MORGAN STANLEY
Form 10-Q
August 06, 2012
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2012

OR

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

EXCHANGE ACT OF 1934

Commission File Number 1-11758

(Exact Name of Registrant as specified in its charter)

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

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

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

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

Large Accelerated Filer x Accelerated Filer ¨

Non-Accelerated Filer ¨ 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 x

As of July 31, 2012, there were 1,975,507,265 shares of the Registrant s Common Stock, par value $0.01 per share, outstanding.

Table of Contents

QUARTERLY REPORT ON FORM 10-Q

For the quarter ended June 30, 2012

Table of Contents		Page
Part I Financial Information		
Item 1.	Financial Statements (unaudited)	1
	Condensed Consolidated Statements of Financial Condition June 30, 2012 and December 31, 2011	1
	Condensed Consolidated Statements of Income Three and Six Months Ended June 30, 2012 and 2011	3
	Condensed Consolidated Statements of Comprehensive Income Three and Six Months Ended June 30, 2012 and 2011	4
	Condensed Consolidated Statements of Cash Flows Six Months Ended June 30, 2012 and 2011	5
	Condensed Consolidated Statements of Changes in Total Equity Six Months Ended June 30, 2012 and 2011	6
	Notes to Condensed Consolidated Financial Statements (unaudited)	8
	Report of Independent Registered Public Accounting Firm	89
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	90
	Introduction	90
	Executive Summary	91
	Business Segments	101
	Accounting Developments	117
	Other Matters	118
	Critical Accounting Policies	119
	Liquidity and Capital Resources	124
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	140
Item 4.	Controls and Procedures	155
Financial Data Supplement (Unaudited)		156
Part II Other Information		
Item 1.	Legal Proceedings	162
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	164
Item 6.	Exhibits	164

Table of Contents

AVAILABLE INFORMATION

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

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

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

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

Integrity Hotline information.

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

Table of Contents

Part I Financial Information.

Item 1. Financial Statements.

MORGAN STANLEY

Condensed Consolidated Statements of Financial Condition

(dollars in millions, except share data)

(unaudited)

	June 30, 2012	December 31, 2011
Assets		
Cash and due from banks ($477 and $511 at June 30, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities generally not available to the Company)	$ 12,408	$ 13,165
Interest bearing deposits with banks	29,598	34,147
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	29,418	29,454
Financial instruments owned, at fair value (approximately $131,397 and $140,749 were pledged to various parties at June 30, 2012 and December 31, 2011, respectively):		
U.S. government and agency securities	54,138	63,449
Other sovereign government obligations	33,628	29,059
Corporate and other debt ($2,734 and $3,007 at June 30, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities, generally not available to the Company)	57,757	68,923
Corporate equities	46,346	47,966
Derivative and other contracts	34,343	48,064
Investments ($1,809 and $1,666 at June 30, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities, generally not available to the Company)	8,229	8,195
Physical commodities	6,141	9,697
Total financial instruments owned, at fair value	240,582	275,353
Securities available for sale, at fair value	31,442	30,495
Securities received as collateral, at fair value	12,150	11,651
Federal funds sold and securities purchased under agreements to resell (includes $622 and $112 at fair value at June 30, 2012 and December 31, 2011, respectively)	147,988	130,155
Securities borrowed	134,263	127,074
Receivables:		
Customers	37,666	33,977
Brokers, dealers and clearing organizations	9,107	5,248
Fees, interest and other	10,208	9,444
Loans (net of allowances of $77 and $17 at June 30, 2012 and December 31, 2011, respectively)	21,394	15,369
Other investments	4,730	4,832
Premises, equipment and software costs (net of accumulated depreciation of $5,311 and $4,852 at June 30, 2012 and December 31, 2011, respectively) ($229 and $234 at June 30, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities, generally not available to the Company)	6,343	6,457
Goodwill	6,610	6,686
Intangible assets (net of accumulated amortization of $1,078 and $910 at June 30, 2012 and December 31, 2011, respectively) (includes $8 and $133 at fair value at June 30, 2012 and December 31, 2011, respectively)	3,987	4,285
Other assets ($355 and $446 at June 30, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities, generally not available to the Company)	10,623	12,106

Total assets	$ 748,517	$ 749,898

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

Condensed Consolidated Statements of Financial Condition (Continued)

(dollars in millions, except share data)

(unaudited)

	June 30, 2012	December 31, 2011
Liabilities and Equity		
Deposits (includes $1,965 and $2,101 at fair value at June 30, 2012 and December 31, 2011, respectively)	$ 68,252	$ 65,662
Commercial paper and other short-term borrowings (includes $840 and $1,339 at fair value at June 30, 2012 and December 31, 2011, respectively)	1,988	2,843
Financial instruments sold, not yet purchased, at fair value:		
U.S. government and agency securities	27,770	19,630
Other sovereign government obligations	22,208	17,141
Corporate and other debt	9,041	8,410
Corporate equities	29,521	24,497
Derivative and other contracts	34,935	46,453
Physical commodities		16
Total financial instruments sold, not yet purchased, at fair value	123,475	116,147
Obligation to return securities received as collateral, at fair value	17,078	15,394
Securities sold under agreements to repurchase (includes $346 and $348 at fair value at June 30, 2012 and December 31, 2011, respectively)	108,678	104,800
Securities loaned	30,762	30,462
Other secured financings (includes $9,236 and $14,594 at fair value at June 30, 2012 and December 31, 2011, respectively) ($1,419 and $2,316 at June 30, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities and are non-recourse to the Company)	17,323	20,719
Payables:		
Customers	119,455	117,241
Brokers, dealers and clearing organizations	4,158	4,082
Interest and dividends	3,166	2,292
Other liabilities and accrued expenses ($55 and $121 at June 30, 2012 and December 31, 2011, respectively, related to consolidated variable interest entities and are non-recourse to the Company)	14,717	15,944
Long-term borrowings (includes $42,482 and $39,663 at fair value at June 30, 2012 and December 31, 2011, respectively)	167,828	184,234
	676,880	679,820
Commitments and contingent liabilities (see Note 11)		
Equity		
Morgan Stanley shareholders equity:		
Preferred stock	1,508	1,508
Common stock, $0.01 par value;		
Shares authorized: 3,500,000,000 at June 30, 2012 and December 31, 2011;		
Shares issued: 2,038,893,979 at June 30, 2012 and 1,989,377,171 at December 31, 2011;		
Shares outstanding: 1,977,402,742 at June 30, 2012 and 1,926,986,130 at December 31, 2011	20	20
Paid-in capital	23,151	22,836
Retained earnings	40,586	40,341
Employee stock trust	3,198	3,166
Accumulated other comprehensive loss	(220)	(157)
Common stock held in treasury, at cost, $0.01 par value; 61,491,237 shares at June 30, 2012 and 62,391,041 shares at December 31, 2011	(2,204)	(2,499)

Common stock issued to employee trust	(3,198)	(3,166)
Total Morgan Stanley shareholders equity	62,841	62,049
Noncontrolling interests	8,796	8,029
Total equity	71,637	70,078
Total liabilities and equity	$ 748,517	$ 749,898

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

Condensed Consolidated Statements of Income

(dollars in millions, except share and per share data)

(unaudited)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Revenues:				
Investment banking	$ 1,104	$ 1,695	$ 2,167	$ 2,909
Principal transactions:				
Trading	2,469	3,484	4,876	6,461
Investments	63	402	148	731
Commissions and fees	1,040	1,283	2,217	2,722
Asset management, distribution and administration fees	2,268	2,174	4,420	4,257
Other	170	237	280	(237)
Total non-interest revenues	7,114	9,275	14,108	16,843
Interest income	1,323	1,961	2,865	3,820
Interest expense	1,484	2,029	3,085	3,882
Net interest	(161)	(68)	(220)	(62)
Net revenues	6,953	9,207	13,888	16,781
Non-interest expenses:				
Compensation and benefits	3,633	4,622	8,064	8,907
Occupancy and equipment	380	395	772	792
Brokerage, clearing and exchange fees	405	410	808	811
Information processing and communications	487	444	946	884
Marketing and business development	156	151	302	293
Professional services	478	467	890	870
Other	474	748	963	1,353
Total non-interest expenses	6,013	7,237	12,745	13,910
Income from continuing operations before income taxes	940	1,970	1,143	2,871
Provision for income taxes	226	538	280	294
Income from continuing operations	714	1,432	863	2,577
Discontinued operations:				
Gain (loss) from discontinued operations	49	(22)	76	(51)
Provision for (benefit from) income taxes	13	4	55	(10)
Net gain (loss) from discontinued operations	36	(26)	21	(41)
Net income	$ 750	$ 1,406	$ 884	$ 2,536
Net income applicable to noncontrolling interests	159	213	387	375
Net income applicable to Morgan Stanley	$ 591	$ 1,193	$ 497	$ 2,161

