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MORGAN STANLEY & CO. INTERNATIONAL plc

Report and financial statements

31 December 2012

MORGAN STANLEY & CO. INTERNATIONAL plc

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DIRECTORS' REPORT

The Directors present their report and consolidated financial statements of Morgan Stanley & Co. International plc (the "Company") and all of its subsidiary and associated undertakings (together "the Group"), which comprise the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity, consolidated statement of financial position, consolidated statement of cash flows and the related notes 1 to 36, together with the Company's balance sheet and related notes for the year ended 31 December 2012. The Group's consolidated financial statements have been prepared in accordance with applicable United Kingdom ("UK") law and International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU"). The Company's balance sheet and related notes have been prepared in accordance with applicable UK law and UK accounting standards.

RESULTS AND DIVIDENDS

The Group's profit for the year, after tax, was $9 million (2011: $573 million profit after tax).

During the year, a dividend of $1 million was paid on the Class C preference shares (2011: $110 million was paid on the Class D preference shares and a dividend of $18 million was paid on the Class B preference shares). No final dividends are proposed (2011: $ nil).

PRINCIPAL ACTIVITY

The principal activity of the Group is the provision of financial services to corporations, governments and financial institutions.

The Company operates branches in the Dubai International Financial Centre, France, Korea, the Netherlands, New Zealand, Poland, the Qatar Financial Centre and Switzerland. The Company's Greek branch was closed in August 2012.

The Company is authorised and regulated by the Financial Services Authority ("FSA"). From 1 April 2013, the FSA was replaced by two separate regulatory authorities; the Company is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

There have not been any changes in the Group's principal activity in the year under review and no significant change in the Group's principal activity is expected other than on 1 January 2013, the financial advisory business conducted by another UK Morgan Stanley Group undertaking, Morgan Stanley & Co. Limited, was contributed to the Company. This new business is not expected to have a significant impact on the Group's results.

The Group's ultimate parent undertaking and controlling entity is Morgan Stanley, which, together with the Group and Morgan Stanley's other subsidiary undertakings, form the "Morgan Stanley Group".

The Morgan Stanley Group is a global financial services firm that maintains significant market positions in each of its business segments: Institutional Securities, Global Wealth Management Group and Asset Management. The Morgan Stanley Group 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. As a key contributor to the execution of the Morgan Stanley Group's Institutional Securities strategy in Europe, the Middle East and Africa ("EMEA"), the Group provides capital raising; financial advisory services, including advice on mergers and acquisitions, restructurings, real estate and project finance; corporate lending; sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange and commodities; and investment activities.

DIRECTORS' REPORT

BUSINESS REVIEW

During 2012, global market and economic conditions improved modestly as European policymakers became more determined in combating the region's debt crisis and central bankers around the globe took a number of actions to stimulate the economic recovery. Despite these improvements, global market and economic conditions in 2012 were challenged by concerns about the ongoing European sovereign debt crisis, the United States ("US") "fiscal cliff" (i.e., the combination of expiring tax cuts and spending cuts on or after 1 January 2013), the US federal debt ceiling and its potential adverse impact on the US economy, and slowing economic growth in emerging markets.

These on-going conditions present difficulties and uncertainty for the business outlook that may adversely impact the financial performance of the Group in the future.

In Europe, major equity market indices ended 2012 higher compared with the beginning of the year, primarily due to investors' optimism about Europe's progress in addressing its sovereign debt crisis, especially in Greece, Ireland, Italy, Portugal and Spain (the "European Peripherals"), and the sovereign debt exposures in the European banking system. In the euro-area, gross domestic product declined in 2012 and the unemployment rate increased to 11.7% at 31 December 2012 from 10.4% at 31 December 2011. At 31 December 2012, the European Central Bank's ("ECB") benchmark interest rate was 0.75% (2011: 0.5%). The Bank of England's ("BOE") benchmark interest rate was 0.5% and was unchanged from a year ago. To inject further monetary stimulus into the economy in the UK, the BOE increased the size of its quantitative easing program on two separate occasions in 2012. In 2012, the ECB conducted its second three-year refinancing operation and widened the pool of eligible collateral for refinancing operations to ease funding conditions for euro-area banks. In addition, EU leaders agreed on a new bailout and debt-restructuring agreement designed to reduce Greece's debt and reached another agreement to ease the recapitalisation of struggling European banks. In September 2012, the ECB outlined the details of a plan to buy euro-area government bonds and reiterated its pledge to preserve the euro. In December 2012, EU finance ministers reached an agreement to bring many of the continent's banks under a single supervisor. Despite these actions, several major rating agencies downgraded the credit ratings for some euro-zone countries, and some EU member countries, such as Italy and Spain, entered into a technical recession (two consecutive quarters of negative change in gross domestic product) in 2012.

In response to the ongoing uncertainties in Europe the Group has continued to reduce its net exposure to European Peripherals. At 31 December 2012, exposure before hedges to European peripheral countries was $3,373 million (2011: $5,893 million) and the net exposure after hedges was $2,719 million (2011: $4,806 million). Details of the country risk exposures to European Peripherals are provided on page 6 of the Directors' Report.

The consolidated income statement for the year is set out on page 16. The Group's profit after tax for the year decreased by $564 million to $9 million, a decrease of 98% compared to the year ended 31 December 2011.

The Group's revenues are best reviewed across the aggregate of 'Net gains on financial instruments classified as held for trading', 'Net gains on financial instruments designated at fair value through profit or loss', 'Net gains on available-for-sale financial assets', 'Interest income', 'Interest expense' and 'Other income' ("aggregate revenues"). Aggregate revenues for the year declined by 10% to $3,674 million compared to $4,092 million in 2011.

Investment banking revenues during the year were lower compared to 2011, reflecting lower revenues from advisory and underwriting transactions.

Equity sales and trading revenues decreased during the year compared to 2011, despite reflecting an accrual for expected reimbursement from clients on certain equity transactions (see note 6). The decrease was driven by lower core and portfolio equity products revenues as well as by negative revenues related to changes in the fair value of net derivative contracts and on borrowings that are measured at fair value attributable to the tightening of Morgan Stanley's credit default swap spreads. This was partly offset by an increase in equity derivative products revenues.

BUSINESS REVIEW (CONTINUED)

Revenues within fixed income and commodities sales and trading decreased during the year compared to 2011. Results in 2012 included negative revenues from the impact of the tightening of Morgan Stanley's debt-related credit spreads on borrowings that are measured at fair value, as well as reduced revenues on credit derivative products and non-core fixed income products. This was partially offset by increased revenues in interest rate, foreign exchange, corporate debt, securitised and commodity products.

Aggregate revenues for the year exclude net day one gains of $141 million not recognised upon initial recognition of financial instruments measured at fair value where valuation techniques include unobservable market data (2011: $307 million).

Other expense increased from $3,293 million in 2011 to $3,402 million in 2012 mainly driven by increased management charges from other Morgan Stanley Group undertakings relating to other services, partially offset by decreases in brokerage fees and administration and corporate services expenses.

The Group's effective tax rate for the year was 96% compared to 31% for the prior year, driven by a non-UK capital gains tax provision and the impact of group relief. See note 8 for further details.

The consolidated statement of financial position presented on page 19 reflects decreases in the Group's total assets and total liabilities of $11,174 million and $11,221 million respectively, a decrease of 2% as at 31 December 2012 when compared to 31 December 2011. The decrease in total assets is mainly driven by a decrease in financial assets classified as held for trading of $12,449 million. The decrease in total liabilities is driven by reductions in financial liabilities classified as held for trading of $19,777 million and in other payables of $4,091 million partially offset by increases in cash collateral on securities loaned and securities sold under agreements to repurchase of $12,110 million. The decrease in financial assets and liabilities held for trading is primarily driven by reduced derivative positions.

The consolidated statement of cash flows presented on page 20 shows a net increase in cash of $323 million during the year (2011: net increase of $573 million). Net cash flows used in operating activities was $1,519 million (2011: $2,300 million), offset by proceeds from disposal of subsidiaries and available-for-sale financial assets amounting to $1,979 million. Interest paid on subordinated debt was $137 million (2011: $125 million).

The performance of the Group is included in the results of the Morgan Stanley Group which are disclosed in the Morgan Stanley Group's Annual Report on Form 10-K to the United States Securities and Exchange Commission. The Morgan Stanley Group manages its key performance indicators on a global basis but in consideration of individual legal entities. For this reason, the Group's Directors believe that providing further performance indicators for the Group itself would not enhance an understanding of the development, performance or position of the business of the Group.

The risk management section below sets out the Group's and the Morgan Stanley Group's policies for the management of liquidity and cash flow risk and other significant business risks.

Risk management

Risk is an inherent part of both Morgan Stanley's and the Group's business activity and is managed by the Group within the context of the broader Morgan Stanley Group's business activities. The Morgan Stanley Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its activities on a global basis, in accordance with defined policies and procedures and in consideration of the individual legal entities.

Note 25 to the consolidated financial statements provides qualitative and quantitative disclosures about the Group's management of and exposure to financial risks.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Market risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as liquidity, will result in losses for a position or portfolio.

The Morgan Stanley Group manages the market risk associated with its trading activities on a global basis, at both a trading division and an individual product level, which includes consideration of market risk for each individual legal entity.

The Group has enhanced its VaR model during 2012 to make it more responsive to current market conditions while maintaining a longer-term perspective. This enhancement is consistent with regulatory requirements. The current VaR model estimates are lower than the VaR estimates produced under the previously used model because the prior model places more emphasis on the large market moves experienced during the 2008 financial crisis, while the current model places more emphasis on more recent volatility, which has been generally lower.

Under the current VaR model, the Group's average VaR for Primary Risk Categories for 2012 was $24 million compared with $31 million under the previous model. The period end VaR was $21 million while it was $26 million under the previous model. The average Credit Portfolio VaR for 2012 was $14 million compared with $16 million under the previous model. The average total trading VaR for 2012 was $30 million compared with $38 million under the previous model.

Under the previous VaR model, the Group's average VaR for Primary Risk Categories for 2012 was $31 million compared with $43 million for 2011. The decrease in average VaR for Primary Risk Categories is primarily due to reduced risk taking in fixed income products. The average Credit Portfolio VaR for 2012 was $16 million compared with $21 million for 2011. The decrease in the average VaR over the year was from decreased counterparty exposure during 2012. The average total trading VaR for 2012 was $38 million compared with $54 million for 2011.

Credit risk

Credit risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its obligations.

The Morgan Stanley Group manages credit risk exposure on a global consolidated basis as well as giving consideration to individual legal entities. It does this by ensuring transparency of material credit risks, ensuring compliance with established limits, approving material extensions of credit, escalating risk concentrations to appropriate senior management and mitigating credit risk through the use of collateral and other arrangements.

Country risk exposure

The Morgan Stanley Group and the Group have exposure to country risk. Country risk exposure is the risk that events within a country, such as currency crises, regulatory changes and other political events, will adversely affect the ability of the sovereign government and/or obligors within the country to honour their obligations to the Group.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Country risk exposure (continued)

Country risk exposure is measured in accordance with the Morgan Stanley Group and the Group's internal risk management standards and includes obligations from sovereign governments, corporations, clearing houses and financial institutions. The Morgan Stanley Group and the Group actively manage country risk exposure through a comprehensive risk management framework that combines credit and market fundamentals as well as scenario analysis, and allows the Group to effectively identify, monitor and limit country risk. Country risk exposure before and after hedges is monitored and managed, with stress testing and scenario analysis conducted on a continuous basis, to identify exposure concentrations, wrong way risk (the risk that occurs when exposure to a counterparty is adversely correlated with the credit quality of that counterparty) and the impact of idiosyncratic events. In addition, indirect exposures are identified through the Group's counterparty credit analysis as having a vulnerability or exposure to another country or jurisdiction. Examples of such counterparties include: mutual funds that invest in a single country, offshore companies whose assets reside in another country to that of the offshore jurisdiction and finance company subsidiaries of corporations. The outcome of such identification can result in a reclassification of country risk, amendment of counterparty limits or exposure mitigation. The Group reduces its country risk exposure through the effect of risk mitigants, such as netting agreements with counterparties that permit the Group to offset receivables and payables with such counterparties, obtaining collateral from counterparties, and by hedging.

The Group's country risk exposure, including the effect of the risk mitigants as at 31 December 2012 is shown across the following two tables. The basis for determining the domicile of the exposure is based on the country of jurisdiction for the obligor or guarantor, factors such as physical location of operations or assets, location and source of cash flows/revenues, and location of collateral (if applicable). Credit Default Swaps ("CDSs") are incorporated in the exposure where protection is both purchased and sold.

The Group's sovereign exposures consist of financial instruments entered into with sovereign and local governments. Its non-sovereign exposures comprise exposures to corporations, clearing houses and financial institutions.

Select European Countries

In connection with certain of its Institutional Securities business segment activities, the Group has country risk exposure to many foreign countries. During the year ended 31 December 2012, the European Peripherals and France continued to experience varying degrees of credit deterioration due to weaknesses in their economic and fiscal situations.

The following table shows the Group's country risk exposure to European Peripherals and France at 31 December 2012. The majority of the financial instruments included in the table below are classified as held for trading and are measured at fair value or are collateralised borrowings or lendings. As a result, the Group does not have any recognised impairment on the financial instruments included in its country risk exposure to European Peripherals and France. Exposure to other Morgan Stanley Group undertakings has been excluded from the table below.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Select European Countries (continued)

Country	Net Inventory[(1)] $millions	Net Counterparty Exposure[(2)] $millions	Unfunded Commitments $millions	CDS Adjustments[(3)] $millions	Exposure Before Hedges $millions	Hedges[(4)] $millions	Net Exposure[(5)] $millions
Greece							
Sovereigns	5	-	-	-	5	-	5
Non-sovereigns	52	-	-	-	52	(3)	49
Total Greece	57	-	-	-	57	(3)	54
Ireland							
Sovereigns	82	7	-	5	94	-	94
Non-sovereigns	58	12	-	1	71	-	71
Total Ireland	140	19	-	6	165	-	165
Italy							
Sovereigns	(21)	288	-	320	587	(154)	433
Non-sovereigns	372	432	265	84	1,153	(195)	958
Total Italy	351	720	265	404	1,740	(349)	1,391
Portugal							
Sovereigns	(38)	32	-	31	25	(71)	(46)
Non-sovereigns	66	31	-	27	124	(30)	94
Total Portugal	28	63	-	58	149	(101)	48
Spain							
Sovereigns	61	1	-	458	520	(75)	445
Non-sovereigns	240	284	99	119	742	(126)	616
Total Spain	301	285	99	577	1,262	(201)	1,061
Sovereigns	89	328	-	814	1,231	(300)	931
Non-sovereigns	788	759	364	231	2,142	(354)	1,788
Total European Peripherals	**877**	**1,087**	**364**	**1,045**	**3,373**	**(654)**	**2,719**
France							
Sovereigns	(898)	13	-	-	(885)	(15)	(900)
Non-sovereigns	(375)	1,745	609	11	1,990	(269)	1,721
Total France	(1,273)	1,758	609	11	1,105	(284)	821

(1) Net inventory represents exposure to both long and short single-name and index positions (i.e. bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable).

(2) Net counterparty exposure (i.e. repurchase transactions, securities lending and OTC derivatives) takes into consideration legally enforceable master netting agreements and collateral.

(3) CDS adjustment represents credit protection purchased from European Peripherals' banks on European Peripherals' sovereign and financial institution risk, or French banks on French sovereign and financial institution risk. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(4) Represents CDS hedges (purchased and sold) on net counterparty exposure and funded lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Group. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(5) In addition, as at 31 December 2012, the Group had European Peripherals and French exposure for overnight deposits with banks of approximately $1 million and $21 million, respectively.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Non-UK country risk exposure

The following table shows the Group's significant non-UK country risk exposure at 31 December 2012, excluding select European countries disclosed above. Exposure to other Morgan Stanley Group undertakings has been excluded from the table below.

Country	Net Inventory[(1)] $millions	Net Counterparty Exposure[(2)] $millions	Funded Lending $millions	Exposure Before Hedges $millions	Hedges[(3)] $millions	Net Exposure[(4)] $millions
Germany						
Sovereigns	4,622	593	-	5,215	(696)	4,519
Non-sovereigns	(95)	2,078	31	2,014	7	2,021
Total Germany	4,527	2,671	31	7,229	(689)	6,540
United States						
Sovereigns	(542)	66	-	(476)	-	(476)
Non-sovereigns	(497)	2,517	-	2,020	(88)	1,932
Total United States	(1,039)	2,583	-	1,544	(88)	1,456
Russian Federation						
Sovereigns	(3)	-	-	(3)	(87)	(90)
Non-sovereigns	935	261	-	1,196	(255)	941
Total Russian Federation	932	261	-	1,193	(342)	851
Japan						
Sovereigns	(100)	-	-	(100)	-	(100)
Non-sovereigns	41	819	-	860	-	860
Total Japan	(59)	819	-	760	-	760
Netherlands						
Sovereigns	(127)	7	-	(120)	(240)	(360)
Non-sovereigns	282	701	-	983	(91)	892
Total Netherlands	155	708	-	863	(331)	532

(1) Net inventory represents exposure to both long and short single-name and index positions (i.e. bonds and equities at fair value and CDS based on notional amount assuming zero recovery adjusted for any fair value receivable or payable).

(2) Net counterparty exposure (i.e. repurchase transactions, securities lending and OTC derivatives) taking into consideration legally enforceable master netting agreements and collateral.

(3) Represents CDS hedges (purchased and sold) on net counterparty exposure and funded lending executed by trading desks responsible for hedging counterparty and lending credit risk exposures for the Group. Based on the CDS notional amount assuming zero recovery adjusted for any fair value receivable or payable.

(4) In addition, as at 31 December 2012, the Group had exposure to these countries for overnight deposits with banks of approximately $450 million.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Liquidity and capital resources

Liquidity and funding risk refers to the risk that the Group will be unable to meet its funding obligations in a timely manner. Liquidity risk stems from the potential risk that the Group will be unable to obtain necessary funding through borrowing money at favourable interest rates or maturity terms, or selling assets in a timely manner and at a reasonable price.

The primary goal of the Morgan Stanley Group's liquidity risk management framework is to ensure that the Morgan Stanley Group, including the Group, have access to adequate funding across a wide range of market conditions. The framework is designed to enable the Group to fulfil its financial obligations and support the execution of the Group's business strategies. The Group's capital management framework is further described in note 31.

Morgan Stanley continues to actively manage its capital and liquidity position to ensure adequate resources are available to support the activities of the Morgan Stanley Group, including the Group, to enable the Morgan Stanley Group to withstand market stresses, and to meet regulatory stress testing requirements proposed by regulators globally. The Morgan Stanley Group uses Liquidity Stress Tests to model liquidity outflows across multiple scenarios over a range of time horizons. These scenarios contain various combinations of idiosyncratic and systemic stress events.

On 21 June 2012, Moody's Investor Services announced the conclusion of an industry-wide reassessment and revised ratings for 15 global capital markets banks. The Morgan Stanley Group's long- and short- term debt ratings were lowered two notches to Baa1/P-2 from A2/P-1, and a negative outlook was assigned.

While certain aspects of a credit ratings downgrade are quantifiable pursuant to contractual provisions, the impact it will have on the Morgan Stanley Group's business and results of operation in future periods is inherently uncertain and will depend on a number of inter-related factors, including among others, the magnitude of the downgrade, individual client behaviour and future mitigating actions the Morgan Stanley Group may take. The liquidity impact of additional collateral requirements is included in the Morgan Stanley Group's Liquidity Stress Tests.

Operational risk

Operational risk refers to the risk of financial or other loss, or potential damage to the Group's or the Morgan Stanley Group's reputation, resulting from inadequate or failed internal processes, people, resources and systems or from other external events (e.g. fraud, legal and compliance risks, damage to physical assets, etc.). Legal, regulatory and compliance risk is included in the scope of operational risk and is discussed below under "Legal, regulatory and compliance risk".

The Group's business is highly dependent on the ability to process, on a daily basis, a large number of transactions across numerous and diverse markets in many currencies. In general, the transactions processed are increasingly complex. The Group relies on the ability of the Morgan Stanley Group's employees, its internal systems, and systems at technology centres operated by unaffiliated third parties to process a high volume of transactions.

The Group also faces the risk of operational failure or termination of any of the clearing agents, exchanges, clearing houses or other financial intermediaries it uses to facilitate securities transactions. In the event of a breakdown or improper operation of the Group's or a third party's systems or improper or unauthorised action by third parties or the Morgan Stanley Group's employees, the Group could suffer financial loss, an impairment to its liquidity, a disruption of its businesses, regulatory sanctions or damage to its reputation.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Operational risk (continued)

The Group's operations rely on the secure processing, storage and transmission of confidential and other information in its computer systems. Like other financial services firms, we have been and continue to be subject to unauthorised access, mishandling or misuse, computer viruses and other events. Events such as these could have a security impact on the Group's systems and jeopardise the Group's or the Group's clients' or counterparties' personal, confidential, proprietary or other information processed and stored in, and transmitted through, the Group's computer systems. Furthermore, such events could cause interruptions or malfunctions in the Group's, the Group's clients', the Group's counterparties' or third parties' operations, which could result in reputational damage, litigation or regulatory fines or penalties not covered by insurance maintained by the Group, or adversely affect the business, financial condition or results of operations.

The Morgan Stanley Group has established an operational risk management process that operates on a global and regional basis to identify, measure, monitor and control risk. Effective operational risk management is essential to reducing the impact of operational risk incidents and mitigating legal, regulatory, and reputational risks.

Legal, regulatory and compliance risk

Legal risk includes the risk of exposure to fines, penalties, judgements, damages and/or settlements in connection with regulatory or legal actions as a result of non-compliance with applicable legal or regulatory requirements and standards or litigation. Legal risk also includes contractual and commercial risk such as the risk that a counterparty's performance obligations will be unenforceable. The Morgan Stanley Group is generally subject to extensive regulation in the different jurisdictions in which it conducts its business. In the current environment of rapid and possibly transformational regulatory change, the Morgan Stanley Group also views regulatory change as a component of legal risk.

The Morgan Stanley Group has established procedures based on legal and regulatory requirements on a worldwide basis that are designed to foster compliance with applicable statutory and regulatory requirements. The Morgan Stanley Group, principally through the Legal and Compliance Division, also has established procedures that are designed to require that the Morgan Stanley Group's policies relating to business conduct, ethics and practices are followed globally. In connection with its businesses, the Morgan Stanley Group has and continuously develops various procedures addressing issues such as regulatory capital requirements, sales and trading practices, new products, information barriers, potential conflicts of interest, structured transactions, use and safekeeping of customer funds and securities, lending and credit granting, anti-money laundering, privacy and recordkeeping. In addition, the Morgan Stanley Group has established procedures to mitigate the risk that a counterparty's performance obligations will be unenforceable, including consideration of counterparty legal authority and capacity, adequacy of legal documentation, the permissibility of a transaction under applicable law and whether applicable bankruptcy or insolvency laws limit or alter contractual remedies. The legal and regulatory focus on the financial services industry presents a continuing business challenge for the Morgan Stanley Group.

Significant changes in the way that major financial services institutions are regulated are occurring in the United Kingdom ("UK"), Europe, the US and worldwide. The reforms being discussed and, in some cases, already implemented, include several that contemplate comprehensive restructuring of the regulation of the financial services industry. Such measures will likely lead to stricter regulation of financial institutions generally, and heightened prudential requirements for systemically important firms in particular. Such measures could include taxation of financial transactions, liabilities and employee compensation as well as reforms of the over-the-counter ("OTC") derivatives markets, such as mandated exchange trading and clearing, position limits, margin, capital and registration requirements. Changes in tax legislation in the UK and worldwide, such as taxation of financial transactions, liabilities and employees compensation, are also possible.

BUSINESS REVIEW (CONTINUED)

Risk management (continued)

Many of these reforms, if enacted, may materially affect the Group's and the Morgan Stanley Group's business, financial condition, results of operations and cash flows in the future.

Basel II Pillar 3 disclosures

The disclosures made in order to comply with the FSA's rules, which implement in the UK the EU Directives underlying the revised capital adequacy framework, are available on the Morgan Stanley website.

Going Concern

Business risks associated with the uncertain market and economic conditions are being monitored and managed by the Morgan Stanley Group and the Group. Retaining sufficient liquidity and capital to withstand these market pressures remains central to the Morgan Stanley Group's and the Group's strategy. In particular, the Morgan Stanley Group's capital is deemed sufficient to exceed the minimum capital ratio under the most negative stressed scenario reviewed by the US Federal Reserve.

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Group will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly they continue to adopt the going concern basis in preparing the annual report and financial statements.

DIRECTORS

The following Directors held office throughout the year and to the date of approval of this report (except where otherwise shown):

P Bailas	(ceased to be a director on 18 September 2012)
C D S Bryce	
L G P M Francois	(resigned 16 March 2012)
Sir E J W Gieve	(appointed 1 October 2012)
T C Kelleher (Chairman)	
N Nandra	(appointed 20 March 2013 and resigned 16 April 2013)
F R Petitgas	
I Plenderleith	
R Rooney	
D A Russell	
C E Woodman	

DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

Directors' and Officers' Liability Insurance is taken out by Morgan Stanley, the Group's ultimate parent undertaking, for the benefit of the Directors and Officers of the Company and its subsidiaries.

DIRECTORS' INDEMNITY

Qualifying third party indemnity provisions (as defined in section 234 of the Companies Act 2006) were in force during the year and up to and including the date of the Director's report for the benefit of the Directors of the Group.

DIRECTORS' REPORT

AUDIT COMMITTEE

Morgan Stanley International Limited ("MSI"), the Company's ultimate UK parent undertaking, has an Audit Committee which assists the Boards of MSI, the Company, other MSI regulated subsidiary undertakings and certain other Morgan Stanley Group undertakings in meeting their responsibilities in ensuring an effective system of internal control and compliance, and in meeting their external financial reporting obligations. The Audit Committee meets regularly and reports to the MSI Board on a quarterly basis.

EMPLOYEES

Both the Group and the Morgan Stanley Group place considerable value on the investment in their employees and have continued their practice of keeping employees informed on matters affecting them. Employees are encouraged to present their suggestions and views on Morgan Stanley Group's performance to management and employees participate directly in the success of the business through Morgan Stanley Group's various compensation incentive plans.

Every effort is also made to ensure that disabled applicants, or those existing employees who are disabled or may have become disabled, are treated as fairly as possible on terms comparable with those of other employees. Appropriate training is arranged for disabled persons, including retraining for alternative work for employees who become disabled, to promote their career development within the organisation.

EMPLOYEE REMUNERATION

The Group employs staff directly through branches of the Company, in addition to utilising staff employed by other Morgan Stanley Group undertakings. The Group's policies are comparable and consistent with those of Morgan Stanley Group, which include the deferral of significant portions of certain key employees' discretionary compensation. Note 32 to the consolidated financial statements provides additional information and disclosure regarding the Group's compensation policies.

EVENTS AFTER THE REPORTING DATE

Contribution of business from Morgan Stanley & Co. Limited

On 1 January 2013, the financial advisory business conducted by another Morgan Stanley Group undertaking, Morgan Stanley & Co. Limited, was contributed to the Company. This new business is not expected to have a significant impact on the Group's results.

FSA Core Group

In accordance with the FSA's Core Group regulations, on 27 March 2013, the Company entered into a Deed of Agreement ("the agreement") whereby certain other Morgan Stanley Group undertakings, known collectively as the Contributing Entities, undertook to provide additional capital resources to the Company and certain Morgan Stanley Group undertakings registered with the FSA (collectively the 'Authorised Firms') if required in compliance with the regulatory requirements applicable to the members of a core UK group.

In the event that the capital resources of the Company were to fall below its capital requirements as determined by the FSA, the agreement gives the Company the unilateral right to demand a contribution of capital resources from the Contributing Entities, in order to meet its capital requirements.

The amount of the contribution is limited to the Contributing Entities' surplus capital, to the extent that such capital is not required to repay that company's liabilities, as defined in the agreement. The capital resources may be provided in the form of a subscription and payment for shares or other capital instruments; to the extent legally permissible through payment of dividends or other distributions of capital resources or through such other legally permissible means as may be determined to be appropriate.

Entering into the agreement did not result in any adjustments to the Group's consolidated statement of financial position at 31 December 2012. The agreement will remain in force while the Company is an Authorised Firm in Morgan Stanley's UK core group, as determined for regulatory purposes, subject to earlier termination in certain circumstances.

DIRECTORS' REPORT

POLICY AND PRACTICE ON PAYMENT OF CREDITORS

It is the Group's and the Company's policy that payments to suppliers are made in accordance with those terms and conditions agreed between the Group or the Company and its suppliers, providing that all trading terms and conditions have been complied with.

The Group's and the Company's trade creditors balance is comprised primarily of unsettled securities transactions with exchanges, clearing houses, market counterparties, individual investors and other Morgan Stanley Group undertakings. It is the Group's and the Company's policy that these transactions are settled in accordance with the standard terms of the relevant exchange or market and disclosure of creditor days is not considered a relevant measure.

AUDITOR

Deloitte LLP have expressed their willingness to continue in office as auditor of the Group and a resolution to re-appoint them will be proposed at the forthcoming annual general meeting.

Statement as to disclosure of information to the auditor

Each of the persons who are Directors of the Company at the date when this report is approved confirms that:

- so far as each of the Directors is aware, there is no relevant audit information (being information needed by the Group's auditor in connection with preparing their report) of which the Group 's auditor is unaware; and
- each of the Directors has taken all the steps that he/she ought to have taken as a Director to make himself/ herself aware of any relevant audit information and to establish that the Group's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

Approved by the Board and signed on its behalf by

Director COLIN BRYCE

22 April 2013

MORGAN STANLEY & CO. INTERNATIONAL plc

DIRECTORS' REPORT

DIRECTORS' RESPONSIBILITIES STATEMENT

The Directors are responsible for preparing their report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the financial statements in accordance with IFRSs as adopted by the EU and Article 4 of the International Accounting Standards ("IAS") Regulation. Under company law the Directors must not approve the accounts unless they are satisfied that they give a true and fair view of the state of affairs of the Group and of the profit or loss of the Group for that period.

In preparing the Group financial statements, the Directors are required by IAS 1 '*Presentation of financial statements*' ("IAS 1") to:

(a) properly select and apply accounting policies;
(b) present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
(c) provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
(d) make an assessment of the Group's ability to continue as a going concern.

