

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
*For the quarterly period ended March 31, 2011*

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

Commission File Number 1-11758

**Morgan Stanley**

(Exact Name of Registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**1585 Broadway**  
**New York, NY 10036**  
(Address of principal executive  
offices, including zip code)

**36-3145972**  
(I.R.S. Employer Identification No.)

**(212) 761-4000**  
(Registrant's telephone number,  
including area code)

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

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

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

Large Accelerated Filer   
Non-Accelerated Filer

Accelerated Filer   
Smaller reporting company

(Do not check if a smaller reporting company)

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

As of April 30, 2011, there were 1,544,658,124 shares of the Registrant's Common Stock, par value \$0.01 per share, outstanding.



# Morgan Stanley

## QUARTERLY REPORT ON FORM 10-Q For the quarter ended March 31, 2011

Table of Contents		Page
<b>Part I—Financial Information</b>		
Item 1.	Financial Statements (unaudited) . . . . .	1
	Condensed Consolidated Statements of Financial Condition—March 31, 2011 and December 31, 2010 . . . . .	1
	Condensed Consolidated Statements of Income—Three Months Ended March 31, 2011 and 2010 . . . . .	3
	Condensed Consolidated Statements of Comprehensive Income—Three Months Ended March 31, 2011 and 2010 . . . . .	4
	Condensed Consolidated Statements of Cash Flows—Three Months Ended March 31, 2011 and 2010 . . . . .	5
	Condensed Consolidated Statements of Changes in Total Equity—Three Months Ended March 31, 2011 and 2010 . . . . .	6
	Notes to Condensed Consolidated Financial Statements (unaudited) . . . . .	8
	Note 1. Introduction and Basis of Presentation . . . . .	8
	Note 2. Significant Accounting Policies . . . . .	10
	Note 3. Fair Value Disclosures . . . . .	11
	Note 4. Securities Available for Sale . . . . .	30
	Note 5. Collateralized Transactions . . . . .	32
	Note 6. Variable Interest Entities and Securitization Activities . . . . .	34
	Note 7. Financing Receivables . . . . .	42
	Note 8. Goodwill and Net Intangible Assets . . . . .	44
	Note 9. Long-Term Borrowings and Other Secured Financings . . . . .	45
	Note 10. Derivative Instruments and Hedging Activities . . . . .	46
	Note 11. Commitments, Guarantees and Contingencies . . . . .	54
	Note 12. Regulatory Requirements . . . . .	60
	Note 13. Total Equity . . . . .	63
	Note 14. Earnings per Common Share . . . . .	63
	Note 15. Interest Income and Interest Expense . . . . .	65
	Note 16. Employee Benefit Plans . . . . .	65
	Note 17. Income Taxes . . . . .	66
	Note 18. Segment and Geographic Information . . . . .	67
	Note 19. Equity Method Investments . . . . .	69
	Note 20. Discontinued Operations . . . . .	70
	Note 21. Subsequent Events . . . . .	71
	Report of Independent Registered Public Accounting Firm . . . . .	72
Item 2.	Management’s Discussion and Analysis of Financial Condition and Results of Operations . .	73
	Introduction . . . . .	73
	Executive Summary . . . . .	74
	Business Segments . . . . .	82
	Accounting Developments . . . . .	93
	Other Matters . . . . .	94
	Critical Accounting Policies . . . . .	97
	Liquidity and Capital Resources . . . . .	102
Item 3.	Quantitative and Qualitative Disclosures about Market Risk . . . . .	115

Table of Contents		Page
Item 4.	Controls and Procedures .....	127
Financial Data Supplement (Unaudited) .....		128
<b>Part II—Other Information</b>		
Item 1.	Legal Proceedings .....	131
Item 1A.	Risk Factors .....	133
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds .....	134
Item 6.	Exhibits .....	134

## AVAILABLE INFORMATION

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

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

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

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

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

## Part I—Financial Information.

### Item 1. Financial Statements.

#### MORGAN STANLEY

#### CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(dollars in millions, except share data)

(unaudited)

	March 31, 2011	December 31, 2010
<b>Assets</b>		
Cash and due from banks (\$310 and \$297 at March 31, 2011 and December 31, 2010, respectively, related to consolidated variable interest entities generally not available to the Company) . . . . .	\$ 8,120	\$ 7,341
Interest bearing deposits with banks . . . . .	44,488	40,274
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements . . . . .	21,932	19,180
Financial instruments owned, at fair value (approximately \$132 billion and \$130 billion were pledged to various parties at March 31, 2011 and December 31, 2010, respectively):		
U.S. government and agency securities . . . . .	46,626	48,446
Other sovereign government obligations . . . . .	38,878	33,908
Corporate and other debt (\$4,316 and \$3,816 at March 31, 2011 and December 31, 2010, respectively related to consolidated variable interest entities, generally not available to the Company) . . . . .	88,459	88,154
Corporate equities (\$655 and \$625 at March 31, 2011 and December 31, 2010, respectively related to consolidated variable interest entities, generally not available to the Company) . . . . .	67,042	68,416
Derivative and other contracts . . . . .	49,913	51,292
Investments (\$1,881 and \$1,873 at March 31, 2011 and December 31, 2010, respectively related to consolidated variable interest entities, generally not available to the Company) . . . . .	9,068	9,752
Physical commodities . . . . .	8,126	6,778
Total financial instruments owned, at fair value . . . . .	308,112	306,746
Securities available for sale, at fair value . . . . .	27,733	29,649
Securities received as collateral, at fair value . . . . .	13,161	16,537
Federal funds sold and securities purchased under agreements to resell . . . . .	162,923	148,253
Securities borrowed . . . . .	142,937	138,730
Receivables:		
Customers . . . . .	43,959	35,258
Brokers, dealers and clearing organizations . . . . .	6,131	9,102
Fees, interest and other . . . . .	8,840	9,790
Loans (net of allowances of \$45 and \$82 at March 31, 2011 and December 31, 2010, respectively) . . . . .	11,882	10,576
Other investments . . . . .	4,719	5,412
Premises, equipment and software costs (net of accumulated depreciation of \$4,259 and \$4,476 at March 31, 2011 and December 31, 2010, respectively) (\$352 and \$321 at March 31, 2011 and December 31, 2010, respectively related to consolidated variable entities, generally not available to the Company) . . . . .	6,366	6,154
Goodwill . . . . .	6,743	6,739
Intangible assets (net of accumulated amortization of \$692 and \$605 at March 31, 2011 and December 31, 2010, respectively) (includes \$144 and \$157 at fair value at March 31, 2011 and December 31, 2010, respectively) . . . . .	4,581	4,667
Other assets (\$232 and \$118 at March 31, 2011 and December 31, 2010, respectively, related to consolidated variable interest entities generally not available to the Company) . . . . .	13,558	13,290
Total assets . . . . .	<u>\$836,185</u>	<u>\$807,698</u>

See Notes to Condensed Consolidated Financial Statements.

**MORGAN STANLEY**

**CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION—(Continued)**  
**(dollars in millions, except share data)**  
**(unaudited)**

	<u>March 31,</u> <u>2011</u>	<u>December 31,</u> <u>2010</u>
<b>Liabilities and Equity</b>		
Deposits (includes \$2,848 and \$3,027 at fair value at March 31, 2011 and December 31, 2010, respectively) . . . . .	\$ 63,495	\$ 63,812
Commercial paper and other short-term borrowings (includes \$1,657 and \$1,799 at fair value at March 31, 2011 and December 31, 2010, respectively) . . . . .	3,302	3,256
Financial instruments sold, not yet purchased, at fair value:		
U.S. government and agency securities . . . . .	31,488	27,948
Other sovereign government obligations . . . . .	23,133	22,250
Corporate and other debt . . . . .	10,443	10,918
Corporate equities . . . . .	26,621	19,838
Derivative and other contracts . . . . .	44,585	47,802
Total financial instruments sold, not yet purchased, at fair value . . . . .	<u>136,270</u>	<u>128,756</u>
Obligation to return securities received as collateral, at fair value . . . . .	18,069	21,163
Securities sold under agreements to repurchase (includes \$890 and \$849 at fair value at March 31, 2011 and December 31, 2010, respectively) . . . . .	156,891	147,598
Securities loaned . . . . .	36,084	29,094
Other secured financings (includes \$8,052 and \$8,490 at fair value at March 31, 2011 and December 31, 2010, respectively) (\$2,812 and \$2,656 at March 31, 2011 and December 31, 2010, respectively, related to consolidated variable interest entities and are non-recourse to the Company) . . . . .	12,958	10,453
Payables:		
Customers . . . . .	121,574	123,249
Brokers, dealers and clearing organizations . . . . .	8,278	3,363
Interest and dividends . . . . .	2,659	2,572
Other liabilities and accrued expenses (\$177 and \$117 at March 31, 2011 and December 31, 2010, respectively, related to consolidated variable interest entities and are non-recourse to the Company) . . . . .	13,961	16,518
Long-term borrowings (includes \$43,575 and \$42,709 at fair value at March 31, 2011 and December 31, 2010, respectively) . . . . .	<u>196,136</u>	<u>192,457</u>
	<u>769,677</u>	<u>742,291</u>
Commitments and contingent liabilities (see Note 11)		
Equity		
Morgan Stanley shareholders' equity:		
Preferred stock . . . . .	9,597	9,597
Common stock, \$0.01 par value;		
Shares authorized: 3,500,000,000 at March 31, 2011 and December 31, 2010;		
Shares issued: 1,603,913,074 at March 31, 2011 and December 31, 2010;		
Shares outstanding: 1,545,064,012 at March 31, 2011 and 1,512,022,095 at December 31, 2010 . . . . .	16	16
Paid-in capital . . . . .	12,185	13,521
Retained earnings . . . . .	39,269	38,603
Employee stock trust . . . . .	3,468	3,465
Accumulated other comprehensive loss . . . . .	(426)	(467)
Common stock held in treasury at cost, \$0.01 par value; 58,849,062 shares at March 31, 2011 and 91,890,979 shares at December 31, 2010 . . . . .	(2,455)	(4,059)
Common stock issued to employee trust . . . . .	<u>(3,468)</u>	<u>(3,465)</u>
Total Morgan Stanley shareholders' equity . . . . .	<u>58,186</u>	<u>57,211</u>
Noncontrolling interests . . . . .	8,322	8,196
Total equity . . . . .	<u>66,508</u>	<u>65,407</u>
Total liabilities and equity . . . . .	<u>\$836,185</u>	<u>\$807,698</u>

See Notes to Condensed Consolidated Financial Statements.

**MORGAN STANLEY**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(dollars in millions, except share and per share data)  
(unaudited)

	Three Months Ended March 31,	
	2011	2010
Revenues:		
Investment banking .....	\$ 1,214	\$ 1,060
Principal transactions:		
Trading .....	2,977	3,758
Investments .....	329	369
Commissions .....	1,449	1,260
Asset management, distribution and administration fees .....	2,109	1,963
Other .....	(444)	294
Total non-interest revenues .....	7,634	8,704
Interest income .....	1,854	1,736
Interest expense .....	1,853	1,368
Net interest .....	1	368
Net revenues .....	7,635	9,072
Non-interest expenses:		
Compensation and benefits .....	4,333	4,416
Occupancy and equipment .....	402	390
Brokerage, clearing and exchange fees .....	405	348
Information processing and communications .....	445	395
Marketing and business development .....	147	134
Professional services .....	428	395
Other .....	603	479
Total non-interest expenses .....	6,763	6,557
Income from continuing operations before income taxes .....	872	2,515
Provision for (benefit from) income taxes .....	(256)	436
Income from continuing operations .....	1,128	2,079
Discontinued operations:		
Loss from discontinued operations .....	—	(99)
Benefit from income taxes .....	(2)	(31)
Net gain (loss) from discontinued operations .....	2	(68)
Net income .....	\$ 1,130	\$ 2,011
Net income applicable to noncontrolling interests .....	162	235
Net income applicable to Morgan Stanley .....	\$ 968	\$ 1,776
Earnings applicable to Morgan Stanley common shareholders .....	\$ 736	\$ 1,411
Amounts applicable to Morgan Stanley:		
Income from continuing operations .....	\$ 966	\$ 1,844
Net gain (loss) from discontinued operations .....	2	(68)
Net income applicable to Morgan Stanley .....	\$ 968	\$ 1,776
Earnings (loss) per basic common share:		
Income from continuing operations .....	\$ 0.50	\$ 1.12
Net gain (loss) from discontinued operations .....	0.01	(0.05)
Earnings per basic common share .....	\$ 0.51	\$ 1.07
Earnings per diluted common share:		
Income from continuing operations .....	\$ 0.50	\$ 1.03
Loss from discontinued operations .....	—	(0.04)
Earnings per diluted common share .....	\$ 0.50	\$ 0.99
Average common shares outstanding:		
Basic .....	1,456,015,979	1,314,608,020
Diluted .....	1,472,307,592	1,626,207,327

See Notes to Condensed Consolidated Financial Statements.



**MORGAN STANLEY**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
**(dollars in millions)**  
**(unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Net income . . . . .	\$1,130	\$2,011
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustments(1) . . . . .	37	2
Amortization of cash flow hedges(2) . . . . .	1	3
Net unrealized loss on Securities available for sale(3) . . . . .	(36)	(20)
Pension, postretirement and other related adjustments(4) . . . . .	5	4
Comprehensive income . . . . .	\$1,137	\$2,000
Net income applicable to noncontrolling interests . . . . .	162	235
Other comprehensive loss applicable to noncontrolling interests . . . . .	(34)	(12)
Comprehensive income applicable to Morgan Stanley . . . . .	\$1,009	\$1,777

- (1) Amounts are net of provision for (benefit from) income taxes of \$(68) million and \$89 million for the quarters ended March 31, 2011 and 2010, respectively.
- (2) Amounts are net of provision for income taxes of \$2 million for both quarters ended March 31, 2011 and 2010.
- (3) Amounts are net of benefit from income taxes of \$24 million and \$14 million for the quarters ended March 31, 2011 and 2010, respectively.
- (4) Amounts are net of provision for (benefit from) income taxes of \$(4) million and \$2 million for the quarters ended March 31, 2011 and 2010, respectively.

See Notes to Condensed Consolidated Financial Statements.

**MORGAN STANLEY**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(dollars in millions)  
(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 1,130	\$ 2,011
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
(Gain) loss on equity method investees	660	(66)
Compensation payable in common stock and options	340	370
Depreciation and amortization	379	154
Loss on business dispositions	—	932
Gain on sale of securities available for sale	(12)	—
Loss on repurchase of long-term debt	23	—
Insurance reimbursement	—	(31)
Impairment charges and other-than-temporary impairment charges	3	10
Changes in assets and liabilities:		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	(2,752)	1,345
Financial instruments owned, net of financial instruments sold, not yet purchased	7,568	(5,073)
Securities borrowed	(4,207)	(13,554)
Securities loaned	6,990	5,126
Receivables, loans and other assets	(7,417)	4,618
Payables and other liabilities	1,350	5,494
Federal funds sold and securities purchased under agreements to resell	(14,670)	4,575
Securities sold under agreements to repurchase	9,293	15,190
Net cash provided by (used for) operating activities	(1,322)	21,101
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net proceeds from (payments for):		
Premises, equipment and software costs	(409)	(138)
Purchases of securities available for sale	(3,357)	(18,674)
Sales and redemptions of securities available for sale	6,311	—
Net cash provided by (used for) investing activities	2,545	(18,812)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net proceeds from (payments for):		
Commercial paper and other short-term borrowings	46	945
Dividends related to noncontrolling interests	(7)	(7)
Derivatives financing activities	89	(39)
Other secured financings	2,312	1,458
Deposits	(317)	1,711
Net proceeds from:		
Excess tax benefits associated with stock-based awards	29	2
Public offerings and other issuances of common stock	—	1
Issuance of long-term borrowings	14,285	7,755
Payments for:		
Long-term borrowings	(13,046)	(9,693)
Repurchases of common stock for employee tax withholding	(273)	(262)
Cash dividends	(302)	(293)
Net cash provided by financing activities	2,816	1,578
Effect of exchange rate changes on cash and cash equivalents	644	(380)
Effect of cash and cash equivalents related to variable interest entities	310	—
Net increase in cash and cash equivalents	4,993	3,487
Cash and cash equivalents, at beginning of period	47,615	31,991
Cash and cash equivalents, at end of period	\$ 52,608	\$ 35,478
<b>Cash and cash equivalents include:</b>		
Cash and due from banks	\$ 8,120	\$ 5,979
Interest bearing deposits with banks	44,488	29,499
Cash and cash equivalents, at end of period	\$ 52,608	\$ 35,478

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION**

Cash payments for interest were \$1,697 million and \$1,178 million for the quarters ended March 31, 2011 and 2010, respectively. Cash payments for income taxes were \$250 million and \$169 million for the quarters ended March 31, 2011 and 2010, respectively.

See Notes to Condensed Consolidated Financial Statements.

**MORGAN STANLEY**  
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY**  
**Three Months Ended March 31, 2011**  
**(dollars in millions)**  
**(unaudited)**

	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non- controlling Interests	Total Equity
<b>BALANCE AT</b>										
<b>DECEMBER 31, 2010</b> .....	\$9,597	\$ 16	\$13,521	\$38,603	\$3,465	\$(467)	\$(4,059)	\$(3,465)	\$8,196	\$65,407
Net income .....	—	—	—	968	—	—	—	—	162	1,130
Dividends .....	—	—	—	(302)	—	—	—	—	—	(302)
Shares issued under employee plans and related tax effects .....	—	—	(1,336)	—	3	—	1,877	(3)	—	541
Repurchases of common stock .....	—	—	—	—	—	—	(273)	—	—	(273)
Net change in cash flow hedges .....	—	—	—	—	—	1	—	—	—	1
Pension, postretirement and other related adjustments .....	—	—	—	—	—	5	—	—	—	5
Foreign currency translation adjustments .....	—	—	—	—	—	71	—	—	(34)	37
Change in net unrealized losses on securities available for sale .....	—	—	—	—	—	(36)	—	—	—	(36)
Decrease in noncontrolling interests related to dividends of noncontrolling interests .....	—	—	—	—	—	—	—	—	(7)	(7)
Other increases in noncontrolling interests .....	—	—	—	—	—	—	—	—	5	5
<b>BALANCE AT MARCH 31,</b>										
<b>2011</b> .....	<u>\$9,597</u>	<u>\$ 16</u>	<u>\$12,185</u>	<u>\$39,269</u>	<u>\$3,468</u>	<u>\$(426)</u>	<u>\$(2,455)</u>	<u>\$(3,468)</u>	<u>\$8,322</u>	<u>\$66,508</u>

See Notes to Condensed Consolidated Financial Statements.

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY—(Continued)

Three Months Ended March 31, 2010  
(dollars in millions)  
(unaudited)

	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non- controlling Interests	Total Equity
<b>BALANCE AT DECEMBER 31,</b>										
<b>2009</b> .....	\$9,597	\$ 15	\$ 8,619	\$35,056	\$4,064	\$(560)	\$(6,039)	\$(4,064)	\$6,092	\$52,780
Net income .....	—	—	—	1,776	—	—	—	—	235	2,011
Dividends .....	—	—	—	(293)	—	—	—	—	—	(293)
Shares issued under employee plans and related tax effects .....	—	—	(1,869)	—	(292)	—	2,223	292	—	354
Repurchases of common stock .....	—	—	—	—	—	—	(262)	—	—	(262)
Net change in cash flow hedges .....	—	—	—	—	—	3	—	—	—	3
Pension and postretirement adjustments .....	—	—	—	—	—	4	—	—	—	4
Foreign currency translation adjustments .....	—	—	—	—	—	14	—	—	(12)	2
Change in net unrealized losses on securities available for sale .....	—	—	—	—	—	(20)	—	—	—	(20)
Increase in noncontrolling interests related to the consolidation of certain real estate partnerships sponsored by the Company .....	—	—	—	—	—	—	—	—	468	468
Decrease in noncontrolling interests related to dividends of noncontrolling interests .....	—	—	—	—	—	—	—	—	(7)	(7)
Other increases in noncontrolling interests .....	—	—	—	—	—	—	—	—	139	139
<b>BALANCE AT MARCH 31,</b>										
<b>2010</b> .....	<u>\$9,597</u>	<u>\$ 15</u>	<u>\$ 6,750</u>	<u>\$36,539</u>	<u>\$3,772</u>	<u>\$(559)</u>	<u>\$(4,078)</u>	<u>\$(3,772)</u>	<u>\$6,915</u>	<u>\$55,179</u>

See Notes to Condensed Consolidated Financial Statements.

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Introduction and Basis of Presentation.

**The Company.** Morgan Stanley, a financial holding company, is a global financial services firm that maintains significant market positions in each of its business segments—Institutional Securities, Global Wealth Management Group and Asset Management. Unless the context otherwise requires, the terms “Morgan Stanley” and the “Company” mean Morgan Stanley and its consolidated subsidiaries.

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

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

*Global Wealth Management Group*, which includes the Company’s 51% interest in Morgan Stanley Smith Barney Holdings LLC (“MSSB”), provides brokerage and investment advisory services to individual investors and small-to-medium sized businesses and institutions covering various investment alternatives; financial and wealth planning services; annuity and other insurance products; credit and other lending products; cash management services; retirement services; and trust and fiduciary services and engages in fixed income principal trading, which primarily facilitates clients’ trading or investments in such securities.

*Asset Management* provides a broad array of investment strategies that span the risk/return spectrum across geographies, asset classes and public and private markets to a diverse group of clients across the institutional and intermediary channels as well as high net worth clients (see “Discontinued Operations—Retail Asset Management Business” herein).

#### **Discontinued Operations.**

*Retail Asset Management Business.* On June 1, 2010, the Company completed the sale of substantially all of its retail asset management business (“Retail Asset Management”), including Van Kampen Investments, Inc., to Invesco Ltd. (“Invesco”). The Company received \$800 million in cash and approximately 30.9 million shares of Invesco stock upon the sale. The results of Retail Asset Management are reported as discontinued operations within the Asset Management business segment for all periods presented through the date of sale.

The Company recorded the 30.9 million shares as securities available for sale. In the fourth quarter of 2010, the Company sold its investment in Invesco.

*Revel Entertainment Group, LLC.* On March 31, 2010, the Board of Directors authorized a plan of disposal by sale for Revel Entertainment Group, LLC (“Revel”), a development stage enterprise and subsidiary of the Company that was primarily associated with a development property in Atlantic City, New Jersey. On February 17, 2011, the Company completed the sale of Revel to a group of investors led by Revel’s chief executive officer. The Company did not retain any stake or ongoing involvement. The sale price approximated the carrying value of Revel and, accordingly, the Company did not recognize any pre-tax gain or loss on the sale. Total assets of Revel included in the Company’s condensed consolidated statement of financial condition at December 31, 2010 approximated \$28 million. The results of Revel are reported as discontinued operations within the Institutional Securities business segment for all periods presented through the date of sale. The quarter ended March 31, 2010 included losses of approximately \$932 million in connection with such planned disposition. See Note 17 for additional information about an income tax benefit related to Revel.

*CityMortgage Bank.* In the third quarter of 2010, the Company completed the disposal of CityMortgage Bank (“CMB”), a Moscow-based mortgage bank. The results of CMB are reported as discontinued operations for all periods presented through the date of disposal within the Institutional Securities business segment.

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

*Other.* In the third quarter of 2010, the Company completed a disposal of a real estate property within the Asset Management business segment. The results of operations are reported as discontinued operations for all periods presented through the date of disposal.

*Discover.* On June 30, 2007, the Company completed the spin-off of its business segment Discover Financial Services (“DFS”) to its shareholders. On February 11, 2010, DFS paid the Company \$775 million in complete satisfaction of its obligations to the Company regarding the sharing of proceeds from a lawsuit against Visa and MasterCard. The payment was recorded as a gain in discontinued operations for the quarter ended March 31, 2010.

Prior period amounts have been recast for discontinued operations. See Note 20 for additional information on discontinued operations.

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

Material intercompany balances and transactions have been eliminated.

The condensed consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010 (the “Form 10-K”). The condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for the fair presentation of the results for the interim period. The results of operations for interim periods are not necessarily indicative of results for the entire year.

***Consolidation.*** The condensed consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest, including certain variable interest entities (“VIE”) (see Note 6). For consolidated subsidiaries that are less than wholly owned, the third-party holdings of equity interests are referred to as noncontrolling interests. The portion of net income attributable to noncontrolling interests for such subsidiaries is presented as Net income (loss) applicable to noncontrolling interests on the condensed consolidated statements of income, and the portion of the shareholders’ equity of such subsidiaries is presented as Noncontrolling interests in the condensed consolidated statements of financial condition and condensed consolidated statements of changes in total equity.

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

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

For investments in entities in which the Company does not have a controlling financial interest but has significant influence over operating and financial decisions, the Company generally applies the equity method of accounting with net gains and losses recorded within Other revenues. Where the Company has elected to measure certain eligible investments at fair value in accordance with the fair value option, net gains and losses are recorded within Principal transactions—Investments (see Note 3).

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

The Company's significant regulated U.S. and international subsidiaries include Morgan Stanley & Co. Incorporated ("MS&Co."), Morgan Stanley Smith Barney LLC, Morgan Stanley & Co. International plc ("MSIP"), Morgan Stanley MUFG Securities, Co., Ltd. ("MSMS"), Morgan Stanley Bank, N.A. and Morgan Stanley Investment Advisors Inc.

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

#### **2. Significant Accounting Policies.**

For a detailed discussion about the Company's significant accounting policies, see Note 2 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K.

During the quarter ended March 31, 2011, other than the following, no other updates were made to the Company's significant accounting policies.

#### **Financial Instruments and Fair Value.**

Fair value for many cash instruments and OTC derivative contracts is derived using pricing models. Pricing models take into account the contract terms (including maturity) as well as multiple inputs, including, where applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, creditworthiness of the Company, option volatility and currency rates. Where appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality, model uncertainty and concentration risk. Adjustments for liquidity risk adjust model derived mid-market levels of Level 2 and Level 3 financial instruments for the bid-mid or mid-ask spread required to properly reflect the exit price of a risk position. Bid-mid and mid-ask spreads are marked to levels observed in trade activity, broker quotes or other external third-party data. Where these spreads are unobservable for the particular position in question, spreads are derived from observable levels of similar positions. The Company applies credit-related valuation adjustments to its short-term and long-term borrowings (primarily structured notes) for which the fair value option was elected and to OTC derivatives. The Company considers the impact of changes in its own credit spreads based upon observations of the Company's secondary bond market spreads when measuring the fair value for short-term and long-term borrowings. For OTC derivatives, the impact of changes in both the Company's and the counterparty's credit standing is considered when measuring fair

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

value. In determining the expected exposure, the Company simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party credit default swap (“CDS”) spread data. Where CDS spread data are unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty’s credit rating or CDS spread data that reference a comparable counterparty may be utilized. The Company also considers collateral held and legally enforceable master netting agreements that mitigate the Company’s exposure to each counterparty. Adjustments for model uncertainty are taken for positions whose underlying models are reliant on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible. The Company generally subjects all valuations and models to a review process initially and on a periodic basis thereafter. The Company may apply a concentration adjustment to certain of its OTC derivatives portfolios to reflect the additional cost of closing out a particularly large risk position. Where possible, these adjustments are based on observable market information but in many instances significant judgment is required to estimate the costs of closing out concentrated risk positions due to the lack of liquidity in the marketplace.

#### **Accounting Developments.**

##### *Goodwill Impairment Test.*

In December 2010, the Financial Accounting Standards Board (the “FASB”) issued accounting guidance that modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity shall consider whether there are any adverse qualitative factors indicating that an impairment may exist. The qualitative factors are consistent with the existing guidance. This guidance became effective for the Company on January 1, 2011. The adoption of this accounting guidance did not have a material impact on the Company’s condensed consolidated financial statements.

### **3. Fair Value Disclosures.**

#### *Fair Value Measurements.*

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

#### *Financial Instruments Owned and Financial Instruments Sold, Not Yet Purchased.*

##### *U.S. Government and Agency Securities.*

- U.S. Treasury Securities. U.S. treasury securities are valued using quoted market prices. Valuation adjustments are not applied. Accordingly, U.S. treasury securities are generally categorized in Level 1 of the fair value hierarchy.
- U.S. Agency Securities. U.S. agency securities are composed of three main categories consisting of agency-issued debt, agency mortgage pass-through pool securities and collateralized mortgage obligations. Non-callable agency-issued debt securities are generally valued using quoted market prices. Callable agency-issued debt securities are valued by benchmarking model-derived prices to quoted market prices and trade data for identical or comparable securities. The fair value of agency mortgage



## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

pass-through pool securities is model-driven based on spreads of the comparable To-be-announced (“TBA”) security. Collateralized mortgage obligations are valued using indices, quoted market prices and trade data for identical or comparable securities. Actively traded non-callable agency-issued debt securities are generally categorized in Level 1 of the fair value hierarchy. Callable agency-issued debt securities, agency mortgage pass-through pool securities and collateralized mortgage obligations are generally categorized in Level 2 of the fair value hierarchy.

#### *Other Sovereign Government Obligations.*

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

#### *Corporate and Other Debt.*

- State and Municipal Securities. The fair value of state and municipal securities is determined using recently executed transactions, market price quotations and pricing models that factor in, where applicable, interest rates, bond or credit default swap spreads and volatility. These bonds are generally categorized in Level 2 of the fair value hierarchy.
- Residential Mortgage-Backed Securities (“RMBS”), Commercial Mortgage-Backed Securities (“CMBS”) and other Asset-Backed Securities (“ABS”). RMBS, CMBS and other ABS may be valued based on price or spread data obtained from observed transactions or independent external parties such as vendors or brokers. When position-specific external price data are not observable, the fair value determination may require benchmarking to similar instruments and/or analyzing expected credit losses, default and recovery rates. In evaluating the fair value of each security, the Company considers security collateral-specific attributes, including payment priority, credit enhancement levels, type of collateral, delinquency rates and loss severity. In addition, for RMBS borrowers, Fair Isaac Corporation (“FICO”) scores and the level of documentation for the loan are also considered. Market standard models, such as Intex, Trepp or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category. Valuation levels of RMBS and CMBS indices are also used as an additional data point for benchmarking purposes or to price outright index positions.

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

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

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

- Collateralized Debt Obligations (“CDO”). The Company holds cash CDOs that typically reference a tranche of an underlying synthetic portfolio of single name credit default swaps. The collateral is usually ABS or other corporate bonds. Credit correlation, a primary input used to determine the fair value of a cash CDO, is usually unobservable and derived using a benchmarking technique. The other model inputs such as credit spreads, including collateral spreads, and interest rates are typically observable. CDOs are categorized in Level 2 of the fair value hierarchy when the credit correlation input is insignificant. In instances where the credit correlation input is deemed to be significant, these instruments are categorized in Level 3 of the fair value hierarchy.
- Corporate Loans and Lending Commitments. The fair value of corporate loans is determined using recently executed transactions, market price quotations (where observable), implied yields from comparable debt, and market observable credit default swap spread levels obtained from independent external parties such as vendors and brokers adjusted for any basis difference between cash and derivative instruments, along with proprietary valuation models and default recovery analysis where such transactions and quotations are unobservable. The fair value of contingent corporate lending commitments is determined by using executed transactions on comparable loans and the anticipated market price based on pricing indications from syndicate banks and customers. The valuation of loans and lending commitments also takes into account fee income that is considered an attribute of the contract. Corporate loans and lending commitments are categorized in Level 2 of the fair value hierarchy except in instances where prices or significant spread inputs are unobservable, in which case they are categorized in Level 3 of the fair value hierarchy.
- Mortgage Loans. Mortgage loans are valued using observable prices based on transactional data for identical or comparable instruments, when available. Where observable prices are not available, the Company estimates fair value based on benchmarking to prices and rates observed in the primary market for similar loan or borrower types or based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved or a methodology that utilizes the capital structure and credit spreads of recent comparable securitization transactions. Mortgage loans valued based on observable transactional data for identical or comparable instruments are categorized in Level 2 of the fair value hierarchy. Where observable prices are not available, due to the subjectivity involved in the comparability assessment related to mortgage loan vintage, geographical concentration, prepayment speed and projected loss assumptions, mortgage loans are categorized in Level 3 of the fair value hierarchy.
- Auction Rate Securities (“ARS”). The Company primarily holds investments in Student Loan Auction Rate Securities (“SLARS”) and Municipal Auction Rate Securities (“MARS”) with interest rates that are reset through periodic auctions. SLARS are ABS backed by pools of student loans. MARS are municipal bonds often wrapped by municipal bond insurance. ARS were historically traded and valued as floating rate notes, priced at par due to the auction mechanism. Beginning in fiscal 2008, uncertainties in the credit markets have resulted in auctions failing for certain types of ARS. Once the auctions failed, ARS could no longer be valued using observations of auction market prices. Accordingly, the fair value of ARS is determined using independent external market data where available and an internally developed methodology to discount for the lack of liquidity and non-performance risk.

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

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

#### *Corporate Equities.*

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

#### *Derivative and Other Contracts.*

- Listed Derivative Contracts. Listed derivatives that are actively traded are valued based on quoted prices from the exchange and are categorized in Level 1 of the fair value hierarchy. Listed derivatives that are not actively traded are valued using the same approaches as those applied to OTC derivatives; they are generally categorized in Level 2 of the fair value hierarchy.
- OTC Derivative Contracts. OTC derivative contracts include forward, swap and option contracts related to interest rates, foreign currencies, credit standing of reference entities, equity prices or commodity prices.

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

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

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

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

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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

#### *Investments.*

- The Company's investments include investments in private equity funds, real estate funds, hedge funds and direct investments in equity securities. Direct investments are presented in the fair value hierarchy table as Principal investments and Other. Initially, the transaction price is generally considered by the Company as the exit price and is the Company's best estimate of fair value.

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

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

#### *Physical Commodities.*

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

#### *Securities Available for Sale.*

- Securities available for sale are composed of U.S. government and agency securities, including U.S. Treasury securities, agency-issued debt, agency mortgage pass-through securities and collateralized mortgage obligations. Actively traded U.S. Treasury securities and non-callable agency-issued debt securities are generally categorized in Level 1 of the fair value hierarchy. Callable agency-issued debt securities, agency mortgage pass-through securities and collateralized mortgage obligations are generally categorized in Level 2 of the fair value hierarchy. For further information on securities available for sale, see Note 4.

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

#### *Commercial Paper and Other Short-term Borrowings/Long-term Borrowings.*

- Structured Notes. The Company issues structured notes that have coupon or repayment terms linked to the performance of debt or equity securities, indices, currencies or commodities. Fair value of structured notes is determined using valuation models for the derivative and debt portions of the notes. These models incorporate observable inputs referencing identical or comparable securities, including prices that the notes are linked to, interest rate yield curves, option volatility and currency, commodity or equity rates. Independent, external and traded prices for the notes are also considered. The impact of the Company's own credit spreads is also included based on the Company's observed secondary bond market spreads. Most structured notes are categorized in Level 2 of the fair value hierarchy.

#### *Deposits.*

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

#### *Securities Sold under Agreements to Repurchase.*

- In 2010, the fair value option was elected for certain securities sold under agreements to repurchase. The fair value of a repurchase agreement is computed using a standard cash flow discounting methodology. The inputs to the valuation include contractual cash flows and collateral funding spreads, which are estimated using various benchmarks, interest rate yield curves and option volatilities. In instances where the unobservable inputs are deemed significant, repurchase agreements are categorized in Level 3 of the fair value hierarchy; otherwise, they are categorized in Level 2 of the fair value hierarchy.

The following fair value hierarchy tables present information about the Company's assets and liabilities measured at fair value on a recurring basis at March 31, 2011 and December 31, 2010.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at March 31, 2011

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at March 31, 2011
(dollars in millions)					
<b>Assets</b>					
Financial instruments owned:					
U.S. government and agency securities:					
U.S. Treasury securities	\$ 15,174	\$ 21	\$ —	\$ —	\$ 15,195
U.S. agency securities	4,253	27,121	57	—	31,431
Total U.S. government and agency securities	19,427	27,142	57	—	46,626
Other sovereign government obligations	30,494	8,258	126	—	38,878
Corporate and other debt:					
State and municipal securities	—	3,370	4	—	3,374
Residential mortgage-backed securities	—	3,572	361	—	3,933
Commercial mortgage-backed securities	—	2,782	132	—	2,914
Asset-backed securities	—	2,355	—	—	2,355
Corporate bonds	—	40,454	1,366	—	41,820
Collateralized debt obligations	—	1,961	1,593	—	3,554
Loans and lending commitments	—	16,757	11,218	—	27,975
Other debt	—	2,369	165	—	2,534
Total corporate and other debt	—	73,620	14,839	—	88,459
Corporate equities(1)	64,037	2,503	502	—	67,042
Derivative and other contracts:					
Interest rate contracts	1,578	534,820	5,767	—	542,165
Credit contracts	—	85,999	13,012	—	99,011
Foreign exchange contracts	—	58,336	389	—	58,725
Equity contracts	1,577	38,555	1,043	—	41,175
Commodity contracts	6,829	57,540	1,056	—	65,425
Other	—	119	143	—	262
Netting(2)	(8,337)	(677,036)	(11,186)	(60,291)	(756,850)
Total derivative and other contracts	1,647	98,333	10,224	(60,291)	49,913
Investments:					
Private equity funds	—	—	2,006	—	2,006
Real estate funds	—	6	1,251	—	1,257
Hedge funds	—	666	871	—	1,537
Principal investments	269	193	3,057	—	3,519
Other	191	160	398	—	749
Total investments	460	1,025	7,583	—	9,068
Physical commodities	—	8,126	—	—	8,126
Total financial instruments owned	116,065	219,007	33,331	(60,291)	308,112
Securities available for sale:					
U.S. government and agency securities	15,157	12,576	—	—	27,733
Securities received as collateral	13,007	154	—	—	13,161
Intangible assets(3)	—	—	144	—	144
<b>Liabilities</b>					
Deposits	\$ —	\$ 2,848	\$ —	\$ —	\$ 2,848
Commercial paper and other short-term borrowings	—	1,653	4	—	1,657
Financial instruments sold, not yet purchased:					
U.S. government and agency securities:					
U.S. Treasury securities	29,260	4	—	—	29,264
U.S. agency securities	2,147	77	—	—	2,224
Total U.S. government and agency securities	31,407	81	—	—	31,488

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at March 31, 2011
	(dollars in millions)				
Other sovereign government obligations	19,784	3,349	—	—	23,133
Corporate and other debt:					
State and municipal securities	—	4	—	—	4
Asset-backed securities	—	7	—	—	7
Corporate bonds	—	9,421	150	—	9,571
Collateralized debt obligations	—	—	2	—	2
Unfunded lending commitments	—	435	171	—	606
Other debt	—	73	180	—	253
Total corporate and other debt	—	9,940	503	—	10,443
Corporate equities(1)	25,713	899	9	—	26,621
Derivative and other contracts:					
Interest rate contracts	1,366	508,086	5,825	—	515,277
Credit contracts	—	80,208	6,933	—	87,141
Foreign exchange contracts	—	60,507	343	—	60,850
Equity contracts	1,663	43,003	1,688	—	46,354
Commodity contracts	7,477	59,024	726	—	67,227
Other	—	581	651	—	1,232
Netting(2)	(8,337)	(677,036)	(11,186)	(36,937)	(733,496)
Total derivative and other contracts	2,169	74,373	4,980	(36,937)	44,585
Total financial instruments sold, not yet purchased	79,073	88,642	5,492	(36,937)	136,270
Obligation to return securities received as collateral	17,915	154	—	—	18,069
Securities sold under agreements to repurchase	—	538	352	—	890
Other secured financings	—	7,447	605	—	8,052
Long-term borrowings	21	42,180	1,374	—	43,575

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

(2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled "Counterparty and Cash Collateral Netting." For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 10.

(3) Amount represents mortgage servicing rights ("MSR") accounted for at fair value. See Note 6 for further information on MSRs.

**Transfers Between Level 1 and Level 2 During the Quarter Ended March 31, 2011.**

*Financial instruments owned—Derivative and other contracts and Financial instruments sold, not yet purchased—Derivative and other contracts.* During the quarter ended March 31, 2011, the Company reclassified approximately \$0.6 billion of derivative assets and approximately \$0.8 billion of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange.



MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at December 31, 2010

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at December 31, 2010
	(dollars in millions)				
<b>Assets</b>					
Financial instruments owned:					
U.S. government and agency securities:					
U.S. Treasury securities	\$ 19,226	\$ —	\$ —	\$ —	\$ 19,226
U.S. agency securities	3,827	25,380	13	—	29,220
Total U.S. government and agency securities	23,053	25,380	13	—	48,446
Other sovereign government obligations	25,334	8,501	73	—	33,908
Corporate and other debt:					
State and municipal securities	—	3,229	110	—	3,339
Residential mortgage-backed securities	—	3,690	319	—	4,009
Commercial mortgage-backed securities	—	2,692	188	—	2,880
Asset-backed securities	—	2,322	13	—	2,335
Corporate bonds	—	39,569	1,368	—	40,937
Collateralized debt obligations	—	2,305	1,659	—	3,964
Loans and lending commitments	—	15,308	11,666	—	26,974
Other debt	—	3,523	193	—	3,716
Total corporate and other debt	—	72,638	15,516	—	88,154
Corporate equities(1)	65,009	2,923	484	—	68,416
Derivative and other contracts:					
Interest rate contracts	3,985	616,016	966	—	620,967
Credit contracts	—	95,818	14,316	—	110,134
Foreign exchange contracts	1	61,556	431	—	61,988
Equity contracts	2,176	36,612	1,058	—	39,846
Commodity contracts	5,464	57,528	1,160	—	64,152
Other	—	108	135	—	243
Netting(2)	(8,551)	(761,939)	(7,168)	(68,380)	(846,038)
Total derivative and other contracts	3,075	105,699	10,898	(68,380)	51,292
Investments:					
Private equity funds	—	—	1,986	—	1,986
Real estate funds	—	8	1,176	—	1,184
Hedge funds	—	736	901	—	1,637
Principal investments	286	486	3,131	—	3,903
Other(3)	403	79	560	—	1,042
Total investments	689	1,309	7,754	—	9,752
Physical commodities	—	6,778	—	—	6,778
Total financial instruments owned	117,160	223,228	34,738	(68,380)	306,746
Securities available for sale:					
U.S. government and agency securities	20,792	8,857	—	—	29,649
Securities received as collateral	15,646	890	1	—	16,537
Intangible assets(4)	—	—	157	—	157
<b>Liabilities</b>					
Deposits	\$ —	\$ 3,011	\$ 16	\$ —	\$ 3,027
Commercial paper and other short-term borrowings	—	1,797	2	—	1,799
Financial instruments sold, not yet purchased:					
U.S. government and agency securities:					
U.S. Treasury securities	25,225	—	—	—	25,225
U.S. agency securities	2,656	67	—	—	2,723
Total U.S. government and agency securities	27,881	67	—	—	27,948



MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at December 31, 2010
	(dollars in millions)				
Other sovereign government obligations . . . .	19,708	2,542	—	—	22,250
Corporate and other debt:					
State and municipal securities . . . . .	—	11	—	—	11
Asset-backed securities . . . . .	—	12	—	—	12
Corporate bonds . . . . .	—	9,100	44	—	9,144
Collateralized debt obligations . . . . .	—	2	—	—	2
Unfunded lending commitments . . . . .	—	464	263	—	727
Other debt . . . . .	—	828	194	—	1,022
Total corporate and other debt . . . . .	—	10,417	501	—	10,918
Corporate equities(1) . . . . .	19,696	127	15	—	19,838
Derivative and other contracts:					
Interest rate contracts . . . . .	3,883	591,378	542	—	595,803
Credit contracts . . . . .	—	87,904	7,722	—	95,626
Foreign exchange contracts . . . . .	2	64,301	385	—	64,688
Equity contracts . . . . .	2,098	42,242	1,820	—	46,160
Commodity contracts . . . . .	5,871	58,885	972	—	65,728
Other . . . . .	—	520	1,048	—	1,568
Netting(2) . . . . .	(8,551)	(761,939)	(7,168)	(44,113)	(821,771)
Total derivative and other contracts . . . . .	3,303	83,291	5,321	(44,113)	47,802
Total financial instruments sold, not yet purchased . . . . .	70,588	96,444	5,837	(44,113)	128,756
Obligation to return securities received as collateral . . . . .	20,272	890	1	—	21,163
Securities sold under agreements to repurchase . .	—	498	351	—	849
Other secured financings . . . . .	—	7,474	1,016	—	8,490
Long-term borrowings . . . . .	—	41,393	1,316	—	42,709

- (1) The Company holds or sells short for trading purposes equity securities issued by entities in diverse industries and of varying size.
- (2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled "Counterparty and Cash Collateral Netting." For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 10.
- (3) In June 2010, the Company voluntarily contributed \$25 million to certain other investments in funds that it manages in connection with upcoming rule changes regarding net asset value disclosures for money market funds. Based on current liquidity and fund performance, the Company does not expect to provide additional voluntary support to non-consolidated funds that it manages.
- (4) Amount represents MSRs accounted for at fair value. See Note 6 for further information on MSRs.

**Transfers Between Level 1 and Level 2 during the Quarter Ended March 31, 2010.**

*Financial instruments owned—Derivative and other contracts and Financial instruments sold, not yet purchased—Derivative and other contracts.* During the quarter ended March 31, 2010, the Company reclassified approximately \$1.3 billion of derivative assets and approximately \$1.5 billion of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange.

*Financial instruments owned—Corporate equities.* During the quarter ended March 31, 2010, the Company reclassified approximately \$1.0 billion of certain Corporate equities from Level 2 to Level 1 as transactions in these securities occurred with sufficient frequency and volume to constitute an active market.

The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the quarters ended March 31, 2011 and 2010, respectively. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realized and unrealized gains (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

realized and unrealized gains (losses) on hedging instruments that have been classified by the Company within the Level 1 and/or Level 2 categories.

Additionally, both observable and unobservable inputs may be used to determine the fair value of positions that the Company has classified within the Level 3 category. As a result, the unrealized gains (losses) during the period for assets and liabilities within the Level 3 category presented in the tables below may include changes in fair value during the period that were attributable to both observable (*e.g.*, changes in market interest rates) and unobservable (*e.g.*, changes in unobservable long-dated volatilities) inputs.

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

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended March 31, 2011

	Beginning Balance at December 31, 2010	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at March 31, 2011	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at March 31, 2011(2)
(dollars in millions)									
<b>Assets</b>									
Financial instruments owned:									
U.S. agency securities	\$ 13	\$ —	\$ 103	\$ (52)	\$ —	\$ —	\$ (7)	\$ 57	\$ —
Other sovereign government obligations	73	—	59	—	—	—	(6)	126	—
Corporate and other debt:									
State and municipal securities	110	(1)	4	(96)	—	—	(13)	4	—
Residential mortgage-backed securities	319	(58)	198	(183)	—	(1)	86	361	(21)
Commercial mortgage-backed securities	188	16	9	(30)	—	—	(51)	132	10
Asset-backed securities	13	—	12	(19)	—	—	(6)	—	—
Corporate bonds	1,368	33	255	(215)	—	—	(75)	1,366	55
Collateralized debt obligations	1,659	254	355	(595)	—	(36)	(44)	1,593	93
Loans and lending commitments	11,666	386	1,023	(643)	—	(1,024)	(190)	11,218	382
Other debt	193	(6)	1	(22)	—	—	(1)	165	(16)
Total corporate and other debt	15,516	624	1,857	(1,803)	—	(1,061)	(294)	14,839	503
Corporate equities	484	(53)	101	(98)	—	—	68	502	(18)
Net derivatives and other contracts(3):									
Interest rate contracts	424	169	1	—	(663)	(114)	125	(58)	100
Credit contracts	6,594	(673)	128	—	(152)	71	111	6,079	(245)
Foreign exchange contracts	46	(124)	—	—	—	127	(3)	46	(100)
Equity contracts	(762)	75	65	(12)	(85)	15	59	(645)	75
Commodity contracts	188	(9)	161	—	(132)	85	37	330	(4)
Other	(913)	209	—	—	(5)	205	(4)	(508)	203
Total net derivative and other contracts	5,577	(353)	355	(12)	(1,037)	389	325	5,244	29
Investments:									
Private equity funds	1,986	107	32	(190)	—	—	71	2,006	95
Real estate funds	1,176	64	14	(3)	—	—	—	1,251	102
Hedge funds	901	(9)	135	(189)	—	—	33	871	(9)
Principal investments	3,131	66	202	(301)	—	—	(41)	3,057	(85)
Other	560	8	1	(14)	—	—	(157)	398	3
Total investments	7,754	236	384	(697)	—	—	(94)	7,583	106
Securities received as collateral	1	—	—	(1)	—	—	—	—	—
Intangible assets	157	(15)	3	(1)	—	—	—	144	(14)
<b>Liabilities</b>									
Deposits	\$ 16	\$ 2	\$ —	\$ —	\$ —	\$ (14)	\$ —	\$ —	\$ —
Commercial paper and other short-term borrowings									
	2	—	—	—	4	(2)	—	4	—
Financial instruments sold, not yet purchased:									
Corporate and other debt:									
Corporate bonds	44	1	(27)	155	—	—	(21)	150	8
Collateralized debt obligations	—	1	—	3	—	—	—	2	1
Unfunded lending commitments	263	92	—	—	—	—	—	171	92
Other debt	194	—	—	—	—	—	(14)	180	—
Total corporate and other debt	501	94	(27)	158	—	—	(35)	503	101
Corporate equities	15	(1)	(8)	1	—	—	—	9	—
Obligation to return securities received as collateral	1	—	(1)	—	—	—	—	—	—
Securities sold under agreements to repurchase	351	(2)	—	—	—	(1)	—	352	(2)
Other secured financings	1,016	(12)	—	—	—	(117)	(306)	605	(12)
Long-term borrowings	1,316	(84)	—	—	141	(180)	13	1,374	(83)

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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- (1) Total realized and unrealized gains (losses) are primarily included in Principal transactions—Trading in the condensed consolidated statements of income except for \$236 million related to Financial instruments owned—Investments, which is included in Principal transactions—Investments.
  - (2) Amounts represent unrealized gains (losses) for the quarter ended March 31, 2011 related to assets and liabilities still outstanding at March 31, 2011.
  - (3) Net derivative and other contracts represent Financial instruments owned—Derivative and other contracts net of Financial instruments sold, not yet purchased—Derivative and other contracts. For further information on Derivative instruments and hedging activities, see Note 10.

*Financial instruments owned—Corporate and other debt.* During the quarter ended March 31, 2011, the Company reclassified approximately \$1.6 billion of certain Corporate and other debt, primarily corporate loans, from Level 3 to Level 2. The Company reclassified the corporate loans as external prices and/or spread inputs for these instruments became observable.

The Company also reclassified approximately \$1.3 billion of certain Corporate and other debt from Level 2 to Level 3. The reclassifications were primarily related to corporate loans and were generally due to a reduction in market price quotations for these or comparable instruments, or a lack of available broker quotes, such that unobservable inputs had to be utilized for the fair value measurement of these instruments.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended March 31, 2010

	Beginning Balance at December 31, 2009	Total Realized and Unrealized Gains (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers	Ending Balance at March 31, 2010	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at March 31, 2010(2)
	(dollars in millions)					
<b>Assets</b>						
Financial instruments owned:						
U.S. agency securities .....	\$ 36	\$ —	\$ (35)	\$ —	\$ 1	\$ —
Other sovereign government obligations .....	3	2	76	(1)	80	1
Corporate and other debt:						
State and municipal securities .....	713	(18)	(297)	—	398	1
Residential mortgage-backed securities .....	818	24	(220)	3	625	19
Commercial mortgage-backed securities .....	1,573	109	(860)	(43)	779	42
Asset-backed securities .....	591	1	(440)	(3)	149	10
Corporate bonds .....	1,038	(55)	128	34	1,145	(48)
Collateralized debt obligations .....	1,553	133	(171)	(3)	1,512	121
Loans and lending commitments .....	12,506	155	572	270	13,503	143
Other debt .....	1,662	252	8	(1)	1,921	244
Total corporate and other debt .....	20,454	601	(1,280)	257	20,032	532
Corporate equities .....	536	70	(7)	(63)	536	56
Net derivative and other contracts:						
Interest rate contracts .....	387	9	7	(19)	384	1
Credit contracts .....	8,824	(434)	96	(534)	7,952	(352)
Foreign exchange rate contracts ..	254	(285)	201	36	206	(308)
Equity contracts .....	(689)	(96)	58	26	(701)	(88)
Commodity contracts .....	7	(25)	108	—	90	83
Other .....	(437)	(147)	4	1	(579)	(113)
Total net derivative and other contracts(3) .....	8,346	(978)	474	(490)	7,352	(777)
Investments .....	7,613	56	19	(142)	7,546	50
Securities received as collateral .....	23	—	(23)	—	—	—
Intangible assets .....	137	38	—	—	175	30
<b>Liabilities</b>						
Deposits .....	\$ 24	\$ 1	\$ —	\$ (8)	\$ 15	\$ 1
Commercial paper and other short-term borrowings .....						
	—	—	300	—	300	—
Financial instruments sold, not yet purchased:						
Corporate and other debt:						
Asset-backed securities .....	4	—	—	—	4	—
Corporate bonds .....	29	(42)	(79)	25	17	(36)
Collateralized debt obligations .....	3	—	(3)	—	—	—
Unfunded lending commitments .....	252	(32)	(71)	—	213	(29)
Other debt .....	431	25	(76)	(13)	317	24
Total corporate and other debt .....	719	(49)	(229)	12	551	(41)
Corporate equities .....	4	(1)	5	3	13	—
Obligation to return securities received as collateral .....						
	23	—	(23)	—	—	—
Other secured financings .....	1,532	(104)	175	—	1,811	(104)
Long-term borrowings .....	6,865	5	45	(177)	6,728	5

**MORGAN STANLEY**

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

- (1) Total realized and unrealized gains (losses) are primarily included in Principal transactions—Trading in the condensed consolidated statements of income except for \$56 million related to Financial instruments owned—Investments, which is included in Principal transactions—Investments.
- (2) Amounts represent unrealized gains (losses) for the quarter ended March 31, 2010 related to assets and liabilities still outstanding at March 31, 2010.
- (3) Net derivative and other contracts represent Financial instruments owned—Derivative and other contracts net of Financial instruments sold, not yet purchased—Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 10.

*Financial instruments owned—Corporate and other debt.* During the quarter ended March 31, 2010, the Company reclassified approximately \$0.6 billion of certain Corporate and other debt, primarily corporate loans, from Level 3 to Level 2. The Company reclassified the corporate loans as external prices and/or spread inputs for these instruments became observable.

The Company also reclassified approximately \$0.9 billion of certain Corporate and other debt from Level 2 to Level 3. The reclassifications were primarily related to corporate loans and were generally due to a reduction in market price quotations for these or comparable instruments, or a lack of available broker quotes, such that unobservable inputs had to be utilized for the fair value measurement of these instruments. The Company reclassified the corporate loans as external prices and/or spread inputs became unobservable.

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

***Fair Value of Investments that Calculate Net Asset Value.***

The Company's Investments measured at fair value were \$9,068 million and \$9,752 million at March 31, 2011 and December 31, 2010, respectively. The following table presents information solely about the Company's investments in private equity funds, real estate funds and hedge funds measured at fair value based on net asset value at March 31, 2011 and December 31, 2010, respectively.

	At March 31, 2011		At December 31, 2010	
	Fair Value	Unfunded Commitment	Fair Value	Unfunded Commitment
	(dollars in millions)			
Private equity funds .....	\$1,968	\$1,111	\$1,947	\$1,047
Real estate funds .....	1,225	552	1,154	500
Hedge funds(1):				
Long-short equity hedge funds .....	877	4	1,046	4
Fixed income/credit-related hedge funds .....	304	—	305	—
Event-driven hedge funds .....	196	—	143	—
Multi-strategy hedge funds .....	161	—	140	—
<b>Total .....</b>	<b><u>\$4,731</u></b>	<b><u>\$1,667</u></b>	<b><u>\$4,735</u></b>	<b><u>\$1,551</u></b>

- (1) Fixed income/credit-related hedge funds, event-driven hedge funds, and multi-strategy hedge funds are redeemable at least on a six-month period basis primarily with a notice period of 90 days or less. At March 31, 2011, approximately 57% of the fair value amount of long-short equity hedge funds is redeemable at least quarterly, 20% is redeemable every six months and 23% of these funds have a redemption frequency of greater than six months. At December 31, 2010, approximately 49% of the fair value amount of long-short equity hedge funds is redeemable at least quarterly, 24% is redeemable every six months and 27% of these funds have a redemption frequency of greater than six months. The notice period for long-short equity hedge funds is primarily greater than 90 days.

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

*Private Equity Funds.* Amount includes several private equity funds that pursue multiple strategies including leveraged buyouts, venture capital, infrastructure growth capital, distressed investments, and mezzanine capital. In addition, the funds may be structured with a focus on specific domestic or foreign geographic regions. These investments are generally not redeemable with the funds. Instead, the nature of the investments in this category is that distributions are received through the liquidation of the underlying assets of the fund. At March 31, 2011, it is estimated that 6% of the fair value of the funds will be liquidated in the next five years, another 36% of the fair value of the funds will be liquidated between five to 10 years and the remaining 58% of the fair value of the funds have a remaining life of greater than 10 years.

*Real Estate Funds.* Amount includes several real estate funds that invest in real estate assets such as commercial office buildings, retail properties, multi-family residential properties, developments or hotels. In addition, the funds may be structured with a focus on specific geographic domestic or foreign regions. These investments are generally not redeemable with the funds. Distributions from each fund will be received as the underlying investments of the funds are liquidated. At March 31, 2011, it is estimated that 19% of the fair value of the funds will be liquidated within the next five years, another 33% of the fair value of the funds will be liquidated between five to 10 years and the remaining 48% of the fair value of the funds have a remaining life of greater than 10 years.

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

- *Long-short Equity Hedge Funds.* Amount includes investments in hedge funds that invest, long or short, in equities. Equity value and growth hedge funds purchase stocks perceived to be undervalued and sell stocks perceived to be overvalued. Investments representing approximately 22% of the fair value of the investments in this category cannot be redeemed currently because the investments include certain initial period lock-up restrictions. The remaining restriction period for 100% of investments subject to lock-up restrictions ranged from one to three years at March 31, 2011. Investments representing approximately 23% of the fair value of the investments in long-short equity hedge funds cannot be redeemed currently because an exit restriction has been imposed by the hedge fund manager. The restriction period for 100% of investments subject to an exit restriction was primarily two years or less at March 31, 2011.
- *Fixed Income/Credit-Related Hedge Funds.* Amount includes investments in hedge funds that employ long-short, distressed or relative value strategies in order to benefit from investments in undervalued or overvalued securities that are primarily debt or credit related. At March 31, 2011, investments representing approximately 18% of the fair value of the investments in fixed income/credit-related hedge funds cannot be redeemed currently because the investments include certain initial period lock-up restrictions. The remaining restriction period for these investments was two years or less at March 31, 2011.
- *Event-Driven Hedge Funds.* Amount includes investments in hedge funds that invest in event-driven situations such as mergers, hostile takeovers, reorganizations, or leveraged buyouts. This may involve the simultaneous purchase of stock in companies being acquired and the sale of stock in its acquirer, hoping to profit from the spread between the current market price and the ultimate purchase price of the target company. At March 31, 2011, investments representing approximately 37% of the value of the investments in this category cannot be redeemed currently because the investments include certain initial period lock-up restrictions. The remaining restriction period for these investments was two years or less at March 31, 2011.
- *Multi-strategy Hedge Funds.* Amount includes investments in hedge funds that pursue multiple strategies to realize short- and long-term gains. Management of the hedge funds has the ability to

**MORGAN STANLEY**

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

overweight or underweight different strategies to best capitalize on current investment opportunities. At March 31, 2011, investments representing approximately 35% of the fair value of the investments in this category cannot be redeemed currently because the investments include certain initial period lock-up restrictions. The remaining restriction period for 72% of investments subject to lock-ups was two years or less at March 31, 2011. The remaining restriction period for the other 28% of investments subject to lock-up restrictions was greater than three years at March 31, 2011. Investments representing approximately 23% of the fair value of investments in multi-strategy hedge funds cannot be redeemed currently because of an exit restriction that has been imposed by the hedge fund manager. The restriction period for 100% of investments subject to an exit restriction was indefinite at March 31, 2011.

***Fair Value Option.***

The Company elected the fair value option for certain eligible instruments that are risk managed on a fair value basis to mitigate income statement volatility caused by measurement basis differences between the elected instruments and their associated risk management transactions or to eliminate complexities of applying certain accounting models. The following tables present net gains (losses) due to changes in fair value for items measured at fair value pursuant to the fair value option election for the quarters ended March 31, 2011 and 2010, respectively.

	<b>Principal Transactions- Trading</b>	<b>Interest Expense</b>	<b>Gains (Losses) Included in Net Revenues</b>
	(dollars in millions)		
<i>Three Months Ended March 31, 2011</i>			
Deposits .....	\$ 13	\$ (30)	\$ (17)
Commercial paper and other short-term borrowings .....	(5)	—	(5)
Long-term borrowings .....	(1,266)	(290)	(1,556)
Securities sold under agreements to repurchase .....	(2)	—	(2)
<i>Three Months Ended March 31, 2010</i>			
Deposits .....	\$ (25)	\$ (47)	\$ (72)
Commercial paper and other short-term borrowings .....	13	—	13
Long-term borrowings .....	(366)	(202)	(568)

In addition to the amounts in the above table, as discussed in Note 2 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K, all of the instruments within Financial instruments owned or Financial instruments sold, not yet purchased are measured at fair value, either through the election of the fair value option, or as required by other accounting guidance.

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

**Gains (Losses) due to Changes in Instrument Specific Credit Spreads**

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
	(dollars in millions)	
Short-term and long-term borrowings(1) .....	\$(189)	\$ 54
Loans(2) .....	140	316
Unfunded lending commitments(3) .....	10	(21)

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



**MORGAN STANLEY**

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

**Amount by Which Contractual Principal Amount Exceeds Fair Value**

	At March 31, 2011	At December 31, 2010
	(dollars in billions)	
Short-term and long-term borrowings(1) . . . . .	\$ 1.1	\$ 0.6
Loans(2) . . . . .	23.6	24.3
Loans 90 or more days past due and/or on non-accrual status(2)(3) . . . . .	21.2	21.2

- (1) These amounts do not include structured notes where the repayment of the initial principal amount fluctuates based on changes in the reference price or index.
- (2) The majority of this difference between principal and fair value amounts emanates from the Company's distressed debt trading business, which purchases distressed debt at amounts well below par.
- (3) The aggregate fair value of loans that were in non-accrual status, which includes all loans 90 or more days past due, was \$2.7 billion and \$2.2 billion at March 31, 2011 and December 31, 2010, respectively. The aggregate fair value of loans that were 90 or more days past due was \$2.0 billion at both March 31, 2011 and December 31, 2010.

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

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

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

The following tables present, by caption on the condensed consolidated statements of financial condition, the fair value hierarchy for those assets measured at fair value on a non-recurring basis for which the Company recognized a non-recurring fair value adjustment for the quarters ended March 31, 2011 and 2010, respectively.

*Three Months Ended March 31, 2011.*

		Fair Value Measurements Using:			
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Carrying Value at March 31, 2011	\$	\$	\$	\$	\$
(dollars in millions)					
Loans(2) . . . . .	\$559	\$—	\$ 46	\$513	\$16
Other investments(3) . . . . .	77	—	—	77	(9)
Intangible assets(4) . . . . .	—	—	—	—	(3)
Total . . . . .	\$636	\$—	\$ 46	\$590	\$ 4

- (1) Losses are recorded within Other expenses in the condensed consolidated statement of income except for fair value adjustments related to Loans and losses related to Other investments, which are included in Other revenues.
- (2) Non-recurring change in fair value for loans held for investment was calculated based upon the fair value of the underlying collateral. The fair value of the collateral was determined using internal expected recovery models. The non-recurring change in fair value for mortgage loans held for sale is based upon a valuation model incorporating market observable inputs.
- (3) Losses recorded were determined primarily using discounted cash flow models.
- (4) Losses primarily related to investment management contracts, including contracts associated with FrontPoint, and were determined primarily using discounted cash flow models.

**MORGAN STANLEY**

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

There were no liabilities measured at fair value on a non-recurring basis during the quarter ended March 31, 2011.

*Three Months Ended March 31, 2010.*

	Carrying Value at March 31, 2010	Fair Value Measurements Using:			Total Losses for the Three Months Ended March 31, 2010(1)
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
		(dollars in millions)			
Loans(2) . . . . .	\$634	\$ —	\$—	\$634	\$ (3)
Other investments(3) . . . . .	17	—	—	17	(5)
Intangible assets(4) . . . . .	5	—	—	5	(10)
Total . . . . .	<u>\$656</u>	<u>\$ —</u>	<u>\$—</u>	<u>\$656</u>	<u>\$(18)</u>

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

In addition to the losses included in the table above, the Company incurred a loss of approximately \$932 million in connection with the planned disposition of Revel, which was included in discontinued operations. The loss primarily related to premises and equipment and was included in discontinued operations (see Note 1). The fair value of Revel, net of estimated costs to sell, included in Premises, equipment and software costs was approximately \$240 million at March 31, 2010 and was classified in Level 3. Fair value was determined using discounted cash flow models.

There were no liabilities measured at fair value on a non-recurring basis during the quarter ended March 31, 2010.

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

Some of the Company’s financial instruments are not measured at fair value on a recurring basis but nevertheless are recorded at amounts that approximate fair value due to their liquid or short-term nature. Such financial assets and financial liabilities include: Cash and due from banks, Interest bearing deposits with banks, Cash deposited with clearing organizations or segregated under federal and other regulations or requirements, Federal funds sold and Securities purchased under agreements to resell, Securities borrowed, certain Securities sold under agreements to repurchase, Securities loaned, Receivables—Customers, Receivables—Brokers, dealers and clearing organizations, Payables—Customers, Payables—Brokers, dealers and clearing organizations, certain Commercial paper and other short-term borrowings, certain Deposits and certain Other secured financings.

The Company’s long-term borrowings are recorded at amortized amounts unless elected under the fair value option or designated as a hedged item in a fair value hedge. For long-term borrowings not measured at fair value, the fair value of the Company’s long-term borrowings was estimated using either quoted market prices or discounted cash flow analyses based on the Company’s current borrowing rates for similar types of borrowing

**MORGAN STANLEY**

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

arrangements. At March 31, 2011, the carrying value of the Company’s long-term borrowings not measured at fair value was less than \$0.1 billion lower than fair value. At December 31, 2010, the carrying value of the Company’s long-term borrowings not measured at fair value was approximately \$1.8 billion higher than fair value.

**4. Securities Available for Sale.**

The following table presents information about the Company’s available for sale (“AFS”) securities:

		At March 31, 2011				
		Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Other-than- Temporary Impairment	Fair Value
		(dollars in millions)				
Debt securities available for sale:						
U.S. government and agency securities:						
	U.S. Treasury securities .....	\$13,537	\$149	\$ 40	\$—	\$13,646
	U.S. agency securities .....	<u>14,194</u>	<u>15</u>	<u>122</u>	<u>—</u>	<u>14,087</u>
	Total U.S. government and agency securities .....	<u>\$27,731</u>	<u>\$164</u>	<u>\$162</u>	<u>\$—</u>	<u>\$27,733</u>
		At December 31, 2010				
		Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Other-than- Temporary Impairment	Fair Value
		(dollars in millions)				
Debt securities available for sale:						
U.S. government and agency securities:						
	U.S. Treasury securities .....	\$18,812	\$199	\$ 34	\$—	\$18,977
	U.S. agency securities .....	<u>10,774</u>	<u>16</u>	<u>118</u>	<u>—</u>	<u>10,672</u>
	Total U.S. government and agency securities .....	<u>\$29,586</u>	<u>\$215</u>	<u>\$152</u>	<u>\$—</u>	<u>\$29,649</u>

**MORGAN STANLEY**

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

The table below presents the fair value of investments in debt securities available for sale that have been in an unrealized loss position:

	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>
<b>At March 31, 2011</b>						
			(dollars in millions)			
Debt securities available for sale:						
U.S. government and agency securities:						
U.S. Treasury securities	\$ 2,253	\$ 40	\$—	\$—	\$ 2,253	\$ 40
U.S. agency securities	9,783	122	—	—	9,783	122
Total U.S. government and agency securities	<u>\$12,036</u>	<u>\$162</u>	<u>\$—</u>	<u>\$—</u>	<u>\$12,036</u>	<u>\$162</u>
<b>At December 31, 2010</b>						
			(dollars in millions)			
Debt securities available for sale:						
U.S. government and agency securities:						
U.S. Treasury securities	\$ 1,960	\$ 34	\$—	\$—	\$ 1,960	\$ 34
U.S. agency securities	7,736	118	—	—	7,736	118
Total U.S. government and agency securities	<u>\$ 9,696</u>	<u>\$152</u>	<u>\$—</u>	<u>\$—</u>	<u>\$ 9,696</u>	<u>\$152</u>

Gross unrealized losses are recorded in Accumulated other comprehensive income.

The Company does not intend to sell these securities or expect to be required to sell these securities prior to recovery of the amortized cost basis. In addition, the Company does not expect these securities to experience a credit loss given the explicit and implicit guarantee provided by the U.S. government. The Company believes that the debt securities with an unrealized loss in Accumulated other comprehensive income were not other-than-temporarily impaired at March 31, 2011 and December 31, 2010.

The following table presents the amortized cost and fair value of debt securities available for sale by contractual maturity dates at March 31, 2011.

	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Annualized Average Yield</u>
	(dollars in millions)		
U.S. government and agency securities:			
U.S. Treasury securities:			
Due within 1 year	\$ 1,857	\$ 1,866	0.9%
After 1 year but through 5 years	11,680	11,780	1.5%
Total	<u>\$13,537</u>	<u>\$13,646</u>	
U.S. agency securities:			
Due within 1 year	\$ 786	\$ 792	1.1%
After 1 year but through 5 years	714	719	1.2%
After 5 years	12,694	12,576	1.5%
Total	<u>\$14,194</u>	<u>\$14,087</u>	
Total U.S. government and agency securities:	<u>\$27,731</u>	<u>\$27,733</u>	1.4%

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table presents information pertaining to sales of debt securities available for sale during the three months ended March 31, 2011 (dollars in millions):

Gross realized gains	\$ 12
Gross realized losses	\$ —
Proceeds of sales of debt securities	\$6,121

Gross realized gains and losses are recognized in Other revenues in the condensed consolidated states of income. There were no sales of AFS securities during the three months ended March 31, 2010.

#### 5. Collateralized Transactions.

The Company enters into reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions to, among other things, acquire securities to cover short positions and settle other securities obligations, to accommodate customers' needs and to finance the Company's inventory positions. The Company's policy is generally to take possession of Securities received as collateral, Securities purchased under agreements to resell and Securities borrowed. The Company manages credit exposure arising from reverse repurchase agreements, repurchase agreements, securities borrowed and securities loaned transactions by, in appropriate circumstances, entering into master netting agreements and collateral arrangements with counterparties that provide the Company, in the event of a customer default, the right to liquidate collateral and the right to offset a counterparty's rights and obligations. The Company also monitors the fair value of the underlying securities as compared with the related receivable or payable, including accrued interest, and, as necessary, requests additional collateral to ensure such transactions are adequately collateralized. Where deemed appropriate, the Company's agreements with third parties specify its rights to request additional collateral.

The Company also engages in securities financing transactions for customers through margin lending. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. government and agency securities, other sovereign government obligations, corporate and other debt, and corporate equities. Customer receivables generated from margin lending activity are collateralized by customer-owned securities held by the Company. The Company monitors required margin levels and established credit limits daily and, pursuant to such guidelines, requires customers to deposit additional collateral, or reduce positions, when necessary. Margin loans are extended on a demand basis and are not committed facilities. Factors considered in the review of margin loans are the amount of the loan, the intended purpose, the degree of leverage being employed in the account, and overall evaluation of the portfolio to ensure proper diversification or, in the case of concentrated positions, appropriate liquidity of the underlying collateral or potential hedging strategies to reduce risk. Additionally, transactions relating to concentrated or restricted positions require a review of any legal impediments to liquidation of the underlying collateral. Underlying collateral for margin loans is reviewed with respect to the liquidity of the proposed collateral positions, valuation of securities, historic trading range, volatility analysis and an evaluation of industry concentrations. For these transactions, adherence to the Company's collateral policies significantly limits the Company's credit exposure in the event of customer default. The Company may request additional margin collateral from customers, if appropriate, and, if necessary, may sell securities that have not been paid for or purchase securities sold but not delivered from customers. At March 31, 2011 and December 31, 2010, there were approximately \$24.6 billion and \$18.0 billion, respectively, of customer margin loans outstanding.

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financings. Pledged financial instruments that can be sold or repledged by the secured party are identified as Financial instruments owned (pledged to various parties) in the condensed consolidated statements of financial

**MORGAN STANLEY**

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

condition. The carrying value and classification of financial instruments owned by the Company that have been loaned or pledged to counterparties where those counterparties do not have the right to sell or repledge the collateral were as follows:

	At March 31, 2011	At December 31, 2010
	(dollars in millions)	
Financial instruments owned:		
U.S. government and agency securities .....	\$ 9,126	\$11,513
Other sovereign government obligations .....	7,988	8,741
Corporate and other debt .....	12,198	12,333
Corporate equities .....	24,219	21,919
Total .....	\$53,531	\$54,506

The Company receives collateral in the form of securities in connection with reverse repurchase agreements, securities borrowed and derivative transactions, and customer margin loans. In many cases, the Company is permitted to sell or repledge these securities held as collateral and use the securities to secure repurchase agreements, to enter into securities lending and derivative transactions or for delivery to counterparties to cover short positions. The Company additionally receives securities as collateral in connection with certain securities-for-securities transactions in which the Company is the lender. In instances where the Company is permitted to sell or repledge these securities, the Company reports the fair value of the collateral received and the related obligation to return the collateral in the condensed consolidated statements of financial condition. At March 31, 2011 and December 31, 2010, the fair value of financial instruments received as collateral where the Company is permitted to sell or repledge the securities was \$577 billion and \$537 billion, respectively, and the fair value of the portion that had been sold or repledged was \$430 billion and \$390 billion, respectively.

At March 31, 2011 and December 31, 2010, cash and securities deposited with clearing organizations or segregated under federal and other regulations or requirements were as follows:

	At March 31, 2011	At December 31, 2010
	(dollars in millions)	
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements .....	\$21,932	\$19,180
Securities(1) .....	15,486	18,935
Total .....	\$37,418	\$38,115

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

Other secured financings include the liabilities related to transfers of financial assets that are accounted for as financings rather than sales, consolidated VIEs where the Company is deemed to be the primary beneficiary, and certain equity-linked notes and other secured borrowings. These liabilities are generally payable from the cash flows of the related assets accounted for as Financial instruments owned (see Note 6).

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

#### 6. Variable Interest Entities and Securitization Activities.

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

The Company applies accounting guidance for consolidation of VIEs to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. Excluding entities subject to the Deferral (as defined in Note 2 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K), the primary beneficiary of a VIE is the party that both (1) has the power to direct the activities of a VIE that most significantly affect the VIE's economic performance and (2) has an obligation to absorb losses or the right to receive benefits that in either case could potentially be significant to the VIE. The Company consolidates entities of which it is the primary beneficiary.

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

- Interests purchased in connection with market-making and retained interests held as a result of securitization activities.
- Guarantees issued and residual interests retained in connection with municipal bond securitizations.
- Loans and investments made to VIEs that hold debt, equity, real estate or other assets.
- Derivatives entered into with VIEs.
- Structuring of credit-linked notes ("CLN") or other asset-repackaged notes designed to meet the investment objectives of clients.
- Other structured transactions designed to provide tax-efficient yields to the Company or its clients.

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

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

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

Except for consolidated VIEs included in other structured financings in the tables below, the Company accounts for the assets held by the entities primarily in Financial instruments owned and the liabilities of the entities as

**MORGAN STANLEY**

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

Other secured financings in the condensed consolidated statements of financial condition. The Company includes assets held by consolidated VIEs included in other structured financings in the tables below primarily in Premises, equipment and software costs, and Other assets in the condensed consolidated statements of financial condition. Except for consolidated VIEs included in other structured financings, the assets and liabilities are measured at fair value, with changes in fair value reflected in earnings.

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

The following tables present information at March 31, 2011 and December 31, 2010 about VIEs that the Company consolidates. Consolidated VIE assets and liabilities are presented after intercompany eliminations and include assets financed on a non-recourse basis.

	At March 31, 2011				
	Mortgage and Asset-backed Securitized	Collateralized Debt Obligations	Managed Real Estate Partnerships	Other Structured Financings	Other
	(dollars in millions)				
VIE assets . . . . .	\$3,154	\$125	\$2,078	\$ 699	\$3,467
VIE liabilities . . . . .	\$2,332	\$ 94	\$ 103	\$2,626	\$1,122

	At December 31, 2010				
	Mortgage and Asset-Backed Securitized	Collateralized Debt Obligations	Managed Real Estate Partnerships	Other Structured Financings	Other
	(dollars in millions)				
VIE assets . . . . .	\$3,362	\$129	\$2,032	\$ 643	\$2,584
VIE liabilities . . . . .	\$2,544	\$ 68	\$ 108	\$2,571	\$1,219

In general, the Company's exposure to loss in consolidated VIEs is limited to losses that would be absorbed on the VIE's assets recognized in its financial statements, net of losses absorbed by third-party holders of the VIE's liabilities. At March 31, 2011 and December 31, 2010, managed real estate partnerships reflected noncontrolling interests in the Company's condensed consolidated financial statements of \$1,536 million and \$1,508 million, respectively. The Company also had additional maximum exposure to losses of approximately \$478 million and \$884 million at March 31, 2011 and December 31, 2010, respectively. This additional exposure related primarily to certain derivatives (*e.g.*, credit derivatives in which the Company has sold protection to synthetic collateralized debt obligations, typically for the most senior tranche, instead of purchasing senior securities) and commitments, guarantees and other forms of involvement.



**MORGAN STANLEY**

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

The following tables present information about certain non-consolidated VIEs in which the Company had variable interests at March 31, 2011 and December 31, 2010, respectively. The tables include all VIEs in which the Company has determined that its maximum exposure to loss is greater than specific thresholds or meets certain other criteria.

	At March 31, 2011				
	Mortgage and Asset-Backed Securitizations	Collateralized Debt Obligations	Municipal Tender Option Bonds	Other Structured Financings	Other
	(dollars in millions)				
VIE assets that the Company does not consolidate (unpaid principal balance)(1) . . . . .	\$263,119	\$40,747	\$6,946	\$2,084	\$6,121
Maximum exposure to loss:					
Debt and equity interests(2) . . . . .	\$ 7,825	\$ 1,102	\$ 169	\$1,024	\$1,748
Derivative and other contracts . . . . .	120	920	4,346	—	1,738
Commitments, guarantees and other . . . . .	—	456	—	809	328
Total maximum exposure to loss . . . . .	\$ 7,945	\$ 2,478	\$4,515	\$1,833	\$3,814
Carrying value of exposure to loss—Assets:					
Debt and equity interests(2) . . . . .	\$ 7,825	\$ 1,102	\$ 169	\$ 726	\$1,748
Derivative and other contracts . . . . .	115	731	—	—	414
Total carrying value of exposure to loss— Assets . . . . .	\$ 7,940	\$ 1,833	\$ 169	\$ 726	\$2,162
Carrying value of exposure to loss—Liabilities:					
Derivative and other contracts . . . . .	\$ 17	\$ 108	\$ —	\$ —	\$ 23
Commitments, guarantees and other . . . . .	—	427	—	17	302
Total carrying value of exposure to loss— Liabilities . . . . .	\$ 17	\$ 535	\$ —	\$ 17	\$ 325

(1) Mortgage and asset-backed securitizations include VIE assets as follows: \$40.1 billion of residential mortgages; \$173.2 billion of commercial mortgages; \$28.8 billion of U.S. agency collateralized mortgage obligations; and \$21.0 billion of other consumer or commercial loans.

(2) Mortgage and asset-backed securitizations include VIE debt and equity interests as follows: \$1.9 billion of residential mortgages; \$2.0 billion of commercial mortgages; \$2.7 billion of U.S. agency collateralized mortgage obligations; and \$1.2 billion of other consumer or commercial loans.