Earnings (loss) applicable to Morgan Stanley common shareholders	$ 564	$ (558)	$ 446	$ 188
Amounts applicable to Morgan Stanley:				
Income from continuing operations	$ 563	$ 1,221	$ 485	$ 2,205
Net gain (loss) from discontinued operations	28	(28)	12	(44)
Net income applicable to Morgan Stanley	$ 591	$ 1,193	$ 497	$ 2,161
Earnings (loss) per basic common share:				
Income (loss) from continuing operations	$ 0.28	$ (0.36)	$ 0.23	$ 0.16
Net gain (loss) from discontinued operations	0.02	(0.02)	0.01	(0.03)
Earnings (loss) per basic common share	$ 0.30	$ (0.38)	$ 0.24	$ 0.13
Earnings (loss) per diluted common share:				
Income (loss) from continuing operations	$ 0.28	$ (0.36)	$ 0.23	$ 0.16
Net gain (loss) from discontinued operations	0.01	(0.02)		(0.03)
Earnings (loss) per diluted common share	$ 0.29	$ (0.38)	$ 0.23	$ 0.13
Average common shares outstanding:				
Basic	1,885,179,182	1,464,295,984	1,881,070,509	1,460,155,981
Diluted	1,911,709,377	1,464,295,984	1,907,107,639	1,477,572,132

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

Condensed Consolidated Statements of Comprehensive Income

(dollars in millions)

(unaudited)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net income	$ 750	$ 1,406	$ 884	$ 2,536
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments(1)	$ (151)	$ 94	$ (131)	$ 131
Amortization of cash flow hedges(2)	1	3	3	4
Net unrealized gain (loss) on Securities available for sale(3)	41	50	22	14
Pension, postretirement and other related adjustments(4)	17	2	19	7
Total other comprehensive income (loss)	$ (92)	$ 149	$ (87)	$ 156
Comprehensive income	$ 658	$ 1,555	$ 797	$ 2,692
Net income applicable to noncontrolling interests	159	213	387	375
Other comprehensive income (loss) applicable to noncontrolling interests	68	43	(24)	9
Comprehensive income applicable to Morgan Stanley	$ 431	$ 1,299	$ 434	$ 2,308

(1) Amounts are net of provision for (benefit from) income taxes of $172 million and $(68) million for the quarters ended June 30, 2012 and 2011, respectively, and $176 million and $(136) million for the six months ended June 30, 2012 and 2011, respectively.

(2) Amounts are net of provision for income taxes of $1 million for the quarter ended June 30, 2012, and $2 million and $2 million for the six months ended June 30, 2012 and 2011, respectively.

(3) Amounts are net of provision for income taxes of $30 million and $34 million for the quarters ended June 30, 2012 and 2011, respectively, and $17 million and $10 million for the six months ended June 30, 2012 and 2011, respectively.

(4) Amounts are net of provision for income taxes of $8 million and $4 million for the quarters ended June 30, 2012 and 2011, respectively, and $10 million for the six months ended June 30, 2012.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

Condensed Consolidated Statements of Cash Flows

(dollars in millions)

(unaudited)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 884	$ 2,536
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Loss on equity method investees	20	725
Compensation payable in common stock and options	618	728
Depreciation and amortization	793	759
Gain on business dispositions	(108)	
Gain on sale of securities available for sale	(23)	(94)
(Gain) loss on retirement of long-term debt	(27)	31
Impairment charges and other-than-temporary impairment charges	33	3
Changes in assets and liabilities:		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	36	(6,324)
Financial instruments owned, net of financial instruments sold, not yet purchased	41,351	22,984
Securities borrowed	(7,189)	6,638
Securities loaned	300	6,281
Receivables, loans and other assets	(15,192)	(6,271)
Payables and other liabilities	5,318	13,458
Federal funds sold and securities purchased under agreements to resell	(17,833)	(32,737)
Securities sold under agreements to repurchase	6,885	(13,891)
Net cash provided by (used for) operating activities	15,866	(5,174)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net proceeds from (payments for):		
Premises, equipment and software costs	(436)	(725)
Business dispositions, net of cash disposed	1,536	
Purchases of securities available for sale	(6,418)	(8,632)
Sales, maturities and redemptions of securities available for sale	5,439	14,245
Net cash provided by investing activities	121	4,888
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from (payments for):		
Commercial paper and other short-term borrowings	(855)	310
Distributions related to noncontrolling interests	(178)	(153)
Derivatives financing activities	128	146
Other secured financings	(4,822)	3,176
Deposits	2,590	1,713
Net proceeds from:		
Excess tax benefits associated with stock-based awards	42	29
Issuance of long-term borrowings	9,422	22,596
Payments for:		
Long-term borrowings	(26,445)	(24,192)
Repurchases of common stock for employee tax withholding	(191)	(283)
Cash dividends	(230)	(594)
Net cash provided by (used for) financing activities	(20,539)	2,748

Effect of exchange rate changes on cash and cash equivalents	(307)	416
Effect of cash and cash equivalents related to variable interest entities	(447)	254
Net increase (decrease) in cash and cash equivalents	(5,306)	3,132
Cash and cash equivalents, at beginning of period	47,312	47,615
Cash and cash equivalents, at end of period	$ 42,006	$ 50,747
Cash and cash equivalents include:		
Cash and due from banks	$ 12,408	$ 9,066
Interest bearing deposits with banks	29,598	41,681
Cash and cash equivalents, at end of period	$ 42,006	$ 50,747

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for interest were $2,404 million and $3,144 million for the six months ended June 30, 2012 and 2011, respectively.

Cash payments for income taxes were $220 million and $530 million for the six months ended June 30, 2012 and 2011, respectively.

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

Condensed Consolidated Statements of Changes in Total Equity

Six Months Ended June 30, 2012

(dollars in millions)

(unaudited)

	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non-controlling Interests	Total Equity
BALANCE AT DECEMBER 31, 2011	$ 1,508	$ 20	$ 22,836	$ 40,341	$ 3,166	$ (157)	$ (2,499)	$ (3,166)	$ 8,029	$ 70,078
Net income				497					387	884
Dividends				(252)						(252)
Shares issued under employee plans and related tax effects			315		32		486	(32)		801
Repurchases of common stock							(191)			(191)
Net change in cash flow hedges						3				3
Pension, postretirement and other related adjustments						14			5	19
Foreign currency translation adjustments						(102)			(29)	(131)
Change in net unrealized gains on securities available for sale						22				22
Other net increases in noncontrolling interests									404	404
BALANCE AT JUNE 30, 2012	$ 1,508	$ 20	$ 23,151	$ 40,586	$ 3,198	$ (220)	$ (2,204)	$ (3,198)	$ 8,796	$ 71,637

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

Condensed Consolidated Statements of Changes in Total Equity (Continued)

Six Months Ended June 30, 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
BALANCE AT DECEMBER 31, 2010	$ 9,597	$ 16	$ 13,521	$ 38,603	$ 3,465	$ (467)	$ (4,059)	$ (3,465)	$ 8,196	$ 65,407
Net income				2,161					375	2,536
Dividends				(401)						(401)
Shares issued under employee plans and related tax effects			(1,072)		(80)		1,858	80		786
Repurchases of common stock							(283)			(283)
Net change in cash flow hedges						4				4
Pension, postretirement and other related adjustments						7				7
Foreign currency translation adjustments						122			9	131
Change in net unrealized gains on securities available for sale						14				14
Other increase in equity method investments			86							86
MUFG stock conversion	(8,089)	4	9,811	(1,726)						
Other net decreases in noncontrolling interests									(144)	(144)
BALANCE AT JUNE 30, 2011	$ 1,508	$ 20	$ 22,346	$ 38,637	$ 3,385	$ (320)	$ (2,484)	$ (3,385)	$ 8,436	$ 68,143

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Introduction and Basis of Presentation.

The Company. Morgan Stanley, 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 and the term Parent means the parent company, Morgan Stanley.

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.

Discontinued Operations.

Saxon. On October 24, 2011, the Company announced that it had reached an agreement to sell Saxon, a provider of servicing and subservicing of residential mortgage loans, to Ocwen Financial Corporation. During the first quarter of 2012, the transaction was restructured as a sale of Saxon s assets, which was substantially completed in the second quarter of 2012. The remaining operations of Saxon are expected to be wound down within the year. The Company expects to incur incremental wind-down costs in future periods. The results of Saxon are reported as discontinued operations within the Institutional Securities business segment for all periods presented.

