MORGAN STANLEY
Form 10-Q
November 08, 2010
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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 September 30, 2010

OR

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

EXCHANGE ACT OF 1934

Commission File Number 1-11758

(Exact Name of Registrant as specified in its charter)

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

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

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

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

Large Accelerated Filer x	Accelerated Filer ¨
Non-Accelerated Filer ¨	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 October 31, 2010, there were 1,512,877,397 shares of the Registrant s Common Stock, par value $0.01 per share, outstanding.

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QUARTERLY REPORT ON FORM 10-Q

For the quarter ended September 30, 2010

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AVAILABLE INFORMATION

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

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

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

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

Code of Conduct; and

Integrity Hotline information.

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

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Part I Financial Information.

Item 1. Financial Statements.

MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(dollars in millions, except share data)

(unaudited)

	September 30, 2010	December 31, 2009
Assets		
Cash and due from banks ($245 at September 30, 2010 related to consolidated variable interest entities generally not available to the Company)	$ 6,936	$ 6,988
Interest bearing deposits with banks	26,179	25,003
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	20,273	23,712
Financial instruments owned, at fair value (approximately $147 billion and $101 billion were pledged to various parties at September 30, 2010 and December 31, 2009, respectively):		
U.S. government and agency securities	64,823	62,215
Other sovereign government obligations	38,210	25,445
Corporate and other debt ($3,917 at September 30, 2010 related to consolidated variable interest entities, generally not available to the Company)	93,096	90,454
Corporate equities	61,835	57,968
Derivative and other contracts	57,054	49,081
Investments ($1,656 at September 30, 2010 related to consolidated variable interest entities, generally not available to the Company)	10,033	9,286
Physical commodities	6,668	5,329
Total financial instruments owned, at fair value	331,719	299,778
Securities available for sale	24,254	
Securities received as collateral, at fair value	17,062	13,656
Federal funds sold and securities purchased under agreements to resell	153,952	143,208
Securities borrowed	162,434	167,501
Receivables:		
Customers	33,140	27,594
Brokers, dealers and clearing organizations	9,866	5,719
Fees, interest and other	9,959	11,164
Loans	9,568	7,259
Other investments	5,712	3,752
Premises, equipment and software costs (net of accumulated depreciation of $4,322 and $3,734 at September 30, 2010 and December 31, 2009, respectively) ($485 at September 30, 2010 related to consolidated variable entities, generally not available to the Company)	6,032	7,067
Goodwill	6,766	7,162
Intangible assets (net of accumulated amortization of $542 and $275 at September 30, 2010 and December 31, 2009, respectively) (includes $139 and $137 at fair value at September 30, 2010 and December 31, 2009, respectively)	4,808	5,054

Other assets		12,712		16,845
Total assets	$	841,372	$	771,462

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION (CONTINUED)

(dollars in millions, except share data)

(unaudited)

	September 30, 2010	December 31, 2009
Liabilities and Equity		
Commercial paper and other short-term borrowings (includes $2,220 and $791 at fair value at September 30, 2010 and December 31, 2009, respectively)	$ 4,649	$ 2,378
Deposits (includes $4,214 and $4,967 at fair value at September 30, 2010 and December 31, 2009, respectively)	61,202	62,215
Financial instruments sold, not yet purchased, at fair value:		
U.S. government and agency securities	25,092	20,503
Other sovereign government obligations	23,154	18,244
Corporate and other debt	10,363	7,826
Corporate equities	28,987	22,601
Derivative and other contracts	54,988	38,209
Total financial instruments sold, not yet purchased, at fair value	142,584	107,383
Obligation to return securities received as collateral, at fair value	17,062	13,656
Securities sold under agreements to repurchase (includes $266 at fair value at September 30, 2010)	167,111	159,401
Securities loaned	31,123	26,246
Other secured financings (includes $8,481 and $8,102 at fair value at September 30, 2010 and December 31, 2009, respectively) ($2,970 at September 30, 2010 related to consolidated variable interest entities and are non-recourse to the Company)	9,826	8,102
Payables:		
Customers	124,185	117,058
Brokers, dealers and clearing organizations	3,447	5,423
Interest and dividends	2,813	2,597
Other liabilities and accrued expenses	15,297	20,849
Long-term borrowings (includes $40,809 and $37,610 at fair value at September 30, 2010 and December 31, 2009, respectively)	196,491	193,374
	775,790	718,682
Commitments and contingencies		
Equity		
Morgan Stanley shareholders equity:		
Preferred stock	9,597	9,597
Common stock, $0.01 par value;		
Shares authorized: 3,500,000,000 at September 30, 2010 and December 31, 2009;		
Shares issued: 1,603,913,074 at September 30, 2010 and 1,487,850,163 at December 31, 2009;		
Shares outstanding: 1,512,989,777 at September 30, 2010 and 1,360,595,214 at December 31, 2009	16	15
Paid-in capital	13,389	8,619
Retained earnings	38,056	35,056
Employee stock trust	3,549	4,064
Accumulated other comprehensive loss	(116)	(560)
	(4,066)	(6,039)

Common stock held in treasury, at cost, $0.01 par value; 90,923,297 shares at September 30, 2010 and 127,254,949 shares at December 31, 2009		
Common stock issued to employee trust	(3,549)	(4,064)
Total Morgan Stanley shareholders equity	56,876	46,688
Noncontrolling interests	8,706	6,092
Total equity	65,582	52,780
Total liabilities and equity	$ 841,372	$ 771,462

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

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

(unaudited)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Revenues:				
Investment banking	$ 1,221	$ 1,208	$ 3,361	$ 3,347
Principal transactions:				
Trading	1,439	3,399	8,552	6,536
Investments	820	95	1,137	(1,180)
Commissions	1,068	1,244	3,636	2,986
Asset management, distribution and administration fees	1,940	1,886	5,877	3,910
Other	186	139	630	775
Total non-interest revenues	6,674	7,971	23,193	16,374
Interest income	1,859	1,851	5,334	5,722
Interest expense	1,754	1,354	4,722	5,500
Net interest	105	497	612	222
Net revenues	6,779	8,468	23,805	16,596
Non-interest expenses:				
Compensation and benefits	3,686	4,896	11,987	10,673
Occupancy and equipment	401	419	1,190	1,126
Brokerage, clearing and exchange fees	332	285	1,051	800
Information processing and communications	412	356	1,223	951
Marketing and business development	134	118	421	348
Professional services	460	381	1,351	1,068
Other	554	520	1,570	1,309
Total non-interest expenses	5,979	6,975	18,793	16,275
Income from continuing operations before income taxes	800	1,493	5,012	321
Provision for (benefit from) income taxes	(23)	521	650	(384)
Income from continuing operations	823	972	4,362	705
Discontinued operations:				
Gain (loss) from discontinued operations	(146)	(278)	626	(95)
Provision for (benefit from) income taxes	36	(99)	352	(26)
Net gain (loss) from discontinued operations	(182)	(179)	274	(69)
Net income	$ 641	$ 793	$ 4,636	$ 636
Net income (loss) applicable to noncontrolling interests	510	36	769	(93)