**MORGAN STANLEY**

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

	At December 31, 2010				
	Mortgage and Asset-Backed Securizations	Collateralized Debt Obligations	Municipal Tender Option Bonds	Other Structured Financings	Other
	(dollars in millions)				
VIE assets that the Company does not consolidate (unpaid principal balance)(1) . . . . .	\$172,711	\$38,332	\$7,431	\$2,037	\$11,262
Maximum exposure to loss:					
Debt and equity interests(2) . . . . .	\$ 8,129	\$ 1,330	\$ 78	\$1,062	\$ 2,678
Derivative and other contracts . . . . .	113	942	4,709	—	2,079
Commitments, guarantees and other . . . . .	—	—	—	791	446
Total maximum exposure to loss . . . . .	\$ 8,242	\$ 2,272	\$4,787	\$1,853	\$ 5,203
Carrying value of exposure to loss—Assets:					
Debt and equity interests(2) . . . . .	\$ 8,129	\$ 1,330	\$ 78	\$ 779	\$ 2,678
Derivative and other contracts . . . . .	113	753	—	—	551
Total carrying value of exposure to loss— Assets . . . . .	\$ 8,242	\$ 2,083	\$ 78	\$ 779	\$ 3,229
Carrying value of exposure to loss—Liabilities:					
Derivative and other contracts . . . . .	\$ 15	\$ 123	\$ —	\$ —	\$ 23
Commitments, guarantees and other . . . . .	—	—	—	44	261
Total carrying value of exposure to loss— Liabilities . . . . .	\$ 15	\$ 123	\$ —	\$ 44	\$ 284

(1) Mortgage and asset-backed securitizations include VIE assets as follows: \$34.9 billion of residential mortgages; \$94.0 billion of commercial mortgages; \$28.8 billion of U.S. agency collateralized mortgage obligations; and \$15.0 billion of other consumer or commercial loans.

(2) Mortgage and asset-backed securitizations include VIE debt and equity interests as follows: \$1.9 billion of residential mortgages; \$2.1 billion of commercial mortgages; \$3.0 billion of U.S. agency collateralized mortgage obligations; and \$1.1 billion of other consumer or commercial loans.

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

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

Securitization transactions generally involve VIEs. The Company owned additional securities issued by securitization SPEs for which the maximum exposure to loss is less than specific thresholds. These additional securities totaled \$4.8 billion at March 31, 2011. These securities were either retained in connection with

**MORGAN STANLEY**

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

transfers of assets by the Company or acquired in connection with secondary market-making activities. Securities issued by securitization SPEs consist of \$1.9 billion of securities backed primarily by residential mortgage loans, \$0.6 billion of securities backed by U.S. agency collateralized mortgage obligations, \$0.8 billion of securities backed by commercial mortgage loans, \$0.9 billion of securities backed by collateralized debt obligations or collateralized loan obligations and \$0.6 billion backed by other consumer loans, such as credit card receivables, automobile loans and student loans. The Company's primary risk exposure is to the securities issued by the SPE owned by the Company, with the risk highest on the most subordinate class of beneficial interests. These securities generally are included in Financial instruments owned—Corporate and other debt and are measured at fair value. The Company does not provide additional support in these transactions through contractual facilities, such as liquidity facilities, guarantees or similar derivatives. The Company's maximum exposure to loss generally equals the fair value of the securities owned.

The Company's transactions with VIEs primarily includes securitizations, municipal tender option bond trusts, credit protection purchased through CLNs, other structured financings, collateralized loan and debt obligations, equity-linked notes, managed real estate partnerships and asset management investment funds. Such activities are described in Note 7 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K.

***Transfers of Assets with Continuing Involvement.***

The following tables present information at March 31, 2011 regarding transactions with SPEs in which the Company, acting as principal, transferred assets with continuing involvement and received sales treatment.

	At March 31, 2011			
	Residential Mortgage Loans	Commercial Mortgage Loans	U.S. Agency Collateralized Mortgage Obligations	Credit- Linked Notes and Other
	(dollars in millions)			
SPE assets (unpaid principal balance)(1) . . . . .	\$47,089	\$89,033	\$29,314	\$19,303
Retained interests (fair value):				
Investment grade . . . . .	\$ 38	\$ 110	\$ 1,786	\$ 3
Non-investment grade . . . . .	345	56	—	2,525
Total retained interests (fair value) . . . . .	<u>\$ 383</u>	<u>\$ 166</u>	<u>\$ 1,786</u>	<u>\$ 2,528</u>
Interests purchased in the secondary market (fair value):				
Investment grade . . . . .	\$ 67	\$ 307	\$ 145	\$ 433
Non-investment grade . . . . .	317	103	86	35
Total interests purchased in the secondary market (fair value) . . . . .	<u>\$ 384</u>	<u>\$ 410</u>	<u>\$ 231</u>	<u>\$ 468</u>
Derivative assets (fair value) . . . . .	\$ 55	\$ 1,095	\$ —	\$ 295
Derivative liabilities (fair value) . . . . .	\$ 34	\$ —	\$ —	\$ 242

(1) Amounts include assets transferred by unrelated transferors.

**MORGAN STANLEY**

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

	At March 31, 2011			
	Level 1	Level 2	Level 3	Total
	(dollars in millions)			
Retained interests (fair value):				
Investment grade	\$—	\$1,921	\$ 16	\$1,937
Non-investment grade	—	160	2,766	2,926
Total retained interests (fair value)	\$—	\$2,081	\$2,782	\$4,863
Interests purchased in the secondary market (fair value):				
Investment grade	\$—	\$ 951	\$ 1	\$ 952
Non-investment grade	—	324	217	541
Total interests purchased in the secondary market (fair value)	\$—	\$1,275	\$ 218	\$1,493
Derivative assets (fair value)	\$—	\$ 902	\$ 543	\$1,445
Derivative liabilities (fair value)	\$—	\$ 244	\$ 32	\$ 276

The following tables present information at December 31, 2010 regarding transactions with SPEs in which the Company, acting as principal, transferred assets with continuing involvement and received sales treatment.

	At December 31, 2010			
	Residential Mortgage Loans	Commercial Mortgage Loans	U.S. Agency Collateralized Mortgage Obligations	Credit- Linked Notes and Other
	(dollars in millions)			
SPE assets (unpaid principal balance)(1)	\$48,947	\$85,974	\$29,748	\$11,462
Retained interests (fair value):				
Investment grade	\$ 46	\$ 64	\$ 2,636	\$ 8
Non-investment grade	206	81	—	2,327
Total retained interests (fair value)	\$ 252	\$ 145	\$ 2,636	\$ 2,335
Interests purchased in the secondary market (fair value):				
Investment grade	\$ 118	\$ 643	\$ 155	\$ 21
Non-investment grade	205	55	—	11
Total interests purchased in the secondary market (fair value)	\$ 323	\$ 698	\$ 155	\$ 32
Derivative assets (fair value)	\$ 75	\$ 955	\$ —	\$ 78
Derivative liabilities (fair value)	\$ 29	\$ 80	\$ —	\$ 314

(1) Amounts include assets transferred by unrelated transferors.

**MORGAN STANLEY**

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

	At December 31, 2010			
	Level 1	Level 2	Level 3	Total
	(dollars in millions)			
Retained interests (fair value):				
Investment grade	\$—	\$2,732	\$ 22	\$2,754
Non-investment grade	—	241	2,373	2,614
Total retained interests (fair value)	\$—	\$2,973	\$2,395	\$5,368
Interests purchased in the secondary market (fair value):				
Investment grade	\$—	\$ 929	\$ 8	\$ 937
Non-investment grade	—	255	16	271
Total interests purchased in the secondary market (fair value)	\$—	\$1,184	\$ 24	\$1,208
Derivative assets (fair value)	\$—	\$ 887	\$ 221	\$1,108
Derivative liabilities (fair value)	\$—	\$ 360	\$ 63	\$ 423

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

Net gains on sales of assets in securitization transactions at the time of the sale were not material in the quarters ended March 31, 2011 and 2010.

During the quarters ended March 31, 2011 and 2010, the Company received proceeds from new securitization transactions of \$7.9 billion and \$5 billion, respectively. During the quarters ended March 31, 2011 and 2010, the Company received proceeds from cash flows from retained interests in securitization transactions of \$2.4 billion and \$1.2 billion, respectively.

The Company has provided, or otherwise agreed to be responsible for, representations and warranties regarding certain assets transferred in securitization transactions sponsored by the Company (see Note 11).

***Failed Sales.***

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

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

**MORGAN STANLEY**

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

The following table presents information about the carrying value of assets and liabilities resulting from transfers of assets treated by the Company as secured financings:

	<u>At March 31, 2011</u>		<u>At December 31, 2010</u>	
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
	(dollars in millions)			
Commercial Mortgage Loans . . . . .	\$ 112	\$ 112	\$ 128	\$ 124
Credit-Linked Notes . . . . .	710	670	784	781
Equity-Linked Transactions . . . . .	1,896	1,859	1,618	1,583
Other . . . . .	131	131	62	61

***Mortgage Servicing Activities.***

*Mortgage Servicing Rights.* The Company may retain servicing rights to certain mortgage loans that are sold. These transactions create an asset referred to as MSRs, which totaled approximately \$144 million and \$157 million at March 31, 2011 and December 31, 2010, respectively, and are included within Intangible assets and carried at fair value in the condensed consolidated statements of financial condition.

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

The Company provides no credit support as part of its servicing activities. The Company is required to make servicing advances to the extent that it believes that such advances will be reimbursed. Reimbursement of servicing advances is a senior obligation of the SPE, senior to the most senior beneficial interests outstanding. Outstanding advances are included in Other assets and are recorded at cost. Advances at March 31, 2011 and December 31, 2010 totaled approximately \$1.4 billion and \$1.5 billion, respectively, net of allowance of \$5 million and \$10 million at March 31, 2011 and December 31, 2010, respectively.

The following tables present information about the Company's mortgage servicing activities for SPEs to which the Company transferred loans at March 31, 2011 and December 31, 2010:

	<u>At March 31, 2011</u>			
	<u>Residential Mortgage Unconsolidated SPEs</u>	<u>Residential Mortgage Consolidated SPEs</u>	<u>Commercial Mortgage Unconsolidated SPEs</u>	<u>Commercial Mortgage Consolidated SPEs</u>
	(dollars in millions)			
Assets serviced (unpaid principal balance) . . . . .	\$10,306	\$2,287	\$7,241	\$2,096
Amounts past due 90 days or greater (unpaid principal balance)(1) . . . . .	\$ 3,568	\$ 408	\$ —	\$ —
Percentage of amounts past due 90 days or greater(1) . . . . .	34.6%	17.9%	—	—
Credit losses . . . . .	\$ 155	\$ 9	\$ —	\$ —

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

**MORGAN STANLEY**

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

	At December 31, 2010			
	Residential Mortgage Unconsolidated SPEs	Residential Mortgage Consolidated SPEs	Commercial Mortgage Consolidated SPEs	Commercial Mortgage Consolidated SPEs
	(dollars in millions)			
Assets serviced (unpaid principal balance) . . . . .	\$10,616	\$2,357	\$7,108	\$2,097
Amounts past due 90 days or greater (unpaid principal balance)(1) . . . . .	\$ 3,861	\$ 446	\$ —	\$ —
Percentage of amounts past due 90 days or greater(1) . . .	36.4%	18.9%	—	—
Credit losses . . . . .	\$ 1,098	\$ 35	\$ —	\$ —

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

The Company also serviced residential and commercial mortgage loans for SPEs sponsored by unrelated parties with unpaid principal balances totaling \$13 billion at both March 31, 2011 and December 31, 2010.

**7. Financing Receivables.**

*Loans held for investment.*

The Company's loans held for investment are recorded at amortized cost and classified as Loans in the condensed consolidated statements of financial condition.

The Company's loans held for investment at March 31, 2011 and December 31, 2010 included the following:

	At March 31, 2011	At December 31, 2010
		(dollars in millions)
Commercial and industrial . . . . .	\$ 4,133	\$ 4,054
Consumer loans . . . . .	4,093	3,974
Residential real estate loans . . . . .	2,631	1,915
Wholesale real estate loans . . . . .	646	468
Total loans held for investment(1) . . . . .	\$11,503	\$10,411

(1) Amounts are net of allowances of \$45 million and \$82 million at March 31, 2011 and December 31, 2010, respectively.

The above table does not include loans held for sale of \$379 million and \$165 million at March 31, 2011 and December 31, 2010, respectively.

The Company's Credit Risk Management Department evaluates new obligors before credit transactions are initially approved, and at least annually thereafter for consumer and industrial loans. For corporate and commercial loans, credit evaluations typically involve the evaluation of financial statements, assessment of leverage, liquidity, capital strength, asset composition and quality, market capitalization and access to capital markets, cash flow projections and debt service requirements, and the adequacy of collateral, if applicable. The Company's Credit Risk Management Department will also evaluate strategy, market position, industry dynamics, obligor's management and other factors that could affect the obligor's risk profile. For residential real estate and consumer loans, the initial credit evaluation includes, but is not limited to review of the obligor's income, net worth, liquidity, collateral, loan-to-value ratio, and credit bureau information. Subsequent credit monitoring for residential real estate loans is performed at the portfolio level and for consumer loans collateral, values are monitored on an ongoing basis.

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

At March 31, 2011, the Company collectively evaluated for impairment gross commercial and industrial loans, consumer loans, residential real estate loans and wholesale real estate loans of \$3,949 million, \$4,020 million, \$2,632 million and \$324 million, respectively. The Company individually evaluated for impairment gross commercial and industrial loans, consumer and wholesale real estate loans of \$210 million, \$74 million and \$339 million, respectively. Commercial and industrial loans of approximately \$80 million and wholesale real estate loans of approximately \$76 million were impaired at March 31, 2011. Approximately 99% of the Company's loan portfolio was current at March 31, 2011.

At December 31, 2010, the Company collectively evaluated for impairment gross commercial and industrial loans, consumer loans, residential real estate loans and wholesale real estate loans of \$3,791 million, \$3,890 million, \$1,915 million and \$90 million, respectively. The Company individually evaluated for impairment gross commercial and industrial loans, consumer and wholesale real estate loans of \$307 million, \$85 million and \$415 million, respectively. Commercial and industrial loans of approximately \$170 million and wholesale real estate loans of approximately \$108 million were impaired at December 31, 2010. Approximately 99% of the Company's loan portfolio was current at December 31, 2010.

The Company assigned an internal grade of "doubtful" to certain commercial asset-backed and wholesale real estate loans totaling \$249 million and \$500 million at March 31, 2011 and December 31, 2010, respectively. Doubtful loans can be classified as current if the borrower is making payments in accordance with the loan agreement. The Company assigned an internal grade of "pass" to the majority of the remaining loans.

For a description of the Company's loan portfolio and credit quality indicators utilized in its credit monitoring process, see Note 8 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K.

#### *Employee Loans.*

Employee loans are granted primarily in conjunction with a program established in the Global Wealth Management Group business segment to retain and recruit certain employees. These loans are recorded in Receivables—Fees, interest and other in the condensed consolidated statements of financial condition. These loans are full recourse, require periodic payments and have repayment terms ranging from four to 12 years. The Company establishes a reserve for loan amounts it does not consider recoverable from terminated employees, which is recorded in Compensation and benefits expense. At March 31, 2011, the Company had \$5,488 million of employee loans, net of an allowance of approximately \$100 million. At December 31, 2010, the Company had \$5,831 million of employee loans, net of an allowance of approximately \$111 million.

#### *Collateralized Transactions.*

In certain instances, the Company enters into reverse repurchase agreements and securities borrowed transactions to acquire securities to cover short positions, to settle other securities obligations and to accommodate customers' needs. The Company also engages in securities financing transactions for customers through margin lending (see Note 5).

#### *Servicing Advances.*

As part of its servicing activities, the Company is required to make servicing advances to the extent that it believes that such advances will be reimbursed (see Note 6).



**MORGAN STANLEY**

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

**8. Goodwill and Net Intangible Assets.**

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

The estimated fair values of the reporting units are generally determined utilizing methodologies that incorporate price-to-book, price-to-earnings and assets under management multiples of certain comparable companies. The Company also utilizes a discounted cash flow methodology for certain reporting units.

The Company completed its annual goodwill impairment testing as of July 1, 2010. The Company's testing did not indicate any goodwill impairment. Due to the volatility in the equity markets, the economic outlook and the Company's common shares trading below book value during the quarters ended December 31, 2010 and March 31, 2011, the Company performed additional impairment testing at December 31, 2010 and March 31, 2011, which did not result in any goodwill impairment. Adverse market or economic events could result in impairment charges in future periods.

***Goodwill.***

Changes in the carrying amount of the Company's goodwill, net of accumulated impairment losses for the quarter ended March 31, 2011, were as follows:

	<b>Institutional Securities</b>	<b>Global Wealth Management Group</b>	<b>Asset Management</b>	<b>Total</b>
	<b>(dollars in millions)</b>			
<b>Goodwill at December 31, 2010(1)</b> .....	\$383	\$5,616	\$740	\$6,739
Foreign currency translation adjustments and other .....	4	—	—	4
<b>Goodwill at March 31, 2011(1)</b> .....	\$387	\$5,616	\$740	\$6,743

(1) The amount of the Company's goodwill before accumulated impairments of \$700 million at both March 31, 2011 and December 31, 2010, was \$7,443 million and \$7,439 million, respectively.

**MORGAN STANLEY**

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

***Net Intangible Assets.***

Changes in the carrying amount of the Company's intangible assets for the quarter ended March 31, 2011 were as follows:

	<u>Institutional Securities</u>	<u>Global Wealth Management Group</u>	<u>Asset Management</u>	<u>Total</u>
	(dollars in millions)			
<b>Amortizable net intangible assets at December 31,</b>				
<b>2010</b> .....	\$262	\$3,963	\$ 5	\$4,230
Mortgage servicing rights (see Note 6) .....	151	6	—	157
Indefinite-lived intangible assets .....	—	280	—	280
<b>Net intangible assets at December 31, 2010</b> .....	<u>\$413</u>	<u>\$4,249</u>	<u>\$ 5</u>	<u>\$4,667</u>
<b>Amortizable net intangible assets at December 31,</b>				
<b>2010</b> .....	\$262	\$3,963	\$ 5	\$4,230
Foreign currency translation adjustments and other .....	17	—	—	17
Amortization expense .....	(6)	(81)	—	(87)
Impairment losses .....	—	—	(3)	(3)
<b>Amortizable net intangible assets at March 31,</b>				
<b>2011</b> .....	273	3,882	2	4,157
Mortgage servicing rights (see Note 6) .....	132	12	—	144
Indefinite-lived intangible assets .....	—	280	—	280
<b>Net intangible assets at March 31, 2011</b> .....	<u>\$405</u>	<u>\$4,174</u>	<u>\$ 2</u>	<u>\$4,581</u>

**9. Long-Term Borrowings and Other Secured Financings.**

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

	<u>At March 31, 2011</u>	<u>At December 31, 2010</u>
	(dollars in millions)	
Senior debt .....	\$187,319	\$183,514
Subordinated debt .....	3,972	4,126
Junior subordinated debentures .....	4,845	4,817
Total .....	<u>\$196,136</u>	<u>\$192,457</u>

During the quarter ended March 31, 2011, the Company issued notes with a principal amount of approximately \$14 billion. During the quarter ended March 31, 2011, approximately \$13 billion of notes were repaid.

The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately 5.2 years at March 31, 2011 and December 31, 2010.

***FDIC's Temporary Liquidity Guarantee Program.***

At March 31, 2011 and December 31, 2010, the Company had long-term debt outstanding of \$19.3 billion and \$21.3 billion, respectively, under the Temporary Liquidity Guarantee Program ("TLGP"). The issuance of debt under the TLGP debt expired on December 31, 2010, but the existing long-term debt outstanding is guaranteed

**MORGAN STANLEY**

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

until June 30, 2012. These borrowings are senior unsecured debt obligations of the Company and guaranteed by the FDIC under the TLGP. The FDIC has concluded that the guarantee is backed by the full faith and credit of the U.S. government.

***Other Secured Financings.***

The Company's other secured financings consisted of the following:

	<b>At March 31, 2011</b>	<b>At December 31, 2010</b>
	<b>(dollars in millions)</b>	
Secured financings with original maturities greater than one year .....	\$ 9,863	\$ 7,398
Secured financings with original maturities one year or less .....	323	506
Failed sales(1) .....	2,772	2,549
Total(2) .....	\$12,958	\$10,453

(1) For more information on failed sales, see Note 6.

(2) Amounts include \$8,052 million at fair value at March 31, 2011 and \$8,490 million at fair value at December 31, 2010.

**10. Derivative Instruments and Hedging Activities.**

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

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

The Company's derivative products consist of the following:

	<b>At March 31, 2011</b>		<b>At December 31, 2010</b>	
	<b>Assets</b>	<b>Liabilities</b>	<b>Assets</b>	<b>Liabilities</b>
	<b>(dollars in millions)</b>			
Exchange traded derivative products .....	\$ 6,016	\$ 7,746	\$ 6,099	\$ 8,553
OTC derivative products .....	43,897	36,839	45,193	39,249
Total .....	\$49,913	\$44,585	\$51,292	\$47,802

The Company incurs credit risk as a dealer in OTC derivatives. Credit risk with respect to derivative instruments arises from the failure of a counterparty to perform according to the terms of the contract. The Company's exposure to credit risk at any point in time is represented by the fair value of the derivative contracts reported as assets. The fair value of a derivative represents the amount at which the derivative could be exchanged in an

**MORGAN STANLEY**

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

orderly transaction between market participants and is further described in Notes 2 and 3.

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

The tables below present a summary by counterparty credit rating and remaining contract maturity of the fair value of OTC derivatives in a gain position at March 31, 2011 and December 31, 2010, respectively. Fair value is presented in the final column, net of collateral received (principally cash and U.S. government and agency securities):

**OTC Derivative Products—Financial Instruments Owned at March 31, 2011(1)**

<u>Credit Rating(2)</u>	<u>Years to Maturity</u>				<u>Cross-Maturity and Cash Collateral Netting(3)</u>	<u>Net Exposure Post-Cash Collateral</u>	<u>Net Exposure Post-Collateral</u>
	<u>Less than 1</u>	<u>1 - 3</u>	<u>3 - 5</u>	<u>Over 5</u>			
	(dollars in millions)						
AAA .....	\$ 579	\$ 1,534	\$ 1,106	\$ 9,332	\$ (6,166)	\$ 6,385	\$ 6,109
AA .....	5,899	5,974	4,662	17,111	(24,639)	9,007	6,519
A .....	8,418	5,774	6,095	24,014	(31,311)	12,990	11,403
BBB .....	3,340	3,043	1,967	5,993	(7,289)	7,054	5,548
Non-investment grade .....	3,684	3,043	1,858	4,377	(4,501)	8,461	6,160
Total .....	<u>\$21,920</u>	<u>\$19,368</u>	<u>\$15,688</u>	<u>\$60,827</u>	<u>\$(73,906)</u>	<u>\$43,897</u>	<u>\$35,739</u>

(1) Fair values shown represent the Company's net exposure to counterparties related to the Company's OTC derivative products. The table does not include listed derivatives and the effect of any related hedges utilized by the Company. The table also excludes fair values corresponding to other credit exposures, such as those arising from the Company's lending activities.

(2) Obligor credit ratings are determined by the Company's Credit Risk Management Department.

(3) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within such maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.

**OTC Derivative Products—Financial Instruments Owned at December 31, 2010(1)**

<u>Credit Rating(2)</u>	<u>Years to Maturity</u>				<u>Cross-Maturity and Cash Collateral Netting(3)</u>	<u>Net Exposure Post-Cash Collateral</u>	<u>Net Exposure Post-Collateral</u>
	<u>Less than 1</u>	<u>1 - 3</u>	<u>3 - 5</u>	<u>Over 5</u>			
	(dollars in millions)						
AAA .....	\$ 802	\$ 2,005	\$ 1,242	\$ 8,823	\$ (5,906)	\$ 6,966	\$ 6,683
AA .....	6,601	6,760	5,589	17,844	(27,801)	8,993	7,877
A .....	8,655	8,710	6,507	26,492	(36,397)	13,967	12,383
BBB .....	2,982	4,109	2,124	7,347	(9,034)	7,528	6,001
Non-investment grade .....	2,628	3,231	1,779	4,456	(4,355)	7,739	5,348
Total .....	<u>\$21,668</u>	<u>\$24,815</u>	<u>\$17,241</u>	<u>\$64,962</u>	<u>\$(83,493)</u>	<u>\$45,193</u>	<u>\$38,292</u>

(1) Fair values shown represent the Company's net exposure to counterparties related to the Company's OTC derivative products. The table does not include listed derivatives and the effect of any related hedges utilized by the Company. The table also excludes fair values corresponding to other credit exposures, such as those arising from the Company's lending activities.

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

- (2) Obligor credit ratings are determined by the Company's Credit Risk Management Department.
- (3) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within such maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.

#### ***Hedge Accounting.***

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

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

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

***Fair Value Hedges—Interest Rate Risk.*** The Company's designated fair value hedges consisted primarily of interest rate swaps designated as fair value hedges of changes in the benchmark interest rate of fixed rate senior long-term borrowings. The Company uses regression analysis to perform an ongoing prospective and retrospective assessment of the effectiveness of these hedging relationships (*i.e.*, the Company applies the "long-haul" method of hedge accounting). A hedging relationship is deemed effective if the fair values of the hedging instrument (derivative) and the hedged item (debt liability) change inversely within a range of 80% to 125%. The Company considers the impact of valuation adjustments related to the Company's own credit spreads and counterparty credit spreads to determine whether they would cause the hedging relationship to be ineffective.

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

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

**MORGAN STANLEY**

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

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

	Assets at March 31, 2011		Liabilities at March 31, 2011	
	Fair Value	Notional	Fair Value	Notional
	(dollars in millions)			
Derivatives designated as accounting hedges:				
Interest rate contracts	\$ 4,442	\$ 68,405	\$ 325	\$ 11,757
Foreign exchange contracts	57	5,420	293	13,043
Total derivatives designated as accounting hedges	4,499	73,825	618	24,800
Derivatives not designated as accounting hedges(1):				
Interest rate contracts	537,723	20,355,888	514,952	20,944,379
Credit contracts	99,011	2,471,756	87,141	2,268,204
Foreign exchange contracts	58,668	1,743,895	60,557	1,713,501
Equity contracts	41,175	625,610	46,354	644,102
Commodity contracts	65,425	450,550	67,227	438,858
Other	262	6,878	1,232	18,964
Total derivatives not designated as accounting hedges	802,264	25,654,577	777,463	26,028,008
Total derivatives	\$ 806,763	\$25,728,402	\$ 778,081	\$26,052,808
Cash collateral netting	(53,870)	—	(30,516)	—
Counterparty netting	(702,980)	—	(702,980)	—
Total derivatives	\$ 49,913	\$25,728,402	\$ 44,585	\$26,052,808

(1) Notional amounts include net notionals related to long and short futures contracts of \$84 billion and \$79 billion, respectively. The variation margin on these futures contracts (excluded from the table above) of \$561 million and \$93 million is included in Receivables—Brokers, dealers and clearing organizations and Payables—Brokers, dealers and clearing organizations, respectively, on the condensed consolidated statements of financial condition.

**MORGAN STANLEY**

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

	Assets at December 31, 2010		Liabilities at December 31, 2010	
	Fair Value	Notional	Fair Value	Notional
(dollars in millions)				
Derivatives designated as accounting hedges:				
Interest rate contracts	\$ 5,250	\$ 68,212	\$ 177	\$ 7,989
Foreign exchange contracts	64	5,119	420	14,408
Total derivatives designated as accounting hedges	5,314	73,331	597	22,397
Derivatives not designated as accounting hedges(1):				
Interest rate contracts	615,717	16,305,214	595,626	16,267,730
Credit contracts	110,134	2,398,676	95,626	2,239,211
Foreign exchange contracts	61,924	1,418,488	64,268	1,431,651
Equity contracts	39,846	571,767	46,160	568,399
Commodity contracts	64,152	420,534	65,728	414,535
Other	243	6,635	1,568	16,910
Total derivatives not designated as accounting hedges	892,016	21,121,314	868,976	20,938,436
Total derivatives	\$ 897,330	\$21,194,645	\$ 869,573	\$20,960,833
Cash collateral netting	(61,856)	—	(37,589)	—
Counterparty netting	(784,182)	—	(784,182)	—
Total derivatives	\$ 51,292	\$21,194,645	\$ 47,802	\$20,960,833

(1) Notional amounts include net notionals related to long and short futures contracts of \$71 billion and \$76 billion, respectively. The variation margin on these futures contracts (excluded from the table above) of \$387 million and \$1 million is included in Receivables—Brokers, dealers and clearing organizations and Payables—Brokers, dealers and clearing organizations, respectively, on the condensed consolidated statements of financial condition.

The following tables summarize the gains or losses reported on derivative instruments designated and qualifying as accounting hedges for the quarters ended March 31, 2011 and 2010, respectively.

*Derivatives Designated as Fair Value Hedges.*

The following table presents gains (losses) reported on derivative instruments and the related hedge item as well as the hedge ineffectiveness included in Interest expense in the condensed consolidated statements of income from interest rate contracts:

<u>Product Type</u>	Three Months Ended March 31,	
	2011	2010
(dollars in millions)		
Gain (loss) recognized on derivatives	\$(1,095)	\$ 721
Gain (loss) recognized on borrowings	1,258	(566)
Total	\$ 163	\$ 155

**MORGAN STANLEY**

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

*Derivatives Designated as Net Investment Hedges.*

<u>Product Type</u>	<u>Gains Recognized in OCI (effective portion)</u>	
	<u>Three Months Ended March 31,</u>	
	<u>2011</u>	<u>2010</u>
	<u>(dollars in millions)</u>	
Foreign exchange contracts(1) .....	\$126	\$220
Total .....	<u>\$126</u>	<u>\$220</u>

(1) Losses of \$47 million and \$36 million were recognized in income related to amounts excluded from hedge effectiveness testing during the quarters ended March 31, 2011 and 2010, respectively.

The table below summarizes gains (losses) on derivative instruments not designated as accounting hedges for the quarters ended March 31, 2011 and 2010, respectively:

<u>Product Type</u>	<u>Gains (Losses) Recognized in Income(1)(2)</u>	
	<u>Three Months Ended March 31,</u>	
	<u>2011</u>	<u>2010</u>
	<u>(dollars in millions)</u>	
Interest rate contracts .....	\$ 925	\$ 620
Credit contracts .....	(697)	(597)
Foreign exchange contracts .....	(339)	(157)
Equity contracts .....	(1,319)	(483)
Commodity contracts .....	(271)	551
Other contracts .....	<u>208</u>	<u>(57)</u>
Total derivative instruments .....	<u>\$(1,493)</u>	<u>\$(123)</u>

(1) Gains (losses) on derivative contracts not designated as hedges are primarily included in Principal transactions—Trading.

(2) Gains (losses) associated with derivative contracts that have physically settled are excluded from the table above. Gains (losses) on these contracts are reflected with the associated cash instruments, which are also included in Principal transactions—Trading.

The Company also has certain embedded derivatives that have been bifurcated from the related structured borrowings. Such derivatives are classified in Long-term borrowings and had a net fair value of \$83 million and \$109 million at March 31, 2011 and December 31, 2010, respectively, and a notional of \$4,328 million and \$4,256 million at March 31, 2011 and December 31, 2010, respectively. The Company recognized losses of \$19 million and gains of \$13 million related to changes in the fair value of its bifurcated embedded derivatives for the quarters ended March 31, 2011 and 2010, respectively.

At March 31, 2011 and December 31, 2010, the amount of payables associated with cash collateral received that was netted against derivative assets was \$53.9 billion and \$61.9 billion, respectively, and the amount of receivables in respect of cash collateral paid that was netted against derivative liabilities was \$30.5 billion and \$37.6 billion, respectively. Cash collateral receivables and payables of \$419 million and \$105 million, respectively, at March 31, 2011 and \$435 million and \$37 million, respectively, at December 31, 2010, were not offset against certain contracts that did not meet the definition of a derivative.



**MORGAN STANLEY**

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

***Credit-Risk-Related Contingencies.***

In connection with certain OTC trading agreements, the Company may be required to provide additional collateral or immediately settle any outstanding liability balances with certain counterparties in the event of a credit ratings downgrade. At March 31, 2011 and December 31, 2010, the aggregate fair value of derivative contracts that contain credit-risk-related contingent features that are in a net liability position totaled \$29,210 million and \$32,567 million, respectively, for which the Company has posted collateral of \$22,721 million and \$26,904 million, respectively, in the normal course of business. At March 31, 2011 and December 31, 2010, the amount of additional collateral or termination payments that could be called by counterparties under the terms of such agreements in the event of a one-notch downgrade of the Company's long-term credit rating was approximately \$636 million and \$873 million, respectively. Additional collateral or termination payments of approximately \$1,454 million and \$1,537 million could be called by counterparties in the event of a two-notch downgrade at March 31, 2011 and December 31, 2010, respectively. Of these amounts, \$1,439 million and \$1,766 million at March 31, 2011 and December 31, 2010, respectively, related to bilateral arrangements between the Company and other parties where upon the downgrade of one party, the downgraded party must deliver incremental collateral to the other party. These bilateral downgrade arrangements are a risk management tool used extensively by the Company as credit exposures are reduced if counterparties are downgraded.

***Credit Derivatives and Other Credit Contracts.***

The Company enters into credit derivatives, principally through credit default swaps, under which it provides counterparties protection against the risk of default on a set of debt obligations issued by a specified reference entity or entities. A majority of the Company's counterparties are banks, broker-dealers, insurance and other financial institutions, and monoline insurers. The table below summarizes certain information regarding protection sold through credit default swaps and other credit contracts at March 31, 2011:

<u>Credit Ratings of the Reference Obligation</u>	<u>Protection Sold</u>				<u>Fair Value (Asset)/ Liability(1)(2)</u>	
	<u>Maximum Potential Payout/Notional</u>					
	<u>Years to Maturity</u>					
	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>	<u>Total</u>	
	(dollars in millions)					
Single name credit default swaps:						
AAA .....	\$ 2,777	\$ 11,098	\$ 16,085	\$ 19,523	\$ 49,483	\$ 2,385
AA .....	12,606	40,370	40,083	36,609	129,668	3,103
A .....	47,402	126,917	70,230	47,650	292,199	(2,578)
BBB .....	74,786	189,203	107,394	78,857	450,240	(4,215)
Non-investment grade .....	70,680	168,078	78,345	57,992	375,095	5,674
Total .....	<u>208,251</u>	<u>535,666</u>	<u>312,137</u>	<u>240,631</u>	<u>1,296,685</u>	<u>4,369</u>
Index and basket credit default swaps:						
AAA .....	17,017	86,153	29,899	28,940	162,009	(2,157)
AA .....	412	3,592	3,185	15,787	22,976	199
A .....	1,617	7,029	54,387	17,213	80,246	1,291
BBB .....	31,668	103,757	180,379	118,701	434,505	(808)
Non-investment grade .....	45,656	112,452	83,756	109,273	351,137	11,147
Total .....	<u>96,370</u>	<u>312,983</u>	<u>351,606</u>	<u>289,914</u>	<u>1,050,873</u>	<u>9,672</u>
Total credit default swaps sold .....	<u>\$304,621</u>	<u>\$848,649</u>	<u>\$663,743</u>	<u>\$530,545</u>	<u>\$ 2,347,558</u>	<u>\$14,041</u>
Other credit contracts(3)(4) .....	\$ 65	\$ 1,177	\$ 393	\$ 3,457	\$ 5,092	\$ (1,339)
Total credit derivatives and other credit contracts .....	<u>\$304,686</u>	<u>\$849,826</u>	<u>\$664,136</u>	<u>\$534,002</u>	<u>\$ 2,352,650</u>	<u>\$12,702</u>

(1) Fair value amounts are shown on a gross basis prior to cash collateral or counterparty netting.

**MORGAN STANLEY**

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

- (2) Fair value amounts of certain credit default swaps where the Company sold protection have an asset carrying value because credit spreads of the underlying reference entity or entities tightened during the terms of the contracts.  
 (3) Other credit contracts include CLNs, CDOs and credit default swaps that are considered hybrid instruments.  
 (4) Fair value amount shown represents the fair value of the hybrid instruments.

The table below summarizes certain information regarding protection sold through credit default swaps and other credit contracts at December 31, 2010:

<u>Credit Ratings of the Reference Obligation</u>	<u>Protection Sold</u>					<u>Fair Value (Asset)/ Liability(1)(2)</u>
	<u>Maximum Potential Payout/Notional</u>					
	<u>Years to Maturity</u>					
	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>	<u>Total</u>	
	(dollars in millions)					
Single name credit default swaps:						
AAA .....	\$ 2,747	\$ 7,232	\$ 13,927	\$ 22,648	\$ 46,554	\$ 3,193
AA .....	13,364	44,700	35,030	33,538	126,632	4,260
A .....	47,756	131,464	79,900	50,227	309,347	(940)
BBB .....	74,961	191,046	115,460	76,544	458,011	(2,816)
Non-investment grade .....	70,691	173,778	84,605	59,532	388,606	6,984
Total .....	<u>209,519</u>	<u>548,220</u>	<u>328,922</u>	<u>242,489</u>	<u>1,329,150</u>	<u>10,681</u>
Index and basket credit default swaps:						
AAA .....	17,437	67,165	26,172	26,966	137,740	(1,569)
AA .....	974	3,012	695	18,236	22,917	305
A .....	447	9,432	44,104	4,902	58,885	2,291
BBB .....	24,311	80,314	176,252	69,218	350,095	(278)
Non-investment grade .....	53,771	139,875	95,796	106,022	395,464	13,802
Total .....	<u>96,940</u>	<u>299,798</u>	<u>343,019</u>	<u>225,344</u>	<u>965,101</u>	<u>14,551</u>
Total credit default swaps sold .....	<u>\$306,459</u>	<u>\$848,018</u>	<u>\$671,941</u>	<u>\$467,833</u>	<u>\$2,294,251</u>	<u>\$25,232</u>
Other credit contracts(3)(4) .....	\$ 61	\$ 1,416	\$ 822	\$ 3,856	\$ 6,155	\$ (1,198)
Total credit derivatives and other credit contracts .....	<u>\$306,520</u>	<u>\$849,434</u>	<u>\$672,763</u>	<u>\$471,689</u>	<u>\$2,300,406</u>	<u>\$24,034</u>

- (1) Fair value amounts are shown on a gross basis prior to cash collateral or counterparty netting.  
 (2) Fair value amounts of certain credit default swaps where the Company sold protection have an asset carrying value because credit spreads of the underlying reference entity or entities tightened during the terms of the contracts.  
 (3) Other credit contracts include CLNs, CDOs and credit default swaps that are considered hybrid instruments.  
 (4) Fair value amount shown represents the fair value of the hybrid instruments.

**Single Name Credit Default Swaps.** A credit default swap protects the buyer against the loss of principal on a bond or loan in case of a default by the issuer. The protection buyer pays a periodic premium (generally quarterly) over the life of the contract and is protected for the period. The Company in turn will have to perform under a credit default swap if a credit event as defined under the contract occurs. Typical credit events include bankruptcy, dissolution or insolvency of the referenced entity, failure to pay and restructuring of the obligations of the referenced entity. In order to provide an indication of the current payment status or performance risk of the credit default swaps, the external credit ratings, primarily Moody's credit ratings, of the underlying reference entity of the credit default swaps are disclosed.

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

***Index and Basket Credit Default Swaps.*** Index and basket credit default swaps are credit default swaps that reference multiple names through underlying baskets or portfolios of single name credit default swaps. Generally, in the event of a default on one of the underlying names, the Company will have to pay a pro rata portion of the total notional amount of the credit default index or basket contract. In order to provide an indication of the current payment status or performance risk of these credit default swaps, the weighted average external credit ratings, primarily Moody's credit ratings, of the underlying reference entities comprising the basket or index were calculated and disclosed.

The Company also enters into index and basket credit default swaps where the credit protection provided is based upon the application of tranching techniques. In tranching transactions, the credit risk of an index or basket is separated into various portions of the capital structure, with different levels of subordination. The most junior tranches cover initial defaults, and once losses exceed the notional of the tranche, they are passed on to the next most senior tranche in the capital structure. As external credit ratings are not always available for tranching indices and baskets, credit ratings were determined based upon an internal methodology.

***Credit Protection Sold through CLNs and CDOs.*** The Company has invested in CLNs and CDOs, which are hybrid instruments containing embedded derivatives, in which credit protection has been sold to the issuer of the note. If there is a credit event of a reference entity underlying the instrument, the principal balance of the note may not be repaid in full to the Company.

