,043	(40,672)	14,875	12,839
BBB	3,774	4,853	2,803	9,120	(11,566)	8,984	7,049
Non-investment grade	2,860	3,109	1,892	4,309	(4,118)	8,052	5,847
Total	$ 22,311	$ 25,529	$ 20,091	$ 71,354	$ (91,029)	$ 48,256	$ 40,811

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(1) Fair values shown represent the Company s net exposure to counterparties related to the Company s OTC derivative products. The table does not include listed derivatives and the effect of any related hedges utilized by the Company. The table also excludes fair values corresponding to other credit exposures, such as those arising from the Company s lending activities.
(2) Obligor credit ratings are determined by the Company s Credit Risk Management Department.
(3) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within such maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.

OTC Derivative Products Financial Instruments Owned at December 31, 2009(1)

Credit Rating(2)	Years to Maturity Less than 1	1-3	3-5	Over 5	Cross-Maturity and Cash Collateral Netting(3)	Net Exposure Post-Cash Collateral	Net Exposure Post-Collateral
	(dollars in millions)						
AAA	$ 852	$ 2,026	$ 3,876	$ 9,331	$ (6,616)	$ 9,469	$ 9,082
AA	6,469	7,855	6,600	15,071	(25,576)	10,419	8,614
A	8,018	10,712	7,990	22,739	(38,971)	10,488	9,252
BBB	3,032	4,193	2,947	7,524	(8,971)	8,725	5,902
Non-investment grade	2,773	3,331	2,113	4,431	(4,534)	8,114	6,525
Total	$ 21,144	$ 28,117	$ 23,526	$ 59,096	$ (84,668)	$ 47,215	$ 39,375

(1) Fair values shown represent the Company s net exposure to counterparties related to the Company s OTC derivative products. The table does not include listed derivatives and the effect of any related hedges utilized by the Company. The table also excludes fair values corresponding to other credit exposures, such as those arising from the Company s lending activities.
(2) Obligor credit ratings are determined by the Company s Credit Risk Management Department.
(3) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within such maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.

Hedge Accounting.

The Company applies hedge accounting using various derivative financial instruments and non-U.S. dollar-denominated debt used to hedge interest rate and foreign exchange risk arising from assets and liabilities not held at fair value as part of asset and liability management and foreign currency exposure management.

The Company s hedges are designated and qualify for accounting purposes as one of the following types of hedge: hedges of exposure to changes in fair value of assets and liabilities being hedged (fair value hedges) and hedges of net investments in foreign operations whose functional currency is different from the reporting currency of the parent company (net investment hedges).

For all hedges where hedge accounting is being applied, effectiveness testing and other procedures to ensure the ongoing validity of the hedges are performed at least monthly.

Fair Value Hedges Interest Rate Risk. The Company s designated fair value hedges consisted primarily of interest rate swaps designated as fair value hedges of changes in the benchmark interest rate of fixed rate senior long-term borrowings. The Company uses regression analysis to perform an ongoing prospective and retrospective assessment of the effectiveness of these hedging relationships (*i.e.*, the Company applies the

long-haul method of hedge accounting). A hedging relationship is deemed effective if the fair values of the hedging instrument (derivative) and the hedged item (debt liability) change inversely within a range of 80% to 125%. The Company considers the impact of valuation adjustments related to the Company s own credit spreads and counterparty credit spreads to determine whether they would cause the hedging relationship to be ineffective.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Net Investment Hedges. The Company may utilize forward foreign exchange contracts and non-U.S. dollar-denominated debt to manage the currency exposure relating to its net investments in non-U.S. dollar functional currency operations. No hedge ineffectiveness is recognized in earnings since the notional amounts of the hedging instruments equal the portion of the investments being hedged, and, where forward contracts are used, the currencies being exchanged are the functional currencies of the parent and investee; where debt instruments are used as hedges, they are denominated in the functional currency of the investee. The gain or loss from revaluing hedges of net investments in foreign operations at the spot rate is deferred and reported within Accumulated other comprehensive income (loss) in Equity, net of tax effects. The forward points on the hedging instruments are recorded in Interest income.

The following tables summarize the fair value of derivative instruments designated as accounting hedges and the fair value of derivative instruments not designated as accounting hedges by type of derivative contract on a gross basis at June 30, 2010 and December 31, 2009. Fair values of derivative contracts in an asset position are included in Financial instruments owned Derivative and other contracts. Fair values of derivative contracts in a liability position are reflected in Financial instruments sold, not yet purchased Derivative and other contracts.

	Assets at June 30, 2010		Liabilities at June 30, 2010	
	Fair Value	Notional	Fair Value	Notional
	(dollars in millions)			
Derivatives designated as accounting hedges:				
Interest rate contracts	$ 6,550	$ 78,726	$	$
Foreign exchange contracts	252	7,899	173	9,093
Total derivatives designated as accounting hedges	6,802	86,625	173	9,093
Derivatives not designated as accounting hedges(1):				
Interest rate contracts	747,263	15,731,042	725,842	15,771,659
Credit contracts	137,536	2,308,464	119,866	2,201,645
Foreign exchange contracts	60,666	1,327,082	64,765	1,373,390
Equity contracts	44,980	537,929	49,643	535,205
Commodity contracts	64,667	475,687	64,376	429,013
Other	289	10,569	1,665	6,444
Total derivatives not designated as accounting hedges	1,055,401	20,390,773	1,026,157	20,317,356
Total derivatives	$ 1,062,203	$ 20,477,398	$ 1,026,330	$ 20,326,449
Cash collateral netting	(69,393)		(39,725)	
Counterparty netting	(938,957)		(938,957)	
Total derivatives	$ 53,853	$ 20,477,398	$ 47,648	$ 20,326,449

(1) Notional amounts include net notionals related to long and short futures contracts of $69 billion and $60 billion, respectively. The variation margin on these futures contracts (excluded from the table above) of $(339) million and $6 million is included in Receivables Brokers, dealers and clearing organizations and Payables Brokers, dealers and clearing organizations, respectively, on the condensed consolidated statements of financial condition.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Assets at December 31, 2009	Liabilities at December 31, 2009
	Fair Value	