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**MORGAN STANLEY & CO. INTERNATIONAL plc**

**Half-yearly financial report**

**30 June 2011**

# **MORGAN STANLEY & CO. INTERNATIONAL plc**

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# **MORGAN STANLEY & CO. INTERNATIONAL plc**

## **INTERIM MANAGEMENT REPORT**

The Directors present their interim management report and the condensed consolidated financial statements of Morgan Stanley and Co. International plc (the “Company”) and all of its subsidiary and associated undertakings (together the “Group”), for the six months ended 30 June 2011. This interim report has been prepared for the Group as a whole and therefore gives greater emphasis to those matters which are significant to the Company and its subsidiary and associated undertakings when viewed as a whole.

The interim management report contains certain forward-looking statements. These statements are made by the Directors in good faith based on the information available at the time of their approval of this report and such statements should be treated with caution due to the inherent uncertainties, including both economic and business risk factors, underlying any such forward-looking information.

### **RESULTS AND DIVIDENDS**

The Group’s profit for the six months to 30 June 2011, after tax, is \$252 million (30 June 2010: \$351 million). No interim dividends were paid or declared (30 June 2010: \$nil).

### **PRINCIPAL ACTIVITY**

The principal activity of the Group is the provision of financial services to corporations, governments and financial institutions. There have not been any significant changes in the Group’s principal activities in the six months period under review and no significant change in the Group’s principal business is expected. The Company is authorised and regulated by the Financial Services Authority (“FSA”).

The Company operates branches in the Dubai International Financial Centre, France, Greece, Korea, the Netherlands, New Zealand, Poland, the Qatar Financial Centre and Switzerland.

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”).

### **BUSINESS REVIEW**

During the six months ended 30 June 2011, global market and economic conditions were negatively impacted by concerns about a sovereign debt crisis in Europe and the U.S. federal debt ceiling. Global economic conditions were also affected by the natural disaster in Japan and political unrest in the Middle East and North Africa. European equity and debt markets were affected by adverse economic developments, including investor concerns about the sovereign debt crisis, especially in Greece, Portugal, Ireland, Spain and Italy.

The challenging market conditions present uncertainty for the business outlook, which may adversely impact the financial performance of the Group in the future. The condensed consolidated income statement for the six months to 30 June 2011 is set out on page 9. The Group’s profit after tax for the six month period to 30 June 2011 decreased by \$99 million to \$252 million, a decrease of 28% compared to the six month period to 30 June 2010.

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’. Using this measure, aggregate revenues have declined by 7% to \$2,220 million in the six month period to 30 June 2011 compared to \$2,398 million for the six month period to 30 June 2010. Revenues declined primarily in Fixed Income sales and trading, offset by modest increases in revenues from Equity sales and trading, compared to the six months ended 30 June 2010. In addition, Group revenues for the six months ended 30 June 2011 exclude \$247 million of gains not recognised upon initial recognition of financial instruments where valuation techniques include unobservable market data, compared to \$58 million for the six months to 30 June 2010.

The Group’s net interest expense has decreased by 91% to \$26 million. Within this, interest income and interest expense have increased by 37% and 18% respectively. The movement was driven by increased trading activity in securities lending and repurchase agreements during the period. The Group’s non-interest expenses have remained in line with the prior period.

The Group’s effective income tax rate was 40% for the six months ended 30 June 2011 compared to 42% for the six months ended 30 June 2010.

# **MORGAN STANLEY & CO. INTERNATIONAL plc**

## **INTERIM MANAGEMENT REPORT (CONTINUED)**

The condensed consolidated statement of financial position presented on page 12 of the financial statements reflects increases in the Group's total assets and total liabilities of 11% as at 30 June 2011 when compared to 31 December 2010. Financial assets and financial liabilities held for trading have increased by \$38,685 million and \$25,473 million respectively. These movements are primarily due to increases in the Group's derivatives instruments and corporate equity instruments, driven by increased trading activity and market volatility in the period. Notable increases occurred in derivative assets and liabilities of \$25,347 million and \$26,083 million respectively, as well as corporate equities assets of \$11,721 million. Other increases in the Group's balance sheet were in trade receivables and trade payables of \$19,109 million and \$26,236 million respectively, due to increased trading activity in the period ended 30 June 2011 compared to 31 December 2010. These increases have been partially offset by reductions in securities purchased under agreements to resell of \$10,813 million and in securities sold under agreements to repurchase of \$14,288 million.

### **Special purpose entities and securitisation exposures**

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 30 June 2011 the total assets of SPEs in which the Group has an interest, but which are not consolidated by the Group, are \$232 million (31 December 2010: \$135 million) and the Group's maximum exposure to loss relating to such SPEs is \$139 million (31 December 2010: \$59 million). The increase in non-consolidated SPE assets and the related maximum exposure to loss is due to increased positions in non-consolidated trades. The Group's condensed consolidated balance sheet includes \$4,265 million of assets arising from consolidated SPEs (31 December 2010: \$4,252 million). The Group's maximum exposure to loss relating to these assets is \$1,526 million (31 December 2010: \$2,036 million). The increase in the consolidated assets is due to newly consolidated SPEs with a low maximum exposure to loss, partly offset by the unwind of a trade that had a large maximum exposure to loss relative to the asset base.

The Group has exposure to mortgage-related risk. As at 30 June 2011 the amount recognised on the Group statement of financial position in relation to residential mortgage backed securities ("RMBS") was \$694 million (31 December 2010: \$783 million). The Group continues to have exposure to commercial mortgage-backed securities ("CMBS") arising from its trading activities. As at 30 June 2011 the amount recognised on the statement of financial position in relation to CMBS is \$789 million (31 December 2010: \$812 million).

### **Exposure to European peripheral countries**

In connection with certain of its Institutional Securities business segment activities, the Group has exposure to European peripheral countries, which are defined as exposures in Greece, Ireland, Italy, Portugal and Spain. At 30 June 2011, gross funded exposure before the benefit of hedges was approximately \$4,200 million and net funded exposure after hedges was approximately \$2,900 million. The majority of this gross funded exposure and net funded exposure is concentrated in Spain and Italy. Gross funded exposure includes obligations from sovereign governments, corporations, and financial institutions and the net funded exposure includes the impact of hedges held by the Group, including credit default swap contracts. Net funded exposure excludes hedges held by members of the Morgan Stanley Group outside the Group. Gross and net funded exposures arise on financial instruments classified as held for trading which are recognised at fair value in the Group's consolidated statement of financial position, with changes in fair value recognised in the consolidated income statement. In addition to the gross funded exposure, at 30 June 2011, the Group had European peripheral country exposure for overnight deposits with banks of approximately \$1,700 million which are recognised at amortised cost in the Group's consolidated statement of financial position. Substantially all of these deposits are held with Spanish banks. The Group also has unfunded loans to Italian and Spanish corporations of approximately \$300 million.

### **US Sovereign credit downgrade**

On 5 August 2011, Standard & Poor's lowered its long term sovereign credit rating on the United States of America from AAA to AA+. While U.S. lawmakers reached agreement to raise the federal debt ceiling on 2 August 2011, the downgrade reflected Standard & Poor's view that the fiscal consolidation plan within that agreement fell short of what would be necessary to stabilize the U.S. government's medium term debt dynamics. Subsequently, Fitch and Moody's reaffirmed the AAA rating, although Moody's has cut its outlook to negative. The Standard & Poor's downgrade could have material adverse impacts on financial markets and economic conditions in the United States and throughout the world.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT (CONTINUED)

### US Sovereign credit downgrade (continued)

Because of the unprecedented nature of negative credit rating actions with respect to U.S. government obligations, the ultimate impacts on global markets and our business, financial condition and liquidity are unpredictable and may not be immediately apparent.

### Bank levy

In July 2011, the UK Government enacted legislation imposing a bank levy on relevant liabilities and equities on the consolidated balance sheets of "UK Banking Groups," as defined under the bank levy legislation at 31 December 2011. The Group continues to evaluate the impact of this legislation, and estimates the UK Banking Group will incur a full year charge of \$125 million, of which the Group will incur \$120 million. Due to the bank levy being determined on relevant liabilities and equities at 31 December 2011, the final charge may differ from this estimate. The levy is not deductible for UK Corporation Tax purposes.

### 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. 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. The Group's own risk management policies and procedures are consistent with those of the Morgan Stanley Group.

#### *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 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 Morgan Stanley Group, including reporting of material risks identified to appropriate key management personnel of the Group. Sound market risk management is an integral part of the Group's culture. The various business units and trading desks are responsible for ensuring that market risk exposures are well-managed and prudent. The market risk department is responsible 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 its market risk against limits on aggregate risk exposures, performs a variety of risk analyses and maintains the Value at Risk ("VaR") system. A variety of limits are designed to control price and liquidity risk. Market risk is monitored through various measures: statistically (using 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.

Morgan Stanley utilises Stress VaR ("S-VaR"), which is a proprietary methodology that seeks to measure both the Group's market and credit risks, while adjusting for the different liquidity characteristics of the underlying risks (in contrast to traditional VaR measures which are typically calculated using the same horizon for all risks). It is an important metric used in establishing the Group's risk tolerance 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 which are particularly relevant for credit portfolios.