In preparing the Company financial statements the Directors are required to:

(a) select suitable accounting policies and then apply them consistently;

(b) make judgements and estimates that are reasonable and prudent;

(c) state whether applicable UK Accounting Standards have been followed; and

(d) prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group's transactions and disclose with reasonable accuracy at any time the financial position of the Group and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors, the names of whom are set out on page 10 of the Directors' report, confirm to the best of their knowledge:

- in accordance with rule 4.1.12(3)(a) of the FSA's Disclosure and Transparency Rules, the consolidated financial statements, which have been prepared in accordance with IFRSs as issued by the International Accounting Standards Board ("IASB") and as endorsed by the EU, have been prepared in accordance with the applicable set of accounting standards and give a true and fair view of the assets, liabilities, financial position and profit or loss of the Group and the undertakings included in the consolidation taken as a whole; and

- the management report represented by the Directors' report has been prepared in accordance with rule 4.1.12(3)(b) of the Disclosure and Transparency Rules, and includes a fair review of the development and performance of the business and the position of the Group and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that the Group faces.

Approved by the Board and signed on its behalf by

Director COLIN BRYCE

22 April 2013

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY & CO. INTERNATIONAL plc

We have audited the Group and Company financial statements of Morgan Stanley & Co. International plc for the year ended 31 December 2012 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity, the consolidated statement of financial position and the consolidated statement of cash flows and the Company balance sheet and the related notes 1 to 36 for the consolidated financial statements and the related notes 1 to 21 for the Company financial statements. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and IFRSs as adopted by the EU. The financial reporting framework that has been applied in the preparation of the Company financial statements is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the Group's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Group's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Group and the Group's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditor

As explained more fully in the Directors' responsibilities statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Group's affairs as at 31 December 2012 and of its profit for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MORGAN STANLEY & CO. INTERNATIONAL plc

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Robert Topley (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London

22 April 2013

CONSOLIDATED INCOME STATEMENT
Year ended 31 December 2012

	Note	2012 $millions	2011 $millions
Net gains on financial instruments classified as held for trading		3,571	3,539
Net gains on financial instruments designated at fair value through profit or loss		96	275
Net gains on available-for-sale financial assets	4	50	-
Interest income	5	2,596	4,003
Interest expense	5	(3,033)	(3,990)
Other income	6	394	265
Other expense	7	(3,402)	(3,293)
Gain on disposal of joint venture	34	-	21
(Loss)/ gain on disposal of subsidiaries	34	(30)	5
PROFIT BEFORE INCOME TAX		242	825
Income tax expense	8	(233)	(252)
PROFIT FOR THE YEAR		9	573
Attributable to:			
Owners of the parent		8	572
Non-controlling interests		1	1
PROFIT FOR THE YEAR		9	573

All operations were continuing in the current and prior year.

The notes on pages 21 to 105 form an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
Year ended 31 December 2012

	Note	2012 $millions	2011 $millions
PROFIT FOR THE YEAR		9	573
OTHER COMPREHENSIVE INCOME			
Currency translation reserve:			
Foreign currency translation differences on foreign operations		24	(20)
Reclassification of foreign currency translation differences on disposal of foreign operations		30	(5)
Available-for-sale reserve:			
Net change in fair value of available-for-sale financial assets	13	30	24
Reclassification adjustments relating to available-for-sale financial assets disposed of during the year	4	(46)	-
Pension reserve:			
Actuarial gains on post employment benefit schemes	33	-	2
Income tax credit/(expense) relating to components of other comprehensive income	8	1	(3)
OTHER COMPREHENSIVE INCOME/(LOSS) AFTER INCOME TAX FOR THE YEAR		39	(2)
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		48	571
Attributable to:			
Owners of the parent		45	573
Non-controlling interests		3	(2)
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		48	571

The notes on pages 21 to 105 form an integral part of the consolidated financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
Year ended 31 December 2012

	Note	Share capital $millions	Share premium $millions	Currency translation reserve $millions	Capital redemption reserve $millions	Capital contribution reserve $millions	Available-for-sale reserve $millions	Retained earnings $millions	Attributable to owners of parent $millions	Non-controlling interests $millions	Total equity $millions
Balance at 1 January 2011		5,578	513	(149)	1,399	3	(2)	1,716	9,058	73	9,131
Total comprehensive income/ (loss)		-	-	(19)	-	-	18	563	562	(2)	560
Reclassified foreign currency translation differences on liquidation of foreign operation		-	-	11	-	-	-	-	11	-	11
Transactions with owners:											
Issue of capital	20	5,386	-	-	-	-	-	-	5,386	-	5,386
Preference shares repurchased	20	(1,500)	-	-	-	-	-	-	(1,500)	-	(1,500)
Dividends	21	-	-	-	-	-	-	(110)	(110)	-	(110)
Balance at 31 December 2011		9,464	513	(157)	1,399	3	16	2,169	13,407	71	13,478
Total comprehensive income/ (loss)		-	-	22	-	-	(12)	5	15	3	18
Reclassified foreign currency translation differences on disposal of foreign operation		-	-	30	-	-	-	-	30	-	30
Transactions with owners:											
Dividends	21	-	-	-	-	-	-	(1)	(1)	-	(1)
Balance at 31 December 2012		9,464	513	(105)	1,399	3	4	2,173	13,451	74	13,525

The notes on pages 21 to 105 form an integral part of the consolidated financial statements.

MORGAN STANLEY & CO. INTERNATIONAL plc

Registered number: 2068222

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
As at 31 December 2012

	Note	2012 $millions	2011 $millions
ASSETS			
Loans and receivables:			
Cash and short term deposits	9	11,526	11,180
Cash collateral on securities borrowed		31,303	29,575
Securities purchased under agreements to resell		99,782	97,218
Trade receivables		66,438	67,371
Other receivables	10	5,676	7,225
		214,725	212,569
Financial assets classified as held for trading (of which $42,457 million (2011: $33,132 million) were pledged to various parties)	11	341,694	354,143
Financial assets designated at fair value through profit or loss	12	7,591	8,562
Available-for-sale financial assets	13	40	67
Current tax assets		210	145
Deferred tax assets	18	91	44
Prepayments and accrued income		53	45
Property, plant and equipment	14	7	10
TOTAL ASSETS		564,411	575,585
LIABILITIES AND EQUITY			
Financial liabilities at amortised cost:			
Bank loans and overdrafts		23	124
Cash collateral on securities loaned		29,336	26,016
Securities sold under agreements to repurchase		85,694	76,904
Trade payables		83,161	83,626
Subordinated loans	15	7,906	7,906
Other payables	16	17,616	21,707
		223,736	216,283
Financial liabilities classified as held for trading	11	314,048	333,825
Financial liabilities designated at fair value through profit or loss	12	12,560	11,710
Provisions	17	82	10
Current tax liabilities		243	68
Deferred tax liabilities	18	4	7
Accruals and deferred income		208	200
Post employment benefit obligations	33	5	4
TOTAL LIABILITIES		550,886	562,107
EQUITY			
Share capital	20	9,464	9,464
Share premium account		513	513
Currency translation reserve		(105)	(157)
Available-for-sale reserve		4	16
Capital contribution reserve		3	3
Capital redemption reserve		1,399	1,399
Retained earnings		2,173	2,169
Equity attributable to the owners of the parent		13,451	13,407
Non-controlling interest		74	71
TOTAL EQUITY		13,525	13,478
TOTAL LIABILITIES AND EQUITY		564,411	575,585

These consolidated financial statements were approved by the Board and authorised for issue on 22 April 2013. Signed on behalf of the Board

Director COLIN BRYCE

The notes on pages 21 to 105 form an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENT OF CASH FLOWS
Year ended 31 December 2012

	Note	2012 $millions	2011 $millions
NET CASH FLOWS USED IN OPERATING ACTIVITIES	22b	(1,519)	(2,300)
INVESTING ACTIVITIES			
Purchase of property, plant and equipment	14	(1)	(3)
Purchase of available-for-sale financial assets	13	(2)	-
Proceeds from disposal of available-for-sale financial assets	13	59	1
Dividends received from available-for-sale financial assets	4	4	-
Proceeds from disposal of subsidiaries, net of cash disposed	34 (a)	1,920	-
Proceeds from disposal of joint venture	34 (b)	-	28
NET CASH FLOWS FROM INVESTING ACTIVITIES		1,980	26
FINANCING ACTIVITIES			
Issue of ordinary share capital	20	-	5,386
Repayment of equity preference shares		-	(1,500)
Dividends paid on preference shares		-	(18)
Repayment of preference shares classified as debt		-	(786)
Interest on subordinated loan liabilities		(137)	(125)
Dividends paid to owners of the parent	21	(1)	(110)
NET CASH FLOWS (USED IN)/FROM FINANCING ACTIVITIES		(138)	2,847
NET INCREASE IN CASH AND CASH EQUIVALENTS		323	573
Currency translation differences on foreign currency cash balances		124	107
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	22a	11,056	10,376
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	22a	11,503	11,056

The notes on pages 21 to 105 form an integral part of the consolidated financial statements.

1. CORPORATE INFORMATION

The principal activity of the Group is the provision of financial services to corporations, governments and financial institutions.

The Company is incorporated and domiciled in England and Wales, at the following address: 25 Cabot Square, Canary Wharf, London, E14 4QA. The Company is authorised and regulated by the FSA.

The Company's immediate parent undertaking is Morgan Stanley UK Group which is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Cardiff CF14 3UZ.

The Company's ultimate parent undertaking and controlling entity is Morgan Stanley which, together with the Group and Morgan Stanley's other subsidiary undertakings, form the Morgan Stanley Group. Morgan Stanley is incorporated in the state of Delaware, the United States of America.

2. BASIS OF PREPARATION

Statement of compliance

The Group has prepared its annual consolidated financial statements in accordance with IFRSs issued by the IASB as adopted by the EU, Interpretations issued by the IFRS Interpretations Committee ("IFRIC") and the UK Companies Act 2006.

New standards and interpretations adopted during the year

The following amendment to a standard relevant to the Group's operations was adopted during the year. This amendment did not have a material impact on the Group's consolidated financial statements.

An amendment to IFRS 7 *'Financial instruments: Disclosures – transfers of financial assets'* was issued by the IASB in October 2010 for prospective application in annual periods beginning on or after 1 July 2011. The amendment was endorsed by the EU in November 2011.

There were no other standards or interpretations relevant to the Group's operations which were adopted during the year.

New standards and interpretations not yet adopted

As at the date of authorisation of these consolidated financial statements, the following standards and interpretations relevant to the Group's operations were issued by the IASB but not yet mandatory. Except where otherwise stated, the Group does not expect that the adoption of the following standards and interpretations will have a material impact on the Group's consolidated financial statements.

An amendment to IAS 1 was issued by the IASB in June 2011 for application in annual periods beginning on or after 1 July 2012. The revised standard was endorsed by the EU in June 2012.

An amendment to IAS 19 '*Employee benefits'* was issued by the IASB in June 2011 for retrospective application in annual periods beginning on or after 1 January 2013. The revised standard was endorsed by the EU in June 2012.

IAS 27 *'Consolidated and separate financial statements'* and IAS 28 *'Investment in associates and joint ventures'* were revised by the IASB in May 2011, for application in annual periods beginning on or after 1 January 2013. The revised standards were endorsed by the EU in December 2012 such that a Group shall apply them at the latest as from the commencement date of its first financial year starting on or after 1 January 2014. It is the Group's intention to adopt these revised standards from 1 January 2013.

An amendment to IAS 32 *'Financial instruments: Presentation – offsetting financial instruments'* was issued by the IASB in December 2011, for retrospective application in annual periods beginning on or after 1 January 2014. The amendment was endorsed by the EU in December 2012.

2. BASIS OF PREPARATION (CONTINUED)

An amendment to IFRS 7 *'Financial instruments: Disclosures – offsetting financial assets and financial liabilities'* was issued by the IASB in December 2011 for retrospective application in annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The amendment was endorsed by the EU in December 2012.

IFRS 9 *'Financial instruments'* was issued by the IASB in November 2009 for retrospective application in annual periods beginning on or after 1 January 2015. Although there are expected to be significant changes to the presentation of financial instruments by the Group, there is not expected to be a significant impact on net assets.

IFRS 10 *'Consolidated financial statements'*, IFRS 11 *'Joint arrangements'* and IFRS 12 *'Disclosure of interests in other entities'* were issued by the IASB in May 2011 for retrospective application in annual periods beginning on or after 1 January 2013. The standards were endorsed by the EU in December 2012 such that a Group shall apply them at the latest as from the commencement date of its first financial year starting on or after 1 January 2014. It is the Group's intention to adopt these standards from 1 January 2013.

Amendments to IFRS 10 *'Consolidated financial statements'*, IFRS 11 *'Joint arrangements'* and IFRS 12 *'Disclosure of interests in other entities'* were issued by the IASB in June 2012 for retrospective application in annual periods beginning on or after 1 January 2013.

IFRS 13 *'Fair value measurement'* was issued by the IASB in May 2011 for prospective application in annual periods beginning on or after 1 January 2013 and was endorsed by the EU in December 2012.

As part of the May 2012 Improvements to IFRSs, the IASB made amendments to the following standards that are relevant to the Group's operations: IAS 1, IAS 32 *'Financial instruments: Presentation'* and IAS 34 *'Interim financial reporting'* (for application in accounting periods beginning on or after 1 January 2013).

Basis of measurement

The consolidated financial statements of the Group are prepared under the historical cost convention except for certain financial instruments that have been measured at fair value as explained in the accounting policies below.

Use of estimates and sources of uncertainty

The preparation of the Group's consolidated financial statements require management to make judgements, estimates and assumptions regarding the valuation of certain financial instruments, deferred tax assets, pension obligations, the outcome of litigation, and other matters that affect the consolidated financial statements and related disclosures. The Group believes that the estimates utilised in preparing the consolidated financial statements are reasonable, relevant and reliable. Actual results could differ from these estimates.

Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of the Company and its subsidiaries as at 31 December 2012. The financial statements for the subsidiaries are prepared for the same reporting year as the Group, using consistent accounting policies. The financial statements of overseas subsidiaries are translated into US dollars as described in note 3(b). Subsidiaries are consolidated from the date that the Group gains control until the date that control ceases.

Intra-group balances, transactions, income and expenses and profits and losses resulting from intra-group transactions are eliminated in preparing the consolidated financial statements.

2. BASIS OF PREPARATION (CONTINUED)

Basis of consolidation (continued)

Non-controlling interests represent the portion of profit or loss and total equity not owned, directly or indirectly, by the Group and are presented separately in the consolidated income statement, consolidated statement of comprehensive income and within equity in the consolidated statement of financial position, separately from parent shareholders' equity. The amount of non-controlling interest is measured either at fair value or at the non-controlling interest's proportionate share of the identifiable net assets.

The going concern assumption

The Group's business activities, together with the factors likely to affect its future development, performance and position, are reflected in the Business Review section of the Directors' report on pages 2 to 10. In addition, the notes to the consolidated financial statements include the Group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments; and its exposures to credit risk and liquidity risk.

As set out in the Directors' report, retaining sufficient liquidity and capital to withstand market pressures remains central to the Morgan Stanley Group's and the Group's strategy.

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Group will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and consolidated financial statements.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. Functional currency

Items included in the consolidated financial statements are measured and presented in US dollars, the currency of the primary economic environment in which the Group operates.

All currency amounts in the consolidated financial statements and Directors' report are rounded to the nearest million US dollars.

b. Foreign currencies

All monetary assets and liabilities denominated in currencies other than US dollars are translated into US dollars at the rates ruling at the reporting date. Transactions in currencies other than US dollars are recorded at the rates prevailing at the dates of the transactions. Foreign exchange differences on financial assets classified as available-for-sale are recorded in the 'Available-for-sale reserve' in equity, with the exception of translation differences on the amortised cost of monetary available-for-sale assets, which are recognised through the consolidated income statement. Assets and liabilities of foreign operations are translated into US dollars using the closing rate method. Translation differences arising from the net investments in the foreign operations are taken to the 'currency translation reserve'. All other translation differences are taken through the consolidated income statement. Exchange differences recognised in the consolidated income statement are presented in 'Other income' or 'Other expense', except where noted in 3(c) below.

On disposal of a foreign operation, the related cumulative gain or loss in the 'currency translation reserve' attributable to the owners of the parent is reclassified to the consolidated income statement and recorded within gain or loss on disposal.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments

The Group classifies its financial assets into the following categories on initial recognition: financial assets classified as held for trading; financial assets designated at fair value through profit or loss; available-for-sale financial assets; and loans and receivables.

The Group classifies its financial liabilities into the following categories on initial recognition: financial liabilities classified as held for trading, financial liabilities designated at fair value through profit or loss and financial liabilities at amortised cost.

More information regarding these classifications is included below:

i) Financial instruments classified as held for trading

With the exception of loans, financial instruments classified as held for trading, including all derivatives, are initially recorded on trade date at fair value (see note 3(d) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends are reflected in the consolidated income statement in 'Net gains/ (losses) on financial instruments classified as held for trading'.

For loans classified as held for trading, from the date a loan's terms are agreed (trade date), until the loan is funded (settlement date), the Group recognises any unrealised fair value changes in the loan as financial instruments classified as held for trading. On settlement date, the fair value of consideration given is recognised as a financial asset classified as held for trading. All subsequent changes in fair value, foreign exchange differences and interest are reflected in the consolidated income statement in 'Net gains/ (losses) from financial instruments classified as held for trading'.

For all financial instruments classified as held for trading, transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the consolidated income statement in 'Other expense'.

ii) Financial instruments designated at fair value through profit or loss

The Group has designated certain financial assets and financial liabilities at fair value through profit or loss when:

- the financial assets or financial liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation at fair value eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the financial asset or financial liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

From the date the transaction in a financial instrument designated at fair value is entered into (trade date) until settlement date, the Group recognises any unrealised fair value changes in the contract as financial instruments designated at fair value through profit or loss. On settlement date, the fair value of consideration given or received is recognised as a financial instrument designated at fair value through profit or loss (see note 3(d) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends are reflected in the consolidated income statement in 'Net gains/ (losses) on financial instruments designated at fair value through profit or loss'.

Transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the consolidated income statement in 'Other expense'.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

iii) Available-for-sale financial assets

Financial assets classified as available-for-sale are non-derivative financial assets that are either designated in this category or not classified in any of the other categories of financial instruments. Financial assets classified as available-for-sale are recorded on trade date and are initially recognised and subsequently measured at fair value (see note 3(d) below).

Transaction costs that are directly attributable to the acquisition of the available-for-sale financial asset are added to the fair value on initial recognition.

For debt instruments, interest calculated using the effective interest method (see note 3(c)(iv) below), impairment losses and reversals of impairment losses and foreign exchange differences on the amortised cost of the asset are recorded in the consolidated income statement in ‘Net gains/ (losses) on available-for-sale financial assets’.

For equity instruments, dividend income and impairment losses are recognised in the consolidated income statement in ‘Net gains/ (losses) on available-for-sale financial assets’. All other gains and losses on debt and equity instruments classified as available-for-sale are recognised in the ‘Available-for-sale reserve’ within equity.

On disposal or impairment of an available-for-sale financial asset, the cumulative gain or loss in the ‘Available-for-sale reserve’ is reclassified to the consolidated income statement and reported in ‘Net gains/ (losses) on available-for-sale financial assets’.

iv) Loans and receivables and financial liabilities at amortised cost

Financial assets classified as loans and receivables are initially recognised on settlement date at fair value (see note 3(d) below) and subsequently measured at amortised cost less allowance for impairment. Interest is recognised in the consolidated income statement in ‘Interest income’, using the effective interest rate method as described below. Transaction costs that are directly attributable to the acquisition of the financial asset are added to or deducted from the fair value on initial recognition. Impairment losses and reversals of impairment losses on financial assets classified as loans and receivables are recognised in the consolidated income statement in ‘Other expense’.

Financial liabilities held at amortised cost are initially recognised on settlement date at fair value (see note 3(d) below) and subsequently measured at amortised cost. Interest is recognised in the consolidated income statement in ‘Interest expense’ using the effective interest rate method as described below. Transaction costs that are directly attributable to the issue of the financial liability are added to or deducted from the fair value on initial recognition.

The effective interest rate method is a method of calculating the amortised cost of a financial asset or financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the expected life of the financial asset or financial liability. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or financial liability (or, where appropriate a shorter period) to the carrying amount of the financial asset or financial liability. The effective interest rate is established on initial recognition of the financial asset and financial liability. The calculation of the effective interest rate includes all fees and commissions paid or received, transaction costs, and discounts or premiums that are an integral part of the effective interest rate. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

c. Financial instruments (continued)

iv) Loans and receivables and financial liabilities at amortised cost (continued)

In the course of financing its business and as part of its trading activities, the Group enters into arrangements which involve the sale of securities with agreements to repurchase, the purchase of securities with resale agreements, the lending of securities with collateral received and the borrowing of securities with collateral given. Cash collateral balances repayable and accrued interest arising under repurchase agreements and securities lending arrangements are classified as 'Financial liabilities at amortised cost' and the related securities, where owned by the Group, are included in 'Financial assets classified as held for trading'. Cash collateral balances receivable and accrued interest arising under resale agreements and securities borrowing arrangements are classified as 'Loans and receivables'. Securities received by the Group under resale arrangements and securities borrowing arrangements are generally not recognised on the consolidated statement of financial position.

d. Fair value of financial instruments

Fair value measurement

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 Group uses various valuation approaches and establishes a hierarchy for inputs used in measuring fair value that maximises the use of relevant observable inputs and minimises 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 Group. Unobservable inputs are inputs that reflect the Group'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 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 product. 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 judgement.

The Group 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.

Valuation techniques

Fair value for many cash and over-the-counter ("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, model uncertainty and concentration risk.

Adjustments for liquidity risk adjust model-derived valuations of 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 trader 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.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value of financial instruments (continued)

Valuation techniques (continued)

Credit valuation adjustments are applied to both cash instruments and OTC derivatives. For cash instruments, the impact of changes in its own credit spreads is considered when measuring the fair value of liabilities and the impact of changes in the counterparty's credit spreads is considered when measuring the fair value of assets. For OTC derivatives, the impact of changes in both the Group's and the counterparty's credit standing is considered when measuring fair value. In determining the expected exposure the Group simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party CDS spread data. Where CDS spread data are unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty's credit rating or CDS spread data that reference a comparable counterparty may be utilised. The Group also considers collateral held and legally enforceable master netting agreements that mitigate the Group's exposure to each counterparty.

Adjustments for model uncertainty are taken for positions where 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 Group generally subjects all valuations and models to a review process initially and on a periodic basis thereafter.

The Group may apply a concentration adjustment to certain of its OTC derivatives portfolios to reflect the additional cost of closing out a particularly large risk exposure. Where possible, these adjustments are based on observable market information but in many instances significant judgement is required to estimate the costs of closing out concentrated risk exposures due to the lack of liquidity in the marketplace.

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 Group's own assumptions are set to reflect those that the Group believes market participants would use in pricing the asset or liability at the measurement date.

Valuation process

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

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value of financial instruments (continued)

Valuation process (continued)

The Group's control processes apply to all financial instruments, unless otherwise noted. These control processes include:

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

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

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

For financial instruments where the fair value is based on unobservable inputs, VRG reviews the business unit's valuation techniques to ensure these are consistent with market participant assumptions.

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

Review of Transactions where the valuation is based on unobservable inputs. VRG reviews the models and valuation methodology used to price all new material Level 3 transactions and both the Financial Control Group and Market Risk Department management must approve the fair value of the trade that is initially recognised.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

d. Fair value of financial instruments (continued)

Gains and losses on inception

In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (i.e. the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Group recognises a gain or loss on inception of the transaction.

When unobservable market data has a significant impact on determining fair value at the inception of the transaction, the entire initial gain or loss indicated by the valuation technique as at the transaction date is not recognised immediately in the consolidated income statement and is recognised instead when the market data becomes observable.

e. Derecognition of financial assets and liabilities

The Group derecognises a financial asset only when the contractual rights to the cash flows from the asset expire, or when it transfers the financial asset and substantially all the risk and rewards of ownership of the asset.

The Group derecognises financial liabilities when the Group's obligations are discharged, cancelled or they expire.

f. Impairment of financial assets

At each reporting date, an assessment is made as to whether there is any objective evidence of impairment in the value of a financial asset classified as either available-for-sale or loans and receivables. Impairment losses are recognised if an event has occurred which will have an adverse impact on the expected future cash flows of an asset and the expected impact can be reliably estimated.

Impairment losses on available-for-sale financial assets are measured as the difference between cost (net of any principal repayment and amortisation) and the current fair value. Where there is evidence that the available-for-sale financial asset is impaired, the cumulative loss that had been previously recognised in other comprehensive income is reclassified from the 'Available-for-sale reserve' and recognised in the consolidated income statement within 'Net gains/ (losses) on available-for-sale financial assets'.

Impairment losses on loans and receivables carried at amortised cost are measured as the difference between the carrying amount of the financial asset and the present value of estimated cash flows discounted at the asset's original effective interest rate. Such impairment losses are recognised in the consolidated income statement within 'Other expense' and are recognised against the carrying amount of the impaired asset on the consolidated statement of financial position. Interest on the impaired asset continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset.

Subsequent increases in fair value of previously impaired equity available-for-sale financial assets are reported as fair value gains in the 'Available-for-sale reserve' through other comprehensive income and not separately identified as an impairment reversal. For all other financial assets, if in a subsequent year, the amount of the estimated impairment loss decreases because of an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed as detailed by financial asset in note 3c(iii) and (iv). Any reversal is limited to the extent that the value of the asset may not exceed the original amortised cost of the asset had no impairment occurred.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

g. Impairment of non-financial assets

Non-financial assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash generating units). Non-financial assets, other than goodwill, that have suffered an impairment are reviewed for possible reversal of the impairment at the end of each reporting period. Such impairment losses are recognised in the consolidated income statement within 'Other expense' and are recognised against the carrying amount of the impaired asset on the consolidated statement of financial position.

h. Fees and commissions

Fees and commissions classified within 'Other income' in the consolidated income statement include account servicing fees, investment management fees, sales commissions, placement fees, advisory fees and syndication fees. Fees and commissions classified within 'Other expense' include transaction and service fees. These amounts are recognised as the related services are performed or received.

i. Property, plant and equipment

Property, plant and equipment are stated at cost net of depreciation and any provision for impairment in value, which are included within 'Other expense' in the consolidated income statement. For assets in the course of construction, interest that is directly attributable to the construction of the qualifying asset is capitalised as a cost of the asset. The interest capitalisation rate is based on the Morgan Stanley Group's blended funding rates.

For premises held under operating leases, a reinstatement provision is recognised for the estimated cost to reinstate the premises at the end of the lease period. When the reinstatement provision is established and included within 'Provisions' in the consolidated statement of financial position, an equivalent asset is recognised and included in the cost of leasehold improvements at the initial present value of any reinstatement obligations. The discount effect included in the reinstatement provision is reversed over time using a constant effective yield method and included within 'Interest expense' in the consolidated income statement. The reinstatement asset is depreciated over the useful economic life of the relevant leasehold improvement asset and the depreciation charge is included within 'Other expense'.

Depreciation is provided on property, plant and equipment at rates calculated to write off the cost of the assets on a straight line basis over their expected useful lives as follows:

Leasehold improvements including reinstatement assets	- shorter of remaining lease term and 25 years
Fixtures, fittings and equipment	- 3 to 8 years

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

j. Business combinations and disposals

When subsidiaries are sold or the Group ceases to control an entity, the difference between the proceeds (plus the fair value of any investment retained), and the total assets less total liabilities disposed of, cumulative translation differences and unamortised goodwill, is recognised in the consolidated income statement within 'Gain/ loss on disposal of subsidiary'. Where the disposal or loss of control over an entity includes a foreign operation, all foreign exchange differences accumulated in the 'currency translation reserve' attributable to the equity holders of the Parent are reclassified to the consolidated income statement within 'Gain/ loss on disposal of subsidiary'.

k. Cash and cash equivalents

For the purposes of the consolidated statement of cash flows, cash and cash equivalents comprise cash and demand deposits with banks, net of outstanding bank overdrafts, along with highly liquid investments, with original maturities of three months or less, that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

l. Income tax

The tax expense represents the sum of the tax currently paid and payable and deferred tax.

The tax currently payable is based on taxable profit for the year. Taxable profit may differ from net profit as reported in the consolidated income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date. Current tax is charged or credited in the consolidated income statement, except when it relates to items charged or credited directly to other comprehensive income or equity, in which case the current tax is also dealt with in other comprehensive income or equity respectively.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the consolidated financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and associates, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at each reporting date and limited to the extent that it is probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised. Deferred tax is charged or credited in the consolidated income statement, except when it relates to items charged or credited directly to other comprehensive income or equity, in which case the deferred tax is dealt with in other comprehensive income or equity, respectively.

Current tax assets are offset against current tax liabilities and deferred tax assets are offset against deferred tax liabilities when there is a legally enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Group intends to settle its current tax assets and current tax liabilities on a net basis.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

m. Operating leases

Rentals payable under operating leases are charged to 'Other expense' in the consolidated income statement on a straight line basis over the lease term. Lease incentives are allocated on a straight line basis over the lease term as a reduction to rental expense.

Rentals receivable under operating leases are credited to 'Other income' in the consolidated income statement on a straight line basis over the lease term. Initial direct costs incurred in negotiating and arranging the lease are added to the carrying amount of the leased asset and recognised in the consolidated income statement on a straight line basis over the lease term. Lease incentives are allocated on a straight line basis over the lease term.

n. Provisions

Provisions are recognised when the Group has a present obligation as a result of a past event, when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and when a reliable estimate can be made of the amount of the obligation. The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the year end date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimate to settle the present obligation, its carrying amount is the present value of those cash flows.

o. Employee compensation plans

i) Equity-settled share-based compensation plans

Morgan Stanley operates equity based compensation plans on behalf of the Group in relation to which, the Group pays Morgan Stanley in consideration of the procurement of the transfer of shares to employees. The cost of equity based transactions with employees is measured based on the fair value of the equity instruments at grant date. Fair value of stock unit awards is based on the market price of Morgan Stanley shares and fair value of stock option awards is estimated using the Black-Scholes option pricing model, which takes into account the option's exercise price, its expected term, the risk free interest rate and the expected volatility of the market price of Morgan Stanley shares. Non-market vesting conditions are not taken into account when measuring fair value, but are reflected by adjusting over time the number of equity instruments included in the measurement of the transaction such that the amount ultimately recognised reflects the number that actually vest. The expense for IFRS 2 *'Share-based payment'* ("IFRS 2") purposes is recorded within 'Direct staff costs' in 'Other expense' in the consolidated income statement; the corresponding credit to retained earnings is reduced to the extent that payments are due to Morgan Stanley in respect of these awards.

ii) Other deferred compensation plans

Morgan Stanley also maintains 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. Liabilities for these awards, which are included within 'Accruals and deferred income' in the consolidated statement of financial position, are measured at fair value and recognised over time in accordance with the awards' vesting conditions. The related expense is recorded within 'Direct staff costs' in 'Other expense'. The Group economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivatives are recognised within 'Financial instruments classified as held for trading' in the consolidated statement of financial position and the related gains and losses are recorded within 'Net gains/ (losses) on financial instruments classified as held for trading' in the consolidated income statement.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

p. Post employment benefits

The Group operates defined contribution and defined benefit post employment plans.