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

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 and intangible assets, compensation, deferred tax assets, the outcome of litigation and tax matters, and other matters that affect the condensed consolidated financial statements and related disclosures. The Company believes that the estimates utilized in the preparation of the condensed consolidated financial statements are prudent and reasonable. Actual results could differ materially from these estimates.

Intercompany balances and transactions have been eliminated.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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, 2011 (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 condensed 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 in 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 VIEs (i.e., entities that do not meet these criteria), the Company consolidates those entities where the Company has the power to make the decisions that most significantly affect the economic performance of the VIE and has the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE, except for certain VIEs that are money market funds, investment companies or are entities qualifying for accounting purposes as investment companies. Generally, the Company consolidates those entities when it absorbs a majority of the expected losses or a majority of the expected residual returns, or both, of the entities.

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

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 fees and interest income, along with the associated interest expense, as one integrated activity.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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, 2011 included in the Form 10-K.

During the six months ended June 30, 2012, other than the following, no other updates were made to the Company s significant accounting policies.

Financial Instruments and Fair Value Valuation Process.

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

The Company s control processes apply to financial instruments categorized in Level 1, Level 2 or Level 3 of the fair value hierarchy, unless otherwise noted. These control processes include:

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

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

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

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For financial instruments categorized within Level 3 of the fair value hierarchy, VRG reviews the business unit s valuation techniques to ensure these are consistent with market participant assumptions.

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

Review of New Level 3 Transactions. VRG reviews the model and valuation methodology used to price all new material Level 3 transactions and both FCG and MRD management must approve the fair value of the trade that is initially recognized.

Securities Available for Sale Other-than-temporary Impairment.

For available for sale (AFS) debt securities, a credit loss exists if the present value of cash flows expected to be collected is less than the amortized cost basis of the security. When determining if a credit loss exists, the Company considers all relevant information including the length of time and the extent to which the fair value has been less than the amortized cost basis; adverse conditions specifically related to the security, an industry, or geographic area; changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors; the historical and implied volatility of the fair value of the security; the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future; failure of the issuer of the security to make scheduled interest or principal payments; any changes to the rating of the security by a rating agency and recoveries or additional declines in fair value after the balance sheet date. When estimating the present value of expected cash flows, information shall include the remaining payment terms of the security, prepayment speeds, financial condition of the issuer(s), expected defaults and the value of any underlying collateral.

For AFS equity securities, the Company considers various factors including the intent and ability to hold the equity security for a period of time sufficient to allow for any anticipated recovery in market value in evaluating whether an other-than-temporary impairment (OTTI) exists. If the equity security is considered other-than-temporarily impaired, the security will be written down to fair value, with the full difference between fair value and cost recognized in earnings.

Condensed Consolidated Statements of Cash Flows.

For purposes of the condensed consolidated statements of cash flows, cash and cash equivalents consist of Cash and due from banks and Interest bearing deposits with banks, which are highly liquid investments with original maturities of three months or less and readily convertible to known amounts of cash, and are held for investment purposes. In the six months ended June 30, 2012, the Company s significant non-cash activities include approximately $2.4 billion and $1.0 billion, respectively of assets and liabilities disposed of, in connection with business dispositions. At June 30, 2011, Mitsubishi UFJ Financial Group, Inc. (MUFG) and the Company converted MUFG s outstanding Series B Non-Cumulative Non-Voting Perpetual Convertible Preferred Stock (Series B Preferred Stock) in the Company with a face value of $7.8 billion (carrying value $8.1 billion) into the Company s common stock. As a result of the adjustment to the conversion ratio, pursuant to the transaction agreement, the Company incurred a one-time, non-cash negative adjustment of approximately $1.7 billion in its calculation of basic and diluted earnings per share during the quarter and six months ended June 30, 2011 (see Note 14).

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounting Developments.

Reconsideration of Effective Control for Repurchase Agreements.

In April 2011, the Financial Accounting Standards Board (the FASB) issued accounting guidance that modifies the criteria that must be satisfied for a transfer of financial assets to be accounted for as a sale. If the transferor maintains effective control over the transferred assets, the transaction is to be accounted for as a financing. This guidance eliminates from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. This guidance is effective for transfers occurring on and after January 1, 2012. The adoption of this accounting guidance did not have a material impact on the Company s condensed consolidated financial statements.

Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS.

In May 2011, the FASB issued an accounting update that clarifies existing fair value measurement guidance and changes certain principles or requirements for measuring fair value or disclosing information about fair value measurements. This update results in common principles and requirements for measuring fair value and for disclosing information about fair value measurement in accordance with U.S. GAAP and International Financial Reporting Standards (IFRS). The guidance became effective for the Company beginning on January 1, 2012. See Note 3 for additional disclosures as required by this accounting guidance.

Goodwill Impairment Test.

In September 2011, the FASB issued accounting guidance that simplifies how entities test goodwill for impairment. This guidance allows entities an option to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Under that option, an entity no longer would be required to calculate the fair value of a reporting unit unless the entity determines, based on that qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. This guidance became effective for the Company beginning on January 1, 2012. 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

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Other Sovereign Government Obligations.

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

Corporate and Other Debt.

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

Residential Mortgage-Backed Securities (RMBS), Commercial Mortgage-Backed Securities (CMBS) and other Asset-Backed Securities (ABS). RMBS, CMBS and other ABS may be valued based on price or spread data obtained from observed transactions or independent external parties such as vendors or brokers. When position-specific external price data are not observable, the fair value determination may require benchmarking to similar instruments and/or analyzing expected credit losses, default and recovery rates. 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 position-specific external price data are not observable, fair value is determined based on either benchmarking to similar instruments or cash flow models with yield curves, bond or single name credit default swap spreads and recovery rates as significant inputs. Corporate bonds are generally categorized in Level 2 of the fair value hierarchy; in instances where prices, spreads or any of the other aforementioned key inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

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

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

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

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

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

ARS is determined using independent external market data where available and an internally developed methodology to discount for the lack of liquidity and non-performance risk.

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

Corporate Equities.

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

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

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

Derivative and Other Contracts.

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

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.

15

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

Investments.

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

After initial recognition, in determining the fair value of non-exchange-traded internally and externally managed funds, the Company generally considers the NAV of the fund provided by the fund manager to be the best estimate of fair value. For non-exchange-traded investments either held directly or held within internally managed funds, fair value after initial recognition is based on an assessment of each underlying

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

investment, considering rounds of financing and third-party transactions, discounted cash flow analyses and market-based information, including comparable company transactions, trading multiples and changes in market outlook, among other factors. Exchange-traded direct equity investments are generally valued based on quoted prices from the exchange.

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

Physical Commodities.

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

Securities Available for Sale.

Securities available for sale are composed of U.S. government and agency securities (*e.g.*, U.S. Treasury securities, agency-issued debt, agency mortgage pass-through securities and collateralized mortgage obligations), Federal Family Education Loan Program (FFELP) student loan asset-backed securities, auto loan asset-backed securities, corporate bonds and equity securities. Actively traded U.S. Treasury securities, non-callable agency-issued debt securities and equity securities are generally categorized in Level 1 of the fair value hierarchy. Callable agency-issued debt securities, agency mortgage pass-through securities, collateralized mortgage obligations and FFELP student loan asset-backed securities, auto loan asset-backed securities and corporate bonds are generally categorized in Level 2 of the fair value hierarchy. For further information on securities available for sale, see Note 4.

Deposits.

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

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

Structured Notes. The Company issues structured notes that have coupon or repayment terms linked to the performance of fixed income 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 prices. 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.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

The following fair value hierarchy tables present information about the Company s assets and liabilities measured at fair value on a recurring basis at June 30, 2012 and December 31, 2011.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2012.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at June 30, 2012
			(dollars in millions)		
Assets at Fair Value					
Financial instruments owned:					
U.S. government and agency securities:					
U.S. Treasury securities	$ 25,656	$	$	$	$ 25,656
U.S. agency securities	3,985	24,497			28,482
Total U.S. government and agency securities	29,641	24,497			54,138
Other sovereign government obligations	28,744	4,883	1		33,628
Corporate and other debt:					
State and municipal securities		2,799	3		2,802
Residential mortgage-backed securities		1,500	24		1,524
Commercial mortgage-backed securities		1,240	256		1,496
Asset-backed securities		965	9		974
Corporate bonds		18,142	745		18,887
Collateralized debt obligations		682	1,457		2,139
Loans and lending commitments		12,771	7,794		20,565
Other debt		9,357	13		9,370
Total corporate and other debt		47,456	10,301		57,757
Corporate equities(1)	44,200	1,664	482		46,346
Derivative and other contracts:					
Interest rate contracts	807	870,435	4,597		875,839
Credit contracts		92,251	9,213		101,464
Foreign exchange contracts	11	49,876	337		50,224
Equity contracts	1,493	42,578	834		44,905
Commodity contracts	6,324	24,654	2,539		33,517
Other		126			126
Netting(2)	(3,943)	(980,633)	(9,430)	(77,726)	(1,071,732)
Total derivative and other contracts	4,692	99,287	8,090	(77,726)	34,343
Investments:					
Private equity funds			2,005		2,005
Real estate funds		6	1,326		1,332
Hedge funds		349	533		882
Principal investments	118	93	3,047		3,258
Other	143	66	543		752
Total investments	261	514	7,454		8,229
Physical commodities		6,141			6,141