#### *Credit risk*

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

The Morgan Stanley Group manages credit risk exposure on a global basis as well as giving consideration to each individual legal entity. 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.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT (CONTINUED)

### **Risk management (continued)**

#### *Liquidity and funding risk*

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 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 and 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 Group's and the Morgan Stanley Group's business strategies while ensuring ongoing and sufficient liquidity through the business cycle and during periods of stressed market conditions.

In managing both the Group's and the Morgan Stanley Group's liquidity and funding risk the composition and size of the entire balance sheet, not just financial liabilities, is monitored and evaluated. A substantial portion of the Group and Morgan Stanley Group's total assets consist of liquid marketable securities and short-term receivables arising from its sales and trading activities. The liquid nature of these assets provides the Group and the Morgan Stanley Group with flexibility in financing and managing its business.

This liquidity and funding risk management framework continues to provide sufficient liquidity to the Morgan Stanley Group and to the Group, and as a result, the Group's capital and liquidity position is satisfactory.

#### *Operational risk*

Operational risk refers to the risk of financial or other loss, or damage to the Group's or the Morgan Stanley Group's reputation, resulting from inadequate or failed internal processes, people, resources, systems or from other internal or external events (e.g. internal or external fraud, legal and compliance risks, damage to physical assets, etc.). Legal and compliance risk is included in the scope of operational risk and is discussed below under "Legal and regulatory 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 its employees, its internal systems, and systems at technology centres operated by 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 action by third parties or employees, the Group could suffer financial loss, an impairment to its liquidity, a disruption of its businesses, regulatory sanctions or damage to its reputation.

The Group's operations rely on the secure processing, storage and transmission of confidential and other information in its computer systems and may be vulnerable to unauthorized access, mishandling or misuse, computer viruses and other events that could have a security impact on such systems. If one or more of such events occur, this potentially could jeopardize 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 which 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.

Despite the business contingency plans the Group has in place, the Group's ability to conduct its business may also be adversely affected by a disruption in the infrastructure that supports its business and the communities in which it is located. This may include a disruption involving physical site access, terrorist activities, disease pandemics, catastrophic events, electrical, environmental, communications or other services used by the Group, its employees or third parties with whom the Group conducts business.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## INTERIM MANAGEMENT REPORT (CONTINUED)

### **Risk management (continued)**

#### *Operational risk (continued)*

The business continuity management function is responsible for identifying key risks and threats to the Morgan Stanley Group's resiliency and planning to ensure a recovery strategy and required resources are in place for the resumption of critical business functions following a disaster or other business interruption. Disaster recovery plans are in place for critical facilities and resources on a global basis. The key components of the disaster recovery plans include: crisis management; business recovery plans; applications / data recovery; work area recovery; and other elements addressing management, analysis, training and testing.

#### *Legal and regulatory risk*

Legal and regulatory risk includes the risk of exposure to fines, penalties, judgements, damages and / or settlements in conjunction with regulatory or legal actions as a result of non-compliance with applicable legal or regulatory requirements or litigation. Legal risk also includes contractual risk such as the risk that a counterparty's performance obligations will be unenforceable. 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 conduct, ethics and business practices be 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, potential conflicts of interest, structured transactions, use and safekeeping of customer funds and securities, credit granting, 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 UK, the rest of 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, an increase in the number of jurisdictions taxing 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.

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.

# **MORGAN STANLEY & CO. INTERNATIONAL plc**

## **INTERIM MANAGEMENT REPORT (CONTINUED)**

### **Going concern**

The economic conditions for the first half of the year were challenging and present difficulties and uncertainty for the business outlook which may adversely impact the financial performance of the Group in the future. The Group's senior management views capital as an important source of financial strength. 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.

In line with this active management, during June 2011, Morgan Stanley strengthened its capital position by converting its outstanding Series B Non-Cumulative Non-Voting Perpetual Convertible Preferred Stock with a face value of \$7.8 billion and a 10% dividend issued to Mitsubishi UFJ Financial Group Inc ("MUFG"), for 385,464,097 shares in Morgan Stanley's common stock.

As set out above, the Group operates within the global liquidity management framework of the Morgan Stanley Group. This framework is expected to continue to provide sufficient liquidity to the Morgan Stanley Group and to the Group, and the Group's capital and liquidity position is satisfactory.

Taking all of the above factors into consideration, the Directors have no reason to believe that the Group will not 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 half-yearly report and condensed financial statements.

Approved by the Board and signed on its behalf by

Director

25 August 2011



# **MORGAN STANLEY & CO. INTERNATIONAL plc**

## **DIRECTORS' RESPONSIBILITY STATEMENT**

The Directors, the names of whom are set out below, confirm that to the best of their knowledge:

- (a) the condensed set of financial statements has been prepared in accordance with International Accounting Standard ("IAS") 34 '*Interim Financial Reporting*' as adopted by the European Union ("EU"), give a true and fair view of the assets, liabilities, financial position and result of the Group; and
- (b) the interim management report includes a fair review of the information required by DTR4.2.7R of the Disclosure and Transparency Rules, being an indication of the important events that have occurred during the period and their impact on the condensed set of financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year.

By order of the Board on 25 August 2011

Director

Board of Directors:

P Bailas  
C Bryce  
L Francois  
C Kelleher  
F Petitgas  
R Rooney  
D Russell  
C Woodman

# **INDEPENDENT REVIEW REPORT TO MORGAN STANLEY & CO. INTERNATIONAL plc**

We have been engaged by the Company to review the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2011 which comprises the condensed consolidated income statement, the condensed consolidated statement of comprehensive income, the condensed consolidated statement of changes in equity, the condensed consolidated statement of financial position, the condensed consolidated statement of cash flows, and related notes 1 to 10. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

This report is made solely to the Company in accordance with International Standard on Review Engagements (UK and Ireland) 2410, "*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*" issued by the Auditing Practices Board. Our work has been undertaken so that we might state to the Company those matters we are required to state to them in an independent review 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 Company, for our review work, for this report, or for the conclusions we have formed.

## **Directors' responsibilities**

The half-yearly financial report is the responsibility of, and has been approved by, the Directors. The Directors are responsible for preparing the half-yearly financial report in accordance with the Disclosure and Transparency Rules of the United Kingdom's Financial Services Authority.

As disclosed in note 1, the annual financial statements of the Group are prepared in accordance with IFRSs as adopted by the European Union. The condensed set of financial statements included in this half-yearly financial report has been prepared in accordance with International Accounting Standard 34 "*Interim Financial Reporting*", as adopted by the European Union.

## **Our responsibility**

Our responsibility is to express to the Company a conclusion on the condensed set of financial statements in the half-yearly financial report based on our review.

## **Scope of review**

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, "*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*" issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical procedures and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

## **Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2011 is not prepared, in all material aspects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Services Authority.

Deloitte LLP  
Chartered Accountants and Statutory Auditor  
London  
25 August 2011

**MORGAN STANLEY & CO. INTERNATIONAL plc****CONDENSED CONSOLIDATED INCOME STATEMENT**  
**Six months ended 30 June 2011**

	Note	Six months ended 30 June 2011 \$millions (unaudited)	Six months ended 30 June 2010 \$millions (unaudited)
Net gains on financial instruments classified as held for trading		2,061	2,442
Net gains on financial instruments designated at fair value through profit or loss		41	106
Net gains on available-for-sale financial assets		-	57
Interest income		2,314	1,685
Interest expense		(2,340)	(1,985)
Other income		144	93
Other expense		(1,797)	(1,793)
<b>PROFIT BEFORE TAX</b>		<u>423</u>	<u>605</u>
Income tax expense	2	(171)	(254)
<b>PROFIT FOR THE PERIOD</b>		<u><u>252</u></u>	<u><u>351</u></u>
Attributable to:			
Equity holders of the Company		251	350
Non-controlling interests		1	1
<b>PROFIT FOR THE PERIOD</b>		<u><u>252</u></u>	<u><u>351</u></u>

All operations were continuing in the current and prior period.

The notes on pages 14 to 44 form an integral part of the financial statements.

**MORGAN STANLEY & CO. INTERNATIONAL plc****CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**  
**Six months ended 30 June 2011**

	Note	Six months ended 30 June 2011 \$millions (unaudited)	Six months ended 30 June 2010 \$millions (unaudited)
<b>PROFIT FOR THE PERIOD</b>		<u>252</u>	<u>351</u>
<b>OTHER COMPREHENSIVE INCOME</b>			
Currency translation reserve:			
Foreign currency translation differences arising on foreign operations during the period		70	(9)
Fair value reserve:			
<i>Available-for-sale financial assets:</i>			
Net change in fair value recognised directly in equity		7	(1)
Income tax relating to components of other comprehensive income		(9)	-
<b>OTHER COMPREHENSIVE INCOME AFTER INCOME TAX</b>		<u>68</u>	<u>(10)</u>
<b>TOTAL COMPREHENSIVE INCOME</b>		<u><u>320</u></u>	<u><u>341</u></u>
Attributable to:			
Equity holders of the Company		313	351
Non-controlling interests		7	(10)
<b>TOTAL COMPREHENSIVE INCOME</b>		<u><u>320</u></u>	<u><u>341</u></u>

The notes on pages 14 to 44 form an integral part of the condensed financial statements.