Net income applicable to Morgan Stanley	$	131	$	757	$	3,867	$	729
Earnings (loss) applicable to Morgan Stanley common shareholders	$	(91)	$	498	$	2,971	$	(1,301)
Amounts applicable to Morgan Stanley:								
Income from continuing operations	$	313	$	936	$	3,593	$	814
Net gain (loss) from discontinued operations		(182)		(179)		274		(85)
Net income applicable to Morgan Stanley	$	131	$	757	$	3,867	$	729
Earnings (loss) per basic common share:								
Income (loss) from continuing operations	$	0.07	$	0.51	$	2.04	$	(1.06)
Net gain (loss) from discontinued operations		(0.14)		(0.12)		0.18		(0.07)
Earnings (loss) per basic common share	$	(0.07)	$	0.39	$	2.22	$	(1.13)
Earnings (loss) per diluted common share:								
Income (loss) from continuing operations	$	0.05	$	0.50	$	1.98	$	(1.06)
Net gain (loss) from discontinued operations		(0.12)		(0.12)		0.17		(0.07)
Earnings (loss) per diluted common share	$	(0.07)	$	0.38	$	2.15	$	(1.13)
Average common shares outstanding:								
Basic		1,377,230,354		1,294,298,229		1,336,508,289		1,148,161,310
Diluted		1,443,100,524		1,300,070,107		1,709,544,142		1,148,161,310

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(dollars in millions)

(unaudited)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Net income	$ 641	$ 793	$ 4,636	$ 636
Other comprehensive income, net of tax:				
Foreign currency translation adjustments(1)	178	40	215	98
Amortization of cash flow hedges(2)	2	2	7	10
Net unrealized gain on securities available for sale (3)	145		232	
Pension and postretirement related adjustments(4)	4	7	113	16
Comprehensive income	$ 970	$ 842	$ 5,203	$ 760
Net income (loss) applicable to noncontrolling interests	510	36	769	(93)
Other comprehensive income applicable to noncontrolling interests	91	6	123	3
Comprehensive income applicable to Morgan Stanley	$ 369	$ 800	$ 4,311	$ 850

(1) Amounts are net of benefit from income taxes of $219 million and $106 million for the quarters ended September 30, 2010 and 2009, respectively, and $149 million and $317 million for the nine months ended September 30, 2010 and 2009, respectively.

(2) Amounts are net of provision for income taxes of $1 million and $2 million for the quarters ended September 30, 2010 and 2009, and $5 million and $6 million for the nine months ended September 30, 2010 and 2009, respectively.

(3) Amounts are net of provision for income taxes of $78 million for the quarter ended September 30, 2010 and $154 million for the nine months ended September 30, 2010.

(4) Amounts are net of provision for income taxes of $2 million and $1 million for the quarters ended September 30, 2010 and 2009, respectively, and $70 million and $9 million for the nine months ended September 30, 2010 and 2009, respectively.

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in millions)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
	(unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 4,636	$ 636
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Compensation payable in common stock and options	977	1,021
Depreciation and amortization	1,837	829
Gain on business dispositions	(514)	(480)
Gain on repurchase of long-term debt		(460)
Insurance reimbursement	(88)	
Loss on assets held for sale	1,158	
Impairment charges and other-than-temporary impairment charges	66	689
Changes in assets and liabilities:		
Cash deposited with clearing organizations or segregated under federal and other regulations or requirements	3,439	2,286
Financial instruments owned, net of financial instruments sold, not yet purchased	4,421	(52,560)
Securities borrowed	5,067	(40,870)
Securities loaned	4,877	11,602
Receivables, loans and other assets	(6,081)	(1,029)
Payables and other liabilities	2,451	(2,707)
Federal funds sold and securities purchased under agreements to resell	(10,744)	(24,276)
Securities sold under agreements to repurchase	7,710	55,131
Net cash provided by (used for) operating activities	19,212	(50,188)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (payments for) proceeds from:		
Premises, equipment and software costs	(800)	(2,307)
Business acquisitions, net of cash acquired	(1,028)	(2,160)
Business dispositions, net of cash disposed	800	565
MUFG transaction	247	
Purchases of securities available for sale	(23,374)	
Redemption of securities available for sale	31	
Net cash used for investing activities	(24,124)	(3,902)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from (payments for):		
Short-term borrowings	2,271	(7,189)
Dividends received from Noncontrolling interests	20	
Derivatives financing activities	(76)	(78)
Other secured financings	(409)	(2,261)
Deposits	(1,013)	11,060
Excess tax benefits associated with stock-based awards	4	12
Net proceeds from:		
Morgan Stanley public offerings of common stock		6,212
Issuance of common stock	5,581	41
Issuance of long-term borrowings	26,648	36,342
Payments for:		
Long-term borrowings	(20,662)	(28,546)

Series D Preferred Stock and warrant		(10,950)
Redemption of junior subordinated debentures related to CIC	(5,579)	
Repurchases of common stock for employee tax withholding	(298)	(37)
Cash dividends	(867)	(1,445)
Net cash (used for) provided by financing activities	5,620	3,161
Effect of exchange rate changes on cash and cash equivalents	171	869
Cash and cash equivalents related to variable interest entities	245	
Net increase (decrease) in cash and cash equivalents	1,124	(50,060)
Cash and cash equivalents, at beginning of period	31,991	78,670
Cash and cash equivalents, at end of period	$ 33,115	$ 28,610
Cash and cash equivalents include:		
Cash and due from banks	$ 6,936	$ 6,218
Interest bearing deposits with banks	26,179	22,392
Cash and cash equivalents, at end of period	$ 33,115	$ 28,610

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash payments for interest were $4,066 million and $5,679 million for the nine months ended September 30, 2010 and 2009, respectively.