Total financial instruments owned	107,538	184,442	26,328	(77,726)	240,582
Securities available for sale	11,561	19,881			31,442
Securities received as collateral	12,126	24			12,150
Federal funds sold and securities purchased under agreements to resell		622			622
Intangible assets(3)			8		8
Total assets measured at fair value	$ 131,225	$ 204,969	$ 26,336	$ (77,726)	$ 284,804

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at June 30, 2012
			(dollars in millions)		
Liabilities at Fair Value					
Deposits	$	$ 1,965	$	$	$ 1,965
Commercial paper and other short-term borrowings		838	2		840
Financial instruments sold, not yet purchased:					
U.S. government and agency securities:					
U.S. Treasury securities	26,197				26,197
U.S. agency securities	1,421	152			1,573
Total U.S. government and agency securities	27,618	152			27,770
Other sovereign government obligations	20,863	1,345			22,208
Corporate and other debt:					
State and municipal securities		7			7
Residential mortgage-backed securities		8	4		12
Corporate bonds		7,570	127		7,697
Collateralized debt obligations		159	1		160
Unfunded lending commitments		866	51		917
Other debt		185	63		248
Total corporate and other debt		8,795	246		9,041
Corporate equities(1)	28,695	779	47		29,521
Derivative and other contracts:					
Interest rate contracts	859	840,040	4,769		845,668
Credit contracts		90,845	5,371		96,216
Foreign exchange contracts	14	53,049	561		53,624
Equity contracts	1,530	45,501	2,007		49,038
Commodity contracts	7,352	24,582	1,602		33,536
Other		43	27		70
Netting(2)	(3,943)	(980,633)	(9,430)	(49,211)	(1,043,217)
Total derivative and other contracts	5,812	73,427	4,907	(49,211)	34,935
Total financial instruments sold, not yet purchased	82,988	84,498	5,200	(49,211)	123,475
Obligation to return securities received as collateral	17,047	31			17,078
Securities sold under agreements to repurchase		161	185		346
Other secured financings		8,766	470		9,236
Long-term borrowings	1	40,271	2,210		42,482
Total liabilities measured at fair value	$ 100,036	$ 136,530	$ 8,067	$ (49,211)	$ 195,422

(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 June 30, 2012.

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

Financial instruments owned Derivative and other contracts and Financial instruments sold, not yet purchased Derivative and other contracts. During the quarter ended June 30, 2012, the Company reclassified approximately $1.5 billion of derivative assets and approximately $1.7 billion of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange. Also during the quarter ended June 30, 2012, the Company reclassified approximately $0.5

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

billion of derivative assets and approximately $0.7 billion of derivative liabilities from Level 1 to Level 2 as transactions in these contracts did not occur with sufficient frequency and volume to constitute an active market.

Transfers Between Level 1 and Level 2 During the Six Months Ended June 30, 2012.

Financial instruments owned Derivative and other contracts and Financial instruments sold, not yet purchased Derivative and other contracts. During the six months ended June 30, 2012, the Company reclassified approximately $2.0 billion of derivative assets and approximately $1.8 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. Also during the six months ended June 30, 2012, the Company reclassified approximately $0.4 billion of derivative assets and approximately $0.4 billion of derivative liabilities from Level 1 to Level 2 as transactions in these contracts did not occur with sufficient frequency and volume to constitute an active market.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at December 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 December 31, 2011
			(dollars in millions)		
Assets at Fair Value					
Financial instruments owned:					
U.S. government and agency securities:					
U.S. Treasury securities	$ 38,769	$ 1	$	$	$ 38,770
U.S. agency securities	4,332	20,339	8		24,679
Total U.S. government and agency securities	43,101	20,340	8		63,449
Other sovereign government obligations	22,650	6,290	119		29,059
Corporate and other debt:					
State and municipal securities		2,261			2,261
Residential mortgage-backed securities		1,304	494		1,798
Commercial mortgage-backed securities		1,686	134		1,820
Asset-backed securities		937	31		968
Corporate bonds		25,873	675		26,548
Collateralized debt obligations		1,711	980		2,691
Loans and lending commitments		14,854	9,590		24,444
Other debt		8,265	128		8,393
Total corporate and other debt		56,891	12,032		68,923
Corporate equities(1)	45,173	2,376	417		47,966
Derivative and other contracts:					
Interest rate contracts	1,493	906,082	5,301		912,876
Credit contracts		123,689	15,102		138,791
Foreign exchange contracts		61,770	573		62,343
Equity contracts	929	44,558	800		46,287
Commodity contracts	6,356	31,246	2,176		39,778
Other		292	306		598
Netting(2)	(7,596)	(1,045,912)	(11,837)	(87,264)	(1,152,609)
Total derivative and other contracts	1,182	121,725	12,421	(87,264)	48,064
Investments:					
Private equity funds		7	1,936		1,943
Real estate funds		5	1,213		1,218
Hedge funds		473	696		1,169
Principal investments	161	104	2,937		3,202
Other	141	21	501		663
Total investments	302	610	7,283		8,195
Physical commodities		9,651	46		9,697

Total financial instruments owned	112,408	217,883	32,326	(87,264)	275,353
Securities available for sale	13,437	17,058			30,495
Securities received as collateral	11,530	121			11,651
Federal funds sold and securities purchased under agreements to resell		112			112
Intangible assets(3)			133		133
Total assets measured at fair value	$ 137,375	$ 235,174	$ 32,459	$ (87,264)	$ 317,744

22

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at December 31, 2011
			(dollars in millions)		
Liabilities at Fair Value					
Deposits	$	$ 2,101	$	$	$ 2,101
Commercial paper and other short-term borrowings		1,337	2		1,339
Financial instruments sold, not yet purchased:					
U.S. government and agency securities:					
U.S. Treasury securities	17,776				17,776
U.S. agency securities	1,748	106			1,854
Total U.S. government and agency securities	19,524	106			19,630
Other sovereign government obligations	14,981	2,152	8		17,141
Corporate and other debt:					
State and municipal securities		3			3
Residential mortgage-backed securities			355		355
Commercial mortgage-backed securities		14			14
Corporate bonds		6,217	219		6,436
Collateralized debt obligations		3			3
Unfunded lending commitments		1,284	85		1,369
Other debt		157	73		230
Total corporate and other debt		7,678	732		8,410
Corporate equities(1)	24,347	149	1		24,497
Derivative and other contracts:					
Interest rate contracts	1,680	873,466	4,881		880,027
Credit contracts		121,438	9,288		130,726
Foreign exchange contracts		64,218	530		64,748
Equity contracts	877	45,375	2,034		48,286
Commodity contracts	7,144	31,248	1,606		39,998
Other		879	1,396		2,275
Netting(2)	(7,596)	(1,045,912)	(11,837)	(54,262)	(1,119,607)
Total derivative and other contracts	2,105	90,712	7,898	(54,262)	46,453
Physical commodities		16			16
Total financial instruments sold, not yet purchased	60,957	100,813	8,639	(54,262)	116,147
Obligation to return securities received as collateral	15,267	127			15,394
Securities sold under agreements to repurchase		8	340		348
Other secured financings		14,024	570		14,594
Long-term borrowings	10	38,050	1,603		39,663
Total liabilities measured at fair value	$ 76,234	$ 156,460	$ 11,154	$ (54,262)	$ 189,586

(1) The Company holds or sells short for trading purposes equity securities issued by entities in diverse industries and of varying size.
(2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 10.
(3) Amount represents MSRs accounted for at fair value. See Note 6 for further information on MSRs.

Transfers Between Level 1 and Level 2 During the Quarter Ended June 30, 2011.

Financial instruments owned Derivative and other contracts and Financial instruments sold, not yet purchased Derivative and other contracts. During the quarter ended June 30, 2011, the Company reclassified approximately $0.9 billion of derivative assets and approximately $1.3 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.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Transfers Between Level 1 and Level 2 During the Six Months Ended June 30, 2011.