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY**  
**Six months ended 30 June 2011**

<b>2010</b>	<b>Share capital</b>	<b>Share premium</b>	<b>Currency translation reserve</b>	<b>Capital redemption reserve</b>	<b>Capital contribution reserve</b>	<b>Fair value reserve</b>	<b>Retained earnings</b>	<b>Equity attributable to equity holders of the Company</b>	<b>Non-controlling interest</b>	<b>Total equity</b>
	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>	<b>\$millions</b>
Balance at 1 January 2010	3,078	513	(62)	1,399	3	(3)	1,815	6,743	74	6,817
Profit for the period	-	-	-	-	-	-	350	350	1	351
Other comprehensive income:										
Foreign currency translation differences on foreign operations	-	-	2	-	-	-	-	2	(11)	(9)
Net change in fair value of available-for-sale assets recognised directly in equity	-	-	-	-	-	(1)	-	(1)	-	(1)
Total comprehensive income	-	-	2	-	-	(1)	350	351	(10)	341
Balance at 30 June 2010	3,078	513	(60)	1,399	3	(4)	2,165	7,094	64	7,158
<b>2011</b>										
Balance at 1 January 2011	5,578	513	(149)	1,399	3	(2)	1,716	9,058	73	9,131
Profit for the period	-	-	-	-	-	-	251	251	1	252
Other comprehensive income:										
Foreign currency translation differences on foreign operations	-	-	64	-	-	-	-	64	6	70
Net change in fair value of available-for-sale assets recognised directly in equity	-	-	(7)	-	-	5	-	(2)	-	(2)
Total comprehensive income	-	-	57	-	-	5	251	313	7	320
Balance at 30 June 2011	5,578	513	(92)	1,399	3	3	1,967	9,371	80	9,451

The notes on pages 14 to 44 form an integral part of the condensed financial statements.

**CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION**  
**As at 30 JUNE 2011**

	Note	30 June 2011 \$millions (unaudited)	31 December 2010 \$millions
<b>ASSETS</b>			
Loans and receivables:			
Cash at bank		15,302	10,436
Securities borrowed		33,899	27,852
Reverse repurchase agreements		101,370	112,183
Trade receivables		83,136	64,027
Other receivables		8,091	13,567
		241,798	228,065
Financial assets classified as held for trading (of which approximately \$71,819 million (2010: \$51,974 million) were pledged to various parties)	4	309,679	270,994
Financial assets designated at fair value through profit or loss		10,760	9,359
Available-for-sale financial assets		51	44
Current tax		410	377
Deferred tax assets		46	48
Prepayments and accrued income		42	29
Property, plant and equipment		10	12
Joint venture		7	7
<b>TOTAL ASSETS</b>		562,803	508,935
<b>LIABILITIES AND EQUITY</b>			
Financial liabilities at amortised cost:			
Bank loans and overdrafts		298	60
Securities loaned		71,099	53,059
Repurchase agreements		88,240	102,528
Trade payables		101,875	75,639
Other payables		21,955	24,557
Subordinated loans		7,906	7,906
Preference shares		786	786
		292,159	264,535
Financial liabilities classified as held for trading	4	246,266	220,793
Financial liabilities designated at fair value through profit or loss		14,255	13,713
Provisions		20	29
Current tax		403	434
Deferred tax liabilities		5	5
Accruals and deferred income		240	291
Retirement benefit obligations		4	4
<b>TOTAL LIABILITIES</b>		553,352	499,804
<b>EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE COMPANY</b>			
Share capital		5,578	5,578
Share premium account		513	513
Other reserves		1,313	1,251
Retained earnings		1,967	1,716
		9,371	9,058
Non-controlling interest		80	73
<b>TOTAL EQUITY</b>		9,451	9,131
<b>TOTAL LIABILITIES AND EQUITY</b>		562,803	508,935

The notes on pages 14 to 44 form an integral part of the condensed financial statements.

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**

**As at 30 June 2011**

	Note	Six months ended 30 June 2011 \$millions (unaudited)	Six months ended 30 June 2010 \$millions (unaudited)
<b>NET CASH FLOWS FROM OPERATING ACTIVITIES</b>	3(b)	4,383	1,175
<b>INVESTING ACTIVITIES</b>			
Purchase of property, plant and equipment		-	1
Purchase of available-for-sale financial assets		-	(2)
Proceeds from sale of available-for-sale financial assets		-	2
<b>NET CASH FLOWS FROM INVESTING ACTIVITIES</b>		<u>-</u>	<u>1</u>
<b>FINANCING ACTIVITIES</b>			
Interest paid on subordinated loans		(61)	(69)
<b>NET CASH FLOWS FROM FINANCING ACTIVITIES</b>		<u>(61)</u>	<u>(69)</u>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>		4,322	1,107
Currency translation differences on foreign currency cash balances		306	(598)
<b>CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD</b>		10,376	13,454
<b>CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD</b>	3(a)	<u>15,004</u>	<u>13,963</u>

The notes on pages 14 to 44 form an integral part of the condensed financial statements.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**1. BASIS OF PREPARATION**

**a. General information**

The information in this interim report does not constitute statutory accounts within the meaning of Section 434 of the Companies Act 2006.

The information for the year ended 31 December 2010 does not constitute statutory accounts as defined in section 434 of the Companies Act 2006. A copy of the statutory accounts for that year has been delivered to the Registrar of Companies. The auditors' report on those accounts, which was unqualified, did not draw attention to any matters by way of emphasis and did not contain statements under section 237(2) or (3) of the Companies Act 2006.

**b. Accounting policies**

The Group prepares its annual financial statements in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU"). The condensed financial statements have been prepared in accordance with the Disclosure and Transparency Rules of the Financial Services Authority and in accordance with International Accounting Standard ("IAS") 34 'Interim Financial Reporting', as adopted by the EU.

In preparing these condensed financial statements the Group has applied consistently the accounting policies and methods of computation used in the Group's financial statements for the year ended 31 December 2010.

**New standards and interpretations adopted during the period**

The following standards and interpretations relevant to the Group's operations were adopted during the period. Except where otherwise stated, the standards and interpretations did not have a material impact on the Group's financial statements.

IAS 24 'Related party disclosures' was revised by the IASB in November 2009 for retrospective application in annual periods beginning on or after 1 January 2011. The revised standard was endorsed by the EU in July 2010.

An amendment to IAS 32 '*Financial instruments: presentation – classification of rights issues*' was issued by the IASB in October 2009 for retrospective application in annual periods beginning on or after 1 February 2010. The amendment was endorsed by the EU in December 2009.

As part of the May 2010 *Improvements to IFRSs*, the IASB made amendments to the following standards that are relevant to the Group's operations: IFRS 3 '*Business combinations*' and IAS 27 '*Consolidated and separate financial statements*' (for application in accounting periods beginning on or after 1 July 2010). The improvements were endorsed by the EU in February 2011.

An amendment to IFRIC 14 '*Prepayments of a minimum funding requirement*' was issued by the IASB in November 2009 for retrospective application in annual periods beginning on or after 1 January 2011. The amendment was endorsed by the EU in July 2010.

IFRIC 19 '*Extinguishing financial liabilities with equity instruments*' was issued by the IASB in November 2009 for retrospective application in annual periods beginning on or after 1 July 2010 and was endorsed by the EU in July 2010.



**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**1. BASIS OF PREPARATION (CONTINUED)**

**New standards and interpretations not yet adopted**

At the date of authorisation of these 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 financial statements.

An amendment to IAS 12 '*Income taxes*' was issued by the IASB in December 2010 for retrospective application in annual periods beginning on or after 1 January 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.

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 accounting periods beginning on or after 1 January 2013.

As part of the May 2010 Improvements to IFRSs, the IASB made amendments to IFRS 7 '*Financial instruments: Disclosures*' (for application in accounting periods beginning on or after 1 January 2011) and in October 2010 an amendment to IFRS 7 was issued by the IASB for prospective application in annual periods beginning on or after 1 July 2011.

IFRS 9 '*Financial instruments*' was issued by the IASB in November 2009 for retrospective application in annual periods beginning on or after 1 January 2013. 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 expected impact on the Group financial statements of adopting these new standards is currently being assessed.

IFRS 13 '*Fair value measurement*' was issued by the IASB in May 2011 for retrospective application in annual periods beginning on or after 1 January 2013. The expected impact of adopting this standard on the Group financial statements is currently being assessed.

**Use of estimates and sources of uncertainty**

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

**2. TAX EXPENSE**

The Group's tax expense for the period has been accrued based on the expected tax rate of 40% for the period to 30 June 2011 (30 June 2010: 42%). This takes into account current expectations concerning allocation of group relief within the Morgan Stanley UK tax group and prevailing tax rates in the jurisdictions in which the Group operates.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
Six months ended 30 June 2011

3. ADDITIONAL CASH FLOW INFORMATION

a. Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise the following balances which have less than three months maturity.