Contributions due in relation to the Group's defined contribution post employment plan are recognised in 'Other expense' in the consolidated income statement when payable.

For the Group's defined benefit post employment plan, the plan obligations are measured on an actuarial basis in accordance with the advice of an independent qualified actuary using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the plan liabilities. Plan assets are measured at their fair value at the reporting date. A surplus or deficit of plan assets over liabilities is recognised in the consolidated statement of financial position as an asset or a liability respectively. The value of any asset recognised is restricted to the sum of any unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan. The current service cost and any past service costs together with the expected return on plan assets less the unwinding of the discount on the plan liabilities is charged to 'Direct staff costs' within 'Other expense' in the consolidated income statement. Actuarial gains and losses that arise in calculating the Group's obligation in respect of a plan are recognised in other comprehensive income, in the period in which they occur.

Details of the plans are given in note 33 to these consolidated financial statements.

q. Offsetting of financial assets and financial liabilities

Where there is a current legally enforceable right to set off the recognised amounts and an intention to either settle on a net basis or to realise the asset and the liability simultaneously, financial assets and financial liabilities are offset and the net amount is presented on the consolidated statement of financial position. In the absence of such conditions, financial assets and financial liabilities are presented on a gross basis.

4. NET GAINS ON AVAILABLE-FOR-SALE FINANCIAL ASSETS

	2012 $millions	2011 $millions
Dividend income	4	-
Net fair value gains reclassified from the available-for-sale reserve on disposal of asset	46	-
	50	-

5. INTEREST INCOME AND INTEREST EXPENSE

'Interest income' and 'Interest expense' represent total interest income and total interest expense for financial assets and financial liabilities that are not carried at fair value.

No other gains or losses have been recognised in respect of loans and receivables other than as disclosed as 'Interest income' and foreign exchange differences disclosed within 'Other income' within the consolidated income statement.

No other gains or losses have been recognised in respect of financial liabilities measured at amortised cost other than as disclosed in 'Interest expense' within the consolidated income statement.

Included within interest expense in 2011 was $18 million paid on the Class B preference shares, which were classified as debt (see note 21).

6. OTHER INCOME

	2012 $millions	2011 $millions
Fee and commission income:		
Advisory fees	87	151
Non-UK capital gains tax recoverable	150	-
Trust and other fiduciary activities	130	114
Net foreign exchange gains	27	-
	394	265

Non-UK capital gains tax recoverable represents the expected reimbursement from clients on certain equity transactions. Contractually the clients are legally bound to reimburse the Group for any tax, levy, impost duty, charge, assessment or fee, directly or indirectly, in connection with or arising from these equity transactions. Such tax incurred by the Group in relation to these equity transactions is included in 'Income tax expense' within the consolidated income statement (see note 8).

7. OTHER EXPENSE

	2012 $millions	2011 $millions
Fee and commission expense:		
Brokerage fees	463	508
Direct staff costs	187	182
Bank levy:		
- Current year expense	36	43
- Prior year over provision	(10)	-
Operating lease rentals	10	5
Depreciation on property, plant and equipment	3	4
Net foreign exchange losses	-	30
Administration and corporate services	347	453
Auditors remuneration:		
- Fees payable to the Company's auditor and their associates for the audit of the Company's annual financial statements	4	3
- Audit of the Company's subsidiaries	1	1
- Other services	-	-
Management charges from other Morgan Stanley Group undertakings relating to staff costs	1,469	1,511
Management charges from other Morgan Stanley Group undertakings relating to other services	474	281
Other	418	272
	3,402	3,293

7. OTHER EXPENSE (CONTINUED)

Included within both 'Direct staff costs' and 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' is an amount totalling $163 million (2011: $185 million) in relation to equity-settled share-based compensation plans, granted to employees of the Group. These costs reflect the amortisation of equity-based awards granted to employees over the last three years and are therefore not directly aligned with other staff costs in the current year. Also included within 'Direct staff costs' and 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' are amounts totalling $60 million (2011: $62 million) in relation to defined contribution pension plans.

The average number of employees of the Group including the Directors is analysed below:

	Number	
	Year ended 31 December 2012	Year ended 31 December 2011
Company and institutional securities infrastructure	152	160
Business units and other	206	210
	358	370

The cost of staff is analysed below:

	2012 $millions	2011 $millions
Wages and salaries	158	160
Social security costs	26	17
Pension costs	3	5
	187	182

The Group paid no remuneration to its Directors during the current or prior year but incurred management recharges in respect of Directors' services provided to the Group which are included within 'Management charges from other Morgan Stanley Group undertakings relating to staff costs' within 'Other expense'. The amount of remuneration received by Directors in respect of their services to the Group is disclosed in note 35.

8. INCOME TAX EXPENSE

	2012 $millions	2011 $millions
Current tax expense		
United Kingdom corporation tax charge		
- current year	89	249
- adjustments in respect of prior years	(60)	(53)
Double taxation relief		
- current year	(49)	(77)
- adjustments in respect of prior years	7	(46)
Overseas tax		
- current year	146	181
- adjustments in respect of prior years	149	1
	282	255
Deferred tax expense		
Origination and reversal of temporary differences	(53)	(2)
Adjustment in respect of prior years	-	(2)
Effect of changes in tax rates	4	1
	(49)	(3)
Income tax expense	233	252

8. INCOME TAX EXPENSE (CONTINUED)

Reconciliation of effective tax rate

The current year income tax expense is higher (2011: higher) than that resulting from applying the average standard rate of corporation tax in the UK for the year of 24.50% (2011: 26.49%). The main differences are explained below:

	2012 $millions	2011 $millions
Profit before income tax	242	825
Income tax using the average standard rate of corporation tax in the UK of 24.50% (2011: 26.49%)	59	219
Impact on tax of:		
Expenses not deductible for tax purposes:		
UK bank levy	6	11
Other expenses	2	3
Interest not deductible for tax purposes:		
Preference share dividends shown as interest expense	-	5
Other interest expense	2	2
Carry forward/ (utilisation) of prior years tax losses	4	(14)
Group relief surrendered for no cash consideration	82	150
Effect of tax rates in foreign jurisdictions	119	1
Currency translation on tax	(1)	(6)
Tax exempt income	(12)	(13)
Tax (over)/ under provided in prior years	(55)	12
Recognition/ (utilisation) of tax reserves in respect of prior years	6	(111)
Other	21	(7)
Total income tax expense in the consolidated income statement	233	252

Included within 'Overseas tax – adjustments in respect of prior years' and in 'Effect of tax rates in foreign jurisdictions' is an amount of $144 million that represents a potential non-UK capital gains tax liability that may arise on equity investments made by the Group to hedge client positions. Should this tax liability arise it is expected to be reimbursed from clients and the right to reimbursement is included in 'Other income' in the consolidated income statement (see note 6).

The Group has a policy of surrendering tax-deductible losses ('group relief') for nil consideration to other members of the Morgan Stanley UK tax group. Within the Group, a number of subsidiary undertakings generate tax-deductible losses which are surrendered to other Morgan Stanley subsidiary undertakings outside the Group.

Finance Act 2011 enacted a reduction to the UK corporation tax rate to 25% with effect from April 2012. Finance Act 2012 increased the reduction by a further 1%. The combined reduction in the rate to 24% from April 2012 impacted the current tax charge in 2012.

Finance Act 2012 also enacted an additional reduction of 1% in the UK corporation tax rate to 23% with effect from April 2013. This further reduction in the tax rate will impact the current tax charge in 2013.

8. INCOME TAX EXPENSE (CONTINUED)

In addition to the amount charged to the consolidated income statement, the aggregate amount of current and deferred tax relating to each component of other comprehensive income was as follows:

	2012			2011		
	Before tax $millions	Tax (expense)/ benefit $millions	Net of tax $millions	Before tax $millions	Tax (expense)/ benefit $millions	Net of tax $millions
Foreign currency translation reserve:						
Foreign currency translation differences on foreign operations	24	-	24	(17)	3	(14)
Reclassification of foreign currency translation differences on disposal of foreign operations	30	-	30	-	-	-
Available-for-sale reserve:						
Net change in fair value of available-for-sale financial assets	30	(7)	23	24	(6)	18
Reclassification adjustments relating to available-for-sale assets disposed of during the year	(46)	11	(35)	-	-	-
Actuarial gains on post employment benefit schemes	-	-	-	2	-	2
Unwinding of deferred tax on net day one gains not recognised upon initial recognition of financial instruments	-	(3)	(3)	-	-	-
Other comprehensive income/ (loss)	38	1	39	9	(3)	6

9. CASH AND SHORT TERM DEPOSITS

Included within cash and short term deposits is an amount of $7,480 million (2011: $8,171 million) which represents segregated client money, held in accordance with the FSA's Client Money Rules, and an amount of $334 million (2011: $8 million) which represents other client money.

10. OTHER RECEIVABLES

	2012 $millions	2011 $millions
Amounts held at exchanges	403	160
Amounts due from other Morgan Stanley Group undertakings	5,139	5,165
Other amounts receivable	134	1,900
	5,676	7,225

11. FINANCIAL ASSETS AND FINANCIAL LIABILITIES CLASSIFIED AS HELD FOR TRADING

Financial assets and financial liabilities classified as held for trading are summarised as follows:

	2012		2011	
	Assets $millions	Liabilities $millions	Assets $millions	Liabilities $millions
Government debt securities	18,153	17,009	9,249	10,193
Corporate and other debt	10,376	2,096	12,474	2,727
Corporate equities	30,505	16,673	22,282	14,762
Derivatives	282,660	278,270	310,138	306,143
	341,694	314,048	354,143	333,825

12. FINANCIAL ASSETS AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

Financial instruments designated at fair value through profit or loss consist primarily of the following financial assets and financial liabilities:

Prepaid "OTC" contracts: The risk on these financial instruments, both financial assets and financial liabilities, is primarily hedged using financial instruments classified as held for trading including equity securities and interest rate swaps. These prepaid OTC contracts are designated at fair value through profit or loss as such contracts, as well as the financial instruments, with which they are hedged, are risk managed on a fair value basis as part of the Group's trading portfolio and the risk is reported to key management personnel on this basis.

Issued structured notes: These relate to financial liabilities which arise from selling structured products generally in the form of notes or certificates. These structured notes are designated at fair value through profit or loss as the risks to which the Group is a contractual party are risk managed on a fair value basis as part of the Group's trading portfolio and the risk is reported to key management personnel on this basis.

Corporate loans: Certain loans to customers are designated at fair value through profit or loss because either the risks of the loans have been matched with other financial instrument contracts accounted for at fair value and such a designation reduces an accounting mismatch; or as part of a documented risk management strategy the risks of the loan are managed on a fair value basis as part of the Group's trading portfolio and the risk is reported to key management personnel on this basis; or because the loan contract itself contains an embedded derivative that must otherwise be separated and measured at fair value.

Other financial assets and liabilities: These include financial assets and liabilities such as those that arise upon the consolidation of certain special purpose entities and those that arise as a result of continuing recognition of certain financial assets and the simultaneous recognition of an associated financial liability. These financial assets and liabilities are designated at fair value as the risks to which the Group is a contractual party are risk managed on a fair value basis as part of the Group's trading portfolio and the risk is reported to key management personnel on this basis.

12. FINANCIAL ASSETS AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS (CONTINUED)

	2012		2011	
	Assets $millions	Liabilities $millions	Assets $millions	Liabilities $millions
Prepaid OTC contracts	4,310	3,174	3,264	2,676
Corporate loans	1,117	-	1,377	-
Issued structured notes	-	1,390	-	1,099
Other financial assets and liabilities	2,164	7,996	3,921	7,935
	7,591	12,560	8,562	11,710

The maximum exposure to credit risk of loans and receivables designated at fair value through profit or loss as at 31 December 2012 is $1,117 million (2011: $1,377 million). The cumulative change in fair value of loans attributable to changes in credit risk amounts to a loss of $4 million (2011: loss of $4 million) and the change for the current year is a gain of $1 million (2011: loss of $4 million).

The change in fair value recognised through the consolidated income statement attributable to own credit risk for financial liabilities designated at fair value during the year is a loss of $187 million (2011: gain of $128 million) and cumulatively is a gain of $62 million (2011: gain of $249 million). This change is determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to credit risk.

The carrying amount of financial liabilities designated at fair value was $59 million higher than the contractual amount due at maturity (2011: $144 million lower).

13. AVAILABLE-FOR-SALE FINANCIAL ASSETS

Financial assets that are classified as available-for-sale consist of corporate equities, of which $2 million are listed investments (2011: $2 million).

Movement in available-for-sale financial assets

	2012 $millions	2011 $millions
Fair value		
At 1 January	67	44
Additions	2	-
Changes in fair value recognised in the available-for-sale reserve	30	24
Disposals and other settlements	(59)	(1)
At 31 December	40	67

14. PROPERTY, PLANT AND EQUIPMENT

2012	Leasehold improvements $millions	Fixtures, fittings and equipment $millions	Total $millions
Cost			
At 1 January 2012	23	23	46
Additions	-	1	1
Foreign exchange revaluation	1	1	2
Disposals	-	(1)	(1)
At 31 December 2012	24	24	48
Depreciation			
At 1 January 2012	18	18	36
Charge for the year	2	1	3
Foreign exchange revaluation	1	1	2
At 31 December 2012	21	20	41
Carrying amount			
At 31 December 2012	3	4	7

2011	Leasehold improvements $millions	Fixtures, fittings and equipment $millions	Total $millions
Cost			
At 1 January 2011	24	21	45
Additions	-	3	3
Foreign exchange revaluation	(1)	(1)	(2)
At 31 December 2011	23	23	46
Depreciation			
At 1 January 2011	16	17	33
Charge for the year	2	2	4
Foreign exchange revaluation	-	(1)	(1)
At 31 December 2011	18	18	36
Carrying amount			
At 31 December 2011	5	5	10

There was no impairment identified in 2012 (2011: $nil).

15. SUBORDINATED LOANS

The amounts subject to subordinated loan agreements are wholly repayable as shown below:

Counterparty	**Repayment Date**	**Interest Rate**	**2012 $millions**	**2011 $millions**
Morgan Stanley UK Financing I LP	31 October 2025	LIBOR plus 1.25%	7,906	7,906
			7,906	7,906

All amounts outstanding under subordinated loan agreements are repayable at any time at the Group's option, subject to two business days' notice to the lender and at least one month's notice to the FSA.

The Group has not defaulted on principal, interest or made any other breaches with respect to its subordinated loans during the year.

16. OTHER PAYABLES

	2012 $millions	**2011 $millions**
Amounts due to other Morgan Stanley Group undertakings	17,506	17,849
Other amounts payable	110	3,858
	17,616	21,707

17. PROVISIONS

	Property $millions	**Litigation $millions**	**Total $millions**
At 1 January 2012	4	6	10
Additional provisions	-	87	87
Provisions utilised	(1)	(9)	(10)
Unused provisions reversed	-	(5)	(5)
At 31 December 2012	3	79	82

Property

Property provisions represent the net present value of expected future costs of excess office space (net of sublease income) and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term. Lease reinstatement provisions are released when the reinstatement obligations have been fulfilled. The related asset for lease reinstatement provisions is included in 'Leasehold improvements' within 'Property, plant and equipment' (note 14).

17. PROVISIONS (CONTINUED)

Litigation matters

In the normal course of business, the Group has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the entities that would otherwise be the primary defendants in such cases are bankrupt or are in financial distress. These actions have included, but are not limited to, residential mortgage and credit crisis related matters. Over the last several years, the level of litigation and investigatory activity focused on residential mortgage and credit crisis related matters has increased materially in the financial services industry. As a result, the Group may become the subject of increased claims for damages and other relief regarding residential mortgages and related securities in the future and, while the Group has identified below any individual proceedings where the Group believes a material loss to be reasonably possible and reasonably estimable, there can be no assurance that material losses will not be incurred from claims that have not yet been notified to the Group or are not yet determined to be probable or possible and reasonably estimable losses.

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

The Group contests liability and/or the amount of damages as appropriate in each pending matter. Where available information indicates that it is probable a liability had been incurred at the date of the consolidated financial statements and the Group can reasonably estimate the amount of that loss, the Group accrues the estimated loss by a charge to income. In many proceedings, however, it is inherently difficult to determine whether any loss is probable or even possible or to estimate the amount of any loss. In addition, even where loss is possible or an exposure to loss exists in excess of the liability already accrued with respect to a previously recognized loss contingency, it is not always possible to reasonably estimate the size of the possible loss or range of loss.

For certain legal proceedings, the Group cannot reasonably estimate such losses, particularly for proceedings that are in their early stages of development or where plaintiffs seek substantial or indeterminate damages. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, determination of issues related to class certification and the calculation of damages, and by addressing novel or unsettled legal questions relevant to the proceedings in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for any proceeding.

For certain other legal proceedings, the Group can estimate reasonably possible losses, additional losses, ranges of loss or ranges of additional loss in excess of amounts accrued, but does not believe, based on current knowledge and after consultation with counsel, that such losses will have a material adverse effect on the Group’s consolidated financial statements as a whole, other than the matters referred to in the following paragraphs.

17. PROVISIONS (CONTINUED)

Litigation matters (continued)

On 25 August 2008, the Morgan Stanley Group, the Group and two ratings agencies were named as defendants in a purported class action related to securities issued by a structured investment vehicle ("SIV") called Cheyne Finance plc and Cheyne Finance LLC (together, the "Cheyne SIV"). The case is styled Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al. and is pending in the United States District Court for the Southern District of New York ("SDNY"). The complaint alleges, among other things, that the ratings assigned to the securities issued by the Cheyne SIV were false and misleading, including because the ratings did not accurately reflect the risks associated with the subprime residential mortgage backed securities held by the Cheyne SIV. The plaintiffs currently assert allegations of aiding and abetting fraud and negligent misrepresentation relating to approximately $852 million of securities issued by the Cheyne SIV. The plaintiffs' motion for class certification was denied in June 2010. The court denied the Morgan Stanley Group's and the Group's motion for summary judgment on the aiding and abetting fraud claim in August 2012. On 30 November 2012, the Morgan Stanley Group and the Group filed a motion for summary judgment on the negligent misrepresentation claim. On 18 April 2013, the Morgan Stanley Group and the Group have reached an agreement in principle to settle this matter.

On 15 July 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Morgan Stanley Group, which is styled China Development Industrial Bank v. Morgan Stanley & Co. Incorporated et al. and is pending in the Supreme Court of the State of New York, New York County. The complaint relates to a $275 million credit default swap referencing the super senior portion of the STACK 2006-1 CDO. The complaint asserts claims for common law fraud, fraudulent inducement and fraudulent concealment and alleges that the Morgan Stanley Group misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Morgan Stanley Group knew that the assets backing the CDO were of poor quality when it entered into the credit default swap with CDIB. The complaint seeks compensatory damages related to the approximately $228 million that CDIB alleges it has already lost under the credit default swap, rescission of CDIB's obligation to pay an additional $12 million, punitive damages, equitable relief, fees and costs. On 28 February 2011, the court presiding over this action denied the Morgan Stanley Group's motion to dismiss the complaint. On 7 July 2011, the appellate court affirmed the lower court's decision denying the motion to dismiss. Based on currently available information, the Morgan Stanley Group believes it could incur a loss of up to approximately $240 million plus pre- and post-judgment interest, fees and costs.

17. PROVISIONS (CONTINUED)

Litigation matters (continued)

In addition, the Group has identified the following proceeding:

On 10 June 2010, the Morgan Stanley Group and the Group was named as a new defendant in a pre-existing purported class action related to securities issued by a SIV called Rhinebridge plc and Rhinebridge LLC (together the "Rhinebridge SIV"). The case is styled King County, Washington, et al. v. IKB Deutsche Industriebank AG, et al. and is pending in the SDNY before the same judge presiding over the litigation concerning the Cheyne SIV, described above. The complaint alleges, among other things, that the ratings assigned to the securities issued by the SIV were false and misleading, including because the ratings did not accurately reflect the risks associated with the subprime RMBS held by the SIV. The court dismissed plaintiffs' claims for breach of fiduciary duty and negligence on 4 May 2012. On 7 September 2012 the Morgan Stanley Group and the Group moved for summary judgment with respect to the remaining claims for fraud, negligent misrepresentation and aiding and abetting fraud. On 3 January 2013 the court granted the motion for summary judgment with respect to the fraud and negligent misrepresentation claims and denied it with respect to the aiding and abetting fraud claim. On 18 April 2013, the Morgan Stanley Group and the Group have reached an agreement in principle to settle this matter.

In addition to the matters disclosed above, on 2 October 2012, the United States Court of Appeals for the Second Circuit affirmed the 27 June 2011 judgment of the SDNY in Citibank, N.A. v. Morgan Stanley & Co. International plc in favour of Citibank, N.A. for $269 million plus post-judgment interest and costs. The Group has satisfied the judgment. In compliance with certain intra-group policies of the Morgan Stanley Group, all costs related to this matter were transferred to other Morgan Stanley Group undertakings outside of the Group.

18. DEFERRED TAX ASSETS AND LIABILITIES

Deferred taxes are calculated on all temporary differences under the liability method. The movement in the deferred tax account is as follows:

	2012		2011	
	Deferred tax asset $millions	**Deferred tax liability $millions**	**Deferred tax asset $millions**	**Deferred tax liability $millions**
At 1 January	44	(7)	46	(5)
Amount recognised in the consolidated income statement	53	-	3	1
Amount recognised in other comprehensive income	(2)	4	(3)	(3)
Impact of changes in tax rates recognised in the consolidated income statement	(4)	-	(1)	-
Impact of changes in tax rates recognised in other comprehensive income	(1)	-	-	-
Foreign exchange adjustment	1	(1)	(1)	-
At 31 December	91	(4)	44	(7)

18. DEFERRED TAX ASSETS AND LIABILITIES (CONTINUED)

The deferred tax included in the consolidated statement of financial position and changes recorded in the 'Income tax expense' are as follows:

	Deferred tax asset 2012 $millions	Deferred tax liability 2012 $millions	Consolidated income statement 2012 $millions	Deferred tax asset 2011 $millions	Deferred tax liability 2011 $millions	Consolidated income statement 2011 $millions
Depreciation - temporary differences	5	-	1	6	-	1
Deferred compensation	25	-	4	27	-	(4)
Available-for-sale financial assets	-	(1)	-	-	(4)	-
Forecast currency hedges	-	(3)	(1)	-	(3)	(1)
Amounts not recognised due to unobservable market data	8	-	-	10	-	-
Deferred interest	45	-	(45)	-	-	-
Other temporary differences	8	-	(8)	1	-	1
	91	(4)	(49)	44	(7)	(3)

Finance Act 2012 enacted further reductions in the rate of UK corporation tax to 24% with effect April 2012 and 23% with effect from April 2013. This overall rate reduction to 23% has had an impact on the Group's deferred tax balance as indicated above.

As part of the Chancellor's 2012 Budget, a reduction to 22% was announced effective from April 2014. This was then revised down to 21% (still from April 2014) in the Autumn Statement in December 2012. In addition, it was announced in the 2013 Budget that the rate will fall a further 1% to 20% from April 2015. These 21% and 20% rates will be included in Finance Bill 2013, due to be enacted in summer 2013.

However, as neither rate reduction was substantively enacted as at 31 December 2012, their effect has not been applied to the valuation of the Group's deferred tax assets and liabilities. The potential impact resulting from the further rate reductions is a reduction in the net deferred tax asset of approximately $3 million.

The deferred tax assets recognised are based on management assessment that it is probable that the Group will have taxable profits against which the temporary differences can be utilised.

Deferred tax assets have not been recognised in respect of the following items (amounts shown are as at the end of the reporting period):

	2012 $millions	2011 $millions
Unused tax losses	38	38

The aggregate amount of temporary differences associated with investments in subsidiaries, branches and joint ventures, for which deferred tax liabilities have not been recognised in $nil (2011: $nil).

19. COMMITMENTS AND CONTINGENCIES

Leases

The Group has entered into non-cancellable commercial leases on premises and equipment. These leases have a life of between two and eight years. The leases on the premises include renewal options and escalation clauses in line with general rental market conditions and rent adjustments based on price indices. The lease agreements do not contain contingent rent payment clauses or purchase options and they do not impose any restrictions on the Group's ability to pay dividends, engage in debt financing transactions or enter into further lease agreements.

	2012 $millions	2011 $millions
Lease payments under non-cancellable operating leases recognised as an expense in the year		
- Minimum lease payments	10	5

Future minimum lease payments under non-cancellable operating leases at 31 December are due as follows:

	2012 $millions	2011 $millions
Within one year	8	9
In two to five years	23	13
Over five years	13	-
	44	22

Contingent liability relating to tax

The tax position of a subsidiary undertaking of the Group is currently under review by the Dutch tax authorities. The review has not progressed sufficiently to determine the timings of resolution or the amount of any outflow. The current estimate of the maximum amount payable, if any, arising from this review is Euro 132 million.

Other commitments and contingent liabilities

At 31 December, the Group had the following outstanding commitments and contingent liabilities arising from off-balance sheet financial instruments:

Contingent liabilities	2012 $millions	2011 $millions
Financial guarantees	-	1
Forward starting reverse repurchase agreements	25,370	22,448
Letters of credit	5	-
	25,375	22,449

Commitments	2012 $millions	2011 $millions
Loan commitments	985	986
Contingent commitments	2,172	3,010
Underwriting commitments	44	156
	3,201	4,152

20. EQUITY

	Ordinary shares of $1 each $millions	Ordinary shares of £1 each $millions	Class A ordinary shares of $1 each $millions	Class C, non-cumulative, preference shares of $1 each $millions	Class D, non-cumulative, preference shares of $1 each $millions	Class D1, non-cumulative, preference shares of $0.4 each $millions	Class D2, non-cumulative, preference shares of $0.6 each $millions	Total shares $millions
Issued and fully paid:								
At 1 January 2011	2,998	30	-	50	2,500	-	-	5,578
Issued in the year:								
Subdivision of D preference shares	-	-	-	-	(2,500)	1,000	1,500	-
$1 ordinary shares issued	3,886	-	-	-	-	-	-	3,886
Class A ordinary shares issued	-	-	1,500	-	-	-	-	1,500
D2 preference shares repurchased	-	-	-	-	-	-	(1,500)	(1,500)
At 31 December 2011	6,884	30	1,500	50	-	1,000	-	9,464
At 31 December 2012	6,884	30	1,500	50	-	1,000	-	9,464
Voting rights	69.59% (1)	0.41% (1)	Non-voting	20%	-	10%	-	100%

(1) Ordinary shares are pari passu with each other regardless of currency and together carry 70% of the vote

At 31 December 2012 the total issued share capital equated to $9,464 million (2011: $9,464 million) comprising 6,884,105,148 ordinary shares of $1 each, 17,615,107 ordinary shares of £1 each, 1,500,000,000 Class A Non-Voting ordinary shares of $1 each, 50,000,000 Class C non-redeemable non-cumulative preference shares of $1 each and 2,500,000,000 Class D1 non-cumulative voting preference shares of $0.4 each. All issued shares are fully paid.

The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled, on a show of hands, to one vote and, on a poll, one vote per share at meetings of the shareholders of the Company. All shares rank equally with regard to the Company's residual assets, except that preference shareholders participate only to the extent of the nominal value of the shares plus any accrued dividends.

All ordinary shares are recorded at the rates of exchange ruling at the date the shares were paid up.

20. EQUITY (CONTINUED)

Reserves

Share premium

The ‘Share premium account’ comprises the capital raised in an issue of shares that exceeds the nominal value of the shares.

Currency translation reserve

The ‘Currency translation reserve’ comprises all foreign exchange differences arising from the translation of the total assets less total liabilities of foreign operations. The tax effect of these movements is also included in the ‘currency translation reserve’.

The Group hedges foreign exchange exposure arising from its investments in foreign branch operations by utilising forward foreign currency exchange contracts (synthetic hedges) effected through intercompany accounts with the ultimate parent company, Morgan Stanley.

During the year, the Group disposed of two wholly owned subsidiaries, Morgan Stanley Euro Financing (Luxembourg) and Morgan Stanley Moselle S.à r.l., which were non-US dollar functional entities, to other Morgan Stanley Group undertakings. A consequence of these disposals was that accumulated foreign exchange losses totalling $30 million were reclassified from the ‘currency translation reserve’ to the consolidated income statement.

Available-for-sale reserve

The ‘Available-for-sale reserve’ includes the cumulative net change in the fair value of available-for-sale financial assets held at the reporting date. The tax effect of these movements is also included in the ‘Available-for-sale reserve’.

Capital contribution reserve

The ‘Capital contribution reserve’ comprises contributions of capital from the Group’s parent company to subsidiaries of the Group.

Capital redemption reserve

The ‘Capital redemption reserve’ represents transfers in prior years from retained earnings in accordance with relevant legislation.

21. DIVIDENDS

The following amounts represent the dividends paid in the current and prior year:

	2012		2011	
	Per share	Total	Per share	Total
	$	$millions	$	$millions
Dividends on Class B preference shares	-	-	0.02	18
Dividends on Class C preference shares	0.014	1	-	-
Dividends on Class D preference shares	-	-	0.04	110
		1		128

In 2011, dividends of $18 million were paid to the holders of the Class B redeemable non-cumulative preference shares. This dividend payment was included in 'Interest expense' within the consolidated income statement as the Class B preference shares were classified as debt. The Class B preference shares were repurchased by the Company on 22 December 2011.

The Directors have not proposed the payment of a final dividend out of reserves available at 31 December 2012 (2011: $nil).

22. ADDITIONAL CASH FLOW INFORMATION

a. Cash and cash equivalents

For the purposes of the consolidated statement of cash flows, cash and cash equivalents comprise the following balances, which have less than three months maturity from the date of acquisition:

		2012	2011
	Note	$millions	$millions
Cash and short-term deposits	9	11,526	11,180
Bank loans and overdrafts		(23)	(124)
		11,503	11,056

Included within 'Cash and short term deposits' is $7,814 million (2011: $8,179 million) of segregated client funds that are not available for use by the Group. The corresponding payable is recognised and included in 'Trade payables' within 'Financial liabilities at amortised cost'.