Financial instruments owned Derivative and other contracts and Financial instruments sold, not yet purchased Derivative and other contracts. During the six months ended June 30, 2011, the Company reclassified approximately $1.1 billion of derivative assets and approximately $0.9 billion of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on quoted prices from the exchange.

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

The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter and six months ended June 30, 2012 and 2011, respectively. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realized and unrealized gains (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realized and unrealized gains (losses) on hedging instruments that have been classified by the Company within the Level 1 and/or Level 2 categories.

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

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

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Quarter Ended June 30, 2012.

	Beginning Balance at March 31, 2012	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at June 30, 2012	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2012(2)
	(dollars in millions)								
Assets at Fair Value									
Financial instruments owned:									
U.S. agency securities	$ 23	$	$	$ (23)	$	$	$	$	$
Other sovereign government obligations	8		1	(1)			(7)	1	
Corporate and other debt:									
State and municipal securities	3	1		(1)				3	
Residential mortgage-backed securities	43	(6)	17	(33)			3	24	(23)
Commercial mortgage-backed securities	127	(3)	146	(12)			(2)	256	1
Asset-backed securities	3	(1)	8	(1)				9	(1)
Corporate bonds	899	(39)	277	(428)			36	745	(27)
Collateralized debt obligations	1,165	20	509	(241)			4	1,457	(10)
Loans and lending commitments	8,597	(126)	326	(1,320)		(580)	897	7,794	(173)
Other debt	57	(2)	14	(56)				13	(5)
Total corporate and other debt	10,894	(156)	1,297	(2,092)		(580)	938	10,301	(238)
Corporate equities	554	34	(14)	(45)			(47)	482	2
Net derivative and other contracts(3):									
Interest rate contracts	22	(35)	158		(235)	59	(141)	(172)	17
Credit contracts	4,381	340	19		(401)	(272)	(225)	3,842	181
Foreign exchange contracts	66	(103)				(187)		(224)	(147)
Equity contracts	(1,442)	218	31	(2)	(33)	15	40	(1,173)	213
Commodity contracts	803	142				(9)	1	937	89
Other	(23)					(4)		(27)	
Total net derivative and other contracts	3,807	562	208	(2)	(669)	(398)	(325)	3,183	353
Investments:									
Private equity funds	1,994	15	50	(54)				2,005	7
Real estate funds	1,338	12	30	(54)				1,326	10
Hedge funds	623	(23)	6	(25)			(48)	533	(23)
Principal investments	3,194	(9)	51	(80)			(109)	3,047	(22)
Other	527	23	19	(23)			(3)	543	21
Total investments	7,676	18	156	(236)			(160)	7,454	(7)
Intangible assets	99	(5)		(84)		(2)		8	(4)
Liabilities at Fair Value									
Commercial paper and other short-term borrowings	$ 15	$	$	$	$	$ (13)	$	$ 2	$
Other sovereign government obligations	1		(1)						

Financial instruments sold, not yet purchased:									
Corporate and other debt:									
Residential mortgage-backed securities	61	57						4	57
Corporate bonds	193	32	(164)	139			(9)	127	59
Collateralized debt obligations			(1)	2				1	
Unfunded lending commitments	60	9						51	9
Other debt	33	16	(2)	48				63	16
Total corporate and other debt	347	114	(167)	189			(9)	246	141
Corporate equities	2	(27)	(13)	25			6	47	(26)
Obligation to return securities									
Securities sold under agreements to repurchase	186	1						185	1
Other secured financings	594	(4)			41	(152)	(17)	470	(4)
Long-term borrowings	2,143	(59)			315	(284)	(23)	2,210	(146)

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(1) Total realized and unrealized gains (losses) are primarily included in Principal transactions Trading in the condensed consolidated statements of income except for $18 million related to Financial instruments owned Investments, which is included in Principal transactions Investments.
(2) Amounts represent unrealized gains (losses) for the quarter ended June 30, 2012 related to assets and liabilities still outstanding at June 30, 2012.
(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.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Six Months Ended June 30, 2012.

	Beginning Balance at December 31, 2011	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at June 30, 2012	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2012(2)
	(dollars in millions)								
Assets at Fair Value									
Financial instruments owned:									
U.S. agency securities	$ 8	$	$	$ (7)	$	$	$ (1)	$	$
Other sovereign government obligations	119		1	(118)			(1)	1	
Corporate and other debt:									
State and municipal securities		1		(1)			3	3	1
Residential mortgage-backed securities	494	(27)	3	(265)			(181)	24	(61)
Commercial mortgage-backed securities	134	25	138	(37)		(1)	(3)	256	23
Asset-backed securities	31		8	(29)			(1)	9	(1)
Corporate bonds	675	6	331	(391)			124	745	(8)
Collateralized debt obligations	980	137	725	(335)			(50)	1,457	52
Loans and lending commitments	9,590	(168)	1,410	(2,269)		(695)	(74)	7,794	(312)
Other debt	128	(7)	32	(158)			18	13	(12)
Total corporate and other debt	12,032	(33)	2,647	(3,485)		(696)	(164)	10,301	(318)
Corporate equities	417	(13)	215	(149)			12	482	(20)
Net derivative and other contracts(3):									
Interest rate contracts	420	(28)	164		(240)	37	(525)	(172)	62
Credit contracts	5,814	(1,083)	81		(411)	(267)	(292)	3,842	(1,539)
Foreign exchange contracts	43	(40)				(207)	(20)	(224)	(102)
Equity contracts	(1,234)	117	211	(1)	(74)	(244)	52	(1,173)	102
Commodity contracts	570	320	5		(4)	34	12	937	338
Other	(1,090)	59				264	740	(27)	57
Total net derivative and other contracts	4,523	(655)	461	(1)	(729)	(383)	(33)	3,183	(1,082)
Investments:									
Private equity funds	1,936	15	143	(89)				2,005	(5)
Real estate funds	1,213	64	117	(68)				1,326	148
Hedge funds	696	(1)	24	(58)			(128)	533	1
Principal investments	2,937	24	230	(144)				3,047	(17)
Other	501	(12)	52	(24)			26	543	(18)
Total investments	7,283	90	566	(383)			(102)	7,454	109
Physical commodities	46					(46)			

Intangible assets	133	(39)	(84)	(2)	8	(8)

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Beginning Balance at December 31, 2011	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at June 30, 2012	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2012(2)
					(dollars in millions)				
Liabilities at Fair Value									
Commercial paper and other short-term borrowings	$ 2	$	$	$	$	$	$	$ 2	$
Financial instruments sold, not yet purchased:									
Other sovereign government obligations	8		(8)	1			(1)		
Corporate and other debt:									
Residential mortgage-backed securities	355	(4)	(355)					4	(4)
Corporate bonds	219	(25)	(203)	111			(25)	127	49
Collateralized debt obligations							1	1	
Unfunded lending commitments	85	34						51	34
Other debt	73	11	(1)	46		(55)	11	63	13
Total corporate and other debt	732	16	(559)	157		(55)	(13)	246	92
Corporate equities	1	(21)		27			(2)	47	(53)
Securities sold under agreements to repurchase	340	3					(152)	185	3
Other secured financings	570	(19)			52	(149)	(22)	470	(19)
Long-term borrowings	1,603	(190)			444	(102)	75	2,210	(214)

(1) Total realized and unrealized gains (losses) are primarily included in Principal transactions Trading in the condensed consolidated statements of income except for $90 million related to Financial instruments owned Investments, which is included in Principal transactions Investments.
(2) Amounts represent unrealized gains (losses) for the six months ended June 30, 2012 related to assets and liabilities still outstanding at June 30, 2012.
(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 Net derivative and other contracts. The net loss in Net derivative and other contracts was primarily driven by tightening of credit spreads on underlying reference entities of basket credit default swaps.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Quarter Ended June 30, 2011.