	<b>30 June 2011 \$millions</b>	<b>30 June 2010 \$millions</b>
Cash at bank	15,302	14,166
Bank loans and overdrafts	(298)	(203)
	<u>15,004</u>	<u>13,963</u>

Included within 'Cash at bank' is \$9,167 million (30 June 2010: \$7,864 million) of segregated client funds that are not available for use by the Group. The corresponding payable is recognised and included in 'financial liabilities at amortised cost'.

b. Reconciliation of cash flows from operating activities

	<b>Six months ended 30 June 2011 \$millions</b>	<b>Six months ended 30 June 2010 \$millions</b>
Profit for the period	252	351
Adjustments for:		
Depreciation on property, plant and equipment	1	2
Net gains on available-for-sale investments	-	(57)
Interest income	(2,314)	(1,685)
Interest expense	2,340	1,985
Income tax expense	171	254
Profit before changes in operating assets and liabilities	<u>450</u>	<u>850</u>
Change in operating assets		
Net increase in loans and receivables	(8,690)	(38,194)
Net increase in financial assets classified as held for trading	(38,685)	(16,569)
Net increase in financial assets designated at fair value through profit or loss	(1,401)	(682)
	<u>(48,776)</u>	<u>(55,445)</u>
Change in operating liabilities		
Net increase in financial liabilities at amortised cost	26,981	32,898
Net increase in financial liabilities classified as held for trading	25,473	21,290
Net increase in financial liabilities designated at fair value through profit or loss	543	1,527
Net decrease in provisions	(9)	(1)
	<u>52,988</u>	<u>55,714</u>
Effect of foreign exchange movements	(245)	587
<b>Cash from operating activities</b>	<u>4,417</u>	<u>1,706</u>
Interest received	2,124	1,178
Interest paid	(1,924)	(1,675)
Income taxes paid	(234)	(34)
<b>Net cash flows from operating activities</b>	<u>4,383</u>	<u>1,175</u>

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2011

### 4. FINANCIAL ASSETS AND FINANCIAL LIABILITIES CLASSIFIED AS HELD FOR TRADING

Financial assets and financial liabilities categorised as held for trading are summarised in the table below.

	30 June 2011	30 June 2011	31 December	31 December
	Assets	Liabilities	2010	2010
	\$millions	\$millions	Assets	Liabilities
			\$millions	\$millions
<b>Fair value</b>				
Government debt securities	16,433	16,843	16,371	15,105
Corporate equities	57,909	11,995	46,188	14,029
Corporate and other debt	23,651	4,407	22,096	4,721
Derivatives	211,686	213,021	186,339	186,938
	<u>309,679</u>	<u>246,266</u>	<u>270,994</u>	<u>220,793</u>

### 5. 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 one reportable business segment, Institutional Securities, which provides financial services to corporations, governments and financial institutions including sales, trading, financing and market-making activities in equity and fixed income securities and related products, including foreign exchange. Morgan Stanley Global Wealth Management and Asset Management businesses are presented within 'Other' in the tables below.

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

Condensed consolidated income statement information Six months ended 30 June 2011	Institutional Securities \$millions	Other \$millions	Total \$millions
Net gains on financial instruments classified as held for trading	2,049	12	2,061
Net gains on financial instruments designated at fair value through profit or loss	41	-	41
Net gains on available-for-sale financial assets	-	-	-
Net interest	(28)	2	(26)
Other income	140	4	144
<b>External revenues net of interest expense</b>	<u>2,202</u>	<u>18</u>	<u>2,220</u>
Other expense	(1,753)	(44)	(1,797)
<b>Profit / (loss) before tax</b>	<u>449</u>	<u>(26)</u>	<u>423</u>
Income tax (expense) / credit	(181)	10	(171)
<b>Profit / (loss) for the period</b>	<u>268</u>	<u>(16)</u>	<u>252</u>

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**5. SEGMENT REPORTING (CONTINUED)**

**Business segments (continued)**

<b>Condensed consolidated statement of financial position information</b> <b>As at 30 June 2011</b>	<b>Institutional Securities</b> <b>\$millions</b>	<b>Other</b> <b>\$millions</b>	<b>Total</b> <b>\$millions</b>
Segment assets	558,332	4,464	562,796
Associate	7	-	7
<b>Total assets</b>	<b>558,339</b>	<b>4,464</b>	<b>562,803</b>
Segment liabilities	548,897	4,455	553,352
<b>Total Liabilities</b>	<b>548,897</b>	<b>4,455</b>	<b>553,352</b>
<b>Other segment information</b>			
Property, plant and equipment capital expenditure	-	-	-
Depreciation on property, plant and equipment	1	-	1

<b>Condensed consolidated income statement information</b> <b>Six months ended 30 June 2010</b>	<b>Institutional Securities</b> <b>\$millions</b>	<b>Other</b> <b>\$millions</b>	<b>Total</b> <b>\$millions</b>
Net gains on financial instruments classified as held for trading	2,443	(1)	2,442
Net gains on financial instruments designated at fair value through profit or loss	106	-	106
Net gains on available-for-sale financial assets	57	-	57
Net interest	(310)	10	(300)
Other income	100	(7)	93
<b>External revenues net of interest expense</b>	<b>2,396</b>	<b>2</b>	<b>2,398</b>
Other expense	(1,751)	(42)	(1,793)
<b>Profit / (loss) before tax</b>	<b>645</b>	<b>(40)</b>	<b>605</b>
Income tax (expense) / credit	(271)	17	(254)
<b>Profit / (loss) for the period</b>	<b>374</b>	<b>(23)</b>	<b>351</b>

**Condensed consolidated statement of financial position information**  
**As at 31 December 2010**

Segment assets	503,600	5,328	508,928
Joint venture	7	-	7
<b>Total assets</b>	<b>503,607</b>	<b>5,328</b>	<b>508,935</b>
Segment liabilities	496,503	3,301	499,804
<b>Total Liabilities</b>	<b>496,503</b>	<b>3,301</b>	<b>499,804</b>
<b>Other Segment Information</b>			
Property, plant and equipment capital expenditure	-	-	-
Depreciation on property, plant and equipment	2	-	2

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**5. 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.

Geographical segments	EMEA		Americas		Asia		Total	
	30 June 2011 \$millions	30 June 2010 \$millions	30 June 2011 \$millions	30 June 2010 \$millions	30 June 2011 \$millions	30 June 2010 \$millions	30 June 2011 \$millions	30 June 2010 \$millions
External revenues net of interest	2,153	2,352	60	48	7	(2)	2,220	2,398
Profit / (loss) before income tax	371	646	46	25	6	(66)	423	605
	30 June 2011 \$millions	31 Dec 2010 \$millions	30 June 2011 \$millions	31 Dec 2010 \$millions	30 June 2011 \$millions	31 Dec 2010 \$millions	30 June 2011 \$millions	31 Dec 2010 \$millions
Total assets	478,010	401,829	33,234	58,653	51,559	48,453	562,803	508,935

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**6. FINANCIAL 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. 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.

As disclosed in the interim management report, the Group has exposure to European peripheral countries, which are defined as Portugal, Ireland, Italy, Greece and Spain. The Group's exposure is included within either the credit risk or the market risk disclosures below consistent with how the financial instrument is managed.

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 from a borrower or counterparty default.

The Morgan Stanley Group manages credit risk exposure on a global basis, but in consideration of each individual legal entity, including those of the Group. The credit risk management policies and procedures of the Morgan Stanley Group include ensuring transparency of material credit risks, ensuring compliance with established limits, approving material extensions of credit 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 is exposed primarily to significant single-name credit risk, requiring credit analysis of specific counterparties, both initially and on an ongoing basis. Credit risk management takes place at the transaction, counterparty and portfolio levels. In order to help protect the Group from losses resulting from its business activities, the Group analyses all material lending and derivative transactions and ensures that the creditworthiness of the Group's counterparties and borrowers is reviewed regularly and that credit exposure is actively monitored and managed. The Group assigns obligor credit ratings to its counterparties and borrowers which are intended to assess a counterparty's probability of default and are derived using methodologies generally consistent with those used by external rating agencies. For lending transactions, the Group evaluates the relative position of its particular exposure in the borrower's capital structure and relative recovery prospects. Where applicable, the Group also considers collateral arrangements and other structural elements of the particular transaction. The Group has credit guidelines that limit 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 30 June 2011, credit exposure was concentrated in North America and Western European countries including certain European peripheral countries. In addition, the Group pays particular attention to smaller exposures in emerging markets given their higher 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 30 June 2011, the Group's material credit exposure was to corporate entities (including financial institutions) and sovereign-related entities.

*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 provided as collateral generally are not recognised in the consolidated statement of financial position.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**6. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Credit risk (continued)**

*Reverse repurchase agreements and securities borrowed*

The Group manages credit exposure arising from reverse repurchase agreements 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 reverse repurchase agreements and securities borrowed transactions, the Group receives collateral, including U.S. 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 compared to 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. At the transaction level, the Group seeks to mitigate risk through management of key risk elements such as size and maturity. The Group actively hedges its credit exposure arising from derivatives through various financial instruments which may include single name, portfolio and structured credit derivatives. Additionally, 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 offset a counterparty's rights and obligations, to request additional collateral when necessary and to liquidate the collateral 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 of the Group as at 30 June 2011 is disclosed below, based on the carrying amount of the financial assets the Group believes is subject to credit risk, without taking account of any collateral held or any other credit enhancement. 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. The "unrated" balance represents the pool of counterparties that individually generate no material credit exposure. This pool is highly diversified, monitored and subject to limits.