Cash payments for income taxes were $378 million and $785 million for the nine months ended September 30, 2010 and 2009, respectively.

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY

Nine Months Ended September 30, 2010

(dollars in millions)

(unaudited)

	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non-controlling Interests	Total Equity
BALANCE AT DECEMBER 31, 2009	$ 9,597	$ 15	$ 8,619	$ 35,056	$ 4,064	$ (560)	$ (6,039)	$ (4,064)	$ 6,092	$ 52,780
Net income				3,867					769	4,636
Dividends				(867)						(867)
Shares issued under employee plans and related tax effects			(1,539)		(515)		2,271	515		732
Repurchases of common stock							(298)			(298)
Net change in cash flow hedges						7				7
Pension and postretirement adjustments						113				113
Foreign currency translation adjustments						92			123	215
Gain on MUFG transaction			731							731
Change in net unrealized gains on securities available for sale						232				232
Redemption of CIC equity units and issuance of common stock		1	5,578							5,579
Increases in noncontrolling interest related to MUFG transaction									1,130	1,130
Increases in noncontrolling interest for issuances of shares by a subsidiary of the Company									51	51
Increases in noncontrolling interest for the sale of a subsidiary s shares by the Company									56	56
Increase in noncontrolling interests related to the consolidation of certain real estate partnerships sponsored by the Company									468	468
Decrease in noncontrolling interests related to dividends of noncontrolling interests									(20)	(20)
Other increases in noncontrolling interests									37	37
BALANCE AT SEPTEMBER 30, 2010	$ 9,597	$ 16	$ 13,389	$ 38,056	$ 3,549	$ (116)	$ (4,066)	$ (3,549)	$ 8,706	$ 65,582

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN TOTAL EQUITY (Continued)

Nine Months Ended September 30, 2009

(dollars in millions)

(unaudited)

	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Employee Stock Trust	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury at Cost	Common Stock Issued to Employee Trust	Non-controlling Interests	Total Equity
BALANCE AT DECEMBER 31, 2008	$ 19,168	$ 12	$ 459	$ 36,154	$ 4,312	$ (420)	$ (6,620)	$ (4,312)	$ 703	$ 49,456
Net income (loss)				729					(93)	636
Dividends				(1,023)					(17)	(1,040)
Shares issued under employee plans and related tax effects			307		(254)		526	254		833
Repurchases of common stock							(37)			(37)
Morgan Stanley public offerings of common stock		3	6,209							6,212
Preferred stock extinguished and exchanged for common stock	(503)		705	(202)						
Series D preferred stock and warrant	(9,068)		(950)	(932)						(10,950)
Gain on MSSB transaction			1,711							1,711
Net change in cash flow hedges						10				10
Pension and postretirement adjustments						16				16
Foreign currency translation adjustments						95			3	98
Increases in noncontrolling interests related to MSSB transaction									4,821	4,821
Increases in noncontrolling interests related to the consolidation of two real estate funds sponsored by the Company									649	649
Decreases in noncontrolling interests related to disposition of a subsidiary									(229)	(229)
Other increases in noncontrolling interests									38	38
BALANCE AT SEPTEMBER 30, 2009	$ 9,597	$ 15	$ 8,441	$ 34,726	$ 4,058	$ (299)	$ (6,131)	$ (4,058)	$ 5,875	$ 52,224

See Notes to Condensed Consolidated Financial Statements.

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Introduction and Basis of Presentation.

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

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

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

Global Wealth Management Group, which includes the Company s 51% interest in Morgan Stanley Smith Barney Holdings LLC (MSSB) (see Note 3), provides brokerage and investment advisory services to individual investors and small-to-medium sized businesses and institutions covering various investment alternatives; financial and wealth planning services; annuity and other insurance products; credit and other lending products; cash management services; retirement services; and trust and fiduciary services.

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

Discontinued Operations.

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

The Company recorded the 30.9 million shares as securities available for sale (see Note 5 for further information).

Revel Entertainment Group, LLC. On March 31, 2010, the Board of Directors authorized a plan of disposal by sale for Revel Entertainment Group, LLC (Revel), a development stage enterprise and subsidiary of the Company that is primarily associated with a development property in Atlantic City, New Jersey. Total assets of Revel included in the Company s condensed consolidated statement of financial condition at September 30, 2010 approximated $40 million, which represented its fair value, net of estimated costs to sell. The results of Revel are reported as discontinued operations for all periods presented within the Institutional Securities business segment. The quarter and nine months ended September 30, 2010 includes losses of approximately $229 million and approximately $1.2 billion, respectively, in connection with write-downs and related costs of such planned disposition.

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

MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

See Note 20 for additional information on discontinued operations.

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

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

Material intercompany balances and transactions have been eliminated.

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

shareholders equity of such subsidiaries is presented as Noncontrolling interests in the condensed consolidated statements of financial condition and condensed consolidated statements of changes in total equity.

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

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

For investments in entities in which the Company does not have a controlling financial interest but has significant influence over operating and financial decisions, the Company generally applies the equity method of accounting with net gains and losses recorded within Other revenues. Where the Company has elected to measure certain eligible investments at fair value in accordance with the fair value option, net gains and losses are recorded within Principal transactions Investments (see Note 4).

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

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies.

Revenue Recognition.

Investment Banking. Underwriting revenues and advisory fees from mergers, acquisitions and restructuring transactions are recorded when services for the transactions are determined to be substantially completed, generally as set forth under the terms of the engagement. Transaction-related expenses, primarily consisting of legal, travel and other costs directly associated with the transaction, are deferred and recognized in the same period as the related investment banking transaction revenue. Underwriting revenues are presented net of related expenses. Non-reimbursed expenses associated with advisory transactions are recorded within Non-interest expenses.