22. ADDITIONAL CASH FLOW INFORMATION (CONTINUED)

b. Reconciliation of cash flows from operating activities

	Note	2012 $millions	2011 $millions
Profit for the year		9	573
Adjustments for:			
Net gains on available-for-sale financial assets	4	(50)	-
Non-UK capital gains tax recoverable	6	(150)	-
Depreciation on property, plant and equipment	14	3	4
Interest income		(2,596)	(4,003)
Interest expense		3,033	3,990
Income tax expense		233	252
Loss/ (gain) on disposal of subsidiary / joint venture	34	30	(21)
Other expenses		-	1
Operating cash flows before changes in operating assets and liabilities		512	796
Changes in operating assets			
(Increase)/ decrease in loans and receivables, excluding cash and short term deposits		(3,631)	16,093
Decrease/(increase) in financial assets classified as held for trading		12,449	(83,149)
Decrease in financial assets designated at fair value through profit or loss		971	797
		9,789	(66,259)
Changes in operating liabilities			
Increase/ (decrease) in financial liabilities at amortised cost, excluding bank loans and overdrafts		7,402	(47,613)
(Decrease)/increase in financial liabilities classified as held for trading		(19,777)	113,032
Increase/ (decrease) in financial liabilities designated at fair value through profit or loss		850	(2,003)
Increase/ (decrease) in provisions		72	(19)
		(11,453)	63,397
Interest received		2,489	4,134
Interest paid		(2,736)	(3,853)
Income taxes paid		(24)	(387)
Effect of foreign exchange movements		(96)	(128)
Net cash flows used in operating activities		**(1,519)**	**(2,300)**

23. EXPECTED MATURITY OF FINANCIAL ASSETS AND LIABILITIES

The table below shows an analysis of assets and liabilities analysed according to when they are expected to be recovered, realised or settled.

At 31 December 2012	Less than twelve months $millions	Equal to or more than twelve months $millions	Total $millions
ASSETS			
Loans and receivables:			
Cash and short term deposits	11,526	-	11,526
Cash collateral on securities borrowed	31,303	-	31,303
Securities purchased under agreements to resell	99,403	379	99,782
Trade receivables	66,438	-	66,438
Other receivables	5,273	403	5,676
	213,943	782	214,725
Financial assets classified as held for trading	341,694	-	341,694
Financial assets designated at fair value through profit or loss	3,644	3,947	7,591
Available-for-sale financial assets	-	40	40
Current tax assets	210	-	210
Deferred tax assets	-	91	91
Prepayments and accrued income	53	-	53
Property, plant and equipment	-	7	7
	559,544	4,867	564,411
LIABILITIES			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	23	-	23
Cash collateral on securities loaned	29,032	304	29,336
Securities sold under agreements to repurchase	81,673	4,021	85,694
Trade payables	83,161	-	83,161
Subordinated loans	-	7,906	7,906
Other payables	14,393	3,223	17,616
	208,282	15,454	223,736
Financial liabilities classified as held for trading	314,048	-	314,048
Financial liabilities designated at fair value through profit or loss	8,725	3,835	12,560
Provisions	82	-	82
Current tax liabilities	243	-	243
Deferred tax liabilities	-	4	4
Accruals and deferred income	208	-	208
Post-employment benefit obligations	-	5	5
	531,588	19,298	550,886

23. EXPECTED MATURITY OF FINANCIAL ASSETS AND LIABILITIES (CONTINUED)

At 31 December 2011	Less than twelve months $millions	Equal to or more than twelve months $millions	Total $millions
ASSETS			
Loans and receivables:			
Cash and short term deposits	11,180	-	11,180
Cash collateral on securities borrowed	29,575	-	29,575
Securities purchased under agreements to resell	95,909	1,309	97,218
Trade receivables	67,371	-	67,371
Other receivables	7,065	160	7,225
	211,100	1,469	212,569
Financial assets classified as held for trading	354,140	3	354,143
Financial assets designated at fair value through profit or loss	2,144	6,418	8,562
Available-for-sale financial assets	-	67	67
Current tax assets	145	-	145
Deferred tax assets	-	44	44
Prepayments and accrued income	45	-	45
Property, plant and equipment	-	10	10
	567,574	8,011	575,585
LIABILITIES			
Financial liabilities at amortised cost:			
Bank loans and overdrafts	124	-	124
Cash collateral on securities loaned	25,516	500	26,016
Securities sold under agreements to repurchase	73,290	3,614	76,904
Trade payables	83,626	-	83,626
Subordinated loans	-	7,906	7,906
Other payables	20,654	1,053	21,707
	203,210	13,073	216,283
Financial liabilities classified as held for trading	333,825	-	333,825
Financial liabilities designated at fair value through profit or loss	8,835	2,875	11,710
Provisions	6	4	10
Current tax liabilities	68	-	68
Deferred tax liabilities	-	7	7
Accruals and deferred income	200	-	200
Post-employment benefit obligations	-	4	4
	546,144	15,963	562,107

24. SEGMENT REPORTING

Segment information is presented in respect of the Group's business and geographical segments. The business segments and geographical segments are based on the Group's management and internal reporting structure. Transactions between business segments are on normal commercial terms and conditions.

Business segments

Morgan Stanley structures its business segments primarily based upon the nature of the financial products and services provided to customers and Morgan Stanley's internal management structure. The Group's own business segments are consistent with those of Morgan Stanley.

The Group has two reportable business segments; Institutional Securities, Asset Management Institutional securities include the following activities: financial advisory and capital raising services; 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. Asset management include a range of alternative investment, real estate investing and merchant banking products for institutional investors and high net worth individuals.

Selected financial information to reconcile segment information to the Group's information is presented below.

2012	Institutional securities $millions	Asset management $millions	Other $millions	Total $millions
Consolidated income statement information:				
Net gains/ (losses) on financial instruments classified as held for trading	3,577	-	(6)	3,571
Net gains on financial instruments designated at fair value through profit or loss	96	-	-	96
Net gains on available-for-sale financial assets	50	-	-	50
Net interest	(438)	-	1	(437)
Other income	345	41	8	394
External revenues net of interest	3,630	41	3	3,674
Other expense	(3,334)	(67)	(1)	(3,402)
Loss on disposal of subsidiaries	(30)	-	-	(30)
Profit/ (loss) before income tax	266	(26)	2	242
Income tax expense/ (credit)	(239)	6	-	(233)
Profit/ (loss) for the year	27	(20)	2	9
Consolidated statement of financial position information:				
Segment assets	560,049	4	4,358	564,411
Total assets	560,049	4	4,358	564,411
Segment liabilities	547,239	1	3,646	550,886
Total liabilities	547,239	1	3,646	550,886
Other segment information:				
Capital expenditure	1	-	-	1
Depreciation and amortisation	3	-	-	3

24. SEGMENT REPORTING (CONTINUED)

Business segments (continued)

2011	Institutional securities $millions	Other $millions	Total $millions
Consolidated income statement information:			
Net gains on financial instruments classified as held for trading	3,455	84	3,539
Net gains on financial instruments designated at fair value through profit or loss	275	-	275
Net gain on disposal of joint venture	21	-	21
Net gain on disposal of subsidiaries	5	-	5
Net interest	30	(17)	13
Other income	257	8	265
External revenues net of interest	4,043	75	4,118
Other expense	(3,224)	(69)	(3,293)
Profit before income tax	819	6	825
Income tax expense	(251)	(1)	(252)
Profit for the year	568	5	573
Consolidated statement of financial position information:			
Segment assets	571,117	4,468	575,585
Total assets	571,117	4,468	575,585
Segment liabilities	557,827	4,280	562,107
Total liabilities	557,827	4,280	562,107
Other segment information:			
Capital expenditure	3	-	3
Depreciation and amortisation	4	-	4

24. SEGMENT REPORTING (CONTINUED)

Geographical segments

The Group operates in three geographic regions as listed below:

- Europe, Middle East and Africa ("EMEA")
- Americas
- Asia

The following table presents selected consolidated income statement and consolidated statement of financial position information of the Group's operations by geographic area. The external revenues (net of interest expense) and total assets disclosed in the following table reflect the regional view of the Group's operations, on a managed basis. The basis for attributing external revenues (net of interest expense) and total assets is determined by a combination of client and trading desk location.

	EMEA		Americas		Asia		Total	
	2012 $millions	2011 $millions	2012 $millions	2011 $millions	2012 $millions	2011 $millions	2012 $millions	2011 $millions
External revenues net of interest	3,530	4,006	(20)	97	164	15	3,674	4,118
Profit / (loss) before income tax	332	747	(120)	68	30	10	242	825
Total assets	465,666	442,096	55,397	93,754	43,348	39,735	564,411	575,585

External revenues net of interest and profit before tax for the Asia geographic segment includes other income of $150 million representing the expected reimbursement from clients on certain equity positions, as discussed in note 6.

25. FINANCIAL RISK MANAGEMENT

Risk management procedures

Risk is an inherent part of both Morgan Stanley's and the Group's business activity and is managed by the Group within the context of the broader Morgan Stanley Group. The Morgan Stanley Group seeks to identify, assess, monitor and manage each of the various types of risk involved in its business activities in accordance with defined policies and procedures. The Group's own risk management policies and procedures are consistent with those of the Morgan Stanley Group.

Significant risks faced by the Group resulting from its trading, financing and investment activities are set out below.

Credit risk

Credit risk refers to the risk of loss arising when a borrower, counterparty or issuer does not meet its financial obligations.

The Morgan Stanley Group manages credit risk exposure on a global consolidated basis and in consideration of individual legal entities. The credit risk management policies and procedures of the Morgan Stanley Group include ensuring transparency of material credit risks, ensuring compliance with established limits and escalating risk concentrations to appropriate senior management. Credit risk management policies and procedures for the Group are consistent with those of the Morgan Stanley Group and include escalation to appropriate key management personnel of the Group.

The Group incurs credit risk exposure to institutions and sophisticated investors primarily through the Institutional Securities segment. Credit risk incurred through the Institutional Securities business segment may arise from a variety of business activities, including, but not limited to, entering into swap or other derivative contracts under which the counterparties have obligations to make payments to the Group; extending credit to clients through various lending commitments; providing short-term or long-term funding that is secured by physical or financial collateral whose value may at times be insufficient to cover the loan repayment amount; and posting margin and/ or collateral to clearing houses, clearing agencies, exchanges, banks, securities firms and other financial counterparties. The Group also incurs credit risk in traded securities and loan pools, whereby the value of these assets may fluctuate based on realised or expected defaults on the underlying obligations or loans.

Credit risk management takes place at the transaction, counterparty and portfolio levels. In order to protect the Group from losses resulting from these activities, the Credit Risk Management Department ensures lending transactions and derivative exposures are evaluated, that the creditworthiness of the Group's counterparties and borrowers is reviewed regularly and that credit exposure is actively monitored and managed. This includes an assessment of an obligor's probability of default and relative recovery prospects. Where applicable, the Group also considers collateral arrangements and other structural elements of the particular transaction. The Group has limits that manage potential credit exposure to any one borrower or counterparty and to aggregates of borrowers or counterparties; these limits are monitored and credit exposures relative to these limits are reported to key management personnel.

As well as assessing and monitoring its credit exposure and risk at the individual counterparty level, the Group also reviews its credit exposure and risk to geographic regions. As at 31 December 2012, credit exposure was concentrated in Asian and Western European countries. In addition, the Group pays particular attention to smaller exposures in emerging markets given their unique risk profile. Country ceiling ratings are derived using methodologies generally consistent with those employed by external rating agencies.

The Group also reviews its credit exposure and risk to types of customers. At 31 December 2012, the Group's material credit exposure was to corporate entities, sovereign-related entities and financial institutions.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Collateral and other credit enhancements

The amount and type of collateral required by the Group depends on an assessment of the credit risk of the counterparty. Collateral held is managed in accordance with the Group's guidelines and the relevant underlying agreements. The market value of securities received as collateral is monitored on a daily basis and securities received as collateral generally are not recognised on the consolidated statement of financial position.

- *Securities purchased under agreements to resell and securities borrowed*

The Group manages credit exposure arising from securities purchased under agreements to resell and securities borrowed transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Group, in the event of a counterparty default, the right to liquidate collateral and the right to offset a counterparty's rights and obligations. Under these securities purchased under agreements to resell and securities borrowed transactions, the Group receives collateral, including US government and agency securities, other sovereign government obligations, corporate and other debt and corporate equities. The Group 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 collateralised.

- *Derivatives*

The Group may seek to mitigate credit risk from its derivatives transactions in multiple ways, including collateral provisions, guarantees and hedges. At the transaction level, the Group seeks to mitigate risk through management of key risk elements such as size, tenor, financial covenants, seniority and collateral. The Group actively hedges its derivatives exposure through various financial instruments that may include single-name, portfolio and structured credit derivatives. The Group may enter into master netting agreements and collateral arrangements with counterparties. These master netting agreements and collateral arrangements may provide the Group with the ability to demand collateral, as well as to liquidate collateral and offset receivables and payables covered under the same master netting agreement in the event of counterparty default. The Group monitors the creditworthiness of counterparties to these transactions on an ongoing basis and requests additional collateral in accordance with collateral arrangements when deemed necessary.

Exposure to credit risk

The maximum exposure to credit risk ("gross credit exposure") of the Group as at 31 December 2012 is disclosed below, based on the carrying amounts of the financial assets the Group believes are subject to credit risk. Exposure arising from financial instruments not recognised on the consolidated statement of financial position is measured as the maximum amount that the Group could have to pay, which may be significantly greater than the amount that would be recognised as a liability. This table does not include receivables arising from pending securities transactions with market counterparties. Where the Group enters into credit enhancements, including receiving cash and security as collateral and master netting agreements, to manage the credit exposure on these financial instruments the financial effect of the credit enhancements is also disclosed below. The net credit exposure represents the credit exposure remaining after the effect of the credit enhancements

Financial assets classified as held for trading, excluding derivatives, are subject to traded credit risk through exposure to the issuer of the financial asset; the Group manages this issuer credit risk through its market risk management infrastructure and this traded credit risk is incorporated within the Value at Risk ("VaR") -based risk measures included in the market risk disclosure.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Exposure to credit risk (continued)

Exposure to credit risk by class:

Class	**2012**			**2011**		
	Gross credit exposure (1)	**Credit enhancements**	**Net credit exposure (2)**	**Gross credit exposure (1)**	**Credit enhancements**	**Net credit exposure (2)**
	$millions	**$millions**	**$millions**	**$millions**	**$millions**	**$millions**
Loans and receivables:						
Cash and short term deposits	11,526	-	11,526	11,180	-	11,180
Cash collateral on securities borrowed	31,303	(31,201)	102	29,575	(28,604)	971
Securities purchased under agreements to resell	99,782	(99,344)	438	97,218	(96,576)	642
Trade receivables (3)	47,246	-	47,246	44,113	-	44,113
Other receivables	5,139	-	5,139	7,096	-	7,096
Derivatives	266,643	(253,192)	13,451	291,005	(268,962)	22,043
Financial assets designated at fair value through profit or loss	7,591	(6,174)	1,417	8,562	(7,410)	1,152
	469,230	(389,911)	79,319	488,749	(401,552)	87,197
Unrecognised financial instruments						
Contingent commitments	2,172	-	2,172	3,010	-	3,010
Financial guarantees	-	-	-	1	-	1
Letters of credit	5	-	5	-	-	-
Loan commitments	985	-	985	986	-	986
Underwriting commitments	44	-	44	156	-	156
Unsettled securities purchased under agreements to resell (4)	25,370	-	25,370	22,448	-	22,448
	497,806	(389,911)	107,895	515,350	(401,552)	113,798

(1) The carrying amount recognised in the consolidated statement of financial position best represents the Group's maximum exposure to credit risk.

(2) Of the residual net credit exposure, intercompany cross product netting arrangements are in place which would allow for an additional $9,897 million (2011: $4,032 million) to be offset in the event of default by certain Morgan Stanley counterparties.

(3) Trade receivables primarily include cash collateral pledged against the payable on OTC derivative positions. These derivative liabilities are included within financial liabilities classified as held for trading in the consolidated statement of financial position.

(4) For contingent settlement provisions, collateral in the form of securities will be received at the point of settlement. Since the value of collateral is determined at a future date it is currently unquantifiable and not included in the table.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Exposure to credit risk (continued)

Maximum exposure to credit risk by credit rating(1):

	Gross credit exposure	
Credit rating	**2012 $millions**	**2011 $millions**
AAA	19,267	22,157
AA	109,840	79,850
A	290,395	338,888
BBB	51,106	49,771
BB	14,478	7,086
B	6,604	9,924
CCC	3,833	3,592
Unrated	2,283	4,082
Total	497,806	515,350

(1) Internal credit rating derived using methodologies generally consistent with those used by external rating agencies.

Liquidity risk

Liquidity risk is the risk that the entity may encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

The Morgan Stanley Group's senior management establishes the overall liquidity and funding policies of the Morgan Stanley Group and the liquidity risk management policies and procedures conducted within the Group are consistent with those of the Morgan Stanley Group. The Morgan Stanley Group's liquidity and funding risk management policies are designed to mitigate the potential risk that entities within the Morgan Stanley Group, including the Group, may be unable to access adequate financing to service their financial liabilities when they become payable without material, adverse franchise or business impact. The key objective of the liquidity and funding risk management framework is to support the successful execution of both the Morgan Stanley Group's and the Group's business strategies while ensuring ongoing and sufficient liquidity through the business cycle and during periods of stressed market conditions.

Liquidity management policies

The core components of the Morgan Stanley Group's and the Group's liquidity management framework, are the Contingency Funding Plan ("CFP"), Liquidity Stress Tests and the Global Liquidity Reserve, which support the Morgan Stanley Group's, as well as the Group's, target liquidity profile.

Contingency Funding Plan. The CFP describes the data and information flows, limits, targets, operating environment indicators, escalation procedures, roles and responsibilities, and available mitigating actions in the event of a liquidity stress. The CFP also sets forth the principal elements of the Morgan Stanley Group's and the Group's liquidity stress testing which identifies stress events of different severity and duration, assesses current funding sources and uses and establishes a plan for monitoring and managing a potential liquidity stress event.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Liquidity Stress Tests. The Morgan Stanley Group uses Liquidity Stress Tests to model liquidity outflows across multiple scenarios over a range of time horizons.

The assumptions underpinning the Liquidity Stress Tests include, but not are limited to, the following: (i) no government support; (ii) no access to unsecured debt markets; (iii) repayment of all unsecured debt maturing within the stress horizon; (iv) higher haircuts and significantly lower availability of secured funding; (v) additional collateral that would be required by trading counterparties and certain exchanges and clearing organisations related to multi-notch credit rating downgrades; (vi) additional collateral that would be required due to collateral substitutions, collateral disputes and uncalled collateral; (vii) discretionary unsecured debt buybacks; (viii) drawdowns on unfunded commitments provided to third parties; (ix) client cash withdrawals and reduction in customer short positions that fund long positions; (x) limited access to the foreign exchange swap markets; (xi) return of securities borrowed on an uncollateralised basis; and (xii) maturity roll-off of outstanding letters of credit with no further issuance.

The Liquidity Stress Tests are produced at the Morgan Stanley Group and major operating subsidiary level, including the Group, as well as major currency levels, to capture specific cash requirements and cash availability at various legal entities. The Liquidity Stress Tests assume that subsidiaries, including the Group, will use their own liquidity first to fund their obligations before drawing liquidity from Morgan Stanley. It is also assumed that Morgan Stanley does not have access to cash that may be held at certain subsidiaries that are subject to regulatory, legal or tax constraints.

The CFP and Liquidity Stress Tests are evaluated on an on-going basis and reported to the Firm Risk Committee, Asset/ Liability Management Committee, and other appropriate risk committees including the Morgan Stanley International Limited Board Risk Committee.

Global Liquidity Reserve. The Morgan Stanley Group and the Group maintain sufficient liquidity reserves (“the Global Liquidity Reserve”) to cover daily funding needs and meet strategic liquidity targets sized by the CFP and Liquidity Stress Tests. These liquidity targets are based on the Morgan Stanley Group’s risk tolerance, consolidated statement of financial position level and composition, subsidiary funding needs, and upcoming debt maturities, which are subject to change dependent on market and firm-specific events.

The Global Liquidity Reserve is held within Morgan Stanley and the Morgan Stanley Group’s major operating subsidiaries and consists of highly liquid and diversified cash and cash equivalents and unencumbered securities (including US government securities, US agency securities, US agency mortgage-backed securities, Federal Deposit Insurance Corporation - guaranteed corporate debt and non-US government securities). In addition to the Global Liquidity Reserve, the Group maintains a locally managed liquidity reserve which consists of cash and cash equivalents and central bank eligible unencumbered securities. In addition to the liquidity reserve held by the Group, the Group has access to the Global Liquidity Reserve.

Funding management policies

The Morgan Stanley Group manages its funding in a manner that reduces the risk of disruption to the Morgan Stanley Group’s and the Group’s operations. The Morgan Stanley Group pursues a strategy of diversification of secured and unsecured funding sources (by product, by investor and by region) and attempts to ensure that the tenor of the Morgan Stanley Group’s, and the Group’s, liabilities equals or exceeds the expected holding period of the assets being financed.

The Morgan Stanley Group funds its consolidated statement of financial position on a global basis through diverse sources, which includes consideration of the funding risk of each legal entity. These sources may include the Morgan Stanley Group’s equity capital, long-term debt, securities sold under agreements to repurchase, securities lending, deposits, commercial paper, letters of credit and lines of credit. The Morgan Stanley Group has active financing programs for both standard and structured products, targeting global investors and currencies.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

In managing both the Morgan Stanley Group's and the Group's funding risk the composition and size of the entire consolidated statement of financial position, not just financial liabilities, is monitored and evaluated. A substantial portion of the Morgan Stanley Group's total assets consists of liquid marketable securities and short-term collateralised receivables arising from its Institutional Securities business segment's sales and trading activities. The liquid nature of these assets provides the Morgan Stanley Group and the Group with flexibility in funding and managing their business.

Maturity analysis

In the following maturity analysis of financial liabilities, derivative contracts and other financial liabilities held as part of the Group's trading activities are disclosed as on demand and presented at fair value, consistent with how these financial liabilities are managed. Derivatives not held as part of the Group's trading activities and financial liabilities designated at fair value through profit and loss are disclosed according to their earliest contractual maturity; all such amounts are presented at their fair value, consistent with how these financial liabilities are managed. All other amounts represent undiscounted cash flows payable by the Group arising from its financial liabilities to earliest contractual maturities as at 31 December 2012. Repayments of financial liabilities that are subject to immediate notice are treated as if notice were given immediately and are classified as on demand. This presentation is considered by the Group to appropriately reflect the liquidity risk arising from those financial liabilities, presented in a way that is consistent with how the liquidity risk on these financial liabilities is managed by the Group.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Maturity analysis (continued)

31 December 2012	On demand $millions	Less than 1 month $millions	Equal to or more than 1 month but less than 3 months $millions	Equal to or more than 3 months but less than 1 year $millions	Equal to or more than 1 year but less than 5 years $millions	Equal to or more than 5 years $millions	Total $millions
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	23	-	-	-	-	-	23
Cash collateral on securities loaned	24,526	1,396	973	2,137	304	-	29,336
Securities sold under agreements to repurchase	29,916	27,874	11,600	12,283	3,697	324	85,694
Trade payables	83,161	-	-	-	-	-	83,161
Subordinated loans	-	-	-	144	847	10,516	11,507
Other payables	8,170	1	3	6,234	63	4,160	18,631
Financial liabilities classified as held for trading:							
Derivatives	278,270	-	-	-	-	-	278,270
Other	35,778	-	-	-	-	-	35,778
Financial liabilities designated at fair value through profit or loss	8,004	69	81	571	3,227	608	12,560
Total financial liabilities	467,848	29,340	12,657	21,369	8,138	15,608	554,960
Unrecognised financial instruments							
Contingent commitments	2,172	-	-	-	-	-	2,172
Lease commitments	-	1	2	5	23	13	44
Letters of credit	5	-	-	-	-	-	5
Loan commitments	985	-	-	-	-	-	985
Underwriting commitments	44	-	-	-	-	-	44
Unsettled securities purchased under agreements to resell(1)	20,648	4,722	-	-	-	-	25,370
Total unrecognised financial instruments	23,854	4,723	2	5	23	13	28,620

(1) The Group enters into forward starting reverse repurchase agreements (agreements which have a trade date at or prior to 31 December 2012 and settle subsequent to period end). These agreements primarily settle within three business days and of the total amount at 31 December 2012, $20,648 million settled within three business days.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Maturity analysis (continued)

31 December 2011	On demand $millions	Less than 1 month $millions	Equal to or more than 1 month but less than 3 months $millions	Equal to or more than 3 months but less than 1 year $millions	Equal to or more than 1 year but less than 5 years $millions	Equal to or more than 5 years $millions	Total $millions
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	124	-	-	-	-	-	124
Cash collateral on securities loaned	21,569	200	1,508	2,239	500	-	26,016
Securities sold under agreements to repurchase	11,798	33,682	19,148	8,745	3,614	-	76,987
Trade payables	83,626	-	-	-	-	-	83,626
Subordinated loans	-	12	24	109	579	9,209	9,933
Other payables	12,949	-	-	7,705	-	1,053	21,707
Financial liabilities classified as held for trading:							
Derivatives	306,143	-	-	-	-	-	306,143
Other	27,682	-	-	-	-	-	27,682
Financial liabilities designated at fair value through profit or loss	7,999	53	280	503	2,148	727	11,710
Total financial liabilities	471,890	33,947	20,960	19,301	6,841	10,989	563,928
Unrecognised financial instruments							
Contingent commitments	3,010	-	-	-	-	-	3,010
Lease commitments	9	-	-	-	13	-	22
Financial guarantees	1	-	-	-	-	-	1
Underwriting commitments	100	-	-	56	-	-	156
Loan commitments	986	-	-	-	-	-	986
Unsettled securities sold under agreement to repurchase	22,448	-	-	-	-	-	22,448
Total unrecognised financial instruments	26,554	-	-	56	13	-	26,623

The Group does not expect that all of the cash flows associated with financial guarantees, letters of credits and loan commitments will be required.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as market liquidity, will result in losses for a position or portfolio.

Sound market risk management is an integral part of the Group's and the Morgan Stanley Group's culture. The Group is responsible for ensuring that market risk exposures are well-managed and prudent and more broadly for ensuring transparency of material market risks, monitoring compliance with established limits, and escalating risk concentrations to appropriate senior management.

To execute these responsibilities, the Morgan Stanley Group monitors the market risk of the firm against limits on aggregate risk exposures, performs a variety of risk analyses, routinely reports risk summaries and maintains the VaR and scenario systems. These limits are designed to control price and market liquidity risk. Market risk is also monitored through various measures: using statistics (including VaR and related analytical measures); by measures of position sensitivity; and through routine stress testing and scenario analyses. The material risks identified by these processes are summarised and reported to senior management.

The Group is managed within the Morgan Stanley Group's global framework. The market risk management policies and procedures of the Group are consistent with those of the Morgan Stanley Group, including reporting of material risks identified to appropriate key management personnel of the Group.

Risk and capital management initiative

The Morgan Stanley Group frequently enhances its market and credit risk management framework to address severe stresses that are observed in global markets during economic downturns. During 2012, the Morgan Stanley Group expanded and improved its risk measurement processes, including stress tests and scenario analysis, and further refined its market and credit risk limit framework. Stress Value-at-Risk ("S-VaR"), a proprietary methodology that comprehensively measures the Group's market and credit risks, was further refined and continues to be an important metric used in establishing the Group's risk appetite and its capital allocation framework. S-VaR simulates many stress scenarios based on more than 25 years of historical data and attempts to capture the different liquidities of various types of general and specific risks. Additionally, S-VaR captures event and default risks that are particularly relevant for credit portfolios.

Primary market risk exposures and market risk management

During the year ended 31 December 2012, the Group had exposures to a wide range of interest rates, equity prices, foreign exchange rates and commodity prices and the associated implied volatilities and spreads, related to the global markets in which it conducts its trading activities.

The Group is exposed to interest rate and credit spread risk as a result of its market-making activities and other trading in interest rate sensitive financial instruments (e.g. risk arising from changes in the level or implied volatility of interest rates, the shape of the yield curve and credit spreads). The activities from which those exposures arise and the markets in which the Group is active include, but are not limited to, the following: corporate and government debt across both developed and emerging markets and asset-backed debt (including mortgage-related securities).

The Group is exposed to equity price and implied volatility risk as a result of making markets in equity securities and derivatives and maintaining other positions (including positions in non-public entities). Positions in non-public entities may include, but are not limited to, exposures to private equity, venture capital, private partnerships, real estate funds and other funds. Such positions are less liquid, have longer investment horizons and are more difficult to hedge than listed equities.

The Group is exposed to foreign exchange rate and implied volatility risk as a result of making markets in foreign currencies and foreign currency derivatives, from maintaining foreign exchange positions and from holding non-US dollar-denominated financial instruments.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Primary market risk exposures and market risk management (continued)

The Group is exposed to commodity price and implied volatility risk as a result of market-making activities and maintaining commodity positions in physical commodities (such as crude and refined oil products, natural gas, electricity, and precious and base metals) and related derivatives. Commodity exposures are subject to periods of high price volatility as a result of changes in supply and demand. These changes can be caused by weather conditions, physical production, transportation and storage issues; or geopolitical and other events that affect the available supply and level of demand for these commodities.

The Group, as part of the Morgan Stanley Group's global market risk management framework 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). Hedging activities may not always provide effective mitigation against trading losses due to differences in the terms, specific characteristics or other basis risks that may exist between the hedge instrument and the risk exposure that is being hedged. The Group manages the market risk associated with its trading activities on an entity-wide basis, on a worldwide trading division level and on an individual product strategy. The Group manages and monitors its market risk exposures in such a way as to maintain a portfolio that the Group believes is well-diversified in the aggregate with respect to market risk factors and that reflects the Group's aggregate risk tolerance, as established by the Group's senior management.

Aggregate market risk limits have been approved for the Group, and major trading divisions worldwide, as well as for the firm globally. Additional market risk limits are assigned to trading desks and, as appropriate, products and regions. Trading division risk managers, desk risk managers, traders and the market risk department monitor market risk measures against limits in accordance with policies set by senior management.

VaR

The Group uses the statistical technique known as VaR as one of the tools used to measure, monitor and review the market risk exposures of its trading portfolios. The Market Risk Department calculates and distributes daily VaR-based risk measures to various levels of management.

VaR methodology, assumptions and limitations

The Group has enhanced its VaR model during 2012 to make it more responsive to current market conditions while maintaining a longer-term perspective. This enhancement is consistent with regulatory requirements. The current VaR model has been approved by the Group's regulators for use in regulatory capital calculations.