	Beginning Balance at March 31, 2011	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at June 30, 2011	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2011(2)
					(dollars in millions)				
Assets at Fair Value									
Financial instruments owned:									
U.S. agency securities	$ 57	$ 1	$ 29	$ (72)	$	$	$ (13)	$ 2	$
Other sovereign government obligations	126	9		(4)			1	132	9
Corporate and other debt:									
State and municipal securities	4		21	(25)					
Residential mortgage-backed securities	361	(10)	101	(54)			111	509	
Commercial mortgage-backed securities	132	(21)	81	(10)			(46)	136	(1)
Asset-backed securities		259	4				35	298	259
Corporate bonds	1,366	(93)	216	(353)			43	1,179	(57)
Collateralized debt obligations	1,593	17	357	(352)		(19)	54	1,650	14
Loans and lending commitments	11,218	(168)	1,898	(676)		(1,285)	(567)	10,420	(236)
Other debt	165	5	6	(13)				163	1
Total corporate and other debt	14,839	(11)	2,684	(1,483)		(1,304)	(370)	14,355	(20)
Corporate equities	502	11	127	(144)			(35)	461	24
Net derivative and other contracts(3):									
Interest rate contracts	(58)	472	22		(45)	(62)	(12)	317	376
Credit contracts	6,079	1,002	1,089		(109)	(737)	68	7,392	958
Foreign exchange contracts	46	(34)	2			30		44	(39)
Equity contracts	(645)	58	77	(7)	(1,163)	52	(33)	(1,661)	60
Commodity contracts	330	(129)	330		(146)	(99)	30	316	(139)
Other	(508)	(74)	2		(112)	296	(1)	(397)	(81)
Total net derivative and other contracts	5,244	1,295	1,522	(7)	(1,575)	(520)	52	6,011	1,135
Investments:									
Private equity funds	2,006	153	91	(90)				2,160	129
Real estate funds	1,251	81	17	(59)				1,290	148
Hedge funds	871	(17)	20	(120)			73	827	(17)
Principal investments	3,057	182	75	(108)			(86)	3,120	(15)
Other	398	2	2	(3)			126	525	(2)
Total investments	7,583	401	205	(380)			113	7,922	243

Physical commodities		(48)	721		673	(48)
Intangible assets	144	(11)	1	(1)	133	(11)

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Beginning Balance at March 31, 2011	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at June 30, 2011	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2011(2)
					(dollars in millions)				
Liabilities at Fair Value									
Commercial paper and other short-term borrowings	$ 4	$ 7	$	$	$ 29	$ (3)	$	$ 23	$ 7
Financial instruments sold, not yet purchased:									
Corporate and other debt:									
Residential mortgage-backed securities		(13)	(13)	41				41	(13)
Corporate bonds	150	49	(324)	336			(78)	35	60
Collateralized debt obligations	2		(1)				(1)		
Unfunded lending commitments	171	(69)						240	(69)
Other debt	180	13		13			(2)	178	13
Total corporate and other debt	503	(20)	(338)	390			(81)	494	(9)
Corporate equities	9	13	(8)	12			1	1	3
Securities sold under agreements to repurchase	352	(5)			1			358	(5)
Other secured financings	605	(9)			145	(17)		742	(9)
Long-term borrowings	1,374	38			215	(175)	(125)	1,251	20

(1) Total realized and unrealized gains (losses) are primarily included in Principal transactions Trading in the condensed consolidated statements of income except for $401 million related to Financial instruments owned Investments, which is included in Principal transactions Investments.
(2) Amounts represent unrealized gains (losses) for the quarter ended June 30, 2011 related to assets and liabilities still outstanding at June 30, 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 June 30, 2011, the Company reclassified approximately $1.2 billion of certain Corporate and other debt, primarily corporate loans, from Level 3 to Level 2. The Company reclassified the corporate loans as external prices and/or spread inputs for these instruments became observable.

The Company also reclassified approximately $0.8 billion of certain Corporate and other debt from Level 2 to Level 3. The 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.

30

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Six Months Ended June 30, 2011.

	Beginning Balance at December 31, 2010	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at June 30, 2011	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2011(2)
					(dollars in millions)				
Assets at Fair Value									
Financial instruments owned:									
U.S. agency securities	$ 13	$	$ 34	$ (40)	$	$	$ (5)	$ 2	$
Other sovereign government obligations	73	8	56				(5)	132	8
Corporate and other debt:									
State and municipal securities	110	(1)		(96)			(13)		
Residential mortgage-backed securities	319	(62)	279	(193)		(1)	167	509	(71)
Commercial mortgage-backed securities	188	(19)	96	(30)			(99)	136	(18)
Asset-backed securities	13	259	13	(17)			30	298	258
Corporate bonds	1,368	(26)	273	(409)		34	(61)	1,179	42
Collateralized debt obligations	1,659	273	641	(862)		(55)	(6)	1,650	70
Loans and lending commitments	11,666	213	2,321	(537)		(2,038)	(1,205)	10,420	212
Other debt	193		5	(33)			(2)	163	(9)
Total corporate and other debt	15,516	637	3,628	(2,177)		(2,060)	(1,189)	14,355	484
Corporate equities	484	(207)	219	(176)			141	461	1
Net derivative and other contracts(3):									
Interest rate contracts	424	702	19		(704)	(192)	68	317	600
Credit contracts	6,594	388	1,148		(197)	(614)	73	7,392	772
Foreign exchange contracts	46	(159)	1			159	(3)	44	(130)
Equity contracts	(762)	105	119		(1,236)	98	15	(1,661)	96
Commodity contracts	188	165	455		(321)	(281)	110	316	153
Other	(913)	117	2		(116)	428	85	(397)	110
Total net derivative and other contracts	5,577	1,318	1,744		(2,574)	(402)	348	6,011	1,601
Investments:									
Private equity funds	1,986	260	88	(245)			71	2,160	209
Real estate funds	1,176	145	31	(62)				1,290	255
Hedge funds	901	(25)	15	(172)			108	827	(25)
Principal investments	3,131	242	(26)	(195)			(32)	3,120	(105)
Other	560	51	(4)	(11)			(71)	525	41
Total investments	7,754	673	104	(685)			76	7,922	375
Physical commodities		(48)	721					673	(48)

Securities received as collateral	1			(1)					
Intangible assets	157	(26)	5	(1)	(1)	(1)		133	(26)

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Beginning Balance at December 31, 2010	Total Realized and Unrealized Gains (Losses)(1)	Purchases	Sales	Issuances	Settlements	Net Transfers	Ending Balance at June 30, 2011	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at June 30, 2011(2)
					(dollars in millions)				
Liabilities at Fair Value									
Deposits	$ 16	$ 2	$	$	$	$ (14)	$	$	$
Commercial paper and other short-term borrowings	2	7			29	(1)		23	7
Financial instruments sold, not yet purchased:									
Corporate and other debt:									
Residential mortgage-backed securities		(13)	(12)	40				41	(13)
Commercial mortgage-backed securities		1		1					
Corporate bonds	44	40	(367)	426			(28)	35	30
Unfunded lending commitments	263	23						240	23
Other debt	194	4	(10)	14			(16)	178	4
Total corporate and other debt	501	55	(389)	481			(44)	494	44
Corporate equities	15	5	(19)	6			4	1	3
Obligation to return securities received as collateral	1		(1)						
Securities sold under agreements to repurchase	351	(6)	1					358	(8)
Other secured financings	1,016	(12)			142	(122)	(306)	742	(12)
Long-term borrowings	1,316	(28)			388	(342)	(139)	1,251	(22)

(1) Total realized and unrealized gains (losses) are primarily included in Principal transactions Trading in the condensed consolidated statements of income except for $673 million related to Financial instruments owned Investments, which is included in Principal transactions Investments.

(2) Amounts represent unrealized gains (losses) for the six months ended June 30, 2011 related to assets and liabilities still outstanding at June 30, 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 six months ended June 30, 2011, the Company reclassified approximately $1.8 billion of certain Corporate and other debt, primarily corporate loans, from Level 3 to Level 2. The Company reclassified these corporate loans as external prices and/or spread inputs for these instruments became observable.

The Company also reclassified approximately $0.6 billion of certain Corporate and other debt from Level 2 to Level 3. The 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.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Quantitative Information about and Sensitivity of Significant Unobservable Inputs used in Recurring Level 3 Fair Value Measurements at June 30, 2012