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

Asset Management, Distribution and Administration Fees. Asset management, distribution and administration fees are recognized over the relevant contract period. Sales commissions paid by the Company in connection with the sale of certain classes of shares of its open-end mutual fund products are accounted for as deferred commission assets. The Company periodically tests the deferred commission assets for recoverability based on cash flows expected to be received in future periods. In certain management fee arrangements, the Company is entitled to receive performance-based fees (also referred to as incentive fees) when the return on assets under management exceeds certain benchmark returns or other performance targets. In such arrangements, performance fee revenue is accrued (or reversed) quarterly based on measuring account/fund performance to date versus the performance benchmark stated in the investment management agreement. Performance-based fees are recorded within Principal transactions investments or Asset management, distribution and administration fees depending on the nature of the arrangement. The amount of performance-based fee revenue at risk of reversing if fund performance falls below stated investment management agreement benchmarks was approximately $172 million at September 30, 2010 and approximately $122 million at December 31, 2009.

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

Financial Instruments and Fair Value.

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Gains and losses on all of these instruments carried at fair value are reflected in Principal transactions Trading revenues, Principal transactions Investment revenues or Investment banking revenues in the condensed consolidated statements of income, except for Securities available for sale (see Securities Available for Sale section herein and Note 5) and derivatives accounted for as hedges (see Hedge Accounting section herein and Note 10). Interest income and expense are recorded within the condensed consolidated statements of income depending on the nature of the instrument and related market conventions. When interest is included as a component of the instruments fair value, interest is included within Principal transactions Trading revenues or Principal transactions Investment revenues. Otherwise, it is included within Interest income or Interest expense. Dividend income is recorded in Principal transactions Trading or Principal transactions Investment revenues depending on the business activity. The fair value of over-the-counter (OTC) financial instruments, including derivative contracts related to financial instruments and commodities, is presented in the accompanying condensed consolidated statements of financial condition on a net-by-counterparty basis, when appropriate. Additionally, the Company nets fair value of cash collateral paid or received against fair value amounts recognized for net derivative positions executed with the same counterparty under the same master netting arrangement.

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

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

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

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

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

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

The availability of observable inputs can vary from product to product and is affected by a wide variety of factors, including, for example, the type of product, whether the product is new and not yet established in the marketplace, the liquidity of markets and other characteristics particular to the transaction. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of fair value requires more judgment. Accordingly, the degree of judgment exercised by the Company in determining fair value is greatest for instruments categorized in Level 3.

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

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

Hedge Accounting.

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

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

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

Condensed Consolidated Statements of Cash Flows.

For purposes of the condensed consolidated statements of cash flows, cash and cash equivalents consist of Cash and due from banks and Interest bearing deposits with banks, which are highly liquid investments with original maturities of three months or less and readily convertible to known amounts of cash. The Company s significant non-cash activities include assets acquired of approximately $0.4 billion and assumed liabilities of approximately $0.1 billion in connection with a business acquisition and approximately $0.6 billion of equity securities received in connection with the sale of Retail Asset Management in the nine months ended September 30, 2010. The Company s significant non-cash activities include assets acquired of $11.0 billion and assumed liabilities of $3.2 billion, in connection with business acquisitions in the nine months ended September 30, 2009. During the nine months ended September 30, 2009, the Company consolidated two real estate funds sponsored by the Company with assets of $600 million, liabilities of $18 million and Noncontrolling interests of $582 million.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Repurchase and Securities Lending Transactions.

Securities borrowed or purchased under agreements to resell and securities loaned or sold under agreements to repurchase are treated as collateralized financings. Securities purchased under agreements to resell (reverse repurchase agreements) and Securities sold under agreements to repurchase (repurchase agreements) are carried on the condensed consolidated statements of financial condition at the amounts at which the securities will be subsequently sold or repurchased, plus accrued interest, except for certain repurchase agreements for which the Company has elected the fair value option (See Note 4). Where appropriate, transactions with the same counterparty are reported on a net basis. Securities borrowed and securities loaned are recorded at the amount of cash collateral advanced or received.

Securitization Activities.

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

Earnings per Common Share.

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

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

In December 2007, the Company sold Equity Units that included contracts to purchase Company common stock to a wholly owned subsidiary of CIC (the CIC Entity) for approximately $5,579 million. On July 1, 2010, Moody s Investor Services announced that it was lowering the equity credit assigned to such Equity Units. The

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terms of the Equity Units permitted the Company to redeem the junior subordinated debentures underlying the Equity Units upon the occurrence and continuation of such a change in equity credit (a Rating Agency Event). In response to this Rating Agency Event, the Company redeemed the junior subordinated debentures in August 2010 and the redemption proceeds were subsequently used by the CIC Entity to settle its obligation under the purchase contracts. The settlement of the purchase contracts and delivery of 116,062,911 shares of Company common stock to the CIC Entity occurred in August 2010.

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

Goodwill and Intangible Assets.

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

Deferred Compensation Arrangements.

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

Employee Loans.

At September 30, 2010 and December 31, 2009, the Company had $5.9 billion and $3.5 billion, respectively, of loans outstanding primarily to certain MSSB employees that are included in Receivables Fees, interest and other on the condensed consolidated statements of financial condition. These loans are full-recourse, require periodic payments and have repayment terms ranging from 4 to 12 years.

Securities Available for Sale (AFS).

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Accounting Developments.

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

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

Scope Exception Related to Embedded Credit Derivatives. In March 2010, the FASB issued accounting guidance that changes the accounting for credit derivatives embedded in beneficial interests in securitized financial assets. The new guidance eliminates the scope exception for embedded credit derivatives, unless they are created solely by subordination of one financial instrument to another. Bifurcation and separate recognition may be required for certain beneficial interests that are currently not accounted for at fair value through earnings. The adoption of this accounting guidance on July 1, 2010 did not have a material impact on the Company s condensed consolidated financial statements.

3. Morgan Stanley Smith Barney Holdings LLC.

Smith Barney. On May 31, 2009, the Company and Citigroup Inc. (Citi) consummated the combination of the Company s Global Wealth Management Group and the businesses of Citi s Smith Barney in the U.S., Quilter Holdings Ltd in the U.K., and Smith Barney Australia (collectively, Smith Barney). In addition to the Company s contribution of respective businesses to MSSB, the Company paid Citi $2,755 million in cash. The

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

combined businesses operate as Morgan Stanley Smith Barney. Pursuant to the terms of the amended contribution agreement, dated at May 29, 2009, certain businesses of Smith Barney and Morgan Stanley will be contributed to MSSB subsequent to May 31, 2009 (the delayed contribution businesses). Morgan Stanley and Citi will each own their delayed contribution businesses until they are transferred to MSSB and gains and losses from such businesses will be allocated to the Company s and Citi s respective share of MSSB s gains and losses. The Company owns 51% and Citi owns 49% of MSSB.