The Group estimates VaR using a model based on volatility adjusted historical simulation for general market risk factors and Monte Carlo simulation for name-specific risk in corporate shares, bonds, loans and related derivatives. The model constructs a distribution of hypothetical daily changes in the value of trading portfolios based on the following: historical observation of daily changes in key market indices or other market risk factors; and information on the sensitivity of the portfolio values to these market risk factor changes. The Group's current VaR model uses four years of historical data with a volatility adjustment to reflect current market conditions. The Group's prior VaR model also uses four years of historical data, but does not make any volatility adjustments and is therefore less responsive to current market conditions. To facilitate the transition to the current VaR model, results using both the current and prior VaR models are included in the Trading Risks section below. The Group's 95%/one-day VaR corresponds to the unrealised loss in portfolio value that, based on historically observed market risk factor movements, would have been exceeded with a frequency of 5%, or five times in every 100 trading days, if the portfolio were held constant for one day.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR (continued)

Among their benefits, VaR models permit estimation of a portfolio's aggregate market risk exposure, incorporating a range of varied market risks and portfolio assets. One key element of the VaR model is that it reflects risk reduction due to portfolio diversification or hedging activities. However, VaR has various strengths and limitations, which include but are not limited to: use of historical changes in market risk factors, which may not be accurate predictors of future market conditions, and may not fully incorporate the risk of extreme market events that are outsized relative to observed historical market behaviour or reflect the historical distribution of results beyond the 95% confidence interval; and reporting of losses in a single day, which does not reflect the risk of positions that cannot be liquidated or hedged in one day. A small proportion of market risk generated by trading positions is not included in VaR. The modeling of the risk characteristics of some positions relies on approximations that, under certain circumstances, could produce significantly different results from those produced using more precise measures. VaR is most appropriate as a risk measure for trading positions in liquid financial markets and will understate the risk associated with severe events, such as periods of extreme illiquidity. The Group is aware of these and other limitations and, therefore, uses VaR as only one component in its risk management oversight process. As explained above, this process also incorporates stress testing and scenario analyses and extensive risk monitoring, analysis, and control at the trading desk, division, entity and global levels.

The Group's VaR model evolves over time in response to changes in the composition of trading portfolios and to improvements in modelling techniques and systems capabilities. The Group is committed to continuous review and enhancement of VaR methodologies and assumptions in order to capture evolving risks associated with changes in market structure and dynamics. As part of regular process improvement, additional systematic and name-specific risk factors may be added to improve the VaR model's ability to more accurately estimate risks to specific asset classes or industry sectors.

Since the VaR statistics reported below are estimates based on historical data, VaR should not be viewed as predictive of the Group's future revenues or financial performance or of its ability to monitor and manage risk. There can be no assurance that the Group's actual losses on a particular day will not exceed the VaR amounts indicated below or that such losses will not occur more than five times in 100 trading days for a 95%/one-day VaR. VaR does not predict the magnitude of losses which, should they occur, may be significantly greater than the VaR amount.

Sensitivity analysis

VaR for the year ended 31 December 2012

The table below presents the VaR for the Group's Trading portfolio on a year-end, annual average and annual high and low basis for 31 December 2012 and 31 December 2011.

The Credit Portfolio VaR is disclosed as a separate category from the Primary Risk Categories. The Credit Portfolio VaR includes the mark-to-market lending exposures and associated hedges as well as counterparty credit valuation adjustments and related hedges.

The table below presents 95%/ one-day VaR, under the previous VaR model, for each of the Group's primary market risk categories and on an aggregate basis.

The table below presents 95%/ one-day VaR for each of the Group's primary market risk categories and on an aggregate basis.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR (continued)

Sensitivity analysis (continued)

95% Total VaR primary market risk category (previous model)	**95%/ one-day VaR 2012**				**95%/ one-day VaR 2011**			
	Period end $millions	**Average $millions**	**High $millions**	**Low $millions**	**Period end $millions**	**Average $millions**	**High $millions**	**Low $millions**
Market risk category:								
Interest rate and credit spread	22	24	37	19	27	36	52	24
Equity price	16	20	45	15	16	21	33	13
Foreign exchange rate	4	5	10	2	6	6	15	2
Commodity price	2	3	4	1	3	5	12	2
Less diversification benefit (1)(2)	(17)	(21)	N/A	N/A	(25)	(25)	N/A	N/A
Primary Risk Categories	26	31	50	25	27	43	67	27
Credit Portfolio	16	16	21	11	18	21	26	16
Less diversification benefit (1)(2)	(8)	(9)	N/A	N/A	(10)	(10)	N/A	N/A
Total trading VaR	34	38	60	29	35	54	78	35

(1) Diversification benefit equals the difference between total trading VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated one-day losses for each of the four primary market risk categories occur on different days; similar diversification benefits also are taken into account within each category.

(2) N/A - Not Applicable. The minimum and maximum VaR values for the total VaR and each of the component VaRs might have occurred on different days during the year and therefore the diversification benefit is not an applicable measure.

Under the previous VaR model, the Group's average VaR for Primary Risk Categories for 2012 was $31 million compared with $43 million for 2011. The decrease in average VaR for Primary Risk Categories is primarily due to reduced risk taking in fixed income products.

The average Credit Portfolio VaR for 2012 was $16 million compared with $21 million for 2011. The decrease in the average VaR over the year was from decreased counterparty exposure during 2012.

The average total trading VaR for 2012 was $38 million compared with $54 million for 2011.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

VaR (continued)

Sensitivity analysis (continued)

95% Total VaR primary market risk category	95% one-day VaR for the 9 months ended 31 December 2012 (current model)				95% one-day VaR for the 12 months ended 31 December 2012 (previous model)			
	Period end $millions	Average $millions	High $millions	Low $millions	Period end $millions	Average $millions	High $millions	Low $millions
Market risk category:								
Interest rate and credit spread	17	18	28	14	22	24	37	19
Equity price	13	16	29	12	16	20	45	15
Foreign exchange rate	3	3	8	2	4	5	10	2
Commodity price	1	2	4	1	2	3	4	1
Less diversification benefit (1)(2)	(13)	(15)	N/A	N/A	(17)	(21)	N/A	N/A
Primary Risk Categories	21	24	42	19	26	31	50	25
Credit Portfolio	13	14	17	12	16	16	21	11
Less diversification benefit (1)(2)	(7)	(8)	N/A	N/A	(8)	(9)	N/A	N/A
Total trading VaR	27	30	51	22	34	38	60	29

(1) Diversification benefit equals the difference between total trading VaR and the sum of the VaRs for the four risk categories. This benefit arises because the simulated one-day losses for each of the four primary market risk categories occur on different days; similar diversification benefits also are taken into account within each category.

(2) N/A - Not Applicable. The minimum and maximum VaR values for the total VaR and each of the component VaRs might have occurred on different days during the year and therefore the diversification benefit is not an applicable measure.

The current VaR model estimates are lower than the VaR estimates produced under the previously used model because the prior model places more emphasis on the large market moves experienced during the 2008 financial crisis, while the current model places more emphasis on more recent volatility, which has been generally lower.

Under the current VaR model, the Group's average VaR for Primary Risk Categories for 2012 was $24 million compared with $31 million under the previous model. The period end VaR was $21 million while it was $26 million under the previous model.

The average Credit Portfolio VaR for 2012 was $14 million compared with $16 million under the previous model.

The average total trading VaR for 2012 was $30 million compared with $38 million under the previous model.

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Non trading risks for the year ended 31 December 2012

The Group believes that sensitivity analysis is an appropriate representation of the Group's non-trading risks. Reflected below is this analysis, which covers substantially all of the non trading risk in the Group's portfolio.

Interest rate risk

The Group's VaR excludes certain funding liabilities and money market transactions. The application of a parallel shift in interest rates of 50 basis points increase or decrease to these positions would result in a net loss or gain of approximately $2.5 million, compared to a net gain or loss of $3.8 million as at 31 December 2011.

Counterparty exposure related to own spreads

The credit spread risk relating to the Group's own mark-to-market derivative counterparty exposure corresponds to an increase in value of approximately $3 million and $2 million for each 1 basis point widening in the Group's credit spread level for both 31 December 2012 and 31 December 2011, respectively.

Funding liabilities

The credit spread risk sensitivity of the Group's mark-to-market structured notes corresponds to an increase in value of approximately $0.7 million and $0.4 million for each 1 basis point widening in the Group's credit spread level for both 31 December 2012 and 31 December 2011, respectively.

Equity investments price risk

The Group is exposed to equity price risk as a result of changes in the fair value of its investments in both exchange traded equity securities and private equities classified as available-for-sale financial assets. These investments are predominantly equity positions with long investment horizons, the majority of which are for business facilitation purposes. The market risk related to these investments is measured by estimating the potential reduction in net revenues associated with a 10% decline in asset values as shown in the table below.

	31 December 2012 10% sensitivity $millions	31 December 2011 10% sensitivity $millions
Available-for-sale financial assets	4	7

25. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

Currency risk

The Group has foreign currency exposure arising from foreign operations. The majority of this foreign currency risk has been hedged by other members of the Morgan Stanley Group, primarily Morgan Stanley, by utilising forward foreign currency exchange contracts.

The analysis below details the foreign currency exposure for the Group, by foreign currency, relating to the retranslation of its non-US dollar denominated branches and subsidiaries. The analysis calculates the impact on total comprehensive income of a reasonably possible parallel shift of the foreign currency against the US dollar, with all other variables held constant. This analysis does not take into account the effect of the foreign currency hedges held by other members of the Morgan Stanley Group.

	2012			2011		
		Sensitivity to applied percentage change in currency (+/-)			Sensitivity to applied percentage change in currency (+/-)	
	Foreign currency exposure	Percentage change applied	Other comprehensive income	Foreign currency exposure	Percentage change applied	Other comprehensive income
	$millions	%	$millions	$millions	%	$millions
Australian Dollar	(16)	27%	(4)	(6)	27%	2
British Pound	55	29%	16	51	29%	15
Euro	450	7%	31	405	7%	28
New Taiwan Dollar	62	8%	5	66	8%	5
New Zealand Dollar	2	24%	-	2	24%	-
Polish Zloty	2	16%	-	-	16%	-
Singapore Dollar	-	9%	-	-	9%	-
South Korean Won	206	42%	87	168	42%	71
Swedish Krona	16	23%	4	15	23%	3
Swiss Franc	10	10%	1	7	10%	1
	787		140	708		125

The reasonably possible percentage change in the currency rate against US dollars has been calculated based on the greatest annual percentage change over a five-year period from 1 December 2007 to 31 December 2012 (2011: over a four-year period from 1 December 2007 to 31 December 2011). Thus, the percentage change applied may not be the same percentage change in the currency rate for the year.

The Group also has foreign currency exposure arising from its trading activities and assets and liabilities in currencies other than US dollars, which it actively manages by hedging with other Morgan Stanley Group undertakings. The residual currency risk for the Group from this activity is not material.

26. TRANSFERS OF FINANCIALS ASSETS, INCLUDING PLEDGES OF COLLATERAL

Transferred financial assets that are not derecognised in their entirety

In the ordinary course of business, the Group enters into various arrangements including selling securities under agreements to repurchase, purchasing securities under agreements to resell, securities borrowed and securities loaned to, amongst other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers' needs and to finance the Group's inventory positions.

The Group pledges certain financial instruments to collateralise repurchase agreements and other securities financings. Pledged financial instruments that can be sold or repledged by the secured party are identified as financial instruments classified as held for trading (pledged to various parties) in the consolidated statement of financial position. The Group has determined that it retains substantially all the risks and rewards of these financial instruments including credit risk, settlement risk, country risk and market risk, and therefore has not derecognised them. In addition, it recognises a financial liability in respect of the consideration received.

Other financial assets transferred that continue to be recognised for accounting purposes include pledges of securities as collateral for derivative transactions or otherwise, as well as certain sales of securities with related transactions, such as derivatives, that result in the Group retaining substantially all the risks and rewards of the financial assets transferred. In addition, it recognises a financial liability in respect of the consideration received.

All of these transactions are mostly conducted under standard agreements used by financial market participants and are undertaken with counterparties subject to the Group's normal credit risk control processes. The resulting credit exposures are controlled by daily monitoring and collateralisation of the positions. The carrying amount of the associated financial liabilities related to financial assets transferred that continue to be recognised approximate the carrying amount of those transferred assets.

The following table presents those financial assets which have been sold or otherwise transferred, but which for accounting purposes remain recognised on the consolidated statement of financial position.

	2012 $millions	2011 $millions
Financial assets classified as held for trading		
Government debt securities	20,095	6,765
Corporate and other debt	11,432	17,454
Corporate equities	22,732	17,722
	54,259	41,941

27. FINANCIAL ASSETS ACCEPTED AS COLLATERAL

The Group's policy is generally to take possession of securities received as collateral, securities purchased under agreements to resell and securities borrowed. The Group 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 collateralised. Where deemed appropriate, the Group's agreements with third parties specify its rights to request additional collateral. These transactions are mostly conducted under standard documentation used by financial market participants.

The fair value of collateral accepted under these arrangements as at 31 December 2012 was $207,063 million (2011: $179,493 million). Of this amount $170,564 million (2011: $147,681 million) has been sold or repledged to third parties in connection with financing activities, or to comply with commitments under short sale transactions.

28. SPECIAL PURPOSE ENTITIES

The Group is involved with various entities in the normal course of business that may be deemed to be special purpose entities ("SPEs"). The Group's interests in SPEs include debt and equity interests and derivative instruments, and these interests primarily arise from trading activity and structured transactions. Consolidation of SPEs is determined in accordance with the Group's accounting policies. As at 31 December 2012 the total assets of SPEs in which the Group has an interest, but which are not consolidated by the Group, are $378 million (2011: $212 million) and the Group's maximum exposure to loss relating to such SPEs is $147 million (2011: $174 million). The Group's consolidated statement of financial position includes $1,933 million of assets arising from consolidated SPEs (2011: $2,904 million). The Group's maximum exposure to loss relating to these assets is $1,413 million (2011: $1,279 million).

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE

a. Fair value hierarchy disclosure

Financial instruments recognised at fair value are broken down for disclosure purposes into a three level fair value hierarchy based on the observability of inputs as follows:

- Quoted prices (unadjusted) in an active market for identical assets or liabilities (Level 1) – Valuations based on quoted prices in active markets for identical assets or liabilities that the Morgan Stanley Group 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 judgement.
- Valuation techniques using observable inputs (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.
- Valuation techniques with significant unobservable inputs (Level 3) – Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

Fair value control processes

The Group employs control processes to validate the fair value of its financial instruments, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to assure that the valuation approach utilised is appropriate and consistently applied and that the assumptions are reasonable. These control processes include reviews of the pricing model's theoretical soundness and appropriateness by Morgan Stanley Group personnel with relevant expertise who are independent from the trading desks.

Additionally, groups independent from the trading divisions within the financial control, market risk and credit risk management departments participate in the review and validation of the fair values generated from pricing models, as appropriate. Where a pricing model is used to determine fair value, recently executed comparable transactions and other observable market data are considered for purposes of validating assumptions underlying the model.

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE

a. Fair value hierarchy disclosure (continued)

Financial assets and liabilities recognised at fair value

The following tables present the carrying value of the Group's financial assets and financial liabilities recognised at fair value, classified according to the fair value hierarchy described above:

2012

	Quoted prices in active market (Level 1) $millions	**Valuation techniques using observable inputs (Level 2) $millions**	**Valuation techniques with significant unobservable inputs (Level 3) $millions**	**Total $millions**
Financial assets classified as held for trading:				
Government debt securities	14,783	3,368	2	18,153
Corporate and other debt	1	9,412	963	10,376
Corporate equities	29,624	768	113	30,505
Derivatives	470	279,179	3,011	282,660
Total financial assets classified as held for trading	44,878	292,727	4,089	341,694
Financial assets designated at fair value through profit or loss	-	7,014	577	7,591
Available-for-sale financial assets:				
Corporate equities	2	-	38	40
Total financial assets measured at fair value	44,880	299,741	4,704	349,325
Financial liabilities classified as held for trading:				
Government debt securities	14,638	2,371	-	17,009
Corporate and other debt	4	2,057	35	2,096
Corporate equities	16,240	430	3	16,673
Derivatives	426	273,601	4,243	278,270
Total financial liabilities classified as held for trading	31,308	278,459	4,281	314,048
Financial liabilities designated at fair value through profit or loss	-	12,252	308	12,560
Total financial liabilities measured at fair value	31,308	290,711	4,589	326,608

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE

a. Fair value hierarchy disclosure (continued)

Financial assets and liabilities recognised at fair value (continued)

2011	**Quoted prices in active market (Level 1) $millions**	**Valuation techniques using observable inputs (Level 2) $millions**	**Valuation techniques with significant unobservable inputs (Level 3) $millions**	**Total $millions**
Financial assets classified as held for trading:				
Government debt securities	5,699	3,549	1	9,249
Corporate and other debt	3	10,236	2,235	12,474
Corporate equities	15,832	6,288	162	22,282
Derivatives	535	303,785	5,818	310,138
Total financial assets classified as held for trading	22,069	323,858	8,216	354,143
Financial assets designated at fair value through profit or loss	-	8,562	-	8,562
Available-for-sale financial assets:				
Corporate equities	2	-	65	67
Total financial assets measured at fair value	22,071	332,420	8,281	362,772
Financial liabilities classified as held for trading:				
Government debt securities	7,023	3,170	-	10,193
Corporate and other debt	3	2,654	70	2,727
Corporate equities	12,245	2,516	1	14,762
Derivatives	360	298,333	7,450	306,143
Total financial liabilities classified as held for trading	19,631	306,673	7,521	333,825
Financial liabilities designated at fair value through profit or loss	-	11,329	381	11,710
Total financial liabilities measured at fair value	19,631	318,002	7,902	345,535

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

The Group's valuation approach and fair value hierarchy categorisation for certain significant classes of financial instruments recognised at fair value is as follows:

Financial assets and financial liabilities classified as held for trading and available-for-sale financial assets

- *Government debt securities*

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

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

Non-US Sovereign Government Obligations. Non-US 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 categorised in Levels 1 or 2 of the fair value hierarchy.

- *Corporate and other debt*

US 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 categorised 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 external 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 analysing expected credit losses, default and recovery rates. In evaluating the fair value of each security, the Group considers security collateral-specific attributes, including payment priority, credit enhancement levels, type of collateral, delinquency rates and loss severity. In addition, for RMBS borrowers, Fair Isaac Corporation ("FICO") scores and the level of documentation for the loan are also considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category Valuation levels of RMBS and CMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions.

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

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

- *Corporate and other debt (continued)*

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 does not reference the issuer, then data that reference a comparable issuer are used. When position-specific external price data are not observable, fair value is determined based on either benchmarking to similar instruments or cash flow models with yield curves, bond or single name credit default swap spreads and recovery rates as significant inputs. Corporate bonds are generally categorised in Level 2 of the fair value hierarchy; in instances where prices, spreads or any other of the aforementioned key inputs are unobservable, they are categorised in Level 3 of the fair value hierarchy.

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

Mortgage Loans. Mortgage loans are valued using observable prices based on transactional data or third party pricing for identical or comparable instruments, where available. Where position-specific external prices are not observable, the Group estimates fair value based on benchmarking to prices and rates observed in the primary market for similar loan or borrower types, or based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved or a methodology that utilises the capital structure and credit spreads of recent comparable securitisation transactions. Mortgage loans valued based on observable market data for identical or comparable instruments are categorised in Level 2 of the fair value hierarchy. Where observable prices are not available, due to the subjectivity involved in comparability assessment related to mortgage loan vintage, geographical concentration, prepayment speed and projected loss assumptions, mortgage loans are classified in Level 3 of the fair value hierarchy.

- *Corporate Equities*

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

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

- *Corporate Equities (continued)*

Investments (other than investments in other Morgan Stanley Group undertakings). The Group's investments include direct investments in equity securities as well as investments in private equity funds, real estate funds and hedge funds, which include investments made in connection with certain employee deferred compensation plans. Initially, the transaction price is generally considered by the Group as the exit price and is the Group's best estimate of fair value.

After initial recognition, in determining the fair value of internally and externally managed funds, the Group generally 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 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. Exchanged-traded direct equity investments are generally valued based on quoted prices from the exchange.

Exchange-traded direct equity investments that are actively traded are categorised 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 categorised 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 categorised in Level 2 of the fair value hierarchy; otherwise they are categorised in Level 3 of the fair value hierarchy.

Equity investments in other Morgan Stanley Group undertakings. Where the Group has equity investments in other Morgan Stanley Group undertakings that are neither subsidiaries nor associates, the Group's share of the net asset value of the undertaking is considered the best representation of fair value for the investment. These investments are included in Level 3 of the fair value hierarchy because net asset value amounts are not considered observable.

- *Derivatives*

Listed Derivative Contracts. Listed derivatives that are actively traded are valued based on quoted prices from the exchange and are categorised 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 categorised 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 modelled 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 judgement, 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 Group are widely accepted by the financial services industry. A substantial majority of OTC derivative products valued using pricing models fall into this category and are categorised within Level 2 of the fair value hierarchy.

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

- *Derivatives (continued)*

Other derivative products, including complex products that have become illiquid, require more judgement in the implementation of the valuation technique applied due to the complexity of the valuation assumptions and the reduced observability of inputs. This includes certain types of interest rate derivatives with both volatility and correlation exposure and credit derivatives including mortgage-related CDO securities, certain types of ABS credit default swaps, basket credit default swaps and CDO-squared positions where direct trading activity or quotes are unobservable. These instruments involve significant unobservable inputs and are categorised 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 limited, are valued based on an evaluation of the market and model input parameters sourced from similar positions as indicated by primary and secondary market activity. Each position is evaluated independently taking into consideration available comparable market levels as well as cash-synthetic basis, or the underlying collateral performance and pricing, behaviour of the tranche under various cumulative loss and prepayment scenarios, deal structures (e.g., non-amortising 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 judgement.

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 standardised 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 categorised in Level 3 of the fair value hierarchy; otherwise, the instruments are categorised in Level 2 of the fair value hierarchy.

The Group 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 categorised in Level 2 of the fair value hierarchy; in instances where significant inputs are unobservable, they are categorised in Level 3 of the fair value hierarchy.

Financial assets and financial liabilities designated at fair value through profit or loss

- *Prepaid OTC contracts and issued structured notes designated as fair value through profit or loss*

The Group issues structured notes and trades prepaid OTC derivatives that have coupons or repayment terms linked to the performance of debt or equity securities, indices, currencies or commodities. The fair value of structured notes and prepaid OTC derivatives is determined using valuation models for the derivative and debt portions of the notes. These models incorporate observable inputs referencing identical or comparable securities, including prices 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 own credit spreads is also included based on observed secondary bond market spreads. Most structured notes and prepaid OTC derivatives are categorised in Level 2 of the fair value hierarchy.

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

a. Fair value hierarchy disclosure (continued)

- *Customer Loans*

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

Mortgage Loans. Mortgage loans are valued using observable prices based on transactional data or third party pricing for identical or comparable instruments, where available. Where position-specific external prices are not observable, the Group estimates fair value based on benchmarking to prices and rates observed in the primary market for similar loan or borrower types, or based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved or a methodology that utilises the capital structure and credit spreads of recent comparable securitisation transactions. Mortgage loans valued based on observable market data for identical or comparable instruments are categorised in Level 2 of the fair value hierarchy. Where observable prices are not available, due to the subjectivity involved in comparability assessment related to mortgage loan vintage, geographical concentration, prepayment speed and projected loss assumptions, mortgage loans are classified in Level 3 of the fair value hierarchy.

b. Changes in Level 3 assets and liabilities measured at fair value

The following table presents the changes in the fair value of the Group's Level 3 financial assets and financial liabilities for the year ended 31 December 2012. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realised and unrealised gains (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realised and unrealised gains (losses) on hedging instruments that have been classified by the Group 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 Group has classified within the Level 3 category. As a result, the unrealised 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.

The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. Where the trading positions included in the below table are risk managed using financial instruments held by other Morgan Stanley Group undertakings, these policies potentially result in the recognition of offsetting gains or losses in the Group.

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

b. Changes in Level 3 assets and liabilities measured at fair value (continued)

2012

	Balance at 1 January 2012 $millions	Total gains/ (losses) recognised in consolidated income statement $millions	Total gains/ (losses) recognised in consolidated statement of comprehensive income $millions	Purchases $millions	Sales $millions	Issues $millions	Settlements $millions	Net transfers in and/or out of Level 3 (1) $millions	Balance at 31 December 2012 $millions	Unrealised gains/ (losses) for Level 3 assets/ liabilities outstanding as at 31 December 2012 (2) $millions
Financial assets classified as held for trading:										
Government debt securities	1	-	-	-	-	-	-	1	2	-
Corporate and other debt	2,235	(41)	-	352	(394)	-	(1,043)	(146)	963	(33)
Corporate equities	162	3	-	45	(32)	-	-	(65)	113	6
Total financial assets classified as held for trading	2,398	(38)	-	397	(426)	-	(1,043)	(210)	1,078	(27)
Financial assets designated at fair value through profit or loss	-	-	-	266	-	-	-	311	577	-
Available-for-sale financial assets:										
Corporate equities	65	46	(16)	2	-	-	(59)	-	38	-
Total financial assets measured at fair value	**2,463**	**8**	**(16)**	**665**	**(426)**	**-**	**(1,102)**	**101**	**1,693**	**(27)**
Financial liabilities classified as held for trading:										
Corporate and other debt	(70)	-	-	44	(29)	-	-	20	(35)	13
Corporate equities	(1)	2	-	1	(2)	-	-	(3)	(3)	(1)
Net derivative contracts (3)	(1,632)	(342)	-	375	(5)	(135)	(41)	548	(1,232)	(175)
Total financial liabilities classified as held for trading	(1,703)	(340)	-	420	(36)	(135)	(41)	565	(1,270)	(163)
Financial liabilities designated at fair value through profit or loss	(381)	55	-	-	-	-	18	-	(308)	55
Total financial liabilities measured at fair value	**(2,084)**	**(285)**	**-**	**420**	**(36)**	**(135)**	**(23)**	**565**	**(1,578)**	**(108)**

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

(2) Amounts represent unrealised gains or (losses) for the year ended 31 December 2012 related to assets and liabilities still outstanding at 31 December 2012. The unrealised gains or (losses) are regonised in the consolidated income statement or consolidated statement of comprehensive income as detailed in the financial instruments accounting policy (note 3c).

(3) Net derivative contracts represent financial assets classified as held for trading – derivative contracts net of financial liabilities classified as held for trading – derivative contracts. All cash flows on derivative contracts are presented in settlements.

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

b. Changes in Level 3 assets and liabilities measured at fair value (continued)

2011

	Balance at 1 January 2011 $millions	Total gains/ (losses) recognised in consolidated income statement $millions	Total gains/ (losses) recognised in consolidated statement of comprehensive income $millions	Purchases $millions	Sales $millions	Issues $millions	Settlements $millions	Net transfers in and/or out of Level 3 (1) $millions	Balance at 31 December 2011 $millions	Unrealised gains/ (losses) for Level 3 assets/ liabilities outstanding as at 31 December 2011 (2) $millions
Financial assets classified as held for trading:										
Government debt securities	-	-	-	1	-	-	-	-	1	-
Corporate and other debt	3,359	(102)	-	768	(2,153)	-	-	363	2,235	(143)
Corporate equities	146	(24)	-	148	(107)	-	-	(1)	162	(24)
Total financial assets classified as held for trading	3,505	(126)	-	917	(2,260)	-	-	362	2,398	(167)
Financial assets designated at fair value through profit or loss	529	-	-	-	-	-	-	(529)	-	-
Available-for-sale financial assets:										
Corporate equities	40	-	26	-	(1)	-	-	-	65	-
Total financial assets measured at fair value	**4,074**	**(126)**	**26**	**917**	**(2,261)**	**-**	**-**	**(167)**	**2,463**	**(167)**
Financial liabilities classified as held for trading:										
Corporate and other debt	(26)	(4)	-	9	(68)	-	1	18	(70)	3
Corporate equities	(11)	(1)	-	12	(1)	-	-	-	(1)	-
Net derivative contracts (3)	(1,499)	159	-	323	-	(1,697)	736	346	(1,632)	522
Total financial liabilities classified as held for trading	(1,536)	154	-	344	(69)	(1,697)	737	364	(1,703)	525
Financial liabilities designated at fair value through profit or loss	(855)	214	-	-	-	(101)	78	283	(381)	214
Total financial liabilities measured at fair value	**(2,391)**	**368**	**-**	**344**	**(69)**	**(1,798)**	**815**	**647**	**(2,084)**	**739**

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

(2) Amounts represent unrealised gains or (losses) for the year ended 31 December 2011 related to assets and liabilities still outstanding at 31 December 2011. The unrealised gains or (losses) are regonised in the consolidated income statement or consolidated statement of comprehensive income as detailed in the financial instruments accounting policy (note 3c).

(3) Net derivative contracts represent financial assets classified as held for trading – derivative contracts net of financial liabilities classified as held for trading – derivative contracts. All cash flows on derivative contracts are presented in settlements.

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

b. Changes in Level 3 assets and liabilities measured at fair value (continued)

During the year, the Group reclassified approximately $1,604 million (2011: $529 million) of derivative assets and $2,152 million (2011: $nil) of derivative liabilities from Level 3 to Level 2. These reclassifications were primarily related to hybrid contracts for which external prices became observable and the remaining unobservable inputs were deemed insignificant to the overall measurement.

There were no significant transfers from Level 2 to Level 3 of the fair value hierarchy during the year (2011: $nil).

c. Significant transfers between Level 1 and Level 2 of the fair value hierarchy

During the year, the Group reclassified approximately $2,700 million of derivative assets and approximately $1,981 million of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange. Also during the year, the Group reclassified approximately $302 million of listed derivative assets from Level 1 to Level 2 as transactions in these contracts did not occur with sufficient frequency and volume to constitute an active market.

During 2011, the Group reclassified approximately $1,027 million of government debt security assets and approximately $1,778 million of government debt security liabilities from Level 1 to Level 2. These reclassifications primarily related to certain European peripheral government bonds as these securities traded with a high degree of pricing volatility, dispersion and wider bid-ask spreads. The Group continues to mark these securities to observable market price quotations.

d. Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives

All financial instruments are valued in accordance with the techniques outlined in the fair value hierarchy disclosure above. Some of these techniques, including those used to value instruments categorised in Level 3 of the fair value hierarchy, are dependent on unobservable parameters and the fair value for these financial instruments has been determined using parameters appropriate for the valuation methodology based on prevailing market evidence. It is recognised that the unobservable parameters could have a range of reasonably possible alternative values.

In estimating the change in fair value, the unobservable parameters were varied to the extremes of the ranges of reasonably possible alternatives using statistical techniques, such as dispersion in comparable observable external inputs for similar asset classes, historic data or judgement if a statistical technique is not appropriate. Where a financial instrument has more than one unobservable parameter, the sensitivity analysis reflects the greatest reasonably possible increase or decrease to fair value by varying the assumptions individually. It is unlikely that all unobservable parameters would be concurrently at the extreme range of possible alternative assumptions and therefore the sensitivity shown below is likely to be greater than the actual uncertainty relating to the financial instruments.