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

	Balance at June 30, 2012 (dollars in millions)	Valuation Technique(s)	Significant Unobservable Input(s) / Sensitivity of the Fair Value to Changes in the Unobservable Inputs	Range(1)
Assets				
Financial instruments owned:				
Corporate and other debt:				
Commercial mortgage-backed securities	$ 256	Comparable pricing(2)	Comparable bond price / (A)	40 to 98 points
Corporate bonds	745	Comparable pricing(2)	Comparable bond price / (A)	2 to 138 points
Collateralized debt obligations	1,457	Comparable pricing(2)	Comparable bond price / (A)	16 to 84 points
		Correlation model	Credit correlation / (B)	25 to 58%
Loans and lending commitments	7,794	Corporate loan model	Credit spread / (C)	33 to 1,255 basis points
		Option model	At the money volatility / (C)	45 to 47%
		Comparable pricing(2)	Comparable loan price / (A)	55 to 100 points
Corporate equities(3)	482	Net asset value	Discount to net asset value /(C)	0 to 33%
		Discounted cash flow	Implied weighted average cost of capital / (C)	10 to 18%
		Market approach	Earnings before interest, taxes, depreciation and amortization (EBITDA) multiple / (A)	3 to 21 times
Net derivative and other contracts:				
Interest rate contracts	(172)	Option model	Interest rate volatility concentration liquidity multiple / (C)(D)	0 to 12 times
			Interest rate volatility skew / (A)(D)	15 to 90%
Credit contracts	3,842	Comparable pricing(2)	Cash synthetic basis / (C)	2 to 10 points
			Comparable bond price / (C)	3 to 75 points
		Correlation model	Credit correlation / (B)	21 to 94%
Foreign exchange contracts(4)	(224)	Option model	Comparable bond price / (A)(D)	5 to 96 points
			Interest rate quanto correlation / (A)(D)	-14 to 24%
			Interest rate - credit spread correlation / (A)(D)	-2 to 46%
			Interest rate - Foreign exchange correlation / (A)(D)	25 to 67%
			Interest rate volatility skew / (A)(D)	15 to 90%
Equity contracts(4)	(1,173)	Option model	At the money volatility / (C)(D)	2 to 32%
			Volatility skew / (C)(D)	-5 to 0%
			Equity - Equity correlation / (C)(D)	40 to 96%
			Equity - Foreign exchange correlation / (C)(D)	-45 to 50%
			Equity - Interest rate correlation / (C)(D)	-62 to 79%
Commodity contracts	937	Option model	Forward power price / (C)(D)	$34 to $ 80 per Megawatt hour
			Commodity volatility / (A)(D)	20 to 100%
			Cross commodity correlation / (C)(D)	49 to 91%

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Balance at June 30, 2012 (dollars in millions)	Valuation Technique(s)	Significant Unobservable Input(s) / Sensitivity of the Fair Value to Changes in the Unobservable Inputs	Range(1)
Investments (3):				
Principal investments	3,047	Discounted cash flow	Implied weighted average cost of capital / (C)(D)	9 to 18%
			Exit multiple / (A)(D)	5 to 10 times
		Discounted cash flow	Capitalization rate / (C)(D)	5 to 10%
			Equity discount rate / (C)(D)	15 to 35%
		Market approach	EBITDA multiple / (A)	3 to 10 times
Other	543	Discounted cash flow	Implied weighted average cost of capital / (C)(D)	12 to 17%
			Exit multiple / (A)(D)	5 to 10 times
		Market approach	EBITDA multiple / (A)	3 to 14 times
Liabilities				
Financial instruments sold, not yet purchased:				
Corporate and other debt:				
Corporate bonds	$ 127	Comparable pricing(2)	Comparable bond price /(A)	5 to 125 points
Unfunded lending commitments	51	Corporate loan model	Credit spread / (C)	43 to 887 basis points
Other debt	63	Comparable pricing(2)	Comparable bond price /(A)	100 points
			Comparable bond price /(C)	2 to 10 points
Securities sold under agreements to repurchase	185	Discounted cash flow	Funding spread / (A)	95 to 362 basis points
Other secured financings	470	Comparable pricing(2)	Comparable bond price /(A)	86 to 138 points
		Discounted cash flow	Funding spread / (A)	314 to 325 basis points
Long-term borrowings	2,210	Option model	At the money volatility /(A)(D)	10 to 15%
			Volatility skew / (A)(D)	-2 to 0%
			Equity - Equity correlation / (C)(D)	50 to 97%
			Equity - Foreign exchange correlation / (A)(D)	-70 to -15%

(1) The ranges of significant unobservable inputs are represented in points, percentages, basis points, times or megawatt hours. Points are a percentage of par; for example, 98 points would be 98% of par. A basis point equals 1/100th of 1%; for example, 1,255 basis points would equal 12.55%.
(2) Prices for the identical instrument are not available and significant subjectivity may be involved when fair value is determined using pricing data available for comparable instruments.
(3) Investments in funds measured using an unadjusted net asset value are excluded.
(4) Includes derivative contracts with multiple risks (i.e., hybrid products).

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

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

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fair Value of Investments that Calculate Net Asset Value.

The Company s Investments measured at fair value were $8,229 million and $8,195 million at June 30, 2012 and December 31, 2011, 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 June 30, 2012 and December 31, 2011, respectively.

	At June 30, 2012		At December 31, 2011	
	Fair Value	Unfunded Commitment	Fair Value	Unfunded Commitment
	(dollars in millions)			
Private equity funds	$ 2,005	$ 765	$ 1,906	$ 938
Real estate funds	1,332	261	1,188	448
Hedge funds(1):				
Long-short equity hedge funds	472		545	5
Fixed income/credit-related hedge funds	22		124	
Event-driven hedge funds	62		163	
Multi-strategy hedge funds	326	2	335	
Total	$ 4,219	$ 1,028	$ 4,261	$ 1,391

(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 June 30, 2012, approximately 37% of the fair value amount of long-short equity hedge funds is redeemable at least quarterly, 36% 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 at June 30, 2012 is primarily greater than six months. At December 31, 2011, approximately 38% of the fair value amount of long-short equity hedge funds is redeemable at least quarterly, 32% is redeemable every six months and 30% of these funds have a redemption frequency of greater than six months. The notice period for long-short equity hedge funds at December 31, 2011 is primarily greater than six months.

Private Equity Funds. Amount includes several private equity funds that pursue multiple strategies including leveraged buyouts, venture capital, infrastructure growth capital, distressed investments, and mezzanine capital. In addition, the funds may be structured with a focus on specific domestic or foreign geographic regions. These investments are generally not redeemable with the funds. Instead, the nature of the investments in this category is that distributions are received through the liquidation of the underlying assets of the fund. At June 30, 2012, it is estimated that 6% of the fair value of the funds will be liquidated in the next five years, another 31% of the fair value of the funds will be liquidated between five to 10 years and the remaining 63% 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 June 30, 2012, it is estimated that 4% of the fair value of the funds will be liquidated within the next five years, another 41% of the fair value of the funds will be liquidated between five to 10 years and the remaining 55% 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.

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 9% of the fair value of the investments in this category cannot be redeemed currently because the investments include certain initial period lock-up restrictions. The remaining restriction period for these investments subject to lock-up restrictions was three years or less at June 30, 2012. Investments representing approximately 7% of the fair value of the investments in long-short equity hedge funds cannot be redeemed currently because an exit restriction has been imposed by the hedge fund manager. The restriction period for these investments subject to an exit restriction was primarily one year or less at June 30, 2012.

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 June 30, 2012, 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 subject to lock-up restrictions was primarily one year or less at June 30, 2012.

Event-Driven Hedge Funds. Amount includes investments in hedge funds that invest in event-driven situations such as mergers, hostile takeovers, reorganizations, or leveraged buyouts. This may involve the simultaneous purchase of stock in companies being acquired and the sale of stock in its acquirer, with the expectation to profit from the spread between the current market price and the ultimate purchase price of the target company. At June 30, 2012, there were no restrictions on redemptions.

Multi-strategy Hedge Funds. Amount includes investments in hedge funds that pursue multiple strategies to realize short- and long-term gains. Management of the hedge funds has the ability to overweight or underweight different strategies to best capitalize on current investment opportunities. At June 30, 2012, investments representing approximately 70% of the fair value of the investments in this category cannot be redeemed currently because the investments include certain initial period lock-up restrictions. The remaining restriction period for these investments subject to lock-up restrictions was primarily two years or less at June 30, 2012.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fair Value Option.

The Company elected the fair value option for certain eligible instruments that are risk managed on a fair value basis to mitigate income statement volatility caused by measurement basis differences between the elected instruments and their associated risk management transactions or to eliminate complexities of applying certain accounting models. The following tables present net gains (losses) due to changes in fair value for items measured at fair value pursuant to the fair value option election for the quarters and six months ended June 30, 2012 and 2011, respectively.

	Principal Transactions-Trading	Interest Income (Expense) (dollars in millions)	Gains (Losses) Included in Net Revenues
Three Months Ended June 30, 2012			
Federal funds sold and securities purchased under agreements to resell	$ 12	$ 1	$ 13
Deposits	15	(22)	(7)
Commercial paper and other short-term borrowings(1)	211		211
Securities sold under agreements to repurchase	5	(1)	4
Long-term borrowings(1)	1,300	(325)	975
Six Months Ended June 30, 2012			
Federal funds sold and securities purchased under agreements to resell	$ 8	$ 2	$ 10
Deposits	25	(44)	(19)
Commercial paper and other short-term borrowings(1)	82		82
Securities sold under agreements to repurchase	3	(2)	1
Long-term borrowings(1)	(1,651)	(669)	(2,320)
Three Months Ended June 30, 2011			
Deposits	$ 18	$ (30)	$ (12)
Commercial paper and other short-term borrowings(2)	49		49
Securities sold under agreements to repurchase	2		2
Long-term borrowings(2)	(42)	(270)	(312)
Six Months Ended June 30, 2011			
Deposits	$ 31	$ (60)	$ (29)
Commercial paper and other short-term borrowings(2)	44		44
Securities sold under agreements to repurchase			
Long-term borrowings(2)	(1,308)	(560)	(1,868)

(1) Of the total gains (losses) recorded in Principal Transactions Trading for short-term and long-term borrowings for the quarter and six months ended June 30, 2012, $350 million and $(1,628) million, respectively, are attributable to changes in the credit quality of the Company and the respective remainder is attributable to changes in foreign currency rates or interest rates or movements in the reference price or index for structured notes, before the impact of related hedges.