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

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

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

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Pro forma condensed combined financial information

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

	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2009
	(unaudited)	
Net revenues	$ 8,474	$ 19,407
Total non-interest expenses	6,976	18,726
Income from continuing operations before income taxes	1,498	681
Provision for (benefit from) income taxes	522	(315)
Income from continuing operations	976	996
Discontinued operations:		
Loss from discontinued operations	(278)	(95)
Benefit from income taxes	(99)	(26)
Loss on discontinued operations	(179)	(69)
Net income	797	927
Net income applicable to noncontrolling interests	38	84
Net income applicable to Morgan Stanley	$ 759	$ 843
Earnings (loss) applicable to Morgan Stanley common shareholders	$ 500	$ (1,187)
Earnings (loss) per basic common share:		
Income (loss) from continuing operations	$ 0.51	$ (0.96)
Net loss from discontinued operations	(0.12)	(0.07)
Earnings (loss) per basic common share	$ 0.39	$ (1.03)
Earnings (loss) per diluted common share:		
Income (loss) from continuing operations	$ 0.50	$ (0.96)
Net loss from discontinued operations	(0.12)	(0.07)
Earnings (loss) per diluted common share	$ 0.38	$ (1.03)

The unaudited pro forma condensed combined financial information is presented for illustrative purposes only and does not indicate the actual financial results of the Company had the closing of Smith Barney and Citi Managed Futures been completed on January 1, 2009, nor is it indicative of the results of operations in future periods. Included in the unaudited pro forma combined financial information for the quarter and nine months ended September 30, 2009 were pro forma adjustments to reflect the results of operations of Smith Barney and Citi Managed Futures as well as the impact of amortizing certain purchase accounting adjustments such as amortizable intangible assets. The pro forma condensed financial information does not indicate the impact of possible business model changes nor does it consider any potential impacts of market conditions, expense efficiencies or other factors.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Fair Value Disclosures.

Fair Value Measurements.

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

Financial Instruments Owned and Financial Instruments Sold, Not Yet Purchased

U.S. Government and Agency Securities

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

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

Other Sovereign Government Obligations

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

Corporate and Other Debt

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

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

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each deal. 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 categorized in Level 3 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; otherwise, they are categorized in Level 2 of the fair value hierarchy.

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

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

Corporate Loans and Lending Commitments. The fair value of corporate loans is 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 these commitments also takes into account certain fee income. Corporate loans and lending commitments are generally categorized in Level 2 of the fair value hierarchy; in instances where prices or significant spread inputs are unobservable, they are categorized in Level 3 of the fair value hierarchy.

Mortgage Loans. Mortgage loans are valued using observable prices based on transactional data for identical or comparable instruments, when available. Where observable prices are not available, the Company estimates fair value based on benchmarking to prices and rates observed in the primary market for similar loan or borrower types, or based on the present value of expected future cash flows using its best estimates of the key assumptions, including forecasted credit losses, prepayment rates, forward yield curves and discount rates commensurate with the risks involved or a methodology that utilizes the capital structure and credit spreads of recent comparable securitization transactions. Mortgage loans valued based on observable transactional data for identical or comparable instruments are categorized in Level 2 of the fair value hierarchy. Where observable prices are not available, due to the subjectivity involved in

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comparability assessment related to mortgage loan vintage, geographical concentration, prepayment speed and projected loss assumptions, mortgage loans are classified in Level 3 of the fair value hierarchy.

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

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

Corporate Equities.

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

Derivative and Other Contracts.

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

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

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

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

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

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

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

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

Investments.

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

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

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

Physical Commodities.

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

Securities Available for Sale.

Securities available for sale are comprised of U.S. government and agency securities and equity securities, including U.S. Treasury securities, agency-issued debt, agency mortgage pass-through securities 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 are generally categorized in Level 2 of the fair value hierarchy. For further information on securities available for sale, see Note 5.

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

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

Deposits.

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

Securities sold under agreements to repurchase.

The fair value of a repurchase agreement is computed using a standard cash-flow discounting methodology. The inputs to the valuation include contractual cash flows and collateral funding spreads, which are estimated using various benchmarks, interest rate yield curves and option volatilities. Due to the significance of the unobservable inputs, repurchase agreements are categorized in Level 3 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 September 30, 2010 and December 31, 2009. See Note 2 for a discussion of the Company s policies regarding the fair value hierarchy.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Counterparty and Cash Collateral Netting	Balance at September 30, 2010
			(dollars in millions)		
Assets					
Financial instruments owned:					
U.S. government and agency securities:					
U.S. Treasury securities	$ 21,896	$ 21	$	$	$ 21,917
U.S. agency securities	9,646	33,259	1		42,906
Total U.S. government and agency securities	31,542	33,280	1		64,823
Other sovereign government obligations	29,362	8,783	65		38,210
Corporate and other debt:					
State and municipal securities		4,008	100		4,108
Residential mortgage-backed securities		3,277	237		3,514
Commercial mortgage-backed securities		2,976	366		3,342
Asset-backed securities		2,418	23		2,441
Corporate bonds		44,234	1,642		45,876
Collateralized debt obligations		2,142	1,746		3,888
Loans and lending commitments		13,882	12,110		25,992
Other debt		3,718	217		3,935
Total corporate and other debt		76,655	16,441		93,096
Corporate equities(1)	56,376	5,019	440		61,835
Derivative and other contracts:					
Interest rate contracts	1,549	838,925	1,231		841,705
Credit contracts		103,178	18,803		121,981
Foreign exchange contracts	3	71,342	393		71,738
Equity contracts	2,818	41,239	926		44,983
Commodity contracts	5,126	58,812	1,156		65,094
Other		299	185		484
Netting(2)	(7,706)	(993,126)	(12,933)	(75,166)	(1,088,931)
Total derivative and other contracts	1,790	120,669	9,761	(75,166)	57,054
Investments(3)					
Private equity funds			1,956		1,956
Real estate funds		7	2,282		2,289
Hedge funds		907	840		1,747
Principal investments	109	1,146	1,818		3,073
Other	418	95	455		968
Total investments	527	2,155	7,351		10,033
Physical commodities		6,668			6,668
Total financial instruments owned	119,597	253,229	34,059	(75,166)	331,719
Securities available for sale:					