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 VaR-based risk measures included in the market risk disclosure.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
Six months ended 30 June 2011

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Credit risk (continued)

Exposure to credit risk by class

Class	Gross credit exposure	Gross credit exposure
	30 June 2011	31 December 2010
	\$millions	\$millions
Loans and receivables:		
Cash at bank	15,302	10,436
Securities borrowed	33,899	27,852
Reverse repurchase agreements	101,370	112,183
Trade receivables	36,504	39,632
Other receivables	7,907	13,437
Financial assets classified as held for trading:		
OTC Derivatives	196,732	171,386
Financial assets designated at fair value through profit or loss	10,760	9,359
	<u>402,474</u>	<u>384,285</u>
<b>Unrecognised financial instruments</b>		
Contingent commitments	3,227	1,194
Financial guarantees	1	-
Underwriting commitments	76	128
Loan commitments	771	682
Unsettled reverse repurchase agreements	49,939	29,784
	<u>456,488</u>	<u>416,073</u>

Maximum exposure to credit risk by credit rating<sup>(1)</sup>

Credit rating	Gross credit exposure	Gross credit exposure
	30 June 2011	31 December 2010
	\$millions	\$millions
AAA	16,751	34,944
AA	112,514	99,461
A	265,914	230,416
BBB	26,377	22,707
BB	7,766	7,402
B	13,258	5,932
CCC	6,333	7,984
Unrated	7,575	7,227
Total	<u>456,488</u>	<u>416,073</u>

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



**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**6. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Credit risk (continued)**

At 30 June 2011 there were no financial assets past due but not impaired (31 December 2010: None). At 30 June 2011 there were no financial assets individually impaired (31 December 2010: None).

**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 those of 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 Group's and the Morgan Stanley 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 principal elements of the Morgan Stanley Group's and the Group's liquidity management framework, are the Contingency Funding Plan ("CFP") and liquidity reserves. Comprehensive financing guidelines (secured funding, long-term funding strategy, surplus capacity, diversification and staggered maturities) support the Morgan Stanley Group, as well as the Group's, target liquidity profile.

*Contingency Funding Plan.* CFP is the Morgan Stanley Group's primary liquidity risk management tool. The CFP models a potential, prolonged liquidity contraction over a one-year time period and sets forth a course of action to effectively manage a liquidity event. The CFP and liquidity risk exposures are evaluated on an ongoing basis and reported to the Firm Risk Committee, Asset / Liability Management Committee, and other appropriate risk committees including the European Financial Risk Committee.

CFP is produced on a Morgan Stanley Group as well as major group and subsidiary level, including the Group, to capture specific cash requirements and cash availability at various legal entities. The CFP assumes that Morgan Stanley does not have access to cash that may be held at certain subsidiaries due to regulatory, legal or tax constraints but that the Group does have access to the cash or liquidity reserve held by Morgan Stanley as do all other Morgan Stanley subsidiaries.

The Morgan Stanley Group's and the Group's CFP model incorporates scenarios with a wide range of potential cash outflows during a liquidity stress event, including, but not limited to, the following: (i) repayment of all unsecured debt maturing within one year and no incremental unsecured debt issuance; (ii) maturity roll-off of outstanding letters of credit with no further issuance and replacement of cash collateral; (iii) return of unsecured securities borrowed and any cash raised against these securities; (iv) additional collateral that would be required by counterparties in the event of a three-notch long-term credit ratings downgrade; (v) higher haircuts on or lower availability of secured funding; (vi) client cash withdrawals; (vii) drawdowns on unfunded commitments provided to third parties; and (viii) discretionary unsecured debt buybacks.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**6. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Liquidity risk (continued)**

*Liquidity management policies (continued)*

*Global Liquidity Reserves.* The Morgan Stanley Group seeks to maintain a target liquidity reserve ("the global liquidity reserve") that is sized to cover daily funding needs and meet strategic liquidity targets as outlined in the CFP. The global liquidity reserve is held within Morgan Stanley and the Morgan Stanley Group's major operating subsidiaries and consists of cash and cash equivalents and central bank eligible unencumbered securities (predominantly consisting of U.S. and European government bonds and U.S. agency and agency mortgage-backed 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 (predominantly consisting of European and UK government bonds). In addition to the liquidity reserve held by the Group, the Group has access to the global liquidity reserve. The Morgan Stanley Group's and the Group's funding requirements and target liquidity reserves may vary based on changes to the level and composition of its balance sheet, timing of specific transactions, client financing activity, market conditions and seasonal factors.

*Funding management policies*

The Morgan Stanley Group's funding management policies are designed to provide for financings that are executed 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. Maturities of financings are designed to manage exposure to refinancing risk in any one period.

The Morgan Stanley Group funds its balance sheet on a global basis through diverse sources. These sources may include the Morgan Stanley Group's equity capital, long-term debt, repurchase agreements, 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 in the U.S., European and Asian markets, targeting global investors and currencies such as U.S. dollar, Euro, British pound, Australian dollar and Japanese Yen.

In managing both the Group's and the Morgan Stanley Group's funding risk the composition and size of the entire statement of financial position, not just financial liabilities, is monitored and evaluated. A substantial portion of the Morgan Stanley Group's total assets consist of highly liquid marketable securities and short-term receivables arising from its Institutional Securities sales and trading activities. The liquid nature of these assets provides the Group and the Morgan Stanley Group with flexibility in financing and managing its 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 on demand and presented at fair value, consistent with how these financial liabilities are managed. Financial liabilities designated at fair value are disclosed according to their earliest contractual maturity; and 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 30 June 2011. 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
Six months ended 30 June 2011

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

Maturity analysis (continued)

	On demand	Less than 1 month	More than 1 month but less than 3 months	More than 3 months but less than 1 year	More than 1 year but less than 5 years	More than 5 years	Total
30 June 2011	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
<b>Financial liabilities</b>							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	298	-	-	-	-	-	298
Securities loaned	64,404	1,351	2,548	2,796	-	-	71,099
Repurchase agreements	25,542	38,769	15,842	7,302	2,677	-	90,132
Trade payables	101,875	-	-	-	-	-	101,875
Other payables	10,761	-	-	7,812	2,272	1,110	21,955
Subordinated loans	-	9	20	89	473	8,852	9,443
Preference shares *	-	-	16	-	70	1,203	1,289
Financial liabilities classified as held for trading:							
Derivatives	213,021	-	-	-	-	-	213,021
Other	33,245	-	-	-	-	-	33,245
Financial liabilities designated at fair value through profit or loss	9,011	57	73	820	3,761	533	14,255
<b>Total financial liabilities</b>	<b>458,157</b>	<b>40,186</b>	<b>18,499</b>	<b>18,819</b>	<b>9,253</b>	<b>11,698</b>	<b>556,612</b>
<b>Unrecognised financial instruments</b>							
Contingent commitments	3,227	-	-	-	-	-	3,227
Financial guarantees	1	-	-	-	-	-	1
Lease commitments	6	-	-	-	16	-	22
Underwriting commitments	-	76	-	-	-	-	76
Loan commitments	771	-	-	-	-	-	771
Unsettled reverse repurchase agreements	49,939	-	-	-	-	-	49,939
<b>Total unrecognised financial instruments</b>	<b>53,944</b>	<b>76</b>	<b>-</b>	<b>-</b>	<b>16</b>	<b>-</b>	<b>54,036</b>

\* The principal portion of the Preference shares is assumed to be redeemed in 20 years

The Group does not expect that all of the cash flows associated with contingent commitments and loan commitments will be required.

# MORGAN STANLEY & CO. INTERNATIONAL plc

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2011

### 6. FINANCIAL RISK MANAGEMENT (CONTINUED)

#### Liquidity risk (continued)

##### Maturity analysis (continued)

	On demand	Less than 1 month	More than 1 month but less than 3 months	More than 3 months but less than 1 year	More than 1 year but less than 5 years	More than 5 years	Total
31 December 2010	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Financial liabilities							
Financial liabilities at amortised cost:							
Bank loans and overdrafts	60	-	-	-	-	-	60
Securities loaned	43,335	1,366	4,450	3,601	307	-	53,059
Repurchase agreements	30,380	51,130	13,073	6,105	1,894	-	102,582
Trade payables	75,639	-	-	-	-	-	75,639
Other payables	10,157	-	-	11,187	2,137	1,076	24,557
Subordinated loans	-	10	20	92	491	9,114	9,727
Preference shares *	-	-	-	18	80	1,287	1,385
Financial liabilities classified as held for trading:							
Derivatives	186,937	-	-	-	-	-	186,938
Other	33,856	-	-	-	-	-	33,855
Financial liabilities designated at fair value through profit or loss	8,012	627	208	732	3,131	1,003	13,713
<b>Total financial liabilities</b>	<b>388,376</b>	<b>53,133</b>	<b>17,751</b>	<b>21,735</b>	<b>8,040</b>	<b>12,480</b>	<b>501,515</b>
<b>Unrecognised financial instruments</b>							
Contingent commitments	1,194	-	-	-	-	-	1,194
Financial guarantees	-	-	-	-	-	-	-
Lease commitments	7	-	-	-	19	-	26
Underwriting commitments	-	-	128	-	-	-	128
Loan commitments	682	-	-	-	-	-	682
Unsettled reverse repurchase agreements	29,784	-	-	-	-	-	29,784
<b>Total unrecognised financial instruments</b>	<b>31,667</b>	<b>-</b>	<b>128</b>	<b>-</b>	<b>19</b>	<b>-</b>	<b>31,814</b>

\* The principal portion of Preference shares is assumed to be redeemed in 20 years

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

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**6. 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 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 Value at Risk ("VaR") system. These limits are designed to control price and market liquidity risk. Market risk is monitored through various measures: statistically (using 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 Group also performs routine stress testing to more comprehensively monitor the risks in the portfolio. Morgan Stanley utilises Stress VaR ("S-VaR"), which is a proprietary methodology that seeks to measure both the Group's market and credit risks, while adjusting for the different liquidity characteristics of the underlying risks (in contrast to traditional VaR measures which are typically calculated using the same horizon for all risks). It is an important metric used in establishing the Group's risk tolerance 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 which are particularly relevant for credit portfolios.