(2) Of the total gains (losses) recorded in Principal Transactions Trading for short-term and long-term borrowings for the quarter and six months ended June 30, 2011, $244 million and $55 million, respectively, are attributable to changes in the credit quality of the Company and the respective remainder is attributable to changes in foreign currency rates or interest rates or movements in the reference price or index for structured notes, before the impact of related hedges.

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, 2011 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 amounts in the above table are included within Net revenues and do not reflect gains or losses on related hedging instruments, if any.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(dollars in millions)			
Short-term and long-term borrowings(1)	$ 350	$ 244	$ (1,628)	$ 55
Loans(2)	(119)	(146)	174	(108)
Unfunded lending commitments(3)	78	(223)	485	(213)

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

Net Difference between Contractual Principal Amount and Fair Value.

	Contractual Principal Amount Exceeds Fair Value	
	At June 30, 2012	At December 31, 2011
	(dollars in billions)	
Short-term and long-term borrowings(1)	$ 1.4	$ 2.5
Loans(2)	26.7	27.2
Loans 90 or more days past due and/or on non-accrual status(2)(3)	21.9	22.1

(1) These amounts do not include structured notes where the repayment of the initial principal amount fluctuates based on changes in the reference price or index.
(2) The majority of this difference between principal and fair value amounts emanates from the Company s distressed debt trading business, which purchases distressed debt at amounts well below par.
(3) The aggregate fair value of loans that were in non-accrual status, which includes all loans 90 or more days past due, was $1.3 billion and $2.0 billion at June 30, 2012 and December 31, 2011, respectively. The aggregate fair value of loans that were 90 or more days past due was $0.8 billion and $1.5 billion at June 30, 2012 and December 31, 2011, respectively.

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

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

Certain assets were measured at fair value on a non-recurring basis and are not included in the tables above. These assets may include loans, 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 and six months ended June 30, 2012 and 2011, respectively.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Three and Six Months Ended June 30, 2012.

	Carrying Value At June 30, 2012(1)	Fair Value Measurements Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses) for the Three Months Ended June 30, 2012(2)	Total Gains (Losses) for the Six Months Ended June 30, 2012(2)
	(dollars in millions)					
Loans(3)	$ 762	$	$ 146	$ 616	$ (13)	$ (19)
Other investments(4)	86			86	(7)	(8)
Premises, equipment and software costs(4)	1			1		(2)
Intangible assets(4)					(2)	(4)
Total	$ 849	$	$ 146	$ 703	$ (22)	$ (33)

(1) Carrying values relate only to those assets that had fair value adjustments during the quarter ended June 30, 2012. These amounts do not include assets that had fair value adjustments during the six months ended June 30, 2012, unless the assets also had a fair value adjustment during the quarter ended June 30, 2012.
(2) Losses are recorded within Other expenses in the condensed consolidated statement of income except for fair value adjustments related to Loans and losses related to Other investments, which are included in Other revenues.
(3) Non-recurring changes 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. The non-recurring change in fair value for mortgage loans held for sale is based upon a valuation model incorporating market observable inputs.
(4) Losses recorded were determined primarily using discounted cash flow models.

In addition to the losses included in the table above, there was a pre-tax gain of approximately $51 million (related to Other assets) included in discontinued operations in the six months ended June 30, 2012 in connection with the disposition of Saxon (see Notes 1 and 20). This pre-tax gain was primarily due to the subsequent increase in fair value of Saxon, which had incurred impairment losses of $98 million in the quarter ended December 31, 2011. The fair value of Saxon was determined based on the revised purchase price agreed upon with the buyer.

There were no liabilities measured at fair value on a non-recurring basis during the quarter and six months ended June 30, 2012.

Three Months and Six Month Ended June 30, 2011.

	Carrying Value At June 30, 2011(1)	Fair Value Measurements Using: Quoted Prices in Active Markets for Identical	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses) for the Three Months Ended June 30,	Total Gains (Losses) for the Six Months Ended June 30,

		Assets (Level 1)			2011(2)	2011(2)
				(dollars in millions)		
Loans(3)	$ 183	$	$ 92	$ 91	$ 3	$ 18
Other investments(4)	84			84	(20)	(28)
Intangible assets(5)						(3)
Total	$ 267	$	$ 92	$ 175	$ (17)	$ (13)

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(1) Carrying values relate only to those assets that had fair value adjustments during the quarter ended June 30, 2011. These amounts do not include assets that had fair value adjustments during the six months ended June 30, 2011, unless the assets also had a fair value adjustment during the quarter ended June 30, 2011.
(2) Losses are recorded within Other expenses in the condensed consolidated statement of income except for fair value adjustments related to Loans and losses related to Other investments, which are included in Other revenues.
(3) Non-recurring changes 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. The non-recurring change in fair value for mortgage loans held for sale is based upon a valuation model incorporating market observable inputs.
(4) Losses recorded were determined primarily using discounted cash flow models.
(5) Losses primarily related to investment management contracts and were determined primarily using discounted cash flow models.

There were no liabilities measured at fair value on a non-recurring basis during the quarter and six months ended June 30, 2011.

Financial Instruments Not Measured at Fair Value.

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

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

The fair value of sweep facilities whereby cash balances are swept into separate money market savings deposits and transaction accounts included within Deposits is determined using a standard cash flow discounting methodology.

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

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

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

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Financial Instruments Not Measured at Fair Value at June 30, 2012.

	At June 30, 2012		Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
			(dollars in millions)		
Financial Assets:					
Cash and due from banks	$ 12,408	$ 12,408	$ 12,408	$	$
Interest bearing deposits with banks	29,598	29,598	29,598		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	29,418	29,418	29,418		
Federal funds sold and securities purchased under agreements to resell	147,366	147,388		145,704	1,684
Securities borrowed	134,263	134,261		134,252	9
Receivables:(1)					
Customers	37,666	37,666		37,666	
Brokers, dealers and clearing organizations	9,107	9,107		9,107	
Fees, interest and other	6,256	6,074			6,074
Loans(2)	21,394	21,446		2,808	18,638
Financial Liabilities:					
Deposits	$ 66,287	$ 66,413	$	$ 66,413	$
Commercial paper and other short-term borrowings	1,148	1,148		860	288
Securities sold under agreements to repurchase	108,332	108,397		100,698	7,699
Securities loaned	30,762	29,896		28,890	1,006
Other secured financings	8,087	7,963		6,342	1,621
Payables:(1)					
Customers	119,455	119,455		119,455	
Brokers, dealers and clearing organizations	4,158	4,158		4,158	
Long-term borrowings	125,346	117,698		105,971	11,727

(1) Accrued interest, fees and dividend receivables and payables where carrying value approximates fair value have been excluded.
(2) Includes all loans measured at fair value on a non-recurring basis.

The fair value of the Company s unfunded lending commitments, primarily related to corporate lending in the Institutional Securities business segment, that are not carried at fair value at June 30, 2012 was $747 million, of which $560 million and $187 million would be categorized in Level 2 and Level 3 of the fair value hierarchy, respectively. The carrying value of these commitments, if fully funded, would be $39.5 billion. For a description of the Company s lending commitments, see Note 13 to the consolidated financial statements for the year ended December 31, 2011 included in the Form 10-K.

Table of Contents

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Securities Available for Sale.

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

	At June 30, 2012				
	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	$ 11,415	$ 142	$	$	$ 11,557
U.S. agency securities	15,450	112	6		15,556
Total U.S. government and agency securities	26,865	254	6		27,113
Corporate and other debt:					
Auto loan asset-backed securities	914	2			916
Corporate bonds	1,467	5	1		1,471
FFELP student loan asset-backed securities(1)	1,928	9			1,937
Total Corporate and other debt	4,309	16	1		4,324
Total debt securities available for sale	31,174	270	7		31,437
Equity securities available for sale	15		10		5
Total	$ 31,189	$ 270	$ 17	$	$ 31,442

(1) Amounts are backed by a guarantee from the U.S. Department of Education of at least 95% of the principal balance and interest on such loans.

	At December 31, 2011
	Amortized Cost