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives (continued)

The following tables present the sensitivity of the fair value of Level 3 financial assets and financial liabilities as at 31 December 2012 to reasonably possible alternative assumptions.

2012		**Effect of reasonably possible alternative assumptions**	
	Fair value $millions	**Increase in fair value $millions**	**Decrease in fair value $millions**
Financial assets classified as held for trading:			
Government debt securities	2	-	-
Corporate and other debt	963	45	(33)
Corporate equities	113	4	(4)
Financial assets designated at fair value through profit or loss:			
Prepaid OTC contracts	14	-	(13)
Other	563	-	-
Available-for-sale financial assets:			
Corporate equities	38	1	(13)
Financial liabilities classified as held for trading:			
Corporate and other debt	35	-	-
Corporate equities	3	-	-
Net derivatives contracts(1)	1,232	132	(111)
Financial liabilities designated at fair value through profit or loss:			
Prepaid OTC contracts	134	2	(2)
Issued structured notes	1	-	-
Other	173	-	-

(1) Net derivative contracts represent financial assets classified as held for trading – derivative contracts net of financial liabilities classified as held for trading – derivative contracts.

29. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

d. Changes in Level 3 assets and liabilities measured at fair value (continued)

2011	Fair value $millions	Effect of reasonably possible alternative assumptions: Increase in fair value $millions	Effect of reasonably possible alternative assumptions: Decrease in fair value $millions
Financial assets classified as held for trading:			
Government debt securities	1	-	-
Corporate and other debt	2,235	38	(36)
Corporate equities	162	6	(14)
Available-for-sale financial assets:			
Corporate equities	65	7	(1)
Financial liabilities classified as held for trading:			
Corporate and other debt	70	-	-
Corporate equities	1	-	-
Net derivatives contracts(1)	1,632	139	(137)
Financial liabilities designated at fair value through profit or loss:			
Prepaid OTC contracts	111	8	(8)
Issued structured notes	5	-	-
Other	265	2	(2)

(1) Net derivative contracts represent financial assets classified as held for trading – derivative contracts net of financial liabilities classified as held for trading – derivative contracts.

e. Financial instruments valued using unobservable market data

The amounts not recognised in the consolidated income statement relating to the difference between the fair value at initial recognition (the transaction price) and the amounts determined at initial recognition using valuation techniques are as follows:

	2012 $millions	2011 $millions
At 1 January	536	260
New transactions	141	307
Amounts recognised in the consolidated income statement during the year	(118)	(31)
At 31 December	559	536

Although the consolidated statement of financial position categories ‘Financial assets and financial liabilities classified as held for trading’, ‘Financial assets and financial liabilities designated at fair value’, and ‘Available-for-sale financial assets’ include financial instruments whose fair value is based on valuation techniques using unobservable market data, the balance above predominantly relates to derivative contracts.

30. FINANCIAL INSTRUMENTS NOT MEASURED AT FAIR VALUE

For all financial assets and financial liabilities not measured at fair value, the carrying amount is considered to be a reasonable approximation of fair value due to the short term nature of these financial assets and financial liabilities, except for the following:

	Carrying value $millions	Fair value $millions	Unrecognised gain $millions
Financial liabilities			
Subordinated loans:			
As at 31 December 2012	7,906	6,663	1,243
As at 31 December 2011	7,906	5,769	2,137

The fair value for subordinated loans has been determined based on the assumption that all subordinated loans are held to the latest repayment date, although the amounts outstanding are repayable at any time at the Group's option, subject to prior consent from the FSA.

31. CAPITAL MANAGEMENT

The Morgan Stanley Group manages its capital on a global basis with consideration for its legal entities. The capital managed by the Morgan Stanley Group broadly includes ordinary share capital, preference share capital, subordinated loans and reserves.

The Morgan Stanley Group’s required capital estimation is based on the Required Capital Framework, an internal capital adequacy measure. The framework is a risk-based internal use of capital measure, which is compared with the Morgan Stanley Group’s regulatory capital to help ensure the Morgan Stanley Group maintains an amount of risk-based going concern capital after absorbing potential losses from extreme stress events where applicable, at a point in time. The difference between the Morgan Stanley Group’s regulatory capital and aggregate Required Capital is the Morgan Stanley Group’s Parent capital.

The Required Capital Framework will evolve over time in response to changes in the business and regulatory environment and to incorporate enhancements in modelling techniques.

The Morgan Stanley Group actively manages its consolidated capital position based upon, among other things, business opportunities, risks, capital availability and rates of return together with internal capital policies, regulatory requirements and rating agency guidelines and, therefore, in the future may expand or contract its capital base to address the changing needs of its businesses.

The Morgan Stanley Group also aims to adequately capitalise at a legal entity level whilst safeguarding that entity’s ability to continue as a going concern and ensuring that it meets all regulatory capital requirements, so that it can continue to provide returns for the Morgan Stanley Group.

In order to maintain or adjust the capital structure as described above, the Group may adjust the amount of dividends paid, return capital to shareholders, issue new shares, issue or repay subordinated debt or sell assets to reduce debt.

The Company is regulated by the FSA and as such is subject to minimum capital requirements. The Group’s capital is monitored on an ongoing basis to ensure compliance with the rules within the FSA’s General Prudential Sourcebook. At a minimum, the Group must ensure that Capital Resources (share capital, subordinated debt, audited profit and loss and eligible reserves) are greater than the Capital Resource Requirement covering credit, market and operational risk.

31. CAPITAL MANAGEMENT (CONTINUED)

The Morgan Stanley International Limited Group ("MSI Group") prepares an Internal Capital Adequacy Assessment Process ("ICAAP") document in order to meet its obligations under BIPRU 2.2 "Internal Capital Adequacy Standards". The Company, as the main operating entity within the MSI Group is captured in this analysis. The MSI Group's Required Capital Framework captures risks not adequately covered under Pillar 1 and calculates an additional capital buffer required to absorb stress losses. The framework is based on regional management's own risk assessment and is broadly consistent with the Morgan Stanley Group's Required Capital framework. It is used to ensure that the MSI Group carries, or has access to, sufficient capital to support all material risks residing within the MSI Group.

The MSI Group ICAAP identifies and measures material risks, sets and assesses internal capital adequacy operating targets and limits that relate directly to risk through the Required Capital framework and the risk appetite defined by UK Group Governing Bodies and assesses current and future capital adequacy under normal and stressed operating environments over the capital planning horizon.

The FSA reviews the ICAAP document through its Supervisory Review Process and issues an Individual Capital Guidance which sets the minimum level of regulatory capital for the MSI Group and the Company. In addition, the FSA sets a capital planning buffer which is available to support the MSI Group in a stressed market environment.

The Group complied with all of its regulatory capital requirements during the year.

In December 2010, the Basel Committee on Banking Supervision published the final rules text on a comprehensive set of reform measures, developed to strengthen the regulation, supervision and risk management of the banking sector ("the Basel III Framework"). In July 2011, the European Commission published draft legislation to implement these measures in Europe with an expected implementation date in 2014.

The Basel III Framework covers both microprudential and macroprudential elements. It sets out requirements for higher and better-quality capital, improved risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the build up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards. The Morgan Stanley Group is currently working to ensure compliance with these new regulatory standards as they are implemented from 2014 onwards.

New standards relating to market risk capital requirements, referred to as Basel 2.5, were implemented with effect from 31 December 2011.

The Group manages the following items as capital:

	2012 $millions	2011 $millions
Ordinary share capital	8,414	8,414
Preference share capital	1,050	1,050
Subordinated debt	7,906	7,906
Reserves	3,987	3,943
	21,357	21,313

Basel II Pillar 3 disclosures

The Company is captured in the MSI Group Pillar 3 disclosures which allow investors and other market participants to understand capital adequacy, particular risk exposures and risk management processes of individual firms required by the UK implementation of Basel II. The 2011 Pillar 3 disclosure for the MSI Group can be found at www.morganstanley.com.

32. EMPLOYEE COMPENSATION PLANS

As described in note 7, the Group utilises staff employed by other Morgan Stanley Group undertakings and incurs management charges in respect of these employee services. These management charges include the costs of equity-based compensation provided to these employees.

Equity-settled share based compensation plans

- **Deferred restricted stock units**

Morgan Stanley has granted deferred stock awards pursuant to several equity-based compensation plans. The plans provide for the deferral of a portion of certain employees' long-term incentive compensation with awards made in the form of a right to receive unrestricted shares of common stock in the future. Awards under these plans are generally subject to vesting over time contingent upon continued employment and to restrictions on sale, transfer or assignment until the end of a specified period, generally two to three years from date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant restriction period. All or a portion of a vested award also may be cancelled in certain limited situations, including termination for cause during the relevant restriction period. Recipients of deferred stock awards may have voting rights, at the Morgan Stanley Group's discretion, and generally receive dividend equivalents.

During the year Morgan Stanley granted 720,821 units of deferred restricted stock units to employees of the Group with a weighted average fair value per unit of $18.21 (2011: 385,877 units, weighted average fair value $29.24 per unit), based on the market value of Morgan Stanley shares at grant date.

- **Stock options**

Morgan Stanley has also granted stock option awards in the form of stock options on Morgan Stanley's common stock. The stock options generally have an exercise price of not less than the fair value of Morgan Stanley's common stock on the date of grant and generally become exercisable over a three year period, expiring ten years from the date of grant, subject to accelerated expiration upon termination of employment. Stock option awards have vesting, restriction and cancellation provisions that are similar to those in deferred restricted stock units.

There were no options granted during the year (2011: none).

The following table shows activity relating to the Morgan Stanley Group's stock option awards for employees of the Group:

	2012		2011	
	Number of options	**Weighted average exercise price**	**Number of options**	**Weighted average exercise price**
	'000s	**$**	**'000s**	**$**
Options outstanding at 1 January	241	50.99	263	51.74
Expired during the year	(67)	51.11	(22)	59.82
Options outstanding at 31 December	174	50.94	241	50.99
Options exercisable at 31 December	174	50.94	241	50.99

There were no options exercised during the year (2011: none).

32. EMPLOYEE COMPENSATION PLANS (CONTINUED)

The following table presents information relating to the stock options outstanding:

	2012			2011		
Range of exercise prices	Number of options '000s	Weighted average exercise price $	Weighted average remaining life in years	Number of options '000s	Weighted average exercise price $	Weighted average remaining life in years
$30.00 - $39.99	52	36.22	-	59	36.25	1.0
$40.00 - $49.99	59	47.01	1.0	103	47.42	1.4
$60.00 - $69.99	63	66.73	4.0	79	66.73	5.0
Total	174	50.94	1.8	241	50.99	2.5

Other deferred compensation plans

The Group has granted non-equity based deferred compensation awards to certain of its key employees. The plans provide for the deferral of a portion of the employees' discretionary compensation with awards that provide a return based upon the performance of various referenced investments. Awards under these plans are generally subject to a sole vesting condition of service over time, which normally ranges from six months to three years from the date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant vesting period. The awards are settled in cash at the end of the relevant vesting period.

Awards with a value of $28 million (2011: $11 million) have been granted to employees during the year and an expense of $30 million (2011: $26 million) has been recognised within 'Direct staff costs' in 'Other expense' in the consolidated income statement in relation to awards outstanding. The liability to employees at the end of the year, reported within 'Accruals and deferred income' in the consolidated statement of financial position, is $25 million (2011: $30 million).

The Group economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivative balance at the end of the year, recognised within 'Financial assets classified as held for trading' in relation to these deferred compensation schemes is $1 million (2011: $nil), and recognised within 'Financial liabilities classified as held for trading' is $3 million (2011: $3 million). The related profit or loss recorded within 'Net gains/ (losses) on financial instruments classified as held for trading' for the year is $nil (2011: $nil).

33. POST EMPLOYMENT BENEFITS

Defined contribution plans

The Group operates several Morgan Stanley defined contribution plans which require contributions made to the plans to be held in trust, separate from the assets of the Group.

The defined contribution plans are as follows:

- Morgan Stanley Flexible Company Pension Plan (Amsterdam)
- MSII Offshore Retirement Benefit Plan IV, Dubai Section
- Morgan Stanley Asia Limited Retirement Benefit Plan - (Taiwan)

33. POST EMPLOYMENT BENEFITS (CONTINUED)

Defined contribution plans (continued)

During the year, the Athens Branch was closed along with its associated defined contribution plan, the Morgan Stanley & Co International plc (Greece Branch) Group Insurance Policy. At the time of closure, there were no outstanding contributions.

The defined contribution pension charge recognised within 'Direct staff costs' in 'Other expense' in the consolidated income statement was $3 million for the year (2011: $3 million) of which $nil was accrued at 31 December 2012 (2011: $nil).

Defined benefit plans

The Group also operates several Morgan Stanley defined benefit plans, which provide pension benefits that are based on an actuarial valuation. The Group's policy is to fund at least the amounts sufficient to meet minimum funding requirements under applicable employee benefit and tax regulations.

The defined benefits plans are as follows:

- Morgan Stanley & Co International plc Paris Branch IFC (Indemnites de Fin de Carriere) ("Paris Branch Plan")
- Morgan Stanley France (SAS) Leaving Indemnity Plan (Indemnites de Fin de Carriere) ("MS France Plan")
- Morgan Stanley Asia (Taiwan) Limited Retirement Scheme ("Taiwan Retirement Plan")
- Morgan Stanley Asia (Taiwan) Limited Book Reserve Plan ("Taiwan Reserve Plan")
- Personalvorsorgestiftung der Bank Morgan Stanley AG Plan ("Zurich Branch Plan")
- Morgan Stanley Dubai End of Service Gratuity ("Dubai Branch Plan")

During the year, the Athens Branch was closed along with its associated defined benefit plan, the Morgan Stanley & Co International plc (Athens Branch) Retirement Indemnity. At the time of closure, there were no assets or outstanding obligations.

Defined benefit plan expense

The amounts recognised in 'Direct staff costs', within 'Other expense', in the consolidated income statement in respect of these defined benefit plans are as follows:

	2012 $millions	2011 $millions
Current service cost	2	2
Past service cost	-	(1)
Interest on obligation	1	1
Defined benefit plan expense	3	2

Actuarial gains and losses and the effect of the limit to the pension asset under IAS19 '*Employee benefits'* paragraph 58 have been reported in other comprehensive income.

The cumulative amount of actuarial gains and losses recognised in other comprehensive income is $2 million gain (2011: $2 million gain).

33. POST EMPLOYMENT BENEFITS (CONTINUED)

Post employment benefit obligation

The following table provides a reconciliation of the present value of the defined benefit obligation and fair value of plan assets included in the consolidated statement of financial position, as well as a summary of the funded status of the plans:

	2012 $millions	2011 $millions
Present value of funded defined benefit obligation	(20)	(19)
Fair value of plan assets	17	17
	(3)	(2)
Present value of unfunded defined benefit obligation	(2)	(2)
Net liability	(5)	(4)
Post employment benefit obligation recognised in the consolidated statement of financial position:		
Liabilities	(22)	(21)
Assets	17	17
Net liability	(5)	(4)

Contributions for the year to the defined benefit plans totalled $1 million (2011: $2 million), of which $nil was accrued at 31 December 2012 (2011: $nil). The Group expects to contribute $1 million (2011: $1 million) in the next financial year, based upon the current funded status and the expected return assumptions for the next financial year.

Changes in the present value of the defined benefit obligation during the year were as follows:

	2012 $millions	2011 $millions
Defined benefit obligation at 1 January	21	15
Current service cost	2	2
Past service cost	-	(1)
Interest cost	1	1
Actuarial loss on obligations	-	1
Transfer in	-	3
Benefits paid	(3)	(1)
Plan participants' contributions	1	1
Defined benefit obligations at 31 December	22	21

33. POST EMPLOYMENT BENEFITS (CONTINUED)

Changes in the fair value of plan assets were as follows:

	2012 $millions	2011 $millions
Fair value of scheme assets at 1 January	17	11
Expected return on plan assets	1	-
Transfer in	-	3
Employer contributions	1	2
Benefits paid	(3)	(1)
Plan participants' contributions	1	1
Foreign exchange rate changes	-	1
Fair value of plan assets at 31 December	17	17

	2012 $millions	2011 $millions
Actual return on plan assets	1	-

The major categories of the total plan assets are as follows:

	Fair value of assets	
	2012 $millions	2011 $millions
Equity securities	5	4
Fixed income securities	7	7
Property	1	1
Other - primarily cash	4	5
	17	17

The expected long-term rate of return on assets represents the Group's best estimate of the long-term return on the plans assets and generally was estimated by computing a weighted average return of the underlying long-term expected returns on the different asset classes, based on the target asset allocations. For plans where there is no established target asset allocation, actual asset allocations were used. The expected long-term return on assets is a long-term assumption that generally is expected to remain the same from one year to the next unless there is a significant change in the target asset allocation, the fees and expenses paid by the plans or market conditions.

The Group, in consultation with its independent investment consultants and actuaries, determined the asset allocation targets based on its assessment of business and financial conditions, demographic and actuarial data, funding characteristics and related risk factors. Other relevant factors, including industry practices, long-term historical and prospective capital market returns, were also considered.

The return objectives of the plans provide long-term measures for monitoring the investment performance against growth in the pension obligations. The overall allocation is expected to help protect the plans' funded status while generating sufficiently stable real returns (net of inflation) to help cover current and future benefit payments.

33. POST EMPLOYMENT BENEFITS (CONTINUED)

Both the equity and fixed income portions of the asset allocation use a combination of active and passive investment strategies and different investment styles. The fixed income asset allocation consists of longer duration fixed income securities in order to help reduce plan exposure to interest rate variation and to better correlate assets with obligations. The longer duration fixed income allocation is expected to help stabilise plan contributions over the long run.

The following table presents the principal actuarial assumptions at the end of the reporting period:

	2012	**2011**
	%	%
Discount rate	1.50% - 3.65%	1.75% - 4.75%
Rate of increase in salaries	1.50% - 4.00%	2.25% - 4.00%
Inflation assumption	1.50% - 2.00%	1.50% - 2.00%
Expected long-term rate of return on plan assets:		
- At 1 January	2.25% - 4.10%	2.50% - 4.60%
- At 31 December	2.25% - 3.85%	2.25% - 4.10%

The mortality assumptions used give the following life expectations at 65:

	Mortality table	**Life expectancy at age 65 for a male member currently:**		**Life expectancy at age 65 for a female member currently:**	
		Aged 65	**Aged 45**	**Aged 65**	**Aged 45**
31 December 2012					
Switzerland	Swiss BVG 2010, Generational Mortality Table	86.3	88.1	88.8	90.5
31 December 2011					
Switzerland	Swiss BVG 2010, Static Mortality Table	84.7	84.7	87.0	87.0

33. POST EMPLOYMENT BENEFITS (CONTINUED)

The sensitivities regarding the principal assumptions used to measure the defined benefit obligation are as follows:

Assumption	Change in assumption	Impact on scheme liabilities
Paris Branch Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 6.25% / increase by 6.86%
MS France Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 1.94% / increase by 2.13%
Taiwan Retirement Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 5.66% / increase by 6.18%
Rate of increase in salaries	Increase by 0.5% / decrease by 0.5%	Increase by 6.11% / decrease by 5.66%
Taiwan Reserve Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 4.80% / increase by 5.25%
Zurich Branch Plan		
Discount rate	Increase by 0.5% / decrease by 0.5%	Decrease by 3.10% / increase by 4.80%
Inflation assumption	Increase by 0.5% / decrease by 0.5%	Increase by 1.90% / decrease by 1.00%
Rate of increase in salaries	Increase by 0.5% / decrease by 0.5%	Increase by 0.90% / decrease by 0.30%
Dubai Branch Plan		
Discount rate	Increase by 0.25% / decrease by 0.25%	Decrease by 2.53% / increase by 2.60%
Rate of increase in salaries	Increase by 0.25% / decrease by 0.25%	Increase by 2.60% / decrease by 2.53%

The five year history of experience adjustments is as follows:

	2012	2011	2010	2009	2008
Present value of defined benefit obligation ($millions)	(22)	(21)	(15)	(7)	(5)
Fair value of plan assets ($millions)	17	17	11	3	3
Deficit ($millions)	(5)	(4)	(4)	(4)	(2)
Experience adjustments on plan liabilities:					
- Increase/ (decrease) ($millions)	(1)	-	1	(1)	(1)
- Percentage of plan liabilities (%)	(2.32%)	1.41%	4.38%	(12.48%)	(15.85%)
Experience adjustments on plan assets:					
- Increase/ (decrease) ($millions)	-	-	-	-	-
- Percentage of plan assets (%)	2.55%	(2.94%)	(1.30%)	2.22%	(3.79%)

33. POST EMPLOYMENT BENEFITS (CONTINUED)

Plans operated by fellow Morgan Stanley undertakings

Along with a number of other Morgan Stanley Group companies, the Group incurs management charges from a fellow Morgan Stanley undertaking, Morgan Stanley UK Limited ("MSUK"), in respect of MSUK's employees' services. These management recharges include pension costs related to the Morgan Stanley UK Group Pensions Plan (the "UK Plan"). The UK Plan is a defined contribution scheme with a closed defined benefit section. There is no contractual arrangement for recharging the costs of the UK Plan as a whole measured in accordance with IAS 19. Accordingly, the Group recognised its contribution payable for the period as an expense. On this basis, the management recharge for the year in respect of the plan recognised in the consolidated income statement was $10 million (2011: $10 million).

For the purposes of IAS 19 disclosure, information about the defined benefit section of the UK Plan as a whole, is presented below.

Defined benefit plan (income)/ expense

The amounts that would be recognised in 'Direct staff costs', within 'Other expense', in the consolidated income statement in respect of this defined benefit plan is as follows:

	2012	**2011**
	$millions	**$millions**
Expected return on scheme assets	(8)	(8)
Interest on obligation	9	8
Foreign exchange rate changes	(2)	1
Defined benefit plan (income)/ expense	(1)	1

Post employment benefit asset/obligation

The following table provides a reconciliation of the present value of the defined benefit obligation and fair value of plan assets, as well as a summary of the funded status of the plan:

	2012	**2011**
	$millions	**$millions**
Present value of funded defined benefit obligation	(206)	(183)
Fair value of plan assets	250	229
	44	46
Adjustment for ceiling	(44)	(46)
Net liability	-	-

Contributions for the year to the defined benefit plan totalled $10 million (2011: $10 million), of which $nil was accrued at 31 December 2012 (2011: $nil). The Group expects to contribute $11 million (2011: $10 million) in the next financial year, based upon the current funded status and the expected return assumptions for the next financial year.

33. POST EMPLOYMENT BENEFITS (CONTINUED)

Changes in the present value of the defined benefit obligation during the year were as follows:

	2012 $millions	2011 $millions
Defined benefit obligation at 1 January	183	145
Interest cost	9	8
Actuarial loss on obligations	10	34
Benefits paid	(4)	(3)
Foreign exchange rate changes	8	(1)
Defined benefit obligations at 31 December	206	183

Changes in the fair value of plan assets were as follows:

	2012 $millions	2011 $millions
Fair value of scheme assets at 1 January	229	167
Expected return on plan assets	8	8
Actuarial (loss)/gain	(3)	49
Employer contributions	10	10
Benefits paid	(4)	(3)
Foreign exchange rate changes	10	(2)
Fair value of plan assets at 31 December	250	229

	2012 $millions	2011 $millions
Actual return on plan assets	5	57

The major categories of the total plan assets are as follows:

	Fair value of assets 2012 $millions	2011 $millions
Equity securities	-	2
Fixed income securities	250	227
	250	229

The following table presents the principle actuarial assumptions at the end of the reporting period:

	2012 %	2011 %
Pre-retirement discount rate	3.75%	4.60%
Post-retirement discount rate	4.05%	3.60%
Inflation assumption	2.95%	3.60%
Expected rate of return on plan assets:		
- Equity securities	-	7.00%
- Fixed income securities	3.35%	3.20%

33. POST EMPLOYMENT BENEFITS (CONTINUED)

The mortality assumptions used give the following life expectations at 65:

	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
	Aged 65	**Aged 45**	**Aged 65**	**Aged 45**
31 December 2012				
UK	89.5	92.3	92.0	95.0
31 December 2011				
UK	89.2	92.2	91.9	94.8

The sensitivities regarding the principal assumptions used to measure the defined benefit obligation are as follows:

Assumption	**Change in assumption**	**Impact on scheme liabilities**
Discount rate	Increase / decrease by 0.25%	Decrease by 8.04% / increase by 8.91%
Inflation assumption	Increase / decrease by 0.25%	Increase by 4.81% / decrease by 4.50%
Rate of mortality	Increase by 1 year	Increase by 2.37%

The five year history of experience adjustments is as follows:

	2012	**2011**	**2010**	**2009**	**2008**
Present value of defined benefit obligation ($millions)	(206)	(183)	(145)	(148)	(131)
Fair value of plan assets ($millions)	250	229	167	151	149
Surplus ($millions)	44	46	22	3	18
Experience adjustments on plan liabilities:					
- Increase/ (decrease) ($millions)	(2)	2	(10)	-	-
- Percentage of plan liabilities (%)	(0.87%)	1.10%	(7.12%)	0%	0%
Experience adjustments on plan assets:					
- Increase/ (decrease) ($millions)	3	(48)	(9)	27	1
- Percentage of plan assets (%)	1.33%	(20.80%)	(5.18%)	17.86%	0.68%

34. DISPOSAL OF SUBSIDIARY AND JOINT VENTURE

a) Disposal of subsidiary

During the year the Group disposed of two wholly owned subsidiaries, Morgan Stanley Euro Financing (Luxembourg) and Morgan Stanley Moselle S.à r.l. to another Morgan Stanley Group undertaking.

During 2011, the Group disposed of two wholly owned subsidiaries, Archimedes Investments Ltd and Morgan Stanley Norton Investments, which were non-US dollar functional entities. The carrying value of the net assets at the date of disposal was immaterial.

The carrying value of the net assets of these subsidiaries at the date of disposal was as follows:

	2012 At disposal $millions	2011 At disposal $millions
ASSETS		
Trade receivables	1,920	-
NET ASSETS	1,920	-
Proceeds on disposal	1,920	-
Cumulative currency translation differences	(30)	5
(Loss)/ gain on disposal	(30)	5

b) Disposal of Joint Venture

During 2011, the Group sold its interest in Tarvos Investments GmbH ("Tarvos"), a limited liability company incorporated in Germany. The Group had contributed 50% of the capital in the company and accounted for the investment using the equity method of accounting as the majority of the risks and rewards of the company were absorbed by entities outside the Group.

The sale of Tarvos resulted in a net gain of $21 million reported in the consolidated income statement, calculated as the difference between the proceeds of $28 million and the carrying value of the investment at disposal of $7 million.

35. RELATED PARTY DISCLOSURES

Parent and subsidiary relationships

Parent and ultimate controlling entity

The Group's immediate parent undertaking is Morgan Stanley UK Group which is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Cardiff CF14 3UZ.

The ultimate parent undertaking and controlling entity and the largest group of which the Group is a member and for which group financial statements are prepared is Morgan Stanley. Morgan Stanley is incorporated in the state of Delaware, the United States of America and copies of its financial statements can be obtained from www.morganstanley.com/investorrelations.

35. RELATED PARTY DISCLOSURES (CONTINUED)

Subsidiaries

The principal subsidiaries of the Group are as follows:

Name of Company	Country of Incorporation	Holding (per share class)	Type of shares held	Proportion of voting rights	Nature of business
Morgan Stanley Derivative Products (Netherlands) B.V.	Netherlands	100%	Ordinary	100%	Investment company
Morgan Stanley Derivative Products Spain S.L.	Spain	100%	Ordinary	100%	Investment company
Morgan Stanley Equity Derivative Services (Luxembourg) S.ar.l	Luxembourg	100%	Ordinary	100%	Investment company
Morgan Stanley Equity Finance (Denmark) APS	Denmark	100%	Ordinary	100%	Investment company
Morgan Stanley Equity Financing Services (Sweden) AB	Sweden	100%	Ordinary	100%	Investment company
Morgan Stanley Equity Investments (UK) Limited	Cayman Islands	100%	Ordinary	100%	Investment company
Morgan Stanley Equity Trading (DIFC) Limited	United Arab Emirates	100%	Ordinary	100%	Investment company
Morgan Stanley (France) SAS	France	100%	Ordinary	100%	Investment company
Morgan Stanley Global Equity Trading (Jersey) L.P.	Jersey	100%	Ordinary	100%	Investment company
Morgan Stanley Langton Limited	United Kingdom	100%	Ordinary	100%	Investment company
Morgan Stanley Langtree Investments B.V.	Netherlands	100%	Ordinary	100%	Investment company
Morgan Stanley Longcross Limited	United Kingdom	100%	Ordinary	100%	Investment company
Morgan Stanley Millbrae Investments B.V.	Netherlands	100%	Ordinary	100%	Investment company
Morgan Stanley Taiwan Limited	Republic of Taiwan	100%	Ordinary	100%	Financial services
Morgan Stanley Waterloo Limited	Cayman Islands	100%	Ordinary	100%	Investment company

During 2012 and 2011, none of the Group's subsidiaries has experienced significant restrictions on paying dividends or repaying loans and advances.

Key management compensation

Key management personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the Group.

The Morgan Stanley Group's corporate governance framework gives consideration to legal, geographical and business lines through a combination of boards of directors, and regional and global management committees. Accordingly, in addition to the Directors of the Company, key management personnel of the Group is considered to include the boards of directors of certain parent companies, including that of Morgan Stanley, certain members of key Morgan Stanley Group management committees, and certain executive officers of Morgan Stanley.

35. RELATED PARTY DISCLOSURES (CONTINUED)

Key management compensation (continued)

The boards of the Group's parent companies, the management committees and the executive officers cover the full range of the Morgan Stanley Group's business activities. Only those members with responsibility for the Institutional Securities business, being the only reportable business segment of the Group, are considered to be key management personnel of the Group. The aggregate compensation below represents the proportion of compensation paid to these key management personnel, including the Directors of the Company, in respect of their services to the Group.

Compensation paid to key management personnel in respect of their services rendered to the Group is:

	2012 $millions	2011 $millions
Short-term employee benefits	28	29
Post-employment benefits	1	1
Share-based payments	43	37
Other long-term employee benefits	39	47
	111	114

The share-based payment costs disclosed above reflect the amortisation of equity-based awards granted to key management personnel over the last three years and are therefore not directly aligned with other staff costs in the current year.

Key management personnel compensation is borne by other Morgan Stanley Group undertakings in both the current and prior years.

Directors loans

Secured loan facilities may be provided to Directors on a discretionary basis. During 2012, there was one facility in place (2011: one). The maximum amount of credit available under this facility is $1 million (2011: $1 million) and credit may be drawn in US dollars or Sterling at interest rates of LIBOR plus 120 basis points and SONIA plus 175 bases points respectively. The total amounts drawn down and repaid during the year are set out in the table below. As the facility may be drawn down and repaid frequently throughout the year, the total amounts advanced and repaid represent the cumulative transactions.