*Sales and Trading and Related Activities*

*Primary market risk exposures and market risk management*

During the first half of 2011, 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: government debt, investment grade and non-investment grade corporate debt, interest rate derivatives, emerging market corporate and government debt, and distressed corporate debt.

The Group is exposed to equity price and implied volatility risk as a result of making markets in equity securities and derivatives as well as maintaining proprietary positions. 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 and from holding non U.S. dollar-denominated financial instruments. The Group is exposed to commodity price and implied volatility risk as a result of market-making activities and maintaining positions in physical commodities (such as 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 physical production, transportation and storage issues; or geopolitical and other events that affect the available supply and level of demand for these commodities.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**6. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Market risk (continued)**

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 a Group basis, on an entity-wide basis, on a worldwide trading division level and on an individual product strategy level. 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 aggregate risk tolerance of key entities within the Group as established by the Group's senior management.

Aggregate market risk limits have been approved for the key entities within the Group and major trading divisions globally (equity and fixed income, which includes interest rate products, credit products, foreign exchange and commodities) as well as for the Morgan Stanley Group. 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.

The market risk department independently reviews the Group's trading portfolios on a regular basis from a market risk perspective utilising VaR and other quantitative and qualitative risk measures and analyses. The Group's trading businesses and the market risk department also use, as appropriate, measures such as sensitivity to changes in interest rates, prices, implied volatilities and time decay to monitor and report market risk exposures. Net exposure, defined as the potential loss to the Group over a period of time in the event of default of a referenced asset, assuming zero recovery, is one key measure the Group employs to standardise the aggregation of market risk exposures across cash and derivative products. Stress testing, which measures the impact on the value of existing portfolios of specified changes in market factors for certain products, is performed periodically and is reviewed by trading division risk managers, desk risk managers and the market risk department.

*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 estimates VaR using a model based on historical simulation for major market risk factors and Monte Carlo simulation for name-specific risk in certain equity and fixed income exposures. Historical simulation involves constructing a distribution of hypothetical daily changes in the value of trading portfolios based on two sets of inputs: historical observation of daily changes in key market indices or other market factors ("market risk factors"); and information on the current sensitivity of the portfolio values to these market risk factor changes. The Group's VaR model uses approximately four years of historical data to characterise potential changes in market risk factors. 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.

The Group's VaR model generally takes into account linear and non-linear exposures to price risk and interest rate risk, and linear exposures to implied volatility risks. Market risks that are incorporated in the VaR model include equity and commodity prices, interest rates, foreign exchange rates and associated implied volatilities. As a supplement to the use of historical simulation for major market risk factors, the Group's VaR model uses Monte Carlo simulation to capture name-specific risk in equities and credit products (i.e. corporate bonds and credit derivatives).

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**6. FINANCIAL RISK MANAGEMENT (CONTINUED)**

**Market risk (continued)**

The Group's VaR models evolve 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.

Among their benefits, VaR models permit estimation of a portfolio's aggregate market risk exposure, incorporating a range of varied market risks; reflect risk reduction due to portfolio diversification or hedging activities; and can cover a wide range of portfolio assets. However, VaR risk measures should be interpreted carefully in light of the methodology's limitations, which include the following: past changes in market risk factors may not always yield accurate predictions of the distributions and correlations of future market movements; changes in portfolio value in response to market movements (especially for complex derivative portfolios) may differ from the responses calculated by a VaR model; VaR using a one-day time horizon may not fully capture the market risk of positions that cannot be liquidated or hedged within one day; the historical market risk factor data used for VaR estimation may provide only limited insight into losses that could be incurred under market conditions that are unusual relative to the historical period used in estimating the VaR; and published VaR results reflect past trading positions while future risk depends on future positions. 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, group and global levels.

*VaR for the six months ended 30 June 2011*

The table presents the Group's Trading, Non-trading and Aggregate VaR for each of the Group's primary market risk exposures on a period-end, average and high and low basis for the six months ending 30 June 2011 and year ended 31 December 2010, incorporating substantially all financial instruments generating market risk that are managed by the Group's trading businesses. This measure of VaR incorporates most of the Group's trading-related market risks. However, a small proportion of trading positions generating market risk is not included in VaR, and the modelling of the risk characteristics of some positions relies upon approximations that, under certain circumstances, could produce different VaR results from those produced using more precise measures.

The Group's Trading VaR includes mark-to-market lending exposures and associated hedges. In addition, counterparty credit valuation adjustments and related hedges are also included in Trading VaR.

Since the VaR statistics reported below are estimates based on historical position and market 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. VaR does not predict the magnitude of losses which, should they occur, may be significantly greater than the VaR amount.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
Six months ended 30 June 2011

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market risk (continued)

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

95% Total VaR	95% One-Day VaR for the six months ended 30 June 2011				95% One-Day VaR for the year ended 31 December 2010			
	Period End \$'m	Average \$'m	High \$'m	Low \$'m	Period End \$'m	Average \$'m	High \$'m	Low \$'m
Primary Market Risk Category								
Interest rate and credit spread	47	53	65	47	55	60	79	35
Equity price	21	21	35	16	26	21	53	11
Foreign exchange rate	9	8	16	3	10	9	18	3
Commodity price	5	3	6	2	2	3	9	2
Less diversification benefit(1)(2)	(32)	(28)	N/A	N/A	(24)	(26)	(61)	(10)
<b>Total trading VaR</b>	<b>50</b>	<b>57</b>	<b>78</b>	<b>46</b>	<b>69</b>	<b>67</b>	<b>98</b>	<b>41</b>

(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 VaR values for the total and each of the four risk categories might have occurred on different days during the period and therefore the diversification benefit is not an applicable measure

The Group's Average Trading VaR for the six months ended 30 June 2011 was \$57 million compared with \$67 million for the year ended 31 December 2010. The decrease has been driven primarily by a decrease in interest rate and credit spread risk.

*Interest rate risk*

The Group's Trading VaR excludes certain funding liabilities and money market transactions. As at 30 June 2011, the net notional amount of certain funding liabilities and money market transactions excluded from the Group's Trading VaR was approximately \$1 billion, compared to \$12 billion as at 31 December 2010. The application of a parallel shift in interest rates of 50 basis points increase or decrease to these positions would result in a net gain or loss to the Group of approximately \$2.4 million as at 30 June 2011 compared to a net gain or loss of \$2.5 million as at 31 December 2010.



NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
Six months ended 30 June 2011

6. FINANCIAL RISK MANAGEMENT (CONTINUED)

Market Risk (continued)

Currency risk

The Group has foreign currency exposure arising from its investments in branches and subsidiaries where those investments operate in currencies other than US dollars. For the foreign currency exposure arising from its investment in subsidiaries and branches that operate in currencies other than US dollars, the majority of this foreign currency risk has been hedged by other members of the Morgan Stanley Group, primarily Morgan Stanley, by utilising both forward foreign currency exchange contracts and non-US dollar denominated debt.

The analysis below details this foreign currency exposure for the Group, by foreign currency, and calculates the impact on other 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 any foreign currency hedges held by the Company or by other members of the Morgan Stanley Group.

	30 June 2011			31 December 2010		
	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	(19)	27%	5	(6)	27%	2
British Pound	50	29%	15	44	29%	13
Euro	474	9%	43	366	7%	25
New Taiwan Dollar	69	8%	6	60	8%	5
New Zealand Dollar	2	24%	-	2	24%	-
Singapore Dollar	4	9%	-	4	9%	-
South Korean Won	227	42%	95	183	42%	77
Swedish Krona	16	23%	4	15	23%	3
Swiss Franc	8	10%	1	5	10%	-
	<u>831</u>			<u>673</u>		

The reasonably possible percentage change in the currency rate against US dollars has been calculated based on the greatest annual percentage change in the periods effective from 1 December 2007. The percentage change applied may not be the same percentage change in the currency rate for the period.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE**

**a. Fair value hierarchy**

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, valuations of these products do 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 non-observable 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.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