***Purchased Credit Protection.*** For single name credit default swaps and non-tranching index and basket credit default swaps, the Company has purchased protection with a notional amount of approximately \$1.8 trillion at both March 31, 2011 and December 31, 2010, compared with a notional amount of approximately \$2.1 trillion and \$2.0 trillion, at March 31, 2011 and December 31, 2010, respectively, of credit protection sold with identical underlying reference obligations. In order to identify purchased protection with the same underlying reference obligations, the notional amount for individual reference obligations within non-tranching indices and baskets was determined on a pro rata basis and matched off against single name and non-tranching index and basket credit default swaps where credit protection was sold with identical underlying reference obligations. The Company may also purchase credit protection to economically hedge loans and lending commitments. In total, not considering whether the underlying reference obligations are identical, the Company has purchased credit protection of \$2.4 trillion with a positive fair value of \$26 billion compared with \$2.3 trillion of credit protection sold with a negative fair value of \$14 billion at March 31, 2011. In total, not considering whether the underlying reference obligations are identical, the Company has purchased credit protection of \$2.3 trillion with a positive fair value of \$40 billion compared with \$2.3 trillion of credit protection sold with a negative fair value of \$25 billion at December 31, 2010.

The purchase of credit protection does not represent the sole manner in which the Company risk manages its exposure to credit derivatives. The Company manages its exposure to these derivative contracts through a variety of risk mitigation strategies, which include managing the credit and correlation risk across single name, non-tranching indices and baskets, tranching indices and baskets, and cash positions. Aggregate market risk limits have been established for credit derivatives, and market risk measures are routinely monitored against these limits. The Company may also recover amounts on the underlying reference obligation delivered to the Company under credit default swaps where credit protection was sold.

#### **11. Commitments, Guarantees and Contingencies.**

##### ***Commitments.***

The Company's commitments associated with outstanding letters of credit and other financial guarantees obtained to satisfy collateral requirements, investment activities, corporate lending and financing arrangements,

**MORGAN STANLEY**

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

mortgage lending and margin lending at March 31, 2011 are summarized below by period of expiration. Since commitments associated with these instruments may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	Years to Maturity				Total at March 31, 2011
	Less than 1	1-3	3-5	Over 5	
	(dollars in millions)				
Letters of credit and other financial guarantees obtained to satisfy collateral requirements . . . . .	\$ 1,012	\$ 1	\$ 10	\$ —	\$ 1,023
Investment activities . . . . .	1,329	299	77	357	2,062
Primary lending commitments—investment grade(1)(2) . . . . .	9,044	28,563	10,560	584	48,751
Primary lending commitments—non-investment grade(1) . . . . .	1,071	5,957	6,730	1,006	14,764
Secondary lending commitments(1) . . . . .	46	152	173	176	547
Commitments for secured lending transactions . . . . .	620	710	1	135	1,466
Forward starting reverse repurchase agreements(3) . . . . .	59,397	—	—	—	59,397
Commercial and residential mortgage-related commitments . . . . .	464	11	77	643	1,195
Underwriting commitments . . . . .	970	—	—	—	970
Other commitments . . . . .	97	171	42	5	315
<b>Total . . . . .</b>	<b>\$74,050</b>	<b>\$35,864</b>	<b>\$17,670</b>	<b>\$2,906</b>	<b>\$130,490</b>

- (1) These commitments are recorded at fair value within Financial instruments owned and Financial instruments sold, not yet purchased in the condensed consolidated statements of financial condition (see Note 3).
- (2) This amount includes commitments to asset-backed commercial paper conduits of \$275 million at March 31, 2011, of which \$138 million have maturities of less than one year and \$137 million have maturities of one to three years.
- (3) The Company enters into forward starting securities purchased under agreements to resell (agreements that have a trade date at or prior to March 31, 2011 and settle subsequent to period-end) that are primarily secured by collateral from U.S. government agency securities and other sovereign government obligations. These agreements primarily settle within three business days and at March 31, 2011, \$55.3 billion settled within three business days.

For further description of these commitments, refer to Note 13 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K.

The Company sponsors several non-consolidated investment funds for third-party investors where the Company typically acts as general partner of, and investment advisor to, these funds and typically commits to invest a minority of the capital of such funds, with subscribing third-party investors contributing the majority. The Company's employees, including its senior officers, as well as the Company's directors may participate on the same terms and conditions as other investors in certain of these funds that the Company forms primarily for client investment, except that the Company may waive or lower applicable fees and charges for its employees. The Company has contractual capital commitments, guarantees, lending facilities and counterparty arrangements with respect to these investment funds.

**MORGAN STANLEY**

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

**Guarantees.**

The table below summarizes certain information regarding the Company's obligations under guarantee arrangements at March 31, 2011:

Type of Guarantee	Maximum Potential Payout/Notional					Carrying Amount (Asset)/Liability	Collateral/Recourse
	Years to Maturity						
	Less than 1	1-3	3-5	Over 5	Total		
	(dollars in millions)						
Credit derivative contracts(1) . . . . .	\$ 304,621	\$848,649	\$663,743	\$530,545	\$2,347,558	\$14,041	\$—
Other credit contracts . . . . .	65	1,177	393	3,457	5,092	(1,339)	—
Non-credit derivative contracts(1)(2) . . . . .	1,041,301	995,778	382,116	324,527	2,743,722	71,861	—
Standby letters of credit and other financial guarantees issued(3)(4) . . . . .	1,977	1,971	537	5,680	10,165	(18)	5,668
Market value guarantees . . . . .	—	—	170	645	815	17	90
Liquidity facilities . . . . .	4,601	259	187	71	5,118	—	6,233
Whole loan sales representations and warranties . . . . .	—	—	—	24,877	24,877	47	—
Securitization representations and warranties . . . . .	—	—	—	88,582	88,582	25	—
General partner guarantees . . . . .	204	2	56	254	516	71	—

- (1) Carrying amount of derivative contracts are shown on a gross basis prior to cash collateral or counterparty netting. For further information on derivative contracts, see Note 10.
- (2) Amounts include a guarantee to investors in undivided participating interests in claims the Company made against a derivative counterparty that filed for bankruptcy protection. To the extent, in the future, any portion of the claims is disallowed or reduced by the bankruptcy court in excess of a certain amount, then the Company must refund a portion of the purchase price plus interest. See Note 18 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K.
- (3) Approximately \$2.5 billion of standby letters of credit are also reflected in the "Commitments" table in primary and secondary lending commitments. Standby letters of credit are recorded at fair value within Financial instruments owned or Financial instruments sold, not yet purchased in the condensed consolidated statements of financial condition.
- (4) Amounts include guarantees issued by consolidated real estate funds sponsored by the Company of approximately \$443 million. These guarantees relate to obligations of the fund's investee entities, including guarantees related to capital expenditures and principal and interest debt payments. Accrued losses under these guarantees of approximately \$108 million are reflected as a reduction of the carrying value of the related fund investments, which are reflected in Financial instruments owned—Investments on the condensed consolidated statement of financial condition.

For further description of these guarantees, refer to Note 13 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K.

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

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

#### *Other Guarantees and Indemnities.*

In the normal course of business, the Company provides guarantees and indemnifications in a variety of commercial transactions. These provisions generally are standard contractual terms. Certain of these guarantees and indemnifications are described below.

- Trust Preferred Securities. The Company has established Morgan Stanley Capital Trusts for the limited purpose of issuing trust preferred securities to third parties and lending the proceeds to the Company in exchange for junior subordinated debentures. The Company has directly guaranteed the repayment of the trust preferred securities to the holders thereof to the extent that the Company has made payments to a Morgan Stanley Capital Trust on the junior subordinated debentures. In the event that the Company does not make payments to a Morgan Stanley Capital Trust, holders of such series of trust preferred securities would not be able to rely upon the guarantee for payment of those amounts. The Company has not recorded any liability in the condensed consolidated financial statements for these guarantees and believes that the occurrence of any events (*i.e.*, non-performance on the part of the paying agent) that would trigger payments under these contracts is remote. See Note 15 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K for details on the Company's junior subordinated debentures.
- Indemnities. The Company provides standard indemnities to counterparties for certain contingent exposures and taxes, including U.S. and foreign withholding taxes, on interest and other payments made on derivatives, securities and stock lending transactions, certain annuity products and other financial arrangements. These indemnity payments could be required based on a change in the tax laws or change in interpretation of applicable tax rulings or a change in factual circumstances. Certain contracts contain provisions that enable the Company to terminate the agreement upon the occurrence of such events. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated.
- Exchange/Clearinghouse Member Guarantees. The Company is a member of various U.S. and non-U.S. exchanges and clearinghouses that trade and clear securities and/or derivative contracts. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange or the clearinghouse. While the rules governing different exchange or clearinghouse memberships vary, in general the Company's guarantee obligations would arise only if the exchange or clearinghouse had previously exhausted its resources. The maximum potential payout under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in the condensed consolidated financial statements for these agreements and believes that any potential requirement to make payments under these agreements is remote.
- Merger and Acquisition Guarantees. The Company may, from time to time, in its role as investment banking advisor be required to provide guarantees in connection with certain European merger and acquisition transactions. If required by the regulating authorities, the Company provides a guarantee that the acquirer in the merger and acquisition transaction has or will have sufficient funds to complete the transaction and would then be required to make the acquisition payments in the event the acquirer's funds are insufficient at the completion date of the transaction. These arrangements generally cover the time frame from the transaction offer date to its closing date and, therefore, are generally short term in nature. The maximum potential amount of future payments that the Company could be required to make cannot be estimated. The Company believes the likelihood of any payment by the Company under these arrangements is remote given the level of the Company's due diligence associated with its role as investment banking advisor.
- Guarantees on Morgan Stanley Stable Value Program. On September 30, 2009, the Company entered into an agreement with the investment manager for the Stable Value Program ("SVP"), a fund within the Company's 401(k) plan, and certain other third parties. Under the agreement, the Company contributed



## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

\$20 million to the SVP on October 15, 2009 and recorded the contribution in Compensation and benefits expense. Additionally, the Company may have a future obligation to make a payment of \$40 million to the SVP following the third anniversary of the agreement, after which the SVP would be wound down over a period of time. The future obligation is contingent upon whether the market-to-book value ratio of the portion of the SVP that is subject to certain book-value stabilizing contracts has fallen below a specific threshold and the Company and the other parties to the agreement all decline to make payments to restore the SVP to such threshold as of the third anniversary of the agreement. The Company has not recorded a liability for this guarantee in the condensed consolidated financial statements.

In the ordinary course of business, the Company guarantees the debt and/or certain trading obligations (including obligations associated with derivatives, foreign exchange contracts and the settlement of physical commodities) of certain subsidiaries. These guarantees generally are entity or product specific and are required by investors or trading counterparties. The activities of the subsidiaries covered by these guarantees (including any related debt or trading obligations) are included in the Company's condensed consolidated financial statements.

#### *Contingencies.*

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

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

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

For certain legal proceedings, the Company cannot reasonably estimate such losses, particularly for proceedings that are in their early stages of development or where plaintiffs seek substantial or indeterminate damages. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

important factual matters, determination of issues related to class certification and the calculation of damages, and by addressing novel or unsettled legal questions relevant to the proceedings in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for any proceeding.

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

On September 25, 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 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 a right 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 May 13, 2010, the court granted Citi N.A.'s motion for judgment on the pleadings on its claim for breach of contract. On October 8, 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. The Company's motion for summary judgment and Citi N.A.'s cross motion for summary judgment are fully briefed and pending. Based on currently available information, the Company believes it could incur a loss of up to \$245 million.

On August 25, 2008, 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 SDNY. 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 September 2, 2009, the court dismissed all of the claims against the Company except for plaintiffs' claims for common law fraud. On June 15, 2010, the court denied plaintiffs' motion for class certification. On July 20, 2010, the court granted plaintiffs leave to replead their aiding and abetting common law fraud claims against the Company, and those claims were added in an amended complaint filed on August 5, 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 March 11, 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 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 \$983 million of securities issued by the Cheyne SIV.

On July 15, 2010, China Development Industrial Bank ("CDIB") filed a complaint against the Company, 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 Company misrepresented the risks of the STACK 2006-1 CDO to CDIB, and that the Company 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



## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

under the credit default swap, rescission of CDIB's obligation to pay an additional \$12 million, punitive damages, equitable relief, fees and costs. On February 28, 2011, the court presiding over this action denied the Company's motion to dismiss the complaint. On March 21, 2011, the Company appealed the order denying its motion to dismiss the complaint. Based on currently available information, the Company believes it could incur a loss of up to \$240 million.

In addition to the three matters referenced above, on April 20, 2011, the court presiding over the action styled *U.S. Bank, N.A. v. Barclays Bank PLC and Morgan Stanley Capital Services Inc.*, entered a stipulation and order of dismissal reflecting the parties' agreement to resolve this litigation pursuant to a settlement. While the terms of the settlement agreement are confidential, the loss to the Company as a result of the settlement is substantially less than the amount of potential loss disclosed in the Form 10-K.

#### 12. Regulatory Requirements.

*Morgan Stanley.* The Company is a financial holding company under the Bank Holding Company Act of 1956 and is subject to the regulation and oversight of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Federal Reserve establishes capital requirements for the Company, including well-capitalized standards, and evaluates the Company's compliance with such capital requirements. The Office of the Comptroller of the Currency establishes similar capital requirements and standards for the Company's national bank subsidiaries.

The Company calculates its capital ratios and Risk Weighted Assets ("RWA") in accordance with the capital adequacy standards for financial holding companies adopted by the Federal Reserve. These standards are based upon a framework described in the "International Convergence of Capital Measurement and Capital Standards," July 1988, as amended, also referred to as Basel I. In December 2007, the U.S. banking regulators published final regulation incorporating the Basel II Accord, which requires internationally active banking organizations, as well as certain of their U.S. bank subsidiaries, to implement Basel II standards over the next several years. The timeline set out in December 2007 for the implementation of Basel II in the U.S. may be impacted by the developments concerning Basel III described below. Starting July 2010, the Company has been reporting on a parallel basis under the current regulatory capital regime (Basel I) and Basel II. During the parallel run period, the Company continues to be subject to Basel I but simultaneously calculates its risks under Basel II. The Company reports the capital ratios under both of these standards to the regulators. There will be at least four quarters of parallel reporting before the Company enters the three-year transitional period to implement Basel II standards. In addition, under provisions of the Dodd-Frank Act, the generally applicable capital standards, which are currently based on Basel I standards, but may themselves change over time, would serve as a permanent floor to minimum capital requirements calculated under the Basel II standard the Company is currently required to implement, as well as future capital standards.

In December 2009, the Basel Committee of Banking Supervision (the "Basel Committee") released proposals on risk-based capital, leverage and liquidity standards, known as Basel III. The proposal described new standards to raise the quality of capital and strengthen counterparty credit risk capital requirements; introduced a leverage ratio as a supplemental measure to the risk-based ratio and introduced a countercyclical buffer. The Basel III proposals complement an earlier proposal for revisions to the Market Risk Framework that increases capital requirements for securitizations within the Company's trading book. The Basel Committee published final rules in December 2010, which were ratified at the G-20 Leaders Summit in November 2010. The U.S. regulators will require implementation of Basel III subject to an extended phase-in period. The Basel Committee is also working with the Financial Stability Board to develop additional requirements for systemically important banks, which could include capital surcharges.

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

At March 31, 2011, the Company was in compliance with Basel I capital requirements with ratios of Tier 1 capital to RWAs of 16.5% and total capital to RWAs of 18.4% (6% and 10% being well-capitalized for regulatory purposes, respectively). In addition, financial holding companies are also subject to a Tier 1 leverage ratio as defined by the Federal Reserve. The Company calculated its Tier 1 leverage ratio as Tier 1 capital divided by adjusted average total assets (which reflects adjustments for disallowed goodwill, certain intangible assets, deferred tax assets and financial and non-financial equity investments). The adjusted average total assets are derived using weekly balances for the year.

The following table summarizes the capital measures for the Company:

	March 31, 2011		December 31, 2010	
	Balance	Ratio	Balance	Ratio
	(dollars in millions)			
Tier 1 capital . . . . .	\$ 49,619	16.5%	\$ 52,880	16.1%
Total capital . . . . .	55,453	18.4%	54,477	16.5%
RWAs . . . . .	301,482	—	329,560	—
Adjusted average assets . . . . .	809,398	—	802,283	—
Tier 1 leverage . . . . .	—	6.1%	—	6.6%

Tier 1 capital ratio increased quarter-over-quarter due to a decrease of RWAs. Tier 1 leverage decreased quarter-over-quarter due to an increase of adjusted average assets and a decrease in Tier 1 capital.

*The Company's Significant U.S. Bank Operating Subsidiaries.* The Company's domestic bank operating subsidiaries are subject to various regulatory capital requirements as administered by U.S. federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional, discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's U.S. bank operating subsidiaries' financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company's U.S. bank operating subsidiaries must meet specific capital guidelines that involve quantitative measures of the Company's U.S. bank operating subsidiaries' assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices.

At March 31, 2011, the Company's U.S. bank operating subsidiaries met all capital adequacy requirements to which they are subject and exceeded all regulatory mandated and targeted minimum regulatory capital requirements to be well-capitalized. There are no conditions or events that management believes have changed the Company's U.S. bank operating subsidiaries' category.

The table below sets forth the Company's significant U.S. bank operating subsidiaries' capital.

	March 31, 2011		December 31, 2010	
	Amount	Ratio	Amount	Ratio
	(dollars in millions)			
<i>Total capital (to RWAs):</i>				
Morgan Stanley Bank, N.A. . . . .	\$9,750	18.4%	\$9,568	18.6%
Morgan Stanley Private Bank, N.A. . . . .	\$ 912	42.3%	\$ 909	37.4%
<i>Tier 1 capital (to RWAs):</i>				
Morgan Stanley Bank, N.A. . . . .	\$8,248	15.6%	\$8,065	15.7%
Morgan Stanley Private Bank, N.A. . . . .	\$ 911	42.3%	\$ 909	37.4%
<i>Leverage ratio:</i>				
Morgan Stanley Bank, N.A. . . . .	\$8,248	12.3%	\$8,065	12.1%
Morgan Stanley Private Bank, N.A. . . . .	\$ 911	12.0%	\$ 909	12.4%

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Under regulatory capital requirements adopted by the U.S. federal banking agencies, U.S. depository institutions, in order to be considered well-capitalized, must maintain a ratio of total capital to RWAs of 10%, a capital ratio of Tier 1 capital to RWAs of 6%, and a ratio of Tier 1 capital to average book assets (leverage ratio) of 5%. Each U.S. depository institution subsidiary of the Company must be well-capitalized in order for the Company to continue to qualify as a financial holding company and to continue to engage in the broadest range of financial activities permitted to financial holding companies. At March 31, 2011 and December 31, 2010, the Company's three U.S. depository institutions maintained capital at levels in excess of the universally mandated well-capitalized levels. These subsidiary depository institutions maintain capital at levels sufficiently in excess of the "well-capitalized" requirements to address any additional capital needs and requirements identified by the federal banking regulators.

*MS&Co. and Other Broker-Dealers.* MS&Co. is a registered broker-dealer and registered futures commission merchant and, accordingly, is subject to the minimum net capital requirements of the U.S. Securities and Exchange Commission ("SEC"), the Financial Industry Regulatory Authority and the U.S. Commodity Futures Trading Commission. MS&Co. has consistently operated with capital in excess of its regulatory capital requirements. MS&Co.'s net capital totaled \$7,306 million and \$7,463 million at March 31, 2011 and December 31, 2010, respectively, which exceeded the amount required by \$6,113 million and \$6,355 million, respectively. MS&Co. is required to hold tentative net capital in excess of \$1 billion and net capital in excess of \$500 million in accordance with the market and credit risk standards of Appendix E of SEC Rule 15c3-1. MS&Co. is also required to notify the SEC in the event that its tentative net capital is less than \$5 billion. At March 31, 2011, MS&Co. had tentative net capital in excess of the minimum and the notification requirements.

Morgan Stanley Smith Barney LLC is a registered broker-dealer and registered futures commission merchant and, accordingly, is subject to the minimum net capital requirements of the SEC, the Financial Industry Regulatory Authority, Inc. and the U.S. Commodity Futures Trading Commission. Morgan Stanley Smith Barney LLC has operated with capital in excess of its regulatory capital requirements. Morgan Stanley Smith Barney LLC clears certain customer activity directly and introduces other business to MS&Co. and Citi. MSIP, a London-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Authority, and MSMS, a Tokyo-based broker-dealer subsidiary, is subject to the capital requirements of the Financial Services Agency. MSIP and MSMS have consistently operated in excess of their respective regulatory capital requirements.

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

Morgan Stanley Derivative Products Inc. ("MSDP"), a derivative products subsidiary rated Aa3 by Moody's and AAA by Standard & Poor's Ratings Services, a Division of the McGraw-Hill Companies Inc. ("S&P"), maintains certain operating restrictions that have been reviewed by Moody's and S&P. On December 17, 2010, MSDP was downgraded from an Aa2 rating to an Aa3 rating by Moody's but maintained its AAA rating by S&P. While MSDP has made substantial effort to address Moody's comments, MSDP's counterparty rating remains on review for possible downgrade while Moody's continues to evaluate MSDP's capital adequacy. The recent downgrade did not significantly impact the Company's results of operations or financial condition. MSDP is operated such that creditors of the Company should not expect to have any claims on the assets of MSDP, unless and until the obligations to its own creditors are satisfied in full. Creditors of MSDP should not expect to have any claims on the assets of the Company or any of its affiliates, other than the respective assets of MSDP.

**MORGAN STANLEY**

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

**13. Total Equity.**

*Common Equity Offerings.* During the quarters ended March 31, 2011 and 2010, the Company did not purchase any of its common stock as part of its share repurchase program. At March 31, 2011, the Company had approximately \$1.6 billion remaining under its current share repurchase authorization. Share repurchases by the Company are subject to regulatory approval.

**14. Earnings per Common Share.**

Basic EPS is computed by dividing income available to Morgan Stanley common shareholders by the weighted average number of common shares outstanding for the period. Common shares outstanding include common stock and vested RSUs where recipients have satisfied either the explicit vesting terms or retirement eligibility requirements. Diluted EPS reflects the assumed conversion of all dilutive securities. The Company calculates EPS using the two-class method and determines whether instruments granted in share-based payment transactions are participating securities (see Note 2 to the consolidated financial statements for the year ended December 31, 2010 in the Form 10-K). The following table presents the calculation of basic and diluted EPS (in millions, except for per share data):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Basic EPS:</b>		
Income from continuing operations . . . . .	\$1,128	\$2,079
Net gain (loss) from discontinued operations . . . . .	2	(68)
Net income . . . . .	1,130	2,011
Net income applicable to noncontrolling interests . . . . .	162	235
Net income applicable to Morgan Stanley . . . . .	968	1,776
Less: Preferred dividends (Series A Preferred Stock) . . . . .	(11)	(11)
Less: Preferred dividends (Series B Preferred Stock) . . . . .	(196)	(196)
Less: Preferred dividends (Series C Preferred Stock) . . . . .	(13)	(13)
Less: Allocation of earnings to participating RSUs(1):		
From continuing operations . . . . .	(12)	(54)
From discontinued operations . . . . .	—	2
Less: Allocation of undistributed earnings to Equity Units(2):		
From continuing operations . . . . .	—	(99)
From discontinued operations . . . . .	—	6
Earnings applicable to Morgan Stanley common shareholders . . . . .	\$ 736	\$1,411
Weighted average common shares outstanding . . . . .	1,456	1,315
Earnings per basic common share:		
Income from continuing operations . . . . .	\$ 0.50	\$ 1.12
Net gain (loss) from discontinued operations . . . . .	0.01	(0.05)
Earnings per basic common share . . . . .	\$ 0.51	\$ 1.07

**MORGAN STANLEY**

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

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Diluted EPS:</b>		
Earnings applicable to Morgan Stanley common shareholders .....	\$ 736	\$1,411
Impact on income of assumed conversions:		
Preferred stock dividends (Series B Preferred Stock) .....	—	196
Earnings applicable to common shareholders plus assumed conversions .....	\$ 736	\$1,607
Weighted average common shares outstanding .....	1,456	1,315
Effect of dilutive securities:		
Stock options and RSUs(1) .....	16	1
Series B Preferred Stock .....	—	310
Weighted average common shares outstanding and common stock equivalents .....	1,472	1,626
Earnings per diluted common share:		
Income from continuing operations .....	\$ 0.50	\$ 1.03
Net loss from discontinued operations .....	—	(0.04)
Earnings per diluted common share .....	\$ 0.50	\$ 0.99

(1) RSUs that are considered participating securities participate in all of the earnings of the Company in the computation of basic EPS, and therefore, such RSUs are not included as incremental shares in the diluted calculation.

(2) See Note 15 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K for further information on Equity Units.

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

<b>Number of Antidilutive Securities Outstanding at End of Period:</b>	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(shares in millions)</b>	
RSUs and PSUs .....	26	47
Stock options .....	60	73
Equity Units(1) .....	—	116
Series B Preferred Stock .....	311	—
Total .....	397	236

(1) See Note 2 and Note 15 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K for additional information on the Equity Units regarding the change in methodology to the if-converted method and the redemption of the junior subordinated debentures underlying the Equity Units and issuance of common stock.

**MORGAN STANLEY**

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

**15. Interest Income and Interest Expense.**

Details of Interest income and Interest expense were as follows:

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(dollars in millions)</b>	
Interest income(1):		
Financial instruments owned(2) .....	\$ 918	\$1,131
Securities available for sale .....	88	10
Loans .....	105	70
Interest bearing deposits with banks .....	35	41
Federal funds sold and securities purchased under agreements to resell and Securities borrowed .....	277	150
Other .....	431	334
Total Interest income .....	<u>\$1,854</u>	<u>\$1,736</u>
Interest expense(1):		
Deposits .....	\$ 66	\$ 172
Commercial paper and other short-term borrowings .....	8	3
Long-term debt .....	1,313	1,064
Securities sold under agreements to repurchase and Securities loaned .....	471	286
Other .....	(5)	(157)
Total Interest expense .....	<u>\$1,853</u>	<u>\$1,368</u>
Net interest .....	<u>\$ 1</u>	<u>\$ 368</u>

(1) Interest income and expense are recorded within the condensed consolidated statements of income depending on the nature of the instrument and related market conventions. When interest is included as a component of the instrument's fair value, interest is included within Principal transactions—Trading revenues or Principal transactions—Investments revenues. Otherwise, it is included within Interest income or Interest expense.

(2) Interest expense on Financial instruments sold, not yet purchased is reported as a reduction to Interest income.

**16. Employee Benefit Plans.**

The Company sponsors various pension plans for the majority of its U.S. and non-U.S. employees. The Company provides certain other postretirement benefits, primarily health care and life insurance, to eligible U.S. employees. The Company also provides certain postemployment benefits to certain former employees or inactive employees prior to retirement.

Effective January 1, 2011, the Morgan Stanley Employees Retirement Plan (the "Pension Plan") for U.S. participants ceased accruals of benefits under the Pension Plan. Any benefits earned by participants under the Pension Plan at December 31, 2010 were preserved and will be payable in the future based on the Pension Plan's provisions.

**MORGAN STANLEY**

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

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

	Three Months Ended March 31,	
	2011	2010
	(dollars in millions)	
Service cost, benefits earned during the period .....	\$ 8	\$ 26
Interest cost on projected benefit obligation .....	42	41
Expected return on plan assets .....	(33)	(32)
Net amortization of prior service costs .....	(4)	(2)
Net amortization of actuarial loss .....	5	8
Net periodic benefit expense .....	\$ 18	\$ 41

**17. Income Taxes.**

The Company is under continuous examination by the Internal Revenue Service (the “IRS”) and other tax authorities in certain countries, such as Japan and the United Kingdom (the “U.K.”), and states in which the Company has significant business operations, such as New York. The Company is currently in the early stages of an IRS audit for tax years 2006 – 2008. During 2012, the Company expects to reach a conclusion with the IRS on issues covering tax years 1999 – 2005. During 2011, the Company expects to commence an audit with New York State and New York City covering tax years 2007 – 2009. Also during 2011, the Company expects to reach a conclusion with the U.K. tax authorities on substantially all issues through tax year 2008, including those in appeals. During 2012, the Company expects to reach a conclusion with the Japanese tax authorities on substantially all issues covering tax years 2007 – 2008. The Company periodically evaluates the likelihood of assessments in each taxing jurisdiction resulting from current and subsequent years’ examinations.

The Company believes that the resolution of tax matters will not have a material effect on the condensed consolidated statements of financial condition of the Company, although a resolution could have a material impact on the Company’s condensed consolidated statements of income for a particular future period and on the Company’s effective income tax rate for any period in which such resolution occurs. The Company has established a liability for unrecognized tax benefits that the Company believes is adequate in relation to the potential for additional assessments. Once established, the Company adjusts unrecognized tax benefits only when more information is available or when an event occurs necessitating a change.

It is reasonably possible that significant changes in the gross balance of unrecognized tax benefits may occur within the next 12 months. At this time, however, it is not possible to reasonably estimate the expected change to the total amount of unrecognized tax benefits and impact on the effective tax rate over the next 12 months.

The Company’s effective tax rate from continuing operations for the quarter ended March 31, 2011 included a \$447 million net tax benefit from the remeasurement of a deferred tax asset and the reversal of a related valuation allowance. The deferred tax asset and valuation allowance were recognized in income from discontinued operations in the year ended December 31, 2010 in connection with the recognition of a \$1.2 billion loss due to writedowns and related costs following the Company’s commitment to a plan to dispose of Revel. The Company recorded the valuation allowance because the Company did not believe it was more likely than not that it would have sufficient future net capital gain to realize the benefit of the expected capital loss to be recognized upon the disposal of Revel. During the quarter ended March 31, 2011, the disposal of Revel was restructured as a tax-free like kind exchange and the disposal was completed. The restructured transaction changed the character of the



**MORGAN STANLEY**

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

future taxable loss to ordinary. The Company reversed the valuation allowance because the Company believes it is more likely than not that it will have sufficient future ordinary taxable income to recognize the recorded deferred tax asset. In accordance with the applicable accounting literature, this reversal of a previously established valuation allowance due to a change in circumstances was recognized in income from continuing operations.

**18. Segment and Geographic Information.**

***Segment Information.***

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

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

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the business segment results to the Company's consolidated results. Intersegment eliminations also reflect the effect of fees paid by the Institutional Securities business segment to the Global Wealth Management Group business segment related to the bank deposit program.

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

<u>Three Months Ended March 31, 2011</u>	<u>Institutional Securities</u>	<u>Global Wealth Management Group</u>	<u>Asset Management</u>	<u>Intersegment Eliminations</u>	<u>Total</u>
	(dollars in millions)				
Total non-interest revenues . . . . .	\$3,925	\$3,095	\$634	\$ (20)	\$7,634
Net interest . . . . .	(333)	342	(8)	—	1
Net revenues(1) . . . . .	<u>\$3,592</u>	<u>\$3,437</u>	<u>\$626</u>	<u>\$ (20)</u>	<u>\$7,635</u>
Income from continuing operations					
before income taxes . . . . .	\$ 397	\$ 348	\$127	\$—	\$ 872
Provision for (benefit from) income taxes . . . . .	(378)	91	31	—	(256)
Income from continuing operations . . . . .	<u>775</u>	<u>257</u>	<u>96</u>	<u>—</u>	<u>1,128</u>
Discontinued operations(2):					
Gain (loss) from discontinued					
operations . . . . .	(5)	—	5	—	—
Benefit from income taxes . . . . .	<u>(2)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(2)</u>
Net gain (loss) on discontinued					
operations . . . . .	<u>(3)</u>	<u>—</u>	<u>5</u>	<u>—</u>	<u>2</u>
Net income . . . . .	772	257	101	—	1,130
Net income applicable to noncontrolling					
interests . . . . .	61	74	27	—	162
Net income applicable to Morgan Stanley . . . . .	<u>\$ 711</u>	<u>\$ 183</u>	<u>\$ 74</u>	<u>\$—</u>	<u>\$ 968</u>



**MORGAN STANLEY**

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

<u>Three Months Ended March 31, 2010</u>	<u>Institutional Securities</u>	<u>Global Wealth Management Group</u>	<u>Asset Management</u>	<u>Discover</u>	<u>Intersegment Eliminations</u>	<u>Total</u>
			(dollars in millions)			
Total non-interest revenues .....	\$5,227	\$2,914	\$672	\$—	\$(109)	\$8,704
Net interest .....	111	191	(19)	—	85	368
Net revenues(1) .....	<u>\$5,338</u>	<u>\$3,105</u>	<u>\$653</u>	<u>\$—</u>	<u>\$ (24)</u>	<u>\$9,072</u>
Income (loss) from continuing operations						
before income taxes .....	\$2,065	\$ 278	\$174	\$—	\$ (2)	\$2,515
Provision for (benefit from) income taxes ..	330	64	43	—	(1)	436
Income (loss) from continuing operations ..	<u>1,735</u>	<u>214</u>	<u>131</u>	<u>—</u>	<u>(1)</u>	<u>2,079</u>
Discontinued operations(2):						
Gain (loss) from discontinued operations .....	(936)	—	64	775	(2)	(99)
Benefit from income taxes .....	—	—	(30)	—	(1)	(31)
Net gain (loss) on discontinued operations(3) .....	<u>(936)</u>	<u>—</u>	<u>94</u>	<u>775</u>	<u>(1)</u>	<u>(68)</u>
Net income (loss) .....	799	214	225	775	(2)	2,011
Net income applicable to noncontrolling interests .....	4	115	116	—	—	235
Net income (loss) applicable to Morgan Stanley .....	<u>\$ 795</u>	<u>\$ 99</u>	<u>\$109</u>	<u>\$775</u>	<u>\$ (2)</u>	<u>\$1,776</u>

- (1) In certain management fee arrangements, the Company is entitled to receive performance-based fees (also referred to as incentive fees) when the return on assets under management exceeds certain benchmark returns or other performance targets. In such arrangements, performance fee revenue is accrued (or reversed) quarterly based on measuring account fund performance to date versus the performance benchmark stated in the investment management agreement. The amount of performance-based fee revenue at risk of reversing if fund performance falls below stated investment management agreement benchmarks was approximately \$226 million at March 31, 2011 and approximately \$208 million at December 31, 2010 (see Note 2 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K).
- (2) See Note 1 for discussion of discontinued operations.
- (3) Amounts for the quarter ended March 31, 2010 included a loss of \$932 million related to the planned disposition of Revel included within the Institutional Securities business segment and a gain of \$775 million related to the legal settlement with DFS.

<u>Net Interest</u>	<u>Institutional Securities</u>	<u>Global Wealth Management Group</u>	<u>Asset Management</u>	<u>Intersegment Eliminations</u>	<u>Total</u>
			(dollars in millions)		
<i>Three Months Ended March 31, 2011</i>					
Interest income .....	\$1,480	\$454	\$ 4	\$(84)	\$1,854
Interest expense .....	1,813	112	12	(84)	1,853
Net interest .....	<u>\$ (333)</u>	<u>\$342</u>	<u>\$ (8)</u>	<u>\$—</u>	<u>\$ 1</u>
<i>Three Months Ended March 31, 2010</i>					
Interest income .....	\$1,396	\$339	\$ 6	\$ (5)	\$1,736
Interest expense .....	1,285	148	25	(90)	1,368
Net interest .....	<u>\$ 111</u>	<u>\$191</u>	<u>\$(19)</u>	<u>\$ 85</u>	<u>\$ 368</u>

**MORGAN STANLEY**

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

<u>Total Assets(1)</u>	<u>Institutional Securities</u>	<u>Global Wealth Management Group</u>	<u>Asset Management</u>	<u>Total</u>
	(dollars in millions)			
At March 31, 2011 . . . . .	\$725,804	\$102,696	\$7,685	\$836,185
At December 31, 2010 . . . . .	\$698,453	\$101,058	\$8,187	\$807,698

(1) Corporate assets have been fully allocated to the Company's business segments.

***Geographic Information.***

The Company operates in both U.S. and non-U.S. markets. The Company's non-U.S. business activities are principally conducted through European and Asian locations. The following tables present selected income statement information and total assets of the Company's operations by geographic area. The selected income statement information and total assets disclosed in the following tables reflect the regional view of the Company's consolidated net revenues, income (loss) from continuing operations before income taxes, net income (loss) applicable to Morgan Stanley and total assets, on a managed basis, based on the following methodology:

- Institutional Securities: advisory and equity underwriting—client location, debt underwriting—revenue recording location, sales and trading—trading desk location.
- Global Wealth Management Group: global representative coverage location.
- Asset Management: client location, except for Merchant Banking and Real Estate Investing businesses, which are based on asset location.

<u>Net revenues</u>	<u>Three Months Ended March 31,</u>	
	<u>2011</u>	<u>2010</u>
	(dollars in millions)	
Americas . . . . .	\$5,490	\$6,200
Europe, Middle East, and Africa . . . . .	1,704	2,006
Asia . . . . .	441	866
Net revenues . . . . .	\$7,635	\$9,072

**19. Equity Method Investments.**

The Company has investments accounted for under the equity method (see Note 1) included in Other investments in the condensed consolidated statements of financial condition. See Note 24 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K for further information.

***Japanese Securities Joint Venture.***

On May 1, 2010, the Company and MUFG formed a joint venture in Japan of their respective investment banking and securities businesses. MUFG and the Company have integrated their respective Japanese securities companies by forming two joint venture companies. MUFG contributed the investment banking, wholesale and retail securities businesses conducted in Japan by Mitsubishi UFJ Securities Co., Ltd. into one of the joint venture entities named Mitsubishi UFJ Morgan Stanley Securities Co., Ltd. ("MUMSS"). The Company contributed the investment banking operations conducted in Japan by its subsidiary, MSMS, formerly known as Morgan Stanley Japan Securities Co., Ltd., into MUMSS (MSMS, together with MUMSS, the "Joint Venture"). The Company owns a 40% economic interest in the Joint Venture and MUFG owns a 60% economic interest in the Joint Venture. The Company holds a 40% voting interest and MUFG holds a 60% voting interest in MUMSS, while the Company holds a 51% voting interest and MUFG holds a 49% voting interest in MSMS. The Company

**MORGAN STANLEY**

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

continues to consolidate MSMS in its condensed consolidated financial statements and, commencing on May 1, 2010, accounted for its interest in MUMSS as an equity method investment within the Institutional Securities business segment.

During the quarter ended March 31, 2011, the Company recorded a loss of \$655 million arising from the Company's 40% stake in MUMSS, recorded within Other revenues in the condensed consolidated statement of income. In order to enhance the risk management at MUMSS, during the quarter ended March 31, 2011, the Company entered into a transaction with MUMSS, whereby the fixed income trading positions that previously caused the majority of the aforementioned MUMSS losses were transferred to MSMS. In return for entering into the transaction, the Company received total consideration of \$659 million, which represented the estimated fair value of the transaction.

Pursuant to a shareholder agreement between MUFG and the Company, MUFG is responsible for ensuring that MUMSS remains adequately capitalized, and the Company is not obligated to contribute additional capital to MUMSS. Because of the losses incurred by MUMSS, MUFG contributed approximately \$370 million of capital to MUMSS on April 22, 2011.

During the quarter ended March 31, 2011, the Company performed an impairment review of its equity method investment in MUMSS in view of the deterioration in the financial performance of MUMSS and the earthquake in Japan on March 11, 2011. The Company recorded no other-than-temporary impairment loss at March 31, 2011. Adverse market or economic events, as well as further deterioration of post earthquake economic performance could result in impairment charges of this investment in future periods.

***FrontPoint.***

On March 1, 2011, the Company and the principals of FrontPoint Partners LLC ("FrontPoint") completed the previously announced transaction, whereby FrontPoint senior management and portfolio managers own a majority equity stake in FrontPoint, and the Company retains a minority stake. FrontPoint has replaced the Company's affiliates as the investment advisor and general partner of the FrontPoint funds. At March 1, 2011, the Company accounts for its interest in FrontPoint as an equity method investment within the Asset Management business segment.

**20. Discontinued Operations.**

See Note 1 for a discussion of the Company's discontinued operations.

The table below provides information regarding amounts included in discontinued operations:

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(dollars in millions)</b>	
Pre-tax gain (loss) on discontinued operations(1):		
Revel(2) .....	\$ (10)	\$(938)
Retail Asset Management .....	5	66
DFS(3) .....	—	775
CMB .....	6	2
Other .....	(1)	(4)
	\$—	\$ (99)

(1) Amounts included eliminations of intersegment activity.