	2012 $'000	2011 $'000
Outstanding at 1 January	800	600
Drawn down during year	1,000	200
Repaid during the year	(1,800)	-
Outstanding at 31 December	-	800

35. RELATED PARTY DISCLOSURES (CONTINUED)

Directors' emoluments

	2012 $millions	2011 $millions
Total emoluments of all Directors:		
Aggregate emoluments	4	7
Long term incentive schemes	11	3
	15	10
Disclosures in respect of highest paid Director:		
Aggregate emoluments	2	2
Long term incentive schemes	3	1
	5	3

Directors' emoluments have been calculated as the sum of cash, bonuses and benefits in kind.

Directors who are employees of the Morgan Stanley Group are eligible for shares and share options of the parent company, Morgan Stanley, awarded under the Morgan Stanley Group's equity-based long-term incentive schemes. In accordance with Schedule 5 paragraph 1(3)(a) of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the above disclosures include neither the value of shares or share options awarded, nor the gains made on exercise of share options. During the year no Directors exercised share options awarded under these incentive schemes, including the highest paid Director (2011: none).

The value of assets (other than shares or share options) awarded under other long term incentive schemes has been included in the above disclosures when the awards vest, which is generally within three years from the date of the award.

There are seven Directors to whom retirement benefits are accruing under a money purchase scheme (2011: nine). In addition, one Director has benefits accruing under a Morgan Stanley non-UK defined benefits scheme (2011: four).

Transactions with related parties

The Morgan Stanley Group conducts business for clients globally through a combination of both functional and legal entity organisational structures. Accordingly, the Group is closely integrated with the operations of the Morgan Stanley Group and enters into transactions with other Morgan Stanley Group undertakings on an arm's length basis for the purposes of utilising financing, trading and risk management, and infrastructure services. The nature of these relationships along with information about the transactions and outstanding balances is given below. The Group has not recognised any expense and has made no provision for impairment relating to the amount of outstanding balances from related parties (2011: $nil).

Funding

The Group receives funding from and provides funding to other Morgan Stanley Group undertakings in the following forms:

- *General funding*

Funding may be received or provided for specific transaction related funding requirements, or for general operational purposes, in which case it is undated, unsecured, floating rate lending. The interest rates are established by the Morgan Stanley Group Treasury function for all entities within the Morgan Stanley Group and approximate the market rate of interest that the Morgan Stanley Group incurs in funding its business.

35. RELATED PARTY DISCLOSURES (CONTINUED)

Transactions with related parties (continued)

Funding (continued)

- *General funding (continued)*

Details of the outstanding balances on these funding arrangements and the related interest income or expense recognised in the consolidated income statement during the year are shown in the table below:

	2012 Interest $millions	2012 Balance $millions	2011 Interest $millions	2011 Balance $millions
Amounts due from the Group's direct and indirect parent undertakings	45	1,837	39	1,887
Amounts due from other Morgan Stanley Group undertakings	121	3,318	85	3,298
	166	5,155	124	5,185
Amounts due to the Group's direct and indirect parent undertakings	234	4,324	373	5,447
Amounts due to other Morgan Stanley Group undertakings	342	13,182	386	12,367
	576	17,506	759	17,814

- *Subordinated loans*

The Group receives subordinated loans from other Morgan Stanley Group undertakings. Details of the terms of such loans, including the contractual maturity and the interest rates are in note 15. The interest rates are established by the Morgan Stanley Group Treasury function based on available market information at the time the loan is provided.

Trading and risk management

In the course of funding its business, the Group enters into collateralised financing transactions with other Morgan Stanley Group undertakings. All such transactions are entered into on an arm's length basis.

Details of the outstanding balances on such transactions and the related interest income/expense recognised in the consolidated income statement during the year are shown in the table below:

	2012 Interest $millions	2012 Balance $millions	2011 Interest $millions	2011 Balance $millions
Amounts due from other Morgan Stanley Group undertakings	1,280	59,675	974	48,814
Amounts due to other Morgan Stanley Group undertakings	1,486	62,210	1,735	60,865

35. RELATED PARTY DISCLOSURES (CONTINUED)

Transactions with related parties (continued)

Trading and risk management (continued)

The Group enters into purchases and sales of securities and derivative transactions with other Morgan Stanley Group undertakings to facilitate the provision of financial services to clients on a global basis and to manage the market risks associated with such business. The Group also enters into derivative transactions with other Morgan Stanley Group undertakings to manage the market risks associated with certain of its compensation plans. All such transactions are entered into on an arm's length basis. The total amounts receivable and payable on such securities transactions not yet settled and the fair value of such derivatives contracts outstanding at the year end were as follows:

	2012 $millions	2011 $millions
Amounts due from the Group's direct and indirect parent undertakings on unsettled securities and derivative transactions	1,392	977
Amounts due from other Morgan Stanley Group undertakings on unsettled securities and derivative transactions	105,240	127,748
	106,632	128,725
Amounts due to the Group's direct and indirect parent undertakings on unsettled securities and derivative transactions	1,011	1,884
Amounts due to other Morgan Stanley Group undertakings on unsettled securities and derivative transactions	102,583	130,730
	103,594	132,614

The Group has received collateral of $5,366 million (2011: $9,205 million) from other Morgan Stanley Group undertakings and has pledged collateral of $9,123 million (2011: $8,961 million) to other Morgan Stanley Group undertakings to mitigate credit risk on exposures arising under derivatives contracts between the Group and other Morgan Stanley Group undertakings.

In addition, the management and execution of business strategies on a global basis results in many Morgan Stanley transactions impacting a number of Morgan Stanley Group entities. The Morgan Stanley Group operates a number of intra-group policies to ensure that, where possible, revenues and related costs are matched. For the year ended 31 December 2012, $638 million (2011: $949 million) was transferred to other Morgan Stanley Group undertakings relating to such policies and recognised in the consolidated income statement.

35. RELATED PARTY DISCLOSURES (CONTINUED)

Infrastructure services

The Group receives and incurs management charges to and from other Morgan Stanley Group undertakings for infrastructure services, including the provision of staff and office facilities. Management recharges received and incurred during the year are as follows:

	2012		2011	
	Staff costs $millions	Other services $millions	Staff costs $millions	Other services $millions
Amounts recharged from the Group's direct and indirect parent undertakings	-	221	-	201
Amounts recharged from other Morgan Stanley Group undertakings	1,469	253	1,511	123
	1,469	474	1,511	324

Amounts outstanding at the reporting date are included within the general funding balances disclosed above.

Taxation

The Group has surrendered group relief to other members of the Morgan Stanley UK tax group for no cash consideration (see note 8).

Other related party transactions

The Group has received a guarantee from Morgan Stanley International Limited, to guarantee the obligations under derivative contracts of Morgan Stanley Capital Services Inc., Morgan Stanley Capital Group Inc., MSDW Equity Finance Services (Cayman) Limited, MSDW Equity Finance Services (Lux) S.á.r.l. and Morgan Stanley Asia Securities Products LLC to the Company. All entities are fellow Morgan Stanley Group undertakings. As at 31 December 2012, no call had been made by the Group under these arrangements.

36. EVENTS AFTER THE REPORTING PERIOD

Contribution of business from Morgan Stanley & Co. Limited

On 1 January 2013, the financial advisory business conducted by another Morgan Stanley Group undertaking, Morgan Stanley & Co. Limited, was contributed to the Company. This new business is not expected to have a significant impact on the Group's results.

FSA Core Group

In accordance with the FSA's Core Group regulations, on 27 March 2013, the Company entered into a Deed of Agreement ("the agreement") whereby certain other Morgan Stanley Group undertakings, known collectively as the Contributing Entities, undertook to provide additional capital resources to the Company and certain other Morgan Stanley Group undertakings registered with the FSA (collectively the 'Authorised Firms') if required in compliance with the regulatory requirements applicable to the members of a core UK group.

In the event that the capital resources of the Company were to fall below its capital requirements as determined by the FSA, the agreement gives the Company the unilateral right to demand a contribution of capital resources from the Contributing Entities, in order to meet its capital requirements.

The amount of the contribution is limited to the Contributing Entities' surplus capital, to the extent that such capital is not required to repay that company's liabilities, as defined in the agreement. The capital resources may be provided in the form of a subscription and payment for shares or other capital instruments; to the extent legally permissible through payment of dividends or other distributions of capital resources or through such other legally permissible means as may be determined to be appropriate.

Entering into the agreement did not result in any adjustments to the Group's consolidated statement of financial position at 31 December 2012. The agreement will remain in force while the Company is an Authorised Firm in Morgan Stanley's UK core group, as determined for regulatory purposes, subject to earlier termination in certain circumstances.

MORGAN STANLEY & CO. INTERNATIONAL plc
Registered number: 2068222

COMPANY BALANCE SHEET
As at 31 December 2012

	Note	2012 $millions	2011 $millions
FIXED ASSETS			
Tangible assets	3	4	8
Investments:			
- Available-for-sale financial assets	4	38	67
- Subsidiary and associated undertakings	4	87	87
		129	162
CURRENT ASSETS			
Financial assets classified as held for trading (of which $42,457 million (2011: $33,132 million) were pledged to various parties)	5	347,714	350,536
Financial assets designated at fair value through profit or loss	6	7,591	8,562
Loans and receivables:			
- Debtors	7	214,377	217,369
- Cash at bank	8	11,255	10,943
Other assets	9	384	313
		581,321	587,723
CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR			
Financial liabilities classified as held for trading	5	312,793	331,755
Financial liabilities designated at fair value through profit and loss	6	8,170	7,176
Financial liabilities at amortised cost	11	227,466	219,536
Other creditors	12	322	171
		548,751	558,638
NET CURRENT ASSETS		32,570	29,085
TOTAL ASSETS LESS CURRENT LIABILITIES		32,699	29,247
CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR			
Financial liabilities designated at fair value through profit and loss	6	3,860	2,896
Financial liabilities at amortised cost	11	15,448	13,073
PROVISIONS FOR LIABILITIES	13	82	8
NET ASSETS EXCLUDING PENSION LIABILITIES		13,309	13,270
Pension liability		4	3
NET ASSETS		13,305	13,267
CAPITAL AND RESERVES			
Called up share capital	14	9,464	9,464
Share premium account	15	513	513
Currency translation reserve	15	(58)	(77)
Available-for-sale reserve	15	5	21
Capital contribution reserve	15	3	3
Capital redemption reserve	15	1,399	1,399
Profit and loss account	15	1,979	1,944
SHAREHOLDERS' FUNDS		13,305	13,267

These financial statements were approved by the Board and authorised for issue on 22 April 2013.
Signed on behalf of the Board

Director COLIN BRYCE

The notes on pages 107 to 135 form an integral part of the financial statements.

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2012

1. ACCOUNTING POLICIES

The Company's principal accounting policies are summarised below and have been applied consistently throughout the current and preceding year.

a) Basis of preparation

The financial statements are prepared under the historical cost convention, modified by the inclusion of financial instruments at fair value as described in note 1(e) below, and in accordance with applicable United Kingdom company law and accounting standards.

The Company's ultimate UK parent undertaking, Morgan Stanley International Limited, presents information in accordance with FRS 29 *Financial instruments: Disclosures*. Accordingly, the Company is exempt from the disclosure requirements of FRS 29.

b) The going concern assumption

The Company's business activities, together with the factors likely to affect its future development, performance and position, are reflected in the Business Review section of the Directors' report on pages 2 to 10.

As set out in the Directors' report, retaining sufficient liquidity and capital to withstand market pressures remains central to the Morgan Stanley Group's and the Company's strategy.

Taking all of these factors into consideration, the Directors believe it is reasonable to assume that the Company will have access to adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and financial statements.

c) Functional currency

Items included in the financial statements are measured and presented in US dollars, the currency of the primary economic environment in which the Company operates.

All currency amounts in the financial statements and Directors' report are rounded to the nearest million US dollars.

d) Foreign currencies

All monetary assets and liabilities denominated in currencies other than US dollars are translated into US dollars at the rates ruling at the balance sheet date. Transactions in currencies other than US dollars are recorded at the rates prevailing at the dates of the transactions. Foreign exchange differences on financial assets classified as available-for-sale are recorded in the 'Available-for-sale reserve' in equity, with the exception of translation differences on the amortised cost of monetary available-for-sale assets, which are recognised through the profit and loss account. Assets and liabilities of foreign operations are translated into US dollars using the closing rate method. Translation differences arising from the net investments in the foreign operations are taken to the 'Foreign currency revaluation reserve'. All other translation differences are taken through the profit and loss account. Exchange differences recognised in the profit and loss account are presented in 'Other income' or 'Other expense', except where noted in 1(e) below.

On disposal of a foreign operation, the related cumulative gain or loss in the 'Foreign currency revaluation reserve' attributable to the equity holders of the Company is reclassified to the profit and loss account and recorded within gain or loss on disposal.

1. ACCOUNTING POLICIES (CONTINUED)

e) Financial instruments

The Company classifies its financial assets into the following categories on initial recognition: financial assets classified as held for trading; financial assets designated at fair value through profit or loss; available-for-sale financial assets; investments in subsidiary and associated undertakings and loans and receivables.

The Company classifies its financial liabilities into the following categories on initial recognition: financial liabilities classified as held for trading, financial liabilities designated at fair value through profit or loss and financial liabilities at amortised cost.

More information regarding these classifications is included below:

i) Financial instruments classified as held for trading

With the exception of loans, financial instruments classified as held for trading, including all derivatives, are initially recorded on trade date at fair value (see note 1(f) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends, are reflected in the profit and loss account in 'Net gains/(losses) on financial instruments classified as held for trading'.

For loans classified as held for trading, from the date a loan's terms are agreed (trade date), until the loan is funded (settlement date), the Company recognises any unrealised fair value changes in the loan as financial instruments classified as held for trading. On settlement date, the fair value of consideration given is recognised as a financial asset classified as held for trading. All subsequent changes in fair value, foreign exchange differences and interest are reflected in the profit and loss account in 'Net gains/ (losses) from financial instruments classified as held for trading'.

For all financial instruments classified as held for trading, transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the profit and loss account in 'Other expense'.

ii) Financial instruments designated at fair value through profit or loss

The Company has designated certain financial assets and financial liabilities at fair value through profit or loss when:

- the financial assets or financial liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation at fair value eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the financial asset or financial liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

From the date the transaction in a financial instrument designated at fair value is entered into (trade date) until settlement date, the Company recognises any unrealised fair value changes in the contract as financial instruments designated at fair value through profit or loss. On settlement date, the fair value of consideration given or received is recognised as a financial instrument designated at fair value through profit or loss (see note 1(f) below). All subsequent changes in fair value, foreign exchange differences, interest and dividends are reflected in the profit and loss account in 'Net gains/ (losses) on financial instruments designated at fair value through profit or loss'.

Transaction costs are excluded from the initial fair value measurement of the financial instrument. These costs are recognised in the profit and loss account in 'Other expense'.

1. ACCOUNTING POLICIES (CONTINUED)

e) Financial instruments (continued)

iii) Available-for-sale fixed asset investments

Financial assets classified as available-for-sale are non-derivative financial assets that are either designated in this category or not classified in any of the other categories of financial instruments. Financial assets classified as available-for-sale are recorded on trade date and are initially recognised and subsequently measured at fair value (see note 1(f) below).

Transaction costs that are directly attributable to the acquisition of the available-for-sale financial asset are added to the fair value on initial recognition.

For debt instruments, interest calculated using the effective interest method (see note 1(e)(v) below), impairment losses and reversals of impairment losses and foreign exchange differences on the amortised cost of the asset are recognised in the profit and loss account in 'Net gains/(losses) on fixed asset investments in available-for-sale financial assets'. For equity instruments, dividend income and impairment losses are recognised in the profit and loss account in 'Net gains/(losses) on fixed asset investments in available-for-sale financial assets'. All other gains and losses on debt and equity instruments classified as available-for-sale are recognised in the 'Available-for-sale reserve' within equity.

On disposal or impairment of an available-for-sale financial asset, the cumulative gain or loss in the 'Available-for-sale reserve' is reclassified to the profit and loss account and reported in 'Net gains/ (losses) on fixed asset investments in available-for-sale financial assets'.

iv) Investments in subsidiary and associated undertakings

Investments in subsidiary and associated undertakings outside the scope of FRS 26 *Financial instruments: Recognition and measurement*, are recorded within 'Investments in subsidiary and associated undertakings' and are stated at cost, less provision for any impairment. Interest (recognised on an accruals basis), dividend income (recognised when the Company's right to receive payment is established), impairment losses, reversals of impairment losses, and foreign exchange differences on monetary investments are all reported in the profit and loss account in 'Net gains/ (losses) on fixed asset investments in subsidiary and associated undertakings'.

All other investments in Morgan Stanley Group undertakings are classified as available-for-sale fixed asset investments and accounted for as described in note 1(e)(iii).

On disposal of an investment in a subsidiary, the cumulative gain or loss is reclassified to the profit and loss account and reported in 'Gain/ (loss) on disposal of subsidiary.

v) Loans and receivables and financial liabilities at amortised cost

Financial assets classified as loans and receivables are initially recognised on settlement date at fair value (see note 1(f) below) and subsequently measured at amortised cost less allowance for impairment. Interest is recognised in the profit and loss account in 'Interest income', using the effective interest rate method as described below. Transaction costs that are directly attributable to the acquisition of the financial asset are added to or deducted from the fair value on initial recognition. Impairment losses and reversals of impairment losses on financial assets classified as loans and receivables are recognised in the profit and loss account in 'Other expense'.

Financial liabilities held at amortised cost are initially recognised on settlement date at fair value (see note 1(f) below) and subsequently measured at amortised cost. Interest is recognised in the profit and loss account in 'Interest expense' using the effective interest rate method as described below. Transaction costs that are directly attributable to the issue of the financial liability are added to or deducted from the fair value on initial recognition.

1. ACCOUNTING POLICIES (CONTINUED)

e) Financial instruments (continued)

v) Loans and receivables and financial liabilities at amortised cost (continued)

The effective interest rate method is a method of calculating the amortised cost of a financial asset or financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the expected life of the financial asset or financial liability. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or financial liability (or, where appropriate a shorter period) to the carrying amount of the financial asset or financial liability. The effective interest rate is established on initial recognition of the financial asset and financial liability. The calculation of the effective interest rate includes all fees and commissions paid or received, transaction costs, and discounts or premiums that are an integral part of the effective interest rate. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.

In the course of financing its business and as part of its trading activities, the Company enters into arrangements which involve the sale of securities with agreements to repurchase, the purchase of securities with resale agreements, the lending of securities with collateral received and the borrowing of securities with collateral given. Cash collateral balances repayable and accrued interest arising under repurchase agreements and securities lending arrangements are classified as 'Financial liabilities at amortised cost' and the related securities, where owned by the Company, are included in 'Financial assets classified as held for trading'. Cash collateral balances receivable and accrued interest arising under resale agreements and securities borrowing arrangements are classified as 'Loans and receivables'. Securities received by the Company under resale arrangements and securities borrowing arrangements are generally not recognised on the balance sheet.

f) Fair value of financial instruments

Fair value measurement

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 maximises the use of relevant observable inputs and minimises 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 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 product. 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 judgement.

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.

1. ACCOUNTING POLICIES (CONTINUED)

f) Fair value of financial instruments (continued)

Valuation techniques

Fair value for many cash and over-the-counter ("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, model uncertainty and concentration risk.

Adjustments for liquidity risk adjust model-derived valuations of 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 trader 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.

Credit valuation adjustments are applied to both cash instruments and OTC derivatives. For cash instruments, the impact of changes in its own credit spreads is considered when measuring the fair value of liabilities and the impact of changes in the counterparty's credit spreads is considered when measuring the fair value of assets. For OTC derivatives, the impact of changes in both the Company's and the counterparty's credit standing is considered when measuring fair value. In determining the expected exposure the Company 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 are unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty's credit rating or CDS spread data that reference a comparable counterparty may be utilised. 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 where 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.

The Company may apply a concentration adjustment to certain of its OTC derivatives portfolios to reflect the additional cost of closing out a particularly large risk exposure. Where possible, these adjustments are based on observable market information but in many instances significant judgement is required to estimate the costs of closing out concentrated risk exposures due to the lack of liquidity in the marketplace.

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.

1. ACCOUNTING POLICIES (CONTINUED)

f) Fair value of financial instruments (continued)

Valuation process

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

The Company's control processes apply to all financial instruments, unless otherwise noted. These control processes include:

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

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

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

For financial instruments where the fair value is based on unobservable inputs, VRG reviews the business unit's valuation techniques to ensure these are consistent with market participant assumptions.

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

1. ACCOUNTING POLICIES (CONTINUED)

f) Fair value of financial instruments (continued)

Review of Transactions where the valuation is based on unobservable inputs. VRG reviews the model and valuation methodology used to price all new material Level 3 transactions and both the Financial Control Group and Market Risk Department management must approve the fair value of the trade that is initially recognised.

Gains and losses on inception

In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (i.e. the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Company recognises a gain or loss on inception of the transaction.

When unobservable market data has a significant impact on determining fair value at the inception of the transaction, the entire initial gain or loss indicated by the valuation technique as at the transaction date is not recognised immediately in the profit and loss account and is recognised instead when the market data becomes observable.

g) Derecognition of financial assets and liabilities

The Company derecognises a financial asset only when the contractual rights to the cash flows from the asset expire, or when it transfers the financial asset and substantially all the risk and rewards of ownership of the asset.

The Company derecognises financial liabilities when the Company's obligations are discharged, cancelled or they expire.

h) Impairment of financial assets

At each balance sheet date, an assessment is made as to whether there is any objective evidence of impairment in the value of financial assets classified as either available-for-sale, fixed asset investments, other fixed asset investments or loans and receivables. Impairment losses are recognised if an event has occurred which will have an adverse impact on the expected future cash flows of an asset and the expected impact can be reliably estimated.

Impairment losses on available-for-sale financial assets are measured as the difference between cost (net of any principal repayment and amortisation) and the current fair value. Where there is evidence that the available-for-sale financial asset is impaired, the cumulative loss that had been previously recognised in other comprehensive income is reclassified from the 'Available-for-sale reserve' and recognised in the profit and loss account within 'Net gains/(losses) on fixed asset investments in available-for-sale financial assets'.

Impairment losses on fixed asset investments in subsidiary and associated undertakings are measured as the difference between cost and the current estimated recoverable amount. When the recoverable amount is less than the cost, an impairment is recognised within the profit and loss account in 'Net gains/(losses) on fixed asset investments in subsidiary and associated undertakings' and is reflected against the carrying amount of the impaired asset on the balance sheet.

Impairment losses on loans and receivables carried at amortised cost are measured as the difference between the carrying amount of the financial asset and the present value of estimated cash flows discounted at the asset's original effective interest rate. Such impairment losses are recognised in the profit and loss account within 'Other expense' and are recognised against the carrying amount of the impaired asset on the balance sheet. Interest on the impaired asset continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset.

1. ACCOUNTING POLICIES (CONTINUED)

h) Impairment of financial assets (continued)

Subsequent increases in fair value of previously impaired equity available-for-sale financial assets are reported as fair value gains in the 'Available-for-sale reserve' through other comprehensive income and not separately identified as an impairment reversal. For all other financial assets, if in a subsequent year, the amount of the estimated impairment loss decreases because of an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed as detailed by financial asset in note 1(e)(iii) and (v). Any reversal is limited to the extent that the value of the asset may not exceed the original amortised cost of the asset had no impairment occurred.

i) Fees and commissions

Fees and commissions classified within 'Other income' in the profit and loss account include account servicing fees, investment management fees, sales commissions, placement fees, advisory fees and syndication fees. Fees and commissions classified within 'Other expense' include transaction and service fees. These amounts are recognised as the related services are performed or received.

j) Tangible fixed assets

Tangible fixed assets are stated at cost net of depreciation and any provision for impairment in value, which are included within 'Other expense' in the profit and loss account. For assets in the course of construction, interest that is directly attributable to the construction of the qualifying asset is capitalised as a cost of the asset. The interest capitalisation rate is based on the Morgan Stanley Group's blended funding rates.

For premises held under operating leases, a reinstatement provision is recognised for the estimated cost to reinstate the premises at the end of the lease period. When the reinstatement provision is established and included within 'Provisions for liabilities' in the balance sheet, an equivalent asset is recognised and included in the cost of leasehold improvements at the initial present value of any reinstatement obligations. The discount effect included in the reinstatement provision is reversed over time using a constant effective yield method and included within 'Interest expense' in the profit and loss account. The reinstatement asset is depreciated over the useful economic life of the relevant leasehold improvement asset and the depreciation charge is included within 'Other expense'.

Depreciation is provided on tangible fixed assets at rates calculated to write off the cost of the assets on a straight line basis over their expected useful lives as follows:

Leasehold improvements, including reinstatement assets	- shorter of remaining lease term and 25 years
Fixtures, fittings and equipment	- 3 to 8 years

k) Operating leases

Rentals payable under operating leases are charged to 'Other expense' in the profit and loss account on a straight-line basis over the lease term. Lease incentives are recognised as a reduction of rentals payable and are allocated on a straight line basis over the shorter of the lease term and a period ending on a date from which it is expected the market rent will be payable.

1. ACCOUNTING POLICIES (CONTINUED)

l) Taxation

UK corporation tax is provided at amounts expected to be paid/ recovered using the tax rates and laws that have been enacted or substantively enacted at the balance sheet date.

Full provision has been made for deferred tax assets and liabilities arising from timing differences. Deferred tax is measured using the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered. Deferred tax assets and liabilities are not discounted.

Current tax assets are offset against current tax liabilities when there is a legally enforceable right to offset current tax assets against current tax liabilities and when they relate to taxes levied by the same taxation authority and the Company intends to settle its current tax assets and current tax liabilities on a net basis. Deferred tax assets are offset against deferred tax liabilities to the extent that they relate to taxes levied by the same tax authority and arise in the same taxable entity.

m) Employee compensation plans

i) Equity-settled share-based compensation plans

Morgan Stanley operates equity based compensation plans on behalf of the Company, in relation to which, the Company pays Morgan Stanley in consideration of the procurement of the transfer of shares to employees. The cost of equity based transactions with employees is measured based on the fair value of the equity instruments at grant date. Fair value of stock unit awards is based on the market price of Morgan Stanley shares and the fair value of stock option awards is estimated using the Black-Scholes option pricing model, which takes into account the option's exercise price, its expected term, the risk free interest rate and the expected volatility of the market price of Morgan Stanley shares. Non-market vesting conditions are not taken into account when measuring fair value, but are reflected by adjusting over time the number of equity instruments included in the measurement of the transaction such that the amount ultimately recognised reflects the number that actually vest. The expense for FRS 20 *Share-based payment* ("FRS 20") purposes is recorded within 'Staff costs' in 'Other expense' in the profit and loss account; the corresponding credit to the profit and loss account is reduced to the extent that payments are due to Morgan Stanley in respect of these awards.

ii) Other deferred compensation plans

Morgan Stanley also maintains 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. Liabilities for these awards, which are included within 'Accruals and deferred income' in the balance sheet, are measured at fair value and recognised over time in accordance with the awards' vesting conditions. The related expense is recorded within 'Staff costs' in 'Other expense'. The Company economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivatives are recognised within 'Financial instruments classified as held for trading' in the balance sheet and the related gains and losses are recorded within 'Net gains/(losses) on financial instruments classified as held for trading' in the profit and loss account.

1. ACCOUNTING POLICIES (CONTINUED)

n) Retirement benefits

The Company operates a defined contribution scheme and a defined benefit pension scheme.

Contributions due in relation to the Company's defined contribution scheme are recognised in 'Other expense' in the profit and loss account when payable.

For the Company's defined benefit scheme, liabilities are measured on an actuarial basis using the projected unit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. A surplus of scheme assets over liabilities is recognised in the balance sheet as an asset where recoverable. Where scheme liabilities exceed scheme assets, the deficit is recognised in the balance sheet as a liability. The current service cost and any past service costs are charged to 'Other expense'. The expected return on scheme assets and the unwinding of the discount on the scheme liabilities are presented net and recognised within either 'Interest income' or 'Interest expense'. Actuarial gains and losses are recognised in full in the period in which they occur in the statement of total recognised gains and losses.

Details of the plans are given in note 18 to these financial statements.

o) Cash flow statement

The Company's ultimate parent undertaking produces consolidated financial statements in which the Company is included and which are publicly available. Accordingly, the Company, which is a wholly-owned subsidiary, has elected to avail itself of the exemption provided in FRS 1 (Revised 1996) *Cash flow statements* and not present a cash flow statement.

2. PROFIT FOR THE YEAR

As permitted by section 408 of the Companies Act 2006, the Company has elected not to present its own profit and loss account for the period. The Company reported a profit after tax of $39 million for the year ended 31 December 2012 (2011: $547 million).

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2012

3. TANGIBLE FIXED ASSETS

	Leasehold improvements $millions	Fixtures, fittings and equipment $millions	Total $millions
Cost			
At 1 January 2012	17	14	31
Additions	-	1	1
Disposals	-	(1)	(1)
Foreign exchange revaluation	1	(1)	-
At 31 December 2012	18	13	31
Depreciation			
At 1 January 2012	12	11	23
Charge for the year	1	1	2
Foreign exchange revaluation	2	-	2
At 31 December 2012	15	12	27
Net book value			
At 31 December 2011	5	3	8
At 31 December 2012	3	1	4

4. FIXED ASSET INVESTMENTS

Fixed asset investments classified as available-for-sale

Fixed asset investments that are categorised as available-for-sale consist of corporate equities, of which $2 million are listed investments (2011: $2 million).

Movements in fixed asset investments classified as available-for-sale during the year are as follows:

	2012 $millions	2011 $millions
At 1 January	67	44
Changes in fair value recognised in the 'available-for-sale reserve'	30	24
Disposals and other settlements	(59)	(1)
At 31 December	38	67

4. FIXED ASSET INVESTMENTS (CONTINUED)

Fixed asset investments in subsidiary undertakings

	Subsidiary undertakings $millions	Total $millions
Cost		
At 1 January 2012	1,081	1,081
At 31 December 2012	1,081	1,081
Impairment provisions		
At 1 January 2012	(994)	(994)
At 31 December 2012	(994)	(994)
Net book value		
At 31 December 2011	87	87
At 31 December 2012	87	87

Details of the significant subsidiary undertakings are provided in note 36 of the consolidated financial statements. A full list of the Company's subsidiary undertakings will be annexed to the Company's next annual return and filed with the Registrar of Companies.