**Financial assets and liabilities recognised at fair value**

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

**30 June 2011**

	<b>Quoted prices in active market (Level 1) \$millions</b>	<b>Valuation techniques using observable inputs (Level 2) \$millions</b>	<b>Valuation techniques with significant non- observable inputs (Level 3) \$millions</b>	<b>Total \$millions</b>
Financial assets classified as held for trading:				
- Government debt securities	11,943	4,490	-	16,433
- Corporate equities	48,172	9,523	214	57,909
- Corporate and other debt	22	19,648	3,981	23,651
- Derivatives	5,132	202,911	3,643	211,686
Total financial assets classified as held for trading	<u>65,269</u>	<u>236,572</u>	<u>7,838</u>	<u>309,679</u>
Financial assets designated at fair value through profit or loss				
	-	10,760	-	10,760
Available-for-sale financial assets:				
- Corporate equities	3	-	48	51
Total financial assets measured at fair value	<u>65,272</u>	<u>247,332</u>	<u>7,886</u>	<u>320,490</u>
Financial liabilities classified as held for trading:				
- Government debt securities	13,652	3,191	-	16,843
- Corporate equities	9,168	2,827	-	11,995
- Corporate and other debt	5	4,402	-	4,407
- Derivatives	9,483	197,774	5,764	213,021
Total financial liabilities classified as held for trading	<u>32,308</u>	<u>208,194</u>	<u>5,764</u>	<u>246,266</u>
Financial liabilities designated at fair value through profit or loss				
	-	13,917	338	14,255
Total financial liabilities measured at fair value	<u>32,308</u>	<u>222,111</u>	<u>6,102</u>	<u>260,521</u>

**MORGAN STANLEY & CO. INTERNATIONAL plc**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

**Financial assets and liabilities recognised at fair value (continued)**

**31 December 2010**

	Quoted prices in active market (Level 1) \$millions	Valuation techniques using observable inputs (Level 2) \$millions	Valuation techniques with significant non- observable inputs (Level 3) \$millions	Total \$millions
Financial assets classified as held for trading:				
- Government debt securities	12,369	4,002	-	16,371
- Corporate equities	44,908	1,134	146	46,188
- Corporate and other debt	110	18,627	3,359	22,096
- Derivatives	968	183,006	2,365	186,339
Total financial assets classified as held for trading	58,355	206,769	5,870	270,994
Financial assets designated at fair value through profit or loss	-	8,830	529	9,359
Available-for-sale financial assets:				
- Corporate equities	4	-	40	44
Total financial assets measured at fair value	58,359	215,599	6,439	280,397
Financial liabilities classified as held for trading:				
- Government debt securities	11,944	3,161	-	15,105
- Corporate equities	13,571	447	11	14,029
- Corporate and other debt	-	4,695	26	4,721
- Derivatives	924	182,150	3,864	186,938
Total financial liabilities classified as held for trading	26,439	190,453	3,901	220,793
Financial liabilities designated at fair value through profit or loss	-	12,858	855	13,713
Total financial liabilities measured at fair value	26,439	203,311	4,756	234,506

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

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

- *Government debt securities*

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

- *Corporate equities*

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

*Investments.* The Group's investments include exchange-traded equity securities, direct private equity investments and investments in private equity funds, real estate funds and hedge funds. 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 considers the net asset value of the fund provided by the fund manager to be the best estimate of fair value. For direct private investments and privately held investments 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. If the investments are exchange-traded they will be categorised as Level 1, otherwise they will be categorised as Level 3.

- *Corporate and other debt*

*Corporate Bonds.* The fair value of corporate bonds is estimated using recently executed transactions, market price quotations (where observable), bond spreads or credit default swap spreads adjusted for any basis difference between cash and derivative instruments. The spread data used are for the same maturity as the bond. If the spread data does not reference the issuer, then data that reference a comparable issuer are used. When observable price quotations are not available, fair value is determined based on cash flow models with yield curves, bond or single name credit default swap spreads and recovery rates 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.

*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. When position-specific external price data are not observable, the valuation is based on prices of comparable bonds. Valuation levels of RMBS and CMBS indices are used as an additional data point for benchmarking purposes or to price outright index positions.

Fair value for retained interests in securitised financial assets (in the form of one or more tranches of the securitisation) is determined using observable prices or, in cases where observable prices are not available for certain retained interests, the fair value is estimated based on the present value of expected future cash flows using the best estimate of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved.

RMBS, CMBS and other ABS, including retained interests in these securitised financial assets, are categorised in Level 3 if external prices or spread inputs are unobservable or if the comparability assessment involves significant subjectivity related to property type differences, cash flows, performance and other inputs; otherwise, they are categorised in Level 2 of the fair value hierarchy.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

*Financial assets and financial liabilities classified as held for trading and available-for-sale financial assets (continued)*

- *Corporate and other debt (continued)*

*Collateralised Debt Obligations (“CDOs”).* The Group holds CDOs where the collateral primarily is synthetic and references either a basket credit default swap or CDO-squared (a CDO-squared is a special purpose vehicle that issues interests, or tranches, that are backed by tranches issued by other CDOs). The correlation input between reference credits within the collateral is unobservable and is benchmarked to standardised proxy baskets for which correlation data are available. The other model inputs such as credit spreads, interest rates and recovery 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.

- *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 analytical 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 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.

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 derivative interests in certain mortgage-related CDO securities, basket credit default swaps, CDO-squared positions and certain types of ABS credit default swaps where direct trading activity or quotes are unobservable. These instruments involve significant unobservable inputs and are categorised in Level 3 of the fair value hierarchy.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**a. Fair value hierarchy (continued)**

*Financial assets and financial liabilities classified as held for trading and available-for-sale financial assets (continued)*

- *Derivatives (continued)*

*OTC Derivative Contracts (continued)*

Derivative interests in mortgage-related CDOs, and credit default swaps, for which observability of external price data is extremely limited, are valued based on an evaluation of the market and model input parameters sourced from similar positions as indicated by primary and secondary market activity. Each position is evaluated independently taking into consideration the underlying collateral performance and pricing, 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 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. In instances where the correlation input is deemed to be significant, these instruments are categorised in Level 3 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 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. Fair value of structured notes and prepaid OTC derivatives is estimated using calculation 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 based on observed secondary bond market spreads. Most structured notes and prepaid OTC derivatives are categorised in Level 2 of the fair value hierarchy.

This includes financial liabilities such as those arising from the consolidation of certain special purpose entities and those that arise as a result of continuing recognition of certain assets, where the Group retains substantially all the risks and rewards of the transferred assets, and the simultaneous recognition of an associated liability. The fair value of these financial liabilities, which are effectively secured financing liabilities, is estimated using the appropriate valuation methodology for the related assets that continue to be recognised, adjusted for any differences between the assets that continue to be recognised and the liability that is simultaneously recognised. Generally these financial liabilities are recognised in Level 2 of the fair value hierarchy.

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**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**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 six months ended 30 June 2011:

30 June 2011

	Balance at 1 January 2011	Total gains or losses recognised in profit or loss	Total gains or losses recognised in other comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and / or out of Level 3 (1)	Balance at 30 June 2011	Unrealised gains or (losses) for level 3 assets / liabilities outstanding as at 30 June 2011 (2)
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Financial assets classified as held for trading:										
- Corporate equities	146	2	-	124	(85)	-	-	27	214	-
- Corporate and other debt	3,359	67	-	1,493	(957)	-	(143)	162	3,981	133
<b>Total financial assets classified as held for trading</b>	<b>3,505</b>	<b>69</b>	<b>-</b>	<b>1,617</b>	<b>(1,042)</b>	<b>-</b>	<b>(143)</b>	<b>189</b>	<b>4,195</b>	<b>133</b>
Financial assets designated at fair value through profit or loss	529	-	-	-	-	-	-	(529)	-	-
Available-for-sale financial assets:										
- Corporate equities	40	-	8	-	-	-	-	-	48	-
<b>Total financial assets measured at fair value</b>	<b>4,074</b>	<b>69</b>	<b>8</b>	<b>1,617</b>	<b>(1,042)</b>	<b>-</b>	<b>(143)</b>	<b>(340)</b>	<b>4,243</b>	<b>133</b>
Financial liabilities classified as held for trading:										
- Corporate equities	(11)	-	-	-	-	-	11	-	-	-
- Corporate and other debt	(26)	73	-	-	(50)	-	3	-	-	-
- Net derivative contracts (3)	(1,499)	46	-	-	-	-	(670)	2	(2,121)	530
<b>Total financial liabilities classified as held for trading</b>	<b>(1,536)</b>	<b>119</b>	<b>-</b>	<b>-</b>	<b>(50)</b>	<b>-</b>	<b>(656)</b>	<b>2</b>	<b>(2,121)</b>	<b>530</b>
Financial liabilities designated at fair value through profit or loss	(855)	14	-	-	-	-	37	466	(338)	14
<b>Total financial liabilities measured at fair value</b>	<b>(2,391)</b>	<b>133</b>	<b>-</b>	<b>-</b>	<b>(50)</b>	<b>-</b>	<b>(619)</b>	<b>468</b>	<b>(2,459)</b>	<b>544</b>

- (1) For financial assets and financial liabilities that were transferred into and out of Level 3 during the period, 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 period.
- (2) Amounts represent unrealized gains or (losses) for the period related to assets and liabilities still outstanding as at the end of the period.
- (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.