Debt securities:					
U.S. government and agency securities	20,084	3,514			23,598
Equity securities(4)	656				656
Total securities available for sale	20,740	3,514			24,254
Securities received as collateral	16,152	910			17,062
Intangible assets(5)			139		139
Liabilities					
Commercial paper and other short-term borrowings	$	2,217	3		2,220
Deposits		4,199	15		4,214
Financial instruments sold, not yet purchased:					
U.S. government and agency securities:					
U.S. Treasury securities	22,221				22,221
U.S. agency securities	2,825	46			2,871
Total U.S. government and agency securities	25,046	46			25,092

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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 September 30, 2010
			(dollars in millions)		
Other sovereign government obligations	19,272	3,882			23,154
Corporate and other debt:					
State and municipal securities		14			14
Asset-backed securities		20			20
Corporate bonds		8,283	262		8,545
Unfunded lending commitments		505	323		828
Other debt		763	193		956
Total corporate and other debt		9,585	778		10,363
Corporate equities(1)	27,050	1,921	16		28,987
Derivative and other contracts:					
Interest rate contracts	1,617	809,978	487		812,082
Credit contracts		94,778	11,157		105,935
Foreign exchange contracts	2	75,527	498		76,027
Equity contracts	3,157	47,811	1,898		52,866
Commodity contracts	5,844	59,440	980		66,264
Other		533	1,619		2,152
Netting(2)	(7,706)	(993,126)	(12,933)	(46,573)	(1,060,338)
Total derivative and other contracts	2,914	94,941	3,706	(46,573)	54,988
Total financial instruments sold, not yet purchased	74,282	110,375	4,500	(46,573)	142,584
Obligation to return securities received as collateral	16,152	910			17,062
Securities sold under agreements to repurchase			266		266
Other secured financings		7,405	1,076		8,481
Long-term borrowings		39,510	1,299		40,809

(1) The Company holds or sells short for trading purposes equity securities issued by entities in diverse industries and of varying size.
(2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 10.
(3) In June 2010, the Company voluntarily contributed $25 million to certain other investments in funds that it manages in connection with upcoming rule changes regarding net asset value disclosures for money market funds. Based on current liquidity and fund performance, the Company does not expect to provide additional voluntary support to non-consolidated funds that it manages.
(4) In connection with the Company s sale of Retail Asset Management to Invesco, the Company received equity securities of Invesco. For further information regarding these securities available for sale, see Note 5.
(5) Amount represents mortgage servicing rights (MSRs) accounted for at fair value. See Note 7 for further information on MSRs.

Transfers Between Level 1 and Level 2 During the Quarter Ended September 30, 2010.

Financial instruments owned Derivative and other contracts and Financial instruments sold, not yet purchased Derivative and other contracts. During the quarter ended September 30, 2010, the Company reclassified approximately $1.6 billion of derivative assets and approximately $1.6 billion of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on exchange-quoted prices.

Transfers Between Level 1 and Level 2 During the Nine Months Ended September 30, 2010.

Financial instruments owned Derivative and other contracts and Financial instruments sold, not yet purchased Derivative and other contracts. During the nine months ended September 30, 2010, the Company reclassified approximately $2.2 billion of derivative assets and approximately $2.3 billion of derivative liabilities from Level 2 to Level 1 as these listed derivatives became actively traded and were valued based on exchange-quoted prices.

Financial instruments owned Corporate equities. During the nine months ended September 30, 2010, the Company reclassified approximately $1.2 billion of certain Corporate equities from Level 2 to Level 1 as transactions in these securities occurred with sufficient frequency and volume to constitute an active market.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at December 31, 2009

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

Asset-backed securities		63	4		67
Corporate bonds		5,812	29		5,841
Collateralized debt obligations			3		3
Unfunded lending commitments		732	252		984
Other debt		483	431		914
Total corporate and other debt		7,107	719		7,826
Corporate equities(1)	18,125	4,472	4		22,601
Derivative and other contracts(2)	3,383	67,847	6,203	(39,224)	38,209
Total financial instruments sold, not yet purchased	58,735	80,946	6,926	(39,224)	107,383
Obligation to return securities received as collateral	12,778	855	23		13,656
Other secured financings		6,570	1,532		8,102
Long-term borrowings		30,745	6,865		37,610

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(1) The Company holds or sells short for trading purposes equity securities issued by entities in diverse industries and of varying size.
(2) For positions with the same counterparty that cross over the levels of the fair value hierarchy, both counterparty netting and cash collateral netting are included in the column titled Counterparty and Cash Collateral Netting. For contracts with the same counterparty, counterparty netting among positions classified within the same level is included within that level. For further information on derivative instruments and hedging activities, see Note 10.
(3) Amount represents MSRs accounted for at fair value. See Note 7 for further information on MSRs.

The following tables present additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter and nine months ended September 30, 2010 and for the quarter and nine months ended September 30, 2009, respectively. Level 3 instruments may be hedged with instruments classified in Level 1 and Level 2. As a result, the realized and unrealized gains (losses) for assets and liabilities within the Level 3 category presented in the tables below do not reflect the related realized and unrealized gains (losses) on hedging instruments that have been classified by the Company in 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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended September 30, 2010