## MORGAN STANLEY

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

- (2) Amount included a loss of approximately \$932 million in the three months ended March 31, 2010 in connection with the planned disposition of Revel.
- (3) Amount relates to the legal settlement with DFS.

Net revenues included in discontinued operations for the three months ended March 31, 2011 included \$6 million related to CMB. Net revenues included in discontinued operations for the three months ended March 31, 2010 included \$185 million related to Retail Asset Management and \$6 million related to CMB.

#### **21. Subsequent Events.**

##### *Common Dividend.*

On April 21, 2011, the Company announced that its Board of Directors declared a quarterly dividend per common share of \$0.05. The dividend is payable on May 13, 2011 to common shareholders of record on April 29, 2011.

##### *Long-Term Borrowings.*

Subsequent to March 31, 2011 and through April 30, 2011, the Company's long-term borrowings (net of repayments) decreased by approximately \$1 billion.

##### *MUFG Stock Conversion.*

On April 21, 2011, MUFG and the Company announced that they have entered into an agreement to convert MUFG's outstanding Series B Non-Cumulative Non-Voting Perpetual Convertible Preferred Stock ("Series B Preferred Stock") in the Company into the Company's common stock. Under the terms of the transaction, MUFG will exchange the Series B Preferred Stock with a face value of \$7.8 billion and a 10% dividend for approximately 385 million shares of Company common stock, reflecting an increase in the conversion rate of 75 million shares and providing MUFG with an ownership interest in the Company of 22.4%. The 75 million share increase in the conversion rate (which, based on the Company's closing stock price on April 21, 2011, would be approximately \$2 billion) will be treated as a preferred stock dividend at closing. The transaction is subject to certain closing conditions, including receipt of required regulatory approvals in certain jurisdictions globally.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of Morgan Stanley:

We have reviewed the accompanying condensed consolidated statement of financial condition of Morgan Stanley and subsidiaries (the "Company") as of March 31, 2011, and the related condensed consolidated statements of income, comprehensive income, cash flows and changes in total equity for the three-month periods ended March 31, 2011 and March 31, 2010. These condensed consolidated financial statements are the responsibility of the management of the Company.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial condition of the Company as of December 31, 2010, and the consolidated statements of income, comprehensive income, cash flows and changes in total equity for the year then ended (not presented herein) included in the Company's Annual Report on Form 10-K; and in our report dated February 28, 2011, which report contains an explanatory paragraph concerning the Company changing its fiscal year end from November 30 to December 31, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial condition as of December 31, 2010 is fairly stated, in all material respects, in relation to the consolidated statement of financial condition from which it has been derived.

/s/ Deloitte & Touche LLP  
New York, New York  
May 9, 2011

## **Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.**

### **Introduction.**

Morgan Stanley, a financial holding company, is a global financial services firm that maintains significant market positions in each of its business segments—Institutional Securities, Global Wealth Management Group and Asset Management. The Company, through its subsidiaries and affiliates, provides a wide variety of products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. Unless the context otherwise requires, the terms “Morgan Stanley” and the “Company” mean Morgan Stanley and its consolidated subsidiaries.

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

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

*Global Wealth Management Group*, which includes the Company’s 51% interest in Morgan Stanley Smith Barney Holdings LLC (“MSSB”), provides brokerage and investment advisory services to individual investors and small-to-medium sized businesses and institutions covering various investment alternatives; financial and wealth planning services; annuity and other insurance products; credit and other lending products; cash management services; retirement services; and trust and fiduciary services and engages in fixed income principal trading, which primarily facilitates clients’ trading or investments in such securities.

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

See Note 1 to the condensed consolidated financial statements for a discussion of the Company’s discontinued operations.

The results of operations in the past have been, and in the future may continue to be, materially affected by many factors, including the effect of political and economic conditions and geopolitical events; the effect of market conditions, particularly in the global equity, fixed income and credit markets, including corporate and mortgage (commercial and residential) lending and commercial real estate investments; the impact of current, pending and future legislation (including the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)), regulation (including capital requirements), and legal actions in the United States of America (“U.S.”) and worldwide; the level and volatility of equity, fixed income, and commodity prices and interest rates, currency values and other market indices; the availability and cost of both credit and capital as well as the credit ratings assigned to the Company’s unsecured short-term and long-term debt; investor sentiment and confidence in the financial markets; the performance of the Company’s acquisitions, joint ventures, strategic alliances or other strategic arrangements (including MSSB and with Mitsubishi UFJ Financial Group, Inc. (“MUFG”)); the Company’s reputation; inflation, natural disasters, and acts of war or terrorism; the actions and initiatives of current and potential competitors and technological changes; or a combination of these or other factors. In addition, legislative, legal and regulatory developments related to the Company’s businesses are likely to increase costs, thereby affecting results of operations. These factors also may have an impact on the Company’s ability to achieve its strategic objectives. For a further discussion of these and other important factors that could affect the Company’s business, see “Competition” and “Supervision and Regulation” in Part I, Item 1, and “Risk Factors” in Part I, Item 1A of the Company’s Annual Report on Form 10-K for the year ended December 31, 2010 (the “Form 10-K”) and “Other Matters—Regulatory Outlook” in Part I, Item 2 herein.

The discussion of the Company’s results of operations below may contain forward-looking statements. These statements, which reflect management’s beliefs and expectations, are subject to risks and uncertainties that may

cause actual results to differ materially. For a discussion of the risks and uncertainties that may affect the Company's future results, please see "Forward-Looking Statements" immediately preceding Part I, Item 1, "Competition" and "Supervision and Regulation" in Part I, Item 1, "Risk Factors" in Part I, Item 1A and "Executive Summary—Significant Items" in Part II, Item 7 of the Form 10-K and "Other Matters—Regulatory Outlook" herein.

## Executive Summary.

*Financial Information and Statistical Data (dollars in millions, except where noted and per share amounts).*

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Net revenues:</b>		
Institutional Securities . . . . .	\$3,592	\$5,338
Global Wealth Management Group . . . . .	3,437	3,105
Asset Management . . . . .	626	653
Intersegment Eliminations . . . . .	(20)	(24)
Consolidated net revenues . . . . .	<u>\$7,635</u>	<u>\$9,072</u>
<b>Net income</b> . . . . .	1,130	2,011
<b>Net income applicable to noncontrolling interests</b> . . . . .	162	235
<b>Net income applicable to Morgan Stanley</b> . . . . .	<u>\$ 968</u>	<u>\$1,776</u>
<b>Income from continuing operations applicable to Morgan Stanley:</b>		
Institutional Securities . . . . .	\$ 714	\$1,731
Global Wealth Management Group . . . . .	183	99
Asset Management . . . . .	69	15
Intersegment Eliminations . . . . .	—	(1)
Income from continuing operations applicable to Morgan Stanley . . . . .	<u>\$ 966</u>	<u>\$1,844</u>
<b>Amounts applicable to Morgan Stanley:</b>		
Income from continuing operations applicable to Morgan Stanley . . . . .	\$ 966	\$1,844
Net gain (loss) from discontinued operations applicable to Morgan Stanley(1) . . . . .	2	(68)
<b>Net income applicable to Morgan Stanley</b> . . . . .	<u>\$ 968</u>	<u>\$1,776</u>
<b>Earnings applicable to Morgan Stanley common shareholders</b> . . . . .	<u>\$ 736</u>	<u>\$1,411</u>
<b>Earnings (loss) per basic common share:</b>		
Income from continuing operations . . . . .	\$ 0.50	\$ 1.12
Net gain (loss) from discontinued operations(1) . . . . .	0.01	(0.05)
Earnings per basic common share(2) . . . . .	<u>\$ 0.51</u>	<u>\$ 1.07</u>
<b>Earnings (loss) per diluted common share:</b>		
Income from continuing operations . . . . .	\$ 0.50	\$ 1.03
Net loss from discontinued operations(1) . . . . .	—	(0.04)
Earnings per diluted common share(2) . . . . .	<u>\$ 0.50</u>	<u>\$ 0.99</u>
<b>Regional net revenues(3):</b>		
Americas . . . . .	\$5,490	\$6,200
Europe, Middle East and Africa . . . . .	1,704	2,006
Asia . . . . .	441	866
Net revenues . . . . .	<u>\$7,635</u>	<u>\$9,072</u>



*Financial Information and Statistical Data (dollars in millions, except where noted and per share amounts)—(Continued).*

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Average common equity (dollars in billions)(4):</b>		
Institutional Securities .....	\$ 20.7	\$ 17.3
Global Wealth Management Group .....	6.7	6.9
Asset Management .....	1.9	2.2
Parent capital .....	18.8	11.2
Total from continuing operations .....	48.1	37.6
Discontinued operations .....	—	0.5
Consolidated average common equity .....	<u>\$ 48.1</u>	<u>\$ 38.1</u>
<b>Return on average common equity(4):</b>		
Consolidated .....	6%	16%
Institutional Securities(4) .....	10%	38%
Global Wealth Management Group .....	9%	5%
Asset Management .....	12%	2%
<b>Book value per common share(5)</b> .....	\$ 31.45	\$ 27.65
<b>Tangible common equity(6)</b> .....	\$41,673	\$31,097
<b>Tangible book value per common share(7)</b> .....	\$ 26.97	\$ 22.24
<b>Effective income tax rate provision (benefit) from continuing operations(8)</b> .....	(29.4)%	17.3%
<b>Worldwide employees</b> .....	62,494	61,335
<b>Average liquidity (dollars in billions)(9):</b>		
Parent company liquidity .....	\$ 77	\$ 65
Bank and other subsidiary liquidity .....	95	90
Total liquidity .....	<u>\$ 172</u>	<u>\$ 155</u>
<b>Capital ratios at March 31, 2011 and 2010(10):</b>		
Total capital ratio .....	18.4%	16.1%
Tier 1 capital ratio .....	16.5%	15.1%
Tier 1 leverage ratio .....	6.1%	6.1%
Tier 1 common ratio(10) .....	11.7%	8.3%
<b>Consolidated assets under management or supervision (dollars in billions)(11):</b>		
Asset Management(12) .....	\$ 284	\$ 262
Global Wealth Management Group .....	510	413
Total .....	<u>\$ 794</u>	<u>\$ 675</u>

*Financial Information and Statistical Data (dollars in millions, except where noted and per share amounts)—(Continued).*

	Three Months Ended March 31,	
	2011	2010
<b>Institutional Securities:</b>		
Pre-tax profit margin(13)	11%	39%
<b>Global Wealth Management Group:</b>		
Global representatives	17,800	18,140
Annualized net revenue per global representative (dollars in thousands)(14)	\$ 767	\$ 685
Assets by client segment (dollars in billions):		
\$10 million or more	\$ 545	\$ 481
\$1 million to \$10 million	733	670
Subtotal \$1 million or more	1,278	1,151
\$100,000 to \$1 million	401	408
Less than \$100,000	39	45
Total client assets	\$ 1,718	\$ 1,604
Fee-based assets as a percentage of total client assets	29%	26%
Client assets per global representative(15)	\$ 97	\$ 88
Global retail net new assets (dollars in billions):		
Domestic	\$ 9.2	\$ 6.9
International	2.2	2.4
Total retail net new assets	\$ 11.4	\$ 9.3
Global fee based asset flows (dollars in billions)	17.8	9.1
Global retail locations	832	905
Bank deposits (dollars in billions)(16)	\$ 112	\$ 114
Pre-tax profit margin(13)	10%	9%
<b>Asset Management:</b>		
Assets under management or supervision (dollars in billions)	\$ 284	\$ 262
Pre-tax profit margin(13)	20%	27%

(1) See Note 1 to the condensed consolidated financial statements for information on discontinued operations.

(2) For the calculation of basic and diluted earnings per share ("EPS"), see Note 14 to the condensed consolidated financial statements.

(3) In the quarter ended March 31, 2011, regional net revenues, primarily in the Americas, were negatively impacted by the tightening of the Company's credit spreads, which resulted in the increase in the fair value of certain of the Company's long-term and short-term borrowings, primarily structured notes. For a discussion of the Company's methodology used to allocate revenues among the regions, see Note 18 to the condensed consolidated financial statements.

(4) The computation of average common equity for each business segment is determined using the Company's Required Capital framework ("Required Capital Framework"), an internal capital adequacy measure (see "Liquidity and Capital Resources—Required Capital" herein). The Required Capital Framework will evolve over time in response to changes in the business and regulatory environment and to incorporate enhancements in modeling techniques. The return on average common equity uses income from continuing operations applicable to Morgan Stanley less preferred dividends as a percentage of average common equity. See "Liquidity and Capital Resource—Required Capital" herein for more information on the calculation of the average common equity by segment. The effective tax rates used in the computation of business segment return on average common equity were determined on a separate entity basis. Excluding the effect of the discrete tax benefit in the quarter ended March 31, 2011, the return on average common equity for the Institutional Securities business segment would have been 1% (see "Executive Summary—Overview of the Quarter Ended March 31, 2011 Financial Results" herein).

(5) Book value per common share equals common shareholders' equity of \$48,589 million at March 31, 2011 and \$38,667 million at March 31, 2010, divided by common shares outstanding of 1,545 million at March 31, 2011 and 1,398 million at March 31, 2010.

(6) Tangible common equity is a non-Generally Accepted Accounting Principle ("GAAP") financial measure that the Company considers to be a useful measure that the Company and investors use to assess capital adequacy. For a discussion of tangible common equity, see "Liquidity and Capital Resources—The Balance Sheet" herein.

(7) Tangible book value per common share is a non-GAAP financial measure that the Company considers to be a useful measure that the Company and investors use to assess capital adequacy. Tangible book value per common share equals tangible common equity divided by period-end common shares outstanding.

- (8) For a discussion of the effective income tax rate, see “Executive Summary—Overview of the Quarter Ended March 31, 2011 Financial Results” herein.
- (9) For a discussion of average liquidity, see “Liquidity and Capital Resources—Liquidity Management—Global Liquidity Reserve” herein.
- (10) Tier 1 common ratio is a non-GAAP financial measure that the Company considers to be a useful measure that the Company and investors use to assess capital adequacy. For a discussion of total capital ratio, Tier 1 capital ratio and Tier 1 leverage ratio, see “Liquidity and Capital Resources—Regulatory Requirements” herein. For a discussion of Tier 1 common ratio, see “Liquidity and Capital Resources—The Balance Sheet” herein.
- (11) Revenues and expenses associated with these assets are included in the Company’s Asset Management and Global Wealth Management Group business segments.
- (12) Amounts include Asset Management’s proportionate share of assets managed by entities in which it owns a minority stake.
- (13) Pre-tax profit margin is a non-GAAP financial measure that the Company considers to be a useful measure that the Company and investors use to assess operating performance. Percentages represent income from continuing operations before income taxes as a percentage of net revenues.
- (14) Annualized net revenues per global representative for the quarters ended March 31, 2011 and 2010 equals Global Wealth Management Group’s net revenues divided by the quarterly weighted average global representative headcount for the quarters ended March 31, 2011 and 2010, respectively.
- (15) Client assets per global representative equal total period-end client assets divided by period-end global representative headcount.
- (16) Approximately \$54 billion and \$56 billion of the bank deposit balances at March 31, 2011 and 2010, respectively, are held at Company-affiliated depositories with the remainder held at Citigroup, Inc. (“Citi”) affiliated depositories. These deposit balances are held at certain of the Company’s Federal Deposit Insurance Corporation (the “FDIC”) insured depository institutions for the benefit of the Company’s clients through their accounts.

### ***Global Market and Economic Conditions.***

During the first quarter of 2011, global market and economic conditions were affected by the earthquake and tsunami in Japan, political unrest in the Middle East and military operations in Libya.

In the U.S., major equity market indices ended the first quarter of 2011 higher compared with the beginning of the year primarily due to better than expected corporate earnings. Positive market and economic developments, which included a modest improvement in the unemployment rate, were partially offset by the negative global market effects from the earthquake and tsunami in Japan and the continued sovereign debt crisis within the European region. Certain sectors of the residential real estate market and investments in commercial real estate projects remained challenged. Consumer spending and business investments continued to improve. Concerns about crude oil supplies contributed to a rise in oil prices during the quarter. Deficit reductions and balanced budgets remain critical focus items at the federal, state and local levels of government. The unemployment rate decreased to 8.8% at March 31, 2011 from 9.4% at December 31, 2010. The Federal Open Market Committee (“FOMC”) of the Board of Governors of the Federal Reserve System (the “Federal Reserve”) kept key interest rates at historically low levels, and at March 31, 2011, the federal funds target rate was between zero and 0.25%, and the discount rate was 0.75%. The FOMC continued to pursue quantitative easing policies, in which the FOMC purchased securities with the objective of improving economic conditions by increasing the money supply.

In Europe, equity market indices in France and Germany ended the first quarter of 2011 higher, as compared with the beginning of the year, while in the United Kingdom (“U.K.”), they were relatively unchanged. Results in the European equity markets were affected by adverse economic developments, including investor concerns about the sovereign debt crisis, especially in Portugal, Ireland, Greece and Spain. Industrial output in the region was primarily driven by German exports. The euro area unemployment rate remained relatively unchanged at approximately 10% at March 31, 2011. At March 31, 2011, the European Central Bank’s (“ECB”) benchmark interest rate was 1.00% and the Bank of England’s (“BOE”) benchmark interest rate was 0.50%. The BOE continued to pursue quantitative easing policies, in which the BOE purchased securities, including U.K. Government Gilts, with the objective of improving economic conditions by increasing the money supply. In April 2011, the ECB increased its benchmark interest rate by 0.25% from 1.00% to 1.25%.

In Asia, industrial output was driven by exports from China and Japan. China’s economy continued to benefit from government spending for capital projects, a significant amount of foreign currency reserves and a relatively

high domestic savings rate. Japan's economic recovery stalled and exports declined due to the earthquake and tsunami that occurred in March 2011. Equity markets in China and Hong Kong ended the first quarter of 2011 higher compared with the beginning of the year, while results in Japan were lower. During the first quarter of 2011, the People's Bank of China raised the one-year yuan lending rate by 0.25% from 5.81% to 6.06% and the one-year yuan deposit rate by 0.25% from 2.75% to 3.00%. In April 2011, the People's Bank of China raised the one-year yuan lending rate by 0.25% from 6.06% to 6.31% and the one-year yuan deposit rate by 0.25% from 3.00% to 3.25%.

***Overview of the Quarter Ended March 31, 2011 Financial Results.***

*Consolidated Review.* The Company recorded net income applicable to Morgan Stanley of \$968 million during the quarter ended March 31, 2011, a 45% decrease from \$1,776 million in the prior year period.

Net revenues decreased 16% to \$7,635 million in the quarter ended March 31, 2011 from \$9,072 million in the prior year period. Net revenues in the quarter ended March 31, 2011 included a pre-tax loss of \$655 million, or \$0.26 per diluted share, arising from the Company's 40% stake in the Japanese securities joint venture with MUFG, Mitsubishi UFJ Morgan Stanley Securities Co., Ltd. ("MUMSS") (see Note 19 to the condensed consolidated financial statements). Net revenues in the quarter ended March 31, 2011 also included negative revenues of \$189 million due to the tightening of the Company's credit spreads on certain of the Company's long-term and short-term borrowings, primarily structured notes, for which the fair value option was elected, compared with gains of approximately \$54 million in the prior year period related to the widening of the Company's credit spreads on such borrowings. Non-interest expenses increased 3% to \$6,763 million in the quarter ended March 31, 2011. Compensation and benefits expense decreased 2%. Non-compensation expenses increased 13%, primarily reflecting higher levels of business activity, litigation expenses and ongoing investments in technology. Diluted EPS were \$0.50 in the quarter ended March 31, 2011 compared with \$0.99 in the prior year period. Diluted EPS from continuing operations were \$0.50 in the quarter ended March 31, 2011 compared with \$1.03 in the prior year period.

The Company's effective income tax rate from continuing operations was a benefit of (29.4)% for the quarter ended March 31, 2011. The effective tax rate for the quarter ended March 31, 2011 included a net tax benefit of \$447 million, or \$0.30 per diluted share, from the remeasurement of a deferred tax asset and the reversal of a related valuation allowance. The deferred tax asset and valuation allowance were recognized in income from discontinued operations in 2010 in connection with the recognition of a \$1.2 billion loss due to writedowns and related costs following the Company's commitment to a plan to dispose of Revel Entertainment Group, LLC ("Revel"). Excluding this discrete tax benefit the annual effective tax rate in the quarter ended March 31, 2011 would have been 22.0%. For further discussion of the discrete tax benefit, see "Significant Items—Income Tax Benefit" herein.

The Company's effective income tax rate from continuing operations was 17.3% for the quarter ended March 31, 2010. The effective tax rate for the quarter ended March 31, 2010 included a tax benefit of \$382 million, or \$0.21 per diluted share, related to the reversal of U.S. deferred tax liabilities associated with prior-years' undistributed earnings of certain non-U.S. subsidiaries that were determined to be indefinitely reinvested abroad. Excluding this benefit, the annual effective tax rate in the quarter ended March 31, 2010 would have been 32.5%.

Discontinued operations for the quarter ended March 31, 2010 included a loss of \$932 million due to writedowns and related costs associated with the planned disposition of Revel and a gain of \$775 million related to a legal settlement with Discover Financial Services ("DFS").

*Institutional Securities.* Income from continuing operations before income taxes was \$397 million in the quarter ended March 31, 2011 compared with \$2,065 million in the prior year period. Net revenues were \$3,592 million in the quarter ended March 31, 2011 compared with \$5,338 million in the prior year period. Investment banking revenues increased 14% from the prior year period, reflecting higher revenues from equity and

fixed income underwriting transactions and higher advisory fees. Equity sales and trading revenues increased 20% to \$1,702 million in the quarter ended March 31, 2011, primarily reflecting higher revenues in the derivatives and cash businesses driven by increased levels of both client activity and market volatility. Fixed income and commodities sales and trading revenues decreased 35% to \$1,770 million in the quarter ended March 31, 2011 from \$2,717 million in the prior year period, primarily reflecting lower results in credit products, partly offset by higher net revenues in interest rates and commodities. Results in the quarter ended March 31, 2011 included negative revenue of approximately \$159 million due to the tightening of the Company's credit spreads resulting from the increase in the fair value of certain of the Company's long-term and short-term borrowings, primarily structured notes, for which the fair value option was elected compared with positive revenues of \$2 million in the quarter ended March 31, 2010 due to the widening of such spreads. Principal transaction net investment gains of \$143 million were recognized in the quarter ended March 31, 2011 compared with net investment gains of \$174 million in the prior year period. Other losses of \$573 million were recognized in the quarter ended March 31, 2011 compared with other revenues of \$142 million in the quarter ended March 31, 2010. The results in the current quarter included a pre-tax loss of \$655 million arising from the Company's 40% stake in MUMSS (see "Business Segments—Institutional Securities—Other" herein for further information). Non-interest expenses decreased 2% in the quarter ended March 31, 2011, primarily due to lower compensation and benefits expenses, partially offset by an increase in non-compensation expenses. Compensation and benefits expenses decreased 10% in the quarter ended March 31, 2011. Non-compensation expenses increased 13% in the quarter ended March 31, 2011 from a year ago resulting from higher levels of business activity and ongoing investments in technology.

*Global Wealth Management Group.* Income from continuing operations before income taxes was \$348 million in the quarter ended March 31, 2011 compared with \$278 million in the prior year period. Net revenues were \$3,437 million in the quarter ended March 31, 2011 compared with \$3,105 million in the prior year period. Investment banking revenues increased 18% in the quarter ended March 31, 2011, primarily due to higher closed-end fund and unit investment trusts activity, partially offset by lower fixed income underwriting activity. Principal transactions trading revenues decreased 2% in the quarter ended March 31, 2011 primarily due to lower revenues from corporate fixed income and government securities, partially offset by higher revenues from municipal and corporate equity securities and gains related to investments associated with certain employee deferred compensation plans. Commission revenues increased 14% in the quarter ended March 31, 2011, primarily due to higher client activity. Asset management, distribution and administration fees increased 3% in the quarter ended March 31, 2011, primarily due to higher fee based revenues partially offset by the change in classification of the bank deposit program (see "Global Wealth Management Group—Asset Management, Distribution and Administration Fees" herein). Other revenues increased 10% in the quarter ended March 31, 2011, primarily due to gains on securities available for sale. Net interest increased 79% in the quarter ended March 31, 2011, primarily resulting from an increase in Interest income due to the securities available for sale portfolio and the change in classification of the bank deposit program noted above. Non-interest expenses were \$3,089 million in the quarter ended March 31, 2011 compared with \$2,827 million in the prior year period.

*Asset Management.* Income from continuing operations before income taxes was \$127 million in the quarter ended March 31, 2011 compared with \$174 million in the prior year period. Net revenues were \$626 million in the quarter ended March 31, 2011 compared with \$653 million in the prior year period as higher results in the Traditional Asset Management business were offset by lower gains on principal investments in the Real Estate Investing business. Non-interest expenses increased 4% to \$499 million in the quarter ended March 31, 2011.

### ***Significant Items.***

*Japanese Securities Joint Venture.* During the quarter ended March 31, 2011, the Company recorded a pre-tax loss of \$655 million within Other revenues in the condensed consolidated statement of income, arising from the Company's 40% stake in MUMSS (see Note 19 to the condensed consolidated financial statements), included within Other revenues in the condensed consolidated statement of income. See "Other Matters—Japanese Securities Joint Venture" herein for further information.

*Real Estate Investments.* The Company recorded gains (losses) in the following business segments related to real estate investments. These amounts exclude investments associated with certain deferred compensation and employee co-investment plans.

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(dollars in billions)</b>	
Institutional Securities		
Continuing operations(1) . . . . .	\$ 0.5	\$—
Discontinued operations(2) . . . . .	—	(0.9)
Total Institutional Securities . . . . .	0.5	(0.9)
Asset Management:		
Continuing operations(3) . . . . .	0.1	0.1
Total Asset Management . . . . .	0.1	0.1
Amounts applicable to noncontrolling interests . . . . .	0.1	0.1
Total . . . . .	<u>\$ 0.5</u>	<u>\$ (0.9)</u>

- (1) Amount includes a tax benefit related to Revel (see “Income Tax Benefit” below), and net realized and unrealized losses from the Company’s limited partnership investments in real estate funds.
- (2) On March 31, 2010, the Board of Directors authorized a plan of disposal by sale for Revel. The results of Revel, including the estimated loss from the planned disposal, are reported as discontinued operations for all periods presented within the Institutional Securities business segment. On February 17, 2011, the Company completed the sale of Revel to a group of investors led by Revel’s chief executive officer (see Note 1 to the condensed consolidated financial statements).
- (3) Gains related to net realized and unrealized gains (losses) from real estate limited partnership investments in the Company’s Real Estate Investing business and are reflected in Principal transactions—Investments in the condensed consolidated statements of income.

See “Other Matters—Real Estate” herein for further information.

*Income Tax Benefit.* The Company’s effective tax rate from continuing operations for the quarter ended March 31, 2011 included a \$447 million net tax benefit from the remeasurement of a deferred tax asset and the reversal of a related valuation allowance. The deferred tax asset and valuation allowance were recognized in income from discontinued operations in 2010 in connection with the recognition of a \$1.2 billion loss due to writedowns and related costs following the Company’s commitment to a plan to dispose of Revel. The Company recorded the valuation allowance because the Company did not believe it was more likely than not that it would have sufficient future net capital gain to realize the benefit of the expected capital loss to be recognized upon the disposal of Revel. During the quarter ended March 31, 2011, the disposal of Revel was restructured as a tax-free like kind exchange and the disposal was completed. The restructured transaction changed the character of the future taxable loss to ordinary. The Company reversed the valuation allowance because the Company believes it is more likely than not that it will have sufficient future ordinary taxable income to recognize the recorded deferred tax asset. In accordance with the applicable accounting literature, this reversal of a previously established valuation allowance due to a change in circumstances was recognized in income from continuing operations.

The Company’s effective tax rate from continuing operations for the quarter ended March 31, 2010 included a tax benefit of \$382 million, or \$0.21 per diluted share, related to the reversal of U.S. deferred tax liabilities associated with prior-years’ undistributed earnings of certain non-U.S. subsidiaries that were determined to be indefinitely reinvested abroad.

*Morgan Stanley Debt.* Net revenues reflected negative revenues of \$189 million and gains of \$54 million in the quarters ended March 31, 2011 and 2010, respectively, from the tightening and widening, respectively, of the Company’s credit spreads on certain long-term and short-term borrowings, primarily structured notes that are accounted for at fair value.



During the quarter ended March 31, 2011, net revenues included losses on economic hedges related to the Company's long-term debt (see "Business Segments—Institutional Securities—Sales and Trading Revenues—Other" herein).

*Monoline Insurers.* The quarter ended March 31, 2011 included losses of \$318 million related to the Company's Monoline counterparty credit exposures, principally MBIA, compared with losses of \$143 million in the prior year period.

Monoline insurers ("Monolines") provide credit enhancement to capital markets transactions. The current credit environment continues to affect the ability of such financial guarantors to provide enhancement to existing capital market transactions. The Company's direct exposure to Monolines is limited to bonds that are insured by Monolines and to derivative contracts with a Monoline as counterparty (principally an affiliate of MBIA Inc. ("MBIA")). The Company's exposure to Monolines at March 31, 2011 includes \$1.6 billion of insured municipal bond securities, \$282 million of mortgage and asset-backed securities enhanced by financial guarantees, and positive net derivative counterparty exposure of \$782 million (gross counterparty exposure of approximately \$4.2 billion net of cumulative credit valuation adjustments and hedges), which was primarily related to MBIA. Positive net derivative counterparty exposure is defined as the sum of net long positions for each individual counterparty and represents the potential loss to the Company over a period of time in an event of 100% default of a Monoline, assuming zero recovery. The increase in positive net derivative counterparty exposure from December 31, 2010 is primarily due to a reduction of MBIA-related hedges.

The Company's hedging program for Monoline counterparty exposure continues to become more costly and difficult to effect, and, as such, the losses in the quarter ended March 31, 2011 reflected those additional costs as well as volatility on those hedges caused by the tightening of both MBIA and commercial mortgage-backed spreads. The Company proactively manages its Monoline exposure; however, as market conditions continue to evolve, significant additional losses could be incurred. The Company's hedging program includes the use of single name and index transactions that mitigate credit exposure to the Monolines as well as certain market risk components of existing underlying commercial mortgage-backed securities transactions with the Monolines and is conducted as part of the Company's overall market risk management. See "Qualitative and Quantitative Disclosures about Market Risk—Risk Management—Market Risk" in Part II, Item 7A of the Form 10-K.

*Settlement with DFS.* On June 30, 2007, the Company completed the spin-off of its business segment DFS to its shareholders. On February 11, 2010, DFS paid the Company \$775 million in complete satisfaction of its obligations to the Company regarding the sharing of proceeds from a lawsuit against Visa and MasterCard. The payment was recorded as a gain in discontinued operations in the condensed consolidated statement of income for the quarter ended March 31, 2010.



## **Business Segments.**

Substantially all of the Company's operating revenues and operating expenses can be directly attributed to its business segments. Certain revenues and expenses have been allocated to each business segment, generally in proportion to its respective revenues or other relevant measures.

As a result of treating certain intersegment transactions as transactions with external parties, the Company includes an Intersegment Eliminations category to reconcile the business segment results to the Company's consolidated results. Intersegment Eliminations also reflect the effect of fees paid by the Institutional Securities business segment to the Global Wealth Management Group business segment related to the bank deposit program. The Company did not recognize any Intersegment Elimination gain or loss in the quarter ended March 31, 2011 and losses from continuing operations before income taxes recorded in Intersegment Eliminations were \$2 million in the quarter ended March 31, 2010.

**INSTITUTIONAL SECURITIES**  
**INCOME STATEMENT INFORMATION**

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(dollars in millions)</b>	
Revenues:		
Investment banking .....	\$1,008	\$ 887
Principal transactions:		
Trading .....	2,646	3,418
Investments .....	143	174
Commissions .....	670	580
Asset management, distribution and administration fees .....	31	26
Other .....	(573)	142
Total non-interest revenues .....	<u>3,925</u>	<u>5,227</u>
Interest income .....	1,480	1,396
Interest expense .....	1,813	1,285
Net interest .....	(333)	111
Net revenues .....	<u>3,592</u>	<u>5,338</u>
Compensation and benefits .....	1,953	2,169
Non-compensation expenses .....	1,242	1,104
Total non-interest expenses .....	<u>3,195</u>	<u>3,273</u>
Income from continuing operations before income taxes .....	397	2,065
Provision for (benefit from) income taxes .....	(378)	330
Income from continuing operations .....	<u>775</u>	<u>1,735</u>
Discontinued operations:		
Losses from discontinued operations .....	(5)	(936)
Benefit from income taxes .....	(2)	—
Net losses on discontinued operations .....	<u>(3)</u>	<u>(936)</u>
Net income .....	<u>772</u>	<u>799</u>
Net income applicable to noncontrolling interests .....	<u>61</u>	<u>4</u>
Net income applicable to Morgan Stanley .....	<u>\$ 711</u>	<u>\$ 795</u>
Amounts applicable to Morgan Stanley:		
Income from continuing operations .....	\$ 714	\$1,731
Net loss from discontinued operations .....	<u>(3)</u>	<u>(936)</u>
Net income applicable to Morgan Stanley .....	<u>\$ 711</u>	<u>\$ 795</u>

On February 17, 2011, the Company completed the sale of Revel. The sale price approximated the carrying value of Revel and, accordingly, the Company did not recognize any pre-tax gain or loss on the sale. The results of Revel are reported as discontinued operations within the Institutional Securities business segment for all periods presented through the date of sale. The quarter ended March 31, 2010 included losses of approximately \$932 million in connection with writedowns and related costs of such planned disposition. For further information on Revel, see “Executive Summary—Significant Items—Income Tax Benefit” herein and Note 28 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K.

**Investment Banking.** Investment banking revenues for the quarter ended March 31, 2011 increased 14% from the comparable period in 2010, reflecting higher revenues from equity and fixed income underwriting transactions and higher advisory fees. Overall, underwriting revenues of \$623 million increased 11% from the quarter ended March 31, 2010. Equity underwriting revenues increased 8% to \$285 million, as market activity increased versus the same period a year ago. Fixed income underwriting revenues increased 14% to \$338 million, primarily due to higher loan syndication fees. Advisory fees from merger, acquisition and restructuring transactions were \$385 million, an increase of 18% from the comparable period of 2010 driven by an increase in completed deal activity.

**Sales and Trading Revenues.** Sales and trading revenues are composed of Principal transactions—Trading revenues; Commissions; Asset management, distribution and administration fees; and Net interest revenues (expenses). In assessing the profitability of its sales and trading activities, the Company views Principal transactions—Trading revenues; Commissions; Asset management, distribution and administration fees; and Net interest revenues (expenses) in the aggregate. In addition, decisions relating to principal transactions are based on an overall review of aggregate revenues and costs associated with each transaction or series of transactions. This review includes, among other things, an assessment of the potential gain or loss associated with a transaction, including any associated commissions, dividends, the interest income or expense associated with financing or hedging the Company’s positions, and other related expenses.

Effective March 31, 2011, the Institutional Securities business segment’s “fixed income” business has been renamed the “fixed income and commodities” business. The IRCC business has been renamed the “fixed income” business. These name changes did not affect current or previously reported results for these businesses.

Total sales and trading revenues decreased 27% in the quarter ended March 31, 2011 from the comparable period of 2010, reflecting lower fixed income sales and trading revenues and higher losses in other sales and trading, partially offset by higher equity sales and trading revenues.

Sales and trading revenues were as follows:

	Three Months Ended March 31,	
	2011	2010(1)
	(dollars in millions)	
Equity .....	\$1,702	\$1,419
Fixed income and commodities .....	1,770	2,717
Other(2) .....	(458)	(1)
Total sales and trading revenues .....	\$3,014	\$4,135

(1) All prior-period amounts have been reclassified to conform to the current period’s presentation.

(2) Other sales and trading revenues include net gains (losses) from loans and lending commitments and related hedges associated with the Company’s lending activities. Other sales and trading revenues also included losses on economic hedges related to the Company’s long-term debt and net losses associated with costs related to the amount of liquidity (“negative carry”) in the Company’s domestic subsidiary banks, Morgan Stanley Bank, N.A. and Morgan Stanley Private Bank, National Association (formerly, Morgan Stanley Trust FSB) (the “Subsidiary Banks”).

**Equity.** Equity sales and trading revenues increased 20% to \$1,702 million in the quarter ended March 31, 2011 from the comparable period of 2010. The increase primarily reflected higher revenues in the derivatives and cash businesses driven by increased levels of both client activity and market volatility. Results in equity sales and trading revenues were partially offset by negative revenue of approximately \$30 million in the quarter ended March 31, 2011 due to the tightening of the Company’s credit spreads resulting from the increase in the fair value of certain of the Company’s long-term and short-term borrowings, primarily structured notes, for which the fair value option was elected compared with positive revenue of approximately \$48 million in the quarter ended March 31, 2010.

In the quarter ended March 31, 2011, equity sales and trading revenues also reflected unrealized gains of approximately \$12 million related to changes in the fair value of net derivative contracts attributable to the

tightening of counterparties' credit default swap spreads compared with unrealized gains of \$24 million in the quarter ended March 31, 2010. The Company also recorded unrealized losses of \$40 million in the quarter ended March 31, 2011 related to changes in the fair value of net derivative contracts attributable to the tightening of the Company's credit default swap spreads compared with unrealized gains of approximately \$14 million in the quarter ended March 31, 2010 due to the widening of such spreads. The unrealized gains and losses on credit default swap spreads do not reflect any gains or losses on related hedging instruments.

*Fixed Income and Commodities.* Fixed income and commodities sales and trading revenues decreased 35% to \$1,770 million in the quarter ended March 31, 2011 from \$2,717 million in the quarter ended March 31, 2010. Fixed income product revenues in the quarter ended March 31, 2011 decreased 34%, primarily reflecting lower results in credit products, partially offset by higher net revenues in interest rates due to more favorable market conditions. Fixed income product net revenues in the first quarter of 2010 reflected strong results in credit products, particularly in investment grade and distressed debt trading and securitized products. Fixed income product net revenues in the quarter ended March 31, 2011 were also negatively impacted by losses of \$318 million from Monolines compared with losses of \$143 million in the quarter ended March 31, 2010 (see "Executive Summary—Significant Items—Monoline Insurers" herein for further information). Commodity net revenues increased 10% in the quarter ended March 31, 2011, primarily due to improved results in more volatile markets. Results in the quarter ended March 31, 2011 included negative revenue of approximately \$159 million due to the tightening of the Company's credit spreads resulting from the increase in the fair value of certain of the Company's long-term and short-term borrowings, primarily structured notes, for which the fair value option was elected compared with positive revenues of \$2 million in the quarter ended March 31, 2010 due to the widening of such spreads.

In the quarter ended March 31, 2011, fixed income and commodities sales and trading revenues reflected net unrealized gains of \$857 million related to changes in the fair value of net derivative contracts attributable to the tightening of counterparties' credit default swap spreads compared with unrealized gains of approximately \$537 million in the quarter ended March 31, 2010. The Company also recorded unrealized losses of \$156 million in the quarter ended March 31, 2011 related to changes in the fair value of net derivative contracts attributable to the tightening of the Company's credit default swap spreads compared with gains of \$99 million in the quarter ended March 31, 2010 due to the widening of such spreads. The unrealized gains and losses on credit default swap spreads do not reflect any gains or losses on related hedging instruments.

*Other.* In addition to the equity and fixed income and commodities sales and trading revenues discussed above, sales and trading revenues included other trading revenues, consisting of certain activities associated with the Company's lending activities, losses on economic hedges related to the Company's long-term debt and negative carry in the Subsidiary Banks. In the quarter ended March 31, 2011, other sales and trading revenues reflected a net loss of \$458 million compared with a net loss of \$1 million in the quarter ended March 31, 2010. Results in the quarter ended March 31, 2011 were partially offset by net gains of approximately \$74 million associated with loans and lending commitments (mark-to-market valuations and realized gains of approximately \$209 million offset by losses on related hedges of approximately \$135 million). Results for the prior year quarter included net losses of \$15 million associated with loans and lending commitments (losses on related hedges of \$198 million, partially offset by mark-to-market valuations and realized gains of \$183 million). The valuation of these commitments could change in future periods depending on, among other things, the extent that they are renegotiated or repriced or if the associated acquisition transaction does not occur.