5. FINANCIAL ASSETS AND FINANCIAL LIABILITIES CLASSIFIED AS HELD FOR TRADING

Financial assets and financial liabilities classified as held for trading are summarised as follows:

	2012		2011	
	Assets $millions	Liabilities $millions	Assets $millions	Liabilities $millions
Fair value				
Derivative financial instruments (listed and OTC):				
- Interest rate and currency swaps and options, credit derivatives and other fixed income securities contracts	229,713	221,148	223,327	217,043
- Foreign exchange forward contracts and options	9,668	9,420	26,405	26,670
- Equity securities contracts (including equity swaps, warrants and options)	38,399	42,324	46,125	48,800
- Commodity forwards, options and swaps	4,445	4,652	13,959	13,742
	282,225	277,544	309,816	306,255
Government debt securities	18,153	17,009	9,248	10,208
Corporate and other debt	9,851	2,092	10,833	2,723
Corporate equities	37,485	16,148	20,639	12,569
Total financial instruments classified as held for trading	347,714	312,793	350,536	331,755

There are no terms and conditions of any financial asset or liability classified as held for trading that may individually significantly affect the amount, timing and certainty of future cash flows for the Company.

6. FINANCIAL ASSETS AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

Financial assets and financial liabilities designated at fair value through profit or loss are summarised in the table below:

	2012		2011	
	Assets $millions	Liabilities $millions	Assets $millions	Liabilities $millions
Fair value				
Prepaid OTC contracts	4,310	3,174	3,264	2,676
Corporate loans	1,117	-	1,377	-
Issued structured notes	-	1,390	-	1,099
Other financial assets and liabilities	2,164	7,466	3,921	6,297
Total financial instruments designated at fair value through profit or loss	7,591	12,030	8,562	10,072

There are no terms and conditions of any financial asset or liability designated at fair value through profit or loss that may individually significantly affect the amount, timing and certainty of future cash flows for the Company.

7. DEBTORS

	2012 $millions	2011 $millions
Debtors classified within loans and receivables at amortised cost		
Trade debtors:		
- External counterparties	47,254	50,052
- Morgan Stanley Group undertakings	18,908	17,740
Securities purchased under agreements to resell and cash collateral on securities borrowed:		
- External counterparties	71,410	81,271
- Morgan Stanley Group undertakings	71,311	58,683
Other amounts due from Morgan Stanley Group undertakings	5,488	7,692
Other debtors classified within loans and receivables	6	1,931
	214,377	217,369

8. CASH AT BANK

Included within ‘Cash at bank’ is an amount of $7,480 million (2011: $8,171 million) which represents segregated client money, held in accordance with the FSA’s Client Money Rules, and an amount of $209 million (2011: $8 million) which represents other client money.

9. OTHER ASSETS

	2012 $millions	2011 $millions
Deferred tax (see note 10)	75	28
Corporation tax recoverable	159	122
Prepayments and accrued income	150	163
	384	313

10. DEFERRED TAX

Deferred tax has been fully recognised and is analysed as follows:

	2012		2011	
	Asset $millions	**Liability $millions**	**Asset $millions**	**Liability $millions**
Accelerated capital allowances	5	-	6	-
Deferred compensation	10	-	13	-
Deferred interest	45	-	-	-
Other timing differences	15	(3)	12	(3)
	75	(3)	31	(3)

The movement in the deferred tax asset and liability during the year is analysed as follows:

	2012		2011	
	Asset $millions	**Liability $millions**	**Asset $millions**	**Liability $millions**
At 1 January	31	(3)	32	(4)
Amounts recognised in the profit and loss account:				
- Current year timing differences	51	-	1	-
- Prior year timing differences	-	-	2	-
Amounts recognised in equity through the statement of total recognised gains and losses	(2)	-	(2)	-
Future tax charges on transitional accounting adjustments	-	-	-	1
Impact of change in UK Corporation tax rate	(5)	-	(2)	-
At 31 December	75	(3)	31	(3)

Finance Act 2012 enacted further reductions in the rate of UK corporation tax to 24% with effect from April 2011 and 23% with effect from April 2013. This overall rate reduction to 23% has had an impact on the Company's deferred tax balance as indicated above.

As part of the Chancellor's 2012 Budget, a reduction to 22% was announced effective from April 2014. This was then revised down to 21% (still from April 2014) in the Autumn statement in December 2012. In addition, it was announced in the 2013 Budget that the rate will fall a further 1% to 20% from April 2015. These 21% and 20% rates will be included in the Finance Bill 2013, due to be enacted in summer 2013. However, as neither rate reduction was substantively enacted as at 31 December 2012, their effect has not been applied to the valuation of the Company's deferred tax assets and liabilities.

11. FINANCIAL LIABILITIES AT AMORTISED COST

	2012 $millions	2011 $millions
Financial liabilities at amortised cost falling due within one year		
Bank loans and overdrafts	16	124
Trade creditors:		
- External counterparties	69,067	61,251
- Morgan Stanley Group undertakings	14,634	23,200
Securities sold under agreements to repurchase and cash collateral on securities loaned:		
- External counterparties	48,495	42,514
- Morgan Stanley Group undertakings	82,144	70,735
Other amounts owing to Morgan Stanley Group undertakings	13,057	17,876
Other financial liabilities	53	3,836
	227,466	219,536
Financial liabilities at amortised cost falling due after more than one year		
Financial instruments issued:		
- Subordinated loans	7,906	7,906
Securities sold under agreements to repurchase and cash collateral on securities loaned:		
- External counterparties	4,325	4,114
Other amounts owing to Morgan Stanley Group undertakings	3,217	1,053
	15,448	13,073
Total financial liabilities at amortised cost	242,914	232,609

Total financial liabilities at amortised cost of $7,906 million (2011: $7,906 million), included in the above, fall due for payment after five years from the balance sheet date.

Included within 'Other amounts owing to Morgan Stanley Group undertakings' are amounts of $3,708 million (2011: $9,205 million) representing cash collateral received as security for open trading positions held with other Morgan Stanley Group undertakings.

Subordinated loans

The amounts subject to subordinated loan agreements are wholly repayable as shown below:

Counterparty	Repayment Date	Interest Rate	2012 $millions	2011 $millions
Morgan Stanley UK Financing I LP	31 October 2025	LIBOR plus 1.25%	7,906	7,906
			7,906	7,906

All amounts outstanding under subordinated loan agreements are repayable at any time at the Company's option, subject to two business days' notice to the lender and at least one months notice to the FSA, which has the right under the agreement to refuse consent to repayment.

The Company has not defaulted on principal, interest or made any other breaches with respect to its subordinated loans during the year.

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2012

12. OTHER CREDITORS

	2012 $millions	2011 $millions
Amounts falling due within one year		
Corporation tax payable	156	12
Deferred tax (see note 10)	3	-
Accruals and deferred income	163	159
	322	171

13. PROVISIONS FOR LIABILITIES

	Property $millions	Litigation $millions	Total $millions
At 1 January 2012	3	5	8
Additional provisions	-	87	87
Provisions utilised	-	(9)	(9)
Unused provisions reversed	-	(4)	(4)
At 31 December 2012	3	79	82

Property

Property provisions represent the net present value of expected future costs of excess office space (net of sublease income) and the net present value of expected future costs of reinstating leasehold improvements at the end of the lease term. Lease reinstatement provisions are released when the reinstatement obligations have been fulfilled. The related asset for lease reinstatement provisions is included in ‘Leasehold improvements’ within ‘Tangible fixed assets’ (note 3).

Litigation matters

In the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the entities that would otherwise be the primary defendants in such cases are bankrupt or are in financial distress. These actions have included, but are not limited to, residential mortgage and credit crisis related matters. Over the last several years, the level of litigation and investigatory activity focused on residential mortgage and credit crisis related matters has increased materially in the financial services industry. As a result, the Company may become the subject of increased claims for damages and other relief regarding residential mortgages and related securities in the future and, while the Company has identified below any individual proceedings where the Company believes a material loss to be reasonably possible and reasonably estimable, there can be no assurance that material losses will not be incurred from claims that have not yet been notified to the Company or are not yet determined to be probable or possible and reasonably estimable losses.

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

13. PROVISIONS FOR LIABILITIES (CONTINUED)

Litigation matters (continued)

The Company contests liability and/or the amount of damages as appropriate in each pending matter. Where available information indicates that it is probable a liability had been incurred at the date of the financial statements and the Company can reasonably estimate the amount of that loss, the Company accrues the estimated loss by a charge to income. In many proceedings, however, it is inherently difficult to determine whether any loss is probable or even possible or to estimate the amount of any loss. In addition, even where loss is possible or an exposure to loss exists in excess of the liability already accrued with respect to a previously recognized loss contingency, it is not always possible to reasonably estimate the size of the possible loss or range of loss.

For certain legal proceedings, the Company cannot reasonably estimate such losses, particularly for proceedings that are in their early stages of development or where plaintiffs seek substantial or indeterminate damages. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, determination of issues related to class certification and the calculation of damages, and by addressing novel or unsettled legal questions relevant to the proceedings in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for any proceeding.

For certain other legal proceedings, the Company can estimate reasonably possible losses, additional losses, ranges of loss or ranges of additional loss in excess of amounts accrued, but does not believe, based on current knowledge and after consultation with counsel, that such losses will have a material adverse effect on the Company's financial statements as a whole, other than the matters referred to in the following paragraphs.

On 25 August 2008, the Morgan Stanley Group, the Company and two ratings agencies were named as defendants in a purported class action related to securities issued by a structured investment vehicle ("SIV") called Cheyne Finance plc and Cheyne Finance LLC (together, the "Cheyne SIV"). The case is styled Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al. and is pending in the United States District Court for the Southern District of New York ("SDNY"). The complaint alleges, among other things, that the ratings assigned to the securities issued by the Cheyne SIV were false and misleading, including because the ratings did not accurately reflect the risks associated with the subprime residential mortgage backed securities held by the Cheyne SIV. The plaintiffs currently assert allegations of aiding and abetting fraud and negligent misrepresentation relating to approximately $852 million of securities issued by the Cheyne SIV. The plaintiffs' motion for class certification was denied in June 2010. The court denied the Morgan Stanley Group's and the Company's motion for summary judgment on the aiding and abetting fraud claim in August 2012. On 30 November 2012, the Morgan Stanley Group and the Company filed a motion for summary judgment on the negligent misrepresentation claim. On 18 April 2013, the Morgan Stanley Group and the Company have reached an agreement in principle to settle this matter.

13. PROVISIONS FOR LIABILITIES (CONTINUED)

Litigation matters (continued)

On 15 July 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Morgan Stanley Group, which is styled China Development Industrial Bank v. Morgan Stanley & Co. Incorporated et al. and is pending in the Supreme Court of the State of New York, New York County. The complaint relates to a $275 million credit default swap referencing the super senior portion of the STACK 2006-1 CDO. The complaint asserts claims for common law fraud, fraudulent inducement and fraudulent concealment and alleges that the Morgan Stanley Group misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Morgan Stanley Group knew that the assets backing the CDO were of poor quality when it entered into the credit default swap with CDIB. The complaint seeks compensatory damages related to the approximately $228 million that CDIB alleges it has already lost under the credit default swap, rescission of CDIB's obligation to pay an additional $12 million, punitive damages, equitable relief, fees and costs. On 28 February 2011, the court presiding over this action denied the Morgan Stanley Group's motion to dismiss the complaint. On 7 July 2011, the appellate court affirmed the lower court's decision denying the motion to dismiss. Based on currently available information, the Morgan Stanley Group believes it could incur a loss of up to approximately $240 million plus pre- and post-judgment interest, fees and costs.

In addition, the Company has identified the following proceeding:

On 10 June 2010, the Morgan Stanley Group and the Company was named as a new defendant in a pre-existing purported class action related to securities issued by a SIV called Rhinebridge plc and Rhinebridge LLC (together the "Rhinebridge SIV"). The case is styled King County, Washington, et al. v. IKB Deutsche Industriebank AG, et al. and is pending in the SDNY before the same judge presiding over the litigation concerning the Cheyne SIV, described above. The complaint alleges, among other things, that the ratings assigned to the securities issued by the SIV were false and misleading, including because the ratings did not accurately reflect the risks associated with the subprime RMBS held by the SIV. The court dismissed plaintiffs' claims for breach of fiduciary duty and negligence on 4 May 2012. On 7 September 2012 the Morgan Stanley Group and the Company moved for summary judgment with respect to the remaining claims for fraud, negligent misrepresentation and aiding and abetting fraud. On 3 January 2013 the court granted the motion for summary judgment with respect to the fraud and negligent misrepresentation claims and denied it with respect to the aiding and abetting fraud claim. On 18 April 2013, the Morgan Stanley Group and the Company have reached an agreement in principle to settle this matter.

In addition to the matters disclosed above, on 2 October 2012, the United States Court of Appeals for the Second Circuit affirmed the 27 June 2011 judgment of the SDNY in Citibank, N.A. v. Morgan Stanley & Co. International plc in favour of Citibank, N.A. for $269 million plus post-judgment interest and costs. The Company has satisfied the judgment. In compliance with certain intra-group policies of the Morgan Stanley Group, all costs related to this matter were transferred to other Morgan Stanley Group undertakings.

14. CALLED UP SHARE CAPITAL

Shares classified as equity

	2012 $millions	2011 $millions
Allotted and fully paid:		
6,884,105,148 ordinary shares of $1 each	6,884	6,884
17,615,107 ordinary shares of £1 each	30	30
1,500,000,000 Class A non-voting ordinary shares of $1 each	1,500	1,500
50,000,000 Class C non-redeemable non-cumulative preferred shares of $1 each	50	50
2,500,000,000 Class D1 non-redeemable non-cumulative preferred shares of $0.40 each	1,000	1,000
	9,464	9,464

Voting rights:	
Ordinary shares of $1 and £1 each (1)	70.00%
Class A non-voting ordinary shares of $1 each	Non-voting
Class C non-redeemable non-cumulative preferred shares of $1 each	20.00%
Class D1 non-redeemable non-cumulative preferred shares of $0.40 each	10.00%
	100%

(1) Ordinary shares are pari passu with each other regardless of currency and together they carry 70% of the vote

Equity shares

All ordinary shares are recorded at the rates of exchange ruling at the date the shares were paid up.

The holders of the ordinary shares, irrespective of currency denomination, are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Company in accordance with the Company's articles of association.

On a return of capital, the holders of the Class C and Class D1 non-redeemable non-cumulative preferred shares shall rank in priority to the ordinary shares.

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 December 2012

15. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES

	Called up share capital $millions	Share premium account $millions	Currency translation reserve $millions	Capital contribution reserve $millions	Capital redemption reserve $millions	Available-for-sale reserve $millions	Profit and loss account $millions	Total $millions
At 1 January 2011	5,578	513	(66)	3	1,399	(3)	1,507	8,931
Profit for the year	-	-	-	-	-	-	547	547
Other comprehensive income:								
Foreign exchange differences arising on translation of net assets in overseas branches	-	-	(8)	-	-	-	-	(8)
Available-for-sale financial assets net change in fair value recognised directly in equity	-	-	-	-	-	24	-	24
Income tax relating to components of other comprehensive income	-	-	(3)	-	-	-	-	(3)
Total comprehensive (loss)/ income	-	-	(11)	-	-	24	547	560
Transactions with owners:								
Dividends	-	-	-	-	-	-	(110)	(110)
Ordinary shares issued	5,386	-	-	-	-	-	-	5,386
Preference shares repurchased	(1,500)	-	-	-	-	-	-	(1,500)
At 1 January 2012	9,464	513	(77)	3	1,399	21	1,944	13,267
Profit for the year	-	-	-	-	-	-	39	39
Other comprehensive income:								
Foreign exchange differences arising on translation of net assets in overseas branches	-	-	19	-	-	-	-	19
Available-for-sale financial assets net change in fair value recognised directly in equity	-	-	-	-	-	(16)	-	(16)
Income tax relating to components of other comprehensive income	-	-	-	-	-	-	(3)	(3)
Total comprehensive income/ (loss)	-	-	19	-	-	(16)	36	39
Transactions with owners:								
Dividends	-	-	-	-	-	-	(1)	(1)
At 31 December 2012	9,464	513	(58)	3	1,399	5	1,979	13,305

15. RECONCILIATION OF SHAREHOLDERS' FUNDS AND MOVEMENTS ON RESERVES (CONTINUED)

Reserves

Share premium

The ‘Share premium reserve’ comprises the capital raised in an issue of shares that exceeds the nominal value of the shares.

Currency translation reserve

The ‘Currency translation reserve’ comprises all foreign exchange differences arising from the translation of the total assets less total liabilities of foreign operations denominated in currencies other than US dollars.

Available-for-sale reserve

The ‘Available-for-sale reserve’ includes the cumulative net change in the fair value of available-for-sale financial assets held at the reporting date. The tax effect of these movements is also included in the ‘Available-for-sale reserve’.

Capital contribution reserve

The ‘Capital contribution reserve’ comprises contributions of capital from the Company’s parent company to the Company.

Capital redemption reserve

The ‘Capital redemption reserve’ represents transfers in prior years from retained earnings in accordance with relevant legislation.

16. COMMITMENTS AND CONTINGENCIES

During the next year, the Company is committed to pay $5 million (2011: $9 million) in respect of operating leases as follows:

	Land and buildings	
	2012	**2011**
	$millions	**$millions**
Annual commitments under operating leases expiring:		
- Within one year	2	1
- In two to five years	1	8
- After more than five years	2	-
	5	9

17. EMPLOYEE COMPENSATION PLANS

Equity-settled share-based compensation plans

- **Deferred restricted stock units**

Morgan Stanley has granted deferred stock awards pursuant to several equity-based compensation plans. The plans provide for the deferral of a portion of certain employees' long-term incentive compensation with awards made in the form of a right to receive unrestricted shares of common stock in the future. Awards under these plans are generally subject to vesting over time contingent upon continued employment and to restrictions on sale, transfer or assignment until the end of a specified period, generally two to three years from date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant restriction period. All or a portion of a vested award also may be cancelled in certain limited situations, including termination for cause during the relevant restriction period. Recipients of deferred stock awards may have voting rights, at the Morgan Stanley Group's discretion, and generally receive dividend equivalents.

During the year, Morgan Stanley granted 436,384 units of restricted stock units to employees of the Company with a weighted average fair value per unit of $18.19 (2011: 363,255 units, weighted average fair value $29.16), based on the market value of Morgan Stanley shares at grant date.

(e) Stock options

Morgan Stanley has also granted stock option awards in the form of stock options on Morgan Stanley's common stock. The stock options generally have an exercise price of not less than the fair value of Morgan Stanley's common stock on the date of grant and generally become exercisable over a three year period, expiring ten years from the date of grant, subject to accelerated expiration upon termination of employment. Stock option awards have vesting, restriction and cancellation provisions that are similar to those in deferred restricted stock units.

There were no options granted during the year (2011: none).

The following table shows activity relating to the Morgan Stanley Group's stock option awards for employees of the Company:

	2012		2011	
	Number of options '000s	Weighted average exercise price $	Number of options '000s	Weighted average exercise price $
Options outstanding at 1 January	102	52.60	111	52.93
Expired during the year	(41)	53.48	(9)	56.56
Options outstanding at 31 December	61	52.01	102	52.60
Options exercisable at 31 December	61	52.01	102	52.60

There were no options exercised during the year (2011: none).

17. EMPLOYEE COMPENSATION PLANS (CONTINUED)

(f) Stock options (continued)

The following table presents information relating to the stock options outstanding:

	2012			2011		
Range of exercise prices	Number of options '000s	Weighted average exercise price $	Weighted average remaining life in years	Number of options '000s	Weighted average exercise price $	Weighted average remaining life in years
$30.00 - $39.99	14	36.22	-	19	36.33	1.0
$40.00 - $49.99	23	46.73	1.1	44	47.11	1.5
$60.00 - $69.99	24	66.73	3.8	39	66.73	5.0
Total	61	52.01	1.9	102	52.60	2.7

Other deferred compensation plans

The Company has granted non-equity based deferred compensation awards to certain of its key employees. The plans provide for the deferral of a portion of the employees' discretionary compensation with awards that provide a return based upon the performance of various referenced investments. Awards under these plans are generally subject to a sole vesting condition of service over time, which normally ranges from six months to three years from the date of grant. All or a portion of an award may be cancelled if employment is terminated before the end of the relevant vesting period. The awards are settled in cash at the end of the relevant vesting period.

Awards with a value of $16 million (2011: $11 million) have been granted to employees during the year and an expense of $19 million (2011: $15 million) has been recognised within 'Staff costs' in 'Other expense' in the profit and loss account in relation to awards outstanding. The liability to employees at the end of the year, reported within 'Accruals and deferred income' in the balance sheet, is $13 million (2011: $18 million).

The Company economically hedges the exposure created by these deferred compensation schemes by entering into derivative transactions with other Morgan Stanley Group undertakings. The derivative balance at the end of the year, recognised within 'Financial assets classified as held for trading' in relation to these deferred compensation schemes is $1 million (2011:$1 million), and recognised within 'Financial liabilities classified as held for trading' is $2 million (2011:$2 million) and the related profit or loss recorded within 'Net gains/(losses) on financial instruments classified as held for trading' for the year is $nil (2011:$nil).

18. RETIREMENT BENEFITS

Defined contribution plans

The Company operates two Morgan Stanley defined contribution plans which require contributions to be made to funds held in trust, separate from the assets of the Company.

The defined contribution plans are as follows:

- Morgan Stanley Flexible Company Pension Plan (Amsterdam)
- MSII Offshore Retirement Benefit Plan IV, Dubai Section

During the year, the Athens Branch was closed along with its associated defined contribution plan, the Morgan Stanley & Co International plc (Greece Branch) Group Insurance Policy. At the time of closure, there were no outstanding contributions.

The Company pays fixed contributions to the funds, with no legal or constructive obligation to pay further contributions.

The defined contribution pension charge recognised within 'Staff costs' in 'Other expense' in the profit and loss account was $2 million for the year (2011: $1 million) of which $nil was accrued/ prepaid at 31 December 2012 (2011: $nil).

Defined benefit plans

The Company also operates the following defined benefit plans:

- Morgan Stanley & Co International plc Paris Branch IFC (Indemnites de Fin de Carriere) ("Paris Branch Plan")
- Morgan Stanley Dubai End of Service Gratuity ("Dubai Branch Plan")
- Personalvorsorgestiftung der Bank Morgan Stanley AG Plan ("Zurich Branch Plan")

During the year, the Athens Branch was closed along with its associated defined benefit plan, the Morgan Stanley & Co International plc (Athens Branch) Retirement Indemnity. As the time of closure, there no assets or outstanding obligations.

Under the Company's defined benefit plans, the amount of pension benefit that a member is entitled to receive is based on actuarial valuations. The most recent full actuarial valuations of the defined benefit plans were carried out at 31 December 2010. The liabilities of the plans are measured by discounting the best estimate of future cash flows to be paid out by the plan using the projected unit method. The projected unit method is an accrued benefits valuation method in which the plan liabilities make allowance for projected earnings. The accumulated benefit obligation is an actuarial measure of the present value of benefits for service already rendered but differs from the projected unit method in that it includes no assumption for future salary increases. At the balance sheet date the accumulated benefit obligation was $4 million (2011: $3 million).

Defined benefit scheme expense

The amounts recognised in profit or loss in respect of these defined benefit schemes are as follows:

	2012 $millions	2011 $millions
Current service cost	1	2
Past service cost	-	(1)
Total defined benefit scheme expense	1	1

18. RETIREMENT BENEFITS (CONTINUED)

Defined benefit plans (continued)

Of the charge for the year, $1 million (2011: $1 million) has been included in ‘Other expense’. Actuarial gains and losses of $1 million (2011: $nil) have been recognised in the ‘Statement of total recognised gains and losses’.

The cumulative amount of actuarial gains and losses recognised in the ‘Statement of total recognised gains and losses’ is $6 million loss (2011: $5 million loss).

Retirement benefit liability

The following table provides a reconciliation of the present value of scheme liabilities and fair value of scheme assets included in the balance sheet, as well as a summary of the funded status of the schemes:

	2012 $millions	2011 $millions
Present value of funded defined benefit obligation	(18)	(17)
Fair value of scheme assets	15	15
	(3)	(2)
Present value of unfunded defined benefit obligation	(1)	(1)
Deficit	(4)	(3)
Retirement benefit liability recognised in the balance sheet	(4)	(3)

Contributions for the year to the defined benefit plans totalled $1 million (2011: $2 million), of which $nil was accrued at 31 December 2012 (2011: $nil). The Company expects to contribute $1 million (2011: $1 million) in the next financial year, based upon the current funded status and the expected return assumptions for the next financial year.

Changes in the present value of the defined benefit scheme obligations were as follows:

	2012 $millions	2011 $millions
Defined benefit obligation at 1 January	18	13
Current service cost	1	2
Past service cost	-	(1)
Net transfer (out)/in	(3)	2
Actuarial loss/(gain)	1	(1)
Plan participants' contributions	1	1
Foreign exchange rate changes	1	2
Defined benefit obligation at 31 December	19	18

18. RETIREMENT BENEFITS (CONTINUED)

Defined benefit plans (continued)

Changes in the fair value of scheme assets were as follows:

	2012 $millions	2011 $millions
Fair value of scheme assets at 1 January	15	9
Expected return on scheme assets	1	-
Actuarial loss	-	(1)
Employer contributions	1	2
Net transfer (out)/ in	(3)	2
Plan participants' contributions	1	1
Foreign exchange rate changes	-	2
Fair value of scheme assets at 31 December	15	15
Actual return on scheme assets	1	-

The major categories of scheme assets as a percentage of total scheme assets and the expected rates of return are as follows:

	Expected return		Fair value of assets	
	2012 %	2011 %	2012 $millions	2011 $millions
Equity securities	6.1	6.7	5	4
Fixed income securities	1.1	0.9	7	7
Property	6.1	6.1	1	1
Other – primarily cash	1.3	1.3	2	3
			15	15

The expected long-term rate of return on assets represents the Company's best estimate of the long-term return on scheme assets and generally was estimated by computing a weighted average return of the underlying long-term expected returns on the different asset classes, based on the target asset allocations. For schemes where there is no established target asset allocation, actual asset allocations were used. The expected long-term return on assets is a long-term assumption that generally is expected to remain the same from one year to the next unless there is a significant change in the target asset allocation, the fees and expenses paid by the plan or market conditions.

18. RETIREMENT BENEFITS (CONTINUED)

Defined benefit plans (continued)

The following table presents the principal actuarial assumptions at the balance sheet date:

	2012	**2011**
Discount rate	1.70%-3.65%	2.50%-4.70%
Rate of increase in salaries	1.50%-4.00%	1.00%-4.00%
Inflation assumption	1.50%-2.00%	1.50%-2.00%
Expected long-term rate of return on plan assets	3.85%	-

The mortality assumptions used give the following life expectations at 65:

Mortality table		**Life expectancy at age 65 for a male member currently:**		**Life expectancy at age 65 for a female member currently:**	
		Aged 65	**Aged 45**	**Aged 65**	**Aged 45**
31 December 2012					
Zurich Branch	Swiss BVG 2010, Generational Mortality Table	86.3	88.1	88.8	90.5
31 December 2011					
Zurich Branch	Swiss BVG 2010, Static Mortality Table	84.7	84.7	87	87

The sensitivities regarding the principal assumptions used to measure the scheme liabilities are as follows:

Zurich Branch

Assumption	**Change in assumption**	**Impact on plan liabilities**
Discount rate	Increase / decrease by 0.5%	Decrease by 3.1% / increase by 4.8%
Inflation assumption	Increase / decrease by 0.5%	Increase by 1.9% / decrease by 1.0%
Rate of increase in salaries	Increase / decrease by 0.5%	Increase by 0.9% / decrease by 0.3%

18. RETIREMENT BENEFITS (CONTINUED)

Defined benefit plans (continued)

The five year history of experience adjustments is as follows:

	2012	**2011**	**2010**	**2009**	**2008**
Present value of defined benefit obligation ($millions)	19	18	13	6	4
Fair value of scheme assets ($millions)	15	5	9	2	2
Deficit	(4)	(3)	(4)	(4)	(2)
Experience adjustments on scheme liabilities:					
- Increase/ (decrease) ($'000)	15	(599)	592	(1,197)	132
- Percentage of scheme liabilities (%)	-	(3)%	4%	(19)%	3%
Experience adjustments on scheme assets					
- Increase/ (decrease) ($'000)	413	(500)	(125)	112	(134)
- Percentage of scheme assets (%)	3%	(3)%	(1)%	6%	(7)%

19. RELATED PARTY TRANSACTIONS

The Company is exempt from the requirement to disclose transactions with fellow wholly owned Morgan Stanley Group undertakings under paragraph 3(c) of FRS 8 *Related party disclosures*. There were no other related party transactions requiring disclosure.

20. POST BALANCE SHEET EVENTS

Contribution of business from Morgan Stanley & Co. Limited

On 1 January 2013, the financial advisory business conducted by another Morgan Stanley Group undertaking, Morgan Stanley & Co. Limited, was contributed to the Company. This new business is not expected to have a significant impact on the Company's results.

FSA Core Group

In accordance with the FSA's Core Group regulations, on 27 March 2013, the Company entered into a Deed of Agreement ("the agreement") whereby certain other Morgan Stanley Group undertakings, known collectively as the Contributing Entities, undertook to provide additional capital resources to the Company and certain Morgan Stanley Group undertakings registered with the FSA (collectively the 'Authorised Firms') if required in compliance with the regulatory requirements applicable to the members of a core UK group.

In the event that the capital resources of the Company were to fall below its capital requirements as determined by the FSA, the agreement gives the Company the unilateral right to demand a contribution of capital resources from the Contributing Entities, in order to meet its capital requirements.

The amount of the contribution is limited to the Contributing Entities' surplus capital, to the extent that such capital is not required to repay that company's liabilities, as defined in the agreement. The capital resources may be provided in the form of a subscription and payment for shares or other capital instruments; to the extent legally permissible through payment of dividends or other distributions of capital resources or through such other legally permissible means as may be determined to be appropriate.

Entering into the agreement did not result in any adjustments to the Company's balance sheet at 31 December 2012. The agreement will remain in force while the Company is an Authorised Firm in Morgan Stanley's UK core group, as determined for regulatory purposes, subject to earlier termination in certain circumstances.

21. PARENT UNDERTAKINGS

The ultimate parent undertaking and controlling entity and the largest group of which the Company is a member and for which group financial statements are prepared is Morgan Stanley. Morgan Stanley is incorporated in the state of Delaware, the United States of America and copies of its financial statements can be obtained from www.morganstanley.com/investorrelations.

The Company's immediate controlling party is Morgan Stanley UK Group which is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Cardiff CF14 3UZ.

The parent undertaking of the smallest group of companies for which group financial statements are drawn up and of which the Company is a member is Morgan Stanley International Limited, which is registered in England and Wales. Copies of its financial statements can be obtained from the Registrar of Companies for England and Wales, Companies House, Crown Way, Cardiff CF14 3UZ.