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**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

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

31 December 2010

	Balance at 1 January 2010	Total gains or losses recognised in profit or loss	Total gains or losses recognised in other comprehensive income	Purchases	Sales	Issuances	Settlements	Net transfers in and / or out of Level 3 (1)	Balance at 31 December 2010	Unrealised gains or (losses) for level 3 assets / liabilities outstanding as at 31 December 2010 (2)
	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions	\$millions
Financial assets classified as held for trading:										
- Government debt securities	2	-	-	-	-	-	-	(2)	-	-
- Corporate equities	49	42	-	126	(120)	-	-	49	146	27
- Corporate and other debt	2,351	131	-	1,468	(907)	-	(114)	430	3,359	67
<b>Total financial assets classified as held for trading</b>	<b>2,402</b>	<b>173</b>	<b>-</b>	<b>1,594</b>	<b>(1,027)</b>	<b>-</b>	<b>(114)</b>	<b>477</b>	<b>3,505</b>	<b>94</b>
Financial assets designated at fair value through profit or loss	1,411	-	-	527	-	-	-	(1,409)	529	-
Available-for-sale financial assets:										
- Corporate equities	42	-	1	7	(10)	-	-	-	40	-
<b>Total financial assets measured at fair value</b>	<b>3,855</b>	<b>173</b>	<b>1</b>	<b>2,128</b>	<b>(1,037)</b>	<b>-</b>	<b>(114)</b>	<b>(932)</b>	<b>4,074</b>	<b>94</b>
Financial liabilities classified as held for trading:										
- Corporate equities	(3)	1	-	-	(48)	-	50	(11)	(11)	1
- Corporate and other debt	(4)	4	-	-	(108)	-	73	9	(26)	-
- Net derivative contracts (3)	(1,662)	(41)	-	-	-	-	191	13	(1,499)	(313)
<b>Total financial liabilities classified as held for trading</b>	<b>(1,669)</b>	<b>(36)</b>	<b>-</b>	<b>-</b>	<b>(156)</b>	<b>-</b>	<b>314</b>	<b>11</b>	<b>(1,536)</b>	<b>(312)</b>
Financial liabilities designated at fair value through profit or loss	(892)	(167)	-	-	121	(105)	39	149	(855)	(258)
<b>Total financial liabilities measured at fair value</b>	<b>(2,561)</b>	<b>(203)</b>	<b>-</b>	<b>-</b>	<b>(35)</b>	<b>(105)</b>	<b>353</b>	<b>160</b>	<b>(2,391)</b>	<b>(570)</b>

- (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 unrealized gains or (losses) for the year related to assets and liabilities still outstanding as at the end of the year.
- (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.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

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

As disclosed in note 8 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 above gains or losses are risk managed using financial instruments across a number of Morgan Stanley Group entities, these policies potentially result in the recognition of offsetting gains or losses in the Group.

During the period ended 30 June 2011 the Group reclassified approximately \$529 million (31 December 2010: \$1,409 million) of certain financial assets designated at fair value through profit and loss from Level 3 to Level 2. The Group reclassified these hybrid contracts as external prices became observable and the remaining unobservable inputs were deemed insignificant to the overall measurement.

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

During the period, there were no significant reclassifications between Level 1 and Level 2.

**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 increase or decrease to fair value by varying the assumptions individually. It is unlikely that all unobservable parameters would concurrently be 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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
Six months ended 30 June 2011

7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

The following table presents the sensitivity of the fair value of Level 3 financial assets and financial liabilities as at 30 June 2011 to reasonably possible alternative assumptions:

30 June 2011	Fair value \$millions	Effect of reasonably possible alternative assumptions	
		Increase in fair value \$millions	Decrease in fair value \$millions
Financial assets classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	214	5	(10)
- Corporate and other debt	3,981	37	(41)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	-	-	-
- Structured notes	-	-	-
- Other	-	-	-
Available-for-sale financial assets:			
- Corporate equities	48	2	(2)
Financial liabilities classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	-	-	-
- Corporate and other debt	-	-	-
- Net derivatives contracts <sup>(1)</sup>	(2,121)	139	(84)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	(3)	-	-
- Structured notes	-	-	-
- Other	(335)	1	(1)

(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.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
Six months ended 30 June 2011

7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)

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

31 December 2010	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	-	-	-
- Corporate equities	146	3	(3)
- Corporate and other debt	3,359	211	(210)
Financial assets designated at fair value through profit or loss:			
- Prepaid OTC contracts	-	-	-
- Structured notes	-	-	-
- Other	529	11	(6)
Available-for-sale financial assets:			
- Corporate equities	40	1	(1)
Financial liabilities classified as held for trading:			
- Government debt securities	-	-	-
- Corporate equities	(11)	-	(1)
- Corporate and other debt	(26)	1	(1)
- Net derivatives contracts <sup>(1)</sup>	(1,499)	126	(147)
Financial liabilities designated at fair value through profit or loss:			
- Prepaid OTC contracts	(3)	-	-
- Structured notes	-	-	-
- Other	(852)	8	(8)

(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.

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Six months ended 30 June 2011**

**7. FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE (CONTINUED)**

**e. Financial instruments valued using unobservable market data**

The amounts not recognised in the consolidated statement of comprehensive income 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:

	<b>30 June 2011 \$millions</b>	<b>31 December 2010 \$millions</b>
At 1 January	260	215
New transactions	247	94
Amounts recognised in the consolidated income statement during the period	(8)	(49)
At 30 June / 31 December	499	260

The balance above predominantly relates to derivatives.

The 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.

**8. RELATED PARTY DISCLOSURES**

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 six months ended 30 June 2011, a net loss of \$691 million was recognised in the consolidated income statement arising from such policies (30 June 2010: net loss of \$686 million).

**9. LITIGATION**

During the period the Group has been involved in various continuing and other litigation matters.

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 called Cheyne Finance (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 Southern District of New York. The complaint alleges, among other things, that the ratings assigned to the securities issued by the Cheyne SIV were false and misleading because the ratings did not accurately reflect the risks associated with the subprime residential mortgage backed securities held by the Cheyne SIV. On 2 September 2009, the court dismissed all of the claims against the Morgan Stanley Group and the Company except for plaintiffs' claims for common law fraud. On 15 June 2010, the court denied plaintiffs' motion for class certification. On 20 July 2010, the court granted plaintiffs leave to replead their aiding and abetting common law fraud claims against the Morgan Stanley Group and the Company, and those claims were added in an amended complaint filed on 5 August 2010. Since the filing of the initial complaint, various additional plaintiffs have been added to the case. The deadline for new plaintiffs to join the case expired on 11 March 2011. There are currently 15 plaintiffs asserting individual claims related to approximately \$983 million of securities issued by the Cheyne SIV. Plaintiffs have not provided information quantifying the amount of compensatory damages they are seeking and are also seeking unspecified punitive damages. Based on currently available information, the Morgan Stanley Group and the Company believes that the defendants could incur a loss up to the amount of plaintiffs' claimed compensatory damages, once specified, related to their alleged purchase of approximately \$983 million of securities issued by the Cheyne SIV plus pre- and post-judgment interest, fees and costs.

## MORGAN STANLEY & CO. INTERNATIONAL plc

### NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Six months ended 30 June 2011

#### 9. LITIGATION (CONTINUED)

On 25 September 2009, the Company was named as a defendant in a lawsuit styled *Citibank, N.A. v. Morgan Stanley & Co. International, PLC*, which is pending in the United States District Court for the Southern District of New York (“SDNY”). The lawsuit relates to a credit default swap entered into by the Company referencing the Capmark VI CDO, (“Capmark”) which was structured by Citibank, N.A. (“Citi N.A.”). At issue is whether, as part of the swap agreement, Citi N.A. was obligated to obtain the Company’s prior written consent before it exercised its rights to liquidate Capmark upon the occurrence of certain contractually-defined credit events. Citi N.A. is seeking approximately \$245 million in compensatory damages plus interest and costs. On 12 May 2010, the court granted Citi N.A.’s motion for judgment on the pleadings on its claim for breach of contract. On 8 October 2010, the court issued an order denying Citi N.A.’s motion for judgment on the pleadings as to the Company’s counterclaim for reformation and granting Citi N.A.’s motion for judgment on the pleadings as to the Company’s counterclaim for estoppel. On 25 May 2011, the court denied the Company’s motion for summary judgment and granted Citi N.A.’s cross motion for summary judgment. On 27 June 2011, the court entered a judgment in favor of Citi N.A. for \$269 million plus post-judgment interest and the Company filed a notice of appeal to the United States Court of Appeals for the Second Circuit. Based on currently available information, the Morgan Stanley Group believes it could incur a loss of up to approximately \$269 million plus post-judgment interest. In compliance with the intra-group policies, revenues and costs related to the Capmark deal referenced above, including any potential litigation costs, are transferred to other Morgan Stanley Group undertakings outside the Group.

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 motion to dismiss the complaint. On 21 March 2011, the Morgan Stanley Group appealed the order denying its motion to dismiss the complaint. Based on currently available information, the Morgan Stanley Group believes it could incur a loss of up to \$240 million. On 7 July 2011, the appellate court affirmed the lower court’s decision denying the Morgan Stanley Group motion to dismiss.

The Directors are of the opinion that it would be seriously prejudicial to the position of the Group to disclose further details of these or any other individual continuing litigation matters and the amounts, if any, provided in respect of them.

#### 10. POST BALANCE SHEET EVENT

In July 2011, the UK Government enacted legislation imposing a bank levy on relevant liabilities and equities on the consolidated balance sheets of “UK Banking Groups,” as defined under the bank levy legislation at 31 December 2011. The Group continues to evaluate the impact of this legislation, and estimates the UK Banking Group will incur a full year charge of \$125 million, of which the Group will incur \$120 million. Due to the bank levy being determined on relevant liabilities and equities at 31 December 2011, the final charge may differ from this estimate. The levy is not deductible for UK Corporation Tax purposes.