*Principal Transactions—Investments.* Principal transaction net investment gains of \$143 million were recognized in the quarter ended March 31, 2011 compared with net investment gains of \$174 million in the quarter ended March 31, 2010. The results in both periods reflected gains on principal investments in real estate funds and investments associated with certain employee deferred compensation and co-investment plans.

*Other.* Other losses of \$573 million were recognized in the quarter ended March 31, 2011 compared with other revenues of \$142 million in the quarter ended March 31, 2010. The results in the current quarter included a

pre-tax loss of \$655 million arising from the Company's 40% stake in MUMSS (see "Executive Summary—Overview of the Quarter Ended March 31, 2011 Financial Results" herein). The results in the previous quarter included higher net servicing fee income.

***Non-interest Expenses.*** Non-interest expenses decreased 2% in the quarter ended March 31, 2011, primarily due to lower compensation and benefits expenses, partially offset by an increase in non-compensation expenses. Compensation and benefits expenses decreased 10% in the quarter ended March 31, 2011, primarily due to lower net revenues. Occupancy and equipment expense increased 14% in the first quarter of 2011, primarily due to expansion of data center space. Brokerage and clearing expense increased 13% in the quarter ended March 31, 2011, primarily due to higher levels of business activity. Information processing and communications expense increased 13% in the quarter ended March 31, 2011, primarily due to ongoing investments in technology. Professional services expense decreased 11% in the quarter ended March 31, 2011, primarily due to lower consulting expenses. Other expenses increased 55% in the quarter ended March 31, 2011, primarily related to higher litigation expenses.

**GLOBAL WEALTH MANAGEMENT GROUP**  
**INCOME STATEMENT INFORMATION**

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(dollars in millions)</b>	
Revenues:		
Investment banking .....	\$ 204	\$ 173
Principal transactions:		
Trading .....	334	342
Investments .....	4	6
Commissions .....	779	682
Asset management, distribution and administration fees .....	1,683	1,628
Other .....	91	83
Total non-interest revenues .....	<u>3,095</u>	<u>2,914</u>
Interest income .....	454	339
Interest expense .....	112	148
Net interest .....	<u>342</u>	<u>191</u>
Net revenues .....	<u>3,437</u>	<u>3,105</u>
Compensation and benefits .....	2,125	1,972
Non-compensation expenses .....	964	855
Total non-interest expenses .....	<u>3,089</u>	<u>2,827</u>
Income from continuing operations before income taxes .....	348	278
Provision for income taxes .....	91	64
Income from continuing operations .....	<u>257</u>	<u>214</u>
Net income .....	257	214
Net income applicable to noncontrolling interests .....	74	115
Net income applicable to Morgan Stanley .....	<u>\$ 183</u>	<u>\$ 99</u>

**Investment Banking.** Investment banking revenues increased 18% in the quarter ended March 31, 2011, primarily due to higher closed-end fund and unit investment trusts activity, partially offset by lower fixed income underwriting activity.

**Principal Transactions—Trading.** Principal transactions trading revenues decreased 2% in the quarter ended March 31, 2011 primarily due to lower revenues from corporate fixed income and government securities, partially offset by higher revenues from municipal and corporate equity securities and gains related to investments associated with certain employee deferred compensation plans.

**Principal Transactions—Investments.** Principal transaction net investment gains were \$4 million in the quarter ended March 31, 2011 compared with \$6 million in the quarter ended March 31, 2010. The decrease primarily reflected losses related to investments associated with certain employee deferred compensation plans compared with such investments in the prior year period.

**Commissions.** Commission revenues increased 14% in the quarter ended March 31, 2011, primarily due to higher client activity.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees increased 3% in the quarter ended March 31, 2011, primarily due to higher fee based revenues partially

offset by the change in classification of the bank deposit program. From June 2009 until April 1, 2010, revenues in the bank deposit program were primarily included in Asset management, distribution and administration fees. Beginning on April 1, 2010, revenues in the bank deposit program held at the Company's U.S. depository institutions were recorded as Interest income due to renegotiations of the revenue sharing agreement as part of the Global Wealth Management Group business segment's retail banking strategy. The Global Wealth Management Group business segment will continue to earn referral fees for deposits placed with Citi depository institutions, and these fees will continue to be recorded in Asset management, distribution and administration fees until the legacy Smith Barney deposits are migrated to the Company's U.S. depository institutions. The referral fees for deposits were \$65 million and \$100 million for the quarters ended March 31, 2011 and 2010, respectively.

Balances in the bank deposit program decreased to \$111.5 billion at March 31, 2011 from \$113.5 billion at March 31, 2010. The unlimited FDIC program expired on June 30, 2010 for deposits held by the Company's depository institutions. Deposits held by Company-affiliated FDIC-insured depository institutions were \$54.4 billion of the \$111.5 billion deposits at March 31, 2011.

Client assets in fee-based accounts increased to \$501 billion and represented 29% of total client assets at March 31, 2011, compared with \$413 billion and 26% at March 31, 2010, respectively. Total client asset balances increased to \$1,718 billion at March 31, 2011 from \$1,604 billion at March 31, 2010, primarily due to improved market conditions and an increase in net new assets. Net new assets for the quarter ended March 31, 2011 were \$11.4 billion, an increase from \$9.3 billion at March 31, 2010. Client asset balances in households with assets greater than \$1 million increased to \$1,278 billion at March 31, 2011 from \$1,151 billion at March 31, 2010. Global fee-based asset flows increased to \$17.8 billion at March 31, 2011 from \$9.1 billion at March 31, 2010.

**Other.** Other revenues were \$91 million in the quarter ended March 31, 2011, an increase of 10% from \$83 million in the quarter ended March 31, 2010. The increase was primarily due to gains on securities available for sale.

**Net Interest.** Net interest increased 79% in the quarter ended March 31, 2011, primarily resulting from an increase in Interest income due to the securities available for sale portfolio and the change in classification of the bank deposit program noted above.

**Non-interest Expenses.** Non-interest expenses increased 9% in the quarter ended March 31, 2011. Compensation and benefits expense increased 8% in the quarter ended March 31, 2011, primarily reflecting higher net revenues and payroll taxes, partially offset by lower severance costs. Non-compensation expenses increased 13% in the quarter ended March 31, 2011. In the quarter ended March 31, 2011, marketing and business development expense increased 47% primarily due to higher costs associated with conferences and seminars. Professional services expense increased 33% primarily due to increased technology consulting costs. Information processing and communications expense increased 17% primarily due to higher telecommunications and data storage costs.



**ASSET MANAGEMENT**  
**INCOME STATEMENT INFORMATION**

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(dollars in millions)</b>	
Revenues:		
Investment banking .....	\$ 2	\$—
Principal transactions:		
Trading .....	(1)	(1)
Investments .....	182	189
Asset management, distribution and administration fees .....	409	414
Other .....	42	70
Total non-interest revenues .....	<u>634</u>	<u>672</u>
Interest income .....	4	6
Interest expense .....	12	25
Net interest .....	<u>(8)</u>	<u>(19)</u>
Net revenues .....	<u>626</u>	<u>653</u>
Compensation and benefits .....	255	275
Non-compensation expenses .....	244	204
Total non-interest expenses .....	<u>499</u>	<u>479</u>
Income from continuing operations before income taxes .....	127	174
Provision for income taxes .....	31	43
Income from continuing operations .....	<u>96</u>	<u>131</u>
Discontinued operations:		
Gain from discontinued operations .....	5	64
Benefit from income taxes .....	—	(30)
Net gain from discontinued operations .....	<u>5</u>	<u>94</u>
Net income .....	101	225
Net income applicable to noncontrolling interests .....	27	116
Net income applicable to Morgan Stanley .....	<u>\$ 74</u>	<u>\$109</u>
Amounts applicable to Morgan Stanley:		
Income from continuing operations .....	\$ 69	\$ 15
Net gain from discontinued operations .....	5	94
Net income applicable to Morgan Stanley .....	<u>\$ 74</u>	<u>\$109</u>

On March 1, 2011, the Company and the principals of FrontPoint completed a transaction whereby FrontPoint senior management and portfolio managers own a majority equity stake in FrontPoint and the Company retains a minority stake. FrontPoint has replaced the Company's affiliates as the investment advisor and general partner of the FrontPoint funds. The Company's investment in FrontPoint is accounted for under the equity method of accounting. Prior to March 1, 2011, the Company consolidated FrontPoint.

Beginning in the quarter ended March 31, 2011, the Asset Management business segment was reorganized into three businesses: Traditional Asset Management, Real Estate Investing and Merchant Banking. Traditional Asset Management includes Long-only, which is comprised of Equity and Fixed Income, Liquidity and the Alternative Investment Products fund-of-funds businesses. Real Estate Investing was previously reported as part of Merchant

Banking. Merchant Banking includes the Private Equity and Infrastructure business and hedge fund stake investments. The Company's equity investment in FrontPoint, subsequent to the restructuring of that business, is included in Merchant Banking. The results of the FrontPoint business for all periods prior to the restructuring are also included in Merchant Banking.

**Statistical Data.**

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

	At March 31,		Average For The Three Months Ended March 31,	
	2011	2010(1)	2011	2010(1)
	(dollars in billions)			
Assets under management or supervision by asset class:				
Traditional Asset Management:				
Equity .....	\$116	\$ 96	\$112	\$ 93
Fixed income .....	61	60	61	59
Liquidity .....	55	51	55	55
Alternatives(2) .....	18	17	18	17
Total Traditional Asset Management .....	<u>250</u>	<u>224</u>	<u>246</u>	<u>224</u>
Real Estate Investing .....	<u>17</u>	<u>15</u>	<u>16</u>	<u>15</u>
Merchant Banking:				
Private Equity .....	9	9	9	8
FrontPoint(3) .....	<u>—</u>	<u>7</u>	<u>3</u>	<u>7</u>
Total Merchant Banking .....	<u>9</u>	<u>16</u>	<u>12</u>	<u>15</u>
Total assets under management or supervision .....	276	255	274	254
Share of minority stake assets(3)(4) .....	8	7	8	7
Total .....	<u>\$284</u>	<u>\$262</u>	<u>\$282</u>	<u>\$261</u>

(1) All prior-period amounts have been reclassified to conform to the current period's presentation.

(2) The alternatives asset class includes a range of investment products such as hedge funds, funds of hedge funds and funds of private equity funds.

(3) On March 1, 2011, the Company and the principals of FrontPoint completed a transaction whereby FrontPoint senior management and portfolio managers own a majority equity stake in FrontPoint and the Company retains a minority stake. At March 31, 2011, the assets under management attributed to FrontPoint are represented within the share of minority stake assets.

(4) Amounts represent Asset Management's proportional share of assets managed by entities in which it owns a minority stake.

Activity in Asset Management's assets under management or supervision during the quarters ended March 31, 2011 and 2010 was as follows:

	Three Months Ended March 31,	
	2011	2010(1)
	(dollars in billions)	
<b>Balance at beginning of period</b> .....	\$279	\$266
Net flows by asset class:		
Traditional Asset Management:		
Equity .....	2	(1)
Fixed income .....	(1)	2
Liquidity .....	2	(8)
Alternatives(2) .....	—	(1)
Total Traditional Asset Management .....	<u>3</u>	<u>(8)</u>
Real Estate Investing .....	—	1
Merchant Banking:		
Private equity .....	—	—
FrontPoint(3) .....	(2)	—
Total Merchant Banking .....	<u>(2)</u>	<u>—</u>
Total net flows .....	1	(7)
Net market appreciation .....	7	3
Decrease due to FrontPoint transaction .....	(4)	—
Total net increase (decrease) .....	4	(4)
Net increase in share of minority stake assets(4) .....	1	—
<b>Balance at end of period</b> .....	<u>\$284</u>	<u>\$262</u>

(1) All prior-period amounts have been reclassified to conform to the current presentation.

(2) The alternatives asset class includes a range of investment products such as hedge funds, funds of hedge funds and funds of private equity funds.

(3) The amount for the quarter ended March 31, 2011 includes two months of net flows related to FrontPoint, whereas the quarter ended March 31, 2010 includes three months of net flows related to FrontPoint.

(4) Amounts represent Asset Management's proportional share of assets managed by entities in which it owns a minority stake. At March 31, 2011, the assets under management attributed to FrontPoint are represented within the share of minority stake assets.

**Principal Transactions—Investments.** The Company recorded principal transactions net investment gains of \$182 million in the quarter ended March 31, 2011 compared with gains of \$189 million in the quarter ended March 31, 2010. The results in the quarters ended March 31, 2011 and 2010 were primarily related to net investment gains associated with the Company's Real Estate Investing business, primarily due to valuation gains within certain consolidated real estate funds sponsored by the Company, and net gains on the Company's Merchant Banking and Traditional Asset Management investments.

**Asset Management, Distribution and Administration Fees.** Asset management, distribution and administration fees decreased 1% in the quarter ended March 31, 2011, primarily reflecting lower performance fees related to FrontPoint. The Company's assets under management increased \$22 billion from March 31, 2010 to March 31, 2011 reflecting market appreciation and net customer inflows primarily in the Company's liquidity funds. The Company recorded net customer inflows of \$1.4 billion in the quarter ended March 31, 2011 compared with net outflows of \$6.8 billion in the quarter ended March 31, 2010.

**Other.** Other revenues decreased \$28 million in the quarter ended March 31, 2011 compared with the quarter ended March 31, 2010. The decrease primarily reflected lower revenues associated with the Company's minority stake investments in Lansdowne Partners, a London-based investment manager.

***Non-interest Expenses.*** Non-interest expenses increased 4% in the quarter ended March 31, 2011 compared with the quarter ended March 31, 2010, primarily reflecting an increase in Non-compensation expenses, partially offset by a decrease in Compensation and benefits expense. Compensation and benefits expenses decreased 7% in the quarter ended March 31, 2011 primarily related to FrontPoint, as the quarter ended March 31, 2011 included two months of expenses for FrontPoint compared with three months of expenses in the quarter ended March 31, 2010. Non-compensation expenses increased 20% for the quarter ended March 31, 2011 primarily due to an increase in Other expenses, due to indemnification losses related to the FrontPoint transaction.

## **Accounting Developments.**

### **Reconsideration of Effective Control for Repurchase Agreements.**

In April 2011, the Financial Accounting Standards Board (the “FASB”) issued accounting guidance that removes the requirement to consider whether sufficient collateral is held when determining whether to account for repurchase agreements and other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity as sales or as secured financings. The guidance is effective for the Company prospectively for transactions beginning on January 1, 2012. The Company is currently evaluating the impact of this accounting guidance.

## **Other Matters.**

### **Real Estate.**

The Company acts as the general partner for various real estate funds and also invests in certain of these funds as a limited partner. The Company's real estate investments at March 31, 2011 and December 31, 2010 are described below. Such amounts exclude investments associated with certain employee deferred compensation and co-investment plans.

At both March 31, 2011 and December 31, 2010, the condensed consolidated statements of financial condition included amounts representing real estate investment assets of consolidated subsidiaries of approximately \$1.9 billion, including noncontrolling interests of approximately \$1.5 billion, for a net amount of \$0.4 billion. This net presentation is a non-GAAP financial measure that the Company considers to be a useful measure that the Company and investors use to assess the Company's net exposure. In addition, the Company has contractual capital commitments, guarantees, lending facilities and counterparty arrangements with respect to real estate investments of \$1.0 billion at March 31, 2011 (see Note 11 to the condensed consolidated financial statements).

In addition to the Company's real estate investments, the Company engages in various real estate-related activities, including origination of loans secured by commercial and residential properties. The Company also securitizes and trades in a wide range of commercial and residential real estate and real estate-related whole loans, mortgages and other real estate. In connection with these activities, the Company has provided, or otherwise agreed to be responsible for, representations and warranties. Under certain circumstances, the Company may be required to repurchase such assets or make other payments related to such assets if such representations and warranties were breached. The Company continues to monitor its real estate-related activities in order to manage its exposures and potential liability from these markets and businesses. See "Legal Proceedings—Residential Mortgage and Credit Crisis Related Matters" in Part II, Item 1, herein and see Note 11 to the condensed consolidated financial statements.

See "Executive Summary—Significant Items—Real Estate Investments" herein for further information.

### **Morgan Stanley and Huaxin Securities Joint Venture.**

In January 2011, the Company and Huaxin Securities Co., Limited ("Huaxin Securities") (also known as China Fortune Securities Co., Limited) jointly announced that the establishment of their securities joint venture in China had been approved by the China Securities Regulatory Commission ("CSRC") on December 31, 2010. The incorporation of the joint venture is subject to obtaining the appropriate licenses including the business license from the State Administration for Industry & Commerce of the People's Republic of China. Final CSRC approval is required before the commencement of business operations. In the second quarter of 2011, upon closing, the Company expects to incur costs of approximately \$130 million related to the formation of this securities joint venture.

The joint venture, Morgan Stanley Huaxin Securities Company Limited, will be registered and principally located in Shanghai. Huaxin Securities will hold a two-thirds stake in the joint venture while the Company will own a one-third interest. The establishment of the joint venture allows the Company to further build on its established onshore businesses in China. The scope of business will include underwriting and sponsorship of shares in the domestic China market (including A shares and foreign investment shares), as well as underwriting, sponsorship and principal trading of bonds (including government and corporate bonds).

### **Japanese Securities Joint Venture.**

On May 1, 2010, the Company and MUFG formed a joint venture in Japan of their respective investment banking and securities businesses. MUFG and the Company have integrated their respective Japanese securities companies by forming two joint venture companies. MUFG contributed the investment banking, wholesale and retail securities businesses conducted in Japan by Mitsubishi UFJ Securities Co., Ltd. into one of the joint venture entities named Mitsubishi UFJ Morgan Stanley Securities Co., Ltd. ("MUMSS"). The Company

contributed the investment banking operations conducted in Japan by its subsidiary, MSMS, formerly known as Morgan Stanley Japan Securities Co., Ltd., into MUMSS (MSMS, together with MUMSS, the “Joint Venture”). The Company owns a 40% economic interest in the Joint Venture and MUFG owns a 60% economic interest in the Joint Venture. The Company holds a 40% voting interest and MUFG holds a 60% voting interest in MUMSS, while the Company holds a 51% voting interest and MUFG holds a 49% voting interest in MSMS. The Company continues to consolidate MSMS in its condensed consolidated financial statements and, commencing on May 1, 2010, accounted for its interest in MUMSS as an equity method investment within the Institutional Securities business segment.

During the quarter ended March 31, 2011, the Company recorded a loss of \$655 million arising from the Company’s 40% stake in MUMSS, recorded within Other revenues in the condensed consolidated statement of income. In order to enhance the risk management at MUMSS, during the quarter ended March 31, 2011, the Company entered into a transaction with MUMSS whereby the fixed income trading positions that previously caused the majority of the aforementioned MUMSS losses were transferred to MSMS. In return for entering into the transaction, the Company received total consideration of \$659 million, which represented the estimated fair value of the transaction.

Pursuant to a shareholder agreement between MUFG and the Company, MUFG is responsible for ensuring that MUMSS remains adequately capitalized, and the Company is not obligated to contribute additional capital to MUMSS. Because of the losses incurred by MUMSS, MUFG contributed approximately \$370 million of capital to MUMSS on April 22, 2011. The MUFG capital injection will improve the capital base and restore the capital adequacy ratio of MUMSS, and will partially mitigate, to the extent of approximately \$145 million, the reduction in the Company’s book value that results from the MUMSS losses. This adjustment to book value will be reflected in the quarter ended June 30, 2011.

During the quarter ended March 31, 2011, the Company performed an impairment review of its equity method investment in MUMSS in view of the deterioration in the financial performance of MUMSS and the earthquake in Japan on March 11, 2011. The Company recorded no other-than-temporary impairment loss at March 31, 2011. Adverse market or economic events, as well as further deterioration of post-earthquake economic performance could result in impairment charges of this investment in future periods.

See “Significant Items—Japanese Securities Joint Venture” herein for further information.

### **MUFG Stock Conversion.**

On April 21, 2011, MUFG and the Company announced that they have entered into an agreement to convert MUFG’s outstanding Series B Non-Cumulative Non-Voting Perpetual Convertible Preferred Stock (“Series B Preferred Stock”) in the Company into the Company’s common stock. Under the terms of the transaction, MUFG will exchange the Series B Preferred Stock with a face value of \$7.8 billion and a 10% dividend for approximately 385 million shares of Company common stock, reflecting an increase in the conversion rate of 75 million shares and providing MUFG with an ownership interest in the Company of 22.4%. The 75 million share increase in the conversion rate (which, based on the Company’s closing stock price on April 21, 2011, would be approximately \$2 billion) will be treated as a preferred stock dividend at closing. The transaction is subject to certain closing conditions, including receipt of required regulatory approvals in certain jurisdictions globally.

### **Regulatory Outlook.**

On July 21, 2010, President Obama signed the Dodd-Frank Act into law. While certain portions of the Dodd-Frank Act were effective immediately, other portions will be effective only following extended transition periods. At this time, it is difficult to assess fully the impact that the Dodd-Frank Act will have on the Company and on the financial services industry generally. Implementation of the Dodd-Frank Act will be accomplished through numerous rulemakings by multiple governmental agencies. The Dodd-Frank Act also mandates the preparation of studies on a wide range of issues, which could lead to additional legislation or regulatory changes.



In addition, legislative and regulatory initiatives continue outside the U.S. which may also affect the Company's business and operations. For example, the Basel Committee on Banking Supervision (the "Basel Committee") has issued new capital, leverage and liquidity standards, known as "Basel III," which U.S. banking regulators are expected to introduce in the U.S. The Financial Stability Board and the Basel Committee are also developing standards designed to apply to systemically important financial institutions, such as the Company. In addition, initiatives are under way in the European Union and Japan, among other jurisdictions, that would require centralized clearing, reporting and recordkeeping with respect to various kinds of financial transactions and other regulatory requirements that are in some cases similar to those required under the Dodd-Frank Act.

It is likely that the year 2011 and subsequent years will see further material changes in the way major financial institutions are regulated in both the U.S. and other markets in which the Company operates, though it is difficult to predict which further reform initiatives will become law, how such reforms will be implemented or the exact impact they will have on the Company's business, financial condition, results of operations and cash flows for a particular future period.

For a further discussion regarding the regulatory outlook for the Company, please refer to "Supervision and Regulation" in Part I, Item 1 and "Management's Discussion and Analysis of Financial Condition and Results of Operations—Regulatory Outlook" in Part II, Item 7, included in the Form 10-K.

## Critical Accounting Policies.

The Company's condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions (see Note 1 to the condensed consolidated financial statements). The Company believes that of its significant accounting policies (see Note 2 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K), the following involve a higher degree of judgment and complexity.

### Fair Value.

**Financial Instruments Measured at Fair Value.** A significant number of the Company's financial instruments are carried at fair value. The Company makes estimates regarding valuation of assets and liabilities measured at fair value in preparing the condensed consolidated financial statements. These assets and liabilities include but are not limited to:

- Financial instruments owned and Financial instruments sold, not yet purchased;
- Securities available for sale;
- Securities received as collateral and Obligation to return securities received as collateral;
- Certain Commercial paper and other short-term borrowings, primarily structured notes;
- Certain Deposits;
- Certain Securities sold under agreements to repurchase;
- Certain Other secured financings; and
- Certain Long-term borrowings, primarily structured notes.

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

In determining fair value, the Company uses various valuation approaches. A hierarchy for inputs is used in measuring fair value that maximizes the use of observable prices and inputs and minimizes the use of unobservable prices and inputs by requiring that the relevant observable inputs be used when available. The hierarchy is broken down into three levels, wherein Level 1 uses observable prices in active markets, and Level 3 consists of valuation techniques that incorporate significant unobservable inputs, and, therefore require the greatest use of judgment. In periods of market disruption, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3. In addition, a downturn in market conditions could lead to declines in the valuation of many instruments. For further information on the fair value definition, Level 1, Level 2, Level 3 and related valuation techniques, see Note 2 to the consolidated financial statements for the year ended December 31, 2010 included in Form 10-K and Notes 2 and 3 to the condensed consolidated financial statements.

**Level 3 Assets and Liabilities.** The Company's Level 3 assets before the impact of cash collateral and counterparty netting across the levels of the fair value hierarchy were \$33.5 billion and \$34.9 billion at March 31, 2011 and December 31, 2010, respectively, and represented approximately 10% at March 31, 2011 and December 31, 2010 of the assets measured at fair value (4% of total assets at March 31, 2011 and December 31, 2010). Level 3 liabilities before the impact of cash collateral and counterparty netting across the levels of the fair value hierarchy were \$7.8 billion and \$8.5 billion at March 31, 2011 and December 31, 2010, respectively, and represented approximately 4% of the Company's liabilities measured at fair value.

**Transfers In/Out of Level 3 During the Quarter Ended March 31, 2011.** During the quarter ended March 31, 2011, the Company reclassified approximately \$1.6 billion of certain Corporate and other debt, primarily corporate loans, from Level 3 to Level 2. The Company reclassified the corporate loans as external prices and/or spread inputs for these instruments became observable.

The Company also reclassified approximately \$1.3 billion of certain Corporate and other debt from Level 2 to Level 3. The reclassifications were primarily related to corporate loans and were generally due to a reduction in market price quotations for these or comparable instruments, or a lack of available broker quotes, such that unobservable inputs had to be utilized for the fair value measurement of these instruments.

***Assets and Liabilities Measured at Fair Value on a Non-recurring Basis.*** Certain of the Company's assets were measured at fair value on a non-recurring basis, primarily relating to loans, other investments, goodwill and intangible assets. The Company incurs losses or gains for any adjustments of these assets to fair value. A downturn in market conditions could result in impairment charges in future periods.

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

For further information on financial assets and liabilities that are measured at fair value on a non-recurring basis, see Note 3 to the condensed consolidated financial statements.

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

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

### **Goodwill and Intangible Assets.**

***Goodwill.*** The Company tests goodwill for impairment on an annual basis and on an interim basis when certain events or circumstances exist. The Company tests for impairment at the reporting unit level, which is generally at the level of or one level below its business segments. Goodwill no longer retains its association with a particular acquisition once it has been assigned to a reporting unit. As such, all of the activities of a reporting unit, whether acquired or organically developed, are available to support the value of the goodwill. Goodwill impairment is determined by comparing the estimated fair value of a reporting unit with its respective book value. If the estimated fair value exceeds the book value, goodwill at the reporting unit level is not deemed to be impaired. If the estimated fair value is below book value, however, further analysis is required to determine the amount of the impairment. Additionally, if the book value of a reporting unit is zero or a negative value and it is determined

that it is more likely than not the goodwill is impaired, further analysis is required. The estimated fair values of the reporting units are derived based on valuation techniques the Company believes market participants would use for each of the reporting units. The estimated fair values are generally determined utilizing methodologies that incorporate price-to-book, price-to-earnings and assets under management multiples of certain comparable companies. The Company also utilizes a discounted cash flow methodology for certain reporting units.

*Intangible Assets.* Amortizable intangible assets are amortized over their estimated useful lives and reviewed for impairment on an interim basis when certain events or circumstances exist. For amortizable intangible assets, an impairment exists when the carrying amount of the intangible asset exceeds its fair value. An impairment loss will be recognized only if the carrying amount of the intangible asset is not recoverable and exceeds its fair value. The carrying amount of the intangible asset is not recoverable if it exceeds the sum of the expected undiscounted cash flows.

Indefinite-lived intangible assets are not amortized but are reviewed annually (or more frequently when certain events or circumstances exist) for impairment. For indefinite-lived intangible assets, an impairment exists when the carrying amount exceeds its fair value.

For both goodwill and intangible assets, to the extent an impairment loss is recognized, the loss establishes the new cost basis of the asset. Subsequent reversal of impairment losses is not permitted. For amortizable intangible assets, the new cost basis is amortized over the remaining useful life of that asset. Adverse market or economic events could result in impairment charges in future periods.

See Note 3 and Note 8 to the condensed consolidated financial statements for additional information about goodwill and intangible assets.

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

In the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution.

Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the entities that would otherwise be the primary defendants in such cases are bankrupt or in financial distress.

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

Accruals for litigation and regulatory proceedings are generally determined on a case-by-case basis. Where available information indicates that it is probable a liability had been incurred at the date of the condensed consolidated financial statements and the Company can reasonably estimate the amount of that loss, the Company accrues the estimated loss by a charge to income. In many proceedings, however, it is inherently difficult to determine whether any loss is probable or even possible or to estimate the amount of any loss. For certain legal proceedings, the Company can estimate possible losses, additional losses, ranges of loss or ranges of additional loss in excess of amounts accrued. For certain other legal proceedings, the Company cannot reasonably estimate such losses, particularly for proceedings that are in their early stages of development or where plaintiffs seek substantial or indeterminate damages. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, and by addressing novel or unsettled legal questions relevant to the proceedings in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for any proceeding.

The Company is subject to the income and indirect tax laws of the U.S., its states and municipalities and those of the foreign jurisdictions in which the Company has significant business operations. These tax laws are complex and subject to different interpretations by the taxpayer and the relevant governmental taxing authorities. The Company must make judgments and interpretations about the application of these inherently complex tax laws when determining the provision for income taxes and the expense for indirect taxes and must also make estimates about when in the future certain items affect taxable income in the various tax jurisdictions. Disputes over interpretations of the tax laws may be settled with the taxing authority upon examination or audit. The Company periodically evaluates the likelihood of assessments in each taxing jurisdiction resulting from current and subsequent years' examinations, and unrecognized tax benefits are established as appropriate. The Company establishes a liability for unrecognized tax benefits related to potential losses that may arise from tax audits in accordance with the guidance on accounting for unrecognized tax benefits. Once established, unrecognized tax benefits are adjusted when there is more information available or when an event occurs requiring a change.

Significant judgment is required in making these estimates, and the actual cost of a legal claim, tax assessment or regulatory fine/penalty may ultimately be materially different from the recorded accruals and unrecognized tax benefits, if any. See Notes 11 and 17 to the condensed consolidated financial statements for additional information on legal proceedings and tax examinations.

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

The Company's involvement with special purpose entities ("SPE") consists primarily of the following:

- Transferring financial assets into SPEs;
- Acting as an underwriter of beneficial interests issued by securitization vehicles;
- Holding one or more classes of securities issued by, or making loans to or investments in, SPEs that hold debt, equity, real estate or other assets;
- Purchasing and selling (in both a market-making and a proprietary-trading capacity) securities issued by SPEs/variable interest entities ("VIE"), whether such vehicles are sponsored by the Company or not;
- Entering into derivative transactions with SPEs (whether or not sponsored by the Company);
- Providing warehouse financing to collateralized debt obligations and collateralized loan obligations;
- Entering into derivative agreements with non-SPEs whose value is derived from securities issued by SPEs;
- Servicing assets held by SPEs or holding servicing rights related to assets held by SPEs that are serviced by others under subservicing arrangements;
- Serving as an asset manager to various investment funds that may invest in securities that are backed, in whole or in part, by SPEs; and
- Structuring and/or investing in other structured transactions designed to provide enhanced, tax-efficient yields to the Company or its clients.

The Company engages in securitization activities related to commercial and residential mortgage loans, U.S. agency collateralized mortgage obligations, corporate bonds and loans, municipal bonds and other types of financial instruments. The Company's involvement with SPEs is discussed further in Note 6 to the condensed consolidated financial statements.

In most cases, these SPEs are deemed for accounting purposes to be VIEs. The Company applies accounting guidance for consolidation of VIEs to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. Entities that previously met the criteria as

qualifying SPEs that were not subject to consolidation prior to January 1, 2010 became subject to the consolidation requirements for VIEs on that date. Excluding entities subject to the Deferral (as defined in Note 2 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K), effective January 1, 2010, the primary beneficiary of a VIE is the party that both (1) has the power to direct the activities of a VIE that most significantly affect the VIE's economic performance and (2) has an obligation to absorb losses or the right to receive benefits that in either case could potentially be significant to the VIE. The Company consolidates entities of which it is the primary beneficiary.

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

## **Liquidity and Capital Resources.**

The Company's senior management establishes the liquidity and capital policies of the Company. Through various risk and control committees, the Company's senior management reviews business performance relative to these policies, monitors the availability of alternative sources of financing, and oversees the liquidity and interest rate and currency sensitivity of the Company's asset and liability position. The Company's Treasury Department, Firm Risk Committee ("FRC"), Asset and Liability Management Committee ("ALCO") and other control groups assist in evaluating, monitoring and controlling the impact that the Company's business activities have on its condensed consolidated statements of financial condition, liquidity and capital structure. Liquidity and capital matters are reported regularly to the Board's Risk Committee.

## **The Balance Sheet.**

The Company actively monitors and evaluates the composition and size of its balance sheet. A substantial portion of the Company's total assets consists of liquid marketable securities and short-term receivables arising principally from sales and trading activities in the Institutional Securities business segment. The liquid nature of these assets provides the Company with flexibility in managing the size of its balance sheet. The Company's total assets increased to \$836,185 million at March 31, 2011 from \$807,698 million at December 31, 2010. The increase in total assets was primarily due to higher interest bearing deposits with banks and securities financing activities.

The Company's assets and liabilities are primarily related to transactions attributable to sales and trading and securities financing activities. At March 31, 2011, securities financing assets and liabilities were \$385 billion and \$333 billion, respectively. At December 31, 2010, securities financing assets and liabilities were \$358 billion and \$321 billion, respectively. Securities financing transactions include repurchase and resale agreements, securities borrowed and loaned transactions, securities received as collateral and obligation to return securities received. Securities borrowed or purchased under agreements to resell and securities loaned or sold under agreements to repurchase are treated as collateralized financings (see Note 2 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K). Securities sold under agreements to repurchase and Securities loaned were \$193 billion at March 31, 2011 and averaged \$199 billion during the quarter. Securities purchased under agreements to resell and Securities borrowed were \$306 billion at March 31, 2011 and averaged \$299 billion during the quarter.

Securities financing assets and liabilities also include matched book transactions with minimal market, credit and/or liquidity risk. Matched book transactions accommodate customers, as well as obtain securities for the settlement and financing of inventory positions. The customer receivable portion of the securities financing transactions includes customer margin loans, collateralized by customer owned securities, and customer cash, which is segregated according to regulatory requirements. The customer payable portion of the securities financing transactions primarily includes customer payables to the Company's prime brokerage clients. The Company's risk exposure on these transactions is mitigated by collateral maintenance policies that limit the Company's credit exposure to customers. Included within securities financing assets were \$13 billion and \$17 billion at March 31, 2011 and December 31, 2010, respectively, recorded in accordance with accounting guidance for the transfer of financial assets that represented offsetting assets and liabilities for fully collateralized non-cash loan transactions.



The following table sets forth the Company's total assets and leverage ratios at March 31, 2011 and December 31, 2010 and average balances during the quarter ended March 31, 2011:

	Balance at		Average Balance(1)
	March 31, 2011	December 31, 2010	For the Three Months Ended March 31, 2011
	(dollars in millions, except ratio data)		
Common equity .....	\$48,589	\$47,614	\$48,127
Preferred equity .....	9,597	9,597	9,597
Morgan Stanley shareholders' equity .....	58,186	57,211	57,724
Junior subordinated debentures issued to capital trusts .....	4,845	4,817	4,828
Less: Goodwill and net intangible assets(2) .....	(6,916)	(6,947)	(6,914)
Tangible Morgan Stanley shareholders' equity .....	\$56,115	\$55,081	\$55,638
Common equity .....	\$48,589	\$47,614	\$48,127
Less: Goodwill and net intangible assets(2) .....	(6,916)	(6,947)	(6,914)
Tangible common equity(3) .....	\$41,673	\$40,667	\$41,213
Tier 1 common ratio(4) .....	11.7%	10.5%	N/M

N/M – Not meaningful.

- (1) The Company calculates its average balances based upon weekly balances, except where weekly balances are unavailable, the month-end balances are used.
- (2) Goodwill and net intangible assets exclude mortgage servicing rights (net of disallowable mortgage servicing rights) of \$130 million and \$141 million at March 31, 2011 and December 31, 2010, respectively, and include only the Company's share of MSSB's goodwill and intangible assets.
- (3) Tangible common equity, a non-GAAP financial measure, equals common equity less goodwill and net intangible assets as defined above. The Company views tangible common equity as a useful measure to investors because it is a commonly utilized metric and reflects the common equity deployed in the Company's businesses.
- (4) The Tier 1 common ratio, a non-GAAP financial measure, equals Tier 1 common equity divided by Risk Weighted Assets ("RWA"). The Company defines Tier 1 common equity as Tier 1 capital less qualifying perpetual preferred stock, qualifying trust preferred securities and other restricted core capital elements, adjusted for the portion of goodwill and non-servicing intangible assets associated with MSSB's noncontrolling interests (*i.e.*, Citi's share of MSSB's goodwill and intangibles). The Company views its definition of the Tier 1 common equity as a useful measure for investors as it reflects the actual ownership structure and economics of MSSB. This definition of Tier 1 common equity may evolve in the future as regulatory rules may be implemented based on a final proposal regarding noncontrolling interest (also referred to as minority interest) as initially presented in December 2009 in the Basel Committee on Banking Supervision Consultative Document *Strengthening the resilience of the banking sector* ("BCBS 164"). For a discussion of RWAs and Tier 1 capital, see "Regulatory Requirements" herein.

### Balance Sheet and Funding Activity for the Three Months Ended March 31, 2011.

During the quarter ended March 31, 2011, the Company issued notes with a principal amount of approximately \$14 billion. In connection with the note issuances, the Company generally enters into certain transactions to obtain floating interest rates based primarily on short-term LIBOR trading levels. The weighted average maturity of the Company's long-term borrowings, based upon stated maturity dates, was approximately 5.2 years at March 31, 2011. Subsequent to March 31, 2011 and through April 30, 2011, the Company's long-term borrowings (net of repayments) decreased by approximately \$1 billion.

At March 31, 2011, the aggregate outstanding principal amount of the Company's senior indebtedness was approximately \$187 billion (including guaranteed obligations of the indebtedness of subsidiaries) compared with \$183 billion at December 31, 2010. The increase in the amount of senior indebtedness was primarily due to foreign currency translation adjustments.

**MUFG Stock Conversion.**

On April 21, 2011, MUFG and the Company announced that they have entered into an agreement to convert MUFG's outstanding Series B Preferred Stock in the Company into the Company's common stock (see "Other Matters—MUFG Stock Conversion" herein).

**Capital Management.**

The Company's senior management views capital as an important source of financial strength. The Company actively manages its consolidated capital position based upon, among other things, business opportunities, risks, capital availability and rates of return together with internal capital policies, regulatory requirements and rating agency guidelines and, therefore, in the future may expand or contract its capital base to address the changing needs of its businesses. The Company attempts to maintain total capital, on a consolidated basis, at least equal to the sum of its operating subsidiaries' equity.

At March 31, 2011, the Company had approximately \$1.6 billion remaining under its current share repurchase program out of the \$6 billion authorized by the Board in December 2006. The share repurchase program is for capital management purposes and considers, among other things, business segment capital needs as well as equity-based compensation and benefit plan requirements. Share repurchases by the Company are subject to regulatory approval. During the quarter ended March 31, 2011, the Company did not repurchase common stock as part of its capital management share repurchase program (see also "Unregistered Sales of Equity Securities and Use of Proceeds" in Part II, Item 2).

The Board determines the declaration and payment of dividends on a quarterly basis. In April 2011, the Company announced that its Board declared a quarterly dividend per common share of \$0.05. The Company also announced that the Board declared a quarterly dividend of \$250.00 per share of Series A Floating Rate Non-Cumulative Preferred Stock (represented by depositary shares, each representing 1/1,000th interest in a share of preferred stock and each having a dividend of \$0.25000); a quarterly dividend of \$25.00 per share of Series B Preferred Stock; and a quarterly dividend of \$25.00 per share of Series C Non-Cumulative Non-Voting Perpetual Preferred Stock.

**Required Capital.**

Beginning with the quarter ended June 30, 2010, the Company's capital estimation is based on the Required Capital Framework, an internal capital adequacy measure. This framework is a risk-based internal use of capital measure, which is compared with the Company's regulatory Tier 1 capital to help ensure the Company maintains an amount of risk-based going concern capital after absorbing potential losses from extreme stress events at a point in time. The difference between the Company's Tier 1 capital and aggregate Required Capital is the Company's Parent capital. Average Tier 1 capital, Required Capital and Parent capital for the quarter ended March 31, 2011 was approximately \$49.3 billion, \$27.5 billion and \$21.8 billion, respectively. The Company generally holds Parent capital for prospective regulatory requirements, including Basel III, organic growth, acquisitions and other capital needs.