	Beginning Balance at June 30, 2010	Total Realized and Unrealized Gains (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at September 30, 2010	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2010(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. agency securities	$ 1	$	$	$	$ 1	$
Other sovereign government obligations	73	7	(7)	(8)	65	7
Corporate and other debt:						
State and municipal securities	221	(3)		(118)	100	(1)
Residential mortgage-backed securities	476	2	(335)	94	237	(7)
Commercial mortgage-backed securities	613	61	(83)	(225)	366	44
Asset-backed securities	101	13	(78)	(13)	23	1
Corporate bonds	1,344	29	247	22	1,642	31
Collateralized debt obligations	1,513	120	109	4	1,746	106
Loans and lending commitments	12,747	141	421	(1,199)	12,110	125
Other debt	1,810	1	(4)	(1,590)	217	(6)
Total corporate and other debt	18,825	364	277	(3,025)	16,441	293
Corporate equities	346	(5)	49	50	440	2
Net derivative and other contracts:						
Interest rate contracts	516	96	(27)	159	744	112
Credit contracts	8,101	(812)	444	(87)	7,646	(623)
Foreign exchange contracts	71	(81)	37	(132)	(105)	(83)
Equity contracts	(998)	(8)	(24)	58	(972)	(75)
Commodity contracts	14	165	75	(78)	176	105
Other	(1,039)	(389)	(27)	21	(1,434)	(393)
Total net derivative and other contracts(3)	6,665	(1,029)	478	(59)	6,055	(957)
Investments:						
Private equity funds	1,839	151	10	(44)	1,956	152
Real estate funds	1,643	323	316		2,282	376
Hedge funds	910	41	(23)	(88)	840	41
Principal investments	2,575	(64)	(53)	(640)	1,818	(73)
Other	444	18	(39)	32	455	13
Total investments	7,411	469	211	(740)	7,351	509
Intangible assets	139	1	(1)		139	1
Liabilities						
Commercial paper and other short-term borrowings	$ 7	$	$	$ (4)	$ 3	$

Deposits	14	(1)			15	(1)
Financial instruments sold, not yet purchased:						
Corporate and other debt:						
Residential mortgage-backed securities	2		(2)			
Commercial mortgage-backed securities		(1)	(1)			
Corporate bonds	80	(1)	202	(21)	262	(2)
Unfunded lending commitments	335	16	4		323	16
Other debt	221	16	(7)	(5)	193	15
Total corporate and other debt	638	30	196	(26)	778	29
Corporate equities	5	2	12	1	16	
Securities sold under agreements to repurchase		(2)	264		266	(2)
Other secured financings	1,910	(31)	140	(1,005)	1,076	(31)
Long-term borrowings	6,509	(19)	(5,268)	39	1,299	(89)

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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 $469 million related to Financial instruments owned Investments, which is included in Principal transactions Investments.
(2) Amounts represent unrealized gains (losses) for the quarter ended September 30, 2010 related to assets and liabilities still outstanding at September 30, 2010.
(3) Net derivative and other contracts represent Financial instruments owned Derivative and other contracts net of Financial instruments sold, not yet purchased Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 10.

Financial instruments owned Corporate and other debt. During the quarter ended September 30, 2010, the Company reclassified approximately $3.9 billion of certain Corporate and other debt, primarily loans and hybrid contracts, from Level 3 to Level 2. The Company reclassified these loans and hybrid contracts as external prices and/or spread inputs became observable and certain unobservable inputs were deemed insignificant to the overall measurement.

The Company also reclassified approximately $0.9 billion of certain Corporate and other debt from Level 2 to Level 3. The reclassifications were primarily related to certain 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.

Other Secured Financings. During the quarter ended September 30, 2010, the Company reclassified approximately $1.0 billion of Other Secured Financings from Level 3 to Level 2. The reclassifications were due to an increase in available broker quotes and/or consensus pricing such that significant inputs for the fair value measurement were observable.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Nine Months Ended September 30, 2010

	Beginning Balance at December 31, 2009	Total Realized and Unrealized Gains (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at September 30, 2010	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2010(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. agency securities	$ 36	$	$ (35)	$	$ 1	$
Other sovereign government obligations	3	3	62	(3)	65	4
Corporate and other debt:						
State and municipal securities	713	(6)	(534)	(73)	100	(10)
Residential mortgage-backed securities	818	4	(640)	55	237	(10)
Commercial mortgage-backed securities	1,573	99	(698)	(608)	366	(16)
Asset-backed securities	591	13	(438)	(143)	23	4
Corporate bonds	1,038	(13)	568	49	1,642	22
Collateralized debt obligations	1,553	219	(27)	1	1,746	129
Loans and lending commitments	12,506	189	(255)	(330)	12,110	136
Other debt	1,662	25	(48)	(1,422)	217	11
Total corporate and other debt	20,454	530	(2,072)	(2,471)	16,441	266
Corporate equities	536	64	(109)	(51)	440	35
Net derivative and other contracts:						
Interest rate contracts	387	136	191	30	744	150
Credit contracts	8,824	(1,167)	1,167	(1,178)	7,646	(371)
Foreign exchange contracts	254	(59)	(188)	(112)	(105)	(270)
Equity contracts	(689)	8	(503)	212	(972)	16
Commodity contracts	7	66	158	(55)	176	142
Other	(437)	(855)	(147)	5	(1,434)	(767)
Total net derivative and other contracts(3)	8,346	(1,871)	678	(1,098)	6,055	(1,100)
Investments:						
Private equity funds	1,628	291	43	(6)	1,956	283
Real estate funds	1,087	509	666	20	2,282	666
Hedge funds	1,678	(175)	(327)	(336)	840	(175)
Principal investments	2,642	(87)	(60)	(677)	1,818	(105)
Other	578	55	(177)	(1)	455	(4)
Total investments	7,613	593	145	(1,000)	7,351	665
Securities received as collateral	23		(23)			
Intangible assets	137	25	(23)		139	4
Liabilities						
Commercial paper and other short-term borrowings	$	$	$ 3	$	$ 3	$

Deposits	24	1		(8)	15	
Financial instruments sold, not yet purchased:						
Corporate and other debt:						
Asset-backed securities	4		(4)			
Corporate bonds	29	3	203	33	262	(4)
Collateralized debt obligations	3		(3)			
Unfunded lending commitments	252	(124)	(53)		323	(124)
Other debt	431	50	(168)	(20)	193	49
Total corporate and other debt	719	(71)	(25)	13	778	(79)
Corporate equities	4	1	6	7	16	
Obligation to return securities received as collateral	23		(23)			
Securities sold under agreements to repurchase		(2)	264		266	(2)
Other secured financings	1,532	(82)	(692)	154	1,076	(82)
Long-term borrowings	6,865	77	(5,323)	(166)	1,299	96

(1) Total realized and unrealized gains (losses) are primarily included in Principal transactions Trading in the condensed consolidated statements of income except for $593 million related to Financial instruments owned Investments, which is included in Principal transactions Investments.

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(2) Amounts represent unrealized gains (losses) for the nine months ended September 30, 2010 related to assets and liabilities still outstanding at September 30, 2010.