Tier 1 capital and common equity attribution to the business segments is based on capital usage calculated by Required Capital. In principle, each business segment is capitalized as if it were an independent operating entity with limited diversification benefit between the business segments. Required Capital is assessed at each business segment and further attributed to product lines. This process is intended to align capital with the risks in each business segment in order to allow senior management to evaluate returns on a risk-adjusted basis. The Required Capital framework will evolve over time, responding to changes in the business and regulatory environment, including Basel III, and incorporating enhancements in modeling techniques (see "Regulatory Requirements" herein for further information on Basel III).

For a further discussion of the Company's Tier 1 capital, see "Regulatory Requirements" herein.

The following table presents the Company's and business segments' average Tier 1 capital and average common equity for the quarter ended March 31, 2011 and the quarter ended December 31, 2010.

	Three Months Ended March 31, 2011		Three Months Ended December 31, 2010	
	Average Tier 1 Capital	Average Common Equity	Average Tier 1 Capital	Average Common Equity
	(dollars in billions)			
Institutional Securities .....	\$23.0	\$20.7	\$25.9	\$18.6
Global Wealth Management Group .....	3.1	6.7	2.9	6.8
Asset Management .....	1.4	1.9	2.0	2.2
Parent capital .....	21.8	18.8	22.3	19.8
Total .....	<u>\$49.3</u>	<u>\$48.1</u>	<u>\$53.1</u>	<u>\$47.4</u>

On March 31, 2011, the Federal Reserve implemented a limit on the amount of the restricted core capital elements (trust preferred securities and certain noncontrolling interests) to 15% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. This restriction resulted in approximately \$3.9 billion of restricted capital being reclassified from Tier 1 Capital to Tier 2 Capital for March 31, 2011. To enhance the comparability of the current quarter's average Tier 1 capital and average common equity by segment to subsequent quarterly averages, the Company applied this limitation to the full quarter average, as if the rule were in place from the beginning of first quarter 2011 (see "Regulatory Requirements" herein for more information).

#### **Capital Covenants.**

In October 2006 and April 2007, the Company executed replacement capital covenants in connection with offerings by Morgan Stanley Capital Trust VII and Morgan Stanley Capital Trust VIII (the "Capital Securities"), which become effective after the scheduled redemption date in 2046. Under the terms of the replacement capital covenants, the Company has agreed, for the benefit of certain specified holders of debt, to limitations on its ability to redeem or repurchase any of the Capital Securities for specified periods of time. For a complete description of the Capital Securities and the terms of the replacement capital covenants, see the Company's Current Reports on Form 8-K dated October 12, 2006 and April 26, 2007.

#### **Liquidity and Funding Management.**

The primary goal of the Company's liquidity management and funding activities is to ensure adequate funding over a wide range of market conditions. Given the mix of the Company's business activities, funding requirements are fulfilled through a diversified range of secured and unsecured financing.

The Company's liquidity and funding risk management framework, including policies and governance structure, helps mitigate the potential risk that the Company may not have access to adequate financing. The framework is designed to help ensure that the Company fulfills its financial obligations and to support the execution of the Company's business strategies. The principal elements of the Company's liquidity and funding risk management framework are the Contingency Funding Plan and the Global Liquidity Reserve that support the target liquidity profile (see "Liquidity Management—Contingency Funding Plan" and "Liquidity Management—Global Liquidity Reserve" herein).

#### **Liquidity Management.**

##### ***Contingency Funding Plan.***

The Contingency Funding Plan ("CFP") is the Company's primary liquidity risk management tool. The CFP outlines the Company's response to liquidity stress in the markets and incorporates stress testing to identify

potential liquidity risk. Liquidity stress tests model multiple scenarios related to idiosyncratic, systemic or a combination of both types of events across various time horizons.

The Company’s CFP incorporates a number of assumptions, including, but not limited to, the following:

- No government support;
- No access to unsecured debt markets;
- Repayment of all unsecured debt maturing within one year;
- Higher haircuts and significantly lower availability of secured funding;
- Additional collateral that would be required by trading counterparties and certain exchanges and clearing organizations related to multi-notch credit rating downgrades;
- Discretionary unsecured debt buybacks;
- Drawdowns on unfunded commitments provided to third parties;
- Client cash withdrawals;
- Limited access to the foreign exchange swap markets;
- Return of securities borrowed on an uncollateralized basis; and
- Maturity roll-off of outstanding letters of credit with no further issuance.

The CFP is produced at the Parent and major operating subsidiary levels, as well as at major currency levels, to capture specific cash requirements and cash availability across the Company. The CFP assumes the subsidiaries will use their own liquidity first to fund their obligations before drawing liquidity from the Parent company. The CFP also assumes that the Parent will support its subsidiaries and will not have access to their liquidity reserves due to regulatory, legal or tax constraints.

At March 31, 2011, the Company maintained sufficient liquidity to meet funding and contingent obligations as modeled in its liquidity stress tests.

***Global Liquidity Reserve.***

The Company maintains sufficient liquidity reserves (“Global Liquidity Reserve”) to cover daily funding needs and meet strategic liquidity targets sized by the CFP. The Global Liquidity Reserve is held within the Parent company and major operating subsidiaries. It is comprised of cash and cash equivalents, securities that have been reversed or borrowed by the Company primarily on an overnight basis (predominantly consisting of U.S. and European government bonds and U.S. agency and agency mortgage-backed securities) and pools of Federal Reserve-eligible (eligible to be pledged to the Federal Reserve’s Discount Window) and other unencumbered liquid securities (see table below). The assets that make up the Global Liquidity Reserve are all unencumbered and are not pledged as collateral on either a mandatory or a voluntary basis. They do not include other unencumbered assets that are available to the Company for additional monetization.

***Global Liquidity Reserve by Type of Investment***

The table below summarizes the Company’s Global Liquidity Reserve by type of investment:

	<u>At March 31, 2011</u> <u>(dollars in billions)</u>
Cash and cash equivalents . . . . .	\$ 47
Securities purchased under agreements to resell/Securities borrowed . . . . .	88
Federal Reserve-eligible and other unencumbered liquid securities . . . . .	37
Global Liquidity Reserve . . . . .	<u>\$172</u>

The vast majority of the assets held in the Global Liquidity Reserve can be monetized on a next-day basis in a stressed environment given the highly liquid and diversified nature of the reserves. The remainder of the assets can be monetized within two to five business days.

The currency composition of the Global Liquidity Reserve is consistent with the CFP on a currency level. The Company's funding requirements and target liquidity reserves may vary based on changes to the level and composition of its balance sheet, subsidiary-funding needs, timing of specific transactions, client financing activity, market conditions and seasonal factors.

*Global Liquidity Reserve Held by the Parent and Subsidiaries*

The table below summarizes the Global Liquidity Reserve held by the Parent and subsidiaries:

	At March 31, 2011	At December 31, 2010	Average Balance(1)	
			For the Three Months Ended March 31, 2011	For the Three Months Ended December 31, 2010
			(dollars in billions)	
Parent .....	\$ 77	\$ 68	\$ 77	\$ 69
Non-Bank Subsidiaries .....	32	35	30	35
Bank Subsidiaries .....	63	68	65	65
Total .....	<u>\$172</u>	<u>\$171</u>	<u>\$172</u>	<u>\$169</u>

(1) Starting January 2011, the Company calculates the average global liquidity reserve based upon daily amounts; previous quarterly average balances were based upon weekly amounts.

The Company is exposed to intra-day settlement risk in connection with liquidity provided to its major broker-dealer subsidiaries for intra-day clearing and settlement of its securities and financing activity.

**Funding Management.**

The Company's funding management policies are designed to provide for financings that are executed in a manner that reduces the risk of disruption to the Company's operations. The Company 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 Company'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 Company funds its balance sheet on a global basis through diverse sources. These sources may include the Company's equity capital, long-term debt, repurchase agreements, securities lending, deposits, commercial paper, letters of credit and lines of credit. The Company has active financing programs for both standard and structured products targeting global investors and currencies.

**Secured Financing.** A substantial portion of the Company's total assets consists of liquid marketable securities and short-term collateralized receivables arising principally from its Institutional Securities sales and trading activities. The liquid nature of these assets provides the Company with flexibility in financing these assets with collateralized borrowings.

The Company's goal is to achieve an optimal mix of secured and unsecured funding while ensuring continued growth in stable funding sources. The Institutional Securities business segment emphasizes the use of collateralized short-term borrowings to limit the growth of short-term unsecured funding, which is generally more subject to disruption during periods of financial stress. The ability to fund less liquid assets on a secured basis may be impaired in a stress environment. To manage this risk, the Company obtains longer-term secured

financing for less liquid assets and has minimal reliance on overnight financing. At March 31, 2011, the weighted average maturity of the Company's secured financing against less liquid collateral was greater than 120 days. The Company defines less liquid collateral as those that are not consistent with the standards of the Global Liquidity Reserve. In addition, the Company minimizes refinancing risk by diversifying across both counterparties and maturities. The Company holds a portion of its Global Liquidity Reserve against a potential disruption to its secured financing capabilities. This potential disruption may be in the form of additional margin or reduced capacity to refinance maturing trades. The Company continues to extend the tenor of secured financing for less liquid collateral and seeks to build a sufficient buffer to offset the risks discussed above.

**Unsecured Financing.** The Company views long-term debt and deposits as stable sources of funding for core inventories and less liquid assets. Securities inventories not financed by secured funding sources and the majority of current assets are financed with a combination of short-term funding, deposits, floating rate long-term debt and fixed rate long-term debt swapped to a floating rate. The Company uses derivative products (primarily interest rate, currency and equity swaps) to assist in asset and liability management and to hedge interest rate risk (see Note 12 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K).

**Temporary Liquidity Guarantee Program ("TLGP").** In October 2008, the Secretary of the U.S. Treasury invoked the systemic risk exception of the FDIC Improvement Act of 1991, and the FDIC announced the TLGP. Based on the Final Rule adopted on November 21, 2008, the TLGP provides a guarantee, through the earlier of maturity or June 30, 2012, of certain senior unsecured debt issued by participating Eligible Entities (including the Company) between October 14, 2008 and June 30, 2009. Of the \$23.8 billion issued under the TLGP, \$4.5 billion (including \$1.4 billion of debt buybacks) were retired through the quarter ended March 31, 2011.

**Short-Term Borrowings.** The Company's unsecured short-term borrowings consist of commercial paper, bank loans, bank notes and structured notes with maturities of 12 months or less at issuance.

The table below summarizes the Company's short-term unsecured borrowings:

	At March 31, 2011	At December 31, 2010
	(dollars in millions)	
Commercial paper .....	\$ 959	\$ 945
Other short-term borrowings .....	2,343	2,311
Total .....	<u>\$3,302</u>	<u>\$3,256</u>

**Deposits.** The Company's bank subsidiaries' funding sources include bank deposits, repurchase agreements, federal funds purchased, certificates of deposit, money market deposit accounts, commercial paper and Federal Home Loan Bank advances.

Deposits were as follows:

	At March 31, 2011(1)	At December 31, 2010(1)
	(dollars in millions)	
Savings and demand deposits .....	\$59,961	\$59,856
Time deposits(2) .....	3,534	3,956
Total .....	<u>\$63,495</u>	<u>\$63,812</u>

(1) Total deposits insured by the FDIC at March 31, 2011 and December 31, 2010 were \$48 billion.

(2) Certain time deposit accounts are carried at fair value under the fair value option (see Note 3 to the condensed consolidated financial statements).



With the passage of the Dodd-Frank Act, the statutory standard maximum deposit insurance amount was permanently increased to \$250,000 per depositor and is in effect for the Subsidiary Banks.

On November 9, 2010, the FDIC issued a Final Rule implementing Section 343 of the Dodd-Frank Act that provides for unlimited insurance coverage of non-interest bearing transaction accounts. Beginning December 31, 2010 through December 31, 2012, all non-interest bearing transaction accounts are fully insured, regardless of the balance of the account, at all FDIC-insured institutions, including the Company's FDIC-insured subsidiaries. This unlimited insurance coverage is available to all depositors and is separate from, and in addition to, the insurance coverage provided to a depositor's other deposit accounts held at an FDIC-insured institution. Money Market Deposit Accounts ("MMDA") and Negotiable Order of Withdrawal ("NOW") accounts are not eligible for this unlimited insurance coverage, regardless of the interest rate, even if no interest is paid on the account.

**Long-Term Borrowings.** The Company uses a variety of long-term debt funding sources to generate liquidity, taking CFP requirements into consideration. In addition, the issuance of long-term debt allows the Company to reduce reliance on short-term credit sensitive instruments (*e.g.*, commercial paper and other unsecured short-term borrowings). Long-term borrowings are generally structured to ensure staggered maturities, thereby mitigating refinancing risk, and to maximize investor diversification through sales to global institutional and retail clients. Availability and cost of financing to the Company can vary depending on market conditions, the volume of certain trading and lending activities, the Company's credit ratings and the overall availability of credit. During the quarter ended March 31, 2011, the Company issued notes with a principal amount of approximately \$14 billion.

The Company may from time to time engage in various transactions in the credit markets (including, for example, debt repurchases) that it believes are in the best interests of the Company and its investors. During the quarter ended March 31, 2011, approximately \$13 billion in aggregate long-term borrowings were repaid.

Long-term borrowings at March 31, 2011 consisted of the following:

	<u>Parent</u>	<u>Subsidiaries</u>	<u>Total</u>
	(dollars in millions)		
Due in 2011 .....	\$ 17,457	\$1,862	\$ 19,319
Due in 2012 .....	35,974	802	36,776
Due in 2013 .....	25,525	839	26,364
Due in 2014 .....	20,652	830	21,482
Due in 2015 .....	17,179	3,834	21,013
Thereafter .....	69,412	1,770	71,182
Total .....	<u>\$186,199</u>	<u>\$9,937</u>	<u>\$196,136</u>

### **Credit Ratings.**

The Company relies on external sources to finance a significant portion of its day-to-day operations. The cost and availability of financing generally is impacted by the Company's credit ratings. In addition, the Company's credit ratings can have a significant impact on certain trading revenues, particularly in those businesses where longer term counterparty performance is critical, such as OTC derivative transactions, including credit derivatives and interest rate swaps. Factors that are important to the determination of the Company's credit ratings include the level and quality of earnings, capital adequacy, liquidity, risk appetite and management, asset quality, business mix and perceived levels of government support.

The rating agencies have stated that they currently incorporate various degrees of uplift from perceived government support in the credit ratings of systemically important banks, including the credit ratings of the



Company. The U.S. financial reform legislation has rating agencies reviewing their methodologies and may be seen as limiting the possibility of extraordinary government support for the financial system in any future financial crises. This may lead to reduced uplift assumptions for U.S. banks and thereby place downward pressure on credit ratings. At the same time, the U.S. financial reform legislation also has credit ratings positive features such as higher standards for capital and liquidity levels. The net result on credit ratings and the timing of any rating agency actions is currently uncertain (see “Other Matters—Regulatory Outlook” herein).

In connection with certain OTC trading agreements and certain other agreements associated with the Institutional Securities business segment, the Company may be required to provide additional collateral or immediately settle any outstanding liability balances with certain counterparties in the event of a credit rating downgrade. At March 31, 2011, the amount of additional collateral or termination payments that could be called by counterparties under the terms of such agreements in the event of a one-notch downgrade of the Company’s long-term credit rating was \$1,260 million. A total of \$3,336 million in collateral or termination payments could be called in the event of a two-notch downgrade.

Also, the Company is required to pledge additional collateral to certain exchanges and clearing organizations in the event of a credit rating downgrade. At March 31, 2011, the increased collateral requirement at certain exchanges and clearing organizations was \$191 million in the event of a one-notch downgrade of the Company’s long-term credit rating. A total of \$1,543 million of collateral is required in the event of a two-notch downgrade.

The liquidity impact of additional collateral requirements is accounted for in the Company’s CFP.

At April 30, 2011, the Company’s and Morgan Stanley Bank, N.A.’s senior unsecured ratings were as set forth below:

	Company			Morgan Stanley Bank, N.A.		
	Short-Term Debt	Long-Term Debt	Rating Outlook	Short-Term Debt	Long-Term Debt	Rating Outlook
Dominion Bond Rating Service Limited . . . .	R-1 (middle)	A (high)	Negative	—	—	—
Fitch Ratings . . . . .	F1	A	Stable	F1	A	Stable
Moody’s . . . . .	P-1	A2	Negative	P-1	A1	Negative
Rating and Investment Information, Inc. . . . .	a-1	A+	Negative	—	—	—
Standard & Poor’s . . . . .	A-1	A	Negative	A-1	A+	Negative

**Off-Balance Sheet Arrangements with Unconsolidated Entities.**

The Company enters into various arrangements with unconsolidated entities, including variable interest entities, primarily in connection with its Institutional Securities business segment. See “Off-Balance Sheet Arrangements with Unconsolidated Entities” included in Part II, Item 7, of the Form 10-K for further information.

See Note 11 to the condensed consolidated financial statements for further information on Guarantees.

## Commitments.

The Company's commitments associated with outstanding letters of credit and other financial guarantees obtained to satisfy collateral requirements, investment activities, corporate lending and financing arrangements, mortgage lending and margin lending at March 31, 2011 are summarized below by period of expiration. Since commitments associated with these instruments may expire unused, the amounts shown do not necessarily reflect the actual future cash funding requirements:

	Years to Maturity				Total at March 31, 2011
	Less than 1	1-3	3-5	Over 5	
	(dollars in millions)				
Letters of credit and other financial guarantees obtained to satisfy collateral requirements . . . . .	\$ 1,012	\$ 1	\$ 10	\$ —	\$ 1,023
Investment activities . . . . .	1,329	299	77	357	2,062
Primary lending commitments—investment grade(1)(2) . . . . .	9,044	28,563	10,560	584	48,751
Primary lending commitments—non-investment grade(1) . . . . .	1,071	5,957	6,730	1,006	14,764
Secondary lending commitments(1) . . . . .	46	152	173	176	547
Commitments for secured lending transactions . . . . .	620	710	1	135	1,466
Forward starting reverse repurchase agreements(3) . . . . .	59,397	—	—	—	59,397
Commercial and residential mortgage-related commitments . . . . .	464	11	77	643	1,195
Underwriting commitments . . . . .	970	—	—	—	970
Other commitments . . . . .	97	171	42	5	315
Total . . . . .	<u>\$74,050</u>	<u>\$35,864</u>	<u>\$17,670</u>	<u>\$2,906</u>	<u>\$130,490</u>

- (1) These commitments are recorded at fair value within Financial instruments owned and Financial instruments sold, not yet purchased in the condensed consolidated statements of financial condition (see Note 3 to the condensed consolidated financial statements).
- (2) This amount includes commitments to asset-backed commercial paper conduits of \$275 million at March 31, 2011, of which \$138 million have maturities of less than one year and \$137 million have maturities of one to three years.
- (3) The Company enters into forward starting securities purchased under agreements to resell (agreements that have a trade date as of or prior to March 31, 2011 and settle subsequent to period-end) that are primarily secured by collateral from U.S. government agency securities and other sovereign government obligations. These agreements primarily settle within three business days and at March 31, 2011, \$55.3 billion settled within three business days.

## Regulatory Requirements.

### Capital.

The Company is a financial holding company under the Bank Holding Company Act of 1956 and is subject to the regulation and oversight of the Federal Reserve. The Federal Reserve establishes capital requirements for the Company, including well-capitalized standards, and evaluates the Company's compliance with such capital requirements. The Office of the Comptroller of the Currency establishes similar capital requirements and standards for the Company's national bank subsidiaries (see "Other Matters—Regulatory Outlook" herein).

The Company calculates its capital ratios and RWAs in accordance with the capital adequacy standards for financial holding companies adopted by the Federal Reserve. These standards are based upon a framework described in the "International Convergence of Capital Measurement and Capital Standards," July 1988, as amended, also referred to as Basel I. In December 2007, the U.S. banking regulators published final regulation incorporating the Basel II Accord, which requires internationally active banking organizations, as well as certain of their U.S. bank subsidiaries, to implement Basel II standards over the next several years. The timeline set out in December 2007 for the implementation of Basel II in the U.S. may be impacted by the developments

concerning Basel III described below. Starting July 2010, the Company has been reporting on a parallel basis under the current regulatory capital regime (Basel I) and Basel II. During the parallel run period, the Company continues to be subject to Basel I but simultaneously calculates its risks under Basel II. The Company reports the capital ratios under both of these standards to the regulators. There will be at least four quarters of parallel reporting before the Company enters the three-year transitional period to implement Basel II standards. In addition, under provisions of the Dodd-Frank Act, the generally applicable capital standards, which are currently based on Basel I standards, but may themselves change over time, would serve as a permanent floor to minimum capital requirements calculated under the Basel II standard the Company is currently required to implement, as well as future capital standards.

Basel III contains new capital standards that raise the quality of capital and strengthen counterparty credit risk capital requirements and introduces a leverage ratio as a supplemental measure to the risk-based ratio. Basel III includes a new capital conservation buffer, which imposes a common equity requirement above the new minimum that can be depleted under stress, subject to restrictions on capital distributions, and a new countercyclical buffer which regulators can activate during periods of excessive credit growth in their jurisdiction. The Basel III proposals complement an earlier proposal for revisions to the Market Risk Framework that increases capital requirements for securitizations within the Company's trading book. In 2011, the U.S. regulators have issued proposed rules that are intended to implement certain aspects of the Market Risk Framework proposals. The U.S. regulators will require implementation of Basel III subject to an extended phase-in period.

Under the Basel Committee's proposed framework, based on a preliminary analysis of the guidelines published to date, the Company estimates its Tier 1 common ratio will be in a range between 8% and 10% by the end of 2012, including the effects of the MUFG Stock Conversion (see "Other Matters—MUFG Stock Conversion" herein). This is a preliminary estimate and may change based on guidelines for implementation to be issued by the Federal Reserve.

The new proposed framework includes new standards to raise the quality of capital which may impact the components of Tier 1 capital and Tier 1 common equity. The Company currently defines Tier 1 common equity as Tier 1 capital less qualifying perpetual preferred stock, qualifying restricted core capital elements (including junior subordinated debt issued to trusts ("trust preferred securities") and noncontrolling interest), adjusted for the portion of goodwill and non-servicing intangible assets associated with MSSB's noncontrolling interests (*i.e.*, Citi's share of MSSB's goodwill and intangibles). This definition of Tier 1 common equity may evolve in the future as regulatory rules may be implemented based on a final proposal regarding noncontrolling interest as initially presented by the Basel Committee. For the discussion of Tier 1 common equity, please see "The Balance Sheet" herein.

Pursuant to provisions of the Dodd-Frank Act, over time, trust preferred securities will no longer qualify as Tier 1 capital but will only qualify as Tier 2 capital. This change in regulatory capital treatment will be phased in incrementally during a transition period that will start on January 1, 2013 and end on January 1, 2016. This provision of the Dodd-Frank Act accelerates the phasing in of the disqualification of the trust preferred securities as provided for by Basel III.

Starting March 31, 2011, the Federal Reserve required implementation of a rule limiting the amount of restricted Tier 1 core capital elements to 15% of the core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. As a result of this regulation, \$3.9 billion of restricted core capital shifted from Tier 1 to Tier 2 at March 31, 2011.

At March 31, 2011, the Company was in compliance with Basel I capital requirements with ratios of Tier 1 capital to RWAs of 16.5% and total capital to RWAs of 18.4% (6% and 10% being well-capitalized for regulatory purposes, respectively). In addition, financial holding companies are also subject to a Tier 1 leverage ratio as defined by the Federal Reserve. The Company calculated its Tier 1 leverage ratio as Tier 1 capital

divided by adjusted average total assets (which reflects adjustments for disallowed goodwill, certain intangible assets, deferred tax assets and financial and non-financial equity investments). The adjusted average total assets are derived using weekly balances for the year.

The following table reconciles the Company's total shareholders' equity to Tier 1 and Total capital as defined by the regulations issued by the Federal Reserve and presents the Company's consolidated capital ratios at March 31, 2011 and December 31, 2010:

	<u>At March 31, 2011</u>	<u>At December 31 2010</u>
	(dollars in millions)	
<b>Allowable capital</b>		
<i>Tier 1 capital:</i>		
Common shareholders' equity .....	\$ 48,589	\$ 47,614
Qualifying preferred stock .....	9,597	9,597
Qualifying restricted core capital elements .....	9,132	12,924
Less: Goodwill .....	(6,743)	(6,739)
Less: Non-servicing intangible assets .....	(4,451)	(4,526)
Less: Net deferred tax assets .....	(5,280)	(3,984)
Less: After-tax debt valuation adjustment .....	95	(20)
Other deductions .....	(1,320)	(1,986)
Total Tier 1 capital .....	<u>49,619</u>	<u>52,880</u>
<i>Tier 2 capital:</i>		
Other components of allowable capital:		
Qualifying subordinated debt and restricted core capital elements .....	6,340	2,412
Other qualifying amounts .....	45	82
Other additions (deductions) .....	(551)	(897)
Total Tier 2 capital .....	<u>5,834</u>	<u>1,597</u>
Total allowable capital .....	<u>\$ 55,453</u>	<u>\$ 54,477</u>
<b>Total risk weighted assets .....</b>	<u>\$301,482</u>	<u>\$329,560</u>
<b>Capital ratios</b>		
Total capital ratio .....	<u>18.4%</u>	<u>16.5%</u>
Tier 1 capital ratio .....	<u>16.5%</u>	<u>16.1%</u>
Tier 1 leverage ratio .....	<u>6.1%</u>	<u>6.6%</u>

Total allowable capital is composed of Tier 1 and Tier 2 capital. Tier 1 capital consists predominately of common shareholders' equity as well as qualifying preferred stock and qualifying restricted core capital elements (trust preferred securities and noncontrolling interests) less goodwill, non-servicing intangible assets (excluding allowable mortgage servicing rights), net deferred tax assets (recoverable in excess of one year), an after-tax debt valuation adjustment and certain other deductions, including equity investments. The debt valuation adjustment in the above table represents the cumulative change in fair value of certain long-term and short-term borrowings that was attributable to the Company's own instrument-specific credit spreads and is included in retained earnings. For a further discussion of fair value, see Note 3 to the condensed consolidated financial statements.

At March 31, 2011, the Company calculated its RWAs in accordance with the regulatory capital requirements of the Federal Reserve, which is consistent with guidelines described under Basel I. RWAs reflect both on and off-balance sheet risk of the Company. The risk capital calculations will evolve over time as the Company enhances its risk management methodology and incorporates improvements in modeling techniques while

maintaining compliance with the regulatory requirements and interpretations. RWAs decreased from December 31, 2010 to March 31, 2011 as a result of a combination of business mix, analytics and collateral changes.

Market RWAs reflect capital charges attributable to the risk of loss resulting from adverse changes in market prices and other factors. For a further discussion of the Company's market risks and Value-at-Risk ("VaR") model, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management" in Part II, Item 7A, of the Form 10-K and in Part 1, Item 3 herein. Market RWAs incorporate two components: systematic risk and specific risk. Systematic and specific risk charges are computed using either the Company's VaR model or Standardized Approach in accordance with regulatory requirements.

Credit RWAs reflect capital charges attributable to the risk of loss arising from a borrower or counterparty failing to meet its financial obligations. For a further discussion of the Company's credit risks, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management—Credit Risk" in Part II, Item 7A, of the Form 10-K and in Part 1, Item 3 herein.

***Liquidity.***

The Basel Committee on Banking Supervision has developed two standards for supervisors to use in liquidity risk supervision. The first standard's objective is to promote the short-term resilience of the liquidity risk profile of banks and bank holding companies. The Committee developed the Liquidity Coverage Ratio ("LCR") to ensure banks have sufficient high-quality liquid assets to cover net outflows arising from significant stress lasting 30 calendar days. The standard requires that the value of the ratio be no lower than 100%. The second standard's objective is to promote resilience over a longer time horizon. The Net Stable Funding Ratio ("NSFR") has a time horizon of one year and builds on traditional "net liquid asset" and "cash capital" methodologies used widely by internationally active banking organizations to provide a sustainable maturity structure of assets and liabilities. The NSFR is defined as the amount of available stable funding to the amount of required stable funding. This ratio must be greater than 100%. After an observation period beginning in 2011, the LCR, including any revisions, will be introduced on January 1, 2015. The NSFR, including any revisions, will move to a minimum standard by January 1, 2018. The Company will continue to monitor the development and the potential impact of these standards.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

#### **Market Risk.**

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, implied volatilities (the price volatility of the underlying instrument imputed from option prices), correlations or other market factors, such as market liquidity, will result in losses for a position or portfolio. Generally, the Company incurs market risk as a result of trading, investing and client facilitation activities, principally within the Institutional Securities business segment where the substantial majority of the Company's VaR for market risk exposures is generated. In addition, the Company incurs trading related market risk within the Global Wealth Management Group. Asset Management incurs principally Non-trading market risk primarily from capital investments in real estate funds and investments in private equity vehicles. Regarding sales and trading and related activities, the Company is exposed to concentration risk in certain of its OTC derivatives portfolios related to the additional cost of closing out particularly large risk positions. For a further discussion of the Company's Market Risk, see "Quantitative and Qualitative Disclosures about Market Risk—Risk Management" in Part II, Item 7A of the Form 10-K.

#### **VaR.**

The Company uses VaR as one of a range of risk management tools. VaR methodology has various strengths and limitations, which include, but are not limited to: use of historical changes in market risk factors, which may not be accurate predictors of future market conditions, and may not fully incorporate the risk of extreme market events that are outsized relative to observed historical market behavior or reflect the historical distribution of results beyond the 95% confidence interval; and reporting of losses in a single day, which does not reflect the risk of positions that cannot be liquidated or hedged in one day. A small proportion of market risk generated by trading positions is not included in VaR. The modeling of the risk characteristics of some positions relies on approximations that, under certain circumstances, could produce significantly different results from those produced using more precise measures.

The Company's VaR model evolves over time in response to changes in the composition of trading portfolios and to improvements in modeling techniques and systems capabilities. The Company 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. Additionally, the Company continues to evaluate enhancements to the VaR model to make it more responsive to more recent market conditions, while maintaining a longer-term perspective.

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

The tables below present VaR for the Company's Trading portfolio, on a quarter-end, quarterly average, and quarterly high and low basis (see Table 1 below). The VaRs that would result if the Company were to adopt alternative parameters for its calculations, such as a higher confidence level for the VaR statistic (99% rather than 95%) or a shorter historical time series of market data (one year rather than four years), are also disclosed (see Table 2 below).

The Company'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.



The Company has adopted alternative measures for the disclosure of non-trading risks and will therefore no longer disclose Non-trading and Aggregate VaR. Due to a variety of factors (e.g. trading restrictions, illiquidity); the Company believes that sensitivity analysis is a more appropriate representation of the Company's non-trading risks. These are covered in the Non-Trading Risks section below.

**Trading Risks.**

The table below presents the Company's 95%/one-day Trading VaR:

<u>Primary Market Risk Category</u>	<u>95%/One-Day VaR for the Quarter Ended March 31, 2011</u>				<u>95%/One-Day VaR for the Quarter Ended December 31, 2010</u>			
	<u>Period End</u>	<u>Average</u>	<u>High</u>	<u>Low</u>	<u>Period End</u>	<u>Average</u>	<u>High</u>	<u>Low</u>
	(dollars in millions)							
Interest rate and credit spread	\$123	\$105	\$131	\$ 91	\$102	\$120	\$138	\$100
Equity price	29	28	33	23	30	31	52	25
Foreign exchange rate	19	18	27	10	21	22	40	9
Commodity price	30	33	44	26	30	26	35	21
Less Diversification benefit(1)	(67)	(63)	(90)	(47)	(65)	(67)	(117)	(38)
Total Trading VaR	<u>\$134</u>	<u>\$121</u>	<u>\$145</u>	<u>\$103</u>	<u>\$118</u>	<u>\$132</u>	<u>\$148</u>	<u>\$117</u>

(1) Diversification benefit equals the difference between Total VaR and the sum of the VaRs for the four primary 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.

The Company's average Trading VaR for the quarter ended March 31, 2011 was \$121 million compared with \$132 million for the quarter ended December 31, 2010. The decrease was driven by reductions in credit and foreign exchange.

**VaR Statistics under Varying Assumptions.**

VaR statistics are not readily comparable across firms because of differences in the breadth of products included in each firm's VaR model, in the statistical assumptions made when simulating changes in market factors, and in the methods used to approximate portfolio revaluations under the simulated market conditions. These differences can result in materially different VaR estimates for similar portfolios. The impact varies depending on the factor history assumptions, the frequency with which the factor history is updated, and the confidence level. As a result, VaR statistics are more reliable and relevant when used as indicators of trends in risk taking rather than as a basis for inferring differences in risk taking across firms.

Table 2 presents the VaR statistics that would result if the Company were to adopt alternative parameters for its calculations, such as the reported confidence level (95% versus 99%) for the VaR statistic or a shorter historical time series (four-year versus one-year) for market data upon which it bases its simulations. The four-year VaR measure continues to be sensitive to the high market volatilities experienced in the fourth quarter of 2008, while the one-year VaR is no longer affected by this phenomenon. Consequently, the four-year VaR remains a more conservative approximation of the Company's portfolio risk.

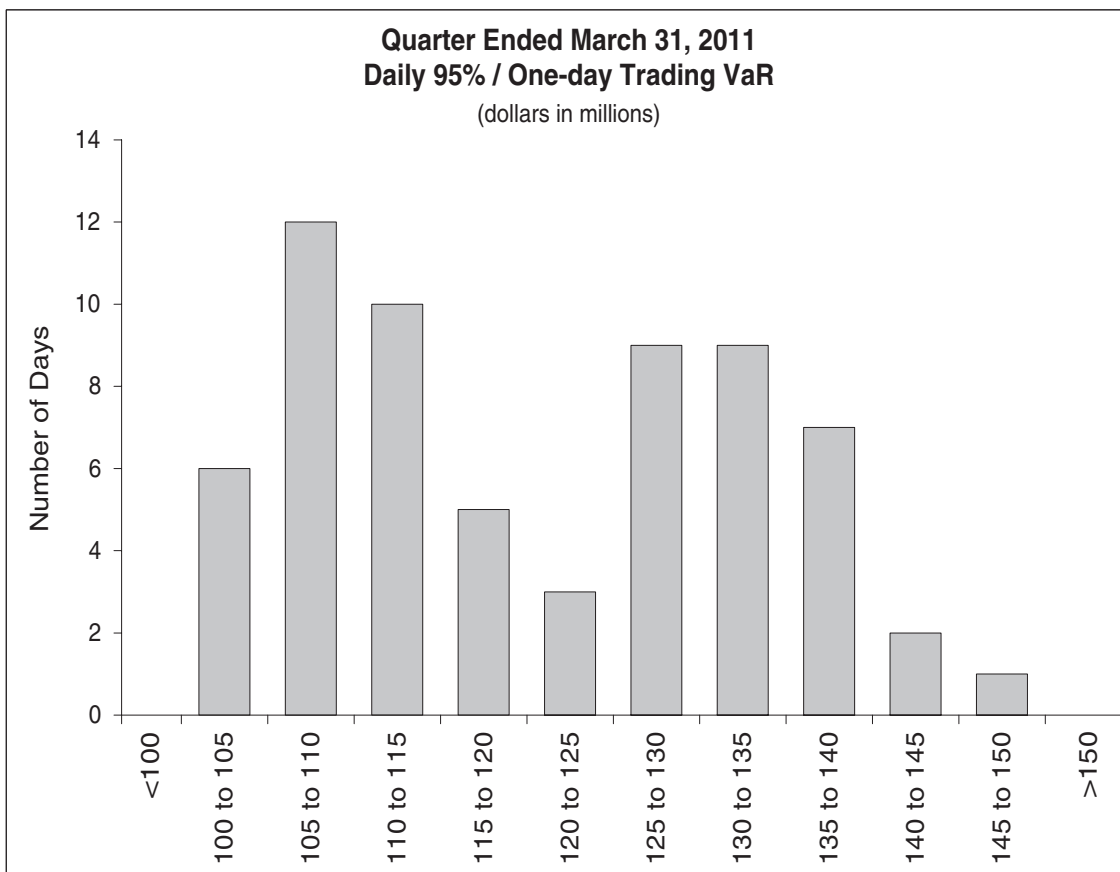
<u>Primary Market Risk Category</u>	<u>95% Average One-Day VaR for the Quarter Ended March 31, 2011</u>		<u>99% Average One-Day VaR for the Quarter Ended March 31, 2011</u>	
	<u>Four-Year Factor History</u>	<u>One-Year Factor History</u>	<u>Four-Year Factor History</u>	<u>One-Year Factor History</u>
	(dollars in millions)			
Interest rate and credit spread	\$105	\$ 71	\$ 207	\$129
Equity price	28	23	39	34
Foreign exchange rate	18	16	28	27
Commodity price	33	23	58	32
Less Diversification benefit(1)	(63)	(47)	(111)	(65)
Total Trading VaR	<u>\$121</u>	<u>\$ 86</u>	<u>\$ 221</u>	<u>\$157</u>



- (1) Diversification benefit equals the difference between Total VaR and the sum of the VaRs for the four primary 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.

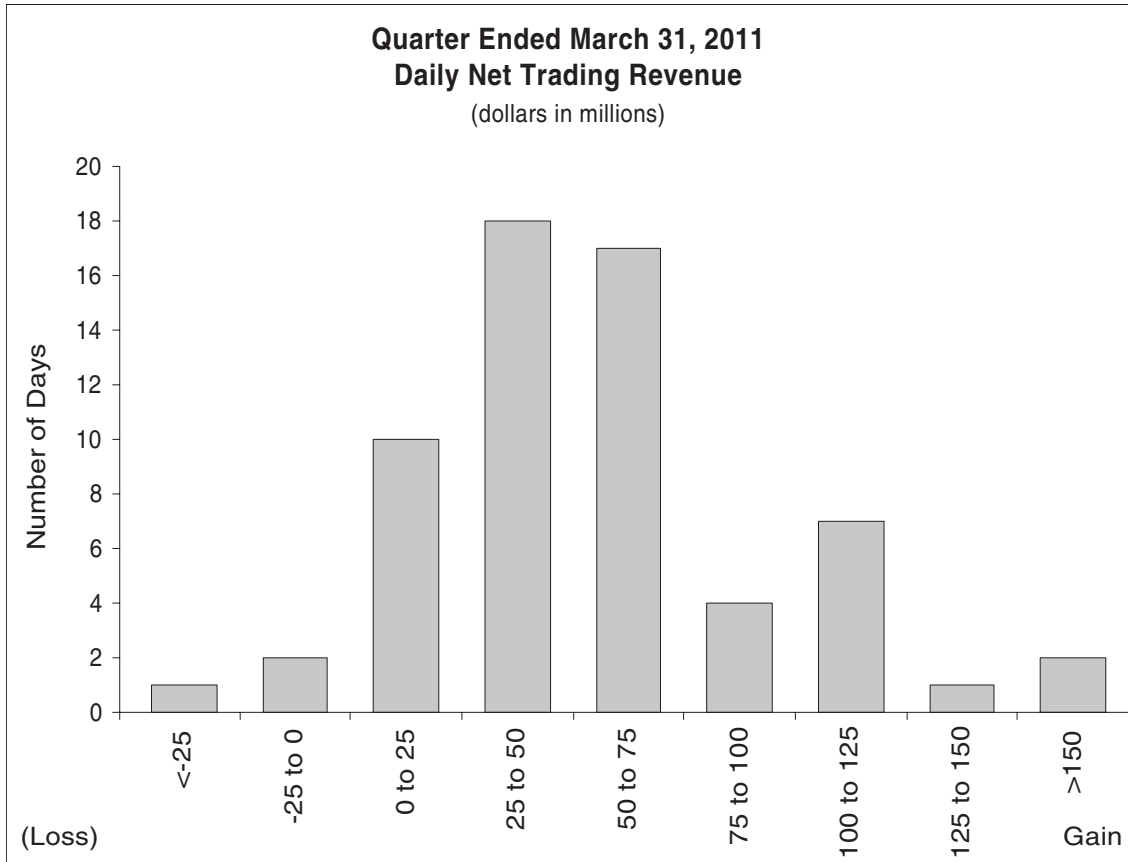
***Distribution of VaR Statistics and Net Revenues for the quarter ended March 31, 2011.***

As shown in Table 1, the Company’s average 95%/one-day Trading VaR for the quarter ended March 31, 2011 was \$121 million. The histogram below presents the distribution of the Company’s daily 95%/one-day Trading VaR for the quarter ended March 31, 2011. The most frequently occurring value was between \$105 million and \$110 million, while for approximately 56% of trading days during the quarter, VaR ranged between \$100 million and \$125 million.