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

Financial instruments owned Corporate and other debt. During the nine months ended September 30, 2010, the Company reclassified approximately $3.5 billion of certain Corporate and other debt, primarily loans and hybrid contracts, from Level 3 to Level 2. The Company reclassified these loans and hybrid contracts as external prices and/or spread inputs became observable and certain unobservable inputs were deemed insignificant to the overall measurement.

The Company also reclassified approximately $1.0 billion of certain Corporate and other debt from Level 2 to Level 3. The reclassifications were primarily related to certain 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.

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

During the nine months ended September 30, 2010, the Company reclassified approximately $1.1 billion of certain Net derivative contracts from Level 3 to Level 2. These reclassifications were related to certain tranched bespoke credit basket default swaps and single name credit default swaps for which certain unobservable inputs were deemed insignificant.

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MORGAN STANLEY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Three Months Ended September 30, 2009

	Beginning Balance at June 30, 2009	Total Realized and Unrealized Gains (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at September 30, 2009	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2009(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. agency securities	$ 28	$	$ (23)	$	$ 5	$
Other sovereign government obligations	3		4		7	
State and municipal securities	1,705	4	(72)	(901)	736	2
Residential mortgage-backed securities	820	(29)	23	(43)	771	(41)
Commercial mortgage-backed securities	1,506	(420)	1,574	(434)	2,226	(442)
Asset-backed securities	1,827	8	(444)	(722)	669	14
Corporate bonds	2,449	41	(1,484)	137	1,143	9
Collateralized debt obligations	508	370	171	82	1,131	304
Loans and lending commitments	19,436	594	(1,081)	(1,461)	17,488	670
Other debt	1,489	398	(283)	21	1,625	421
Total corporate and other debt	29,740	966	(1,596)	(3,321)	25,789	937
Corporate equities	1,101	(79)	(102)	(60)	860	(34)
Net derivative and other contracts(3)	12,606	(1,654)	(1,179)	(301)	9,472	(1,251)
Investments	8,172	61	332	(3)	8,562	41
Securities received as collateral	17		(15)		2	
Intangible assets	173	(29)			144	(29)
Liabilities						
Commercial paper and other short-term borrowings	$	$ 2	$	$ 18	$ 16	$ 2
Deposits				14	14	
Financial instruments sold, not yet purchased:						
Commercial mortgage-backed securities	4	(1)	(4)		1	(1)
Asset-backed securities	4				4	
Corporate bonds	132	(9)	(151)	38	28	(18)
Unfunded lending commitments	303	60	227		470	60
Other debt	86	(36)	(81)	59	100	(40)
Total corporate and other debt	529	14	(9)	97	603	1
Corporate equities	22	27	3	24	22	(6)
Obligation to return securities received as collateral	17		(15)		2	

Other secured financings	4,463	(272)	(100)	(447)	4,188	(272)
Long-term borrowings	5,900	(77)	(7)	1,284	7,254	(77)

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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 $61 million related to Financial instruments owned Investments, which is included in Principal transactions Investments.
(2) Amounts represent unrealized gains (losses) for the quarter ended September 30, 2009 related to assets and liabilities still outstanding at September 30, 2009.
(3) Net derivative and other contracts represent Financial instruments owned Derivative and other contracts net of Financial instruments sold, not yet purchased Derivative and other contracts. For further information on derivative instruments and hedging activities, see Note 10.

Financial instruments owned Corporate and other debt. The net gains in Corporate and other debt were primarily driven by mark-to-market gains on corporate loans, CDOs and certain other debt, partially offset by losses in commercial mortgage-backed securities.

During the quarter ended September 30, 2009, the Company reclassified approximately $3.3 billion of certain Corporate and other debt from Level 3 to Level 2. The reclassifications were primarily related to corporate loans, state and municipal securities, asset-backed securities and commercial mortgage-backed securities. The reclassifications were primarily due to an increase in market price quotations for these or comparable instruments, or available broker quotes, such that observable inputs were utilized for the fair value measurement of these instruments. Corporate loans were reclassified as more liquidity entered the market and price transparency increased for certain corporate loans due to refinancing activities. Separately, certain SLARS were reclassified from Level 3 to Level 2 as there was increased activity in the SLARS market and restructuring activity of the underlying trusts.

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

Long-term borrowings. During the quarter ended September 30, 2009, the Company reclassified approximately $1.3 billion of certain Long-term borrowings from Level 2 to Level 3. The reclassifications primarily related to structured notes for which certain significant inputs became unobservable and deemed significant.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis for the Nine Months Ended September 30, 2009

	Beginning Balance at December 31, 2008	Total Realized and Unrealized Gains (Losses)(1)	Purchases, Sales, Other Settlements and Issuances, net	Net Transfers In and/or (Out) of Level 3	Ending Balance at September 30, 2009	Unrealized Gains (Losses) for Level 3 Assets/ Liabilities Outstanding at September 30, 2009(2)
	(dollars in millions)					
Assets						
Financial instruments owned:						
U.S. agency securities	$ 127	$ (3)	$ (95)	$ (24)	$ 5	$
Other sovereign government obligations	1	(2)	4	4	7	
Corporate and other debt:						
State and municipal securities	2,065	10	(398)	(941)	736	(17)
Residential mortgage-backed securities	1,251	(118)	(119)	(243)	771	(99)
Commercial mortgage-backed securities	3,130	(1,455)	1,168	(617)	2,226	(1,468)
Asset-backed securities	968	84	(342)	(41)	669	12
Corporate bonds	3,088	222	(2,328)	161	1,143	13
Collateralized debt obligations	982	365	309	(525)	1,131	235
Loans and lending commitments	19,701	(1,169)	(2,608)	1,564	17,488	(896)
Other debt	3,733	727	(1,847)	(988)	1,625	672
Total corporate and other debt	34,918	(1,334)	(6,165)	(1,630)	25,789	(1,548)
Corporate equities	976	105	(663)	442	860	(187)
Net derivative and other contracts(3)	23,382	(4,283)	(867)	(8,760)	9,472	(3,191)
Investments	9,698	(1,430)	336	(42)	8,562	(1,337)
Securities received as collateral	30		(28)		2	
Intangible assets	184	(40)			144	(42)
Liabilities						
Commercial paper and other short-term borrowings	$	$ 11	$	$ 27	$ 16	$ 11
Deposits		(1)		13	14	(1)
Financial instruments sold, not yet purchased:						