One method of evaluating the reasonableness of the Company’s VaR model as a measure of the Company’s potential volatility of net revenue is to compare the VaR with actual trading revenue. Assuming no intra-day trading, for a 95%/one-day VaR, the expected number of times that trading losses should exceed VaR during the year is 13, and, in general, if trading losses were to exceed VaR more than 21 times in a year, the accuracy of the VaR model could be questioned. Accordingly, the Company evaluates the reasonableness of its VaR model by comparing the potential declines in portfolio values generated by the model with actual trading results. For days where losses exceed the 95% or 99% VaR statistic, the Company examines the drivers of trading losses to evaluate the VaR model’s accuracy relative to realized trading results.

The histogram below shows the distribution of daily net trading revenue for the quarter ended March 31, 2011 for the Company's trading businesses (these figures include revenue from the counterparty portfolio and also include net interest and non-agency commissions but exclude certain non-trading revenues such as primary, fee-based and prime brokerage revenue credited to the trading businesses). During the quarter ended March 31, 2011, the Company experienced net trading losses on 3 days, none of which were in excess of the 95%/one-day Trading VaR.



***Non-Trading Risks.***

Reflected below is a sensitivity analysis covering substantially all of the non-trading risk in the Company's portfolio.

***Counterparty Exposure Related to the Company's Own Spread.***

The credit spread risk relating to the Company's own mark-to-market derivative counterparty exposure is managed separately from VaR. The credit spread risk sensitivity of this exposure corresponds to an increase in value of approximately \$8 million for each 1 basis point widening in the Company's credit spread level for both March 31, 2011 and December 31, 2010.

***Funding Liabilities.***

The credit spread risk and interest rate risk associated with non-mark-to-market funding liabilities related to fixed and other non-trading assets are also excluded from VaR. At March 31, 2011 and December 31, 2010, non-mark-to-market funding liabilities related to fixed and other non-trading assets were approximately \$3.0 billion and \$3.5 billion, respectively.

The Company's VaR also does not capture the credit spread risk sensitivity of the Company's mark-to-market funding liabilities, which corresponded to an increase in value of approximately \$13 million and \$14 million for each 1 basis point widening in the Company's credit spread level at March 31, 2011 and December 31, 2010, respectively.

*Interest Rate Risk Sensitivity on Income from Continuing Operations.*

The Company measures the interest rate risk of certain assets and liabilities not included in Trading VaR by calculating the hypothetical sensitivity of income from continuing operations (before income taxes) to potential changes in the level of interest rates over the next twelve months. This sensitivity analysis includes positions that are mark-to-market as well as positions that are accounted for on an accrual basis.

Given the currently low interest rate environment, the Company uses the following two interest rate scenarios to quantify the Company's sensitivity: instantaneous parallel shocks of 100 and 200 basis point increases to all points on all yield curves simultaneously. With respect to MSSB, the Company's assessment of interest rate risk focuses on its economic investment in MSSB (the Company's 51% share of MSSB's income from continuing operations before income taxes).

For non-interest-bearing positions and for interest-sensitive positions that are not mark-to-market, the Company measures the incremental impact of the funding expense or coupon accrual over the next 12 months. For interest rate-sensitive positions that are mark-to-market, the sensitivities include the income impact of the instantaneous yield curve shock. The income impact of the yield curve shock measures the present value over the life of the position. For interest rate derivatives that are perfect economic hedges to non-mark-to-market assets or liabilities, the disclosed sensitivities include only the impact of the coupon accrual mismatch. This treatment mitigates the effects caused by the measurement basis differences between the economic hedge and the corresponding hedged instrument.

The hypothetical model does not assume any growth, change in business focus, asset pricing philosophy or asset/liability funding mix and does not capture how the Company would respond to significant changes in market conditions. Furthermore, the model does not reflect the Company's expectations regarding the movement of interest rates in the near term, nor the actual effect on income from continuing operations before income taxes if such changes were to occur.

	<u>March 31, 2011</u>		<u>December 31, 2010</u>	
	<u>+100</u>	<u>+200</u>	<u>+100</u>	<u>+200</u>
	<u>basis</u>	<u>basis</u>	<u>basis</u>	<u>basis</u>
	<u>points</u>	<u>points</u>	<u>points</u>	<u>points</u>
	<u>(dollars in millions)</u>			
Impact on income from continuing operations before income taxes . . . . .	\$543	\$1,090	\$560	\$1,084
Impact on income from continuing operations before income taxes excluding Citi's shares of MSSB(1) . . . . .	365	730	343	664

(1) Reflects the exclusion of the portion of income from continuing operations before income and taxes associated with MSSB's noncontrolling interest in the joint venture.

### *Principal Investments.*

The Company makes investments in both public and private companies, primarily in its Institutional Securities and Asset Management business segments. These investments are predominantly equity positions with long investment horizons, the majority of which are for business facilitation purposes. The market risk related to these investments is measured by estimating the potential reduction in net revenues (including the impact of leverage) associated with a 10% decline in asset values.

<u>Investments</u>	<u>10% Sensitivity</u>	
	<u>March 31, 2011</u>	<u>December 31, 2010</u>
	(dollars in millions)	
Investments related to Asset Management activities:		
Hedge fund investments . . . . .	\$178	\$169
Private equity and infrastructure funds . . . . .	114	115
Real estate funds . . . . .	113	108
Other investments:		
Mitsubishi UFJ Financial Group JV . . . . .	110	179
Other Company investments . . . . .	302	344

### **Credit Risk.**

For a further discussion of the Company’s credit risks, see “Quantitative and Qualitative Disclosures about Market Risk—Risk Management—Credit Risk” in Part II, Item 7A of the Form 10-K.

***Credit Exposure—Corporate Lending.*** In connection with certain of its Institutional Securities business segment activities, the Company provides loans or lending commitments (including bridge financing) to selected corporate clients. Such loans and lending commitments can generally be classified as either “relationship-driven” or “event-driven.”

“Relationship-driven” loans and lending commitments are generally made to expand business relationships with select clients. Commitments associated with “relationship-driven” activities may not be indicative of the Company’s actual funding requirements, as the commitment may expire unused or the borrower may not fully utilize the commitment. The Company may hedge its exposures in connection with “relationship-driven” transactions, and commitments may be subject to conditions including financial covenants.

“Event-driven” loans and lending commitments refer to activities associated with a particular event or transaction, such as to support client merger, acquisition or recapitalization activities. Commitments associated with these “event-driven” activities may not be indicative of the Company’s actual funding requirements since funding is contingent upon a proposed transaction being completed. In addition, the borrower may not fully utilize the commitment or the Company’s portion of the commitment may be reduced through the syndication process. The borrower’s ability to draw on the commitment is also subject to certain terms and conditions, among other factors. The Company risk manages its exposures in connection with “event-driven” transactions through various means, including syndication, distribution and/or hedging.

The following table presents information about the Company’s corporate funded loans and lending commitments carried at fair value at March 31, 2011. The “total corporate lending exposure” column includes both lending commitments and funded loans. Fair value of corporate lending exposure represents the fair value of loans that have been drawn by the borrower and lending commitments that were outstanding at March 31, 2011. Lending commitments represent legally binding obligations to provide funding to clients at March 31, 2011 for both “relationship-driven” and “event-driven” lending transactions. As discussed above, these loans and lending commitments have varying terms, may be senior or subordinated, may be secured or unsecured, are generally contingent upon representations, warranties and contractual conditions applicable to the borrower, and may be syndicated, traded or hedged by the Company.

At March 31, 2011, the aggregate amount of investment grade loans was \$5.3 billion and the aggregate amount of non-investment grade loans was \$6.5 billion. In connection with these corporate lending activities (which include corporate funded loans and lending commitments), the Company had hedges (which include “single name,” “sector” and “index” hedges) with a notional amount of \$23.9 billion related to the total corporate lending exposure of \$75.3 billion at March 31, 2011.

The table below shows the Company’s credit exposure from its corporate lending positions and lending commitments at March 31, 2011. Since commitments associated with these business activities may expire unused, they do not necessarily reflect the actual future cash funding requirements:

**Corporate Lending Commitments and Funded Loans at March 31, 2011**

<u>Credit Rating(1)</u>	<u>Years to Maturity</u>				<u>Total Corporate Lending Exposure(2)</u>	<u>Corporate Lending Exposure at Fair Value(3)</u>	<u>Corporate Lending Commitments(4)</u>
	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>			
	(dollars in millions)						
AAA .....	\$ 401	\$ 349	\$ —	\$ —	\$ 750	\$ —	\$ 750
AA .....	3,461	5,321	1,836	69	10,687	1,139	9,548
A .....	2,691	11,041	3,381	35	17,148	783	16,365
BBB .....	3,499	14,543	6,913	545	25,500	3,412	22,088
Investment grade .....	10,052	31,254	12,130	649	54,085	5,334	48,751
Non-investment grade .....	1,672	7,595	10,315	1,638	21,220	6,456	14,764
Total .....	<u>\$11,724</u>	<u>\$38,849</u>	<u>\$22,445</u>	<u>\$2,287</u>	<u>\$75,305</u>	<u>\$11,790</u>	<u>\$63,515</u>

(1) Obligor credit ratings are determined by the Credit Risk Management Department.

(2) Total corporate lending exposure represents the Company’s potential loss assuming the fair value of funded loans and lending commitments was zero.

(3) The Company’s corporate lending exposure carried at fair value includes \$12.4 billion of funded loans and \$0.6 billion of lending commitments recorded in Financial instruments owned and Financial instruments sold, not yet purchased, respectively, in the condensed consolidated statements of financial condition at March 31, 2011. See Notes 7 and 11 to the condensed consolidated financial statements for information on corporate loans and corporate lending commitments, respectively.

(4) Amounts represent the notional amount of unfunded lending commitments less the amount of commitments reflected in the Company’s condensed consolidated statements of financial condition. For syndications led by the Company, lending commitments accepted by the borrower but not yet closed are net of the amounts agreed to by counterparties that will participate in the syndication. For syndications that the Company participates in and does not lead, lending commitments accepted by the borrower but not yet closed include only the amount that the Company expects it will be allocated from the lead syndicate bank.

*“Event-Driven” Loans and Lending Commitments at March 31, 2011.*

Included in the total corporate lending exposure amounts in the table above at March 31, 2011 is “event-driven” exposure of \$5.8 billion composed of funded loans of \$1.0 billion and lending commitments of \$4.8 billion. Included in the \$5.8 billion of “event-driven” exposure at March 31, 2011 were \$3.7 billion of loans and lending commitments to non-investment grade borrowers that were closed.

Activity associated with the corporate “event-driven” lending exposure during the quarter ended March 31, 2011 was as follows (dollars in millions):

“Event-driven” lending exposures at December 31, 2010 .....	\$ 5,409
Closed commitments .....	3,862
Net reductions, primarily through distributions .....	(3,473)
Mark-to-market adjustments .....	50
“Event-driven” lending exposures at March 31, 2011 .....	<u>\$ 5,848</u>

**Credit Exposure—Derivatives.** The table below presents a summary by counterparty credit rating and remaining contract maturity of the fair value of OTC derivatives in a gain position at March 31, 2011. Fair value is presented in the final column, net of collateral received (principally cash and U.S. government and agency securities):

**OTC Derivative Products—Financial Instruments Owned at March 31, 2011(1)**

<u>Credit Rating(2)</u>	<u>Years to Maturity</u>				<u>Cross-Maturity and Cash Collateral Netting(3)</u>	<u>Net Exposure Post-Cash Collateral</u>	<u>Net Exposure Post-Collateral</u>
	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>			
	(dollars in millions)						
AAA .....	\$ 579	\$ 1,534	\$ 1,106	\$ 9,332	\$ (6,166)	\$ 6,385	\$ 6,109
AA .....	5,899	5,974	4,662	17,111	(24,639)	9,007	6,519
A .....	8,418	5,774	6,095	24,014	(31,311)	12,990	11,403
BBB .....	3,340	3,043	1,967	5,993	(7,289)	7,054	5,548
Non-investment grade .....	3,684	3,043	1,858	4,377	(4,501)	8,461	6,160
Total .....	<u>\$21,920</u>	<u>\$19,368</u>	<u>\$15,688</u>	<u>\$60,827</u>	<u>\$(73,906)</u>	<u>\$43,897</u>	<u>\$35,739</u>

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

The following tables summarize the fair values of the Company's OTC derivative products recorded in Financial instruments owned and Financial instruments sold, not yet purchased, by product category and maturity at March 31, 2011, including on a net basis, where applicable, reflecting the fair value of related non-cash collateral for financial instruments owned:

**OTC Derivative Products—Financial Instruments Owned at March 31, 2011**

<u>Product Type</u>	<u>Years to Maturity</u>				<u>Cross-Maturity and Cash Collateral Netting(1)</u>	<u>Net Exposure Post-Cash Collateral</u>	<u>Net Exposure Post-Collateral</u>
	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>			
	(dollars in millions)						
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts .....	\$ 7,870	\$13,766	\$14,190	\$58,392	\$(64,235)	\$29,983	\$25,115
Foreign exchange forward contracts and options .....	5,780	675	236	58	(2,522)	4,227	3,590
Equity securities contracts (including equity swaps, warrants and options) .....	2,553	1,265	408	1,601	(3,322)	2,505	1,255
Commodity forwards, options and swaps ...	5,717	3,662	854	776	(3,827)	7,182	5,779
Total .....	<u>\$21,920</u>	<u>\$19,368</u>	<u>\$15,688</u>	<u>\$60,827</u>	<u>\$(73,906)</u>	<u>\$43,897</u>	<u>\$35,739</u>

- (1) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity and product categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within the maturity category, where appropriate. Cash collateral received is netted on a counterparty basis, provided legal right of offset exists.

## OTC Derivative Products—Financial Instruments Sold, Not Yet Purchased, at March 31, 2011(1)

<u>Product Type</u>	<u>Years to Maturity</u>				<u>Cross-Maturity and Cash Collateral Netting(2)</u>	<u>Total</u>
	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>		
	(dollars in millions)					
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts . . . . .	\$ 6,400	\$10,398	\$12,675	\$29,317	\$(37,027)	\$21,763
Foreign exchange forward contracts and options . . . . .	6,274	815	327	77	(3,037)	4,456
Equity securities contracts (including equity swaps, warrants and options) . . . . .	4,123	2,948	1,446	941	(5,234)	4,224
Commodity forwards, options and swaps . . . . .	6,164	3,546	1,298	639	(5,251)	6,396
Total . . . . .	<u>\$22,961</u>	<u>\$17,707</u>	<u>\$15,746</u>	<u>\$30,974</u>	<u>\$(50,549)</u>	<u>\$36,839</u>

(1) Since these amounts are liabilities of the Company, they do not result in credit exposures.

(2) Amounts represent the netting of receivable balances with payable balances for the same counterparty across maturity and product categories. Receivable and payable balances with the same counterparty in the same maturity category are netted within the maturity category, where appropriate. Cash collateral paid is netted on a counterparty basis, provided legal right of offset exists.

The Company's derivatives (both listed and OTC), on a net of counterparty and cash collateral basis, at March 31, 2011 and December 31, 2010 are summarized in the table below, showing the fair value of the related assets and liabilities by product category:

<u>Product Type</u>	<u>At March 31, 2011</u>		<u>At December 31, 2010</u>	
	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
	(dollars in millions)			
Interest rate and currency swaps, interest rate options, credit derivatives and other fixed income securities contracts . . . . .	\$30,500	\$22,324	\$32,163	\$24,743
Foreign exchange forward contracts and options . . . . .	4,227	4,456	3,722	4,625
Equity securities contracts (including equity swaps, warrants and options) . . . . .	7,595	10,317	7,865	10,939
Commodity forwards, options and swaps . . . . .	7,591	7,488	7,542	7,495
Total . . . . .	<u>\$49,913</u>	<u>\$44,585</u>	<u>\$51,292</u>	<u>\$47,802</u>

Each category of derivative products in the above tables includes a variety of instruments, which can differ substantially in their characteristics. Instruments in each category can be denominated in U.S. dollars or in one or more non-U.S. currencies.

The Company determines the fair values recorded in the above tables using various pricing models. For a discussion of fair value as it affects the condensed consolidated financial statements, see "Critical Accounting Policies" in Part I, Item 2 herein and Note 3 to the condensed consolidated financial statements and Note 2 to the consolidated financial statements for the year ended December 31, 2010 included in the Form 10-K.

**Credit Derivatives.** A credit derivative is a contract between a seller (guarantor) and buyer (beneficiary) of protection against the risk of a credit event occurring on a set of debt obligations issued by a specified reference entity. The beneficiary pays a periodic premium (typically quarterly) over the life of the contract and is protected for the period. If a credit event occurs, the guarantor is required to make payment to the beneficiary based on the terms of the credit derivative contract. Credit events include bankruptcy, dissolution or insolvency of the referenced entity, failure to pay, obligation acceleration, repudiation and payment moratorium. Debt



restructurings are also considered a credit event in some cases. In certain transactions referenced to a portfolio of referenced entities or asset-backed securities, deductibles and caps may limit the guarantor's obligations.

The Company trades in a variety of derivatives and may either purchase or write protection on a single name or portfolio of referenced entities. The Company is an active market-maker in the credit derivatives markets. As a market-maker, the Company works to earn a bid-offer spread on client flow business and manage any residual credit or correlation risk on a portfolio basis. Further, the Company uses credit derivatives to manage its exposure to residential and commercial mortgage loans and corporate lending exposures during the periods presented.

The Company actively monitors its counterparty credit risk related to credit derivatives. A majority of the Company's counterparties are banks, broker-dealers, insurance and other financial institutions, and Monolines. Contracts with these counterparties do not include ratings-based termination events but do include counterparty rating downgrades, which may result in additional collateral being required by the Company. For further information on the Company's exposure to Monolines, see "Executive Summary—Significant Items—Monoline Insurers" in Part I, Item 2 herein. The master agreements with these Monoline counterparties are generally unsecured, and the few ratings-based triggers (if any) generally provide the Company the ability to terminate only upon significant downgrade. As with all derivative contracts, the Company considers counterparty credit risk in the valuation of its positions and recognizes credit valuation adjustments as appropriate within Principal transactions—Trading.

The following table summarizes the key characteristics of the Company's credit derivative portfolio by counterparty at March 31, 2011. The fair values shown are before the application of any counterparty or cash collateral netting:

	At March 31, 2011			
	Fair Values(1)		Notionals	
	Receivable	Payable	Beneficiary	Guarantor
	(dollars in millions)			
Banks and securities firms . . . . .	\$86,270	\$78,603	\$2,075,828	\$2,055,224
Insurance and other financial institutions . . . . .	9,951	8,408	287,190	288,464
Monolines(2) . . . . .	2,628	—	25,390	—
Non-financial entities . . . . .	162	130	3,994	3,870
Total . . . . .	<u>\$99,011</u>	<u>\$87,141</u>	<u>\$2,392,402</u>	<u>\$2,347,558</u>

(1) The Company's credit default swaps are classified in both Level 2 and Level 3 of the fair value hierarchy. Approximately 13% of receivable fair values and 8% of payable fair values represent Level 3 amounts.

(2) Amounts do not include the effect of hedges of Monoline derivative counterparty exposure.

**Country Exposure.** At March 31, 2011 primarily based on the domicile of the counterparty, approximately 5% of the Company's credit exposure (for credit exposure arising from corporate loans and lending commitments as discussed above and current exposure arising from the Company's OTC derivative contracts) was to emerging markets, and no one emerging market country accounted for more than approximately 1% of the Company's credit exposure.

The Company defines emerging markets to include generally all countries where the economic, legal and political systems are transitional and in the process of developing into more transparent and accountable systems that are consistent with advanced countries.

The following tables show the Company's percentage of credit exposure from its primary corporate loans and lending commitments and OTC derivative products by country at March 31, 2011:

<u>Country</u>	<u>Corporate Lending Exposure(1)</u>
United States .....	64%
United Kingdom .....	9
Germany .....	6
Netherlands .....	3
Canada .....	2
France .....	2
Switzerland .....	2
Luxembourg .....	2
Cayman Islands .....	2
Other .....	8
Total .....	<u>100%</u>

<u>Country</u>	<u>OTC Derivative Products(1)(2)</u>
United States .....	34%
Cayman Islands .....	10
United Kingdom .....	9
Italy .....	8
France .....	3
Germany .....	3
Japan .....	2
Chile .....	2
Luxembourg .....	2
Netherlands .....	2
Canada .....	2
Australia .....	2
Austria .....	2
Other .....	19
Total .....	<u>100%</u>

(1) Credit exposure amounts are based on the domicile of the counterparty.

(2) Credit exposure amounts do not reflect the offsetting benefit of financial instruments that the Company utilizes to hedge credit exposure arising from OTC derivative products.

**Industry Exposure.** The Company also monitors its credit exposure to individual industries for credit exposure arising from corporate loans and lending commitments as discussed above and current exposure arising from the Company's OTC derivative contracts.

The following tables show the Company's percentage of credit exposure from its primary corporate loans and lending commitments and OTC derivative products by industry at March 31, 2011:

<u>Industry</u>	<u>Corporate Lending Exposure</u>
Utilities .....	12%
Energy .....	11
Financial institutions(1) .....	9
Chemicals, metals, mining and other materials .....	8
Pharmaceutical and healthcare .....	7
Technology .....	7
Telecommunications services .....	6
Media-related entities .....	6
Food, beverage and tobacco .....	5
Insurance .....	4
Capital goods .....	4
Banks .....	3
Real estate .....	3
Transportation .....	3
Other .....	12
Total .....	<u>100%</u>

<u>Industry</u>	<u>OTC Derivative Products</u>
Financial institutions(1) .....	29%
Sovereign governments .....	12
Banks .....	10
Insurance .....	10
Utilities .....	9
Energy .....	9
Regional governments .....	6
Chemicals, metals, mining and other materials .....	3
Pharmaceutical and healthcare .....	2
Transportation .....	2
Other .....	8
Total .....	<u>100%</u>

(1) Percentage reflects credit exposures from special purpose entity vehicles, other diversified financial service entities and mutual and pension funds, exchanges and clearing houses, and private equity and real estate funds.

#### **Item 4. Controls and Procedures.**

Under the supervision and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

No change in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) occurred during the period covered by this report that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**FINANCIAL DATA SUPPLEMENT (Unaudited)**  
**Average Balances and Interest Rates and Net Interest Income**

	<b>Three Months Ended March 31, 2011</b>		
	<b>Average Weekly Balance</b>	<b>Interest</b>	<b>Annualized Average Rate</b>
	(dollars in millions)		
<b>Assets</b>			
<b>Interest earning assets:</b>			
Financial instruments owned(1):			
U.S. ....	\$ 121,713	\$ 730	2.4%
Non-U.S. ....	120,291	188	0.6
Securities available for sale:			
U.S. ....	27,123	88	1.3
Loans:			
U.S. ....	10,966	100	3.7
Non-U.S. ....	193	5	10.5
Interest bearing deposits with banks:			
U.S. ....	48,102	12	0.1
Non-U.S. ....	14,983	23	0.6
Federal funds sold and securities purchased under agreements to resell and Securities borrowed:			
U.S. ....	199,619	55	0.1
Non-U.S. ....	98,941	222	0.9
Other:			
U.S. ....	40,899	243	2.4
Non-U.S. ....	17,328	188	4.4
<b>Total</b> .....	<u>\$700,158</u>	<u>\$1,854</u>	1.1%
Non-interest earning assets .....	<u>135,698</u>		
<b>Total assets</b> .....	<u><u>\$ 835,856</u></u>		
<b>Liabilities and Equity</b>			
<b>Interest bearing liabilities:</b>			
Deposits:			
U.S. ....	\$ 63,216	\$ 66	0.4%
Non-U.S. ....	65	—	—
Commercial paper and other short-term borrowings:			
U.S. ....	1,476	3	0.8
Non-U.S. ....	1,644	5	1.2
Long-term debt:			
U.S. ....	186,108	1,304	2.8
Non-U.S. ....	6,676	9	0.5
Financial instruments sold, not yet purchased(1):			
U.S. ....	23,080	—	—
Non-U.S. ....	62,115	—	—
Securities sold under agreements to repurchase and Securities loaned:			
U.S. ....	105,383	185	0.7
Non-U.S. ....	93,514	286	1.2
Other:			
U.S. ....	85,962	(182)	(0.9)
Non-U.S. ....	34,037	177	2.1
<b>Total</b> .....	<u>\$ 663,276</u>	<u>\$ 1,853</u>	1.1
Non-interest bearing liabilities and equity .....	<u>172,580</u>		
<b>Total liabilities and equity</b> .....	<u><u>\$ 835,856</u></u>		
Net interest income and net interest rate spread .....		<u>\$ 1</u>	<u>— %</u>

**FINANCIAL DATA SUPPLEMENT (Unaudited)—Continued**  
**Average Balances and Interest Rates and Net Interest Income**

	<u>Three Months Ended March 31, 2010</u>		
	<u>Average Weekly Balance</u>	<u>Interest</u>	<u>Average Rate</u>
	(dollars in millions)		
<b>Assets</b>			
<b>Interest earning assets:</b>			
Financial instruments owned(1):			
U.S. ....	\$ 155,440	\$ 975	2.5%
Non-U.S. ....	102,951	156	0.6
Securities available for sale:			
U.S. ....	4,749	10	0.9
Loans:			
U.S. ....	6,818	65	3.9
Non-U.S. ....	204	5	9.9
Interest bearing deposits with banks:			
U.S. ....	35,442	23	0.3
Non-U.S. ....	19,924	18	0.4
Federal funds sold and securities purchased under agreements to resell and Securities borrowed:			
U.S. ....	216,466	27	0.1
Non-U.S. ....	101,001	123	0.5
Other:			
U.S. ....	28,065	334	4.8
Non-U.S. ....	20,289	—	—
<b>Total</b> .....	<u>\$ 691,349</u>	<u>\$1,736</u>	1.0%
Non-interest earning assets .....	<u>144,445</u>		
<b>Total assets</b> .....	<u>\$ 835,794</u>		
<b>Liabilities and Equity</b>			
<b>Interest bearing liabilities:</b>			
Deposits:			
U.S. ....	\$ 63,358	\$ 172	1.1%
Non-U.S. ....	101	—	—
Commercial paper and other short-term borrowings:			
U.S. ....	1,677	3	0.7
Non-U.S. ....	744	—	—
Long-term debt:			
U.S. ....	188,994	1,061	2.3
Non-U.S. ....	4,317	3	0.3
Financial instruments sold, not yet purchased(1):			
U.S. ....	14,820	—	—
Non-U.S. ....	64,986	—	—
Securities sold under agreements to repurchase and Securities loaned:			
U.S. ....	150,018	146	0.4
Non-U.S. ....	73,959	140	0.8
Other:			
U.S. ....	84,357	(120)	(0.6)
Non-U.S. ....	35,362	(37)	(0.4)
<b>Total</b> .....	<u>\$ 682,693</u>	<u>\$1,368</u>	0.8
Non-interest bearing liabilities and equity .....	<u>153,101</u>		
<b>Total liabilities and equity</b> .....	<u>\$ 835,794</u>		
Net interest income and net interest rate spread .....		<u>\$ 368</u>	<u>0.2%</u>

(1) Interest expense on Financial instruments sold, not yet purchased is reported as a reduction of Interest income.

**FINANCIAL DATA SUPPLEMENT (Unaudited)—Continued**

**Rate/Volume Analysis**

The following tables set forth an analysis of the effect on net interest income of volume and rate changes:

	Three Months Ended March 31, 2011 versus Three Months Ended March 31, 2010		
	Increase (decrease) due to change in:		
	Volume	Rate	Net change
		(in millions)	
<b>Interest earning assets</b>			
Financial instruments owned:			
U.S. ....	\$(212)	\$ (33)	\$(245)
Non-U.S. ....	26	6	32
Securities available for sale:			
U.S. ....	47	31	78
Loans:			
U.S. ....	40	(5)	35
Interest bearing deposits with banks:			
U.S. ....	8	(19)	(11)
Non-U.S. ....	(4)	9	5
Federal funds sold and securities purchased under agreements to resell and Securities borrowed:			
U.S. ....	(2)	30	28
Non-U.S. ....	(3)	102	99
Other:			
U.S. ....	153	(244)	(91)
Non-U.S. ....	—	188	188
<b>Change in interest income</b> .....	<u>\$ 53</u>	<u>\$ 65</u>	<u>\$ 118</u>
<b>Interest bearing liabilities</b>			
Deposits			
U.S. ....	\$ —	\$(106)	\$(106)
Commercial paper and other short-term borrowings			
Non-U.S. ....	—	5	5
Long-term debt			
U.S. ....	(16)	259	243
Non-U.S. ....	2	4	6
Securities sold under agreements to repurchase and Securities loaned			
U.S. ....	(43)	82	39
Non-U.S. ....	37	109	146
Other			
U.S. ....	(2)	(60)	(62)
Non-U.S. ....	1	213	214
<b>Change in interest expense</b> .....	<u>\$ (21)</u>	<u>\$ 506</u>	<u>\$ 485</u>
<b>Change in net interest income</b> .....	<u>\$ 74</u>	<u>\$(441)</u>	<u>\$(367)</u>



## **Part II—Other Information.**

### **Item 1. Legal Proceedings.**

In addition to the matters described in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 (the "Form 10-K"), and those described below, in the normal course of business, the Company has been named, from time to time, as a defendant in various legal actions, including arbitrations, class actions and other litigation, arising in connection with its activities as a global diversified financial services institution. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the entities that would otherwise be the primary defendants in such cases are bankrupt or in financial distress.

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

The Company contests liability and/or the amount of damages as appropriate in each pending matter. Where available information indicates that it is probable a liability had been incurred at the date of the condensed consolidated financial statements and the Company can reasonably estimate the amount of that loss, the Company accrues the estimated loss by a charge to income.

In many proceedings, however, it is inherently difficult to determine whether any loss is probable or even possible or to estimate the amount of any loss. The Company cannot predict with certainty if, how or when such proceedings will be resolved or what the eventual settlement, fine, penalty or other relief, if any, may be, particularly for proceedings that are in their early stages of development or where plaintiffs seek substantial or indeterminate damages. Numerous issues may need to be resolved, including through potentially lengthy discovery and determination of important factual matters, and by addressing novel or unsettled legal questions relevant to the proceedings in question, before a loss or additional loss or range of loss or additional loss can be reasonably estimated for any proceeding. Subject to the foregoing, the Company believes, based on current knowledge and after consultation with counsel, that the outcome of such proceedings will not have a material adverse effect on the consolidated financial condition of the Company, although the outcome of such proceedings could be material to the Company's operating results and cash flows for a particular period depending on, among other things, the level of the Company's revenues or income for such period.

Recently, the level of litigation activity focused on residential mortgage and credit crisis related matters has increased materially in the financial services industry. As a result, the Company expects that it may become the subject of increased claims for damages and other relief regarding residential mortgages and related securities in the future and, while the Company has identified below certain proceedings that the Company believes to be material, individually or collectively, there can be no assurance that additional material losses will not be incurred from residential mortgage claims that have not yet been notified to the Company or are not yet determined to be material.

The following developments have occurred with respect to certain matters previously reported in the Form 10-K or concern new actions that have been filed since December 31, 2010:

#### **Residential Mortgage and Credit Crisis Related Matters.**

##### ***Class Actions.***

On April 4, 2011, the court presiding over the action styled *Joel Stratte-McClure, et al. v. Morgan Stanley, et al.*, granted defendants' motion to dismiss and granted plaintiffs leave to file an amended complaint with respect to certain of their allegations.

On March 29, 2011, the Company reached an agreement in principle with the class plaintiffs in the action styled *In Re Washington Mutual, Inc. Securities Litigation*, to settle this litigation. The settlement agreement has not yet been completed and will be subject to court approval.

On March 16, 2011, a purported class action, styled *Coulter v. Morgan Stanley & Co. Incorporated et al.*, was filed in the United States District Court for the Southern District of New York asserting claims on behalf of participants in the Company's 401(k) plan and employee stock ownership plan against the Company and certain current and former officers and directors for breach of fiduciary duties under the Employee Retirement Income Security Act of 1974. The complaint alleges, among other things, that defendants knew or should have known that from January 2, 2008 to December 31, 2008, the plans' investment in Company stock was imprudent given the extraordinary risks faced by the Company and its common stock during that period. Plaintiffs are seeking, among other relief, class certification, unspecified compensatory damages, costs, interest and fees.

#### ***Shareholder Derivative Matter.***

On March 31, 2011, the court presiding over the action styled *Steve Staehr, Derivatively on Behalf of Morgan Stanley v. John J. Mack, et al.*, granted defendants' motion to dismiss.

#### ***Other Litigation.***

On March 11, 2011, the deadline for new plaintiffs to join the case styled *Abu Dhabi Commercial Bank, et al. v. Morgan Stanley & Co. Inc., et al.*, expired. There are currently 15 plaintiffs in this action asserting claims related to approximately \$983 million of securities issued by the structured investment vehicle called Cheyne Finance.

On April 20, 2011, the court presiding over the action styled *U.S. Bank, N.A. v. Barclays Bank PLC and Morgan Stanley Capital Services Inc.*, entered a stipulation and order of dismissal reflecting the parties' agreement to resolve this litigation pursuant to a settlement.

On April 18, 2011, defendants in the actions styled *Federal Home Loan Bank of San Francisco v. Credit Suisse Securities (USA) LLC, et al.*, and *Federal Home Loan Bank of San Francisco v. Deutsche Bank Securities Inc. et al.*, filed an omnibus demurrer and motion to strike the amended complaints.

On February 23, 2011, the court presiding over the action styled *The Charles Schwab Corp. v. BNP Paribas Securities Corp. et al.*, remanded the action to the Superior Court of the State of California.

On February 28, 2011, the court presiding over the action styled *China Development Industrial Bank v. Morgan Stanley & Co. Incorporated et al.* denied the Company's motion to dismiss the complaint. On March 21, 2011, the Company appealed the order denying its motion to dismiss the complaint.

On March 15, 2011, the court presiding over the action styled *Federal Home Loan Bank of Chicago v. Bank of America Securities LLC et al.*, which had been removed to the United States District Court for the Central District of California, remanded the action to the Superior Court of the State of California. On March 24, 2011, the court presiding over the action styled *Federal Home Loan Bank of Chicago v. Bank of America Funding Corporation et al.*, which is pending in Illinois state court, granted plaintiff's motion to file an amended complaint.

On February 11, 2011, Cambridge Place Investment Management Inc. filed a new complaint against the Company and other defendants in the Superior Court of the Commonwealth of Massachusetts styled *Cambridge Place Investment Management Inc. v. Morgan Stanley & Co., Inc. et al.* The complaint alleges that the defendants made untrue statements and material omissions in the sale to plaintiff's clients of certain mortgage pass through certificates backed by securitization trusts containing residential mortgage loans. The total amount of certificates allegedly issued or underwritten by the Company or sold to plaintiff's clients by the Company was approximately \$102 million. The complaint raises claims under the Massachusetts Uniform Securities Act and seeks, among other things, to rescind the plaintiff's purchase of such certificates. This action is separate from the similarly styled action filed by Cambridge Place on July 9, 2010 that was previously disclosed in the Form 10-K.

On April 20, 2011, the Federal Home Loan Bank of Boston filed a complaint against the Company and other defendants in the Superior Court of the Commonwealth of Massachusetts styled *Federal Home Loan Bank of Boston v. Ally Financial, Inc. F/K/A GMAC LLC et al.* The complaint alleges that defendants made untrue statements and material omissions in the sale to plaintiff of certain mortgage pass through certificates backed by securitization trusts containing residential mortgage loans. The total amount of certificates allegedly issued by the Company or sold to plaintiff by the Company was approximately \$500 million. The complaint raises claims under the Massachusetts Uniform Securities Act, the Massachusetts consumer protection act and common law and seeks, among other things, to rescind the plaintiff's purchase of such certificates.

### **Item 1A. Risk Factors.**

For a discussion of the risk factors affecting the Company, see "Risk Factors" in Part I, Item 1A of the Form 10-K.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The table below sets forth the information with respect to purchases made by or on behalf of the Company of its common stock during the quarterly period ended March 31, 2011.

### Issuer Purchases of Equity Securities (dollars in millions, except per share amounts)

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased As Part of Publicly Announced Plans or Programs (C)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
<b>Month #1</b>				
<b>(January 1, 2011—January 31, 2011)</b>				
Share Repurchase Program(A) .....	—	—	—	\$1,560
Employee Transactions(B) .....	8,812,772	\$29.40	—	—
<b>Month #2</b>				
<b>(February 1, 2011—February 28, 2011)</b>				
Share Repurchase Program(A) .....	—	—	—	\$1,560
Employee Transactions(B) .....	292,319	\$29.93	—	—
<b>Month #3</b>				
<b>(March 1, 2011—March 31, 2011)</b>				
Share Repurchase Program(A) .....	—	—	—	\$1,560
Employee Transactions(B) .....	162,747	\$28.24	—	—
<b>Total</b>				
Share Repurchase Program(A) .....	—	—	—	\$1,560
Employee Transactions(B) .....	9,267,838	\$29.40	—	—

(A) On December 19, 2006, the Company announced that its Board of Directors authorized the repurchase of up to \$6 billion of the Company's outstanding stock under a share repurchase program (the "Share Repurchase Program"). The Share Repurchase Program is a program for capital management purposes that considers, among other things, business segment capital needs, as well as equity-based compensation and benefit plan requirements. The Share Repurchase Program has no set expiration or termination date. Share repurchases by the Company are subject to regulatory approval.

(B) Includes: (1) shares delivered or attested in satisfaction of the exercise price and/or tax withholding obligations by holders of employee and director stock options (granted under employee and director stock compensation plans) who exercised options; (2) shares withheld, delivered or attested (under the terms of grants under employee and director stock compensation plans) to offset tax withholding obligations that occur upon vesting and release of restricted shares; and (3) shares withheld, delivered and attested (under the terms of grants under employee and director stock compensation plans) to offset tax withholding obligations that occur upon the delivery of outstanding shares underlying restricted stock units. The Company's employee and director stock compensation plans provide that the value of the shares withheld, delivered or attested shall be valued using the fair market value of the Company's common stock on the date the relevant transaction occurs, using a valuation methodology established by the Company.

(C) Share purchases under publicly announced programs are made pursuant to open-market purchases, Rule 10b5-1 plans or privately negotiated transactions (including with employee benefit plans) as market conditions warrant and at prices the Company deems appropriate.

## Item 6. Exhibits.

An exhibit index has been filed as part of this Report on Page E-1.



**EXHIBIT INDEX**  
**MORGAN STANLEY**  
**Quarter Ended March 31, 2011**

<u>Exhibit No.</u>	<u>Description</u>
10.1	Form of Award Certificate for Discretionary Retention Awards of Stock Units.
10.2	Form of Award Certificate for Awards under the Deferred Bonus Program of the Morgan Stanley Compensation Incentive Plan.
10.3	Form of Award Certificate for Performance Stock Units.
10.4	Form of Award Certificate for Special Discretionary Retention Awards of Stock Options.
10.5	Agreement between Morgan Stanley and Gregory J. Fleming, dated February 3, 2010 (filed hereto as a result of Mr. Fleming becoming a named executive officer pursuant to Item 402 of Regulation S-K).
12	Statement Re: Computation of Ratio of Earnings to Fixed Charges and Computation of Earnings to Fixed Charges and Preferred Stock Dividends.
15	Letter of awareness from Deloitte & Touche LLP, dated May 9, 2011, concerning unaudited interim financial information.
31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certification of Chief Executive Officer.
32.2	Section 1350 Certification of Chief Financial Officer.
101	Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Condensed Consolidated Statements of Financial Condition—March 31, 2011 and December 31, 2010, (ii) the Condensed Consolidated Statements of Income—Three Months Ended March 31, 2011 and 2010, (iii) the Condensed Consolidated Statements of Comprehensive Income—Three Months Ended March 31, 2011 and 2010, (iv) the Condensed Consolidated Statements of Cash Flows—Three Months Ended March 31, 2011 and 2010, (v) the Condensed Consolidated Statements of Changes in Total Equity—Three Months Ended March 31, 2011 and 2010, and (vi) Notes to Condensed Consolidated Financial Statements (unaudited).*

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\* As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

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